Rules of Origin in International Trade



Stefano Inama

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RULES OF ORIGIN IN INTERNATIONAL TRADE

This book discusses the different aspects of the rules of origin with a multidisciplinary perspective. It offers the first overview of the status of the negotiations on nonpreferential rules of origin under the World Trade Organization (WTO) agreement on rules of origin, after more than 10 years of negotiations, and its possible implications for other WTO Agreements. This book deals extensively with preferential rules of origin both under unilateral trade instruments like the Generalized System of Preferences, the Everything But Arms initiative, and the Africa Growth and Opportunity Act and in free-trade areas. Inama analyzes the experience of the United States and the European Community (EC) in developing the North American Free-Trade Agreement and the Pan-European rules of origin. He also compares and discusses the parallel experiences of the major southern regional trade agreements, including Mercosur, the Association of Southeast Asian Nations (ASEAN), and the ASEAN-China free-trade area, as well as the Common Market for Eastern and Southern Africa, Eastern Africa Community, and Southern Africa Development Community in their negotiations of the European Partnership Agreements with the EC. It discusses the evolution of the different sets of rules of origin, the economics of the rules of origin, and the technical options for drafting rules of origin including a methodology for drafting product-specific rules of origin.

Stefano Inama is a project manager and senior trade and customs expert for the United Nations Conference on Trade and Development. He has extensively advised governments, private sector, and regional trade secretariats on rules of origin negotiations and has regularly been invited to speak on trade issues by universities such as the Bocconi University in Milan, Italy, and Columbia University in New York, as well as by international organizations.

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Acronyms

Acronym	Definition
ACFTA	ASEAN-China Free-Trade Area
ACP	African, Caribbean, and Pacific
AD	antidumping
ADA	Antidumping Agreement
AFIS	Antifraud Information System
AFTA	ASEAN Free-Trade Area
AGOA	African Growth and Opportunity Act
ALADI	Associacion Latino Americana de Integracion
ARO	Agreement on Rules of Origin
ASCM	Agreement on Subsidies and Countervailing Measures
ASEAN	Association of Southeast Asian Nations
ATC	Agreement on Textiles and Clothing
BTN	Brussels Tariff Nomenclature
CACM	Central American Common Market
CAFTA	Central American Free-Trade Area
CAFTA-DR	CAFTA-Dominican Republic
CARICOM	Caribbean Common Market
CBI	Caribbean Basin Initiative
CBP	Customs and Border Protection (U.S.)
CC	change of chapter
CCC	Community Customs Code
CC Committee	Customs Cooperation Committee
CCCN	Council Cooperation Customs Nomenclature
CCRA	Canada Customs and Revenue Agency
CEEC	Central and Eastern European Countries
CEFTA	Central European Free-Trade Agreement
CEPT	Common Effective Preferential Tariff
CIF	cost insurance and freight

CIS	Customs Information System
CITA	Committee for the Implementation of the Textiles Agreements
COMESA	Common Market for Eastern and Southern Africa
CPA	Cotonou Partnership Agreement
CRO	Committe on Rules of Origin
CTC	change of tariff classification
CTH	change of tariff heading
CTHS	change of tariff heading split
CTSH	change of tariff subheading
CTSHS	change of tariff subheading split
CUSFTA	Canada-U.S. Free-Trade Area
DC	developing country
DFQF	Duty-Free Quota-Free (Initiative)
DRAM	dynamic random-access memory
DSU	Dispute Settlement Understanding
DTI	Department of Trade and Industry
EAC	East Africa Community
EBA	Everything But Arms (Initiative)
EC	European Community
ECJ	European Court of Justice
ECSC	European Coal and Steel Community
EEA	European Economic Area
EEC	European Economic Community
EEZ	exclusive economic zone
EFTA	European Free-Trade Area
EPA	Economic Partnership Agreement
EPROM	erasable programmable read-only memory
ESA	Eastern and Southern Africa
EWS-C	Early Warning System for Customs
EWS-E	Early Warning System for Excise
FAO	Food and Agricultural Organization
FDI	Foreign Direct Investment
FOB	Free On Board
FPA	Fisheries Partnership Agreements
FTA	free-trade area
GAAP	generally accepted accounting principles
GATT	General Agreement on Tariffs and Trade
GC	General Council
GIR	General Interpretation Rule
GPT	General Preferential Tariff
GSP	Generalized System of Preferences
HIC	high-income country
HRO	Harmonized Rules of Origin

HS	Harmonized System
HTS	Harmonized Tariff Schedule
HTSUS	Harmonized Tariff Schedule of United States
HWP	Harmonization Work Program
ISIC	International Standard Industrial Classification
LDC	least-developed country
LDCT	LDC tariff
MARSUR	Maritime Surveillance
MFN	most-favored nation
MMTZ	Malawi, Mozambique, Tanzania, and Zambia
NAFTA	North American Free-Trade Agreement
OCT	overseas countries and territories
OCU	Operations Control Unit
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
OJ	Official Journal of the European Communities
OLAF	Office Européen de Lutte Anti-Fraude
QUAD	quadrilateral countries (the EC, United States, Japan, and Canada)
RBM	ring-binder mechanism
RMG	ready-made garment
RTA	regional trade agreement
RVC	regional value content
SAARC	South Asian Association for Regional Cooperation
SACU	South African Customs Union
SADC	Southern Africa Development Community
SME	square-meter equivalent
SPS	sanitary and phytosanitary
SSA	sub-Saharan African (country)
TAXUD	Taxation and Customs Union Directorate-General (European Commission)
TCRO	Technical Committee on Rules of Origin
TDCA	Trade and Development Cooperation Agreement
TRIP	trade-related aspects of intellectual property (rights agreement)
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
URAA	Uruguay Round Agreements Act
USTR	U.S. Trade Representative
VAR	value-added rule
WAEMU	West African Economic and Monetary Union
WCO	World Customs Organization
WITS	World Integrated Trade Solutions
WTO	World Trade Organization

Preface

As I start writing the preface to this book, my mind goes back to the late 1980s, when technical issues on rules of origin began to arise from the surge of exports of the "Asian Tigers" and the trade defense mechanisms by the European Community (EC) and United States. The issue was mainly related to the alleged circumvention of such trade defense mechanisms in which manufacturers affected by the antidumping (AD) investigations relocated some working or processing operations in neighboring countries or directly in the export market. This move was counteracted by origin findings of the EC and the United States that indicated that the product exported from the neighboring countries or manufactured in their territory was in fact subject to only minimal working or processing, resulting in the product's having the same origin of the product subject to AD duties.

These were the times when rules of origin started to make headlines in the press. The trading community and AD lawyers were suddenly interested in origin issues. I quickly realized that rules of origin were an ideal issue for contention because they provided the grounds for arbitrary or discretionary practices under the cover of technical and obscure details. Only a select few were part of these early developments. Hardly any international rule, convention, or multilateral instrument could provide guidance to these initial debates.

Administrations were slow to answer, demonstrating once again that business life evolves at a faster pace than rule-making, and, to put it simply, rules of origin were, and to some extent still are, a no man's land in international trade law.

Apart from the Kyoto Convention, the first international effort to put rules of origin on a multilateral track was carried out under the United Nations Conference on Trade and Development, which convened in the beginning of the 1970s in the context of the Generalized System of Preferences working groups on rules of origin without much success, but a lot of useful technical work was carried out.

About 20 years later, the World Trade Organization Agreement on rules of origin started the Harmonization Work Program of nonpreferential rules of origin. Once again a lot of excellent technical work was carried out, but final agreement, although close, is still pending at the time of this writing.

I have had the privilege to be exposed to the multidisciplinary nature of rules of origin, and I have drafted this book with the deliberate intent of covering these different aspects. A second important feature of this book is linked to my personal career, which has allowed the mixing of academic and research experiences with technical assistance to developing countries in the field for two decades. Much of the material in this book derives from the unfolding of these experiences. The drafting of this book has also been guided by the desire to maintain a certain degree of pragmatism and to provide the reader with a multidisciplinary instrument to understand rules of origin and their implications.

The views expressed in this book are entirely mine and do not necessarily reflect the views of the United Nations Conference on Trade and Development or any other United Nations agency.

Stefano Inama (June 2008)

1

Efforts to Establish Multilateral Rules

Rules of origin have long been considered a rather technical customs issue, with little bearing on trade and economic policy. However, origin has far-reaching implications, not only for trade policy but also for domestic disciplines regulating the marketing of products to final consumers. Marks of origin, linkages with geographical denomination, or the definition of "domestic industries" may not be directly linked to the traditional view of origin limited to a border control device. The relevance of rules of origin (a "secondary trade policy instrument") may be fully grasped only when they are associated with primary trade policy instruments that they support, such as tariffs, contingency protection measures, and trade preferences.

Rules of origin are often associated with preferential trade regimes, as the fulfillment of origin criteria is a precondition for the application of a preferential tariff. Nonpreferential rules of origin apply to trade flows that do not benefit from tariff or other trade preferences. One of the main differences between nonpreferential and preferential rules of origin is that the former should always provide for an exhaustive method to determine origin. In the case of preferential rules of origin, if the origin criterion is not met, the preferential tariff will not be applied. Unless there are more than two parties involved in a preferential tariff treatment,[1] there is often no need to fall back on alternative methods to secure an origin outcome. In the case of nonpreferential origin rules, there

[1] This is the case, for instance, when parties to free-trade areas have different tariff phaseout schedules or when under a unilateral preference scheme such as the European Community Generalized System of Preferences (EC GSP) scheme there is regional cumulation granted to a regional group comprising both least-developed countries (LDCs) and non-LDC developing countries. In those cases and when two or more countries have been involved in the manufacturing of a finished product subsequently exported to the preference-giving country, there is a need for a "residual" rule to allocate origin among the beneficiaries because different preferential tariffs may be applicable. See also Globalization and the International Trading System: Issue Relating to the Rule of Origin (UNCTAD ITCD/TSB/2, 24 March 1998).

must still be a method to determine the origin of the good to administer trade policy measures, even if the primary origin criterion is not met. Thus, other rules should be provided to determine origin when the primary rule has not been met, as customs administrations must determine where goods are originating from. Such ancillary rules to determine origin whenever the primary rule is not met are commonly referred to as "residual rules."

The origin of goods in international trade has traditionally been considered one of the instruments of customs administration associated with preferential tariff arrangements through colonial links, granted by, for instance, the British Empire.[2] At the outset, the granting of these tariff preferences was conditional on compliance with rules of origin requirements often based on a value-added criterion.

A notable exception to this principle, derived from a different historical background, is the United States' rules of origin, which were first associated with origin marking[3] and not with the granting of preferential tariff treatment. As discussed in the following section, this difference has had direct consequences in the evolution of the origin concept in U.S. legislation.

The issue of rules of origin (as opposed to origin markings, to which GATT Article IX is devoted, because of U.S. influence) did not attract much attention in the negotiation of the original General Agreement on Tariffs and Trade (GATT). On the contrary, during the second session of the Preparatory Committee in 1947, a subcommittee considered that "it is to be clear that it is within the province of each importing member to determine, in accordance with the provisions of its law, for the purpose of applying the most-favored-nation (MFN) provision whether goods do in fact originate in a particular country."[4] Only later – in 1951 and 1952[5] – were the first attempts made (without success) to address the question of harmonization of rules of origin.

The scant attention devoted to the issue of rules of origin in the original GATT was probably because of the preoccupation of the drafters with establishing the unconditional MFN principle contained in Article I. In a MFN world there is no need to examine the origin of goods. This implied that, as

[2] See United Kingdom Finance Act of 1919.

[3] See Tariff Act of 1890, Chapter 1244, paragraph 6, 26 Stat. 567, 613 (1891).

[4] See PCT/174, pp. 3–4.

[5] See, for instance, the 1951 report on "Customs Treatment of Samples and Advertising Material, Documentary Requirements for the Importation of Goods, and Consular Formalities: Resolutions of the International Chamber of Commerce" (GATT/CP.6/36, adopted 24 October 1951, II/210) and the 1952 report on "Documentary Requirements for Imports, Consular Formalities, Valuation for Customs Purposes, Nationality of Imported Goods and Formalities connected with Quantitative Restrictions" (G/28, adopted 7 November 1952, 15/100).

a general concept, origin entered into world trade with a discriminatory bias: Origin needs to be ascertained whenever a discriminatory measure is in place.[6]

Besides these early discussions in GATT, one of the first attempts to establish a harmonized preferential set of rules of origin was made during the discussion in United Nations Conference on Trade and Development (UNCTAD) in connection with the Generalized System of Preferences (GSP). In point of fact, UNCTAD member-states, when discussing the establishment of the GSP, realized the need to examine "origin" at the multilateral and systemic level.[7] However, the preferential nature of the rules, their policy objectives, and the unilateral nature of the GSP did not permit the elaboration of a single set of GSP rules of origin. At the end of the first round of negotiations, preference-giving countries opted to retain their own origin systems and extend them with some adjustments to the GSP. After more than 30 years and in spite of the general lowering of MFN duties, the same reluctance to multilaterally discuss rules of origin under the Duty-Free Quota-Free (DFQF) initiative, which was launched at the World Trade Organization's Hong Kong Ministerial Conference in 2005, has remain unaltered in preference-giving countries.

Efforts to codify and strengthen a general concept of origin in the absence of multilateral disciplines were made at the multilateral level during the Kyoto Convention negotiations in 1973.[8] However, Annex DI of the Convention, containing guidelines, was not sufficiently detailed and left member-states freedom to choose different and alternative methods of determining origin. The low level of harmonization achieved, combined with the fact that few

[6] This consideration, however, does not fully explain why an origin determination was not considered necessary in the framework of Article VI of GATT on antidumping, although an explicit reference is made to the cost of production in the country of origin in paragraph I B ii.

[7] For a brief summary of the work and proceedings of the UNCTAD Working Group on Rules of Origin from 1967 to 1995, see "Compendium of the work and analysis conducted by UNCTAD working groups and sessional committees on GSP rules of origin," part I (UNCTAD/ITD/GSP/34 of 21 February 1996). See also S. Inama, "A comparative analysis of the generalized system of preferential and non-preferential rules of origin in the light of the Uruguay Round Agreement: It is a possible avenue for harmonization or further differentiation," *Journal of World Trade*, vol. 29, no. 1, February 1995.

[8] International Convention on the Simplification and Harmonization of Custom Procedures, adopted in 1974 by the Customs Cooperation Council at its 41st and 42nd sessions, held in Kyoto. In substance, Annex DI did not provide for ready-to-use rules of origin. Although the criterion for products "wholly produced in one country" was sufficiently precise, the "substantial transformation criterion when two or more countries have taken part in the production" was not better specified other than by listing the three different ways in which the substantial transformation may be interpreted: change of tariff heading, *ad valorem* percentage rules, and specific manufacturing or processing operations; see H. Asakura, "The Harmonized System and rules of origin," *Journal of World Trade*, vol. 27, no. 4, August 1993.

countries ratified this annex, meant that the annex became little more than general guidance used in determining origin at a national level.

These meager results achieved at the multilateral level with regard to harmonizing rules of origin or even determining a valid method of origin assessment contrast with the efforts to negotiate the Customs Valuation Code, negotiated during the Tokyo Round in 1979, and the entry into force of the International Convention on the Harmonized Commodity Description and Coding System, negotiated under the auspices of the Customs Cooperation Council in 1988. Thus, until the Uruguay Round Agreement, rules of origin remained the only one of the three basic customs laws operating at the national level not subject to multilateral discipline.

1.1. The Concept of "Substantial Transformation" and First Attempts to Define It at the Multilateral Level: The Kyoto Convention of 1973 and 2000

> "The rules applied to determine origin employ two different basic criteria: the criterion of goods "wholly produced" in a given country, where only one country enters into consideration in attributing origin, and the criterion of "substantial transformation," where two or more countries have taken part in the production of the goods. The "wholly produced" criterion applies mainly to "natural" products and to goods made entirely from them, so that goods containing any parts or materials imported or of undetermined origin are generally excluded from its field of application. The "substantial transformation" criterion can be expressed by a number of different methods of application." (Excerpt from the introduction of 1973 Kyoto Convention)

Substantial Transformation or Sufficient Working or Processing

As a general definition, goods that have been manufactured in a country wholly or partly from imported materials, parts, or components including materials of undetermined origin are considered as originating in that country if those materials, parts, or components have undergone "substantial transformation" or "sufficient working or processing."

The general concept definition of "substantial transformation" or sufficient working or processing is further specified in different multilateral texts or national provisions reflecting on one hand a common understanding of the needs to better define what "substantial transformation" is and on the other hand the beginning of different "models" to define "substantial transformation."

In modern times, one of the oldest definitions of "substantial transformation" was made by a judge in a celebrated case[9]:

> "A substantive transformation occurs when an article emerges from a manufacturing process with a name, character or use which differs from those of the original materials subjected to the process."

In the European context, the first definition at EC level appeared in 1968[10]:

> "Goods whose production involved more than one country shall be deemed to be originated in the country where they underwent the last, substantial, economically justified processing or working in an undertaking equipped for that purpose and resulting in the manufacture of a new product or representing an important stage of manufacture."

In the following decades, it becomes progressively clear that such general definitions did not match the evolving and growing nature of international trade. Annex DI of the 1973 Kyoto Convention was one of the multilateral attempts to clarify some of the conceptual issues arising from the definition of "substantial transformation":

> "In practice the substantial transformation criterion can be expressed:
>
> - by a rule requiring a change of tariff heading in a specified nomenclature, with lists of exceptions, and/or
> - by a list of manufacturing or processing operations which confer, or do not confer, upon the goods the origin of the country in which those operations were carried out, and/or
> - by the ad valorem percentage rule, where either the percentage value of the materials utilized or the percentage of the value added reaches a specified level."
>
> The advantages and disadvantages of these various methods of expression, from the point of view of the Customs and of the user, may be summed up as described in the following subsections.

9 See, "Anheuser-Busch Brewing Assn. v United States, 207 US 556 (1907)."
10 Council Regulation 802/68, OJ L.148/1 (1968).

A. CHANGE OF TARIFF HEADING

The usual method of application is to lay down a general rule whereby the product obtained is considered to have undergone sufficient manufacturing or processing if it falls in a heading of a systematic goods nomenclature different from the headings applicable to each of the materials utilized.

This general rule is usually accompanied by lists of exceptions based on the systematic goods nomenclature; these specify the cases in which a change of heading is not decisive or imposes further conditions.

- Advantages

This method permits the precise and objective formulation of the conditions determining origin. If required to produce evidence, the manufacturer will normally have no difficulty in furnishing data establishing that the goods do in fact meet the conditions laid down.

- Disadvantages

The preparation of lists of exceptions is often difficult, and moreover such lists must normally be constantly updated to keep them abreast of technical developments and economic conditions. Any descriptions of manufacturing or qualifying processes must not be unduly complicated, since otherwise they might lead manufacturers to commit errors in good faith.

In addition, a prerequisite for use of the structure of a systematic goods nomenclature for determining origin is that both the country of exportation and the country of importation have adopted the same nomenclature as a basis for their respective tariffs and apply it uniformly.

B. LISTS OF MANUFACTURING OR PROCESSING OPERATIONS

This method is generally expressed by using general lists describing each product's technical manufacturing or processing operation regarded as sufficiently important ("qualifying processes").

- Advantages

The advantages are the same as those described in Section A.

- Disadvantages

Apart from sharing the disadvantages referred to in Section A, the general lists are longer and more detailed, so their preparation is even more difficult.

C. AD VALOREM PERCENTAGE RULE

To determine origin by this method, one must consider the extent of the manufacturing or processing undergone in a country, by reference to the value thereby added to the goods. When this added value equals or exceeds a specified

percentage, the goods acquire origin in the country where the manufacturing or processing was carried out.

The value added may also be calculated by reference to the materials or components of foreign or undetermined origin used in manufacturing or producing the goods. The goods retain origin in a specific country only if the materials or components do not exceed a specified percentage of the value of the finished product. In practice, therefore, this method involves comparison of the value of the materials imported or of undetermined origin with the value of the finished product.

The value of constituents imported or of undetermined origin is generally established from the import value or the purchase price. The value of the goods as exported is normally calculated using the cost of manufacture, the ex-works price, or the price at exportation.

This method may be applied

- either in combination with the two other methods, by means of the lists of exceptions referred to in Section A or the general lists referred to in Section B, or
- by a general rule prescribing a uniform percentage, without reference to a list of individual products.

- Advantages

The main advantages of this method are its precision and simplicity.

The value of constituent materials imported or of undetermined origin can be established from available commercial records or documents.

Where the value of the exported goods is based on the ex-works price or the price at exportation, as a rule both prices are readily ascertained and can be supported by commercial invoices and the commercial records of the traders concerned.

- Disadvantages

Difficulties are likely to arise especially in borderline cases in which a slight difference above or below the prescribed percentage causes a product to meet, or fail to meet, the origin requirements.

Similarly, the origin attributed depends largely on the fluctuating world market prices for raw materials and also on currency fluctuations. These fluctuations may at times be so marked that the application of rules of origin formulated on this basis is appreciably distorted.

Another major disadvantage is that such elements as cost of manufacture or total cost of products used, which may be taken as the basis for calculating value added, are often difficult to establish and may well have a different makeup and interpretation in the country of exportation and the country of importation. Disputes may arise as to whether certain factors, particularly overheads, are to be allocated to cost of manufacture or, for example, to selling, distribution, or other costs.

> Although these various rules for determining origin all have, in one degree or another, advantages and disadvantages, it must be stressed that the absence of common rules of origin, at both importation and exportation, not only complicates the task of customs administrations and of the bodies empowered to issue documentary evidence of origin but also causes difficulties for those involved in international trade. This points to the desirability of moving progressively toward harmonization in this field. Even where different methods have been introduced to reflect economic conditions or negotiating factors in preferential tariff arrangements, it seems that they should exist within a common or standard framework, for ease of understanding by traders and ease of application by Customs. However, these objectives, although laudable, are in practice not realistic. (Excerpts from 1973 Kyoto Convention)

The revised Kyoto Convention of 2000 contains in Annex K two chapters of the original Annex DI of 1973 Kyoto Convention. These chapters concerning rules of origin were modified probably because the harmonization work in the World Trade Organization (WTO) started. Effectively, the original Chapter 1 covers what is now negotiated inside the WTO in terms of definition of substantial transformation.

> "3. Recommended Practice
>
> Where two or more countries have taken part in the production of the goods, the origin of the goods should be determined according to the substantial transformation criterion.
>
> 4. Recommended Practice
>
> In applying the substantial transformation criterion, use should be made of the International Convention on the Harmonized Commodity Description and Coding System.
>
> 5. Recommended Practice
>
> Where the substantial transformation criterion is expressed in terms of the ad valorem percentage rule, the values to be taken into consideration should be:
>
> - for the materials imported, the dutiable value at importation or, in the case of materials of undetermined origin, the first ascertainable price paid for them in the territory of the country in which manufacture took place; and
> - for the goods produced, either the ex-works price or the price at exportation, according to the provisions of national legislation."

In fact, it has to be noted that the method of expressing substantial transformation using specific manufacturing or processing operations has been

dropped in the revised Kyoto Convention of 2000. However, for future implementation, Chapter 2 of Annex K will be quite relevant because it explicitly covers aspects related to documentary evidence and certificates of origin that are not dealt with by the WTO Agreement on Rules of Origin (hereinafter ARO). Chapter 2 of the revised Kyoto Convention, which covers documentary evidence of origin contains, among other things, the following standards and recommended practices:

- Documentary evidence of origin shall be required only for the application of preferential customs duties, or economic or trade measures.
- Documentary evidence shall not be required for small consignments, goods granted temporary admission, goods in transit, or exemption by bilateral or multilateral agreements.
- Documentary evidence shall be required in case of suspected fraud.
- A model form of a certificate of origin
- The certificate of origin shall also be printed in English or French.
- No translation of the particulars given in certificates of origin shall be required.
- Provision shall be made for sanction against any person who prepares or causes to be prepared a document containing false information.

1.2. The UNCTAD Working Group on Rules of Origin

Well before the Kyoto Convention and the ARO, the first attempt to establish multilateral rules of origin was carried out in UNCTAD.

The idea of preferential tariff rates in the markets of industrialized countries – currently known as Generalized System of Preferences (GSP) – was presented by the first Secretary-General of UNCTAD, Raul Prebisch, at the First Session of the United Nations Conference on Trade and Development (UNCTAD I) in 1964. The idea of the GSP was ultimately adopted in New Delhi, in 1968, in the context of UNCTAD II.

Developing countries are granted preferential tariff treatment in the markets of developed countries under the GSP, in order to help them increase export earnings, promote industrialization, and accelerate rates of economic growth. The GSP is a nonreciprocal and nondiscriminatory system of preferences in favor of developing countries. Select GSP products originating in developing countries are subject to lower or zero tariff rates. Furthermore, the LDCs are allowed to receive special preferential tariff treatments in terms of wider coverage of products.

At GSP's inception, it was immediately clear that a set of rules of origin was necessary to determine what products were eligible for preferential tariff rates.

Drafting a uniform set of origin rules to be applied to the different GSP schemes of preference-giving countries was the principal aim of the Special Committee on Preferences, at its second session.[11] Hence, the Special Committee decided to establish the Working Group on Rules of Origin with the task of initiating consultations on technical aspects of the rules of origin with the objective of preparing draft origin rules to be applied uniformly in the GSP system.

In drawing up the boundaries for work to be undertaken by the Working Group, the Special Committee recalled that rules of origin requiring a very high degree of product transformation to qualify for preferential treatment would have enabled only a very small number of developing countries to benefit from the scheme of preferences. On the other hand, it was pointed out that extremely liberal rules of origin "would have many disadvantages."[12] With rules requiring only minor transformation of the product or small value added, there was the risk that developed countries could receive benefits of the preferential tariff treatment by dispatching products via a developing country, where they would undergo only some minor processing.[13] "Rules that permitted such exports would not appear to be in the interest of the developing countries and neither would the scheme achieve its objective of encouraging the expansion and diversification of industrial production and exports in developing countries."[14]

Furthermore, rules requiring an important degree of processing in developing countries would seem likely to encourage the establishment of production units, encourage investment, and the transfer of technology. Such action would facilitate the expansion and diversification of developing country exports.[15] Thus, it was mandated that the Working Group, in drawing up the rules of origin "should take care to see that they are as simple as possible to administer, as liberal as practicable taking into account the industrial potential of the developing countries, but at the same time as strict as necessary to promote the industrialization and diversification of the economies of developing countries. A reasonable compromise between these requirements must be worked

[11] However, in the Summary and Conclusions of the Report of the Second Session, the Special Committee retained that "it seemed premature to attempt even a first draft for rules of origin because a thorough discussion of all the aspects involved has yet to take place at the international level." See UNCTAD document TD/B/AC.5/3, p. iii, 29.11.1968.

[12] Ibid., para. 7.

[13] Ibid., para. 7.

[14] Ibid., para. 7.

[15] Ibid., para. 8.

out."[16] In light of the above, the application of fairly similar rules of origin was considered by the Special Committee to be a prerequisite for comparable conditions of access to developed countries' markets, thereby ensuring to the extent possible, equivalence in "burden sharing" by developed countries. The Special Committee also recognized that "multiple rules of origin would obviously cause great practical difficulties for the developing countries, and would be likely to hinder an expansion in the exports of these countries."[17]

To fulfill the mandate of the Special Committee, the Working Group initially focused its attention on the rules of origin applied by each developed country in the preferential trade regimes they had established with various developing countries. In particular, the preferential trade arrangements of the following countries were analyzed: Australia, the EC, the European Free-Trade Area, the United Kingdom, and the United States. At the first[18] and second[19] meetings (both held in 1970), the Working Group, after having identified the most important features of the origin rules (criteria for determining the origin – substantial transformation and wholly produced goods, documentary evidence, verification, mutual cooperation, unit of qualification, sanctions, treatment of packing, treatment of mixtures, consignments of small value, exhibitions, certification, minimal processes, direct consignment)[20] analyzed the differences and the points in common in the rules of origin applied by the donor countries in trade with developing countries. The analysis was made through a comparison of the rules of each of these preferential arrangements with regard to the main components of the origin rules previously mentioned.[21] It was only in the third meeting[22] (also held in 1970) that the Working Group elaborated an agreed text[23] concerning various aspects (with the exception of the criteria for determining the substantial transformation) of the rules of origin to be applied in the GSP.[24]

At the same time, the objective of the harmonization of rules of origin for individual GSP schemes of donor countries, and in particular the harmonization of the criteria to determine the origin, was one of the main subjects of the work of the Working Group. However, the solution explored within the

[16] Ibid., paras. 10–74.
[17] Ibid., para. 9.
[18] See UNCTAD document TD/AC.5/3/Add.4, 19 March 1970.
[19] See UNCTAD document TD/B/AC.5/31, 10 July 1970.
[20] See UNCTAD document TD/AC.5/31, para. 24.
[21] See UNCTAD document TD/B/AC.5/3.
[22] See UNCTAD document TD/B/AC.5/38, 21 December 1970.
[23] See UNCTAD document TD/B/AC.5/38.
[24] See UNCTAD document TD/B/AC.5/38, Appendix 1.

Working Group, that is, the "acceptance of a uniform criterion or criteria by all preference-giving countries" met with opposition from these countries.[25] In the Organisation for Economic Co-operation and Development (OECD) Ad Hoc Group of the Trade Committee on Preferences[26] (Paris, 1970), the preference-giving countries expressed the view that, as preferences were being granted unilaterally and noncontractually, the general principle had to be that donor countries were free to decide on the rules of origin that they thought were appropriate after hearing the views of the beneficiary countries. It was thus considered that the texts eventually elaborated by the Working Group regarding some harmonized aspects of rules of origin would be no more than general illustrations, for the information of beneficiary countries, of the kind of elements that donor countries were likely to include in the general statement of their national GSP rules of origin.

In particular, preference-giving countries felt the harmonization process conducted in the UNCTAD Working Group had to be limited to some practical aspects such as certification, control, verification, sanctions, and mutual cooperation. This view was considered in the second session of the Working Group, when it was noted that "in regard to the basic element for any rules of origin, namely the criterion for substantial transformation, it was not considered feasible to arrive at common views at this stage on a single set of uniform criteria."[27] However, the third meeting (December, 1970) was an important step toward the aim of harmonization. The Working Group was able to conclude agreed texts on many subjects and designed appropriate forms to define: (a) wholly produced goods; (b) minimal processes; (c) consignments of small value; (d) direct consignment; (e) documentary evidence; (f) verification; (g) sanctions; (h) mutual cooperation; (i) treatment of packing; (j) unit of qualification; (k) exhibitions and fairs.[28]

The fifth meeting of the Working Group on Rules of Origin was dedicated to carrying out a comparative analysis of the rules of origin adopted by each preference-giving country.[29] This session also indicated the extent to which the text agreed in the previous meeting had been considered in drafting the rules as well as the nature and possible effects of departures from this text. As stated in the third session, the majority of countries based their requirements

[25] See TD/B/AC.5/31, paras. 14, 16, 18 and 22.

[26] See OECD, Ad HOC Working Group of the Trade Committee on Preferences, Rules of Origin, second report, TC/Pref./70.25, p. 9, Paris, 25.9.1970.

[27] See UNCTAD document TD/B/AC.5/31, para. 45, 10.7.1970.

[28] See document TD/B/AC.5/38, 21.12.1970, para. 48.

[29] See, for the fifth meeting, UNCTAD document TD/B/C.5/2, 30.11.92.

for substantial transformation on the process criterion.[30] For countries using this criterion, transformation took place, in general, when exported goods were classified under a Brussels Tariff Nomenclature heading other than that relating to any of the materials and/or components imported or of undetermined origin that were used in production. However, in a great number of cases, these countries drew up two separate lists. List A specified certain working or processing operations that resulted in a change of tariff heading (CTH) without conferring the status of "originating" products on the products undergoing such operations, or that conferred the status only subject to certain conditions. List B specified working or processing operations that did not result in a CTH but conferred the status of "originating" products on the products undergoing such operations.[31] Other countries[32] based their requirements for substantial transformation on the value-added criterion, with percentages required varying from 50 percent to 100 percent.[33] It was agreed at the fifth meeting, that preference-giving member countries of OECD would make every effort to complete their work on linguistic and substantive harmonization of GSP rules of origin. In pursuance of that agreement, the Secretary-General of OECD transmitted to UNCTAD a compendium of GSP rules of origin applied by OECD preference-giving countries.[34]

With the entering into force of the different national GSP schemes, the role of the Working Group was destined to change. In fact, in 1974, all GSP schemes had entered into force.[35]

The new mandate contained in the resolution of the Special Committee[36] at its fifth session was carried out on subsequent sessions of the Working Group through various actions

(1) Preparation of analytical studies that
   (a) Analyzed the problems that had arisen from the application of rules of origin under GSP. These studies also resulted in some concrete proposals for the solution of the above-mentioned problems;

[30] These countries were Austria, Bulgaria, Denmark, European Economic Community, Finland, Ireland, Japan, Norway, Switzerland, and the United Kingdom; see UNCTAD document TD/B/C.5/2, 30.11.1972, para.8.

[31] See UNCTAD document TD/B/C.5/2.

[32] Czechoslovakia, Hungary, and New Zealand; see ibid., para. 10.

[33] Czechoslovakia specified that for goods to be considered as originating in a developing country they must have undergone a manufacturing process in the developing country, as a result of which they had acquired their basic characteristics, provided that the manufacturing process had increased their original value by at least 100 percent: TD/B/C.5/2, para. 10.

[34] See UNCTAD document TD/B/626.

[35] See UNCTAD document TD/B/442, for the date of the entering into force of the different GSP national schemes.

[36] See UNCTAD document TD/B/442.

(b) Monitored existing differences between the rules of origin applied by preference-giving countries in their different national schemes and those contained in texts agreed at previous meetings of the Working Group;

(2) Collection of information regarding the difficulties encountered in preference-receiving and preference-giving countries in the area of rules of origin through the use of questionnaires addressed not only to governments of both preference-giving and preference-receiving countries,[37] but also to certain nongovernmental organizations in preference-giving countries that had interests in or were concerned with GSP[38];

(3) Preparation of compendia that assembled the different rules of origin applied by each preference-giving country in its GSP scheme[39];

(4) Examination of the studies mentioned under item (i) and of the replies to the questionnaires and the formulation of concrete proposals.

In 1987, the Working Group was transformed into a Sessional Committee of the Special Committee on Preferences.[40] This mandate was enlarged in scope, placing particular attention on the harmonization of the different criteria for determining substantial transformation.

Consequently, at the 17th Session of the Special Committee[41] in 1990, it was agreed that

(1) Consideration should be given in the course of the next review to examining the current definitions of "substantial transformation," namely the process criterion and the percentage criterion;

(2) Preference-giving countries, in the course of their review of their schemes, should examine both definitions in the light of their experience over two decades and exchange views thereof during a future session of the Special Committee on Preferences.[42]

[37] Since the entering into force of the GSP schemes, three questionnaires had been addressed by the Working Group, through the Secretary-General of UNCTAD, to the governments of the member countries; see, for the texts and the replies, the following documents:
- TD/B/C.5/WG(VII)/5, 11 August 1978
- TD/B/C.5/WG(X)/2, 19 August 1985
- TD/B/SCP/AC.1/2/Add.1, 8 May 1995.

[38] See UNCTAD document TD/B/C.5/WG(VII)/5 para. 2.

[39] See UNCTAD document TD/B/626, 8 October 1976, Compendium of rules of origin applied under the GSP by OECD preference-giving countries; this compendium was presented during the sixth session of the Working Group on Rules of Origin, held in 1976.

[40] See TD/B/C.5/WG()/2, p. 2.

[41] TD/B/C.5/132, paras. 144–167.

[42] See document TD/B/1263, 14–20 May 1990.

The Sessional Committee held in 1992 during the 19th Session of the Special Committee[43] was entirely dedicated to a comparative analysis between the process criteria and the percentage criteria, to assess what system would better suit the objectives of GSP schemes.[44]

Although further sessional committees were not established until 1995, discussions on GSP rules of origin continued during the 20th[45] and 21st[46] Sessions of the Special Committee on Preferences. The Chairman's Summary[47] of the 20th Session of the Special Committee reported the concern of developing countries "over the lack of progress in harmonizing the rules of origin, which were at present based on two different criteria." Some developing countries expressed dissatisfaction over the fact that "the problem of the rules of origin had not been adequately discussed at the current session of the Committee" and suggested that the next session should undertake a comprehensive and detailed review.

During the 21st Session of the Special Committee, intensive discussions took place on possible ways and means to revitalize the GSP system as a whole. As part of this effort, it was decided to proceed toward harmonization, simplification, and improvement of GSP rules of origin and to establish an Intergovernmental Group of Experts on Rules of Origin as part of the preparation for the 1995 GSP policy review.[48] In fact, the Intergovernmental Group of Experts recommended the Special Committee adopt the following points:

- Follow and monitor, as an observer, the work carried out within the Technical Committee on Rules of Origin (TCRO) and, when appropriate, contribute to the technical aspects of its work;
- Report annually to the Special Committee on Preferences on the progress made and results achieved by the Technical Committee with a view to progressing toward harmonization of GSP rules of origin;
- Propose, once the TCRO achieved its objectives and taking due account of the WTO's work, a harmonized set of rules of origin, including modifications and amendments where appropriate, to UNCTAD member-states, for their consideration and adoption.[49]

[43] See TD/B/39(1)/2, paras. 47–65.

[44] See document TD/B/C.5/141, 28 February 1992, Examination of definitions of substantial transformation and implications of harmonization: possible initiatives in regard to simplification and liberalization.

[45] See document TD/B/40(1)/10.

[46] See TD/B/41(1)/2.

[47] See TD/B/42/(2)/4.

[48] See TD/B/SCP/14.

[49] See "Agreed Conclusions of the Intergovernmental Group of Experts on Rules of Origin," UNCTAD document TD/B/SCP/14, 24 August 1995.

The reform of the UNCTAD secretariat carried out in 1996 during UNCTAD IX in Midrand (South Africa) eliminated all UNCTAD standing committees including the Special Committee on Preferences and its subsidiary bodies, namely, the Sessional Committee on Rules of Origin. Since then, the international trading community lost the only intergovernmental forum to discuss GSP rules of origin. To date, no other intergovernmental expert meeting has been established in UNCTAD on the issue of rules of origin.

2

The Uruguay Round Agreement on Rules of Origin

The Harmonization Work Program of Nonpreferential Rules of Origin

The Harmonization Work Program (HWP) of the nonpreferential rules of origin established pursuant to the WTO Agreement on Rules of Origin (ARO) should have been completed by July 1998. At the time of this writing, such work is near completion, although final agreement is still pending. In this chapter a detailed overview of the current status of the HWP is provided, making ample use of available materials used during the negotiations. Much of the technical work has now been completed, and the final results of the HWP are not expected to differ substantially from what has already been analyzed.

The preliminary results of the HWP extended over three volumes, encompassing more than 2,000 pages and thousands of product-specific rules of origin. A much-needed cleaned-up version of the text has recently appeared with 320 pages (WTO/G/RO/Rev. 2, 23 May 2008). These figures call for some initial comments. At the technical level, the results of the HWP may represent the pinnacle of rules of origin. The amount of energy and human and financial resources spent on the HWP is almost unprecedented although it recalls the more than 10 years of negotiations leading to the adoption of the Harmonized System (HS). However, the high technical level in drafting the HWP has lately given way to compromises in trade policy considerations. The most notable example is the dilution of the obligation contained in Article 1, paragraph 2 and Article 3, paragraph (a) of the ARO (hereinafter the Agreement) of using the results of the HWP equally for all purposes. This was because of the U.S. stance that wished not to use the results of the HWP to determine origin in the context of antidumping (AD) and countervailing proceedings. At the time of this writing, another example of such compromises is the open option for WTO members to use for Chapters 84–90 either a change of tariff classification (CTC) mainly supported by the United States or an *ad valorem* percentage supported by the European Community (EC). This kind of compromise leaves

much to be desired at the technical level, opening the door to implementation difficulties and controversies.

Another important point to note is the liberal character of the results of the HWP. Nonpreferential rules of origin obey different rationales and are linked to trade policy instruments that are different from preferential rules of origin. Even bearing this difference in mind, the results of the HWP at a product-specific level are extremely liberal when compared with the restrictiveness of preferential rules of origin.

Table 2.9 contains a brief comparison table for some major HS chapters among the Pan-European rules, the NAFTA rules, and the results of HWP. The extent of the differences is striking and may be hardly explained by the preferential margin granted to goods complying with preferential rules of origin.

The high participation of industries in the work of the HWP since the early stages may have assisted the negotiators to better evaluate the positive implications of adopting liberal rules of origin. These overall considerations and their implication on other WTO Agreements have eventually prevailed on the narrow interests that are leading to restrictive rules of origin in regional trade agreements (RTAs). This is a positive factor that has yet to be fully analyzed by the literature.

The latest drafts of the Harmonized Rules of Origin (HRO) mentions 2010 as the date for entry into force. On request, a three-year implementation delay is granted to developing countries and least-developed countries (LDCs).

Given the magnitude of the HRO and the technical expertise required to administer it, the implementation and administration of the HRO is likely to be one of most daunting tasks for developing countries and LDCs. Moreover, the Agreement does not refer to a certificate of origin and method of administrative cooperation.

As mentioned, the results of the HWP may be, technically speaking, the most evolved form of rules of origin but are also complex even for those that are conversant with the issue of rules of origin. This holds especially true when one considers that the implementation challenges of the HRO may overlap with those arising from a possible agreement on trade facilitation.

A World Customs Organization (WCO) document[1] of the Technical Committee on Rules of Origin (TCRO) summarizes the main requirements to implement the results of the HWP:

- To apply the nonpreferential rules of origin in those areas of application described in Article 1, paragraph 2 of the Agreement and as further specified

[1] See TCRO document 0C0066E1 of 3 December on practical guidance on the implementation of the WTO Agreement on rules of origin presented at the 20th Session of 3 December 2001.

by the latest draft of General Rule I on scope of application as subsequently analyzed further.

- To apply the principle that the country to be determined as the origin of a particular good shall be either the country where the good has been wholly obtained, or when more that one country is concerned in the production of the good, the country where the last substantial transformation has been carried out.
- To apply the rules in accordance with the results of the work program and not to apply rules for imports or exports that are more stringent than those applied to determine whether a good is of domestic origin.
- Not to discriminate between Members, irrespective of the affiliation of the manufacturer(s) of the good concerned.
- To administer the rules in a consistent, uniform, impartial, and reasonable manner.
- To publish laws, regulations, judicial decisions, and administrative rulings of general application relating to rules of origin.
- To provide assessments of origin within 150 days as in the case of preferential origin examined in Chapter 1.
- Not to apply changes in rules of origin retroactively.
- To permit the review of any administrative origin-determining ruling by judicial, arbitral, or administrative tribunals independent of the authority issuing the ruling.
- To treat information confidentially, unless there is specific authorization from the person or government providing that information or it is published in the context of judicial proceedings.

For developing countries and especially LDCs, one of the major challenges would be to identify the governmental or intergovernmental authority responsible for implementing these various tasks. Neither the Kyoto Convention nor the ARO indicated what governmental or intergovernmental authority is charged with in implementing the ARO. The word "authorities" may indicate that it must be a government department; however, experience has shown that the various responsibilities related to origin may be allocated among different entities that may include also nongovernment actors, such as the chambers of commerce. It may be likely that the authority responsible for ensuring the proper application of rules of origin for the preceding purposes will differ from country to country. It may be the Ministry of Trade, Industry, or Finance. The issue is who will apply the rules of origin on a day-to-day basis. Although in many cases customs will be involved, other services will also intervene, depending on the administrative structure of each World Trade Organization

(WTO) Member, such as Chamber of Commerce, national statistics office, government procurement committee, or national control service (e.g., for origin marking).

2.1. The Agreement on Rules of Origin

The absence of a clear and binding multilateral discipline in the field of rules of origin has been one of the reasons for opening the way to the utilization of rules of origin as a trade policy instrument. The growing concern over trade policy implications of rules of origin ultimately generated efforts that matured into the long-awaited multilateral discipline.[2] In comparison with past multilateral negotiations on this subject, the ARO broke new ground in several aspects, and clearly defines the difference between, and the field of application of, nonpreferential and preferential rules of origin systems.

Article 1, paragraph 1 of the ARO defines nonpreferential rules of origin as follows:

> For the purposes of Parts I to IV of this Agreement, rules of origin shall be defined as those laws, regulations, and administrative determinations of general application applied by any Member to determine the country of origin of goods provided such rules of origin are not related to contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of paragraph 1 of Article I of GATT 1994.

Article 1 of paragraph 2 provides that rules of origin are to be utilized to determine the origin of goods for the following purposes:

- Most-favored-nation (MFN) tariffs and national treatment
- Quantitative restrictions
- AD and countervailing duties
- Safeguards measures
- Origin-marking requirement
- Any discriminatory quantitative restriction and tariff quotas
- Government procurement
- Trade statistics

The commitment of using the HRO for the trade policy instruments mentioned earlier was one key objective of the ARO. Article 3, paragraph (a) regulating disciplines after the transition period is clear that once the harmonization

[2] On the U.S. approach leading to the ARO, see D. Palmeter, "The US rules of origin proposal to GATT: Monotheism or polytheism," *Journal of World Trade*, vol. 24, no. 2, 1990.

work program is over the harmonized rules should be equally utilized for all purposes:

> Taking into account the aim of all Members to achieve, as a result of the HWP set out in Part IV, the establishment of HRO, Members shall ensure, on the implementation of the results of the HWP that:
> (a) they apply rules of origin equally for all purposes as set out in Article 1.

The existence of a transition period was due to the fact that the agreement contained a built-in agenda laying down the HWP to achieve the harmonization of nonpreferential rules of origin in Article 9, paragraph 2:

> *Work Programme*
> 2. (a) The work programme shall be initiated as soon after the entry into force of the WTO Agreement as possible and will be completed within three years of initiation.
> (b) The Committee and the Technical Committee provided for in Article 4 shall be the appropriate bodies to conduct this work.
> (c) To provide for detailed input by the Community Customs Code (CCC), the Committee shall request the Technical Committee to provide its interpretations and opinions resulting from the work described below on the basis of the principles listed in paragraph 1. To ensure timely completion of the work programme for harmonization, such work shall be conducted on a product sector basis, as represented by various chapters or sections of the Harmonized System (HS) nomenclature.
>
> (i) *Wholly Obtained and Minimal Operations or Processes*
>
> The Technical Committee shall develop harmonized definitions of:
> - the goods that are to be considered as being wholly obtained in one country. This work shall be as detailed as possible;
> - minimal operations or processes that do not by themselves confer origin to a good.
>
> The results of this work shall be submitted to the Committee within three months of receipt of the request from the Committee.
>
> (ii) *Substantial Transformation – Change in Tariff Classification*
>
> - The Technical Committee shall consider and elaborate upon, on the basis of the criterion of substantial transformation, the use of change in tariff subheading or heading when developing rules of origin for particular products or a product sector and, if appropriate, the minimum change within the nomenclature that meets this criterion.
> - The Technical Committee shall divide the above work on a product basis taking into account the chapters or sections of the HS nomenclature, so as to submit results of its work to the Committee at least on a quarterly basis. The Technical Committee shall complete the above work within one year and three months from receipt of the request of the Committee.

(iii) *Substantial Transformation – Supplementary Criteria*

Upon completion of the work under subparagraph (ii) for each product sector or individual product category where the exclusive use of the HS nomenclature does not allow for the expression of substantial transformation, the Technical Committee:

- shall consider and elaborate upon, on the basis of the criterion of substantial transformation, the use, in a supplementary or exclusive manner, of other requirements, including *ad valorem* percentages[3] and/or manufacturing or processing operations,[4] when developing rules of origin for particular products or a product sector;
- may provide explanations for its proposals;
- shall divide the above work on a product basis taking into account the chapters or sections of the HS nomenclature, so as to submit results of its work to the Committee at least on a quarterly basis. The Technical Committee shall complete the above work within two years and three months of receipt of the request from the Committee.

Although the work program was to be completed within three years of entry into force of the WTO, that is, mid-1998, at the time of this writing the work had not been completed as scheduled because of the complexity of issues involved.

Article 4 of the ARO established the Committee on Rules of Origin (CRO) in WTO and the TCRO at the WCO. Each of these committees has its own clearly defined responsibilities contained in Article 4, paragraphs 1 and 2 and Article 6 of the ARO. The specific responsibilities of TCRO are contained in Annex 1 of the ARO.

Practically speaking, the bulk of the technical work to negotiate the HRO has been carried out by TCRO. On the other hand, the CRO was intended as the so-called "political" committee to deal with policy questions other than technical ones. Later in the negotiations a good part of the technical work was also conducted in the CRO to devise technical solutions to the most intractable issues.

Some of the main technical aspects of the rules – what methodology has to be applied to determine if substantial transformation was achieved – are clearly spelled out in the ARO. Article 9, paragraph 2 (c) states that the TCRO has to develop harmonized definitions of

(i) wholly obtained products and minimal operations or processes
(ii) substantial transformation–change in tariff classification

[3] If the *ad valorem* criterion is prescribed, the method for calculating this percentage shall also be indicated in the rules of origin.

[4] If the criterion of manufacturing or processing operation is prescribed, the operation that confers origin on the product concerned shall be precisely specified.

(iii) supplementary criteria, on completion of the work under subparagraph (ii) and on the basis of the criterion of substantial transformation

The ARO clearly stipulates that the TCRO should elaborate the criterion of substantial transformation primarily on the use of a change of tariff classification [i.e., change of tariff subheading (CTSH) or change of tariff heading (CTH)]. In addition, the work of the TCRO should be divided on a product basis considering the chapters or sections of the HS nomenclature.[5]

Article 9, paragraph 2 (iii), provides for the TCRO to consider and elaborate on supplementary criteria to be used: "When, upon completion of the work under subparagraph (ii) [i.e. the work based on the CTH criterion] for each product sector or individual product category . . . the exclusive use of the HS nomenclature does not allow for the expression of substantial transformation."

This precise sequencing on the criteria to be used to develop HRO has informed all the negotiating processes since its inception.

In spite of these relevant achievements, the ARO failed to regulate preferential rules of origin. This leaves an enormous loophole in the multilateral disciplines of rules of origin. WTO members that are negotiating free-trade areas (FTAs) or are granting autonomous preferences are free to determine their rules of origin. In this area, the WTO members limited themselves to a Common Declaration. In comparison with the specific program for harmonizing the nonpreferential rules of origin and the clear commitments undertaken by parties with respect to these, the Common Declaration contains "best endeavors" commitments. Its main practical outcome seems to be the establishment of an advance origin ruling procedure.[6]

Article 2 of the Common Declaration defines the scope of preferential rules of origin, used to determine whether goods qualify for preferential (better than MFN) tariff treatment under contractual or autonomous trade regimes, discussed in Chapter 3. Examples of preferential rules of origin include

- Autonomous preferential tariff treatment
  - GSP Rules of Origin
  - African Growth and Opportunity Act (AGOA)
  - Contractual nonreciprocal rules of origin such as those that were contained in the former Cotonou Partnership Agreement between the EC and African, Caribbean, and Pacific (ACP) Countries

[5] The Harmonized Commodity Description and Coding System (HS) is a uniform nomenclature employed in the customs tariffs and trade statistical nomenclature of almost 180 countries covering over 90 percent of world trade.

[6] See paragraph 3(D) of Annex II of the Common Declaration with Regard to Preferential Rules of Origin of the ARO.

- Contractual reciprocal rules of origin, i.e., FTAs
  - North American Free-Trade Agreement (NAFTA) Rules of Origin
  - Pan-European Rules of Origin and rules of origin contained in the Economic Partnership Agreements (EPAs) concluded with African, Caribbean, and Pacific Countries
  - El Mercado Común del Sur (Mercosur), Southern Africa Development Community (SADC), Eastern and Southern Africa (COMESA), Association of Southeast Asian Nations (ASEAN) Rules of Origin

Paragraph 3 of the Common Declaration contains the substantive requirements that WTO Members have agreed to ensure in the area of preferential rules of origin:

> The Members *agree* to ensure that:
> (a) when they issue administrative determinations of general application, the requirements to be fulfilled are clearly defined. In particular:
> (i) in cases in which the criterion of CTC is applied, such a preferential rule of origin, and any exceptions to the rule, must clearly specify the subheadings or headings within the tariff nomenclature that are addressed by the rule;
> (ii) in cases in which the *ad valorem* percentage criterion is applied, the method for calculating this percentage shall also be indicated in the preferential rules of origin;
> (iii) in cases in which the criterion of manufacturing or processing operation is prescribed, the operation that confers preferential origin shall be precisely specified;
> (b) their preferential rules of origin are based on a positive standard. Preferential rules of origin that state what does not confer preferential origin (negative standard) are permissible as part of a clarification of a positive standard or in individual cases for which a positive determination of preferential origin is not necessary;
> (c) their laws, regulations, judicial decisions, and administrative rulings of general application relating to preferential rules of origin are published as if they were subject to, and in accordance with, the provisions of paragraph 1 of Article X of GATT 1994;
> (d) on request of an exporter, importer, or any person with a justifiable cause, assessments of the preferential origin they would accord to a good are issued as soon as possible but no later than 150 days[7] after a request for such an assessment provided that all necessary elements have been submitted. Requests for such assessments shall be accepted before trade in the good concerned begins and may be accepted at any later point in time. Such assessments

[7] In respect of requests made during the first year from entry into force of the WTO agreement, members shall only be required to issue these assessments as soon as possible.

shall remain valid for three years provided that the facts and conditions, including the preferential rules of origin, under which they have been made, remain comparable. Provided that the parties concerned are informed in advance, such assessments will no longer be valid when a decision contrary to the assessment is made in a review as referred to in subparagraph (f). Such assessments shall be made publicly available subject to the provisions of subparagraph (g);

(e) when introducing changes to their preferential rules of origin or new preferential rules of origin, they shall not apply such changes retroactively as defined in, and without prejudice to, their laws or regulations;

(f) any administrative action which they take in relation to the determination of preferential origin is reviewable promptly by judicial, arbitral, or administrative tribunals or procedures, independent of the authority issuing the determination, which can effect the modification or reversal of the determination;

(g) all information that is by nature confidential or that is provided on a confidential basis for the purpose of the application of preferential rules of origin is treated as strictly confidential by the authorities concerned, which shall not disclose it without the specific permission of the person or government providing such information, except to the extent that it may be required to be disclosed in the context of judicial proceedings.

Paragraph 4 of the declaration provides as follows:

> Members *agree* to provide to the Secretariat promptly their preferential rules of origin, including a listing of the preferential arrangements to which they apply, judicial decisions, and administrative rulings of general application relating to their preferential rules of origin in effect on the date of entry into force of the WTO Agreement for the Member concerned. Furthermore, Members agree to provide any modifications to their preferential rules of origin or new preferential rules of origin as soon as possible to the Secretariat. Lists of information received and available with the Secretariat shall be circulated to the Members by the Secretariat.

In reality, many of the provisions contained in the preceding paragraphs were already contained in the main set of rules of origin (e.g., the Pan-European rules of origin or NAFTA) and therefore did not constitute a novelty nor require action or further obligations from the major users of preferential rules of origin. In the case of developing countries it is difficult to measure the degree of implementation of paragraph 3 in relation to the set of rules of origin used in south–south RTAs as the notifications to WTO Secretariat have been quite limited. The binding origin information in paragraph (d) is likely to be the most difficult commitment to implement, especially for customs administrations in developing countries.

2.2. The HWP and the Method of Work Adopted by the TCRO to Develop HRO

At the outset of the HWP, technical issues were given priority. Only after a number of years is it possible to analyze their development.[8] This section provides an overview of the HWP using materials and examples drawn from the negotiating history. As explained in the following sections, the TCRO did not embrace the simplest way to draft rules of origin. Whereas the ARO foresaw that the technical work should have been completed within three years – by July 1998 – the TCRO had, despite major efforts,[9] requested an extension. The CRO therefore requested the TCRO to conclude its work by May 1999 and submit all open questions to Geneva.

Moreover, this last TCRO effort was unable to solve a number of major questions. Once negotiations on the technical work were considered exhausted and the supplementary time lapsed, the TCRO passed outstanding issues to the CRO. The CRO found itself confronted with 455 open questions.[10] As a consequence, the CRO had to build the capacity to deal with many technical questions. Factually, the work of the TCRO continued – partially with the same people and experts at the beginning – in the CRO.

The HWP was extended a number of times, and at the time of this publication had yet to be completed, although most of the technical work has been carried out. At the spring meeting of 2001, WTO members agreed on a timetable to complete the HWP by the Fourth WTO Ministerial held in Doha.

The report of the 20th Session of the TCRO[11] explains that the CRO held five sessions during 2001, and that over 300 outstanding issues were resolved, leaving another 155 outstanding. However, few believed that the HWP would be completed on time because a number of major issues were still outstanding. As the Doha deadline was again missed and the flexibility of Members hardened considerably, the General Council (GC) was forced to extend the deadline to the end of 2002. However, the CRO was instructed to hold only two additional sessions in an attempt to resolve remaining issues and to also identify a limited

[8] For an examination of the history of the negotiating process in the TCRO and CRO see H. Imagawa and E. Vermulst in "The Agreement on Rules of Origin." In P. F. J. Macrory, A. E. Appleton, and M. G. Plummer (eds.). The World Trade Organization: *Legal Economic and Political Analysis*, Volume I (2005).

[9] The TCRO devolved several meetings each of two or three weeks with working hours from 9 A.M. to 7 P.M. and short lunch.

[10] Contained in G/RO/41 and many additions to that main document (i.e., G/RO/41/Add.1 ecc).

[11] See TCRO document No. OC0071E2, 20 February 2002.

number of core policy-level issues to refer to the GC for discussion and decision by the end of June 2002.

By mid-July 2002, the chairman of the CRO reported to the GC 94 core policy-level issues.[12] Members considered only about 50 issues as noncrucial and therefore remained at the level of the CRO.

At the GC level, several informal talks gave the desired result of solving the majority of the 94 core-policy-level issues. Again, the GC extended the deadline for completion of the remaining work from December 2002 until July 2003 and to the end of 2003 for the CRO to complete the remaining technical work. These deadlines were, once again, missed.

A major effort was undertaken in 2006 by the chairperson of the CRO to work out a breakthrough of the negotiating process to meet the deadline for resolution of the core policy issues in July 2006. At the informal consultation in February 2006, the chairperson made a series of suggestions for future work: (a) recognizing that the implications issues and horizontal issues on machinery, because of high sensitivity, need more time and effort for decision, Members would first take up the product-specific issues with a view to completing the work by May 2006; (b) the CRO chair would circulate by early April 2006 the final package for all product-specific rules of origin, except those for machinery; (c) Members would discuss the proposed final package at the next open-ended consultations on 30 May 2006, with a view to endorsing (or not endorsing) the package as a whole; (d) Members, after resolving the product-specific issues, would address the implications issue, product-specific rules of origin for machinery and definition 2 of Appendix 1 [fish taken from the exclusive economic zone (EEZ)].

This line of work was accepted by the WTO members and at a July meeting in 2006 convened to examine the chairperson proposal, the majority of delegations expressed their support for the package. However, a series of product-specific issues were still to be considered, and some delegations requested more time to consider the package in detail.

At the time of this writing, the work of the CRO has been extended until the end of 2008 and a breakthrough on several issues was widely expected by the end of 2007. The latest version of the drafts provides for the entry into force of the HWP by 2010. Developing country members and LDCs may, according the draft, request to delay the application for three additional years. The last meeting of the CRO held in October 2008 did not set a deadline to complete the negotiations.

[12] See WTO document G/RO/52.

Some Initial Difficulties and Core Substantive Issues Arising During the Negotiations

Because it was initially assumed that the whole concept of origin was to allocate the origin of a product to a specific country, the first difficulties emerged on defining "country" and "territorial sea" for the purpose of rules of origin.[13] The implications of this apparently legalistic definition process became rapidly clear when discussions started on whether customs unions should be included within the definition of "country." In such a case, the EC would be considered a single country for the purpose of origin and trade measures, such as quotas and AD duties.

The definition of country should have been contained in the "overall architecture," but it is evident that this issue was dropped during the negotiations of the CRO, as the term country does not appear in the current list of definitions. This was also the case in General Rule 3, stating the determination of origin, but lacking guidance as to country identification.

DEFINITION OF COUNTRY

The lack of a clear and predictable principle in the definition of country may have future implications during implementation of the agreement.

A Swiss enterprise exporting ball bearings from different EC member-states to the United States, declared them as originating in the EC and a certificate of origin was obtained from the competent Chamber of Commerce. Nevertheless, the United States did not accept this declaration of "EU origin" as they imposed different quotas on ball bearings depending on their country of origin – in this case from Italy, France, and Germany – U.S. authorities consequently levying a fine of more than $20,000 to the Swiss enterprise.

In the absence of a clear definition, determining origin rests with the practices of individual countries. This loophole may create problems and difficulties at the time of implementation. For instance, in the preceding case the United States held the origin of the ball bearings as Italian, French, or German, depending on where they were manufactured. The Swiss on the other hand consider all EC countries as making up a single entity and equally accepted as "country" of origin.

The ARO has largely guided the method of work adopted by the TCRO by putting at the core of its agenda the elaboration of the rules of origin

[13] See, among other related documents, the report of the first session of the TCRO, document 39–310 of 10 February 1995, and WTO document G/RO/W/3 of 7 June 1995, "Definition of the term 'country': Request from the Technical Committee on Rules of Origin."

on the basis of the CTC criterion. The structure of the harmonized nonpreferential rules of origin follows to some extent the classical pattern of the rules of origin, which are based on the principles of wholly obtained products and minimal operations and processes not considered as origin-conferring events.

The TCRO spent considerable time harmonizing the definitions of wholly obtained products and of minimal operations and processes. The scope of these latter definitions had been severely limited during negotiations. After making progress on these definitions, it then turned its attention toward the elaboration of specific rules of origin on a product-by-product basis, starting with the least troublesome HS chapter, namely Chapter 25 (salt, sulphur, earths, and stone). As widely expected, the exclusive use of the HS nomenclature to determine the origin of goods was one of the first major problems the TCRO faced, given that the HS was originally intended only as customs classification and not for origin purposes. Thus some practical adaptation was necessary.

The suitability of the HS for determining the country of origin depends largely on its basic structure. Goods in the HS are first grouped into 21 sections and then into 96 two-digit chapters, which, in principle, are established by industrial sectors. Chapters are divided into four-digit headings and six-digit subheadings. In principle, headings are placed within a chapter in the order based on the degree of processing.[14] These features make the HS a suitable device for applying the concept of "substantial transformation" in determining the country of origin through the change of tariff classification method.

In principle, according to the original CTC criteria, a final product is considered to have undergone sufficient manufacturing or processing if its tariff classification is different from that of the nonoriginating materials used for its manufacture: Thus the product acquires the origin of the country in which it is manufactured (i.e., where the "last substantial transformation" occurred).

However, the structure of the HS varies from chapter to chapter or section to section, depending on the nature of goods being classified. Although in certain chapters (such as those covering wood and articles of wood, cork and articles of cork, base metals and articles of base metals) the principle of classification on the basis of the degree of processing is easily and generally applied;

[14] For example, Chapter 72, on iron and steel begins with pig iron (heading 72.01), and the heading number increases as the product is further processed, thus: ingot (heading 72.04), semifinished products (heading 72.06), flat-rolled products (headings 72.08 to 72.12), bars and rods (headings 72.13 to 72.15), and angles, shapes, and sections (heading 72.17).

in other chapters, especially the agricultural ones, it is difficult to apply. A typical example is Chapter 1, which covers different kinds of live animals, with respect to which no degree of processing can occur, to be reflected in the HS structure. In other words, there is no chapter classifying what a horse was prior to its birth. In these cases, for which the change of chapter (CC) rule is not applicable, the TCRO has developed a particular language that clearly explains the path to be followed to identify the country of origin of the good (see Table 2.1).

The solutions offered by delegations during the discussions in the TCRO can be analyzed, bearing in mind that "live animals born and raised in one country" are included in the list of the harmonized definitions of wholly obtained products. As regards heading 01.01, option I implicitly states that (a) raising imported horses cannot be regarded as reflecting the last substantial transformation. Option 2 perfectly echoes the previously mentioned definition of wholly obtained. Options 3 and 4 reflect options 1 and 2, respectively, but imply that raising or fattening imported animals radically transforms the animals concerned, given that their weight, size, and commercial value increase substantially; specific conditions are set forth as to the minimum raising or fattening period required for origin to be conferred on the country where the animals are raised. The same can be said for the criteria proposed for determining the origin of products falling under heading 02.05. A slight, but meaningful, difference can be found in option 2, according to which a CC is required: This means that, in order to obtain originating "meat of horses . . . " of heading 02.05, it is sufficient to use the "live horses . . . " of heading 01.01 – in other words slaughtering horses is a substantial transformation.

To take another example, the CC criterion applies to all headings in Chapter 5, because this chapter covers a variety of materials of animal origin, which are not dealt with in any other chapter of the nomenclature. Thus, no degree of processing can occur with respect to products of headings 05.01–05.11 of different animal origins. The CTH role is not applicable in this case because there is no other product in Chapter 5 from which, for example, horsehair could be obtained; therefore, a CC is required.

In the case of coffee (heading 09.01 of the HS), further discussion was required, because no agreement has been reached on the issues of decaffeinating and roasting (see Table 2.2).

On the one hand, coffee that has not been roasted, or decaffeinated, has origin in the country in which the plant grew – that is, was wholly obtained. On the other hand, if coffee undergoes decaffeinating or roasting, it depends on the applicable rule of origin whether or not one or both of these processes is considered an origin-conferring event. Subheading 0901.12 covers coffee

TABLE 2.1. *Suggested origin criteria for certain animals and animal products*

HS code	Description of goods	Primary rule	Comments
01.01	Live horses, asses, mules, and hinnies	[The country of origin of the goods of this heading shall be the country in which the animal was born (CH)(MAL)(CAN) (MEX) (US)(ARG) (NZ)(FIJ)(AUS)(THA) (IND) (BRA)(HON)]	Submitted to Committee on Rules of Origin (CRO) for decision (Doc. 42.146, Issue 1)
		[The country of origin of the goods of this heading shall be the country in which the animal was born and raised (EC) (JPN) (MOR)]	Please note that, in principle, only the issue relating to the last stage of processing is always indicated in column E
		[The country of origin of the goods of this heading shall be the country in which the animal was fattened for at least 6 months; or the country in which the animal was born (EGY) (KOR) (DOM) (EC) (JPN) (MOR) (PHI) (VEN)]	For sausages the issues of raising of animals is not mentioned, because it was already relevant in earlier stages of production. (Sec)
		[The country of origin of the goods of this heading shall be the country in which the animal was fattened for at least 6 months; or the country in which the animal was born and raised (MOR)]	
02.05	Meat of horses, mules, or hinnies, fresh, chilled, or frozen	[The country of origin of the goods of this heading shall be the country in which the animal was born (SEN) (ARG) (PHI)]	Submitted to CRO for decision (Doc. 42.146, Issue 2)

(*continued*)

TABLE 2.1 (*continued*)

HS code	Description of goods	Primary rule	Comments
		[CC (CAN) (US) (MEX) (MAL) (AUS) (CH) (JPN)(GUA)(IND)] *[The country of origin of the goods of this heading shall be the country in which the animal was born and raised; or the country in which the animal was fattened for at least 3 months (EC)]* [The country of origin of the goods of this heading shall be the country in which the animal was fattened for at least three months; or the country in which the animal was born and raised (KOR) (MOR)(EC)(VEN) (EGY) (JPN)(BRA)]	
05.03	Horsehair and horsehair waste, whether or not put up as a layer with or without supporting material	CC	Basket 1 (Endorsed by CRO)

Notes: (1) The options in italics have been discarded as a result of discussions in the CRO; and (2) options in square brackets did not meet consensus and are awaiting formal resolution (it is possible that informally the issues in the tables shown are solved but formal endorsement is pending in the CRO). The tables in this section are excerpted from the WTO document G/RO/45 with several additions, as revised and amended. Several unofficial papers used during the negotiations have been used as reference material in this chapter.
Source: WTO doc. n. G/RO/45/ADD8/REV.3.

that has not been roasted but has undergone decaffeinating. Although some delegations held the view that decaffeinating is not substantial transformation and consequently should not be considered in determining the origin of the goods, other delegations considered changes in the chemical structure of the input material to imply that decaffeinating should be regarded as resulting in

TABLE 2.2 *Suggested origin criteria for coffee in various forms*

HS code number	Description of goods	Origin criteria	Comments
Chapter 9	Coffee, tea, maté, and spices		
09.01	Coffee, whether or not roasted or decaffeinated; coffee husks and skins; coffee substitutes containing coffee in any proportion	*Proposals as specified for subheadings*	
	– Coffee, not roasted		
0901.11	– Not decaffeinated	The country of origin of the goods of this subheading shall be the country in which the plant grew	Basket 1 (Endorsed by CRO)
0901.12	– Decaffeinated	[The country of origin of the goods of this subheading shall be the country in which the plant grew (BRA)(CAN)(CH)(CI) (COL) (CR)(ECU) (US) (GUA) (HON) (IND)(JPN) (KEN) (MEX) (UGA) (PER) (PHI) (SEN) (URU)(KOR)(MAL)](SRI) (VEN)(EC)(NZ)(NOR)(CH) (THA)] [CTSH (SG) (ARG) (EGY)]	Submitted to CRO for decision (Doc. 42.146, Issue 30)
	– Coffee, roasted		
0901.21	– Not decaffeinated	[The country of origin of the goods of this subheading shall be the country in which the plant grew (BRA) (CI) (COL) (GUA) (IND) (KEN) (MEX) (UGA) (PER) (PHI) (SEN) (URU) (MAL) (KOR)](SRI) (VEN)(CUB)] [CTSH (EC) (CH) (SG) (CAN) (NZ) (JPN) (US)](ARG) (EGY)(NZ)(THA)]	Submitted to CRO for decision (Doc. 42.146, Issue 31)

(*continued*)

TABLE 2.2 (*continued*)

HS code number	Description of goods	Origin criteria	Comments
0901.22	– Decaffeinated	[The country of origin of the goods of this subheading shall be the country in which the plant grew (BRA) (CI) (COL) (GUA) (IND) (KEN) (MEX) (UGA) (PER) (PHI) (SEN) (URU) (MAL) (KOR)(EC)(THA)] [CTSH (SG)](ARG)(EGY)] [CTSH, except from subheading 0901.21 (CAN) (NZ) (US) (JPN)]	Submitted to CRO for decision (Doc. 42.146, Issues 30, 31)

Source: WTO doc. n. G/RO/45/ADD8/REV.3.

a new product, so that the origin of the goods is the country where this process has taken place as the last substantial transformation. In the latter case, the origin criterion to be applied is the CTSH rule. The same reasoning can also be applied in the case of roasting. In the case of subheading 0901.22, Table 2.2 shows a third option: Roasted, decaffeinated coffee cannot originate from roasted, caffeinated coffee. In this case, the goods acquire the origin of the country in which the process of roasting has taken place.

2.3. Adapting the HS to Origin: Some Decisive Technical Issues and Their Implications

During the initial phases of the negotiations, the TCRO has also proceeded with a more sophisticated adaptation of the HS whenever the exclusive use of the HS nomenclature may give rise to difficulties in determining origin or when the HS is not structured in a manner that recognizes certain manufacturing processes as origin-conferring events. In a 1995 document, the WCO secretariat enumerated the instances in which this need was likely to arise and proposed the following solutions[15]:

(1) Cases of products or product sectors in which an unspecified change in subheading or heading is not sufficient to express substantial transformation.

[15] See WCO document 39.486 E, "Method of work for phase II of the work programme" of 10 July 1995.

TABLE 2.3. *Example of change of tariff heading with exception*

HS code number	Description of goods	Origin criteria	Comments
72.13	Bars and rods, hot-rolled, in irregularly wound coils, of iron or non-alloy steel.	CTH, except from heading 72.14	Basket 1 (Endorsed by CRO)
72.14	Other bars and rods of iron or non-alloy steel, not further worked than forged, hot-rolled, hot-drawn or hot-extruded, but including those twisted after rolling.	CTH, except from heading 72.13	Basket 1 (Endorsed by CRO)

Source: WTO document G/RO/45/ADD12/REV.2.

The TCRO may come up with a rule under which the nonoriginating materials used in the manufacture of the products concerned must be classified under specifically designated subheadings or headings (such as "change to heading *xx.xx* from heading *yy.yy*") or, where appropriate, chapters. Where necessary, the expression of substantial transformation for a product or product sector may require the use of a clarifying negative standard such as "CTH except for subheading *zz.zz.zz*," "CTH, except for *xx.xx* to *xx.yy*," or even "CTH, except for *xx.xx* with an additional specific condition" (see Table 2.3).

(2) Cases in which the subheadings or headings do not provide a sufficiently precise description of products to enable those subheadings or headings to be used to express the necessary rule for the particular products in question.[16] The TCRO may, in these cases, split those subheadings or headings using the designation "*ex*." The basic rule of origin will be the change of tariff heading split (CTHS) or change of tariff subheading split (CTSHS) rule, in which respectively.

(3) Cases in which origin rules for the product sector or the individual product category cannot be expressed by the exclusive use of the HS nomenclature. The elaboration of supplementary criteria is then deemed necessary.

[16] Especially "basket" subheadings or headings, which include all items not covered in the previous subheadings or headings in the chapter. A longer-term approach would be to request the HS Committee, after the completion of the work program, to split the subheading or headings in question to provide more specific descriptions of the products that accommodate the needs of origin determination.

TABLE 2.4. *Suggested adjustments to the HS structure*

HS code number	Description of goods	Origin criteria
Chapter 25	Salt; sulfur; earths and stone; plastering materials, lime, and cement	
25.07	Kaolin and other kaolinic clays, whether or not calcined	As indicated at the subheading level
ex 25.07 (a)	Calcined	CTHS
ex 25.07 (b)	Other	Chapter rule
25.18	Dolomite, whether or not calcined; dolomite roughly trimmed or merely cut, by sawing or otherwise, into blocks or slabs of a rectangular (including square) shape; agglomerated dolomite (including tarred dolomite)	As indicated at the subheading level
2518.10	Dolomite not calcined	The country of origin of the goods shall be the country in which the dolomite of this subheading is obtained in its natural or unprocessed state
2518.20	Calcined dolomite	CTSH

Source: WTO document G/RO/45/Add.3/Rev.1.

It is clear that the suitability of the HS for use in determining the country of origin also depends on its objective and accurate classification, which is a far from easy task given the millions of different kinds of goods on the international market. Moreover, the HS classification does not always reflect all the manufacturing processes that the TCRO may consider as entailing substantial transformation.

As previously mentioned, the product-by-product analysis started from what was initially considered the least troublesome chapter (Chapter 25). In this context, as a rule at chapter level, the TCRO had, in principle, endorsed the following terminology (the so-called Ottawa language referred to in Section 2.5) to reflect mineral substances that occur naturally: "The origin of the good shall be the country in which the material of this heading (to be adjusted as appropriate) is obtained in its natural or unprocessed state." However, a number of delegations held the view that the process of calcination of mineral substances is an origin-conferring process. For example, as shown in Table 2.4, HS heading 25.07 ("kaolin and other kaolinic clays, whether or not calcined")

does not present any further subdivision: Such clays remain in the same heading even when calcined. In this case, to adjust the HS structure for origin purposes and recognize calcination as an origin-conferring process, it is necessary to create two split headings: one for calcined kaolin, whose origin is conferred, through a CTHS rule, on the country where the imported kaolin undergoes calcination, and another one, "other than calcined kaolin," to which the general rule applies. At the end the process, calcination was endorsed as an origin-conferring process.

On the other hand, HS heading 25.18 ("dolomite, calcined or not calcined . . . ") is already adequately subdivided into two subheadings (subheading 2518.10, "dolomite not calcined," and subheading 2518.20, "calcined dolomite"); a CTSH rule easily serves the purpose of allocating the origin of calcined dolomite to the country where the calcination occurs.

During the negotiation a terminology guide was developed designed to explain the variety of formulations that has been used to express the CTC requirement as shown in the following section.

TERMINOLOGY GUIDE

I. Rules presented at heading level:

(a) *If the rule is for the whole heading*:
CTH – change to this heading from any other heading

(b) *If the rule is for a split heading*:
CTHS – change to this split heading from any other split of this heading or from any other heading
CTH – change to this split heading from any other heading (N.B.: change from any other split of this heading is excluded.)

II. Rules presented at subheading level:

(a) *If the rule is for the whole subheading*:
CTSH – change to this subheading from any other subheading or from any other heading
CTH – change to this subheading from any other heading (N.B.: change from any other subheading of this heading is excluded.)

(b) *If the rule is for a split subheading*:
CTSHS – change to this split subheading from any other split of this subheading or from any other subheading or heading

CTSH – change to this split subheading from any other subheading or heading (N.B. change from any other split of this subheading is excluded)

CTH – change to this split subheading from any other heading (N.B.: change from any other split of this subheading or from any other subheading of this heading is excluded.)

III. Rules presented at heading or subheading level

CC – change to this chapter from any other chapter

2.3.1. Definition of "Assembly" in Machinery

A problem encountered by the TCRO in elaborating the harmonized set of origin rules utilizing the HS was the treatment of incomplete or unassembled articles. In fact, the HS provides six general rules for its interpretation, laying down the principles governing classification. One of the most important concepts underlying classification in the HS nomenclature is the "essential character" of goods. In particular, this concept relates to the classification of incomplete or unfinished articles and unassembled or disassembled articles.

The first part of interpretative rule 2(a) of the HS explanatory notes, on "Incomplete or unfinished articles," extends the scope of any heading that refers to a particular article to cover not only the complete or finished article but also to that article in an incomplete or unfinished state, provided that, as presented, it has the essential character of the complete or finished article. The second part of rule 2(a), on "Articles presented unassembled or disassembled," states that complete or finished articles presented unassembled or disassembled are to be classified under the same heading as the assembled article. When goods are so presented, it is usually for reasons such as the requirements or convenience of packing, handling, or transport.

The explanatory notes to the HS offer many specific examples to clarify the concept of essential character in the context of rule 2 (a). Throughout Section XVI on machinery, for instance, any reference to a machine or apparatus covers not only the complete machine but also an incomplete machine. That is, an assembly of parts so far advanced that it already has the essential character of the complete machine. A good example is given by the general explanatory note to Chapter 87 on vehicles:

> An incomplete or unfinished vehicle is classified as the corresponding complete or finished vehicle provided it has the essential character of the latter, as for example:
> A motor vehicle, not yet fitted with the wheels or tires and battery;
> A motor vehicle not equipped with its engine or with its interior fittings.
> A bicycle without saddle and tires.

Incomplete or unfinished articles, including such articles unassembled or disassembled, constitute one of the most complex areas for determining the country of origin. In general, the TCRO has come to the common understanding that the assembly of a good from parts results basically in a substantial transformation. However, members disagreed on a common rule of origin and have proposed different approaches as reflected in Table 2.5.

The HS identifies three broad categories of parts: (a) parts for general use, (b) parts suitable for use solely or principally for machines of a particular heading, and (c) finished goods that will themselves be used as parts or components for other goods. For some goods, therefore, assembly of parts to produce the finished good will result in a change of heading (for example, manufacture of motor vehicles of 87.01–87.05 from parts of 85.08), for others a change in subheading (for example, trailers and semitrailers of 87.16 from parts of 8716.90). However, in some cases parts are classified under the heading with the vehicles produced, without subheadings, and thus undergo no change of classification when used for production of the article such as baby carriages of 87.15 (see Table 2.5).

Naturally, the issue of distinguishing parts from the incomplete or complete articles is relevant throughout the whole machinery sector. During the negotiations, the main concern of all delegations consisted in capturing substantial transformation while excluding simple assembly operations (so-called "screwdriver operations," also connected to AD procedures). As a result of those concerns, many delegations presented their own proposals. Some focused largely on the HS, recognizing the change from the parts to the finished article as substantial transformation, sometimes with limitations to this change to exclude simple assembly. Chapter notes were proposed to cover different aspects of assembly in the machineries, such as what should happen in the case of disassembly of goods or if the change in classification is achieved through simple operations like retesting or recertification (i.e., the HS classifies some machines or appliances in conformity with their power or voltage). A systemic problem consisted of defining incomplete or unfinished articles (and parts) and what rule should be applied to them.

The EC was concerned about simple assembly and proposed to use a value-added rule (VAR) to confer origin for assembly operations. Brazil also initially joined the EC position; however, support by the rest of the countries to this approach was limited.

Attempts were also made to focus on the different operations taking place during an assembly operation like gluing, soldering, or bolting together parts to form the final article. However, the problem was that, depending on the type of machines, such operations might be considered simple or complicated.

TABLE 2.5. *Classification of finished goods and parts in Chapter 87*

HS code number	Description of goods	Primary rule	Comments
Chapter 87	Vehicles other than railway or tramway rolling stock, and parts and accessories thereof	As indicated at the heading or subheading level	
87.02	Motor vehicles for the transport of 10 or more persons, including the driver	[CTH (CH) (JPN) (MEX) (EGY) (MOR) (TUN) (TUR) (SG) (US) (IND) (THA)] (CAN) (PHI)] [CTH, except from heading 87.06 (MAL)] [30 percent value added rule (IND)] [60 percent value added rule (EC) (AUS)] (BRA)]	Submitted to CRO for decision
87.15	Baby carriages and parts thereof	[CTH (JPN) (MEX) (SG) (MAL)] [CTH; or 45 percent value added rule (EC) (AUS)]	
		[As specified for split heading (CH) (CAN) (US) (KOR) (PHI) (TH)]	Submitted to CRO for decision Issues nos. 1 to 6, 8 to 13
ex 87.15(a)	Baby carriages	[CTHS (CH) (CAN) (US) (KOR) (PHI) (TH)]	Submitted to CRO for decision Issues nos. 1 to 6, 8 to 13
ex 87.15(b)	Parts of baby carriages	[CTH (CH) (CAN) (US) (KOR) (PHI) (TH)]	

Note: When a split heading or split subheading is proposed, the description is underlined to show that it is not HS text.
Source: WTO document G/RO/45/ADD15/Rev.1.

Also a combination of such operations occurring during assembly failed to be considered as a possible solution because the products to cover were simply too different.

A further difficulty arose from the fact that goods classified as parts could also be assembled substantially from smaller parts, and the rule recognizing the assembly from parts to (un)finished machines should give credit to the same operations carried out inside a heading or subheading. Although a rather

pragmatic approach led to a proposal of counting the components to assemble a part (recognizing that the assembly of five parts or more would have given origin), the EC value-added criteria would have the apparent advantage of recognizing similar assembly operations at whatever level of the manufacturing stage they were carried out. Also the third option of defining different processing criteria would take care of such assembly operations.

The following excerpts from an earlier negotiating text demonstrate the variety of approaches that have been raised during the negotiations and the technical complexities:

EXTRACT OF PROPOSED APPROACHES TO ASSEMBLY AT CHAPTER LEVEL

[Origin-Conferring Primary Rules (Sec)]: (SG) (IND)

[A]. Goods of this chapter that are not wholly the product of one country shall be deemed to originate in the last country where one of the following occurs:

(a) Nonoriginating materials undergo a change of classification from any other subheading, including a subheading of the same heading (CTSH); or from any other heading (CTH) as indicated in the specific headings or subheadings; or
(b) Obtaining goods from parts by assembly, including subassembly, shall be considered as reflecting last substantial transformation; or
(c) Process (such as mounting of integrated circuits) as defined for the specific headings or subheadings which result in new characteristics or use in the finished product. (SG)

[B]. An assembly operation resulting in a new good having new characteristics is considered to be substantial transformation. (IND) (MOR) (SEN for Chapters 84 to 86 only)

[C]. *Finished goods or parts produced from unfinished goods or parts, other than blanks*: (CH)

Whenever the change of classification rules set out for goods of Chapters 84–90 and 93 are not determinant of the country of origin of the good, the following substantial transformation rules are to be applied:

(a) A finished good or part produced from a nonoriginating unfinished good or part classified in the same heading or subheading as the finished good or part shall originate in the country in which the good or part was finished, provided:
    (i) the unfinished good or part is not functioning for its ultimate use in its imported condition and has undergone at least two or more of the following processes:

- assembly by build-up such as but not limited to welding, soldering, shrinking, bolting, gluing, fitting, fixing, spooling, winding, connecting, wiring, coupling; or
- heat treatment or thermochemical treatment such as glowing, tempering, hardening; or
- treatment for the purpose of shaping, forming such as cold or warm forming; or
- mechanical treatment, refining of form positional, and surface tolerances of functional finished shapes such as turning, milling, drilling, broaching, grinding, polishing, honing, eroding; or
- surface treatment such as coating, compressing, condensing, impregnating (excluding temporary conservation for transport and/or storage purpose), insulating; or
- system engineering, software-development and application; and

(ii) The finished good or part has undergone final testing such as but not limited to balancing, spinning, voltage testing, performance or isolation test.

[D] *[Other (US)] [Chapter Residual Rules (Sec)]*: (Issue No. 1)
Where neither the product-specific rules in the matrix nor the preceding legal notes are determinant of origin, the following shall apply: (US) (CH) (AUS) [(TUR for ex 8471.60(a) for split subheadings (A) and (B) only)]

(1) Goods produced by assembly of five or more parts (other than parts of general use, as defined in [Note 2 to Section XV or similar parts of plastic (Chapter 39) (US)] [note 1(g) to Section XVI of the HS (AUS)] shall have origin in the country of assembly, or (US) (AUS) [TUR for ex 8471.60(a) for split subheadings (A) and (B) only]

(2) Goods produced as a result of processing nonoriginating components into a device or apparatus capable of performing one or more new mechanical or electrical functions shall have origin in the country of such processing, or (US) [TUR for ex 8471.60(a) for split subheadings (A) and (B) only]

(3) *[Residual rule]*. – Goods produced by the assembly of fewer than five parts [other than parts of general use, as defined in Note 2 to Section XV of the HS or similar parts of plastic (Chapter 39)], and one or more of whose parts (other than parts of general use, as defined in [Note 2 to Section XV of the HS or similar parts of plastic (Chapter 39) (US)] [note 1(g) to Section XVI of the HS (AUS)] satisfies the requirements for origin in the country of assembly, shall have origin in the country of assembly. (US) (AUS) [TUR for ex 8471.60(a) for split subheadings (A) and (B) only].

Many of the difficulties during the negotiations derived from the fact that industries in North America and in Europe use different origin rule systems

TABLE 2.6. *Classification of finished goods and parts in Chapter 84*

HS code number	Description of goods	Primary rule	Comments
84.20	– Calendering or other rolling machines, other than for metals or glass, and cylinders therefore	*As indicated at the subheading level*	
8420.10	– Calendering or other rolling machines	[CTSH] (JPN) (US) (CAN) (CH) (MEX) (COL) (SG) (PHI) (MOR) (AUS) (HK) [CTH; or 45 percent value added rule] (EC) [60 percent VAR] (BRA)	Submitted to CRO for decision Issues nos. 1 to 13
	– Parts		
8420.91	– Cylinders	[CTH] (JPN) (US) (CAN) (CH) (MEX) (COL) (SG) (PHI) (AUS) [CTH; or 45 percent VAR] (EC) [60 percent value-added rule] (BRA)	Submitted to CRO for decision Issues nos. 1 to 13
8420.99	– Other		

Source: WTO document G/RO/45/Add.15.

(also because of different preferential rules of origin). For the machinery sector in general the EC insisted on using the *ad valorem* percentage criterion whereas the United States wished to use the CTC. Taking this aspect into account on the latest proposal of compromise, the GC was to introduce both rules alternatively as primary rules. Recent drafts at the time of this writing indicate that the option to apply one or the other method will be left to the importing country when drafting legislation of the HWP. Once the choice is made, the WTO member will have to notify the CRO within 90 days.

Leaving this option open will mean that producers and exporters would have to check first what option has been selected by the country of importation to determine if they comply with origin through the tariff (sub)heading change or through the fulfillment of the VAR.

An example of these different approaches could provide some clarifications: If we take the calendering machine as described in Table 2.6 under the CTSH rule proposed for the machine classified under heading 8420.10 itself, the assembly of parts alone would be enough to confer origin by using the parts

classified in 8420.91 and 8420.99. Taking the EC approach, the assembly of the parts to form the finished (or unfinished) article should lead to a considerable increase in value (the rule shown in Table 2.5 is a simplified version and should read: "Manufacture in which the value of all nonoriginating materials used does not exceed 45 percent of the ex-works price of the product").

If the various proposals contained in the preceding excerpt are considered, the assembly of five or more parts is sufficient to confer origin even within a subheading such as 8420.91 or 8420.99 to form for instance a bigger part. Similarly, assembly of the good in 8420.10 is an origin-conferring event if this operation has created a device performing new mechanical or electrical functions or if it had new characteristics. However, some difficulties of interpretation between the members may arise about these "new" functions.

2.3.2. *Definition of "Assembly" in Textiles and Clothing*

The issue of assembly of parts is also relevant in the context of textile products, which represent one of the most sensitive sectors for origin determination. For goods of Chapter 61 ("Articles of apparel and clothing accessories, knitted or crocheted"), alternative proposals were discussed in the CRO. One of the questions concerned the process of assembly of an article of headings 61.01 to 61.05 – rule at split chapter level from parts knitted or crocheted to shape and, in particular, whether this process can be regarded as an origin-conferring event, as the assembly is not sufficient to substantially transform the goods in the view of many countries (see Table 2.7). To determine the origin of these goods, the compilation of chapter notes has been deemed necessary.

With regard to option 1 in Table 2.7, some delegations held that the assembly of an article in one country from parts knitted or crocheted to shape is a substantial transformation, if all the main assembly operations following the cutting of the fabric, or the knitting or crocheting, to shape have been performed in a single country. Some minor operations (such as making buttonholes, hemming, or attaching items including accessories, buttons, or other fasteners, pockets, etc.) are not taken into account in determining whether the good has been assembled in a single country. In this case, the applicable rule of origin should be a change to goods of this split chapter, provided that the goods are assembled in accordance with chapter note 1/option 1 (not included in Table 2.7).

Delegations supporting options 2 and 3 held the opinion that the assembly of an article in one country from parts knitted or crocheted to shape requires only a minor operation to attach the parts together by looping or simple sewing, and thus no substantial transformation is reflected by this kind of process. According to these proposals, the country of origin would be the country where the goods

TABLE 2.7. *Example of a split chapter*

HS code number	Description of goods	Primary rules	Comments
Chapter 61	Articles of apparel and clothing accessories, knitted or crocheted	*As indicated at split chapter level*	
ex-Chapter 61 (a)(ex 61.01 through 61.17)	*Goods including parts and accessories, knitted or crocheted to shape*	The country of origin of the goods of this split chapter is the country in which these goods have been knitted or crocheted to shape *(option 1)*	Basket 1*
ex-Chapter 61 (b)(ex 61.01 through ex 61.15)	*Goods of heading 61.01 through 61.15 assembled from parts knitted or crocheted to shape*	[Change to this split chapter in accordance with chapter note (option 5) (IND)] [Change to goods of this split chapter provided that the goods are assembled in a single country in accordance with chapter Note (option 1) (EC, JPN, PHI, MAL, TUR, CH, NOR, FIJ, CR)] [CC provided that the parts of these goods are both knitted or crocheted to shape and sewn or otherwise assembled in the country claiming origin (ARG, PAK, THA, UR)] *(option 2)* [The country of origin of the goods of this split chapter is the country in which the parts of these goods have been knitted or crocheted to shape (US, IND, MEX, CAN, SEN, EGY, GUA, AUS, BRA, JPN, KOR, NZ, PHI)] (option 3)	Submitted to CRO for decision (Doc. 42.271) Issue 45

Notes: (1) When a split heading or split subheading is proposed, the description is underlined to show that it is not HS text; and (2) *(PHI) considers that embroidery of goods including parts and accessories of this split chapter should be considered as substantial transformation with conditions included in ex-Chapter 61 (i).*

Source: WTO document G/RO/45/ADD1/Rev.2.

have been both knitted or crocheted to shape and sewn or otherwise assembled, or the single country where the parts were knitted or crocheted, whether or not assembled in the same country.

2.4. Secondary or Residual Rules of Origin

As previously mentioned, nonpreferential rules of origin are aimed at assigning origin to all goods imported into a country. Thus there must be an origin determination in all cases, as the customs authorities must ascertain the origin of the goods in order to administer the trade policy instruments. If the primary origin criterion is not met (CTH, processing requirements, or value-added criteria), secondary, residual rules should be available to determine origin. Even if the ARO itself is silent on this point, members considered that the previously mentioned arguments needed to be addressed and thus residual rules should apply.

The second basic question confronted by the TCRO was how to determine the sequence of application of residual rules and their implementation – what happens when the goods cannot be subject to the primary rule of origin and the residual rules come into play. Two basic approaches have been discussed. One approach, supported for a long time by the United States, entails that, if the primary rule is not met for a country, then the primary rule should be applied to countries further down the production chain to ascertain if the rule has been met in any of them. Only when the primary rule has not been met in any "preceding" country would the use of residual rules be warranted. This has been called the "tracing-back" option. A second approach, supported by the EC, limits the utilization of the primary rule to the country where the "last production process has taken place." Thus, if the primary rule is not met in the country where the last production process has taken place, residual rules should be utilized there.

It then became essential to assess the potential implications of these alternative rules. Under the tracing-back proposal, the customs administration would, where applicable, have to trace back on the basis of the available documentation the origin through preceding countries. In some cases, this procedure would have been difficult and laborious, as it requires the custom administration to identify the different manufacturing stages that a finished product underwent, specifying the operations carried out in different countries. Commercial reasons and confidentiality may also be impediments to this tracing-back method. For developing country exporters, producers, and administrations, the application of this rule would have demanded a high degree of customs cooperation. Moreover, the provision of relevant information and documentation

may require extensive knowledge of the rules and awareness of the possible implications on the part of exporters, producers, and customs administrations.

Under the EC approach, origin determination relies to a greater extent on the ability of customs administrations to determine origin at the time of importation. If the primary rule is not satisfied, the operator or customs official will have to immediately resort to the residual rules. However, this approach would imply that the operator or the official in charge of applying the HRO in the country of importation has knowledge of the origin of all components used in the production.

In November 1999, a partial agreement was reached on this issue in the TCRO. This involved rejection of the tracing-back approach in general, but retaining the tracing-back method in the residual rules and to some extent in the list rules on wholly obtained products in Appendix II. In fact, when the "Ottawa rules" are read, the origin always refers to a country where a certain process or operation has occurred, implying that the last country of exportation must have some basic knowledge of the processes occurring in other countries. The scope of application of "tracing-back" is likely to resurface during the very last phases of the negotiations.

2.5. The Current Status of the Harmonized Nonpreferential Rules of Origin[17]

2.5.1. *The Architecture*

The term "architecture" commonly refers to the framework and sequencing of application of the HRO. It encompasses the whole structure of the rules and the disciplines applicable to them.

As for the organization and structure of the HRO, the ARO was not providing clear guidelines in many respects. However, it soon appeared clear that there was a need for general provisions that would govern the entire set of rules. The TCRO soon entered on an examination of the product-specific rules, and the CRO requested that the TCRO should also devise an overall structure as early as November 1995. In the request the CRO demanded the TCRO to "forward . . . a general format establishing the overall architectural design within which the results of the different phases of the Harmonization Work Program will be finalized as provided in Article 9.4."

[17] This section has been written using as reference material unofficial records and drafts circulating until end of February 2007. At the time of revision of the manuscript (October 2008) no other relevant drafts have been circulated or were available. See the latest consolidated version G/RO/W/111/Rev. 2, 23 May 2008.

Although the relevant provisions of the ARO have largely guided the negotiations on architecture and the current structure, there were various questions that remained unanswered and that subsequently emerged as the negotiations progressed.

In particular, Article 9, paragraph 1(b) of the ARO provides that "rules of origin should provide for the country to be determined as the origin of a particular good to be either the country where the good has been wholly obtained or, when more than one country is concerned in the production of the good, the country where the last substantial transformation has been carried out."

It follows that the structure of the HWP should develop definitions of goods that are to be considered wholly obtained in one country, the minimal operations or processes that do not by themselves confer origin to a good [Article 9, paragraph 2(c)(i)] and the use of change in tariff classification [part 9, paragraph 2(c)(ii)]. Supplementary criteria, including *ad valorem* percentages and/or manufacturing or processing operations, are envisaged as well [Article 9, paragraph 2(c)(iii)] but only after that it was demonstrated that the change of tariff classification was not a suitable instrument to define product-specific rules of origin. This sequencing of methodologies in defining product-specific origin rules was a bone of contention between those delegations wishing to adopt supplementary criteria, mainly the EC and the remaining delegations. The United States favored instead an across-the-board application of the CTC. Such contention has not been totally resolved at the time of this writing as demonstrated by the option left open to WTO member importing countries for Chapters 84–90 to adopt the CTC or the *ad valorem* percentage as specified at tariff line level in the respective chapters.

Two key informal meetings (the Ottawa and Meech Lake meetings) were organized to solve some of the crucial issues concerning the architecture. The Ottawa meeting led to the agreements on the scope of application of Appendix 1 (wholly obtained) and Appendix 2 (product-specific rules).

It also served to reach a compromise among the EC and the United States and Canada about the utilization of the wholly obtained term in drafting the Appendix 2 rules (the product-specific rules).

According to its own experience in preferential rules of origin, the EC proposed that, for live animals classified in Chapter 1 of Appendix 2, product-specific rules refer to the concept of wholly obtained goods. On one hand this proposal was opposed by those delegations who considered that the concept of wholly obtained goods has to remain confined to Appendix 1 considering the agreed sequential application of the rules. On the other hand, other delegations found it difficult to apply CTC rules because there are no antecedents in the Harmonized System to live animals classified in Chapter 1.

A compromise was found on the formulation of the following Ottawa language:

(1) For scrap and waste, the rule was to be based on the country where the scrap or waste was derived;
(2) For goods having antecedents, the rule was to be based on the CTC with exclusions; and
(3) For goods not having antecedents, the rule was to be based on the country where the good or material was obtained in its natural or unprocessed state.[18]

The third definition later evolved depending on the chapter in which it was being used. For instance in the case of Chapter 1 the word material was later replaced with animals when product-specific rules were drafted for Chapter 1, milk in the case of dairy products, and so on.

The recommendations that emerged from the Meech Lake meeting informed most of the work later conducted on the architecture according to the following agreed principles:

(1) There was no need for a separate Appendix 3 dealing with minimal operations or processes because they can be placed in the appropriate places in the architecture.
(2) Two type of rules could be devised in Appendix 2: "primary rules" and "residual rules."
(3) In Appendix 2 "primary rules" can be placed at the beginning of the chapter or in the matrix when they are applicable to a particular heading, subheading etc.
(4) The primary rules are co-equal.
(5) The "primary rules may preclude certain operations or processes from conferring origin (negative primary rules).
(6) The residual rules are applicable to a good only when the primary rules do not confer origin.
(7) The residual rules could be placed at the beginning of Appendix 2 or at chapter level.
(8) Within the primary rules and within the residual rules the selection of the rule applied is governed by the time sequence, i.e., the rule that is last satisfied confers origin on a good.

According to the principles and sequencing of methodologies in Article 9 and agreed in the various informal sessions, negotiators have progressively

[18] See Annex C/2 to WCO doc. 40.510.

elaborated an overall architecture setup in three parts (General Rules, Appendix 1 and Appendix 2).

2.5.2. *The General Rules*

Practically, what is referred to as General Rules reflects the overall architecture of the HWP, providing the scope and definitions of the nonpreferential rules of origin, the minimal operations or processes, general rules of application, and, finally, the path for the determination of the country of origin of a good – through the provisions of Appendix 1 and Appendix 2, applied in sequence.

The following are the General Rules, reported together with comments.

GENERAL RULES[19]

GENERAL RULE 1: SCOPE OF APPLICATION

Rules of Origin provided in this Annex shall be as defined in Article 1, paragraph 1 of the Agreement on Rules of Origin annexed to the Agreement Establishing the World Trade Organization (WTO), and shall be applied for the purposes set out in Article 1, paragraph 2 of the Agreement on Rules of Origin. (earlier version)

(B) In framing its legislation each Member shall provide for its non-preferential commercial policy instruments set out in Article 1, paragraph 2 of this Agreement (hereinafter referred to as "Commercial Policy Instruments") in which Rules of Origin provided in Appendix 2 of this Annex shall be used. Each Member shall notify the Committee on Rules of Origin of its Commercial Policy Instruments within 90 days after the date of entry into force of this Annex, for it. (latest draft February 2007)

In a later consolidated version of May 2008 this rule has been removed. (See WTO document G/RO/W/111/Rev 2 of 23 May 2008.) It may be incorporated in the text once final agreement is reached. The earlier version of General Rule 1 (in italics) mirrors the provision of the ARO and is still under negotiation. In fact, the reference to "Purposes set out in Article 1, paragraph 2" of the ARO extends the application of the HRO to other WTO Agreements. This issue, which is commonly referred to as the implications on other WTO Agreements, is dealt with in Section 2.8. The second version provides for two paragraphs.

[19] In this chapter the reference to earlier drafts is to be understood as referring to WTO document G/RO/45/Rev 2. The reference latest draft, February 2007, is to be understood as referring to an informal draft bearing no official record. For ease of reference the two texts are compared to provide the reader with the complexity of the negotiations, the different negotiating positions, and the progress made. At the time of this writing, the draft of February 2007 has now been incorporated in the latest Secretariat consolidated text. See WTO document G/RO/W/111/Rev. 2, 23 May 2008 with some modifications.

Paragraph A (not reported) expressly provides that Appendix 1 defining wholly obtained goods shall be applied equally for the purposes set out in Article 1, paragraph 2 of the WTO Agreement. The second paragraph (b) contains wording suggesting that each WTO member will notify its nonpreferential commercial policy instruments where the product-specific rules of Appendix 2 will apply. For the sake of clarity this provision has been later moved as rule 1 of Appendix 2. As rule 1 of Appendix 2 to be later totally removed from the General Rules pending final agreement. This wording leaves discretion to the WTO members to pick and choose what commercial policy instruments will be using the product-specific rules contained in Appendix 2 to determine origin. As later explained in Section 2.8 this is the compromise emerged from a stalemate over the implications of HWP on other WTO Agreements that was de facto blocking for some years any progress in the HWP.

GENERAL RULE 2: HARMONIZED SYSTEM

References to headings and subheadings are references as they appear in the Harmonized Commodity Description and Coding System (hereinafter referred to as "Harmonized System" or "HS") as amended and in force. Classification of goods within headings and subheadings of the Harmonized System is governed by the General Interpretative Rules and any relative Section, Chapter and Subheading Notes to that System. Classification of goods within any additional subdivisions created for purposes of the rules of origin shall also be governed by the General Interpretative Rules and any relative Section, Chapter and Subheading Notes to the Harmonized System, unless the rules of this Annex otherwise require.[20] (This provision now appears as a general rule in the latest consolidated text of 23 May 2008.)

In view of the periodic changes in the HS nomenclature and the fact that the HWP made extensive use of the Harmonized System in defining product-specific rules of origin there was a need for a provision to determine the relations among the two instruments. This rule should be read in conjunction with Article 6(3) of the ARO where it is provided that the Committee, in cooperation with the TCRO, shall set up a mechanism to consider and propose amendments to the results of the HWP, considering the objectives and principles set out in Article 9. This may include instances where the rules need to be made more operational or need to be updated to consider new production processes or are affected by any technological change.

[20] Alternative text exists as contained in WTO doc. n. G/RO/45/Rev 2. See also this text in conjunction with the draft text on amendments to the rules of origin discussed earlier. See footnote 20.

There was no final agreement at the time of this writing on the mechanism to adopt to ensure that amendments to HS are fully reflected in the HRO, although these aspects together with a proposal of the TCRO to the CRO have been fully discussed.[21] A draft has been circulated setting the various options available. Article 6.3 of the ARO provides that the CRO should set up a mechanism to consider and propose amendments to the results of the harmonization work program, identifying two possible needs for amendments: first, rules need to be made more operational, and second, rules need to be updated because of technological change or new production processes.

However, it has to be considered that the HRO will become an integral part of the ARO, as provided for in Article 9.4 of the ARO. It follows that the new amendment mechanism envisioned by the ARO would have to be considered in connection with the provisions of Article X of the WTO Agreement, which sets out a procedure to amend provisions of the WTO Multilateral Trade Agreements.

The difficulty arises when one confronts the practical exigencies of amending the HRO and the procedures required under Article X of the WTO agreement. Particularly in the case in which changes in the HS necessitate amending the HRO, a collective action by all WTO members will be required. Ideally, a proposal for amendments should be initiated as soon as possible after the HS Committee of the WCO completes its work on amendments to the HS.

Such pragmatic exigencies may be frustrated by legal obligations. Two options have been flagged:

1. The first option would follow the general amendment procedure as set out in Article X of the WTO Agreement: the Council for Trade in Goods, as recommended by the CRO, submits to the GC proposals to amend the HRO; the GC then decides to submit the proposed amendments to the members for acceptance, as provided for in Article X of the WTO Agreement. In the case in which a member submits its proposal to the GC, a decision could be made by the GC, taking into consideration the aforementioned report of the CRO.
2. The second option would be to establish the special amendment mechanism that is to replace Article X of the WTO Agreement. Because the HRO is subject to frequent amendments it seems appropriate to consider its amendments as part of the ongoing responsibilities of the CRO rather than as a treaty-amendment exercise. It should also be noted that amendments to the HRO may alter the balance of interests among members

[21] See Annex E/2 to WCO document OC0071E or WTO G/RO/51.

achieved by the current HRO. In this light, the normal decision-making procedures of the CRO and GC could possibly be applied for the amendments to the HRO rather than Article X of the WTO Agreement.

No option provides an easy solution for the pragmatic exigencies of the HRO. Another draft of arrangements concerning the settlement of disputes relating to customs classifications was circulated at the time of this writing. Customs classification disputes among member-countries are primarily governed by Article 10 of the *International Convention of the Harmonized Commodity Description and Coding System*:

10.1 Any dispute between Contracting Parties concerning the interpretation or application of this Convention shall, so far as possible, be settled by negotiation between them.
10.2 Any dispute which is not so settled shall be referred by the Parties to the dispute to the Harmonized System Committee which shall thereupon consider the dispute and make recommendations for its settlement.
10.3 If the Harmonized System Committee is unable to settle the dispute, it shall refer the matter to the Council which shall make recommendations in conformity with Article III(e) of the Convention establishing the Council.
10.4 The Parties to the dispute may agree in advance to accept the recommendations of the Committee or the Council as binding.

Classification disputes could also be brought before the WTO Dispute Settlement Understanding (DSU) mechanism according to Articles 7 and 8 of the Agreement. The draft seeks an understanding starting from the consideration that, because the decision of the DSU is binding, WTO members are likely to use it over the HS system. However, the draft suggests that the expertise of the HS committee should be used in the panel process to examine the technical aspect of the classification question.

GENERAL RULE 3: DETERMINATION OF ORIGIN

The country of origin of a good shall be determined in accordance with these General Rules and in accordance with the provisions of Appendix 1 and Appendix 2, applied in sequence. (This provision appears as General Rule 2 in the latest consolidated text of 23 May 2008.)

General Rule 3 provides for the sequenced application of the rules according to the classical notion of wholly obtained goods contained in Appendix 1 and goods that are not wholly obtained.

The origin of wholly obtained products will be determined according to the rule contained in Appendix 1. Failing this, for goods that do not meet the definition of wholly obtained, rules of origin contained in Appendix 2 will be applied.

GENERAL RULE 4: NEUTRAL ELEMENTS

In order to determine whether a good originates in a country, the origin of the power and fuel, plant, and equipment, including safety equipment, or machines and tools used to obtain a good or the materials used in its manufacture which do not remain in the good or form part of the good shall not be taken into account. (This provision appears as General Rule 3 in the latest consolidated text of 23 May 2008.)

This is a rather common rule in a number of origin sets, indicating elements that are never to be taken into account in the determination of origin. This rule adds certainty and clarity in the administration of the rules of origin.

GENERAL RULE 5: PACKING AND PACKAGING MATERIALS AND CONTAINERS

Unless the provisions of Appendix 1 or Appendix 2 otherwise require, the origin of packing and packaging materials and containers presented with the goods therein shall be disregarded in determining the origin of the goods under General Rule 3, provided such packing and packaging materials and containers are classified with the goods under the Harmonized System. The packing and packaging materials and containers which are not classified with their contents are separate goods, thus their origin shall be determined in accordance with the appropriate rules set forth in Appendix 1 and Appendix 2. (This provision appears as General Rule 4 in the latest consolidated text of 23 May 2008.)

As mentioned in the preceding case, this provision is rather common in many origin sets and rather self-explanatory. It mirrors General Rule 3 for the interpretation of the HS that provides as follows:

> *(a) Camera cases, musical instrument cases, gun cases, drawing instrument cases, necklace cases and similar containers, specially shaped or fitted to contain a specific article or set of articles, suitable for long-term use and presented with the articles for which they are intended, shall be classified with such articles when of a kind normally sold therewith. This rule does not, however, apply to containers which give the whole its essential character;*
>
> *(b) Subject to the provisions of Rule 5 (a) above, packing materials and packing containers presented with the goods therein shall be classified with the goods if they are of a kind normally used for packing such goods. However, this provision is not binding when such packing materials or packing containers are clearly suitable for repetitive use.*

The issue of "put up for retail sale" discussed in this context was later addressed on a product-specific basis as there are specific HS subheadings covering this expression.

GENERAL RULE 6: ACCESSORIES AND SPARE PARTS AND TOOLS

Accessories, spare parts, tools and instructional or other informational material classified and presented with a good shall be disregarded in determining the origin of that good under General Rule 3, provided they are normally sold therewith and correspond, in kind and number, to the normal equipment thereof. (This provision appears as General Rule 5 in the latest consolidated text of 23 May 2008.)

The classic example provided to explain the scope of this rule is the spare wheel present in a car. To determine the origin of the car, the origin of the spare wheel will have to be disregarded. This principle was agreed to early in the negotiations.

The latest consolidated text of May 2008 adds as General Rule 6 minimal operations and processes that were contained in Appendix I, Rule 2 in an earlier draft shown below.

Appendix 1 – Wholly Obtained Goods

RULE 1: SCOPE OF APPLICATION

This Appendix sets forth the definitions of the goods that are to be considered as being wholly obtained in one country.

RULE 2: MINIMAL OPERATIONS AND PROCESSES

Operations or processes undertaken, by themselves or in combination with each other for the purposes listed below, are considered to be minimal and shall not be taken into account in determining whether a good has been wholly obtained in one country:

(i) ensuring preservation of goods in good condition for the purposes of transport or storage;
(ii) facilitating shipment or transportation;
(iii) Packaging or presenting goods for sale.

Rule 2 has been moved to General Rule 6. Various proposals on General Rule 6 emerged during the CRO meeting of October 2008.

The concept of minimal operations and processes is familiar to the majority of origin sets. Minimal operations or processes are normally included in the general rules rather than in a subsection dealing with wholly obtained goods, according to the Meech Lake understanding examined in Section 2.5. In fact as explained previously, the latest consolidated text of May 2008 has moved this provision as General Rule 6.

In fact, Article 9, paragraph 2(c)(i) of the ARO contained an explicit provision for developing harmonized definitions of "minimal operations or processes *that do not wholly obtain goods and by themselves confer origin to a good.*"

During the early stages of the negotiations, these rules were contained in Appendix 3. A second formulation split the application of rules in Appendices 1 and 2. During the HWP, there were debates among delegations over the content and the scope of application of this general rule on minimal operations or processes. Drafts containing explanatory notes and descriptions of minimal working or processing were circulated among delegations.

Some delegations were of the opinion that the preparation of product-specific rules and the fact that the issue of minimal operations is often addressed by a chapter note made the provision of a general rule redundant. Other delegations believed a list of minimal operations or processes could be useful.

Lately some delegations have come to believe that there is no need for such rules to apply to Appendix 2 because the applicable primary rules would have already determined whether a certain minimal working or processing operation is origin conferring or not.

Consensus was reached by the insertion of what was originally General Rule 5 as a rule of Appendix 1 applicable only to wholly obtained goods. The actual rule appeared to be a pragmatic compromise considering that many issues concerning minimal operations or processes are covered in Appendix 2 at chapter note level.

DEFINITIONS OF WHOLLY OBTAINED GOODS

Definitions	Notes
(1) The following goods are to be considered as being wholly obtained in one country:	
(a) Live animals born and raised in that country;	In definitions 1 (a), (b), and (c) the term "animals" covers all animal life, including mammals, birds, fish, crustaceans, mollusks, reptiles, bacteria, and viruses.
(b) Animals obtained by hunting, trapping, fishing, gathering or capturing in that country;	Definition 1 (b) covers animals obtained in the wild, whether live or dead, whether or not born and raised in that country.
(c) Products obtained from live animals in that country;	Definition 1 (c) covers products obtained from live animals without further processing, including milk, eggs, natural honey, hair, wool, semen, and dung.

(d) Plants and plant products harvested, picked, or gathered in that country;	Definition 1 (d) covers all plant life, including fruit, flowers, vegetables, trees, seaweed, fungi, and live plants grown in that country.
(e) Minerals and other naturally occurring substances, not included in definitions (a)–(d), extracted or taken in that country;	Definition 1 (e) covers crude minerals and other naturally occurring substances, including rock or solar salt, crude mineral sulphur occurring in free state, natural sands, clays, stones, metallic ores, crude oil, natural gas, bituminous minerals, natural earths, ordinary natural waters, natural mineral waters, natural snow and ice.
(f) Scrap and waste derived from manufacturing or processing operations or from consumption in that country and fit only for disposal or for the recovery of raw materials;	Definition 1(f) covers all scrap and waste, including scrap and waste resulting from manufacturing or processing operations or consumption in the same country, scrap machinery, discarded packaging and household rubbish and all products that can no longer perform the purpose for which they were produced, and are fit only for discarding or for the recovery of raw materials. Such manufacturing or processing operations include all types of processing, not only industrial or chemical but also mining, agricultural, construction, refining, incineration, and sewage treatment operations.
(g) Articles collected in that country that can no longer perform their original purpose there nor are capable of being restored or repaired and that are fit only for disposal or for the recovery of parts or raw materials;	
(h) Parts or raw materials recovered in that country from articles that can no longer perform their original purpose nor are capable of being restored or repaired;	

(i)	Goods obtained or produced in that country solely from products referred to in (a)–(h) above.

As of May 2008.

There was agreement among all members that the origin of fish and other products taken from the territorial sea (not exceeding 12 nautical miles) of a country should be the coastal state. The outstanding question concerns the origin of fish and other products taken from the exclusive economic zone (EEZ) (not exceeding 200 nautical miles). Among the alternative texts, one text suggested that the origin of fish and other products taken from the EEZ should be the country of the flag of the vessel. Another alternative suggested that the origin of fish and other products taken from the EEZ should be the coastal state mainly supported by developing countries.

The last alternative text suggested that the best way to address this issue should be to leave the importing country to determine the origin of the good in accordance with its legal standpoint of the Law of the Sea.

After lengthy negotiations lasting several years, the most recent draft shows a tentative agreement on the thorny issue of rules of origin on fishery products:

	Definitions	Notes
(2) (i)	Products of sea-fishing and other products taken from the sea outside a country are considered to be wholly obtained in the country whose flag the vessel that carries out those operations is entitled to fly.	
(ii)	Goods obtained or produced on board a factory ship outside a country are considered to be wholly obtained in the country whose flag the ship that carries out those operations is entitled to fly, provided that these goods are manufactured from products referred to in subparagraph (i) originating in the same country.	
(iii)	Products taken from the seabed or subsoil beneath the seabed outside a country, are considered to be wholly obtained in the country that has the rights to exploit that seabed or subsoil in accordance with the provisions of the UN Convention on the Law of the Sea.[22]	

As of May 2008.

[22] It is understood that these definitions are without prejudice to members' rights and obligations who are not States Parties to the UN Convention on the Law of the Sea.

As outlined in the previous section, the elaboration of a list of definitions of wholly obtained goods was one of the first tasks of the TCRO.

A list of wholly obtained goods is present in all sets of origin rules. The current version is more precise than the one contained in the Kyoto Convention. In particular, there were intense debates over the definitions of 8(g) and 8(h) and possible environmental considerations.

Appendix 1 as contained in definition (i) also covers the origin of a good exported from the country where it was obtained solely from materials or products wholly obtained therein as shown in the following examples.[23]

Country A exports:

- *ground natural calcium phosphates (2510.20) obtained solely from natural phosphates taken from the natural rock in this country; or*
- *natural honey (0409) obtained solely from bee-hives in this country; or*
- *cereals (1001 through 1008) harvested solely in this country.*

Because these processes are carried out without any foreign material added to the exported good, country A is the country where the goods have been wholly obtained and, consequently, the country of origin of the goods.

Country B exports:

- *cane sugar (1701) obtained in this country from sugar cane (1212) imported from country* A

Because the cane sugar in this example is not a wholly obtained product it follows that country B is not the country where the goods have been wholly obtained, even though this country shall be the country of origin of the goods, according to Appendix 2 rules.

Appendix 2 – Product-Specific Rules of Origin

RULE 1: SCOPE OF APPLICATION

This Appendix sets forth rules for determining the country of origin of a good when the origin of the good is not determined under Appendix 1 (earlier version)

(a) This Appendix sets forth rules for determining the country of origin of a good when the origin of the good is not determined under Appendix 1.

[23] These examples are excerpted from WTO document G/RO/W/56.

(b) In framing its legislation each Member shall provide for the application of a set of primary rules of Chapters 84–90 and 92 referred to either in column (3) or in column (4), for it. However, for the purpose each of headings 87.01 to 87.16 each Member shall choose one of the primary rules of origin referred to in either column (3) or (4), for it. Each Member shall notify the Committee on Rules of Origin of its chosen rules of origin within 90 days after the date of entry into force of this Annex, for it. (as of May 2008)

As earlier noted, the latest draft above (b) appears to be a compromise among the EC and United States as to whether product-specific rules in Chapters 84–90 have to be drafted using the CTC or an *ad valorem* percentage. The compromise reached at this stage is that each WTO member will have to specify what system will be used by its national administration within 90 days.

RULE 2: APPLICATION OF RULES

(a) The rules provided in this Appendix are to be applied to goods based on their classification in the HS and any additional subdivisions created thereunder, as referred to in General Rule 2 of this Annex.
(b) All primary rules specified at the levels of specific chapter, heading, subheading, or split (sub)heading in this Appendix are co-equal in determining the origin of the goods in accordance with Rule 3 of this Appendix.
(c) Primary rules based on tariff classification shall apply only to nonoriginating materials.
(d) Where the primary rules require a change in classification, the following changes in classification shall not be considered in determining the origin of the good:
  - changes that result from disassembly;
  - changes that result from packaging or repackaging;
  - changes that result solely from application of General Rule of Interpretation 2 (a) of the HS with respect to collections of parts that are presented as unassembled or disassembled articles; however, such changes shall not preclude conferring on a good if origin is conferred as result of other operations
(e) When a good is produced exclusively from originating materials in a country, the good shall be originating in that country.
(f) Where none of the primary rules are satisfied, origin shall be determined according to Rule 3 (c) through (f) of this Appendix.

(as of May 2008)

Given the current globalization of production in which goods are increasingly manufactured in more than one country, Appendix 2 contains the rules applicable to the majority of goods currently produced and traded and is one of the most tormented and negotiated provisions.

Appendix 2 contains seven rules, of which rules 1–3 relate to the most crucial issues relevant to the overall architecture.

Rule 2(a) provides that application of rules of origin begins with classification of the goods in the HS and the identification of the corresponding product description in the nonpreferential HRO.

Rule 2(b) provides that all primary rules that may be found at chapter or matrix level are co-equal, that is, they are equally origin conferring.

These rules reflect some of the basic understandings reached at the Meech Lake meeting. The need for such rules emerged during discussions of the chemicals chapters in which more than one rule was proposed at chapter level (chemical reaction) and at a product-specific subheading (CTSH). However, it was considered that thousands of chemicals can be substantially transformed into other chemicals and remain in the same subheading. The TCRO estimated that it was simply not feasible to split a subheading into thousands of subheadings in order to use a CTSHS rule to capture all these occurrences. The preference was to place the chemical reaction rule at the beginning of the chapter. This, however, created possible confusion between the chapter rule and the CTSH rule at a product-specific level. Hence the need for rule 2(b).

Rule 2(d) covers a number of situations related to a change of classification that is not origin conferring. Normally operations such as packaging and repackaging as well as disassembly are part of the debate over "minimal operations or processes" and are covered by a provision defining minimal working or processing operations, as previously explained. However, during the negotiations it was preferred to address it in different contexts rather than in a unique provision to provide more specific guidance.

It was agreed that disassembly is not an origin-conferring event. The first paragraph deals with a rule covering origin of a disassembled (recovered) part or a removed article from the good that would have performed its original purpose or would have been restored or repaired.

Thus this issue deals with parts or articles that are not subject to definitions (f), (g), and (h) of the wholly obtained goods.

It covers situations in which used and depreciated parts are disassembled into parts and components. For instance, it is common practice to upgrade computers by replacing a new processor, though the PC itself is still used. In those cases there is a CTH because the old processor moves from heading 84.71 to a cartridge-contained microprocessor of heading 84.73. It follows that if the rule of 84.73 is a CTH or CTSH rule, the disassembly would be origin conferring. Because it would have been impossible to cover such occurrences at a product-specific level, the TCRO agreed to this negative rule.

The second issue in rule 2(d) refers to a change of classification by virtue of packaging or repackaging. It should also be noted that during the negotiations it

was agreed that a repackaging would not lead to a change of classification. At its 23rd Session, the HS committee took note of this. However, to ensure that in all cases a packaging or repackaging cannot be considered as an origin-conferring event, this rule has been proposed.

The third paragraph of rule 2(d) refers to a situation in which goods are presented to Customs unassembled or disassembled. The General Interpretation Rule (GIR) 2(a) of the HS provides as follows:

> *2(a) Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished, provided that, as presented, the incomplete or unfinished article has the essential character of the complete or finished article. It shall also be taken to include a reference to that article complete or finished (or falling to be classified as complete or finished by virtue of this rule), presented unassembled or disassembled.*

In international trade a situation may occur in which components and parts of goods are imported in one country and then exported as kits to another country. In this situation a CTH by application of GIR 2(a) may apply.

The scope of this rule is to avoid the situation previously described in which the simple collection of parts of a finished good classified in other headings may change heading by virtue of (GIR) 2(a) and therefore confer origin.

Determination of origin according to Rule 3

Rule 3 is the core of Appendix 2 and provides for the sequential application of the primary rules and the residual rules. At present there are seven paragraphs in rule 3 and different drafts proposed by some delegations. Because rule 3 covers a number of complex situations and alternative drafts, this rule is further subdivided in primary rules and residual rules.

RULE 3: DETERMINATION OF ORIGIN

The country of origin shall be determined in accordance with the following provisions, applied in sequence:

Primary Rules

(a) *[The country of origin of a good is the country designated as such in the applicable primary rule.](EC) [NOR](JPN)*

[When a primary rule specifies that the origin of a good is the country in which the good was obtained in its natural or unprocessed state, the country of origin of the good shall be the [single (IND)] country in which the good was obtained in that condition;] (IND)

[When a primary rule requires that the country of origin of a good is the country in which:

(i) the good was obtained in its natural or unprocessed state, the country of origin of the good shall be the single country in which the good was obtained in that condition; or

(ii) a specifically designated stage of production was attained, the country of origin of the good shall be the single country in which such stage of production was attained;] (US)

[The country of origin is the country determined as such by the application of the primary rule] (CAN)[NOR]

(b) The country of origin of a good is the last country of production, provided that a primary rule applicable to the good was satisfied in that country[24]*(Earlier draft)*

RULE 3: DETERMINATION OF ORIGIN

The country of origin shall be determined in accordance with the following provisions, applied in sequence:

Primary Rules

(a) When a primary rule itself designates the country in which a good was obtained in its natural or unprocessed state as the country of the good, or designates otherwise the country of origin of a good, the country of origin of the good shall be the single country designated as such;

(b) The country of origin of a good is the last country of production, provided that a primary rule applicable to the good was satisfied in that country (latest draft May 2008)

As pointed out at the beginning of rule 3, it is important to highlight the sequenced conceptual application under rule 3 because paragraph (a) and (b) applies to the primary rules whereas the remaining paragraphs (c) to (f) are dealing with residual rules. This structure of rule 3 has remained unchanged in the latest draft of May 2008.

As shown in the earlier draft above, different drafting techniques divided some delegations in the drafting of rule 3(a). However, the difference was not substantial but was instead based on questions of definitions. The draft of May 2008 shows considerable progress and convergence.

The former EC proposal under the rule 3(a) refers to the product-specific rules of origin in the Appendix at a product-specific level, such as that described in the preceding example.

The U.S. former version of rule 2(a) explicitly refers to the so-called "Ottawa language" and to other "specific designated stage of production" that may be

[24] This applies also to primary rules requiring that the country of origin of a good is the country in which the good was obtained in its natural or unprocessed state. (Philippines [PHI])

required in the product-specific rules. There are examples of this latter kind of rule in the machinery sector in which it may be expressly requested to manufacture the cathode ray tube to acquire the origin of TV sets.

Rule 2(b) in its current form covers a situation in which originating and nonoriginating goods are processed in the last country of production. This last country of production is considered the country of origin as far as a primary rule is satisfied as contained in the following example:

***Country B exports*:**

- *either cocoa shells (1802), or iron slag (2619) or cotton waste (5202) that result from the processing of, respectively, originating cocoa beans (1801), iron ores (2601), and cotton (5201); or*
- *fruits preserved by sugar (2006) obtained from originating and nonoriginating fruits (0810) and cane sugar (1701); or*
- *organic chemicals of Chapter 29 obtained by chemical reaction, or mixture, or purification of originating and nonoriginating organic chemicals of the same HS chapter; or*
- *shape-cut industrial diamonds (7102.29) obtained from imported unworked diamonds (7102.21).*

In all four situations, country B satisfies the primary rule applicable to the exported goods, namely the Ottawa language in the first paragraph, the CC in the second paragraph, the chapter rule in the third paragraph, and the change of subheading plus a specific process in the fourth paragraph.

RULE 3 – RESIDUAL RULES

(c) When a good is produced by further processing of an article that is classified in the same subdivision as the good, the country of origin of the good shall be the single country in which that article originated. (Latest draft May 2008)

[When a good undergoes one or more operations that do not result in a change in its classification, the origin of the resulting good is the single country from which the good originated immediately prior to such operations, provided that any material that might have been added satisfies any CTC rule applicable to the good]. (Earlier alternative draft to (c) above).

The paragraphs of rule 3 provided for residual rules that apply in sequence when primary rules are not met. As previously explained, the need for residual rules in nonpreferential rules of origin is motivated by their exhaustive nature:

There must always be an origin outcome and rules should provide for it. The latest version of February 2007 provides for paragraphs (c)–(f) as shown in the following pages. The latest draft of May 2008 is also shown in the following pages.

The scope and applicability of residual 3(c) (commonly referred to as the origin retention rule) cover a situation in which an originating good is further processed in a second country and this latter process was not sufficient to change the tariff classification of the originating good. In other words, the tariff classification does not change. In these cases the origin is "retained" by the country producing the originating good. It was agreed that the term classification/subdivision in both earlier drafts refers to the level of tariff classification/subdivision applicable in the primary rule.

Examples[25]:
Country A exports to country C:

- *originating cider in bulk (2206); in country C this cider is further fermented, sweetened with sugar (1701) from country B and re-exported in bottles (2206); or*
- *wholly-obtained natural cork, raw, (4501.10); in country C this cork is ground and granulated and re-exported (4501.90); or*
- *originating articles of carbon fibres and graphite (ex6815.10(b)); in country C this articles are processed and transformed in carbon fibres (ex6815.10(a)) that are re-exported.*

In these cases, the origin determination for the reexported goods by rule 2(c) shall be the origin of the imported materials, namely country A, insofar as the processes carried out in country C did not change the level of classification requested by the primary rule applicable to those goods (i.e., CTH).

The subparagraphs of rule 3 and especially those after paragraph (c) have been one of the most negotiated issues. Subsequent drafts have been included to provide some background.

RULE 3 – RESIDUAL RULES (EARLIER DRAFT)

(d) The country of origin of the good shall be determined as indicated in the applicable residual rule specified at the chapter level;
(e) When the good is produced from materials that all originated in a single country, the country of origin of the good shall be the country in which those materials originated;
(f) [When the good is produced from materials (whether or not originating) of more than one country, the country of origin of the good shall be the country

[25] These examples are excerpted from WTO document G/RO/W56.

in which the major portion of those materials originated, as determined on the basis specified in each chapter, (and in the event of two or more countries equally contributing major portions of those materials, the good shall be assigned a multicountry origin)]; (IND)

When the good is produced from materials (whether or not originating) of more than one country, the country of origin is the single country of origin of the materials that did not satisfy a primary rule applicable to the goods; (US)

[When the good is produced from materials of more than one country, the country of origin of the good shall be the country in which the major portion of the nonoriginating materials originated, as determined on the basis specified in each chapter. However, when the originating materials represent at least 50% of all the materials used, the country of origin of the good shall be the country of origin of those materials]; (EC)

(g) [When the good is produced from materials (whether or not originating) of more than one country that did not satisfy the primary rule applicable to the good, the country of origin of the good shall be the country in which the major portion of those materials originated, as determined on the basis specified in each chapter]. (US)

Rules 3(d) and 3(e) were rather self-explanatory. In the case of rule 3(d), it was evident that, if there was a residual rule at chapter level, that rule provided an origin outcome.

Rule 3(f) was often referred to as the major portion rule. However, the U.S. position on rule 3(f) based the origin on the country of origin of the material(s) originating in a single country that did not satisfy a primary rule, and thus complemented the outcome of the primary rule. If the applicable primary rule was change of heading "except from a specified heading," then obviously the intent of the primary rule was that the specified change did not result in substantial transformation. According to the U.S. proposal, it was thus logical and appropriate to focus on the origin of the materials that did not undergo the required change. The EC proposal contained reference to a value-added approach. During consultations it was commonly understood that the application of the sequenced residual rules would start from the application of primary rules in the last country of production as a first test, the application of the origin retaining the concept of a second test, and the major portion the concept of a final test. Differences, however, remained in the earlier draft on how the concept of a major portion applies, especially between the EC and the United

States. Some examples provided may further clarify the application of residual rules.

Examples:
***Country C exports*:**
- *polished rice (1006.30) that resulted from the processing of paddy rice (1006.10) originated in country A and husked rice (1006.20) originated in country B; or*
- *not-impregnated or coated bandages for medical purposes [ex3005(b)] produced from fabrics (Section XI) imported from countries A and B and originating fabrics; or*
- *x-ray photographic plates (3701.10), produced from x-ray films in rolls (3702.10) originated in country A and country B,*
- *complete watch movements, unassembled, [ex9110(a)] produced from originating watch parts (9114) and rough watch movements [ex9110(a)] from country A and country B.*

In these examples, all the materials (whether or not originating) used for the production of the exported goods did not satisfy the primary rule applicable to these goods. Therefore both options of rule 2(f) should attribute the origin to the country – A, B, or C – contributing the major portion of the materials or, according to the U.S. approach, to the origin of the materials that did not satisfy a primary rule.

Another example has been circulated during the negotiations to illustrate the different scope and outcome depending on alternatives adopted.[26]

Country A exports manioc pellets (heading 0714, 100 kg) produced from originating fresh manioc (cassava) (heading 07.14,200 kg, $50), together with flour of manioc originating in country B (heading 11.06, 50 kg, $150), and binder (molasses) originating in country C (heading 17.03, 3 kg, $20). The product-specific primary rule for heading 0714 is a CTH, except from 11.06. Assuming that the criteria to apply rule 2(g) or (f) are by weight, which country is the origin of the manioc pellets?

It is clear that no primary rule has been met because goods of heading 11.06 have been used. Rule 2(c) is not applicable; rule 2(e) is not applicable either because the material originates in more than one country.

According to the first alternative of rule 2(f) supported by India and rule 2(g) supported by United States, the country of origin will be country A because it supplies the major part of the materials.

[26] This example was originally developed by the Secretariat and later used by the WCO during technical assistance activities, and it has also been reported in Imagawa and Vermulst. In this version it has been adapted to respond to the version of the Architecture rule appearing in WTO document G/RO/Rev.2.

However, when the third alternative of rule 2(f) is considered the origin of the pellets will be country B because it supplies the major portion (in this case weight) of nonoriginating materials. This difference of outcome is derived from the absence in the third alternative option of rule 2(f) of the wording "whether or not originating" and the expressed focus on nonoriginating material present in the text. It follows that when the focus is on the nonoriginating materials only, the 200 kg of originating fresh manioc have to be disregarded when determining origin.

RESIDUAL RULES (DRAFT OF FEBRUARY 2007)

(d) The country of origin of the good shall be determined as indicated in the applicable residual rule specified at the chapter level;
(e) When the good is produced from materials all of which originated in a single country, the country of origin of the good shall be the country in which those materials originated;
(f) When the good is produced from materials (whether or not originating) of more than one country, the country of origin is the single country of origin of the materials that did not satisfy a primary rule applicable to the goods;
(g) When the good is produced from materials of more than one country, the country of origin of the good shall be the country in which the major portion of the nonoriginating materials originated, as determined on the basis specified in each chapter. However, when the originating materials represent at least 50% of all the materials used, the country of origin of the good shall be the country of origin of those materials;
(h) When two or more countries equally contribute major portions of those materials, the good shall be split and assigned by such countries. When the good cannot be split, a multicountry origin shall be assigned.

In comparing the two drafts, it appears that a certain degree of consensus has been reached. The main points to be noted are as follows:

- Subparagraphs (d) and (e) remained unchanged.
- Subparagraph (f) and (g) reflecting the original position of the United States and EC, respectively, have also remained unchanged.
- Subparagraph (h) appears to be the compromise subparagraph in which elements of the former alternative text of subparagraph (f) of the Indian proposal has been somewhat merged with the alternative U.S. proposal to rule (g). The result of this merge, as reflected in subparagraph (h), is highly debatable in terms of predictability and ease of administration: Assigning a multicountry origin to a good is counterintuitive to the real essence of the agreement that is to provide a single origin outcome for a given good.

The text reproduced below is the last draft as of May 2008 of paragraphs (d) to (f) of rule 3.

RULE 4: INTERMEDIATE MATERIALS

Materials that have acquired originating status in a country are considered to be originating materials of that country for the purpose of determining the origin of a good incorporating such materials or of a good made from such materials by further working or processing in that country.

(d) The country of origin of the good shall be determined as indicated in the applicable residual rule specified at the chapter level;
(e) When the good is produced from materials all of which originated in a single country, the country of origin of the good shall be the country in which those materials originated;
(f) When the good is produced from materials (whether or not originating) of more than one country, the country of origin of the good shall be the country in which the major portion of those materials originated, as determined on the basis specified in each Chapter.

The previous options (f), (g), and (h) have now been merged in a single paragraph (f) that appears to solve many of the concerns previously raised.

This rule reflects the consensus earlier reached in the TCRO that, once origin is conferred to a good in a country, the good will not lose origin by subsequent processing operations in the same country. This rule of intermediate material features in mainly preferential rules of origin and is often referred to as absorption rules under the EC preferential rules of origin or roll-up test under the North American model of preferential rules of origin.[27] It provides legal certainty and clarity to the rules.

RULE 5: [INTERCHANGEABLE GOODS AND MATERIALS]

Where it is not commercially practical to keep separate stocks of interchangeable materials or goods originating in different countries, the country of origin of each of the commingled materials or goods may be allocated on the basis of an inventory management method recognized in the country in which the materials or goods were commingled. The use of this system shall not give rise to more products originating in a specific country than would have been the case had the commingled materials or goods been physically segregated. (as of May 2008)

[27] For example and explanations of these rules see Chapter 3.

This rule covers a situation in which a producer is utilizing fungible materials imported from different countries in order to produce a final good, that is, raw chemicals in bulk to produce finished goods. For commercial reasons it may be difficult or impossible to stock these goods separately according to their origin, and therefore these inputs may be commingled and the origin of these materials will have to be kept according to an inventory management method.

RULE 6: PUTTING UP IN SETS OR KITS

A. *[US] Unless otherwise provided in this Appendix, goods put up in sets shall retain the origin of the individual articles in the set.*
B. *[IND] Goods put up in sets or kits shall retain the origin of the individual articles except when such goods are explicitly mentioned as sets or kits in a heading or subheading of the HS or are classified as sets or kits by application of GIR 3(b) of the HS, in which case the origin of the set or kit shall be the country where it is put up.*
C. *Merely putting articles into sets is not origin conferring: With this option there is no need for a specific provision for sets, although it might be advisable to have this element included in the new rule 2(b)/old rule 3 (Application of Rules). The rule in this case might read "a CTH resulting from merely putting up in sets is not considered as origin conferring." (MEX)(earlier draft)*

Rule 6 does not appear in the latest draft of May 2008.

This rule was designed to cover a situation in which articles originating in more than one country are put together in one set. There might be three different types of sets:

(1) Sets that are explicitly mentioned in the HS (e.g., 82.14 – manicure sets; 3006.50 – first aid boxes and kits; 96.05 – travel sets for personal toilette);
(2) Goods that are classified as sets by application of GIR 3(b) or (c);
(3) Goods merely put together that are not classified as sets by either GIR 3(b) or (c) within the HS.

There was growing consensus during the negotiations that putting up in sets was not origin conferring and that there was no need for a specific rule as well as for reference in rule 2(d) of Appendix 2. This has led to the disappearance of this rule 6 in the latest draft of February 2007. The country of origin of a set put up from articles that originate in more than one country shall be determined according to Residual Rule 3(f).

[RULE 7: DE MINIMIS]

For the application of the provision of the rule 3(B) of this appendix, nonoriginating materials that do not satisfy the rule shall be disregarded, provided that the totality of such materials does not exceed [10%] in value, weight, or volume, as specified in each chapter, of the good. (latest version of May 2008)

A *de minimis* approach is familiar to a number of customs administrations as a way to disregard materials that otherwise would prevent an origin rule from being met. In this respect, the *de minimis* rules or tolerances, as argued by many delegations during the negotiations, give greater possibilities for primary rules to be satisfied and reduce overdependence on residual rules.

There was intense debate over the positive and negative merits of this rule and whether it would be applicable on a horizontal basis or only to Appendix 2. In particular, it was considered whether the rule was applicable in the case of an origin rule that was based on specific working or processing, what rationale was to be used to set thresholds, and what difficulties could this rule generate for developing countries. There has been growing consensus on the rule and the square-bracketed 10 percent as proposed by the facilitator.

2.6. Outstanding Product-Specific Issues

For some years, delegations have been unable to reach consensus on issues concerning some specific goods. Although worded in a technical language they reflected a disagreement over the trade policy implications of a certain origin outcome. Only recently has some notable progress been recorded.

At the end of the TCRO, by May 1999, the product-specific rules for 511 headings (or 41 percent) out of 1,241 were agreed on by consensus. There were 66 referral documents covering 486 product-specific unresolved issues involving 730 headings. The TCRO referral documents included 650 pages of narrative explanation and amounted to over 2,000 pages. In 2001 there was considerable progress in solving many of the product-specific issues because over 300 were solved. However, as progress slowed down considerably during 2002 in July the Chairman of the CRO submitted to the GC 94 core policy issues, of which 12 were considered crucial.

At the meeting of the WTO GC of 27 July 2005, the chairman reported the limited progress made on the outstanding 94 core policy issues. Ninety-three of these issues are product specific, and the remaining one is related to the

cross-cutting issue of the implications of the implementation of the HRO for other WTO Agreements.

Although progress has been recorded on a number of areas and there has been a narrowing down of position, until the beginning of 2006, consensus was reached only on two products issues, mixing of coffee and mixing of petroleum products.

Many delegations feel that the resolution of the remaining outstanding issues has to come as a package. However, it was clear that such a package could materialize only once a common understanding of the implications of the harmonized rules for other WTO Agreements relating to trade remedies was achieved.

The disentangling of the issue of trade remedies through the reformulation of General 1, scope of application, during the fall of 2006 opened the way to a series of compromises in view of a final package. The latest documentation shows a number of developments made in a many outstanding issues, however.[28]

A brief analysis of the most relevant product-specific outstanding issues and their evolution is described in this section. This analysis is based on a former proposal of the chair of the CRO[29] (hereinafter referred to as "The July 2006 package") grouping and summarizing different issues for ease of reference. It follows that this review is far from complete and detailed on product/issue-specific topics. It aims simply at providing some indications and an overview of certain negotiating issues and their evolution. The CRO chairperson in fact circulated a final package for product-specific rules of origin pursuant to a series of suggestion made in 2006 and discussed earlier in Section 2.2.

The package was based on the objectives and principles of HRO as provided in Article 9.1 of the ARO. The package was also based on the observation that the negotiations on HRO should minimize any possible impacts on the status quo of the current trade regimes of goods concerned, as clearly provided in Article 9.1(d), which says "notwithstanding the measure or instrument to which they may be linked, rules of origin should not be used as instruments to pursue trade objectives directly or indirectly."

2.6.1. *Fishery Products*

Apart from the outstanding issue of the definition of territorial sea discussed in Section 2.2, the issues of drying, (heavy) salting of fish, smoking of fish, and filleting of fish are unresolved.

[28] See WTO, JOB(01)/52/Rev.6 of 22 February 2007. In the following text this document is referred to as the "latest draft of February 2007."

[29] See JOB(06)/86/Rev.2 of 17 July 2006.

Some delegations, mainly Japanese and Korean, are of view that filleting operations are not origin conferring and that origin should be referred back to the country where the fish has been captured or farmed. In the case of filleting of fish a compromise proposal by Japan recognized filleting as origin conferring only for the species that are not subject to conservation measures applied by regional fisheries management organizations. These organizations establish joint measures including import bans to prevent overfishing.

According to Japan and Korea for tuna and tunalike species of fish, joint measures, including import bans on these species of fish and their products from certain countries, are now taken to prevent overfishing under the existing regional frameworks for conservation and management of these resources. If it was decided that filleting of tuna and tunalike species can confer their origin, then circumvention on import bans ("tuna laundering") could easily take place, because it would become difficult for the customs authorities to carry out necessary import controls to fulfill the obligations under the resource conservation organizations. On such a basis, Japan and Korea considered it inappropriate to authorize an origin rule that can hamper the effective implementation of joint measures for the conservation of these species. The issue is still unresolved according to a latest draft of 2007, which recorded a chairperson's recommendation toward considering filleting a non-origin-conferring operation.

In the case of drying and smoking fish, there were signs of growing consensus toward recognizing them as origin-conferring operations. In these cases Japan and Korea indicated that they were able to join consensus if their concerns on the implications of the application of the result to labeling requirements and sanitary and phytosanitary measures were duly accommodated.

In particular Japan held the following opinions:

(i) In certain cases, it is rather inappropriate to thoroughly and automatically apply the results of the ongoing harmonization work to the labeling requirements of foods applied domestically.
(ii) It is not logical to refer to the HRO in deciding whether to apply sanitary and phytosanitary measures.[30]

In practice, the request of Japan and Korea is to disregard the HRO in the case of labeling requirements and Sanitary and Phytosanitary (SPS) measures. In the case of labeling, consumer policy objectives may require a labeling that goes beyond the requirement to show a single origin of the product for the

[30] See WTO document G/RO/W/74.

purpose of customs procedures. In the case of processed foods it may be required, at the domestic level, to declare the origin of the ingredients in addition to the single origin of the product. Japan argues that harmonized rules should not prevent the necessary labeling to satisfy consumer concerns that it is often going beyond the declaration of the single origin of the product. The same reasoning applies in the case of SPS. *A fortiori* domestic SPS legislation demands not only the origin of the product but the history of the product (where the fish has been caught, frozen prepared, or otherwise preserved, or transported etc.).

It follows that the HRO should not prevent the application of SPS measures to avoid pests or diseases. The heavy salting of fish is a process resulting in the emergence of the so-called "stockfish" consensus that considers this process to be origin conferring. However, this consensus is emerging for the heavy salting process according to definitions provided by Norway[31] and the Food and Agricultural Organization (FAO). Conversely, simply salting fish is not considered an origin-conferring operation.

In the July 2006 package, the chairperson's proposal may be summarized as follows:

- Drying, smoking, or heavy salting of fish are origin-conferring operations,
- Filleting is not an origin-conferring operation, and the origin of the fish fillets shall be the country in which they have been captured; or, if farmed, the country in which the fish has been raised from egg or fry (including fingerling).

2.6.2. *Slaughtering*

The slaughtering and fattening of live animals has been one of the issues on the agenda since the inception of the work of the HWP. Like the debate over filleting fish, the bone of contention is related to SPS concerns and consumer information.

Meat-producing countries such as the United States, Argentina, Brazil, and Australia hold that slaughtering is an origin-conferring operation and that SPS concerns should be addressed by appropriate measures like quarantine and not through rules of origin.

A second group of countries including the EC, Japan, and some Latin American countries believe that slaughtering confers origin only in combination with

[31] Salted fish under heading 03.05 is a fishery product in which the fish meat is fully saturated with salt, such that the amount of salt is at least 26.4 grams per 100 grams of water.

a certain period of fattening – four months. The EC is concerned that slaughtering could be used by some countries to circumvent the ban of hormone beef.

Fattening is still a controversial issue for Argentina, Australia, and India, who appear to be quite isolated according to the latest draft of February 2007 in respect to a growing group of countries including the EC, United States, Japan, and Canada, who consider fattening an origin-conferring operation.

2.6.3. *Dairy Products*

Obtaining recombined or reconstituted milk, condensed milk, milk powder, products, cheese, and beverages containing more than 50 percent of milk solids are processes that Australia, New Zealand, and other delegations consider origin conferring.

The EC, on the other hand, believes that these processes are not origin conferring. Such divergence of views between members of the Cairns group, promoting agricultural trade liberalization, and the EC, the most protectionist on dairy products, may be hardly surprising. However, in this case the EC position appears to be motivated by the concern of application of internal rules concerning payment of export subsidies rather than protectionist intents. The EC standpoint that origin always goes back to the country that has produced the milk is to avoid the misuse of such subsidies.

Moreover, retaining or losing origin in dairy products may have some implications for marketing the finished products to consumers. This issue is particularly relevant in the case of processed cheese and yogurts. The liberal rules supported by Australia and New Zealand seem to contradict the standpoint of many producers of raw agricultural products who wish to retain the origin of the product when it undergoes further processing.

The CRO chairperson proposed in the July 2006 package that, for all the milk-derived products, the country of origin shall be the country in which the milk is obtained in its natural or unprocessed state. However, obtaining yogurts or food preparations containing more than 50 percent of milk solids was proposed as a compromise.

Obviously this compromise did not satisfy all countries. The concern of New Zealand was over the value added to these milk-derived products through agriculture processing activities.[32] New Zealand observed that there was a lack of coherence in a package that recognized the transformation of cocoa paste to cocoa powder as substantial, but at the same time denied that same recognition

[32] JOB(06)/86/Rev.2/Add.1 of 19 July 2006.

to the transformation of milk to milk powder or the transformation of cheese into processed cheeses. Both these processes were sophisticated and were a highly capital-intensive operation. Just as cocoa powder was a different article of commerce from cocoa paste, so too were milk powder and processed cheeses. The position of New Zealand on these issues was also driven by the instructions provided in Article 9 of the ARO that "rules of origin should not be used as an instrument to pursue trade objectives directly or indirectly."

2.6.4. Coffee Products

As in the case of slaughtering, the debate over coffee products arose during the early stages of the negotiations. Countries such as Colombia, which are major producers of coffee, wish to retain origin and do not consider roasting and decaffeination to be origin-conferring operations. On the other hand, countries that are transforming coffee by roasting, roasting and blending, decaffeination, or making coffee preparations wish to acquire origin through these operations.

As further dealt with in Section 2.8, retaining origin for countries growing coffee may be an important marketing tool, especially when it is linked to brand images such as "Cafe de Colombia" or "Blue Mountain Jamaica."

Commercial realities indicate that different qualities of coffee (Arabica, Robusta, etc.) are often blended to make coffee and coffee preparations. This blending is necessary to make a cup of coffee with varying acidity and different characteristics to meet consumer preferences.

An earlier compromise proposal circulated by the chairperson of the CRO was to allocate origin to the country that accounts for 85 percent of green coffee beans used in the case of roasting. When such a percentage is not met, the origin will be allocated to the country in which the roasting is carried out.

Because coffee or coffee preparations are often made with different kinds of coffee, it is difficult to assess whether a requirement of 85 percent may result in the rule having limited application, leaving in practice much more scope to the alternative rule (origin is allocated to the country where the roasting takes place).

The July 2006 package proposal suggested splitting the subheading into two split headings and provided for the following requirements:

HS 0901.21

- ex 0901.21(a) (coffee, roasted, of coffee beans of subheading 0901.11, wholly obtained in a single country)
  Origin rule: The country of origin of the goods of this split subheading shall be the country in which the plant grew.

- ex 0901.21(b) (other)
  Origin rule: CTSH

Accordingly, under ex 0901.21(a), roasting without blending of different kinds of coffee is not origin conferring. However, roasting accompanied by blending is an origin-conferring operation. The latest draft of February 2007 reported a growing consensus to consider the decaffeination of coffee as a non-origin-conferring operation.

2.6.5. *Refining Fats and Oils*

The United States, joined by other delegations such as Brazil and Argentina are of the view that refining oils and fats is not an origin-conferring operation because the essential characteristics are not changed by refining.

The EC, joined by Japan and other delegations, holds that the refining process is an origin-conferring operation because it makes the crude oils and fats suitable for consumption or use. They argue that, to confer origin, the process of refining entails that three operations have to be carried out in a single country, namely neutralization, decolorizing, and deodorizing. The latest draft of February 2007 does not report any relevant progress in this area.

The July 2006 package proposal adopted the following tentative compromise:

CTH; or change by refining (origin conferring) for 15.01–15.06, 15.08–15.13, subheadings 1515, 11–19, 30–90, heading 15.16 and split heading ex 15.21(a).
CTH (non-origin-conferring) for headings 15.07 (soya-bean oil), 15.14 (rape, colza, or mustard oil) and 1515.21–29 [maize (corn) oil]

2.6.6. *Refining Sugar and Sugar Products and Molasses*

International trade in sugar is a sensitive matter, and it is not surprising that there is no consensus on some issues involving sugar. Major sugar producers such as Australia, Cuba, and New Zealand hold the view that refining sugar is an origin-conferring operation.

A group of countries, including the EC, the United States, and some developing countries like Brazil (also a major producer of sugar) are of the view that refining is not an origin-conferring operation. A similar situation is occurring on related matters such as manufacturing invert sugar, obtaining sugar syrups, and obtaining molasses. Countries that are producing and exporting sugar at competitive prices such as Australia and New Zealand may wish to lose origin as soon as possible to avoid protective measures applicable to sugar and sugar products.

On the other hand, countries traditionally adopting more protectionist trade policies on sugar, such as the EC and United States, wish to have rules retaining origin for the purpose of administration of such policies to avoid the circumvention of trade measures or misuse of domestic subsidies. The CRO chairperson's proposal in the July 2006 package stated that refining was not to be considered as substantial transformation.

2.6.7. *Cocoa Products and Chocolate*

The underlying differences among delegations are that countries producing the raw material, namely cocoa beans, wish to retain origin of the downstream products like cocoa paste and cocoa butter. Other countries are of the view that making cocoa powder from cocoa paste is origin conferring.

A related issue is making finished retail chocolate preparations from chocolate crumbs. Countries producing raw cocoa materials argue for more restrictive rules of origin. Other countries are of the view that preparing retail products from chocolate crumbs is an origin-conferring operation.

Industrialized countries with major confectionery industries are of the view that a relatively simple operation as just described is origin conferring. Some other industrialized countries that have specialized in manufacturing certain quality chocolate products may also wish to have a restrictive rule. This may be the case of Swiss position that does not considers the processing of chocolate crumbs into retail chocolate an origin-conferring operation.

The July package 2006 proposal put forward the following compromises:

- Processing cocoa beans into cocoa paste is a substantial transformation.
- Processing cocoa paste into cocoa butter is a substantial transformation.
- Processing cocoa powder into sweetened cocoa powder by adding sugar is not a substantial transformation.
- Processing cocoa powder into a cocoa preparation (other than sweetened cocoa powder) in liquid, paste, powder or granular form, of a content exceeding 2 kg is a substantial transformation.
- Processing chocolate crumbs into a finished retail chocolate is a substantial transformation.

2.6.8. *Juices and Wines*

As in cocoa preparation, the issue at stake is among the countries producing the raw material (fruits, vegetables, and grapes) and those countries that are transforming this raw material into the finished products.

The countries growing the fruits (mainly developing countries) are of the view that origin of the juices should remain with the country where the fruits

were grown and harvested. Other countries hold that the preparation of fruit or vegetable juices from imported fruits and vegetables is origin conferring. Finally, some countries are of the view that reconstituting juices and adding oil and essences is origin conferring. This last rule appears liberal especially when it is contrasted with other proposals. In a recent compromise proposal supported by Brazil and the United States, a more restrictive approach was adopted in the case of citrus fruits (CC) whereas a more liberal one (CTH) was taken in the cases of other juices.

Wines bring about similar disputes between the countries that are traditional producers of wines and countries that either do not produce wines or are relative newcomers to wine producing, like Australia.

However, even new producers, such as Argentina and Chile, hold the view that wine is a special product and that the distinctive features of the wine are defined by the quality and thus the origin of the raw material, the grapes, in combination with certain wine-making techniques. Accordingly, these countries consider that, in the case of wine and grape must, the origin should remain with the country where the grapes grew.

The United States and other developing countries are of the view that producing wine from imported grapes or from wine must is an origin-conferring operation. It is obvious that the debate stems from the desire to retain the origin of wines, such as those made in France or Italy, versus the desire to acquire origin by developing new wine-making techniques in the case of newcomers to wine production. Once again, the link between the HRO and its implication on labeling is the real contentious issue.

However, it must be noted that implementation of rules of origin in this field might be quite difficult because of the intrinsic nature of the product: It is difficult to distinguish local grapes and grape must from imported ones. Moreover, application of residual rules in certain cases may result in an origin outcome that may not reflect the original objective of the rules.

The July package 2006 proposed the following:

For juices:

- Processing fruits or vegetables of Chapter 20 into juices is a substantial transformation, except for citrus juices, which are produced from fresh citrus fruits.
- Processing fruit or vegetable juice concentrates into reconstituted juices is not a substantial transformation

For wine:

- Processing grapes into grape must of subheading 2204.30 is not a substantial transformation.

- Processing grape must (HS 2204.30) into wine is not a substantial transformation.
- Processing grape juice (Chapter 20) into wine is a substantial transformation.

2.6.9. *Mixtures/Blends*

Discussions about mixtures took place quite early in the TCRO negotiations, but the final text submitted to the CRO did not contain any specific provision and the origin determination was left to the application of residual rules. However, during the negotiations in the TCRO two approaches were proposed: (i) product-specific mixtures rules of origin on a case-by-case or sector-by-sector basis, or (ii) a general rule for mixtures covering all products.

The product-specific approach was later pursued in the chemicals and agricultural sector where product-specific rules were drafted. The main contention derives from blending of wines and whisky, spices, and mixtures of vegetables or fruits. On wines and whisky, for instance, some countries hold the view that blending is an origin-conferring operation.

In general, the mixing of agricultural products is not considered to be an origin-conferring operation. Nevertheless, mixing and blending of agricultural products is a commercial reality that has to be addressed by an appropriate rule.

As a compromise text, the chairperson adopted a former EC proposal.[33] According to this proposal, a specific residual rule has to be established for these agricultural mixtures at chapter level.

Accordingly, in the matrix, the following residual rule should be placed at the beginning of each of the chapters covering agricultural products:

"Chapter residual rule applicable to mixtures."

(1) *"For the purposes of this residual rule, "mixing" means the deliberate and proportionally controlled operation consisting in binging together two or more identical or different fungible materials.*

(2) *The origin of a mixture of agricultural products shall be the country of origin of the material that accounts for more than X percent by volume weight of the mixture. The volume/weight of materials of the same origin shall be taken together.*

(3) *When none of the materials used meet the percentage required, the origin of the mixture shall be the country in which the mixing was carried out."*

According to this compromise proposal, the minimum percentage required shall be fixed at 50 percent. Setting this level implies that a country should

[33] See WTO document G7RO/W/64.

contribute more than half of the materials used in order to be decisive for the origin of the mixture. When this condition is not fulfilled, the product is originating in the country in which the mixing operation is carried out.

However, to take into account of the specific nature of certain products, higher percentages might be required. The EC has put forward proposals in this context:

- For wine and spirits of heading 2204 and ex-heading 2208, the minimum percentage required is fixed at 85 percent in volume of the mixed product;
- For olive oil (heading 1509), the minimum percentage required is fixed at 75 percent in weight of the mixed product.

The CRO chairperson proposal in the July 2006 package was quite similar: Origin shall be conferred to the country of origin of materials that account for more than 50 percent by weight of all materials used. When none of the materials used meets the percentage required, the origin of the goods shall be the country in which mixing was carried out.

Exception: 85 percent in volume of alcohol content for wine (heading 2204), spirits (heading 2208), and 75 percent in weight for olive oil (heading 1509).

2.6.10. *Grinding of Spices*

The divisive issue in this area is the split between those countries that are growing and harvesting spices as part of their natural endowments and those countries that are actually importing and commercializing these spices after crushing and grinding them. The former argues that crushing and grinding spices are minimal processing operations that do not confer any new property to the spices and the latter argues that crushing and grinding change the character of the good because it increases their surface area, releases essential oils, and creates a form of seasoning that can be easily dispensed.

The July 2006 package proposed that "processing spices into crushed or ground spices is not a substantial transformation."

2.6.11. *Cement*

Cement is obtained from grounding clinker. The EC and other countries are of the view that this process is origin conferring. The United States is of the view that this process is not origin conferring. It appears the main reason underlying these different positions is related to existing AD measures in the United States and the concern that liberal rules of origin may lead to circumvention of these measures. In addition, Australia believes that a specific mixture rule is

appropriate for cement because it is a common commercial practice to mix clinkers of different origins to produce cement.

The July 2006 package contained a consensus rule that processing clinker into cement is to be considered a substantial transformation. In addition, the CRO chairperson proposed the following residual rule: "The origin of cement produced from the mixture of clinker of different origins, shall be the country of origin of the greatest proportion of clinker by weight of the total clinker in the cement."

2.6.12. Chemicals

There are a number of issues applying in a cross-cutting fashion in the chemical chapters (HS 28–40) related to industries carrying out specific working or processing operations. The operations performed by these industries are to standardize or make suitable for a specific use finished chemical products or components. These operations may consist of deliberate and proportionally controlled mixing or blending of materials to conform to predetermined specifications.

In the case of petroleum products a consensus has been reached that "the deliberate and proportionally controlled mixing or blending (including dispersing) of materials to conform to predetermined specifications which results in the production of a good having physical, chemical characteristics which are relevant to the purposes or uses of the good and are different from the input materials is to be considered to be origin conferring."

Consensus has yet to be reached on whether the increase of particle size is an origin-conferring operation. This issue resembles the one concerning petroleum products, and a proposal in this sense argues for a chapter note as follows:

> The deliberate and controlled modification in particle size of a good, other than by merely crushing or pressing, resulting in a good having a defined particle size, defined particle size distribution, or defined surface area, which are relevant to the purposes of the resulting good and have different physical or chemical characteristics from the input materials is considered to be origin conferring. A compromise proposal of the chairman would use this rule across all chemical chapters with the exclusion of medicaments classified in heading 30.04.

According to the proponents of this chapter rule, crude solid chemicals from synthesis are normally in the form of powders with a very broad particle size distribution. In this form, they generally cannot be used by the processing industry, as they also contain very small particles (below 50 micrometers) behaving like dust. Products with intrinsically valuable chemical characteristics, but being

prevented from their use by detrimental (mean) particle size, particle size distribution, or surface area can be physically modified into valuable products by the controlled increase of particle size. Such an increase of particle size represents a substantial transformation, which should confer origin.

The same fashion consensus has to be reached concerning the process of dilution. The addition of a diluent alone to a chemical or a premix, in deliberate and proportionally controlled conditions, may constitute the critical aspect of a mixing and blending operation and can result in physical or chemical characteristics relevant to the purposes or uses of the good that are different from those of the input matter. Accordingly, some countries are of the view that such a process is origin conferring.

Finally, the production of tablets, capsules, and granules from prepared medicaments is also an industrial process that has been the center of debate over whether it is origin conferring.

Switzerland and other countries are of view that these operations are origin conferring. On the other hand, the United States holds the opposite view, arguing that the increase in particle size and addition of diluents are not origin-conferring operations. A compromise proposal later emerged on medicaments.

The July 2006 package contained the following proposals:

For Chapter 30: Chapter rule, except for heading 30.04, where the rule on increase of particle size would not apply.
For Chapters 28, 29, 32, 38, and 39: same as above.

The following is the chapter rule:

> The deliberate and controlled modification in particle size of a good, other than by merely crushing or pressing, resulting in a good having a defined particle size, defined particle size distribution or defined surface area, which are relevant to the purposes of the resulting good and have different physical or chemical characteristics from the input materials is considered to be origin conferring.
>
> In addition:
> Processing chemicals into diluted chemicals is not a substantial transformation.
> The proposed rule for heading 30.04 (medicaments) is as follows:
> CTH, except by mere pressing of tablets or by mere encapsulation.

2.6.13. Leather

The leather issues have been progressively solved since consensus was reached that retanning leather is considered an origin-conferring operation. The remaining issue is the operation of finishing leather.

The EC and other countries believe that carrying out operations such as dyeing, graining, stamping, sizing, polishing, and waxing are origin conferring whereas other leather-producing countries such as Argentina believe that the finishing of leather may be origin conferring only if at least three operations occur.

The chairperson's compromise proposals cut across all kinds of finished leather (heading 4104 through 4107) and resulted in the following:

4104, leather of bovine or equine animals provisionally prepared = CTH except from heading 4101.
Tanned, in the wet state – CTHS;
Other – CTHS.

2.6.14. Textiles and Clothing

Textiles and clothing is one of the most sensitive sectors in international trade. As expected, the end of the Agreements on Textiles and Clothing (ATC) transitional period for the abolition of quotas in January 2005 did not bring a period of peace in this sensitive sector. Import increases in the EC and U.S. markets triggered a variety of trade contingency protections such as safeguard, quotas, and AD measures that are closely intertwined with origin determination. The concern over circumvention of these trade contingency measures is currently underlying many of the negotiating positions. It is therefore hardly surprising that a number of unresolved issues are concentrated in this sector.

During the early stages of the negotiations in the TCRO a series of important principles were agreed: (i) the production of yarn from fibers, (ii) fabric from yarn, (iii) apparel, parts, or accessories of garments knitted or crocheted to shape are origin-conferring operations.

This early understanding meant that the criteria of a double or triple transformation present in the textile and clothing sector in many preferential trade agreements were not adopted. It followed that a number of working or processing operations were recognized as origin conferring and that the HRO introduced a significant element of trade liberalization in this area.

Obviously a number of differences still exist. The United States and a group of countries hold the view that printing and dyeing of yarns is not an origin-conferring operation. Other countries like the EC joined by the big yarn producers like India and Egypt believe that permanent dyeing or printing from unbleached yarn is an origin-conferring operation.

Different proposals have been recorded on the issue of dying and printing of fabrics. In the case of dyeing and printing fabric, the United States recognized

that, if accompanied by two or more defined finishing operations, dyeing and printing might be origin conferring.

The EC and a majority of countries, including India, Egypt, and Pakistan, consider dyeing or printing from unbleached fabrics with at least two preparatory or finishing operations to be origin conferring. A third group of countries, mainly from Latin America, believes that dyeing and printing, even when performed together, are not a substantial transformation.

A similar issue is the coating of fabrics. A majority of countries were inclined to consider it as origin conferring. The United States added the condition that the weight of rubber or plastics of the finished good be more than 50 percent of the weight of the product. The latest draft of February 2007 reports consensus subject to Malaysia, Pakistan, and India that coating of fabrics is not an origin-conferring operation.

Embroidery has also proved to be a divisive process. There are different proposals based on different drafting techniques and different substantive views. In the case of embroidery there is a common understanding that embroidery may be origin conferring; however, origin is made subject to either (i) a value-added text in the case of a widely supported proposal from the EC, (ii) weight of embroidery in the case of the Mexican proposal, and (iii) distance between the edges of the plain fabric and the embroidery in the case of the proposal by Canada and Japan. In the case of embroidery of flat products a conservative approach is taken by the United States in which origin remains with the country that produced the fabric, provided that the fabric was produced from yarn or fiber. Other countries are of the view that a value-added test could be a valid rule.

The latest draft of February 2007 indicates some consensus on the matter of embroidery without visible ground (CTH) and embroidering in strips or motifs (CTH) as origin-conferring operations.

The major concern of the countries supporting stringent rules of origin in all aforementioned issues is the circumvention of trade contingency measures. This concern is also reflected in some of the outstanding issues concerning assembly of textile products to a finished article.

There is almost consensus that assembly of apparel and clothing accessories of parts cut to shape is an origin-conferring operation. Conversely, there are remaining difficulties in considering that assembly of apparel and clothing accessories from parts knitted to shape is origin conferring.

There were still difficulties in flat products and three-dimensional goods; the United States and other countries are of the view that origin remains with the country that produced the fabric but some progress has been lately recorded. Other countries, mainly India and Hong Kong, consider that cutting or knitting to shape and assembly in the same country is sufficient to confer origin. The

final point of contrast in the textiles and apparel sector concerns the need for chapter residual rules for assembly of apparel from parts.

The July 2006 CRO chairperson's proposal was as follows:

- Permanent dyeing or printing from unbleached or prebleached yarn/fabrics with at least two preparatory or finishing operations is be considered a substantial transformation.
- Processing fabrics into coated fabrics with rubber or plastics is a substantial transformation.
- Processing fabric to embroidery in the piece with visible ground and other embroidery is to be considered a substantial transformation; Change to this heading if the value of nonoriginating materials does not exceed 50 percent of the ex-works price of the product.
- Assembling parts knitted or crocheted to shape into apparel is not to be considered a substantial transformation. (The country of origin of the goods of this split chapter is the country in which the parts of these goods have been knitted or crocheted to shape.)
- Assembling parts cut to shape into apparel is not to be considered a substantial transformation. (Change to goods of this split chapter provided that the goods are assembled in a single country in accordance with Chapter Note (option 1).)
- Assembly parts knitted or crocheted to shape into clothing accessories (ties, gloves, etc.) is not to be considered a substantial transformation. (The country of origin of the goods of this split chapter is the country in which the parts of these goods have been knitted or crocheted to shape.)
- Assembly parts cut to shape into clothing accessories (ties, headbands, etc.) is to be considered a substantial transformation. (Change to goods of this split chapter provided that the goods are assembled in a single country in accordance with Chapter Note (option 1).)
- Processing fabrics into flat products (scarves, bed linen, etc.) is to be considered a substantial transformation when bleaching, dyeing/printing, cutting, and hemming take place in a single country. This process should be considered a substantial transformation. (CTH, provided the starting material is prebleached or unbleached fabric.)
- Processing fabrics into three-dimensional goods is to be considered a substantial transformation.

2.6.15. Footwear

A series of outstanding issues are related to the manufacturing of shoes. A majority of countries including the United States, the EC, Japan, and other

developing countries believe that the assembly of footwear from parts is origin conferring except from uppers to which an inner sole is permanently attached that corporately closes the bottom. India and Morocco are of the view that assembly of uppers even with inner soles is origin conferring. Heading 6406 classifies different parts of footwear.

To ease the task of defining an origin rule according to a tariff/shift criterion, heading 6406 has been split into

- Ex 6406(a) uppers to which an inner sole is permanently attached,
- Ex 6406(b) others,
- Ex 6406(c) parts of uppers,

There is a series of outstanding issues around footwear, including production of footwear from unformed uppers and from other parts of footwear.

The CRO chairperson's proposal in the July 2006 package was as follows: Processing uppers and parts thereof is a substantial transformation:

- Ex 6406(a) (uppers to which an inner sole is permanently attached that completely closes the bottom): CTHS,
- Ex 6406(b) (other): CTHS,
- Ex 6406(c) (parts of uppers): CTH.

Processing footwear from uppers is a substantial transformation.

CRO chairperson proposal: CTH, except from ex 6406(a) (uppers to which an inner sole is permanently attached that completely closes the bottom

2.6.16. *Coating of Steel Products*

Like textiles and clothing, steel products comprise another category of products that are import sensitive and subject to import restrictions or trade contingency measures in various countries. As in previous sensitive sectors, the main concern of those supporting more restrictive rules is the possible circumvention of trade defense measures.

The United States and other countries are of the view that coating or plating of steel, usually with zinc or another base metal, involves dipping the finished product in the molten material or processing by electrolytic means. The purpose of the operation is to provide a measure of corrosion resistance to the steel, although in time the coating may wear away. The process does not change the steel in any other manner. It does not meaningfully affect its malleability, tensile strength, or other characteristics or its dimensions. Therefore, no substantial transformation takes place as a result of the process. They contrast coating with

cladding, which is considered origin conferring. In fact, cladding is a process involving the integration of two or more metals that results in a product with significantly different strength and other metallurgical characteristics from the constituent input materials.

The EC is leading a group of countries arguing that coating of hot-rolled products or cold-rolled products is more than a process involving a simple process of uncoiling the hot coil, sprinkling the spray, painting, and then recoiling. It requires a multistage process that consists of pretreatment, coating, baking, and posttreatment. The surface of the color steel has three layers – zinc coating, chromate coating, and oil coating – which cover the base metal. The colored steel is considered a new product, creating almost 100 percent of added value, and is used for interior and exterior decorations of buildings because of its high corrosion resistance and weatherproof qualities, and also for electrical home appliances such as refrigerators, air conditioners, and so on for its attractive appearance.[34]

The July 2006 packages proposed the following principles followed by product-specific rules for input steel products:

- Processing of flat products, and angles, shapes and section into coated steel products with tin, zinc, etc., is a substantial transformation.
- Processing of wires, tubes, and pipe sections into coated steel products with tin, zinc, etc., is nonorigin conferring.

2.6.17. *Machinery and Electronics*

The main technical issues concerning the machinery sector have been discussed in subsection 2.3.1. This subsection further explained the evolution of negotiating positions using some earlier CRO chairperson's proposals as well as the latest update of March 2007.

On the one hand, the complexity of the machinery sector is partly related to the structure of the HS. On the other hand, the fragmentation of production in the machinery and electronic sectors has also raised a series of questions that require a technical solution acceptable to all delegations. For instance the question of assembly of machinery has been the focus of the debate since the beginning of the negotiations. Assembly operations are usually conceived as assembling parts of an article to a finished article. However, it was soon realized that in today's business operation the concept of assembly is also a "parts-to-parts" issue. Industries are sourcing subassemblies and components to make

[34] See unrecorded technical briefs circulated in the CRO.

parts that are later assembled into other parts. This manufacturing chain in which the sourcing of inputs and subassemblies is increasingly diversified is driven by the need of firms to remain competitive and cost efficient.

The technical solutions to such increasingly complex fragmentation of production have resulted in two alternative approaches – the assembly approach, expressed in the CTC proposed by the United States, and the value-added approach, supported by the EU. Both options are still on the table, and the latest compromise proposal was advanced in March 2007. These proposals are summarized in the following pages. In any case, even within the proponents of the assembly approach there have been differences when dealing with the "parts-to-parts" issue. In particular, some countries such as Canada and Japan insisted on splitting subheadings and headings into split headings in a manner such that assembly operations of parts to parts fulfill a CTC. According to their original proposal, this splitting exercise may not need to be exhaustive because residual rules may have been used as a complementary alternative. The United States, supported by India, proposed the establishment of definitions or requirements for such an assembly of parts to parts coupled with the use of CTC.[35] Paradoxically, this latest methodology is quite similar to the use of manufacturing or processing operations to define a substantial transformation as contained in Article 9 (2) (c) (iii) of the ARO on supplementary criteria.

The chairperson of the CRO drafted a series of compromise proposals that summarize the main issues arising from the negotiations on the machinery products. The latest proposals combine the EU the U.S. approaches, basically providing for alternative rules of origin.

One of the latest formulations of the chairperson's proposal is as follows[36]:

(1) *For parts produced from articles of other heading (making parts): CTH.*
(2) *For parts obtained from parts of the same heading, for machines obtained from parts and for machines ("goods") finished from machines of the same heading/subheading:*

CTH, CTSH, CTHS, CTSHS
or
Manufacture in which the value of all non originating materials used does not exceed 60 percent of the ex-works price of the product

In an attempt to reach compromise, this proposal adopted both approaches utilizing a value-added criteria and the CTC. Behind this rather simple

[35] For a series of examples of this approach see Section 2.7.
[36] See JOB(03)/132/Rev.8 of 15 May 2005.

formulation, there are a series of rather complex technical issues that may be better explained by using a former compromise proposal of the chairperson that dealt with these technical issues separately. Independent of the evolution of the negotiating text and the final result of the negotiations, these issues remain valid and relevant because they are related to the structure of the HS when used to determine origin in the area of machinery. Ultimately these cross-cutting issues are key concepts to understanding the different negotiating techniques and positions as well as the final outcome of the HWP. The latest CRO proposal as of March 2007 will be discussed further in the following subsections.

Parts produced from articles of other headings

This issue relates to parts of machinery that are produced utilizing articles of other headings. According to the chairperson's proposal, the making of parts from articles of other headings is an origin-conferring operation. Because this manufacturing operation (making parts from articles of other headings) normally implies a CTH, there are no particular difficulties in adopting a simple CTH rule; for example, if an electric motor (HS 8501) was imported and fitted to the interior case of a dishwasher (HS 8422.90 parts).[37]

There are differences among delegations over whether in certain cases making parts from parts is origin conferring. Some delegations like the EC support the CTH rule, assembly of non-originating engines, motors or other materials classified in other headings to produce those parts listed above, is to be considered as origin conferring. Others are of view that CTH except electric motor (HS 8501) is the rule to be adopted.

For parts obtained from parts of the same heading

An assembly operation of parts to parts that may not imply a change of tariff classification because not all manufacturing operations are reflected in the HS. In this case the chairperson's proposal is the appropriate CTC or a value-added approach. This issue represents one of the most complicated technical aspects and a number of examples are provided in a technical annex circulated during the negotiations:

Examples: *Doors suitable for use solely with dish washing machines (HS 8422.90) were imported and attached to external boxes of dish washing machines* (*HS 8422.90*).

[37] Vice versa, when parts are imported and the outputs of assembly are still those parts, this assembly, under the CTH rule, is not origin conferring. However, under the proposal "or valued-added rule," origin may be conferred if the value addition complies with the required percentage.

To recognize the assembly operation of doors into external boxes as origin conferring the following alternatives may be used:

(a) Create a split subheading and apply a CTSHS rule.
(b) Define assembly operations with or without CTSHS, i.e., CTSHS by welding doors to external boxes.
(c) A VAR.

For machines obtained from parts:

Assembly operations of parts classified in different headings or subheadings of the HS are considered origin-conferring operations and meet the required CTC.

Examples: *Assembly of imported parts of dry cleaning machines (845190) to finished dry cleaning machines* (8542.10).

For machines ("goods") finished from machines of the same heading/ subheading

This situation occurs for finishing and assembling operations of machines that have the essential characteristics of the finished product. Normally these operations are not reflected in the HS. Accordingly, the structure of the HS has to be modified to accommodate origin needs.

Examples: *Manufacture of finished spanners of subheading 8204.11 from blanks of steel spanner of the same heading. Manufacture of high-performance spinning rings of subheading 8448.33 from slugs of spinning rings of the same heading through special heat treatment, structuring of the surface, and thermochemical treatment.*[38]

In addition to these proposed rules, legal notes were discussed as reported below:

Legal notes

Independent of the individual negotiating position, the legal notes outlined in the following section are featured, with some variations, in both the U.S. and EU approaches.

Note 1: Collection of parts:

Where a change in classification results from the application of HS GIR 2(a) with respect to collections of parts that are presented as unassembled articles of another heading or subheading the individual parts shall retain their origin prior to such collection.

[38] Example excerpted from unrecorded technical briefs circulated during negotiations.

Examples: *Parts and components of a machine or of a good are imported for temporary storing and exported as kits.*

In these cases, there might be CTC of parts to a finished article without any substantial working or processing in the country. This CTC that occurred by virtue of GIR 2(a) is disregarded and origin will be retained by the parts and components.

Note 2: Assembly of the collection of parts:

Goods assembled from a collection of parts classified as the assembled good by application of GIR 2 shall have origin in the country of assembly, provided the assembly would have satisfied the primary rule for the good had each of the parts been presented separately and not as a collection.

Examples: *Assuming that the primary rule for HS 8703 (Cars) is "CTH." In this case, if country A imports all parts as a collection from country B and assembles a passenger car, origin is to be conferred to country A, because each part would satisfy the CTH rule. If country A imports semiassembled cars from country B that have the essential character of a car, as well as other remaining parts, assembly is not origin conferring.*

Note 3: Recertification or retesting (could be fitted under Note 7):

A change of classification that results from the recertification or retesting of the good shall not be considered as the change required by the rule set out in the matrix.

Note 4: Disassembly of goods:

A change of classification that results from the disassembly of goods shall not be considered as the change required by the rule set forth in the matrix. The country of origin of the parts recovered from the goods shall be the country where the parts are recovered, unless the importer, exporter, or any person with a justifiable cause to determine the origin of parts demonstrates another country of origin on the basis of verifiable evidence such as origin marks on the part itself or documents.

Examples: *To upgrade PCs, old processors may be replaced with more modern ones. This disassembly operation entails a CTA from heading 8471 to a microprocessor of heading 8473. If the applicable rule for heading 8473 is a CTH or a CTSH, this simple disassembly operation may be origin conferring. This rule confers origin to the country where the parts are recovered as it was considered that it was the easiest to administer with the caveat that in some circumstances the original origin may be easily traced back by the means of origin marking.*

Note 5: Parts and accessories produced from blanks:

The country of origin of goods that are produced from blanks that by application of the HS GIR 2(a) are classified in the same heading or subheading as the complete or finished goods shall be the country in which the blank was finished, provided finishing included configuring to final shape by the removal of material (other than merely by honing or polishing or both), or by forming processes such as bending, hammering, pressing, or stamping.

Paragraph 1 applies to goods classifiable in provisions for parts or parts and accessories, including goods specifically named under such provisions, and to goods classifiable in headings 84.80 and 84.83.

Other outstanding issues in the machinery and electronics

Assembly of memory modules

This issue relates to the assembly of electronic integrated circuits or microassemblies. The majority of delegations consider this assembly operation to be origin conferring and propose a CTH rule or a VAR. The United States proposed a CTH rule except heading 8542 excluding that assembly of memory modules from integrated circuits is origin conferring. In the case of mounted semiconductors and unmounted semiconductors, the majority of delegations referred to the issue of diffusion.

Assembly of television receivers

This issue relates to the assembling of television receivers from cathode and tubes. The United States holds the view that these assembly operations are not origin conferring and that origin remains with the country of origin of the cathode ray tube. Other countries hold a CTH rule is sufficient while the EC proposes that a VAR is more appropriate.

Assembly of vehicles

The EC and other delegations hold the view that a VAR is the appropriate rule of origin:

"Manufacture where the increase in value acquired as a result of working and processing, and, if applicable, the incorporation of parts originating in the country of manufacture represents at least (45–60 percent) of the ex-works price of the product."

The United States and other delegations insist on a tariff shift approach:

"CTH, provided either the body, chassis, engine, transmission or steering system originates in the country of assembly."

Assembly of watches

The final issue concerns the assembly of watches. Switzerland and the EC hold the view that assembly, mainly represented by testing and adjustments, is an origin-conferring operation. On the other hand, Hong Kong, Korea, and the United States believe that, in the case of assembly of watches from movement, the origin is retained by the country manufacturing the movements.

The CRO chairperson's proposal in the July 2005 package was as follows:

- Processing movements into watches or clocks was to be considered a substantial transformation.

2.7. The Chairperson's Proposal on Machinery and Electronic Sectors

As mentioned in the preceding section the latest CRO chairperson's proposal[39] combines both the EC and the U.S. approaches. However, rather than leaving the option open to choose one of the alternative rules as in the former proposal rule 1 of the text provides that WTO members will have, at the time of the implementation of the HRO, to chose either the U.S. or the EC rules of origin approach for the machinery sector.

Column C in paragraph (b) contains the U.S. proposal and column D reproduces the EC proposal.

> **Rule 1: Scope of Application**
>
> (a) This Appendix sets forth rules for determining the country of origin of a good when the origin of the goods is not determined under Appendix 1.
>
> (b) In framing its legislation each member shall provide for the application of one of the optional primary rules of Chapters 84–90 referred to in either column C or D, which are set out at the levels of heading, split heading, subheading or split subheading, for it. Each member shall notify the CRO of its application within 90 days after the date of entry into force of this Annex, for it.

Contrary to the expectations of some delegations that hoped to find a compromise by adopting alternative rules of origin, it was concluded that for each product the alternative rules or origin could be adopted. However, such a choice has to be made once and for all at the time of implementation of the HRO.

This proposal combines with some minor adjustments the earlier U.S. and EC approaches. In the case of the U.S. approach, the following text has been excerpted with the relevant examples from an earlier proposal. It is basically identical to the current text's latest proposal of March 2007 but with a number

[39] Dated 8 March 2007.

of examples and comments in order to provide a full technical explanation on how the proponents of a pure tariff shift approach are solving some technical difficulties that may arise from the structure of the HS.

The first part of the current U.S. proposal is very similar to the preceding legal notes. In the following section, the whole text has been reproduced.

PRIMARY RULES FOR CHAPTERS 84–90 APPLICABLE TO PRIMARY RULES CONTAINED IN COLUMN C

1. *Limitations on change in classification rules in the matrix*.- Where satisfaction of the rules of this Chapter results solely from the following circumstances, origin shall be determined as indicated herein:

   Goods obtained by disassembly

   A change of classification which results from the disassembly of goods shall not be considered as the change required by the rule set forth in the matrix. The country of origin of the parts recovered from the goods shall be the country where the parts are recovered, unless the importer, exporter or any person with a justifiable cause to determine the origin of parts demonstrates another country of origin on the basis of verifiable evidence such as origin marks on the part itself or documents.

   Collection of parts

   Where a change in classification results from the application of HS General Interpretative Rule 2(a) with respect to collections of parts that are presented as unassembled articles of another heading or subheading the individual parts shall retain their origin prior to such collection.

   Recertification or retesting

   A change of classification which results from the recertification or retesting of the good shall not be considered as the change required by the rule set out in the matrix.

   Assembly of the collection of parts

   Goods assembled from a collection of parts classified as the assembled good by application of General Interpretative Rule 2 shall have origin in the country of assembly, provided the assembly would have satisfied the primary rule for the good had each of the parts been presented separately and not as a collection.

2. *Additional Primary Chapter Rule* – When Chapter Rule 1 does not apply and the other primary rules in this Chapter are not met in the last country of production, the following shall be applied in sequence:

a) *Parts and accessories produced from blanks*
   (1) The country of origin of goods that are produced from blanks which, by application of the HS General Interpretative Rule 2(a), are classified in the same heading or subheading as the complete or finished goods, shall be the country in which the blank was finished provided finishing included configuring to final shape by the removal of material (other than merely by honing or polishing or both), or by forming processes such as bending, hammering, pressing or stamping.
   (2) Paragraph 1 above applies to goods classifiable in provisions for parts or parts and accessories, including goods specifically named under such provisions, and to goods classifiable in headings 84.80 and 84.83.

b) When the good is produced from materials or components that changed classification but did not satisfy the primary rule applicable to the good, the country of origin of the good is the country that furnished all or the major portion of that material or component.

c) The following rules apply only to goods classifiable under provisions for "parts" or "parts and accessories" and which are not described by name in the Harmonized System, applied in sequence.

[Explanation: Chapter rule 2(C) is to be applied to parts and accessories which are not provided for by name in the Harmonized System. For example, it would not apply to subheading 8420.91 (which provides for cylinders which are classified as parts of rolling machines) but it would apply to 8420.99 (which provides for other non-enumerated parts of rolling machines). The rule also applies to goods assembled from kits.]

2. Goods produced by assembly of 5 or more parts (whether or not originating), other than parts provided for in rule 2(C)(3) shall have origin in the country of assembly.

[Explanation: Producing parts or accessories by assembling other parts will be an origin conferring event provided that (1) the assembly involves at least 5 parts and (2) operations other than those enumerated in Chapter Rule 2(C)(3) below are involved. Parts of general use and other parts referred to in Chapter Rule 2(C)(3) are not counted toward the requirements of this Rule.]

2. Goods produced as a result of processing non-originating components other than parts provided for in rule 2(C)(3) into a device or apparatus capable of performing one or more new mechanical or electrical functions shall have origin in the country of such processing.

[Explanation: Producing parts which have a mechanical or electrical function which was not present in the materials used in their production will be an origin conferring event provided that operations other than those enumerated in

Chapter Rule 2(C)(3) below are involved. Examples are attached as an annex to this document.]

3. The following parts shall not be counted for purposes of rule 2(C)(1) nor shall the operations described be deemed to result in a new mechanical or electrical function for purposes of rule 2(C)(2):
   (i) the attachment of machinery to a base;
   (ii) the installation of machinery or apparatus into cabinets or similar encasements;
   (iii) the attachment of parts of general use as defined in Note 2 to Section XVI of the Harmonized System or similar parts of plastic (Chapter 39);
   (iv) the attachment of handles, dials, knobs, hand cranks, and other consumer-operated controls;
   (v) the attachment of a power cord or change of mains voltage/frequency by adding transformer, adapter or converter;
   (vi) the installation of batteries, accumulators, sensors, thermostats or other articles not designed to become a permanent part of the good.

CHAPTER RESIDUAL RULES

For purposes of Rule 3(d) of Appendix 2 the following residual rules shall be applied in sequence:

1. For goods classifiable under provisions for "parts" or "parts and accessories" and which are not described by name, the country of origin shall be the country of assembly provided the goods are produced by the assembly of two or more parts (other than parts of general use, as defined in Note 2 to Section XV or similar parts of plastic (Chapter 39)), and one or more of the parts (other than parts of general use, as defined in Note 2 to Section XV or similar parts of plastic (Chapter 39)) satisfies the requirements for origin in the country of assembly. For purposes of this rule, the following parts shall not be counted nor shall the operations described be deemed to be origin conferring operations:

[Explanation: Producing parts or accessories by assembling 2 or more lesser parts will be an origin conferring event provided that (1) at least one of those parts had origin in the country of assembly and (2) operations other than those enumerated below are involved. This rule is to be applied only to parts or parts and accessories which are not provided for by name in the Harmonized System. For example, it would not apply to subheading 8420.91 (which provides for cylinders which are parts of rolling machines) but it would apply to 8420.99 (which provides for other non-enumerated parts of rolling machines).]

2. When the good is produced from materials originating in a single country that did not undergo the change in classification or did not otherwise satisfy the primary rule applicable to the good, the country of origin is the country in which those materials originated;
3. The country of origin shall be the country of origin of that [material] [functional element] that gives the good its essential character, to the extent to which the principle of essential character can be applied. Otherwise, the country of origin shall be the country in which the major portion of those materials originated, as determined on the basis of weight].

C. *Primary Rule: Legal Note for Subheadings 8471.50, 8471.60, 8471.70 and 8471.80*

For purposes of subheadings 8471.50, 8471.60, 8471.70 and 8471.80, the assembly of goods of those subheadings in the same housing with units of other subheadings within that group shall be origin conferring. (A slightly revised version of the U.S. proposal appears (without examples) in the latest consolidated version of the WTO Secretariat of May 2008.)

EXAMPLES OF PROCESSING COMPONENTS INTO A DEVICE OR APPARATUS CAPABLE OF PERFORMING A NEW MECHANICAL OR ELECTRICAL FUNCTION

1. Assembly of a video recording head for a video tape recorder (VCR) (8522.90) from the following 4 components:

   Base (8522.90)
   Printed circuit (8534.00)
   Head chip (8522.90)
   Head wire (8544.11)

   Origin would be conferred on the country of assembly because the assembled head would have a new electrical function, e.g., converting variations in electrical current flow into a fluctuating magnetic field for video recording on magnetic tape.
2. Assembly of a plasma display panel for a plasma display unit of an automatic data processing machine (8473.30) from the following 3 components (Issue No. 32):

   Back panel (8473.30)
   Front panel (8473.30)
   NeXe gas

   Origin would be conferred on the country of assembly because the assembled panel would have a new electrical function, e.g., converting an electrical current flow into electromagnetic energy in the visible light spectrum.

3. Assembly of a blade assembly unit for an electrical, hand operated, hedge trimmer (8508.80) from the following components:

   Top plate (8508.90)
   Cutting blade (8208)
   Base plate (8508.90)
   Parts of general use

   Origin would be conferred on the country of assembly because the assembled unit would have a new mechanical function, e.g., converting horizontal motion into a shearing force.
4. Assembly of an impeller plate for a kitchen waste disposer from the following components:

   Impeller plate (8509.90)
   Impeller arm (8509.90)
   Impeller arm cushion (8509.90)
   Parts of general use

   Origin would be conferred on the country of assembly because the assembled unit would have a new mechanical function, e.g., using centrifugal force to move the food waste from the center of the disposer chamber to the outside of the chamber where it forces the waste against the shredder ring.

The EC proposal: Value-added approach

The value-added approach is preferred by the EC and some other delegations. In spite of the definition of "value added," the way of calculating is based on a formula that is obtaining the value added by subtraction. According to a former submission the value added according to the proponent is calculated as follows:

> *the ex-works price of the product obtained minus the value of all the non-originating materials (customs value for imported materials or ex-works price for the other materials).*

Such a way of calculating the value added by subtraction is consistent with the usual practice in the EC preferential rules of origin. However, considering the draft text of the proposal below, the calculation formula does not appear to be straightforward and clear in comparison with the formula utilized by the EC in its preferential rules of origin.[40] Moreover, it is rather surprising to see that the EC makes reference to a concept of value added at a time when, as

[40] Compare with the formulas contained in Chapter 3.

examined in Chapter 5, drafting rules of origin, the rest of the world (led by the United States) is moving away from such a methodology in drafting rules of origin. This is even more surprising considering that the EC seldom used value added as an across-the-board criterion in spite of the fact that a proposal was made to use such an approach in the GSP preferential rules of origin in the context of the Green Paper examined in Chapter 6.

Looking at the product-specific rules for the machinery it may noted that in the large majority of cases the product-specific rules provides for a CTH or a 35 percent VAR. In other cases a CTH with exception and a 35 percent value-added requirement is required. In a few cases a CTH is required with no alternative. In the case of motor vehicles a 35 percent or 45 percent of value added is required.

The fact that there are no major differences in the level of the percentages of value-added required contradicts some assumptions made in earlier discussions. A previous negotiating text reported as possible levels of percentages of value added the following:

Electronics:	25%
Electromechanical:	30%
Mechanics:	40%
Commercial vehicles:	40%
Passenger cars:	45–50%

Alternative rules for the same product are also featured in the EC preferential rules but these rules appear more refined in their approach than the widespread use of the CTH or 35 percent made in the product-specific rules of the HRO. There are some specific cases in which the approach has been different, as in the case of ball bearings for which specific processing is required. In some cases, such as for TV sets, only the 45 percent value added is required.

Here below the complete text of the EC proposal has been excerpted:

D. PRIMARY RULES FOR CHAPTERS 84–90 APPLICABLE TO PRIMARY RULES CONTAINED IN COLUMN D

(a) *Application of the value added rule*

The term "**x% value added rule**" shall mean manufacture where the increase in value acquired as a result of working and processing, and if applicable, the incorporation of parts originating in the country of manufacture represents at least x% of the ex-works price of the product. "X" is the percentage indicated for each heading.

The term "**ex-works price**" shall mean the price to be paid for the product obtained to the manufacturer in whose undertaking the last working or processing is carried out (this price shall not include internal taxes which are, or may be, repaid when such product is exported);

The term "**value acquired as a result of working and processing and incorporation of parts originating in the country of manufacture**" shall mean the increase in value resulting from the assembly itself, together with any preparatory, finishing and checking operations, and from the incorporation of any parts originating in the country where the operations in question were carried out, including profit and the general costs borne in that country as a result of the operations;

The term "**value of non-originating materials**" means the customs value at the time of importation of the non-originating materials used, or, if this is not known and cannot be ascertained, the first ascertainable price paid for the materials in the country of importation.

(b) *Change in classification*

2.6.1. Goods obtained by disassembly

A change of classification which results from the disassembly of goods shall not be considered as the change required by the rule set forth in this Appendix. The country of origin of the parts recovered from the goods shall be the country where the parts are recovered.

2.6.2. Collection of parts

Where a change in classification results from the application of HS General Interpretative Rule 2(a) with respect to collections of parts that are presented as unassembled articles of another heading or subheading the individual parts shall retain their origin prior to such collection.

2.6.3. Recertification or retesting

A change of classification which results from the recertification or retesting of the good shall not be considered as the change required by the rule set out in this Appendix.

2.6.4. Assembly of the collection of parts

Goods assembled from a collection of parts classified as the assembled good by application of General Interpretative Rule 2 shall have origin in the country of assembly, provided the assembly would have satisfied the primary rule for the good had each of the parts been presented separately and not as a collection.

(c) *Parts and accessories produced from blanks*

The country of origin of goods that are produced from blanks which, by application of the HS General Interpretative Rule 2(a), are classified in the same heading or subheading as the complete or finished goods, shall be the country in which the

blank was finished provided finishing included configuring to final shape by the removal of material (other than merely by honing or polishing or both), or by forming processes such as bending, hammering, pressing or stamping.

Paragraph 1 above applies to goods classifiable in provisions for parts or parts and accessories, including goods specifically named under such provisions, and to goods classifiable in headings 84.80 and 84.83.

(d) *Application of Residual Rule 3(f) of this Appendix – major portion rule*

For the purposes of Chapters 84–90, the criterion used to determine the major portion of the materials as set forth in Rule 3, (f) of this Appendix is their value.

2.8. Trade Policy Implications of the HWP on Rules of Origin and Other WTO Agreements: The Issue of "Equally all Purposes"

At the earlier stages of negotiations in the TCRO, trade policy considerations were not openly discussed. However, possible implications and trade policy effects of the harmonized set of rules of origin were already the subject of debate and considerably influenced the positions of WTO members.

Article 1 and Article 3(a) of the ARO clearly lay out that, on implementation of the HWP, WTO members shall "apply rules of origin equally for all purposes as set out in Article 1."

The fact that the harmonized set of nonpreferential rules of origin must be applied in the context of several WTO Agreements has resulted in profound repercussions and implications on the slow pace of the negotiations because this provision contradicts prior practices of some WTO members and/or simply represents a novelty for the majority of developing country WTO members. For instance, only 42 WTO members have so far notified to have nonpreferential rules of origin while 41 have notified not to have such rules.[41]

WTO members referred to the issue of "equally all purposes" mentioned in Article 3(a) of the ARO as "the implication issue."[42]

In fact, the application of origin rules may have various unexpected and unintended implications in a number of areas. If these areas are multiplied for the numbers of products-specific rules and the various possible origin outcomes the result of such combination is likely to be of the order of infinite and to a

[41] See WTO document G/RO/W/92.
[42] See further details in this section.

certain extent unpredictable. In many instances, especially for the agriculture and processed foodstuffs sectors, origin may be attributed to another country as a result of relatively simple processing, with implications for measures such as tariff quotas or the application of SPS measures. If origin is conferred on a certain manufacturing or processing operation, this may have implications for the likelihood of triggering contingency protection measures. For example, if a rule of origin is considering manufacturing of shoes from shoe parts as an origin-conferring operation, this may have different implications for the application of contingent protection measures, depending on the structure of the industry. For instance, if assembly is carried out in many different countries, such a rule will spread the production of "originating shoes" across many countries. Conversely, let's suppose that origin rules for shoes require that origin depends on specific manufacturing operations such as the making of shoe uppers. Suppose also that, given the structure of the industry, only a few specialized industries carry out such manufacturing, the final result will be that from an "origin point of view" the production of shoes may become more concentrated in one or more countries manufacturing shoes with uppers, possibly facilitating the targeting of contingency protection measures. Depending on production and industrial strategies, industries will have different incentives in lobbying for different rules of origin requirements.

To give another example, if a country is a big producer and exporter of cotton fabrics – commonly a "sensitive product" subject to trade contingency measures – it may have an interest in ensuring that printing or dyeing are origin-conferring operations. In that case, all cotton fabrics exported from this country to third countries for printing or dyeing will obtain the origin of that country once reexported from these counties to the country of final destination. In this manner, the fabric-producing country's exports will be spread and less concentrated, possibly reducing the threat that exports of cotton fabrics will trigger trade contingency protection measures. Conversely, if printing or dyeing are not considered as origin conferring – even if these operations are carried out in third countries – this will have no effect in terms of the origin determination of the fabric and all fabrics will result in the country where the fabric first originated.

For years another issue concerning the filleting of fish occupied both the TCRO and the CRO. On one hand, discussions turned around the technical issue whether turning a live fish into a "flat" fillet should be considered as substantial transformation because it may be doubling its value. On the other hand, discussions showed that some members feared implications that go beyond origin matters arising from such a rule. In particular, concern was expressed over the functioning of some regional fishery management methods

and quota mechanisms and the possibility of circumvention by changing the origin of the fish in a third country through the filleting operation. In fact, the concern was motivated by the fact that not all fishing countries are part of such regional fishery management organizations. Some of these countries, however, tend to fish also protected species such as tuna in a protected area. The consequence is that the countries, which are parties of such fishery management organizations, ban the fish from such third countries from being imported into their country.

The concern of the members of such organizations was that through the filleting process in another country, the banned fish could change origin and circumvent such ban nullifying the efforts of management and conservation of the stocks. Consequently, these countries, since the beginning of the negotiations, held that the filleting should not be considered a substantial transformation.

In some other cases, countries may be interested in "obtaining" origin even if the amount of working and processing is minimal. This can occur in the case of agroprocessing and foodstuffs. For instance, in the discussion of the Technical Committee, one delegation argued that drying and seasoning of imported meat was an origin-conferring operation. The domestic industry involved sold a dried meat product in the domestic market that usually fetched high prices, given consumer perceptions that this product had a distinct character. Traditionally, the meat used also originated in a particular region of that country; however, more recently local manufacturers have begun to utilize imported meat. If this processing conferred origin, the dried and seasoned meat obtained from imported fresh meat could legitimately be sold as originating from the region. Therefore, domestic producers of dried and seasoned meat could utilize cheaper imported meat while retaining origin and labeling of high-quality regional products.

In other cases, a country may have an interest in "retaining" origin even if the exported product is processed in a third country before being sold to consumers. For example, Colombia argued in the TCRO that the processes of decaffeinating and roasting were not origin-conferring operations, whereas the United States, EC, and Japan hold the opposite view. If roasting and decaffeinating is considered as origin conferring, the majority of Colombian coffee roasted or decaffeinated in the United States and the EC could be marketed as U.S. and EC products. This in the eyes of Colombian delegation could severely diminish the image value and marketing potential of Colombian coffee as a quality product with a distinct character and taste.[43]

[43] In this specific case, it appears that Café de Colombia is a private trademark owned by a private federation.

In summary, a major issue for countries to decide on HRO is to "lose," "retain," or "obtain" origin. The difficulty is that this must be done by product or by categories of products, and the best rule for each country may depend on industrial base or industrial strategy considerations at the global level.

Another issue concerns the relationship between the compilation of trade statistics and the HRO. Applying the same origin rules for both statistical and customs purposes is almost unprecedented in world trade. In the majority of cases, import statistics are classified according to the country of origin indicated in the invoice. This is, for the most part, the country of exportation and not necessarily the origin of the goods for customs purposes. Moving toward greater consistency between customs origin rules and collection of trade statistics could have major implications for the measured magnitude of trade flows and trade balances.

In the case of trade contingency measures, WTO Agreements such as AD, subsidies, and countervailing and safeguarding all *de minimis* threshold are based on import volume measures on trade statistics. A change of the methodology to collect statistics may have direct implications on the triggering mechanisms of these latter provisions.

THE SUBSTANTIAL ECONOMIC BENEFIT CRITERIA, GLOBALIZATION AND TRADE STATISTICS

A press report outlined a relevant case, which combined the issues of origin criteria, globalization of production, and trade statistics.

A Barbie doll is for sale in a shop in the United States in a box labeled "made in China," at a price of $9.99. By means of deduction, the writer of the report has been able to establish that, through multicountry processing utilizing different intermediate inputs, China is the country of origin of the Barbie doll. U.S. Customs hold the same view. However, it has been found that, out of the $9.99 retail price, China's "substantial economic benefit" is only about 35 cents. The tracing back of the manufacture of the Barbie doll has made possible the following cost analysis:

Retail price	$9.99
Shipping, ground transportation, marketing, wholesaling, retailing, and profit	$7.99
Export value from China	$2.00

The export value may be further broken down into the following country figures:

Overhead and management (Hong Kong, China)	$1.00

Intermediate materials:	
Nylon hair (Japan), vinyl plastic (Taiwan Province of China), packaging (United States), oil to produce vinyl plastic (Saudi Arabia), other (China)	$0.65
Labor (China)	$0.35

Because China is the country of origin, it is charged an export value of $2.00 in trade statistics, whereas the economic benefit deriving from it is just 35 cents. According to U.S. Customs, toys imported from China in 1995 totaled $5.4 billion, about one-sixth of the 36.2 billion of the total United States trade deficit. China, however, contends that these U.S. trade figures are distorted because they take into account neither economic reality nor the value-added operation carried out in Hong Kong, China, and other intermediate processing or shipping operations. Thus, in 1995, the U.S. Commerce Department put the U.S. trade deficit at $3.8 billion, whereas China said it was $8.6 billion.

In this multicountry production chain, the U.S. Mattel holding corporation is estimated to make $1.00 profit on each Barbie doll and most of the Barbie doll cost of $ 9.99 is estimated to be accumulated in the United States. This finding seems to contradict the fear of job losses often raised in some U.S. trade policy statements.

The Barbie doll case provides a valuable example of the results of a reverse engineering analysis. It reveals the chain of production and the substantial economic beneficiaries. At the same time, it provides an example of the difficulties of origin determination and its suitability for trade statistics calculations. On the basis of these findings, some analysts have started to put forward the idea of investigating the origin of the company rather than the origin of the goods produced. However, given the current trend of mergers, acquisitions, and joint ventures, this may prove as difficult as in the case of goods. (R. Tempest, Times London, 22 September 1996)

As illustrated, there is a strong link between customs origin and marks of origin that are aimed at informing consumers of a product's country of origin. The issue of the relationship between mark of origin (how a finished product is to be labeled before being marketed to final consumers) and origin for customs purposes is addressed in Article IX of GATT 1994. A change of the country of origin will also imply a change in the mark of origin. This can have important consequences on consumer choices, especially where brand names or certain quality goods are commonly identified with certain countries. Environmental or humanitarian concerns may influence consumer choices toward products from countries that are recognized as respecting human rights, labor laws, or environmental treaties. Although the globalization of production has rendered outdated the notion that a product is wholly produced and obtained in a

particular country, consumers may still identify certain quality products with specific geographical regions or countries.

Finally, environmental concerns and recycling industry considerations have entered into the negotiations when the origin of waste and scrap, parts recovered from waste and scrap, and used articles have been discussed. The question revolves around the country to which origin should had been allocated: The country that produces the waste and scrap, has produced the article from parts that have been collected or where the article has been used, or the country that reutilizes these goods? Depending on origin allocation, developing countries are deeply concerned with being classified into different categories.

Allocating origin to the collecting of parts could be a potential incentive to locate recycling or hazardous industries in developing countries. Other concerns could be linked to the fact that used articles might be competing with domestic products in developing countries. Overall, there may be differing perceptions of what is considered to be waste and scrap or used articles in an industrialized country and in a LDC. For example, the average commercial life of a computer in industrialized countries is estimated at two to three years, whereas in a developing country context a computer of that age may still have substantial commercial value.

All these concerns are replaced with a definitive ruling. It was agreed that scrap and waste,[44] derived from manufacturing or processing operations or from consumption in a country and fit only for disposal or for the recovery of raw materials, shall be considered wholly obtained in that country. Namely, the country that produces the waste retains origin.

Avoiding the danger of locating recycling or hazardous industries in a developing country, the rules on collected stuff refer solely to articles, and not to parts. The goods, which can no longer perform their original purpose nor are capable of being restored or repaired and are fit only for disposal or for the recovery of parts or raw materials, are considered wholly obtained in the country where they are collected.

Parts or raw materials from articles, which can no longer perform their original purpose nor are capable of being restored or repaired, are considered as originating in the country where they are recovered.

[44] It is specified that waste and scrap mean materials resulting from manufacturing or processing operations or consumption in the same country, scrap machinery, discarded packaging, household rubbish, and all products that can no longer perform the purpose for which they were produced, and are fit only for discarding or for the recovery of raw materials. Such manufacturing or processing operations include all types of processing, not only industrial or chemical but also mining, agricultural, construction, refining, incineration, and sewage treatment operations. See Overall Architecture in Integrated Negotiation Text for the Harmonization Work Programme. G/RO/45/Rev.1, 30 April 2001.

A proposal, originally presented by the United States, is to apply these rulings to Appendix II – product-specific rules of origin. At the same time, particular attention has been given to Chapter 84 of the HS dealing with machinery. Concern is related to the origin of a collected, recovered, or disassembled part or a removed article, thus covering parts or articles that are not subject to the definition of the wholly obtained goods.

Even if it is stated as general rule that disassembly is not an origin-conferring event, the country of origin of a disassembled or recovered part or a removed article shall be the country where the parts are recovered, unless the importer, exporter, or any person with a justifiable cause to determine the origin of parts demonstrates another country of origin on the basis of verifiable evidence such as origin marks on the part itself or documents. The second part of the rule appears to be intuitive: Given a recovered part that clearly shows a mark of origin – for example, a car engine labeled as made in Italy – there is no reason to give a new origin to the country where the part has been recovered.

In general, it may be observed that, at a product-specific level, the preliminary outcome of negotiations has been, given their technical nature, mostly industry driven. Most unresolved issues were so because of the different views held by domestic industries on what kind of processing should be treated as "substantial transformation." Most domestic industries have tended to defend their case by arguing that the working or processing they carry out on their premises is a substantial transformation and deserves origin. Moreover, there may be genuine technical problems in determining origin or difficulty in understanding processing using new technology.

Because many similar issues were on the table for several years, slowing considerably the pace of the negotiations, one of main issues that WTO members had to consider was to decide if they wanted to take care of such considerations utilizing rules of origin or if they could solve the problem using other trade policy instruments.

2.8.1. *Negotiating Issues and Proposals on the Implications of HWP on Other WTO Agreements*

The implications of the rules of origin on other WTO Agreements was first openly raised in 1998 in a submission from India, other developing countries, and the United States.[45] The latter submission openly unveiled, with a series of illustrative examples, the possible implications of the application of the ARO, on a series of agreements such as the ATC, marks of origin, trade-related

[45] For more information, see WTO documents: G/RO/W/42, G/RO/W/48, G/RO/W/50, and G/RO/W/65.

aspects of intellectual property (TRIPs), SPS, and so on. It was noted that such implications affected the flexibility of members in attaining consensus on a number of issues because there were concerns as to how to maintain integrity of certain trade policy measures or regimes affecting particular products or product areas.

The United States suggested that one possible solution to this impasse was to agree on a common interpretation on the future obligation of applying rules of origin "equally for all such purposes," which does not necessarily entail that members have "to use rules of origin for all such purposes." Undoubtedly, for some members this kind of "à la carte menu" may facilitate the creation of a consensus, however, for other members this flexibility may greatly diminish the value of the whole HWP exercise because it will impair the legal certainty and predictability that the whole agreement was designed to play in the absence of multilaterally agreed rules. As examined in Section 2.6, under one of the most recent draft of General Rule 1 concerning the scope of application, it appears that members would be left free to select for which "commercial policy instruments" they will use the results of the HWP for origin determination. (A later draft does not even mention such a rule.)

Developing countries, especially the least developed among them, may find some attraction in such a proposal because it may be understood as relieving them from part of the obligations arising from the ARO and the implementation burden. As earlier stated, the results of the HWP may turn out to be complicated to implement for developing countries and burdensome to apply for their customs administration.

However, one must recall that, in any case, even if they decide to "opt out," exports originating in developing countries will remain subject to the disciplines of the HWP when shipped to those WTO members accepting to apply the ARO in its entirety. Thus, the choice to apply or not to apply the results of the HWP to some commercial policy instruments is in reality limited to the importing side and to national legislation. Ultimately, exporters and producers will remain concerned by the implications of the HWP on other WTO Agreements in the importing countries that are implementing the results of the HWP according to their own priorities and trade interests. Thus the largest importers, such as the United States and the EC, will be likely to determine the extent of such implications.

An earlier alternative way to proceed that was mentioned in the U.S. submission was to conduct an examination of the possible implication of the HWP on other WTO Agreements through communication with all other WTO bodies responsible for matters outlined in Article 1 of the ARO. Although this approach may appear theoretically more correct, it was later found to further limit the possibility to conclude the HWP work in a realistic time frame

given the amount of implications and the degree of complexity of the issues involved.

A submission by Brazil made on 7 October 2002[46] focused on the implication issue and a possible resolution. Recalling the background of the discussions starting in 1998, Brazil reiterated the principles laid down in Article 3(a) and Article 1 of the ARO and recollected the broad understanding in the CRO as follows:

(a) "Members have undertaken to apply rules of origin equally for all purposes (Article 9(a) of the ARO).
(b) Article 1.2 of the ARO limits itself to providing an illustrative list of situations in which, whenever rules of origin are used, the harmonized rules of origin shall be applicable.
(c) It is up to Members to decide, in light of their commitments deriving from other WTO agreements, whether a determination of origin is a mandatory requirement in a particular instance.
(d) In all such instances where a determination of origin is a mandatory requirement as well as in those instances in which a Member autonomously decides to undertake a determination of origin, the harmonized rules of origin annexed to the ARO (once concluded) shall be applied.
(e) It is the responsibility of relevant bodies of the WTO to decide if an interpretation of the respective Agreement is required regarding the instances where a determination of origin is mandatory.
(f) Such an understanding in no way precludes the rights of Members to adopt laws, regulations or administrative determinations that go beyond the specific determination of origin according to the harmonized rules of origin, so long as such actions are consistent with their rights and obligations deriving from other WTO agreements; Members will always retain the right to exercise their rights regarding the manner in which another Member has implemented its commitments."

According to this understanding, the implementation of the ARO is the responsibility of each member. The member must also decide if a determination of origin is a mandatory requirement in a particular issue (i.e., in the application of another agreement). If the member decides that such a requirement exists or decides singularly to use nonpreferential rules of origin, then the HRO should be used.

[46] See WTO document G/RO/90 or WT/GC/W/479.

Brazil also addressed the issue of rules that go further than the rules of origin. Such measures are permitted as long as they are consistent with the obligations derived from the other WTO Agreement, such as with SPS measures.[47]

If a member feels that other agreements are unclear on whether to apply rules of origin or not, the Brazil proposal suggested that it is the responsibility of the relevant WTO bodies to decide whether an interpretation of other agreements is necessary. In the final analysis, only the Ministerial Conference is empowered to interpret WTO Agreements.

The last statement in the proposal by Brazil indicates that members will always be able to exercise their rights regarding the manner in which another member has implemented its commitments. The clause is certainly not revolutionary, but even if a member believes it is correctly applying WTO Agreements, another member disputing the interpretation about the correctness of the implementation of rules of origin could still challenge it. The normal dispute settlement procedure would then take place.

Apparently several delegations appreciated Brazil's efforts and suggestions to solve the issue of implications. However, they found that the solution to add a single phrase in General Rule 1[48] would be insufficient to incorporate all concerns.

Despite different attempts at the General Council (GC) level, one solution is to leave with WTO members the discretion to choose and notify the CRO of the commercial policy instruments that will be using the HRO.

Australia and New Zealand also participated actively in the debate and expressed their concern on a former CRO chairperson's implications proposal subsequently discussed that was formulated as follows:[49]

Paragraph 2 of General Rule 1:

> Rules of Origin provided in this Annex shall be applied equally for the purposes set out in Article 1, paragraph 2 of the Agreement on Rules of Origin, whenever a Member is required, or in the absence of such a requirement voluntarily decides, to determine the country of origin of a good in the application of an agreement set out in Annex 1A of the WTO Agreement. However, the Rules of Origin in this Annex shall be without prejudice to Members' rights and obligations in respect of the application of non-preferential commercial policy instruments.

47 See also point 2.8.4 hereafter.

48 General Rule 1 in the Annex to the ARO would then read: "Rules of Origin provided in this Annex shall be as defined in article 1, paragraph 1, of the Agreement on Rules of Origin annexed to the Agreement Establishing the World Trade Organization (WTO). Such Rules of Origin shall be applied equally for all purposes as set out in article 1, paragraph 2, of the Agreement on Rules of Origin and in a manner consistent with the rights and obligations derived from the relevant agreements of the WTO."

49 See WTO document JOB(03)/132.

Australia and New Zealand observed that the first sentence can be better explained by way of an example, such as the Antidumping Agreement (ADA). The ADA provides that a member can either use "country of origin" or "country of export" to determine origin. In this case, a member could choose to use the "country of export" criteria, avoiding the need to use harmonized rules. However, there may be cases (possibly one in which a good is transshipped through a third country or not produced in the country of export) that the member would have to use the "country of origin" criteria. In that case, they would have to use the harmonized rules.

The main target of the Australia and New Zealand comments was the second sentence. They found that it was unclear what the second sentence means. "Rules of Origin used in nonpreferential commercial policy instruments" are defined in Article 1 (para. 2) of the ARO to include the application of MFN, National Treatment, Schedules of Concession, Marks of Origin, Quotas, AD, Countervailing duties, and Safeguards Measures. The second sentence could be read to exclude certain measures from the scope of the ARO. Australia and New Zealand questioned whether it would mean that even where a member chooses, or is required, to determine origin, e.g., to use the "country of origin" criteria in the ADA, the HRO do not have to be used.

Finally, Australia and New Zealand rightly pointed out that the second sentence could give members too much flexibility to choose how they apply the harmonized rules. In their view it also conflicted with the first sentence in the proposed text and with Article 1, paragraph 2, of the ARO.

A suggestion was made to either delete the second sentence or amend it to reflect the original wording of Brazil's proposal, including Australia's suggested amendment, that is, "in a manner consistent with the rights and obligations derived from the WTO Agreements." The second sentence of paragraph 2 would therefore read

> The Rules of Origin in this Annex shall be applied in a manner consistent with the rights and obligations derived from the WTO Agreements.

The Brazil proposal and the Australian and New Zealand comments and suggestions appeared in the latest revision of the chairperson's proposal of April 2006.[50]

The most recent draft of General Rules 1 circulated in February 2007 and May 2008 has been discussed in subsection 2.5.2. No solution was in sight on the implication issue during the CRO meeting of October 2008.

[50] JOB(03)/132/Rev.11 of 5 April 2006.

2.8.2. *Possible Implications on the Agreement on Implementation of Article VI of the GATT 1994: "Antidumping Agreement"*[51]

The first cases in which the absence of multilateral disciplines on nonpreferential rules of origin started to attract the attention of policy makers and analysts occurred in the 1980s in connection with the enforcement of AD duties and other trade contingency or protectionist measures.

The emergence of the AD law as one of the most important trade policy instruments during the 1980s and 1990s has largely been responsible for the growing attention to the use of rules of origin as commercial policy instruments that could influence the interaction between the internationalization of production and its location. Imposition of AD duties coinciding with increasing globalization of production created the first tangible relocation cases of certain companies in strategic markets such as the EC and the United States. Claims by the EC and U.S. domestic industries regarding the establishment of screwdriver factories on their territories led the two jurisdictions to adopt anticircumvention legislation in the 1980s.[52]

AD proceedings are normally initiated at the request of a complainant domestic industry against products originating in a certain country. Thus a normal AD procedure requires that, other than findings relating to dumping and injury, the investigating authorities determine the origin of the product exported from the third country. However, the investigating authorities do not always consistently do this.[53]

On the other hand, it may be expected that the origin of the product of the domestic industry that filed the complaint will be examined as well. However,

[51] For a pioneering study in the area that has largely inspired this section, see UNCTAD publication: "Globalization and The International Trading System: Issues relating to rules of origin" (UNCTAD/ITCD/TSB/2, 24 March 1998); "Rules of Origin in International Trade: A Comparative Study" by E. Vermulst, P. Waer, J. Bourgeois, 1994, University of Michigan Press; and Inama and Vermulst in "Anticircumvention and AD Proceedings" in P. Mavroidis, forthcoming.

[52] See, for the U.S. legislation, Pub. L. No. 100-418, § 1321, 102 Stat. 1192, adding § 781 to the Tariff Act of 1930, as amended, 19, USCA § 1677j. For an analysis of the U.S. anticircumvention measures, see N. Komuro, "US anti-circumvention measures and GATT rules," *Journal of World Trade*, vol. 28, no. 3, June 1994. For the EC legislation on anticircumvention, see, as originally adopted, Council Regulation 1761/81 of 22 June 1987, O.J. 2167 [1987]. For a detailed discussion of EC AD and the anticircumvention measures, see E. Vermulst and P. Waer, *EC Anti-Dumping Law and Practice*, Sweet and Maxwell, 1996.

[53] The WTO ADA does not indicate this requirement clearly in its Article 9(2). In a specific AD case involving small-screen color televisions from the Republic of Korea, the European Community Commission opted for the country of production rather than the country of origin. See O.J. L.324/1 [1990] (provisional); O.J. L.107/56 [1990] (definitive). An illustration of this case is provided in Vermulst and Waer, op. cit.

proof of domestic industry origin is generally not required of the complainant on the part of the domestic industries. Article 4 of the Uruguay Round ADA (definition of domestic industry) does not require that, in order to file a complaint, domestic producers manufacture originating products.[54] Hence, a double standard is applied where origin is examined as regards exports of allegedly dumped products but not as regards the local industry filing the complaint. On the other hand, domestic industries complain about dumping of products from country A while simultaneously importing parts to manufacture the same product. In certain AD proceedings instituted by the EC during the 1980s, this question arose in realistic terms. Especially in the photocopiers case and others,[55] the EC investigating authorities found out that, under EC Rules of Origin, certain models of photocopy machines consisted of parts imported from Japan. However, because the factory in question was planning to increase the community content, the issue was dropped.

From a legal point of view, the basic problem of anticircumvention measures is the absence of multilateral agreed rules and the resulting unilateral discretionary practices of the investigating authorities. Until recently, neither the United States nor the EC – the main users of such measures – had codified detailed nonreferential rules of origin. Moreover, they sometimes applied

54 See Article 4 of the WTO ADA for the definition of domestic industry.

55 In the photocopiers, outboard motors, video cassette recorders, small-screen color televisions, dynamic random-access memory, and erasable programmable read-only memory cases, the EC Commission had to examine the position of certain EC producers and the position of manufacturing bases in the EC owned by or having links with producers under investigation for injurious dumping. In particular, during the photocopiers case investigation, the Commission had to examine the position of Rank Xerox, which was one of the complainants. The origin determination carried out by the Commission revealed that at least in one factory most parts of the photocopiers originated in Japan and to a lesser degree in the Community. Nevertheless, and taking into consideration factors not related to origin determination such as "long-standing manufacturers in the Community," etc., the Commission accepted Rank Xerox as domestic producer. For a deeper analysis see P. Waer "Rules of Origin in International Trade," in E. Vermulst, P. Waer, and J. Bourgeois (eds.), Ann Arbor University of Michigan Press, 1994. For the specific investigations see "Outboard motors from Japan" [1983] O.J. L152/18 (provisional); Plain paper photocopiers from Japan [1987] O.J. L54/12 (definitive); Video cassette recorders from Japan and Rep. of Korea [1088] O.J. L 240/5 (provisional); Small-screen color televisions from Rep. of Korea [1990] O.J. L 107/56 (definitive); Dynamic random access memories from Japan [1990] O.J. L 193/1 (definitive); erasable programmable read-only memories from Japan [1991] O.J. L 65/1 (definitive). In the U.S. context, see, for instance, Brother Industries v. US, No. 91-11-00794 (slip. op 92-152) [1992], where the U.S. Court of International Trade reversed a determination of the Department of Commerce that Brother lacked standing to file an AD complaint. On this latter case, see Palmeter in Vermulst, Waer, and Bourgeois, op. cit.

different tests of origin depending on the trade instruments within which the origin determination had been carried out.

For example, in U.S. practice, the origin of semiconductors determined by the Commerce Department in the context of AD proceedings was different from that determined by the U.S. Customs Service.[56] Codification of nonpreferential rules was rare or absent in EC legislation until the entry into force of the common customs code in 1992. Even then such codification was incomplete. Only after the progress made in the HWP did the EC started to apply a consistent policy on nonpreferential rules of origin, adopting on a *de facto* basis the preliminary results of the HWP. Before these developments the EC Commission investigations used to rely on a rule of thumb of a 45 percent value-added test.[57] This, however, did not prevent the EC authorities from developing ad hoc rules on assembly products for which the circumstances of the case required, as was arguably the case for ball bearings,[58] photocopiers,[59] and semiconductors.[60] The draft ADA of the December 1991 Draft Final Act (referred to as the "Dunkel Draft"[1]) contained detailed provisions on circumvention. However, the U.S. negotiators were of the opinion that they were "weak" and succeeded in deleting these provisions from the final ADA.

The Draft was replaced with a Ministerial Decision that recognizes the "problem" of circumvention and the desirability of having uniform rules on anticircumvention as soon as possible. The Decision referred the matter to the Committee on Anti-Dumping Practices for resolution.

The United States and other WTO members held that the Ministerial Decision constitutes recognition of the legitimacy of anticircumvention measures

[56] See Palmeter "Rules of origin in the United States" in Vermulst, Waer, and Bourgeois, op. cit., p. 74, and the following decision in which Customs concluded that assembling and testing conferred origin on a semiconductor: C.S.D. 80-227, 14 Cust. b & Dec. 1133 (1980). In the following case, the Commerce Department decided that, for AD purposes, assembling and testing did not confer origin: Erasable Programmable Read-Only Memories (EPROMs) from Japan; Final determination of sales at less than fair value, 51, Fed. Reg. 39680, 39692 (1986). See also D. Palmeter, "Rules of origin or rules of restrictions: A commentary on a new form of protectionism," *Fordham International Law Journal*, vol. 11, no. 1, 1987.

[57] See E. Vermulst and P. Waer, "European Community rules of origin as commercial policy instruments?," *Journal of World Trade*, 1990.

[58] See Commission Regulation (EEC) No. 3672/90 of 18 December 1990 on determining the origin of ball, roller, or needle roller bearings, O.J. L 356 [1990].

[59] See, for instance, Commission Regulation 2971/89 of 11 July 1989 on determining the origin of photocopying apparatus [1989], O.J. L 196/24.

[60] See Commission Regulation (EEC) No. 288/89 of 3 February 1989 on determining the origin of integrated circuits, O.J. L 33 [1989].

and does not preclude members from maintaining, modifying, or enacting anticircumvention measures.

In the aftermath of the Uruguay ARO it was considered and hoped that the results of the HWP could be used to satisfactorily address the issue of anticircumvention. As the ARO expressly provided that the results of the HWP would be used in the context of AD proceedings, the HWP could be consistently used to determine if a product exported via a third country is truly originating in that country or if it has been exported via that third country only to circumvent the AD duty.

Some countries make large use of AD procedures to protect their own industries from competition. As pointed out by the United States[61] according to the Secretariat, 36 members have notified they do not have nonpreferential rules of origin.[62] Although many of these same members are known to utilize AD measures, it would appear that rules of origin are not being used for such measures – given that these members have notified that they do not have nonpreferential rules of origin. These members, many of which are active in the HWP, are likely to support the adoption of the latest formulation of rule I on the scope of application to maintain their discretional practices in AD proceedings.

Moreover, the Republic of Korea[63] argues that AD measures are based on the concept of "exporting country" rather than "origin country." To calculate the dumping margin, derived from the difference between export price and normal price, the domestic price of the like product in the exporting country is used as the normal price. Only in the exceptional cases referred to in Article 2.2 and in Article 2.5 does the country of origin play a role in the ADA. The first case (Article 2.2) refers to a situation in which there are no sales of the like product in the ordinary course of trade in the domestic market of the exporting country or low level of sales in domestic market of the exporting country is not appropriate to be used for normal price. In such cases, the origin country of that product is meaningful. The second case (Article 2.5) refers to a situation in which products are imported through an intermediate country (exporting country). If the products are merely transhipped, or such products are not produced in the exporting country, or there is no comparable price for them

[61] See WTO document G/RO/W/65, Implications of the implementation of the HRO on other WTO agreements.

[62] See WTO document G/RO/W/73, Committee on Rules of Origin – Draft – Seventh Annual Review of the Implementation and Operation of the Agreement on Rules of Origin – Note by the Secretariat.

[63] See WTO document G/RO/W/38, Implications of the implementation of the harmonized rules of origin on other WTO agreements.

in exporting country, the comparison for dumping margin may be made with the price in the origin country.

The view set forth in this description by the Republic of Korea may be difficult to apply in the situation involving the 36 members previously cited that have notified the WTO that they do not even have nonpreferential rules of origin, even though many of these members are known to utilize AD measures. There are, in fact, an apparent wide variety of practices as to "exporting country" versus "origin country" in AD regimes, and there is also an apparent absence of a common understanding of the implications of the prospective obligation to apply equally the HRO for all purposes.

A footnote at the end of Article 1, paragraph 2 of the ARO states that "it is understood that this provision is without prejudice to those determinations made for purposes of defining "domestic industry" or "like products of domestic industry" or similar terms wherever they apply." In India's opinion[64] could it mean that the member applying a restriction might define domestic industry by a criterion that is different from the rule of origin applicable to the products in question? This could lead to a situation of domestic industry appearing to suffer greater damage than may be the case if domestic production were defined according to the HRO. If for purposes of AD the terms "like product" may be defined differently than for the harmonized rule, then it would be contrary to the principle of the ARO to apply rules of origin equally for all purposes.

2.8.3. *Possible Implications of Article IX of the GATT 1994: Marks of Origin*

The link between customs origin and mark of origin derives from U.S. practice. The requirement to mark goods imported into the United States with their country of origin dates back to 1890, and has been reiterated since.[65] The purpose of this requirement was to inform consumers of a product's country of origin, but it could also have the indirect effect of favoring domestic products over competing foreign goods. Thus, as in many "buy national" campaigns periodically launched in certain countries, marks of origin may function as nontariff barriers.

[64] See WTO document G/RO/W/42, Implications of certain major proposals for harmonized rules of origin for access under the agreement on textile and clothing: an analysis of possible effects.

[65] For a discussion of U.S. marks of origin see Samter in "National Juice Products Association v. United States: A narrower approach to substantial transformation determinations for country of origin marking," *Journal of Law and Policy in International Business*, 1986, p. 671.

IMPLICATIONS OF MARKS OF ORIGIN

During the early negotiations of the TCRO, the Swiss delegation proposed that the assembly of watches from parts should confer origin because this process involves a series of complex operations requiring specialized services. The comparative rule of origin adopted by Switzerland under its GSP scheme requires, in general, that the foreign inputs used in the manufacture of a watch not exceed 40 percent of its ex-works value and that the value of the nonoriginating inputs not exceed the value of the domestic input. Also, the Swiss delegation argued that customs origin is not necessarily to be regarded as a sufficient criterion when it comes to marking the goods with the name of the country of production since member-states may require additional criteria, such as in the case of Swiss legislation a national geographical indication for watches and their parts. The delegate argued further that the national legislation of his country was to be considered a geographical indication under Article 22 of the WTO Agreement on TRIPs and Article IX, paragraph 6, of GATT 1996, and that this kind of geographical indication might go beyond the simple "customs origin" concept. Other delegations, especially those from the Asian region, were of the opinion that origin should be conferred on the country that manufactured the clock movement. They argued that the essential function of a watch is to measure intervals of time. This measurement is performed by the clock movement, and not by the assembly and testing operations.

As a possible result, the Swiss proposal on nonpreferential rules of origin would allow Swiss watchmakers to import Japanese or third-country clock movements and retain origin, while third-country watchmakers for GSP purposes would face much stricter rules, making it difficult for their products to qualify for GSP benefits. Moreover, the Swiss proposal to link origin marking to the geographical indication under Article 22 of the WTO TRIPs Agreement may have obvious trade policy and marketing implications. This linkage seems to be actually ruled out by the preambles of the HRO in the recent draft in which it is expressly stated that the Agreement does not prejudice the rights and obligations under the provisions of Annexes 1B and 1C of the WTO Agreement. The Swiss proposal of allowing the CTH would lead to change in origin due to assembly of movement into a complete watch, but the marking would not be possible because of other constraints by the Swiss made legislation.

Given the historical background, the question of mark of origin in the United States has been the subject of several dispute decisions involving the U.S. courts, customs, and importers of foreign goods. Most disputes arose in sensitive sectors such as foodstuffs, textiles, steel products, and footwear,[66] in which

[66] One type of controversy encountered in the determination of the country of origin under the marking regulations is illustrated by the decision in Koru North America v. United States. In this case, vessels caught hoki fish outside New Zealand's territorial waters. The vessels were

TABLE 2.8. *Changes in U.S. textiles and apparel rules of origin*

Main category of textile product	Before July 1996 origin-conferring operations	After 1996 origin-conferring operations
Apparel	Cutting	Assembly
Fabrics	Dyeing of fabric and printing if accompanied by two or more finishing operations	Weaving from yarn

labeling, import sensitivity, and consumer health considerations may have had a bearing on the final outcome. A general analysis of these disputes gives rise to the following points:

(1) The difficulty, given the globalization of production, in origin determination. From an importer's point of view, this difficulty is exacerbated by the fact that a wrong declaration of origin or incorrect labeling of origin may give rise to heavy penalties.
(2) Marking and customs origin are becoming increasingly insufficient criteria to determine which countries have derived substantial economic benefit from the sale of a product.
(3) Mark of origin may have a far-reaching effect on consumers' choice in certain categories of products such as foodstuffs, pharmaceuticals, and fashion goods.

A trade dispute in the WTO between the United States and the EC on rules and marks of origin may best summarize the implications of a change in rules of origin and open the way to further considerations regarding the impact on rules of origin and trade statistics.

In July 1996, new legislation on textile origin was promulgated in the United States. The new rules of origin for textile articles introduced several changes in relation to past practice and U.S. legislation. Those changes are summarized in Table 2.8.

chartered to a New Zealand corporation, but were flying the flags of New Zealand, the Soviet Union, and Japan. The fish were caught, gutted, and frozen on the catching vessels within New Zealand's EEZ. The fish were then landed and consolidated for shipment in New Zealand, and shipped to the Republic of Korea, whence they were shipped to the United States. The importer claimed that the hoki fillets' country of origin was New Zealand, whereas the Customs Service argued that the origin of the fish was New Zealand, the Soviet Union, and Japan. The court determined, however, that the hoki fillets were substantially transformed in the Republic of Korea, and were therefore products of that country. In the textiles sector, a report in the *Financial Times* of 10 April 1997 indicated that a major U.S. retailer was to be charged with millions of dollars of customs duties owed on allegedly mislabeled Chinese products.

The Italian Association of Textile Producers lodged a complaint[67] against the changes in the U.S. textile rules to the EC Commission as early as October 1996. Because it contained sufficient evidence, the matter was subsequently taken by the Commission to the WTO, where consultations with the U.S. authorities started in due course.[68] The fact at issue was that, under the new rules, originating status was not granted for scarves that have been dyed, printed, and finished in the EC member-states on loom-state fabrics produced in third countries. A significant aspect of the complaint related to the requirement that the products in question be labeled as originating in the country that produced the fabric being China, with obvious consequences for U.S. consumers, who may not positively identify EC products.

Although it may be difficult to quantify, it is obvious that in the upper-textile market of haute couture, brand name and mark of origin have a considerable influence on consumer choice, which may justify the concern of producers of finished products. Although the globalization of production has rendered outdated the notion that a product is wholly produced and obtained in a particular country, consumers may still identify certain quality products with specific geographical regions or countries. Moreover, the noninclusion of design and style in expenditure on advertising and research, which may be incurred in the fashion textile industry, together with ownership of the manufacturing plant, may not be in line with the substantial transformation concept.

2.8.4. *Possible Implications of the Agreement on the Application of Sanitary and Phytosanitary Measures*

A submission by Japan[69] on the relations between the HRO and the labeling requirements on foods addresses the problems that may arise from the implementation of the HWP and other non-WTO agreements such as the Codex General Standard for the Labeling of Prepackaged Foods. Provisions contained in a non-WTO agreement may go beyond what is required for rules of origin purposes because the objectives are different, as in the case of the Codex, which aims at achieving consumer policy interest (consumer protection) going beyond customs administration purposes.

[67] See O.J. C.351 of 22 November 1996. See also the box in page 123 of this book: "The India/U.S. dispute."

[68] See Commission decision of 18 February 1997 on the initiation of international consultation and dispute settlement procedures concerning changes to U.S. rules of origin for textile products resulting in the nonconferral of Community origin on certain products processed in the EC. O.J. L 62 [1997], and WTO document G/TBT/D/13 of 3 June 1997, "United States measures applying textile and apparel products: Request for consultation by the European Community."

[69] See WTO document G/RO/W/66.

The fact is that, in Article 1 of the ARO, it is stipulated that "origin marking requirements are within the scope of that Agreement." However, as already pointed out in previous sessions of the CRO, the said article has no mention as to whether the ARO should also apply to origin labeling requirements according to the Japanese submission. In the view of Japan, "it was important to reach a common understanding on this matter, in order to avoid any possible disputes arising on the interpretation of the text."

It is important to keep in mind that the principle of the Codex Standard is to prevent consumers from being misled or deceived as contained in the relevant provisions on this issue included in the Codex General Standard for the Labeling of Prepackaged Foods. These objectives are different from those of harmonization work of rules of origin, which are primarily designed for the purpose of customs procedures.

Furthermore, a discussion paper was submitted to revise the existing arrangements for origin labeling under the Codex Standard. It has been proposed that the origin of meat shall be that of the sole place where birth, rearing, and slaughter actually took place.[70] Should such places differ, each additional one should be declared accordingly.

The thread of this proposal in the Codex Alimentarius indeed reflects the reality of matters. This reality is that the requirements necessary for achieving consumer policy objectives when carrying out "origin labeling" (by providing accurate information, including the history of a product to consumers) are different from those required for customs administration purposes (which need only one origin country for each product).

In light of the above, Japan observed that it is legitimate, as well as appropriate, to argue that a reasonable distinction can be made between the rulings

[70] Proposal to revise the Codex General Standard for the Labeling of Prepackaged Foods:

- The country of origin of the food shall be declared;
- The term "produce of" (or equivalent, such as "product of," "produced in," "origin," Swiss, etc.) shall only be used where all the significant ingredients or components come from the identified country and virtually all of the production/manufacturing processes associated with the food occur within that place or country. An exception is allowed where significant ingredients cannot come from the country in question;
- For meat, the country of origin is the place of birth, rearing, and slaughter. If these places differ, then each shall be declared;
- Where the term "produce of" or equivalent is not used, the origin declaration should identify the country in which the food last underwent a substantial change in its nature and use appropriate terminology, such as "cured in," "made in," "prepared in," or "manufactured in." Packing, cutting, slicing, mincing, shredding, grating, and other similar processes are not, for these purposes, processes that substantially change the nature of the food;
- Where the label carries other material that may imply origin, the declaration should be sufficiently prominent to avoid misleading consumers.

under the ongoing harmonization work in the CRO and the labeling standards established in the Codex Alimentarius Commission and that they should not negatively influence each other in order not to upset the legal stability of domestic food labeling systems applied by members when introducing the HRO.

Also, a SPS concern aroused in the different options taken by members in the question of slaughtering of live animals, but this time not only by the concern raised by Japan, but above all the sanitary measures taken by some members based on the origin of the goods. It was observed that in the case in which the origin would be conferred on the country where the live animal was slaughtered, this would lead to a nonapplication of imposed SPS measures. In other words, the measure could be circumvented easily. To avoid this circumvention some delegations proposed that the operation of slaughtering was linked to a certain period of fattening of the live animal in the same country.

MAD COW DISEASE, MOVEMENT OF CATTLE, AND LABELING

In 2003, the carcass of a single cow tested positive in Canada for mad cow disease. This provoked the immediate ban on Canadian beef from 30 countries including major importers. Animal health experts slaughtered more than 2,000 cows but no scientific explanation was found on how a single cow in a remote ranch contracted the disease. Thus, the ban continued.

U.S. officials wished to help the Canadian farmers out. However, Japanese officials said that a restarting of U.S. imports of Canadian beef could interrupt U.S. beef exports to Japan unless U.S. beef products were labeled in a way to exclude Canadian beef and by-products from shipment to Japan.

U.S. officials claimed the labeling process was too costly and time consuming since the U.S. and Canada cattle industries are thoroughly integrated with movements of cattle crossing the border daily.

Source: Herald Tribune

Such SPS concerns appears to have been reflected and addressed in the preambles of the latest draft of the HRO in which it is expressly stated that:

> *Recognizing* that rules of origin do not prejudice Members' rights and obligations in respect of the application of domestic requirements for food labelling or for sanitary and phytosanitary measures.

The insertion of this statement seems to carve out many of the SPS measures from the implication of the HRO.

2.8.5. *Possible Implications of the ARO on Textiles and Clothing*

According to the view of some countries, rules of origin discussions were greatly influenced during the negotiations by their implication on the quota allocation systems in the textile and clothing area. However, the Multiple Fibre Agreements with their quota systems have now lapsed, meaning that the implication issue may become irrelevant. Some members, however, are of the view that such an issue is still relevant because some quotas still exist and others have been replaced with AD proceedings.

Recognizing printing or dyeing of fabrics as origin-conferring events may have had great implications on the "old" quota utilization rates and traditional trade flows. Countries with large exports of greige fabric would have profited from the fact that countries further up in the production chain would have no longer filled the quota of the previous country but their own. Countries with both production chains or with only the printing or dyeing industry would have suddenly faced a reduction of the volumes as third-country greige fabric would have been accounted to their own quota whereas previously such printed or dyed fabric would have maintained origin of the greige fabric.

According to this view, as not all countries were subject to quota systems, it would have also been possible to utilize the greige fabric of a country that had already exhausted its quota by having it printed or dyed in a third country exempted from such measures.

THE INDIA/U.S. DISPUTE: CHANGES IN U.S. APPAREL RULES OF ORIGIN DURING THE TRANSITIONAL PERIOD

On 11 January 2001, India raised a series of issues concerning U.S. rules of origin for textiles and apparel products set out in Section 334 of the Uruguay Round Agreements Act, Section 405 of the Trade and Development Act of 2000 and the customs regulations implementing these provisions.

Section 334 of the Uruguay Round Agreements Act (URAA), provides new regulations for determining the country of origin of textile and apparel products, e.g., certain fabrics, silk handkerchiefs, and scarves are considered to originate where the base fabric is knit and woven, notwithstanding any further processing.

Section 405 of the Trade and Investment Act of 2000, firstly, amends the textile rules of origin set out at Section 334 of the Uruguay Round Agreements Act. It restores the pre-URAA rule of origin that existed for fabrics of silk cotton, man-made fibers and vegetable fibers. Under this rule, where greige fabrics were subjected to printing and dyeing, plus at least two other named finishing operations in a second country, that country would be deemed the country of origin. However, the new law

does not change the country of origin rule for wool fabrics; their origin continues to be determined by the country where they were formed (woven or knitted).

Secondly, Section 405 also changes rules of origin for certain non-apparel textile articles, most of which are currently subject to the "Special Rule" of origin set out at 19 U.S.C. Section 3592(b)(2)(A). Currently, the origin of those products is determined according to the country where their constituent fabric was woven or knitted. Under the new legislation, the origin of some of these products will be determined according to the country where their constituent fabric was dyed, printed, and subject to two or more specified finishing operations. Other nonapparel textile products, including products composed of cotton or wool fabrics, or of "cotton rich" fabrics [i.e., containing 16 percent or more by weight of cotton], will continue to have their origin determined according to the country where their constituent fabrics were formed in the "greige" state.

As a precedent to the India/US dispute, in May 1997, the European Union (EU) requested consultations, complaining that the changes to the rules of origin made by URAA violate U.S. obligations under a number of agreements. EU acted on behalf of its scarf-making, fabric-finishing, and bedding industries. A "procès-verbal" was concluded between the two countries in July 1997, which was later amended. Formal consultations were held in January 1999.

In August 1999, the United States and the EU agreed to settle definitively the dispute. A second "procès-verbal" concluded between the two countries included the commitment by the U.S. administration to submit legislation which, as described above, amends the rule-of-origin requirements in section 334 of the URAA in order to allow dyeing, printing, and two or more finishing operations to confer origin on certain fabrics and goods. In particular, this dyeing and printing rule would apply only to fabrics classified under the Harmonized Tariff Schedule (HTS) as silk, cotton, man-made, and vegetable fibers. It would also apply to the various products classified in 18 specific subheadings of the HTS listed in the bill, except for goods made from cotton, wool, or fiber blends containing 16 percent or more of cotton.

India claimed that the U.S. rules of origin set out in section 334 and modified in section 405 and the customs regulations implementing these statutory provisions, and the application of these statutory provisions and implementing regulations:

(a) are being used by the United States as instruments to pursue trade objectives, thereby violating Article 2(b) of the RO Agreement. Section 334 is being used as an instrument to protect the United States' textile and apparel industry. Section 405 is being used as an instrument to favour imports of the products of concern to the European Communities;
(b) create restrictive, distorting and disruptive effects on international trade and are, therefore, inconsistent with the United States' obligations under Article 2(c), first sentence, of the RO Agreement;

(c) require the fulfillment of a certain condition not related to manufacturing or processing and pose unduly strict requirements and are, therefore, inconsistent with Article 2(c), second sentence, of the RO Agreement; and
(d) with respect to section 405, discriminate between Members, and in particular, discriminate in favour of the European Communities and are, therefore, inconsistent with the United States' obligations under Article 2(d) of the RO Agreement."[1]

The Panel dismissed India's claims under (a) because India did not provide empirical evidence that the fabric formation rules bring more imports of made-up articles under quota in the United States.[1]

In any case, even if India has provided such information, the Panel noted "that the mere fact of making the quota system more restrictive could not, ipso facto, condemn the fabric formation rule. A restrictive fabric formation rule may have been adopted in pursuit of legitimate objectives."

In order to understand the Panel reasoning, one has to consider that, any change in rules of origin would have an effect on trade flows. Thus, to simply claim that the "fabric formation" rule had a restrictive trade effect does not "ipso facto" entail more protection for domestic industry and use of origin in pursuit of trade objectives. In other words, according to the Panel, India failed to demonstrate that the fabric formation rule had a quantitative restrictive effect and that these effects were "not incidental to the pursuit of legitimate objectives."

With the same kind of reasoning, the Panel dismissed the claim by India that section 405 is being used as an instrument to favor imports from the EU. Again on the second claim under (b) the Panel found that there was little evidence in quantitative terms, that the fabric formation rule had a restrictive effect.

Other arguments based on (b) were equally dismissed since it cannot simply be inferred that a change in rules of origin creates distorting or disruptive effects in international trade.

2.8.6. *Section 3 of the ARO on Trade-Related Aspects of Intellectual Property Rights: Geographical Indications*

The linkages of the HWP with geographical indications, under Trade-Related Aspects of Intellectual Property (TRIPs) Articles 22.1 and Article 23, are disputed but they both refer to the issue of origin and originating products. Some countries hold the view that because the ARO is contained in Annex A (Multilateral Agreements on Trade in Goods), the ARO cannot apply to Annex 1C (Agreements on Trade-Related Aspects of Intellectual Property Rights). Thus, if the HWP is equally applied to origin under TRIPs, there might be implications

for products that are not produced in a specific region but do meet the origin requirements according to the HWP and vice versa. For instance, during the ongoing negotiations, it has been argued by some members that making wine from imported grapes should be considered as an origin-conferring operation. This proposal, if adopted, could potentially have implications on the protection of geographical indications under TRIPs Article 23, because some wine producers could argue that they are producing originating Bordeaux because they are fulfilling the origin requirement laid down in the HWP, that is, making wine from imported grapes is origin conferring. Obviously, traditional WTO member wine producers have opposed this view, arguing that the production of wine is origin conferring only if the wine is made from grapes that are grown and harvested in the same country. A compromise proposal has been put forward, which considers the production of wine as an origin-conferring operation only if the whole process from grapes to wine is performed in the same country.

2.8.7. *Nonpreferential Rules of Origin and Circumvention*

The clearest sign of the interaction between rules of origin and globalization was and still is provided by the unresolved issue of the appropriateness of anticircumvention measures in the context of AD legislation. Various cases of textile quotas circumvention have also been recorded in AD cases.

As anticipated in Section 2.82, the anticircumvention provision contained in the 1980s European Community Anti-Dumping Regulation was successfully challenged by Japan in the GATT (see following box).

CIRCUMVENTION BY TRANSPLANT OPERATIONS

The 1988 EC regulation on anti-dumping contained an anti-circumvention provision that allowed the imposition of anti-dumping duties on products that were introduced into the commerce of the community after having been assembled or produced in the community, if the following conditions were met:

- "assembly or production is carried out by a party which is related or associated to any of the manufacturers whose exports of the like product are subject to a definitive anti-dumping duty;
- the assembly or production operation was started or substantially increased after the opening of the anti-dumping investigation;
- the value of parts or materials used in the assembly or production operation and originating in the country of exportation of the product subject to the anti-dumping duty exceeds the value of all parts or materials used by at least 50 per cent;

In applying this provision, account shall be taken of the circumstances of each case and, inter alia, of the variable costs incurred in the assembly or production operation and of the research and development carried out and the technology applied within the Community."

Under this provision, seven proceedings concerning assembly operations in the EC were initiated from 1987 to 1989. They concerned Japanese transplant operations for the assembly of electronic typewriters, electronic scales, photocopiers, ball bearings, excavators, and so on.

The provision was successfully challenged by the government of Japan through a GATT panel regulation. The GATT panel examined whether anti-circumvention measures could be justified under GATT article XX (s), which provides that:

> "nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Contracting Party of measures . . . d) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement . . . "

The panel examined whether anti-circumvention measures could be considered necessary in order to secure compliance with the regulations imposing a definitive anti-dumping duty on the importation of the finished product ("law or regulations"). In this respect, the EC argued that the term "secure compliance with" should be broadly construed to cover not only the enforcement of laws and regulations per se but also the prevention of actions which have the effect of undermining the objectives of laws and regulations. The panel did not accept this broad interpretation. It noted that the text of GATT article XX (d) does not refer to "objectives" of laws or regulations but only to laws or regulations.

It therefore clearly follows from this GATT panel decision that GATT article XX (d) cannot be invoked as a general legal basis for adopting anti-circumvention measures, which would deviate from the conditions set forth in article VI (concerning anti-dumping). It is thus clear that any anti-circumvention measures can be adopted only in full compliance with the GATT conditions for imposing anti-dumping duties, that is, establishment of findings of dumping and material injury and a causal relation between the two.

In the Uruguay Round negotiations, no agreement was reached on anti-circumvention measures. In fact, the Marrakesh Final Act only referred this matter "to the Committee on anti-dumping practices" established under that Agreement for resolution. This legal vacuum has been filled by a new and amended version of the original anti-circumvention provision in the most recent EC anti-dumping legislation.

The specific issue of circumvention may take the following forms: (i) relocation of assembly factories to the importing country; (ii) relocation of factories

to third markets; and (iii) exportation of disassembled articles to be assembled in the importing country – really a variant of (i).[71] The different approaches of complainants and defendants must be considered in order to follow the rationale for anticircumvention. Complainants usually argue that the relocation of a factory to the home market of the complainant or to a third country has as its main purpose the avoidance of AD duties and that the working or processing operations carried out there are only minor and not origin conferring. Thus they argue that AD duties should also be imposed on products manufactured in the third country or in the home market because they retain the initial origin status of the third country's products subjected to AD duties (see following box). For their part, the exporters tend to argue that the relocation is a genuine foreign direct investment, a simple step in the globalization of production, and that the amount of value added and/or working or processing carried out in the third country or home market is sufficient for acquiring origin.

CIRCUMVENTION THROUGH THIRD-COUNTRY ASSEMBLY OPERATIONS[72]

(1) **Change of origin during anti-dumping procedures**
In an anti-dumping case concerning typewriters from Taiwan Province of China, the EC Commission terminated investigation proceedings it had initiated on the ground that the production processes carried out there were not sufficient to confer Taiwan Province of China origin. The practical consequence of these findings was that the products assembled in Taiwan Province of China continued to have Japanese origin and therefore *de facto* were subjected to the anti-dumping duties imposed with respect to such products originating in Japan.[73] Subsequently, the customs authorities in some member States even took the position that anti-dumping duties should be levied retroactively on prior imports of typewriters from Taiwan Province of China. This ultimately gave rise to the Brother case,[74] where the customs authorities in Germany,

[71] This latter form of circumvention is not further examined here because it is not related to rules of origin but rather to interpretative rules of the HS. See, for instance, the comments made on the Eisbein Case (Case C.35/93, Dr. Eisbein GMBH v. Hauptzollamt Stuttgart [1994], European Court of Justice Report, 1–2655) in Vermulst and Waer, op. cit., where Eisbein, a German factory which imported disassembled typewriters, argued that these kits should be classified as "parts" and not be object of the AD duty charged against the finished typewriters.

[72] For a detailed analysis of the various issues involved in these cases, see Vermulst and Waer (in footnote 52 and Inama and Vermulst).

[73] Electronic typewriters from Taiwan Province of China [1986] O.J. L 140/52.

[74] See case 26/88, "Brother International GMBH v. Hauptzollamt Giessen," European Court of Justice Report [1989].

after an on-the-spot investigation at Brother premises, again determined that the typewriters in question could not be considered as originating in Taiwan Province of China but in Japan, and that the anti-dumping duty applied against imports of Japanese typewriters was applied to the typewriters exported from Taiwan Province of China with retroactive effect. The consequence was that the German customs authorities ordered Brother to pay over DM three million in anti-dumping duties. Brother appealed against this decision on the ground that the typewriters in question should be considered as originating in Taiwan Province of China on the basis of the application of the EC's origin rules. They argued that while most of the parts came from Japan, they were mounted and assembled in Taiwan Province of China in a fully equipped factory into ready-for-use typewriters.

(2) **Origin-specific determination**

The absence of multilateral discipline on rules of origin allowed both the United States and the EC to issue ad hoc origin determinations concerning origin disputes with regard to third-country production. In some cases these decisions led to international criticism and to bizarre or contradictory regulations. In the late 1980s, an investigation conducted on the spot by the EC Commission at the Ricoh photocopier plant in California concluded that such photocopiers should be denied United States origin and should continue to be of Japanese origin. Subsequently, the Commission enacted a specific regulation on the origin of photocopiers, which although couched in general terms was essentially tailored to the Ricoh situation. As a direct consequence of this origin determination, anti-dumping duties imposed on direct import of Ricoh photocopiers from Japan were extended to Ricoh exports from California to the EC despite the fact that these photocopiers presumably included substantial United States value added.

This photocopier decision drew criticism from some of the community's main trading partners. At that time, the United States and Japan argued that these regulations were protectionist because they determined the nature of manufacturing operations carried out by European producers in the Community rather than providing objective criteria for determining origin and/or because they indirectly promoted manufacturing in Europe policies.

For instance, in the Integrated Circuits Regulation, the Commission ruled that diffusion rather than assembly was origin conferring, despite the fact that diffusion is always followed by assembly and testing, that assembly and testing are more labor intensive than diffusion, and that the value added in the assembly and testing process can be as high as, and sometimes even higher than, the value added in the diffusion process. The regulation tended to work to the advantage of major European companies such as Siemens which (at the time of adoption) carried out the diffusion process in the EC and testing and assembly in third countries,

to the disadvantage of Japanese producers which assembled and tested integrated circuits in the EC.[75]

The Integrated Circuits Regulation came at both a convenient and an embarrassing time for the pending anti-dumping proceedings concerning DRAMs[76] and EPROMs[77] from Japan. Until the adoption of the regulation, some member-states' customs authorities had held that the process of assembly and testing constituted the last substantial transformation. Such an attitude could have been disastrous for the outcome of the anti-dumping proceedings initiated because it would have led to the inescapable conclusion that the only Community industry, which existed, was Japanese-owned!

The later U.S. objection to the EC's determination to consider diffusion as the last substantial process or operation for determining the origin of integrated circuits seem inconsistent in the light of the fact that the U.S. Commerce Department, for the purposes of applying the anti-dumping law, has explicitly held that diffusion rather than assembly constitutes the last substantial transformation, thereby overruling the established practice of the U.S. Customs Service, which for its own purposes had previously rules that assembly and testing conferred origin.

Once the harmonization program has been completed, it was considered that the HRO may help to resolve the issue of third-country anticircumvention actions. These became controversial in the early 1990s and involved actions against imports of products subject to AD duties from countries not originally subject to such actions. These anticircumvention actions were motivated on the basis of claims that the firms previously found to be dumping had shifted to production facilities located in third countries. The WTO ADA does not appear to be clear-cut on the issue of rules of origin because it refers to both "exporting country" and "origin country," as pointed out by the Republic of Korea in its submission (G/RO/W/38), in Articles 2.2 and 2.5 of the ARO.

Some countries have argued that the utilization of harmonized residual rules of origin in case of third-country circumvention, coupled with rule 2(A) of the HS,[78] should allow this issue to be addressed. Pending absence of an agreement

[75] See Note 52.
[76] See Note 52.
[77] See Note 52.
[78] The first part of rule 2(a) extends the scope of any heading that refers to a particular article to cover not only the complete article but also that part of the article that is incomplete or unfinished, provided that, as presented, it has the essential character of the complete or finished article. The second part of rule 2(a) provides that complete or finished articles presented unassembled or disassembled are to be classified in the same heading as the assembled article. When goods are

on this issue of third-country circumvention, a substantial number of countries, including not only the United States and the EC, but also Latin American developing countries, have unilaterally adopted anticircumvention provisions. Thus nonharmonized, nonpreferential rules of origin continue to be used to enforce AD duties and, consequently, to combat third-country circumvention. A harmonized approach would thus be beneficial.

In a submission[79] to the negotiating group on rules, Brazil strongly argued that origin determination made by AD investing authorities are different from those made for instance by customs valuation authorities. According to Brazil "*there seems to be no conceptual or theoretical reason to tie the concept of origin in the ADA to the one in the ARO. Although using the same concepts of "substantial transformation" and "value added," anti-dumping investigating authorities and custom valuation authorities will look at the same t-shirt and ask themselves different questions regarding the origin of that t-shirt. The answers, of course, may differ.*"

It follows that, according to Brazil, *Any future multilateral disciplines on circumvention shall explicitly recognize that rules of origin, in the sense of the ARO, do not apply in anti-circumvention.*

A proposal by the United States[80] further delinks any consideration of origin in possible discipline of anticircumvention.

The United States proposes the insertion in the ADA and Agreement on Subsidies and Countervailing Measures (ASCM) of language aimed at (1) providing explicit recognition of the two forms of circumvention traditionally recognized by members using trade remedies; and (2) adopting uniform and transparent procedures for conducting anticircumvention inquiries.

The first paragraph of the proposal codifies the practice of enlarging the scope of an AD order without engaging on an new AD investigation: *Notwithstanding any other provision of this Agreement or of Article VI of the GATT 1994, the authorities may impose [an anti-dumping duty] [a countervailing duty] with respect to a product that was not within the product under consideration in an investigation which resulted in imposition of a duty, if the authorities determine, pursuant to a review carried out in accordance with this paragraph, that exports of the product are in circumvention of the [anti-dumping duty] [countervailing duty] originally imposed.*

so presented, it is usually for reasons such as requirements or convenience of packing, handling, or transport.

79 See WTO document TN/RL/W/200 of 3 March 2006.

80 See WTO document TN/RL/GEN/71 of 14 October 2005.

In a nutshell the U.S. proposal aims at inserting in the ADA and ASCM provisions ensuring that both Agreements should make explicit the right of authorities to examine the facts of the case and make a determination based on those facts. One may then legitimately wonder what would change from the current status quo of absence of multilateral rules except a consolidation of current U.S. practices.

Subsequently the U.S. proposal provides examples of circumvention based on their key concept that the alteration of the original product may be relatively minor, such that the altered product has essentially the same characteristics and uses as the original product covered by the measure. For example, if an exporter adds an additional low-value ingredient to a chemical product that changes its classification, but does not change its essential nature from the point of view of customers, authorities may conclude that the altered product has circumvented the measure on the original product. Once delinked from origin, authorities will have a free hand in determining if the alteration has changed or not the commercial use of the good.

The wide discretion left to the authorities may be drawn from the following language:

> *Exports of a product that is not within the product under consideration are in circumvention of the [anti-dumping duty][countervailing duty] originally imposed if:*
> *(i) subsequent to the filing of the application, exports of the product under consideration have been supplanted, in whole or in part, by exports from the same country of another product that has the same general characteristics and uses as the product under consideration.*

A second form of circumvention involves replacement of trade in a product with trade in its subcomponents, which are then assembled or finished either in a third country or in the country of import. According to the U.S. proposal, as long as the assembly or finishing operation is relatively minor, there is no reason to consider that moving the locus of this operation should have any effect on the AD or countervailing duty measure.

This statement seems to forget that issues of what constitute simple assembly and assembly involving substantial transformation have been debated during the HWP and a number of technical solutions have been agreed on.

The real point is that although the United States recognizes that some assembly or finishing steps may be complex and their location of great commercial significance they do not wish to tie their hands and prefer to delegate to the investigating authorities the right to examine the facts and make a determination based on those facts as subsequently given:

Exports of a product that is not within the product under consideration are in circumvention of the [anti-dumping duty][countervailing duty] originally imposed if: (i)[see above]; or

(ii) subsequent to the filing of the application, exports of the product under consideration have been supplanted, in whole or in part, by exports of parts or unfinished forms of the product under consideration, where only a minor or insignificant process of finishing or assembly is necessary to convert the parts or unfinished forms into the product under consideration.

Most recently a proposal on circumvention is contained in the chairperson's draft[81] of the negotiating group on rules:

Circumvention

9bis.1 The authorities may extend the scope of application of an existing definitive anti-dumping duty to imports of a product that is not within the product under consideration from the country subject to that duty if the authorities determine that such imports take place in circumstances that constitute circumvention of the existing anti-dumping duty.[82]

9bis.2 Authorities may only find circumvention within the meaning of paragraph 1 if they demonstrate that:

(i) *Subsequent to the initiation of the investigation that resulted in the imposition of the existing definitive anti-dumping duty, imports of the product under consideration from the country subject to that duty have been supplanted, in whole or in part*[83]:
- *by imports from the country subject to the anti-dumping duty of parts or unfinished forms of a product for assembly or completion into a product that is the same as the product under consideration;*
- *by imports of a product that is the same as the product under consideration and that has been assembled or completed in a third country from parts or unfinished forms of a product imported from the country subject to the existing anti-dumping duty; or*

[81] TN/RL/W/213 of 30 November 2007.

[82] Throughout this article AD duty will be understood as duty or undertaking.

[83] Factors pertinent to a consideration of whether imports of the product under consideration have been supplanted include whether there has been a change in the pattern of trade of the exporters subject to the AD duty, the timing of such change, and any association or compensatory arrangement between the exporter and the importer or a third party. No one or several of these factors can necessarily give decisive guidance.

- *by imports of a slightly modified product*[84] *from the country subject to the existing anti-dumping duty;*

(ii) *The principal cause of the change described in subparagraph 2(i) is the existence of the anti-dumping duty on the product under consideration from the country subject to the duty rather than economic or commercial factors unrelated to that duty;*[85] *and*

(iii) *The imports that have supplanted the imports of the product under consideration from the country subject to the existing anti-dumping duty undermine the remedial effect of that duty.*[86]

9bis.3 With respect to imports referred to in 9bis.2 of parts or unfinished forms of a product and imports referred to in 9bis.2 of a product assembled or completed in a third country, the authorities shall only find circumvention if they establish that (i) the process of assembly or completion is minor or insignificant[87] *and (ii) the cost of the parts or unfinished forms makes up a significant proportion of the total cost of the assembled or completed product. The authorities shall in no case find that circumvention exists unless they determine that the value of the parts or unfinished forms is 60 per cent of the total value of the parts or unfinished forms of the assembled or completed product or more, and that the value added to the parts or unfinished forms during the assembly or completion process is 25 per cent of the total cost of manufacture or less.*

[84] A slightly modified product is a product that is not within the product under consideration but has the same general characteristics as the product under consideration. Factors pertinent to a consideration of whether a product is slightly modified include general physical characteristics, purchaser expectations, end uses, channels of trade, the interchangeability of the products, the processes, facilities and employees used in production of the products, differences in the costs of production, the manner in which the products are advertised and displayed, and the costs to transform the slightly modified product into the product under consideration. No one or several of these factors can necessarily give decisive guidance.

[85] Factors pertinent to a consideration of the possible role of economic or commercial factors unrelated to the duty include technological developments, changes in customers' preferences, and changes in relative costs. No one or several of these factors can necessarily give decisive guidance.

[86] Factors pertinent to a consideration of whether the remedial effect of an existing AD duty is undermined include the evolution of the prices and quantities of the product assembled or completed in the importing country or in a third country or of the slightly modified product and whether those products are sold to the same customers and for the same uses as the product subject to the existing definitive AD duty. No one or several of these factors can necessarily give decisive guidance.

[87] Factors pertinent to a consideration of whether a process of completion or assembly is minor or insignificant include the level of investment, research and development related to the completion or assembly, the nature and cost of the production process and the extent of the facilities used for completion or assembly. No one or several of these factors can necessarily give decisive guidance.

9bis.4 The authorities may extend the scope of application of an existing definitive anti-dumping duty to imports of parts or unfinished forms of the product under consideration assembled or completed in a third country only if they find that such imports are dumped pursuant to Article 2.

9bis.5 A determination of the existence of circumvention within the meaning of this Article shall be based on a formal review initiated pursuant to a duly substantiated request. Except in special circumstances, such a review shall not be initiated unless the authorities have determined, on the basis of an examination of the degree of support for, or opposition to, the request expressed by domestic producers of the like product that the request has been made by or on behalf of the domestic industry within the meaning of Article 5.4.

9bis.6 The provisions regarding evidence and procedure in Article 6 shall apply to any review carried out under this Article. Any such review shall be carried out expeditiously and shall normally be concluded within 12 months of the date of initiation of the review.

9bis.7 If the authorities have determined in accordance with this Article that circumvention exists, they may apply the anti-dumping duty to the imported products found to be circumventing the existing definitive anti-dumping duty[88]*, including retroactively to imports entered after the date of the initiation of the review.*

This draft calls for the following preliminary comments:

- The three indents of paragraph 9bis.2 identify the three classic forms of circumvention: (i) import of disassembled products into parts, (ii) circumvention by third-country operations, and (iii) minimal alteration of the original product and does not significantly differ from previous practice or the preceding U.S. proposal given the latitude of discretion that the authorities may exert in interpreting these forms of circumvention.
- There are a number of conditions to be filled for imposing AD duties, most notably the one contained in the second paragraph of Article 9.3: *The authorities shall in no case find that circumvention exists unless they determine that the value of the parts or unfinished forms is 60 per cent of the total value of the parts or unfinished forms of the assembled or completed product*

[88] If a review under this article has been initiated on a countrywide basis, the authorities shall exempt imports from particular exporters from the scope of any extended AD duty if they find that those imports take place in circumstances that do not constitute circumvention of an existing AD duty.

or more, and that the value added to the parts or unfinished forms during the assembly or completion process is 25 per cent of the total cost of manufacture or less.

However, although the formula for the calculation of the first criterion is quite straightforward because it is a value of parts test (even if it does not say how the value of materials could be assessed: One may argue according to the WTO Agreement on customs valuation), the methodology for calculating the second criterion does not sufficiently clarify the numerator and denominator.

It is not clear what is the total cost of manufacture or what are the costs that can be allowed to be counted as cost of manufacture and those that are not. As noted earlier this is one of the inherent difficulties of a value-added calculation of this nature.

Finally, these rule of origin requirements appear restrictive if we compare them with the rather liberal approach adopted in the HWP. Perhaps this once again explains the resistance of some Administration, namely the United States, not to adopt the results of the HWP for AD purposes.

- Paragraph 9 bis 4 provides for a fundamental condition because a finding of dumping is now required before the scope of the AD duties is extended.

Summing up, the proposal could be read as a compromise that may allow some progress on the issue of circumvention and may indirectly facilitate a final agreement of the HWP under the ARO.

2.9. Implementation Issues

Business life evolves at a faster pace than multilateral trade negotiations. Customs and trade officials at the borders in WTO member-countries will always have to determine origin, apply the rules, and enforce them on a daily basis. The fast pace of globalization may provide some explanation of the reasons why the elaboration of the harmonized rules has reached a level of technical detail and sophistication that is almost unrivalled in comparison with other WTO Agreements. The rules of origin that are being negotiated are mostly tailored to the industrial and technological processes mainly used in main industrialized countries and large developing countries. These exigencies do not necessarily mirror the needs, abilities, and resources of other developing countries and especially LDCs and customs administrations. The benefits of transparency and predictability of harmonized rules are certainly positive for the multilateral trading system. However, when translated into a WTO commitment, they

may become an additional burden for those administrations not adequately equipped.

Furthermore, the ARO is silent on several issues related to implementation, such as certificates of origin and their administration, as well as verification of origin. For instance, the agreement does not provide guidance if, following the implementation of the HWP, WTO members may request for each import transactions certificates of origin, neither is it clear who should be issuing and certifying such certificates. The fact that at the present stage of negotiations WTO members may opt to adopt different version of the HWP in the sector of machinery and electronics and have different interpretations of the implications on other WTO Agreements may cast additional doubts on the harmonization efforts. On the matter of certificate of origin a TCRO document[89] is helpful. Even if the issue is not covered in the ARO, the Kyoto Convention, in particular Annex K, can be used as guidance on the issue of certificates of origin and their administration. In fact, from the replies to the questionnaire underlying the TCRO document, it appeared that many administrations apply *de facto* a number of the Convention's standards and recommended practices without being signatories to the Convention itself. It was found that countries follow the Kyoto Convention's provision in indicating nonpreferential rules of origin, dealing with proof of nonpreferential rules of origin, and verifying the proof of origin.

Whether origin is indicated or not, some administrations[90] always require documentary evidence of origin at importation and more particularly a certificate of origin.[91] In the TCRO's opinion, it would be better to analyze each particular situation to determine the need to request a certificate of origin, instead of hampering the normal progress of international trade. Of course, it

[89] See document n. OC0067E1, Comparative study on systems of certification and verification as well as documentation for customs clearance with respect to nonpreferential rules of origin. To compare the different methods of proofs of origin it was decided to send a questionnaire modeled as closely as possible on the relevant annexes to the Kyoto Convention. 82 members replied to it. Recently, the WCO made a small update of this document, contained in OC0084E1, bringing the contributions from members or observers to over 100.

[90] These administrations – 14 percent of the ones that answered the questionnaire – are Albania, Azerbaijan, Bahrain, Bangladesh, Brunei, Cameroon, Egypt, Ethiopia, Jordan, Kyrgyzstan, Mauritius, the Philippines, Syrian Arab Republic, Trinidad, and Tobago. Without requesting any proof of origin to be presented, 92 administrations require mandatory an indication of origin on the import declaration. For 55 of the administrations, origin must be even indicated on the customs export declaration.

[91] It is specified that a certificate of origin is a specific form identifying the goods, in which the authority or body empowered to issue it certifies expressly that the goods to which the certificate relates originate in a specific country. This certificate may also include a declaration by the manufacturer, producer, supplier, exporter, or other competent person.

is not forbidden to require the certificate of origin but cases should be limited to those that are strictly necessary.

The Kyoto Convention also addresses some principles that regulate the verification of proof of nonpreferential origin, namely administrative cooperation, reciprocity, and rational reasons for requesting controls. There are two different kinds of controls: The first concerns the authenticity of origin, and the second the validity of origin. It is an aspiration of the TCRO to reach a higher degree of maturity in international trade and of simplicity in the application of these principles, after the completion of the HWP.

Nevertheless, several methods of looking at the documentary evidence of origin still exist. According to the TCRO document, it was easy to explain these differences because the customs exigencies and measures to facilitate international trade are perceived differently by customs administrations.

The document presents a conclusion that points out that, once the HWP is finished, the situation should be clarified. Nevertheless, commerce operators utilizing different types of proof of origin may still resist rigid rules in this area. A second possible option was given – specifically to proceed on a work of harmonization of the proof of origin. However, numerous interested parties are discouraged by the amount of time spent in another harmonization exercise after the experience of the HWP.

Obviously a *sui generis* certificate of origin, purposely created by TCRO, would bring into the international trade a uniform method of proving origin. In addition, all WTO members would have applied this new method attaining further simplification of commerce.

Another document[92] has been provided by TCRO concerning implementation issues. This document was conceived, *inter alia*, as a means to discuss controversial points and help trade operators not conversant with origin matters. It analyzes and explains the work carried out in the HWO. The paper deals with three specific matters: the application of international or national legal instruments; the availability of industrial and trade information and technical data; and the setting up of a number of organizational mechanisms within the authorities responsible for implementing the agreement.

Some fundamental concepts and definitions are explained in order to make them clear how they are linked to the ARO. Additionally, persons who are involved and connected with the rules of origin are invited to divulge all the information in their possession: basically, commerce operators, customs, other agencies, and chambers of commerce.

[92] See TCRO document n. OC0066E1, Practical guidance on the implementation of the WTO ARO, Brussels, 3 December 2001.

Particular attention was given to the assessment of origin or binding ruling. The economic operator requesting an assessment of origin shall be the importer or exporter and can include the operator's representative. The request for an assessment of origin has to be lodged with the duly designated competent authority. This could be a ministry of trade, ministry of industry, some other ministry, chambers of commerce, or customs administrations.

The question may arise as to where the request for an assessment of origin should be lodged. Article 3 of the ARO does not specify a particular place. It can be either the country of importation or the country of exportation. It is also provided that the authority that issued the assessment of origin should make publicly available (subject to the provisions of paragraph (i) relating to confidentiality) the result of the assessment.

In terms of time, validity is set for three years by the ARO itself, provided that the conditions of manufacture of the goods and the rules of origin are not amended. The validity of the assessment in geographical terms is, however, not indicated in the ARO. As previously indicated, the assessment of origin can be requested in the country of importation or the country of exportation.

As a last step, the TCRO paper deals with the importance of disseminating the information in the form of published handbooks to be used, or usable, as practical guidance by operators or any interested parties.

For the implementation of the ARO, it will be necessary to determine the role of each authority involved in the field of nonpreferential rules of origin, both nationally and locally. Each member will need to distribute the responsibilities to its national or local authorities, as it considers appropriate. Again, the agencies could include various ministries, chambers of commerce, and customs administrations. Finally, the document points out that it would be helpful if each member would set up a centralized origin administration that could play a coordinating role through the preparation of legal texts, practical guides, and handbooks; provision of logistical support; by processing cases, legal papers, and assessment; or by sending and receiving requests for administrative assistance.

An update to this document about implementation deals with the timing for implementation of the HWP.[93] In fact, Article 9.4 of the ARO states that the Ministerial Conference shall also establish a time frame for the entry into force of the annex on rules of origin.

The WCO secretariat, in analyzing the complexity of the future annex, suggested a two-year limit for entry into force. Among others, the following

[93] See TCRO document n. OC0081E1, Proposed timeline for the implementation of the harmonized nonpreferential rules of origin, Brussels, 12 November 2002.

tasks have to be addressed by members: Drafting the necessary legal texts (in some countries legal procedures are cumbersome and long), preparing handbooks and practical guides, providing logistic support, national training, and technical assistance to operators and governmental authorities that will apply the annex on rules of origin.

The latest draft of May 2008 provides for a three-year period for the entry into force and the possibility to request an extension of further three years maximum for developing countries and LDCs.

2.10. Conclusions

Undoubtedly, the harmonization of nonpreferential rules of origin will be considered a new milestone in ensuring a transparent and predictable regulatory framework in the international trading system. In the TCRO, negotiations have been mainly driven by certain industries seeking to have their manufacturing process recognized as substantial transformation. In practice, especially in sectors such as textiles, industrial interests are often subordinated to broader trade policy considerations. A further complication is the fact that recognition of certain working or processing operations as substantial transformation does not always coincide with the structure of the HS. Attempts have therefore been made to adapt the HS by means of "*ex* headings or *ex* subheadings," chapter notes, and so on to make it suitable for the purposes of determining origin. The preliminary outcome of the negotiations thus appears to be a very precise but complicated set of rules.

The almost exclusive use, pursuant to Article 9 of the ARO and strenuously supported by some delegations, of the CTC criterion meant that the various industrial processes affecting all categories of goods had to be expressed in HS terms. Thus the structure of the HS had to be modified to suit the purposes of determining origin. On the one hand, this process has enhanced the predictability and accuracy of the rules of origin, reduced the margin of discretion, and, to a certain extent, facilitated the administration of the rules. On the other hand, the almost exclusive use of the CTH criterion has entailed a complete overhaul of the layout of the rules, a difficult exercise for those who are not familiar with the HS structure and rules. Some delegations are still proposing that in some cases *ad valorem* rules or specific working or processing may be used.

The use of the HS structure for drafting product-specific rules of origin has also made the results of the HWP subject to the various updating of the HS. One may argue why product rules of origin based on description of specific

working or process operations have been widely discarded on the grounds that they would be overtaken by technological progress while the same applies to the HS structure that is periodically updated to take into account business and industrial development.

The question of the impact of "retaining," "obtaining," or "losing" origin of a product remains the driving force to defining the possible implications in respect to other WTO Agreements and the implications of origin marking, statistics, and the like.

At the time of this writing, a number of issues are still pending. The issue of whether raising animals confers origin was never solved. Some countries have shifted their position from the rule that the origin should go to the animal born in a country toward the "raising" option. However, the proponents of this option have not agreed on a common period of fattening and raising. A related issue is slaughtering in Chapter 2 of the HS. In this area, SPS questions issues such as whether it would be possible to circumvent a ban against a certain product (hormone beef) if slaughtering alone would confer origin continue to be underneath the negotiations. A related issue is the filleting of fish, which is of high importance for processing countries that have exhausted the livestock in their waters and conservation of the species.

A number of unresolved issues in dairy products have provoked much controversial discussion. Some countries are considering all transformations of milk and derived products as origin conferring whereas others are advocating more stringent rules, tracing back the origin of products such as milk powder, reconstituted milk, yogurts, or coffee creamers to the origin of the milk used in the first place. Main arguments of a technical nature cannot conceal the fact that export subsidies could also be the real reasons for such different positions.

Similar to the issue of coffee discussed in this chapter is the refining of oil. Some countries are clearly interested in obtaining origin through the refining of imported oil; other countries do not wish to lose origin because they want the country's name to continue to appear in the next step of production.

In the field of production of sugar, technical arguments are again commingled with agricultural subsidies. The most controversial question is the refining of the sugar itself. However, the issues concerning the production steps going from the cocoa beans to the finished chocolate are still unresolved.

Fruit juices are made from fresh fruits or are reconstituted from concentrate (which is cheaper to ship around the world). It is of no surprise that many industrialized countries usually are in favor of production of juices or reconstitution as an origin-conferring event. However, developing countries providing the raw material wish to retain origin of the reconstituted juices.

The position of certain countries that the origin of a wine should be traced back to the grape clearly shows that they link the origin of wine to the geographical denomination where wine is specially protected.

The mixing of like products may be explained by technical reasons or by the desire of lowering or raising the quality of a finished product. A rule of origin, restrictive or not, cannot forbid such operations but has to regulate it in an exhaustive manner.

For many years, the production of cement was a hot topic in the TCRO in Brussels and in the CRO. A latest text proposes that production from clinker to cement should not be considered a substantial transformation. In the field of chemicals, there are some open questions remaining, the most important concerning the production of medicaments in heading 3004 from the bulk form under heading 3003.

Textiles and clothing have been, since the early days of the negotiations, a disputed issue. Naturally the rules of origin have had several implications on the attribution of the quotas under the ATC agreements. As quotas under the ATC are liberalized, some progress may be made, unless attention is shifted to other trade remedies such as AD.

The main question will remain one of the printing or dyeing of yarn and fabrics. The other issues, such as coating, embroidery, or assembly of apparel, may be areas for which a compromise is possible.

The steel sector is affected by several trade defense measures; therefore the issue of coating steel products (i.e., galvanizing, painting, or similar processes) is highly sensitive. It cannot be denied that many types of coating are sophisticated and add great value to the end product. However, there is concern that some operators could profit from rules of origin to circumvent trade measures.

Once the trade volume involved is considered, one of the biggest issues is the assembly in the machinery chapters and automobile sectors, ranging from Chapters 84 to 90. Two main approaches are still on paper; on the one hand, the U.S.-based HS approach proposing that the assembly should always be considered origin conferring if the change in (sub)heading is satisfied; on the other hand, the EC and Brazil continue to propose the value-added approach in their reasoning to prevent simple assembly operations. The solution could be to commingle both approaches as alternative options for the producers.

In the automotive sector, the possible differences between tariff shift and value-added approach are more complicated. It appears that there are strong interests calling for the maintenance of a minimal local value content.

One of the last specific assembly questions relates to clocks and watches. The major watch producers have some differences of view whether the origin of a watch should go to the place of final assembly or to the origin of the

movement. If the main rule for the whole machinery chapter should logically apply, the origin should be the place of assembly.

Finally, early consideration should be given to the implementation aspects of the HRO and especially to the requirements to equally apply these rules for all purposes. As previously outlined, this latter aspect may have decisive and different implications depending on the country and product involved and on the direction of import or export trade flows. Applying a harmonized set of rules is a sophisticated and technical affair requiring a highly trained administration and informed private sector. The rules that will apply will largely be "inherited" from the institutional memory and domestic *acquis* prevailing in the major trading nations. Most of the implementation burden may therefore be expected to fall on developing countries. Lessons learned with difficulties on meeting the requirements of preferential rules of origin, especially as far as the issuance of certificates of origin is concerned, should be duly taken into account in order not to transform the results of the HWP in unnecessary administrative formalities contrary to the recent initiatives on trade facilitation.

TABLE 2.9. *Comparison Table: Pan-Euro and NAFTA Rules of Origin and the Harmonized Rules of Origin*

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA[1]	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
Chapter 2	Meat of bovine animals, fresh or chilled	NAFTA: A change to heading nos. 02.01 through 02.10 from any other chapter. Pan-Euro: Manufacture in which all materials of Chapters 1 and 2 used are wholly obtained	[CC]
0302 to 0305	Fish, other than live fish	Pan-Euro: Manufacture in which all the materials of Chapter 3 used are wholly obtained (see also requirement for wholly obtained produscts for fisheries) NAFTA: A change to heading nos. 03.01 through 03.07 from any other chapter.	[The country of origin of the goods of this heading shall be the country in which they have been captured; or if farmed, the country in which the fish has been raised from egg or fry (including fingerling)] Still open the issue of smoking fiish and making pellets of fish)
04	DAIRY PRODUCE; BIRDS' EGGS' NATURAL HONEY; EDIBLE PRODUCTS OF ANIMAL	Pan-Euro: Manufacture in which all the material of Chapter 4 are already originating.	
Pan-Euro : Ex Chapter 4 NAFTA : all chapter	Dairy produce; birds eggs; natural honey; edible products of animal originnot elsewhere specified or included except for (see below)	NAFTA: A change to heading nos. 04.01 through 04.10 from any other chapter, except from tariff item no. 1901.90.31, 1901.90.32, 1901.90.33, 1901.90.34, 1901.90.39, 1901.90.51, 1901.90.52, 1901.90.53, 1901.90.54 or 1901.90.59.	
0403	Buttermilk, curdled milk and cream, yoghurt, kephir and other fermented or acidified milk and cream, whether or not concentrated or containing added sugar or other sweetening matter or flavoured or containing added fruit or cocoa	Pan-Euro: Manufacture in which: • all the materials of Chapter 4 used must already be originating, • all fruit juice (excepts of pineapples lime or grapefruit) of heading no. 2009 used is originating, and • the value of any materials of Chapter 17 used does not exceed 30 percent of the ex-works price of the product	[CTH]
09	COFFE , TEA, MATÉ AND SPICES EXCEPT FOR	Pan-Euro: Manufacture in which all the materials of Chapter 9 used are wholly obtained	
0901	Coffee	Pan-Euro: Manufacture from materials of any heading	[The country of origin of the goods of this subheading

(*continued*)

[1] Table 2.9 is for reference use only given that the rules of origin under the HRO, Pan-Euro, and NAFTA differ in providing product-specific rules of origin at chapter, heading, and subheading levels, it is difficult to draw an accurate comparison table. Hence, the table is simply showing a comparison of selected HS chapters or headings to illustrate the differences in terms of drafting and in terms of level of stringency of rules among the HRO, Pan-Euro, and NAFTA rules.

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		NAFTA: A change to heading 09.01 from any other chapter.	shall be the country in which the plant grew] or [The country of origin of the goods of this split subheading shall be the country in which all components are obtained in their natural or unprocessed state.] depending at subheading level
0902	Tea	Pan-Euro: Manufacture from materials of any heading NAFTA: 0902.10-0902.40 A change to subheadings 0902. 10 through 0902.40 from any other subheading, including another subheading within that group.	The country of origin of the goods of this heading shall be the country in which the plant grew.
Ex 0910	Mixtures of spices	Pan-Euro: Manufacture from materials of any heading NAFTA: 0910. 10 A change to a good of subheading 0910.10 from within that subheading or any other chapter. 0910.20 A change to subheading 0910.20 from any other chapter. 0910.30 A change to a good of subheading 0910.30 from within that subheading or any chapter	[CTHS] [The country of origin of the goods of this split heading shall be the country in which the plant grew.]
11	PRODUCTS OF THE MILLING INDUSTRY; MALT; STARCHES; INULIN; WHEAT GLUTEN		
ex Chapter 11	Products of the milling industry; malt, starches; inulin; wheat gluten, except for heading no. ex 1106	Pan-Euro: Manufacture in which all the cereals, edible vegetables, roots and tubers of heading no. 0714 or fruit used are wholly obtained NAFTA: A change to heading nos. 11.01 through 11.09 from any other chapter.	CC
16	**PREPARATIONS OF MEAT, OF FISH OR OF CRUSTACEANS, MOLLUSCS OR OTHER AQUATIC INVERTEBRATES**	NAFTA: All chapter: A change to heading nos. 16.01 through 16.05 from any other chapter.	
1601	Sausages and similar products, of meat, meat offal or blood; food preparations based on these products	Pan-Euro: Manufacture from animals of Chapter 1	[CC, subject to Chapter Note 1(a)][2]

(*continued*)

[2][Changes to this Chapter from Chapter 2 or 3 merely by addition of seasoning or preservatives (including sugar) are not considered as substantial transformation.]

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
1602	Other prepared or preserved meat, meat offal or blood	Pan-Euro: Manufacture from animals of Chapter 1	[CC]
1603	Extracts and juices of meat, fish or crustaceans, molluscs or other aquatic invertebrates	Pan-Euro: Manufacture from animals of Chapter 1. However, all fish, crustaceans, molluscs or other aquatic invertebrates used must already be originating	CTH
1604	Prepared or preserved fish; caviar and caviar substitutes prepared from fish eggs	Pan-Euro: Manufacture in which all the fish or fish eggs used must already be originating	[CTH; subject to Chapter Note 1]
1605	Crustaceans, molluscs and other aquatic invertebrates, prepared or preserved	Pan-Euro: Manufacture in which all the crustaceans, molluscs or other aquatic invertebrates used must already be originating	[CTH]
19	**PREPARATIONS OF CEREALS, FLOUR, STARCH OR MILK; PASTRY COOKS PRODUCTS**		
1901	Malt extract; food preparations of flour, meal, starch or malt extract, not containing cocoa powder or containing cocoa powder in a proportion by weight of less than 50 percent, not elsewhere specified or included; food preparations of goods of heading nos. 0401 to 0404, not containing cocoa powder or containing cocoa powder in a proportion by weight of less than 10 percent, not elsewhere specified or included: • Malt extract • Other	Manufacture from cereals of Chapter 10 Manufacture in which all the materials used are classified within a heading other than that of the product. However, sugar of heading no. 1701 may not be used NAFTA: 1901.10.20 A change to tariff item no. 1901.10.20 from any other chapter, except from Chapter 4. 1901.90.59 A change to tariff item no. 1901.90.31, 1901.90.32, 1901.90.33, 1901.90.34, 1901.90.39, 1901.90.51, 1901.90.52, 1901.90.53, 1901.90.54 or 1901.90.59 from any other chapter, except from Chapter 4	CTSH
1902	Pasta, whether or not cooked or stuffed (with meat or other substances) or otherwise prepared, such as spaghetti, macaroni, noodles, lasagne, gnocchi, ravioli, cannelloni; couscous, whether or not prepared	Pan-Euro: Manufacture in which all the cereals (except durum wheat), meat, meat offal, fish, crustaceans or molluscs used must already be originating NAFTA: A change to heading nos. 19.02 through 19.03 from any other chapter.	CTH

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
1903	Tapioca and substitutes therefore prepared from starch, in the form of flakes, grains, pearls, siftings or in similar forms	Pan-Euro: Manufacture in which all the materials used must already be originating	CTH
ex 1904	Prepared foods obtained by the swelling or roasting of cereals or cereal products (for example, cornflakes); cereals, other than maize (corn), in grain form, precooked or otherwise prepared: • Not containing cocoa • Containing cocoa	Pan-Euro: Manufacture in which all the materials used must already be originating Pan-Euro: Manufacture from materials of any heading, including other materials of heading no. 1904, except sugar of heading no. 1701, provided the value of any materials of Chapter 18 used does not exceed 40 percent of the ex-works price of the product NAFTA: 1904.10: A change to subheading no. 1904.10 from any other chapter 1904.20 : A change to subheading no. 1904.20 from any other subheading no., except from Chapter 20.	CTH
1905	Bread, pastry, cakes, biscuits and other bakers' wares, whether or not containing cocoa; communion wafers, empty cachets of a kind suitable for pharmaceutical use, sealing wafers, rice paper, and similar products	Pan-Euro: Manufacture from materials of any heading except those of Chapter 11 NAFTA: 19.05 A change to heading no. 19.05 from any other chapter.	CTH
30	**PHARMACEUTICAL PRODUCTS**[3]		

(*continued*)

[3] Primary Rules:
Chapter Notes:

1. Chemical Reaction

A "chemical reaction" is a process (including a biochemical process) which results in a molecule with a new structure by breaking intramolecular bonds and by forming new intramolecular bonds, or by altering the spatial arrangement of atoms in a molecule.

The following are not considered to be chemical reactions for the purposes of this definition:
(a) dissolving in water or other solvents;
(b) the elimination of solvents including solvent water; or
(c) the addition or elimination of water of crystallization

A chemical reaction as defined above is to be considered origin conferring.

TABLE 2.9 (*continued*)

2. Mixtures and blends

[Except for goods of heading 30.03 The deliberate and proportionally controlled mixing or blending (including dispersing) of materials other than the addition of diluents only to conform to pre-determined specifications which results in the production of a good having physical or chemical characteristics which are relevant to the purposes or uses of the good and are different from the input materials is to be considered to be origin conferring.]

3. Purification

Purification is considered to be origin conferring provided that one of the following criteria is satisfied:

(a) purification of a good resulting in the elimination of 80 percent of the content of existing impurities; or

(b) the reduction or elimination of impurities resulting in a good suitable for one or more of the following applications:

(i) pharmaceutical, medical, cosmetic, veterinary or food grade substances;
(ii) chemical products and reagents for analytical, diagnostic or laboratory uses;
(iii) elements and components for use in in micro-electronics;
(iv) specialized optical uses;
(v) biotechnical use (e.g., in cell culturing, in genetic technology, or as a catalyst);
(vi) carriers used in a separation process; or
(vii) nuclear grade uses.

4. Change in particle size

[The deliberate and controlled modification in particle size of a good, other than by merely crushing or pressing, resulting in a goodhaving a defined particle size, defined particle size distribution or defined surface area, which are relevant to the purposes of the resulting good and have different physical or chemical characteristics from the input materials is considered to be origin conferring. This rule shall not be applied to heading 30.04.]

5. Standard Materials

Standard materials (including standard solutions) are preparations suitable for analytical, calibrating or referencing uses having precise degrees of purity or proportions which are certified by the manufacturer. The production of standard materials is to be considered as origin conferring.

6. Isomer Separation

The isolation or separation of isomers from a mixture of isomers is to be considered as origin conferring.

7. Non-origin-conferring processes

[For the purposes of Chapters 3038 the addition, whether or not in combination, of the additives enumerated in HS Chapter Notes 1(f) and 1(g) to Chapter 29 for the purposes indicated therein is not origin conferring.]

8. Packing for retail sale

The change of classification resulting from the mere putting up for retail sale of products of this Chapter is to be disregarded for the determination of origin.

9. Biotechnological Processes

(a) Biologicalor biotechnological culturing, hybridization or genetic modification of:
(i) micro-organisms (bacteria, viruses (including phages) etc.) or
(ii) human, animal or plant cells; and

(b) production, isolation or purification of cellular or intercellularstructures (such as isolated genes, gene fragments and plasmids) are regarded as origin conferring.

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
ex Chapter 30	Pharmaceutical products, except for heading nos. 3002, 3003, 3004, 3005 and ex 3006, for which the rules are set out below	Pan-Euro: Manufacture in which all the materials used are classified within a heading other than that of the product. However, materials classified within the same heading may be used provided their value does not exceed 20 percent of the ex-works price of the product	
3003 and 3004	Medicaments (excluding goods of heading no. 3002, 3005 or 3006)	Pan-Euro: Manufacture from materials other than active substances. However, materials of heading nos. 3003 or 3004 may be used provided their value, taken together, does not exceed 20 percent of the ex-works price of the product NAFTA: 3003.10-3003.90 (1) A change to subheadings 3003.10 through 3003.90 from any other heading, except from subheading 3006.80; or VI-20 (2) A change to subheadings 3003.10 through 3003.90 from any other subheading within heading 30.03, whether or not there is also a change from any other heading, except from subheading 3006.80, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 3004.10-3004.31 (1) A change to subheading 3004.10 through 3004.31 from any other heading	30.03. (CTH) 30.04 :[CTH, except by mere pressing of tablets or by mere encapsulation.]

(*continued*)

Chapter Residual Rule

[When application of the primary rules of this chapter (including the product specific rules provided in the matrix) does not result in a determination of a country of origin, the country of origin shall be determined as follows:

1. Goods of headings 30.03 and 30.04 produced by mixing or otherwise combining materials of different origins, originate in the country that produced the therapeutic or prophylactic materials (disregarding solvents and other nonactive additives) that predominate by weight or volume, as appropriate, over those of each other single country.

2. Goods of Subheading 3006.50 that satisfy the change of heading rule merely as a result of putting up articles in first aid boxes or kits, originate in the country that produced the largest number of articles in the box or kit.

3. The country of origin of goods of subheading 3005.90 that contain textile material shall be the country where the textile material was formed, or in the case of a good containing textile materials of more than one country, the origin of the good is the country in which the textile material that predominates by weight was formed.]

[Criteria to apply Appendix 2, Rule 3(f)]

[The criteria to determine the major portion of the materials as set forth in Appendix 2, Rule 3(f) for this Chapter are weight, volume or value, as appropriate.]

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
3005	Wadding, gauze, bandages and similar articles (for example, dressings, adhesive plasters, poultices), impregnated or coated with pharmaceutical substances or put up in forms or packings for retail sale for medical, surgical, dental or veterinary purposes	Pan-Euro: Manufacture from materials of any heading, except pharmaceutical substances. However, the value of the materials of heading no. 3005 used may not exceed 20 percent of the ex-works price of the product NAFTA: 3005.10-3005.90 (1) A change to subheadings 3005.10 through 3005.90 from any other heading, except from subheading 3006.80; or (2) A change to subheadings 3005.10 through 3005.90 from any other subheading within heading 30.05, whether or not there is also a change from any other heading, except from subheading 3006.80, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used.	Ex 3505 Impregnated CTH
ex 3006	Chemical contraceptive preparations based on hormones or spermicide; bone reconstruction cements	Pan-Euro: Manufacture from materials of any heading, except active substances NAFTA: (1) A change to subheading 3006.10 from any other heading; or (2) A change to subheading 3006.10 from any other subheading within heading 30.06, except from subheading 3006.80, whether or not there is also a change from any other heading, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used.	CTH
31	**FERTILIZERS**		
ex Chapter 31	Fertilizers except for heading no. ex 3105 for which the rule is set out below	Pan-Euro: Manufacture in which all the materials used are classified within a heading other than that of the product. However, materials classified within the same heading may be used provided their value does not exceed 20 percent of the ex-works price of the product	CTH

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		NAFTA: 31.01 A change to heading no. 31.01 from any other heading no. 3102.10 -3105.90 A change to subheading nos. 3102.10 through 3105.90 from any other subheading no., including another subheading no. within that group	
ex 3105	Mineral or chemical fertilizers containing two or three of the fertilizing elements nitrogen, phosphorus and potassium; other fertilizers; goods of this chapter, in tablets or similar forms or in packages of a gross weight not exceeding 10 kg, except for: • Sodium nitrate • Calcium cyanamide • Potassium sulphate • Magnesium potassium sulphate	Pan-Euro: Manufacture in which: • all the materials used are classified within a heading other than that of the product. However, materials classified within the same heading may be used provided their value does not exceed 20 percent of the ex works price of the product, and • the value of all the materials used does not exceed 50 percent of the ex-works price of the product	CTH
Ex 393	PLASTICS AND ARTICLES THEREOF		
3901 to 3915	Plastics in primary forms, waste, parings an scrap, of plastic: • Addition homopolymerization products • Other	Pan-Euro: Manufacture in which: • the value of all the materials used does not exceed 50 percent of the ex-works price of the product, and • the value of any materials of Chapter 39 used does not exceed 20 percent of the ex-works price of the product Manufacture in which the value of any materials of Chapter 39 used does not exceed 20 percent of the ex-works price of the product NAFTA: 39.01-39.20 A change to heading nos. 39.01 through	CTH 3915: The origin of the goods shall be the country in which the waste and scrap of this heading is collected or derived from manufacturing or processing operations or from consumption

[4] The same chapter notes of chapter 30 apply.

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketedagreement not reached)
		39.20 from any other heading no., including another heading no. within that group, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used.	
3916 to 3921	Semi-manufactures of plastics: • Flat products, further worked than only surface-worked or cut into forms other than rectangles; other product, further worked than only surface-worked • Other: • Addition homopolymerization products	Pan-Euro: Manufacture in which the value of any materials of Chapter 39 used does not exceed 50 percent of the ex-works price of the product Manufacture in which: • the value of all the materials used does not exceed 50 percent of the ex-works price of the product, and • the value of any materials of Chapter 39 used does not exceed 20 percent of the ex-works price of the product	3916 : CTH, or change within this heading to reinforced, laminated or supported material 39.17 CTH, or change within this heading to reinforced, laminated or supported material 39.21 CTH, or change within this heading to reinforced, laminated or supported material, or change within this heading following the vacuum deposition of metal on the surface of plastics.
	• Other	Manufacture in which the value of any materials of Chapter 39 used does not exceed 20 percent of the ex-works price of the product NAFTA: 3921.14 A change to subheading no. 3921.14 from any other heading no., except from subheading no. 3920.20 or 3920.71. In addition, the regional value content must be not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 3921.19 A change to subheading no. 3921.19 from any other heading no., provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used.	

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		3921.90 A change to subheading no. 3921.90 from any other heading no., except from subheading no. 3920.20 or 3920.71. In addition, the regional value content must be not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used	
3922 to 3926	Articles of plastic	Pan-Euro: Manufacture in which the value of all the materials used does not exceed 50 percent of the ex-works price of the product	CTH 39.26.20 [CTH; provided that the goods are assembled in a single country in accordance of the Note of Chapters 61 or 62.]
41	**RAW HIDES AND SKINS (OTHER THAN FURSKINS) AND LEATHER**		
ex 4102	Raw skins of sheep or lambs, without wool on	Pan-Euro: Removal of wool from sheep or lamb skins, with wool on NAFTA: 41.02 (1) A change to hides or skins of heading 41.02 which have undergone a tanning (including pretanning) process which is reversible from any other good of heading 41.02 or any other chapter; or (2) A change to any other good of heading 41.02 from any other chapter	CTH
4104 to 4107	Leather, without hair or wool other than leather of heading no. 4108 or 4109	Pan-Euro: Retaining of pretanned leather, or Manufacture in which all the materials used are classified within a heading other than that of the product NAFTA: 41.04 A change to heading 41.04 from any other heading, except from hides or skins of heading 41.01 which have undergone a tanning (including pretanning) process which is reversible or headings 41.05 through 41.15. 41.05 A change to heading 41.05 from heading 41.02, tariff item no. 4105.10.21 or 4105.10.29, or any other chapter, except from hides or skins of heading 41.02 which have undergone a tanning (including pretanning) process which is reversible.	CTH or CTHS

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		4106.21-4106.22 A change to subheadings 4106.21 through 4106.22 from heading 41.03, tariff item no. 4106.21.21 or 4106.21.29 or any other chapter, except from hides or skins of subheading 4103.10 which have undergone a tanning (including pretanning) process which is reversible. 4106.31-4106.32 A change to subheadings 4106.31 through 4106.32 from heading 41.03, tariff item no. 4106.31.10 or any other chapter, except from hides or skins of subheading 4103.30 which have undergone a tanning (including pretanning) process which is reversible. 4106.40-4106.92 A change to subheadings 4106.40 through 4106.92 from heading 41.03 or any other chapter, except from hides or skins of subheading 4103.20 or 4103.90 which have undergone a tanning (including pretanning) process which is reversible. 41.07 A change to heading 41.07 from heading 41.01 or any other chapter, except from hides or skins of heading 41.01 which have undergone a tanning (including pretanning) process which is reversible.	
4109	Patent leather and patent laminated leather; metallized leather	Pan-Euro: Manufacture from leather of heading nos. 4104 to 4107 provided its value does not exceed 50 percent of the ex-works price of the product	CTH
60	**KNITTED OR CROCHETED FABRICS**		
Chapter 60	Knitted or crocheted fabrics	Pan-Euro: Manufacture from: • natural fibres, • man-made staple fibres not carded or combed or otherwise processed for spinning, or • chemical materials or textile pulp NAFTA: 60.01-60.06 A change to headings 60.01 through 60.06 from any other chapter, except from headings 51.06 through 51.13, Chapter 52, heading	Ex 60.01(a) Pile fabrics, including "long pile" fabrics and terry fabrics, knitted or crocheted, printed, dyed (including dyed white): [CTH; or change from unbleached or prebleached fabric to the product of this split heading by permanent dyeing or printing, accompanied by at least two preparatory or finishing operations.] Ex 60.01 (b): Other: CTH Ex 60.02 (a) Other knitted or crocheted fabrics: printed, dyed (including dyed white): [CTH; Change from unbleached or prebleached fabric

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		53.07 through 53.08 or 53.10 through 53.11 or Chapters 54 through 55.	to the product of this split heading by permanent dyeing or printing, accompanied by at least two preparatory or finishing operations.] Ex 60.02 (b) other .CTH

(*continued*)

Chapter 6
4 Primary Rules:
Section Note:
[Minor processing operations not affecting origin.

For the purposes of determining the country of origin for goods falling within Section XI that are not wholly obtained in one country, the following individual processes, considered singly, shall not affect the origin of the goods concerned, whether or not such processes result in changes of classification:

(a) Working or finishing one or more edges by hemming, rolling, whipping or similar means or by knotting fringe;
(b) Cutting fabrics, yarns or other textile materials; or separating goods produced in the finished state by cutting along dividing threads;
(c) Assembling or joining goods by sewing or stitching for convenience of shipment or other temporary purposes;
(d) Putting up goods for retail sale or in sets or ensembles.]

Chapter Notes

(a) For the purposes of this chapter, and subject to paragraph (b), the term 'assembled in a single country' means that all of the assembly operations following the cutting of the fabric, or the knitting or crocheting, to shape of the parts have been performed in that country.
(b) For the purposes of paragraph (a) performing or not performing operations such as the following shall not affect the determination of whether the good has been assembled in a single country:
- attaching to garments or accessories items such as accessories, buttons and other fasteners, pockets, trimmings, cuffs, plackets, labels, foot straps, ornaments, belt loops, epaulettes collars;
- making button holes, hemming, pressing, stone or acid washing."

[Application of the value added rule

(a) The term "**x percent value added rule**" shall mean manufacture where the increase in value acquired as a result of working and processing, and if applicable, the incorporation of parts originating in the country of manufacture represents at least x percent of the ex-works price of the product. "X" is the percentage indicated for each heading.
(b) The term "**ex-works price**" shall mean the price to be paid for the product obtained to the manufacturer in whose undertaking the last working or processing is carried out (this price shall not include internal taxes which are, or may be, repaid when such product is exported);
(c) The term "**value acquired as a result of working and processing and incorporation of parts originating in the country of manufacture**" shall mean the increase in value resulting from the assembly itself, together with any preparatory, finishing and checking operations, and from the incorporation of any parts originating in the country where the operations in question were carried out, including profit and the general costs borne in that country as a result of the operations;
(d) The term "**value of nonoriginating materials**" means the customs value at the time of importation of the non-originating materials used, or, if this is not known and cannot be ascertained, the first ascertainable price paid for the materials in the country of importation.]

[Chapter Residual Rule

When application of the primary rules of this Chapter (including the product specific rules provided in the matrix) do not result in a determination of a country of origin, the country of origin shall be determined as follows:

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
Chapter 61	CLOTHING ACCESSORIES, KNITTED OR CROCHETED	Pan-Euro: Manufacture from: • yarn, • natural fibres, • man-made staple fibres not carded or combed or otherwise processed for spinning, or • chemical materials or textile pulp NAFTA: 6101.10-6101.30 A change to subheading nos. 6101.10 through 6101.30 from any other chapter, except from heading nos. 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapter 54, or heading nos. 55.08 through 55.16 or 60.01 through 60.06, provided that: (a) the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the NAFTA countries, and (b) the visible lining fabric listed in Note 1 to Chapter 61 satisfies the tariff change requirements provided therein. 6101.90 A change to subheading no. 6101.90 from any other chapter, except from heading nos. 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapter 54, or heading nos. 55.08 through 55.16	ex Chapter 61(a) (ex 61.01 through 61.17)Goods including parts and accessories, knitted or crocheted to shape : The country of origin of the goods of this split chapter is the country in which these goods have been knitted or crocheted to shape ex Chapter 61(b) (ex 61.01 through ex 61.15)Goods of heading 61.01 through 61.15 assembled from parts knitted or crocheted to shape: [The country of origin of the goods of this split chapter is the country in which the parts of these goods have been knitted or crocheted to shape.] ex Chapter 61(c) (ex 61.01 through ex 61.15 Goods of heading 61.01 through 61.15 assembled from parts cut to shape: [Change to goods of this split chapter provided that the goods are assembled in a single country in accordance with Chapter Note.] ex Chapter 61(d)(ex 6117.10, ex 6117.80) Embroidered flat products (handkerchiefs, shawls, scarves, mufflers, mantillas, veils and the like: [Change to goods of this split chapter if the value of nonoriginating materials used does not exceed 50 percent of the ex-work price of the product.] ex Chapter 61(e)(ex 6117.10, ex 6117.80 Other flat products (other handkerchiefs, shawls, scarves, mufflers, mantillas,veils and the like): [Change to this split Chapter provided the starting material is prebleached on unbleached fabric.]

(*continued*)

(1) Where the primary rule for a good assembled from parts requires that the good be wholly assembled in a single country, the country of origin of such a good that was not wholly assembled in a single country, is the country in which the most significant assembly operations were performed in the making-up of the good, without regard to the addition of buttons and other fasteners, belt and hanger loops, belts, patch pockets, labels, foot straps, epaulettes, ornaments and other minor components.

(2) The country of origin of other goods of this Chapter shall be the country where the textile fabric or knit-to-shape components was formed, or in the case of a good containing textile fabrics or knit-to-shape component of more than one country, the origin of the good is the country in which the textile fabric or knit-to-shape component that predominates by weight was formed.]

[Criteria to apply Appendix 2, Rule 3(f)]

[The criteria to determine the major portion of the materials as set forth in Appendix 2, Rule 3(f) for this Chapter are value.]

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		or 60.01 through 60.06, provided that the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the NAFTA countries.	ex Chapter 61(f)(ex 61.16, ex 6117.20, ex 6117.80 Accessories assembled from parts knitted or crocheted to shape (ties, bow ties, cravats, gloves, mittens, mitts, muffs, headbands and the like) [The country of origin of the goods of this split chapter is the country in which the parts of these goods have been knitted or crocheted to shape.] ex Chapter 61(g)(ex 61.16 ex 6117.20, ex 6117.80)Accessories assembled from parts cut to shape (ties, bow ties, cravats, gloves, mittens, mitts, muffs, headbands and the like [Change to goods of this split chapter provided that the goods are assembled in a single country in accordance with Chapter Note.]
62	ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, NOT KNITTED OR CROCHETED		
ex Chapter 6	Articles of apparel and clothing accessories, not knitted or crocheted, except for heading nos. 6213 and 6214 for which the rules are set out	Pan-Euro: Manufacture from yarn NAFTA: 6201.11-6201.13 A change to subheading nos. 6201.11 through 6201.13 from any other chapter, except from heading nos. 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapter 54, or heading nos. 55.08 through 55.16, 58.01 through 58.02 or 60.01 through 60.06, provided that: (a) the good is both cut and sewn or otherwise assembled in the territory of one or more of the NAFTA countries, and (b) the visible lining fabric listed in Note 1 to Chapter 62 satisfies the tariff change requirements provided therein. 6201.19 A change to subheading no. 6201.19 from any other chapter, except from heading nos. 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapter 54, or heading nos. 55.08 through 55.16, 58.01 through 58.02 or 60.01 through 60.06, provided that the good is both cut and	ex Chapter 62(a)(ex 62.01 through ex 62.12) Goods of heading 62.01 through 62.12 assembled from parts, other than diapers of heading 62.09: [Change to goods of this split chapter provided that the goods are assembled in a single country in accordance with Chapter Note.] ex Chapter 62(b)(ex 62.09) Diapers of heading 62.09 : [CC, except by cutting and/or hemming only.]

(*continued*)

[5] Same chapter rules of chapter 61 apply.

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		sewn or otherwise assembled in the territory of one or more of the NAFTA countries.	
6213 and 6214	Handkerchiefs, shawls, scarves, mufflers, mantillas, veils and the like	Pan-Euro: Manufacture from unbleached single yam NAFTA: 62.13-62.17 A change to heading nos. 62.13 through 62.17 from any other chapter, except from heading nos. 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapter 54, or heading nos. 55.08 through 55.16, 58.01 through 58.02 or 60.01 through 60.06, provided that the good is both cut and sewn or otherwise assembled in the territory of one or more of the NAFTA countries	ex Chapter 62(c)(ex 62.13, ex 62.14, ex 6217.10) Embroidered flat products (handkerchiefs, shawls, scarves, mufflers, mantillas, veils and the like): [Change to goods of this split chapter if the value of nonoriginating materials used does not exceed 45 percent of the ex-work price of the product.] ex Chapter 62(d)(ex 62.13, ex 62.14,ex 6217.10 Other flat products (other handkerchiefs, shawls, scarves, mufflers, mantillas, veils and the like): [Change to goods of this split chapter provided the starting material is prebleached or unbleached fabric.] ex Chapter 62(e)(ex 62.15, ex 62.16, ex 6217.10) Accessories assembled from parts (ties, bowties, cravats, gloves, mittens, mitts, muffs, headbands and the like) [Change to goods of this split chapter provided that the goods are assembled in a single country in accordance with Chapter Note.] ex Chapter 62(f) Other [The country of origin of the goods of this split chapter shall be the country of origin of the fabric.]
64	**FOOTWEAR, HALTERS AND THE LIKE; PARTS OF SUCH ARTICLES**		
6401 to 6405	Footwear	Pan-Euro: Manufacture from materials of any heading except for non-metal parts for footwear of heading no. 6406 NAFTA: 64.01-64.05 A change to heading nos. 64.01 through 64.05 from any heading no. outside that group, except from subheading no. 6406.10, provided there is a regional value content of not less than 55 percent under the net cost method. 6406.10 A change to subheading no. 6406.10 from any other subheading no., except from heading nos. 64.01 through 64.05, provided there is a regional value content of not less than 55 percent under the net cost method.	CTH, except from split heading ex 64.06(A)

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		6406.20-6406.99 A change to subheading nos. 6406.20 through 6406.99 from any other chapter.	
70	**GLASS AND GLASSWARE**		
7006	Glass of heading no. 7003, 7004 or 7005, bent, edge-worked, engraved, drilled, enamelled or otherwise worked, but not framed or fitted with other materials	Pan-Euro: Manufacture from materials of heading no. 7001 NAFTA: 70.03-70.09 A change to heading nos. 70.03 through 70.09 from any heading no. outside that group.	ex 70.06(a) - Thin dielectric or metallic film coated flat glass*: CTHS ex 70.06(b) other CTH, except from heading 70.03, 70.04 or 70.05
7007	Safety glass, consisting of toughened (tempered) or laminated glass	Pan-Euro: Manufacture from materials of heading no. 7001	CTH
7008	Multiple-walled insulating units of glass	Pan-Euro: Manufacture from materials of heading no. 7001	CTH
7009	Glass mirrors, whether or not framed, including rear-view mirrors	Pan-Euro: Manufacture from materials of heading no. 7001	CTH
7010	Carboys, bottles, flasks, jars, pots, phials, ampoules and other containers, of glass, of a kind used for the conveyance or packing of goods; preserving jars of glass; stoppers, lids and other closures, of glass	Manufacture within which all the materials used are classified in a heading other than that of the product or Cutting of bottles or flasks, provided their value does not exceed 50 percent of the ex-works price of the product NAFTA: 70.10-70.20 A change to heading nos. 70.10 through 70.20 from any other heading no., except from heading nos. 70.07 through 70.20.	[CTH or change by chemically etching, sandblasting or grinding with subsequent acid polishing, of unworked glassware (not etched, sand-blasted, ground, carved, engraved or otherwise decorated).]
7013	Glassware of a kind used for table, kitchen, toilet, office, indoor decoration or similar purposes (other than that of heading no. 7010 or 7018)	Pan-Euro: Manufacture within which all the materials used are classified in a heading other than that of the product or Cutting of glassware, provided the value of at the uncut glassware does not exceed 50 percent of the ex-workd price of the product	[CTH or change by chemically etching, sand-blasting or grinding with subsequent acid polishing, of unworked glassware (not etched, sand-blasted, ground, carved, engraved or otherwise decorated).]

(*continued*)

* Glass of this split heading consists of a glass substrate with multiple coatings applied in accordance with the following technologies:
- physical vapor deposition by thermal evaporation
- sputtering
- chemical vapor deposition

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
ex 7019	Articles (other than yarn) of glass fibres	Pan Euro: Manufacture from: • uncolored slivers, rovings, yarn or chopped strands, or • glass wool	[CTH or CTSH depending on specific subheading
72	**IRON AND STEEL**		
7207	Semi-finished products of iron or non-alloy steel	Pan Euro: Manufacture from materials of heading no. 7201, 7202, 7203, 7204 or 7205 NAFTA: 72.06-72.07 A change to heading nos. 72.06 through 72.07 from any heading outside that group.	CTH
7208 to 7216	Flat-rolled products, bars and rods, angles, shapes and sections of iron or non-alloy steel	Pan Euro: Manufacture from ingots or other primary forms of heading no. 7206 NAFTA: 72.08-72.16 A change to heading nos. 72.08 through 72.16 from any heading no. outside that group.	CTH, except from heading 72.13 ex 72.10(a) Clad CTHS ex 72.10(b) Plated or coated with tin, and printed or lacquered [CTHS] ex 72.10(c) Plated or coated with zinc, and corrugated CTH ex 72.10(d) other [CTHS] ex 72.11(a) Hot-rolled ex 72.11(b) Cold-rolled (cold-reduced) CTHS
7217	Wire of iron or non-alloy steel	Pan Euro: Manufacture from semi-finished materials of heading no. 7207 NAFTA: A change to heading no. 72.17 from any other heading no., except from heading nos. 72.13 through 72.15.	CTH, except from headings 72.13 through 72.15; or change from headings 72.13 through 72.15, provided the material has been cold-formed in conformity with. the Chapter Note
ex 7218, 7219 to 7222	Semi-finished products, flat-rolled products, bars and rods, angles and sections of stainless steel	Pan Euro: Manufacture from ingots or other primary forms of heading no. 7218 NAFTA: 72.18-72.22 A change to heading nos. 72.18 through 72.22 from any heading no. outside that group.	7218: CTH
7223	Wire of stainless steel	Pan Euro: Manufacture from semi-finished materials of heading no. 7218	[CTH, except from 7221 through 7222; or change from headings 7221 through 7222, provided the

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		NAFTA: A change to heading no. 72.23 from any other heading no., except from heading nos. 72.21 through 72.22.	material has been cold-formed in conformity with the Chapter Note.]
ex 7224, 7225 to 7227	Semi-finished products, flat-rolled products, bars and rods, in irregularly wound coils, of other alloy steel	Pan-Euro: Manufacture from ingots or other primary forms of heading no. 7224 NAFTA: A change to heading nos. 72.24 through 72.28 from any heading no. outside that group	CTH
7229	Wire of other alloy steel	Pan-Euro: Manufacture from semi-finished materials of heading no. 7224 NAFTA: A change to heading no. 72.29 from any other heading no., except from heading nos. 72.27 through 72.28.	CTH, except from headings 72.27 through 72.28; or change from headings 72.27 through 72.28, provided the material has been cold-formed in conformity with the Chapter Note.
73	**ARTICLES OF IRON AND STEEL**		
ex 7301	Sheet piling M	Pan-Euro: Manufacture from materials of heading no. 7206	CTH
7302	Railway or tramway track construction material of iron or steel, the following: rails, check, -rails and rack rails, switch blades, crossing frogs, point rods and other crossing pieced, sleepers (cross-ties), fishplates, chairs, chair wedges, sole plates (base plates), rail clips, bedplates, ties and other material specialized for jointing or fixing rails	Pan-Euro: Manufacture from materials of heading no. 7206 NAFTA: 73.01-73.03 A change to heading nos. 73.01 through 73.03 from any other chapter	CTH
7304 7305 and 7306	Tubes, pipes and hollow profiles, of iron (other than cast iron) or steel	Pan-Euro: Manufacture from materials of heading no. 7206, 7207, 7218 or 7224 NAFTA: 7304.41 7304.41.11, 7304.41.19 A change to tariff item no. 7304.41.11 or 7304.41.19 from subheading no. 7304.49 or any other chapter. 7304.41 A change to subheading no. 7304.41 from any other chapter. 7304.49-7304.90 A change to subheading nos. 7304.49 through 7304.90 from any other chapter. 73.05-73.07 A change to heading nos. 73.05 through 73.07 from any other chapter.	CTH
7308	Structures (excluding prefabricated buildings of	Pan-Euro: Manufacture in which all the materials used are classified	ex 73.08(a) Structures CTHS

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
	heading no. 9406) and parts of structures (for example, bridges and bridge-sections, lock-gates, towers, latticemasts, roofs, roofing frameworks, doors and windows and their frames and thresholds for doors, shutters, balustrades, pillars and columns), of iron or steelplates, rods, angles, shapes, sections, tubes and the like, prepared for use in structures, of iron or steel	with in a heading other than that of the product. However, welded angles, shapes and sections of heading no. 7301 may not be used NAFTA: A change to heading no. 73.08 from any other heading no., except for changes resulting from the following processes performed on angles, shapes, or sections of heading no. 72.16:	ex 73.08(b) Parts of structures CTH ex 73.08 © Other CTH, except from headings 72.08 through 72.16,73.01 or 73.04 through 73.06
84	**NUCLEAR REACTORS, BOILERS, MACHINERY AND MECHANICAL APPLIANCES; PARTS THEREOF**		
8407	Spark-ignition reciprocating or rotary internal combustion piston engines	Pan-Euro: Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product NAFTA: 84.07-84.08 A change to heading nos. 84.07 through 84.08 from any other heading no., including another heading no. with in that group, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net costmethod isused.	CTH CTH, except from heading 84.09; or 35 percent value
8408	Compression-ignition internal combustion piston engines (diesel or semi-diesel engines)	Pan-Euro: Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-work sprice of the product	CTH CTH, except from heading 84.09; or 35 percent value-added rule
8409	Parts suitable for use solely or principally with the engines of heading no. 8407 or 8408	Pan-Euro: Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product NAFTA: 8409.10 A change to subheading no. 8409.10 from any other heading no. 8409.91 (1) A change to subheading no. 8409.91 from any other heading no.; or (2) No required change in tariff classification to subheading no. 8409.91, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used.	CTH

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		8409.99 (1) A change to subheading no. 8409.99 from any other heading no.; or (2) No required change in tariff classification to subheading no. 8409.99, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net costmethod isused	
8415	Air conditioning machines, comprising a motor-driven fan and elementsfor changing the temperature and humidity, including those machines in which the humidity cannot be separately regulated	Pan-Euro: Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product NAFTA: 8415.10 (1) A change to self-contained window or wall type air conditioning machines of subheading 8415.10 from any other subheading, except from tariff item no. 8415.90.11,8415.90.21 or 8415.90.22 or assemblies incorporating more than one of the following: compressor, condenser, evaporator, connecting tubing; (2) A change to "split-systems" of subheading 8415.10 from any other subheading, except from subheadings 8415.20 through 8415.83, tariff item no. 8415.90.11, 8415.90.21 or 8415.90.22 or assemblies incorporating more than one of the following: compressor, condenser, evaporator, connecting tubing; or XVI - 6 (3) A change to "split-systems" of subheading 8415.10 from tariff item no. 8415.90.11,8415.90.21 or 8415.90.22 or assemblies incorporating more than one of the following: compressor, condenser, evaporator, connecting tubing, whether or not there is also a change from subheadings 8415.20 through 8415.83, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net costmethod is used.	CTSH CTH; or 35 percent value-added rule
8418	Refrigerators, freezers and other refrigerating or freezing equipment,electric or other; heat pumps other than air conditioning machines of	Pan-Euro: Manufacture: • in which the value of all the materials used	CTSH

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
	heading no. 8415	dos not exceed 40 percent of the ex-works price of the product, and • where, within the above limit, the materials classified within the same heading as the product are only used up to a value of 5 percent of the ex-works price of the product, and • where the value of all the non-originating materials used does not exceed the value of the originating materials used NAFTA: 8418.10-8418.21 A change to subheading nos. 8418.10 through 8418.21 from any subheading no. outside that group, except from subheading no. 8418.91 or tariff item no. 8418.99.10 or from assemblies incorporating more than one of the following: compressor, condenser, evaporator, connecting tubing. 8418.22 (1) A change to subheading no. 8418.22 from any other heading no.; or (2) A change to subheading no. 8418.22 from subheading nos. 8418.91 through 8418.99, whether or not there is also a change from any other heading no., provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 8418.29-8418.40 A change to subheading nos. 8418.29 through 8418.40 from any subheading no. outside that group, except from subheading no. 8418.91 or tariff item no. 8418.99.10 or from assemblies incorporating more than one of the following: compressor, condenser, evaporator, connecting tubing. 8418.50-8418.69 (1) A change to subheading nos. 8418.50 through 8418.69 from any other heading no.; or (2) A change to subheading nos. 8418.50 through 8418.69 from subheading nos. 8418.91 through 8418.99, whether or not there is also a change from any other heading no., provided there is a regional value content	CTH; or 35 percent value-added rule

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 8418.91 A change to subheading no. 8418.91 from any other subheading no. 8418.99 8418.99.10A change to tariff item no. 8418.99.10 from any other tariff item no. 8418.99 A change to subheading no. 8418.99 from any other heading no.	
85	**ELECTRICAL MACHINERY AND EQUIPMENT AND PARTS THEREOF; SOUND RECORDERS AND REPRODUCERS, TELEVISION IMAGE AND SOUND RECORDERS AND REPRODUCERS, AND PARTS AND ACCESSORIES OF SUCH ARTICLES**		
ex Chapter 85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers and parts and accessories of such articles; except for those falling within the following headings or parts of headings for which the rules are set out below: 8501, 8502, ex 8518, 8519 to 8529, 8535, 8537, 8542, 8544 to 8548	Pan-Euro: Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, and • where, within the above limit, the materials classified within the same heading as the product are only used up to a value of 5 percent of the ex-works price of the product	
8501	Electric motors and generators (excluding generating sets)	Pan-Euro: Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, and • where, within the above limit, the materials classified within heading 8503 are only used up to a value of 5 percent of the ex-works price of the product NAFTA: 85.01 (1) A change to heading no. 85.01 from any other heading no., except from tariff item nos. 8503.00.10; or (2) A change to heading no. 85.01 from tariff item nos.	CTH CTH, except from heading 85.03; or 35 percent value-added rule

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		8503.00.10, whether or not there is also a change from any other heading no., provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used.	
8520	Magnetic tape recorders and other sound recording apparatus, whether or not incorporating a sound reproducing device	Pan-Euro: Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, • where the value of all the nonoriginating materials used does not exceed the value of the originating materials used, and • all the transistors of heading no. 8541 used are originating products NAFTA: 8520.10-8520.90 A change to subheading nos. 8520.10 through 8520.90 from any other subheading no., including another subheading no. within that group, except from tariff item no. 8522.90.10	CTH 45 percent value added rule
8521	Video recording or reproducing apparatus	Pan-Euro: Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, • where the value of all the non-originating materials used does not exceed the value of the originating materials used, and • all the transistors of heading no. 8541 used are originating products NAFTA: 8521.10-8521.90 A change to subheading nos. 8521.10 through 8521.90 from any other subheading no., including another subheading no. within that group, except from tariff item no. 8522.90.10	CTH 45 percent value added rule
8522	Parts and accessories of apparatus of heading	Pan-Euro: Manufacture in which the value of all the materials used	CTH

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
	nos. 8519 to 8521	does not exceed 40 percent of the ex-works price of the product NAFTA: 85.22 A change to heading no. 85.22 from any other heading no.	45 percent value added rule
8525	Transmission apparatus for radio-telephony, radio-telegraphy, radio-broadcasting or television, whether or not incorporating reception apparatus or sound recording or reproducing apparatus; television cameras	Pan-Euro: Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, • where, within the above limit, the materials classified within heading no. 8529 are only used up to a value of 5 percent of the ex-works price of the product, • where the value of all the nonoriginating materials used does not exceed the value of the originating materials used, and • all the transistors of heading no. 8541 used are originating products NAFTA: 85.23-85.24 A change to heading nos. 85.23 through 85.24 from any other heading no., including another heading no. within that group. 8525.10-8525.20 A change to subheading nos. 8525.10 through 8525.20 from any subheading no. outside that group, provided that, with respect to printed circuit assemblies (PCAs) of tariff item no. 8529.90.11, 8529.90.12 or 8529.90.19: (a) except as provided in paragraph (b), for each multiple of nine PCAs, or any portion thereof, that is contained in the good, only one PCA may be a non-originating PCA, and (b) if the good contains less than three PCAs, all of the PCAs must be originating PCAs. 8525.30 8525.30.11, 8525.30.12 A change to tariff item no. 8525.30.11 or 8525.30.12 from any other tariff	CTH 45 percent value added rule

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		item no., except from tariff item no. 8525.30.20. 8525.30 A change to subheading no. 8525.30 from any other subheading no., except from tariff item no. 8529.90.11, 8529.90.12 or 8529.90.19. 8525.40 A change to subheading no. 8525.40 from any other subheading no., except from tariff item no. 8529.90.11, 8529.90.12 or 8529.90.19	
8528	Television receivers (including video monitors and video projectors), whether or not combined, in the same housing, with radio broadcast receivers or sound or video recording or reproducing apparatus	Pan-Euro: Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, • where, within the above limit, the materials classified within heading no. 8529 are only used up to a value of 5 percent of the ex-works price of the product, • where the value of all the non-originating materials used does not exceed the value of the originating materials used, and • all the transistors of heading no. 8541 used are originating products NAFTA: 8528.12 8528.12.10 A change to tariff item no. 8528.12.10 from any other heading no., except from tariff item no. 8529.90.31. 8528.12.81 (1) A change to tariff item no. 8528.12.81 from tariff item no. 8528.12.10 or any other heading no., except from tariff item no. 8540.12.11, 8540.12.19 or 8540.91.10. In addition, no more than half the number of semiconductors of tariff item no. 8542.21.10, used in the television receiver component, may be nonoriginating; or (2) A change to tariff item no. 8528.12.81 from tariff item no. 8528.12.10 or any other heading no., except from tariff item no. 8540.12.11, 8540.12.19 or 8540.91.10. In addition, the regional value content	CTH 45 percent value added rule

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketedagreement not reached)
		must be not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 8528.12.82 (1) A change to tariff item no. 8528.12.82 from tariff item no. 8528.12.10 or any other heading no., except from tariff item no. 8540.11.11, 8540.11.12 or 8540.91.10. In addition, no more than half the number of semiconductors of tariff item no. 8542.21.10 used in the television receiver component, may be non-originating; or (2) A change to tariff item no. 8528.12.82 from tariff item no. 8528.12.10 or any other heading no., except from tariff item no. 8540.11.11, 8540.11.12 or 8540.91.10. In addition, the regional value content must be not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 8528.12.83, 8528.12.96 A change to tariff item no. 8528.12.83 or 8528.12.96 from tariff item no. 8528.12.10 or any other heading no., except from tariff item no. 8529.90.40. 8528.12.91 A change to tariff item no. 8528.12.91 from any other heading no., except from tariff item no. 8529.90.11, 8529.90.12, 8529.90.19, 8529.90.31 or 8529.90.39	
8529	Parts suitable for use solely or principally with the apparatus of heading nos. 8525 to 8528		
	• Suitable for use only or principally with video recording or reproducing apparatus	Pan-Euro: Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	CTH or CTSH or 45 percent
	• Other	Manufacture:	

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		• in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, • where, within the above limit, the materials classified within the same heading as the product are only used up to a value of 5 percent of the x-works price of the product, • where the value of all the nonoriginating materials used does not exceed the value of the originating materials used, and • all the transistors of heading no. 8541 of head no. 8541 used are originating products NAFTA: 8529.10 (1) A change to subheading 8529.10 from any other heading; or (2) No required change in tariff classification to subheading 8529.10, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used 8529.90 8529.90.11, 8529.90.12, 8529.90.19 A change to tariff item no. 8529.90.11, 8529.90.12 or 8529.90.19 from any other tariff item no. 8529.90.20 A change to tariff item no. 8529.90.20 from any other tariff item no. 8529.90.31 A change to tariff item no. 8529.90.31 from any other tariff item no. 8529.90.39 A change to tariff item no. 8529.90.39 from any other tariff item no. 8529.90.40 A change to tariff item no. 8529.90.40 from any other tariff item no. 8529.90.50 A change to tariff item no. 8529.90.50 from any other tariff item no. 8529.90.61, 8529.90.69 (1) A change to tariff item no. 8529.90.61 or 8529.90.69 from any other heading no.; or	

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		(2) No required change in tariff classification to tariff item no. 8529.90.61 or 8529.90.69, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 8529.90 (1) A change to subheading 8529.90 from any other heading; or (2) No required change in tariff classification to subheading 8529.90, provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used.	
8542	Electronic integrated circuits and microassemblies	Pan-Euro: Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, and • where, within the above limit, the materials classified within heading no. 8541 or 8542, taken together, are only used up to a value of 5 percent of the ex-works price of the product NAFTA: 85.41-85.42 ***Note***: *Notwithstanding section 16 (Transshipment) of these Regulations, a good of subheading nos. 8541.10 through 8541.60 or 8542.10 through 8542.70 qualifying under the rule below as an originating good may undergo further production outside the territory of the NAFTA countries and, when imported into the territory of a NAFTA country, will originate in the territory of a NAFTA country, provided that such further production did not result in a change to a subheading no. outside that group.* No required change in tariff classification to subheadings 8541.10 through 8542.90. 8543.11-8543.81 (1) A change to subheading	The country of origin of a good of this heading shall be the country of diffusion for electronic integrated circuits The operation of diffusion (where integrated circuits are formed o a semi-conductor substrate by the selective introdu-ction of an appropriate dopant for other: CTH; or 35 percent value added rule

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
87	**VEHICLES OTHER THAN RAILWAY OR TRAMWAY ROLLING-STOCK, AND PARTS AND ACCESSORIES THEREOF**		
ex Chapter 87	Vehicles other than railway or tramway rolling-stock and parts and accessories thereof; except for those falling with in the following headings or parts of headings for which the rules are set out below: 8709 to 8711, ex 8712, 8715 and 8716	Pan-Euro: Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product NAFTA: 8703.10 A change to subheading no. 8703.10 from any other heading no., provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 8703.21-8703.90 A change to subheading nos. 8703.21 through 8703.90 from any other heading no., provided there is a regional value content of not less than 50 percent under the net cost method	CTH [35 or 45] percent value-added rule
8711	Motorcycles (including mopeds) and cycles fitted with an auxiliary motor, with or without side-cards; side-cars	Pan-Euro: Manufacture: • in which the value of all materials used does not exceed 40 percent of the ex-works price of the product, and • where, within the above limit, the materials classified within the same heading as the product are only used up to a value of 5 percent of the ex-works price of the product NAFTA: 87.11 (1) A change to heading no. 87.11 from any other heading no., except from heading no. 87.14; or (2) A change to heading no. 87.11 from heading no. 87.14, whether or not there is also a change from any other heading no., provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used	CTH [35 or 45] percent value-added rule
ex 8712	Bicycles without ball bearings	Pan-Euro: Manufacture from materials not classified within heading	CTH

(*continued*)

TABLE 2.9 (*continued*)

HS code	Description	Excerpts from product-specific requirement of Pan-European rules of origin and NAFTA	Excerpts from the agreed rules of the HWP (where bracketed agreement not reached)
		No. 8714 NAFTA: (1) A change to heading no. 87.12 from any other heading no., except from heading no. 87.14; or (2) A change to heading no. 87.12 from heading no. 87.14, whether or not there is also a change from any other heading no., provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used.	CTH, except from heading 87.14 ; or 35 percent value added rule
8716	Trailers and semi-trailers; other vehicles, not mechanically propelled; parts thereof	Pan-Euro: Manufacture: • in which the value of all materials used does not exceed 40 percent of the ex-works price of the product, and • where, within the above limit, the materials classified within the same heading as the product are only used up to a value of 5 percent of the ex-works price of the product NAFTA: 8716.10-8716.80 (1) A change to subheading nos. 8716.10 through 8716.80 from any other heading no.; or (2) A change to subheading nos. 8716.10 through 8716.80 from subheading no. 8716.90, whether or not there is also a change from any other heading no., provided there is a regional value content of not less than: (a) 60 percent where the transaction value method is used, or (b) 50 percent where the net cost method is used. 8716.90 A change to subheading no. 8716.90 from any other heading no.	CTSH CTH; or 35 percent value added rule

3

Preferential Rules of Origin

Until the beginning of the 1990s, there were only a few preferential rules of origin, mainly regulating some autonomous tariff preferential like the Generalized System of Preferences (GSP) schemes. Only the European Community (EC), because of the free-trade areas (FTAs) network with the remaining European Free-Trade Area (EFTA) countries had developed a comprehensive policy on rules of origin.

In the years that followed, and especially after the U.S.–Canada FTA and later North American Free-Trade Agreement (NAFTA) were concluded, rules of origin proliferated. This proliferation follows the path of the flourishing of regional trade agreements (RTAs). In fact, every time that RTAs are entered into, rules of origin have to be part of the agreement.

This chapter deals with (i) unilateral rules of origin contained under autonomous trade regimes like the GSP schemes and other unilateral preferences like the African Growth and Opportunity Act (AGOA) and (ii) contractual rules of origin contained in FTAs like NAFTA and those concluded by the EC with a variety of partners including their respective evolution.

As examined earlier, there are no binding multilateral rules on preferential rules of origin, nor are there efforts to harmonize them. It follows that not only are there different rules of origin in the case of the GSP schemes but, because a number of RTAs have been concluded between developed countries and also increasingly among developed and developing countries and among developing countries, there is an increased diversification of the content and nature of preferential rules of origin.

At the same time the techniques and experience of the main users of rules of origin, namely the United States and the EC, have been heavily influencing the drafting of the rules of origin in South–South agreements. This holds especially true when one of the partners of the South–South agreement previously entered into a RTA with one of them. In these cases, experience has shown

that the model inherited by the partner of the North will shape the content of the rules of origin of the RTA among the countries of the South.

This has been the case, for instance, of Mexico, who borrowed the NAFTA rules to negotiate rules of origin with Colombia, Venezuela, and Costa Rica. South Africa utilized the rules of origin contained in the FTA with the EC when it negotiated rules of origin with other Southern Africa Development Community (SADC) partners.

In this chapter, the main preferential rules of origin of either unilateral or contractual nature will be analyzed. The Pan-European and the NAFTA models will be outlined to provide an overview of these two major sets of rules of origin.

Among all the different preferential rules of origin that these two major users have put in place, the main differences relate to the trade instruments and the context in which they are established. Thus unilateral preferential rules of origin and contractual rules of origin are clearly distinguishable.

Unilateral preferential rules of origin are those contained in unilateral preferential trade arrangements, such as the GSP, the Caribbean Basin Initiative (CBI), and the AGOA. This definition may also be extended to cover rules of origin contained in nonreciprocal, but contractual agreements such as the previous Lomé Conventions and the Cotonou Partnership Agreement.

One of the main differences from reciprocal agreements is that the protocols on rules of origin usually attached to these nonreciprocal agreements were not strictly speaking "negotiated," given their unilateral character.

In the case of both unilateral and contractual preferential rules of origin, their main task is to ensure that tariff preferences are granted exclusively to goods originating in the beneficiary countries or in the member countries of the preferential trade area.

Unilateral rules of origin such as GSP rules of origin serve to attain specific trade policy objectives, such as the allocation of preferences to products genuinely produced in preference-receiving countries. However, GSP rules of origin carry, among the various kinds of existing preferential rules of origin, two clear and distinct connotations. First, unlike preferential rules of origin of a contractual nature, GSP rules of origin have been implemented autonomously. As such, they are not the result of strenuous bilateral negotiations but are the expression of the autonomous character of the GSP concession as a whole. This autonomous nature has been recognized in the Common Declaration annexed to the ARO, which distinguishes between autonomous and contractual preferential rules of origin. Second, from the outset, GSP rules of origin have served as an integral part of the GSP system's declared policy objectives, namely, increasing export earnings, promoting industrialization,

and accelerating the rate of economic growth that are common to all GSP schemes.

Unilateral rules of origin, such as those included in the GSP, may be intended to ensure that beneficiaries derive real benefits from trade preferences in terms of value added and investment. In spite of this laudable objective, the rules of origin contained in the GSP schemes and in previous Lomé Conventions and the Cotonou Partnership Agreement have been increasingly indicated as one of the major stumbling blocks of the utilization and use of trade preferences by beneficiaries.[1] Cumulative rules of origin are aimed at encouraging trade among members of a grouping of developing countries or among developing countries in general. However, the technicalities attached to it may frustrate this objective.

In the context of preferential rules of origin of a contractual nature, that is, in the case of free-trade agreements and other regional integration arrangements, rules of origin serve to regulate the trade patterns of the members. In FTAs, as distinct from customs unions, member-countries retain their own external tariffs. This feature opens the possibility that a product destined for a high-tariff member-country will first be imported into the lowest-tariff member-country and then reexported to the former, thus evading the high tariff. More subtly, if inputs imported from outside the FTAs represent a large part of the value added of a product, producers in the member-country with the lowest tariffs on inputs can undercut producers in other member countries. Rules of origin in FTAs serve the purpose of guarding against these possibilities. Strict rules of origin may substantially affect upstream or downstream third-country producers' inputs.

These preferential rules of origin reflect policy objectives. The most obvious is to avoid the deflection of trade in a FTA. However, they are often designed to respond to industrial policy objectives of domestic industries. In the NAFTA framework, for example, the United States sought stringent rules of origin even though U.S. tariffs were generally lower than those of Mexico. This means that, even in the absence of rules of origin, the possibility of final goods imports coming into the United States through Mexico was minimized. Nor would it have made sense for a U.S. producer to import inputs through Mexico. The aim of the rules of origin was mainly a protectionist one: A stringent rule of origin would undermine Mexico's ability to outcompete against an inefficient U.S. firm producing final goods and make the internal market for inputs more

[1] See Chapter 5 on drafting the economic of rules of origin. See also "Improving Market Access for LDCs," UNCTAD, 2001; and "Trade Preferences for LDCs: An Early Assessment and Possible Improvements," UNCTAD, 2003.

profitable. In one sensitive area, textiles and clothing, for which U.S. tariffs were high and the scope for trade creation substantial, the triple transformation rule of origin was adopted to maintain a high level of protection for U.S. producers.[2]

Such protectionist bias is however not limited to NAFTA rules of origin. Similar occurrences have materialized in the most different contexts.

3.1. The Current Rules of Origin under the Generalized System of Preferences

As examined in Chapter 1, since the start of the GSP system, preference-giving countries decided to implement their national schemes independently.[3] This resulted in different GSP schemes and different sets of rules of origin. Thus, each GSP scheme has its own rules of origin that must be complied with in order to take advantage of the GSP preferential tariff. The technical nature and the diversity of rules of origin have brought additional complexity to the GSP schemes and their utilization. For more than 20 years, discussions in the United Nations Conference on Trade and Development (UNCTAD) Working Group on rules of origin have concentrated on the best ways and means to attain the final aims of harmonizing the GSP rules of origin, simplifying and improving them. However, changes over the three decades of operation of the GSP have been limited.

Table 3.1 represents an overview of the main existing regimes of GSP rules of origin as of March 2008. The table attempts to summarize the major features of the different sets of rules currently in force in main preference-giving countries.

As may be noted from Table 3.1, preference-giving countries' rules of origin have been traditionally broadly divided into two main categories by the UNCTAD secretariat: (a) Canada, United States, and, according to the latest notification, Russia, use mainly an across-the-board percentage criterion; (b) the EC, Norway, Switzerland, and Japan use a combination of criteria (usually referred to as process criterion) based on the change of tariff heading (CTH) criterion, with or without exclusion, percentage criterion, specific working or processing requirements. These different product-specific requirements are contained in a so-called "Single List." Moreover, among the preference-giving countries using the percentage criterion, there are marked differences in the amount of minimum local content required and in the mode of calculation. Rules of origin are almost completely harmonized among Norway and

[2] See A. Panagariya, "The Regionalism Debate: An Overview," *The World Economy*, 1999, pp. 477–511.

[3] See OECD document TC/Pref/70.25, 25.9.1970, para. 37.

TABLE 3.1. *Comparative table of GSP rules of origin*

Country/group of countries	Origin criteria	Requirements	Numerator	Denominator	Percentage level	Administrative requirements
European Community (EBA) Japan	Product-specific rules for all products CTH as a general rule and single list of product-specific rules	Change of HS heading with or without exemptions, specific working or processing requirements and/or maximum percentage of imported inputs or combinations of requirements	Customs value of imported inputs, or the earliest ascertainable price paid in the case of materials of unknown, undetermined origin	Ex-works price (FOB price in the case of Japan)	Maximum imported inputs 5 percent, 20 percent, 25 percent, 30 percent, 40 percent, 47.5 percent, 50 percent where used in the Single List.	GSP- Form A compulsory for all products (EBA). Form A to be stamped by officially designated government authority. (Chamber of Commerce accepted in the case of Japan.) GSP – Form A needed only for certain products (Japan)
Former Cotonou Partnership Agreement	Product-specific rules for all products	Same as above	Same as above	Same as above	Same as above	Form EUR.I needed. Self-certificating procedures available.
Canada	One single rule across the board, 40 percent for DCs, 60 percent for LDCs, for all products except textile and apparel articles	Maximum import content requirement	Import content	Ex-factory price	Maximum import content 60 percent for LDCs. Product-specific rules of origin for textiles and clothing	GSP-Form A not required. Self-certification possible. Special certificate of origin for textiles and clothing
United States	One single percentage (35 percent) rule across the board for all products[4]	Minimum local content requirement	Cost of materials produced in preference-receiving country plus the direct cost of processing carried out there	Ex-factory price or appraised value by U.S. Customs	Minimum 35 percent	No certificate of origin required.
AGOA	All products as above except apparel articles[5]	Same as above	Same as above	Same as above	Same as above Special rules for textiles and clothing	Special visa requirements apply for textiles and clothing

Note: Developing Countries (DCs), Everything But Arms (EBA), Free On Board (FOB), Harmonized System (HS), Least-Developed Countries (LDCs).

[4] See Section 3.12.2.2.

[5] For product-specific rules of origin, see Section 3.1.5.

Switzerland and the EC, whereas marked differences persist between the Single-List requirements of these groups of countries and Japan.[6] It must be noted that countries using the process criterion make use of percentages in the requirements laid down in the Single List. This mainly concerns machinery and consumer goods in which the products-specific single-list rules require that the value of the imported inputs should not exceed a certain percentage of the ex-works or free-on-board (FOB) prices of the finished products.

Under the GSP schemes' rules of origin,[7] as in other sets of rules of origin, products exported from a preference-receiving country may be divided into two groups:

(a) products that have been entirely grown, extracted from the soil, or harvested within the exporting country, or manufactured there exclusively from any of these products, qualify as having been of GSP origin by virtue of the total absence of the use of any imported components or materials, or such of unknown origin; or
(b) products that are made from imported materials, parts, or components, that is, products that are manufactured wholly or in part from materials, parts or components imported into the preference-receiving country or that are from unknown origin. These products, which are termed "products with import content," qualify only if they have undergone "sufficient working or processing" (as defined under the individual rules of origin of preference-giving countries) in the preference-receiving exporting country.

Following these basic definitions, each GSP scheme lays down detailed rules or definitions of "sufficient working or processing" that have to be satisfied if goods are to be granted GSP tariff treatment. The common features and the main differences of all schemes are described in the following sections.

3.1.1. "Wholly Obtained" Products

Under the GSP rules of origin the "wholly obtained" criterion is interpreted strictly. Even a minimal content of imported materials, parts or components, or those whose origin cannot be determined, make the finished products lose their qualification as "wholly obtained."

Example: Wooden carvings made from wood "wholly obtained" in a preference-receiving country but polished with imported wax are not "wholly obtained" because of the wax.

[6] For specific examples of such differences, see UNCTAD TD/B/SCP/8, 3 March 1994.
[7] See also UNCTAD "Digest of rules of origin 1999."

The carving would, however, almost certainly qualify for GSP under either the percentage or the process criterion.

Generally speaking, all preference-giving countries[8] accept the following categories of goods as "wholly obtained" in a preference-receiving country:

(a) mineral products extracted from its soil or from its seabed;
(b) vegetable products harvested there;
(c) live animals born and raised there;
(d) products obtained there from live animals;
(e) products obtained from hunting or fishing conducted there;
(f) products obtained from sea fishing and other products taken from the sea by its vessels[9];
(g) products made on board its factory ships exclusively from products referred to in (f);
(h) used articles collected there fit only for the recovery of raw materials;
(i) waste and scrap resulting from manufacturing operations conducted there; and
(j) products obtained there exclusively from products specified in (a) – (i).[10]

The EC has developed a series of rather stringent criteria and definition of vessels that will be dealt with in subsection 3.3.2.1.1.

3.1.2. *Products with an Import Content*

As previously indicated, products that have been manufactured in a preference-receiving country wholly or partly from imported materials, parts, or components, including materials of undetermined or of unknown origin, are considered as originating in that country if those materials, parts, or components have undergone sufficient working or processing there. In general terms, working or processing is regarded as sufficient if it transforms the specific nature and characteristics of the materials used to a substantial degree. This general concept is, however, defined in detail by each preference-giving country.[11]

[8] The United States, although not including a list of "wholly obtained" products in its legislation, recognizes the products listed below as examples that are likely to meet the United States percentage criterion.

[9] The EC and other European countries apply restrictive definitions of the terms "its vessels" and "its factory ships" that are further discussed under the Pan-European rules of origin.

[10] Such as iron sheets; bars produced from iron ore; cotton fabrics woven from row cotton; recovery of lead from used motor cars batteries; recovery of metal from metal shavings.

[11] The rules applied by most preference-giving countries usually exclude what are called "minimal processes." These are regarded as insufficient working or processing and therefore are not qualifying the finished product for GSP tariff treatment.

3.1.2.1. Process Criterion

This criterion is applied by the EC, Japan, Norway, and Switzerland.

As a general rule under this criterion, imported materials, parts, or components (nonoriginating inputs) are considered to have undergone sufficient process when the product obtained comply with the product-specific rules contained in a what has been defined in the GSP jargon as a "Single List."[12] Some of these product-specific rules require a relatively simple CTH with or without exceptions, whereas others require specific working or processing operations or a percentage requirement or a combination of these elements. In the case of Japan, the CTH remains the main general rule coupled with a list of product-specific rules.

The CTH is satisfied when the finished product is classified in a heading of the HS[13] at the four-digit level, which is different from those in which all the nonoriginating materials, parts, or components used in the process are classified (referred to as "change in HS heading").

The list of product-specific rules was deemed necessary because for some products a change in HS heading does not always entail sufficient working or processing (or, *per contra*, although sufficient working or processing may occur, in some cases it does not involve a change in HS heading). The EC, Norway, and Switzerland have drawn up a list (commonly referred to as the *Single List*[14]) of working or processing to be carried out on nonoriginating materials so the product manufactured can obtain originating status. This list now contains all products for which the conditions set out in the list must be fulfilled. In the case of Japan, the list contains the specific conditions that have to be met instead of the basic requirement of change in HS heading. For products contained in the list, the basic requirement of change in HS heading needs to be fulfilled only where it is explicitly mentioned in the list.

The Single List contains Introductory Notes that give interpretations to some of the definitions used therein, as well as some further rulings to particular products, in particular in the textile sector. It should be noted that

[12] Until the adoption of the Pan-European rules of origin, the EC, Switzerland, and Norway adopted as a general rules the CTH coupled with a list of product-specific rules. The list of exceptions under the product-specific rules contained in the list was, however, over 70 pages and covered most of the products.

[13] The Harmonized Commodity Description and Coding System, adopted by the Customs Cooperation Council in Brussels on 14 June 1983 and came into effect on 1 January 1988 with 36 signatories; referred to as the "Harmonized System" or "HS."

[14] The origin of the term Single List derives from the fact that originally there were two lists that were subsequently combined into a "single list."

the provisions of the Introductory Notes also apply, where appropriate, to all products manufactured with nonoriginating inputs even if they are not subject to the specific conditions contained in the list, but are subject instead to the change in heading rule. In the case of introductory notes to the EC Single List, the conditions may refer, *inter alia*, to the following:

(a) The requirement that certain starting materials used in the production process must originate in the exporting preference-receiving country;

Example: For dried fruits of HS heading No. 0813, and for mixtures of nuts or dried fruits of Chapter 08, the List requires that all the fruit or nuts used must be wholly obtained.

(b) The requirement that only certain nonoriginating inputs may be used as starting material;

Example: For sausage and other products of HS heading No. 1601, the List requires the use of animals of Chapter 1 as starting material, i.e. use of imported meat would not confer origin.

(c) A combination of (a) and (b);

Example: For extracts and juices of meat, fish, etc. of HS heading 1603, the List requires manufacture from animals of Chapter 1 as starting materials; however, all fish, etc. used must already be originating.

(d) The requirement that nonoriginating inputs used must be of a certain – normally low – level processing;

Example: –For most articles of apparel and clothing accessories, not knitted or crocheted, of HS Chapter 62, the List requires manufacture from yarn; this means that the use of imported fabric would not confer origin.
–For wire of iron or non-alloy steel of HS heading No. 7217, the List requires manufacture from semi-finished materials of HS heading No. 7207; this means that the use of starting material at a higher level of processing would not confer origin.

(e) The requirement that nonoriginating inputs used not exceed a certain percentage of the ex-works price of the finished product;

Example: For articles of plastic HS heading Nos. 3922 to 3926, the List requires manufacture in which the value of all non-originating inputs used does not exceed 50% of the ex-works price of the product.

(f) The possibility of using nonoriginating inputs falling within the same four-digit HS heading as the exported product.

Example: For articles of hard rubber of HS heading No. 4017, the List permits manufacture from hard rubber as starting material which itself already is to be classified within the same HS heading as the finished product, i.e. articles made therefrom.

For a number of products in the Single List, the condition set out requires that the value of imported input not exceed a given percentage of the value of the product obtained. For the purpose of calculating whether the percentage is satisfied, the following are the numerator and the denominator in the case of the EC, Norway, and Switzerland:

Value of nonoriginating inputs is identified as their customs value at the time of importation into the preference-receiving country or, if this not known or cannot be ascertained, the first ascertainable price paid for them in that country;

Value of the products obtained is the ex-works price of the products (for Japan, the FOB price), less any internal taxes that are, or may be, repaid when the products obtained are exported. It is defined as the price paid to the manufactured in whose undertaking the last working or processing is carried out, provided the price includes the value of all products used in manufacture. The FOB price includes, in addition, all other costs occurring in the producing country, in particular the cost of transport from the factory to the frontier or port and any cost and profit of intermediate trade in that country.

Customs value is defined as the customs value determined in accordance with the Agreement on Implementation of Article VII of GATT, done in Geneva on 12 April 1979.

3.1.2.2. *Percentage Criterion*

This criterion is applied by Canada and the United States. In Canada, a maximum percentage is placed on the value of imported materials, parts, and components (or of unknown origin) that may be used in the manufacture of the exported products. In U.S. GSP rules, a minimum percentage figure is prescribed for their value of domestic materials and processing costs that must be used in the manufacture of the exported product. The percentage criterion as applied by all the preference-giving countries that use it exclusively or in combination with other criteria is described in more detail in the following subsection.

3.1.2.2.1. Canada

Goods originate in a beneficiary country if the value of the materials, parts, or products originating outside that country, or in an undetermined location, and used in the manufacture or production of the goods is no more than 40 percent (60 percent for LDCs) of the ex-factory price of the goods as packed for shipment to Canada.

TABLE 3.2. *Product-specific rules for textiles and clothing under the Canadian initiative for LDCs*

Product description	Manufacturing requirement
Yarns and sewing threads	Spinning and extruding in a LDC and do not undergo further processing outside a LDC.
Fabrics	Manufacturing from yarns originating in a LDC, a developing country beneficiary of the Canadian GSP scheme or Canada provided that yarns do not undergo further processing outside an LDC, a beneficiary country or Canada; the fabrics do not undergo further processing outside a LDC or Canada
Apparel	Assembly in a LDC from fabric cut in that LDC country or in Canada, or parts knit to shape in a LDC or Canada, provided the fabric, or the parts knit to shape, are produced in: (a) any LDC or Canada from yarns originating in an LDC, a beneficiary country or Canada, provided the yarns or fabric do not undergo further processing outside an LDC or Canada; or (b) beneficiary country from yarns originating in a LDC, a beneficiary country or Canada, provided: (i) the yarns and fabric do not undergo further processing outside an LDC, a beneficiary country or Canada; and (ii) the value of any materials, including packing, that are used in the manufacture of the goods and that originate outside the LDC in that the goods are assembled is no more than 75 percent of the ex-factory price of the goods as packed for shipment to Canada.

Source: Based on the paper "An Introductory Guide to the Market Access Initiative for the Least Developed Country and the Least Developed Country Tariff," December 2002, Canada Customs and Revenue Agency (CCRA) and Memorandum DAA-4-4, 27 May 2008.

According to the last amendment of the Canadian GPT (General Preferential Tariff) rules of origin in the case of LDCs for textiles and clothing products, are shown in Table 3.2.

3.1.2.2.2. United States

A "certain percentage" of the value of a growth, product, manufacture, or assembly of a preference-receiving country must consist of

(a) *the cost or value of materials* produced in the preference-receiving country and the cost or value of any article incorporated in the eligible article that

has resulted from substantial transformation[15] of any imported materials into a new and different article of commerce, plus

(b) *the direct cost of processing operations* performed in the preference-receiving country.

In addition Section 10.177 of the Federal Register provides that the cost or value of materials produced in the beneficiary developing country should be interpreted as follows:

"(a) "Produced in the beneficiary developing country".
For purposes of Sections 10.171 through 10.178, the words "produced in the beneficiary developing country" refer to the constituent materials of which the eligible article is composed which are either:
(1) Wholly the growth, product, or manufacture of the beneficiary developing country; or
(2) Substantially transformed in the beneficiary developing country into a new and different article of commerce."

The expression "*a new different article of commerce*" is used by the U.S. Customs Service in the classification of merchandise. Examples of their rulings are as follows:

- *Raw skins imported into a preference-receiving country and tanned into leather would be regarded as a "substantially transformed" material when used in the manufacture of a leather coat*;
- *A mounting made from a imported gold bar would be similarly regarded when made into a ring in a preference-receiving country*;
- *For leather imported into the Philippines, cut into shape pieces, and made into gloves, the shape pieces are "substantially transformed" and their value may be included in order to meet the 35 percent requirement*;
- *For wax imported from Indonesia into Singapore, mixed with additives (dye, perfume, stearic acid) and made into candles, the wax mixed with additives is not regarded as having been substantially transformed, and its value cannot be included in determining whether the 35 percent requirement is satisfied*.

This percentage must be not less than 35 percent of the *appraised value* of the merchandise in the United States. When origin is acquired on the basis of cumulative treatment (see "cumulative origin," *infra*), that is, the merchandise originates in a designated association of countries treated as one country for

[15] The United States has not yet given a more precise definition of "substantial transformation." The examples are excerpted from the "Digest of Rules of Origin," UNCTAD, 1999.

the purpose of the GSP, the percentage must also not be less than 35 percent of the appraised value but it may be acquired with any of the preference-receiving countries forming the designated association.

(a) The expression "**cost or value of materials**" is defined as
  (i) the manufacturer's actual cost for the materials;
  (ii) the freight, insurance, packing, and all other costs incurred in transporting the materials to the manufacturer's plant, if these are not already included in the manufacturer's actual cost for the materials;
  (iii) the actual cost of waste or spoilage (material lost), less the value of recoverable scrap;
  (iv) taxes and/or duties imposed on materials, provided they are not remitted on exportation.

  Where the material is provided to the manufacturer without charge or at less than fair market price, its cost or value is determined by computing the sum of
  (i) all expenses incurred in the growth, production, manufacture, or assembling of materials including general expenses;
  (ii) an amount for profit; and
  (iii) freight, insurance, packing and all other costs incurred in transporting the materials to the manufacturer's plant.

(b) "**Direct cost of processing operations**" means those costs that are either directly incurred in or can be reasonably allocated to the growth, production, manufacture, or assembly of the specific merchandise under consideration. Such costs include
  (i) all actual labor cost involved in the growth, production, manufacture, or assembly of the specific merchandise, including fringe benefits, on-the-job training, and the cost of engineering, supervisory, quality control, and similar personnel;
  (ii) dies, molds, tooling, and depreciation on machinery and equipment are allocable to the specific merchandise;
  (iii) research, development design, engineering, and blueprint cost insofar as they are allocable to the specific merchandise; and
  (iv) cost of inspecting and testing of the specific merchandise.

  The items that are not included within the meaning of the term "direct cost of processing operations" are those that are not directly attributable to the specific merchandise under consideration or are not "costs" of manufacturing the products. These include mainly
  (i) profit, and
  (ii) general expenses of doing business that are either not allocable to the specific merchandise or are not related to the growth, production,

manufacture, or assembly of the merchandise, such as administrative salaries, casualty and liability insurance, advertising, and the salesperson's salaries, commissions, or expenses.

Examples for illustrating the application for the U.S. origin criteria

Suppose motorcycles with an ex-factory price of $500 are manufactured in a beneficiary country and exported to the United States. (It should be noted that the ex-factory price will normally be the appraised value.)

Case 1: The bicycle is manufactured entirely from local materials. The bicycle qualifies for preferential treatment as wholly the manufacture of the beneficiary developing country.

Case 2: The bicycle is manufactured as follows:

(i)	*Gears imported and incorporated into the bicycle*	*$100*
(ii)	*Domestic materials*	*$150*
(iii)	*Direct cost of processing*	*$100*
(iv)	*Indirect cost (overheads, profit, etc.)*	*$150*
	Total:	*$500*

The bicycle qualifies for preferential treatment because the sum of domestic materials and costs of direct processing, namely $250, represents 50 percent of the ex-factory price, – not less than 35 percent of the appraised value. Case 3:

(i)	*Imported gear*	*$100*
(ii)	*Chain, manufactured from imported special steel*	*$50*
	Note: Imported special steel has been substantially transformed	
(iii)	*Saddle (manufactured from imported hide)*	*$25*
	Note: Imported hide has been substantially transformed	
(iv)	*Domestic materials*	*$50*
(v)	*Direct costs of processing*	*$75*
(vi)	*Indirect costs of processing (overheads, profits, etc.)*	*$200*
	Total:	*$500*

In this case, the costs of domestic materials will consist of items (ii), (iii), and (iv), because the chain [item (ii)] and saddle [item (iii)] are products of imported materials that have been substantially transformed in the beneficiary country. Thus, the cost of domestic materials ($200) represents 40 percent of the ex-factory price ($500) – not less than 35 percent of the appraised value. Therefore, the bicycle qualifies for GSP treatment.

Case 4: The bicycle is manufactured as follows:

(i)	*Imported materials (Gears $100, saddle $25, tires $50)*	*$175*
(ii)	*Domestic materials*	*$75*
(iii)	*Direct costs of processing*	*$50*
(iv)	*Indirect cost (overheads, profits, etc.)*	*$200*
	Total:	*$500*

In this case, the sum of domestic materials [item (ii)] and costs of processing [item (iii)], namely $125, represents 25 percent of the ex-factory price, i. e. less than 35 percent of the appraised value. Therefore, the bicycle does not qualify.

Appraised value

The appraised value under the U.S. Customs valuation system is usually equal to the ex-factory price of the export product.

3.1.2.2.3. Russian Federation

Under the last rules of origin notified by the Russian Federation,[16] goods are considered to have undergone sufficient working or processing in a preference-receiving country if two or more countries are involved in producing a product. The country of origin is considered to be the country in which the final processing or manufacturing operations meeting the sufficient processing criteria stipulated in the Code were carried out.

If no special requirements are set forth, in respect of a specific type of product or a country, for determining the country of origin of goods imported into the customs territory of the Russian Federation, the following general rule is applied: A product is considered to originate in a given country if the processing or manufacturing operations carried out in that country result in a change in any of the first four digits of the product's classification code under the Nomenclature of Goods for Foreign Trade.

The following operations do not, however, meet the sufficient processing criteria:

- operations to preserve goods during storage or transportation;
- operations to prepare goods for sale and transportation (separation into batches, preparation of consignments, sorting, repacking);
- simple assembly operations and other operations that do not substantially alter the condition of the goods concerned, as per the list drawn up by the government of the Russian Federation;
- combining of goods originating in different countries if the characteristics of the final product do not differ substantially from those of the goods combined to produce it.

The following sufficient processing criteria are also used to determine the country of origin of goods, under the procedures established by the government of the Russian Federation:

[16] See UNCTAD/ITCD/TSB/MISC/2007/1, 2007 UNCTAD. This is the latest official notification made to the UNCTAD secretariat. Several aspects of these rules remain rather unclear as may be noted from the text of the notification mentioned previously.

(1) carrying out of industrial or technological operations sufficient for the country of origin to be considered the country in which these operations took place;
(2) production of a change in the cost of the goods when the percentage share of the cost of the materials used or the value added attains a given proportion of the price of the final product (*ad valorem* rule).

In establishing the procedures for applying the sufficient processing criteria to specific goods imported from countries to which the Russian Federation has granted preferential tariffs, the government of the Russian Federation has the right to determine the conditions of application of direct purchase and shipment rules for the purpose of granting the preferential tariffs.

3.1.3. *Preference-Giving Country or Donor-Country Content Rule*

Some preference-giving countries apply the rule that allows products (materials, parts, and components) of their manufacture when supplied to a preference-receiving country and used there in a process of production, to be regarded as of that preference-receiving country's origin for determining whether the finished product qualifies for GSP treatment.

Example: Colombia exports insulated wire to Canada. The materials used include steel from the United States (20 percent of the ex-factory price), rubber from Malaysia (30 percent), and 50 percent is attributable to Colombian materials and labor costs. The wire does not qualify for GSP because the import content exceeds 40 percent. If, however, Canadian steel were used, the wire qualifies under the preference-giving country content rule because the import content is only 30 percent of the ex-factory price.

The rule on preference-giving country content is applied by the EC, Canada, Japan, and the Russian Federation. For all these countries, except Japan, any finished product may benefit. For Japan, however, the rule does not apply to a number of finished products.

Products originating in the EC that are subject to sufficient working or processing in a beneficiary country are to be considered as originating in that beneficiary country. This provision further expands the cumulation options by allowing the use of inputs or intermediate products that have already acquired originating status in the EC.

Proof of originating status of EC products has to be provided either by production of a EUR.I movement certificate or by an invoice declaration. The EC provisions concerning the issue, use, and subsequent verification of certificates of origin Form A shall apply *mutatis mutandis* to EUR movement

certificate and, with the exception of the provisions concerning their issue, to invoice declarations. Additional information on procedures for the issuance of GSP Form A and Form EUR.I is contained in Chapter 6.

The EC "donor-country content" rules are also extended to products originating in Norway and Switzerland, insofar as these countries grant generalized preferences and apply a definition of the concept of origin corresponding to that set out in the EC scheme.

When the competent authorities of a beneficiary country are requested to issue a certificate of origin Form A for products manufactured with materials originating in the EC, Norway, or Switzerland, they shall rely on the EUR movement certificate or, where necessary, the invoice declaration. In these cases, box 4 on the certificates of origin Form A shall contain the endorsement "Cumul CE," "Cumul Norvège," "Cumul Suisse" (in French) or "EC cumulation," "Norway cumulation," "Switzerland cumulation" (in English). Since 1 July 1996, Switzerland has applied a donor-country content provision. Under this provision, imported inputs of Swiss origin incorporated in a product eligible for preferential treatment under the Swiss scheme can be counted as though they were wholly produced in the exporting beneficiary country for origin purposes. When the donor-country rule is applied, the issuing authority in the GSP beneficiary country will issue the final certificate of origin Form A, based on a Movement Certificate EUR.I Form, issued by the competent authorities in Switzerland.

Japan requires special documentary evidence to support a claim under this rule. Japan requires, in addition to the normal certificate of origin Form A, the following evidence relating to the materials imported from Japan: a "certificate of materials imported from Japan" issued by the authority entrusted with the issuance of certificates of origin Form A in Japan.

3.1.4. Cumulative Origin in the GSP Schemes

The GSP rules are, in principle, based on the concept of a single-country origin, that is, the origin requirements must be fully complied within *one* exporting preference-receiving country. Under the schemes of some preference-giving countries adopting a partial/diagonal cumulation, this rule has been liberalized to permit a product to be manufactured and finished in a preference-receiving country using imported materials, parts, or components from other preference-receiving countries, and this material could be considered as originating in the preference-receiving country claiming the preferential tariff treatment. Under a more liberal scheme of cumulation – full cumulation, not only originating materials but also working and processes or value added in more than one

preference-receiving country may be added together to comply with origin requirements.

As mentioned, rules of origin in the context of autonomous or unilateral contractual preferences are to be complied with within the customs territory of a single beneficiary country. However, some preference-giving countries as shown in Table 3.3 considered that this requirement per se was not adequate to the existing realities in developing countries, especially in view of the regional trade initiatives taking place among them. First, isolated and stringent requirements to comply with rules of origin may demand excessive "verticalization" of production, which does not exist in developing countries. Second, an excessive requirement demanding multistage operations or value-added operations would frustrate trade creation effects expected from tariff preferences.

Examples of full cumulation:

- *Some origin rules for fabrics require the processes of spinning the yarn and weaving to be undergone in one preference-receiving country. Under some systems of cumulative origin, however, the first process of spinning may be completed in one preference-receiving country and the second process (of weaving) carried out in a second preference-receiving country and the fabric would qualify for GSP;*
- *A subassembly for a radio receiver produced in preference-receiving country A from imported parts may be exported to preference-receiving country B where it is manufactured, together with other imported materials, etc., into a finished radio. The value of the materials and work done in a country A may, under full global system of cumulation, be added to the work done in country B in order to determine whether the radio satisfies the percentage criterion applied by some preference-giving countries.*

There are marked differences between preference-giving countries as to the possibilities for cumulation. In this regard, Canada grants full and global cumulation and donor-country content to all beneficiary countries.

Under the schemes of Canada, all preference-receiving countries are regarded as one single area for determining origin. All value-added and/or manufacturing processes performed in the area may be added together to meet the origin requirements for products to be exported to any of the aforementioned preference-giving countries. This is called *full and global cumulation*. (some qualifications apply for textiles and clothing in the case of LDCs)

The EC, Japan, Norway, Switzerland, and the United States have chosen to grant regional cumulation to certain regional associations. The scope of the regional cumulation facility under the scheme of the EC differs, however, from that granted by the United States and Japan. The EC grants what is called partial or diagonal regional cumulation as opposed to the full regional cumulation

TABLE 3.3. *Main GSP rules of origin: Scope of cumulation and derogation*

Country/Group of countries	Scope of cumulation		Donor-country content	Documentation	Additional requirements/ information	Other conditions	Possible derogation to rules of origin
	Full or diagonal	Global or regional					
European Community EBA	Partial/ diagonal	Regional	Yes	Certificate needed to indicate use of regional cumulation	Coordinating body of regional grouping undertakes to comply with rules. At present SAARC, ASEAN, Andean Group, and CACM	Regional groups must make application and possess central organization capable of ensuring administrative cooperation	Yes, only for LDCs
Former Cotonou Partnership Agreement (CPA[17])	Full	All ACP countries	Yes	Supplier declaration	Not applicable	Limited cumulation with South Africa and other developing countries	Yes, with simplified procedures
Japan	Full	Regional	Yes	Additional certificate required to indicate cumulation	At present, only ASEAN have been granted regional cumulation	Regional groups must make an application	No
United Status	Full	Regional	No	Not specified	At present, ASEAN, CARICOM, SADC, WAEMU, and SAARC are granted regional cumulation	(a) Regional cumulation granted (on application to FTAs and customs unions) (b) Competitive need limits are assessed only against the "country of origin" and not the entire regional grouping	No
AGOA (For textile and apparel products refer to the specific table in the following section)	Full	All sub-Saharan beneficiaries	Yes	Not specified	Not applicable (specific conditions for textiles and clothing)		No
Canada (For textile and apparel products refer to the Table 3.2.)	Full	All beneficiaries	Yes	Not specified	For LDCs cumulation with developing countries materials allowed up to 20 percent of the ex-factory price	See Memorandum D-11 of 27 May 2008	No

Note: African, Caribbean, and Pacific Countries (ACP), Association of Southeast Asian Nations (ASEAN), Caribbean Common Market (CARICOM), Central American Common Market (CACM), South Asian Association for Regional Cooperation (SAARC), West African Economic and Monetary Union (WAEMU).

[17] The Cotonou Parnership Agreement expired on 31 December 2007. However, it remains a valid example of full cumulation granted to ACP countries.

accorded under the schemes of the United States and Japan. Partial or diagonal regional cumulation means that inputs imported from another member of the regional association and utilized for further manufacturing or incorporated in the final exporting country must already have originated there to be considered as domestic content.

This limitation does not exist under the regional cumulation option of the schemes of Japan and the United States, which consider the members of a regional association as one single customs territory. Any working or processing operations may be counted as domestic content in compliance with rules of origin requirements.

To sum up, three kinds of cumulation are used, as far as qualitative aspects are concerned, in autonomous or unilateral contractual trade preferences:

(1) full cumulation;
(2) diagonal or partial cumulation;
(3) bilateral cumulation or donor-country content.

As far as quantitative aspects are concerned, the concept of cumulation is linked to geographical extensions of the cumulation. For example, all beneficiary countries under the Canadian GSP scheme or limited to regional groupings such as Association of Southeast Asian Nations (ASEAN), Central American Common Market (CACM), and ANDEAN and SAARC under the EC GSP.

The most delicate and complex differences relating to cumulation belong to the distinction between full and partial cumulation. This distinction is also valid in the context of contractual preferential rules of origin and has decisive economic effects on the functioning and utilization of trade preferences.

Generally speaking, full cumulation of origin allows more scattered and divided-labor operations among the beneficiary countries because, to fulfill the origin criteria, the distribution of manufacturing may be carried out according to business exigencies within the members of the regional grouping, that is, working or processing may start in A, continue in B, and finish in C according to a cost/benefit analysis. This perspective seems to match the globalization and interdependence of production, whereby developed countries may be attracted to farming out low-tech or labor-intensive production processes in low-cost countries. On one hand, partial cumulation does not particularly favor this approach because it requires higher value-added or more complicated manufacturing processes. On the other hand, and in view of preference-giving countries, partial cumulation may be able to attract more capital-intensive investments accompanied by improved technical know-how and labor skills.

Economic consideration of the impact of full or partial cumulation suggests that full cumulation may allow the massive employment of low-wage, low-skill labor, which some may argue to be a potentially negative factor because

these workers often receive less than average wages and save less than average workers do. Reality suggests, however, in spite of the argument of preference-giving countries suggesting a long-term objective of industrial policy through the adoption of restrictive rules of origin, that labor-intensive lighter industries in developing countries tend to compete most effectively with a similar industry in developed countries. Thus, the argument for full cumulation is strengthened.

In evaluating the effects of the different cumulative systems, one fundamental distinction must be made between cumulative systems in unilateral trade preferences and contractual ones. In the first case, whatever form of cumulation is granted, it aims in principle to facilitate compliance with rules of origin by expanding geographical coverage. In the second case, cumulation may be used to inhibit the use of third-country materials outside the contracting parties, as discussed in subsection 3.2.

3.1.4.1. The Difference between Full and Partial Diagonal Cumulation

As mentioned earlier, there are intrinsic differences between the regional cumulation granted by the EC and the one offered by Japan and the United States. In fact, under their regional cumulation schemes, Japan and the United States consider, for instance, all ASEAN countries as one single customs territory (except that the United States has graduated Singapore and Brunei out of its GSP program). Therefore, all processing or manufacturing carried out in an ASEAN country, irrespective of whether it acquires origin or not, will be counted as local content. Under the "partial" regional cumulation schemes of the EC, only the materials that acquire origin in one member-state of the regional association will be counted as domestic content. Thus, only those products that already originate in other countries of ASEAN, according to the EC GSP rules of origin, could be counted as local content when utilized for further manufacturing or incorporated into the finished product manufactured in the final member-state.

To better illustrate the difference between diagonal and full cumulation, we reconsider the example given under the EC GSP rules of origin for cotton jackets in the light of the "full cumulation" provision of the Former Cotonou Partnership Agreement (CPA). This full cumulation has been, with some changes, maintained in the current interim Economic Partnership Agreements (EPAs) signed with some African regions and in the Cariforum EPA. EC rules of origin under former Cotonou Partnership Agreement and the current EBA initiative for LDCs require that the manufacturing process for apparel not knitted or crocheted (HS 62), when imported inputs are used, start from imported yarn. With diagonal regional cumulation, however,

TABLE 3.4. *Production chain of garments in a partial/diagonal cumulation scenario*

Country A		Country B		Country C		Country D
Natural fiber	⇨	Natural fibers to fabrics = originating	⇨	Fabrics to apparel = originating	⇨	Donor country

preference-receiving country C may utilize imported fabrics from country B – a member of the same regional grouping – and the finished jacket is considered an originating product because the imported fabric is counted under the cumulation rules as a domestic, not an imported, input. However, this applies only when the fabric manufactured in country B is already originating, that is, either it is wholly obtained or it has been manufactured from imported natural fibers according to EC product-specific rules of origin for fabric. This production chain may be visualized as described in Table 3.4. Thus, if the fabrics are produced in country B from imported natural fibers and the apparel is made in country C, the final apparel will be considered as originating.

Before the changes introduced in the Interim EPAs for textiles and garments of Chapters 61 and 62 a single transformation, EC rules of origin in the case of African, Caribbean, and Pacific (ACP) countries required, as in the case of the GSP, that the manufacturing process, when imported inputs are used, start from imported yarn. Because under the EC rules the ACP countries were regarded as a single customs territory for rules of origin purposes, it was sufficient that this requirement was fulfilled within the area. Thus the intermediate materials imported from another member of the ACP group did not need to be already originating. In the case of full cumulation, the production chain was as described in Table 3.5.

It is clear from the preceding example that a full cumulation system permits saving one step in the manufacturing process. That is, in the case of partial cumulation under the GSP, yarn-spinning facilities must be established within the regional grouping to process the natural fibers into yarn, whereas in the

TABLE 3.5. *Production chain of garments in a full cumulation scenario*

Country A		Country B	Country C		Country D
Yarn	⇨	Yarn to fabrics	Fabrics to apparel = originating	⇨	Donor country

case of full cumulation the yarn can be directly imported from a third country outside the region.

3.1.4.2. *Cumulation under the EC GSP Scheme and EBA*

Under the EC GSP scheme, partial or diagonal cumulation is permitted (subject to conditions) on a regional basis. Four regional economic groupings of preference-receiving countries are permitted to utilize the EC regional cumulation system, namely the ASEAN (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam), the CACM (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua), the Andean Group (Bolivia, Colombia, Ecuador, Peru, and Venezuela), and the South Asian Association for Regional Cooperation (SAARC) (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka).

The withdrawal of one country or territory from the list of the countries and territories benefiting from generalized preferences by virtue of the criteria on country graduation mechanism does not affect the possibility of using products originating in that country under the regional cumulation rules.

Under the EC rules for partial and regional cumulation, materials or parts imported by a member country of one of these four groupings from another member country of the same grouping for further manufacture are considered as originating products of the country of manufacture and not as third-country inputs, provided that the materials or parts are already "originating products" of the exporting member country of the grouping. Originating products are those that have acquired origin by fulfilling the individual origin requirements under the EC rules of origin for the GSP purposes.

If one looks at Article 72 of the Community Customs Code (CCC), in which the word "originating" is the determinant, it will be seen that this important issue is not expressed in so many words:

> Paragraph 1:
> "By way of derogation from Article 67, for the purposes of determining whether a product manufactured in a beneficiary country that is a member of a regional group originates therein within the meaning of that Article, products originating in any of the countries of that regional group and used in further manufacture in another country of the group shall be treated as if they originated in the country of further manufacture (regional cumulation)."

Paragraph 1 of Article 72a lays down the rules according to which the country of origin of the final product shall be determined:

"When goods originating in a country which is a member of a regional group are worked of processed in another country of the same regional group, they shall have the origin of the country of the regional group where the last working or processing was carried out provided that:

(a) the value added[18] there is greater than the highest custom value of the products used originating in any of the other countries of the regional group, and
(b) the working or processing carried out there exceeds that set out in article 70 (insufficient working or processing) and, in the case of textile products, also those operations referred to at annex 16."[19]

When the aforementioned conditions are not satisfied, the products shall have the origin of the country of the regional group that accounts for the highest customs value of the originating products coming from other countries of the regional group (Article 72a, paragraph 2 of the CCC).

Example: EC rules of origin require cotton jackets (HS 6203) to be produced from "originating" yarn. With regional cumulation, however, preference-receiving country A may utilize imported fabrics from country B (note that these fabrics must already have originating status B), which is a member of the same regional grouping, and the finished jacket will be considered as an originating product. This is because the imported fabric, which, again, must already have come from an originating producer in the same grouping, is counted under the cumulation rules as a domestic input and not as an imported input. However if the value of the fabric originating in county B is greater than the value added in country A, the origin of the jacket will allocated to B.

Example: The EC rules of origin require that cars classified under heading HS 8702 must not incorporate more than 40 percent of imported inputs. A car manufactured in Malaysia, for example, may incorporate the following inputs (all prices are in US$):

Inputs originating in Singapore	*4,500*
Inputs originating in the Philippines	*1,400*
Inputs originating in Japan	*1,500*
Value added in Malaysia (local content, labor costs, profits)	*2,600*
***Total** (ex-works price)*	*10,000*

According to the partial cumulation provision of the EC, to calculate the percentage of imported inputs, the materials imported from Singapore and the Philippines will not be considered imported materials if they originate

[18] "Value added" means the ex-works price minus the customs value of each of the products incorporated that originated in another country of the regional group.
[19] See Regulation 2454/93 of 2 July 1993.

in these countries. Materials originating in other ASEAN member countries will not be considered as imported inputs. Therefore, only the components imported from elsewhere (in this hypothetical case, Japan, which is not an ASEAN member country) are to be considered as imported inputs. As the amount of the input from Japan is US$1,500, equal to 15 percent of the export price, and as this is less than 40 percent, the car will be considered as originating. However, because the value of inputs originating in Singapore is greater that the value added in Malaysia the car will be considered as originating in Singapore.

Proofs of the originating status of goods exported from a country belonging to a regional group to another country of the same group for further working or processing, or for reexportation without further operations, shall be established by the certificate of origin Form A issued by the first country (Article 72a, paragraph 4 of the CCC). On the basis of this certificate, a further certificate of origin Form A or invoice declaration made out in that country will establish proof of the originating status of the goods reexported to the EC from a country belonging to a regional group (Article 72a, paragraph 5 of the CCC).

Example: An exporter in country C wishes to export a finished product which contains imported inputs originating in countries A and B of the same regional grouping. The exporter will have to submit to the competent authority two certificates of origin Form A relating to the inputs originating in country A and country B, respectively, and issued by the competent authorities in each of these countries. On the basis of these two certificates, the competent authority in country C will then issue the final certificate of origin Form A relating to the finished product to be exported.

3.1.4.3. *Derogation Procedures from Rules of Origin under the EC GSP Scheme*

In the GSP scheme, a procedure for derogations applies only to the LDCs. The procedure is set out in Article 76 of the CCC:

> 1. Derogations from these provisions may be made in favour of the least-developed beneficiary countries benefiting from the generalized system of preferences when the development of existing industries or the creation of new industries justifies them. The least-developed countries are those listed in the Council EC Regulations and ECSC Decisions applying generalized tariff preferences for the current year. For this purpose, the country concerned shall submit to the Commission of the European Communities a request for a derogation together with the reasons for the request in accordance with paragraph 3.

2. The examination of the request shall in particular take into account:
   (a) Cases where the application of existing rules of origin would significantly affect the ability of an existing industry in the country concerned to continue its exports to the Community, with particular reference to cases where this could lead to cessation of these activities;
   (b) Specific cases where it can be clearly demonstrated that significant investment in an industry could be deterred by the rules of origin and where a derogation encouraging implementation of the investment programme would enable the rules to be satisfied by stages;
   (c) The economic and social impact of the decision to be taken especially in respect of employment in the beneficiary country and the Community.
3. In order to facilitate the examination of the request for derogation, the country making the request shall furnish the fullest possible information in support of its request, covering in particular the points listed below:
   - Description of the finished product,
   - Nature and quantity of products which have been processed there,
   - Manufacturing process,
   - Value added,
   - Number of employees in the undertaking concerned,
   - Anticipated volume of exports to the Community,
   - Reasons for the duration requested,
   - Other observations.
4. The Commission shall present the derogation request to the Committee. It shall be decided on according to the committee procedure
5. (. . .)

The provisions of paragraphs 1 to 5 shall apply to any prolongations.

The EC has granted a waiver from the definition of the concept of originating products for certain exports of textiles to take into account the special situation of four LDCs, namely the Lao People's Democratic Republic, Cambodia, Nepal,[20] and Bangladesh.[21] The products, listed in the annexes attached to the related regulations, which are manufactured in those four LDCs from woven fabric (woven items) or yarn (knitted items) imported into those countries and originating in a country belonging to ASEAN – excluding Myanmar – the SAARC or the former Lomé Convention shall be deemed to originate in the Lao People's Democratic Republic, Cambodia, Nepal, or Bangladesh

[20] See Commission Regulations 1713, 1714 and 1715/97, O.J. L 242 (1997).
[21] See Commission Regulation 2260/97, O.J. L 311 (1997).

(Article 1, paragraph 1). The derogation shall apply only to products imported into the EC from the Lao People's Democratic Republic, Cambodia, Nepal, and Bangladesh during a specific period,[22] up to the annual quantities listed in the attached annexes against each product.

3.1.4.4. *Cumulation under the Japanese GSP Scheme*

Under the Japanese arrangement for full and regional cumulation that applies to members of ASEAN in respect to products exported to Japan by a member-country of this grouping, the member-states of ASEAN are treated as a single entity for acquiring origin status. Inputs from any member-state of ASEAN or from Japan (there is, however, a list of products that are excluded from the preference-giving country content rule) are regarded as "ASEAN inputs" regardless of the originating status of the intermediate materials that have been manufactured in the other member-country/countries of ASEAN.

The Form A issued in respect to the finished product must be supported by a "Cumulative Working/Processing Certificate." This certificate is to be issued in the final exporting member-state of ASEAN by the same certifying authority as that of the certificate Form A.

3.1.4.5. *Cumulation under the U.S. GSP Scheme*

Under the scheme of the United States, preference-receiving countries belonging to an association of countries that contributes to comprehensive regional economic integration among its members may jointly request to be considered as one area for meeting the origin requirements. Merchandise that is the growth, product, manufacture, or assembly of two or more of such member-countries would qualify for preferential tariff treatment if the sum of the cost or value of the materials produced in those countries, plus the direct cost of processing operations performed in such countries, is not less than 35 percent of the value of the article as appraised by customs on entry into the United States.

In other words, the 35 percent value added can be spread across more than one country when imported from GSP-eligible members of certain regional associations. Articles produced in two or more eligible member-countries of an association will be accorded duty-free entry if the countries together account

[22] From 1 August 1997 to 31 December 1998 for products imported from the Lao People's Democratic Republic, Cambodia, and Nepal; from 15 October 1997 to 31 December 1998 for products imported from Bangladesh. These derogations have been periodically reviewed and their validity extended until the end of 2008.

for at least 35 percent of the appraised value of the article, the same requirement as for a single country. The competitive-need limits will be assessed only against the country of origin and not against the entire association. There are currently five associations that may benefit from this provision: the Andean Group, the ASEAN excluding Singapore and Brunei Darussalam, the CARICOM, the SADC, and the WAEMU.

3.1.4.6. Cumulation under the Canadian GSP Scheme

In the case of Canada, the recently amended rules of origin for textiles and clothing allow for a liberal cumulation of rules of origin. The following examples contained in this subsection are excerpted from materials of Canadian customs providing valuable guidance on the application and implications of the rules.

The basic concept underlying the functioning of full and global cumulation for LDCs is that, to the calculate the qualifying content, all LDC beneficiary countries are regarded as one single area. All value-added and manufacturing processes performed in the area may be integrated to meet the qualifying content requirement. Any Canadian content used in the production of the goods is also regarded as content from the LDC beneficiary country where the goods originate. In addition, the 40 percent of the ex-factory price of the goods as packed for shipment to Canada may also include a value of up to 20 percent of the ex-factory price of the goods from GPT-eligible countries. However, any parts, materials or inputs used in the production of the goods that have entered the commerce of any country other than a LDC beneficiary country or Canada lose their LDC status.

Example[23]: *Wool of Yemen is combined with spandex of Hong Kong and sewing thread of India to manufacture wool socks in Yemen. Under this subsection, a textile or apparel good must contain parts and materials of LDC origin that represent no less than 40 percent of the ex-factory price of the good as packed for shipment to Canada. The wool of Yemen origin represents 35 percent of the ex-factory price. The sewing thread of India and spandex of Hong Kong represent an additional 7 percent. This subsection permits inputs from GPT beneficiaries, in this case Hong Kong and India, to be included in the 40 percent parts and materials requirement. The 35 percent input of wool from Yemen combined with the 7 percent sewing thread and spandex inputs from the GPT countries exceed the*

[23] All these examples are excerpted from Memorandum D11-4-4 Ottawa, August 29, 2003, Rules of Origin Respecting the General Preferential Tariff and Least Developed Country Tariff as amended by Memorandum D11-4-4 of 27 May 2008.

40 percent minimum input requirement under this subsection. The socks therefore qualify for the LDCT.

Special cumulation rules for LDCs in the case of textiles and clothing

As shown in Table 3.2., according the special rules of origin for LDCs under the Canadian scheme, yarns or sewing threads must be spun or extruded in a beneficiary country. Once spun or extruded, the goods cannot undergo any further processing outside any LDC beneficiary.

Example: Cotton of any country of origin is imported into Bangladesh and spun into yarn in Bangladesh. The yarn is sent to Cambodia to be dyed. When the yarn is returned to Bangladesh, it is sanitized and packed for shipment to Canada. Such goods would be entitled to the LDC.

However, if after the spinning process, the yarns were further processed in China (a developing country benefiting from Canadian GSP benefits defined as a GPT but not a LDC), returned to Bangladesh, then exported to Canada, the goods would not be entitled to be certified as originating in a LDC because further processing occurred outside a LDC beneficiary.

To acquire LDC originating status, fabrics must be produced in a LDC beneficiary from yarns that originate in any LDC or GPT (any developing country benefiting from general preferential tariff) or Canada. The yarns used in the "fabrics" must not undergo any further processing outside any LDC or GPT beneficiary or Canada. The "fabrics" must not undergo any further processing outside any LDC beneficiary or Canada.

Example: Cotton yarn produced in India is exported to Mali where it is woven into cotton fabric that is exported to Canada. As the cotton fabric meets the conditions of this subsection, the goods are entitled to be certified as originating in a LDC.

Example: Yarn produced in Spain is exported to Mali where it is woven into fabric for export to Canada. The fabric would not be entitled to be certified as LDC originating as the yarn does not originate in a LDC beneficiary country, a GPT beneficiary country, or Canada.

To acquire LDC originating status, apparel goods must be assembled in a LDC beneficiary. The fabric used in the assembly of such "apparel goods" must be cut in *that LDC* or Canada, and, in the case in which apparel goods are assembled from parts, those parts must be knit to shape in a LDC or Canada.

Furthermore, the fabric, or parts knit to shape, must be produced in any LDC or in Canada from yarns originating in any LDC or GPT beneficiary or in Canada. The yarns or fabric, or parts knit to shape, must not undergo any further processing outside any LDCT beneficiary or Canada.

Example: Dresses or skirts manufactured in Mali will qualify as originating and be eligible for duty-free LDCT provided that the dresses or skirts are assembled in Mali from fabric that has been cut in Mali or Canada. The fabric must be produced in any LDC or in Canada from yarns that that originate in any LDC, GPT country, or Canada and the yarns or fabric have not undergone any further processing outside any LDC or Canada.

In addition, a second variant of the rules allows the acquisition of LDC originating status even if the fabric used has been imported from another GPT beneficiary. To acquire LDC originating status, such "apparel goods" must be assembled in a LDC beneficiary. The fabric used in the assembly of such "apparel goods" must be cut in *that LDC* or Canada.

Furthermore, the fabric or parts knit to shape must be produced in a GPT beneficiary from yarns originating in any LDC or GPT beneficiary or Canada. The yarns, fabric, or parts knit to shape must not undergo any further processing outside a LDCT beneficiary, a GPT beneficiary or Canada.

Finally, the value of any materials, including packing, that are used in the manufacture of the goods that originate outside the LDC in which the goods are assembled must not be more than 75 percent of the ex-factory price of the goods as packed for shipment to Canada. However, any parts, materials or inputs used in the production of the goods that have entered the commerce of any country other than a LDC beneficiary country or Canada lose their LDC status.

Example: Those same dresses or skirts in the previous example manufactured in Mali will qualify as and be eligible for duty-free LDCT provided that the dresses or skirts are assembled in Mali and the fabric used in the manufacture of the dresses or skirts is produced in a GPT country from yarns originating in a LDC or GPT beneficiary or Canada. The yarns and fabric cannot undergo further processing outside a LDCT or GPT beneficiary or Canada. When using fabric manufactured in a GPT, the value of any materials, including packing, that does not originate in the LDC in which the dresses or skirts are assembled must not exceed 75 percent of the ex-factory price of the goods as packed for shipment to Canada.

To acquire LDC originating status, "made-up textile goods" must be cut, or knit to shape, and sewn or otherwise assembled in a LDCT beneficiary.

Furthermore, the fabric or parts knit to shape must be produced in a LDCT beneficiary or Canada from yarns originating in any LDCT or GPT beneficiary or Canada. The yarns or fabric or parts knit to shape must not undergo any further processing outside a LDCT beneficiary or Canada.

Example: Wool yarn produced in Afghanistan is exported to Bangladesh where the yarn is made into wool fabric. The wool fabric is shipped directly to Lao People's Democratic

Republic for further production into a good classified as "Other Made-up Textile Article." The production process of the finished good in Lao People's Democratic Republic must include cutting, or knitting to shape, of the fabric as well as sewing or otherwise assembling in that country in order for the good to qualify for the LDC.

3.1.5. *Rules of Origin under Other Unilateral Trade Preferences: AGOA and the Former Cotonou Partnership Agreement and the EPAs*

3.1.5.1. *African Growth Opportunity Agreement*

The AGOA[24] is the most recent U.S. initiative authorizing a new trade and investment policy toward Africa. Under Title I-B of the Act, beneficiary countries in sub-Saharan Africa (SSA) that will be designated by the president as eligible for the AGOA benefits will be granted what could be called a "super GSP."

Although the current "normal" GSP program of the United States is subject to periodic short-term renewals and contains several limitations in terms of product coverage, AGOA amends the GSP program by providing duty-free treatment for a wider range of products. This would include, on fulfillment of specific origin and visa requirements, certain textile and apparel articles that were considered import sensitive and thus statutorily excluded from the program.

AGOA legislation has been subsequently amended and renewed.

The Trade Act of 2002 contained amendments to apparel and textile provisions under AGOA. It modified certain provisions under AGOA by including knit-to-shape, increasing the cap on apparel imports, granting LDC status to Botswana and Namibia, and revising the technical definition of merino wool. Furthermore, it clarified the origin of yarns under the Special Rule for designated LDCs and made eligible for preferences "hybrid" apparel articles (i.e., cutting that occurs both in United States and in AGOA countries does not render fabric ineligible).

The most recent report of 2007 stated that the AGOA provides duty-free access to the U.S. market for substantially all products exported from 38 eligible SSAs.[25] AGOA amends the U.S. GSP statute with respect to AGOA-eligible

[24] AGOA, which is part of the Trade and Development Act of 2000, was signed into law by the president of the United States on 18 May 2000. The AGOA implementation regulation was published on 2 October 2000.

[25] The 38 AGOA beneficiary countries are Angola; Benin; Botswana; Burkina Faso; Burundi, Cameroon; Cape Verde; Chad; Republic of Congo; Democratic Republic of Congo; Djibouti; Ethiopia; Gabon; The Gambia; Ghana; Guinea; Guinea-Bissau; Kenya; Lesotho; Liberia;

beneficiaries by extending duty-free treatment until 2015 and expanding GSP product coverage (about 4,600 products) by more than 1,800 additional tariff lines. AGOA also exempts beneficiary countries from GSP competitive need limitations. In 2006, more than 98 percent of U.S. imports from AGOA-eligible countries entered the United States duty-free.

On December 20, 2006, President Bush signed the Africa Investment Incentive Act (AGOA IV). AGOA IV enhances AGOA trade benefits for eligible SSAs and strengthens economic engagement between the United States and sub-Saharan Africa. AGOA IV extends the third-country fabric provision, adds an abundant supply provision, designates certain denim articles as being in abundant supply, and provides duty-free treatment for certain textile and textile articles (nonapparel) imported from lesser-developed AGOA beneficiary countries.

As of April 2007, 26 countries[26] were eligible to receive AGOA apparel benefits. Seventeen of these countries[27] also qualify for AGOA's provisions for handloomed and handmade articles (known as Category 9). The AGOA Acceleration Act of 2004 added ethnic printed fabrics to the types of goods that could be exported under Category 9.

Ethnic prints must meet a specific set of criteria to qualify for AGOA benefits. Mali, Niger, Nigeria and Tanzania have been approved for ethnic printed fabrics.

The "AGOA-enhanced" GSP benefits will be in place until 30 September 2015, providing additional security for investors and traders in qualifying African countries. This element of security is further strengthened by the decision by the Office of the U.S. Trade Representative responsible for GSP matters not to carry out the usual annual reviews of product coverage for AGOA products.

The following paragraphs provide a detailed overview of the provisions of AGOA.

Madagascar; Malawi; Mali; Mauritius; Mozambique; Namibia; Niger; Nigeria; Rwanda; São Tomé and Príncipe; Senegal; Seychelles; Sierra Leone; South Africa; Swaziland; Tanzania; Uganda; and Zambia. For an assessment of the value of trade preferences for LDCs under AGOA, see "Erosion of Trade Preferences in the Post-Hong Hong Framework," "Trade Is Better than Aid," and "Aid for Trade," UNCTAD, 2008.

[26] The 26 countries eligible to receive AGOA apparel benefits are Benin, Botswana, Burkina Faso, Cameroon, Cape Verde, Chad, Ethiopia, Ghana, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, South Africa, Swaziland, Tanzania, Uganda, and Zambia.

[27] The 17 countries are Kenya, Lesotho, Botswana, Madagascar, Malawi, Mali, Namibia, Ghana, Mozambique, Senegal, Ethiopia, Niger, Nigeria, Sierra Leone, Swaziland, Tanzania, and Zambia.

An AGOA article must meet the basic U.S. GSP origin and related rules[28] to receive duty-free treatment (as discussed in Section III.C). In the context of AGOA, application of the basic GSP origin rules is subject to the following two additional rules:

(a) The cost or value of materials produced in the customs territory of the United States may be counted toward the 35 percent requirement up to a maximum amount not to exceed 15 percent of the article's appraised value.
(b) The cost or value of the materials produced in one or more beneficiary sub-Saharan African countries shall be counted toward the 35 percent requirement (cumulation among AGOA-designated countries).

Specific provisions on textile/apparel articles for country eligibility
AGOA provides preferential tariff treatment for imports of certain textile and apparel products from designated SSAs, provided that these countries (a) have adopted an effective visa system and related procedures to prevent illegal transshipment and the use of counterfeit documents; and (b) have implemented and follow, or are making substantial progress toward implementing and following, certain customs procedures that assist the Customs Service in verifying the origin of the products.

Rules of origin and preferential groupings of textile/apparel articles
AGOA provides duty-free and quota-free access for selected textile and apparel articles if they are imported from designated SSAs under the textile/apparel provision. The 35 percent value-added requirement for AGOA GSP treatment is not required for the textile/apparel provision. Apparel products eligible for benefits under the AGOA must fall within one of 10 specific preferential groupings and meet the related requirements. The Trade Act of 2002 modified certain rules by making knit-to-shape articles eligible for duty-free and quota-free treatment in the preferential groupings.

In addition, AGOA IV of 2006 modified certain textile and apparel provisions under AGOA. This latest legislation provided the following:

- extended the third country fabric provision for lesser-developed countries until 2012 and increased the cap for AGOA apparel made of third-country

[28] Section 503(a)(2) of the Trade Act of 1974.

fabric to 3.5 percent of total U.S. apparel imports for the year beginning October 1, 2006;
- provided special rules governing fabrics or yarns that are produced in commercial quantities (or "abundant supply") in designated SSAs for use in qualifying apparel articles;
- expanded duty-free treatment for textile or textile articles (e.g., towels, sheets, made-ups) originating entirely in one or more lesser-developed AGOA beneficiary countries.

Before each preferential group is examined in detail, it is important to note that groupings 4 and 5 are subject to the quantitative limitations called "cap"[29] given the fact that beneficiary countries are allowed to use regional or foreign fabrics or yarns.

The granting of preferential treatment depends on the origin of the fabric and yarn used. This is the rule of origin under AGOA for textile/apparel articles.

Grouping 1

Apparel articles sewn or assembled in one or more beneficiary SSAs from fabrics wholly formed and cut, or from components knit-to-shape, in the United States from yarns wholly formed in the United States[30]: DUTY-FREE and QUOTA-FREE TREATMENT.

Grouping 2

Apparel articles sewn or assembled and further processed[31] in one or more beneficiary SSAs from fabrics wholly formed and cut, or from components knit-to-shape, in the United States from yarns wholly formed in the United States[32]: DUTY-FREE and QUOTA-FREE TREATMENT.

Grouping 3

Apparel articles sewn or assembled in one or more beneficiary SSAs with U.S. thread from fabrics wholly formed in the United States and cut in one or more SSAs from yarns wholly formed in the United States, or from components

[29] The word "cap" is utilized by the U.S. Trade Representative (USTR) as a tariff quota.

[30] Includes fabrics not formed from yarns, if such fabrics are classifiable under Harmonized Tariff Schedule of United States (HTSUS) heading 5602 or 5603 and are wholly formed and cut in the United States. The article is entered under subheading HTSUS 9802.00.80.

[31] Further processing includes embroidery, stone-washing, enzyme-washing, acid washing, permapressing, oven-baking, beaching, garment-dyeing, screen printing, or similar processes.

[32] Includes fabrics not formed from yarns, if such fabrics are classifiable under HTSUS heading 5602 or 5603 and are wholly formed and cut in the United States.

knit-to-shape in the United States from yarns wholly formed in the United States, or both[33]: DUTY-FREE and QUOTA-FREE TREATMENT.

Grouping 4
Apparel articles wholly assembled in one or more beneficiary SSAs from fabric wholly formed in one or more beneficiary SSAs from yarns originating either in the United States or one or more beneficiary SSAs,[34] or from components knit-to-shape in one or more beneficiary SSAs from yarns originating either in the United States or one or more beneficiary SSA, or apparel articles wholly formed on seamless knitting machines in a beneficiary SSA country from yarns originating either in the United States or one or more beneficiary SSAs: DUTY-FREE and QUOTA-FREE TREATMENT WITHIN CAP.

Grouping 5
Under the Special Rule for Lesser Developed Countries,[35] duty-free access within cap is granted to apparel articles wholly assembled, or knit-to-shape and wholly assembled, or both, in one or more lesser-developed beneficiary SSAs, regardless of the country of the origin of the fabric or yarn used: DUTY-FREE and QUOTA-FREE TREATMENT through 30 September 2012 WITHIN CAP.

Grouping 6
Cashmere sweaters: Sweaters in chief weight of cashmere, knit-to-shape in one or more beneficiary SSAs[36]: DUTY-FREE and QUOTA-FREE TREATMENT.

Grouping 7
Merino wool sweaters: Wool sweaters containing 50 percent or more by weight of wool measuring 21.5 micrometers in diameter or finer, knit-to-shape in one or more beneficiary SSAs: DUTY-FREE and QUOTA-FREE TREATMENT.

[33] Includes fabrics not formed from yarns, if such fabrics are classifiable under HTSUS heading 5602 or 5603 and are wholly formed in the United States.

[34] Includes fabrics not formed from yarns, if such fabrics are classifiable under HTSUS heading 5602 or 5603 and are wholly formed in one or more beneficiary SSAs.

[35] For the purposes of the Special Rule for Apparel under AGOA, lesser-developed SSAs are defined as those with a per capita gross national product of less than $1,500 a year in 1998, as measured by the World Bank. On the basis of the data contained in the World Bank's 1999/2000 World Development Report, all sub-Saharan countries except Botswana, Equatorial Guinea, Gabon, Mauritius, Namibia, Seychelles, and South Africa fall below this per capita threshold and have thus been declared eligible to use third-country fabric (non-United States and non-African) in their duty-free apparel exports to the United States through 30 September 2004. AGOA amendments specially grant Botswana and Namibia lesser-developed AGOA status for the Special Rule.

[36] The article is classified under subheading HTSUS 6110.10.

Grouping 8

Apparel articles wholly assembled from fabric or yarn not available in commercial quantities (i.e., "in short supply") in the United States: DUTY-FREE and QUOTA-FREE TREATMENT:

(a) Apparel articles that are both cut and assembled in one or more beneficiary SSAs, from fabric or yarn that is not formed in the United States or a beneficiary SSA country, are subject to duty-free/quota-free treatment to the extent that apparel articles of such fabrics or yarns would be eligible for preferential treatment, without regard to the source of the fabric or yarn, under NAFTA Annex 401.[37] The AGOA provision applies to apparel articles that would be originating goods, and thus would be entitled to preferential duty treatment, under the NAFTA tariff shift and related rules on the basis of the fact that the fabrics or yarns used to produce them were determined to be in short supply in terms of the NAFTA.

(b) At the request of any interested party,[38] the president is authorized to proclaim duty-free/quota-free treatment for apparel articles that are both cut and assembled in one or more beneficiary SSA countries, from fabric or yarn that is not formed in the United States or a beneficiary SSA country, if he has determined that such yarns or fabrics cannot be supplied by the domestic industry in commercial quantities in a timely manner and has proclaimed such treatment.[39]

Grouping 9

Handloomed, handmade, and folklore articles: Products covered under this category will be determined through U.S. consultations with the beneficiary countries and must also be certified by the competent authority of the

[37] NAFTA Annex 401 is available on the NAFTA secretariat's website, http://www.nafta-secalena.org/.

[38] Sec.112 (b)(3)(c)(v) of the Act defines an interested party as "any producer of a like or directly competitive article, a certified union or recognized union or group or workers which is representative of an industry engaged in the manufacture, production, or sale in the United States of a like or directly competitive article, a trade or business association representing producers or sellers of like or directly competitive articles, producers engaged in the production of essential inputs for like or directly competitive articles."

[39] Prior to making such a proclamation, the president must obtain advice from the appropriate advisory committees and the U.S. International Trade Commission, and must provide a report to, and consult with, the House Ways and Means and the Senate Finance Committees. The president delegated to the Committee for the Implementation of the Textiles Agreements (CITA) authority to determine whether yarns or fabric cannot be supplied by the domestic industry in commercial quantities in a timely manner. Updated short-supply information is available at http://otexa.ita.doc.gov/default.htm.

beneficiary countries as handloomed, handmade, or folklore articles: DUTY-FREE and QUOTA-FREE TREATMENT.

Under Executive Order 13191, the President authorized the Committee for the Implementation of the Textiles Agreements (CITA), after consultation with the commissioner of Customs and Border Protection, to consult with beneficiary SSAs and to determine which, if any, particular textile and apparel goods shall be treated as being handloomed, handmade, or folklore articles, or ethnic printed fabrics. As of March 2007, Botswana, Ghana, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mali, Mozambique, Namibia, Niger, Nigeria, Senegal, Sierra Leone, Swaziland, Tanzania, and Zambia have been approved for the handloomed and handmade provisions of Category 9. Mali, Niger, Nigeria, and Tanzania have been approved for ethnic printed fabrics.

In addition to original preferential groupings with some amendments, the textile/apparel provision is further amended by adding the following new paragraph:

Grouping 10
Apparel articles sewn or assembled in one or more beneficiary SSAs with U.S. thread from components cut in the United States and one or more beneficiary SSAs from fabric wholly formed in the United States from yarns wholly formed in the United States, or from components knit to shape in the United States and one or more beneficiary SSAs from yarns wholly formed in the United States, or both[40]: DUTY-FREE and QUOTA-FREE TREATMENT.

Administrable rules on the provision of textile/apparel articles
Groupings 4 and 5 face the cap limitation and surge mechanism as explained in the following section.

Apparel imports under groupings 4 and 5 are subject to a cap that will be filled on a "first-come, first-served" basis.

The CITA has the authority to implement certain provisions of AGOA's textile and apparel benefits, including the following:

- determination of the annual cap on imports of apparel that is assembled in beneficiary countries from fabric formed in beneficiary countries from yarn originating either in the United States or in beneficiary countries. Through September 30, 2012, the statute permits lesser-developed beneficiary

[40] Includes fabrics not formed from yarns, if such fabrics are classifiable under HTSUS heading 5602 or 5603.

countries to obtain preferential treatment for apparel assembled in beneficiary countries from third-country fabric;
- determination that yarn or fabric cannot be supplied by the U.S. industry in commercial quantities in a timely manner, and to extend preferential treatment to eligible apparel from such yarn or fabric (commercial availability);
- determination of eligible handloomed, handmade, or folklore articles and ethnic printed fabrics; such products may be imported quota-free and duty-free;
- a "tariff snapback" in the event that a surge in imports of eligible articles causes serious damage or threat thereof to domestic industry;
- determination of whether U.S. manufacturers produce interlinings in the United States in commercial quantities, thereby rendering articles containing foreign interlinings ineligible for benefits under AGOA; and
- determination of whether exporters have engaged in illegal transshipment, and to deny benefits to such exporters for a period of five years.

Regional and Third-Country Caps

AGOA limits imports of apparel made with regional or third-country fabric to a fixed percentage of the aggregate square-meter equivalents (SMEs) of all apparel articles imported into the United States. For the year beginning 1 October 2006, the aggregate quantity of imports eligible for preferential treatment under these provisions is an amount not to exceed 6.43675 percent of all apparel articles imported into the United States. Of this overall amount, apparel imported under the Special Rule for lesser-developed countries is limited to an amount not to exceed 3.5 percent of apparel imported into the United States in the preceding 12-month period.

Apparel articles entered in excess of these quantities will be subject to otherwise applicable tariffs. The duty-free cap is not allocated among countries; it is filled on a "first-come, first-served" basis. For the most current data on aggregate imports under the cap, please visit http://otexa.ita.doc.gov and click on "AGOA."

Abundant Supply

AGOA IV provides special rules on determining whether fabrics or yarns are produced in commercial quantities (or "abundant supply") in designated SSAs for use in qualifying apparel articles. AGOA IV provides that the U.S. International Trade Commission will make such determinations, and also provides that 30 million SMEs of denim are determined to be in abundant supply

beginning 1 October, 2006. Subject to these rules, certain apparel goods may be excluded from AGOA third-country benefits.

Commercial Availability

CITA may grant duty-free benefits for apparel made of fabric or yarns that cannot be supplied by the domestic industry in commercial quantities in a timely manner. As of April 2007, 11 commercial availability petitions were approved and 8 were denied. For details on products that receive duty-free treatment under the AGOA, please visit http://otexa.ita.doc.gov and click on "Commercial Availability."

Furthermore, in any year when the cap is filled, products may still be imported; however, normal trade tariffs will be assessed at the time of entry. It is important to note that the benefits for apparel and textile provision are significant for certain countries.[41] This fact could mean that those countries that have traditionally exported apparels to the United States might account for a large portion of the cap.

The rules of origin and preferential groups are summarized in Table 3.6.

Other Special Rules on the Provision of Textile/Apparel Articles

An article is eligible for preferential treatment even if it contains findings or trimmings of foreign origin, if the value of such findings or trimmings[42] does not exceed 25 percent of the cost of the components of the assembled article. Examples of findings and trimmings include sewing thread, hooks and eyes, snaps, buttons, "bow buds," decorative lace trims, elastic strips, and zippers. Elastic strips are considered findings or trimmings only if they are each less than 1 inch in width and used in the production of brassieres.

Sewing thread will not be treated as findings or trimmings in the case of grouping 3 and the new preferential grouping because the grouping 3 and the new preferential grouping specify that the thread used in the assembly of the article must be formed in the United States and thus cannot be of "foreign" origin.

Certain interlinings[43] are eligible for duty-free treatment as findings and trimmings. The interlinings permitted include only a chest-type plate, a "hymo" piece, or "sleeve header" made of woven or weft-inserted warp knit

[41] The country-by-country examinations for tariff treatment of principal U.S. imports from sub-Saharan Africa were carried out in the study by Craig VanGrasstek, "The African Growth and Opportunity Act: A Preliminary Assessment," prepared for UNCTAD, June 2002.

[42] AGOA Sec.112(d)(1)(A).

[43] AGOA Sec.112(d)(1)(B).

TABLE 3.6. *Summary of rules of origin and preferential groups*

	Preferential groups (description summarized)	Yarn	Thread	Fabric	Components knit-to-shape	Cutting	Sewn	Assembled	Treatment
1.	Apparel assembled from U.S. formed and cut fabric from U.S. yarns or components knit-to-shape	U.S.		U.S.	U.S.	U.S.	SSA	SSA	Duty–quota-free
2.	Apparel assembled and further processed from U.S. formed and cut fabric from U.S. yarn or components knit to shape	U.S.		U.S.	U.S.	U.S.	SSA	SSA	Duty–quota-free
3.	Apparel assembled with U.S. thread from U.S. formed fabric and SSA cut fabric or components knit to shape from U.S. yarns	U.S.	U.S.	U.S.	U.S.	SSA	SSA	SSA	Duty–quota-free
4.	Apparel articles from regional fabric or yarns	U.S. or SSA		SSA	SSA			SSA Assembled on seamless knitting machine in SSA	Duty–quota-free within cap
5.	Apparel assembled or knit to shape in a lesser developed country using foreign fabric	Foreign country		Foreign country				Lesser-developed SSA	Duty–quota-free within cap
6.	Cashmere sweaters: knit-to-shape			SSA					Duty–quota-free
7.	Merino wool sweaters, knit-to-shape			SSA					Duty–quota-free
8.	Apparel cut and sewn or assembled from fabric or yarns identified in the NAFTA "short supply" or not available in commercial quantities in the United States	Foreign country		Foreign country		SSA	SSA	SSA	Duty–quota-free
9.	Handloomed, handmade, and folklore articles								Duty–quota-free
	New pref. Grouping/Grouping 10 Apparel articles assembled in SSA from U.S. and SSA components	U.S.	U.S.	U.S.	U.S. and SSA	SSA and U.S.	SSA	SSA	Duty-quota-free

construction, and made of coarse animal hair or manmade filaments. An article is eligible for preferential treatment even if the article contains interlinings of foreign origin, if the value of those interlinings (and any findings and trimmings) does not exceed 25 percent of the cost of the components of the assembled article. The president shall terminate this arrangement if he determines that such interlinings are produced in the United States in commercial quantities.

Under the AGOA *de minimis* rule,[44] an article is eligible for preferential treatment because it contains fibers or yarns not wholly formed in the United States or one or more beneficiary SSAs if the total weight of all such fibers and yarns is not more than 7 percent of the total weight of the article.

3.1.5.2. *Rules of Origin under the Former Cotonou Partnership Agreement and the Current Interim EPAs*

The Cotonou Partnership Agreement was the last of a series of conventions formerly under the name of Lomé (actually there have been four Lomé Conventions). It was an international treaty of a contractual nature between the EC and the ACP that lasted until 1 January 2008. The Cotonou Partnership Agreement was the result of a long tradition of privileged relations that the ACP states have had with their former European colonizers, which commenced with the Yaoundé Conventions of 1963 and 1969 for the francophone countries and the Arusha arrangement of 1969 with Kenya, Uganda, and the United Republic of Tanzania. These arrangements merged into the first Lomé Convention in 1975 between the nine member-states of the EEC and 46 ACP countries. The ties and relationship have grown into the Cotonou Partnership as a result of the experience gained by both parties during Lomé Convention II (1980–1985) and III (1985–1990) and the last Lomé Convention IV (1990–2000).

Trade preferences granted under the Cotonou Partnership Agreement have been overlapping with those granted under the EC GSP scheme. This situation could be summarized as:

(a) The EC GSP scheme provided reduced or duty-free rate of duty to developing countries including ACP countries.
(b) The EC GSP scheme, from 5 March 2001 (the date of the entry into force of the EBA amendment) provides, for an unlimited period of time, duty–quota-free treatment for all products originating in LDC beneficiaries,

[44] AGOA Sec. 112(d)(2).

except for arms and ammunition, and with special provisions applicable to three sensitive products, namely rice, sugar, and fresh bananas (where customs duties are phased out over specific transitional periods), and;

(c) The ACP–EC Cotonou Partnership Agreement[45] (the CPA, successor to the Lomé IV Convention), that basically provided for an eight-year rollover of the previous preferences granted under Lomé IV with minor improvements, until 2008.[46]

At present the CPA has lapsed and has been replaced for certain regions and countries by interim EPAs. The ACP countries that have not signed an EPA have fallen back into the tariff preferences provided under GSP as shown in Table 3.7.

Although the CPA has lapsed, much of its institutional memory in terms of rules of origin still present in the interim EPAs. Moreover, the interim EPAs provide for a built-in agenda for negotiating rules of origin as part of the overall reform of the EC rules of origin subsequently discussed. With this in mind, the following subsection outlines the various features and evolution of the EC rules of origin. In fact there are a number of lessons learned from the Lomé Conventions and CPA that may be extremely useful when drafting and negotiating rules of origin under the EPAs.

3.1.5.3. *The Trade Preferences for ACP from the Former Lomé Conventions Through the CPA and to EPAs*

One of the main differences between the tariff preferences provided to ACP by the EC under its pre-EBA GSP scheme and the Lomé/CPA trade regime was in the different legal nature of the two preferential arrangements. Whereas the GSP was conceived as a unilateral, nonreciprocal, unbound grant by industrialized countries aimed at contributing to the economic development of the

[45] The Partnership Agreement between the EC and 78 ACP states was signed at Cotonou, Benin, on 23 June 2000. Pending the ratification process, the Agreement was put into provisional application on 2 August 2000, according to the modalities laid down in Decision No 1/2000 of the ACP–EC Council of Ministers of 27 July 2000 (2000/483/EC, Official Journal L 195 of 1.8.2000, p. 46).

[46] Under the CPA, the EC had anticipated the EBA initiative by entering into a commitment whereby it would "*start a process which, by the end of multilateral trade negotiations and at the latest 2005, will allow duty-free access for essentially all products from all LDCs, building on the level of the existing trade provisions of the Fourth ACP-EC Convention and which will simplify and review the rules of origin, including cumulation provisions, that apply to their exports*" (Article 37, paragraph 9, of the CPA).

TABLE 3.7. *Market access status of ACP countries as regards interim EPAs*

Region	EPA (9 LDCs, 26 non-LDCs)	EBA (32 LDCs)	GSP (10 non-LDCs)
Eastern and Southern Africa	**EAC** (Burundi, **Kenya**, Rwanda, Tanzania, Uganda) Comoros, Madagascar, **Mauritius**, **Seychelles**, **Zimbabwe**	Djibouti, Eritrea, Ethiopia, Malawi, Somalia, Sudan, Zambia	
SADC	**Botswana**, Lesotho, **Namibia**, Mozambique, **Swaziland**, Angola		
Caribbean	**Antigua & Barbuda, Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana**, Haiti, **Jamaica, St. Kitts & Nevis, St. Lucia, St. Vincent and the Grenadines, Surinam, Trinidad and Tobago**.		
Central Africa	**Cameroon**	Central African Republic, DR Congo, Chad, Equatorial Guinea, São Tome	**Gabon, Republic of Congo**
Pacific	**Papua New Guinea, Fiji**	East Timor, Kiribati, Samoa, Solomon Islands, Tuvalu, Vanuatu	**Cook Islands, Tonga, Marshall Islands, Niue, Micronesia, Palau, Nauru**
West Africa	**Côte d'Ivoire, Ghana**	Benin, Burkina Faso, Cape Verde, Gambia, Guinea, Guinea Bissau, Liberia, Mali, Mauritania, Niger, Senegal, Sierra Leone, Togo	**Nigeria**

Note: non-LDCs are denoted in bold. This table reports the status as of June 2008.

developing states, the Lomé/CPA preferences were an integral part of a broader international treaty that was legally binding on the two parties (the EC, on the one hand, and the ACP states, on the other hand) and by which the EC committed itself on a contractual basis to ensuring until 2008 nonreciprocal preferential market access conditions for ACP products. With a view to giving greater stability to the EBA–GSP preferences for LDCs, the EC has undertaken to maintain the special preferential treatment in favor of LDC products for an unlimited period, exempting such treatment from the periodical reviews of the basic GSP scheme or the negotiations for the post-Cotonou Agreement.

At the expiration of the CPA a number of ACP countries have entered into interim EPAs as shown in Table 3.7. The interim EPA consists of a general text with market access concessions attachments appended. However, this interim EPA contains built-in negotiating agendas to continue negotiations in their areas with the aim of concluding a full EPA, as in the case of Cariforum countries. In the case of the countries that have negotiated under the Eastern and Southern Africa (ESA) grouping, there is also a commitment, under Article 3 of the Interim EPA to

- establish a framework, scope, and principles for further negotiations on Trade in Goods (including rules of origin, trade defense instruments, customs cooperation and trade facilitation, Sanitary and Phytosanitary (SPS) measures, technical barriers to trade and agriculture) on the basis of the proposals already submitted;
- establish a framework and scope of potential negotiation in relation to other issues including trade in services, trade-related issues as identified in the CPA (which includes competition policy protection of intellectual property rights, standardization and certification, SPS measures, trade and environment, trade and labor standards, consumer policy and protection of consumer health and a tax carve-out clause) and any other areas of interest to both parties.

Article 53 (Rendezvous Clause) specifies that the parties agree to continue negotiations in accordance with Article 3 with a view to concluding a full and comprehensive EPA covering the following areas:

(a) customs and trade facilitation;
(b) outstanding trade and market access issues including rules of origin and other related issues and trade defense measures including outermost regions;
(c) technical barriers to trade and SPS measures;
(d) trade in services;

(e) trade-related issues, namely:
  (i) competition policy;
  (ii) investment and private sector development;
  (iii) trade, environment, and sustainable development;
  (iv) intellectual property rights;
  (v) transparency in public procurement;
(f) agriculture;
(g) current payments and capital payments;
(h) development issues;
(i) cooperation and dialogue on good governance in the tax and judicial area;
(j) an elaborated dispute settlement mechanism, institutional arrangements; and
(k) any other areas that the parties find necessary including consultations under Article 12 of the CPA.

As under the previous Lomé Conventions the rules of origin contained in the CPA and in the current interin EPAs were quite similar; but a number of substantial changes have taken place in the interim EPAs as explained in the next sections.

3.1.5.4. *Rules of Origin, Cumulation and Derogations Procedures under the Former Cotonou Partnership Agreement*

One of the main differences from the EC GSP and the current EBA scheme rules of origin was that the CPA provided for full cumulation among all ACP countries as well as the EC and the overseas countries and territories (OCTs) provided in Articles 2 and 6 of Protocol 1 of the Partnership Agreement: *Article 2*

ARTICLE 2 OF THE COTONOU PARTNERSHIP AGREEMENT

General requirements

1. For the purpose of implementing the trade co-operation provisions of ANNEX V, the following products shall be considered as originating in the ACP States:
   (a) products wholly obtained in the ACP States within the meaning of Article 3 of this Protocol;
   (b) products obtained in the ACP States incorporating materials which have not been wholly obtained there, provided that such materials have undergone sufficient working or processing in the ACP States within the meaning of Article 4 of this Protocol.
2. For the purpose of implementing paragraph 1, the territories of the ACP States shall be considered as being one territory.

> Originating products made up of materials wholly obtained or sufficiently worked or processed in two or more ACP States shall be considered as products originating in the ACP State where the last working or processing took place, provided the working or processing carried out there goes beyond that referred to in Article 5 of this Protocol.

In addition the CPA contained detailed provisions regulating cumulation with South Africa and other neighboring countries.

Cumulation with South Africa

The cumulation with South Africa had a number of serious limitations. First, it was partial cumulation because: "*Subject to the provisions of paragraphs 4, 5, 6, 7 and 8, **materials** originating in South Africa shall be considered as originating in the ACP States when incorporated into a product obtained there*." The expression "materials originating" clearly limited the scope of the cumulation, allowing only for partial cumulation. Second, products that have been objects of cumulation continued to be considered as products originating in the ACP states only when the value added there exceeded the value of the materials used originating in South Africa. If this is not so, the products concerned were considered as originating in South Africa.

Example: Cotton fabrics (HS 52) originating from South Africa are made into garments (HS 62) in Mauritius. These garments are considered as originating in Mauritius, provided the value added in Mauritius exceeds the value of the cotton fabric.

Third, the cumulation could be applied only after three years for the products listed in Annex XI and six years (i.e., for the products listed in Annex XII respectively, as from the provisional application of the Agreement on Trade, Development and Co-operation between the EC and the Republic of South Africa). The cumulation provided for in paragraph 3 was not applicable to the products listed in Annex XIII.

Products listed in Annex XI of the Cotonou Partnership Agreement covered almost 70 pages at tariff line level to eight digits and concerned products ranging from chemicals and minerals to textiles, leather, and electronic products. Products contained in Annex XII were mainly textiles, garments, and steel products. Annex XIII concerned cars, fruits, and vegetables.

Specific derogations may be applied at the request of the ACP states for the products listed in Annexes XI and XII. The ACP–EC Committee of

Ambassadors shall decide on the ACP requests, product per product, based on a report drawn up by the ACP–EC Customs Co-operation Committee.

The cumulation for fishery products was applicable when the tariffs on these products in the framework of the Agreement on Trade, Development, and Co-operation between the EC and the Republic of South Africa were eliminated.

Finally, the cumulation may be applied only where the South African materials used have acquired the status of originating products by an application of the rules of origin identical to those set out in this Protocol.

As an exception to the rule on partial cumulation, full cumulation was granted to South African Customs Union (SACU) countries according to paragraph 9 of Article 6: "*Without prejudice to paragraphs 5 and 7, working and processing carried out in South Africa shall be considered as having been carried out in an other Member State of the South African Customs Union (SACU) when the materials undergo subsequent working or processing in that other Member State of SACU.*"

Example: Australian woolen yarn (HS 51) is imported into South Africa where it is made into fabrics (HS 5111). These fabrics are then sent to Namibia where they are sewn together into garments (HS 62). Garments of Chapter 62 are originating if manufactured from yarn. This requirement has been met if the processing carried out in all SACU countries is taken into account. As a result, the garments are considered as originating in Namibia.

Finally, and subject to the request of the ACP states, working and processing carried out in South Africa was considered as having been carried out in the ACP states, when the materials undergo subsequent working or processing in an ACP state within the context of a regional economic integration agreement.

Cumulation with neighboring countries:
At the request of the ACP states, materials originating in a neighboring developing country, other than an ACP state, belonging to a coherent geographical entity, was considered as materials originating in the ACP states when incorporated into a product obtained there.

Such partial cumulation was subject to a series of limitations:

- The working or processing carried out in the ACP state exceeds the minimal or processing operations. Products of Chapter 50 to 63 of the HS shall in addition undergo in the ACP state at least working or processing as a result that the product obtained is classified in a heading that is different from those in which the materials originating in the non-ACP developing country used in its manufacture are classified.
- For products listed in Annex IX to this Protocol, only the specific processing referred to in column 3 shall apply, whether or not it involves a change of

heading (this list contains certain textiles that have to undergo specific working or processing in the ACP states).
- The ACP states, the EC, and the other countries concerned have concluded an agreement on adequate administrative procedures that will ensure correct implementation of this paragraph.

This provision did not apply to tuna products classified under HS Chapters 3 or 16, rice products of HS Code 1006, or the textile products listed in Annex X to the Protocol on rules of origin.

This vague expression of neighboring countries was qualified in the Joint Declaration on Cumulation (in Annex LXXXVI):

> *The Contracting Parties agreed that, for the implementation of Article 6(5) of Protocol 1, the following definitions shall apply:*
>
> *Developing country: any country listed as such by the Development Aid Committee of the OECD and the Republic of South Africa except the High Income Countries (HIC) and the countries with a GNP exceeding in 1992 US$100 billion at current prices;*
>
> *The expression 'neighbouring developing country belonging to a coherent geographical entity' shall refer to the following list of countries:*
>
> - *Africa: Algeria, Egypt, Libya, Morocco, Tunisia;*
> - *Caribbean: Colombia, Costa Rica, Cuba, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Venezuela;*
> - *Pacific: Nauru.*

The derogation procedure under the Cotonou Partnership Agreement

In specific cases and under certain conditions, the CPA provided, as in the case of the former Lomé IV Convention, for a special procedure allowing derogation from the normal rules of origin.[47]

It was noticed over the years that the rules of origin contained in the former Lomé Conventions could have a restrictive effect on the development of local industries. Particularly in the ACP context, in which the level of industrial development is generally low, the possibility of importing semimanufactured material to obtain a finished higher-value product was and still-essential for the development of the ACP region. In this connection, the requirements laid down by the ACP rules of origin may lead to a situation in which the

[47] The following derogations were in force: polyester cotton yarn from Zambia (OJ L 123, 4.5.2001, p. 29), valid until 28 February 2006, textiles from Fiji (OJ L 123, 4.5.2001, p. 31), valid until 31 March 2006, core spun yarns from Swaziland (OJ L 144, 30.5.2001, p. 35), valid until 31 March 2006, men's shirts from Cape Verde (OJ L48 of 19.2.2005, p. 43), valid until 31 December 2007, preserved tuna and tuna loins from all ACP states (OJ L 61, 8.3.2005, p. 48), valid until 31 December 2007.

objectives of its provisions may be frustrated. To avoid such cases a procedure for derogation from the rules of origin criterion was included in the third Lomé Convention. However, because of the growing importance of the issue, the whole procedure was revised in the Lomé IV Convention and lately incorporated into the CPA, which provided better administration and lays down specific provisions for its implementation.

More specifically, derogations from the origin criterion could be adopted by the Customs Cooperation Committee (set up by Article 30 of the revised Protocol 1 – hereinafter the CC Committee), for which the development of existing industries or the creation of new industries justifies them. Applications for derogations were to be submitted to the Committee in writing by the ACP states and notified to the EC.

To facilitate the CC Committee's examination of applications, the ACP states must, by means of the form reproduced in Annex XI of Protocol 1, of the Cotonou Partnership Agreement furnish the fullest possible information covering in particular the points listed:

- description of the finished products;
- nature and quantity of materials originating in a third country;
- nature and quantity of materials originating in ACP states, the EC, or overseas countries and territories, or that have been processed there;
- manufacturing processes;
- value added;
- number of employees in the enterprise concerned;
- anticipated volume of exports to the EC;
- other possible sources of supply for raw materials;
- reasons for the period requested in the light of efforts made to find new sources of supply;
- other observations.

The same rules applied to any request for extension.
The examination of requests shall take into account:

(1) the level of development or the geographical situation of the ACP state or states concerned;
(2) cases in which the application of the existing rules of origin would significantly affect the ability of an existing industry in an ACP state to continue its exports to the community;
(3) specific cases in which it can be clearly demonstrated that significant investment in an industry could be deterred by the rules of origin and in which

a derogation favoring the realization of the investment program would enable these rules to be satisfied by stages.

A derogation was granted where the value added to the nonoriginating products used in the ACP states concerned was at least 45 percent of the value of the finished product, provided that it was not such as to cause serious injury to an economic sector of the community or of one or more member-states.

On request, derogations concerning canned tuna and tuna loins were automatically granted, within an annual quota of 4,000 tonnes, for canned tuna, and, within an annual quota of 500 tonnes, for tuna loins. Applications for such derogations were to to be submitted to the CC Committee by the ACP states in accordance with the aforementioned quota and it will give effect to them by means of a decision.

Individual ACP exporters, wishing to obtain a derogation from the definition of the concept of the origin of goods, were not supposed to deal directly with the EC. To apply for a derogation, ACP exporters have to refer to the competent authorities of their governments.

Supposedly, the ACP states concerned, or, where appropriate, the competent authorities of the OCT concerned, submit the request for a derogation to the local EC delegation – which then will notify the EC – together with the reasons for the request, by means of a standard application form, making sure to provide the fullest possible information in support of the request.

The procedural rules to be followed in deciding a request for a derogation were set out in Article 31 of Protocol 1 to Lomé IV Convention and in more detail in Council Decision 90/523/EEC of 8 October 1990.[48]

According to Article 31 of Protocol 1, applications for such derogations were submitted to the ACP–EC CC Committee, which was in charge of carrying out the examination of requests. The EC was supposed to respond positively to all the ACP requests that were duly justified under the relevant provision of Protocol 1 of the Cotonou Partnership Agreement and that cannot cause serious injury to an established community industry. The CC Committee had to take the steps necessary to ensure that a decision was reached as quickly as possible, and in any case no later than 60 working days after the request was received by the EC co-chairperson of the CC Committee. If the EC did not inform the ACP states of its position on the request within this period, the request was deemed accepted.

The derogation granted was valid for a period – generally five years – to be determined by the CC Committee.

[48] O.J. L 290 (1990).

However, the procedural rules laid down in the aforementioned Council Decision did not perfectly match with the ones in Article 31 of Protocol 1 to former Lomé Convention. Article 1 of Council Decision 90/523/EEC[49] (on the procedure concerning derogations from the rules of origin set out in Protocol 1 to the fourth Lomé Convention) stated that it was the Commission that makes the decision with regard to a derogation:

> *[T]he common position of the Community with regard to a request presented by the ACP States for derogation from the rules of origin laid down in Protocol 1 to the ACP-EC Convention shall be adopted by the Commission in accordance with the procedure laid down in Article 2.*

The representative of the Commission shall submit to the Committee on Origin[50] a draft common position within 20 working days after the receipt of a request for derogation by the EC co-chairperson of the CC Committee. The Committee on Origin shall deliver an opinion on the draft within a period laid down by its chairperson, according to the urgency of the matter concerned (Article 2, paragraph 1 of Decision 90/523/1990). The Commission shall adopt the common position and transmit it immediately to the ACP states (Article 2, paragraph 2).

The time limit afforded to the EC for making a decision on a request for derogation from the rules of origin was 60 working days. If no decision was made by then the request was considered accepted. This time limit commenced as soon as the president of the Committee on Origin received a request that satisfies the formal requirements.

The ACP state applying for a derogation must support its request with the fullest possible information, so that the Committee on Origin and the Commission was in a position to decide on the merits of whether a request should be accepted or refused. This did not mean that the request should be duly justified in order for the time limit to commence, because it was sufficient that the formal requirements were satisfied. Consideration of its merits was a completely distinct matter.

3.1.5.5. *Rules of Origin under Interim EPAs and the Cariforum EPAs*

The rules of origin contained in the Interim EPAs and in the full EC–Cariforum EPAs are not substantially different from the Cotonou rules of origin. In spite of the announced reform of EC rules of origin and the ambitions of the ACP countries to review the rules of origin, both parties had to realize that time was too short to negotiate a new protocol on rules of origin.

[49] O.J. L 290 (1990).

[50] See Council Regulation 802/68 of 27 June 1968 on the common definition of the concept of the origin of goods, O.J. L 148 (1968), as last amended by Regulation 1769/89, O.J. L 174 (1989).

This does not mean that the dossier of rules of origin is closed. All Interim EPAs contain an article worded as follows:

> *Within the first three years of the entry into force of this Agreement the Parties shall review the provisions of this Protocol, with a view to further simplifying the concepts and methods used for the purpose of determining origin. In such review the Parties shall take into account the development of technologies, production processes and all other factors, including on-going reforms of rules of origin, which may require modifications to the provisions of this Protocol. Any such modifications shall be effected by a decision of the Joint Council as defined in Article 93. (Excerpt from Article 29 of SADC EPA)*

Thus, as dealt with more extensively in Chapter 5, the current rules of origin in the Interim EPAs could be revisited.

Although similar to the Cotonou rules of origin, the EPA rules of origin contain a number of differences: The EPAs interim protocol on rules of origin builds on the *acquis* of the Cotonou rules of origin.

Although similar there are differences among the EPAs interim rules and Cotonou rules of origin. These differences could be summarized as follows:

(a) **Cotonou plus:** This refers to the revised origin for clothing (one transformation), fisheries (15 percent allowance on nonoriginating inputs although it has yet to be tested how this rule could be practically implemented). A possibility is to use some alternative product-specific rules of origin in the case of agricultural products (see Economic Community of West Africa States draft of July 2008). A closer analysis of the differences in the various interim EPAs and the Cariforum EPAs was not possible at the time of this writing although some differences have been recorded in the latter one especially for some product-specific rules.
(b) **Cotonou minus:** This refers to provisions that have worsened the Cotonou acquis. In particular, the rules allowing cumulation have been made subject to a series of conditionalities that were not present in the Cotonou text and a number of penalties and administrative requirements are now introduced in case of failure of providing administrative cooperation.
(c) **Cotonou status quo:** This refers to provisions and product-specific rule of origin that has not been substantially changed although the ACP States had long expressed their desire for a change. This concerns the limitation on cumulation with South Africa, the procedures for derogations, a general lessening of the product-specific rules especially for fishery products.

The most positive innovation is the removal of the double transformation criteria in Chapters 61 and 62 of the HS that has been replaced with a single transformation allowing the use of imported fabrics.

In addition rules of origin for fisheries and fisheries products have been amended by introducing a 15 percent allowance of imported products as shown below:

> Heading 1604 and 1605-prepared fish: Manufacture in which the value of any materials of Chapter 3 used does not exceed 15 percent of the ex-works price of the product
>
> Heading 0304 to 0307 Fish fillets, crustaceans and molluscs: Manufacture in which the value of any materials of Chapter 3 used does not exceed 15 percent of the ex-works price of the product

The impact of such limited liberalization is difficult to quantify as operators may find difficult to comply with the administrative requirements such as accounting segregation needed to comply with this origin requirement.

Other changes in respect of the Cotonou Partnership Agreements concerned the definition of wholly obtained where a number of requirements related to crew nationality, vessel ownership, and leasing of vessels have been lessened:

(a) *Crew requirement*: The requirement for a vessel's crew to consist of 50 percent nationals of the parties to the agreement has been deleted. The crew requirement has similarly been dropped in the case of leased or chartered vessels. This reform, however, may not benefit all interests in the ACP, especially West Africa, as nationals commonly crew EC vessels because they have the skills and expertise and their labor power is cheaper than the EC equivalent. Nonetheless, for those island and coastal ACP countries with Fisheries Partnership Agreements (FPAs) with the EC, requirements for the use of nationals in the crew can be (and are) written in these Agreements.
(b) *Vessel ownership*: The definition of a qualifying vessel still requires it to be flagged and registered by one of the parties to the agreement. The 50 percent ownership by nationals of parties to the agreement remains, but for the alternative option of company ownership it now only has to have "its head office and . . . main place of business" in an EC or EPA state (rather than the additional component that the chairperson and board members must all be nationals).
(c) *Leasing/chartering of vessels*: To start or develop a fishing fleet is a capital-intensive exercise that ACP countries do not have, hence the Lomé IV Convention and later the CPA provided that if an ACP state offers to negotiate a Fisheries Agreement and the EC refuses then the EC would recognize leased or chartered vessels as ACP vessels. A number of conditionalities concerning crew requirement remained applicable. In the more than a decade that this provision has been in force its use and value has not been assessed. The interim EPA provides that vessels chartered or leased

by operators of an ACP EPA states be treated as "their vessels" in order to undertake fisheries activities in its exclusive economic zone, provided that the charter or lease agreement, for which operators of the EC party have been offered the right of first refusal, has been accepted by the Special Comittee on Customs Cooperation and Trade Facilitation as providing adequate opportunities for developing the fishing capacity of the requesting ACP EPA state and in particular as conferring on such ACP EPA state the nautical and commercial responsibility for the chartered or leased vessels.

Thus there is a significant difference because it is now sufficient that the EC refuses to lease vessels rather than being offered and refuse to enter a Fisheries Agreement.

In the EPA negotiations on fisheries the most significant innovation in EC rules of origin offers was the 'global sourcing' rule provided to the Pacific countries for certain processed fish products classified under heading 1604 and 1605. The text of the agreement reads as follows:

> [P]rocessed fishery products of headings 1604 and 1605 manufactured in that State from non-originating materials of Chapter 03 shall be considered as sufficiently worked or processed (Protocol 1, Article 7(6)(a))

In other words, regardless of where the fish was caught or the status of the vessel's flag, registration or ownership: the fish is originating as long as it is transformed from being fresh or frozen (and thus classified under HS Chapter 3) into being a packaged, canned, etc., product (classified under HS 1604 and 1605).

In general, a number of provisions have been added in all interim EPAs as well as in the Cariforum full EPA to strengthen administrative cooperation and a series of obligations to implement cumulation.These changes recall the Convention on administrative cooperation presented in 2007 and discussed in Chapter 6, providing for alignment of the administrative aspects of the cumulation system with those of the Pan-European rules of origin.

A system of penalties that may justify the temporary suspension of preferential treatment is now associated with the failure of cooperation on origin administration and cooperation. Article 2(g) of the SADC Interim EPA:

The Parties also agree to cooperate in ensuring that the necessary institutional structures enable the responsible authorities effectively respond to requests for assistance in a timely manner.

3. *For the purpose of this Article and without prejudice to Article 9 of Protocol 2, a failure to provide administrative co-operation shall mean, inter alia:*
   (a) a repeated failure to respect the obligations to verify the originating status of the product(s) concerned as provided for in Article 34 of Protocol 1;

(b) *a repeated refusal or undue delay in carrying out and/or communicating the results of subsequent verification of the proof of origin as provided for in Article 34 of Protocol 1;*

(c) *a repeated refusal or undue delay in obtaining authorisation to conduct administrative co-operation missions to verify the authenticity of documents or accuracy of information relevant to the granting of the preferential treatment in question as provided for in Article 7 of Protocol 2.*

4. *For the purpose of this Article a finding of irregularities or fraud may be made, inter alia, where there is a rapid increase, without legitimate explanation, in imports of goods exceeding the usual level of production and export capacity of the other Party that is linked to objective information concerning irregularities or fraud.*
5. *Where a Party or SADC EPA States, as the case may be, has made a finding, on the basis of objective information, of a failure to provide administrative cooperation and/or of irregularities or fraud, the Party concerned may, in exceptional circumstances, temporarily suspend the relevant preferential treatment of the product(s) concerned, and of the specific origin concerned in accordance with this Article. (excerpted from art of the SADC EPA text)*

This provision or an analogue one did not feature at all in the Cotonou Partnership Agreement or previous Lomé Conventions, signaling a substantial hardening of EC stance on the ability of ACP states to effectively administer rules of orign requirements.

As shown below in Article 4 of the SADC EPA, full cumulation among ACP countries has been maintained in the interim EPAs and Cariforum EPA but made subject to a number of administrative requirements. Paragraph 4 of Article 4 shown below of the SADC interim EPA provides that working and processing operations carried out in ACP states could be cumulated. However, paragraph 6 of the same Article sets a number of administrative requirements for the implementation of cumulation including the signature among the ACP countries concerned with an agreement of administrative cooperation. It is not clear what is meant for such agreement and what is the content of such an agreement. Finally such an agreement has to be notified to the Commission according to paragraph 6(c).

None of these conditions were contained in the former Cotonou Partnership Agreement. Although it may be argued that some of these administrative requirements are necessary under the new regime, there is no doubt that they are demanding an increased capacity to handle implementation of the rules of origin protocol on the part of the ACP states. In addition, other

solutions could have been explored before transferring such burden to ACP countries.

Finally, paragraph 7 limits the scope of cumulation with South Africa:

Article 4 of the SADC–EPA Cumulation in the SADC EPA States

1. *Without prejudice to the provisions of Article 2(2), products shall be considered as originating in a SADC EPA State if they are obtained there, incorporating materials originating in the Community, in the other ACP States, in the OCTs or in the other SADC EPA States, provided the working or processing carried out in that SADC EPA State goes beyond that of the operations referred to in Article 7. It shall not be necessary for such materials to have undergone sufficient working or processing.*
2. *Where the working or processing carried out in the SADC EPA State does not go beyond the operations referred to in Article 7, the product obtained shall be considered as originating in that SADC EPA State only where the value added there is greater than the value of the materials used originating in any one of the other countries or territories referred to in paragraph 1. If this is not so, the product obtained shall be considered as originating in the country or territory which accounts for the highest value of originating materials used in the manufacture in that SADC EPA State.*
3. *Products originating in one of the countries or territories referred to in paragraphs 1 and 2 of this Article, which do not undergo any working or processing in the SADC EPA State, retain their origin if exported into one of these countries or territories.*
4. *For the purpose of implementing Article 2(2)(b), working or processing carried out in the Community, in the other SADC EPA States, in the other ACP States or in the OCTs shall be considered as having been carried out in a SADC EPA State when the products obtained undergo subsequent working or processing in this SADC EPA State. Where pursuant to this provision the originating products are obtained in two or more of the countries or territories concerned, they shall be considered as originating in this SADC EPA State only if the working or processing goes beyond the operations referred to in Article 7.*
5. *Where the working or processing carried out in the SADC EPA State does not go beyond the operations referred to in Article 7, the product obtained shall be considered as originating in that SADC EPA State only where the value added there is greater than the value of the materials used originating in any one of the other countries or territories referred to in paragraph 4. If this is not*

so, the product obtained shall be considered as originating in the country or territory which accounts for the highest value of originating materials used in the manufacture.

6. *The cumulation provided in this Article may only be applied provided that:*
   (a) the countries involved in the acquisition of the originating status and the country of destination have concluded an agreement on administrative co-operation which ensures a correct implementation of this Article;
   (b) materials and products have acquired originating status by the application of the same rules of origin as provided in this Protocol;
   (c) the SADC EPA States will provide the Community, through the European Commission, with details of agreements on administrative co-operation with the other countries or territories referred to in this Article. The European Commission shall publish in the Official Journal of the European Union (C series) and the SADC EPA States shall publish according to their own procedures the date on which the cumulation provided for in this article may be applied with those countries or territories listed in this article which have fulfilled the necessary requirements.
7. *The cumulation provided for in this Article shall not be applicable to the products listed in Annex IX. Notwithstanding that, the cumulation provided for in this Article may only be applied after 1 October 2015 for the products listed in Annex IX and after 1 January 2010 for rice of heading 1006 respectively, when the materials used in the manufacture of such products are originating, or the working or processing is carried out in a SADC EPA State or in an other ACP State member of an Economic Partnership Agreement.*
8. *This Article shall not apply to products of Annex X originating in South Africa. The cumulation provided for in this Article shall apply for the products originating in South Africa listed in Annex XI after the date indicated in column 3 of this Annex.*

Article 31 of the Protocol on the rules of origin further emphasizes the commitments to strengthen administrative cooperation, making preferential treatment dependent on the implementation of such administrative requirements:

Administrative conditions for products to benefit from the SADC–EC EPA

1. *For Products originating within the meaning of this Protocol in a SADC EPA State or in the Community shall benefit, at the time of the customs import declaration, from the preferences resulting from the SADC–EC EPA only on*

condition that they were exported on or after the date on which the exporting country complies with the provisions laid down in paragraph 2.

2. *The SADC EPA States and the Community shall undertake to put in place:*
   (a) the necessary national and regional arrangements required for the implementation and enforcement of the rules and procedures laid down in this Protocol, including where appropriate the arrangements necessary for the application of Articles 3 and 4 (Cumulation);
   (b) the administrative structures and systems necessary for an appropriate management and control of the origin of products and compliance with the other conditions laid down in this Protocol.

   It shall make the notifications referred to in Article 32.

Once again, such conditions were not contained in the former CPA.

3.1.5.6. Recent Proposal by the EC Commission on New GSP Rules of Origin from 2009. (Taxation and Customs Union Directorate-General [European Commission] [TAXUD] document 2046 of 2007)

The proposal contains a number of striking changes from traditional EC policy on rules of origin. First, it replaces a product-specific rule of origin approach maintained for over 30 years with a horizontal, across-the-board percentage criterion set in the current proposal at 30 percent for LDCs and 50 percent for developing countries. Second, it changes the administrative procedures, verification requirements, and administrative cooperation from a system based on the certifying authorities to an exporter-based one. In addition noncompliance with these new administrative rules may entail suspension from the tariff preferences granted under the GSP. At a first meeting of the EC Customs Committee held at the end of 2007, this proposal was largely criticized by EC member-states in several respects and merits.

The percentage criterion

According to the proposal, the new rule of origin will be an across-the-board percentage criterion with some additional requirements for specific products. According to the Commission draft, *such a method offers simplicity, flexibility, and transparency. However, for certain specific products such as agricultural products or fisheries products, additional or different conditions are required in order to support development through encouraging the continued use of materials that are wholly obtained in the beneficiary country concerned.*

There is no clear definition of the formula to meet the percentage criterion in the draft proposal, but there are definitions of the formula numerator and denominator as follows:

A sufficient processing threshold of 50 percent (30 percent for LDCs) of the ex-works price where:

"Sufficient processing threshold" means the minimum local value content required to consider a manufacture as working or a processing sufficient to confer originating status on the product, expressed as a percentage of the ex-works price; "ex-works price" means the price paid for the product ex-works to the manufacturer in whose undertaking the last working or processing is carried out, provided that the price includes the value of all the materials used, minus any internal taxes that are, or may be, repaid when the product obtained is exported; "local value content" means the value added in the beneficiary country, being the difference between the ex-works price and the value of the nonoriginating materials used, expressed as a percentage of the ex-works price, which may be expressed as the following formula:

$$\text{Local Value Content} = \frac{\text{Ex-works-price-VNM}}{\text{Ex-works price}} \times 100 \leq 30\%$$

where VNM stands for the value of nonoriginating materials.

According to some Commission officials, one of the reasons for adopting an across-the-board percentage criterion was to fend off the tendency of EC lobbies to negotiate on a product-specific-rule basis. It was considered that negotiations on product-specific would have made the reform of EC rules of origin difficult and time-consuming exercise. After more than 3 years from the publication of the Green Paper and no reform in sight at the time of this writing this statement is, in retrospective, quite puzzling. Moreover, it is not clear how the EC assessed the level of thresholds against the different sectors. It is quite clear that no consultations have been held with developing countries and/or producers and exporters based in developing countries or LDCs, although the EC Commission held that consultations have taken place in Brussels. At a first internal meeting[51] the European federations complained about the adoption of an across-the-board percentage especially in the fishery and textiles and clothing sectors. Many EC member-states questioned the use of a percentage value-added criterion as it brings more complications than simplification.

It may be safely said, at the technical level, that the use of a percentage criterion may not be the best rule in some sectors such as chemicals and steel products and, some would also argue, in textiles and clothing.

[51] See Report of the CC Committee-origin section of 20/11/2007, TAXUD/C5/ADL/RL D(2007)cr \ 16. For the original draft proposal see TAXUD document 2046 of 2007.

Registered exporters

The proposal contains a new system of administering rules of origin based on a database of registered exporters. Exporters should be registered with the competent authorities of the beneficiary countries to facilitate targeted postexport controls. Because it was admitted that such a registration system could not be set up immediately and there was a need to take into account the capacity of beneficiary countries to set up and manage it, a transitional period was provided until 2012. After 2012 the EC is planning to introduce this system of registered exporters according to the proposal.

According to the new system, only registered exporters will be authorized to make statements of origin for benefiting preferential tariff treatment. This implies that a certificate of origin will no longer be needed but certifying authorities in beneficiaries countries will have the authority to designate registered exporters.

To be registered, exporters must lodge an application with the competent authorities of the beneficiary country in accordance with a form. The application shall be accepted by the competent authorities only if it is complete.

Before declaring goods for free circulation in the EC, the declarant shall take due care that the goods comply with the rules, in particular, (a) checking that the exporter is registered to make statements on origin regarding the products concerned and that the statement on origin contains all relevant information, and (b) obtaining, where appropriate, from the exporter written confirmation that the goods declared meet the conditions for preferential treatment.

Some initial considerations may be made. Overall, the system of registered exporters, once joined with the strengthened obligation of administrative cooperation, shifts part of the burden of administering rules of origin to the preference-receiving countries. They will be primarily responsible for managing the database of registered exporters and responding to the EC queries and verifications.

Some exporters could favorably consider such an initiative with this system because origin and related documents are checked only periodically rather than on each consignment and they can deal directly with the EC importers if problems arise. This probably would be true for regular exporters and less for occasional small–medium-size enterprises.

Much will depend on the capacity of the certifying authorities in preference-receiving countries to handle the database and help the business community cope with the new system.

3.2. Contractual Rules of Origin in Free-Trade Areas

Rules of origin are clearly at the very core of regional economic integration schemes because they ensure that preferential market access will be granted only to goods that have actually been "substantially transformed" within the area, and not to goods that are produced elsewhere and simply transhipped through one of the countries participating in the scheme. In the absence of rules of origin it would not be possible to discriminate against imports from third countries, so the significance of regional integration would be drastically diminished.

The main reason for the existence of rules of origin in FTAs is the preoccupation with trade deflection. In FTAs, each country maintains its own external tariff and commercial policy in relation to outside trading partners. To the extent that the tariffs and commercial policy are different with regard to third countries, there is always the incentive to import goods through the country with the most liberal import regime and tariffs. In such a case, importers/producers will eventually operate minimal transformation and finally reexport goods toward the country(ies) with the higher tariffs. To sum up, it would be equivalent to a tariff circumvention operation.

Trade deflection does not have per se a negative economic effect. In fact, it may be, from an economic point of view, considered equivalent to a reduction in the tariff of the country having the higher tariff of the FTAs to the country having the lower tariff and thus positive for economic efficiency. It is, however, regarded as a negative phenomenon because it does not correspond to the objectives of the FTAs contracting parties. Taken to its extreme, trade deflection could go beyond the original intention of the contracting parties by transforming the original FTA into a customs union where *de facto* the external tariff country applying the lower tariffs determines the external tariffs.

The traditional "remedy" for trade deflection is stringent rules of origin. However, the more stringent they are, the more prevalent trade diversion may become, because producers in the FTAs will have an incentive to buy intermediate inputs originating within the area in spite of their higher cost/lower quality in comparison with inputs from countries outside the FTAs.

Thus, trade diversion could be greater the higher the preferential margin associated with origin compliance and the less costly the compliance with rules of origin and related administration costs.

To determine the possible effects of rules of origin in a FTA, it is first necessary to examine the general level of industrial and economic development of the countries involved. It is possible to determine three categories of FTAs:

(1) among developed countries (i.e., the United States/Canada original FTA or the European Economic Area (EEA) Agreement);
(2) among developed and developing countries (i.e., NAFTA, Central American Free-Trade Area (CAFTA), Euro-Mediterranean Partnership Agreements);
(3) among developing countries (i.e., SADC, ASEAN, Mercosur).

Rules of origin adopted in the context of FTAs as in the original U.S./Canada FTA and EEA Agreement, are guided by the principle of integration, specialization of domestic industries, and preference for domestic intermediate inputs over imported ones as well as by the control of trade deflection. Obviously, the more sophisticated the level of industrial development, the more rules of origin may be restrictive as regards third-country inputs without substantially reducing the trade creation effects.

In this section the rules of origin of the two major players in drafting and developing models of rules or origin are examined. The Pan-European rules of origin and the NAFTA rules as well as their respective evolutions are discussed.

3.2.1. *The EC Pan-European Rules of Origin*

The EC practice in the field of rules of origin has been consistent since the adoption of a basic set of rules of origin early in the 1970s and has been maintained over the years. Thus detailed rules of origin were and are a common feature of each free-trade agreement or unilateral trade concession granted by the EC. Overall, the characteristic common to all EC preferential rules of origin was the adoption of the CTH criterion that defines the concept of "substantial transformation" coupled with a list of product-specific rules of origin, requiring CTH with or without exceptions, specific working or processing, or maximum import content percentages.

This adoption of the CTH and product-specific rules distinguished for decades the EC practice from the one adopted by the United States and Canada in autonomous preferential arrangements such as their GSP or the CBI. In fact, under this latter unilateral preference, the U.S. rules of origin consisted of an across-the-board percentage criterion.

This apparent simplicity in dealing with preferential rules of origin in the U.S. administration took a dramatic turn when the U.S.-Canada FTAs and NAFTA rules of origin were negotiated.

The apparent consistency of the EC policy toward origin did not necessarily mean that the EC adopted a single set of rules of origin for all the preferential arrangements it entered into with third countries. On the contrary, given

the CTH and product-specific rules' common starting point, the EC's trade policy on rules of origin has traditionally been as different and complex as its agreements with third countries. In fact, rules of origin have been one of the preferred policy instruments adopted by the EC to modulate and tailor, according to its priorities, the content of the concessions contained in the agreements with third countries.

In contrast to this traditional approach, a communication by the Commission of 30 November 1994 introduced a new policy toward rules of origin[52] by progressively adopting a uniform set of rules of origin commonly referred to as the "Pan-European Rules of Origin." According to this Communication, the EC started to revise and substitute the old Protocols on rules of origin annexed to the Europe Agreements[53] with standard Protocols, which have been utilized to negotiate rules of origin protocols with South Africa and the Mediterranean countries, and have been gradually applied to all the other trading partners benefiting from tariff preferences, including the GSP and the CPA. FTAs with Mexico and Chile have also been negotiated using this standard set of Pan-European rules of origin. The Pan-European rules of origin regulated all trade relations conducted under the former European agreements with Central and Eastern European countries (CEECs) for more than a decade. The concept of Pan-European rules of origin was later extended to the Mediterranean countries with whom the EC launched the Barcelona process for the creation of a Euro-Mediterranean FTA by 2010. Most recently, in the absence of a better altenative, the Pan-European rules of origin model has been used as interim solution, with some changes, to negotiate interim EPAs with ACP states as examined in the previous section.

Following the accession to the EC of the CEECs, and as a coronation of the Euro-Mediterranean process, a system of Pan-Euro-Mediterranean cumulation of origin has been created as originally envisaged in the Barcelona Declaration. The Council of the EC on 11 October 2005 adopted the amended Protocols on rules of origin annexed to the various agreements. The diagonal cumulation is now applicable between the EC and Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, West Bank and Gaza Strip, the EEA / EFTA countries (Iceland, Norway and Switzerland (including Liechtenstein)), the Faeroe Islands, and Turkey.

[52] Communication from the Commission to the Council, concerning the unification of rules of origin in preferential trade between the EC, the Central and East European countries and the EFTA countries, SEC (94) 1897 FINAL.

[53] This process was completed in the mid-1990s.

Curiously enough, almost at the same time of coronation of the implementation of the process of adopting a Pan-European rules lasting almost a decade, the "Green Paper on the Future of Rules of Origin in Preferential Trade Arrangements"[54] opened the way for a gradual rethinking of the EC preferential rules of origin in the near future. According to this communication, the review of the EC rules of origin will not be immediately touching the substance of the rules of origin in FTAs. The original plan of the review appeared to be rather heavily focused on the management procedures related to the administration of the rules of origin. In particular, issuance and verification of certificate of origin and the role played by importers, exporters, and certifying authorities were closely examined in the Green Paper, and various alternatives were clearly spelled out for opening a debate among the Commission, EC member-states, the private sector, and the civil society. The content and options contained in the Green Paper are examined in Chapter 6 of this book.

Pursuant to the spirit of the Green Paper, a document[55] of the Commission circulated during 2007 outlined a drastic change to the Pan-European rules of origin in the framework of the negotiations with the ACP countries to conclude the EPA. The next subsection (3.2.2.) outlines briefly the main features of the possible future evolution of the EC rules. Suffice it here to remember that, according to the new approach, the originating status will be conferred to goods meeting a local value content calculated as the difference between the ex-works price and the customs value of nonoriginating materials. A basic value threshold will be established, coupled, in some cases, with additional value conditions and specific thresholds for some products. In addition, new provisions on cumulation and procedures for control on origin based on exporter declarations are proposed. In 2007 this proposal was officially adopted by the EC Commission as GSP rules for 2009, as discussed in the preceding section. However, this proposal did not make it to the negotiating table of the EPAs.

As discussed earlier, this proposal was limited to the GSP and not to EPAs. If adopted by the EC, will mark a radical shift from the traditional EC approach of adopting product-specific rules of origin and the reliance on the certifying authorities for the administration of rules of origin. The previous subsection, and Chapter 6 further elaborate on the different aspects of these proposals.

54 Communication from the Commission to the Council, The rules of origin in preferential trade arrangements Orientations for the future Brussels, 16.3.2005COM(2005) 100 final.

55 Commission information paper presented at the 133 Committee and to the Customs Committee, March 2007.

3.2.2. *The EC Policy on Preferential Rules of Origin: The Progressive Adoption of the Pan-European Rules of Origin*

Under the different protocol of rules of origin in force before the introduction of the Pan-European Rules of Origin, the proliferation of different sets of preferential rules of origin was extremely complicated and burdensome for all those involved in an international transaction, especially exporters, importers, and customs officials. Moreover, the lowering of the most-favored-nation (MFN) tariffs following the Uruguay Round Negotiations eroded the preferential margin and thus the scope for complying with excessively stringent or complicated preferential rules of origin. These facts and the administrative costs involved in maintaining the complex system of different rules of origin tailored to the commercial policy objectives of each of the preferential trade agreements led the EC Commission at the beginning of the 1990s to adopt a new approach toward this aspect of commercial policy.

In particular, following the fall of the Berlin Wall during the 1990s, the flourishing of an intricate network of regional agreements in Western and Central Europe, each one with a different set of rules of origin, caused difficulties for manufacturers and opened certain loopholes leading to circumvention and trade deflection. The Pan-European rules of origin were first introduced to address this tangle of regional and subregional agreements through harmonizing and simplifying the rules of origin for the EC/EFTA/CEEC, and the EEA.

The EC policy toward the progressive harmonization of preferential rules of origin proceeded from the consideration that the systems of cumulation detailed in the agreements that made up the EC/EFTA/CEEC zone provided for cumulation to take place only between partners in the same agreement (or set of agreements), and that there was no link between the different sets of agreements. For example:

- The original agreements between the EC and the CEEC did not provide for any cumulation with the EFTA countries.
- The Central European Free-Trade Agreement did not provide for cumulation between the Visegrad countries (Poland, Hungary, Czech Republic, and Slovak Republic) and Bulgaria or Romania.
- The Free-Trade Agreements between the EC and the EFTA countries, and the EEA Agreement, did not provide for cumulation with the CEEC.

The harmonization process required the progressive elimination of all differences among the various sets of rules of origin through their alignment with the Pan-European model and the progressive extension of diagonal rules of origin.

The conclusions of the European Council meeting in Essen (Germany) on 9 and 10 December 1994 outlined the new policy toward the Mediterranean

countries, which was finally endorsed by the Barcelona Declaration adopted by the Council at the Euro-Mediterranean Conference (27 and 28 November 1995).[56] It emerged that the EC whose political and economic attention was mainly devoted at the beginning of the 1990s to supporting the changes in Eastern European countries and the entry into force of the Europe Agreements, had developed a new strategy and model for partnership with the Mediterranean countries. This new policy entailed:

- negotiation with Mediterranean countries of FTA agreements of a reciprocal nature covering aspects beyond mere trade in goods;
- creation of a Mediterranean FTA by 2010;
- substantial financial assistance to support the necessary adjustments.

The first step toward the creation of this FTA was the conclusion of a full set of Euro-Mediterranean association agreements between the EC and its partners in the Mediterranean, establishing FTAs of a new generation. These agreements replaced the cooperation agreements concluded in the 1970s that implied unilateral trade preferences. Since 1998, Euro-Mediterranean association agreements with Tunisia, Morocco, Israel, Jordan, Lebanon, the Palestinian Authority (PLO), and Egypt have entered into force. The agreement with Algeria entered into force on 1 September 2005. The association agreement with Syria was initialed on 18 October 2004.

As a corollary of the new policy, a system of Pan-Euro-Mediterranean cumulation of origin has been progressively established in a process that took more than a decade. This process entailed the gradual replacement of the original agreement that the EC negotiated with the Mediterranean countries in the 1970s with new reciprocal FTAs including a new protocol on rules of origin based on the Pan-European model and the evolution of these protocols until the establishment of the Pan-Euro-Mediterranean cumulation.

The accession to the EC by a number of former Eastern European countries, Malta, and Cyprus and the progressive evolution of the of the Pan-Euro-Mediterranean cumulation of origin meant a replacement of the original protocols contained in the EEA Agreement and in the Euro-Mediterranean Agreements.

[56] See also Communication from the Commission to the Council and the European Parliament, "Strengthening the Mediterranean Policy of the European Union: Establishing a Euro-Mediterranean Partnership," 19 October 1994, COM (94) 427 final, and Communication from the Commission to the Council and the European Parliament "Strengthening the Mediterranean Policy of the European Union: Proposals for Implementing a Euro-Mediterranean Partnership," 8 March 1995, COM (95) 72 final. See also S. Inama and E. Vermulst, Customs and Trade Laws of the European Community, Kluwer, 1999.

The Council of the European Union, on 11 October 2005, adopted the amended Protocols on rules of origin annexed to the various agreements, launching the diagonal cumulation system now applicable between the EC-25 and Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, West Bank and Gaza Strip, the EEA/EFTA countries (Iceland, Norway, and Switzerland (including Liechtenstein), The Faeroe Islands, and Turkey (including coal and steel and agricultural products).

The entry into force of these new Protocols is currently underway and is reported in Table 3.8. It has to be noted that, as explained in the following section, the entry into force of the Pan-Euro-Mediterranean cumulation of origin is subject to a number of substantive and formal conditions.

3.2.2.1. *The Common Structure of the Pan-European Rules of Origin*[57]

To explain the common structure of the Pan-European rules of origin Protocol 4 concerning the definition of the concept of originating products and methods of administrative cooperation,[58] the last amended Protocol of the EU-Morocco Association Agreement has been taken as reference.

As in all origin sets, the origin criterion is the core of the rules of origin. It determines how and when a product can be considered as originating in a beneficiary country. Under the Pan-European rules of origin, the origin criterion is invariably defined as follows: "*a product shall be considered as originating in a country if it has been either wholly obtained or undergone sufficient working or processing in that country*."

3.2.2.1.1. *Products Wholly Obtained*

Usually, each Protocol on rules of origin contains a list of products considered to be "wholly obtained." Products fall into this category by virtue of the total absence of imported inputs in their production.

[57] See the User Handbook to rules of preferential origin used in trade between the EC and other European countries and the countries participating from the Euro-Mediterranean Partnership 2006 and explanatory notes concerning the Pan-European-Mediterranean Protocol on rules of origin OJ 2006/C 16/02 of 21 January 2006.

[58] See Decision No 2/2005 of the EU-Morocco Association Council of 18 November 2005 amending Protocol 4 to the Euro-Mediterranean Agreement concerning the definition of the concept of originating products and methods of administrative cooperation – OJ L336, 21 December 2006.

TABLE 3.8. *Entry into force of the protocols on rules of origin providing for diagonal cumulation in the Pan-Euro-Med zone*

	EU	DZ	BU	CH (EFTA)	EG	FO	IL	IS (EFTA)	JO	LB	LI (EFTA)	MA	NO (EFTA)	PS	RO	SY	TN	TR
EU				1.1.2006		1.12.2005	1.1.2006	1.11.2005			1.11.2005	1.12.2005	1.11.2005					
DZ																		
BU																		
CH (EFTA)	1.1.2006					1.1.2006	1.7.2005					1.3.2005						
EG																		
FO	1.12.2005			1.1.2006				1.11.2005					1.12.2005					
IL	1.1.2006			1.7.2005				1.7.2005			1.7.2005		1.7.2005					
IS (EFTA)	1.11.2005					1.11.2005	1.7.2005					1.3.2005						
JO																		
LB																		
LI (EFTA)	1.11.2005						1.7.2005					1.3.2005						
MA	1.12.2005			1.3.2005				1.3.2005			1.3.2005		1.3.2005					1.1.2006
NO (EFTA)	1.11.2005					1.12.2005												
PS																		
RO																		
SY																		
TN																		1.7.2005
TR												1.1.2006					1.7.2005	

(*) Switzerland and the Principality of Liechtenstein form a customs union.

Note: Algeria (DZ), Egypt (EG), European Union (EU), Faeroe Islands (FO), Iceland (IS), Israel (IL), Jordan (JO), Lebanon (LB), Liechtenstein (LI), Morocco (MA), Norway (NO), Occupied (PS), Palestinian Territory, Romania (RO), Switzerland (CH), Syria (SY), Tunisia (TN), and Turkey (TR).

"1. The following shall be normally considered as products "wholly obtained" in the Community or in the Morocco:
   (a) Mineral products extracted from their soil or their seabed;
   (b) Vegetable products harvested there;
   (c) Live animals born and raised there;
   (d) Products from live animals raised there;
   (e) Products obtained by hunting or fishing conducted there;
   (f) Products of sea fishing and other products taken from the sea outside the territorial waters of the Community or of Morocco by their vessels;
   (g) Products made aboard their factory ships exclusively from products referred to in (f);
   (h) Used articles collected there fit only for the recovery of raw materials, including used tyres fit only for retreading or for use as waste;
   (i) Waste and scrap resulting from manufacturing operations conducted there; products extracted from marine soil or subsoil outside their territorial waters provided that they have sole rights to work that soil or subsoil; goods produced there exclusively from the products specified in (a) to (i).
2. The Terms 'their vessels' and 'their factory ships' in paragraph 1 (f) and (g) shall apply only to vessels and factory ships:
   (a) Which are registered or recorded in an EC Member State or in Morocco;
   (b) which sail under the flag of an EC Member State or of Morocco;
   (c) which are owned to an extent of at least 50 percent by nationals of EC Member States or of Morocco, or by a company with its head office in one of these States, of which the manager or managers, Chairman of the Board of Directors or the Supervisory Board, and the majority of the members of such boards are nationals of EC Member States or of Morocco and of which, in addition, in the case of partnerships or limited companies, at least half the capital belongs to those States or to public bodies or nationals of the said States;
   (d) of which the master and officers are nationals of EC Member States or of Morocco; and
   (e) of which at least 75 percent of the crew are nationals of EC Member States or of Morocco."

EC rules of origin for fishery products are extremely stringent and closely linked to the EC policy on fisheries and the fishery agreement that has been concluded with partner countries.

"Territorial waters" within the context of these rules of origin is strictly limited to the 12-mile zone, as laid down in the UN International Law of the Seas (1982 Montego Bay Convention). The existence of an exclusive economic zone

(EEZ) with more extensive coverage (up to a 200-mile limit) is not relevant for this purpose.

Fish caught outside the 12-mile zone ("on the high seas") can be considered to be wholly obtained only if caught by a vessel that satisfies the definition of "its vessels." Fish caught inland or within the territorial waters are always considered to be wholly obtained. Recent changes to the definitions of wholly obtained fish have been introduced in the recent EPAs as outlined in Section 3.2.

The following are examples of wholly obtained products[59]:

1. *Wood felled in Germany is imported into France where it is manufactured into chemical pulp (heading 4701 of the HS) using only chemical products originating in the Community. The product is wholly obtained in the EC.*
2. *Wine bottle corks manufactured in Portugal using natural cork or waste cork produced in Portugal. The corks have been wholly obtained in the EC.*
3. *Linen fabric woven in Italy from flax harvested and spun in France has been wholly obtained in the EC.*
4. *Basketwork and wickerwork manufactured in Morocco from willow, reeds, rushes etc., harvested in Morocco are wholly obtained in Morocco.*
5. *Articles of nontreated natural wood manufactured in Morocco using wood from trees felled in Morocco are considered to be wholly obtained in Morocco.*
6. *Fish are caught in Norwegian territorial waters by Spanish fishing vessels and are landed in Spain. In this instance the fish are regarded as wholly obtained in Norway as they are caught in the territorial waters of Norway.*
7. *Fish are caught in the open sea (outside territorial waters) by a vessel flying the Egyptian flag and satisfying the other nationality conditions of the Protocol. They are prepared and frozen on the vessel before being landed in a French port. In this case the fish are regarded as being wholly obtained in Egypt.*
8. *Fish caught in the open sea by a vessel flying the Turkish flag are landed in an Turkish port and then transported by road to the Community (for example to Germany) under transit arrangements. The fish are regarded as being wholly obtained in Turkey.*

3.2.2.1.2. *Sufficient Working on Processing – The Product-Specific Rules of Origin under the Pan-European Rules of Origin*

As previously mentioned, the adoption of the Pan-European rules of origin relies on the adoption of common rules and a Single List containing identical

[59] These examples have been excerpted from the User Handbook to rules of the preferential origin used in trade between the EC and other European countries and the countries participating from the Euro-Mediterranean Partnership 2006. On rules of origin for fisheries see L. Campling "Fisheries Aspects of the Interim Economic Partnership Agreements," ICTSD, 2008.

product-specific rules of origin. The basic structure of the rules and the product-specific rules of origin contained in the Single List are applied[60] to all current and future trade agreements concluded by the EC. Article 2, paragraph 2(b) of the Morocco Agreement provides that "*products obtained in Morocco incorporating materials which have not been wholly obtained there, provided that such materials have undergone sufficient working or processing in Morocco within the meaning of Article 6*." Thus, the core provision that determines when sufficient working or processing has taken place is as follows (Article 6 of Moroccan Protocol):

> "1. For the purposes of Article 2 [origin determination], products which are not wholly obtained are considered to be sufficiently worked or processed when the conditions set out in the list in Annex II [new single list] are fulfilled.
>
> The conditions referred to above indicate, for all products covered by this Agreement, the working or processing which must be carried out on non-originating materials used in manufacturing and apply only in relation to such materials. Accordingly, it follows that if a product, which has acquired originating status by fulfilling the conditions set out in the list, is used in the manufacture of another product, the conditions applicable to the product in which it is incorporated do not apply to it, and no account shall be taken of the non-originating materials which may have been used in its manufacture.

Paragraph 1 clearly spells out that the list of product-specific rules contained in Annex II is comprehensive, that is, these are not horizontal rules but rather each product has its own product-specific rule.

The second subparagraph of paragraph 1 embodies the so-called absorption principle from the explanatory notes (see the following section) and incorporates it in the main text of the Protocol. The following example excerpted from the explanatory notes to the Protocol contains a valuable example of the operational impact of this rule:

> "The provisions of Article 6 of the protocol concerning products having acquired originating status that are used in the manufacture of other products apply regardless whether this status has been acquired inside the factory where these products are used or in another factory in the Community or in Morocco."

[60] Even the Mexican and Chile FTAs contain rules modeled on the Pan-European rules of origin. Only limited, transitional deviation is allowed from the model in the EC/Mexico Agreement for certain specific products.

Example: An engine of heading no. 8407, for which the rule states that the value of the nonoriginating materials that may be incorporated may not exceed 40 percent of the ex-works price, is made from 'other alloy steel roughly shaped by forging' of heading no. ex 7224. If this forging has been forged in the Community from a non-originating ingot it has already acquired originating status by virtue of the rule for heading no. ex 7224 in the list. The forging can then count as originating in the value calculation for the engine regardless of whether it was produced in the same factory or in another factory in the Community. The value of the nonoriginating ingot is thus not taken into account when adding up the value of the nonoriginating materials used. (explanatory note 3.1 of the Protocol to Moroccan Agreement)

Paragraphs 2 and 3 of Article 6 provide for additional rules related to the value tolerance rules:

> "2. Notwithstanding paragraph 1, originating materials which, according to the conditions set out in the list, should not be used in the manufacture of a product may nevertheless be used, provided that:
>
> (a) their total value does not exceed 10 percent of the ex-works price of the product;
>
> (b) any of the percentages given in the list for the maximum value of non-originating materials are not exceeded through the application of this paragraph.
>
> This paragraph shall not apply to products falling within Chapters 50 to 63 of the Harmonized System.
>
> 3. Paragraphs 1 and 2 shall apply subject to the provisions of Article 7 [insufficient working or processing]."

Article 6(2) above grants a tolerance allowing the use of a small amount of nonoriginating materials to be used in the manufacture of goods. The concession allows for nonoriginating materials to be used up to a maximum value of 10 percent of the ex-works price.

Example: A doll (classified HS 9502) will qualify if it is manufactured from any imported materials which are classified in different heading. This means a manufacturer in a beneficiary country is allowed to import raw materials such as plastics, fabrics etc. which are classified in other chapters of the HS. But the use of doll's parts (e.g., doll's eyes) is not normally possible as these are classified in the same heading (HS 9502). However, the tolerance rule allows the use of these parts if they amount to not more than 10 percent of the doll's value.

However, where there are percentages listed in Annex II for a maximum value of prohibited nonoriginating materials, the maximum in the list cannot

be exceeded by applying this 10 percent tolerance. The 10 percent tolerance rule can be used, for example, when applying the CTH rule.

Textile goods of Chapters 50 to 63, inclusive, are excluded from benefiting from the value tolerance. However, tolerances are granted to textiles products of Chapters 50 to 63, inclusive, as explained in Note 5 of the Introductory Notes to Annex II, which are set out in Annex I to every Protocol of rules of origin.

Notes 5.1 and 5.2 of the introductory notes provide as follows:

> 5.1 Where, for a given product in the list, reference is made to this Note, the conditions set out in column 3 shall not be applied to any basic textile materials used in the manufacture of this product and which, taken together, represent 10 percent or less of the total weight of all the basic textile materials used. (See also Notes 5.3 and 5.4.)
> 5.2 However, the tolerance mentioned in Note 5.1 may be applied only to mixed products which have been made from two or more basic textile materials.

Example: A yarn, of heading 5205, made from cotton fibers of heading 5203 and synthetic staple fibers of heading 5506, is a mixed yarn. Therefore, nonoriginating synthetic staple fibers which do not satisfy the origin rules (which require manufacture from chemical materials or textile pulp) may be used, provided that their total weight does not exceed 10 percent of the weight of the yarn.

3.2.2.1.3. *Product-Specific Rules of Origin Requirements Contained in Annex II of the Protocols Pursuant to Article 6 of the Protocol*

The product-specific requirements contained in the Single List are listed according to HS chapters and headings as shown in Table 3.9. The working or processing referred to in columns 3 and 4 refers to operations that must be carried out on nonoriginating materials before they can obtain the originating status that would make them eligible for the benefits of preferential origin. The listed operations are the minimum that goods must undergo in order to obtain origin. Processing may start at an earlier stage but never at a later one.

Example: Shirts for men or boys are classified in heading 6205 regardless of what fabric they consist of. As Annex II does not have a specific rule for such garments the rule applicable is "manufacture from yarn." This means that in order for the shirts to obtain preferential origin the nonoriginating materials used in their manufacture cannot have been manufactured beyond the stage of yarn. However, you may manufacture the yarn from nonoriginating fibers and still obtain origin but you cannot benefit from preference if you manufacture the shirts from non-originating fabric.

Column 1 of the list (as shown in Table 3.9) indicates the tariff heading or the chapter. This column covers every tariff heading in the HS, even though they may not be specifically mentioned. If a product does not have a specific rule attached to it then the applicable designation may be found at chapter or heading level.

Example: Microwave ovens are classified in tariff heading 8516. Column 1 in the single list makes no reference to a specific rule for goods of 8516. In this case, the rule is to be found at the beginning of the section at "ex-Chapter 85."

When all of the goods falling within a chapter or heading are not subject to the same rule, "ex" is placed before the chapter or heading number. In the preceding example, "ex-Chapter 85" means that the corresponding rules shown in columns 3 and 4 apply to goods classified in Chapter 85 with certain exceptions.

The exceptions are then listed beneath the heading description in column 2 with their corresponding tariff classification in column 1 and rules in columns 3 and 4. These rules may apply only to some goods falling within the heading.

Example: Letter pads are classified with registers and diaries in heading 4820. A search down Column 1 leads to a reference to "ex-4820" alongside a reference to letter pads (Column 2) and a specific rule (Column 3). The "ex" indicates that not all products of heading 4820 are covered by the rule shown in Column 3. Although diaries and registers are classified in the same heading as the letter pads, they are not specifically mentioned in Column 2 and therefore are subject to the general rule that applies to Chapter 48.

Additional excerpts from the Single List of the Pan-European rules of origin are listed in the following section with some example of product-specific rules.

In the examination of the specific requirements of the list, a mixture of criteria for determining origin has been used that may be summarized as follows (examples excerpted from Annex II to the amended Protocol on rules of origin attached to the Morocco Agreement).

Headings 0203, 0206, or 0207 and bones of 0506 refer respectively to meat of swine, edible offal of bovine animals swine, meat and edible offal of poultry, and bones unworked. The rule requires that these materials may not be used to obtain fats classified in heading 1501. In other words, this rule aims at avoiding a situation in which the simple removal of fat from imported meat of swine or bones classified in heading 0506 is origin conferring. (See Table 3.9.)

As previously mentioned, the "ex" in front of heading 1701 means that the rule in column 3 is applicable only to the product described in column 2. The rule in column 3 provides for a limitation on the use of other imported material in the manufacturing of cane or beet sugar, that is, mixing, flavoring,

TABLE 3.9. *CTH requirements*

HS heading no.	Description of product	Working or processing carried out on nonoriginating materials that confers originating status
(1)	(2)	(3) or (4)
1501	Fats from bones or waste	Manufacture from materials of any heading except those of heading nos. 0203, 0206 or 0207 or bones of heading no. 0506

and coloring imported sugar with originating sugar is allowed up to 30 percent of the value of the finished product. (See Table 3.10.)

The rule of origin for Chapter 16 requires that the meat or the fish used in the manufacturing of food preparations such is canned meat or fish is already originating, that is, the use of imported meat or fish is not allowed. (See Table 3.11.)

The rule of origin for garments, shown in Table 3.12, classified in Chapter 62 and described in column 2 is that the manufacturing operations have to start from yarn, that is, the use of imported fabric to manufacture garments of Chapter 62 is not considered an origin-conferring event. This rule is often referred as the double processing requirement because, to acquire origin, two manufacturing operations are required: (1) weaving the yarn into fabric and (2) cutting the fabric to shape and sewing it together into finished garments. In the case of women's, girls', and babies' clothing an alternative rule

TABLE 3.10. *CTH requirements and percentage rules*

HS heading no.	Description of product	Working or processing carried out on nonoriginating materials that confers originating status
(1)	(2)	(3) or (4)
ex 1701	Cane or beet sugar and chemically pure sucrose, in solid form, flavored or colored	Manufacture in that the value of any materials of Chapter 17 used does not exceed 30 percent of the ex-works price of the product

TABLE 3.11. *Specific manufacturing processes or requirements*

HS heading no.	Description of product	Working or processing carried out on nonoriginating materials that confers originating status
(1)	(2)	(3) or (4)
Chapter 16	Preparations of meat, of fish or of crustaceans, mollusks or other aquatic invertebrates	Manufacture from animals of Chapter 1 and/or in which all the materials of Chapter 3 used are wholly obtained

is provided where the use of unembroidered fabric is allowed subject to a percentage requirement. The protocols of the interim EPAs introduced for the first time the notion of single transformation allowing the use of imported fabric.

The Pan-European rules of origin introduced alternative percentage rules, as shown in Table 3.13. These rules provide alternative rules. One rule allows a higher import content but places a limitation of the value of imported material

TABLE 3.12. *Textiles rules mainly involving products classified in ex-heading and basket rule headings*

HS heading no.	Description of product	Working or processing carried out on nonoriginating materials that confers originating status	
(1)	(2)	(3) or (4)	
ex Chapter 62	Articles of apparel and clothing accessories, not knitted or crocheted except for:	Manufacture from yarn	
ex 6202, ex 6204, ex 6206, ex 6209 and ex 6211	Women's, girls' and babies' clothing and clothing accessories for babies, embroidered	Manufacture from yarn	Manufacture from unembroidered fabric provided that the value of the unembroidered fabric used does not exceed 40 percent of the ex-works price of the product

TABLE 3.13. *Alternative rules of origin in Chapters 28–29, 31–39, 84–91, and 94 of the HS in addition to the usual rules*

HS heading no.	Description of product	Working or processing carried out on nonoriginating materials that confers originating status	
(1)	(2)	(3) or (4)	
8528	Reception apparatus for television, whether or not incorporating radio broadcast receivers or sound or video recording or reproducing apparatus, video monitors and video projectors	Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product • in which the value of all the nonoriginating materials used does not exceed the value of the originating materials used	Manufacture in which the value of all the materials used does not exceed 25 percent of the ex-works price of the product

with respect to originating materials. A second rule allows a lower content of imported materials but does not place limitations on the value of nonoriginating materials with respect to originating materials.

3.2.2.1.4. *Additional Features of the Pan-European Rules of Origin*

Relaxation of the principle of territoriality

Rules of origin are based on a principle of territoriality, which requires that the conditions for the acquisition of originating status be fulfilled without interruption in one or more of the territories of the contracting parties. As with the introduction of a general tolerance, a provision for limited derogation from the territorial principle of up to 10 percent was introduced into the EC-EFTA/EEA agreements to facilitate trade. This feature was not included, however, in any other EC preferential arrangement, except the EC-Israel Euro-Mediterranean Agreement. Neither it was included in the Protocols to the CEECs. This principle has been introduced in some of the new protocols, the Euro-Mediterranean cumulation as shown in paragraph 3 of Article 12 of the Euro-Mediterranean Agreement with Morocco:

> The acquisition of originating status in accordance with the conditions set out in Title II shall not be affected by working or processing done outside the Community or Morocco on materials exported from the Community or from Morocco and subsequently re-imported there, provided:
>
> (a) the said materials are wholly obtained in the Community or in Morocco or have undergone working or processing beyond the operations referred to in Article 7 prior to being exported;
>
> and
>
> (b) it can be demonstrated to the satisfaction of the customs authorities that:
>
> (i) the re-imported goods have been obtained by working or processing the exported materials;
>
> and
>
> (ii) the total added value acquired outside the Community or Morocco by applying the provisions of this Article does not exceed 10 of the ex-works price of the end product for which originating status is claimed.

No-drawback rule

The no-drawback rule refers to a provision included in the EEA Agreements, the bilateral EC-EFTA Agreement, and the Stockholm Convention establishing the EFTA, but not in the old generation of Mediterranean Agreements.[61] This procedure is a common customs procedure whereby imported inputs for further manufacturing and reexport are not charged any customs duty in the country of manufacturing. The no-drawback rule prohibits such customs procedure.

In practice, the possible consequences of the absence of the no-drawback rule in the FTAs agreements are best described by an old example provided by the EC Commission in the context of the former Europe agreements:

> *Alternators destined for the EC market are manufactured in Poland from components originating in Taiwan. Without a no-drawback rule, no customs duty is paid on the components in Poland. Neither is any customs duty paid in the EC, for the alternators are considered to originate in Poland within the meaning of the Europe Agreement. If the alternators had been manufactured in the EC and put onto the EC market, the Taiwanese components would have been subject to 5.6 percent customs duty. Similarly, Polish manufacturers would have to pay customs*

[61] The no-drawback clause has been included in the new Protocol on Rules of Origin attached to the new Euro-Mediterranean Association Agreements with Israel, Tunisia, and Morocco.

duties on components imported from Asia and used in the manufacture of a product destined for the Polish market, whereas an EC manufacturer would avoid paying duties for the same components when the manufactured product was exported to Poland.[62]

The absence of a no-drawback rule may thus lead to undesired effects such as tariff circumvention and is also an incentive to import third-country materials rather than utilize the inputs originating in the FTA – that is exactly the situation that the EC wishes to avoid.

This rule was not originally included in the agreements with Tunisia, Morocco, and Algeria. It has now being introduced in the new Protocol of Tunisia and Morocco.

This rule is now also included in the agreements with Israel, PLO, Egypt, Lebanon, Jordan, and Algeria. These last four agreements also provide for the suspension of this rule for a certain period of time after the entry into force of the agreement itself, that is, in the agreements with Egypt, Lebanon, and Algeria this period is six years; in the agreement with Jordan it is four years. This means that this rule will not be applicable respectively until 31 December 2010 for Egypt, 28 February 2009 for Lebanon, until 30 April 2006 for Jordan, and until 31 August 2011 for Algeria. At the end of this period, the agreements with Lebanon, Egypt, and Algeria provide for the application of partial drawback, which implies the payment of a partial duty rate (10 percent for textile products and 5 percent for all the other products, excluding agricultural products) on nonoriginating materials imported from a third country. Even though the agreement with PLO provides for the application of this rule from 1 January 2000, it is suspended. The Morocco and Tunisia new Protocols on origin allow for partial drawback for a limited period. The reason for this derogation is because the customs duties applicable to nonoriginating materials in some countries are considerably higher than those applicable in the EC and, by allowing a refund of the imbalance to a certain level, which could be seen as favoring EC producers, is reduced.

Drawback or remission of duty can be given only in the case that evidence of origin has been wrongly issued or made out if the following three conditions have been met:

(a) the wrongly issued or made out evidence of origin is returned to the authorities in the country of export, or, as an alternative, a written statement is made by the authorities in the importing country that no preference has been or will be granted;

[62] Commission Communication SEC (94) 1897 final; see footnote 132.

(b) the products used in the manufacture would have been entitled to drawback or remission of duties under the provisions in force if evidence of origin had not been used to claim preference;
(c) the period allowed for repayment has not been exceeded and the conditions laid down in the national law of the country concerned governing repayment are met.

Examples:

1. ***Example of the possibility of drawback in bilateral trade:***

Aluminum originating from the United Arab Emirates is imported into Egypt where aluminum screws (HS 7616) are manufactured. The final product originating in Egypt is exported to the Community.

Because Egyptian originating status is obtained on the basis of sufficient working and processing and not on the basis of cumulation with materials originating in one of the countries referred to in Articles 3 and 4, Egyptian customs authorities can grant drawback for nonoriginating materials used in the manufacture of the originating products when it is exported to the Community.

However, the screws cannot be used in the Community for the purpose of Pan-Euro-Mediterranean cumulation. In this example the screws originating in Egypt can be exported to the Community only with a movement certificate EUR.1 or an invoice declaration.

2. ***Example of the prohibition of drawback in diagonal trade:***

Oranges from Costa Rica (HS 0805) and sugar originating in the EC (HS 1701) are imported into Jordan where orange juice (2009) is produced. The value of the EC originating sugar exceeds 30 percent of the ex-works price. The Jordanian originating product is exported to Egypt. Because the origin of the final product is obtained in Jordan on the basis of cumulation with one of the countries referred to in Articles 3 and 4, in this case the EC, the nonoriginating materials cannot be subject in Jordan to drawback of, or exemption from, customs duties of whatever kind. Thus if a preferential proof of origin is made out in Jordan, customs duties need to be paid on the oranges originating in Costa Rica. In this example the product originating in Jordan can be exported to Egypt only with a movement certificate EUR-MED or an invoice declaration EUR-MED. Moreover, the juice can be reexported in the context of diagonal cumulation from Egypt to other countries referred to in Articles 3 and 4. [The use of movement certificates EUR.1 and EUR-MED is explained in Chapter 6.]

Prohibition of drawback is always applicable in trade, whether bilateral or diagonal, between the EC, Turkey, Switzerland, Norway, Iceland, and the Faeroe Islands and in the agreement between the EC and Israel.

Drawback is possible in purely bilateral trade between the EC and Morocco, Algeria, Tunisia, Egypt, West Bank and Gaza Strip, Jordan, Lebanon, and Syria.

Morocco, Algeria, Tunisia, Egypt, the West Bank and Gaza Strip, Jordan, Lebanon, and Syria can apply partial drawback. The application of partial drawback does not exclude goods from diagonal cumulation.

3.2.2.1.5. *Insufficient Working or Processing*

Some manufacturing processes are considered irrelevant or insufficient in order for the final product to obtain originating status. The common rules of origin usually provide a list of what is considered insufficient working or processing (see Article 7 of Protocol 4 to the Morocco Agreement):

"1. Without prejudice to paragraph 2, the following operations shall be considered as insufficient working or processing to confer the status of originating products, whether or not the requirements of Article 6 are satisfied:
   (a) preserving operations to ensure that the products remain in good condition during transport and storage;
   (b) breaking-up and assembly of packages;
   (c) washing, cleaning; removal of dust, oxide, oil, paint or other coverings;
   (d) ironing or pressing of textiles;
   (e) simple painting and polishing operations;
   (f) husking, partial or total leaching, polishing, and glazing of cereals and rice;
   (g) operations to colour sugar or form sugar lumps;
   (h) peeling, stoning and shelling of fruits, nuts and vegetables:
   (i) sharpening, simple grinding or simple cutting;
   (j) sifting, screening, sorting, classifying, grading, matching (including the making-up of sets of articles);
   (k) simple placing in bottles, cans, flasks, bags, cases, boxes, fixing on cards or boards and all other simple packaging operations;
   (l) affixing or printing marks, labels, logos and other like distinguishing signs on products or their packaging;
   (m) simple mixing of products, whether or not of different kinds;
   (n) simple assembly of parts of articles to constitute a complete article or disassembly of products into parts;
   (o) a combination of two or more operations specified in (a) to (n);
   (p) slaughter of animals.
2. All operations carried out either in the Community or in Morocco on a given product shall be considered together when determining whether the working or processing undergone by that product is to be regarded as insufficient within the meaning of paragraph 1."

Insufficient working or processing is sometimes referred to (although not in the legislation) as minimal processing or minimal operations.

Certain processes are considered as having such a minor effect on the finished product that they can never be regarded as conferring originating status, whether carried out individually or in a combination of processes. Simply put, those operations prevent the acquisition of origin. In the context of cumulation, such operations do not confer the origin of the country where they are carried out on goods.

Examples:

(1) *Raw coffee is imported in bulk into the Community from Colombia. The origin rule for coffee is "manufacture from materials of any heading." In the EC, it is dusted, sorted, and split up into different packaging. As neither dusting nor splitting up and repackaging are sufficient operations to confer origin, the coffee retains its Colombian origin.*

(2) *Raw coffee is imported in bulk into the Community from Colombia. In the EC it is dusted, roasted, ground, sorted, and split up into different packaging. As the operations carried out in the Community are sufficient to confer origin ("manufacture from materials of any heading"), the coffee obtains Community origin.*

The first example details a combination of three minimal operations being carried out on the raw coffee. Such operations, whether carried out singly or in a combination, do not confer origin. Therefore the coffee retains its Colombian origin.

In the second example the coffee has not only been dusted and split up into different packaging, but also has also been significantly processed. Therefore, although some minimal operations have been carried out, the more substantial processing must also be considered. It is that processing that, because it fulfills the rule listed in Annex II, results in the end product obtaining EC origin.

Article 7(1) to the Euro-Mediterranean Protocols sets out those processes carried out on nonoriginating materials that singly or in combination do not confer origin. The list is exhaustive but should be interpreted in the broadest sense. For example, sifting or screening can be carried out on both foodstuffs as well as on industrial products.

Example 1: Perfume of Community origin is exported in vats from Austria to Morocco where it is decanted into EC originating bottles and packaged into EC originating packaging. As both operations carried out in Morocco are deemed to be insufficient for conferring Moroccan origin or Czech origin, the final packaged product will retain its Community origin.

However, in this case another aspect must be considered. If the bottles and/or the packaging are wholly obtained in Morocco or have obtained Moroccan origin their value would have to be taken into account when determining the origin of the final product.

Example 2: The components of a sewing set having German origin are exported to Morocco where they are assembled into sets and put into plastic sleeves and packaged.

Neither of the operations carried out in Morocco are sufficient to confer Moroccan origin, therefore the packaged sets retain their Community origin. However, the origin of the plastic sleeve and the packaging may have a bearing on the final origin of the finished product.

3.2.2.1.6. *Explanatory Notes on the List of Product-Specific Pan-European Rules of Origin*

Given the complexity encountered in interpreting the rules of origin, the inclusion of explanatory notes in the Single Lists containing product-specific rules could be regarded as particularly welcome.

Such notes are particularly relevant and important in determining the origin of the intermediate material used in the manufacturing of a final product. In all the lists, the "absorption principle" was expressed in identical terms. The concepts expressed in the absorption principle lead to the same result: If an intermediate product acquires originating status before being incorporated in the final product, the nonoriginating material in the intermediate product should obviously not be counted as an imported input.

Only recently following the progressive adoption of the Pan-European rules of origin, has this principle been openly reflected in the main text of the Protocols (see, for instance, Article 6 of the Protocol of the Moroccan Agreement).

Other explanatory notes refer to textile articles and their accessories, which under the rules contained in the Moroccan Agreement are regulated by Notes 6.1, 6.2, and 6.3:

> "6.1 In the case of those textile products which are marked in the list by a footnote referring to this note, textile materials with the exception of linings and interlinings which do not satisfy the rule set out in the list in column 3 for the made up products concerned may be used provided that they are classified in a heading other than that of the product and that their value does not exceed 8 percent of the ex-works price of the product.

6.2 Without prejudice to Note 6.3, materials that are not classified within Chapters 50 to 63 may be used freely, whether or not they contain textiles. Example: If a rule in the list provides that for a particular textile item, such as trousers, yarn must be used, this does not prevent the use of metal items, such as buttons, because buttons are not classified within Chapters 50 to 63. For the same reason, it does not prevent the use of slide-fasteners even though slide-fasteners normally contain textiles.

6.3 Where a percentage rule applies, the value of materials that are not classified within Chapters 50 to 63 must be taken into account when calculating the value of the non-originating materials incorporated."

3.2.2.1.7. *Progressive Adoption of the Diagonal Cumulation under the Pan-European Rules of Origin and the Enlargement to the Pan-Euro-Mediterranean Cumulation of Origin*

Under the strategy for the implementation of the Pan-European rules of origin, the progressive simplification and harmonization arrangements were carried out by replacing the original Protocol of the Europe Agreements with a new Protocol extending diagonal cumulation to Baltic countries (Latvia, Lithuania, and Estonia), Romania, Bulgaria, Iceland, Norway, and Switzerland. The Protocol aligned to the EEA Protocol contained the no-drawback rule, a revised Single List, and simplified provisions for origin administration and documentary evidence. The progressive implementation of the Pan-European rules of origin entailed the amendment of the original Protocols, including those attached to the EEA Agreement,[63] the former Europe Agreements with the Czech Republic, the Slovak Republic,[64] Lithuania,[65] Poland,[66]

[63] See EEA Joint Committee Decision 71/96 amending Protocol 4 to the EEA Agreement on Rules of Origin, O.J. L 21 (1997).

[64] Decision 2/97 (97/483/ECSC, EC, Euratom) of the Association Council, association between the European Communities and their member-states, of the one part, and the Slovak Republic, of the other part of 9 January 1997 amending Protocol 4 to the Europe Agreement establishing an association between the European Communities and their member-states, of the one part, and the Slovak Republic, of the other part, O.J.L 212 (1997).

[65] Decision 1/97 (97/30/ECSC, EC, Euratom) of the Joint Committee, between the European Communities, of the one part, and the Republic of Lithuania, of the other part of 25 February 1997 amending Protocol 3 to the Agreement on free trade and trade-related matters between the European Community, the European Atomic Energy Community and the European Coal and Steel Community, of the one part, and the Republic of Lithuania, of the other part, O.J. L 136 (1997).

[66] Decision 1/97 (97/593/ECSC, EC, Euratom) of the Association Council, association between the European Communities and their member-states, of the one part, and the Republic of

Hungary,[67] Romania,[68] and Bulgaria.[69] The Association Agreement with Slovenia[70] directly adopted the Protocol.

The accession to the EC of the Czech Republic, Estonia Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, the Slovak Republic, and most recently Romania and Bulgaria meant a geographical redistribution of the application of Pan-European rules of origin. The Pan-European cumulation system created in 1997 on the basis of the EEA agreement (1994) between the EC, the EFTA countries, the CEEC countries and the Baltic States is presently applicable between the EC, the member-states of the EFTA (Iceland, Liechtenstein, Norway, and Switzerland), and Turkey. The text of the Euro-Mediterranean Morocco Agreement in this chapter still refers to Romania and Bulgaria as separated entities from the EC and will have to be updated by the EC legislators. For ease of reference, the original version of the Euro-Mediterranean Morocco Agreement has been used in this chapter.

At the same time, the approval by the EC Council of Ministers of the implementation of a system of a Pan-Euro-Mediterranean cumulation has entailed the progressive replacement of the origin protocols contained in the EEA, Euro-Mediterranean Agreements.

Poland, of the other part of 30 June 1997 amending Protocol 4 to the Europe Agreement establishing an association between the European Communities and their member-states, of the one part, and the Republic of Poland, of the other part, O.J. L 221 (1997).

67 Decision 3/96 (96/230/ECSC, EC, Euratom) of the Association Council, association between the European Communities and their member-states, of the one part, and the Republic of Hungary, of the other part of 28 December 1996 amending Protocol 4 to the Europe Agreement establishing an association between the European Communities and their member-states, of the one part, and the Republic of Hungary, of the other part, O.J. L 92 (1997).

68 Decision 1/97 (97/127/ECSC, EC, Euratom) of the Association Council, association between the European Communities and their member-states, of the one part, and Romania, of the other part of 31 January 1997 amending Protocol 4 to the Europe Agreement establishing an association between the European Communities and their member-states, of the one part, and Romania, of the other part. O.J. L 54 (1997).

69 Decision 1/97 (97/302/ECSC, EC, Euratom) of the Association Council, association between the European Communities and their member-states, of the one part, and the Republic of Bulgaria, of the other part of 6 May 1997 amending Protocol 4 to the Europe Agreement establishing an association between the European Communities and their member-states, of the one part, and the Republic of Bulgaria, of the other part, O.J. L 134 (1997).

70 Council and Commission Decision, 96/752/Euratom, ECSC, EC, of 25 November 1996 on the conclusion of the Interim Agreement on trade and trade-related matters between the European Community, the European Coal and Steel Community and the European Atomic Energy Community, of the one part, and the Republic of Slovenia, of the other part, O.J. L 344 (1996).

3.2.2.1.8. *From Diagonal Cumulation under the Europe Agreements to the System of Euro-Mediterranean Cumulation*

The implementation of the Pan-European rules of origin started with a first amendment made to the Protocol on Rules of Origin of the EEA introducing full cumulation[71] among EEA contracting parties and adopting diagonal cumulation between EEA contracting parties, CEEC countries, and Switzerland. The main differences between the EEA Protocol and the Protocol later adopted by all CEEC countries was the relaxation of the principle of territoriality,[72] the full cumulation among EEA countries, and some administrative procedures.

The second step of the implementation was to replace the original protocols contained in the Europe agreement with the new protocol containing the Pan-European rules of origin and the diagonal cumulation.

In the case of the Mediterranean countries, the first kind of regional cumulation granted by the EC was originally limited to the Maghreb countries (Algeria, Morocco, and Tunisia) and was contained in the agreements concluded in the 1970s. The cumulative option for other Mediterranean countries such as Lebanon and Egypt was limited to the "bilateral cumulation" with the EC.

On adoption of the Pan-European rules of origin strategy, the Euro-Mediterranean Association Agreements with Morocco, Tunisia, and Israel started to be the subject of the Commission's harmonization effort with mixed results.[73] Thus, the Protocols on Rules of Origin attached to these Agreements were partially modeled according to the new EEA Protocol and are

[71] See Article 2, Title II, of the EEA Joint Committee Decision 71/96: "A *product shall be considered to be originating in the EEA within the meaning of this Agreement if it has been either wholly obtained there within the meaning of article 4 or sufficiently worked or processed in the EEA within the meaning of article 5. For this purpose, the territories of the Contracting Parties to which this Agreement applies, shall be considered as a single territory.*"

[72] See Article 11, paragraphs 3 to 7, of the EEA Joint Committee Decision 71/96. The principle of territoriality is also contained in the Euro-Mediterranean Agreement with Israel. This difference with respect to the other Euro-Mediterranean Agreements with Tunisia and Morocco and the CEEC is partly explained by the fact that a similar provision was contained in the earlier agreements of the 1970s.

[73] The Commission's harmonization process continued during the negotiations with other Mediterranean countries (Algeria, Egypt, Jordan, Lebanon, and the Syrian Arab Republic), together with the necessary amendments to the already signed Euro-Mediterranean Agreements with Israel, Morocco, and Tunisia. This latter consideration holds particularly true when it is remembered that the EC Barcelona Ministerial Conference considered the extension of diagonal cumulation between CEECs and Mediterranean countries.

substantially similar to the new Protocol adopted by CEEC countries. However, many differences remained after the first effort of harmonization:

(1) the maintenance of the CTH rule as central criterion (Article 7, paragraph 1, of the Tunisian Euro-Med);
(2) the granting of full cumulation to countries of the Maghreb Union[74] (Algeria, Morocco and Tunisia);
(3) the noninclusion of the no-drawback clause in the Tunisia and Morocco Agreements[75];
(4) the inclusion of the relaxation of the principle of territoriality and the no-drawback clause in the Israel Agreement[76];
(5) other differences concerning the Single List, simplified procedure for the issuance of form EUR.1 and the cumulation administrative procedures.

The concept of diagonal cumulation introduced by the Pan-European rules of origin was also rather complex to understand. To fully grasp the possible implications a comparison among provisions in the former EU-Slovak Agreement[77] and the former EU-Tunisia Agreement may better clarify where the difference in the wording may entail consequences in the content of the provision.

Under the Protocol to the Slovak Agreement adopting the Pan-European rules of origin, Article 4 spelled out the following conditions for diagonal cumulation:

> "1. Without prejudice to the provisions of Article 2(2), products shall be considered as originating in the Slovak Republic if such products are obtained there, incorporating **materials originating in Bulgaria, Switzerland (including Liechtenstein[78]), the Czech Republic, Estonia, Hungary, Iceland, Lithuania, Latvia, Norway, Poland, Romania, Slovenia, the Slovak Republic, Turkey**[79] or in the

74 Full cumulation was also granted to Algeria, Morocco, and Tunisia under the former Cooperation Agreements.

75 The noninclusion of the no-drawback clause will require an additional harmonization effort to bring these agreements into line with the CEEC Protocols.

76 The relaxation of the principle of territoriality and the no-drawback clause was already contained in the former EC–Israel Agreement.

77 The examples in the following section refer to the original Protocol on Rules of Origin of the EC-Slovak Republic Agreement, O.J. L 360 (1994). The new Protocol on Rules of Origin will be discussed in detail in the following section.

78 The principality of Liechtenstein has a customs union with Switzerland, and is a Contracting Party to the Agreement on the European Economic Area.

79 Cumulation as provided for in this Article does not apply to materials originating in Turkey that are mentioned in the list at Annex V.

Community in accordance with the provisions of the Protocol on rules of origin annexed to the Agreements between the Slovak Republic and each of these countries, provided that the working or processing carried out in the Slovak Republic goes beyond the operations referred to in Article 7. It shall not be necessary that such materials have undergone sufficient working or processing.

2. Where the working or processing carried out in the Slovak Republic does not go beyond the operations referred to in Article 7, the product obtained shall be considered as originating in the Slovak Republic only where the value-added there is greater than the value of the materials used originating in any one of the other countries referred to in paragraph 1. If this is not so, the product obtained shall be considered as originating in the country which accounts for the highest value of originating materials used in the manufacture in the Slovak Republic.
3. Products, originating in one of the countries referred to in paragraph 1, which do not undergo any working or processing in the Slovak Republic, retain their origin if exported into one of these countries.
4. The cumulation provided for in this Article may only be applied where the materials used have acquired the status of originating products by an application of rules of origin identical to the rules of origin in this Protocol.
5. The Slovak Republic shall provide the Community, through the European Commission, with details of the Agreements and their corresponding rules of origin, which are applied with the other countries referred to in paragraph 1."

The boldfaced words in the preceding excerpts emphasize the fact that the cumulation was allowed only with "*materials originating in Bulgaria, Switzerland (including Liechtenstein), the Czech Republic, Estonia, Hungary, Iceland, Lithuania, Latvia, Norway, Poland, Romania, Slovenia, the Slovak Republic, Turkey*." This means that **the materials must have already acquired their originating status in those countries according to the rules contained in the single list before being used as inputs for further manufacturing in the Slovak Republic**. According to this reasoning, if these materials have undergone working or processing in their own country which is insufficient for the acquisition of originating status, they cannot be considered as originating materials and will be considered as imported inputs which have to comply with the specific rule of origin.

However, the same reasoning could not be applied when contrasting the wording of Article 4 of Protocol of the Slovak Republic with the one used in Article 5 of the former Protocol of Euro-Mediterranean Tunisian Agreement. Article 5 in the former Protocol on Rules of Origin provided for full cumulation and further clarified the difference between that form of cumulation and diagonal cumulation.

"Article 5:

1. For the purpose of implementing Article 2(1)(b), working or processing carried out in Tunisia, or when the conditions required by Article 4, paragraphs 3 and 4 are fulfilled in Algeria or in Morocco shall be considered as carried out in the Community, when the products obtained undergo subsequent working or processing in the Community.
2. For the purpose of implementing Article 2(2)(b), working or processing carried out in the Community or when the conditions required by Article 4, paragraphs 3 and 4 are fulfilled in Algeria or in Morocco shall be considered as carried out in Tunisia, when the products obtained undergo subsequent working or processing in Tunisia."

Thus, according to Article 5, paragraph 1, any amount of working or processing carried out in Tunisia, the EC, Algeria, and Morocco could be cumulated to comply with the origin requirement.

The granting of full cumulation to the Maghreb countries also entailed a difference in wording and substance with regard to the allocation of origin when more than one country has been involved in the manufacturing, with respect to the wording used in the Slovak Protocol. These differences are summarized in Table 3.14.

Thus, during the process of harmonizing rules of origin in EC trade agreements with third countries, the aforementioned full cumulation system among the Maghreb countries was retained in the Euro-Mediterranean Association Agreements in spite of the widespread adoption of the diagonal rules of origin under the Europe agreements. This represented a transitional exception to the harmonization efforts under the Pan-European rules of origin that remained unaltered in the latest Protocols.

In fact, the new Protocol to the Moroccan Agreement provides for the bilateral cumulation of origin between the EC and Morocco, and for full cumulation of origin between the EC, Tunisia, Algeria, and Morocco.

The new Protocol extends cumulation to using materials originating in the EC, Bulgaria, Romania, Iceland, Norway, Switzerland (including Liechtenstein), the Faeroe Islands, Turkey, or in any other country that is a participant in the Euro-Mediterranean partnership, based on the Barcelona Declaration (Algeria, Egypt, Israel, Jordan, Lebanon, Syria, Tunisia, West Bank, and Gaza strip) according to the principles of the Euro-Mediterranean cumulation.

However, this extended system of cumulation will be applicable only between the countries that have fulfilled the necessary conditions, which may

TABLE 3.14. *Granting of full cumulation*

Allocation of origin in the Tunisian Agreement	Allocation of origin in the Slovak Agreement
4. "where the originating products are obtained in two or more of the States referred to in these provisions or in the Community, they shall be considered as originating products of the State or the Community according to where the last working or processing went beyond that referred to in Article 8 (insufficient working or processing)."	Article 3, paragraph 2: "Products which have acquired originating status by virtue of paragraph 1 shall only be considered as products originating in the Community or in the Slovak Republic when the value added there exceeds the value of the materials used originating in Poland, Hungary or the Slovak Republic. If this is not so, the products concerned shall be considered, for the purpose of implementing this Agreement or the Agreements between the Community and Poland, Hungary and the Slovak Republic, as originating in Poland, Hungary or the Slovak Republic, according to which of these countries accounts for the highest value of originating materials used."

be summarized as follows: (1) the countries must have concluded a FTA agreement and (2) the provisions on rules of origin contained in the protocol also apply in the context of the FTA agreements entered between the countries. These specific conditions are further explained later. The list of countries has been reproduced in Table 3.8.

Paragraph 2 of Article 2 of the Protocol on origin to the Euro-Mediterranean Agreement with Morocco provides for these general origin requirements:

General requirements

1. For the purpose of implementing the Agreement, the following products shall be considered as originating in the Community:
   (a) products wholly obtained in the Community within the meaning of Article 5;
   (b) products obtained in the Community incorporating materials which have not been wholly obtained there, provided that such materials have undergone sufficient working or processing in the Community within the meaning of Article 6;

(c) goods originating in the European Economic Area (EEA) within the meaning of Protocol 4 to the Agreement on the European Economic Area.

2. For the purpose of implementing the Agreement, the following products shall be considered as originating in Morocco:
   (a) products wholly obtained in Morocco within the meaning of Article 5;
   (b) products obtained in Morocco incorporating materials which have not been wholly obtained there, provided that such materials have undergone sufficient working or processing in Morocco within the meaning of Article 6.
3. The provisions of paragraph 1(c) shall apply only provided a free trade agreement is applicable between, on the one hand, Morocco and, on the other hand, the EEA EFTA States (Iceland, Liechtenstein, and Norway).

In practice, Article 2 reflects the usual drafting of the general requirement of other protocol with the exception of the introduction of products originating in the EEA subject to the provision of paragraph 3 requiring the existence of a FTA among EEA and Morocco to make this kind of cumulation operational.

Paragraphs 1 to 4 of Article 3 of the Protocol reproduced below provides for the application of the diagonal cumulation. In particular, paragraph 1 provides for diagonal cumulation among Morocco and Bulgaria, Switzerland, Iceland, Norway, Romania, Turkey, and the EC. Paragraph 2 provides for diagonal cumulation among Morocco, the Faeroe Islands, and the other Mediterranean countries.

Diagonal cumulation in Morocco

1. Without prejudice to the provisions of Article 2(2), products shall be considered as originating in Morocco if they are obtained there, incorporating materials originating in Bulgaria, Switzerland (including Liechtenstein) (1), Iceland, Norway, Romania, Turkey or in the Community, provided that the working or processing carried out in Morocco goes beyond the operations referred to in Article 7. It shall not be necessary for such materials to have undergone sufficient working or processing.
2. Without prejudice to the provisions of Article 2(2), products shall be considered as originating in Morocco if they are obtained there, incorporating materials originating in the Faroe Islands or in any country which is a participant in the Euro-Mediterranean partnership, based on the Barcelona Declaration adopted

> at the Euro-Mediterranean Conference held on 27 and 28 November 1995, other than Turkey, provided that the working or processing carried out in Morocco goes beyond the operations referred to in Article 7. It shall not be necessary that such materials have undergone sufficient working or processing.

Paragraphs 3 and 4 of Article 3 below provide for an allocation of origin criteria when more than one country is involved in the manufacturing of a finished product. In this context it may be reminded that Article 7 quoted in paragraph 3 in the following section refers to minimal working or processing operations:

> 3. Where the working or processing carried out in Morocco does not go beyond the operations referred to in Article 7, the product obtained shall be considered as originating in Morocco only where the value added there is greater than the value of the materials used originating in any one of the other countries referred to in paragraphs 1 and 2. If this is not so, the product obtained shall be considered as originating in the country which accounts for the highest value of originating materials used in the manufacture in Morocco.
> 4. Products originating in one of the countries referred to in paragraphs 1 and 2 which do not undergo any working or processing in Morocco shall retain their origin if exported in to one of these countries.

To fully appreciate the application of the Euro-Mediterranean cumulation, two concepts must be further discussed.

Allocation of origin

As in the case of the regional cumulation under the EC GSP rules of origin, in general, the origin of the final product will be determined through the "last working or processing" carried out, provided that the operations carried out go beyond minimal processing or working operations.

If, in the country of final manufacture, the originating materials from one or more countries are not subject to working or processing beyond minimal operations, the origin of the final product shall be allocated to the country contributing the highest value. For this purpose, the value added in the country of final manufacture – including the value of nonoriginating materials that have been sufficiently processed – is compared with the value of the materials originating in each of the other countries.

If no working or processing is carried out in the country of export, the materials or products simply retain their origin if they are exported to one of the countries concerned.

Variable geometry

Another concept introduced under the Euro-Mediterranean cumulation is the variable geometry. Under this rule, cumulation can be applied only if the countries of final manufacture and of final destination have concluded free-trade agreements, containing identical rules of origin, with all the countries participating in the acquisition of originating status; that is, with all the countries from which all the materials used originate. Materials originating in the country that has not concluded an agreement with the countries of final manufacture and of final destination shall be treated as nonoriginating.

The following examples explain how to determine origin according to the four paragraphs of Articles 3 and 4 reproduced in the previous section:

1. Example for allocation of origin through the last working or processing carried out.

Fabrics (HS 5112; obtained from lambs' wool not combed or carded) originating in the Community are imported into Morocco; lining, made of man-made staple fibre (HS 5513) is originating in Norway. In Morocco, suits (HS 6203) are made up.

The last working or processing is carried out in Morocco; the working or processing (in this case, making-up suits) goes beyond operations referred to in Article 7.

Therefore, the suits obtain Moroccan origin and can be exported to other countries with which cumulation is applicable. If in this example, there is no free trade agreement with Pan-Euro-Med rules of origin between Morocco and Norway, the variable geometry implies that the Norwegian lining would need to be treated as nonoriginating and thus the suits will not obtain originating status.

2. Example for allocation of origin if the last working or processing does not go beyond minimal operations; recourse has to be taken to the highest value of the materials used in the manufacture.

The different parts of an ensemble, originating in two countries, are packed in the Community. The trousers and a skirt, originating in Switzerland, have a value of 180 Euros; the jacket, originating in Jordan, has a value of 100 Euros. The minimal operation ("packing") carried out in the Community costs 2 Euros. The operator uses plastic bags from Ukraine, of a value of 0,5 Euros. The ex-works price of the final product is 330 Euros.

As the operation in the Community is a minimal one the value added there has to be compared with the customs values of the other materials used in order to allocate origin:

Value added in the Community (which includes 2 Euros for the operation and 0,5 Euros for the bag) = 330 Euros (ex-works price) – (minus) 280 Euros (180+100) = 50 Euros = Community "added value"

The Swiss value (180) is higher than the value added in the Community (50) and the values of all other originating materials used (100). Therefore, the final product will have Swiss origin and can be exported to other countries with which cumulation is applicable. If in this example there was no free trade agreement with Pan-Euro-Med rules of origin between the Community and Switzerland the ensemble would have to be treated as non-originating since the Swiss input has neither been sufficiently processed nor allowed to benefit from cumulation of origin.

3. Example for products that are exported without undergoing further working or processing.

A carpet, originating in the Community, is exported to Morocco and is, without undergoing further operations, exported to Syria after 2 years. The carpet does not change origin and still has Community origin upon exportation to Syria.

In this example, a preferential proof of origin can only be issued for exportation from Morocco to Syria if the free trade agreement with Pan-Euro-Med rules of origin between the Community and Syria is in place

Paragraph 4a of Article 3 provides and maintains the full cumulation provision that originally existed in the former origin protocols of Tunisia, Morocco, and Algeria examined in the previous section:

> *4a. For the purpose of implementing Article 2(2)(b), working or processing carried out in the Community, in Algeria or Tunisia shall be considered as having been carried out in Morocco when the products obtained undergo subsequent working or processing in Morocco. Where, pursuant to this provision, the originating products are obtained in two or more of the countries concerned, they shall be considered as originating in Morocco only if the working or processing goes beyond the operations referred to in Article 7.*

Non-originating cotton yarn (HS 5205) is imported into the Community where it is woven into fabrics (HS 5208). The fabrics are then exported from the Community to Tunisia where they are cut and where men's shirts (HS 6205) are sewn.

According to the rules of cumulation of working and processing, the weaving carried out in the Community is considered as having been carried out in Tunisia. In this way the rule for HS 6205 requiring manufacture from yarn is satisfied and the men's shirts obtain originating status. However, since the originating status is obtained in a way which is not compatible with the pan-Euro-Mediterranean requirements, according to which the weaving and sewing should take place in one single country, the men's shirt cannot be exported under preferences from Tunisia to countries other than Maghreb and the EC.

Paragraph 5 of Article 3 sets out the conditions that have to be fulfilled to make the preceding system of Pan-Euro-Mediterranean cumulation operational. It has to be noted that under the former protocol the full cumulation provisions contained in paragraph 4 were not subject to such conditions:

5. The cumulation provided for in this Article may be applied only provided that:

(a) a preferential trade agreement in accordance with Article XXIV of the General Agreement on Tariffs and Trade (GATT) is applicable between the countries involved in the acquisition of the originating status and the country of destination;

(b) materials and products have acquired originating status by the application of rules of origin identical to those given in this Protocol; and

(c) notices indicating the fulfilment of the necessary requirements to apply cumulation have been published in the Official Journal of the European Union (C series) and in Morocco according to its own procedures.

The cumulation provided for in this Article shall apply from the date indicated in the notice published in the Official Journal of the European Union (C series). Morocco shall provide the Community through the Commission of the European Communities with details of the Agreements, including their dates of entry into force, and their corresponding rules of origin, which are applied with the other countries referred to in paragraphs 1 and 2.

The most important condition for Mediterranean countries is the fact that the system of cumulation adopted makes conditional the application of this principle on the existence of a FTA according to Article XXIV of GATT 1994 among them.[80]

Such a condition was always present since the inception of extension of Mediterranean cumulation as witnessed for instance by "Joint Declaration on Article 29" attached to the Jordan Agreement:

Joint Declaration on Article 29

In order to encourage the progressive establishment of a comprehensive Euro-Mediterranean free trade area, in line with the conclusions of the Cannes European Council and those of the Barcelona Conference, the Parties:

- agree to provide the Protocol 3 on the definition of "originating products," for the implementation of diagonal cumulation before the conclusion and entry into force of free trade agreements between Mediterranean countries;
- reaffirm their commitment to the harmonisation of rules of origin across the Euro-Mediterranean free trade area. The Association Council shall take, where necessary, measures to revise the Protocol with a view to respecting this objective."[81]

[80] See A. Tovias "The European Union and Mediterranean countries" in *Regionalism and Multilateralism after the Uruguay Round*, European University Press, Brussels, 1997.

[81] See COM (97) document 554 final of 29/10/1997.

Paragraph 5 in its new form requires not only the establishment of a FTA among Mediterranean countries but also may be understood as requiring that the rules of origin under these FTA countries have to be identical to those entered with the EU.

Given the nature of the Mediterranean region at present, and although there are new signs of a revival of interregional trade and FTAs, some time will be needed before a full-fledged web of FTAs responding to the criteria of Article XXIV is created within this region. In fact, a series of bilateral agreements is already in place among Mediterranean countries, but they do not liberalize "substantially all trade" and their implementation is also lagging behind.

Attention should also be devoted to the second requirement of the application of the diagonal cumulation, that is, the utilization of identical rules of origin when they are applied among Mediterranean countries. Although the terms of this condition were not clearly spelled out under the former protocols, the actual drafting seems to indicate that Mediterranean countries should utilize the same EC rules of origin when establishing a FTA among them. This may create difficulties in meeting rules of origin product-specific requirement not only when exporting to the EC but also when trading among themselves.

Unless the Mediterranean countries undertake a substantial trade liberalization process among themselves, the EC is at the center of a web of bilateral FTAs. In such a situation, the EC might become a potential "hub" for investors who may locate their factories in the EC, benefiting from preferential access to all Mediterranean member-countries and their markets. Unless Mediterranean member-countries negotiate FTAs among themselves, they could be relegated to a "spoke" role because reverse operation would not be possible and only the comparatively limited home market of the "spoke," in addition to the EC market, would be available to factories located in non-EC member-countries.

To avoid such a situation, Mediterranean countries were expected to undertake the negotiations for the establishment of FTAs among themselves to build up the second pillar of the Euro-Mediterranean FTA. Such liberalization of regional trade initiative was undertaken by countries belonging to the Central European Free-Trade Agreement (CEFTA) almost at the same time of the negotiations of the Europe Agreements.

3.2.2.1.9. *Recent Developments in the EC Rules of Origin*

Subsection 3.1.5.3 provided some of the latest developments concerning the initialing of the interim EPAs and the recent proposal by the EC Commission

of new GSP rules of origin for 2009. In this subsection, the background of such initiatives is discussed in greater detail. As mentioned in Section 3.2, following the publication of the "Green Paper on the Future of Rules of Origin in Preferential Trade Arrangements"[82] the European Commission and most notably the Directorate General in charge of customs and fiscal affairs (hereinafter DG TAXUD) and Directorate General in charge of trade matters (hereinafter DG Trade) embarked on a gradual rethinking of the EC preferential rules of origin. Such rethinking has been recently accelerated by the pace of negotiations of the EPAs with the ACP countries that had to be concluded by 31 December 2007 at the latest.[83]

The Green Paper contained a major departure from the traditional path of EC policy toward rules of origin. First, it expressed in clears terms that the Commission favored using a method of evaluation of sufficient processing based on a "value-added test" as the starting point. Under the method proposed, "*a product resulting from the working or processing of imported non-originating materials would be considered as originating if the value-added in the country (or in a region in the event of cumulation), amounts at least to a certain threshold (a minimum 'Local or Regional Value Content'), expressed as a percentage of the net production cost of the final product.*" The Green Paper also introduced a series of new modalities on cumulation.

Second, it introduced various options for a revision of the current EC procedures for the administration and verification of origin requirements. This part of the Green Paper is discussed in Chapter 6, administration of rules of origin.

The statement of the Commission in favor of a value-added test breaks away from a previous practice that for more than three decades used the change of tariff heading as the preferred method of defining sufficient working or processing except on machinery and in the electronic sector. Even when this practice of using the CTH as an across-the-board criterion coupled with a long list of exceptions was replaced under the Pan-European origin with a single list containing product-specific rules for all products, the majority of the rules were defined widely using the HS and more specifically a CTH with exceptions and specific working or processing requirements. This shift is even more surprising when the elements of the calculations refer to a value-added test. It has been a common EC practice since the 1970s to use the concept of the maximum

[82] Communication from the Commission to the Council, the rules of origin in preferential trade arrangements orientations for the future Brussels, 16.3.2005COM(2005) 100 final.

[83] See Article 37 of the CPA, published in the supplement to the Courier, September 2000.

amount of foreign inputs out of the ex-works price when a percentage rules was used in preferential rules of origin. This method of calculation has been consistently recognized to possess a series of advantages by beneficiaries of the GSP schemes[84] over a value-added calculation.

Perhaps the most striking factor is that the percentage of the value added was supposed to be expressed as a percentage of the net production cost. The net production cost is a concept borrowed from the NAFTA practice (further explained in the following section) that has encountered a number of serious difficulties during implementation of NAFTA. For this reason, its use has been limited by U.S. negotiators in following FTAs and has been progressively abandoned.

The Commission's Green Paper outlined a gradual approach because the new policy would be first applied in the framework of the GSP rules of origin first and later in the framework of the EPAs.

Perhaps because of the number of drastic changes from EC traditional policy toward origin and some debatable technical choices proposed in the Green Paper the implementation of the new policy and its concrete elaboration was met by criticism and comments within the EC Commission. Differences of views on the substance of the reform and its sequencing within the services of the Commission have delayed the reform. However, the pressing deadline of the EPAs negotiations and the emphasis of the ACP countries on the renegotiation of the rules of origin in the EPAs created new incentive for the EC Commission services to reach a common approach.

Pursuant to the spirit of the Green Paper, a document[85] of the Commission outlined a possible EC draft Convention on rules of origin for consultation to the ACP countries. The Convention was designed to function as an umbrella for covering all ACP regions who wish to participate. At the time of this writing the status of this Convention is not clear. However, its main features have not been reflected in the protocol of interim EPAs, or in the protocol on rules of origin of the Cariforum EPA. At present, considering the criticisms leveled against the proposed GSP reform, including some features of the Convention, a more cautious approach has been undertaken by the Commission.

Many of the provisions and the overall architecture of the Convention reflect the intention already outlined in the Green Paper of strengthening the

[84] See Chapter 5, Drafting rules of origin.

[85] Commission information paper presented at the 133 and to the Customs Committee, March 2007.

cooperation among the competent authorities designated to administer origin requirements.

The Convention gives an important role to play to the Joint EC–ACP Origin Committee that, acting by mutual agreement, may take important decisions during the implementation phase of the Convention. According to Article 2 of the Convention, the Joint EC–ACP Origin Committee has the following prerogatives:

> *In particular it shall recommend:*
> *(a) amendments to this Convention, other than those referred to in paragraph 3;*
> *(b) any other measure required for its application.*
> *3. It shall adopt by decision:*
> *(a) amendments to the Appendices, including those made necessary by the accession of new countries to the Convention;*
> *(b) other amendments to this Convention made necessary by amendments to the Appendices;*
> *(c) decisions on cumulation under the conditions laid down in Title III of Appendix I.*
> *(d) decisions on derogations from this Convention, under the conditions laid down in Article 32 of Appendix I;*
> *(e) transitional measures required in the case of the accession of new Member States to the European Union.*

Much of the actual relevance and potential of this Committee will depend on its own rules of procedures, level of representation, and expertise of the ACP representatives.

One of the most notable changes to the previous Cotonou rules was that the Convention does not place customs authorities at the center of the administration of origin requirements but leaves the designation of the competent authorities to administer origin to the countries on the condition that the designated authorities be part of the governmental authorities. Another important aspect of architecture of the Convention was the emphasis placed on the cooperation and burden sharing of the responsibilities on origin administration. This aspect will be further examined in Chapter 6.

The basic substantive elements of the Convention reflected some of the proposals made in the Green Paper with some relevant changes:

- The concept of wholly obtained product has been maintained but the draft indicates some flexibility, mentioning the possibility of simplified vessel property conditions and possible deletion of the crew requirement.
- The idea of using a single across-the-board sufficient processing threshold has been maintained.

- The idea of a percentage criterion as a value-added calculation based on the net production cost has been replaced with a concept of local value content amounting to a sufficient processing threshold laid down in a specific Annex. The text specifies that for certain products additional requirements and some specific levels of threshold may be set and supplementary conditions for certain products may also be required. With respect to the previous definition of value added in the Green Paper, the new definition appears to be more in line with the EC traditional use of the percentage criterion. In addition it wisely abandons the early intention to use the net production cost as a denominator for the calculation of the level of the percentage.
- The Convention defines "local value content" as the difference between the ex-works price of the product and the customs value of the nonoriginating materials used in its manufacture.

The Convention also contained a number of suggestions concerning regional cumulation. Full cumulation with the EC and the ACP region is maintained. However, some conditions have been attached to it.

According to the spirit inherited from the Pan-European rules of origin, cumulation was subject to

- Identical rules of origin applied by the partners in the cumulation zone.
- A legal framework linking the partners allowing for cumulation and administrative co-operation. This already represents a form of relaxation of the "normal" condition to have FTAs between all cumulation partners.
- Compliance with cumulation conditions also based on comparison of values: Cumulation applies and origin is conferred to the products if their "*cumulation content*" exceeds a "*cumulation threshold*," expressed as a percentage of the *ex-works price* of the product. Such cumulation threshold concepts appear to be largely inspired to a regional value content borrowed from the NAFTA model.
- Cumulation content, being the result of the difference between the ex-works price of the product and the value of all imported materials used in the manufacture. One may wonder how full cumulation could be applicable under rules based on the value of imported materials. Within this calculation, it is rather intuitive that it is not possible to add up working or processing carried out in different countries because it does not figure in any of the arithmetical parameters of the formula.

According to the original Commission draft EPAs, cumulation was based on a draft single EPA legal instrument (a convention managed by an ACP–EPAs Joint Origin Committee) that

- considers each region as a single territory for the purpose of determining origin, with a single origin (as far as all member countries are subject to the same preferences: Otherwise an allocation of origin by country would be necessary);
- allows for cumulation between the EC and each of the regions (and/or its member countries), between the regions and possibly with other countries or territories, (OCTs, neighboring DCs), subject to compliance with the usual conditions for cumulation. A note in the draft Convention mentions that for South Africa, the most important country for cumulation purposes, the EC position has to be determined. This note casts a rather large shadow on the real intention of the Commission on how cumulation for South Africa will be dealt with after the experience with South Africa cumulation under Cotonou.

With respect to Cotonou rules, full cumulation is maintained but made subject to a number of requirements that, on the one hand, are a result of the partitioning of the ACP into subregions, and, on the other hand, reflect the emphasis of the EC on the need for more coordination and burden sharing among authorities administering origin requirements.

An EPA region may decide not to join this common instrument and remain separate from the other regions in which case no cumulation will be possible with the other regions.

With respect to substantive requirements, the level of leniency or restrictiveness of the rules contained in the Convention largely depended on the thresholds of the percentages that were not indicated in the Draft, as well as the supplementary conditions attached to some particular products. Moreover, it is not known how many different thresholds for how many product categories were to be set.

With respect to supplementary conditions, it is important to note the inclusion in the Convention of a definition of manufacture. Paragraph 4 of Article 5 of the Convention provides that

> *For the purpose of implementing paragraphs 1(b) and 2(b)(product considered as originating) manufacture means any kind of working or processing, as far as it fulfils the following conditions:*
> - *it needs special skills or machines, apparatus or equipment especially produced or installed for carrying it out;*

- *it shall result in a product presenting objective differences (own properties, composition, specific qualities) with the materials used.*

The nature and conduct of the working or processing operation shall be taken into consideration to verify its compliance with these conditions.

The nature and logic of these supplementary criteria are unclear and do not follow usual EC practice. To a certain extent they seem to echo the original wording of the across-the-board EC nonpreferential rule of origin.[86] The definition contained in the second bullet reminds one of the oldest definitions of "substantial transformation" that a judge made rule in a celebrated case in U.S. practice.[87]

In both cases such vague criteria in addition to the substantial criteria add confusion and are open to abuse and discretionary practices. One may not reasonably understand the need to recur to such an obsolete formulation that has been overtaken by evolution. It has become progressively clear that such general definitions do not match the evolving and growing nature of international trade.

As examined in Chapter 6, one of the most important parts of the Convention is the reform of the administration of rules of origin, placing new administrative responsibilities on ACP states.

The present Convention was a draft that has been circulated to the ACP for their comments and reactions. Be this as it may, it revealed some of the trends emerging from the consultations of the different services of the Commission, namely TAXUD, Trade, and Development Directorates on setting new approaches to EC rules of origin and has largely influenced the content of the present protocol of origin of the interim EPAs.

3.2.3. *Rules of Origin of North American Free-Trade Agreement*[88]

The U.S. approach and experience with preferential rules of origin differ widely from those of the EC mainly because of its different trade policies and relations with third countries.

[86] In the European context, the first definition at EC level appeared in 1968: "Goods whose production involved more than one country shall be deemed to be originated in the country where they underwent the last, substantial, economically justified processing or working in an undertaking equipped for that purpose and resulting in the manufacture of a anew product or representing an important stage of manufacture. Council Regulation 802/68, OJ L.148/1 (1968).

[87] "A substantive transformation occurs when an article emerges from a manufacturing process with a name, character or use which differs from those of the original materials subjected to the process." See *Anheuser-Busch Brewing Assn. v United States*, 207 US 556 (1907).

[88] The examples provided in this section are excerpted from the U.S. Customs and Border Protection website available at http://www.cbp.gov/nafta/docs/us/guidproc.htm.

Until the beginning of the 1990s, the United States had few bilateral agreements, and preferential tariff relations were centered around the GSP, the CBI, the Andean Trade Preferences, and the U.S.–Israel FTA. At that time, the U.S. preferential rules of origin were based on the U.S.–GSP rules of origin requiring an across-the-board percentage criterion of 35 percent.[89]

A first rather drastic change in this simple approach to preferential rules of origin occurred when the U.S.–Canada FTA Agreement was negotiated. At that time, the trade volume involved and the subsequent emergence of powerful lobbies during the negotiations demanded a higher degree of discipline and specificity in setting up the rules of origin. The U.S.–Canada Agreement featured product-specific rules of origin that, during the NAFTA negotiations, rapidly evolved into one of the most sophisticated and detailed origin regimes yet devised at that time.

As one commenter described[90] the Canada–U.S. Free-Trade Area (CUSFTA) contained 1,498 separate rules of origin spread among the 20 pages of the relevant annex to the FTA.[91] There is no public count of the number of separate rules of origin in the NAFTA, but the number of pages in the relevant annex (Annex 401) listing the specific rules is 148 (pp. 2–150), and it is a notorious fact that the NAFTA rules were more restrictive and specific that the ones under CUSTFA.[92]

Much of the complexity of NAFTA derived partly from the technical choices made during the negotiations to adopt a tariff-shift approach and partly from the intensity of lobbying and involvement of the specific industrial sectors. These two factors are closely intertwined. In drafting rules of origin, there are a series of technical options that may be pursued in determining when "substantial transformation" occurs.[93] By adopting the "tariff shift" as the main criterion for determining origin, the negotiators implicitly opted for product-specific

[89] For a discussion on the U.S. GSP and Caribbean rules of origin, see, Palmeter, D. "Rules of origin or rules of restriction? A commentary on a new form of protectionism," *Fordham International Law Journal*, vol. 1, number 1, 1987 and Handbook on U.S. GSP Scheme including features of the AGOA, UNCTAD, 2003.

[90] Palmeter, D. "Rules of origin in Regional Trade Agreements" in *Regionalism and Multilateralism after the Uruguay Round, Convergence, Divergence and Interaction*, European Interuniversity Press, Brussels, 1997.

[91] See, Palmeter D., "The FTA rules of origin: Boon or boondoggle," in Dearden, Hart, and Steger (eds), *Living with Free Trade: Canada, the Free Trade Agreement and the GATT*, Institute for Research on Public Policy and Centre for Trade Policy and Law, Ottawa, 1989, 41, 47.

[92] See Estedeavordal, A. and D. Miller, "Rules of origin and the pattern of trade between US and Canada," Integration, Trade and Hemispheric Issues Division, Inter-American Development Bank, 2002.

[93] For a detailed discussion on the drafting of rules of origin, see Chapter 5.

rules of origin, given the inherent structures of the HS. This rendered the rules of origin susceptible to capture by industries interested in minimizing their exposure to competition.[94]

The United States was not the first country to utilize the HS as main criteria to determine origin. In fact, for more than two decades the main general criteria of the EC was the CTH criteria until the introduction of the Pan-European rules of origin. However, the general criterion based on a CTH requirement was coupled with a list of product-specific rules that was around 70 pages long. For the products falling in this list the respective product-specific rules applied instead of the general criterion based on CTH.

The main difference in the utilization of the HS for rules of origin purposes between the United States and the EC resides in the level of detail or disaggregation of the HS that occurs in NAFTA and to NAFTA's similar rules of origin. Such a difference in the design of rules utilizing the full codes at the six-digit level and in some cases at tariff line level in the case of NAFTA, is one of the major differences between the U.S. and EC model remaining valid today.

As pointed out in Chapter 2 the experience that the United States has gained with NAFTA and change of tariff classification (CTC) techniques has largely influenced the Harmonization Work Program (HWP) and the approach to the negotiations of the harmonized set of nonpreferential rules of origin.

As pointed out earlier, the EC utilizes a number of different techniques when drafting rules of origin ranging from specific working or processing to maximum import content and the CTC based on the HS. However, the design and drafting of the rules of origin utilizing the HS in the EC have been always done at heading level (four digits) and never at subheading (six digits) or national line level (see the tariff items in NAFTA), as was the case for NAFTA.

NAFTA negotiators utilized the full disaggregation at the six-digit level of the HS and even recurred in certain products to use national lines at the eight-digit level. This entailed concordances that were to be made among the different national tariff lines (tariff items in NAFTA jargon). Because national tariff lines change on a yearly basis, a complex exercise of concordances had to be repeated every year by customs officers.

In spite of their unprecedented complexity, NAFTA rules of origin were perceived by some commentators and users as rather user friendly. They argued that the extensive use of the HS made rules of origin predictable and transparent even to the private sector.

[94] Palmeter, see supra footnote 90.

Undoubtedly, both in legal and economic literature on rules of origin, NAFTA rules of origin created a watershed in terms of complexity and implications deriving from their use and application. It is therefore not surprising that NAFTA implementation by Canadian and U.S. administrators was in many respects a learning ground and that the post-NAFTA period gradually generated changes in the North American attitude toward preferential rules of origin.

One of the main reasons generating the complexity and the level of detailed discipline of the NAFTA rules was the much-publicized fear of loss of North American jobs during NAFTA negotiations. These fears were partly based on the belief that North American industries would relocate in low-cost Mexico to obtain preferential access and compete with domestic industries in North America. In general, when forming a FTA with a developing country, developed countries that already have a strong industrial basis fear the trade deflecting or delocalization effects of liberal rules of origin more than they value – as exporters – their potential trade-creating effect. This fear prompted U.S. domestic producers to press for finely tuned rules of origin in, for instance, automobiles,[95] textile and toy-manufacturing industries, and color picture tubes. For example, the yarn-forwarding rule adopted in the textile area results in the exclusion of low-cost intermediate materials from East Asia for the manufacturing of NAFTA originating textiles unless natural fibers were imported. This exclusion may have ultimately provided incentives for the development of a capital-intensive industry in Mexico, reducing NAFTA trade creation. U.S. textiles companies potentially wishing to relocate in Mexico had to invest a greater amount of capital to comply with NAFTA origin requirements.

These companies, to take advantage of labor costs and NAFTA preferential rates, had the following choices: (1) to import United States cotton yarn with loss of comparative advantage; (2) to start the manufacturing process from imported natural fibers or from imports of fabrics from North America[96] (i.e., increasing the trade diversion); or (3) require Mexican and Canadian textiles producers to buy yarn from U.S. textile mills before being allowed to sell the clothing to U.S. consumers duty free. The combination of the yarn-forwarding rules and the high tariffs facing textile imports implies that the North American

[95] See Jonathan Cooper, "NAFTA rules of origin and its effect on the North American automotive industry in the North-West," *Journal of International Law and Business*, vol. 14, no. 2, winter 1994. See also Joseph A. La Nasa III, "Rules of origin under the North American Free Trade Agreement: A substantial transformation into objectively transparent protectionism," *Harvard International Law Journal*, vol. 34, no. 2, 1993.

[96] See Richard H. Stringerg, "Antidote to regionalism: Responses to trade diversion effects of NAFTA," *Stanford Journal of International Law*, vol. 29, no. 2, 1993.

producers have an incentive to use U.S.-made fabrics rather than competitive fabrics from Asia.

As discussed in subsection 3.2.3.9, NAFTA rules have also evolved as demonstrated by the recent revision to the NAFTA rules and the negotiations of FTAs with Central America, Colombia, and Peru.

In comparison with the EC, the United States has maintained within the overall architecture of NAFTA style rules a distinct degree of flexibility to better customize the origin rules of the FTAs to the trade patterns and volumes of the partners. This tendency is also reflected in the relative importance given to cumulation in the U.S. FTAs. In the EC context, cumulations is perceived as a major factor in liberalizing rules of origin and stimulating intraregional trade. In the recent FTAs that the United States has entered with Latin American countries there are no plans of establishing cumulation among these countries. It follows that there is no insistence by the United States, as is the case in the EC, when negotiating with partners to use identical rules of origin in different trade agreements. The absence of a plan at this stage to set up a common system of cumulation under U.S. FTAs further provides room for this flexibility.

3.2.3.1. *The Main Criteria for Determining Origin in NAFTA*[97]

According to the original NAFTA text there are four ways in which goods generally meet the NAFTA rule of origin and therefore qualify for NAFTA tariff preference[98]:

(1) Goods "wholly produced or obtained" in the NAFTA region, i.e., they contain no non-NAFTA material;
(2) Goods containing nonoriginating inputs, but meeting the product-specific origin rules;
(3) Goods produced in the NAFTA region wholly from originating materials, i.e., produced from materials that may contain non-NAFTA materials, but these materials have met the NAFTA rule of origin;
(4) Unassembled goods and goods classified in same HS category as their parts, that do not meet product-specific origin rules, but contain sufficient North

[97] The examples and other material in this section have been excerpted from Memorandum D-11-5-1 NAFTA as revised in 2003 by the Canadian Revenue Agency.

[98] If the good is an agricultural good, as defined by the NAFTA, then exporters must ensure that their goods qualify under the special criterion for agricultural goods. Exporters should review the NAFTA definition of an "agricultural" good. Processed foods, often not considered an agricultural product, fall within the NAFTA definition of agriculture, as do raw natural fibers (silk, cotton, etc.) and fur skins.

American regional value content. (Goods qualify in this category only in very limited circumstances.)

(A) Goods falling under (1) respond although with significant variations to the usual list and concept of wholly obtained products used in the Kyoto Convention and in the EC rules of origin:
  (a) a mineral good extracted in the territory of one or more of the NAFTA countries;
  (b) a vegetable or other good harvested in the territory of one or more of the NAFTA countries;
  (c) a live animal born and raised in the territory of one or more of the NAFTA countries;
  (d) a good obtained from hunting, trapping, or fishing in the territory of one or more of the NAFTA countries;
  (e) fish, shellfish, or other marine life taken from the sea by a vessel registered or recorded with a NAFTA country and flying its flag;
  (f) a good produced on board a factory ship from a good referred to in paragraph (e), where the factory ship is registered or recorded with the same NAFTA country as the vessel that took that good and flies that country's flag;
  (g) a good taken by a NAFTA country or a person of a NAFTA country from or beneath the seabed outside the territorial waters of that country, where a NAFTA country has the right to exploit that seabed;
  (h) a good taken from outer space, where the good is obtained by a NAFTA country or a person of a NAFTA country and is not processed outside the territories of the NAFTA countries;
  (i) waste and scrap derived from (i) production in the territory of one or more of the NAFTA countries, or (ii) used goods collected in the territory of one or more of the NAFTA countries, where those goods are fit only for the recovery of raw materials; or
  (j) a good produced in the territory of one or more of the NAFTA countries exclusively from a good referred to in any of paragraphs (a) through (i), or from the derivatives of such a good, at any stage of production.

(B) Goods falling under (2) are the large majority of products, and NAFTA provides basically for a product-specific list where certain requirements have to be met
  (a) CTC,
  (b) CTC and a regional value content,
  (c) a regional value content.

(C) Goods falling under (3) concern goods that are considered originating if they are produced entirely in one or more NAFTA country using only originating materials. This provision encompasses goods made of parts and materials that meet NAFTA rules of origin, even though containing some non-North American inputs.

Example: An agricultural machine such as a wine press made in California of all originating parts could qualify, even if the parts contained non-North American metals. The difference in this case is that foreign materials have been transformed in North America to such an extent that new, originating parts have been created. These originating components are then used to produce the originating wine press.

(D) If a product fails to qualify under product-specific tariff-shift rule of origin – under two limited circumstances under (4) – it may qualify under a regional value content (RVC) requirement, even if the product-specific rule of origin in Annex 401 does not contain RVC provisions. These provisions never apply to products classified in HS Chapters 61–63 (apparel and other made-up textiles items such as blankets, linens, and bags). These two circumstances are applicable when the good is produced entirely in the territory of one or more of the NAFTA countries, but one or more of the nonoriginating materials provided for as parts under the HS that are used in the production of the good does not undergo a CTC because:

- The good was imported into North America in an unassembled or disassembled form, but was classified as an assembled good under the HS system.

  Parts and final products are classified in the same heading or subheading (as long as the description of the HS heading for the good provides for and specifically describes both the good itself and its parts and is not further subdivided into subheadings, or the subheading for the good provides for and specifically describes both the good itself and its parts).

  Bicycle kits from Germany are assembled in Canada and sold in the NAFTA territory. The bicycles would qualify as originating goods if the regional value content requirement is met

- The goods are produced using materials imported into a NAFTA country that are provided for as parts according to the HS, and those parts are classified in the same subheading or undivided heading as the finished goods.

  A barber chair and its parts thereof classified in the Harmonized Tariff Schedule under subheading 9402.10.

As can be easily imagined, the majority of the goods fall under category (2) because the majority of products nowadays contain nonoriginating inputs. In the following section some examples with explanatory comments are provided in order to better realize the technicalities involved and the substance of the NAFTA rules:

Products: Breads, pastries, cakes, biscuits (HS 1905.90) Non-North American input: Flour (classified in HS chapter 11), imported from Europe.

Rule of Origin: "A change to heading 1902 through 1905 from any other chapter."

Explanation: For all products classified in HS headings 1902 through 1905, all non-North American inputs must be classified in an HS chapter other than HS chapter 19 in order for the product to obtain NAFTA tariff preference. These baked goods would qualify for NAFTA tariff preference because the non-originating are classified outside of HS chapter 19. (The flour is in chapter 11). However, if these products were produced with non-originating mixes, then these products would not qualify because mixes are classified in HS chapter 19, the same chapter as baked goods.

3.2.3.2. *De Minimis*

As in the case of the Pan-European rules of origin, NAFTA rules of origin provide for *de minimis* rules. In fact, the reliance of the NAFTA rules of origin on a CTC provides scope for the introduction of such rules. A CTC requires that all nonoriginating materials undergo the required change. It follows that even a very low percentage of the materials may disqualify goods from originating status. NAFTA contains a *de minimis* provision that allows goods to qualify as originating provided such materials are not more than a certain percentage (7 percent in most cases) of the transaction value of the goods adjusted to a FOB basis or, in some cases, of the total cost of the goods.

In addition, where failure of materials to undergo a required CTC triggers a requirement for a minimum RVC, the calculation of that content is waived if the value of all nonoriginating materials used in the production of the goods is not more than the specified *de minimis* amount.

However, if after application of the *de minimis* allowance the goods must still meet a RVC requirement in order to qualify as originating (that is, if the value of all nonoriginating materials exceeds the applicable *de minimis* allowance), the value of all nonoriginating materials must be taken into account in calculating the RVC.

A manufacturer purchases inexpensive textile watch straps made in Taiwan (HTS 91.13), to be assembled with originating mechanical watch movements (HTS 91.08), and originating cases (HTS 91.12). The value of the straps is less than 7 percent of the transaction value of the final watch (HTS 91.02) adjusted to an FOB basis.

The Annex 401 origin criterion for HTS 91.02 is:

A change to heading 91.01 through 91.07 from any other chapter; or

A change to heading 91.01 through 91.07 from 91.14, whether or not there is also a change from any other chapter, provided there is a regional value content of not less than:

(a) *60 percent where the transaction value method is used, or*
(b) *50 percent where the net cost method is used.*

Only non-originating materials need undergo the required tariff classification change: in this case, the textile straps. The straps do not satisfy either of the indicated tariff changes but since their value is less than seven percent of the transaction value of the finished watch adjusted to an FOB basis, the de minimis rule applies and the watches can be considered originating.

There is, however, a rather long list of excluded products, and certain categories of products such a textiles and garments are subject to specific *de minimis* provisions. The Article 405 *de minimis* rule does not apply to the following materials:

- certain dairy products and preparations that are used in the production of goods provided for in Chapter 4 of the Harmonized Tariff Schedule (HTS);
- goods provided for in Chapter 4 of the HTS and some dairy preparations that are used in the production of certain goods containing milk, milk solids, or butterfat;
- some fruits and juices used in the production of certain juices and juice concentrates;
- coffee beans used in the production of unflavored instant coffee (note: the Annex 401 origin criterion for unflavored instant coffee allows up to 60 percent nonoriginating coffee, so substantial allowance is already made for nonoriginating inputs);
- fats, lards, oils, and related products provided for in Chapter 15 of the HTS that are used in the production of Chapter 15 goods (except olive, palm, and coconut oils, to which the *de minimis* rule does apply);
- Cane and beet sugar used in the production of sugars, syrups and other products provided for in HTS headings 1701–1703;
- Sugar, molasses, sugar confectionery, and other goods provided for in Chapter 17 of the HTS and cocoa powder provided for in HTS 18.05 that are used in the production of chocolate and other food preparations containing cocoa;
- beer, wine, and other fermented beverages provided for in HTS headings 22.03–22.08 used in the production of alcoholic beverages and related

products provided for in HTS headings 22.07 and 22.08; any nonoriginating material used in the production of many major appliances such as refrigerators, freezers, air conditioners, stoves, ranges, trash compactors, clothes-dryers, and washing machines;
- printed circuit assemblies used in the production of a good if the CTC prescribed by Annex 401 for that good places restrictions on their use.

Textiles. As in the case of the Pan-European rules of origin, special rules apply to textile and garments. For textile goods classified in Chapters 50 through 63 of the HS, the *de minimis* rule is applied by weight (instead of value) to the component of the good that determines its tariff classification, as determined in accordance with the General Rules of Interpretation of the HS.

A Mexican manufacturer produces women's shirts which have knit bodies and woven sleeves. The composition of the knit bodies is 60 percent cotton, 35 percent wool, and 5 percent rayon, by weight. The sleeves are made of Japanese fabric that is 100 percent polyester. Since the knit bodies give the garments their essential character, the shirts are classified under HTS 6106.10. The Annex 401 rule of origin criterion for HTS 6106.10 is "yarn forward" (see Chapter 5 of this publication for rules of origin for textiles). Assuming the cotton and wool portions of the bodies meet the yarn-forward rule, the garment can still be considered originating even if the rayon yarn was from China since it falls under the de minimis provision. The sleeves are ignored in determining whether the shirts originate because ***only the component that determines the tariff classification*** *of the goods is considered when applying the de minimis provision.*

Agricultural Products. The Article 405 *de minimis* rule does not apply to agricultural goods provided for in Chapters 1 through 27 of the HS unless the nonoriginating materials are classified in subheadings different from the subheadings in which the finished goods are classified.

Ground coffee, sold in retail packages, is produced in Mexico (HTS 0901.21). Most of the beans are grown and roasted in Mexico but to give the coffee a unique flavor the producer adds some roasted beans from Kenya (HTS 0901.21). The value of the beans from Kenya is 5 percent of the transaction value, adjusted to an FOB basis, of each retail package. The Annex 401 origin criterion for HTS 09.01 is:

A change to heading 09.01 through 09.10 from any other chapter.

The coffee cannot be considered originating because the Kenyan beans do not undergo the required tariff change. The de minimis rule does not apply because the Kenyan beans are classified in the same subheading as the final good.

Note: *If green (unroasted) coffee were imported from Kenya and roasted in Mexico, the de minimis rule would apply because green coffee beans are classified in*

HTS 0901.11, a different subheading. Thus, the ground coffee in retail packages would qualify as originating.

Cigars, Cheroots, Cigarillos, and Cigarettes. *The de minimis amount for these products is nine percent, not seven percent, of the transaction value adjusted to an FOB basis.*

Producer A, located in a NAFTA country, uses originating materials and non-originating materials in the production of copper anodes provided for in heading 7402. The NAFTA product-specific rule of origin for heading 7402 specifies a change in tariff classification from any other chapter. There is no applicable regional value-content requirement for this heading. Therefore, in order for the copper anode to qualify as an originating good under the rule set out in Schedule I, Producer A may not use in the production of the copper anode any non-originating material provided for in Chapter 74. All of the materials used in the production of the copper anode are originating materials, with the exception of a small amount of copper scrap provided for in heading 7404, that is in the same chapter as the copper anode. Under the de minimis rules, if the value of the non-originating copper scrap does not exceed seven percent of the transaction value of the copper anode or the total cost of the copper anode, whichever is applicable, the copper anode would be considered an originating good.

Producer A, located in a NAFTA country, uses originating materials and non-originating materials in the production of ceiling fans provided for in subheading 8414.51. There are two alternative product-specific rules of origin for subheading 8414.51, one of which specifies a change in tariff classification from any other heading. The other rule specifies both a change in tariff classification from the subheading under which parts of the ceiling fans are classified and a regional value-content requirement. Therefore, in order for the ceiling fan to qualify as an originating good under the first of the alternative rules, all of the materials that are classified under the subheading for parts of ceiling fans and used in the production of the completed ceiling fan must be originating materials. In this case, all of the non-originating materials used in the production of the ceiling fan satisfy the change in tariff classification set out in the rule that specifies a change in tariff classification from any other heading, with the exception of one non-originating material that is classified under the subheading for parts of ceiling fans. Under the de minimis rules, if the value of the non-originating material that does not satisfy the change in tariff classification specified in the first rule does not exceed seven percent of the transaction value of the ceiling fan or the total cost of the ceiling fan, whichever is applicable, the ceiling fan would be considered an originating good. Therefore, under

de minimis rules the ceiling fan would not be required to satisfy the alternative rule that specifies both a change in tariff classification and a regional value-content requirement.

Producer A, located in a NAFTA country, uses originating materials and non-originating materials in the production of plastic bags provided for in subheading 3923.29. The rule set out in Schedule I for subheading 3923.29 specifies both a change in tariff classification from any other heading, except from subheadings 3920.20 or 3920.71, under which certain plastic materials are classified, and a regional value-content requirement. Therefore, with respect to that part of the rule that specifies a change in tariff classification, in order for the plastic bag to qualify as an originating good, any plastic materials that are classified under subheading 3920.20 or 3920.71 and that are used in the production of the plastic bag must be originating materials. In this case, all of the non-originating materials used in the production of the plastic bag satisfy the specified change in tariff classification, with the exception of a small amount of plastic materials classified under subheading 3920.71. The NAFTA product-specific rules of origin provides that the plastic bag can be considered an originating good if the value of the non-originating plastic materials that do not satisfy the specified change in tariff classification does not exceed seven percent of the transaction value of the plastic bag or the total cost of the plastic bag, whichever is applicable. In this case, the value of those non-originating materials that do not satisfy the specified change in tariff classification does not exceed the seven percent limit. However, the NAFTA product-specific rules set for subheading 3923.29 specifies both a change in tariff classification and a regional value-content requirement. Therefore, under the NAFTA rules, in order to be considered an originating good, the plastic bag must also satisfy the regional value-content requirement specified in that rule. As provided in de minimis rules, the value of the non-originating materials that do not satisfy the specified change in tariff classification, together with the value of all other nonoriginating materials used in the production of the plastic bag, will be taken into account in calculating the regional value content of the plastic bag.

Producer A, located in a NAFTA country, produces women's dresses provided for in subheading 6204.41 from fine wool fabric of heading 5112. This fine wool fabric, also produced by Producer A, is the component of the dress that determines its tariff classification under subheading 6204.41. The NAFTA product-specific rule of origin for subheading 6204.41, under which the dress is classified, specifies both a change in tariff classification from any other chapter, except from those headings and chapters under which certain yarns and fabrics, including combed wool yarn and wool fabric, are classified, and a requirement that the good be cut

and sewn or otherwise assembled in the territory of one or more of the NAFTA countries. Therefore, with respect to that part of the rule that specifies a change in tariff classification, in order for the dress to qualify as an originating good, the combed wool yarn and the fine wool fabric made therefrom that are used by Producer A in the production of the dress must be originating materials. At one point Producer A uses a small quantity of non-originating combed wool yarn in the production of the fine wool fabric. Under the de minimis rules, if the total weight of the non-originating combed wool yarn does not exceed seven percent of the total weight of all the yarn used in the production of the component of the dress that determines its tariff classification, that is, the wool fabric, the dress would be considered an originating good.

3.2.3.3. *Regional Value Content in NAFTA*

In cases in which it was felt that the CTC was not adequate, NAFTA requires a specified amount of "regional value content"[99] in order for a good to obtain NAFTA tariff preference. These regional value-added content calculations are still applicable in spite of the suspicion and dislike for such rules demonstrated by U.S. negotiators during the negotiations on nonpreferential rules of origin.

The usual rule specifies that at least 50 percent of the value of a product must be North American to qualify for NAFTA treatment. RVC rules are used extensively for automotive goods and chemicals, but are quite limited in other product areas.[100]

According to NAFTA, RVC may be calculated by use of two methods: transaction value or net cost. Both formulas are shown in the following section. Their difference lies in the cost basis used to make the calculation:

- transaction value generally means the price actually paid or payable for a good;
- the net cost method removes sales promotion, marketing, and after-sales service costs, royalties, shipping and packing costs, and some interest costs from the equation.

Because the transaction value is a broader basis for calculating content, the RVC required is higher than for net cost. In most cases, the required level of regional value content is 60 percent for transaction value and 50 percent for net cost.

[99] See Rules of Origin, Regional Value Content, NAFTA Facts Document 5011.

[100] It is important to note that the RVC test is not a generally available option for exporters, but may be used when specified in Annex 401 rules.

Generally, exporters and producers may choose which valuation methodology they prefer, but there are exceptions. For automotive goods, footwear, and word processing machines, only the net cost method may be used. This is also true of goods for which there is no acceptable transaction value. Goods designated as "intermediate materials" and goods for which "accumulation" of RVC is used must also use the net cost method.

The transaction value method is generally simpler to use, but a producer may choose whichever method is most advantageous.

The transaction value method calculates the value of the nonoriginating materials as a percentage of the World Trade Organization (WTO) Customs Valuation transaction value of the good, which is the total price paid for the good, with certain adjustments for packing and other items, and is based on principles of the WTO Customs Valuation Agreement. The essence of this method is that the value of nonoriginating materials can be calculated as a percentage of the invoice price, which is usually the price actually paid for them. Because the transaction value method permits the producer to count all of its costs and profit as territorial, the required percentage of RVC under this method is higher than under the net cost method. This method is somewhat similar to the Pan-European method of calculating percentages because it is based on a subtraction methodology rather than, as under the net cost method, a value-added calculation. These different methodologies may have determinant implications on the administration of rules of origin that are further illustrated in Chapter 6.

As previously stated, under NAFTA there are a number of situations for which the transaction value method cannot be used and the net cost method is the only alternative. The net cost method must be used when there is no transaction value, in some related party transactions, for certain motor vehicles and parts, when a producer is accumulating RVC, as well as to determine the RVC for designated intermediate materials. The producer may also revert to the net cost method if the result using the transaction value method is unfavorable.

The formula for calculating the regional value content using the transaction value method is

$$RVC = \frac{TV - VNM}{TV} \times 100,$$

where the RVC is expressed as a percentage; TV is the transaction value of the good adjusted to an FOB basis; and VNM is the value of nonoriginating materials used by the producer in the production of the good.

The net cost method calculates the regional value content as a percentage of the net cost to produce the good. Net cost represents all of the costs incurred by the producer minus expenses for sales promotion (including marketing and after-sales service), royalties, shipping and packing cost, and nonallowable interest costs. The percentage content required for the net cost method is lower than the percentage content required under the transaction value method because of the exclusion of certain costs from the net cost calculation.

The formula for calculating the regional value content using the net cost method is

$$RVC = \frac{NC - VNM}{NC} \times 100,$$

where the RVC is expressed as a percentage; NC is the net cost of the good; and VNM is the value of nonoriginating materials used by the producer in the production of the good.

Hereinafter, an example of rules of origin based on the RVC is given:

Product: Wooden Furniture. Non-North American inputs: Parts of furniture classified in 9403.90

"A change to subheading 9403.10 through 9403.80 from any other chapter; or a change to subheading 9403.10 through 9403.80 from subheading 9403.90, provided there is a regional value-content of not less than:

- *60 percent where the transaction value is used, or*
- *50 percent where the net-cost method is used."*

Explanation: Wooden furniture can qualify for NAFTA tariff preference under two scenarios – a tariff shift, or a combination of a tariff shift and regional value content requirement.

The first option – the tariff-shift rule – requires that all non-originating inputs be classified outside of HS chapter 94 (furniture and bedding). Since the nonoriginating inputs (furniture parts) are classified in chapter 94, (subheading 9403.90), then the product cannot qualify based on tariff shift. However, it may still qualify based on the second part of the rule. The second option has two components – a tariff shift requirement, and a regional value content requirement. The tariff shift requirement is satisfied since the non-originating input (furniture parts) is classified in subheading 9403.90 as specified by the rule. The product must meet its regional value content requirement using the transaction value or the net cost methodology. Given the following values, furniture qualifies for NAFTA tariff preference using the net cost methodology. The calculation is found in Table 3.15, with the following example. Producer's Net Cost $182.00 each (not including

TABLE 3.15. *Examples of calculations*

Transaction value method	*Net cost method*
$(200 - 90) \times 100 = 55$ *Good does not qualify under transaction value method, because it does not have at least 60 percent RVC.*	$(182 - 90) \times 100 = 50.5$ *Good qualifies under net cost region value requirement because it has at least a 50 percent RVC.*

shipping, packing royalties, etc.). Transaction Value $200.00 each piece. Value of Non-Originating Parts $90.00.

An electric hair curling iron (HTS 8516.32) is made in Mexico from Japanese hair curler parts (HTS 8516.90). Each hair curling iron is sold for $4.00; the value of the non-originating hair curler parts is $1.80. The annex 401 rule of origin for HTS 8516.32 states:

- *A change to subheading 8516.32 from subheading 8516.80 or any other heading; or*
- *A change to subheading 8516.32 from subheading 8516.90, whether or not there is also a change from subheading 8516.80 or any other heading, provided there is a regional value content of not less than*:
  - *60 percent, where the transaction value method is used; or*
  - *50 percent, where the net cost method is used.*

The first of these two rules is not met, since there is no heading change. Therefore, the producer must verify whether the curling irons can qualify under the second rule. In the second rule, since the required subheading change is met (from 8516.90 to 8516.32), one proceeds to calculate the regional value content. The regional value content under the transaction value method is

$$\frac{(4.00 - 1.80)}{4.00} \times 100 = 55 \text{ percent.}$$

The hair curler is not considered an originating good under this method, since the required regional value content is 60 percent when the transaction value is used. Instead, the producer uses the net cost method. The total cost of the hair curler is $3.90, which includes $0.25 for shipping and packing costs. There are no costs for royalties, sales promotion, or non-allowable interest. The net cost is therefore $3.65. The regional value content under the net cost method is

$$\frac{(3.65 - 1.80)}{3.65} \times 100 = 50.1 \text{ percent.}$$

The hair curler would be considered originating, since the required regional value content is 50 percent when the net cost method is used.

3.2.3.4. *Some Methodologies and Examples of Calculations under the Net Cost Method*

In the course of implementation of the NAFTA and similar agreements based on the NAFTA model, the net cost method has attracted a number of criticisms because of the complexities of the calculations. Moreover, the next cost method utilized under NAFTA attracts a lot attention because it is the only methodology based on a value added by addition to calculate a percentage criterion applied to large trade flows as in the case of the trade under NAFTA.

As pointed out earlier a valued added by addition methodology is also applied by the United States under a series of unilateral arrangements such as the GSP, AGOA, and trade preferences granted to Caribbean and Andean countries. Most recently such methodology has also been used in the FTA agreements of Morocco and Jordan, albeit a long series of product-specific rules has been added as exception to the general value-added rule (VAR).

The use of the value-added requirements by the United States appears to be guided by the trade flows under these latter arrangements. Textiles and garments are excluded from GSP, and therefore there is no need for product-specific rules. However, when textiles and garments are covered by the arrangements such as under the AGOA, Jordan and Morocco FTA product-specific rules are included and the general valued-added requirement is no longer applicable to these products.

The experience and lessons learned under NAFTA and the NAFTA model rules of origin with the methodology to calculate net costs or valued added by addition may be particularly interesting for those countries or regions who are currently involved in negotiating rules of origin. The examples and comments in the following section excerpted from NAFTA material should be taken into account when discussing options and methodologies for drafting rules of origin contained in Chapter 5.

The examples in the following section illustrate how complicated NAFTA rules have become when addressing the main disadvantages of a methodology based on a calculation of value added by addition, namely (1) definition of allowable costs to be computed, (2) sales to a related party, (3) allocation of costs when more than a product is produced in a factory, and (4) foreign exchange fluctuations.[101]

One of the major difficulties in calculating the value added is to define what costs could be allocated to the costs for the production of the good and what

[101] These, however, are by no means exhaustive of the NAFTA detailed rules to regulate apportionment of costs for inventory management methods and methods for calculating nonallowable interest costs.

costs have to be disregarded, as illustrated in the examples in the following section:

Examples: *A producer located in NAFTA country A sells Good A that is subject to a regional value-content requirement to a buyer located in NAFTA country B. The producer of Good A chooses that the regional value content of that good be calculated using the net cost method. The applicable regional value-content requirement is 50 percent. In order to calculate the regional value-content of Good A, the producer first calculates the net cost of Good A. Under section 6(11)(a),of NAFTA the net cost is the total cost of Good A (the aggregate of the product costs, period costs and other costs) per unit, minus the excluded costs (the aggregate of the sales promotion, marketing and after-sales service costs, royalties, shipping and packing costs and non-allowable interest costs) per unit. The producer uses the following figures to calculate the net cost:*

Product Costs:	
Value of originating materials	$30.00
Value of non-originating materials	$40.00
Other product costs	$20.00
Period costs	$10.00
Other costs	$0.00
Total cost of Good A, per unit	$100.00
Excluded Costs:	
Sales promotion, marketing and after-sales service cost	$5.00
Royalties	$2.50
Shipping and packing costs	$3.00
Non-allowable interest costs	$1.50
Total excluded costs	$12.00

The net cost is the total cost of Good A, per unit, minus the excluded costs:

Total cost of Good A, per unit:	$100.00
Excluded costs	–$12.00
Net cost of Good A, per unit	$88.00

The value for net cost ($88) and the value of non-originating materials ($40) are needed in order to calculate the regional value content. The producer calculates the regional value content of Good A under the net cost method in the following manner:

$$RVC = \frac{NC - VNM}{NC} \times 100,$$

$$RVC = \frac{88 - 40}{88} \times 100.$$

Therefore, under the net cost method, Good A qualifies as an originating good, with a regional value-content of 54.5 percent.

Under NAFTA rules, the RVC has to be calculated according to the net cost method if the producer has sold the majority of its production to related parties as contained in the example in the following section:

Example: *Section 6(6)(c), net cost method required for certain sales to related persons. On January 15, 1994, a producer located in NAFTA country A sells 1,000 units of Good A to a related person, located in NAFTA country B. During the six-month period beginning on July 1, 1993 and ending on December 31, 1993, the producer sold 90,000 units of identical goods and similar goods to related persons from various countries, including that buyer. The producer's total sales of those identical goods and similar goods to all persons from all countries during that six month period were 100,000 units. The total quantity of identical goods and similar goods sold by the producer to related persons during that six month period was 90 percent of the producer's total sales of those identical goods and similar goods to all persons. Under section 6(6)(c), the producer must use the net cost method to calculate the regional value content of Good A sold in January 1994, because the 85 percent limit was exceeded.*

The examples in the following section relate to one of the difficulties intrinsic to the calculation of percentages: The itemization of costs to the single good when the producer is manufacturing different goods. There should be a criterion to reasonably apportion costs to each good to allow the calculation.

NAFTA allows for different options as illustrated in the example in the following section:

> "The net cost of a good may be calculated, at the choice of the producer of the good, by
>
> (a) calculating the total cost incurred with respect to all goods produced by that producer, subtracting any excluded costs that are included in that total cost, and reasonably allocating, in accordance with Schedule VII, the remainder to the good;
> (b) calculating the total cost incurred with respect to all goods produced by that producer, reasonably allocating, in accordance with Schedule VII, that total cost to the good, and subtracting any excluded costs that are included in the amount allocated to that good; or
> (c) reasonably allocating, in accordance with Schedule VII, each cost that forms part of the total cost incurred with respect to the good so that the aggregate of those costs does not include any excluded costs."

Example under (a):
A producer in a NAFTA country produces Good A and Good B during the producer's fiscal year. The producer uses the following figures, which are recorded on the producer's

books and represent all of the costs incurred with respect to both Good A and Good B, to calculate the net cost of those goods:

Product Costs:	
Value of originating materials	*$2,000.00*
Value of non-originating materials	*$1,000.00*
Other product costs	*$2,400.00*
Period costs: (including $1,200 in excluded costs)	*$3,200.00*
Other costs	*$400.00*
Total cost of Good A and Good B	*$9,000.00*

The net cost is the total cost of Good A and Good B, minus the excluded costs incurred with respect to those goods.

Total cost of Good A and Good B	*$9,000.00*
Excluded costs	*–$1,200.00*
Net cost of Good A and Good B	*$7,800.00*

The net cost must then be reasonably allocated, in accordance with the guidelines contained in the following section to Good A and Good B.

Example under (b):
A producer located in a NAFTA country produces Good A and Good B during the producer's fiscal year. In order to calculate the regional value content of Good A and Good B, the producer uses the following figures that are recorded on the producer's books and incurred with respect to those goods:

Product Costs:	
Value of originating materials	*$2,000.00*
Value of non-originating materials	*$1,000.00*
Other product costs	*$2,400.00*
Period costs: (including $1,200 in excluded costs)	*$3,200.00*
Other costs	*$400.00*
Total cost of Good A and Good B	*$9,000.00*

Under section 6(11)(b), the total cost of Good A and Good B is then reasonably allocated, in accordance with Schedule VII, to those goods. The costs are allocated in the following manner:

	Allocated to Good A	*Allocated to Good B*
Total Cost ($9,000 for both Good A And Good B)	*$5,220*	*$3,780*

The excluded costs ($1,200) that are included in total cost allocated to Good A and Good B, in accordance with Schedule VII, are subtracted from that amount.

		Excluded Cost Allocated to Good A	*Excluded Cost Allocated to Good B*
Total Excluded costs:			
Sales promotion, marketing and after-sale service costs	*$500*	*$290*	*$210*
Royalties	*$200*	*$116*	*$84*
Shipping and packing costs	*$500*	*$290*	*$210*
Net cost (total cost minus excluded costs)		*$4,524*	*$3,276*

The net cost of Good A is thus $4,524, and the net cost of Good B is $3,276.

Example under (b):
A Producer located in a NAFTA country produces Good C and Good D. The following costs are recorded on the producer's books for the months of January, February and March, and each cost that forms part of the total cost are reasonably allocated, in accordance with Schedule VII, to Good C and Good D.

	Total cost: Good C and Good D (in thousands of dollars)	*Allocated to Good C (in thousands of dollars)*	*Allocated to Good D (in thousands of dollars)*
Product costs:			
Value of originating materials	*$100*	*$0*	*$100*
Value of non-originating materials	*$900*	*$800*	*$100*
Other product costs	*$500*	*$300*	*$200*
Period costs (including $420 in excluded costs)	*$5,679*	*$3,036*	*$2,643*
Minus Excluded Costs	*420*	*$300*	*$120*
Other Costs	*0*	*$0*	*$0*
	$6,759	*$3,836*	*$2,923*

Sections 3 to 7 on reasonable allocation of costs, related methodologies, and examples are reported in the following section to illustrate the complexities and the level of details that the utilization of a net cost or value-added method implies.

SECTION 3

(1) Where a producer of a good is using, for an internal management purpose, a cost allocation method to allocate to the good direct material costs, or part thereof, and that method reasonably reflects the direct material used in the production of the good based on the criterion of benefit, cause or ability to bear, that method shall be used to reasonably allocate the costs to the good.
(2) Where a producer of a good is using, for an internal management purpose, a cost allocation method to allocate to the good direct labor costs, or part thereof, and that method reasonably reflects the direct labor used in the production of the good based on the criterion of benefit, cause or ability to bear, that method shall be used to reasonably allocate the costs to the good.
(3) Where a producer of a good is using, for an internal management purpose, a cost allocation method to allocate to the good overhead, or part thereof, and that method is based on the criterion of benefit, cause or ability to bear, that method shall be used to reasonably allocate the costs to the good.

SECTION 4

Where costs are not reasonably allocated to a good under section 3, those costs are reasonably allocated to the good if they are allocated,

(a) with respect to direct material costs, on the basis of any method that reasonably reflects the direct material used in the production of the good based on the criterion of benefit, cause or ability to bear;
(b) with respect to direct labor costs, on the basis of any method that reasonably reflects the direct labor used in the production of the good based on the criterion of benefit, cause or ability to bear; and
(c) with respect to overhead, on the basis of any of the following methods:
    (i) the method set out in Addendum A, Addendum B, or Addendum C,
    (ii) a method based on a combination of the methods set out in Addenda A and B or Addenda A and C, and
    (iii) a cost allocation method based on the criterion of benefit, cause or ability to bear.

SECTION 5

Any cost allocation method referred to in section 3 or 4 that is used by a producer for the purposes of this appendix shall be used throughout the producer's fiscal year.

Costs Not Reasonably Allocated

SECTION 6

The allocation to a good of any of the following is considered not to be reasonably allocated to the good:

(a) costs of a service provided by a producer of a good to another person where the service is not related to the good;
(b) gains or losses resulting from the disposition of a discontinued operation;
(c) cumulative effects of accounting changes reported in accordance with a specific requirement of the applicable Generally Accepted Accounting Principles; and.
(d) gains or losses resulting from the sale of a capital asset of the producer.

SECTION 7

Any costs allocated under section 3 on the basis of a cost allocation method that is used for an internal management purpose that is solely for the purpose of qualifying a good as an originating good are considered not to be reasonably allocated.

ADDENDUM A
COST RATIO METHOD

Calculation of Cost Ratio
For the overhead to be allocated, the producer may choose one or more allocation bases that reflect a relationship between the overhead and the good based on the criterion of benefit, cause or ability to bear.
With respect to each allocation base that is chosen by the producer for allocating overhead, a cost ratio is calculated for each good produced by the producer in accordance with the following formula:

CR is the cost ratio with respect to the good;
AB is the allocation base for the good; and
TAB is the total allocation base for all the goods produced by the producer.

Allocation to a Good of Costs Included in Overhead
The costs with respect to which an allocation base is chosen are allocated to a good in accordance with the following formula:

$$CAG = CA \times CR$$

where CAG is the costs allocated to the good;
CA is the costs to be allocated; and
CR is the cost ratio with respect to the good.

Excluded Costs
Under section 6(11)(b) of this appendix, where excluded costs are included in costs to be allocated to a good, the cost ratio used to allocate that cost to the good is

used to determine the amount of excluded costs to be subtracted from the costs allocated to the good.

Allocation Bases for Costs
The following is a non-exhaustive list of allocation bases that may be used by the producer to calculate cost ratios:
Direct Labor Hours
Direct Labor Costs
Units Produced
Machine-hours
Sales Dollars or Pesos
Floor Space

"Examples"
The following examples illustrate the application of the cost ratio method to costs included in overhead.

Example 1: Direct Labor Hours
A producer who produces Good A and Good B may allocate overhead on the basis of direct labor hours spent to produce Good A and Good B. A total of 8,000 direct labor hours have been spent to produce Good A and Good B: 5,000 hours with respect to Good A and 3,000 hours with respect to Good B. The amount of overhead to be allocated is $6,000,000.
Calculation of the Ratios:
Good A: 5,000 hours/8,000 hours =.625
Good B: 3,000 hours/8,000 hours =.375
Allocation of overhead to Good A and Good B:
Good A: $6,000,000 × .625 = $3,750,000
Good B: $6,000,000 × .375 = $2,250,000

Example 2: Direct Labor Costs
A producer who produces Good A and Good B may allocate overhead on the basis of direct labor costs incurred in the production of Good A and Good B. The total direct labor costs incurred in the production of Good A and Good B is $60,000: $50,000 with respect to Good A and $10,000 with respect to Good B. The amount of overhead to be allocated is $6,000,000.
Calculation of the Ratios:
Good A: $50,000/$60,000 =.833
Good B: $10,000/$60,000 =.167
Allocation of Overhead to Good A and Good B:
Good A: $6,000,000 × .833 = $4,998,000
Good B: $6,000,000 × .167 = $1,002,000

Example 3: Units Produced
A producer of Good A and Good B may allocate overhead on the basis of units produced. The total units of Good A and Good B produced is 150,000: 100,000 units

of Good A and 50,000 units of Good B. The amount of overhead to be allocated is $6,000,000.
Calculation of the Ratios:
Good A: 100,000 units/150,000 units =.667
Good B: 50,000 units/150,000 units =.333
Allocation of Overhead to Good A and Good B:
Good A: $6,000,000 × .667 = $4,002,000
Good B: $6,000,000 × .333 = $1,998,000

Example 4: Machine-hours
A producer who produces Good A and Good B may allocate machine-related overhead on the basis of machine-hours utilized in the production of Good A and Good B. The total machine-hours utilized for the production of Good A and Good B is 3,000 hours: 1,200 hours with respect to Good A and 1,800 hours with respect to Good B. The amount of machine-related overhead to be allocated is $6,000,000.
Calculation of the Ratios:
Good A: 1,200 machine-hours/3,000 machine-hours =.40
Good B: 1,800 machine-hours/3,000 machine-hours =.60
Allocation of Machine-Related Overhead to Good A and Good B:
Good A: $6,000,000 × .40 = $2,400,000
Good B: $6,000,000 × .60 = $3,600,000

Example 5: Sales Dollars or Pesos
A producer who produces Good A and Good B may allocate overhead on the basis of sales dollars. The producer sold 2,000 units of Good A at $4,000 and 200 units of Good B at $3,000. The amount of overhead to be allocated is $6,000,000.
Total Sales Dollars for Good A and Good B:
Good A: $4,000 × 2,000 = $8,000,000
Good B: $3,000 × 200 = $600,000
Total Sales Dollars: $8,000,000 + $$600,000 = $$8,600,000
Calculation of the Ratios:
Good A: $$8,000,000/$8,600,000 =.93
Good B: $600,000/$8,600,000 =.07
Allocation of Overhead to Good A and Good B:
Good A: $6,000,000 × .93 = $5,580,000
Good B: $6,000,000 × .07 = $420,000

Example 6: Floor Space
A producer who produces Good A and Good B may allocate overhead relating to utilities (heat, water and electricity) on the basis of floor space used in the production and storage of Good A and Good B.
The total floor space used in the production and storage of Good A and Good B is 100,000 square feet: 40,000 square feet with respect to Good A and 60,000

square feet with respect to Good B. The amount of overhead to be allocated is $6,000,000.

Calculation of the Ratios:
Good A: 40,000 square feet/100,000 square feet =.40
Good B: 60,000 square feet/100,000 square feet =.60
Allocation of Overhead (Utilities) to Good A and Good B:
Good A: $6,000,000 × .40 = $2,400,000
Good B: $6,000,000 × .60 = $3,600,000

ADDENDUM B
DIRECT LABOR AND DIRECT MATERIAL RATIO METHOD

Calculation of Direct Labor and Direct Material Ratio
For each good produced by the producer, a direct labor and direct material ratio is calculated in accordance with the following formula:

$$DLDMR = \frac{DLC + DMC}{TDLC + TDMC}$$

DLDMR is the direct labor and direct material ratio for the good;
DLC is the direct labor costs of the good;
DMC is the direct material costs of the good;
TDLC is the total direct labor costs of all goods produced by the producer; and
TDMC is the total direct material costs of all goods produced by the producer.
Allocation of Overhead to a Good Overhead is allocated to a good in accordance with the following formula:

$$OAG = O \times DLDMR$$

Where OAG is the overhead allocated to the good;
O is the overhead to be allocated; and
DLDMR is the direct labor and direct material ratio for the good.

Excluded Costs
Under section 6(11)(b) of this appendix, where excluded costs are included in overhead to be allocated to a good, the direct labor and direct material ratio used to allocate overhead to the good is used to determine the amount of excluded costs to be subtracted from the overhead allocated to the good.

"Examples"

Example 1:
The following example illustrates the application of the direct labor and direct material ratio method used by a producer of a good to allocate overhead where the

producer chooses to calculate the net cost of the good in accordance with section 6(11)(a) of this appendix. A producer produces Good A and Good B. Overhead (O) minus excluded costs (EC) is $30 and the other relevant costs are set out in the following table:

	Good A	*Good B*	*Total*
Direct labor costs (DLC)	*$5*	*$5*	*$10*
Direct Material costs (DMC)	*$10*	*$5*	*$15*
Totals	*$15*	*$10*	*$25*

Overhead Allocated to Good A
OAG (Good A) = O ($30) × DLDMR ($15/$25)
OAG (Good A) = $18.00
Overhead Allocated to Good B
OAG (Good B) = O ($30) × DLDMR ($10/$25)
OAG (Good B) = $12.00

Example 2:
The following example illustrates the application of the direct labor and direct material ratio method used by a producer of a good to allocate overhead where the producer chooses to calculate the net cost of the good in accordance with section 6(11)(b) of this appendix and where excluded costs are included in overhead.
A producer produces Good A and Good B. Overhead (O) is $50 (including excluded costs (EC) of $20). The other relevant costs are set out in the table of Example 1.
Overhead Allocated to Good A
OAG (Good A) = [O ($50) × DLDMR ($15/$25)] − [EC ($20) × DLDMR($15/$25)]
OAG (Good A) = $18.00
Overhead Allocated to Good B
OAG (Good B) = [O ($50) × DLDMR ($10/$25)] − [EC ($20) × DLDMR($10/$25)]
OAG (Good B) = $12.00

ADDENDUM C
DIRECT COST RATIO METHOD

Direct Overhead
Direct overhead is allocated to a good on the basis of a method based on the criterion of benefit, cause or ability to bear.

Indirect Overhead
Indirect overhead is allocated on the basis of a direct cost ratio.

Calculation of Direct Cost Ratio
For each good produced by the producer, a direct cost ratio is calculated in accordance with the following formula:

$$DCR = \frac{DLC + DMC + DO}{TDLC + TDMC + TDO}$$

DCR is the direct cost ratio for the good;
DLC is the direct labor costs of the good;
DMC is the direct material costs of the good;
DO is the direct overhead of the good;
TDLC is the total direct labor costs of all goods produced by the producer;
TDMC is the total direct material costs of all goods produced by the producer; and
TDO is the total direct overhead of all goods produced by the producer;

Allocation of Indirect Overhead to a Good
Indirect overhead is allocated to a good in accordance with the following formula:

$$IOAG = IO \times DCR$$

where
IOAG is the indirect overhead allocated to the good;
IO is the indirect overhead of all goods produced by the producer; and
DCR is the direct cost ratio of the good.
Excluded Costs
Under section 6(11)(b) of this appendix, where excluded costs are included in

(a) direct overhead to be allocated to a good, those excluded costs are subtracted from the direct overhead allocated to the good; and
(b) indirect overhead to be allocated to a good, the direct cost ratio used to allocate indirect overhead to the good is used to determine the amount of excluded costs to be subtracted from the indirect overhead allocated to the good.

"Examples"

Example 1:
The following example illustrates the application of the direct cost ratio method used by a producer of a good to allocate indirect overhead where the producer chooses to calculate the net cost of the good in accordance with section 6(11)(a) of this appendix. A producer produces Good A and Good B. Indirect overhead (IO) minus excluded costs (EC) is $30. The other relevant costs are set out in the following table:

	Good A	*Good B*	*Total*
Direct labor costs (DLC)	*$5*	*$5*	*$10*
Direct Material costs (DMC)	*$10*	*$5*	*$15*
Direct overhead (DO)	*$8*	*$2*	*$10*
Totals	*$23*	*$12*	*$35*

Indirect Overhead Allocated to Good A
IOAG (Good A) = IO ($30) × DCR ($23/$35)
IOAG (Good A) × $19.71
Indirect Overhead Allocated to Good B
IOAG (Good B) = IO ($30) × DCR ($12/$35)
IOAG (Good B) = $10.29

Example 2:
The following example illustrates the application of the direct cost ratio method used by a producer of a good to allocate indirect overhead where the producer has chosen to calculate the net cost of the good in accordance with section 6(11)(b) of this appendix and where excluded costs are included in indirect overhead.
A producer produces Good A and Good B. The indirect overhead (IO) is $50 (including excluded costs (EC) of $20). The other relevant costs are set out in the table to Example 1.

Indirect Overhead Allocated to Good A
IOAG (Good A) = [IO ($50) × DCR ($23/$35)] − [EC ($20) × DCR ($23/$35)]
IOAG (Good A) = $19.72
Indirect Overhead Allocated to Good B
IOAG (Good B) = [IO ($50) × DCR ($12/$35)] − [EC ($20) × DCR ($12/$35)]
IOAG (Good B) = $10.28

The examples in the following section illustrate how the fluctuations of foreign currencies are dealt with under NAFTA calculation of the net cost method.

Producer A, located in a NAFTA country, produces Good A that is subject to a regional value-content requirement. The producer chooses that the regional value content of that good be calculated using the net cost method and averages the calculation over the producer's fiscal year Producer A determines that during that fiscal year Producer A incurred a gain on foreign currency conversion of $10,000 and a loss on foreign currency conversion of $8,000, resulting in a net gain of $2,000. Producer A also determines that $7,000 of the gain on foreign currency conversion and $6,000 of the loss on foreign currency conversion is related to the purchase of non-originating materials used in the production of Good A, and $3,000 of the gain on foreign currency conversion and $2,000 of the loss on foreign currency conversion is not related to the production of Good A. The producer determines that the total cost of Good A is $45,000 before deducting the $1,000 net gain on foreign currency conversion related to the production of Good A. The total cost of Good A is therefore $44,000. That $1,000 net gain is not included in the value of non-originating materials.

Given the same facts as in example 10, except that Producer A determines that $6,000 of the gain on foreign currency conversion and $7,000 of the loss on foreign currency conversion is related to the purchase of non-originating materials used in the production of Good A. The total cost of Good A is $45,000, which includes the $1,000 net loss on foreign currency conversion related to the production of Good A. That $1,000 net loss is not included in the value of non-originating materials.

3.2.3.5. *Cumulation in NAFTA*

Cumulation in NAFTA is different from the sort of cumulation previously discussed in the case of the unilateral trade preferences or the diagonal cumulation of the Pan-European rules of origin.

In the case of NAFTA, Annex 401 is drafted to incorporate the concept of the diagonal cumulation. In fact, the NAFTA rules of origin provide that rules of origin may be met "*as a result of production occurring entirely in the territory of one or more of the Parties.*"

The RVC calculations discussed are calculated based on the North American and Mexico regions where the nonoriginating materials are those materials imported from third countries.

It follows that, when producers determine the RVC of goods, the entire value of the materials used in the production of the goods that they acquire from suppliers in the NAFTA region is considered as wholly originating or wholly nonoriginating. This is similar to the diagonal cumulation under the Pan-European rules of origin.

In addition, the NAFTA cumulation provisions allow the producer or exporter of goods to choose to include as part of the goods' RVC any regional value added by suppliers of nonoriginating materials used to produce the final goods. Thus, accumulation allows the producer to reduce the value of the nonoriginating materials used in the production of the good by taking into account the NAFTA inputs incorporated into those nonoriginating materials. In this way, the NAFTA cumulation is quite similar to a full cumulation because a producer may add up working or processing in other NAFTA country to comply with origin requirements. An example of this kind of cumulations is given in the following section in example 1, situation (b).

In the case in which a producer who is unable to satisfy a RVC requirement based on (1) his own processing costs and (2) the value of originating materials he uses to produce a good, cumulation allows him to include (3) any regional value added in the NAFTA territory by other persons who produced nonoriginating materials that were subsequently incorporated into the final good.

There are rather detailed conditions for using and administering cumulation:

- producers/exporters who choose to use accumulation must use the net cost method to calculate any RVC;
- producers/exporters of goods must obtain information on net cost and the RVC of nonoriginating materials used to make their goods from the producers (suppliers) of those materials[102];
- all nonoriginating materials used in the production of the goods must undergo the CTC set out in Annex 401 of the Agreement, and the goods must satisfy any applicable RVC requirement, entirely in the territory of one or more of the NAFTA countries; and
- the goods must satisfy all other applicable requirements of the rules of origin.

The following examples were excerpted from U.S. Customs and Border Protection[103] and may assist in clarifying some concepts and method of application of NAFTA cumulation:

Example 1:
Producer A, located in NAFTA country A, imports unfinished bearing rings provided for in subheading 8482.99 into NAFTA country A from a non-NAFTA territory. Producer A further processes the unfinished bearing rings into finished bearing rings, which are of the same subheading. The finished bearing rings of Producer A do not satisfy an applicable

[102] (2) Where a good is subject to a regional value-content requirement and an exporter or producer of the good has a statement signed by a producer of a material that is used in the production of the good that
(a) states the net cost incurred and the value of nonoriginating materials used by the producer of the material in the production of that material,
(i) the net cost incurred by the producer of the good with respect to the material shall be the net cost incurred by the producer of the material plus, where not included in the net cost incurred by the producer of the material, the costs referred to in sections 7(1)(c) through (e), and
(ii) the value of non-originating materials used by the producer of the good with respect to the material shall be the value of non-originating materials used by the producer of the material; or
(b) states any amount, other than an amount that includes any of the value of non-originating materials, that is part of the net cost incurred by the producer of the material in the production of that material,
(i) the net cost incurred by the producer of the good with respect to the material shall be the value of the material, determined in accordance with section 7(1), and
(ii) the value of non-originating materials used by the producer of the good with respect to the material shall be the value of the material, determined in accordance with section 7(1), minus the amount stated in the statement.

[103] See http://www.cbp.gov/nafta/docs/us/guidproc.html#accumulation.

change in tariff classification and therefore do not qualify as originating goods. The net cost of the finished bearing rings (per unit) is calculated as follows:

Product Costs:	
Value of originating materials	*$0.15*
Value of non-originating materials	*$0.75*
Other product costs	*$0.35*
Period costs: (including $0.05 in excluded costs)	*$0.15*
Other costs	*$0.05*
Total cost of the finished bearing rings, per unit	*$1.45*
Excluded costs: (included in period costs)	*$0.05*
Net cost of the finished bearing rings, per unit	*$1.40*

Producer A sells the finished bearing rings to Producer B who is located in NAFTA country A for $1.50 each. Producer B further processes them into bearings, and intends to export the bearings to NAFTA country B. Although the bearings satisfy the applicable change in tariff classification, the bearings are subject to a regional value-content requirement.

Situation A:
Producer B does not choose to accumulate costs incurred by Producer A with respect to the bearing rings used in the production of the bearings. The net cost of the bearings (per unit) is calculated as follows:

Product Costs:	
Value of originating materials	*$0.45*
Value of non originating materials (value, per unit, of the bearing rings purchased from Producer A)	*$1.50*
Other product costs	*$0.75*
Period costs: (including $0.05 in excluded costs)	*$0.15*
Other costs	*$0.05*
Total cost of the finished bearing rings, per unit	*$2.90*
Excluded costs: (included in period costs)	*$0.05*
Net cost of the finished bearing rings, per unit	*$2.85*

Under the net cost method, the regional value content of the bearings is

$$RVC = \frac{NC - VNM}{NC} \times 100,$$

$$RVC = \frac{\$2.85 - \$1.50}{\$2.85} \times 100,$$

$$RVC = 47.4\%.$$

Therefore, the bearings are non-originating goods.

Situation B:

Producer B chooses to accumulate costs incurred by Producer A with respect to the bearing rings used in the production of the bearings. Producer A provides a statement described in section 14(2)(a) reproduced in footnote 89 above to Producer B. The net cost of the bearings (per unit) is calculated as follows:

Product Costs:	
Value of originating materials ($0.45 + $0.15)	*$0.60*
Value of non-originating materials (value, per unit, of the unfinished bearing rings imported by Producer A)	*$0.75*
Other product costs ($0.75 + $0.35)	*$1.10*
Period costs: (($0.15 + $0.15), including $0.05 in excluded costs)	*$0.30*
Other costs ($0.05 + $0.05)	*$0.10*
Total cost of the bearings, per unit	*$2.85*
Excluded costs: (included in period costs)	*$0.10*
Net cost of the bearings, per unit	*$2.75*

Under the net cost method, the regional value content of the bearings is

$$RVC = \frac{NC - VNM}{NC} \times 100,$$

$$RVC = \frac{\$2.75 - \$0.75}{\$2.75} \times 100,$$

$$RVC = 72.7\%.$$

Therefore, the bearings are originating goods.

Situation C:

Producer B chooses to accumulate costs incurred by Producer A with respect to the bearing rings used in the production of the bearings. Producer A provides to Producer B a statement described in section 14(2)(b) contained in footnote 89 above that specifies an amount equal to the net cost minus the value of non-originating materials used to produce the finished bearing rings ($1.40 − $0.75 = $0.65). The net cost of the bearings (per unit) is calculated as follows:

Product Costs:	
Value of originating materials ($0.45 + $0.65)	*$1.10*
Value of non-originating materials ($1.50 − $0.65)	*$0.85*
Other product costs	*$0.75*
Period costs: (including $0.05 in excluded costs)	*$0.15*
Other costs	*$0.05*
Total cost of the bearings, per unit	*$2.90*
Excluded costs: (included in period costs)	*$0.05*
Net cost of the bearings, per unit	*$2.85*

Under the net cost method, the regional value content of the bearings is

$$RVC = \frac{NC - VNM}{NC} \times 100,$$

$$RVC = \frac{\$2.85 - \$0.85}{\$2.85} \times 100,$$

$$RVC = 70.2\%.$$

Therefore, the bearings are originating goods.

Situation D:

Producer B chooses to accumulate costs incurred by Producer A with respect to the bearing rings used in the production of the bearings. Producer A provides to Producer B a statement described in section in section 14(2)(b) contained in footnote 89 that specifies an amount equal to the value of other product costs used in the production of the finished bearing rings ($0.35). The net cost of the bearings (per unit) is calculated as follows:

Product Costs:	
Value of originating materials	*$0.45*
Value of non-originating materials ($1.50 − $0.35)	*$1.15*
Other product costs ($0.75 + $0.35)	*$1.10*
Period costs: (including $0.05 in excluded costs)	*$0.15*
Other costs	*$0.05*
Total cost of the bearings, per unit	*$2.90*
Excluded costs: (included in period costs)	*$0.05*
Net cost of the bearings, per unit	*$2.85*

Under the net cost method, the regional value content of the bearings is

$$RVC = \frac{NC - VNM}{NC} \times 100$$

$$RVC = \frac{\$2.85 - \$1.15}{\$2.85} \times 100$$

$$RVC = 59.7\%$$

Therefore, the bearings are originating goods.

Example 2:

Producer A, located in NAFTA country A, imports non-originating cotton, carded or combed, provided for in heading 5203 for use in the production of cotton yarn provided for in heading 5205. Because the change from cotton, carded or combed, to cotton yarn is a change within the same chapter, the cotton does not satisfy the applicable change in tariff classification for heading 5205, which is a change from any other chapter, with certain exceptions. Therefore, the cotton yarn that Producer A produces from non-originating cotton is a non-originating good.

Producer A then sells the non-originating cotton yarn to Producer B, also located in NAFTA country A, who uses the cotton yarn in the production of woven fabric of cotton provided for in heading 5208. The change from non-originating cotton yarn to woven fabric of cotton is insufficient to satisfy the applicable change in tariff classification for heading 5208, which is a change from any heading outside headings 5208 through 5212, except from certain headings, under which various yarns, including cotton yarn provided for in heading 5205, are classified. Therefore, the woven fabric of cotton that Producer B produces from non-originating cotton yarn produced by Producer A is a non-originating good.

However, under section 14(1)[104]*, if Producer B chooses to accumulate the production of Producer A, the production of Producer A would be considered to have been performed by Producer B. The rule for heading 5208, under which the cotton fabric is classified, does not exclude a change from heading 5203, under which carded or combed cotton is classified. Therefore, under section 15(1), the change from carded or combed cotton provided for in heading 5203 to the woven fabric of cotton provided for in heading 5208 would satisfy the applicable change of tariff classification for heading 5208. The woven fabric of cotton would be considered as an originating good. Producer B, in order to choose to accumulate Producer A's production, must have a statement described in section 14(4)(a)(ii).*

Nevertheless, the above example does not fulfill the rule for cotton yarn. This implies that for knitted or crocheted fabric it is necessary to manufacture the wholly obtained[105] *cotton.*

3.2.3.6. *Other NAFTA Provisions*

Self-produced materials and intermediate materials

This concept is similar to the absorption principle earlier discussed in the case of the Pan-European rules. Although the concept is similar, the modus operandi and the administration of this rule under the NAFTA rules are starkly different. The amount of details and conditions attached to the NAFTA rules on intermediate material found no comparison with those under the Pan-European rules of origin.

According to the NAFTA rules for intermediate materials, a producer may designate as an intermediate material any self-produced, originating material used in the production of the final goods. As long as the intermediate material

[104] Section 14(1) provides as follows: Subject to subsections (2) and (4), for purposes of determining whether a good is an originating good, an exporter or producer of a good may choose to accumulate the production, by one or more producers in the territory of one or more of the NAFTA countries, of materials that are incorporated into that good so that the production of the materials shall be considered to have been performed by that exporter or producer.

[105] See definition of wholly obtained products, supra.

qualifies as an originating material, its entire value may be treated as originating in determining the RVC of the finished goods.

This provision covers all goods and materials except

- automotive goods defined in Article 403(1) and described in Annex 403.1 and;
- components described in Annex 403.2, specifically engines and gearboxes.

An intermediate material may be composed of originating and nonoriginating submaterials. After determining that an intermediate material satisfies the applicable rule of origin under Article 401, the total cost to produce that intermediate material is treated as an originating cost. In other words, the producer would not include the value of the nonoriginating materials used to produce the intermediate material as part of the value of nonoriginating materials when calculating the RVC of the final goods. The benefit of designating an intermediate material is that the producer may treat self-produced materials similarly to the way in which he would treat an originating material purchased at arm's length for purposes of determining the value of the nonoriginating materials of the final goods.

There is a series of limitations to the designation of intermediate materials. The first limitation provides that, if the intermediate material must satisfy a minimum RVC to qualify as originating, the net cost method must be used to calculate that RVC.

A second and more important limitation concerns material subject to a RVC requirement that may not be designated as an intermediate material if it contains submaterials also subject to a RVC requirement that were also designated as intermediate materials. In other words this rule is designed to impede the successive designation of intermediate materials as shown in the example in the following section.

Example[106]

Company Z manufactures forklift trucks in Canada and makes some of the materials used in their production. As illustrated in the graphic above, each geometric symbol represents a material used in the production of the forklift truck.

The circles (i.e., outer races, balls, steel, gaskets, impellers, bearings, engine blocks, crank shafts) are materials acquired from sellers in non-NAFTA countries. The squares (i.e., rod-end bearings, casings, impeller assemblies, engines) are self-produced materials. They are considered horizontal materials in relation to each other. The impeller assemblies

[106] This example has been excerpted from the Trilateral Customs Guide to NAFTA from Revenue Canada Customs available at: http://www.cbsa-asfc.gc.ca./publications/pub/c-124-eng.pdf.

cannot be designated as intermediate materials because they do not meet the Annex 401 rule of origin ("a change to subheading 8413.91 from any other heading"). However, the rod-end bearings, casings, and engines could all be designated intermediate materials, as long as they satisfy the applicable NAFTA product-specific rules of origin. (The casings undoubtedly meet the rule of origin, which provides for "a change to subheading 8412.90 from any other heading." The engines and rod-end bearings meet the required tariff change prescribed in the Annex 401 rules of origin, but would also have to meet a regional value content requirement to qualify as originating.) We assume that the regional value content is met throughout this example.

The rod-end bearings and casings are used in the production of the cylinders. Likewise, the impeller assemblies and engines are used in the production of the pumps that drive the hydraulic mechanisms of the forklifts. The cylinders and pumps (represented by triangles) are intermediate materials that are horizontal in relation to each other, and vertical in relation to the materials from which they were made. As long as there is no regional value content requirement for more than one intermediate material in the vertical stream, each new material can be designated as an intermediate material. The cylinder qualifies as originating under article 401(c) because it is made in Canada exclusively from originating materials. Here, however, both the engine and the pump are subject to regional value content requirements.

*Thus, Company Z can choose to designate the engine or the pump as an intermediate material, **but not both**. Therefore, Company Z must choose which is most advantageous: to designate the engines as an intermediate material, or to designate the pump. The forklift truck will then qualify as an originating good.*

Where a single producer designates intermediate materials that qualify as originating solely based on a tariff change, that is, without having to satisfy a RVC requirement, subsequent designations can be made with previously designated intermediate materials. Thus, in the preceding example, if the engine were not subject to a RVC requirement, both the engine and the pump could be designated as intermediate materials.

The following example further aims at clarifying the differences of when a successive designation of intermediate material is allowed or not, depending, on whether the RVC rules was previously applied.

Example on Single Producer and Successive Designations of Materials Subject to a Regional Value-Content Requirement as Intermediate Materials

Producer A, located in NAFTA country, produces Material X and uses Material X in the production of Good B. Material X qualifies as an originating material because it satisfies the applicable regional value-content requirement. Producer A designates Material A as an intermediate material.

Producer A uses Material X in the production of Material Y, which is also used in the production of Good B. Material Y is also subject to a regional value-content requirement.

Under the proviso set out above, Producer A cannot designate Material Y as an intermediate material, even if Material Y satisfies the applicable regional value-content requirement, because Material X was already designated by Producer A as an intermediate material.

Example on Single Producer and Multiple Designations of Materials as Intermediate Materials

Producer X, who is located in NAFTA country X, uses nonoriginating materials in the production of self-produced materials A, B, and C. None of the self-produced materials are used in the production of any of the other self-produced materials. Producer X uses the self-produced materials in the production of Good O, which is exported to NAFTA country Y. Materials A, B and C qualify as originating materials because they satisfy the applicable regional value-content requirements. Because none of the self-produced materials are used in the production of any of the other self-produced materials, then even though each self-produced material is subject to a regional value-content requirement, Producer X may, under section 7(4), designate all of the self-produced materials as intermediate materials. The proviso set out in section 7(4) only applies where self-produced materials are used in the production of other self-produced materials and both are subject to a regional value-content requirement.

The second set of detailed rules concerns the method for determining the value of the intermediate material. Basically there are two methods for determining the value of an intermediate material:

- the total cost incurred with respect to all goods produced that can be reasonably allocated to that intermediate material; or
- the aggregate of each cost that forms part of the total cost incurred with respect to that intermediate material that can be reasonably allocated to that intermediate material.

The two methods allow producers to select the one that best fits their production and accounting practices. The value of the intermediate material should be approximately the same when either method is used. However, the net cost method must be used for intermediate materials subject to a RVC requirement. Article 402(8) of NAFTA lists those costs that may not be included when calculating the RVC of the intermediate material using the net cost method:

- sales promotion, including marketing and after-sales service costs;
- royalties;
- shipping and packing costs;
- nonallowable interest costs.

Although these costs are excluded in the net cost calculation, they do form part of the total cost of the material. Accordingly, costs such as royalties are

excluded when calculating the net cost for purposes of determining whether the material satisfies a RVC requirement (and thus originates and can be designated an intermediate material), but are included in the total value of the material once its origin has been determined. As previously noted, the total value of an intermediate material may be counted as an originating cost.

THE HONDA CASE[107]

The much-debated and publicized Honda case may be regarded as the classic illustration of the technical complexities of rules of origin, globalization and relocation of industries and the policy and industry decisions underlying them. Ultimately, the Honda case, that arose in the context of the United States/Canada FTA, became the test case for the importance attached to rules of origin in the subsequent NAFTA negotiations.

From a technical point of view and in the opinion of those familiar with rules of origin, the issue at stake had to do with some of the traditional problems linked to origin determination: inadequacy of the change of tariff heading (CTH) rule in specific cases, definition of allowable costs under the percentage criterion and origin determination of intermediate input or components, the latter aspect being particularly related to the increasing globalization of production and the increasing practice by companies, especially in the automobile sector of subcontracting the manufacturing of sub-assemblies according to just-in-time agreements with suppliers. Under the United States/Canada FTA, the origin of automobiles and their components was subject to a CTH test plus a requirement for a minimum of 50 percent local content. Parts or components of an automobile (intermediate products) were also subject to the same rules. Thus, if a subcomponent of an automobile – for example, the engine as in the Honda case – meets the CTH requirement plus the 50 percent local content requirement in the United States, it can be considered to be of American origin. Then, when it is used to complete the automobile manufactured in Canada the value of the engine as a whole (100 percent) will be counted as North American content (and not only the 50 percent of United States original local content), and its whole value will be added to the local content acquired in Canada to fulfill the 50 percent local content requirement for the complete automobile. This rule is called the "roll-up rule." Controversially, when the subcomponent did not acquire originating status the whole value of the component would be counted as foreign (roll-down rule).

[107] See Frédéric P. Cantin and Andreas F. Lowenfeld, "Rules of origin: The Canada-United States FTA and the Honda case," *American Journal of International Law*, vol. 87, no. 3, 1993. See Palmeter in Note 90.

In the Honda case, Honda of Canada and the Canadian Customs for a certain period treated the engines manufactured in the United States as originating and imported them duty-free into Canada. When the engines were subsequently assembled into the Honda Civic their full value was counted as being of North American content in order to reach the minimum 50 percent local content requirement to be re-exported to the United States duty-free. This trend continued until 1992 when a United States Customs investigation determined that the Honda Civic manufactured in Canada and exported to the United States did not meet the 50 percent requirement because it contained too many Japanese parts. Honda was then asked to pay a retroactive bill of $17 million for the 2.5 percent ad valorem tariff evaded on the Honda Civics re-exported to the United States. More specifically, the United States Customs ruled that engines manufactured in the Ohio plant did not qualify as North American. Then, according to the roll-down rule, their whole value could not be counted as local content when calculating the required 50 percent local content for the Honda Civic. As a consequence, the complete Honda Civic manufacture in Canada was not considered North American since the automobiles no longer met the 50 percent domestic content requirement, and had to pay duties as if they were exported direct from Japan.

In particular, the engine was considered not to have United States origin following the United States Customs interpretation that did not allow certain "processing costs and indirect cost" incurred in the United States to be counted as local content. The determination of allowable costs and the accounting method to impute such costs to local content have been a traditional and classic pitfall of the percentage criterion.

These technical details gave rise to various political considerations. First, at that time, the United States authorities were arguing with the EC that Honda Accords made in Ohio were of American origin and that they should therefore not be counted as Japanese cars against the quota that the French authorities maintained on Japanese car imports. Second, Honda's reputation and naturalized American image were affected following the finding by the United States Customs investigation, that accused Honda Japan of price-setting concerning its Honda Canada related suppliers (some of them were 100 percent Japanese owned) and transfer-price manipulation. Third, the issue became the subject of a political debate in which United States policy makers started to weigh and review all aspects of the value of transplant operations in the United States and how they helped or competed with U.S. automobile.

Some Canadian policy makers, on the other hand, regarded the U.S. Customs ruling as a means of diverting Japanese investment from Canada to the United States. The core of the problem, which was heatedly debated at the technical level, lay, as admitted by a senior U.S. official, in a flaw or (as others argue) a loophole in the drafting of the FTA rules of origin, namely in the roll-up rule.

Taking this rule to its extreme, a senior U.S. official admitted that it was possible, through breaking up the car into as many subassemblies as possible, to obtain a 100 percent American car on paper with less than 50 percent local content in reality.[108] Most likely, the original drafters of the NAFTA rules could not imagine, or perhaps underestimated, the practices of multinational corporations and the possibilities offered by the globalization of production which have finally overtaken the traditional concept of origin and the classic method of origin determination. A number of the technical problems in origin determination connected with the Honda case were only a few years ago regarded as existing solely in the imagination of some customs officials. The realities of technological progress and economic interdependence made them real, however. As one executive said, "we have arrived in the era not only of multinational enterprises but of multinational goods." It goes without saying that the roll-up and roll-down rules did not acquire a new lease of life in the NAFTA rules. The domestic content requirement for cars was fixed, after lengthy negotiations, at 62.5 percent, to be implemented progressively.

A producer located in a NAFTA country produces Good B, which is subject to a regional value-content requirement under section 4(2)(b). The producer also produces Material A, which is used in the production of Good B. Both originating materials and non-originating materials are used in the production of Material A. Material A is subject to a change in tariff classification requirement under section 4(2)(a). The costs to produce Material A are the following:

Product Costs:	
Value of originating materials	*$1.00*
Value of non-originating materials	*$7.50*
Other product costs	*$1.50*
Period costs: (including $0.30 in royalties)	*$0.50*
Other costs	*$0.10*
Total cost of Material A:	*$10.60*

The producer designates Material A as an intermediate material and determines that, because all of the non-originating materials that are used in the production of Material A undergo an applicable change in tariff classification set out in Schedule I, Material A would, under paragraph 4(2)(a) qualify as an originating material. The cost of the non-originating materials used in the production of Material A is therefore not included in the value of non-originating materials that are used in the production of Good B for the purpose of determining the regional value content of Good B. Because Material A has been designated as an intermediate material, the total cost of Material A, which is $10.60, is treated

[108] See "Honda: Is it an American car?," *Business Week*, 18 November 1991, p. 39.

as the cost of originating materials for the purpose of calculating the regional value content of Good B. The total cost of Good B is determined in accordance with the following figures:

Product Costs:	
Value of originating materials	
– intermediate materials	*$10.00*
– other materials	*$3.00*
Value of non-originating materials	*$5.50*
Other product costs	*$6.50*
Period costs	*$2.50*
Other costs	*$0.10*
Total cost of Good B	*$28.20*

Example: Originating Materials Acquired from a Producer Who Produced Them Using Intermediate Materials

Producer A, located in NAFTA country A, produces switches. In order for the switches to qualify as originating goods, Producer A designates subassemblies of the switches as intermediate materials. The subassemblies are subject to a regional value-content requirement. They satisfy that requirement, and qualify as originating materials. The switches are also subject to a regional value-content requirement, and, with the subassemblies designated as intermediate materials, are determined to have a regional value content of 65 percent.

Producer A sells the switches to Producer B, located in NAFTA country B, who uses them to produce switch assemblies that are used in the production of Good B. The switch assemblies are subject to a regional value-content requirement. Producers A and B are not accumulating their production within the meaning of section 14.

Producer B is therefore able, under section 7(4), to designate the switch assemblies as intermediate materials.

If Producers A and B were accumulating their production within the meaning of section 14, Producer B would be unable to designate the switch assemblies as intermediate materials, because the production of both producers would be considered to be the production of one producer.

3.2.3.7. *NAFTA Rules of Origin for Textiles and Clothing*

Although based on a CTC, the majority of NAFTA product-specific rules are not overwhelmingly complicated or stringent in the case of agricultural and processed agricultural goods. Complications arise with rules of origin for sensitive industrial products such as textiles and clothing, as shown in this section.[109]

[109] The examples in the following section are excerpted from http://cbp.gov/nafta/docs/us.

As discussed earlier, goods produced by the textile and textile products industries go through many processing steps. However, the NAFTA rules are based on specific rules of origin reflecting four types of processing:

- production of fiber;
- extrusion or spinning of yarn;
- fabric formation through weaving, knitting, or other methods; and
- cutting (or knitting to shape) and sewing or otherwise assembling apparel or made-up textile articles.

Generally, the nonoriginating inputs have to comply with two of the four processing steps to qualify as originating. This basic concept is rather similar to the Pan-European rules of origin but more stringent. In the case of apparel, nonoriginating material has to comply with three of the processing steps. There are also specific instances in which the inputs have to comply with only one processing step.

Fiber forward, yarn forward, fabric forward, and cut and sewn are concepts that are widely used under NAFTA, and they apply to various textile sectors with many exceptions.

Fiber forward: Under this concept, the fiber itself must be either grown or extruded in the NAFTA territory. It applies to products such as naturally occurring cotton fibers and manmade staple fibers. The yarn or thread produced from these fibers must also be formed or spun in a NAFTA territory. The raw material used to produce the manmade fiber may be nonoriginating.

Yarn forward: The yarn must be either spun or extruded in the NAFTA territory. The staple fibers may be nonoriginating.

Fabric forward: The fabric must be processed (i.e., woven or knit) in the NAFTA territory. Where yarns are used, the yarn may be nonoriginating.

Cut and sewn: The finished goods must be cut and sewn or otherwise assembled in the NAFTA territory.

The preceding concepts may be used in describing the production process as follows:

Yarn forward – basic concept – triple transformation

1. production of yarn from nonoriginating bales of cotton (52.01) **produces** cotton yarn (52.05)

2. weaving of fabric cotton yarn (52.05) produces knitted fabric (60.02)
3. production of apparel or other textile articles knitted fabric (60.02) **produces** men's shirt (6105.10) = originating shirt

Example: cotton yarns to woven cotton fabrics; man-made filament yarns to pantyhose; wool yarns to woven wool fabrics to wool apparel.

Specific rule for 6105.10 allows for transformation using input classified as 52.01:

"A change to heading 61.05 through 61.06 from any other chapter, except from headings Nos. 51.06 through 51.13, 52.04 through 52.12 . . . provided that the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the NAFTA parties."

Fiber forward – more restrictive – quadruple transformation

1. production of fiber nonoriginating polymer chips (39.07) **produces** polyester staple fibers (55.03)
2. production of yarn polyester staple fibers (55.03) **produces** yarn of synthetic staple fibers (55.09)
3. production of fabric synthetic staple fibers (55.09) **produces** knitted or crocheted fabric (60.02)
4. production of apparel or other textile article knitted or crocheted fabric (60.02) **produces** table linens (6302.40) = originating table linen

Example: Man-made staple fiber or cotton fiber to man-made staple fiber or cotton (spun) yarn; man-made filaments to nonwovens; man-made staple fiber or cotton fibers to man-made staple fiber or cotton (spun) yarns to man-made or cotton knitted fabrics.

Specific rule for 6302.40 allows for the transformation using input classified as 39.07.

"A change to heading 63.02 from any other chapter, except from headings Nos. 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapters 54 through 55, or heading Nos. 58.01 through 58.02 or 60.01 through 60.02 provided that the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the NAFTA parties."

Fabric forward – less restrictive – double transformation

1. processing of fabric non-originating silk yarn (50.04) produces woven silk fabric (50.07)
2. production of apparel or made-up article woven silk fabric (50.07) produces women's blouse (6206.10) = originating garment

Example: woven man-made filament fabrics to coated fabrics of 5903; woven silk fabrics

Specific rule for 6206.10 allows for transformation using input classified as 50.04.

"A change to heading 62.06 through 62.10 from any other chapter, except from headings Nos. 51.06 through 51.13 . . . provided that the good is both cut and sewn or otherwise assembled in the territory of one or more of the NAFTA countries."

Cut and sewn – less restrictive – single transformation

(1) production of made up textile or apparel article non-originating woven silk fabric (50.07) produces men's shirt (6205.90) = originating shirt

Example: bras; garments made of woven silk fabric; garments made of woven linen fabrics (53.09)

Specific rule for 6205.90 allows for the transformation using input classified as 50.07.

"A change to heading 6205.90 from any other chapter, except from heading Nos. 51.06 through 51.13, 52.04 through 52.12 . . . provided that the good is both cut and sewn or otherwise assembled in the territory of one or more of the NAFTA parties."

There are also basic exceptions to these basic rules that have been widely used especially in the post-NAFTA FTAs to introduce elements of leniency and flexibility in the textile and clothing sector:

Short supply fabric:
By mutual agreement, certain fabrics which are in short supply in North America are exempted from the yarn forward concept for certain specified goods, and are considered to be originating if they are cut and sewn or otherwise assembled in the territory.

Visible lining rule:
This rule applies to some articles classified in HS Chapters 61 and 62.

Visible lining in the body of an article of apparel (i.e., excluding the sleeves), must be manufactured from fabrics made in North America (fabric forward). The yarn may be imported without loss of eligibility for full NAFTA access benefits.

3.2.3.8. *Automotive Products in NAFTA*

NAFTA rules of origin on automotive products are likely the most regulated and detailed rules of origin existing in this sector. In this section certain aspects of the rules are discussed as they may be used further as examples in other chapters.

NAFTA rules on automotive products introduced the concept of tracing. In a word, tracing is exactly the opposite of the rule on intermediate materials. Tracing allows counting value content by tracking the value of major automotive components and subassemblies imported into the NAFTA region. The nonoriginating value of these components and subassemblies is then reflected in the RVC calculation of the motor vehicle or in auto parts destined for original equipment use. For those components subject to tracing, any nonoriginating (non-NAFTA) value will remain nonoriginating through all stages of assembly to the time of calculation of the RVC of the motor vehicle (or auto part destined for original equipment use). The value of traceable automotive components is determined at the time the nonoriginating components are received by the first person in Canada, Mexico, or the United States who takes title to them, after importation from outside the NAFTA region. The value of the components will be determined in accordance with standard valuation norms and will generally be the transaction value. Certain costs must be added to the transaction value if not included in it (e.g., packing, sales commissions).

One can only imagine the complexities of the calculation of the net cost for car manufactures in North America that are producing millions of cars, models using thousands of parts. Another important concept that NAFTA rules have elaborated are the sophisticated rules on averaging methodologies.

Producers of automotive goods may elect to average their costs when calculating the RVC. A motor vehicle producer may average the calculation over its fiscal year either by all motor vehicles or only those motor vehicles in a category that are exported to another NAFTA party. The four categories are

- the same model line of motor vehicles in the same class of vehicles produced in the same plant;
- the same class of motor vehicles produced in the same plant;

- the same model line of motor vehicles produced;
- special averaging rules for CAMI Automotive, Inc.

Producers of components that must be traced may also average their costs. A producer may average its calculation

- over the fiscal year of the motor vehicle producer to whom the good is sold;
- over any quarter or month, or
- over its fiscal year, if the good is sold as an aftermarket part.

Producers may elect to calculate the average separately for any or all goods sold to one or more motor vehicle producers or calculate separately those goods that are exported to Canada, Mexico, and/or the United States.

Other Provisions. The provisions on accumulation, fungible goods, and intermediate materials may be used to integrate and rationalize production processes throughout Canada, Mexico, and the United States. Components that are subject to tracing for autos and light vehicles may be designated as intermediate materials. Producers may not, however, designate as an intermediate material any traceable component for motor vehicles other than autos and light vehicles.

The example in the following section refers to a situation in which tracing is applied.

Example: An electric motor provided for in subheading 8501.10 is imported from outside the territories of the NAFTA countries and is used in the territory of a NAFTA country in the production of a seat frame provided for in subheading 9401.90. The seat frame, with the electric motor attached, is sold to a producer of seats provided for in subheading 9401.20. The seat producer sells the seat to a producer of light-duty vehicles. The seat is to be used as original equipment in the production of that light-duty vehicle. The electric motor is a traced material; the seat is not a traced material because it was not imported from outside the territories of the NAFTA countries. For purposes of calculating the regional value content of the seat, the value of traced materials incorporated into it is included in the value of non-originating materials used in the production of the seat. The value of the electric motor is included in that value. (However, the value of the motor would not be included separately in the net cost of the seat because the value of the motor is included as part of the cost of the seat frame.) For purposes of calculating, under the regional value content of the light-duty vehicle, the value of the electric motor is included in the value of nonoriginating materials used in the production of the light-duty vehicle, even if the seat is an originating material.

The following examples may be contrasted with the example made under the absorption rules described under the Pan-European rules of origin for the manufacturing of an engine. There is stark difference in terms of restrictiveness

of the rules because the Pan-European rules of origin are much more liberal and simpler that the NAFTA rules on the automotive sector.

For instance under the Pan-European rules of origin the whole value of the engine in Example 1 in the following section would be calculated as originating under the absorption rules without deducting the value of the cast block, cast heads, and connecting rod assemblies. The same holds true for Example 2, in which the pistons would not have been calculated as nonoriginating material.

Example 1: Cast blocks, cast heads and connecting rod assemblies provided for in heading 8409 are imported from outside the territories of the NAFTA countries by an engine producer, who has title to them at the time of importation, and are used by the producer in the territory of NAFTA country A in the production of an engine provided for in heading 8407. After the regional value content of the engine is calculated, the engine is an originating good. It is not a traced material because it was not imported from outside the territories of the NAFTA countries. The engine is exported to NAFTA country B, to be used as original equipment by a producer of light-duty vehicles.

For purposes of calculating, the regional value content of the light-duty vehicle that incorporates the engine, because heading 8409 is listed in Schedule IV and because the cast blocks, cast heads and connecting rod assemblies were imported into the territory of a NAFTA country and are incorporated into the light-duty vehicle, the value of those materials, which are traced materials, is included in the value of non-originating materials used in the production of the light-duty vehicle, even though the engine is an originating material. The producer of the light-duty vehicle did not import the traced materials. However, because that producer has a statement stating the value of non-originating materials of the traced materials, the producer of the light-duty vehicle may, in accordance with section 9(8), use that value as the value of non-originating materials of the light-duty vehicle with respect to that engine.

Example 2: Aluminum ingots provided for in subheading 7601.10 and piston assemblies provided for in heading 8409 are imported from outside the territories of the NAFTA countries by an engine producer and are used by that producer in the territory of NAFTA country A in the production of an engine provided for in heading 8407. The aluminum ingots are used by the producer to produce an engine block; the piston assembly is then incorporated into the engine block and the producer designates, a short block provided for in heading 8409 as an intermediate material. The intermediate material qualifies as an originating material. The engine that incorporates the short block is exported to NAFTA country B and used as original equipment in the production of a light-duty vehicle. The piston assemblies provided for in heading 8409 are traced materials; neither the engine nor the short block are traced materials because they were not imported from outside the territories of the NAFTA countries. For purposes of calculating, the regional value content of the engine, the value of the piston assemblies is included in the value of non-originating materials, even if the intermediate material is an originating material. However, the value of the aluminum ingots is not included in the value of non- originating materials because

subheading 7601.10 is not listed in Schedule IV. The value of the aluminum ingots does not need to be included separately in the net cost of the engine because that value is included in the value of the intermediate material, and the total cost of the intermediate material is included in the net cost of the engine. For purposes of calculating the regional value content of the light-duty vehicle that incorporates the engine (and the piston assemblies), the value of the piston assemblies incorporated into that light-duty vehicle is included in the value of non-originating materials of the light-duty vehicle.

3.2.3.9. *The Evolution of the NAFTA Model of Rules of Origin: From NAFTA to CAFTA through U.S.-Chile and U.S.-Singapore and Other FTA Agreements*

NAFTA certainly meant a watershed in the U.S. rules of origin, and the NAFTA model has often been branded as one of the most complicated and stringent set of rules of origin. However, this has not meant that there has not been evolution in the NAFTA model. The NAFTA rules of origin themselves have undergone extensive revisiting at the initiative of the Contracting Parties. In subsequent RTAs that the United States has entered with other partners such as Australia, Singapore, Chile, and, most recently, the Central American FTA (CAFTA), there is marked evolution in some of the rules of origin elements. Since NAFTA there has been a strong tendency to move away from using percentage criteria and especially the net cost method in calculating the RVC. In NAFTA there were 2,601 rules containing a percentage criteria calculation. In the subsequent agreements the percentage criteria based on the transaction and net cost calculation were around 600 marking a significant reduction. (See Table 3.16.)

The use of the net cost method has been significantly reduced from 1,335 in NAFTA to 54 in the U.S.-Australia FTA and the CAFTA and it has been eliminated in the U.S.-Chile and U.S.-Singapore agreement. In contrast to the evolution of the United States in relation to the NAFTA rules are the rules of origin contained in free trade agreements signed by Mexico with neighboring countries. As Table 3.16 shows, it appears there have not been notable changes. In comparison, the agreements signed by Canada show a significant movement.

In particular, the rules of origin contained in the U.S. Agreements after NAFTA made good use of the lessons learned of the difficulties of calculation of the net cost. In all other agreements following NAFTA, the build-down and build-up methods, as described in the following section, have virtually replaced the old calculation methodology. The build-up and build-down calculation methodologies use the value of materials in both calculations. Using such a numerator based uniquely on costs of materials limits considerably the

TABLE 3.16. *Evolution of the NAFTA-based rules of origin*

Regional value content	NAFTA	USAAUS	CHLUSA	CAFTA	USASIN	MEXTN
Transaction	1,266	581	556	549	331	1,311
Net cost	1,335	54	0	54	0	0
Materials	0	517	524	519	363	0

Regional value content	MEXNIC	MEXCRI	MEXBOL	CANCHL	CANCRI
Transaction	1,254	1,243	1,205	1,117	873
Net cost	1,283	1,271	1,234	1,207	49
Materials	0	0	0	0	8

Notes: This table is excerpted from a presentation made by Rafael Cornejo, Inter-American Development Bank, at the regional workshop on negotiations and implementation of new origin regimes, 25–27 April 2006.

inherent difficulties of making the allocation of costs to the single unit of production and the complex averaging calculations that have been shown in the preceding examples. In the following section an excerpt of the U.S.–Chile FTAs is shown as an example of the new formulation of the regional value content:

(i) *Where a rule set forth in subdivision (n) of this note specifies a regional value content for a good, the regional value content of such good shall be calculated, at the choice of the person claiming the tariff treatment authorized by this note for such good, on the basis of the build-down method or the build-up method described in the following section, unless otherwise specified in this note*:

(A) *For the build-down method, the regional value content may be calculated on the basis of the formula* $RVC = ((AV - VNM)/AV) \times 100$, *where RVC is the regional value content, expressed as a percentage; AV is the adjusted value; and VNM is the value of nonoriginating materials used by the producer in the production of the good; or*

(B) *For the build-up method, the regional value content may be calculated on the basis of the formula* $RVC = (VOM/AV) \times 100$, *where RVC is the regional value content, expressed as a percentage; AV is the adjusted value; and VOM is the value of originating materials used by the producer in the production of the good.*

Another excerpt from the U.S.–Chile Agreements shows what is intended as "adjusted value":

The term "adjusted value" means the value determined under articles 1 through 8, article 15 and the corresponding interpretive notes of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade (the Customs Valuation Agreement), except that such value may be adjusted to exclude any costs, charges or expenses incurred for transportation, insurance and related services incident to the international shipment of the merchandise from the country of exportation to the place of importation

It is clear that the reliance on a multilateral instrument such as the Agreement on customs valuation adds predictability to the application and administration of the methodology of calculating RVCs.

This way of calculating RVC is used to define many specific rules in the Central American Free-Trade Area-Dominican Republic (CAFTA-DR) rather than the complex net cost method so often used in NAFTA, that is now only used for automotive industry products. Under CAFTA, for most goods, the Agreement provides for two methods for calculating the RVC: (1) the build-up method, based on the value of originating materials; and (2) the build-down method, based on the value of nonoriginating materials. However, the RVC for certain automotive goods may be calculated with the net cost method. This is limited to the following automotive goods:

HTS	General description
8407.31 through 8407.34	Engines
8408.20	Diesel engines for vehicles
8409	Parts of engines

Another feature brought in the recent FTAs entered by the United States is the issue of remanufactured products. For instance, under CAFTA-DR, remanufactured products are accorded the same tariff treatment as new products, but have some exclusive flexibility in terms of origin.

It has been found that the universe of products that can be remanufactured is considerably larger than that agreed on by the United States in its previous negotiations with Chile and Singapore. For the Central American countries,[110] accepting this larger universe (870 subheadings, 2,000 percent more than in the agreements with Chile and Singapore) did not pose a difficulty for two fundamental reasons. First, remanufactured goods in Central America are

[110] See J. Granados and R. Corneyo, "*Convergence in the Americas: some lessons from the DR-Cafta process,*" World Economy, 2006.

largely subject to zero tariffs because of the absence of regional production. Second, Central American regulations allow used goods to be imported. Another notable similarity in the post-NAFTA Agreements is that the responsibility for providing information to substantiate the claim is on the importer.

Some other innovations contained in the most recent agreement concern the textiles and apparel products.

Under the U.S.-Chile agreement these changes were limited because the basic elements were similar to NAFTA processes but more changes are contained in most recent FTAs such as CAFTA and U.S.-Peru FTA. In the U.S.-Chile Agreement, the following are the basic concepts for textiles and clothing:

(a) yarn – generally, fiber must originate in Chile or the United States to qualify for preferential tariff treatment.
(b) fabric – generally, yarn must originate in Chile or the United States to qualify for preferential tariff treatment. Cotton and manmade knit fabric are under fiber forward rules.
(c) apparel – generally, yarn must originate in Chile or the United States to qualify for preferential tariff treatment.

The CAFTA-DR uses the value of material methodology to determine whether a good qualifies for preferential tariff treatment found in previous agreements such as the U.S.-Chile and Australia Free Trade Agreements. Another notable similarity is that the responsibility for providing information to substantiate the claim is on the importer.

Generally, under the CAFTA-DR (CAFTA-Dominican Republic), a nontextile good is originating where

(a) the good is wholly obtained or produced entirely in the territory of one or more of the Parties (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Dominican Republic, or the United States);
(b) The good is produced entirely in the territory of one or more of the Parties and
    (i) Each of the nonoriginating materials used in the production of the good undergoes an applicable change in tariff classification as specified in the product specific list; or
    (ii) The good otherwise satisfies any applicable RVC specified in GN29(n); and the good satisfies all other applicable requirements; or
(c) The good is produced entirely in the territory of one or more of the Parties exclusively from originating materials.

As in other FTAs, the CAFTA-DR contains a *de minimis* provision of 10 percent that applies to most goods, except some products. This provision is inapplicable to textile articles, which have their own *de minimis* rule (based on a weight percentage). Under the *de minimis* rule, a good that contains materials that do not undergo a required CTC (tariff shift) as specified in GN29(n) may still qualify as originating if the value of all nonoriginating materials used in the production of the good that do not undergo the required change in classification does not exceed 10 percent of the adjusted value of the good. The *de minimis* provision applies provided that the value of such nonoriginating materials will be included in the total value of nonoriginating materials for any applicable RVC requirement.

A textile or wearing apparel good that is not an originating good, because certain fibers or yarns used in the production of the component of the good that determines the tariff classification of the good do not undergo an applicable CTC, shall nonetheless be considered an originating good if the total weight of all such fibers or yarns in that component is not more than 10 percent of the total weight of that component.

The summary of the type of processes required for some of the more basic textile and apparel products in order for them to be considered eligible for CAFTA-DR contains some innovations.

(a) Yarn – generally, fiber must originate in a CAFTA-DR beneficiary country or the United States to qualify for preferential tariff treatment.
(b) Fabric – generally, yarn must originate in a CAFTA-DR beneficiary country or the United States to qualify for preferential tariff treatment. Cotton and manmade knit fabric are under fiber forward rules, meaning the fiber must originate in a CAFTA-DR beneficiary country or the United States to qualify for preferential treatment.
(c) Apparel – generally, yarn must originate in a CAFTA-DR beneficiary country or the U.S. to qualify for preferential tariff treatment.

In addition to this summary, a number of single transformation rules for luggage, cotton, and manmade fiber woven dresses other than corduroy, boxer shorts, brassieres, and boys' and girls' woven pajamas and nightwear have been added.

Another important flexibility introduced in recent FTAs is the possibility of expanding on request the list of textile and garments in short supply. Inclusion on this list allows the use of imported textile materials.

3.2.3.10. *A Brief Comparison between the NAFTA Model and the Pan-European Rules of Origin Approaches: Techniques and Substantive Requirements*

It is undeniable that the NAFTA and the EC approaches in dealing with preferential rules of origin are largely dominating and influencing the scene when preferential rules of origin are drafted in the context of any FTA. Thus it is opportune to draw some comparisons of a technical and substantive nature to illustrate the main differences between the two approaches.[111] There are a series of differences from the EC practice in setting the product-specific rules. In the EC, product-specific rules are set at chapter and heading levels, sometimes referring to specific products classified within the heading by utilizing an "ex," whereas in the case of the NAFTA product-specific rules are set at heading, subheading, and item levels. As later pointed out, the product-specific rules of origin of the Pan-European model are at times more restrictive for agricultural goods. Conversely, the NAFTA rules of origin are more restrictive for textiles, clothing, and motor vehicles. For the large majority of HS chapters, the breakdown at subheading or tariff item level of NAFTA far exceeds those under the Pan-European rules, especially in textiles, clothing, and machinery.

Another remarkable difference in drafting product-specific requirements is that the NAFTA rules do not utilize working or processing operations to confer origin except in very limited cases. The EC rules of origin in the comparison tables shown below are the Pan-European product-specific rules. Thus, they do not show the charges that have been introduced in the EPAs product-specific rules of outlined in Section 3.1.5.5.

One of the most visible differences in the drafting of the rules is the almost exclusive reliance by NAFTA on the tariff-shift approach. For instance, for goods of Chapter 16 classifying prepared foodstuffs, the NAFTA rules require "a change to heading 16.01 through 16.05 from any other chapter."

In plain words this means that a processing entailing a CTC into a good of Chapter 16 from any other chapters of the HS system is origin conferring. On the other hand, the requirement "from any other chapter" expressly impedes the possibility that a process changing the tariff classification within Chapter 16 is origin conferring.

[111] For another analysis of EC and NAFTA, see also A. Estevadeordal and K. Suominem: *Rules of origin in FTAs in Europe and in the Americas: Issues and implication for the EU-Mercosur Interregional Association agreement*. INTEL -ITD, working paper 15 January 2004 and for an overall general comparison see WTO, "*Rules of origin regimes in regional trade agreements*," Committee on Regional Trade Agreements. 5 April 2002.

Assume frozen pork meat (HS 02.03) is imported into the United States from Hungary and is combined with spices imported from the Caribbean (HTS 09.07–09.10) and cereals grown and produced in the United States to make fresh pork sausage (HS 16.01). Because the imported frozen meat is classified in Chapter 2 and the spices are classified in Chapter 9, these nonoriginating materials meet the required tariff change. One does not consider whether the cereal meets the applicable tariff change, because it is originating – only nonoriginating materials have to undergo the tariff change.

Looking at the EC rules of origin for Chapter 16 in Table 3.17, one may note the descriptive character of the rules and the concept of the wholly obtained inserted as origin requirement in the Single List. The use of the concept of wholly obtained does not feature in NAFTA or any other NAFTA-model-oriented rules of origin. As a matter of fact, this use of the concept of wholly obtained products has been object of fierce discussions in the drafting of the harmonized non-preferential rules of origin.[112]

The EC architecture of rules of origin provides, as do many other sets of rules, for the definition of wholly obtained products.[113] According to this concept wholly obtained products qualify as originating by virtue of the total absence of imported inputs. The NAFTA approach based on the tariff shift does not recognize the use of the wholly obtained definition as a product-specific requirement. Even in the case of products classified in Chapter 1 of the HS, live animals, a change of chapter (CC) is required under the NAFTA approach even if such a CC is impossible given the structure of the HS.

If we compare the substance of the rules, meaning how many processes have to be performed on the imported inputs to obtain origin, it can be observed that The EC rules for products of Chapter 16 are more stringent than the NAFTA rules. In the case of the EC, to manufacture originating products classified in Chapter 16 the manufacture has to use materials of Chapter 1 – live animals – or materials from Chapter 3 – fish and crustaceans, mollusks, and other aquatic invertebrates – provided that these latter materials used are wholly obtained. This means that it is not possible to use imported meat to process it into meat preparations. In the case in which imported inputs are used live animals have to be slaughtered in that country, and then the meat could be used to make meat preparation classified in Chapter 16. In the case of

[112] See supra Chapter 2.

[113] See the list of wholly obtained products in the Pan-European rules of origin. See Section 3.2.2.1.1.

TABLE 3.17. *Comparison of product-specific rules for Chapter 16 between Pan-European and NAFTA*

HS code number	Description of goods	NAFTA rules[114]	EC rules[115]
Chapter 16	Preparations of meat, of fish or of crustaceans, mollusks, or other aquatic invertebrates	A change to heading 16.01 through 16.05 from any other chapter	Manufacture from animals of Chapter 1. All the materials of Chapter 3 used must be wholly obtained.

fish preparations, the rule is even stricter because it requires the use of wholly obtained fish, i.e., fish originating in that country that have has been fished in that country,[116] according to EC rules of origin. Conversely, in NAFTA, rules of origin for Chapter 16 are more lenient as they allow the use products of Chapter 2[117] classifying meat that could be processed into products of Chapter 16. The same could be said for fish preparations. Therefore, it is sufficient to start a manufacturing process from meat or meat offal that is fresh, chilled, frozen, or salted[118] into a good of Chapter 16, instead of starting from the live animal – born or raised – as provided by the EC.

Table 3.18 compares EC and NAFTA rules for textiles classified in Chapter 60. Chapter 60 includes textile fabrics that are manufactured, not like woven fabrics by interlacing warp and weft threads, but by the production of a series of interlinking loops, regardless of which of the textiles is used.[119]

[114] *Source*: North American Free Trade Agreement between the Government of Canada, the Government of Mexico, and the Government of the United States of America – NAFTA – *Annex 401: Specific Rules of Origin*.

[115] *Source*: Europe Agreement establishing an association between the European Communities and their member-states, acting within the framework of the European Union, of the one part, and the Republic of Slovenia, of the other part – *Protocol 4* concerning the definition of the concept of 'originating products' and methods of administrative cooperation – Official *Journal L 051, 26/02/1999 P. 0003 – 0206*.

[116] See Section 3.2.2.

[117] Chapter 2 means Meat and Edible Meat Offal. So that Meat and meat offal unsuitable or unfit for human consumption are excluded. As explained in *Customs Co-operation Council, Harmonized Commodity Description and Coding System – Explanatory Notes*.

[118] See General introduction to chapter 2. *Customs Co-operation Council, Harmonized Commodity Description and Coding System – Explanatory Notes*.

[119] See: *Customs Co-operation Council, Harmonized Commodity Description and Coding System – Explanatory Notes*.

TABLE 3.18. *Comparison of product-specific rules for Chapter 60 between Pan-European and NAFTA*

HS code number	Description of goods	NAFTA rules	EC rules
Chapter 60	Knitted or crocheted fabrics	A change to heading 60.01 through 60.02 from any other chapter, except from heading 51.06 through 51.13,[120] Chapter 52,[121] heading 53.07 through 53.08[122] or 53.10 through 53.11[123] or Chapters 54[124] through 55.[125]	Manufacture from[126] • Natural fibers; • Manmade staple fibers not carded or combed or otherwise processed for spinning; or • Chemical materials or textile pulp.

The EC rule of origin requires a specific working or manufacturing process by indicating the nature of the imported inputs, such as natural fibers that have to be spun into yarn and knitted and crocheted together to otain the fabrics.

In the case of NAFTA the first indent of the rule requires that a change from any other chapter be origin conferring, but the rest of the rule provides for a wide range of exceptions expressed as imported materials classified in headings that cannot be used. Once the description of the materials classified in the headings subject to exception is identified, it is possible to find out if the materials excluded are the whole cotton chapter or other vegetable fibers.[127]

[120] That is, the manufacture of the following materials into goods of Chapter 60 is not origin conferring; the materials are yarn of wool or fine animal hair, carded or combed wool, not put up for retail sale; yarn of wool or fine animal hair for retail sale; yarn of coarse animal hair or of horsehair, whether or not put up for retail sale; woven fabric of wool or fine animal hair, carded or combed, or woven fabric of coarse animal hair or of horsehair.

[121] This chapter corresponds to cotton.

[122] That is, the manufacture of the following materials into goods of Chapter 60 is not origin conferring; the materials are yarn of jute or of other textile-based fibers; yarn of other vegetable textile fibers; paper yarn.

[123] That is, the manufacture of the following materials into goods of Chapter 60 is not origin conferring; the materials are woven fabric of jute or of other textile-based fibers; woven fabric of other vegetable textile fibers; woven fabric of paper yarn.

[124] This chapter corresponds to manmade filaments.

[125] This chapter corresponds to manmade staple fibers.

[126] For special conditions relating to products made of a mixture of textile materials, see explanatory notes to the protocols on rules of origin concerning all Pan-Euro rules of origin.

[127] For more details, see footnotes of NAFTA rules for Chapter 60.

The EC rules of origin for knitted and crocheted fabric cotton require at least two operations. In effect, a manufacture from natural fibers[128] into knitted or crocheted fabrics entails the processing of spinning and either knitting or crocheting. The NAFTA rule provides the change from any other chapter, but excluding for instance Chapter 52, which corresponds to cotton products. If a manufacturer of cotton fabric wishes to comply with this product-specific NAFTA rule of origin there is no other solution to fulfill that using wholly obtained cotton products originating in NAFTA countries.

Chapter 61 classifies articles of apparel and clothing accessories, knitted or crocheted. For certain articles of apparel of this chapter[129] the Pan-European rules of origin usually requires two manufacturing operations, namely weaving from yarn into fabric or parts and making up. Thus in a FTA with the EC it is possible to import yarn and then carry out the necessary processes to comply with the rule of origin. For the other goods[130] classified in Chapter 61, the Pan-European rules of origin require the same rule as under Chapter 60.

For the NAFTA rules of origin excerpted in Table 3.19 it is possible to identify a *fiber forward*.[131] This is a rather strict rule of origin that exists for certain textile and apparel articles made of fibers that are produced in abundance in Canada, Mexico, and the United States.

As explained by the Customs Guide to NAFTA Implementation,[132] less strict rules of origin govern certain knitted underwear, brassieres, and shirts made from fabric not commonly produced in North America. For example, silk[133] and linen[134] apparel articles requires a single-transformation rule. Therefore, silk blouses, heading no. 61.06.90, are considered originating even if they are made from nonoriginating fabric, as long as the fabric is cut and sewn in one or more NAFTA countries. These exceptions give producers flexibility to import

[128] See introductory notes to the list of product-specific rules in European Community Agreement. Note 4: (1) the term "natural fibers" is used in the list to refer to fibers other than artificial or synthetic fibers. It is restricted to the stages before spinning takes place, including waste, and, unless otherwise specified, includes fibers that have been carded, combed, or otherwise processed but not spun; (2) the term "natural fibers" includes . . . the cotton fibers of heading 52 01 to 52 03 – i.e. cotton, not carded or combed; cotton waste; cotton, carded or combed.

[129] Obtained by sewing together or otherwise assembling, two or more pieces of knitted or crocheted fabric that have been either cut to form or obtained directly to form.

[130] Other than goods obtained by sewing together or otherwise assembling, two or more pieces of knitted or crocheted fabric which have been either cut to form or obtained directly to form.

[131] See Trilateral Customs Guide to NAFTA. www.ccra-adcr.gc.ca.

[132] See www.aaatrading.com/nafta/guide, but also www.customs.gov/nafta/docs/us/guidproc.html.

[133] Silk is incorporated in Chapter 50.

[134] Flax is incorporated in Chapter 53.

TABLE 3.19. *Comparison of product-specific rules for Chapter 61 between Pan-European and NAFTA*

HS code number	Description of goods	NAFTA rules	EC Rules
Chapter 61	Articles of apparel and clothing accessories, knitted or crocheted	A change at subheading level through all Chapter 61 from any other chapter except from heading 51.06 through 51.13, 52.04 through 52.12,[135] 53.07 through 53.08 or 53.10 through 53.11, Chapter 54 or heading 55.08 through 55.16[136] or 60.01 through 60.02,[137] provided that: (a) the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the Parties, and (b) the visible lining fabric listed in Note 1 to Chapter 61 satisfies the tariff change requirements provided therein.[138,139,140]	Manufacture from yarn[141] Manufacture from[142] • natural fibers; • manmade staple fibers not carded or combed or otherwise processed for spinning; or • chemical materials or textile pulp.

[135] That is, the manufacture of the following materials into goods of Chapter 61 is not origin conferring; the materials are cotton sewing thread for put up for sale or not; cotton yarn (other than sewing thread) combed or not for retail sale or not containing 85 percent of cotton; woven cotton containing at least 85 percent of cotton whether bleached or not, dyed or printed; woven cotton containing at least 85 percent of cotton, with manmade fiber, whether bleached or not, dyed or printed.

[136] That is, the manufacture of the following materials into goods of Chapter 61 is not origin conferring; the materials are sewing thread of synthetic or artificial staple fibers; yarn (other than sewing thread), 85 percent nylon, other polyamide, polyester, acrylic or modacrylic, other synthetic, or artificial staple fiber (manmade) not for retail sale; yarn of manmade staple fibers mixed with artificial staple fiber, or wool or fine animal hair, or cotton, not put up for sale; yarn of manmade staple fibers, not for retail sale; woven fabric, 85 percent of manmade staple fiber, unbleached or bleached or other than unbleached or bleached; fabric containing less than 85 percent manmade staple fiber, with cotton; woven fabric of manmade staple fiber, with or without viscose rayon staple fiber, manmade filaments, wool or fine animal hair; woven fabric, 85 percent manmade staple fiber, unbleached or bleached, dyed, yarn dyed, printed; woven fabric of artificial staple fiber, unbleached or bleached, dyed, yarn dyed, printed.

[137] That is, the manufacture of the following materials into goods of Chapter 61 is not origin conferring; the materials are long pile knitted or crocheted textile fabric; looped pile knitted or crocheted fabric, of cotton, manmade fibers or other textile materials; pile knitted or crocheted fabric, of cotton, manmade fiber or other textile materials; warp knitted fabric, of wool or fine animal hair, cotton, manmade fibers or other materials; knitted or crocheted fabric, of wool or of fine animal hair, cotton, manmade fibers or other materials.

[138] See also *Annex* 300-B (Textile and Apparel Goods), Appendix 6(A) of NAFTA.

materials not widely produced in North America. Actually the basic origin rule for textile and apparel articles is *yarn forward*. This means that the yarn used to form the fabric that will be later used to manufacture the finished apparel must originate in a NAFTA country. Thus a wool shirt made in Canada from fabric woven in Canada of wool[143] using yarn originating in Argentina is not considered originating, because the yarn does not originate within a NAFTA country. If, however, Argentine wool fiber was imported into Canada and spun into wool yarn, and was then used to produce the wool fabric, the shirt is considered originating.

Moreover, certain apparel must satisfy Note 1 to Chapter 61. The note provides a tariff shift for visible lining fabric from headings listed in the note itself. (See Table 3.19).

As shown in Table 3.20, the NAFTA product-specific rules of origin for Chapter 62, articles of apparel and clothing accessories not knitted or crocheted, are not substantially different from the one for Chapter 61 because a fiber-forward rule is required. Under the Pan-European rules of origin the product-specific rules provisions set for Chapter 62 require the manufacturing from yarn.

In some cases specific headings have different requirements. For example, the product-specific rule for heading 62.10 requires the manufacture from manufacture from yarn or manufacture from unembroidered fabric, provided that the value of the unembroidered fabric used does not exceed 40 percent of the ex-works price of the product. Suppose that the customs value of the uncoated

[139] See NAFTA Rule 1 to Chapter 61. *A change to any of the following headings or subheadings for visible lining fabrics: 51.11 through 51.12, 5208.31 through 5208.59, 5209.31 through 5209.59, 5210.31 through 5210.59, 5211.31 through 5211.59, 5212.13 through 5212.15, 5212.23 through 5212.25, 5407.42 through 5407.44, 5407.52 through 5407.54, 5407.61, 5407.72 through 5407.74, 5407.82 through 5407.84, 5407.92 through 5407.94, 5408.22 through 5408.24 (excluding tariff item 5408.22.aa, 5408.23.aa or 5408.24.aa), 5408.32 through 5408.34, 5512.19, 5512.29, 5512.99, 5513.21 through 5513.49, 5514.21 through 5515.99, 5516.12 through 5516.14, 5516.22 through 5516.24, 5516.32 through 5516.34, 5516.42 through 5516.44, 5516.92 through 5516.94, 6001.10, 6001.92, 6002.43 or 6002.91 through 6002.93, from any heading outside that group*.

[140] See NAFTA Rule 2 to Chapter 61. *For purposes of determining the origin of a good of this chapter, the rule applicable to that good shall only apply to the component that determines the tariff classification of the good and such component must satisfy the tariff change requirements set out in the rule for that good. If the rule requires that the good must also satisfy the tariff change requirements for visible lining fabrics listed in Note 1 to this chapter, such requirement shall only apply to the visible lining fabric in the main body of the garment, excluding sleeves, which covers the largest surface area, and shall not apply to removable linings.*

[141] Obtained by sewing together or otherwise assembling two or more piece of knitted or crocheted fabrics that have been either cut to form or obtained directly to form.

[142] Obtained by sewing together or otherwise assembling two or more piece of knitted or crocheted fabrics that have been either cut to form or obtained directly to form.

[143] Wool is incorporated in Chapter 51.

TABLE 3.20. *Comparison of product-specific rules for Chapter 62 between Pan-European and NAFTA*

HS code number	Description of goods	NAFTA rules	EC rules
(*EC description*) Ex[144] Chapter 62	Articles of apparel and clothing accessories, not knitted or crocheted except for:	A change to subheading 6201.19 from any other chapter, except from heading 51.06 through 41.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapter 54, or heading 55.08 through 55.16, 58.01 through 58.02 or 60.01 through 60.02, provided that the good is both cut and sewn or otherwise assembled in the territory of one or more of the Parties.	Manufacture from yarn[145]
ex 62.02	Women's, girls' and babies' clothing and clothing accessories for babies, embroidered	A change to subheading 6202.91 through 6202.93 from any other chapter, except from heading 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapter 54, or heading 55.08 through 55.16, 58.01 through 58.02 or 60.01 through 60.02, provided that: (a) the good is both cut and sewn or otherwise assembled in the territory of one or more of the Parties, and (b) the visible lining fabric listed in Note 1 to Chapter 62 satisfies the tariff change requirements provided therein.	Manufacture from yarn or manufacture from unembroidered fabric provided the value of the unembroidered fabric used does not exceed 40 percent of the ex-works price of the product

[144] See introductory Notes to the list, Note 2:

2.1 The first two columns in the list describe the product obtained. The first column gives the heading number or chapter number used in the Harmonized System and the second column gives the description of goods used in that system for that heading or chapter. For each entry in the first two columns, a rule is specified in columns 3 or 4. Where, in some cases, an "ex" precedes the entry in the first column, this signifies that the rules in columns 3 or 4 apply only to the part of that heading as described in column 2.

[145] For special conditions relating to products made of a mixture of textile materials, see Introductory Note 5 and 6 to the explanatory notes of the protocols on rules of origin annexed to FTAs entered by the EC.

TABLE 3.21. *Comparison of product-specific rules for heading 8407 between Pan-European and NAFTA*

HS code number	Description	NAFTA rules	EC rules
8407	Spark-ignition reciprocating or rotary internal combustion piston engines	A change to heading 84.07 *through* 84.08 from any other heading, including another heading within that group, provided there is a RVC of not less than (a) 60 percent where the transaction value method is used; Or (b) 50 percent where the net cost method is used.	Manufacture in which • The value of all the materials used does not exceed 40 percent of the ex-works price of the product.

fabric used is 900 and the ex-work price of the finished fire-resistant equipment is 2,300. The following is the calculation to be carried out :

$$100 : 2300 = X : 900,$$
$$X = 39 \text{ percent.}$$

Because 39 percent is less than the maximum amount of 40 percent, the product is originating.

In the case of machinery, both NAFTA and the Pan-European rules of origin largely adopt rules based on a percentage criterion. Obviously, the level of percentage and the methodology of calculations is entirely different, as outlined in Table 3.21.

4

The Economics of Rules of Origin

4.1. The Basic Tenets of Rules of Origin and Economics

Until recently, trade economists paid little attention to rules of origin. The literature on the economic effects of rules of origin was comparatively limited up to the beginning of the 1990s. In the traditional literature, the main issues that were approached were the following:

- the effect that rules of origin have on the allocation of resources within one country, and hence on efficiency and welfare;
- whether rules of origin guarantee the achievement of the objectives that underlie the trade instrument under which they are adopted;
- the effect of rules of origin in schemes of economic integration (FTAs, customs unions) particularly as regards the incentive they might represent for "rent seeking"/lobbying activities.

Most of the economic models that were developed did not directly refer to rules of origin but, more generally, to schemes of "local content protection." According to these schemes, local producers are allowed to import inputs and raw materials free of duty so long as the final products contain a minimum percentage of local value added. These models can be adapted to rules of origin issues because, in both cases, the failure to reach a minimum of local value-added results in the obligation to pay a tariff. The difference is, of course, that in the case of rules of origin requirements, the tariff will have to be paid on the exports of the final product, whereas in the case of local content schemes the tariffs will be paid on the imports of the intermediate inputs. It should also be noted that local content models can be adapted not only to rules of origin requirements contained in preferential trade agreements but also to those that relate to antidumping (AD) actions or quotas, although the

TABLE 4.1. *Example of possible implications for noncompliance and application of trade instruments*

Rationale for rules of origin requirement	Implications for noncompliance of rules of origin requirement
Preferential rules of origin	Exports will not be entitled to benefit from the preferential tariff rate
Antidumping	Exports may be subject to antidumping duties
Selective quotas	Exports will not be allowed on the market

implications for noncompliance is quite different in these three cases, as indicated in Table 4.1.

However, some qualifications are in order because the circumventing behavior of the firms that are subject to local content/rules of origin requirements can be very diverse. In fact, in the case of AD and selective quotas, circumvention will imply the establishment of production facilities in the territory of the *importing* country or a third country for the assembly of inputs that originate from countries that are subject to the restrictive measures or the relocation of manufacturing to a third country. In contrast, circumvention of preferential rules of origin implies the establishment of production facilities in the territory of the *exporting* countries for the assembly of inputs that originate from countries that are excluded from the preferential market access arrangements. Legally speaking, these occurrences may also lead to different consequences.

Thus the adaptation of local content models to the reality of rules of origin regulations requires some caution. Additionally, caution is needed because of the standard assumptions on which these models are based (perfect competition on the markets of both the final product and the intermediate inputs, etc.).

It has also been noted that, because rules of origin tend to increase the demand for locally produced intermediates, these rules may be utilized for the so-called "directly unproductive profit-seeking activities," that is, lobbying activities pursued by big industrial groups and business associations. This has been and will continue to be the case, especially during negotiations of free-trade areas (FTAs).

However, these initial findings on the effect of rules of origin have some clear limitations that need to be taken into account:

1. If the rule is not binding, its effect will be nil: In other words, if the efficient combination of the imported and the locally produced input requires a

percentage of the former that producers already met, then they will not need to modify their production mix in the favor of local producers of intermediates.
2. If the rule is too stringent, its effect may also be nil. If the efficient combination of the imported and the locally produced input requires a percentage of the imported inputs that is much lower than the one actually used by producers, then the costs of compliance with the rules may be higher than the anticipated savings in tariffs. In other words, producers of the final goods will not find it economically advantageous to comply with the requirement.

In addition, the final effect of rules of origin on the demand of locally produced inputs also depends on the following:

1. The elasticity of substitution[1] between the imported and the locally produced inputs (the higher the elasticity, the easier it is to substitute the locally produced for the imported, and thus the larger the effect on demand of locally produced inputs).
2. The difference in price between the local and the imported intermediate (the more costly the local inputs, the more difficult the substitution will be, and hence the smaller the effect on the demand of locally produced inputs).
3. The magnitude of the preferential tariff margin or of the AD duty.
4. The elasticity of supply of local production (in fact, if the price of the local intermediate good increases substantially as demand increases, substitution in favor of the locally produced inputs will be limited, and thus the effect on the demand will be smaller).
5. The costs connected to the documentary evidence and administrative paperwork to demonstrate the proof of origin (the higher the costs, the lower the profitability of meeting the requirements, and hence the lower the effect on the demand of the intermediate inputs).

The ultimate consequences to be drawn from the utilization of the local content model to rules of origin is that the increase in demand for nationally produced intermediates has a cost in terms of efficiency and welfare. In fact, such rules are incentives for producers to deviate from the efficient mix of imported and locally produced inputs.

[1] Elasticity of substitution is defined as the percentage of change in the demand for one good resulting from a percentage of change in the relative price of the substitute good. For some early works on economics and rules of origin see P. J. Lloyd, "A tariff substitute for rules of origin in free trade areas," *The World Economy*, 16(6), 1993.

4.1.1. Recent Developments on the Analysis of the Economic Effects of Rules of Origin

At the beginning of the 1990s, the formation of FTAs in North America generated new interest in the issue of rules of origin and the analysis of their economic impact.

Contractual rules of origin are clearly at the very core of FTAs because they ensure that preferential market access will be granted only to goods that have actually been "substantially transformed" within the area, and not to goods that are produced elsewhere and simply transshipped through one for the member-countries. In the absence of rules of origin, it would not be possible to discriminate against imports from third countries, so that the significance of regional integration would be drastically diminished.

Traditionally, the main reason for the existence of rules of origin in FTAs is the preoccupation with trade deflection. In a FTA, each country maintains its own external tariff and commercial policy in relation to outside trading partners. To the extent that the tariffs and commercial policy are different with regard to third countries, the incentive exists to import a good through the country with the most liberal import regime and tariffs. In that case, importers and producers will eventually operate minimal transformation and finally they will reexport the goods toward the countries with the higher tariffs. To sum up, it would be equivalent to a tariff circumvention operation.[2]

In recent years, and especially following the North American Free-Trade Agreement (NAFTA) experience, rules of origin in FTAs have been used as a trade policy instrument to make the tariff preference dependant on the utilization of regional inputs. The case of the yarn-forward rules where garments made in Mexico may benefit of the tariff preference only if U.S. textile material is utilized is a classic example.

Thus stringent rules of origin in FTAs are the result of complicated trade and industry considerations and negotiations. However, the more stringent they are, the more prevalent trade diversion may become, because producers from the integrated area will favor intermediate inputs originating there in spite of their higher cost in comparison with inputs from countries outside the

[2] Trade deflection does not have, *per se*, a negative economic effect; in fact, it may, from an economic point of view, be considered equivalent to a reduction in the tariffs of a high-tariff country and thus indeed positive for its economic efficiency. It is, however, regarded as a negative phenomenon because it does not correspond to the objectives of FTAs' contracting parties. Taken to its extreme, trade deflection could go beyond the original intention of the contracting parties by transforming the original FTA into a customs union in which the external tariffs will be determined by the country applying the lower tariffs.

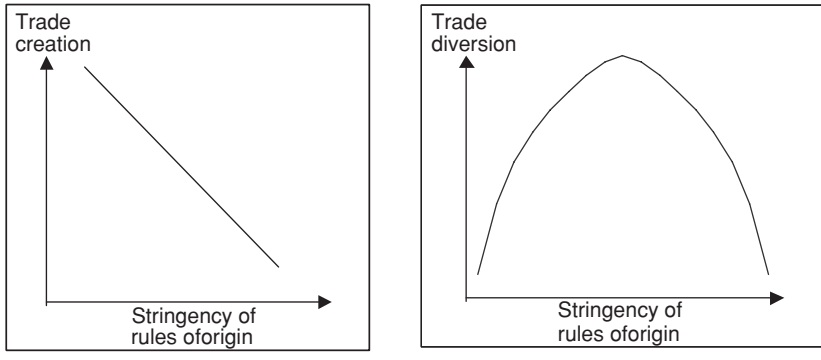


FIGURE 4.1. Effects of stringency of rules of origin on trade creation and trade diversion

FTA. Thus trade diversion will be greater, the higher the preferential margin associated with origin compliance and the less costly the compliance with rules of origin and related administration costs.

In the case of unilateral rules of origin, the conventional wisdom of preference-giving countries is that trade preferences are granted to goods genuinely manufactured in the beneficiary countries and not to goods simply transshipped or made the object of minimal working or processing in the beneficiary countries just to take advantage of the trade preferences.

On the one hand, rules of origin are a secondary trade policy instrument necessary to attain the developmental policy objective underlying the granting of trade preferences, that is, export increases, industrialization, and ultimate economic growth.

On the other hand, beneficiary's countries have maintained since the inception of the first set of unilateral rules of origin under the Generalized System of Preferences (GSP) schemes that rules of origin are one of the main obstacles to the utilization of trade preferences.[3]

Figure 4.1 depicts in simple terms the effects of stringency of rules of origin on trade creation and trade diversion, conveying the reason why preferential rules of origin are such an important dimension of the trade effects of trade preferences.

It should be intuitive that, as rules of origin become stricter and thus more difficult to fulfill, trade creation[4] falls. In fact, either manufacturers will find progressively that the cost of compliance with rules of origin exceeds the value of the margin of preference or the required inputs are simply not available

[3] See various reports of the UNCTAD Working Group on Rules of Origin established in 1970.

[4] Trade creation is defined as the reduction in the domestic production of goods, which are substituted by imports from partner countries.

in the domestic market. Noncompliance with rules of origin implies that the most-favored-nation (MFN) rate of duty will be charged at the time of customs clearance. Thus trade effects expected from trade preferences will be nil.

Although trade effects of trade diversion are more evident in the case of contractual rules of origin, they may also play or deter significant trade effects when unilateral trade preferences are granted on cumulation requirements.[5] Liberal rules of origin are easy to fulfill and could reduce the incentive to source from within the region unless these inputs are really competitive.

Suppose that under a particular regional agreement the transformation of fabrics into ready-made garments is origin conferring. Producers of garments will then be encouraged to continue to source fabrics from within or outside the region from the most competitive supplier, transform them into ready-made clothing, and then export them to partner countries.

If, alternatively, the product-specific rules of origin require that the manufacturing start from imported yarn, but not from imported fabrics, producers of garments will be encouraged to start sourcing fabrics from within the region unless they want to invest in further manufacturing by carrying out the weaving operations from imported yarn. However, sourcing fabrics within the region may imply a trade-diverting effect or investment in textile manufacturing. This example is a reality and a current dilemma in the case of Bangladesh, Cambodia, and other developing countries, small suppliers of garments.

However, when rules of origin under a trade diversion scenario become very stringent, a second, similar effect starts to kick in – the cost of compliance becomes so high that it exceeds the margin of preference. This not only will reduce the incentive to source from a partner country products that were previously sourced from outside the region, but, taken to its extreme, will again result in noncompliance with rules of origin requirements with consequent denial of preferential rate of duty resulting in no trade effects.

Thus expected trade and development effects of trade preferences may, on the one hand, be limited or frustrated by an excessive stringency of the rules of origin requirements attached to the granting of the preferential tariff treatment. On the other hand, the greater the preferential margin and more liberal and not burdensome for the manufacturing industries of the beneficiary countries rules of origin are, the greater the effects that may be expected from the trade preferences.

The lesson to be learned is that when rules of origin are excessively stringent, not matching the current industrial capacity of beneficiary countries,

[5] Trade diversion is defined as the reduction in imports from countries that are not members of the regional agreements and that are substituted by imports from partner countries.

or totally offset a commercially meaningful preferential margin, trade effects of preferences are equal to zero because the MFN rate of duty will be applied.

A pioneer study conducted by Herin[6] measured that impact of rules of origin in the FTA between the European Free-Trade Area (EFTA) and the European Economic Community (EEC). In that study, it was found that many EFTA exporters preferred to pay MFN duties rather than comply with the rules of origin in cases in which the preferential margin was not significant.

Krueger[7] later examined the impact of rules of origin on intermediate products in NAFTA. One of the most convincing arguments of the potential "hidden" protectionism of rules of origin has been elaborated on by Krishna and Krueger [1995] who argued that rules of origin can induce a switch in the sourcing of low-cost nonregional to high-cost regional inputs for producers to take advantage of the preferential rates. Because the tariff applies to the transaction value of final goods whenever preferences are deep and rules of origin are restrictive, there is an incentive for regional producers to buy intermediate goods from regional sources. So by displacing low-cost intermediate goods from the rest of the world, restrictive rules of origin provide additional protection to regional producers of intermediate goods to the apparent detriment of downstream or final goods producers. This apparent conflict could be explained because of the specific production relations that exist between component producers and users. If the linkages between the different parts of the production chain are very tight, it may be difficult for a foreign final good producer to locate components within the region and remain competitive. In this way, rules of origin are somewhat "exporting protection" both for the intermediate and the final goods producers.

Moreover, outside producers of intermediate goods hurt by restrictive rules of origin may have an incentive to move production facilities into the lower-cost country within the region, even though it is not the cost-effective producer worldwide. This situation could potentially distort efficient investment decisions and hinder the liberalizing effects of a FTA.

In particular, Krueger was able to pinpoint in economic terms what was at that time the rule of the game when negotiators and lawyers were involved in NAFTA. It provided an economic reading and logic by transposing a partial equilibrium model theory to the ongoing logic of the negotiations.

[6] See Herin, J., Rules of origin and differences between tariff levels in EFTA and EC, EFTA Occasional Paper N. 13.

[7] See Krueger A., Free Trade Agreements as Protectionist Devices: Rules of Origin. 1993.

At that time, the U.S. negotiators argued especially in case of import-sensitive sectors like textiles and clothing for restrictive rules of origin. Krueger pointed out that restrictive rules of origin in free-trade agreements can constitute a source of bias toward economic inefficiency.

A country like Mexico, with a MFN zero tariff for intermediates b, could find its producers post-FTA diverting their imports from low-cost third-country sources to the United States to be eligible for NAFTA preferential treatment even if, as pointed out, there are no Mexican tariffs on the imports of their intermediate products.

Krueger further reasoned this effect could be generated by restrictive rules of origin: a shift by Mexican producers from low-cost world suppliers to a high-cost U.S. supplier to qualify with rule of origin and gain preferential access to U.S. market.

Another important point gathered was the role that rules of origin may play in the political economy game to win support for a FTA. A later finding on of the effects NAFTA rules of origin was pointed out by Krishna (2004).[8]

Rules of origin can have the effect of insulating an industry from the possible trade liberalization of an FTA. It follows that rules of origin may be modeled according to the political economy to make a FTA more or less acceptable to certain domestic constituencies. The effects of rules of origin on costs of production depicted by Krishna are shown in Figure 4.2.

In Figure 4.2, excerpted from Krishna (2004), *L* and *K* are respectively FTA inputs (*L*) and imported inputs (*K*). To manufacture a finished product, a mixture of *L* and *K* has to be used. In the absence of a binding rule of origin, a producer may freely utilize inputs in *L* and *K* according to the best available sourcing to manufacture the finished product. This is represented by the point label representing the best available mix in the absence of binding rules of origin. The height of the line *AB* represents the lowest unit cost attainable. Binding rules of origin will oblige the producer to change the optimum mix of *L* and *K* inputs and would remove Z from the feasible set.

Suppose the rules of origin require the use of more inputs originating in the FTA as represented in the ray $\alpha > \alpha_{\circ}$. In this case, the input mix at X represents the minimal unit costs and the line *DE* represents unit costs if rules of origin are met. It is easy to note that as line *DE* is higher than line *AB*, unit costs are increased and will continue to do so as more *L* inputs are demanded by the binding rules of origin in the product mix.

[8] See K. Krishna, "Understanding rules of origin," paper prepared for a workshop on Rules of Origin in Regional Trade Agreements: conceptual and empirical approaches, 2004.

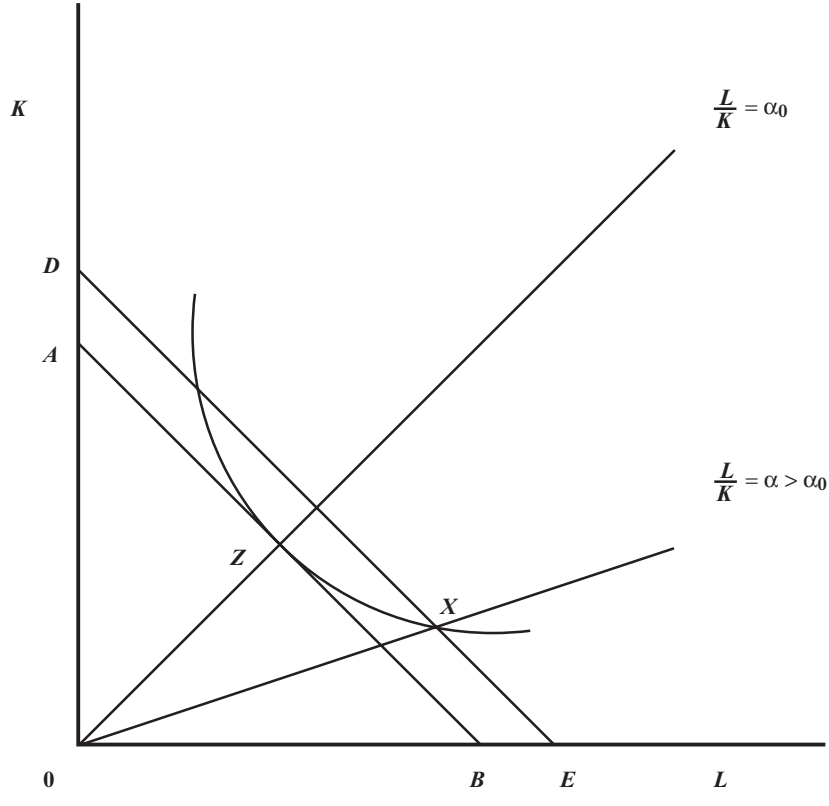


FIGURE 4.2. Physical content of rules of origin and costs

4.1.2. Most Recent Studies on Economics and Rules of Origin: The Elaboration of an Index of Restrictiveness

After Krueger and Krishna, Esterdeavordal (1999 and 2002) advanced a series of elaborate studies centered on the NAFTA model of rules of origin, and their possible impact and evolution in the framework of the FTAs of the Americas. In particular, his studies have elaborated a particular methodology for the measuring the restrictiveness of rules of origin in relation to a tariff phase-out schedule negotiated under NAFTA.[9] Similar assessments were later conducted in the framework of the Pan-European rules to prepare Mercosur Countries

[9] See "Negotiating preferential market access: the case of NAFTA," Inter-American Development Bank, June 1999.

for eventual negotiations of an interregional free-trade area agreement with the EC.[10]

Ultimately the index of restrictiveness elaborated by Estedeavordal has been often used, in a series of econometric papers running regressions. The index of restrictiveness was used in conjunction with the degree or speed of preferential tariff liberalization measured by the number of years to achieve zero intra-agreement tariffs. This latter variable was provided by the tariffs phase-out schedule of NAFTA. According to the structure of the liberalization program, each product line at eight digits Harmonized System (HS) (or in some cases at 10 digits) is associated with a specific phase-out program. This first measurement was designed to identify those tariff lines that were backloaded to match them with the respective rules of origin.

The index of the level of restrictiveness of the NAFTA rules of origin was modeled on the characteristics of NAFTA rules. According to Estedeavordal, rules of origin in the NAFTA agreement were negotiated at the product level (mostly at the six-digit tariff line level) and were defined using three methods: (1) a tariff shift, (2) a regional value content (RVC), or (3) a technical requirement (TECH). The first criterion can be specified as requiring a change at the section level (two-digit HS), heading level (four-digit HS), subheading level (six-digit HS), or item level (higher than six-digit HS), with the possibility of including specific exceptions. The three methods could also be combined under the same rules of origin, for example, a change of subheading plus a specific RVC and a technical requirement. Moreover, there are many cases in which the agreement defines alternative rules of origin for the same product. To obtain the restrictiveness index, Estedeavordal codified each rule or set of rules according to different criteria.

Then, a qualitatively ordered index was constructed under the following assumptions elaborated by Estedeavordal: First, a change of tariff classification (CTC) at the section level tends to be more stringent than at the heading level, a change at the heading level more than at the subheading level, and so on. Second, a regional content requirement adds more restrictiveness to a given rule, as does the technical requirement. For each pair (or sometimes trio) of alternative rules being applied to the same product, Estedeavordal selects the one with the higher restrictiveness index.

A categorical variable rules of origin has been devised accordingly. The index is structured on the basis of a numerical order where number 1 is the more

[10] Rules of origin in FTAs in Europe and the Americas: issues and implications for EC–Mercosur interregional Association agreement. INTAL- ITD, Working paper 15, January 2004.

lenient rule and number 7 the more restrictive. Level 1 occurs when the rule requires a change of tariff item or less. At level 2 the rule requires more than a change of tariff item but is equal to or less than a change of tariff subheading (CTSH). At level 3 the rule requires more than a CTSH but is equal to or less than a CTSH and RVC. At level 4 the rule requires more than a CTSH and RVC but is equal to or less than a change of tariff heading (CTH). At level 5 the rule requires more than a change of tariff level but is equal to or less than CTH and RVC. At level 6 the rule requires more than a change of tariff level and a RVC but is equal to or less than a change of chapter (CC). Finally, at level 7 the rule requires more than a CC but is equal to or less than a CC or technical requirement.

The main limitation of this index is that the starting assumption is based on premises that do not match the reality of the structure of the HS as it is used in the context of drafting rules of origin requirements. The second limitation is that the restrictiveness of rules of origin has to be measured, not against methods of drafting of rules, but against the products, the trade flows, and the manufacturing capacity of countries they are designed to be regulating.

As is widely known, the HS has been conceived for tariff classification and not for drafting rules of origin. It follows that assuming that a change of tariff item (in this case at the eight-digit level) is more lenient than a CTSH is rather arbitrary. As witnessed in the negotiations of nonpreferential rules of origin, there are entire chapters of the HS in which a CTSH may be extremely restrictive. Such is the case of chemical products, which an important chemical reaction may not be reflected in a change of subheading.

It is quite difficult, if not impossible, to classify the level of restrictiveness of rules of origin using the classification made by Estedeavordal. The following examples illustrate these difficulties. Let's assume we are classifying the level of restrictiveness of the rules in the following section excerpted from NAFTA by using Estedeavordal index:

Rule 1 "A *change to heading 6205.90 from any other chapter, except from heading Nos. 51.06 through 51.13, 52.04 through 52.12 . . . provided that the good is both cut and sewn or otherwise assembled in the territory of one or more of the NAFTA parties.*"

Rule 2 "*A change to heading 62.06 through 62.10 from any other chapter, except from headings Nos. 51.06 through 51.13 . . . provided that the good is both cut and sewn or otherwise assembled in the territory of one or more of the NAFTA countries.*"

Rule 3 *"A change to heading 61.05 through 61.06 from any other chapter, except from headings Nos. 51.06 through 51.13, 52.04 through 52.12 . . . provided that the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the NAFTA parties."*

Rule 4 *"A change to heading 63.02 from any other chapter, except from headings Nos. 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapters 54 through 55, or heading Nos. 58.01 through 58.02 or 60.01 through 60.02 provided that the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the NAFTA parties."*

Because none of these rules includes a RVC, the choice in the level of restrictiveness according to the Estedeavordal index is among level 1 or level 2. Because the rules require more than a change of tariff item, one may classify all the rules under level 2 or if one considers that the requirements of the cutting and sewing are technical requirements under level 7. However, a closer look at rules 1 to 4 indicates that they are very different in terms of restrictiveness.

Rule 1 depicts a single transformation requirement from woven silk to a silk shirt. Rule 2 requires a double transformation: (1) the processing of the fabric and (2) the production of the apparel.

Rule 3 requires a triple transformation or yarn forward: from the manufacturing of the yarn to men's shorts. Rule 4 provides for an extremely stringent rule requiring a quadruple transformation.

This example shows that even if the drafting style of rules in this case, *"A change to heading. . . . from any other chapter, except from headings . . ."* might be similar and falling under a certain level of restrictiveness according to Estedeavordal's description the substantive requirements and the corresponding level of restrictiveness may vary considerably.

Estevadeordal and Suominen (2003 and 2005)[11] subsequently introduced a number of modifications to the initial observation rules just outlined. These changes were made in the context of a worldwide analysis and comparison of different origin systems including the Pan-European rules of origin and rules of origin negotiated under South–South agreements.

The modifications were as follows:

- A value content (VC) rule (up to 50 percent) is equated to a CTH rule, both being assigned an index value of four.
- When a VC requirement allows more than 50 percent nonoriginating content, or when it is combined with a technical requirement (TECH),

[11] See above in Note 10.

the resulting criterion (or combination of criteria) is assigned a value of five.

- An exception (EXC) requirement alone is assigned a value of one if the exception concerns a heading or number of headings, and a value of two if the exception concerns a chapter or number of chapters.
- A wholly obtained requirement is assigned a value of seven.

This revision of the index improved somewhat the methodology, however, it remains difficult to assess the criteria and benchmark for the assumptions made by Estedeavordal in assigning a certain level of restrictiveness and equivalence between different methodologies of drafting rules of origin. As shown in the preceding examples apparently similar drafting techniques may result in wide differences of the level of restrictiveness among rules of origin.

Nonetheless, the index of Estevadeordal and Suominen was, according to scholars and economists, instrumental in making the empirical analysis of rules of origin possible. Such an index has been used extensively in carrying out analysis on NAFTA rules of origin[12] using regressions.

After these modifications to the restrictiveness index, other analysts further elaborated it. Most recently, Cadot and De Melo in an analysis[13] carried out in the context of the negotiations of Economic Partnership Agreements (EPAs) between African, Caribbean, and Pacific (ACP) Countries and the European Community (EC) introduced further modifications. It was observed that the index did not take allowances into consideration, although these can substantially alter the restrictiveness of rules of origins. Second, it treated "wholly obtained" criteria as the strictest form of rules of origins. In this respect it was considered that the classification may be misleading as wholly obtained criteria essentially apply to agricultural products for which they are considered rarely problematic to comply with.

The merit of the modifications of De Melo and Cadot to the original index is that they tried to codify what they define as "additional requirements": exceptions and allowances to the basic CTC criteria.

The De Melo and Cadot index is not substantially different from the index developed by Estedeavordal to capture the effects of the product-specific rules of origin under NAFTA. However, the authors introduced significant variations because many of the EC rules of origin are defined at the HS four-digit level, whereas the NAFTA rules of origin for industrial products are generally defined at the six-digit level. To take into account these differences, an index at the HS

[12] See for instance Cadot: Assessing the effect of NAFTA rules of origin, 2002, mimeo.

[13] The rules of origin facing ESA Trade: Analysis and proposals for EPA negotiations, Cadot, De Melo Tumurchudur, mimeo, 2005.

TABLE 4.2. *Textiles rules mainly involving products classified in ex-headings and basket rule headings*

HS heading no.	Description of product	Working or processing carried out on nonoriginating materials that confers originating status	
(1)	(2)	(3) or	(4)
ex Chapter 62	Articles of apparel and clothing accessories, not knitted or crocheted except for:	Manufacture from yarn	
ex 6202, ex 6204, ex 6206, ex 6209 and ex 6211	Women's, girls,' and babies' clothing and clothing accessories for babies, embroidered	Manufacture from yarn	Manufacture from unembroidered fabric provided that the value of the unembroidered fabric used does not exceed 40 percent of the ex-works price of the product

six-digit level that corresponds to the 5,485 lines was worked out by the authors. In spite of the authors remarks, it is not clear how the correspondence between the EC rules of origin and the HS six-digit index has been carried out. In fact, there are significant variations in the architecture of the NAFTA and EC rules of origin that may affect the accuracy of such transposition.

This correspondence could have important implications for the results of the analysis given the structure of the EC rules of origin as contained in the Single List. An example of such implications is given in the following section.

As shown in Table 4.2, in the majority of cases the EC rules provide for a chapter rule containing the product-specific rules of origin for the majority of products classified in a HS chapter. This rule is commonly referred to as a "chapter rule." In Chapter 62, the chapter rule of origin is manufacture from yarn. In some specific instances the EC rules singled out some headings out of a chapter rule by marking them by "ex" and some specific description. In the EC explanatory notes, "ex" means that the product-specific rules of origin in column 3 or 4, distinct from the chapter rule, apply only to part of that heading as described in column 2.

Because the degrees of stringency vary considerably from chapter-wide rules of origin to ex-rules of origin (as in the preceding example). The EC describes the product-specific rules as mainly HS two-digit chapter level, four-digit

heading level, or ex- of four-digit level (heading level). It is, therefore, difficult to make concordances between ex-product-specific rules and a HS 6-digit level rules. In Table 4.2, heading ex 62.02, ex 6204, ex 6206, ex 6209, and ex 6211 with the description of column 2 should be matched with corresponding subheadings. It is not clear how these important aspects of the EC rules have been taken into account in building this index.

In spite of these characteristics of the EC rules of origin, according to De Melo and Cadot, the most commonly used requirement for satisfying the "substantial transformation" in the case of the EC is the CTC rule whereby nonoriginating inputs must be classified in a different Chapter (Change of Chapter – ΔC), a change of Heading (Change of Heading – ΔH), Subheading (Change of Subheading – ΔSH), and Item (change of Item – ΔI), followed by the product.

In line with Estedeavordal, they assumed that the change of chapter requirement is more restrictive than the requirement of a change of heading (ΔH), which in turn is more restrictive than the change of Subheading (ΔSH). Therefore, as far as the CTC is concerned, they assumed the following descending order of restrictiveness:

$$\Delta C > \Delta H > \Delta SH > \Delta I.$$

The merit in the Cadot and De Melo index and elaboration of the index is that they realized that the CTC is seldom used in its simple form and that several complications such as exceptions to the simple CTC may occur, as pointed in the previous comments made to the Estedeavordal original index. Although such observation could have further refined the index, some confusion was made between the concept of negative determination of origin and those of exceptions to the simple CTC.

According to Cadot and De Melo, "a positive test states the tariff classification of imported inputs that can be used in the production of the exported good (for example those in a different subheading). By contrast a negative test states the case when a change of tariff classification does not confer origin. A negative test is presumably more restrictive than a positive test."[14] This distinction, they argued, is not captured in their index.

[14] Leaving aside the legal aspects of this assumption, paragraph (3) (b) of Annex of the agreement on rules of origin of the Common Declaration on preferential rules of origin negative provides that "*their preferential rules of origin are based on a positive standard. Preferential rules of origin that state what does not confer preferential origin (negative standard) are permissible as part of a clarification of a positive standard or in individual cases where a positive determination of preferential origin is not necessary*."

To explain this assumption, Cadot and De Melo quoted two examples of negative tests. "In the case of NAFTA, to protect Mexican producers of tomato paste from Chilean producers (see Palmeter (1997)), ketchup (HS 210320) produced from imported tomatoes or from any chapter will confer origin except when produced from imported tomato paste (HS 200290). In the case of Pan-Euro, bread, biscuits, and pastry products (HS 1905) can be made from any imported products except those of chapter 11 (i.e. flour)."

However, in the same paper they provide examples of what they consider *exceptions*:

> *"Exceptions (EXC). Another important aspect of ROO* [rules of origin] *is the presence of exceptions to the CTC. For example, any non-originating inputs can be used for the production of soups and broths of heading 2104 except from heading 2002 to 2005 (prepared of preserved vegetables). Therefore exceptions reduce the universe of permitted non-originating materials, thereby making a given ROO requirement more restrictive."* (excerpt from Cadot and De Melo)

It follows that the distinction between *negative test* and *exception* is at the least contradictory in light of the wording of the NAFTA rules for tomato ketchup used as the example for a negative test: "2103.20. A change to tariff item No. 2103.20.10 from any other chapter, except from subheading No. 2002.90."

The wording *except from* quoted as *negative test* in the first observation is classified as *an exception* in the second observation. The bottom line is that one may paraphrase the rule for tomato ketchup to make it sound like a negative test whereas in reality it is nothing but a CTC with exception. Obviously this kind of confusion may cast serious doubts as to the final results of the analysis and the accuracy of the index.

Cadot and De Melo also included in their elaboration of the index the concept of *allowances* and *alternative composite rules* coupled with a series of assumptions on assigning values of restrictiveness to such additional concepts.

According to their definitions, allowances are as important as exceptions in evaluating the restrictiveness of a given rules of origin system. *"For example, the ROO for builders' joinery and carpentry of wood under heading 4418 says that all non originating materials must not have a same heading; however cellular wood panels, shingles and shakes of same heading may be used. Thus, this allowance increases the amount of eligible inputs from non-member countries and makes a given ROO requirement less restrictive."*

The case of *alternative composite rule* derives from the fact that in some instances the EC allows for a choice between alternative composite rules to determine the origin of a product.

Table 4.3 is the most recent form of the Cadot and De Melo restrictiveness index.

TABLE 4.3. *Cadot and De Melo restrictiveness index*

Index value	Criteria (y^*)			
	1st	2nd	3rd	4th
	NC			
	EXC	Allow		
	ΔSH	Allow		
1	ΔWH	Allow		
	ΔSH			
	EXC	WH		
2	TECH			
		WH		
	ΔSH	TECH		
	TECH	EXC		
3	ΔH	Allow		
	ΔH	EXC	Allow	
		vc2		
	VC >40 percent	Nonor		
4	WH	EXC	TECH	
		vc2		
	VC<=40 percent	Nonor		
		WH		
		TECH		
		EXC		
		EXC	TECH	
		VC>40 percent		
		VC>40 percent	Nonor	
	ΔH	VC>40 percent	Allow	
		TECH		
		WH		
		ΔSH		
5	VC >40 percent	WH	Nonor	
		TECH		
		WH		
		ΔSH		
	VC <=40 percent	WH	Nonor	
		VC<=40 percent		
		VC<=40 percent	WH	Allow
		VC<=40 percent	Nonor	
		VC<=40 percent	Allow	
		VC>40 percent	TECH	
		VC>40 percent	TECH	EXC
	ΔH	WH	TECH	EXC
		TECH		
6	ΔC	EXC		
		VC<=40 percent	TECH	
		VC<=40 percent	TECH	EXC
	ΔH	EXC	TECH	VC
		EXC	TECH	
		EXC	TECH	WH
7	ΔC	EXC	TECH	VC

As pointed out by the authors, there is little difference between the most recent form of their index with previous ones elaborated on the basis of the original of Estevadeordal. It follows that the previous comments on the accuracy of the Estevadeordal index are still valid. The main fine-tuning concerns the refinement of the value assignment to the wholly obtained product. In the latest index formulation the wholly obtained category was assigned a level of stringency of 1 for products classified in Sections 1 to 3 of the HS, whereas for products in Sections 4 to 21 a value of 4 was assigned. A value of 6 or 7 is assigned if the wholly obtained category is associated with value content or a CTC. Once again one may raise several doubts about the assumptions made in assigning such values.

At the same time, it is worth reporting the comparison made by Cadot and De Melo of the final results on the degree of stringency of the Pan-Euro rules of origin using the two different indexes.

As can be observed from Table 4.4, the main difference between the Cadot and De Melo index and the Estedeavordal index is the treatment of the wholly obtained criterion that shows up in the new index's low value for the first three sections.

The important factor to consider is that the index elaborated by Estedeavordal and subsequently by Cadot and De Melo has been used widely in a variety of econometric studies utilizing regressions. As indicated in the preceding paragraphs, several doubts could be raised of the results of these regressions that are based on an index of restrictiveness that does not reflect the technical meaning of the rules of origin.

Moreover, such an index of restrictiveness is calculated in abstract and is not matched with the industrial and manufacturing capacity of the countries in which the rules of origin are designed to operate.

To partially cover this aspect, a "composition" effect has been carried out by Cadot and De Melo for a subgroup of ACP countries. Such a composition, however, simply matched the index of restrictiveness with the export structure of concerned countries. Such an exercise may provide preliminary indications on the countries and products that may be most affected by stringent rules of origin but may also provide misleading results because it combines an abstract index with an export structure of a country but it does not match it with its natural endowments and manufacturing capacity.

In fact, the level of restrictiveness of a given rule of origin cannot be calculated, delinking it from the natural endowment and industrial context in which it is designed to operate.

A yarn-forward rule for cotton garments is often quoted as one of the most restrictive requirements. Countries like China or India that have vertically integrated manufacturing capacity and comparative advantage will have

TABLE 4.4. *Alternative indexes of SL PSRO restrictiveness*[a]

Section	New rules of origin index[a]	ES's rules of origin index for Pan-Euro
1. Live animals	1.04	7.00
2. Vegetable products	2.23	6.60
3. Fats and oils	3.44	4.70
4. Food, bev & tobacco	3.95	5.00
5. Mineral products	3.26	3.50
6. Chemicals	3.29	3.90
7. Plastics	4.48	4.90
8. Leather goods	3.12	3.30
9. Wood products	2.74	2.90
10. Pulp & paper	4.67	4.40
11. Textile & apparel	5.75	6.10
12. Footwear	2.79	2.80
13. Stone & glass	4.03	3.70
14. Jewelry	4.13	3.70
15. Base metals	4.61	4.20
16. Machinery & elect. eq.	4.99	4.80
17. Transport equip.	4.86	4.70
18. Optics	4.98	5.00
19. Arms & ammunition	5.00	4.00
20. Miscellaneous	4.13	4.10
Total	**4.21**	**4.50**

[a] SL = Single List; PSRO = product-specific rules of origin.

considerable less difficulty complying with such a rule than the average least-developed country (LDC).

The wholly obtained requirement has also been rated as a stringent requirement. However, for countries that have an export structure concentrated in a handful of agricultural products, such a requirement is rather easy to comply with.

A CC, with exceptions, is considered a rather demanding requirement. Assuming a rule of origin requiring for pasta products a CC except for flours from Chapter 11 would have very different implications for countries that have milling capacities and those who do not. The former countries would find it very easy to comply because they can import the cereals, mill them to obtain the flour, and make the pasta out of it. For the latter, compliance with the rules can be achieved only by either importing cereals and establishing their own milling capacity or milling into flour domestic cereals, if they grow them.

Some of these considerations were taken into account in a study by the Overseas Development Institute (ODI).[15] The aim of the study was to draw some possible policy recommendations for reform of EC rules of origin. This study set two alternative goals for the origin rules. The first goal is to avoid trade deflection, and it is described as the "essential goal." The second goal is described as "additional function" and seeks to encourage firms in developing countries to undertake more processing or to use more domestic or regional intermediates by making this a condition to obtain the tariff preferences.

The study seeks to identify the benchmarks to fulfill the "essential goal" of the rules of origin in terms of value added by carrying out two types of analysis. The first analysis is somewhat similar to the composite effect described in the case of Cadot and De Melo. By analyzing trade flows of developing countries to the EC, it identifies those products for which rules of origin are likely to be most relevant.

These results in terms of HS headings are then matched, not with an index of restrictiveness, but with United Nations Industrial Development Organization (UNIDO) statistics on valued added and then compared with the Cotonou requirement on value added. Not surprisingly, the results show that there are wide variations among countries and products and wide average differences with the value-added level required by Cotonou.

The second analysis is based on a modeling exercise using a partial equilibrium model. In both cases the starting point are the UNIDO statistics on value added in manufacturing. Such statistics are based on a calculation of the value added as percentage of labor and operating surplus on the overall value of the output. Such percentages of value added are calculated according to the UNIDO user manual of the UNIDO statistics database:

> *"the measure of value-added normally reported is the census concept, which is defined as the value of census output less the value of census input, which covers*:
> *(a) value of materials and supplies for production (including cost of all fuel and purchased electricity); and (b) cost of industrial services received (mainly payments for contract and commission work and repair and maintenance work)."*

There is a series of observations to make on the how such a definition of value added tallies with the various calculations of valued added according to EC or NAFTA formulas and how UNIDO statistics could be used to assess rules of origin. The most obvious is that, as seen in the preceding chapter, there are a multitude of forms of numerator and denominator to calculate value added, resulting in different outcomes. None of the methods of calculation seem to

[15] See "Creating Development Friendly rules of origin in the EU," August 2006.

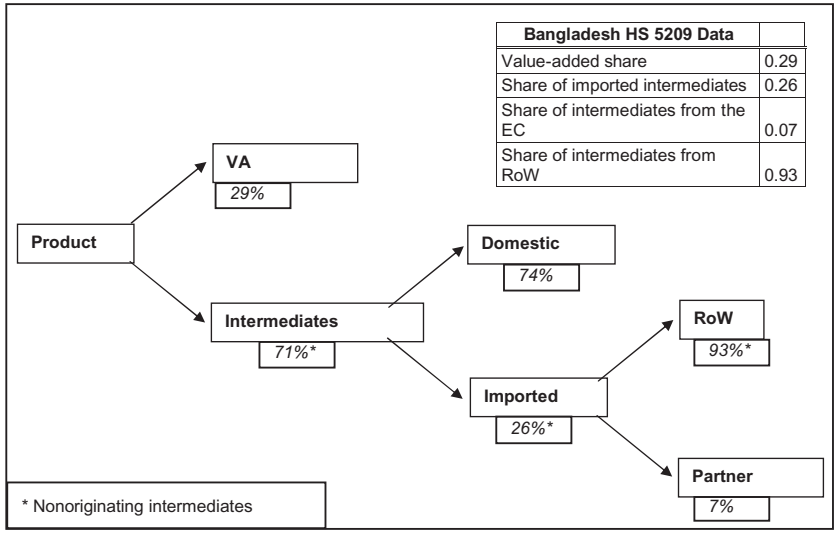


FIGURE 4.3. Calculation of value added and rules of origin restrictiveness. *Source:* ODI.

be close to the preceding method used by UNIDO. It is also important to note that cost of fuel and purchased electricity are defined under most of the rules of origin, including the EC rules of origin as "neutral elements" (i.e., are not computed in the calculation of valued added).[16] Finally, as acknowledged in the study, there are also some aggregation and concordance problems because the value-added data are classified according to the International Standard Industrial Classification (ISIC) four-digit level of aggregation that has to be matched with the HS.

Apart from these initial points, the modeling exercise carried out in the study also demands some comments. The positive side of the modeling is that it takes into consideration as the real constraining factor of rules of origin the issue of the use of intermediate materials, as shown in Figure 4.3.

Such a positive feature is counteracted by a number of assumptions and averages that are made in the model. The first assumption is to divide the

[16] See for instance Article 11 of EU Tunisia Agreement titled Neutral elements: In order to determine whether a product is an originating product, it shall not be necessary to determine the origin of the following which might be used in its manufacture:
(a) energy and fuel;
(b) plant and equipment;
(c) machines and tools;
(d) goods which neither enter into the final composition of the product nor are intended to do so.

value of the finished good between intermediate and value added using the UNIDO statistics. The second assumption is that there is no definition of intermediate products. Normally intermediate products in the context of rules of origin are upstream products that are used in the production of the finished product. These intermediate products may be, as correctly indicated in the figure, imported or produced domestically. The important factor, however, is that they are highly product specific. For example, in the case of woven textiles of HS 5209 the most immediate intermediate product is the yarn that could be sourced domestically or could be imported. This is precisely where the rules of origin are constraining because they mostly regulate the use of intermediate products. However, unless the definition of intermediate product is product specific, the measurement of the degree of constraint of certain rules is based on rather abstract assumptions.

4.1.3. Some Preliminary Conclusions on the Status of the Economic Analysis on Rules of Origin

Three most striking observations could be made to the ongoing work on analyzing the economic impact on rules of origin. The first observation is the almost total lack of a multidisciplinary approach in the analysis carried out so far. Rules of origin are a complex issue involving different skills and backgrounds ranging from legal to customs aspects. Unless these technicalities are reflected in the construction of indexes to be used in regressions, the final results of the exercise may be misleading.

A second observation is made in relation to the context and purposes for which these analyses have been carried out. In the case in which such an approach is restrained to use in theoretical exercises and academic discussions, the consequences may be limited. However, the bulk of such analysis has been conducted to draw policy conclusions on the best form of rules of origin to be adopted in a given context. Often these analyses have been commissioned by international organizations to advise developing countries in their negotiations on rules of origin. In this area the consequences of adopting approaches that do not consider the multifaceted reality of rules of origin and their technical dimension are potentially far reaching.

Policy conclusions on how to draft rules of origin from regressions carried out under debatable assumptions may lead to flawed policy recommendations when the study has been carried out to provide advice to negotiators and trade policy makers. This holds especially true when such policy conclusions appear delinked from the results of the analysis and are, from a technical point of view, highly debatable. For instance, the conclusions of the Cadot and

De Melo study indicate, as an example of a sound rule of origin the following (resembling the one adopted by the Common Market for Eastern and Southern Africa [COMESA], and proposed by Brenton et al. 2004):

- a single CTH, or
- a minimum of 30 percent regional value added, or
- nonoriginating materials not to exceed 50 percent of the value of total inputs.

As discussed in Chapter 5, even if at first sight the use of alternative criteria may appear business friendly and leading to simplification, in reality such an approach is not coherent in terms of level of restrictiveness, and its technical soundness is highly debatable as it may lead to a different origin outcome for the same product, depending on the rules of origin used. Other recommendations of this kind are contained in an extensive policy report[17] on preferential rules of origin in the Asian region. In this report it has been suggested that, in addition to the value-added rule criteria, a CTC be introduced as an additional choice to (and not instead of) the value-added rule, implemented as a common rule across products (for example, change at the heading or four-digit level) and if additional, product-specific exemptions are introduced to the General Rule, they are kept to a minimum.

This suggestion again ignores the fact that the HS design is used as a customs nomenclature and not for rules of origin purposes. The introduction of a common CTH rule across products entails a series of undesirable implications, as explained in Chapter 5, that have to redressed by product-specific rules of origin. The latest consolidated version of Harmonization Work Program (HWP) on nonpreferential rules of origin discussed in Chapter 2 provides valuable examples of the merits and limits of a CTH rule.

The third and perhaps most important observation is that the level of restrictiveness of rules of origin cannot be determined in the abstract. They must be related to the manufacturing capacity and trade flows of the countries where they are meant to operate.

This is an area in which, so far, little analysis has been carried out. It is hoped that in the future the multidisciplinary nature of the rules of origin is better respected among the research and academic communities to better serve the common cause of economic development, especially in developing countries and LDCs.

[17] See Trade issues in East Asia: preferential rules of origin, Policy Research report, June 2007, World Bank, 40216.

4.2. Assessing the Impact of Rules of Origin: Evidence from the Utilization of Trade Preferences under the Generalized System of Preferences

The first multilaterally agreed form of trade preferences was the Generalized System of Preferences (GSP), conceived during the early years of United Nations Conference on Trade and Development (UNCTAD). Within UNCTAD, intergovernmental bodies were created to monitor the performance of the GSP. Throughout the three decades of the existence of the GSP, the UNCTAD Working Group on Rules of Origin and the Special Committee on Preferences have used the utilization rate of the GSP as one of the performance criteria of the GSP. Thus there is wealth of lessons learned and experience that may be useful to draw on for an examination of the issue of the effect of rules of origin on the utilization of trade preferences.

UNCTAD's traditional methodology of assessing the performance of the GSP used a series of indicators as reported in the intergovernmental documents prepared for the Special Committee on Preferences since the early 1970s. These indicators are as follows:

- **Product coverage**, defined as the ratio between imports that are covered by a preferential trade arrangement and total dutiable imports from the beneficiaries' countries. The higher the percentage, the more generous the preferences may appear, depending on the structure of dutiable imports of the beneficiary countries. Coverage does not automatically mean that preferences are granted at the time of customs clearance.
- **Utilization rate**, defined as the ratio between imports actually receiving preference and covered imports. This rate is based on the customs declaration made by the importer at the time of importation. As further examined in the following section, higher or lower utilization rates are mainly the result of the stringency and/or complexity of rules of origin and ancillary requirements. In some cases, exporters may have not submitted the necessary documentation (such as a certificate of origin or through bill of lading) to get preferential treatment because of lack of knowledge or incorrect information.
- **Utility rate**, defined as the ratio of imports actually receiving preference and all dutiable imports (covered or not), refers to the percentage of total dutiable imports that receive preferences. A low level of this ratio means that a large part of dutiable imports (either covered or not) pay the MFN rate.

From the rules of origin perspective, the most important indicator to measure the effect of rules of origin on trade preferences is the utilization rate.

The trade flows on the utilization rates have been notified by the preference-giving countries since the early years of the GSP to permit UNCTAD to discharge its mandate to monitor the performance of the GSP. Utilization rates are computed on the basis of the customs declarations made by the importer at the time of importation.

As a result, they may not be totally accurate in reporting the actual utilization because the importer may claim a preference that may be subsequently denied or may claim a preference for a good that has been granted duty free on a MFN basis. Adjustments are made by the central statistical offices of the preference-giving countries to reflect some of these occurrences. Despite these limitations, trade data notified by preference-giving countries have been largely considered and accepted as reliable sources for conducting analysis on utilization of trade preferences.

As pointed out earlier,[18] traditional methodology outside UNCTAD often assumed that preferences were fully utilized. Market access for developing countries has been analyzed on the assumption that MFN rates were not considered a real market access obstacle because of existing trade preferences.

Contrary to this conventional wisdom, the mere granting of tariff preferences or duty-free market access to exports originating in beneficiary countries does not automatically ensure that the trade preferences are effectively utilized. Preferences are conditional on the fulfillment of an array of requirements related to rules of origin, that, in many instances, beneficiary countries may not be able to comply with.[19]

Recent literature,[20] driven by the flourishing of unilateral and contractual preferential trading, has increasingly indicated rules of origin as prime suspects of underutilization of trade preferences and distortion in FTAs. In spite of the evidence contained in various UNCTAD reports and related studies, since

[18] See Inama, S. "Market access for LDCs, issues to be addressed," *Journal of World Trade*, vol. 36, no.1, February 2002, and UNCTAD "Improving market access for least developed countries," UNCTAD/DITC/TNCD/4, 2 May 2001.

[19] As a matter of fact, this is a day-to-day business. For instance, the UNCTAD secretariat has been maintaining, since the inception of the GSP, a register of customs stamps and signatures of issuing authorities of GSP Form A (GSP Form A is a specific certificate of origin form). Routinely, the UNCTAD members notify UNCTAD of changes in signatures and stamps and the secretariat circulates such notification to all UNCTAD member-states. Quite often urgent calls are made to the UNCTAD secretariat from importers and clearing agents about shipments blocked at the time of customs clearance in a preference-giving country for the simple reason that the stamps and signatures are not the same as those registered. Failures to comply with the rules entail application of the MFN rate.

[20] See for instance, Estevadeordal, A. "Negotiating market access, the use of the North America Free Trade Area Agreement," *Journal of World Trade*, 34(1), 2000, and Brenton, P. "Integrating the least developed countries into the world trading system: The current impact of EU preferences under Everything But Arms," *World Bank*, February 2003.

the last decade, part of this literature is still discussing the empirical foundation of the relation between rules of origin and low utilization rates as a new finding rather than acknowledged reality. Nevertheless, the fact that utilization rate is strictly linked to origin requirements is very clear to beneficiary countries.

As early as 1983, Mexico, at that time a beneficiary of the U.S. GSP scheme,[21] showed that, out of a total of $788.9 million Mexican exports that could have benefited from GSP in 1983, and for which in principle there was no limitation apart from the presentation of origin certificates, 58.7 percent ($462.2 million) comprised goods whose preference margin was less than 5 percent. For such goods, the main reason for the nonuse of preference has been this low margin compared with the more costly administrative requirement needed to establish compliance with the origin rules. The remaining 41.3 percent of exports, with a preference margin exceeding 5 percent, largely represented cases in which the goods had failed to satisfy the origin rules.

As discussed in Chapter 5, preference-receiving countries reported in those years to the UNCTAD committee on rules of origin that insuperable obstacles were caused by the need to devise and operate an accounting system that differed in the definition of concept, application of accounts, precision, scope, and control from its internal legal requirements. The system must provide the cost information to satisfy the rules of the countries of destination, and to check the shares of domestic and imported inputs in the unit cost of the exported goods, in some cases identifying the country of origin of the inputs and establishing direct and indirect processing costs. This often required (and still requires) data-processing techniques that are not in common use, especially in small- and medium-sized enterprises. Also, it was found that the willingness of enterprises to change or adopt accounting systems different from normal systems depends on the volume of exports, the share of such exports in total sales, and the cost involved.[22] In addition, the expenditure incurred in operating a parallel accounting system may outweigh the benefit of tariff preferences, such as where the preferential margin is less than 5 percent.[23]

For instance, a UNCTAD study conducted in 1973 on rules of origin in the textile and clothing industry pointed out that current multistage processes were going "far beyond the conceivable limits of substantive transformation."

Because these textile and clothing rules of origin have undergone only limited changes and modification since 1973, it may be interesting to contrast

[21] See UNCTAD document TD/B/C.5/WG(X)/2, p. 6.
[22] See UNCTAD document TD/B/C.5/WG(X)/2, p. 6.
[23] Ibid. p. 5.

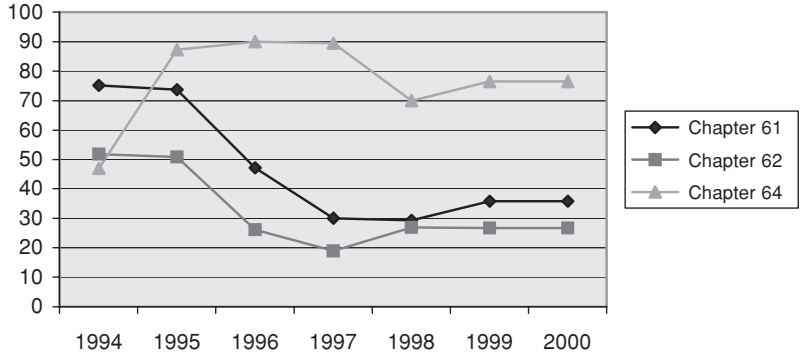


FIGURE 4.4. Average utilization rate of selected Asian non-LDCs, by HS Chapters 61 and 62 (garments) and 64 (footwear) (1994–2000)

them with some more recent data on utilization of trade preferences in this area.

Figure 4.4 depicts the utilization rates of Asian non-LDCs (average utilization rates of India, Philippines, Viet Nam, and Sri Lanka) sectors for Chapter 61 (articles of apparel and clothing accessories, knitted or crocheted), Chapter 62 (articles of apparel and clothing accessories, not knitted or crocheted), and Chapter 64 (footwear, and the like, parts of such articles) under the EC-GSP scheme in the period 1994 to 2000. It shows that, since 1995, there has been rather progressive but drastic lowering of the utilization rate.

Figure 4.5 depicts the average utilization rates of Cambodia, Laos, and Bangladesh for Chapters 61 and 62 from 1994 to 2005. As can be seen, in more than a decade the utilization rate has been steadily low for Chapter 62 for these three Asian LDCs only reaching almost 50 percent in 2005. As far as

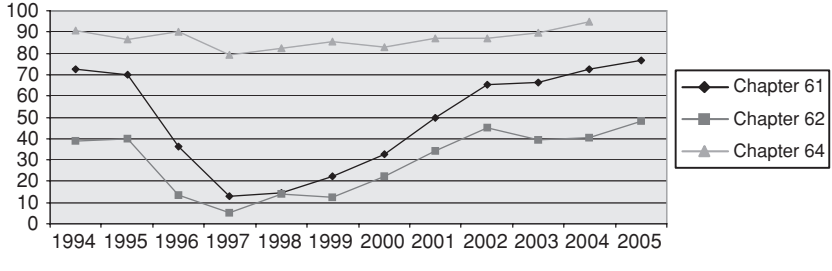


FIGURE 4.5. Average utilization of Bangladesh, Cambodia, and Laos – HS Chapters 61, 62, and 64, 1995–2005

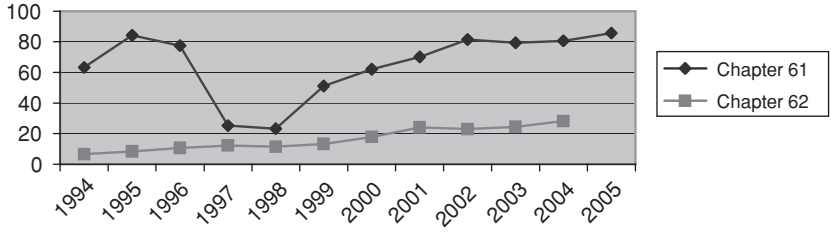


FIGURE 4.6. Bangladesh: EC GSP utilization rates for HS Chapters 61 and 62 (garments) (1994–2005)

Chapter 61 is concerned, a rather progressive improvement has been recorded since 1998, mainly because of an improvement of rules of origin allowing for the use of imported yarn for certain knitted garments.[24]

For Chapter 62, the utilization rates of Cambodia and Bangladesh have been as low as 0.8 percent for Cambodia during the period 1997–1999 and 11 percent or lower for Bangladesh in the period 1994–1998, as shown in Figures 4.6 and 4.7.

As shown in the tables in the following section, in the case of Cambodia, low utilization was particularly striking in the last years of the new decade because they were granted a derogation on rules of origin requirements for certain textiles and clothing. However, such derogation was subject to quotas, rather complex administrative requirements, and did not include the current major suppliers of fabrics, which may largely affect the utilization rate of such derogation.[25] In the following subsection a more detailed analysis has been carried out on the period 1995–2000 using a combination of trade data and field visits.

[24] See also "Trade Preferences for LDCs: An Early Assessment and Possible Improvements," UNCTAD, 2003.

[25] Commission Regulation (EC) no. 292/2002 amending Regulation (EC) no. 1614/2000 derogating from Regulation (EEC) no. 2454/93 with respect to the definition of the concept of originating products used for the purposes of the scheme of generalized preferences to take account of the special situation of Cambodia regarding certain exports of textiles to the Community (OJ 2002 L 46, p. 14). Commission Regulation (EC) no. 291/2002 amending Regulation (EC) no. 1613/2000 derogating from Regulation (EEC) no. 2454/93 with respect to the definition of the concept of originating products used for the purposes of the scheme of generalized preferences to take account of the special situation of Laos regarding certain exports of textiles to the Community (OJ 2002 L 46, p. 12). These regulations are still in force until the end of 2008.

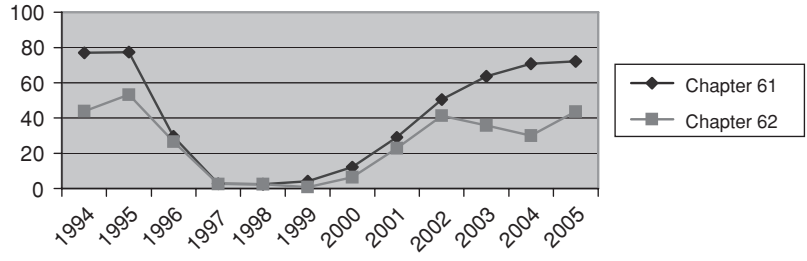


FIGURE 4.7. Cambodia: EC GSP utilization rates for HS Chapters 61 and 62 (garments) (1994–2005)

4.2.1. Linking Low Utilization of Preferences and Rules of Origin: A Methodology

The sourcing implications and related costs of restrictive rules of origin have been correctly identified by the first wave of papers looking at the economic implications of rules of origin. Krueger and Krishna as well as Palmeter (examined in subsection 4.1.2) provided valuable examples of the difficulties and related costs that Mexican producers of textiles and garments had in order to comply with NAFTA rules of origin to gain access to the North American market.

The subsequent wave of authors, starting with Estedeavordal and more recently with Cadot and De Melo (also examined in, subsection 4.1.2), made extensive use of the utilization rates in examining the economic impact of rules origin. In short, recent economic literature discussed in the preceding sections is making ample use of the utilization rates. However, little or no analysis is carried out at a product-specific level to exactly identify the reasons for such low utilization. Although it is widely recognized that low utilization is mainly a function of how rules of origin constrain the use of intermediate materials, little or no empirical analysis has been carried out so far to further examine the implications on stringent rules of origin on preference utilization.

This section reports the results of an analysis on the utilization rate in Cambodia and Bangladesh using the available trade data for 1994–2001 and as far as utilization rate is concerned for 1994–2005. The preliminary results of the desk analysis were subsequently verified during country visits through direct interviews with producers. More particularly, on the basis of the trends of utilization rates recorded further analysis has been conducted to detect and identify the reasons for such low or minimal utilization. Trade preferences of Cambodia

and Bangladesh under the EC GSP schemes have been sampled because they have been granted extensive trade preferences over neighboring countries that either graduated from the EC GSP as far as textiles and clothing are concerned or are not dependent on trade preferences to develop their export markets given their large supply capacity.

Second, Bangladesh and Cambodia have had a minimum base of relatively stable industrial capacity over the years, generating commercially meaningful trade flows of textile and clothing products.

Third, and perhaps most important, these countries are geographically positioned next to the most competitive suppliers of intermediary textile inputs (yarns and fabrics), China and India. Thus it is relatively easier to trace an established pattern of trade flows linked to constant and stable industrial relations and investment trends.

The analysis was conducted by breaking down the production chain of textile and clothing products on the basis of different textile materials (cotton, wool, manmade, synthetic) at different production stages.

The methodology's starting point identified the inputs and components of a specific finished product and matched them with the corresponding HS headings. As an example, the identification of some HS headings for some textiles and clothing items corresponding to the "production chains" of finished garments is outlined below. Starting from the raw material, the sequencing of production stages to get to the finished product has been determined. A similar methodology is suggested in Chapter 5 to draft product-specific rules of origin.

For instance, the production chain for articles of apparel and clothing accessories of cotton, not knitted or crocheted (of HS Chapter 62), can be set out as follows:

RAW COTTON (HS5201)

↓

CARDING OR COMBING

↓

CARDED OR COMBED COTTON (HS5203)

↓

SPINNING

↓

COTTON YARN (HS5205 — 5207)

↓

WEAVING

↓

WOVEN FABRICS OF COTTON (HS5208 – 5212)

↓

MAKING UP

↓

ARTICLES OF COTTON(ex Chapter 62)

In the case of knitted or crocheted articles of cotton (Chapter 61) the last two stages, *weaving* and *making up*, should be replaced with *knitting or crocheting* (knitted or crocheted fabrics of cotton – Chapter 60) and *making up* (knitted or crocheted articles of cotton – Chapter 61).

The same breakdown and identification of the corresponding HS headings and subheadings were carried out for other textile materials such as wool, manmade and synthetics. A subsequent step has been undertaken to match these headings with import statistics of the sample countries on a time series basis of 1994–2001. These data provided a map of imported inputs according to the level of manufacturing over the years and represented the first layer of the input matrix.

The other layer of the matrix represented the output, that is, the exported products of Chapters 60 (fabrics), 61 (garments, knitted or crocheted), and 62 (garments, not knitted or crocheted).

As a subsequent step, both input and output trade flows have been broken down respectively by country of origin for imports and country of destination of exports. The next step is to analyze and contrast the trade flows of imported inputs and their level of manufacturing in the production chain with the EC rules of origin requirements and draw possible conclusions. This analysis has been strengthened by field missions and discussions with the Garment Association in Cambodia and Laos.[26] Moreover, previous analysis has already demonstrated that local output of the different segments of textile inputs in Bangladesh and Cambodia is extremely limited.

As far as Bangladesh is concerned, detailed figures have been reported in a UNCTAD study.[27] It was outlined that the textile sector of Bangladesh consists

[26] See also "Erosion of trade preferences in the post Hong Kong framework: from "trade is better than aid" to "Aid for trade," UNCTAD, 2008.

[27] See Debapriya Bhattacharya, *The Post-MFA Challenges to the Bangladesh Textile and Clothing Sector* in Trade, Sustainable Development and Gender (UNCTAD/EDM/Misc.78, 1999).

of a fragile spinning subsector, a weak weaving subsector, an even weaker dyeing and finishing subsector, and an emerging knitting subsector.

In particular, it has been found that about 80 percent of the demand for yarn was met by imports. The total yarn demand of the country was expected to double by 2005, when 263 million kg will be required for domestic consumption and 554 million kg by the export-oriented ready-made garment (RMG) sector. Current yarn production capacity was expected to count for just 13 percent of the projected demand in 2005.

Most of the local fabrics were reported as unsuitable for the export-oriented RMG sector, which met 86 percent of its demand from imports. It was estimated that the fabric production capacity of Bangladesh would meet less than 15 percent of the projected requirements of 6.1 billion for 2005. In the dyeing and finishing subsector, in 1997, the number of units stood at 250, with an annual production capacity of only 653 million kg, which is also far from meeting the demand of the RMG industry.

These early predictions and findings have been confirmed by a comprehensive report on the status of the RMG sector in Bangladesh.[28] According to this report, despite all the incentives and large protective barriers, the woven fabric section of the textile sector has not been able to reduce the demand–supply gap. It can meet only about one-fifth of the total requirement of the woven RMG sector, and this situation has not changed much over the past five years. The excess demand for woven fabric (over and above domestic supply) has therefore increased over the years. The unavailability of domestic woven fabric not only increases lead time, but also explains the low utilization of trade preference in Chapter 62 and ultimately poses a serious constraint to export competitiveness.

In the case of Cambodia, studies carried out by the World Bank[29] and the Garment Manufacturers Association in Cambodia[30] found that Cambodia has practically no production of fabrics[31] or accessories and it has been fully dependent on imported inputs for garment exports.

[28] End of MFA Quotas: Key Issues and Strategic Options for Bangladesh Readymade Garment Industry, World Bank, 2005.

[29] See Yasuo Konishi, *Towards a Private Sector – Led Growth Strategy for Cambodia, Volume I: Value Chain Analysis*, prepared for The World Bank, June 2003.

[30] See Van David, *Case Study on Trade in Textiles & Clothing*, paper prepared for the UNDP Asia Trade Initiative, Cambodia, October 2003.

[31] Embryonic state of developing a cotton plantation by a U.S.-owned enterprise, Manhattan Textiles, in Cambodia produces currently, 120 MT of cotton fiber p.a. compared with its regular imports of 1,500 MT for its own factories needs.

Bearing in mind the preceding findings concerning the absence or the limitations of the textile inputs in Bangladesh and Cambodia, Figures 4.6 and 4.7 represent the utilization rates from 1994 to 2005 and are the starting point of the analysis. In the case of Bangladesh, it can be easily observed that the minimal utilization of trade preferences has been a constant feature in the exports of finished garments of Chapter 62. The relative positive peaks observed in Bangladesh for garments of Chapter 61 are counterbalanced by the drastic lower rates recorded in 1997 and 1998. These latter variations may be easily explained by the discovery of almost 10,000 wrongly issued certificates of origin by EC authorities, leading to a disruption of transitional trade flows (see box).

THE CASE OF BANGLADESH T-SHIRTS

In March 1995, the Customs of several EU member-states, intrigued by the increase in t-shirt imports from Bangladesh, decided to return systematically the certificates of origin Form A to the Department of Trade and Industry (DTI), asking to confirm the validity of such certificates.

During all of 1995, the DTI did not respond to the requests from the European Customs because there was no personnel in sufficient numbers to cope with this very important task. Under EU rules, a reply is expected within ***10 months maximum*** if the certificates are applicable or not (that means they are not false, and that the criteria of origin for the t-shirts were indeed respected).

Because the maximum delay (10 months) expired in December 1995, the EC decided to launch a post-clearance investigation concerning t-shirt imports from Bangladesh for the period 1993–95.

At the same time, the EC requested the Customs of the 15 Community member-states to gather the certificates of origin submitted by the European importers since 1993 for imports from Bangladesh.

The Community member-states gathered 9,000 certificates covering the period 1993–95.

On the basis of the analysis of trade flows, the EC concluded that the very rapid increase in the rate of these imports (+30 percent for 3 consecutive years) makes it possible to have doubts concerning the genuine origin of these t-shirts given the relative supply capacity of Bangladesh.

The EC decided to carry out a survey on the spot with the aid of customs officers of the Community member-states.

As a result of the on-the-spot investigation, a total of 5,000 certificates were considered inapplicable, according to the following reasons:

It was discovered that 4,000 certificates were issued wrongly, the criteria of origin not having been respected because imported yarn was used. In fact, according to

EU rules of origin for t-shirts, the yarn has to be already originating in the country or manufactured from imported raw cotton. 1,000 certificates were false because they were not issued by the DTI.

Following the withdrawal of the certificates of origin by the DTI, the EC initiated the procedure for the postclearance recovery of customs duty. As a result of these procedures, the European companies had to pay back the customs duties on all shipments covered by the wrongly issued certificates of origin and a customs penalty. This case had profound repercussions on the procedure to issue certificates of origin. Early in 1997, the DTI assembled the federations of products of textile and garments to explain that certificate of origin Form A will no longer be issued unless there is full compliance with the rules of origin requirements. This policy of stricter enforcement of rules of origin has probably led to the fall in the utilization rate in 1997–1998.

In the case of Bangladesh the real boost to the utilization rate in the knit garment manufacturing after 1998–1999 was given by the change in the applicable rules of origin. The relaxation of the stringency of the rules of origin in Chapter 61 moving from the requirement to use fibers to allow the use of imported yarn opened up a huge opportunity for the knit garment manufacturers. Many of them invested in integrated knit plants as the cost of investment was relatively modest. As a result of this change of rules of origin and the investments made, garments knitted or crocheted of Chapter 61 started to qualify for GSP duty-free and quota-free treatment as most of the knit fabric used by the RMG industry was manufactured locally. This gave knit exports from Bangladesh a considerable price advantage over non-LDC competitors because the MFN duty rates on garments in the EC were relatively high (up to 12.8 percent).[32]

A similar development did not happen in the upstream industries of the woven section of the garment industry. The principal reason for this is perhaps the large cost of investment required to set up upstream linkage industries such as spinning and weaving. Although the relatively modest cost of investment for integrated knit plants enabled the knit garment manufacturers to move to knit fabric manufacturing, the same was not possible for most woven garment manufacturers. According to the estimates, the investment cost of manufacturing capacity of a certain volume of processed knitted fabric is less than one-third

[32] In this sense see also, End of MFA Quotas: Key Issues and Strategic Options for Bangladesh Readymade Garment Industry, World Bank, 2005.

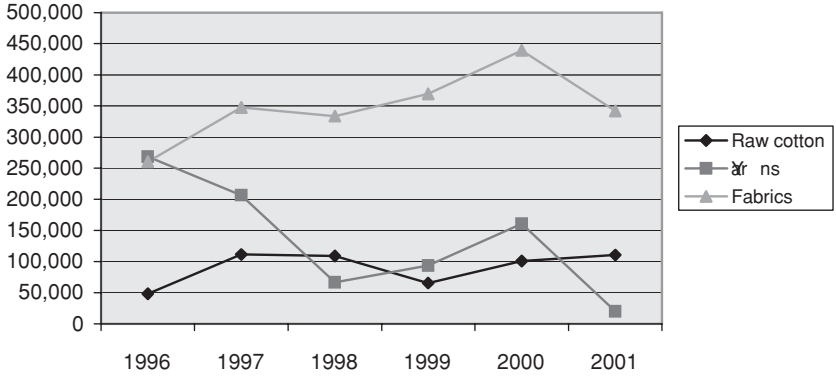


FIGURE 4.8. Bangladesh: Imports cotton (1996–2001)

of the cost of creating the same capacity for processed woven fabric. Hence, unlike the knit industry, woven fabric manufacturing and woven garment manufacturing remained separate (nonintegrated) activities. The large investment requirements of primary textile manufacturing and low international prices because of worldwide excess capacity limited the growth of woven fabric manufacturing.

In the case of Cambodia, the utilization rate for Chapters 61 and 62 follows a similar pattern of initial relatively high utilization rate in the year 1995 and a drastic fall to single-digit numbers from 1997 onward.

The following graphs (Figures 4.8 to 4.11) examine the import trends of textile inputs of Cambodia and Bangladesh according to different textile materials: cotton and manmade. In reading the following graphs, one should bear in mind the following requirements under the EC rules of origin:[33]

- For products classified in Chapter 62, garments not knitted or crocheted, the EC rules of origin state that the manufacturing process from nonoriginating member-states from yarn, i.e., utilization of imported fabrics, is not permitted.
- For products classified in Chapter 61, garments knitted and crocheted, the rules of origin require that the manufacturing process from originating materials start from yarn in cases of assembled products sewn together or natural fibers.

[33] For a detailed description of the rules and the specific working and processing requirements, see Handbook on the GSP scheme of the European Community mentioned in Chapter 3.

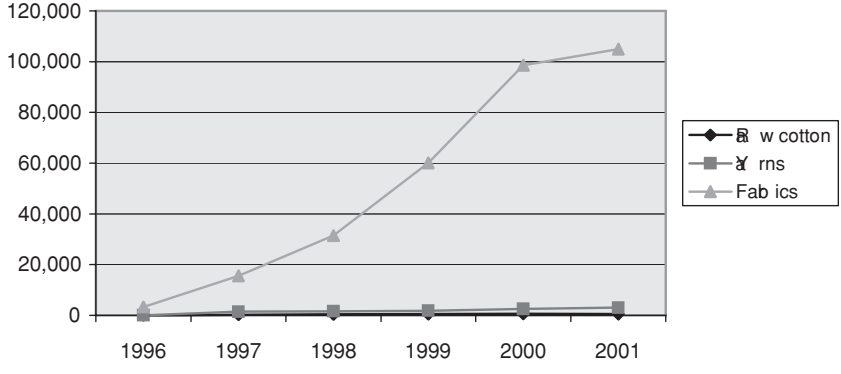


FIGURE 4.9. Cambodia: Imports cotton (1996–2001)

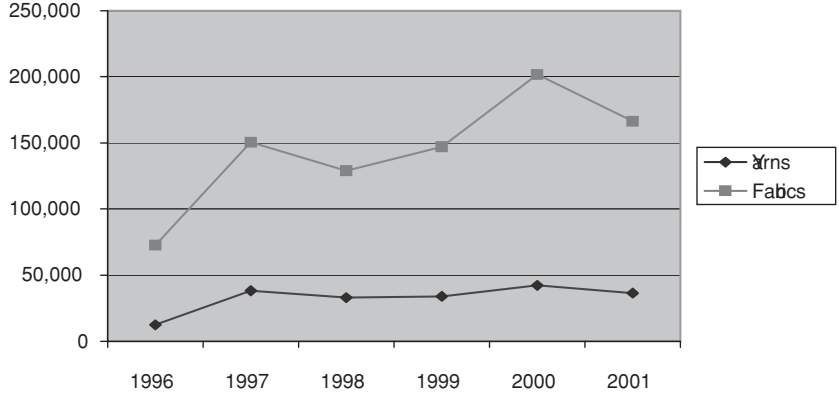


FIGURE 4.10. Bangladesh: Imports manmade and synthetic (1996–2001)

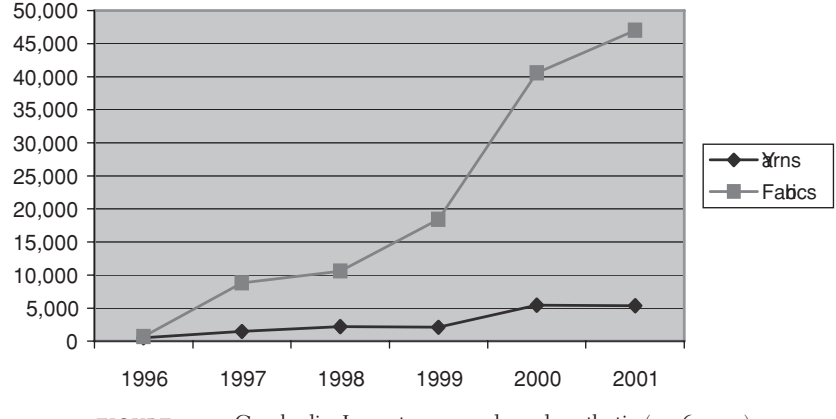


FIGURE 4.11. Cambodia: Imports manmade and synthetic (1996–2001)

Considering these requirements, a peak in imports of fabrics and a parallel low utilization rate can be assumed as a strong indication that the manufacturers in Bangladesh and Cambodia have foregone tariff preferences because they cannot comply with rules of origin requirements.

As shown in Figures 4.8 to 4.11 the analysis of the import flows of yarns and fabrics of cotton and manmade materials in Bangladesh and Cambodia for the period under review clearly showed a consistent and steady increase of the imports of fabrics in both countries in comparison with minimal or decreasing import value of yarns.

In the case of Cambodia, it must be noted that imports of yarn were in the majority of the charts of minimal value in absolute terms and could not be reasonably attributed to existing manufacturing capacity to transform these yarns into fabrics through a weaving process. Conversely, relative substantive import volumes of raw cotton and yarns in Bangladesh may lead to a presumption of existing industrial capacity able to transform these inputs into higher levels of manufacturing.

In any case, imports of fabrics represented the preponderant mass in comparison with imports of yarns and other downstream inputs like raw cotton or filament tow. These trends provide a strong indication that manufacturing industries in Bangladesh and Cambodia were heavily relying on imports of fabrics from third countries.

If the graphs of trade flows of imports of cotton and manmade synthetic inputs are contrasted with the corresponding output of exports of finished garments of Chapters 61 and 62, shown in Figures 4.12 to 4.15, a number of observations can be made. According to the general trends identified in Figures 4.8 to 4.11 when contrasted with Figures 4.12 to 4.15, the more Bangladesh and Cambodia were importing cotton and manmade fabrics, the more the exports of finished garments grew. These trends further strengthen the indication that the manufacturing industries in Bangladesh and Cambodia were and to a large extent still are dependent on the sourcing of fabrics from external suppliers.

Dependence on imports of fabrics appears very pronounced in Cambodia and to a lesser extent in Bangladesh. In particular, it could be observed that imports of raw cotton in Bangladesh were matched by an above-average utilization rate in Chapter 61 and a high concentration of exports in the EC in relation to other markets (76 percent).[34]

[34] See "Trade Preferences for LDCs: An Early Assessment and Possible Improvements," UNCTAD, 2003.

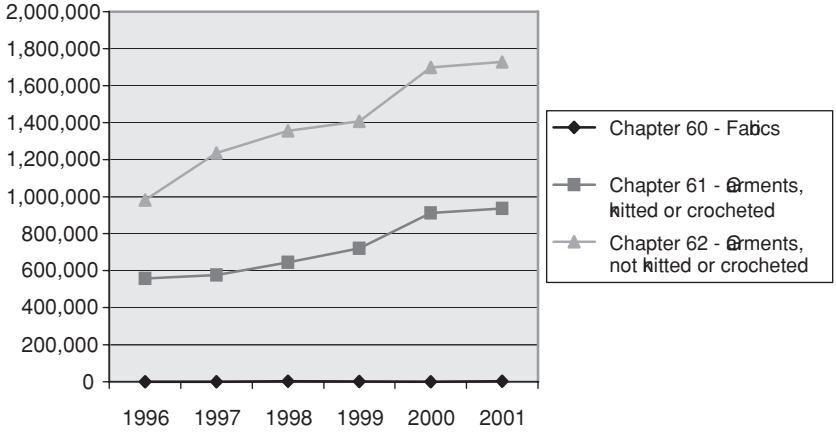


FIGURE 4.12. Bangladesh: Exports cotton (1996–2001)

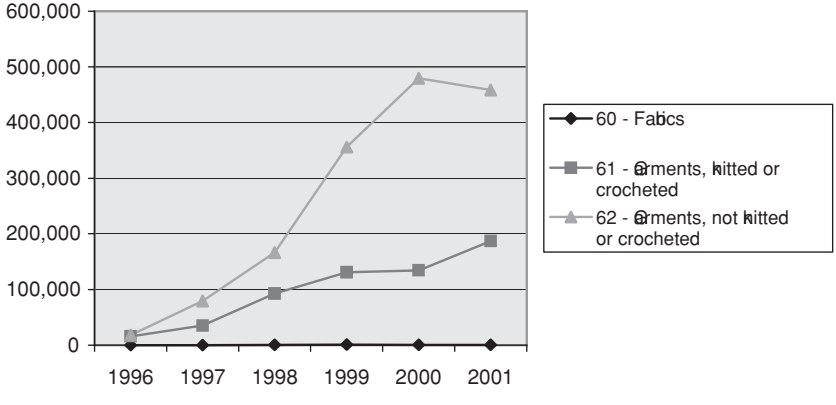


FIGURE 4.13. Cambodia: Exports cotton (1996–2001)

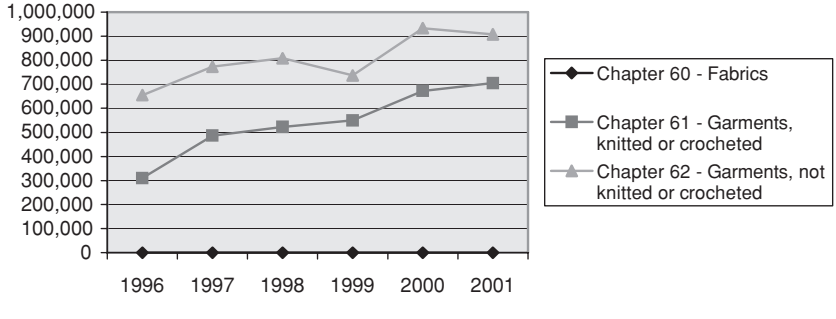


FIGURE 4.14. Bangladesh: Exports manmade and synthetic (1996–2001)

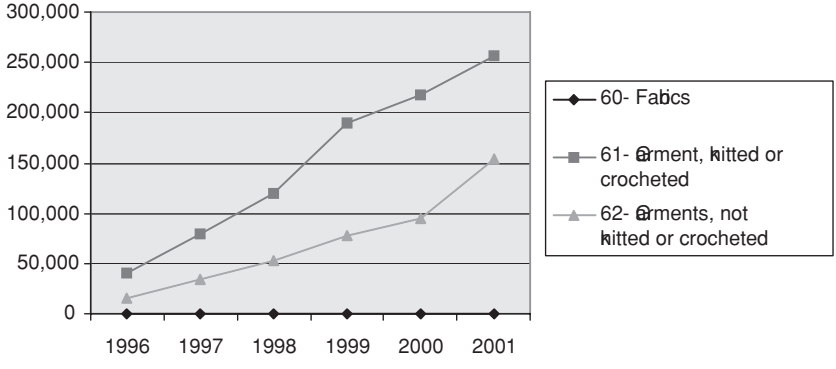


FIGURE 4.15. Cambodia: Exports manmade and synthetic (1996–2001)

As a final exercise, a comparison has been made between the ratio of imports fabrics and exports of finished garments of Chapters 61 and 62 with the utilization rate of Bangladesh and Cambodia. In the case of Bangladesh, a number of observations may be made.

As noted earlier, the low utilization rate recorded in 1997 and 1998 is probably due to a stricter enforcement and surveillance of the issuance of certificates of origin following the investigation carried out by the EC. See box on page 369 ("The Case of Bangladesh T-Shirts").

In the period 1996–1997, the trend is set in a divergent manner: The more fabrics are imported in relation to exports, the more the utilization rate is falling. After 1998, the utilization rate increases at an almost unaltered import/export trade flow. The reason for this increase in utilization is explained by the change on rules of origin for garments of Chapter 61 and the restructuring of the Bangladesh textile and garment industries after the shock of 1997–1998 to comply with origin requirements. This finding appears to be further corroborated by the fact that in 1999 and 2000 the utilization rate and import/exports ratio are parallel.

This may be explained by the fact that, once the adjustment in 1998 took place, given a certain mixture of input/output ratios between imports of fabrics and exports of finished garments of around 30 percent, a corresponding utilization rate may not exceed an average of 30 percent.

Obviously, the charts and percentages require further analysis at a detailed level. A quick glance at the chart of Cambodia is sufficient to note a clear and steady trend. The more the ratio of fabrics to exports is growing, the more the utilization is decreasing or maintained at a minimal level.

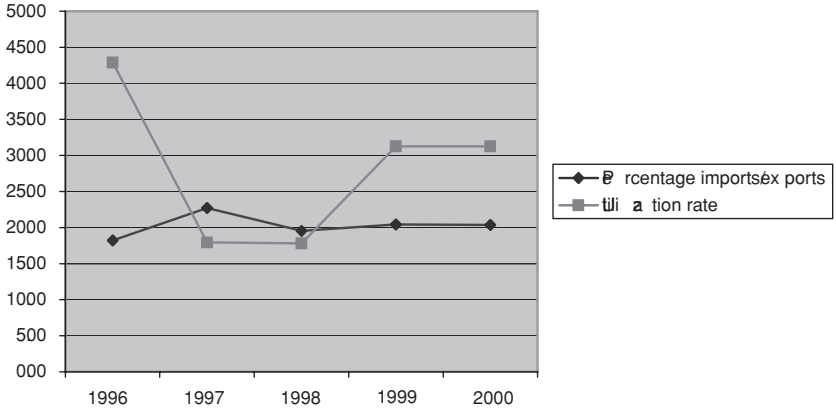


FIGURE 4.16. Bangladesh: Comparison of imports of fabrics/exports, Chapters 61 and 62 (garments), with EC GSP utilization rate (1996–2001)

As a further step, the analysis investigated the sourcing of these inputs to detect a pattern of trade flows. For Cambodia and Bangladesh, Figures 4.15–4.18 provide an indication for 2001 of the sourcing of these inputs. A closer examination of the time series of trade flows from 1998–2001 and 2002–2004 shows that, in general, they have been relatively steady in terms of percentage shares among the various suppliers. Thus, 2001 could be considered a valid representative year.

The examination of the sourcing of fabrics clearly shows the limit of cumulative rules of origin. As explained in Chapter 3, normally, rules of origin in

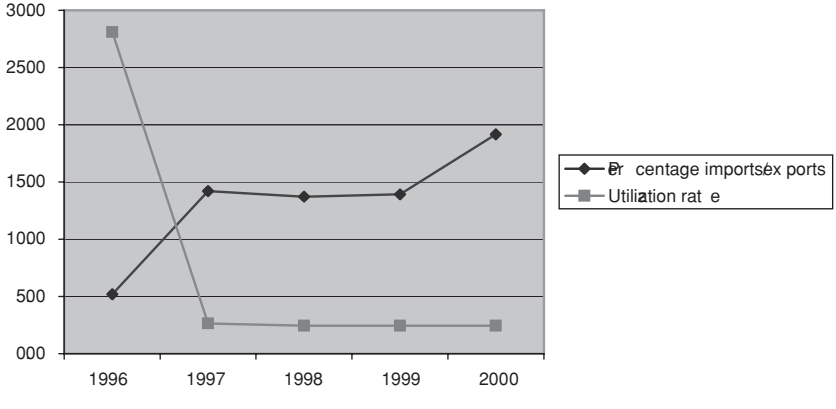


FIGURE 4.17. Cambodia: Comparison of imports of fabrics/exports, Chapters 61 and 62, with EC GSP utilization rate (1996–2001)

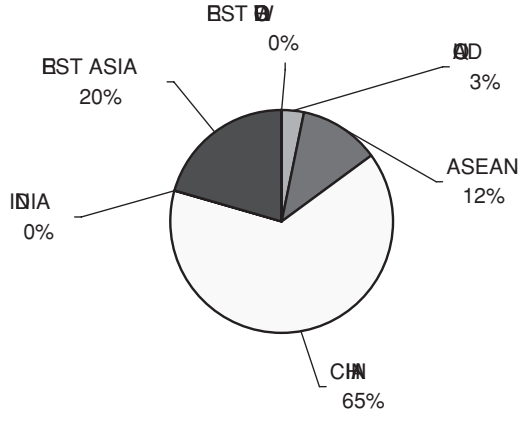


FIGURE 4.18. Bangladesh: Imports of cotton fabrics (2001)

the context of autonomous or unilateral contractual preferences are to be complied with within the customs territory of a single beneficiary country. However, some preference-giving countries considered that this requirement per se was not adequate to the existing realities in developing countries, especially in view of the regional trade initiatives taking place among them.

Under the schemes of some preference-giving countries, this rule has been liberalized to permit imported inputs from other beneficiary countries to be regarded as local content, thus easing compliance with the rules of origin requirements.

Under the EC GSP scheme, cumulation is permitted (subject to certain conditions) on a regional basis. Four regional economic groupings of preference-receiving countries are permitted to utilize the EC regional cumulation system, namely the Association of Southeast Asian Nations (ASEAN) (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam), the Central American Common Market (CACM) (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua), the Andean Group (Bolivia, Colombia, Ecuador, Peru, and Venezuela), and the South Asian Association for Regional Cooperation (SAARC) (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka).

Under EC rules for regional cumulation, materials or parts imported by a member-country of one of these four groupings from another member-country of the same grouping for further manufacture are considered as

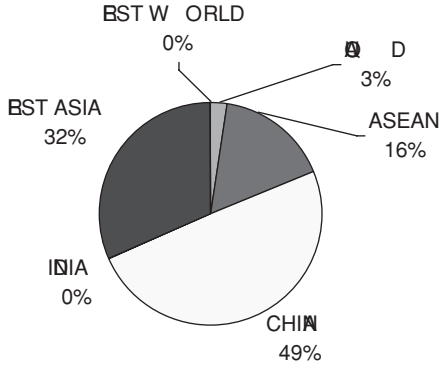


FIGURE 4.19. Cambodia: Imports of cotton fabrics (2001)

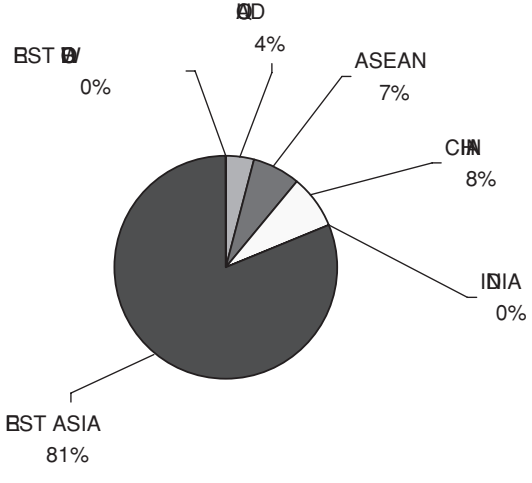


FIGURE 4.20. Bangladesh: Imports of manmade fabrics (2001)

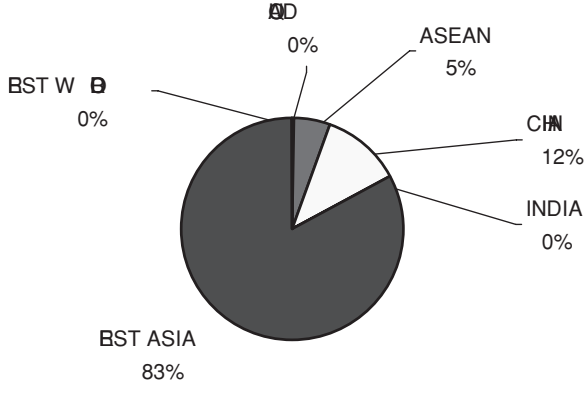


FIGURE 4.21. Cambodia: Imports of manmade fabrics (2001)

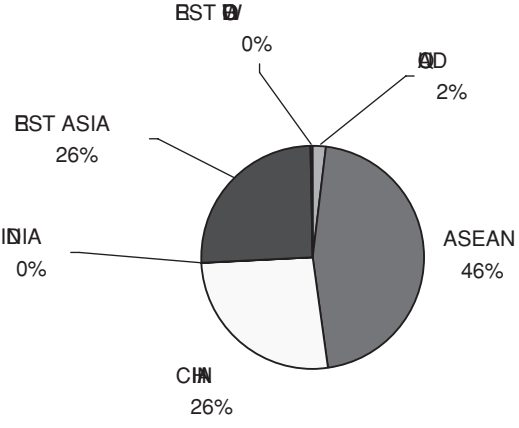


FIGURE 4.22. Cambodia: Imports of manmade synthetic fabrics (2001)

originating products of the country of manufacture and not as third-country inputs, provided that the materials or parts are already "originating products" of the exporting member-country of the grouping. Originating products are those that have acquired origin by fulfilling the individual origin requirements under the basic EC rules of origin for GSP purposes.

However, in the cases of Bangladesh and Cambodia, a quick glance at Figures 4.18 to 4.22 indicates that the countries supplying fabrics are not members of ASEAN or SAARC. Almost half of the imports of cotton fabrics in Cambodia are sourced in China with only 16 percent from ASEAN. In the case of Bangladesh, the percentage of China is even rising to 65 percent. In the case of manmade and synthetic fabrics, Bangladesh and Cambodia are also showing that very little inputs are sourced from their partners in SAARC and ASEAN. Taking into account Figures 4.20 and 4.22, 81 percent and 83 percent of manmade fabrics are sourced by Bangladesh and Cambodia, respectively, from the rest of Asia, mainly Taipei and South Korea. This trend leaves minimal scope for cumulation as a means to improve utilization of trade preferences.

This finding is corroborated by the consideration that, even if the fabric is sourced from regional partners in SAARC and ASEAN, the origin allocation rules would confer origin back to the country that manufactured the fabric. Chapter 5 contains a detailed description of the allocation of origin among country-members of the same regional group under the EC GSP rules of origin.

Quantifying the trade effects of rules of origin: A World Integrated Trade Solutions (WITS) simulation

Among the different econometrics tools that may be used to assess the trade effects of rules of origin, an exercise has been carried out to test the potential trade effects of a change of rules of origin.[35]

Low utilization of available trade preferences means that, in practical terms, at the time of customs clearance the MFN rate is levied on the goods rather than the preferential rate. As a final part of the preceding analysis, a simulation was carried out to calculate estimates of trade effects of rules of origin. The cost of rules of origin has been estimated by taking the amount of "missed trade preferences," that is, the volume of trade that was covered and potentially eligible for preferences but failed to qualify for a preference and simulate[36] the trade effects by counting that amount as if the preferential rate was granted. In short, the trade effects results are estimates of the trade flows generated by a change of rules of origin leading to full utilization of trade preferences.

In this section the simulation has been carried out for EC trade preferences and limited to LDC countries, bearing in mind the previous analysis of utilization of trade preferences by Bangladesh and Combodia. It has to be noted that LDC beneficiaries have been divided into two categories: Those benefiting from ACP preferences under the Cotonou Partnership Agreement (CPA) and former Lomé Conventions and those not benefiting from ACP preferences, practically speaking, the Asian LDCs.

Until the entry into force of the Everything But Arms (EBA) initiative, ACP LDCs were benefiting from more generous trade preferences than non-ACP LDCs, especially for trade coverage of agricultural products and cumulative rules of origin. As a result, ACP LDCs utilized the trade preferences under the Lomé/Cotonou Agreements rather than those available under the EC GSP scheme for LDCs. With the entry into force of the EBA initiative that is providing an equal market access to all LDCs, such a difference is no longer applicable.

However, for the scope of the present simulation that is based on an average of the past three available years (2000–2003), it has been considered that such division between the LDC ACP and LDC non-ACP was necessary in order to utilize a consistent database.

The evaluation of the possible effects that are due to full liberalization (i.e., to full product coverage and/or full utilization) has been carried out through

[35] This analysis has been carried out in the context of an UNCTAD study on "Trade Preferences for LDCs: An Early Assessment and Possible Improvements," UNCTAD, 2003.

[36] WITS developed by the World Bank and UNCTAD is the model that has been utilized to carry out the simulation.

WITS. WITS is a simple tool for quantification of the effects on trade flows induced by changes in market access conditions constructed by the UNCTAD secretariat in cooperation with the World Bank. The model used in WITS is partial equilibrium and is particularly useful for analyzing the first round or impact effects of trade liberalization on specific products. Some caution is advised in looking at the totals across products as these may also be subject to intersectoral effects (general equilibrium considerations), which normally lead to even larger effects. However, given the small value of LDC trade, this may be less serious an issue than a much wider liberalization scenario, for example, World Trade Organization (WTO) negotiations.

This simulation was carried out on the preceding assumptions and does not cover other nontariff barriers that could be liberalized. In particular, the simulation did not take into account the trade effects that may have arisen from the expected end of textile and clothing restrictions under the Agreements on Textiles and Clothing (ATC). This may have had a significant impact on the results of the simulations because, as will be discussed in the following section, the majority of trade effects of the simulation activity take place in the textile and clothing area. Other models and studies are assessing the impact of trade liberalization on textiles and clothing.[37] The exercise was aimed at simply quantifying the "missed trade preferences" either because there is no coverage or because utilization rates are low. Thus the results of the simulation have to be read within this context.

Simulations have been run at the single tariff line. At this level of disaggregation it might well happen that for some products trade is zero either because the beneficiary country does not export that particular good or the good is not covered by a preferential regime. In these cases, when the utilization rate was not available, the utilization rate of the corresponding HS6 (six-digit subheading) or HS4 (four-digit heading) section level was utilized to calculate the effects on trade from full utilization. If neither of these was available, the average utilization rate of all other non-LDC developing countries at the same HS4 section level has been used. Besides, because the utilization rate may vary a lot from year to year due to extemporary reasons, in the simulations we actually take the average of the last three years. The utilization rate in Table 4.5 is nevertheless obtained from 2000 trade data.

As far as non-ACP LDC countries are concerned, the trade effects in textile and textile articles stand out from all the others as shown in Table 4.5, with an increase of more than U.S. $1 billion. This is mainly due to Chapters 61 and 62

[37] See, for instance, Dean Spinanger, *Beyond eternity: What will happen when textile and clothing quotas are eliminated as of 31/12/2003*, mimeo.

TABLE 4.5. *Expected trade effects from full utilization of preferential schemes: EC non-ACP LDCs*

	Description of the HS section	Imports from non-ACP LDCs*	Duty free	Imports covered*	Utilization rate (percent)	TC*	TD*	TE*	TE (percent)
01	Textile & textile articles	3,294,446	74,125	3,220,321	31.68	902,460	420,546	1,323,006	96.90
02	Footwear, headgear, umbrellas, etc.	109,970	31	109,939	78.54	11,377	5,261	16,637	1.29
03	Live animals & products	189,847	307	189,540	75.91	5,365	7,755	13,120	0.96
04	Prepared foodstuffs, beverages, etc.	24,694	6	24,650	56.81	1,774	3,140	4,914	0.36
05	Hides and skins, leather, etc.	109,414	17,721	91,693	86.10	1,930	797	2,727	0.32
06	Machinery & electrical equipment	23,766	11,302	12,464	11.56	813	651	1,464	0.11
07	Plastics & rubber	7,366	1,987	5,359	55.61	735	287	1,022	0.07
08	Wood & articles of wood	50,140	33,798	16,342	68.71	96	464	560	0.04
09	Miscellaneous manufact. articles	14,296	8,441	5,855	63.93	364	150	514	0.04
10	Transport equipment	12,759	170	12,589	93.18	254	125	379	0.03
11	Base metals & products	4,823	2,144	2,679	46.96	139	138	278	0.02
12	Articles of stone, cement, etc.	12,641	49	12,592	96.11	138	66	204	0.01
13	Vegetable products	24,967	15,091	9,876	90.34	37	98	135	0.01
14	Optical & precision instruments	3,245	2,158	1,087	7.36	81	51	132	0.01
15	Precious stones, etc.	7,316	5,564	1,752	52.51	85	45	131	0.01
16	Pulp of wood, paper, books, etc.	3,554	820	2,734	79.96	23	33	56	0.00

Source: Author calculations[a]

* In thousands current U.S. dollars.

[a] Simulations are done using 2000 trade data and 2001 tariffs. Products 2709 (petroleum oils and oils obtained from bituminous minerals, crude), 2710 (petroleum oils and oils obtained from bituminous minerals, other than crude; preparations not elsewhere specified or included, containing by weight 70 percent or more of petroleum oils or of oils obtained from bituminous minerals, these oils being the basic constituents of the preparations) and 88 (aircraft, spacecraft, and parts thereof) are excluded.

(art of apparel and clothing access). "Missed trade" in these two chapters is considerable, the utilization rate being 41 percent and 15 percent, respectively. To a much lesser extent, sections "live animals and products" and "footwear, headgear, umbrellas, etc." also show a relevant increase in exports in spite of a utilization rate that already is relatively high.

The trade effects in selected chapters for each country involved in the simulation is reported in Table 4.6. The country that would benefit more in absolute value if all covered goods in Chapters 61–63 actually received the special treatment they are entitled to is Bangladesh, followed by Cambodia. For a vast majority of countries, imports covered would double. Figures in other sectors not shown in the table are maybe less impressive. Nevertheless, Maldives, for example, would see an increase in its covered exports of prepared fish and crustaceans by almost 20 percent, Myanmar that of sugar by almost 60 percent and that of fish and crustaceans by 4 percent.

As shown in Table 4.7, in the case of ACP LDCs, the biggest trade effect is in Section 1 (textile and textile articles), even if this is much smaller than in the case of Asian LDCs. This is mainly because the EC imports of textiles and textile articles from ACP countries are smaller and also because a considerable part is already duty free. In this case, Madagascar would be the major contributor to the total trade effect with an increase in export of "art of apparel & clothing access" of more than U.S.$87 million.

The increase in exports from full utilization is relevant also for "live animals and products" and "prepared foodstuffs, beverages, etc." (U.S.$40 million and U.S.$46 million, respectively) and, to a lesser extent, for "transport equipment." Covered imports of fish and crustaceans from Madagascar and Mozambique would increase by 10 percent. Covered imports of sugar from Malawi would increase by almost 60 percent (equal to U.S.$23 million). (See Tables 4.6 and 4.7.)

Conclusions

This section has established the link between strict rules of origin not matching the industrial capacity of developing countries and low utilization of trade preferences. Ultimately, rules of origin are frustrating the development objectives of tariff preferences, such as increase of manufacturing capacity and export earnings and accelerated economic growth of the beneficiary countries.

The low utilization rate diminishes the value and effectiveness of trade preferences available to developing countries and especially LDCs. To a different extent, depending on the category of products and the GSP preference-giving country, the low utilization rate is a cross-cutting issue that has to be addressed.

TABLE 4.6. *Expected trade effects from full utilization of preferential schemes: EC non-ACP LDCs – selected countries and markets*

HS section	HS chapter	Chapter description	Country	Imports covered	Utilization rate (percent)	TE*	As a percent of imports covered
11	61	Art of apparel & clothing accessories knitted or crocheted.	Afghanistan	571	2.98	348	60.95
11	61	Idem	Bangladesh	1,186,006	49.55	360,514	30.40
11	61	Idem	Cambodia	193,799	6.97	113,284	58.45
11	61	Idem	Lao P.D.R.	45,854	18.49	23,356	50.94
11	61	Idem	Maldives	8,035	0.02	4,958	61.70
11	61	Idem	Myanmar	151,160	31.58	64,078	42.39
11	61	Idem	Nepal	7,624	76.59	1,081	14.18
11	61	Idem	Yemen	1	0	0	0
11	62	Art of apparel & clothing accessories, not knitted/ crocheted	Afghanistan	1,160	0.09	537	46.29
11	62	Idem	Bangladesh	1,101,511	13.01	582,636	52.89
11	62	Idem	Bhutan	2	50	1	50
11	62	Idem	Cambodia	61,593	3.84	37,710	61.22
11	62	Idem	Lao PDR.	54,963	37.81	20,854	37.94
11	62	Idem	Maldives	8,024	1.16	5,082	63.33
11	62	Idem	Myanmar	112,059	20.76	54,733	48.84
11	62	Idem	Nepal	35,186	71.60	5,272	14.98
11	62	Idem	Yemen	4	50	1	25
11	63	Other made up textile articles; sets; worn clothing, etc.	Afghanistan	90	13.33	28	31.11
11	63	Idem	Bangladesh	44,582	75.21	2,280	5.11
11	63	Idem	Bhutan	1	100	0	0
11	63	Idem	Cambodia	11	0	3	27.27
11	63	Idem	Lao PDR.	5	80	0	0
11	63	Idem	Myanmar	3	66.67	0	0
11	63	Idem	Nepal	686	86.88	28	4.08

Source: UNCTAD calculations.[a]

* In thousands current USD

[a] Simulations are done using 2000 trade data and 2001 tariffs. Products 2709 (petroleum oils and oils obtained from bituminous minerals, crude), 2710 (petroleum oils and oils obtained from bituminous minerals, other than crude; preparations not elsewhere specified or included, containing by weight 70 percent or more of petroleum oils or of oils obtained from bituminous minerals, these oils being the basic constituents of the preparations), and 88 (aircraft, spacecraft, and parts thereof) are excluded.

TABLE 4.7. *Expected trade effects from full utilization of preferential schemes: EC ACP LDCs*

	Description of the HS section	Imports from ACP LDCs*	Duty free	Imports covered*	Utilization rate (percent)	TC*	TD*	TE*	TE (percent)
01	Textile & textile articles	526,028	224,076	301,952	34.87	66,181	34,111	100,293	40.91
02	Prepared foodstuffs, beverages, etc.	340,972	58,632	281,976	46.92	15,462	31,086	46,548	18.99
03	Live animals & products	637,834	8,807	629,027	77.49	17,434	23,041	40,475	16.51
04	Transport equipment	264,390	190,697	73,693	0.43	15,636	9,860	25,496	10.40
05	Vegetable products	844,719	700,881	141,667	37.48	5,692	9,567	15,260	6.22
06	Hides and skins, leather, etc.	103,239	34,427	68,812	49.15	2,813	937	3,751	1.53
07	Fats and oils	83,797	2,152	81,645	64.65	2,097	1,574	3,671	1.50
08	Machinery & electrical equipment	78,704	42,081	36,623	17.88	1,570	1,253	2,823	1.15
09	Base metals & products	117,234	90,277	26,957	46.67	808	1,430	2,238	0.91
10	Optical & precision instruments	21,738	5,586	16,152	18.75	1,229	662	1,891	0.77
11	Footwear, headgear, umbrellas, etc.	14,422	92	14,330	60.63	646	288	934	0.38
12	Miscellaneous manufact. articles	8,989	2,670	6,319	70.63	278	130	408	0.17
13	Chemical products	133,998	129,079	4,651	50.27	166	201	366	0.15
14	Plastics & rubber	11,772	10,046	1,695	44.07	250	101	350	0.14
15	Wood & articles of wood	177,355	164,269	13,086	81.79	95	158	253	0.10
16	Articles of stone, cement, etc.	3,717	191	3,526	75.38	51	89	140	0.06
17	Precious stones, etc.	2,049,189	2,047,946	1,243	38.21	79	42	121	0.05

Source: UNCTAD calculations.[a]

* In thousands current U.S. dollar.

[a] Simulations are done using 2000 trade data and 2001 tariffs. Products 2709 (petroleum oils and oils obtained from bituminous minerals, crude), 2710 (petroleum oils and oils obtained from bituminous minerals, other than crude; preparations not elsewhere specified or included, containing by weight 70 percent or more of petroleum oils or of oils obtained from bituminous minerals, these oils being the basic constituents of the preparations), and 88 (aircraft, spacecraft, and parts thereof) are excluded.

Such a low rate of utilization is mostly reported for industrial products, especially textiles and clothing. Agricultural products tend to have far less problems in complying with rules of origin requirements. However, a study[38] examining the utilization of trade preferences in LDC over two consecutive years found that utilization of trade preferences in agricultural products and processed agricultural product is in some cases rather erratic.

Low utilization of trade preferences, because of rules of origin requirements, has definitively been established at empirical and field levels in the case of some products categories. This holds especially true for clothing, for which developing countries and LDCs such as Bangladesh, Cambodia, and Laos have a potential supply capacity. In this area, currently applied EC rules of origin are clearly having an impact on the utilization of trade preferences and on the industrial and trade policy of these countries. Further research may be carried out to identify rules of origin demanding manufacturing requirements that are unrealistic and not business feasible.

The GSP rules of origin have remained unchanged since the 1970s, despite the current fragmentation of production and MFN rates being lowered in a series of multilateral rounds.

The issue of rules of origin and their impact on the utilization of trade preferences was once again not adequately addressed in the document issuing from the Hong Kong Ministerial Conference. It provides *inter alia* that "Developed members shall, and developing countries members in a position to do so should . . . (b) Ensure that preferential rules of origin applicable to imports from LDCs are simple and transparent, and contribute to facilitating market access."

It does not require much legal or WTO experience to realize that such language is tantamount to a best-endeavor commitment that bears no obligation to be made operational. Previous attempts in the 1970s to elaborate a harmonized set of preferential rules of origin for unilateral trade preferences, such as the GSP under the auspices of UNCTAD, failed because the preference-giving Organisation for Economic Co-operation and Development (OECD) countries argued that those preferences were autonomous.

After a long time, revisiting the issue of rules of origin at the multilateral level may be considered. Canada and the EC have taken action to review their GSP rules of origin. Efforts should be made to bring these individual initiatives to a multilateral level to discuss ways and means to simplify and liberalize rules of origin.

[38] See "Erosion of preferences in the ports Hong Kong framework: from "aid is better than trade" to "aid for trade," UNCTAD,2008.

The LDC group recently made a structured proposal on rules of origin at the WTO based on an across-the-board percentage criterion that reflects the latest experience gained in this area. This initiative should be taken as a starting point by preference-giving countries to engage in a meaningful debate leading to a set of rules of origin that takes into account the industrial reality of LDCs. Unless further efforts are made by the LDCs and WTO members, no action is likely to be undertaken at the multilateral level. The aforementioned wording on the rules of origin in the decision is not legally enforceable. It does not provide for the establishment of any working group or the specification of modalities to prevent the rules of origin from being an obstacle to the utilization of trade preferences.

Chapter 5 will further illustrate[39] how to introduce change and innovation to rules of origin that have not been modified since the 1970s, as recently admitted in a paper of the EC Commission.[40] The current reform that is under way should introduce innovation and liberal rules of origin.

Some advances in revising these EC rules have been made in the Interim Economic Partnership in the African subregion and under the Economic Partnership agreement with Cariforum, where the double transformation requirement has been replaced with a single transformation. However, these improvements have taken place in the context of the negotiations of reciprocal FTAs replacing the former CPA of unilateral natures.

A proposed new rule to assist LDCs such as Bangladesh and Cambodia and ACP countries under the EBA initiative would replace the two-stage processing requirement for Chapters 61 and 62 with a single one. It is suggested that for Chapter 61 the process of knitting and crocheting a finished product to shape is origin conferring. At the same time it is suggested that assembly of parts knitted or crocheted to shape is also an origin-conferring operation. For Chapter 62, it is suggested that the process of cutting the fabric and assembling the parts is an origin-conferring operation. These rules have been inspired by the current results of the HWP of nonpreferential rules of origin carried out under WTO/World Customs Organization (WCO) auspices.

The Uruguay Round Agreement on rules of origin has failed to regulate preferential rules of origin, creating a no-man's land where they have proliferated. In the course of the ongoing debate and initiatives undertaken under the umbrella of the Doha development agenda, a workable way forward for

[39] On specific suggestions for liberalizing product-specific rules of origin see, "*Trade preferences for LDCs*: an early assessment and possible improvements" (UNCTAD/ITCD/TSB/2003/8).

[40] See, "Commission of the European Communities," *Green Paper on the future of rules of origin in preferential trade agreements,*" Brussels, COM (2003) 787 final.

having a common set of preferential rules of origin for unilateral trade preferences could be explored. A similar path for reciprocal rules of origin under FTAs seems largely premature at this stage.

New GSP rules of origin could be formulated to reflect modern and competitive industrial development on the basis of the work carried out by the WCO under the HWP of the nonpreferential rules of origin. The lack of agreement impeding, at the time of this writing, the conclusion of such harmonization in the WTO Committee on Rules of Origin (CRO) has not impeded the Technical Committee on Rules of Origin (TCRO) established in the WCO from completing most of its work. During the negotiations conducted in this latter committee, the international community has been able to give a fresh and highly technical consideration to the whole issue of origin. It is now time to transfer such renewed efforts into new legislation and more liberal rules of origin for LDCs under the duty-free quota-free (DFQF) initiative.

5

Drafting Preferential Rules of Origin

This chapter examines the various modalities for drafting rules origin. It aims at providing guidance to policy makers, customs, and the private sector on the issues to be considered and analyzed when drafting rules of origin. The chapter is divided in three sections. Section 5.1 reports the lessons learned from drafting the Generalized System of Preferences (GSP) rules of origin and the experience and feedback gained during the United Nations Conference on Trade and Development (UNCTAD) working group on rules of origin. Section 5.2 contains the experience on rules of origin of some major regional trading agreement among developing countries in Latin America, Africa, and Asia. Section 5.3 draws some conclusions and makes some suggestions on how to draft rules of origin. It contains a methodology on drafting product-specific rules of origin based on an input/output matrix derived from the Harmonized System (HS).

5.1. Learning Drafting Rules of Origin from the Past: Experience Gained with the Rules of Origin under the GSP

General Observations and Lessons Learned

As is widely known, first Secretary-General Raoul Prebistch of UNCTAD laid down the concept and intellectual foundations of the GSP. Once the principles and objectives of the GSP were finally agreed on at the second UNCTAD conference as contained in UNCTAD resolution 21(II,) the elements and structure of the GSP were still to be defined. To define and agree on these elements among UNCTAD member-states, intergovernmental machinery was created within UNCTAD.

Thus, at the outset of the GSP, drafting a uniform set of rules of origin to be applied to the different GSP schemes adopted by preference-giving countries was one the principal aims of the UNCTAD Special Committee on

Preferences. Hence, the Special Committee on Preferences decided to set up a working group on rules of origin with the task of initiating consultations on the technical aspects of the rules of origin to prepare draft origin rules to be applied uniformly in all the GSP schemes. This working group was one of the first multilateral initiatives to regulate the issue of rules of origin at intergovernmental level.

However, in the Organisation for Economic Co-operation and Development (OECD) ad hoc group of the Trade Committee on Preferences, held in Paris in 1970, the preference-giving countries expressed the view that, as preferences were being granted unilaterally and noncontractually, the general principle had to be that donor countries were free to decide on the rules of origin that they thought were appropriate after hearing the view of the beneficiary countries.[1] Within the general principle just mentioned, the preference-giving countries felt that the process of harmonization had to be limited to some related practical aspects such as certification, control, verification, sanctions, and mutual cooperation. Progress has been extremely limited.

A first implication of the decision taken at the OECD meeting was that different sets of rules of origin applied according to each national GSP scheme. It followed that, because national schemes had different product coverage, different customs regulations, and different previous rules of origin for administering trade preferences, each preference-giving country modeled its own system of rules of origin according to these different parameters.

Preference-giving countries rules of origin were then divided in two broad categories: Those using the process criterion and those using the percentage criterion, but within these criteria there were large differences.

Although changes and modifications have been introduced in the GSP rules of origin since the 1970s, the basic requirements, shortcomings, and rationale for these rules have remained virtually the same for almost 30 years since that meeting.

It follows that the experience analysis and lessons learned, discussed, and identified in the context of the UNCTAD Working Group on Rules of Origin and in the Special Committee on Preferences are still relevant today.

Given the minor changes in the substantive requirements under the different GSP schemes, the large majority of these difficulties and problems discussed at the meetings are somewhat matching and duplicate the actual debates on the need for reform on rules of origin.

It may be noted that, although the need for improvements was recognized and some progress has been made regarding some specific provisions of

[1] See OECD, Ad Hoc Working Group of the Trade Committee on Preferences, Rules of Origin, second report, TC/Pref./70.25, p. 9, Paris, 25.9.1970.

individual schemes, major problems in fulfilling the origin requirements persist. In the following sections, the main experience, lessons learned, and analysis of the UNCTAD working groups on rules of origin are reported because they still represent an invaluable source of reflection and examples that the international trading community may wish to draw from.

5.2. Specific Experiences and Lessons Learned from Drafting and Implementing GSP Rules of Origin

5.2.1. *The Definition of Two Categories of Products: Wholly Produced and Products that Have Undergone Substantial Transformation*

As mentioned earlier,[2] even before the implementation of the national GSP schemes, many industrialized countries had adopted individual preferential arrangements of autonomous and independent character in favor of certain developing countries or former colonies. Each of these arrangements contained origin rules that were tailored to the particular exigencies of each preference-giving country. Thus, to better organize the work that had to be carried out, the second session of the Special Committee felt it necessary to make a comprehensive analysis of the different origin systems, in order to

(i) evaluate the various features of the origin rules applied in the existing preferential arrangements;
(ii) list the problems encountered by preference-giving and preference-receiving countries in the practical application of such rules.[3]

The analysis showed that the definition of the origin of goods was generally based on two different criteria:

(i) The wholly produced products criterion;
(ii) The substantial transformation criterion.

It was found that the first criterion was used when the product had been wholly produced in a preference-receiving country from raw materials that originated in the same country, whereas the second criterion was used for the definition

[2] See Chapter 4. This section draws from materials and analysis of UNCTAD Working Group on Rules of Origin. See "Compendium of the work and analysis conducted by UNCTAD working groups and sessional committees on GSP rules of origin," part I (UNCTAD/ITD/GSP/34 of 21 February 1996).

[3] See TD/B/AC.5/3, p. iii.

of origin when more than one country was involved in the manufacture of the final product.

5.2.2. *Negotiations and Experiences on the Definition of the Wholly Produced Criterion*

The evaluation of the rules of origin applied in individual preferential schemes by some preference-giving countries before the entry into force of the GSP system,[4] undertaken at the second session of the Special Committee in 1968, permitted the Working Group, at its first session in March 1970 to identify the main features of this criterion. In fact, the wholly produced criterion was intended to cover two types of goods, namely:

"(i) goods which were natural products of a particular country, such as unmanufactured raw materials, goods grown, extracted or harvested in that country, and certain marine products, and
(ii) goods which were manufactured in a single country without the use of materials or components imported from other countries."[5]

The criterion was used, *inter alia*, to a certain extent for the determination of origin of used articles and waste and scraps. It did not apply, however, in cases in which the goods whose origin was to be determined had undergone a manufacturing process in more than one country.

At the first session of the Working Group, some doubts were raised as to the possibility of adopting the wholly produced criterion in cases mentioned under (ii). According to this rule, it was considered that goods could be regarded as wholly produced if they were produced within a single country or a group of countries exclusively from materials containing no material imported from a third country or of undetermined origin.[6] In such cases, the producer had to be able to prove the domestic origin of all parts and components of the export goods. However, empirical experience had shown that this could prove difficult in many cases and lead to the result that the goods concerned could not be regarded as "wholly produced." In fact, because of the difficulties for customs authorities to control the origin of all the parts of the product exported, origin documents showing that the wholly produced criterion was satisfied had

[4] The Special Committee evaluated the preferential rules of origin of the following countries: Australia, European Economic Community (EEC), European Free-Trade Area (EFTA), United Kingdom, and the United States. See ibid., paras. 10–74.
[5] See document TD/B/AC.5/3/Add.4, 19 March 1970, para. 70.
[6] Ibid, para. 71.

been considered as false documents even if the goods satisfied another origin criterion (the process criterion or the percentage criterion).[7]

At the same time, it was considered that, because the various existing origin systems examined did not differ very much with regard to the wholly produced criterion, the definition of the wholly produced criterion for GSP purposes might not present insurmountable difficulties. However, in the first meeting of the Working Group, intensive discussions were held that took into account information derived from the analysis of the different origin rules applied individually by some preference-giving countries. There was consensus that the following products were among those to be considered as wholly produced: Unmanufactured raw materials (e.g., mineral products extracted from the soil in the country of origin); petroleum and other minerals extracted from the continental shelf or from other parts of the seabed within the territorial waters of a country; and other products extracted from the seabed outside territorial waters in the narrow sense (provided that the country claiming origin exercised exclusive rights to exploit the seabed in question).[8]

Certain agricultural products were also generally considered wholly produced goods, that is, vegetable products harvested in a country, products obtained by hunting and fishing conducted there, live animals born and raised there, and products obtained from live animals. As regards the latter products, the Working Group raised the question of whether obtaining such products from any live animals within the country concerned was to be considered sufficient, or whether this criterion had to be supplemented by the requirement that the live animals in question be born and/or raised in that country. For example, the question was whether eggs obtained in country X from a hen had to be treated as originating in that country if the hen itself was an animal imported from country Y, or whether the hen had to be an animal born or at least raised in country X itself.[9] With regard to marine products, it was considered that products taken from the sea by a vessel of a particular country were usually considered as goods originating in that country. However, it was found that in some preferential origin systems before 1968, the expression "vessel of a particular country" was defined more precisely. In particular, the EEC rules for imports from the Associated African States[10] required in addition that the vessel be at least half-owned by nationals of the country or by a company whose head office was situated in the country and that had nationals of the country as

[7] See document TD/B/AC.5/3/Add.4, para. 71.
[8] Ibid, para. 73.
[9] Ibid, para. 74.
[10] See TD/B/AC.5/3, paras. 18–23. In this section, EEC refers to European Economic Community.

its managing director or directors, as the chairman of its board of directors or governors. Moreover, the majority of the members of such a board should also be nationals. If it was a partnership or limited liability company, at least half the capital should belong to the country or to public corporations or nationals of the country. In addition, all the vessel's officers and at least 75 percent of its crew had to be nationals of the country. According to European Free Trade Area (EFTA) rules, a vessel was regarded as that of a member-state if it was registered in the state and flew its flag.[11] In this connection, special attention was devoted to the question of goods produced on board factory ships from products of sea fishing and other products taken from the sea, because a number of developing countries had established joint ventures for the exploitation of resources of the sea.

Some existing rules examined by the Working Group contained special regulations for the treatment of used articles, wastes, and scraps. EFTA rules treated used articles that were fit only for the recovery of materials and had been collected from users within EFTA.[12] Scrap and waste resulting from manufacturing operations within EFTA were treated as wholly produced articles. All EC rules at that time accepted scraps and waste from manufacturing operations and disused articles as wholly produced articles, provided they had been collected within the country concerned and could be used only for the recovery of raw materials.[13]

The Working Group considered it necessary to have a definition of the extent and nature of the use that had to be made of goods in a specific country to be able to treat it as the country of origin, in particular in the case of used machinery that had previously been imported. It was suggested that the article exported should show certain traces of usage. If necessary, a certain period of time during which the use had to be exercised should also be required. It was stated that such a requirement could help to avoid abuse of the scheme of preferences by way of delivery of virtually new articles from a developed country via a beneficiary country. Moreover, it was considered to be in the interest of the industrialization of exporting developing countries to be rather restrictive when formulating such a special clause.[14] The analysis of existing preferential schemes revealed that EFTA countries used a complementary provision, called a Basic Material List, which treated particular raw materials and some manufactures as goods from EFTA, whatever their origin.[15] The reason for the

[11] Ibid, para. 75.
[12] Area means the territory of EFTA countries.
[13] Ibid, para. 76.
[14] Ibid, paras. 77–79.
[15] See document TD/B/AC.5/3, paras 47 and 102–107.

rule was an insufficient supply of these materials within the area itself. Consequently, the duties levied by EFTA states were either very low or zero. However, this Basic Material List was used within only EFTA and never for GSP purposes. The United States applied a similar provision on imports from insular possessions under preferential terms. Under this rule, no materials that could be imported into the United States free of duty were considered of foreign origin.[16] At the fourth session in 1973, some developing countries expressed appreciation for the provisions in the New Zealand scheme, which stipulated that goods wholly manufactured from unmanufactured raw materials were wholly produced goods, whatever the origin of the raw materials. Developing countries urged other preference-giving countries to incorporate similar provisions in their schemes. Some developed countries proposed establishing a Basic Material List of products of interest to developing beneficiary countries, which, whatever their actual sources, would be regarded as originating in the preference-receiving countries.[17]

In spite of the recognition by preference-receiving countries of the importance and usefulness of the Basic Material List, the Working Group, at its first session, did not attempt to formulate a specific view or recommendations regarding the establishment of such a list. The question of the Basic Material List was subsequently discussed at the fifth session of the Working Group in 1973. The preference-giving countries suggested that the problem of enabling beneficiaries to make full use of basic materials could best be solved through appropriate adaptations of Lists A and B rather than by providing a Basic Material List. The first Working Group was able to make some suggestions with regard to wholly produced goods:

"(a) mineral products extracted from its/their soil or from the sea bed within its/their territorial waters;
(b) vegetable products harvested there;
(c) live animals born and raised there;
(d) products obtained there from live animals [born and raised there];
(e) products obtained by hunting or fishing conducted there;
(f) products of sea fishing and other marine products taken from the sea by vessels registered in the country/countries and flying its/their flag;
(g) products extracted from the sea bed outside the territorial waters of the country/countries, provided that the country/countries exercise(s) the exclusive rights to exploit the sea-bed in question;

[16] See document TD/B/C.5/WG(IV)/2, para. 100.
[17] See document TD/B/C.5/WG(IV)/L.1, 8 November 1973, para. 30.

(h) products made on board factory ships from products referred to in paragraph (f) above originating there, provided that such factory ships are registered in the country/countries and fly its/their flag;
(i) used articles fit only for the recovery of raw materials, provided that they have been collected there;
(j) waste and scraps resulting from manufacturing operations conducted there;
(k) goods produced there exclusively from the products referred to in paragraphs (a) to (j) above, or from derivatives thereof, or from materials containing no elements imports [from a non-beneficiary country] [from another country] or of undetermined origin;
(l) goods listed in the basic materials list."

The second session of the Working Group in July 1970 was dedicated, *inter alia*, to discussions of the text suggested by the Working Group at its first session. During these discussions it was pointed out that no agreed definition existed with regard to territorial waters.[18] In particular, some developing countries objected, with reference to paragraphs (a) and (g) of the preceding text. They proposed the use of the concept of "continental shelf of the developing beneficiary country or countries" for defining the scope of what constituted "wholly produced goods."[19] The representative of the EEC expressed some concern with regard to the formulation of items (f) and (h). He pointed out that national laws relating to the registration of ships and to the right to fly the flag differed considerably. In some cases, the flying of a flag was therefore not a sufficient criterion for determining the origin of products taken from the sea by fishing vessels or factory ships. Requirements would need to be specified as to the crew and ownership of the vessel.

At its third session in December 1970, the Working Group was able to reach consensus on an agreed text regarding products to be considered as wholly produced:

"The following products shall be regarded as wholly produced in a preference-receiving country:
(a) Mineral products extracted from its oil or from its sea bed;
(b) Vegetable products harvested there;
(c) Live animals born and raised there;
(d) Products obtained there from live animals;
(e) Products obtained by hunting or fishing conducted there;

[18] See document TD/B/AC.5/31, para. 26.
[19] Ibid, para. 27.

(f) products of sea fishing and other marine products taken from the sea by its vessels[20];
(g) products made on board its factory ships exclusively from products referred to in paragraph (f) above;
(h) used articles fit only for the recovery of raw materials, provided that they have been collected there;
(i) waste and scrap resulting from manufacturing operations conducted there;
(j) goods produced there exclusively from the products referred to in paragraphs (a) to (i) above."

The fifth session[21] of the Working Group was dedicated to the review of the main provisions of the rules of origin applied under the GSP. With regard to the wholly produced criterion, it was found that the rules applied by the preference-giving countries[22] generally corresponded to the above-agreed text, with the exception of the rules for the following three categories of products:

(a) marine products and products made on board ships;
(b) products obtained from live animals;
(c) used articles.

According to the agreed text, marine products had to be regarded as "wholly produced in a given preference-receiving country if they were products of sea fishing and other marine products taken from the sea by its vessels or products made on board its factory ships exclusively from such products." As no further definition of the terms "its vessels" and "its factory ships" had been provided, preference-giving countries gave different interpretations to these terms. Some of them contained rather stringent requirements.[23] A number of preference-giving countries had applied different definitions to the terms "its vessels" and "its factory ships." At that time, there was not common agreement among the European states: Under the rules of the United Kingdom, vessels had to be registered in the exporting developing country, whereas under the rules of Finland, Sweden, and Switzerland, the vessels had to be registered in the exporting country and had to sail under its flag. Denmark, EEC, Japan, and Norway required, in addition, that the vessel or factory ship fulfill certain

[20] The developing countries requested the inclusion of products of chartered vessels and chartered factory ships. The preference-giving countries agreed that, if additional wholly produced products are clearly identified during the periodic review, they will be added to the list at that time.

[21] TD/B/C.5/2, paras. 14–112.

[22] The rules of origin of the following states were revised: Austria, Czechoslovakia, Denmark, EEC, Finland, Ireland, Japan, New Zealand, Norway, Sweden, Switzerland, and the United Kingdom.

[23] See document TD/B/C.5/WG(IV)/2, para. 139.

conditions regarding ownership by the beneficiary country.[24] Moreover, the captain, officers, and at least 75 percent of the crew had to be nationals of that country. Austria had not defined under what conditions a vessel or factory ship was considered as belonging to a particular country.

In addition, "the preference-receiving countries had requested from the outset the inclusion of products of chartered vessels and chartered factory ships in any definition of wholly produced goods." At the third session of the Working Group, the preference-giving countries agreed that, if additional wholly produced products were clearly identified during the periodic review, they would be added to the list.[25] No specific promise however was made as regards marine products and chartered vessels. In fact, it never materialized until some vague commitments in the Lomé Convention IV Protocol on rules of origin, i.e., 20 years after the promise.

An UNCTAD study[26] as early as 1973 pointed out that, "... establishing a fishing fleet is a rather capital-intensive undertaking." Many, if not most, developing countries did not, therefore, have fishing fleets of their own. The application of stringent requirements concerning registration, ownership, and crew of vessels, would have deprived most developing countries of the possibility of exploiting their marine wealth and selling the products of their territorial waters on preferential terms. The same would have applied in the case of products of lakes within the territories of developing countries, because the commercial exploitation of lakes also requires major investments.

The study further considered that "the economic needs of many preference-receiving countries could be met by allowing the chartering of vessels and factory ships. At the very least, it should be sufficient that the vessels and the factory ships were registered in the preference-receiving country concerned and fly its flag. According to the rules of EFTA, a vessel was regarded as that of a member State if registered in the State and flying its flag in spite of the fact that all EFTA members had a considerable stake in shipping."[27]

The words "flying its flag" created some difficulties because, in a certain number of cases, joint ventures for the exploitation of the resources of the sea had been established among developing countries. To take account of these cases, the study proposed that the definition should refer to the registration in the preference-receiving country concerned, thus dropping any reference to the flag flown by the ship.

[24] See document TD/B/C.5/2, para. 16.
[25] See document TD/B/AC.5/38, appendix I, p. 2.
[26] See TD/B/C.5/WG(IV)/2, 26 September 1973, para. 141.
[27] Ibid, para. 142.

Other concerns and different interpretations were raised with regard to used articles. Sweden accepted used articles collected in a developing country as being wholly produced there, provided they were fit only for the recovery of materials. By contrast, the rules applied by Austria, Denmark, EEC at that time, Finland, Norway, Switzerland, and the United Kingdom required in line with the agreed text that such products be fit only for the recovery of raw materials to qualify as wholly produced. Under the EFTA rules, on which the Swedish rules were based, used articles fit only for the recovery of materials collected from users within the FTA, were regarded as being wholly produced within EFTA. For example, used batteries, whether or not of EFTA origin, collected from Swiss users and sent to Finland would receive EFTA tariff treatment if they were fit only for the recovery of their lead or other scrap materials. If, however, the batteries sent to Finland were fit for reconditioning, this provision did not apply.[28]

In the agreed conclusions of the Working Group at its sixth session in 1976, the UNCTAD secretariat was requested to "continue the study of the difficulties encountered in the preference-receiving countries in the area of rules of origin."[29] The UNCTAD secretariat, to obtain information on difficulties encountered by preference-giving countries in the area of rules of origin, addressed a questionnaire to the governments of all preference-giving countries.[30] At the seventh session of the Working Group, the information collected was analyzed and commented on. With regard to the concept of wholly produced products, only a few problems emerged from the analysis of the replies to the questionnaire. The major difficulties encountered by some preference-giving countries concerned imports for which the wholly produced criterion, though certified, did not apply.[31] In the view of the Working Group,[32] this was because some exporters and authorities in certain preference-receiving countries did not understand the full significance of the wholly produced criterion, especially as it applied to manufactured goods. No concerns had been raised with regard to the definition of wholly obtained products. The fact that a common definition of wholly produced goods had been accepted by preference-giving countries was considered by the Working Group as one of its most important achievements.[33]

Under the rules of origin applied to Austria, Denmark, EEC, Finland, Japan, Norway, Sweden, and Switzerland, and in line with the agreed text, products

[28] See EFTA, Rules of origin, fourth edition, revised, Geneva, January 1971, p. 28.
[29] See documents TD/B/C.5/55, para. 64, and TD/B/C.5/WG(VI)/5, para. 67.
[30] See Note Verbale, 16 November 1977, reference TD/423(Q).
[31] See document TD/B/C.5/WG(VII)5, para 7.
[32] Ibid, p. 3.
[33] See document TD/B/C.5/76, para. 7.

obtained in a preference-receiving country from live animals were regarded as wholly produced there. This rule covered, *inter alia*, products obtained from live animals that had been imported into the preference-receiving country concerned.[34]

From discussions held at the fifth session of the Working Group,[35] it appeared that this additional requirement was unnecessarily rigid. It assumed that animals might be imported into a preference-receiving country exclusively to confer the status of originating product or products on these animals. In fact, such abuses of the rule were unlikely to occur in practice. With few exceptions, developing countries were remote from countries not recognized as beneficiaries under the GSP, so that such operations would be unprofitable.[36] It appeared, therefore, that there was little justification for this additional requirement.

5.2.3. *Negotiations and Experiences in Drafting Origin Criteria for the Definition of Substantial Transformation*

During the second session of the Special Committee on Preferences, it was noted that all existing rules of origin adopted by preference-giving countries in their trade preferences granted to developing countries before the entry into force of the GSP schemes were based on the criterion of "substantial transformation." At the same time, it was evident that this basic criterion was not "in itself sufficiently precise" and that it admitted "many different interpretations."[37] The analysis of the various rules of origin commonly applied by these donor countries showed that the substantial transformation criterion had been specified in different ways, so that there were several criteria in use for determining the origin of such goods. These criteria were classified within three broad categories:

(a) extent and nature of manufacturing process undergone;
(b) criterion of final transformation process;
(c) percentage of value added.

[34] See "Rules of origin in the general scheme of preferences in favour of the developing countries," report by the UNCTAD secretariat, TD/B/AC.5/3/Add.4, paras. 74–77.

[35] See TD/B/C.5/2, paras. 87–112.

[36] See the relevant discussions at the fifth meeting regarding this particular sector contained in document TD/B/C.5/2, p. 8.

[37] See UNCTAD document TD/B/AC.5/3, 29 November 1968, Rules of origin in the GSP in favour of the developing countries, p. 18, para. 76.

The first criterion identified the rules that conferred the origin in the case of a completion of a specific process deemed sufficient to give the product in question its essential character. To assess whether a specific process could be regarded as being sufficient, two main methods were in use: A list of qualifying processes and use of the Brussels Tariff Nomenclature (BTN). A combination of the two methods was also to be found.

In the first case, it was necessary to compile relatively long lists indicating the qualifying processes in sufficient detail for each of the products falling within the scope of preferences. In the second case, the rules of origin were based on the change of tariff heading (CTH) of the BTN.[38] This method permitted "a short and accurate definition of the materials" that could be used. At that time, it was found that the most important shortcoming of this method was that the BTN was not designed for origin purposes. In some cases, the CTH was not sufficient to complete a substantial transformation; in other cases, the substantial transformation could take place without a CTH. This required a list of supplementary regulations for those products for which special rules were deemed necessary. As has been pointed out a number of times, the same limitations are still totally valid for the HS. It follows that all the experiences recorded in the following section with the CTC are, *mutatis mutandis*, applicable to the change of tariff classification (CTC) or tariff shift applicable under the modern rules.

The second definition – the criterion of final transformation process – was based on the criteria identified in the nonpreferential rules of origin of the EEC, as contained in regulation 802/68[39]:

> "product in the production of which two or more countries were concerned shall be regarded as originating in the country in which the last substantial process or operation that is economically justified was performed, having been carried out in an undertaking equipped for the purpose, and resulting in the manufacture of a new product or representing an important stage of manufacture."

The third criterion is still used today to identify the rule that confers the origin if a certain percentage of value has been added in the beneficiary country or area in the process of manufacturing.

The main problem encountered by the Working Group with regard to the drafting of a uniform set of origin rules to be applied in all the GSP schemes of preference-giving countries was the opposition of the donor countries. These countries rejected the possibility of introducing uniform rules for determining

[38] The actual HS has been conceived on the basis of the Brussels nomenclature.

[39] Official Journal L1481/65, 1968. This text has been now replaced by Commission Regulation 2454/93 (see footnote 4 above).

the origin of goods in a scheme of preference of a noncontractual nature. This opposition was justified by the fact that the customs officials of preference-giving countries had been using specific criteria and administrative procedures since the inception of the preferential arrangements. Whatever change in these rules, it would have meant an increase in the cost for administering the rules of origin. It has to be noted that at that time neither the United States nor Canada had adopted the BTN as tariff nomenclature. As a result, the preference-giving countries announced in the second meeting of the Working Group on Rules of Origin that they would adopt, in their GSP rules of origin, the same criteria used before in the national individual schemes (1970).[40] However, in the third meeting of the Working Group[41] held in 1970, the preference-giving countries "appreciated the problems that would arise if the concept of substantial transformation were defined in many different ways." Following the concern expressed by the preference-receiving countries over the different criteria for determining the origin and the differences existing in the application of each criterion in the preference-giving countries, the preference-giving countries were able to reduce the variant to two broad categories: The process criterion and the percentage criterion.[42] Moreover, although the preference-giving countries utilizing the process criterion said that they would eliminate differences between the process criterion rules "to the greatest extent possible,"[43] the preference-giving countries adopting the percentage criterion said that they would "endeavour to harmonize their national rules."[44]

During this third meeting,[45] the preference-receiving countries agreed to the introduction of these two systems in the expectation that there would be one single system regulating the process criterion and one system regulating the percentage rule. They "trusted that goods qualifying under one set of rules would be accepted for GSP under the other set, in order to ensure equivalence of market access and to avoid distortion of trade."[46] The first objective of the Working Group on Rules of Origin was consequently to analyze the main divergences existing inside the two categories of criteria used for defining the origin of goods as applied by preference-giving countries.

It has to be pointed out that at that time the term process criterion was referring to the countries using the CTH at the four-digit level of the Brussels

[40] See TD/B/AC.5/31, 8 July 1970.
[41] See TD/B/AC.5/38, 21 December 1970.
[42] See UNCTAD document TD/B/AC.5/38, chapter II.
[43] Ibid. para. 12.
[44] Ibid.
[45] Ibid.
[46] Ibid. para. 16.

nomenclature coupled with a list of extensive exceptions contained in Lists A and B as specified in the following section.

List A and List B were later merged into a Single List in the late 1980s.

5.2.3.1. An Analysis of the Experiences and Lessons Learned under the Process Criterion

As mentioned, in carrying out the tasks assigned to the Working Group, the first criterion analyzed was the process criterion and in particular the lists of qualifying and nonqualifying processes (List A and List B) applied by individual preference-giving countries. However, because the BTN was not designed for determining origin, certain qualifying and nonqualifying processes had to be added to the rules in most schemes in the form of two lists. In particular, List A specified processes that, although resulting in a CTH from the starting materials to the finished article, did not confer origin status on the finished article, or did so only under certain conditions. List B comprised processes that did confer origin status on the products obtained, in spite of the fact that there was no CTH. In addition, for a number of tariff headings, these lists stipulated that goods had to be considered as originating in the beneficiary country only if the value of the nonoriginating material worked or processed did not exceed a given percentage of the value of the goods obtained. The analysis of the national rules indicated that, although Lists A and B generally followed the EEC pattern, certain differences, of both a substantive and a drafting nature, existed. In an early report to the Working Group made in 1982 and titled "The GSP: A comparative study of the rules of origin,"[47] the secretariat pointed out a number of such technical differences and classified them into five categories:

1. differences resulting from variations in the product coverage,
2. drafting differences,
3. differences resulting from different methods of describing the same requirements,
4. differences with respect to percentage requirements, and
5. differences of substance.

Differences Resulting from Variations in Product Coverage

Rules of origin under any preferential tariff arrangement utilizing the process criterion specified such requirements only for goods covered by the arrangement. Consequently, the lists (A and B) of nonqualifying and qualifying processes of preference-giving countries under the GSP specified origin

47 See document TD/B/C.5/2, part two, paras. 97–111, 30 November 1972, The GSP: a comparative study of the rules of origin in force.

TABLE 5.1. *Examples of drafting differences in product-specific rules of origin*

Products obtained		Working or processing that confers the status of "originating" products when the following conditions are met:	Preference-giving countries concerned
BTN heading	Description		
38.15	Prepared rubber accelerators	Manufacture in that the value of the products used does not exceed 50 percent of the value of the finished *product*	EEC, Norway, Finland, Sweden
		Manufacture in that the value of the products used does not exceed 50 percent of the value of the finished *goods*	Denmark, Switzerland
		Manufacture using "*nonoriginating products*" whose value does not exceed 50 percent of the value of the finished *product*	Japan
		The 50 percent *imported materials rule*	United Kingdom

Note: The data in the table refer to GSP schemes of 1972. At the time, Austria, Denmark, Finland, Sweden, and the United Kingdom were not members of the EEC, and they had adopted their GSP schemes independently.

requirements only for products covered by their individual scheme of preferences. Differences in product coverage existed (and still exist) between individual schemes of preferences and were most prevalent in BTN Chapters 1–24. For textiles it was found that, as long as these differences persisted, there would be corresponding differences in the lists of nonqualifying and qualifying processes.

Drafting Differences

According to the report, it appeared that preference-giving countries had not been able to agree on a common phraseology to describe origin requirements. First, in a number of cases, Lists A and B provided that goods obtained in a beneficiary country had to be considered as originating therein only if the value of the products worked or processed did not exceeded a given percentage of the value of the goods obtained. As can be seen from Tables 5.1 and 5.2 from List A, preference-giving countries used different wordings to express the value of component requirement. Second, with respect to process requirements, the following examples from List A illustrated to what extent preference-giving countries used different wordings to describe the same requirements as those listed in Tables 5.1 and 5.2.

TABLE 5.2. *Examples of drafting differences in product-specific rules of origin*

Products obtained		Working or processing that does not confer the status of "originating" products	Preference-giving countries concerned
BTN heading	Description		
11.04	Flours of the fruits falling within any heading in chapter 8	Manufacture from fruits of chapter 8	EEC
		Manufacture from fruits *falling within* chapter 8	Norway
		Manufacture from *the* fruit	United Kingdom
19.05	Prepared foods obtained by the swelling or roasting of cereals products (puffed rice, corn flakes, and similar products)	Manufacture from *various products*	EEC, Switzerland
		Manufacture from *any products*	United Kingdom
32.06	Color flakes	*any* manufacture from *materials of headings* nos. 32.04 and 32.05	EEC, Finland, Norway, Sweden
		Manufacture from *products* of nos. 32.04 or 32.05	Austria
		Any manufacture from *products of headings* nos. 32.04 or 32.05	Denmark
		Manufacture from *materials of headings* nos. 32.04 or 32.05	United Kingdom
		Manufacture from *products falling within headings* nos. 32.04 or 32.05	Japan
		Manufacture from *products of headings* nos. 32.04 or 32.05	Switzerland
20.02	Vegetables prepared or preserved otherwise than by vinegar or acetic acid	Manufactures from *"originating" products falling within* chapter 7	Japan
		Manufacture from *"originating" products* of chapter 7	United Kingdom
45.03	Articles of natural cork	Manufacture from *products of heading* no. 45.01	EEC, Denmark, Finland, Norway, Sweden, Switzerland
		Manufacture from *products of* no. 45.01	Austria
		Manufacture from *products falling within heading* no. 45.01	Japan
		Manufacture from *materials of heading* no. 45.01	United Kingdom

Note: The data in the table refer to GSP schemes of 1972. At the time, Austria, Denmark, Finland, Sweden, and the United Kingdom were not members of the EEC, and they had adopted their GSP schemes independently.

TABLE 5.3. *Examples of drafting differences in product-specific rules of origin*

BTN heading	Description	
19.01	Malt extract	Japan regarded the manufacture of malt extract from cereals as conferring the status of "originating" products
		The United Kingdom regarded the manufacture of malt extract from malt as not conferring the status of "originating" products.

Note: The data in the table refer to GSP schemes of 1972. At that time the United Kingdom was not an EC member, and it had adopted its GSP scheme independently.

Differences Resulting from Different Methods of Describing the Same Origin Requirements

For products under a number of BTN headings, some preference-giving countries specified working or processing operations that did not confer the status of "originating" products, whereas other preference-giving countries specified working or processing operations for the same products that did confer such status when certain conditions were met. The origin requirements were virtually the same, the difference being that they had been determined by some preference-giving countries in a negative way and by others in a positive way. Differences that may be relevant in the activity of drafting a set of uniform rules of origin are illustrated by the example shown in Table 5.3.

In this example, if the malt extract is to qualify for preferential tariff treatment in the United Kingdom, the manufacturer has, as in the case of Japan, to start from cereals for the manufacture of malt and subsequently malt extracts.

Differences with Reference to Percentage Requirements

For a number of BTN headings, Lists A and B drawn up by preference-giving countries provided that the goods referred to and obtained in a beneficiary country had to be considered as originating in that country only if the value of the nonoriginating products worked or processed did not exceed a given percentage of the value of the goods obtained. Preference-giving countries specified in their rules of origin[48] that the value to be taken into consideration in determining such percentage was as follows:

(i) *as regards products whose importation could be proven*: their customs value at the time of importation into the developing country;

[48] For relevant extracts, see annex III of document TD/B/C.5/2.

(ii) *as regards products of undetermined origin*: the earliest ascertainable price paid for them in the developing country of manufacture;
(iii) *as regards the goods obtained*: in the case of Japan the Free On Board (FOB) price of the goods, excluding any internal taxes refunded or refundable on exportation; in the cases of Austria, Denmark, EEC, Finland, Norway, Sweden, Switzerland, and the United Kingdom the "ex-works" (ex-factory) price of the goods, excluding any internal taxes refunded or refundable on exportation.

It was clear to the Working Group that the differences in the definition of the value of the goods obtained might have created unequal conditions of access to markets of the preference-giving countries concerned. This situation might have arisen because, although the ex-works price includes the costs of production and the producer's profit, the FOB price includes, in addition, all other costs in the producing country, in particular the costs of transport from the factory to the frontier or port and any cost and profit of trading intermediaries in the country. Where additional costs, such as transportation costs and/or trading costs, occurred after the goods obtained had left the factory, and if the FOB price was used for determining the value of the goods obtained, these costs would add to the base figure for calculating the percentage limit for nonoriginating products. Thus, these costs would decrease proportionately the maximum value of nonoriginating products to be used in the manufacturing process in the total FOB value of the finished product and enable the exported product in borderline cases to qualify for preferential tariff treatment. If, however, the ex-factory price was used for determining the value of the goods obtained, such costs would not be counted toward the percentage limit, and the share of nonoriginating products used in the manufacturing process might exceed the maximum percentage prescribed, thus making the finished products ineligible for preferential tariff treatment.

As experienced in the application of GSP rules of origin, it was also considered that an advantage of the FOB price basis was that it allowed for a liberal operation of percentage value requirements. In fact, a greater proportion of nonoriginating products could be used in the manufacturing process than when the percentage limit was calculated based on the ex-factory price of the products obtained. Moreover, it was noted that the FOB price was probably the price most generally quoted in export transactions.[49] This price is normally readily available and does not need to be specially calculated as a basis for the calculation of the percentage. This is not necessarily true to the same extent

[49] See UNCTAD document TD/B/AC.5/3/Add.4, para. 11.

of the ex-factory price. On the other hand, it was argued that the FOB price entailed the disadvantage that manufactures of a given product in a given beneficiary country might not be treated on an equal footing. Whereas the value of the nonoriginating products used must not exceed 50 percent of the value of the goods obtained, the actual proportion of nonoriginating products allowed to be used in the manufacturing process would depend on whether internal transportation costs and/or trading costs had arisen. Consequently, in a hypothetical borderline case, a manufacturer established near the port of export or exporting directly would have failed to meet the percentage requirement because nonoriginating products amounted to slightly over 50 percent of the value of the manufactured product. By contrast, a manufacturer established elsewhere and operating in identical production conditions might qualify for preference because his FOB price includes internal transportation costs or because an intermediary trader is involved in his trade transactions. The question arose, however, whether in such a case the manufacturer, who had to bear additional internal transportation cost and/or trading costs, would have to reduce his profit margin accordingly to compete with the manufacturer near the port. If he did, the question of unequal treatment assumed above might not have arisen. However, it was further argued that the ex-factory price was closer to the true concept of value added because it constituted a true measure of the manufacturing process leaving aside any postproduction costs, such as internal transportation cost or trading cost.

Differences in Substance

According to the same report, it was thought useful to present some examples that showed the differences in substance of the definition of certain origin requirements which arose with the use of the process criterion. Some of these differences are shown in Table 5.4.

5.2.3.1.1. *An Analysis of the Specific Requirements Related to Selected Products under the Process Criterion*

Drafting Techniques

Another problem of great relevance identified by the UNCTAD studies on the process criterion was linked to the definition of the processes that confer the origin to the goods. In fact, as the problem of definitions connected with the use of the process criterion was easily solved by use of a well-known and accepted nomenclature classification of products, there was also the necessity to provide some kind of definition of the processes that products must have undergone to fulfill the origin requirement. From a theoretical point of view,

TABLE 5.4. *Differences in substantive requirements*

BTN heading	Description	
41.06	Chamois-dressed leather	Japan regarded manufacture from imported raw hides and skins (BTN 41.01) as not conferring the status of "originating" products (List A)
		Under the rules of origin of many countries the chamois-dressed leather was regarded as an originating product (no exception in List A); the general rule of change of BTN heading applied.
ex 31.04	Mineral or chemical fertilizers, potassic	Switzerland regarded manufacture from imported potassium chloride or from crude natural potassium salts as conferring the status of originating product (List B)
		Under the rules of origin of many countries the fertilizers did not qualify (no exception in List B; the general rule of change of BTN applied)
41.08	Patent leather and imitation patent leather; metallized leather	Austria, EEC, and Nordic countries regarded the varnishing or metallizing of imported leather as conferring the status of "originating" products if the value of the skin leather used did not exceed 50 percent of the value of the finished product (List A)
		Under the rules of Japan the leather would qualify if manufactured from imported raw hides or skins (BTN heading 41.01) (List A)
		Ireland regarded the varnishing or metallizing of imported leather as conferring the status of originating products without any further conditions (no exception in List A: the general rule of CTH of BTN applied)

Note: The data in the table refer to GSP schemes of 1972. At that time Austria, Denmark, Finland, Ireland, Sweden, and the United Kingdom were not EC members, and they had adopted their GSP schemes independently.

the best solution that was envisaged was to define the exact process for each single product. However, this system raised the question that in many instances this would have resulted in a splitting up of the headings for the final products into an extremely large number of subheadings, as has happened some 20 years later during the negotiations on nonpreferential rules of origin.

In UNCTAD, it was found that, as the BTN was taken as a basis for discussion, there nevertheless existed some BTN headings that comprised goods differing so considerably from each other that there would be no practical possibility of defining only one process of production for all of them. In fact, it was considered that in certain cases a single heading covered not only goods that could best be described as raw materials, but also goods that were highly manufactured. This consideration may still apply for the HS. HS heading 30.03 comprises medicaments of all kinds, from simple mixtures of plants to the most sophisticated mixtures of equally sophisticated chemical products. The HS provides a splitting up of the heading that, in some cases, permits the description of processes of manufacture that are both economically reasonable and intelligible. However, providing different process criteria for each subheading of the HS may cause an exceptional proliferation of different and very complex rules of origin. It was felt that direct reference to a process, such as printing or rolling, was a simple solution for many products, as it was possible to apply such references even to some whole headings. As an example, the printing process might be mentioned for goods falling in headings 49.01 or 49.02 (books, newspapers, etc.); a similar system was applied by the EEC in the GSP rules of origin in the 1970s.[50]

However, it was felt that even such definitions of the process requirement needed some refinement. For example, the expression "rolling" seemed to be unambiguous as a description for the manufacture of metal sheets. However, cold-rolled steel sheets have undergone many stages of rolling. First, the steel ingots have been rolled down into slabs or sheet bars. The next stage is the production of hot-rolled steel plates, a procedure that means rolling in many steps down to a desired thickness. The cold rolling is a new stage that may again be performed in many steps, depending on the desired final thickness. A rolling process has no doubt been fulfilled by a manufacturer who has performed only the last rolling of an already cold-rolled steel sheet. If the intention is that all cold rolling must be performed according to the origin criterion this must be clearly stated, e.g., by a direct requirement that all cold rolling has to be so performed or that the starting material must be hot-rolled steel sheets. If, on the other hand, the intention is that all rolling (hot and cold) must be performed according to the origin criterion, one solution would be to state that ingots must be used as starting material.

Similar considerations could be applied to other procedures, such as printing (e.g., the printing of only a few pages of a book), painting, and so on. However,

[50] See schedule B mentioned in Article 3(b) in UNCTAD document TB/B/AC.5/3/Add.1, p. 7.

the precautionary measure previously mentioned, namely, to state the starting materials, might be enough even without a reference to the rolling procedure, because the only practicable way to make steel sheets from ingots is the rolling procedure.

5.2.3.1.2. *Early Experience and Difficulties with the Issue of Multistage Operations, Double Jumps, and Double Transformations*

An UNCTAD study conducted in 1973[51] and titled "The GSP: Proposals for improvement and harmonization of the rules of origin" analyzed rules of origin contained in List A and List B of the GSP scheme from a different perspective. The study first considered that, normally, it is expected that each economically justified process adds a certain value to the processed goods. However, the study noted that many of the processes required in List A were multistage operations that did not provide that origin status was conferred by one single process of production (e.g., making garments from yarn, whereas use of textile fabrics as starting material would not confer origin status on the finished garment – processes required for garments falling into BTN headings 61.01–61.04),[52] or else they implied *de facto* that the finished articles must be wholly produced in the preference-receiving countries concerned. These rules, also called multistage rules, were criticized by the preference-receiving countries as going "far beyond the conceivable limits of substantial transformation."[53] Because most of them are still in place today, the following sections may be of extreme relevance for those wishing to avoid such experiences.

The implications of such provisions in the GSP rules of origin in force at that time had been shown in the 1973 study by some technical examples, which are reported in the following paragraphs.[54]

The study considered that, in principle, processes requiring multistage operations may be justified by the fact that in quite a number of cases a manufacturing process can cause a CTH without resulting in sufficient transformation of the starting material. Because the BTN (and the HS) was not devised for purposes of determining origin, it sometimes classified goods that had undergone only a very simple manufacturing process in a tariff heading other than that corresponding to their starting materials.

[51] See document TD/B/C.5/WG(IV)/2, 26 September 1973, "GSP: Proposals for improvement and harmonization of the rules of origin."

[52] Also at present the EC adopted the same rule for articles of Chapter 62 for GSP purposes; see Reg. 2454/93, O.J. L 253/93, p. 286.

[53] See document TD/B/C.5/18, p. 15.

[54] Paras. 68 to 90 with the exception of para. 84 are excerpted from the study: "GSP: Proposals for improvement and harmonization of the rules of origin."

For example, cotton yarn, not put up for retail sale, fell within BTN heading 55.05, whereas the same yarn, put up for retail sale, fell within BTN heading 55.06.[55] It was quite understandable that the process involved in this CTH could not be deemed sufficient for conferring origin status on the cotton yarn put up for sale.

Multistage processing, however, usually involved much more than the simple exclusion of a simple manufacturing or finishing operation. In the examples contained in the study, it was shown that the multistage processing specified in List A generally required in the course of production a percentage of value added unusually high that made it extremely difficult for preference-receiving countries to derive benefits from the GSP.[56]

In examining the percentage requirement laid down in List A, it was noted that, in many cases, the processes in List A conferred origin status only if the value of the nonoriginating material did not exceed a certain percentage of the finished article. The concept of value added in this case was therefore used as a complementary provision.[57] It was found at that time that such a provision had been prescribed for two tariff lines in BTN Chapters 1–24 and for 237 tariff lines in BTN Chapters 25–99 (account being taken of the processes covering whole chapters), making 239 tariff lines in all. Of the 409 processes specified in List A for BTN Chapters 25–99, 58.4 percent involved a percentage requirement. Of these 239 processes involving a percentage requirement, 99 (or 41.4 percent) laid down a nonoriginating percentage limit of 40 percent of the value of the finished products (i.e., required that 150 percent of the value of the imported material be added in the course of manufacture in the preference-receiving country), 80 processes (or 33.5 percent) laid down a nonoriginating percentage of 50 percent (i.e., required 100 percent of value added in the country of origin). One process laid down a nonoriginating percentage of 70 percent for imported raw materials, requiring therefore only 42.9 percent of value added. Thirteen processes (or 5.4 percent) used a combined formula, laying down 40 and 50 percent of nonoriginating elements for various parts of the finished article, respectively.[58]

[55] The same problem has found a solution with the adoption of the HS; in fact, both cotton yarn put up for sale and cotton yarn not put up for sale fall within the same heading (52.04); the first is classified in a different subheading (5204.11) from the second (5204.20).

[56] See, document TD/B/C.5/10 annex 10, para 67a, and document TD/B/C.5/11, p. 24.

[57] In the case of copper powder and flakes, for example, (BTN heading 74.06), a manufacturing process conferred origin status only if the value of the nonoriginating products used did not exceed 50 percent of the value of the finished product; in other words, another 100 percent had to be added, in the course of production, to the value of the nonoriginating products.

[58] In all these calculations, account was taken of processes covering more than one tariff heading.

The calculations made in the following examples concerning textile, plastics, metals, and other products were contained in the UNCTAD study of 1973 and were based on averages pertaining to advanced industrial processing. In doing so, the reader was first warned of the empirical methodology assumed in the study. It was acknowledged that production costs and production techniques vary from one country to another, depending on relative factor endowment and the level of industrialization. Consequently, it was considered that working out examples based on the actual cost situation in a developing country was impossible and in any event time consuming. To simplify matters, the situation obtaining in an advanced industry had been taken and the results obtained had therefore to be interpreted with caution. Another necessary premise was that, in the method of calculation used, the input of raw material, generally of a nonoriginating character, was assumed equivalent to 100. This hypothetical amount was added to the value attributable to a specific process of production (the processing factor) to obtain the value of the intermediate product. Next, the processing factor attributable to the further process of production was added, the result being the value of the finished article. By comparing this value with the value of the input of raw material, which was always 100, the total percentage of value added required by the hypothetical origin rules was obtained.[59]

5.2.3.1.3. *Some Examples of Product-Specific Experiences under the Process Criterion*

Textiles and Garments

According to the requirement laid down in the GSP rules, numerous multistage operations are required in the production of textiles. For example, GSP rules of origin, as in that of the GSP in the early 1970s, required that cotton yarn (BTN 55.05), to obtain the origin, had to be manufactured from cotton, not carded or combed or from cotton linters or from cotton waste not carded or combed (the required process was "manufacture from materials of heading n. 55.01 or 55.03"). According to the average value attributable to the specific

[59] See UNCTAD document TD/B/C.5/WG(IV)/2, p. 9. The following is an example of the calculation: input of raw material of nonoriginating character (e.g., raw cotton): 100

+	first processing factor (e.g., spinning)	75 percent
=	value of the intermediate product (e.g., yarn)	175
+	second processing factor (e.g., weaving):	140 percent
=	value of the finished article (e.g., fabric):	420.

Therefore, in this case value added required is 320 percent.

processing factor, the spinning factor raised the value of the starting material, usually by 75 percent. For 100 units of raw cotton the yarn had a face value of 175, and the percentage of value added required by this process thus amounted on average to 75.[60]

For "other woven fabrics of cotton" (BTN 55.09) the process prescribed in the rules was "Manufacture from materials of headings Nos. 55.01, 55.03 and 55.04." Because the use of nonoriginating yarn was not permitted as raw material, the starting material for production of fabrics must again be raw cotton. Because it was assumed that the average value attributable to the weaving process was equivalent to 140 percent, this process raised the value of the yarn to a value of 420 units. The percentage of value added required by the rules for cotton fabrics is, therefore, not less than 328. For ready-made garments (RMGs), such as men's and boy's outer garments (BTN 61.01), the process prescribed by the rules was that the working or processing conferring originating status was "manufacture from yarn."[61] The study considered that the rule of thumb in the textile industry was that one third of the ex-factory price of the finished garment was accounted for by the material used, one third by the outfitting process, and one third by other items, such as overheads, royalties, taxes, and profits. The expression "material used," however, referred to the textile fabric, and on this assumption, the value of the woven fabric would represent about 33 percent of the value of the finished garment and the value-added would be about 230 (the value of woven fabric is assumed = 100). The origin rules requiring yarn as starting material led to the following result:

value of the yarn	100 percent
processing factor for weaving	about 140 percent
value of the woven fabric	240 percent

Because the fabric represents one-third of the value of the finished garment, the value of the latter will be 720. Moreover, the value of the yarn represents about 14 percent of the value of the finished garment. The origin rule for finished garments, permitting only nonoriginating yarn as starting material,

[60] The same process is still required for the EC GSP rules of origin at present. The rules are as follows: 52.04 to 52.07, including yarn and thread of cotton, are manufactured from (a) natural fibers not carded or combed or otherwise processed for spinning, (b) chemical materials or textile pulp, or (c) papermaking materials (Excerpted from Commission Regulation 2454/93, 2008 consolidated text, page 386–387).

[61] In the EC GSP rules of origin the materials described in the text, classified in Chapter 62 of the HS, obtain the origin if they are manufactured from yarn. In the case of HS Chapter 62, the EC rules require manufacture from yarn (also required in the case of garments obtained by sewing together or otherwise assembling two or more pieces of knitted or crocheted fabric).

would involve, from this method of calculation based on averages, more than 600 percent of value added to the starting material.[62]

These two examples showed clearly the implications of operations involving a two-stage process. In the first case, in which "originating" fabric had to be made from raw cotton, a percentage of value of 320 must be added, instead of 140 percent represented by the processing factor for the weaving process. In the case of garments the starting material of that had to be yarn, the industrially justified percentage of about 200–230 percent resulting from the manufacture of woven fabrics was increased to more than 600.

For yarn of manmade fiber (continuous) (BTN 51.01) the process prescribed was, "manufacture from chemical products or textile pulp."[63] As far as synthetics were concerned, about 40 percent of the ex-factory price of the yarn can be attributed to the chemical raw material. Thus the processing factor accounts for about 150 percent.

For woven fabrics of manmade fibers (continuous) (BTN 51.04), the rules prescribed again, "manufacture from chemical products or textile pulp." The portion of the value of woven fabrics that can be attributed to the yarn varies from 30 percent to 40 percent of value added. The process requested is two stage and leads to the following calculation:

unit value of the raw material (chemical product)	100
value of the yarn	250
value-added	150 percent
value of the woven fabric	625–800
value-added	150–220 percent

The value of the chemical raw material represented between 12.5 percent and 16 percent of the woven fabric. The origin rule for woven synthetic fabrics thus requires, by this method of calculation based on averages, between 500 percent and 700 percent of value added to the starting material.

[62] It has to be noted that Japan has removed the "double jump" requirement for most clothing and accessories in Chapter 62; the amendment of the rules of origin relaxed in such a way that the articles falling in HS Chapter 62 are eligible for GSP even if they are manufactured directly from imported fabrics; However, there are some exceptions to the new rule: "handkerchiefs" of HS heading 6213 and "shawls, etc" of heading 6214 have to be manufactured from material of fiber (chemical products, etc.), and "ties, etc." of heading 6215, "gloves, etc" of heading 6216 and "other made-up clothing accessories, etc." of heading 62.17 have to be manufactured from textile yarn.

[63] See, for example, the nonpreferential rules of origin of the EC contained in Annex 10 of the Reg. 2454/93, in O.J. L 253, 11 October 1993, and the EC GSP rules of origin contained in the same regulations; the manmade filaments are now classified in Chapter 54 of the HS. The rules of origin for these products are still "manufacture from chemical materials or textile pulp."

In the case of textile items made of wool, the processes performed were found to be equivalent to lower percentages of value added. It was assumed that raw wool accounted for about 55 percent of the value of the woolen yarn, representing a processing factor of 80 percent value added. In addition, it was considered that the portion of the value of the woolen fabrics that can be attributed to the woolen yarn amounted to about 45 percent, with the processing factor amounting to about 120 percent of value added. The manufacturing processes prescribed by the rules required for woolen yarn (BTN 53.06), "manufacture from products of headings Nos. 53.01 and 53.03," and for woven woolen fabrics (BTN 53.11), "manufacture from materials of headings nos. 53.01 to 53.05 inclusive." In both cases, the starting material had to be raw wool. However, for the manufacture of woolen fabrics, waste of wool, even pulled or garneted (BTN 53.04), and wool, carded or combed (53.05), were also admitted. A similar rule is still in force in the current rules of origin under the EC GSP scheme. For woolen fabrics (51.06), it is prescribed that the manufacture should start from natural fibers not carded or combed or otherwise prepared for spinning.[64] Assuming that raw wool was used as the starting material, the two-stage process in the rules described leads to the following calculation:

raw wool (starting material)	100
value of the woolen yarn	180
value-added	55 percent
value of the woolen fabric	400
value-added	180 percent.

The value of the raw wool thus calculated represents 25 percent of the value of the woolen fabric. Therefore the origin rule for woolen fabrics required, according to this calculation based on averages, 400 percent of value added to the starting material.

Woven fabrics of true hemp fell within BTN 57.09 and woven fabrics of jute within BTN 57.10. For woven fabrics of true hemp, materials of BTN heading 57.01 ("true hemp, raw or processed but not spun, tow and waste of true hemp (including pulled or garneted rags or ropes)") were required as starting material. For woven fabrics of jute, only raw jute was recognized as starting material. The Working Group considered the possible extension of the process prescribed for BTN 57.10 with a view to allowing the use of materials of heading 57.03. This would have enabled producers in preference-receiving countries to use not only raw jute, but also jute, processed, but not spun, and tow and waste of jute (including pulled or garneted rags or ropes) as starting materials. The manufacture of jute fabrics from these materials would constitute a substantial

[64] See TD/B/C.5/WG(IV)/2.

transformation, and the value thus added would have far exceeded 50 percent of the value of the finished article.

For various textile fabrics of BTN headings 59.07, 59.08, 59.09, 59.11, and 59.12, manufacture from yarn was recognized as conferring origin status. However, for "elastic fabrics and trimmings (other than knitted or crocheted goods) consisting of textile materials combined with rubber threads" (BTN 59.13) and "wicks, of woven, plaited or knitted textile materials, for lamps, stoves, lighters, candles and the like; tubular knitted gas-mantle fabric and incandescent gas mantles" (BTN 59.14), manufacture from single yarn was required. These rules had been reviewed, as the process of doubling and twisting yarn was a relatively wage-intensive one.

In BTN Chapter 61, for garments falling within heading nos. 61.01 to 61.04 manufacture from yarn conferred origin status. For handkerchiefs (BTN 61.05), a special process allowed only the use of unbleached single yarn. Handkerchiefs, especially those of the scarf type, were of special export interest for some preference-receiving countries, and production was based to an extent on handicraft. The special process of manufacture led to an undue restriction of the export possibilities of interested countries.[65]

Plastics

Another type of difficulty facing GSP beneficiaries in fulfilling origin requirements is illustrated by the origin rule relating to BTN 39.07, "articles of materials of the kind described in heading nos. 39.01 to 39.06," i.e., articles of plastic materials.[66] At that time, List A described "working of artificial plastic materials, cellulose ethers and esters, and artificial resins" as a process that did not confer origin status. For a better understanding of this process it should be recalled that BTN Chapter 39 comprised "Artificial resins and plastic materials, cellulose esters and ethers; articles thereof." Artificial resins, plastic materials, and cellulose esters and ethers were covered by heading nos. 39.01 to 39.06 inclusive; the articles made thereof fell within heading no. 39.07. The process rule was obviously intended to exclude in principle manufactures of articles of plastic materials, falling within heading no. 39.07 made from plastic raw materials falling within earlier headings of BTN Chapter 39. The wording of this process rule, however, differed to an important extent from that of similar rules in this respect. It excluded only "working" of materials from headings nos. 39.01 to 39.06, whereas List A referred to "working or processing" that did not confer the status of "originating" products. The conclusion was that nonoriginating starting material from heading nos. 39.01 to 39.06 could be used for the manufacture

[65] See document TD/B/C.5/WG(IV)/2, p. 14.
[66] See document TD/B/C.5/10 Annex A, para. 65.

of "originating" products as long as it was "processed" and not just "worked." The distinction between these two types of manufacture – "working" and "processing" – posed some problems with regard to some borderline cases for which neither "working" nor "processing" would be appropriate in defining the operation performed. In such cases, the first problem was one of interpretation.

Another problem of a technical nature reported in the study arose from the fact that "working" of artificial resins was virtually impossible. If artificial resins in their various forms – such as granules, blocks, emulsions, solutions, and dispersions – undergo a manufacturing process, they become a different kind of article with clearly distinct characteristics. Hence, the finished goods could not be considered "worked raw artificial resins." Thus the exclusion of "working" of artificial resins was superfluous, because only the processing of artificial resins was economically feasible. On the other hand, foils of artificial plastic materials can be heated, coated (even with gold), and stamped with plastic spangles. This kind of manufacture could be held to be "working" rather than "processing" and would therefore not confer the status of "originating" products of the plastic spangle. However, the portion of the value of the finished goods (the plastic spangle) that could be attributed to the starting plastic foil could, in some cases, reach 10 percent at most, and hence the value added during manufacture might reach as much as 90 percent. Even such manufacture would not have conferred origin status on the plastic spangle by the application of the process rule as prescribed.

Further examples were given to show additional hardships created by the process rule for BTN 39.07. Producing plastic articles of polymer material, from monomers of BTN Chapter 29, would have normally led to a value added of about 230 percent, because the proportion of the value of the finished article that could be attributed to the starting monomer would have been, on average, not more than 30 percent. This average could, of course, vary considerably according to the kind of goods concerned. A cup made of polystyrene material with a value of 25 contained a ray monomer material of no more than 3 percent. The processing factor from the monomer to the polymer would have been about 230 percent; from the polymer to the finished cup, it would have been about 150 percent.

To solve this specific problem, the study drew attention to the manner in which the EFTA had dealt with the problem of formulating origin rules for goods falling within BTN 39.07. The qualifying process laid down in Schedule I to Annex B of the Stockholm Convention[67] (list of qualifying processes with alternative percentage criterion) allowed for either:

[67] The Convention establishing the European Free Trade Association was signed at Stockholm on 4 January 1960 and entered into force on 3 May 1960. See the EFTA Convention published in February 1967 by the European Free Trade Association.

> "Manufacture from materials not falling in chapter 39 and not being solutions of artificial resins (ex 32.09) and not being materials which contained materials of chapter 39, or Manufacture from materials falling in 39.01 to 39.03 which are in any form (other than blocks) mentioned in Notes 3 (a) and 3 (b) to chapter 39 or from materials falling in 39.04 to 39.06 or chapter 32 or from materials not being and not containing materials of chapter 39, provided that both (a) the process does not consist solely of agglomerating without change in the degree of polymerization, or sintering, or combination of these processes, and (b) 50 percent or more by weight of the artificial resins used is of Area origin."

The Stockholm Convention[68] also included special arrangements for the application of the 50 percent proviso in the case of articles made from a certain number of artificial resins. In all other cases, the usual 50 percent rule was applicable.[69]

As Chapter 39 of the BTN roughly corresponds to Chapter 39 of the HS and the same happens for Chapter 29 of the BTN with regard to Chapter 29 of the HS, a rule of origin similar to that of the GSP scheme in 1973 would cause the identical problems reported in the text.

In the EC GSP rules of origin the problem was solved in a similar way to that of the Stockholm Convention; the rule is as follows:

3901 to 3915	Plastics in primary forms, waste, parings and scrap, of plastic	Manufacture in which
	• Addition homopolymerization products	• the value of all the materials used does not exceed 50 percent of the ex-works price of the product, and • the value of any materials of Chapter 39 used does not exceed 20 percent of the ex-work price of the product
	• Other	Manufacture in which the value of any materials of Chapter 39 does not exceed 20 percent of the ex-work price of the product. Or Manufacture in which the value of all the materials used does not exceed 25 percent of the ex-works price of the product.

[68] See footnote 108.

[69] See EFTA Convention of 1567 mentioned in previous footnotes.

Recently, in the same HS chapter, some producers encountered difficulties[70] (1987) with regard to polypropylene film, with a rule of origin that required that the "value of any materials of chapter 39 used does not exceed 20 percent of the ex work price of the product." The imported materials are usually homopolymers, copolymers, and polymers; the process of production is represented by the extrusion, cooling longitudinal stretching, transversal stretching, corona treatment, and rolling. At the end of the manufacturing process, the average value of imported materials from Chapter 39 was 28 percent of the ex-work price of the product; so the goods did not obtain the origin,[71] even if a number of processes were carried out.

Metals Products

In the field of metals, the rule requiring a minimum of domestic content was found to create problems for producers. For this kind of product, the study found that the indication of processing factors or average figures for the value added in the process of manufacture had been considered by the Working Group extremely difficult and open to too many misinterpretations. This finding derived not only from the large discrepancies in the value of possible material input and the varying influence of the capital and investment factors in production, but also from the large fluctuations in prices of non-ferrous metals.

In this category of products, it appeared that the 50 percent rule could generally be met more easily in the case of sophisticated products, such as household articles, heating apparatus, builders' sanitary ware, and most "other" articles, than in the case of semimanufactured metal ware. For the latter, the 50 percent rule prevented semimanufactured products made from imported raw material from qualifying for preferential tariff treatment. The effect of the 50 percent rule would be to require that these articles be wholly produced in the preference-receiving country concerned.

Other Products

In the course of the proceedings of the Working Group and the Sessional Committee on Rules of Origin, many other problems related to specific rules of origin are described in the following section, without pretending to be exhaustive.

Many producers faced difficulties in fulfilling a rule of origin relative to electronic security lamps, of Council Cooperation Customs Nomenclature (CCCN) heading 85.20, which required that imported materials must not

[70] See TD/B/C.5/WG()/2, 8 September 1987, p. 23.

[71] See document TD/B/C.5/WG()/2, *Priorities regarding improvements in rules of origin under the generalized system of preferences*, 8 September 1987.

exceed 40 percent of the ex-factory price or the FOB export price. The imported materials in that case are various lamps, bulbs, and transformers; the manufacturing process is the assembling and gluing of plastic and metal parts with resistor, assembly and soldering of electrical and electronic components, winding of coils, final assembly, coloring of bulb, installation of glass fiber, and final testing. The problem is that imported materials account for 53 percent of the sales price, so the goods do not qualify for the origin.[72]

Another important problem was linked to the fact that, with regard to precious goods, the use of percentage criteria instead of CTH implies that the final origin of the good is the origin of the most precious part of the final products. For example, in the case of gold jewellery, according the EC rules of origin, a gold ring manufactured in a country from imported gold metal would obtain origin because, for a product of HS heading 71.14, it is enough to change the tariff heading, but the addition of an original precious stone would disqualify it because the rule for products under tariff heading 71.16 allowed the use of imported materials (in this case, gold) only up to a limit of 50 percent.[73]

As for toys (HS heading 95.43), some developing countries' producers found it impossible to fulfill the rule of origin based on the CTH criterion; in fact, for some countries it is necessary to import some parts also under heading 95.43, so the finished toys cannot obtain the origin.

In general, the rules of origin that provoked the most complaints were the CTH tests coupled with input restrictions. An example from the old EC and EFTA GSP rules of origin is tariff heading 8525, "transmission apparatus for radio-telephony, radio telegraphy, radio broadcasting or television, whether or not incorporating reception apparatus or sound recording or reproducing apparatus; television cameras," which required:

- manufacture in which the value of all the nonoriginating materials used does not exceed 40 percent of the ex-work price of the product (= percentage test);
- where, within the above (40 percent) limit, the materials classified within heading N. 85.29 are only used up to a value of 5 percent of the ex-work price of the product (= input restriction);
- where the value of all the nonoriginating materials used does not exceed the value of the originating materials used (value-of-part-test); and
- all the transistors of heading 8541 used are originating products (= obligatory input).

[72] See document TD/B/C.5/WG()/2, 8 September 1987, p. 23.
[73] See TB/B/C.5/126, 12 July 1989.

The present EC rules of origin for heading 8525 has maintained the percentage test and the value of parts test removing the other requirements. According to the UNCTAD report, manufacturers and exporters have complained about the stringency of this rule, especially where it referred to the obligatory input (transistors). In particular, it was found that the CTH was generally replaced with a 40 percent limit on imported inputs for all machinery, electrical machinery and appliances, most vehicles, and scientific and other instruments (Chapters 84, 85, 86, 87, and 90). In these chapters, additional restrictions on the use of imported materials were frequent for a number of important products. The transistor rule also applied to microphones, loudspeakers, record players, tape recorders, and video recorders. Moreover, restrictions were often imposed on the use of other inputs under different tariff headings. Specific restrictions of that type could be found for sewing machines (8452): In addition to a 40 percent maximum imported input allowance, imported materials may not exceed the value of originating materials used for assembling the head; and the thread tension, crochet, and zigzag mechanisms used must be originating products. This rule is still in force.

In the same document, it was reported that Japan used, for machinery and electrical appliances, the same general rules stipulating a 40 percent limit on imported inputs and limiting the use of parts and components from the same four-digit tariff heading to 5 percent. However, Japanese rules for such products usually did not stipulate additional requirements and were therefore less stringent than those under the EC and EFTA schemes. There were, however, some exceptions, for example, with respect to the use of imported razor blades for the production of motorized shavers and hair clippers (HS 85.10): The only manufacturing processes to qualify were those in which the value of the nonoriginating products of a tariff heading different from the one of the products obtained and nonoriginating razor blades of HS 85.10 does not exceed 40 percent of the value of the products obtained and in which the value of the nonoriginating products (excluding razor blades) of the same tariff heading as the product obtained does not exceed 5 percent of the value of this product. These exceptions were later eliminated.

5.2.3.1.4. *Difficulties Experienced by the Introduction of the Harmonized System and the Single List*

These particular difficulties may not be entirely replicated because the HS is currently implemented worldwide by the customs administration of the preference giving countries. However, even the HS is changing and evolving, and each time a new version enters into force, amendments have to be made to the rules of origin that are using the HS.

Since the introduction of the HS in 1988, the preference-giving countries utilizing the process criterion have implemented these rules of origin requirements based on the new customs nomenclature. However, even the HS system – like the previous BTN and CCCN – was not expressly designed for origin rule purposes and the basic rule of CTH did not in all cases result in a "substantial transformation" to the satisfaction of preference-giving countries. Consequently, preference-giving countries elaborated a list of products accepted from the basic CTH rule and subjected them to separate and specific rules. The list, commonly referred to as the "Single List," contained various formulations of the requirements to be met, and most of the time their content in terms of specific requirements was just the result of a combination of the previous List A and List B.

Goods in the Single List are those for which the CTH is not considered sufficient to define a substantial transformation. It has been assessed that the number and range of products included in the lists of exceptions is extensive. Of the 94 chapters of the complete HS system, about 84 were found on the product lists. All HS chapters on textiles and clothing products, which were of particular interest to preference-giving countries, were represented on the lists. The various types of rules were found to replicate the previous requirements under Lists A and B, as shown in the following section:

- manufactures from specified materials, in some cases:
  - requiring several stages of manufacture:
  - not requiring CTH;
- manufacture with one percentage limitation;
- manufacture from specified materials together with a percentage limitation;
- manufacture resulting in a change of tariff heading together with a percentage limitation;
- manufacture with two or three percentage limitations, in some cases with the added requirement that certain specified materials or parts must be of originating status.

As in Lists A and B and shown in Table 5.5, many of these requirements were expressed in terms of the HS, whereas others were expressed in plain language. Some employed a percentage criterion, occasionally in double or triple form. The percentage criterion was formulated with import content as the numerator and ex-factory price (FOB price in the case of Japan) as the denominator. Another type of rule specified the materials from which the finished product must be made.

TABLE 5.5. *Examples of Single List requirements*

HS heading	Description of goods	Working or processing carried out on such originating materials that confer originating status
ex 4302	Tanned or dressed fur skins, assembled, other than plates, crosses or similar forms	Manufacture from nonassembled tanned or dressed fur skins
4303	Articles of apparel, clothing accessories and other articles of fur skin	Manufacture from nonassembled tanned or dressed fur skins, of heading no. 4302
Chapter 61	Articles of apparel and clothing accessories, knitted or crocheted	Manufacture from: • natural fibers • manmade staple fibers not carded or combed or otherwise prepared from spinning or, • chemical materials or textile pulp
7116	Articles of natural or cultured pearls, precious or semi-precious stones (natural, synthetic or reconstructed)	Manufacture in which the value of all the materials used does not exceed 50 percent of the ex-work price of the product
7117	Imitation jewellery	Manufacture in which all the materials used are classified within a heading other than that of the product, or Manufacture from base metal parts, not plated or covered with precious metal, provided the value of all the materials used does not exceed 50 percent of the ex-work price of the product
8208	Knives and cutting blades, for machines or for mechanical appliances	Manufacture in which: • all the materials used are classified within a heading other than that of the product, and • the value of all the materials used does not exceed 40 percent of the ex-work price of the product

(*continued*)

HS heading	Description of goods	Working or processing carried out on such originating materials that confer originating status
8415	Air-conditioning machines, comprising a motor-driven fan and elements for changing the temperature and humidity, including those machines in that the humidity cannot be separately regulated	Manufacture in that the value of all the materials used does not exceed 40 percent of the ex-work price of the product
8418	Refrigerators, freezers and other refrigerating or freezing equipment, electric or other; heat pumps other than air-conditioning machines of heading no. 8415	Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex works price of the product, and • where, within the above limit, the materials classified within the same heading as the product are only used up to a value of 5 percent of the ex-work price of the product, and • where the value of all the nonoriginating materials used does not exceed the value of the originating materials used

The introduction of the HS entailed certain changes to the GSP rules of origin of the preference-giving country that used the process criterion. Although the basic characteristics remained unaltered, knowledge and correct application of the HS were deemed necessary for understanding and applying the origin rules correctly. Where only the basic rule applied (i.e., CTH), the manufacturer had to ensure that none of the imported materials used fell within the same four-digit tariff heading as the finished product. This required certifying authorities in preference-receiving countries to have a certain expertise in HS classification over a wide range of goods. Cases may arise in which correct HS classification remains in doubt, even after reference to the relevant publications.

To establish and maintain compliance with the basic rule of the process criterion, records would be required of the description, HS classification, and sources of materials used in manufacture. Once compliance with the

criterion was determined, reassessment might be required in a limited range of circumstances, such as if a change were made in the descriptions of imported materials used or if the HS classification were changed. However, in the case of goods that are listed as excepted from the percentage limit, records would be required of costs and quantities of imported materials used in manufacture and prices of finished products. Compliance with such rules needs to be recalculated as costs and prices fluctuate.

It was found that even in the HS a wide range of possibilities existed regarding the degree of restrictiveness imposed by the basic rule on imported materials used in manufacture. At one end of the spectrum, the rule had the appearance of being extremely liberal because it permitted a product to be manufactured entirely from imported materials provided they were not classified in the HS heading of the product. At the other end of the spectrum, the use of any "same heading" materials was totally excluded, no matter how minimal the quantity may be. Some practical examples showing how these possibilities may arise are given in Table 5.6.

The impact of the basic CTH rule varies from case to case, depending upon the nature and the extent of the need to use imported materials, how they are classified in the HS system, what manufacturing process is required to produce the finished product and what HS heading applies to it. The varying impact produced by the rule makes it difficult to provide a general assessment of its overall effects. If a sufficiently wide range of examples, with adequate manufacturing data, were available, an attempt at a general assessment might be feasible. Even then, the task of identifying an adequate range and sources of possible materials that are both suitable and available for use in manufacturing a given product would be also formidable.

5.2.3.2. *An Analysis of the Experiences and Lessons Learned under the Percentage Criterion*

As in the case of the process criterion, each preference-giving country using the "percentage criterion" used its own formulation of percentage.

Under their respective GSP schemes, Canada, the United States, Australia, New Zealand, and at that time the Central and Eastern European countries (CEECs) used the percentage criterion exclusively[74] to determine the origin of products imported from beneficiary countries.

[74] See document UNCTAD/ITD/GSP/31, para. 10, table 1.

TABLE 5.6. *Example of stringency of a CTH criterion*

Finished product	Origin rule	Possible materials	HS classification	Comments
Soft toys (HS 9503)	CTH and value of imported materials must not exceed 50 percent of the ex-work price of the finished product	Stuffing material, thread, eyes, metal inserts for limbs, fabric	a) stuffing materials and thread – not classified in 9503 b) eyes – not classified in 9503 provided they are not mounted c) fabrics – not classified in 9503 provided they are not cut to shape d) metal inserts for limbs – classified in 9503 "solely or principally" for soft toys	The use of this example demonstrates the necessity for HS expertise. Even if all the materials used, except for mounted eyes, originated in a preference-receiving country the finished product would fail to qualify, even if the 50 percent rule was satisfied
Leather handbags (HS 4202)	CTH	Finished leather in the piece, metal or leather handles, metal handbag frames (incorporating clasp and lock), metal handbag corner pieces, handbag locks, thread, glue, rivets	a) finished leather in the piece, thread, glue, rivets – not classified in 4202 b) metal handbag handles – classified in 8302 c) leather handbag handles – classified in 4205 d) metal handbag frames – classified in 8301 (including clasp and lock) e) metal handbag corner pieces – classified in 8302 f) handbag locks – classified in 8301	Compliance with the basic rule is satisfied, i.e. the handbags described may be manufactured from the materials listed, all of which could be imported without altering GSP entitlement

The European Community, Norway, Switzerland, and Japan adopted the "process criterion." This criterion is usually expressed by the CTH rule combined with a so-called Single List[75] of specific working or processing to be carried out on nonoriginating materials in order for the finished product to obtain originating status. However, many of the rules contained in the Single List provide specific percentage limitations on the use of imported materials.[76]

As the experience with the "process criterion" (CTH) has already been analyzed, the present section is dedicated to the analysis of the "percentage criterion."

Notwithstanding the process of harmonization promoted by the Working Group on Rules of Origin and later by the Sessional Committee,[77] there were and still there are wide differences between the preference-giving countries utilizing the "percentage criterion" as the main rule in assessing the substantial transformation.

These differences derive from the fact that, before the implementation of the national GSP schemes, many industrialized countries used to adopt individual preferential arrangements of autonomous and independent character in favor of certain developing countries or former colonies.[78] Each of these arrangements contained origin rules that were tailored to the particular exigencies of each preference-giving country.[79]

When elaborating GSP rules of origin, preference-giving countries were concerned about losing their sovereignty in controlling the benefits granted under their schemes. As preference-giving countries could implement their national schemes independently, they retained the general principle that they were free to decide on the rules of origin that they thought were appropriate after hearing the views of beneficiary countries.[80] Thus the actual differences reflect those that existed before the implementation of the national GSP schemes.

The following subsections focus on the analysis of the differences in the formulation and in the application of the "percentage criterion" by the preference-giving countries in their GSP rules of origin, without taking into consideration

[75] For the definition and the explanation of the characteristics of the Single List, see document UNCTAD/ITD/GSP/31, para. 86 and 87.

[76] This mainly but not exclusively concerns machinery and consumer goods in the case of the EC rules of origin, in Chapters 80–99.

[77] For the description of the activity of harmonization promoted by the Working Group and the Sessional Committee see Compendium see the quoted UNCTAD documents.

[78] See document UNCTAD/ITD/GSP/31, para. 9.

[79] See document TD/B/AC.5/3/Add.4, p. 2 fl.

[80] See OECD document TC/Pref/70.25, 25.9.1970, para. 37.

whether the "percentage criterion" is used as an ancillary or principal criterion to determine the origin of the imported goods.

A first reading of the different origin rules reproduced in Table 5.7 makes it possible to identify the basic common elements of the "percentage criterion," namely:

(a) definitions of the basis used for calculation of the percentage (that is, the numerator and the denominator), as follows:
    (i) domestic content or import content (numerator), and
    (ii) cost assessment basis for origin purposes (denominator);
(b) the level of the required percentage;
(c) the eventual additional requirements.

5.2.3.2.1. *Experiences and Lessons Learned on Different Draftings of the "Percentage Criterion"*

This subsection analyzes the characteristics, advantages, and disadvantages of the various percentage origin determination systems used by preference-giving countries as analyzed during the UNCTAD Working Groups on rules of origin.

(A) Different Ways of Drafting the Numerator

In the case of the United States, New Zealand, and Australia the numerator used for calculating the percentage expressed by reference to "domestic content," whereas in the case of Canada, the EC, Japan, and the other "process criterion" countries, reference is made to "import content." These different approaches to the "percentage criterion" imply that

(a) in the case of "domestic content," a certain minimum percentage of the total value of materials, parts or components originating in the exporting preference-receiving country and costs of processing must be reached; or
(b) in the case of "import content," a maximum proportion of imported materials should not be exceeded, i.e., nonoriginating materials, parts, or components (or materials of undetermined origin) are allowed to be used up to a maximum percentage of the value of the finished product.[81]

Different drafting of the numerator under the domestic content

According to the domestic content determination of origin, as used by Australia, New Zealand, and the United States, both local materials and labor are included in calculating the minimum domestic content requirement. However, there were various definitions on how to compute and allocate these

[81] See also document TD/B/C.5/WG(VI)/4, paras. 55–78.

TABLE 5.7. *Overwiew of the percentage criterion rules used by some preference-giving countries*

Country/Group of countries	Rules	Ancillary/Exclusive
United States	to be eligible for duty-free treatment under GSP, an article must originate in, and be imported directly from, the beneficiary developing country, and the sum of the cost of materials produced in the beneficiary developing country plus the direct cost of processing there must be equal at least 35 percent of the appraised value of the article at the time of its entry into the United States[a]	Ancillary to the "substantial transformation requirement"
Australia	goods must comply with two requirements: (a) the final process of manufacture must have been carried out in the country claiming preference; and (b) at least half of the total factory or works cost of the goods must consist of the value of labor and/or materials of one or more least-developed countries (LDCs) and developing countries (for the purposes of this requirement any Australian content may be counted as if it were developing country content)[b]	Exclusive
New Zealand	. . . at least one half of the factory or work cost of the finished products is represented in each article by the value of: • material the product of any developing country, or • material the produce of New Zealand and/or • other items of factory or works cost incurred in any developing country in New Zealand[c]	Exclusive
Canada	. . . if the value of the import content amounts to not more than 40 percent or, in the case of LDCs, not more than 60 percent of the ex-factory price of the goods as packed for shipment to Canada.	Not Exclusive: coupled with product-specific origin for textiles and clothing under special preferences for LDCs
European Community, Japan	e.g. chp. 82.07: . . . the value of all the materials used does not exceed 40 percent of the ex-work price of the product (in the case of Japan FOB price)	Ancillary

[a] See Trade Act of 1974, Pub. L. No. 93–618, tit. V, 88 Stat. 1978, 2066–71, 19 U.S.C.A. Chpt. 2463 (b). See also the Handbook on the Scheme of the United States of America, UNCTAD/TAP/163/Rev. 12, April 1989. 9 See Handbook on the Scheme of Australia, UNCTAD/TAP/259/Rev. 1, December 1989.

[b] See also for further details Australian Customs Service Manual, volume 8B, 2008.

[c] See document UNCTAD/TAP/258/Rev.2, *Handbook on the Scheme of New Zealand*, 1988, p. 78 and Part IV of the New Zealand Customs and Excise Regulations, 1996.

Requirements	Numerators	Denominator	Percentage level
Minimum local content requirement	Cost of materials produced in the preference-receiving county plus the direct cost of processing carried out there	Ex-factory price or appraised value by U.S. Customs	Minimum 35 percent
Minimum local content requirement	Labor and materials from the preference-receiving country, other LDC preference-receiving countries and Australia (A 25 percent limit applies for expenditures counted as labor of materials in other developing countries.)	Ex-factory or ex-work cost	Minimum 50 percent
Minimum local content requirement	Expenditure on materials and components originating in the preference-receiving country and another preference-receiving countries and New Zealand.	Ex-factory or ex-work cost	Minimum 50 percent
Maximum import content	Value of imported inputs is defined as their customs value at the time of importation into a preference-receiving country or, in the case of inputs of undetermined origin, the earliest ascertainable price paid for them in that country.	Ex-factory price of goods as packed for shipment to Canada.	Not more than 40 percent or 60 percent for LDCs.
Maximum percentage of imported inputs	Custom value of imported inputs, or the earliest ascertainable price paid in the case of materials of unknown, undetermined origin.	Ex-factory price	Maximum 30, 40 percent or 50 percent as well as alternative percentages in the Machinery sector

elements toward the minimum percentage requirement. Allowable costs are differently defined. The Australian rules refer to "labour and materials of the preference-receiving country." The New Zealand rules refer to expenditure on "materials and components originating in a preference-receiving country" and "expenditure on other items of ex-factory or ex-works cost."[82] The United States rules refer to the "cost or value of materials produced in the preference-receiving country" and to "direct costs of processing operations performed in the preference-receiving country."[83]

The definition of costs that may be computed toward the domestic content may be different depending on the definition of allowable costs. The Australian rules allow costs directly attributed to the manufacture of the finished product, for example, factory operatives, foremen, and managers. On the other hand, costs attributed to the advertising or sales of the product are excluded. In particular, the expression "materials of a preference-receiving country" was interpreted as materials that had already acquired the originating status in the preference-receiving country through fulfillment of the Australian GSP rules. In the case of materials of mixed origin, defined as "materials which include content from both the preference area and from elsewhere," new interpretative rules were issued in 1994. According to these rules, in calculating the expenditure on material of mixed origin incorporated for export to Australia, the cost of that material is taken as:

(a) partly of qualifying area content provided that the last process of manufacture occurred in the preference-receiving country. Qualifying area content will be in direct proportion to the actual preference area content, i.e., if a material has 30 percent area content, then 30 percent of the expenditure on that material will be included as qualifying content for the final good;
(b) totally without area content, if it does not meet the "last process of manufacture" requirement for the preference-receiving country.[84]

The United States reference to "cost or value of materials produced in the preference-receiving country" was defined in more detail. It referred to

[82] Ibid. para 65.
[83] Ibid. para. 64.
[84] According to the interpretation provided in the old rules, the expression "materials of a preference-receiving country" had to be intended as materials that had already acquired the originating status in a preference-receiving country through fulfillment of the Australian GSP rules.

materials that were "wholly the growth, product or manufacture of the preference-receiving country."

In particular, it was found that the "cost or value of materials produced in the beneficiary country" included:

(a) actual cost of the materials to the manufacturer;
(b) costs of freight, insurance, packing, and all other costs incurred in transporting the materials to the manufacturer's plant, when not already included in the actual cost of the materials to the manufacturer;
(c) actual cost of waste or spoilage, less value of recoverable scrap;
(d) taxes and/or duties imposed on materials, provided they are not remitted upon exportation.

Where materials are supplied to the manufacturer without charge or at less than fair market value, their cost or value shall be determined by computing the sum of:

(i) all expenses incurred in the growth, production, manufacture, or assembly of the materials, including general expenses;
(ii) an amount for profit;
(iii) freight, insurance, packing, and all other costs incurred in transporting the materials to the manufacturer's plant.

In addition, according to the U.S. rules, intermediate materials that were "substantially transformed (. . .) into a new and different article of commerce" may be also added to the cost or value of materials produced in the beneficiary country.

However, the concept of "substantial transformation" was not clearly defined in the U.S. rules. In fact, in this case, the definition of "substantial transformation" referred to a judge-made rule according to the jurisprudence of the U.S. Federal Circuit Courts. According to the definition of the U.S. courts, a substantial transformation occurs when "a new and different article with a distinctive name, character, or use must emerge from the manufacturing process."[85] As pointed out by authoritative doctrine, "what is new and different and what is a distinctive name, character or use are, of course, difficult questions. The questions are made more difficult because courts have formulated the rule differently from case to case, because the Custom Service itself does not use consistent terminology in its own regulations, and further because Congress

[85] *Anheuser Bush Brewing Assn. v. United States*, 207 U.S. 556 (1907).

has been content to remain silent on the issue."[86] As the question does not involve directly the GSP rules of origin, the interpretation of the definition of "substantial transformation" according to the U.S. courts is on a case-by-case basis.[87] An interpretation in each specific case has to be sought from the U.S. authorities. The U.S. Customs Service gave examples of materials that were substantially transformed.[88] Thus raw skins imported into a beneficiary country and tanned into leather could be a substantially transformed constituent material when used in the subsequent manufacture of a leather coat.[89] Gold bars imported into a beneficiary country and cast into mountings qualify as substantially transformed materials when incorporated in rings exported to the United States. Leather is imported into the Philippines, cut into shaped pieces and made into gloves. The shaped pieces are "substantially transformed" and their value may be included to meet the 35 percent requirement.[90] Wax is imported from Indonesia into Singapore, mixed with additives (dye, perfume, stearic acid), and made into candles. Wax mixed with additives is not regarded as having been substantially transformed, and its value cannot be included in determining whether the 35 percent requirement is satisfied.[91] More examples include cutting plastic sheets into goggle lenses, assembly of magnetic core memories from wires and cores, magnetic recording heads assembled from wire, cables, connectors, brackets, and recording tracks.[92] The full value of the intermediate products resulting from these operations was counted toward fulfillment of the origin criterion by the finished product.

This rule on "substantial transformation" was found to cause delay and uncertainty about entitlement of the finished product to preferential treatment. "Direct costs of processing operations" mean costs either directly incurred in, or that may reasonably be allocated to, the growth, production, manufacture, or assembly of the specific merchandise under consideration. Such costs include, but are not limited to:

(a) all actual labor costs involved in the growth, production, manufacture or assembly of the specific merchandise, including fringe benefits,

[86] See Palmeter, *Rules of origin in the United States*, in Vermulst, Waer, and Bourgeois, *Rules of origin in international trade, a comparative analysis*, Michigan Un. Press, 1994, p. 35.
[87] Ibid. pp. 27–84.
[88] See document TD/B/373/add.5/Annex. See also Annex I below.
[89] See document TD/C.5/WG(VI)/3 para.58.
[90] See document UNCTAD/TAP/133/Rev.6, para. 20.
[91] Ibid.
[92] See TD/B/C.5/WG(VI)/3,* Annex II.

on-the-job training, and the cost of engineering, supervisory, quality control, and similar personnel;
(b) dies, moulds, tooling, and depreciation on machinery and equipment allocable to the specific merchandise;
(c) costs of inspecting and testing the specific merchandise.

Items not included within the meaning of "direct costs of processing operations" are those that are not directly attributable to the merchandise under consideration or that are not "costs" of manufacturing the product. These include, but are not limited to:

(a) profit;
(b) general business expenses that are either not allocable to the specific merchandise or are not related to the growth, production, manufacture or assembly of the merchandise, such as administrative salaries, casualty and liability insurance, advertising, and salesmen's salaries, commissions, or expenses.

There are other costs related to the manufacture of the goods whose status under the U.S. rules was not made clear. For example, costs of packaging, power and fuel, and machinery (other than "dies, moulds and tooling," whose costs are included only if they relate specifically to the particular finished product).

From the account in the previous paragraphs, it was evident that the "domestic content" rules applied by the three preference-giving countries concerned differed in several respects. Only some of these differences can be highlighted because detailed rules of interpretation were not available.

To summarize, differences of substance existed as regards:

(i) *Determination of the extent and conditions under which third-country materials, parts, components, etc., used in manufacture in a preference-receiving country were allowed to be counted towards the domestic content of the finished product.*

The Australian rule related to "materials of" a preference-receiving country without defining what this expression meant or what proportion of the value of such materials was allowed to count as "domestic content." Similar obscurities existed about the New Zealand rule that referred to materials "originating in" a preference-receiving country.

(ii) *Treatment of labour costs*.

For example, the Australian rules referred simply to "labour," without further clarification; the New Zealand definition makes reference to "other items of ex-factory or works cost"; and the United States provided a complicated definition of the term "direct cost of processing operations."

Definition of the Numerator under the Import Content

Among the preference-giving countries utilizing the "percentage criterion" for determining substantial transformation, only Canada calculated the numerator by reference to the value of the import content.

However, all the "process criterion" countries (EC, the other West European preference-giving countries, and Japan) use the "import content" approach as subsidiary rule in the Single List.

One of the characteristics of the "import content" approach is to utilize the customs value of the imported materials based on the rules on customs valuation[2] concluded in the General Agreement on Tariffs and Trade (GATT) valuation code of 1979, later materialized in the 1994 World Trade Organization (WTO) Customs Valuation Agreement.

The use of such a multilateral instrument provides for a common assessment of the determination of the customs value of imported materials, parts, and components. The application of the aforementioned rules by preference-receiving countries ensured a consistent approach to the valuation of imported materials, parts, and components into their territories, and thus improved the operation of the concept of "import content."

5.2.3.2.2. *Preliminary Conclusions and Lessons Learned from the Different Drafting of the Numerator under the Percentage Criterion*

Experience gained in the comparison between "domestic content" and "import content"

In general, the "domestic content" concept consists of two elements: The definition of labor and materials that may be input towards the fulfillment of the percentage required and the cost of originating materials used. On the other hand, the "import content" is based on only one element, namely, materials, either imported or of undetermined origin used in the manufacturing process of a finished article. Thus, the "import content" approach possesses the advantage of immediate simplicity and transparency.

As previously outlined, the preference-giving countries that adopt the "domestic content" approach defined the elements of labor and materials in different ways, with sometimes significant and subtle variations.

Thus, a manufacturer who calculated the labor and materials costs that were admissible under the U.S. rules was unlikely to find that the same calculations will be valid for New Zealand.[93]

It was not easy to determine the distinctions between allowable and non-allowable labor costs that may be input to domestic content. Furthermore, where lines were drawn, they appeared to be arbitrary.

Apart from the problems caused by lack of harmonization of the definition of domestic cost that could be allocated to the domestic content, the varied and incomplete definitions created not only substantial administrative burdens for traders in preference-receiving countries but also doubts as to whether their calculations were valid and accurate. In this connection, it should be borne in mind that the cost of both labor and materials may fluctuate according to currency exchange fluctuations, leading to different levels of "domestic content," with consequent acquisition or loss of preference, although the extent of transformation carried out in the preference-receiving country remained largely unchanged.

By comparison, it was found that "import content" could more easily be defined and its exact value determined, leaving less room for doubtful or incorrect interpretation. Although there is the possibility that the finished product may change its entitlement to preference as the value of imported materials fluctuates, this possibility is more limited than in the case of "domestic content," in which variations in labor costs must also be taken into account. Additionally, the "domestic content" approach was found to have the following disadvantages:

(i) A product, although entirely produced in a preference-receiving country from originating materials, may not, under the rules of some preference-giving countries, achieve the necessary level of "domestic content" and thus be deprived of preference, a situation that could not arise under the "import content" concept. This might, for example, happen in the case of the U.S. GSP rules of origin, in which "domestic content" is defined in regard to the concept of "direct processing costs." In fact, it is theoretically possible that a wholly produced article will not meet the 35 percent origin requirement – when the indirect costs exceed 65 percent of the appraised value of the good imported in the United States.[94] Using the concept of "direct processing costs" in connection with the domestic content as the numerator might also reduce

[93] See GATT, Basic Instruments and Selected Documents, Twenty-Sixth Supplement (Sales no. GATT/1980–3), p 117.

[94] See UNCTAD document TD/B/C.5/WG(VI)/3.

the scope for using imported materials and components.[95] For example, a product may be considered as having an appraised value of $100, of which $50 are direct processing costs and locally produced materials and components and $50 are indirect processing costs. The 35 percent requirement requested by the U.S. rules of origin means that only $15 worth of imported components ($50 direct costs less $35 origin required) may be used. This example and others are illustrated below.

	Case 1	Case 2	Case 3	Case 4
Appraised value	100	100	100	100
Indirect cost	66	50	40	25
Minimum value of originating materials and direct processing costs	35	35	35	35
Maximum import content	Cannot meet the 35 percent rule even if wholly produced	15	25	40

The examples in the preceding table show that, in three of the four cases, only 15 percent, 25 percent, and 40 percent, respectively, of the appraised value can be accounted for by import content. Thus the maximum import content is inversely related to the share of appraised value accounted for by indirect cost.

An UNCTAD study examined selected cost profiles of manufacturing establishments in developing countries. These cost profiles, presented in the following table, permitted a crude division of production costs between direct and indirect costs. The data indicated that the "effective value added" requirement was much higher than the one implied by the 35 percent domestic processing cost rule.[96] In fact, in the case of Portland cement produced in East Africa, the 35 percent requirement would have not been met even if the product had been wholly produced in a single developing country. Moreover, a number of additional production processes could not qualify under the 50 percent cumulative origin provision.

[95] See document TD/B/C.5/WG(VI)/3 para. 47.
[96] See document TD/B/C.5/WG(VI), para. 51.

The following example illustrates how the application of the import content rule permits a more liberal system for determining the origin than the domestic content requirement.

	Import content (max 50 percent)	Domestic content (direct cost of processing)
(a) Domestic materials	1.00	1.00
(b) Foreign materials (not substantially transformed)	4.00	4.00
(c) Direct cost of processing	2.00	2.00
(d) General expenses	1.50	1.50
(e) Profit	1.50	1.50
(f) Appraised value	10.00	10.00
(g) Import content/domestic content	40 percent (rule satisfied) $(d/f) \times 100$	30 percent (rule not satisfied) $[(a + c)/f] \times 100$

As these examples show, a product in a regime of import content would qualify for preferential treatment because the cost of imported materials ($4) is not more than 50 percent of the appraised value ($10). The same product from a beneficiary of the scheme would not qualify for preferences because the cost of domestic materials ($1) plus the direct cost of processing ($2) is less than 35 percent of the appraised value ($10). In the case of the import content established at 50 percent, if all the materials were of foreign origin ($5), the article could still qualify for preferential treatment if the appraised value were simply increased to $10.01. The cost of foreign material would then be just under 50 percent of that value.

(ii) In the case of the "domestic content" approach, an accounting analysis must be made and records of both labor and material costs kept up to date. Such analysis and records would be more detailed and burdensome than those required under the "import content" concept, in which only imported materials and those of undetermined origin need to be assessed. In the case of "import content," if the total material costs (that is, both imported and domestic materials) amount to less than the percentage level prescribed by the preference-giving country, although the total material costs would need to be assessed, there would be no need to distinguish between domestic and imported materials either in the records or in stock holding. The administrative burden would become correspondingly lighter.

The findings made in the formulation of the numerator in terms of "import content" permit drawing the following advantages over "domestic content":

(i) greater simplicity and a smaller burden for preference-receiving countries in terms of administrative effort, including the maintenance of records for imported materials only; a consequently reduced possibility of incorrect certificates of origin;
(ii) less uncertainty in determining entitlement to preferential treatment;
(iii) reduced tendency to result in disqualification of goods

Different Ways of Drafting the Denominator

General
The denominator used for GSP rules of origin is commonly intended to represent the value of the goods for which preference to be claimed. This value may be established at different points in the marketing chain (i.e., from the factory cost of the finished product to its FOB export value or even cost insurance and freight [CIF] import value in the preference-giving country of import). Overall, the higher the value of the denominator, the more liberal will be the rule when the numerator is in terms of "import content." By contrast, if the numerator is in terms of "domestic content," a high level for the denominator will make the percentage rule more restrictive.

Comparison of Different Definitions and Drafting of the Denominator
Originally, there were four methods of determination of the denominator under the "percentage criterion" and "process criterion" used by preference-giving countries:

(i) ex-factory (or ex-works) cost (Australia and New Zealand);
(ii) ex-factory price (Canada, EEC, and other West European preference-giving countries);
(iii) "appraised value" (as determined by the United States authorities) or ex-factory price (United States);
(iv) FOB price (Japan).

Leaving aside for the present the U.S. formulation, which is perhaps unique, the other methods involved ex-factory cost, ex-factory price, and FOB value. The value corresponding to the ex-factory cost is the lowest of these three; the value is higher for the ex-factory price, and highest for the FOB price.

A consideration of the relative merits of these three methods must consider:

(i) the advantages or disadvantages of the administrative effort required in setting up accountancy methods according to denominator;
(ii) the relevance to the concept of "substantial transformation";

(iii) possible inequities that might arise between producers because of, for example, differing levels of efficiency or of location of manufacturing plant.

"Ex-factory cost" was defined[97] in some detail in the New Zealand scheme. Some fine distinctions are drawn. For example, royalties were included if they related to processes or machines used in manufacture of the goods but were excluded if they related to the finished goods themselves. The cost of packing the goods into "outside packages" is also excluded, as well as the cost of the packaging material.

It was found that the "ex-factory cost" may reasonably be used as a denominator to reflect, in conjunction with the numerator, a certain degree of the transformation that has occurred. However, it may exclude some legitimate expenditures. Packing for exports, for instance, could be said to play a significant role in the transformation process, particularly for some types of finished products that are to be transported considerable distances and by several modes of transport.

"Ex-factory price" exceeds ex-factory cost because it includes additional elements, such as manufacturing profit, labor costs of packing, and packing materials, including packing for retail sale. The definition of ex-factory or ex-works price used by the OECD preference-giving countries, except the United States, is "the price paid to the manufacturer in whose undertaking the last working or processing is carried out, provided the price includes the value of all the products used in manufacturing." This definition was, at times, found inadequate. The terms on which the manufacturer sells or the purchaser buys may vary considerably, depending on the extent to which the buyer or seller is responsible for items such as handling, transport, and insurance. This definition does not cover these aspects.

Determination of the ex-factory cost may be a common accounting practice for many enterprises, although it is unlikely to be commercial practice to identify on a product-by-product basis the minor elements that, for example, the New Zealand rules demand (for example, royalties, office expenses, and selling costs). These additional requirements would call for additional effort, the extent of which would vary from product to product. It should also be noted that the import/export trade is not frequently conducted on an "ex-works" basis, because this requires the importer to be responsible for making transport and insurance arrangements and for paying all charges from the time the goods

[97] See document UNCTAD/TAP/133/rev. 6. para. 19.

leave the factory. It is simpler for the manufacturer or an agent to undertake these tasks.

The "FOB price" concept is applied only in the Japanese scheme. In commercial terms, the exporter is responsible for all charges incurred in placing the goods on board of the exporting ship, aircraft, or other vehicle. Thus the FOB price is the highest of the three concepts so far considered (although lower than CIF terms, in which the exporter is responsible for all charges up to arrival at the port or place of ultimate destination).[98]

Although the additional elements contained in the FOB price, such as costs of transport, insurance and handling, may not in themselves relate directly to the degree of transformation that the finished goods may have undergone in the preference-receiving country, they are nevertheless elements of value added contributed by the services and infrastructures of that country and could be said to possess a form of originating status that should be included in the calculation in such a way that it is counted toward the originating status of the product itself.

FOB terms are often preferred in international trade because the foreign customer:

(i) may have other goods being sent to him that can be exported at the same time, so as to save freight charges;
(ii) may use ships and other services of his own country, thus saving foreign currency (in some cases this may be a remote possibility);
(iii) may lack knowledge of the local conditions of transport, insurance, etc., in the preference-receiving country of export.

The difference in levels between ex-works price (ex-factory price) and FOB price may, of course, vary in each case, depending on the nature of the goods, costs of transport services, location of factory, and so on. This difference in practice was provided by a typical illustration concerning the exportation of fabric from the United Kingdom to Milan by sea. In this particular case, the price of the goods, ex-factory and unpacked, amounted to $6,000. The FOB price, which included packing costs, transport to the exporting ship, port dues, and loading charges, amounted to $6,810. Thus, the FOB price, without any addition for insurance, was about 13 percent higher than the ex-factory price. If this transaction was between a preference-receiving and a preference-giving country and if originating status was based on "domestic content" setting at a minimum of 50 percent of the ex-works price, the effect of changing to FOB price would be to require about 6.5 percent of additional domestic content. If

[98] See Inama, *op. cit.*

the basis was 50 percent "import content," an additional 6.5 percent of imported materials could be used.

It was suggested[99] that the use of the FOB price could cause inequitable GSP treatment, depending on the geographical location of manufacturing plants, because the nearer the plant to a point of export, the lower the FOB price. Then, depending on the method of calculation, it could be easier or more difficult to obtain the preferential treatment for products manufactured in plants that are relatively near to the point of export. A variation in the degree of liberality of the origin rule would ensue. However, inequities may also arise in connection with either factory cost or factory price. For example, the most efficient manufacturers will produce at a lower unit cost than the less efficient ones and may thus find the "percentage criterion" more restrictive as to the allowed proportion of imported materials. It thus seems impossible to achieve complete equity in this respect based on the "percentage criterion," because of continuous variations in costs and prices.

The U.S. system of "ex-factory price" and "appraised value" differs from that of other preference-giving countries. In completing Form A, exporters must declare the sum of the cost of materials and the direct cost of processing expressed as a percentage of the "ex-factory price" of the exported goods. Where, however, U.S. Customs decides to appraise the value of the goods at a level higher than that of "ex-factory price," then entitlement to preference must be recalculated based on the higher appraised value. This may lead to loss of entitlement to GSP. In some cases, it also causes a significant volume of work for exporters in preference-receiving countries, who are required to recalculate entitlement. In this connection, it has been observed that there were nine different possibilities for determination of "appraised value."[100]

Most significantly, exporters were not in a position to forecast whether "appraised value" terms would apply, and, if so, whether this value would exceed ex-factory price and by what amount. Exporters were thus hindered, if not prevented, from ensuring that their products would qualify for preference until the U.S. authorities accepted the claim. It was clearly unsatisfactory for entitlement to the GSP to depend on a figure that was not available within the country of export.

5.2.3.2.3. *Preliminary Conclusions and Lessons Learned from the Different Drafting of the Denominator under the Percentage Criterion*

To sum up, "FOB price" was found to have has a number of advantages over the other formulations:

[99] See document TD/B/C.5/WG(IV)/2, paras. 78 ff.

[100] See document TD/B/C.5/WG(VI)/3, paras. 64–94.

(i) It is a price level most frequently quoted and used in international trade and is thus readily available for use in establishing origin states without additional effort or expense;
(ii) The administrative overheads for manufacturers are thus reduced to a minimum, comparing favorably with both factory cost and factory price, where detailed definitions have to be observed;
(iii) Some important elements are included in it that are excluded by other formulations and that may be regarded as "originating elements," for example, local transport, insurance, and packing and handling costs.

Of the other formulations, that of the United States possesses a variety of disadvantages concerning the administrative burdens imposed on the traders in the preference-receiving country. A major disadvantage is the uncertainty caused by where final valuation is made by the U.S. authorities. It did not seem that this uncertainty would be dissipated by implementation of the rules on customs valuation.

5.2.3.2.4. *Early Experience and Lessons Learned from Utilizing the Percentage Criterion under the GSP Schemes*

The rationale and restrictiveness in the percentage criterion have been examined during many meetings of the Working Groups and of the Sessional Committees.[101] In two different documents, the Working Group[102] and the Sessional Committee[103] evaluated the consequences of the differences on the expression of percentage criterion in the individual GSP schemes.

As previously reported, a preference-receiving country pointed out that[104] insuperable obstacles were caused by the need to devise and operate an accounting system that differed in the definition of concept, application of accounts, precision, scope, and control from its internal legal requirements. The system must provide the cost information to satisfy the rules of the countries

[101] See the following documents:
- TD/B/AC.5/3, 10 July 1970
- TD/B/AC.5/3/Add.4, 19 March 1970
- TD/B/AC.5/38, 21 December 1970
- TD/B/C.5/WG(IV)/2, 26 September 1973
- TD/B/C.5/WG(V)/L.2/Add. 1, 6 December 1974
- TD/B/C.5/WG(VI)/4, 14 March 1977
- TD/B/C.5/WG(VIII)/2, 18 July 1980
- TD/B/C.5/141, 28 February 1992.

[102] See document TD/B/C.5/WG(IV)4, paras. 77 ff.
[103] See document TD/B/C.5/WG(VIII) para. 29.
[104] See document TD/B/C.5/WG(X)/2, p. 6.

of destination, to check the shares of domestic and imported inputs in the unit cost of the exported goods, in some cases identifying the country of origin of the inputs, and establishing direct and indirect processing costs. This often required (and still requires) data-processing techniques that are not in common use, especially in small- and medium-sized enterprises. It was pointed out that the willingness of enterprises to change or adopt accounting systems different from normal systems depends on the volume of exports eligible for GSP, the share of such exports in total sales, and the cost involved.[105] In addition, the expenditure incurred in operating a parallel accounting system may outweigh the benefit of GSP, for example, if the preference margin is less than 5 percent.[106]

Other inhibiting factors included uncertainty in supplies of inputs owing to inflation, international variation in prices, and difficulty in obtaining external finance. There was also continuous devaluation, leading to the need to constantly update the cost system for origin rule purposes. More rigorous accounting methods were needed to determine unit costs when the range of exports is large, for which data-processing systems are again required. Where domestic inputs are used that have themselves been manufactured from imported materials it was difficult to obtain evidence of this; such inputs were thus treated as imported products. This occurred in textile handicrafts, leather, and other handicrafts using pigments or coloring matter and chemical and pharmaceutical products. All the problems mentioned were amplified by the fact that, in particular cases, the accounting system adopted to fulfill the requirements of a certain preference-giving countries rule of origin is not useful in providing the required data necessary for the fulfillment of another preference-giving country rule of origin.[107]

Another preference-receiving country gave a practical example that shows how differences between the various origin criteria and in their application considerably diminished the full use of the GSP. Many preference-receiving countries pointed out that the use of imported materials, parts, and components

[105] Ibid. p. 22.

[106] Ibid. p. 5. Mexico showed, as an example, that in the case of the United States, out of a total of $788.9 million of Mexican exports that could have benefited from GSP in 1983, and for which in principle there was no limitation apart from the presentation of origin certificates, 58.7 percent (462.2 million) comprised goods whose preference margin was less than 5 percent. For such goods the main reason for the nonuse of preference might have been this low margin compared with the more costly administrative requirement needed to establish compliance with the origin rules. The remaining 41.3 percent of exports, with a preference margin exceeding 5 percent, largely represented cases in which the goods had failed to satisfy the origin rules.

[107] Ibid.

was limited by not only the origin rules but also the variations between them, mainly in particular sensitive sectors such as textile and electronics.[108]

The hypothetical illustration in the following section shows that, assuming the same cost structure, only shipment to the United States will satisfy the percentage criterion (shipments of the same goods to Australia, Canada (old rules) will not):

I.	Imported materials, parts or components	750
II.A	Materials produced in the preference-receiving country 'X'	200
B	Direct cost of processing operations performed in country 'X'	
	1. Direct labor	100
	2. Overheads	135
III.	Overhead and general expenses and other costs of production involved	5
	EX-FACTORY COST (I + II + III)	1.190
IV.	Profit	50
	EX-FACTORY PRICE (EX-FACTORY COST + IV)	1.240
V.	Cost of transport from the factory to the frontier or port/brokerage/handling expenses	10
	FOB VALUE (EX-FACTORY PRICE + V)	1.250

Country	Method of calculation	Example	Percentage requirement	Satisfied/ not satisfied
Australia	$\frac{\text{Cost of domestic labor and materials}}{\text{EX-FACTORY COST}}$	$\frac{100 + 200}{1.190} = 25$ percent	50 percent minimum	Not satisfied
Canada	$\frac{\text{Value of imported materials and parts}}{\text{EX-FACTORY PRICE}}$	$\frac{750}{1240} = 60$ percent	40 percent maximum	Not satisfied
New Zealand	$\frac{\text{Expenditure on domestic materials}}{\text{EX-FACTORY PRICE}}$	$\frac{200}{1.190} = 17$ percent	50 percent minimum	Not satisfied
United States	$\frac{\text{Cost of domestic materials and direct processes}}{\text{EX-FACTORY PRICE}}$	$\frac{200 + 100 + 135}{1240} = 35$ percent	35 percent minimum	Satisfied

Another preference-receiving country underlined that the access to important markets on a preferential basis was prevented by the lack of harmonization

[108] Ibid. p. 10.

of the rules based on the percentage criterion, particularly with regard to the schemes of the United States, Canada, Japan, and EEC.[109] Therefore it provided an example that showed the different treatment of the ball bearings (classified in CCCN 84.62) depending on the preference-giving country of export:

- United States: They qualified for the GSP because the domestic material cost plus direct cost of processing was more than the 35 percent requirement;
- EEC: They did not qualify because the imported materials used exceeded 40 percent of the value of the product obtained;
- Japan: They qualified for Japanese GSP by use of the cumulation and donor-country content.

Other preference-receiving countries reported the confusion of their exporters because of the lack of a uniform system in the method of calculation, and also regarding the costs that might be counted or excluded for determining either the import or the domestic content (e.g., Canada and New Zealand excluded the cost of labor from the processing cost whereas Australia and the United States included it).[110]

Some concerns had been raised with regard to different interpretations made by the customs authorities of different preference-giving countries about the identical terms used in the percentage criterion. For example, it was pointed out that, whereas Australia and New Zealand considered the appraised value (denominator) as the ex-factory cost, the United States, Canada, EFTA, and Japan applied the appraised value as the value of transaction or FOB value.[111]

5.2.3.2.5. *Difficulties in Interpreting the Terminology Used in the Percentage Criterion*

The problems encountered by preference-receiving countries exporters in fulfilling the requirements of preference-giving countries rules of origin based on percentage criterion may be subsumed in two categories:

(a) problems related to the interpretation of the legal terms;
(b) incapacity or difficulties in fulfilling the administrative requirements as interpreted by preference-giving countries customs authorities.

[109] Ibid. p. 17.
[110] Ibid. p. 16.
[111] Ibid. p. 7.

The following paragraphs give some practical examples to comprehend the problems involved:

(a) substantial variations in the degree of transformation required and consequently in unequal conditions for preferential access to the markets of the preference-giving countries for the same products;
(b) differing degrees of administrative efforts required from the exporters and authorities in the preference-receiving country in order to establish compliance with the rules under the various schemes;
(c) confusion among exporter because of the complexity of the requirements; and
(d) disincentives to manufacture goods capable of satisfying the rules of more than one preference-giving country.

These disadvantages exist in the use of the percentage criterion by the "process criterion" preference-giving countries. However, the effects are more limited than for the four "percentage criterion" preference-giving countries because the range of products affected is comparatively small. Nonetheless, they include some important industrial products.

Apart from these disadvantages of a general nature, some specific complaints were voiced regarding the percentage criterion as applied by both groups of preference-giving countries. It must be reported that preference-receiving countries, on many occasions, pressed for the harmonization and simplification of the various percentage rules (the definition of numerator and of denominator and the level of percentages).[112] The Working Group on Rules of Origin, at its eighth session, pointed out that measures of harmonization and simplification were needed.[113] It was pointed out that the selection of such measures had to consider that

[112] At the third session of the Working Group on Rules of Origin, the group of 77 made some requests to the preference-giving countries regarding the percentage criterion, namely: "Preference-giving countries applying the percentage criterion should seek to achieve harmonization in this respect to the maximum extent possible. In particular, it would be desirable to aim at retaining the best features of the rules in application, as follows:
(i) adoption of a common percentage of value added not exceeding 50 percent of the value of the exported product;
(ii) the share of imported materials in the exported product should preferably serve as a common basis for the determination of such percentage of value added;
(iii) adoption of a common method of valuation of such exported product based on the FOB export price. "See document TD/B/C.5/WG(VI)/4, para. 3."

[113] See document TD/B/C.5/WG(VIII)/2, para. 32. 29 Ibid. para 32.

"(a) one function of the origin rules is to avoid trade deflection, that is, the import under the GSP of goods that are essentially manufactured in countries not beneficiaries of the system. For this reason, the rules restrict the proportion of third-country materials parts and components;
(b) there is need to assist in the promotion of the industrialization of preference-giving countries."

It was noted that each of the definitions of numerator and denominator, and the levels of percentage interacted to affect the degree of transformation (or, in other words, liberality or restrictiveness) that was obtained. It was found that the definitions of numerator and denominator had important effects on the level of administrative burdens and costs that were needed to operate the rules of origin.

After more than 30 years of operations, a lack of harmonization in this area is one of the most important issues to be solved in GSP rules of origin. In the following sections some practical examples are provided of the main problems encountered by preference-receiving countries respecting the requirements of preference-giving countries rules of origin.

5.2.4. Comparisons of Formulations between Percentage and Process Criteria

From the preceding paragraphs, the most important difference between the two formulations is the extensive use of the HS system in the case of the process criterion and the comparative transparency, that is, the use of plain language in the case of the percentage criterion. Comprehension of, and compliance with, the process criterion needs an accurate understanding and interpretation of the HS system. As regards the percentage criterion, the version that uses "import content" as numerator appears readily comprehensible and requires little specialist knowledge.[114] In this regard, it appears simpler than the process criterion. Whereas the percentage criterion uses "domestic content" as numerator, some versions might require expert advice to ensure compliance with the fine distinctions drawn between allowable and unallowable costs. How these versions compare with the formulation of the process criterion is difficult to assess.

The extent to which differences between the two formulations have a practical impact can only be surmised. It is reasonable to suggest that, as far as newcomers to the GSP requirements are concerned, the formulation and presentation of the process criterion rules might initially be expected to produce

[114] See document TD/B/C.5/141, para. 23.

a deterrent effect. This could be serious in if the newcomers had no experience of the HS or were familiar only with the percentage criterion rules. If a reliable source of information and advice were available concerning the HS system, difficulties could readily be overcome and familiarity with the criterion established. The ability to provide such information and guidance in preference-receiving countries is thus important; it will of course vary from country to country.

As far as administrative effort is concerned (i.e., in relation to the establishment of compliance with the criteria and subsequent monitoring to ensure continuing compliance), there appears to be little in general to choose between the two. Possibly the percentage criterion might in practice be more burdensome because there would be an ongoing requirement to update calculations, especially during periods of inflation. This would apply especially where, as in some cases, a certificate of origin has to show the exact percentage content of the goods included in a consignment. By contrast, the process criterion seems to require less monitoring, except in those cases in which goods are excepted from the basic CTH rule and percentage rules apply. Costs of administration are, of course, important, given the declining margins of GSP preference.

Assessment of comparative merits on a theoretical basis provides only an indication; the reality may well be different. Analysis of practical experience in application of the two criteria in both preference-giving and preference-receiving countries might help to provide a judgment of greater validity.

By the term "substance" is meant the operational elements of the origin rules, in particular the limitations, and their stringency, which the criterion places on the use of imported materials, components, or parts in the manufacture of a product. These limitations are intended to serve the purposes of the origin rules as follows:

(i) To reduce or prevent "deflection of trade," (i.e., the undermining of the customs tariff of a preference-giving country). This would occur if duty-free admission were accorded to third-country goods that have merely transited through, or undergone only nominal processing in a preference-receiving country;
(ii) To confine the benefits of preferential admission to bona fide manufactures of a preference-receiving country to improve its export trade and promote industrialization and employment.

Although the criteria are required to satisfy the purposes of (i) and (ii) they are not intended to create unnecessary obstacles to the use of GSP. In that connection, preference-giving countries apply a variety of safeguard measures aimed

at controlling GSP trade; for example, import restrictions such as ceilings and quotas as well as graduation.

The purpose of (i) is of particular importance to preference-giving countries in their wish to maintain the protective purposes of their tariff. They are naturally inclined to prefer stringency rather than liberality in the rules concerning the level of imported material permitted to be used. On the other hand, preference-receiving countries favor less stringency, in the belief that this would better serve the purpose of the origin rules described in (ii), in particular so as to increase export trade. It follows from these separate and somewhat opposing interests that in forming a definition of "substantial transformation" a balance should be struck.

Examination of the substance of the two criteria conducted in the UNCTAD Working Group on rules of origin is attempted below to describe the manner and extent to which each of them appears to fulfill the purposes of the origin rules and achieve an acceptable balance. This examination does not, however, consider several other factors that affect the impact of the two criteria. These factors, whose use varies between preference-giving countries, include the concept of "preference-giving country content," various forms of "cumulation," and, in the case of the EC, the availability of a system of derogation. These tend to moderate the impact of the substance of the criteria in the direction of less stringency.

5.2.4.1. Comparison of Substances between Percentage and Process Criterion

For the purposes of comparison with the percentage criterion, any one of the process criterion versions may be chosen (in respect to both the basic rule and the rules applied to excepted products), because the substance of all versions exhibits close comparability. However, the substance of the four versions of the percentage criterion is clearly diverse. For purposes of comparison, it is necessary to select one version. The Canadian version has been chosen because of its close similarity to the percentage rules applied to some products that are accepted from the process criterion basic rule.

As far as the basic process criterion rule is concerned, there are differences between the methods by which restrictions are applied by that rule and by the percentage criterion. The latter imposes quantitative limitations whereas the former imposes qualitative limitations (i.e., descriptions of materials). The percentage criterion applied by Canada allows the use of up to 40 percent of imported materials of any description in the manufacture of any product. The process criterion in its basic rule is capable, subject to HS classification of the finished product and the imported materials used, of permitting the use of up to 100 percent of imported materials or of disqualifying a product in which

only an infinitesimal quantity of imported materials has been used.[115] This, perhaps extreme, example illustrates the practical consequences of diverse origin criteria. A product can be manufactured to meet the Canadian criterion; the same product could fail to meet the process criterion.

The two methods are so different in approach that an examination of the texts is in itself incapable of producing an overall meaningful comparison. The effects depend on the facts of each case. If imported materials must be used by a particular manufacturer and none is classified with the finished product under the same HS heading, then the basic rule in that particular case is more liberal than the percentage criterion (i.e., the manufacturer can use as much of these materials as he wishes). At the other end of the scale, if a manufacturer wants to use an infinitesimal amount of imported materials classified in the same heading as that of the finished product, its use is prohibited and the product disqualified for GSP. This is a result that the percentage criterion is unlikely to produce. The basic rule in this case is substantially more restrictive than the percentage criterion.

As regards the rules for excepted products, however, some valid comparisons can be made between certain examples, such as those that contain a percentage requirement and the Canadian version of the percentage criterion. The percentage rules for accepted products are expressed in terms of import content with a range of percentage levels and can be compared directly with the Canadian version of the percentage criterion, which is expressed on the same basis with a maximum of 40 percent for all products. However, it has to be mentioned that from the time when this comparison was made in UNCTAD, product-specific rules for textiles and clothing has been introduced by Canada as outlined in Chapter 3.

Comparisons on these lines were made. In summary form, in about 50 four-digit HS headings the process criterion percentage rule corresponded to the Canadian version of the percentage criterion. For 10 four-digit headings the process criterion percentage rules were more liberal than the Canadian. For 5 four-digit headings they were more restrictive because of an additional requirement of CTH. For 14 there may be parity of restrictiveness in practical terms between the process criterion rule (50 percent import content and CTH) and the Canadian rule. There are three other headings for which multiple percentage requirements are specified. These, based on the texts, appear to be substantially more restrictive than the Canadian percentage criterion.

As shown in Table 5.8, another method of making direct comparisons can be applied with respect of process criterion rules (concerning those excepted

[115] See document TD/B/C.5/141, para. 38.

TABLE 5.8. *Comparisons between the Canadian percentage and some specific working and processing operations under the process criterion*

Goods	Process criterion rule	Limit of imported materials expressed in percentage terms
1. Cotton yarn	Manufacture from fiber	57
2. Cotton fabric, woven	Manufacture from fiber	23.8
3. Clothing of woven cotton fabric	Manufacture from fiber	13.6

Finished product	Origin rule requirement	Imported materials	Processed and value-added	Ex-factory value of finished product	Percentage of import content
1. Cotton yarn	Manufacture from fiber	Cotton fiber value 100$ (a)	Spinning: value-added 75$ (b)	175$ (c) (a) + (b) = (c)	(a + c)×100 = 57 percent
2. Cotton fabric, woven	Manufacture from fiber	Cotton fiber value 100$ (a)	Spinning: value-added 75$ (b) Weaving: value-added 145$ (c)	320$ (d) (a) + (b) + (c) = (d)	(a + d)×100 = 23.8 percent
3. Clothing of woven cotton fabric	Manufacture from fiber	Cotton fiber value 100$ (a)	Weaving and making up: value-added 145$ (b) Value of fabric is 245$ (c)	735$ (d)	(a + d)×100 = 13.6 percent

products) that are expressed in plain language. These specify the materials from which manufacturing must commence, such as "manufacture from (various) fibers" or "manufacture from materials of heading. . . ." In such cases, to illustrate comparative restrictiveness vis-à-vis the percentage criterion, it is in some cases possible to convert the rules expressed in this way into their equivalent in percentage terms. To use this method, a breakdown of manufacturing costs for a given finished product is required for establishing costs of, for example, imported inputs and costs (or added value) attributable to the various processes of production. These data are then used to determine the percentage content of imported materials calculated based on processing

costs as numerator and ex-factory price as denominator. The manufacturing data should preferably be obtained from sources in preference-receiving countries in order to arrive at results relevant to manufacturing activities in those countries.

Owing to its commercial confidentiality, there is little available information of this nature. However, some data have been published showing costs of manufacture of a few finished products in a preference-giving country.[116] The data concerned finished products, that is (a) cotton yarns, (b) cotton woven fabric, and (c) garments made from such fabrics. For these products the process criterion rules specify for (a) and (b) that each should be manufactured from fiber. For (c), the rules require manufacture from yarn. Data have been obtained that show the value added at each main stage of manufacture. On this basis, calculations show that the percentage limits for the use of imported material in manufacturing these particular products were for cotton yarn 57 percent, for cotton fabric 23.8 percent, and for garments 13.6 percent.[117] These results, subject to the qualification that they relate to manufacture in a preference-giving country (and which also need to be updated), suggested that for two of the three products the process criterion rules are significantly more restrictive than a 40 percent percentage criterion rule based on import content.

The results described are based on a comparison of the process criterion rules (largely harmonized) with only one of the current percentage criteria. Differing results would no doubt emerge if comparison were based on other versions of the percentage criterion. It is difficult, however, to evaluate those versions in which limitations on imported materials are exercised by reference to domestic content with differing and complex interpretations.

Only limited inferences can be drawn from the examination and results described in previous paragraphs in regard to the theoretical comparative restrictiveness between the process criterion and (one version of) the percentage criterion:

(a) The basic rule of CTH has a widely variable impact that prevents an overall comparison between its restrictive qualities and those of the one version of the percentage criterion (a comparison with some other versions of the percentage criterion, that, per se, are also variable in impact, is likely to support the same inference). Where direct comparisons can be made between some products excepted from the basic rule of CTH and (one version of) the percentage criterion, the results vary: For some products the

[116] See document TD/B/C.5/WG(VI)/2, paras. 31 and 27.
[117] See, http://www.aseansec.org/20750.pdf.

rules for excepted products are subject to the same restrictions, whereas in other cases the restrictions are greater or less.

(b) Although further examination and research may make it possible to draw other and more precise comparisons, the preceding inferences support the view, important in connection with possible harmonization measures, that each of the two criteria produces individually variable impacts that prevent an assessment of the overall correspondence of the one criterion with the other.

(c) Illustrations of the significant disparities between the substance of the criteria underline the importance of harmonization in practical terms, i.e., the more significant the current disparities the more evident it is that harmonization would reduce existing barriers to market access.

The following table summarizes the various findings on the comparative strength and weaknesses identified by the Working Groups and Sessional Committees on rules of origin:

	CTH	*Ad Valorem*	Processing
Strengths	• the rule is visible and ascertainable • determinations are more objective, transparent and trade neutral • eliminates subjective elements • manufacturers/ exporters know with certainty whether their goods qualify • usually unnecessary to know origin of input materials • diminishes record keeping and private sector enquiries • customs administrations can readily verify compliance • relatively straightforward • no costing involved when used on its own	• rule is versatile, can be used with other systems • on the surface, rule is simple in concept • basic cost analysis formula • private sector can determine it independently • if high percentage of national inputs, simple to apply rule • do not have change rule even if technology changes	• rule allows for precise and objective formulation of conditions determining origin • straightforward and uncomplicated • no opportunity for manufacture/exporter to manipulate • private sector can determine independently • relatively easy to verify by customs administrations

(*continued*)

	CTH	*Ad Valorem*	Processing
Weaknesses	• the HS is complicated and technical in its own right • the HS was not originally intended for origin purposes • requires complicated exceptions and additional rules • lack of private sector tariff expertise results in mistakes and high administrative cost • rules need adjustment to keep up with technology • uses value-added and processing lists as supplemental tools, therefore must know three systems • difficult system for developing countries to administer	• cost analysis may differ considerably from country to country depending on their economies • disputes as to what factors are included in cost of production • varying percentage threshold • major interpretative problems with borderline cases • depends on fluctuating world market prices and exchange rates • discriminates against low-cost countries • origin for input materials is relevant • manufacturer/exporter can manipulate outcome • difficult for customs administrations to verify (i.e., only by detailed costing audits) • must rely on records and accounts in foreign countries	• on its own is not particularly well suited for tariff application • requires compilation of extensive lists • most effective if used with other methods or with respect to specific product sectors • descriptions must not be unduly complicated, yet must be precise enough to be meaningful • practical application is limited.

5.3. Learning Drafting Rules of Origin from the Present

Rules of origin are one of the most tormented subjects in free-trade areas (FTAs). Origin is at the core of FTAs and increasingly so since origin issues made headlines in the international press about the stringency of the North American Free-Trade Agreement (NAFTA) rules or the Pan-European rules of origin. In the following sections the experience of some major regional trade agreements (RTAs) in developing countries are outlined including the evolutions and lessons learned.

5.3.1. *Rules of Origin in AFTA and the ASEAN-China Free-Trade Area*

The Asian region has been ambivalent regarding rules of origin. On the one hand, the region as a whole has been the object of an unprecedented series of investigations and origin verification inquiries either in the context

of preferential agreements like the GSP[118] or circumvention of antidumping (AD) duties[119]; on the other hand, the region has always paid high observance to the rules of origin and willingness to strictly discipline, enforce, and police them. These latest efforts have, in spite of such declarations, been met by mixed results taking into account the simple fact that the rules of the origin contained in the original South–South agreements, such as Association of Southeast Asian Nations (ASEAN) FTA (AFTA) and ASEAN-China FTA (ACFTA), were far from perfect in terms of drafting and technicalities. In the absence of clear and unambiguous rules even the best intentions and the skills of an experienced customs officer are frustrated by rules that are inadequate for regulating the intraindustry trade flows of the fastest trade-growing region of the world.

Most recently efforts have been deployed in the ASEAN task force on rules of origin to redress some of the shortcomings of the rules contained in the original AFTA. The result of these efforts is now consolidated in a large annex of product-specific rules.[120]

ACFTA rules of origin are very similar in architecture and design to AFTA rules of origin and unfortunately replicate their shortcomings. In certain cases, some ACFTA rules clearly inspired by the original AFTA rules are even less precise and transparent, ultimately resulting in a worsening of the whole text.

AFTA rules of origin consist of eight main rules (i.e., articles) and two annexes detailing some calculation methods and 23 separate rules concerning operational certification procedures for the rules of origin of the ASEAN Common Effective Preferential Tariff (CEPT) scheme for the ASEAN FTA.

The overall result is that the original AFTA rules focused more on the administrative aspects of the rules rather than on the substantive rules of origin requirements per se.

Similar to those of AFTA, 22 rules of the ACTFA rules of origin contained in Annex 3 of the Vientiane Agreement (this annex is subdivided into rules rather than more appropriately into articles) are dedicated to administrative aspects of rules of origin. The substantive rules are confined to the definition of wholly obtained goods and rule 4 for determining origin requirement for goods not wholly obtained or produced.

[118] See Chapter 6.

[119] See, for instance, the famous case of the t-shirts from Bangladesh as reported in "Trade preferences for LDC, an early assessment and possible improvements" UNCTAD 2003 and the reports of 2001 to 2003 of OLAF, the European Office for the Fight against Fraud.

[120] For product-specific rules, see http://www.aseansec.org/20750.pdf.

Thus the core of the ACFTA rules is a rather simple across percentage criterion, as shown in the following section. This percentage rule is based on the AFTA experience shown in the following box:

RULES OF ORIGIN FOR THE CEPT SCHEME FOR AFTA[121]

Box 1 Not Wholly Produced or Obtained

(a)

(i) A product shall be deemed to be originating from ASEAN Member States, if at least 40% of its content originates from any Member States.

(ii) Locally-procured materials produced by established licensed manufacturers, in compliance with domestic regulations, will be deemed to have fulfilled the CEPT origin requirement; locally-procured materials from other sources will be subjected to the CEPT origin test for the purpose of origin determination.

(iii) Subject to sub-paragraph (i) above, for the purpose of implementing the provisions of Rule I (b), products worked on and processed as a result of which the total value of the materials, parts or produce originating from non-ASEAN countries or of undetermined origin used does not exceed 60% of the FOB value of the product produced or obtained and the final process of the manufacture is performed within the territory of the exporting Member State.

(b) The value of the non-originating materials, parts or produce shall be:

(i) The CIF value at the time of importation of the products or importation can be proven; or

(ii) The earliest ascertained price paid for the products of undetermined origin in the territory of the Member State where the working or processing takes place.

The formula for 40 percent ASEAN Content is as follows:

$$\frac{\text{Value of Imported Non-ASEAN Materials, Parts or Produce} + \text{Value of Undetermined Origin Materials, Parts produce}}{\text{FOB Price}} \times 100 \text{ percent} \leq 60 \text{ percent}$$

(c) The method of calculating local/ASEAN content is as set out in Annex A of these Rules. The principles to determine cost for ASEAN origin and the guidelines for costing methodologies in Annex B shall also be closely adhered to.

[121] (Endorsed by the 17th AFTA Council). See http://www.aseansec.org/17293.pdf.

As contained in box 1, the drafting of the original AFTA rules was rather ambiguous and contained a number of provisions and wording, leaving too much space to interpretation and little guidance to the various actors of customs or the private sector who must implement this rule. Neither the various elements nor the definitions of the rules are laid down in a sequential manner.

For instance, the first paragraph (a) (i) stipulated that *a product is originating if at least 40% of its content originates from any members states*.

This provision in paragraph (a) (i) does not further specify what the criteria are for determining and calculating such 40 percent local content. Moreover, the sentence *from any member-states* suggest a situation in which the local content may originate in different members and may be added up together to reach the required figure of 40 percent. There is no definition of what could be considered local content that is a very vague concept unless properly defined.

The formula contained in paragraph (b)(ii) does not provide any clarification on the definition of local content because it is expressed indirectly: It requires that the amount of third country material or undetermined origin does not exceed 60 percent of the FOB price.

Annexes A and B mentioned in paragraph (c) and attached to the AFTA rules shed some partial light on the definitions of some of the elements and method of calculation of the ASEAN rules of origin. Only from the wording of Annex A, reproduced in the following section, is the reader made aware of the existence of two ways of calculating the required local /ASEAN content: direct and indirect methods.

The annex further stipulates that ASEAN member countries should adhere to only one method of calculation: either direct or indirect. However, the Annex A does not contain the formula or additional elements that are needed for the calculations of the direct method.

Annex A does not expressly provide a method of calculation of local content, and it is limited to define the elements of the FOB price, ex-factory price, and production costs.

For instance, one may wonder, whether under this definition of local content, labor incurred in one or more ASEAN countries could be counted as numerator to reach the 40 percent requirement or whether only material inputs obtained in different ASEAN countries may be cumulated.

ANNEX A
METHOD OF CALCULATION OF LOCAL/ASEAN CONTENT

1. Member Countries shall adhere to only one method of calculating local/ASEAN content, i.e. whether it is the direct or indirect method, although

Member Countries shall not be prevented from changing their method, if deemed necessary. Any change in the calculation method shall be notified to the AFTA Council Meeting.

2. FOB price shall be calculated as follows:
   a. **FOB Price = Ex-Factory Price + Other Costs**
   b. **Other Costs** in the calculation of the FOB price shall refer to the costs incurred in placing the goods in the ship for export, including but not limited to, domestic transport costs, storage and warehousing, port handling, brokerage fees, service charges, etc.
3. Formula for ex-factory price:
   a. **Ex-Factory Price = Production Cost + Profit**
   b. Formula for production cost,
      i. **Production Cost = Cost of Raw Materials + Labor Cost + Overhead Cost**
      ii. **Raw Materials** shall consist of:
         - Cost of raw materials
         - Freight and insurance
      iii. **Labor Cost** shall include:
         - Wages
         - Remuneration
         - Other employee benefits associated with the manufacturing process
      iv. **Overhead Costs**, (non exhaustive list) shall include, but not limited to:
         - real property items associated with the production process (insurance, factory rent and leasing, depreciation on buildings, repair and maintenance, taxes, interests on mortgage)
         - leasing of and interest payments for plant and equipment
         - factory security

Annex B, reproduced in the following section, does not provide additional guidance on defining the numerator for the direct method but rather provides only some principles and guidelines. In the absence of a clear rules defining the numerators it is only by interpretation that one may come to the conclusion that the applicable formula for the direct method could be as follows[122]:

$$\frac{ASEAN\ RM + Labor + Overhead + Profit + Other\ Costs}{\text{FOB}} \times 100 \text{ percent} > 40 \text{ percent}$$

[122] The following calculation is excerpted from a power point presentation of Aaron C. Redubla, Philippines Customs at a Asian Development Bank Seminar (2004).

ANNEX B
PRINCIPLES AND GUIDELINES ON THE CEPT-AFTA RULES OF ORIGIN

A. **Principles to Determine Cost for ASEAN Origin**

i. **Materiality** – all cost material to the evaluation, assessment and determination of origin;

ii. **Consistency** – costing allocation method should be consistent unless justified by commercial reality;

iii. **Reliability** – costing information must be reliability and supported by appropriate information;

iv. **Relevance** – costs must be allocated based on objective and quantifiable data;

v. **Accuracy** – costing methodology should provide an accurate representation of the cost element in question;

vi. **Application of GAAP of the exporting country** – costing information must be prepared based in accordance with the general accepted accounting principles and this includes the avoidance of double-counting of cost items;

vii. **Currency –** updated costing information from existing accounting and costing records of companies should be used to calculate origin.

B. **Guidelines for Costing Methodologies**

i. **Actual Costs** – basis for actual costs should be defined by the company. Actual costs should include all direct and indirect costs incurred in producing the product.

ii. **Projected and Budgeted Costs** – projected costs may be used if it is justified. Companies should provide variance analysis and proof during the period origin is claimed to indicate accuracy of projections.

iii. **Standards Costs** – the basis for standards costs should be indicated. Companies should provide evidence that the costs are used for accounting purposes.

iv. **Average/Moving Average Costs –** average costs may be used if justified; the basis for calculating average costs, including time, etc. should be highlighted. Companies should provide variance analysis and proof during the period origin is claimed to indicate accuracy of average costs.

v. **Fixed Costs –** fixed costs should be apportioned according to sound cost accounting principles. They should be a representative reflection of unit costs for the company in the particular period in question. The method for apportionment should be indicated.

At the same time there is no definition for the "*locally-procured materials*" mentioned under rule 4, paragraph (a) (ii) Should this provision be interpreted as meaning that any material locally sourced will be deemed to be originating? How can this provision be reconciled with the concept of origin? Apparently this provision was meant to be accompanied by a list of ASEAN companies nominated by the respective ASEAN countries producing inputs and intermediates deemed to be *locally produced materials*. However, such a list is apparently not public, or at least it is not posted on the ASEAN website.

Experience has shown that implementation of the calculation guidelines laid down in these two annexes has not been an easy task in ASEAN.[123] The cumulation rules as contained in rule 4 have not been any easier to administer, given the uncertain drafting:

> ***RULE 4 Cumulative Rule of Origin***
> (a) *Products which comply with origin requirements provided for in Rule 1 and which are used in a Member State as inputs for a finished product eligible for preferential treatment in another Member States shall be considered as products originating in the Member State where working or processing of the finished product has taken place provided that the aggregate ASEAN content of the final product is not less than 40%.*
> (b) *If the material has less than 40 percent ASEAN content, the qualifying ASEAN national content shall be in direct proportion to the actual domestic content provided that it is equal to or more than the agreed threshold of 20%.*

It is quite evident that it is difficult to define the methodology of the calculation for cumulation purposes. There is no definition of what could be counted toward the 40 percent aggregate ASEAN content. Paragraph (b) of rule 4 does not provide any further guidance because it is not clear what the *qualifying ASEAN national* is in respect to the *actual domestic content*.

An explanatory note[124] was recently added to rule 4 to better explain the functioning of cumulation in the ASEAN context:

> *To be considered for partial cumulation, the local/ASEAN content of the materials, parts or produce originating from the country of last manufacture should not be less than 20 percent;*
>
> *(b) the formula to be used in the calculation would be similar to the formula for calculating the 40 percent local/ASEAN content;*

[123] This point clearly emerged during a series of workshops held in the ASEAN region. As of June 2008, Annexes A and B are no longer available in the ASEAN secretariat website.

[124] See presentation of Tran Dong Phuong, Director, ASEAN secretariat at the regional workshop on Simplification and Harmonisation of rules of origin, Asian Development Bank, Bangkok, March 2008.

(c) no CEPT preference shall be extended by the importing member country for that particular intermediate good;

Unfortunately, this explanatory note does not shed any light on the definitions of local/ ASEAN content.

Considering this drafting of the AFTA rules of origin, it is not surprising to hear that there have been bitter disputes among ASEAN member-states over the interpretation and implementation of AFTA rules. As a conspicuous sign of these difficulties, ancillary product-specific rules were adopted in the area of textile and textile products because, in the 7th AFTA Council held in 1995, the following statement was made:

Recognizing that the existing percentage criterion of the CEPT Rules of Origin may not be conducive towards the objective of increasing intra-ASEAN trade in textiles and textile products, the 7th AFTA Council at its meeting on 6th September 1995 decided that for the purpose of origin determination of textiles and textile products either the percentage or the substantial transformation criterion can be used by the exporting country. The 7th AFTA Council also decided that an ASEAN Single List identifying the processes for each of the textile and textile products shall be formulated to administer the substantial transformation criterion.

2. When an exporting country chooses to apply the substantial transformation criterion, the following rules of origin shall apply. The rules of origin should be read in conjunction with the attached ***ASEAN Single List****.*

According to the ASEAN Single List and unlike the EC model, the across-the-board general percentage rules continue to apply together with the product-specific rules contained in the Single List. From the preceding text it emerges that the exporting country has the option to choose to adopt the percentage or the substantial transformation criteria.

The product-specific rules contained in the Single List are in general quite liberal, providing for a single process to be carried on nonoriginating materials as outlined in the following section for garments of HS Chapters 61 and 62:

Manufacture through the processes of cutting and assembly of parts into a complete article (for apparel and tents) and incorporating embroidery or embellishment or printing (for made-up articles) from raw or unbleached fabric or finished fabric.

More recently other product-specific rules have been adopted for aluminum products of HS Chapter 76 (CTH with or without exceptions); steel products of HS Chapter 72 (CTH with exceptions, CC); wheat flour (CC); wood products of HS Chapter 44; HS 94.01–94.03, and 94.06 (CTSH six digits).

In the case of wheat flour and wood products, the product-specific rules were accompanied by a text explaining that these product-specific rules apply at the

choice of the exporting country when the substantial transformation criteria is applied.

A recent document that appeared on the ASEAN website (available at http://www.aseansec.org/20750.pdf) seems to consolidate these previous product-specific rules of origin in a unique text containing the progress made in better defining and regulating AFTA rules of origin.

The 166-page text titled "Product Specific Rules of Origin" contains a long list of product-specific rules covering most, but not all, HS chapters, an attachment 1 on substantial transformation criterion for textiles and clothing products and an attachment 2 on explanatory notes on product-specific rules.

The techniques used in drafting product-specific rules of origin follow a rather common pattern: Almost all rules provides for a regional value content (RVC) and, as an alternative, a CTC that could take the form of change from another chapter:

> *A regional value content of not less than 40 percent of the FOB value of the good; or Change to Subheading 1605.30 from any other Chapter.*

A change from another heading:

> *A regional value content of not less than 40 percent of the FOB value of the good; or Change to Subheading 2304.00 from any other Heading.*

A change from another subheading:

> *A regional value content of not less than 40 percent of the FOB value of the good; or Change to Subheading 4409.10 from any other Subheading.*

In the case of textiles and clothing from Chapters 50–63, a series of alternatives among the RVC, the CTC, and a specific working or processing are given in the following example:

> *A regional value content of not less than 40 percent of the FOB value of the good; or Change to Subheading 6105.10 from any other Chapter provided that the good is both cut and sewn in the territory of any Member State; or Process Rules for Textile and Textile Products as set out in Attachment 1*

Attachment 1 provides for specifically one-stage working or processing operations:

> *Working or Processing Carried Out on Non-Originating Materials that Confers Originating Status: Manufacture through the processes of cutting and assembly of parts into a complete article (for apparel and tents) and incorporating embroidery or embellishment or printing (for made-up articles) from:*
> *raw or unbleached fabric*
> *finished fabric*

Attachment 2 contains definitions of RVC and substantial transformation. In this attachment, the formula of RVC is defined as follows:

1. RVC of a good specified in Product Specific Rules shall be calculated in accordance with the following formula
   (a) Direct Method

$$RVC = \frac{\text{ASEAN Material Cost} + \text{Direct Labour Cost} + \text{Direct Overhead Cost} + \text{Other Cost} + \text{Profit}}{\text{FOB Price}} \times 100\%$$

   (b) Indirect Method

$$RVC = \frac{\text{FOB Price} - \text{Value of Nonoriginating Materials, Parts or Produce}}{\text{FOB price}} \times 100\%$$

For the purpose of calculating the regional value content provided in paragraph 1:

(a) *The value of imported non-ASEAN materials, parts or produce shall be*:
   (i) *The CIF value at the time of importation of the products or importation can be proven; or*
   (ii) *The earliest ascertained price paid for the products of undetermined origin in the territory of the Member State where the working or processing takes place.*
(b) *Labour cost shall include wages, remuneration and other employee benefits associated with the manufacturing process;*
(c) *The calculation of overhead cost shall include, but not limited to real property items associated with the production process (insurance, factory rent and leasing, depreciation on buildings, repair and maintenance, taxes, interests on mortgage); leasing of and interest payments for plant and equipment; factory security; insurance (plant, equipment and materials used in the manufacture of the goods); utilities (energy, electricity, water and other utilities directly attributable to the production of the good); research, development, design and engineering; dies, moulds, tooling and the depreciation, maintenance and repair of plant and equipment; royalties or licenses (in connection with patented machines or processes used in the manufacture of the good or the right to manufacture the good); inspection and testing of materials and the goods; storage and handling in the factory; disposal of recyclable wastes; and cost elements in computing the value of raw materials, i.e.*

port and clearance charges and import duties paid for dutiable component; and

(d) *FOB price means the free-on-board value of the good, inclusive of the cost of transport to the port or site of final shipment abroad. FOB price shall be determined by adding the value of materials, production cost, profit and other costs.*

(e) *Other costs shall refer to the costs incurred in placing the goods in the ship for export, including but not limited to, domestic transport costs, storage and warehousing, port handling, brokerage fees, service charges, etc.*

The definition of substantial transformation in attachment 2 is described as follows:

B. Substantial Transformation Criterion

1. *A country of origin is that in which the last substantial transformation or process was performed resulting in a new product. Thus, materials which underwent a substantial transformation in a country shall be a product of that country.*
2. *A product in the production of which two or more countries are involved shall be regarded as originating in the country in which the last substantial transformation or process was performed, resulting in a new product.*
3. *A product will be considered to have undergone a substantial transformation or process if it has been transformed by means of substantial manufacturing or processing into a new and different article of commerce.*
4. *A new and different article of commerce will usually result from manufacturing or processing operations if there is a change in:*
   i. *Commercial designation or identity*
   ii. *Fundamental character, or*
   iii. *Commercial use*
5. *In determining whether a product has been subjected to substantial manufacturing or processing operations, the following will be considered:*
   i. *The physical change in the material or article as a result of the manufacturing or processing operations;*
   ii. *The time involved in the manufacturing or processing operations in the country in which they are performed;*
   iii. *The complexity of the manufacturing or processing operations in the country in which they are performed;*
   iv. *The level or degree of skill and/or technology required in the manufacturing or processing operations.*

C. Specific Rules Applicable for Textile and Textile Products

1. *Textile and Textile Products covered under this Rules are set out in Attachment 1.*
2. *Textile material or article shall be deemed to be originating in a Member State, when it has undergone, prior to the importation to another Member Sate, any of the following:*
   i. *Petrochemicals which have undergone the process of polymerization or polycondensation or any chemicals or physical processes to form a polymer;*
   ii. *Polymer which has undergone the process of melt spinning or extrusion to form a synthetic fiber;*
   iii. *Spinning fiber into yarn;*
   iv. *Weaving, knitting or otherwise forming fabric;*
   v. *Cutting fabric into parts and the assembly of those parts into a completed article;*
   vi. *Dyeing of fabric, if it is accompanied by any finishing operation which has the effect of rendering the dyed good directly;*
   vii. *Printing of fabric, if it is accompanied by any finishing operation which has the effect of rendering the printed good directly usable;*
   viii. *Impregnation or coating when such treatment leads to the manufacture of a new product falling within certain headings of customs tariffs;*
   ix. *Embroidery which represents at least five percent of the total area of the embroidered good.*
3. *Notwithstanding any provisions in the CEPT Rules of Origin, an article or material shall not be considered to be originating in the territory of a Member State by virtue of merely having undergone any of the following:*
   i. *Simple combining operations, labelling, pressing, cleaning or dry cleaning or packaging operations, or any combination thereof;*
   ii. *Cutting to length or width and hemming, stitching or over-locking fabrics which are readily identifiable as being intended for a particular commercial use;*
   iii. *Trimming and/or joining together by sewing, looping, linking, attaching of accessory articles such as straps, bands, beads, cords, rings and eyelets;*
   iv. *One or more finishing operations on yarns, fabrics or other textile articles, such as bleaching, waterproofing, decating, shrinking, mercerizing, or similar operations; or*
   v. *Dyeing or printing of fabrics or yarns.*

The scope of the present section does not permit an extensive comment on these latter rules. Suffice it here to remember that the relation between the text containing the product-specific rules and their attachments and the main text of the rules of origin commented on above is unclear and not defined.

Should one interpret that the product-specific rules contained in the text are alternative criteria to the General Rules or are exceptions to the General Rules? Should one interpret that the definition of RVC is also applicable, or could it be used to complement the definition of the direct and indirect method of calculation in the General Rules? Should one interpret that the definition of substantial transformation in attachment 2 is an ancillary criterion or must it be interpreted in another manner?

These and other questions could be raised concerning the predictability of these rules.

A terminology misunderstanding provides an illuminating overview over the status of rules of origin in ASEAN: In fact some ASEAN officials and official documents refer to the rules on textiles and clothing as adopting the substantial transformation criterion[125] as an alternative to the percentage transformation criterion.

However, the rest of the world and as contained in the WTO Agreement on rules of origin and Annex K of the revised Kyoto Convention consider the term "substantial transformation" a general criterion that has to be further technically defined and expressed by the adoption of different methodologies to determine origin that could be (a) a CTC, or (b) *ad valorem* percentages under the revised Annex K of the Kyoto Convention.

In addition, Article 9 (2) (c) (iii) of the WTO Agreement also provides for specific manufacturing or processing operations as additional methodologies to express the substantial transformation criterion.

Thus it is multilaterally accepted that "substantial transformation" is not an alternative to the *ad valorem* percentage but is one of the methodologies together with the CTC criteria and specific working or processing requirements that may be used to express the "substantial transformation" criterion.

This terminology problem is so deeply rooted in ASEAN that even the recent ASEAN Framework Agreement for the integration of priority sectors still refers in its Article 7 (b) to "*adopting substantial transformation as alternative criterion for conferring origin status*."

When one is considering the ACFTA rule 4 shown in box, the general points raised in the context of AFTA rules are still valid:

[125] The note has been endorsed by the AEM Retreat, Ha Long, 26 April 2005.

ARTICLE 4 OF RULES OF ORIGIN UNDER THE ASEAN – CHINA FTA[126]

a. For the purposes of Rule 2(b), a product shall be deemed to be originating if:
   (i) Not less than 40 percent of its content originates from any Party; or
   (ii) If the total value of the materials, part or produce originating from outside of the territory of a Party (i.e., non-ACFTA) does not exceed 60 percent of the FOB value of the product so produced or obtained provided that the final process of the manufacture is performed within the territory of the Party.

b. For the purposes of this Annex, the originating criteria set out in Rule 4(a)(ii) shall be referred to as the "ACFTA content." The formula for the 40 percent ACFTA content is calculated as follows:

$$\frac{\text{Value of Undetermined Materials} + \text{Value of materials of Non-ACFTA origin}}{\text{FOB Price}} \times 100 \text{ percent} < 60 \text{ percent}$$

   Therefore, the ACFTA content: 100 percent−non-ACFTA material = at least 40 percent.

c. The value of the non-originating materials shall be:
   (i) the CIF value at the time of importation of the materials; or
   (ii) the earliest ascertained price paid for the materials of undetermined origin in the territory of the Party where the working or processing takes place.

d. For the purpose of this Rule, "originating material" shall be deemed a material whose country of origin, as determined under these rules, is the same country as the country in that the material is used in production.

- Under Article 4 (a) (i), the definition of "*40 percent of its content originates from any Party*" is unclear;
- Article 4 (b) may be interpreted as an effort to clarify the ACFTA content but it does not refer to paragraph (a) (i) but to paragraph (a) (ii);
- As a result we have two alternative rules under Article 4, one under paragraph (a) (i) and another under paragraph (a)(ii) further specified in paragraph (b).

[126] The preamble to the textiles and clothing rules provides "The *7th AFTA Council at its meeting on 6th September 1995 decided that for the purpose of origin determination of textiles and textile products either the percentage or the substantial transformation criterion can be used by the exporting country. The 7th AFTA Council also decided that an ASEAN Single List identifying the processes for each of the textile and textile products shall be formulated to administer the substantial transformation criterion.*"

To make some sense of the provision in (a) (i), one may read it as a provision allowing cumulation to reach the 40 percent local content requirement.

However, Article 5 of the ACFTA Annex on rules of origin on cumulation raises additional questions rather than clarifying the provision of Article 4 (a) (i):

> *"Unless otherwise provided for, products which comply with origin requirements provided for in Rule 2 and which are used in the territory of a Party as materials for a finished product eligible for preferential treatment under the Agreement shall be considered as products originating in the territory of the Party where working or processing of the finished product has taken place provided that the aggregate ACFTA content (i.e. full cumulation, applicable among all Parties) on the final product is not less than 40%."*

There are contradicting statements in this provision. In the first part it refers to *products that comply with origin requirements under rule 2*. Because rule 2 of Annex 3 of the Vientiane Agreement determines the rules for originating products, it follows that only material already originating may be cumulated. This means that a partial or diagonal cumulation is applied under ACFTA. However, the last sentence of Article 5 expressly provides for "*full cumulation applicable among the parties*," leaving a lot of uncertainty about the scope and implementation of this cumulation provision.

Finally, Article 6 of Annex 3 of the Vientiane Agreement provides for the elaboration of product-specific rules of origin that had to be negotiated at a later stage.

At the time of this writing, product-specific rules of origin have been elaborated[127] as an exclusive criterion to the General Rule for around 565 items for products such as processed fish, plastics, leather items, textile items, and clothing. However, more detailed information on the nature and content of these product-specific rules of origin is not available.

The elaboration of product-specific rules of origin may be an opportunity to impart clear and predictable rules, easy to implement and administer. On the other hand, if badly drafted or excessively stringent, these product-specific rules could potentially become another formidable obstacle to the effective functioning of ACFTA.

Previous experience in elaborating product-specific rules of origin in South–South agreements does not augur well. For instance, in the South American region in the case of the G3 agreement among Mexico, Venezuela, and

[127] Excerpt from the Protocol 3 of the Vientiane Agreement. See the list of product-specific rules at http://www.thaifta.com/english/index_eng.html.

Colombia, the drafted rules were clearly inspired by NAFTA. These rules turned out to be excessively complicated and stringent in relation to the manufacturing capacity of the region and intraregional trade flows. In another region, the exercise of elaborating product-specific rules of origin in Southern Africa Development Community (SADC) turned out to be a disappointing experience because of the insistence of South Africa on elaborating restrictive product-specific rules of origin to promote the utilization of regional inputs over imported ones.

Another factor that makes negotiations of rules of origin difficult is the fact that, at times, customs administrations do not play significant roles during the negotiations on the substantive aspects rules of origin in developing countries. Reportedly this is case in the AFTA and ACFTA context. As a result, the substantive requirements of the rules of origin are negotiated among trade officials with inputs, in some cases, from the private sector. This might be one of the reasons for the poor technical quality of the substantive rules of origin in both AFTA and ACFTA.

Practical experience and exchange of views indicated that the attention of many customs administrations in Asia were focused on the verification of certificates of origin and other rather mechanical aspects of the agreements. Little interest was shown until recently on the substantive aspects of the rules and how to shape and draft product-specific rules of origin. However, the implementation problems encountered seem to have generated an evolution of the AFTA rules of origin. Much remains to be done to increase transparency and predictability. The status and working methods of the AFTA negotiations on rules of origin seem to be far from transparent and the results of the negotiations are not widely available, not even to the private sectors. In addition, when progress is made there is little effort to coordinate the results of the negotiations with previous legislation.

5.3.2. *The SADC and COMESA Experience*

COMESA and SADC, the two larger blocs in Eastern and Southern Africa, are showing rather similar paths on the rules of origin. The rules of origin that were first contained in the original SADC Protocol were inspired by those adopted by COMESA. Goods would qualify for SADC tariff preferences if they underwent a CTH, contained a minimum of 35 percent regional value added, or included non-SADC imported materials worth no more than 60 percent of the value of total inputs used. The CTH rule contained in the original Protocol was accompanied by a provision in paragraph 2 of the same Article for the elaboration of a list of working and processing to be carried out

on nonoriginating materials in order for the manufactured product to obtain originating status.[128] Another paragraph provided for cumulative treatment of goods processed in more than one member-state. Finally, these requirements were subject to derogations, as provided by rule 12.[129]

Earlier in the negotiations on the implementation of SADC Trade Protocol South African Customs Union (SACU) but mainly South Africa proposed implementing the aforementioned paragraph 2 by developing product-specific rules, especially in a very important manufacturing sector such as the textile and garment industry.[130] South Africa was concerned that the Trade Protocol, in its original formulation, provided for three general alternative rules of origin, opening the possibility of circumvention.

At the time when the SADC rules of origin started to be considered, South Africa had already entered in the Trade and Development Cooperation Agreement (TDCA) with the EC. The TDCA was a FTA of a new generation, encompassing areas besides trade in goods. In the case of rules origin, the TDCA adopted the Pan-European rules of origin with minimal variations. During the SADC negotiations, it became rather clear that South Africa wished to adopt a similar model in the SADC context. Widespread opposition by other SADC member-states initially met such a proposal from South Africa. However, later in the negotiations, it was agreed to adopt a negotiating text that was partially based on the EC architecture of preferential rules of origin. This marked a radical shift from the across-the-board set of rules of origin contained in the SADC Trade Protocol to product-specific rules of origin negotiations.

At a technical level such a move might have been justified by the desire to provide a transparent and fair set of rules of origin for the SADC region. It soon emerged during the negotiations that other reasons were the real underpinnings of such an approach.

One of the first SACU proposals of product-specific rules demanded a wholly obtained requirement for many agricultural chapters, including those classifying food processing products.

SACU required in a number of cases that the raw materials undergo a "double transformation," and not a CTH, in order for the manufactured product to acquire originating status. For example, in the case of "articles of apparel and

[128] This list was originally scheduled to be elaborated in the following months, prior to the entry into force of the Trade Protocol or at a later stage, after a three-year test-period.

[129] Rule 3 contained the list of operations and processes that do not by themselves confer originating status.

[130] See Flatters: SADC rules of origin: Undermining regional free trade, 2002 TIPS forum.

clothing accessories, not knitted or crocheted,"[131] ex HS Chapter 62, the rule of origin required the manufacture to start from yarn. A garment maker who imports woven fabrics from outside the region would not be able to benefit from the preferential access to the SADC market because his finished products would not comply with the previously mentioned origin rule. Thus it would be necessary either to spin the yarn locally or to import the fabric from another SADC producer, so that the rule would be fulfilled through the cumulation mechanism. SACU held that view that these rules of origin should help in the development of regional industry making sure that regional inputs should be favored over local inputs.

Other SADC member-states argued that rules requiring a double transformation were basically mirroring the same EC rules that have been hampering the utilization of trade preferences under GSP or Lomé/Cotonou preferences for the last decades.

Ultimately the product-specific approach opened the Pandora's box to lobbies and powerful South African labor unions with the direct consequence that the area of contentions expanded to wheat, wheat flours and their products, coffee, tea and spices, machinery and electrical products. At times bizarre arguments such as environmental considerations accompanied the justification for restrictive rules of origin.

In the majority of cases, the crucial point debated during the negotiations was the implication of product-specific rules of origin on the existing production chains of the SADC region. A double processing requirement may be matching certain vertically, oriented production facilities. In cases in which production is mainly concentrated on a one-stage process, the application of product-specific rules of origin requiring double processing may be problematic because the producer will have either to change the source of its inputs or invest in new machinery or forego the tariff preferences. The ultimate result of such fierce and at times acrimonious negotiations[132] resulted in a compromise rule for certain garments between SACU and MMTZ (Malawi, Mozambique, Tanzania, and Zambia). Under this arrangement, MMTZ were allowed to use imported fabrics to manufacture garments exported to SACU exports under a quota system. This compromise allowed reaching the critical mass of consensus to make operational the SADC Trade Protocol. However, at the time of approval of the final negotiating package of the SADC Trade Protocol by

[131] Except for the following headings to which other rules are applicable: ex 6202, ex 6204, ex 6206, ex 6209 and ex 6211; ex 6210 and 6216; 6213 and 6214; and 6217.

[132] For series of examples and background on the negotiations of SADC rules of origin, see F. Flatters in footnote 130.

SADC Ministers in 2000, a number of product-specific rules of origin were not agreed. Subsequent negotiations were unable to bridge a compromise, and SADC rules of origin are commonly considered as an example of the most restrictive and business-unfriendly set of rules of origin.

At the time of this writing the COMESA rules of origin have basically retained their across-the-board, *pick-and-choose* approach:

> *1. Goods shall be accepted as originating in a member State if they are consigned directly from a member State to a consignee in another member State and*:
>
> *a. they have been wholly produced as provided for in Rule 3 of this Protocol; or*
>
> *b. they have been produced in the member-states wholly or partially from materials imported from outside the member-states or of undetermined origin by a process of production which effects a substantial transformation of those materials such that*:
>
> *(i) The c.i.f. value of those materials does not exceed 60 percent of the total cost of the materials used in the production of the goods; or*
>
> *i. The value added resulting from the process of production accounts for at least 35 percent of the ex-factory cost of the goods; or*
>
> *ii. The goods are classified or become classifiable under a tariff heading other than the tariff heading under which they were imported; or*
>
> *a. produced in the member State and designated in a list by the Council upon the recommendation of the Committee through the IC to be goods of particular importance to the economic development of the member-states, and containing not less than 25 percent of value-added notwithstanding the provisions of sub-paragraph (b) (ii) of paragraph 1 of this Rule.*

COMESA rules of origin provide for alternative rules of origin criteria, ranging from a CTH, not more than 60 percent of imported material in the total cost of materials used, and a valued added of 35 percent. The COMESA architecture of rules of origin is somewhat similar to the original rules of origin text contained in Mercosur, SADC, and ASEAN rules. It may be defined as a *pick-and-choose* approach insofar it allows the exporter/producer to choose from among the different criteria the one that suits him best.

There is nothing wrong in providing alternative rules of origin for the same product. The Pan-European model of rules of origin, NAFTA, and the other recent U.S.-inspired rules of origin containing provisions for alternative rules of origin or different figures of percentages. However, the alternatives provided must logically have the same or equivalent degree of restrictiveness (i.e., to borrow a term from the nonpreferential alternative rules of origin they should be coequal in term of stringency). Failing this, the exporter/producer will have a strong incentive to pick and choose the easiest rule to comply with.

As widely known, the CTH is quite easy to comply with for some products and quite stringent for other kinds of products. It follows that producers will choose the CTH when is easy to comply with and will switch to percentage requirements when they cannot satisfy the CTH. This may sound business-friendly but in reality does not provide a workable basis for administering a set of rules of origin. It is unknown or it will require extensive research to find all the occurrences when the CTH is easy to comply with or vice versa regarding a percentage rule. This point has been addressed in Section 5.2.4.1. Ultimately adopting CTH as an across-the-board criterion is tantamount to leaving the origin to be determined by the hazard. The latest consolidated version of Harmonization Work Program (HWP) of nonpreferential rules of origin probably represent a valuable example of the maximum use that could be made of a CTH rule.

A COMESA initiative aims at turning the original across-the-board CTH origin criterion for all products into a product-specific rule, leaving at same time the option to use the percentage requirements.

Under this initiative, for products such as wheat and wheat products (i.e., flour) there is a proposal requiring that, to manufacture flour, only originating wheat has to be used. Apart from the fact that such a rule is overly stringent within the COMESA context, leaving the other across-the-board options available will mean that such a stringent rule maybe easily avoided by the exporter/producer who will be able to pick the 35 percentage requirements rather than comply with product-specific rules that are too stringent.

ASEAN, COMESA, and SADC have experienced problems with the origin criteria for flour. Some of their member-states hold the view that grinding cereals of Chapter 10 into flour of Chapter 11 is not origin conferring. Others argue that grinding cereals into flour is an origin-conferring operation.

If we adopt the suggested rules and *pick* the 35 percent criterion, origin may be conferred by grinding because the calculation of the valued added may eventually satisfy the 35 percent requirement. Conversely, if I am a customs officer of an importing country, I may *choose* that the flour does not comply with the product-specific rules of origin requiring use of originating wheat to make flour.

Thus, depending on the criteria used, we may have two different origin outcomes. The following is another example:

Materials Cost (currency unit)
Timber:
Local timber 200
From member State Z 100
Malaysian origin 900

Other costs:
Glue (imported from Brazil) 5
Varnish (imported from Germany) 8
Factory overheads:
Rent and rates 100
Depreciation of machinery 80
Direct labor 300
Ex-factory cost 1693

Calculations:
(a) (i) Import material content

$$= \frac{900 + 5 + 8}{200 + 100 + 900 + 5 + 8} = \frac{913}{1213} = 75 \text{ percent}$$

OR

$$\text{(ii) Local material content} = \frac{200 + 100}{200 + 100 + 900 + 5 + 8} = \frac{300}{1213} = 25 \text{ percent}$$

$$\text{(b) Value added} = \frac{1693 - 913}{1693} = \frac{780}{1693} = 46 \text{ percent}$$

The material content and value added should be calculated to the nearest whole number.

Explanation[133]
It is clear that the table largely satisfies the value-added criterion. However, the same table would not satisfy the material content criterion of the COMESA, because imported materials exceed 60 percent of the total cost of materials used in producing the table.

This example shows the consequences of a pick-and-choose approach. Some believe, however, that such an approach with different alternatives is business-friendly because the producers/manufacturers have the flexibility to choose the rule that suits them best. However, when this reasoning is pushed to the extreme with the option of complying with a simple CTH criterion, it is obvious that such a loophole may work as an incentive to be exploited by unscrupulous traders. Ultimately, it may defeat the original purpose of rules of origin to avoid trade deflection.

A number of problems with the current rules of origin have been reported and discussed by COMESA member-states within the internal negotiating

[133] Example excerpted from All You Have to Know About COMESA Rules of Origin, available at http://www.ecatradehub.com/reports/rp.downloads/2005.COMESA.Rules.of.Origin.pdf.

machinery.[134] These difficulties have eventually generated the current initiative of further defining the meaning of rule 2(1)(b)(iii) of the Protocol by developing product-specific rules of origin. According to this initiative the original across-the-board CTH approach is replaced with product-specific rules based on a simple CTH or a CTH with exception or other criteria. The alternative rules of origin based on the value added and the local material content will still be applicable. As shown in the example in the following section, the simple CTH rules in the case of Chapter 61 have been replaced with a CTH with exception to impede the manufacture of products of Chapter 62 from parts and accessories classified in heading 62.17 and confer originating status, as shown in the following table:

HS code	Description of goods	Working or processing carried out on nonoriginating materials that confers originating status
A	B	C
Ex. Chapter 62	Articles of apparel and clothing accessories, not knitted or crocheted	Manufacture from materials classified in a heading other than that of the product, except from materials from heading 62.17.
62.17	Other clothing accessories; parts of garments or of clothing accessories, other than those of heading No. 62.12.	Manufacture from materials classified in a heading other than that of the product, except from materials of other headings of this Chapter.

As in the case of SADC the elaboration of product-specific rules opened the Pandora's box of protectionist intents and related concerns. This has meant persistent disagreement on a number of tariff lines, in particular headings 11.01, 11.02, 15.07, 15.08, 15.10, 84.22, 84.39 to 84.42, 84.76–84.79, 85.09, 85.10, 85.12, and 85.16 and Chapters 50, 51, 53, 54, and 55, and those related headings.

Past experience would suggest that there is a need to rationalize the architecture of COMESA rules of origin before entering into such a complex and time-consuming discussion at the product-specific level. COMESA member-states should make the best possible efforts to refrain from adopting restrictive product-specific rules of origin that do not reflect production reality in the region.

[134] See for instance the COMESA report of the trade and customs committee October 2006, CS/TC/XIX/21, in which a number of controversies about rules of origin among member-states were reported.

5.3.3. *Mercosur Rules of Origin*

The original text of the Mercosur rules of origin is found in Annex II to the Treaty of Asunción. Although the wording is a bit elaborate, the rules of origin were based on an across-the-board approach:

> *Article 1*
>
> The following shall be classified as originating in the States Parties:
>
> (a) Products manufactured wholly in the territory of any of the Parties, when only materials originating in the States Parties are used in their manufacture;
>
> (b) Products included in the chapters or headings of the tariff nomenclature of the Latin American Integration Association referred to in Annex 1 of resolution 78 of the Committee of Representatives of that Association, simply by virtue of the fact that they are produced in their respective territories.
>
> The following shall be classified as produced in the territory of a State Party:
>
> (i) Mineral, plant and animal products, including hunting and fishing products, extracted, harvested or gathered, born and raised in its territory or in its territorial waters or exclusive economic zone;
>
> (ii) Marine products extracted outside its territorial waters and exclusive economic zone by vessels flying its flag or leased by companies established in its territory; and
>
> (iii) Products resulting from operations or processes carried out in its territory by which they acquire the final form in which they will be marketed, except when such processes or operations simply involve assembly, packaging, division into lots or volumes, selection and classification, marking, the putting together of assortments of goods or other equivalent operations or processes;
>
> (c) Products in whose manufacture materials not originating in the States Parties are used, when such products are changed by a process carried out in the territory of one of the States Parties which results in their reclassification in the tariff nomenclature of the Latin American Integration Association under a heading different from that of such materials, except in cases where the States Parties determine that the requirement of Article 2 of this Annex must also be met.
>
> However, products resulting from operations or processes carried out in the territory of a State Party, by which they acquire the final form in which they will be marketed, shall not be classified as originating in the States Parties when such operations or processes use only materials or inputs not originating in their respective countries and simply involve assembly, division

into lots or volumes, selection, classification, marking, the putting together of assortments of goods or other similar operations or processes;

(d) Until 31 December 1994, products resulting from assembly operations carried out in the territory of a State Party using materials originating in the States Parties and third countries, when the value of those materials is not less than 40 per cent of the f.o.b. export value of the final product; and

(e) Products which, in addition to being produced in their territory, meet the specific requirements established in Annex 2 of Resolution 78 of the Committee of Representatives of the Latin American Integration Association.

Article 2

In cases where the requirement of Article 1 (c) cannot be met because the process carried out does not involve a change in nomenclature heading, it shall suffice that the c.i.f. value of the third country materials at the port of destination or the maritime port does not exceed 50 per cent of the f.o.b. export value of the goods in question.

In considering materials originating in third countries for States Parties with no outlet to the sea, warehouses and free zones granted by the other States Parties when the materials arrive by sea shall be treated as the port of destination.

Article 3

The States Parties may establish, by mutual consent, specific requirements of origin which shall prevail over general classification criteria.

Article 4

In determining the specific requirements of origin referred to in Article 3 and in reviewing those already established, State Parties shall take the following elements, individually or jointly, as a basis:

I. Materials and other inputs used in production:
   (a) Raw materials:
      (i) Preponderant raw material or that which essentially characterizes the product; and
      (ii) Main raw materials.
   (b) Parts or components:
      (i) Part or component which essentially characterizes the product;
      (ii) Main parts or components; and
      (iii) Percentage of parts or components in relation to total weight.
   (c) Other inputs.
II. Type of processing used.
III. Maximum proportion of the value of materials imported from third countries in relation to the total value of the product arrived at using the valuation procedure agreed to in each case.

The basic rule of Mercosur was the CTH based on the Associacion Latino Americana de Integracion (ALADI) nomenclature or, failing this, the percentage rule that the value of imported materials calculated on a CIF does not exceed 50 percent of the FOB price of the finished product. Articles 3 and 4 provided for the development of product-specific rules. In fact, a number of changes have occurred since the original rules were conceived.

Most recently a consolidated version[135] of the Mercosur rules of origin grouped all the modifications and changes. The current regime indicates a move from rules of origin based of an across-the-board approach to a product-specific approach.

With respect to the original version of the rules of origin reported, the across-the-board CTHs remain the basic criteria used in Mercosur but using the Mercosur nomenclature rather than the previous ALADI nomenclature. In addition there is long annex of product-specific rules.

According to paragraph (d) of the consolidated text[136] products that do not meet the CTH requirement may qualify as originating products if the value of imported materials calculated on a CIF does not exceed 40 percent of the FOB price of the finished product. The requirement of 40 percent seems to liberalize the former requirement of 50 percent.

In addition paragraphs (d) and (e) further specify that products resulting from assembly operations utilizing inputs from third countries would have to comply with the same rule as above: the valued of imported inputs calculated on a CIF basis must not exceed 40 percent of the FOB.

A new paragraph (f) of the consolidated text requires that capital products should comply with 60 percent of RVC. However, there is no mention in the consolidated text of the method of calculation of the RVC.

A long annex of product-specific rules of origin has also been added. The product-specific requirements contained in the annex concern the majority of tariff lines from Chapter 1 to Chapter 90. The product-specific requirements are usually a 60 percent RVC with or without the requirement of a CTH. In the case of electronic products, specific rules of assembly operation are demanded as technical requirements.

The absence in the consolidated text of a clear methodology to calculate the RVC is somewhat similar to the ASEAN peculiarity indicated earlier. It is only by interpretation that one may infer that the 40 percent method of

[135] Mercosur/XXXV CCM/DI no. 28/06 available in Spanish and Portuguese at http://www.mercosur.int/msweb/portal%20intermediario/es/index.htm.

[136] At the time of this writing only the Spanish and Portuguese versions of the consolidated text are available.

calculation in paragraph (e) is the method of calculation of the 60 percent RVC. Obviously, this interpretation may be contested, and, as experienced in ASEAN, it may lead to a series of implementation problems.

Article 7 of the consolidated text on cumulation and related footnotes are rather confusing. It first clearly mentions full cumulation, but it still refers in some parts of the text to materials and percentages rather than stating unequivocally that any working or processing operations carried out in Mercosur could be cumulated.

5.4. Drafting Rules of Origin: Some Lessons Learned and Advice

5.4.1. *The Main Actors in Drafting and Administering Rules of Origin*

As illustrated in the preceding chapters, rules of origin are a very complex issue, both when they are negotiated and when they have to be administered.

Rules of origin require an uncommon mixture of skills and experience very seldom found in one single person. In fact, rules of origin demand a multidisciplinary approach comprising knowledge of customs laws, industrial trade policy aspects, and, ultimately, economics.

Because rules of origin are originally perceived as one of the sets main customs laws together with customs valuation and customs classification, it should be rather intuitive that knowledge of the HS, custom valuation, and practical experience in customs administration are needed when dealing with rules of origin.

However, the time has gone since the rules were considered as a rather obscure and technical customs issue, with little bearing on trade and economic policy.

Thus, on the one hand customs-related aspects in rules of origin are at times (with a certain shortsighted view) relegated or perceived by even customs officials as mainly related to the implementation phase of the rules of origin. On the other hand it is not rare to meet senior customs officials waiting outside the negotiating room just to be consulted for few minutes on some technical questions of the rules (those that the negotiator is unable to appreciate or understand).[137]

[137] This was indeed the case during SADC negotiations on rules of origin. In a multilateral context once the work of the Technical Committee on nonpreferential rules of origin was terminated and had to be continued in the WTO Committee on Rules of Origin (CRO) in Geneva, the World Customs Organization (WCO) officials who were heavily involved in the work and widely consulted in the Technical Committee on rules of origin encountered procedural

It is undeniable that rules of origin have lately become a subject matter increasingly dealt with by negotiators, economists, and trade policy makers.

On the one hand, this is a positive development because the debate over rules of origin is becoming increasingly transparent and open to intervention from many different actors. On the other hand, too many cooks spoil the soup. In a platonian vision of the rules of origin, the ideal sequence of the making of the rule would be that the first input is provided by the manufacturers/producers of the goods. In fact, the manufacturers/producers of the goods are the best positioned to know and describe how the finished product has been obtained and what kind of manufacture or processing operations have been carried out. Thus the producer/manufacturer should be placed at the very center of the drafting process of the rules of origin.

The customs legal expert should then be in a position to transform the raw inputs provided by the producer/manufacturer into a technically sound rule of origin reflecting the processing and manufacturing operations carried out by the producer. Thus, if we take as an example a manufacturer producing flat-rolled products out of imported slabs, the rule of origin may read according to one of the methodologies normally used to current draft rules of origin, as follows:

Option 1	Option 2	Option 3
Manufacturing from slabs and other semifinished products of heading 7207	Change of tariff heading	Manufacture in that the value of imported materials do not exceed *xy* percent of the ex-works price of the finished product

It is obvious that such a process may open the Pandora's box of product-specific rules of origin to the influence of lobbies in the drafting. In this area, NAFTA negotiations on rules of origin undoubtedly set a precedent. As pointed out by many commentators and former negotiators of NAFTA rules of origin, it was the first time that the lobbyists and producers become aware of the intrinsic potential of rules of origin as rent-seeking devices.

Once designed by customs experts, the rule should be then examined in the overall context of the negotiating scenario by the trade policy makers/negotiators who will have to carefully balance their priorities in the different

difficulties, in spite of their experience and knowledge of the rules, to be admitted to the informal meetings of the WTO CRO. At that time, this was a paradoxical example because the majority of delegates in the WTO CRO were mainly diplomats or at best trade negotiators having little or no experience on the technicalities of the rules of origin.

negotiating contexts, assess the economic and industrial implications of a specific rule, and seek the possible options.

Some examples in two different regional contexts may illustrate the difficult trade and economic policy choices with which trade negotiators are sometimes faced.

The economy of Bangladesh is heavily reliant on its export of garments. Yet the backward linkages of the RMGs are not fully developed, and the demand for imported fabric to manufacture RMGs is high. At the same time, some local businesspersons have taken up the challenges to produce local competitive yarn and fabrics to partially replace imported fabrics and yarns.

In the discussion with the EC over the granting of regional cumulation to South Asian Association for Regional Cooperation (SAARC) under the EC GSP rules of origin, the Bangladesh manufacturers of fabrics have been opposing the granting of regional cumulation because it would have permitted the utilization of Indian fabrics to manufacture RMGs. The trade policy makers in this case had to balance obvious considerations of political economy between upstream products of fabrics and downstream exporters of RMGs, industrial strategy, and negotiating priorities.

A similar dilemma turned into one of the most contentious issues that emerged during the negotiations on rules of origin in the context of SADC FTA. For many of the LDCs belonging to SADC, the most relevant benefit from such FTA was the prospect of improved market access in the garment sector to the South African Market. However, it become soon clear that South African negotiators, under severe pressure from domestic trade unions in the garment sector (but also in the agricultural), argued for rules of origin on garments borrowed from their FTA earlier negotiated with the EC.

Under the rules of origin proposed by South Africa, it was not possible to use imported fabric outside the SADC region to manufacture RMGs with duty-free access to the South Africa market. The LDCs argued that the regional production of yarn and fabrics is limited in quantity and quality in the region and that the adoption of similar rules of origin would have been tantamount to a zero-sum situation because tariff concessions were nullified by overly stringent rules of origin.

In an ideal situation, these negotiating dilemmas and issues of contention should be addressed by analytical studies based on industrial accounting and consultations with the private sector to identify which of the different rules of origin on the table ensure medium–long-term viability and sustainability of the domestic industry. On the basis of such pragmatic analysis, the negotiator could then make an informed decision. Customs and trade policy experts could contribute their own experience drawn from other regions and draft

possible negotiating scenarios for the ways forward. Economists could resort to modeling scenarios on the merits of each proposal.

In practice, this seldom happens. Limitations on technical expertise and resources are sometimes the constraining factors, especially during negotiations of FTAs among developing countries. However, once the growing technical assistance offered to many developing countries is considered, this issue should become less of a problem.

Experience has shown that the lack of expertise and the failure of a well-functioning negotiating machinery at the domestic level are the most formidable stumbling blocks to consensus building and sometimes may lead to fatal mistakes when negotiating rules of origin.

Besides the NAFTA case, in which rules of origin became major victims of lobbies and industrial interests, there are a lot of other human and political factors that may turn rules of origin into a nightmare.

In this context, the major issue for some of the developing countries involved in negotiating rules of origin is that the rules of origin in North–South FTAs are based on the "model" developed by their more industrialized partners. However, because the "models" are based on consultations and fine-tuning with domestic constituencies and stakeholders in the United States, Japan, and the EC, it follows that the rules of origin requirements and administrating techniques are tailored to the interests and industrial strategy of these industries. Hence these rules of origin may not match the manufacturing capacity of the developing countries. For instance, the Pan-European rules of origin might have worked reasonably well in the context of the European Agreements with countries in Eastern Europe with a relatively large industrial base in some sectors. However, the same rules may not be equally suitable in the context of a free-trade agreement or Economic Partnership Agreement that the EC is negotiating with certain regional groups composed of African, Caribbean, and Pacific (ACP) countries. The same observations may be made in the case of the NAFTA rules when the United States is negotiating FTAs with Central American countries, or the Free Trade of the Americas.

The difficulties in negotiating and drafting rules of origin are also present during the negotiations of South–South FTAs or RTAs. One would expect that the lessons learned from the GSP utilization and Lomé/Cotonou rules of origin and negotiations with industrialized countries would be used to draft balanced and workable rules of origin. Contrary to this, in the case of some major RTAs among developing countries major mistakes have been made and continue to be made in this area.

Basically, these are four negotiating scenarios in which developing countries are confronted by origin. The first is related to participating in the negotiation of

the harmonized nonpreferential rules of origin. The second and third scenarios are related to the negotiation and implementation of rules of origin in FTAs. In the second scenario, developing countries are negotiating rules of origin with a developed country, and in the third they are negotiating FTAs among themselves. The fourth is related to preferential rules of origin used in the context of autonomous preferential tariff concessions like GSP, African Growth and Opportunity Act (AGOA), and the Cotonou Partnership Agreement (CPA). Under this latter scenario the unilateral nature of these preferences means that there is not a real negotiation but discussions are periodically held in various fora.

Given the increasing pace of regionalism, the major scenario in which developing countries might be facing and experiencing challenges is negotiating and implementing rules of origin in free-trade agreements.

Although the EC has been traditionally proliferous with FTA agreements, most recently the United States and Japan and major developing countries like China, Brazil, South Korea, and South Africa have been launching a series of FTAs.

The United States and the EC together with Japan have been able to progressively develop their "model" of rules of origin that with variations are applied in many of these FTAs. The shape and drafting of the nonpreferential rules of origin have been largely influenced by these two models.

On the one hand, the experience gained by the United States and the EC in developing their own models of rules of origin has not been exempt from mistakes. On the other hand, the lessons learned have allowed a progressive evolution of their respective models of rules of origin. Parallel to this evolution, the negotiating and administrative machinery of consultations with the various stakeholders involved with the negotiations and implementation of rules of origin have dramatically improved to the extent that some of the consultations with private sectors now take place by exchange of electronic messages.

Both systems, the NAFTA-inspired approach in the case of the United States and the Pan-European rules of origin, are under review. In the case of NAFTA, trilateral consultations among the United States, Canada, and Mexico are ongoing to simplify the exasperating complexity of some NAFTA rules. It has been noted that the latest free-trade agreements signed by the United States have already shown some degree of simplification and drastic changes in the calculation of the RVCs.

In the case of developing countries and especially LDCs, there is still room to gain considerable experience in negotiating and drafting rules of origin. In the following sections, some consideration and advice are given on how to approach and design rules of origin.

5.4.2. *The Main Parameters for Drafting Rules of Origin*

This subsection provides some general advice and guidance on the drafting of rules of origin. This advice is not designed and should not be construed as limiting the possibility and rights of the countries in designing their own rules of origin.

This general advice is divided in two parts. The first part uses the WTO Hong Kong Ministerial Decision of providing Duty-Free and Quota-Free (DFQF) initiative as example for drafting rules of origin for LDCs. It has to be noted that such guidance and advice could also be used for drafting rules of origin in other contexts such as FTAs or regional South–South agreements. The second part develops a methodology for drafting product-specific rules of origin that could be used in different preferential rules of origin contexts.

This subsection aims at clarifying some rules of origin issues for developing countries based on the experience gained on preferential rules under the GSP and other preferential trade agreements. It builds upon the recent discussion and literature about preferential origin with the objective of clearing the ground of some falsely popular *quick fix* to the issue of rules of preferential rules of origin.

With the caveat that there is no such a thing as a perfect rule of origin, in its conclusion this subsection provides guidelines and options for adopting a sensible and technically sound approach in drafting rules of origin under FTAs and autonomous regimes like the GSP or the DFQF initiative.

5.4.2.1. *A Drafting Dilemma: What Are the Good and Bad Rules of Origin and How Should a Good Rules of Origin Be Drafted?*

The debate in literature about rules of origin is relatively new and largely stems from the increasing attention given by economists to preferential trade flows granted under FTAs or autonomous preferences like the DFQF initiative. The basic problem of adopting a solely economic approach in this literature is the scant attention given to the multidisciplinary nature of the rules of origin. Rules of origin are by their very nature "*Rules*," involving legal, customs, and industrial considerations of a complex nature. Moreover, these aspects are closely intertwined, making rules of origin an almost intractable subject matter. Ignoring such a multidisciplinary nature leads to flawed policy recommendations.

The truth of the matter is that more than 30 years of experience with GSP rules of origin have amply demonstrated that there is not such a thing as perfect and balanced rules of origin.

The reason is rather simple. Because rules of origin are industry related, a rule of origin that may work quite well in the North American or European industrial context may be absurd in the context of Central Africa. In principle, rules of origin should match and reflect the industrial capacity of the countries receiving trade preferences or in the context of FTAs of the countries that are party to the agreement. This rather intuitive statement is counteracted by the fear and concern of transshipment or trade deflection and, in the case of RTAs, protectionist interest of producers of intermediate inputs. Between these opposing poles, the truth lies in the middle.

In assessing the good and bad of rules of origin, there are two basic parameters that may be used. The first parameter is the *index of restrictiveness*.[138] Such an index is related to the degree of stringency or leniency of a given rule of origin with respect to the industrial capacity and trade flows of the parties to an agreement or to the beneficiaries of the preferential arrangement. This parameter may not be measured in the abstract as it is dependent on the industrial capacity, trade flows, and trade policy objectives of the preferential trade arrangement and the countries concerned. The assessment of this index is a complicated exercise and is subject to different perspectives. There are, however, a number of lessons that could be learned as shown in this chapter.

The second parameter is the *index of technical soundness*. This parameter is determined against the accuracy and predictability of given rules of origin in providing an origin outcome in the simplest and most predictable manner and its ease in administering it. There are a number of lessons learned from the international community providing guidance on the technical soundness of a given rule. There are objective technical considerations, international agreed tools like the HS and the customs valuation agreements that are useful instruments in drawing the boundaries of the degree of technical soundness.

From the preceding definition of the *index of restrictiveness* it follows that the assessment of a given rule of origin out of the context of the preferential arrangement where it is designed to operate does not make sense as it would be tantamount to an arbitrary exercise. The index is further discussed in Section 5.4.3, reviewing the methodology to design product-specific rules of origin. This section will now focus on the definition of some elements of the *index of technical soundness* of a given or proposed rule of origin.

There is much neutral territory where there are substantial gains to be had for the international community and origin experts in clearing the grounds of some misconceptions.

[138] This is not to be confused with the index of restrictiveness adopted by Estedeavordal (2002) in which a number of assumptions were made in building the index.

5.4.2.2. Defining the Index of Technical Soundness

When rules of origin are designed and drafted, the immediate challenge is to identify a substantive origin requirement that (i) provides a predictable and business-friendly origin outcome corresponding to the trade policy objectives for which the rule of origin has been designed, and (ii) safeguards the legitimate interests of preference-giving countries or parties to the preferential trade agreements from transshipment and circumvention, ensuring that preferences are limited to those products that are genuinely manufactured in preference-receiving counties.

Experience has shown that, given the complexity of rules of origin, there are several misunderstandings that may occur when drafting rules of origin. These misunderstandings may have devastating effects once rules that do not reflect commercial realities and manufacturing capacities have to be administered and applied in the field.

Most recently there have been proposals to adopt rules of origin requiring a mere 10 percent value added; some studies argued that a sensible rule of origin to be adopted under the economic partnership agreements was an across-the-board, simple CTH for all products.

Some have argued that rules of origin to be adopted under a South–South FTA like SADC could be as follows:

> *Sensible requirements for goods to be classed as originating in SADC would be that they*:
> - *are wholly produced in the region, or*
> - *undergo a single change of tariff heading, or*
> - *contain non-SADC imported materials worth no more than 65 percent of the net cost of the good (or a regional content of 35 percent of net cost) or no more than 60 percent of the ex-works price of the good (regional content of 40 percent).*[139]

These rules of origin suggestions are taken as an example to better determine what is intended as the index of technical soundness and to clarify some of the most common mistakes or misunderstandings in drafting rules of origin:

(a) The wholly produced or under other definitions wholly obtained products, rather than being origin criteria *per se*, are usually referred as a category of products as reflected in the revised Kyoto Convention. Even if it is true that the EU uses the definition of wholly obtained in some of the product-specific rules of origin requirements, the two concepts should remain distinct to avoid confusion.

[139] See Brenton, Flatters, and Kalenga: *Rules of origin and SADC: the case for change in the mid term review of the protocol*, African region,working paper series No.83, World Bank, 2005.

Wholly obtained products are deemed to be originating products because they do not contain any imported input. As such, they should not be used as an origin criterion but as one category of products. A standard list (as reported in the following section under 5.4.2.3) commonly in use in all rules of origin sets may be adopted. Within this list the definition of "vessels" will have to be clearly regulated to avoid overly stringent rules of origin like those existing under the EC rules. Other refinements of some definitions may also be in order.

(b) Under the rules suggested, origin is acquired either if the CTH requirement at a four-digit level is met or if it does not contain nonoriginating imported materials worth no more than 65 percent of the net cost of the good (or a regional content of 35 percent of net cost), or no more than 60 percent of the ex-works price of the good (regional content of 40 percent), or a 35 percent value addition based on CIF costs of inputs.

As mentioned, there is nothing wrong in providing alternative rules of origin for the same product. Both the Pan-European model of rules origin, NAFTA, and the other most recent U.S.-inspired rules of origin contain provisions for alternative rules of origin or different figures of percentages. However, the alternatives provided must logically have the same or equivalent degree of restrictiveness (i.e., to borrow a term from the nonpreferential rules of origin, should be fairly coequal in term of restrictiveness). Failing this, the exporter/producer will pick and choose for the easiest rule to comply with. Circumvention and trade deflection will then take place with consequent anarchy.

The main shortcoming of rules of origin providing alternative rules of origin for the same product that is not co-equal is that they may provide different origin outcomes for the same products depending on the criteria adopted. The index of technical soundness for these rules is therefore equal to zero. *Inter alia*, this is demonstrated by the fact that experience and difficulties in administering the original rules of origin under the SADC and COMESA that had initially adopted such an approach have gradually forced these regional groupings to adopt product-specific rules of origin. Unfortunately, the opportunity to revisit the original rules of origin contained in the SADC Trade Protocol and remedy their shortcomings by introducing product-specific rules turned into a sour and regrettable exercise in the case of SADC. A missed opportunity, however, should not be read as a failure.

In fact, it may not be inferred from these negative experiences that product-specific rules of origin are intrinsically not appropriate or technically wrong as a method to draft rules of origin. However, the same experience has shown that the elaboration of product-specific rules of origin (1) is a highly complicated

technical affair and, most important, (2) it opens a leeway for protectionist intents and lobbies.

The need for developing product-specific rules of origin should also be understood as a *function* of the magnitude of the trade flows, the preferential margin, and the import or export sensitivity of a given sector in the context of a preferential agreement.

In spite of its shortcomings the 35 percent value-added requirement is still applicable under the U.S.-GSP after more than three decades. The same rule is applicable under AGOA and the U.S.-Morocco FTAs.

However the U.S. GSP scheme does not cover textiles and clothing whereas in the case of AGOA and the U.S.-Morocco FTAs covering textiles and clothing product-specific rules of origin have been elaborated as an exception to the basic 35 percent requirement.

It is obvious that the high preferential margins available in the United States for textile and clothing products and their import sensitivity demand for product-specific rules of origin that are not necessary for other trade flows under the U.S.-GSP where an across-the-board criterion could be maintained.

The use of the CTH alongside other percentage requirements as in the preceding example raises the issue of the suitability of the HS for drafting rules of origin. On the one hand, it is widely recognized that the HS is not designed to use for rules of origin but for customs classification purposes. On the other hand, it is also true that the HS has been used extensively in drafting rules of origin under the EC and NAFTA rules and lately in the HWP under the WTO Agreement on rules of origin.

Some negotiators and trade policy makers have referred to the preference of the HWP for the CTC over other drafting techniques, such as percentages or specific working or processing as a signal that the international trading community was unanimously moving in that direction.

However, it has to be considered that in the case of the HWP the rules of origin adopted on the basis of the HS were not simple CTHs at the four-digit level applying across the board to all products.

As examined in Chapter 2, the CTC adopted in the context of nonpreferential rules of origin is a far cry from the adoption of a simple CTH or change of tariff subheading (CTSH) approach.

In the case of the EC, the basic CTH was coupled with exceptions, and in the case of NAFTA and the HWP rules based on the HS are, at times, defined at six-digit levels with exceptions.

Despite this evidence, there is still in some circles the urban legend of an across-the-board CTH or CTSH. It is widely known among practitioners that the adoption of a CTH at the four-digit level implies that sometimes insufficient

processing involve a change in a HS heading whereas at other times sufficient processing does not involve a change in a HS heading or subheading.

The CTH or CTC may be very useful in drafting rules of origin, but it is far from perfect for use as an across-the-board origin criterion.

Some commentators have put forward that a list of minimal working or processing operations excluding operations such as simple assembly, packaging, and labeling from conferring origin would remedy the problems and inconsistencies previously mentioned. Apart from the fact that it is virtually impossible to list all possible minimal operations that may generate a CTH as pointed out in Section 5.2.3.1.4, there are inherent problems in defining notions such as simple assembly. To address the intrinsic limitations of the CTH, some preference-giving countries provided adjustment provisions in the form of product-specific lists and enumeration of simple operations such as cutting, sorting, placing in bottles, change of packing, and affixing marks that do not confer the status of originating products.

Definitions of minimal working or processing operations in the context of the HWP were kept to a minimum because it was considered a source of confusion.

Finally, practitioners and negotiators familiar with negotiations in the HWP process could witness the difficulty in assessing, from among the millions of assembly operations that could be undertaken, what could be considered simple or complex assembly.

Under CTH criteria, any imported inputs are considered to have undergone sufficient working or processing if the finished products fall under a tariff heading of the HS at a four-digit level different from that of any inputs used in the process. So, when imported materials or origin unknown materials were used, there must be a change in HS heading.

The following examples provide evidence of the implications arising from the adoption of an across-the-board CTH.

Example 1: Cocoa and cocoa preparations

Harmonized System Heading No.	18.01	Cocoa beans
	18.02	Cocoa shells
	18.03	Cocoa paste
	18.04	Cocoa butter
	18.05	Cocoa powder
	18.06	Chocolate, etc.

In this example the HS reflects the manufacturing chain of a chocolate bar. It turns out that the CTH requirement is very liberal because, for instance, breaking the cocoa beans to obtain the cocoa shells is an origin-conferring

operation. Making butter from cocoa paste is a manufacturing process including refining, and purifying the cocoa paste is also an origin-conferring operation. It may be argued that breaking the beans is a rather simple operation when compared with the process of obtaining the butter from the cocoa paste. Such possible inequalities are the natural implication of the use of an across-the-board CTH.

Example 2: Iron and steel

Iron ores	→	Pig iron	→	Ingot	→	Bars	72.11 72.13 72.14 Etc.
HS 25.01		72.01		82.06		Sheets	72.08 72.09 72.10 Etc.

This example shows the manufacturing chain of steel products such as bars and rods from iron ores. Even in this example, the CTH requirement shows quite liberal implications because each stage of the manufacturing process is origin conferring. On the one hand, some may argue that substantial processes like cladding, plating, or coating of bars and sheets are not recognized as substantial transformations since they do not imply a CTH but in some cases a CTSH. On the other hand, it may be argued why the process of rolling to reduce the width of a flat-rolled product is a substantial transformation in certain cases, that is, when it is reflected in the CTH, and not sufficient in others.

Heading 72.12 classifies flat-rolled products of iron or nonalloy steel, of a width of less than 600 mm, clad, plated, or coated.

Heading 72.10 classifies flat-rolled products of iron or nonalloy steel, of a width of 600 mm or more, clad, plated, or coated.

If one product is rolled to move from a width of 500 mm to a width of 400 mm the rolling is not origin conferring because the product will remain in heading 72.12. However, if the rolling reduces the width from 600 mm to 500 mm, the rolling is origin conferring because the product will move from 72.10 to 72.12.

Example 3:

Watch movement HS 91.04	——————→	Watch
Clock case HS 91.12	——————→	91.03

Is the process of assembly of a clock case and a watch movement origin conferring? A simple CTH would imply substantial transformation even if the watch movement and the clock case are imported. Such an apparent liberal rule is counteracted by the fact that a CTH would not recognize the operations as testing.

Example 4:

Fresh vegetables	→	Dried vegetables
HS 07.01 09		HS 07.12

Is drying of vegetables a process that could be considered substantial transformation?

To make cotton jackets, for example, basically these are the main processes:

Example 5: Normal case: Cotton jackets

- To get a raw cotton (fiber) HS 52.01
- To make a cotton yarn HS 52.05
- To make cotton fabrics HS 52.08
- To make cotton jackets HS 62.03

It should be noted that, on the one hand a mere adoption of the CTH criteria will eliminate a double or triple transformation requirement. On the other hand, processes such as dyeing, washing, and printing are excluded from origin conferring at the CTH level.

Example 6: Diamonds

- Rough/unworked HS 71.02
- Cut/worked

In sharp contrast to the preceding cases, there are some instances in which a process or manufacture does not involve a change in a HS heading, but can well be regarded as the process or manufacture that has undergone a substantial transformation.

Example 7: With regard to toys (HS heading 95.43), some developing countries producers find it impossible to fulfill the rule of origin based on the CTH criterion; in fact, for some countries it is necessary to import some parts also under heading 95.43, like the eyes of a teddy bear.

Problems with Adopting Simple CTH in the Machinery and Electronic Sector

The HS identifies three broad categories of parts: (a) parts for general use, (b) parts suitable for use solely or principally for machines of a particular heading,

and (c) finished goods that will themselves be used as parts or components for other goods. For some goods, therefore, assembly of parts to produce the finished good will result in a change of heading (for example, manufacture of motor vehicles of 87.01 to 87.05 from parts of 85.08), for others a change in subheading (for example, trailers and semitrailers of 87.16 from parts of 8716.90). However, in some cases, parts are classified under the heading with the vehicles produced, without subheadings, and thus undergo no change of classification when used for production of an article such as baby carriages of 87.15.

These examples show that the use of the CTH requirement as an across-the-board criterion implies different origin outcomes. Depending on the structure of the HS, at times a very complex assembly operation may be denied origin using a CTH requirement whereas a mere assembly operation of parts may be considered origin conferring even if it is a screwdriver operation.

5.4.2.3. *Suggestions on Defining the Index of Technical Soundness*

First Suggestion: Divide products under two broad categories: (a) wholly obtained products and (b) products with imported inputs or when more than one country has taken part in the manufacturing of the finished product.

Rationale

According to Revised Kyoto Convention and practically almost all sets of rules of origin, there are two categories of products:

(a) **Wholly obtained products** in which a standard list has been elaborated according to a draft list as follows:

> "The following products shall be regarded as wholly obtained in a preference-receiving country:
> (a) Mineral products extracted from its oil or from its sea bed;
> (b) Vegetable products harvested there;
> (c) Live animals born and raised there;
> (d) Products obtained there from live animals;
> (e) Products obtained by hunting or fishing conducted there;
> (f) products of sea fishing and other marine products taken from the sea by its vessels[140];
> (g) products made on board its factory ships exclusively from products referred to in paragraph (f) above;
> (h) used articles fit only for the recovery of raw materials, provided that they have been collected there;

[140] This definition has to be spelled out in order to avoid restrictions as in the EC case.

(i) waste and scrap resulting from manufacturing operations conducted there;
(j) goods produced there exclusively from the products referred to in paragraphs (a) to (i) above."

(b) **Products with imported inputs**: *Where two or more countries have taken part in the production of the goods, the origin of the goods should be determined according to the substantial transformation criterion*

Goods that have been manufactured in a country wholly or partly from imported materials, parts, or components, including material of undetermined origin, are considered as originating in that country if those material parts or components have undergone "substantial transformation" or "sufficient working or processing."

The general concept of the definition of "substantial transformation" or sufficient working or processing is further specified in different multilateral texts or national provisions reflecting, on the one hand, a common understanding of the need is, to better define what "substantial transformation" and, on the other hand, the beginning of different "models" to define "substantial transformation." In modern times, one of the oldest definitions of "substantial transformation" was made by a judge in a celebrated case[141]:

"A substantive transformation occurs when an article emerges from a manufacturing process with a name, character, or use that differs from those of the original materials subjected to the process."

In the European context, the first definition at the EC level appeared in 1968[142]: "*Goods whose production involved more than one country shall be deemed to be originated in the country where they underwent the last, substantial, economically justified processing or working in an undertaking equipped for that purpose and resulting in the manufacture of a new product or representing an important stage of manufacture*."

In the following decades, it becomes progressively clear that such general definitions did not match the evolving and growing nature of international trade. As examined in Chapter 1, Annex DI of the Kyoto Convention was one of the multilateral attempts to clarify some of the conceptual issues arising from the definition of substantial transformation.

There are today a variety of techniques in drafting rules of origin that have been widely discussed in this book. The pros and cons of the different

[141] See, "Anheuser-Busch Brewing Assn. v United States, 207 U.S. 556 (1907).

[142] See Article 38 of Protocol 1 concerning the definition of the concept of "originating products" and methods of administrative cooperation, to the ACP-European Union Partnership Agreement, signed in Cotonou on 23 June 2000.

approaches have been discussed in detail in the section on experience from the GSP rules[143] and all thorough this book

Second Suggestion: An across-the-board or product-specific approach?
This issue carries both technical and substantive aspects. It is a fact that the worldwide tendency is to move toward product-specific rules of origin and progressively abandon an across-the-board approach, even if many commentators are still suggesting across-the-board criteria. At the same time, the development of product-specific rules of origin is rightly considered one of the reasons for the increasing complexity and stringency of product-specific rules of origin.

From a technical point of view an across-the-board criterion carries a presumption of simplicity and flexibility but lacks precision and may result in arbitrary outcomes because it will apply the same criteria to thousands of different goods. Product-specific rules of origin may allow fine-tuning and predictability but too often have fallen prey of protectionist intents and technocracies. To obtain some orientation on the best approach to adopt, carrying out an analysis at the tariff line basis of the trade flows of the parties to the agreements is suggested. By depending on such an analysis and taking into account different parameters (such as trade volume, margin of preferences, import sensitivity and export relevance, the nature of the products, that is, raw agricultural products, processed agricultural products, textiles and garments, electronics, etc.) it will be possible to identify the areas where the legitimate interests may be better served by product-specific rules of origin or across-the-board criteria.

A second analysis will also have to be carried out to identify the imported inputs that are used in the manufacturing of the exported products.

This methodology is further discussed in Section 5.4.3.

Third Suggestion: In the case in which a percentage criterion is adopted in defining substantial transformation, it may be considered to adopt a criterion based on value of materials rather on a value-added criterion.

Rationale
As reported in subsection 5.2, during the UNCTAD Working Groups and from evidence drawn from questionnaires submitted to exporters and producers, there is a tendency, if not a consensus, among exporters/manufacturers to prefer the adoption of a maximum imported input allowance rather than a minimum value-added requirement. There are two reasons for this preference:

[143] See also Chapter 2 on the experiences that may be drawn from the HWP.

1. The percentage calculation of the values of the imported inputs or materials is easier to compute, and the values of the imported inputs may be supported by suppliers' invoices. The EC has used them for a long period. The term "value of imported material" rather than being left vague and subject to the discretion of customs authorities may be anchored to the customs value as determined in accordance with the Agreement on Implementation of Article VII of the GATT 1994. Most recently in the Central American Free-Trade Area (CAFTA) the calculation based on material has been defined according to two definitions: *the build-down and build-up method*. Although methodologies for the calculation may vary according to the EC and U.S. approaches, the essence of the calculation is the same because in both cases they refer to "materials" used in the manufacturing process of the finished product.
2. The calculation of the value added or a "net cost" approach is complex as it entails:
   - a distinction of costs that could be computed as local value added;
   - itemization of such cost to the single unit of production. As a consequence it often requires accounting, and discretion may be used in assessing unit costs. Additionally, currency fluctuations in beneficiary countries may affect the value of the calculation.
   - Low labor costs in developing countries may result in low value added and instead of being a factor of competitiveness may turn out to be a factor that penalizes producers based in developing countries.

There are important differences in the formulation of the numerator and denominator used in the calculation of percentages. The major differences in the numerator reflect two approaches, one that places a maximum limit on the use of imported material, and another that places a minimum limit on the domestic content contributed by the preference-receiving country.

Subsection 5.2.3.2 also discussed the various pros and cons of adopting different methods of valuating imported inputs. One of the possible solutions could be to provide some flexibilities on the use of FOB and CIF prices. *Mutatis mutandis* is what CAFTA is doing.

Under CAFTA the methodology used to calculate value addition is based on two formulas called build-down and buiied-up, as follows:

Method Based on Value of Nonoriginating Materials ("Build-down Method")

$$\text{RVC} = \frac{\text{AV} - \text{VNM} \times 100}{\text{AV}}$$

Method Based on Value of Originating Materials ("Build-up Method")

$$\text{RVC} = \frac{\text{VOM} \times 100}{\text{AV}}$$

where:

- RVC is the regional value content, expressed as a percentage;
- AV is the adjusted value;
- VNM is the value of nonoriginating materials that are acquired and used by the producer in the production of the good; VNM does not include the value of a material that is self-produced; and
- VOM is the value of originating materials acquired or self-produced, and used by the producer in the production of the good.

In the case of the U.S.-CAFTA agreement, the denominator is based on the concept of adjusted value based on the following definition:

> *For the purposes of this note, the term "adjusted value" means the value determined under articles 1 through 8, article 15 and the corresponding interpretive notes of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade (the Customs Valuation Agreement), except that such value may be adjusted to exclude any costs, charges or expenses incurred for transportation, insurance and related services incident to the international shipment of the merchandise from the country of exportation to the place of importation.*

In addition, CAFTA provides, under Article 4.4, "Further Adjustments to the Value of Materials" (this means that the value of material either originating or not could be adjusted accordingly):

1. *Each Party shall provide that, for originating materials, the following expenses, where not included under Article 4.3, may be added to the value of the material*:
   (a) *the costs of freight, insurance, packing, and all other costs incurred in transporting the material within a Party's territory or between the territories of two or more Parties to the location of the producer*;
   (b) *duties, taxes, and customs brokerage fees on the material paid in the territory of one or more of the Parties, other than duties and taxes that are waived, refunded, refundable, or otherwise recoverable, including credit against duty or tax paid or payable; and*
   (c) *the cost of waste and spoilage resulting from the use of the material in the production of the good, less the value of renewable scrap or by-product.*

2. *Each Party shall provide that, for non-originating materials, the following expenses, where included under Article 4.3, may be deducted from the value of the material*:
   (a) *the costs of freight, insurance, packing, and all other costs incurred in transporting the material within a Party's territory or between the territories of two or more Parties to the location of the producer*;
   (b) *duties, taxes and customs brokerage fees on the material paid in the territory of one or more of the Parties, other than duties and taxes that are waived, refunded, refundable, or otherwise recoverable, including credit against duty or tax paid or payable*;
   (c) *the cost of waste and spoilage resulting from the use of the material in the production of the good, less the value of renewable scrap or by-product; and*
   (d) *the cost of originating materials used in the production of the non-originating material in the territory of a Party*.

In plain words, the preceding provision permits, under paragraph 1, the addition of cost of transport, duties, and brokerage fees when an originating input is used in the calculation of the build-up percentage. Conversely, it allows the deduction of cost of transport, duties, and brokerage fees when nonoriginating materials are used. In both cases, such possibilities may greatly facilitate compliance with rules of origin. Moreover they seem particularly favorable to developing countries, especially landlocked countries that are affected by high freight charges.

From these considerations, the essential lesson to be learned from the practice is to adopt a percentage based on value of materials rather than on value-added or cost of processing operations. It may not be a perfect solution, but it appears to be preferable to other methodologies based on percentage criterion.

Fourth Suggestion: Draft a complete structured draft containing all elements and reflecting the concerns of the parties to the agreement and adopt it as negotiating instrument.

Rules of origin are a set of rules designed not only for providing an origin outcome but also for administering the rules and impart predictability. It is suggested that a draft be prepared that contains the following elements that will be progressively discussed and elaborated during negotiations with the aim of progressively achieving a complete proposal. It would impart guidance and structure to the negotiations among the parties.

Elements of draft rules of origin:

- definitions of terminology,
- general requirements,
- wholly obtained products including definition of vessels,
- substantial transformation: definition of appropriate methodology,
- insufficient working or processing operations,
- tolerance rules,
- cumulation,
- allocation of origin in cumulation,
- definition of administrative rules concerning proof of origin and related trade facilitation aspects,
- verifications procedures and penalties for false declaration of origin.

5.4.3. *Defining the Index of Restrictiveness When Drafting Product-Specific Rules of Origin: A Methodology Used in Different Scenarios*

As briefly addressed under suggestion two of the preceding section, one of the first dilemmas to be addressed when drafting rules of origin is whether to adopt an across-the-board criteria or a product-specific approach. When confronted with the current evolution of the rules of origin, this debate may turn out to be academic because in international trade there is clear tendency toward the adoption of product-specific rules. There are, however, enormous differences among those RTAs adopting product-specific rules of origin, depending on

(a) the methodology used,
(b) the degree of stringency of the product-specific rules,
(c) the degree of difference among the product-specific rules, and
(d) the number of product-specific rules.

For instance, the product-specific rules in ASEAN and Mercosur rules of origin are almost the same or quite similar for an impressive number of chapters, whereas in the case of the NAFTA or Pan-European model, the requirements of the product-specific rules of origin may differ substantially and are set at subheading, heading, or chapter level.

These differences signal the fact that the need for product-specific rules of origin vary significantly among regions and product-specific rules may not necessary for all the tariff lines or headings of the HS. An analysis of the trade flows of the parties to a RTA may quickly show the headings for which product-specific rules could be most needed and justified. For instance, this analysis of trade flow has probably led the United States to insert product-specific rules of origin for textiles and garments when negotiating FTAs with Jordan and Morocco.

Raw agricultural products and minerals, petroleum oils, and commodities in general, often representing the bulk of the exports from some developing countries, normally are wholly obtained products, therefore qualifying as originating products.

The notable exceptions are fish and fishery products, especially in the context of the EC preferential rules of origin, in which the various requirements are raising the series of important considerations examined in Chapters 2 and 3.

Once the headings or subheadings for which product-specific rules might be needed are identified, the index of restrictiveness of the product-specific rule remains to be decided.

However, given the low trade volumes and limited supply capacity from some developing countries it may be the case that such analysis may bring little results. This could be the case for instance for LDC exports to Japan.

One may argue that such low value of preferential trade flows into Japan from LDCs is relatively small because of restrictive rules of origin. Data relating to 2004 and 2005 indicates that 85 percent of preferential imports from LDCs are in 4 tariff lines at the 10-digit level.

However, this does not respond to the second question: What are the product-specific rules of origin that one may wish to see liberalized?

This question may be answered considering the trade flows on non-LDCs countries that may constitute potential trade flows for LDCs.

Indications from the trade flows suggest that there is significant non-LDC trade taking place in products that could be manufactured in LDCs (e.g. – products in Chapter 42 – travelling bags – where Japan imports more than US$1.14b from China with a most-favored-nation (MFN) provision of 8 percent and Chapter 94 – mattress supports – where Japan imports about US$440m with an MFN of 3.8 percent mainly from China). If rules of origin were more lenient for LDCs, LDCs could attract Foreign Direct Investment (FDI) in these sectors to take advantage of these preferences.

Similar exercises could be carried out for other groups of countries or regions to explore potential trading opportunities.

This section is suggesting a methodology based on the use of the HS to design product-specific rules of origin requirements that match the level of industrial development of a given party of RTAs similar to the exercise carried out in Section 4.2.

The starting point of the present methodology is the structure of the HS. Some of the previous examples on the limits of the HS in designing rules of origin have shown that the HS does not provide magic solutions. However, the structure of the HS could be used to develop an input/output matrix that, when matched with trade flows of a given country party to a RTA or beneficiary

of a unilateral trade preference, may provide significant guidance in designing rules of origin.[144] This analysis will permit the identification of export products for which imported inputs have been used. This should not be construed as implying that this methodology favors the adoption of the HS as a main criterion to define substantial transformation.

On the contrary, once the product has been indentified through the input/output matrix, different drafting techniques could be used to draft the product-specific rules.

The input/output matrix linked to imported trade flows permits the identification of imported inputs that may be used in manufacturing exported finished products. Obviously this finding has to be corroborated by consultations with the domestic manufacturers. If the initial evidence identified by the input/output analysis is confirmed, a rule of origin requiring a switch from such a pattern will imply a cost.

In these cases a cost assessment of a given rule of origin with respect to another may be a useful tool for a negotiator or researcher. How much does it cost for Malawi to be forced to use SADC fabrics instead of Chinese fabrics to manufacture garments for exports to South Africa?

The starting point of further elaborating the methodology is to bring in other elements for consideration. The first element is the preferential margin. Rules of origin are complied with because they are associated with the benefit of duty free or reduced rates of duty. The adoption of suboptimal rules of origin that do not allow compliance or will increase costs of the inputs will generate costs.

Such a cost and its trade effects may vary, depending on a variety of functions: (a) the availability of domestic inputs of the same quality and price, (b) if there is availability of domestic inputs, the difference in prices and quality of these inputs in respect to the imported inputs, and (c) the preferential margin i.e., the difference of the MFN and the preferential rate.

In the case in which option (a) is not available because there are no domestic inputs and the rule of origin does not allow the use of the imported input, the penalty will be equal to the preferential margin. Under this scenario in a partial equilibrium model, there will not be trade creation generated by the RTA because the rules of origin have not been met and the MFN tariff remains applicable. In the simplest scenario under (b), the cost may be equivalent to the difference in prices between the domestic and the imported input and the consequent trade diversion effects.

[144] Some of the product-specific rules of origin proposed for consideration in Table 2.9 are drawn from the results of this methodology and have been used during negotiations.

However, in the case of differences in quality not matching the requirement of the importer or if the price of using the domestic input exceeds the benefit of the preferential margin, the result will be the same as that under (a) in a partial equilibrium scenario: The manufacturers will chose to ignore the rules of origin and trade under MFN conditions.

Admittedly, there are a number of variables that are not captured by these assumptions. Nevertheless such exercise could produce some useful figures that may provide guidance during negotiations. When trying to identify numerical figures to make the equation works we can observe the following:

- The numerical value under (c) is the preferential margin that could be easily found.
- Under (b) the numerical value could be the difference in price calculated as unit prices between the domestic input and the imported one. This could be translated into a tariff applied to the exported finished products that will diminish the preferential margin. In the case of difference in quality the calculation will have to be carried in consultation with the private sector. If it is found that the switching to the domestic quality will mean loss of sales, the numerical value is zero as there are no trade effects. In the case in which the switch in quality will mean lower export prices in order to sell, the numerical value will be given by these losses compared with the potential gains of the preferential margin.

More analysis will have to be conducted to further develop this methodology drawing from the lessons learned described in the following sections.

5.4.3.1. The Experience with the EC GSP Rules of Origin

This methodology has been used in Chapter 4 to identify the reasons for low utilization of trade preferences under the EC GSP scheme for certain garments originating in Bangladesh, Cambodia, and Laos. The first step of the methodology was to break down the HS into production chains for garments according the materials and inputs such as yarn and fabrics used in manufacturing garments. The second step was matching the HS heading and tariff lines corresponding to the different inputs used in manufacturing garments import figures. Through this analysis it was found that the three countries were importing most fabric used in manufacturing the finished garments. Hence the low utilization rates of the Everything But Arms (EBA) initiative for certain tariff lines because the EC rules of origin do not allow use of imported fabric to manufacture garments.

This finding may be complemented by an analysis of the domestic production and possibility for expansion of backward linkages. Be this as it may, desk

analysis based on this methodology could be precious when consultations are held with the domestic private sector.

The findings arising from the use of the methodology then have to be translated into drafting new rules of origin as reported in Chapter 4. This would entail the following change in the EC rules of origin for Chapter 62 as shown below.

HS code	Description of product	Working or processing operations conferring origin 2
ex Ch. 62	Articles of apparel and clothing accessories, not knitted or crocheted, except for:	Manufacture from yarn(current) Manufacture from fabric (revised)
ex 6202, ex 6204, ex 6206, ex 6209 and ex 6211	Women's, girls' and babies' clothing and clothing accessories for babies, embroidered	Manufacture from yarn (Revised: fabric), or Manufacture from unembroidered fabric (provided the value of the unembroidered fabric used does not exceed 40 percent of the ex-works price of the product) (Under the revised rule it is suggested to delete the percentage requirement)

The rules of origin for products classified under HS Chapter 62 (clothing articles) under the EC current EBAs require that, when imported inputs are utilized, the manufacturing process of apparel should start from yarn. Thus two processing operations (weaving and making up – "double jump") are required to be carried out in the exporting preference-receiving country.

The most recent negotiations on nonpreferential rules of origin in the context of the WCO/WTO and recent initiatives in the field of preferential rules of origin have demonstrated that, besides the mere production stages of the textile and clothing sectors, there are other significant manufacturing operations that may be origin conferring, either stand alone or taken in combination.

For instance, manufacturing processes, such as bleaching, printing, dyeing, coating, laminating, preparing for spinning, mercerizing, texturing, or bulking, production of mixed or rubberized fabrics with cotton and manmade fibers, have developed over the years in response to fashion trends and technological progress to produce new and competitive fabrics and clothing. Some of these processes may not qualify as minimal processing because they may require sophisticated production techniques and should not be disregarded when origin-conferring requirements are considered.

The current preferential rules of origin require double or even triple manufacturing stages to achieve substantial transformation. It is striking to find that the same concept of substantial transformation lying at the core of the current negotiations on nonpreferential rules of origin is not translated into manufacturing stages but rather into assembly operations. In fact, the current text of preferential rules of origin for clothing articles ex HS Chapter 62 provides for goods to undergo assembly in a single country. For example, all of the assembly operations following the cutting of the fabric of the parts must be performed in that single country. The rule in this case provides for the manufacture to start from parts, such as from cut fabrics or parts of garments knitted to shape.

Such a wide difference in origin-conferring operations between preferential and nonpreferential origin systems can only partly be explained by their different purpose, because they have been conceived and negotiated starting from the same concept of substantial transformation and, in the case of nonpreferential rules of origin, neutrality.

5.4.3.2. *The SADC Experience*

A similar exercise as the one in Chapter 4 was conducted during the SADC negotiations on rules origin for garments of Chapter 62. The HS headings of the production chains have been matched with trade data on imports and exports in the textile and clothing sector for selected SADC countries, namely Malawi, Mauritius, SACU, United Republic of Tanzania, Zambia, and Zimbabwe.

The main issue was the product-specific origin rules for garments industry. The Trade Protocol, in its original current formulation, provided for three general alternative rules of origin including a simple CTH.

During the negotiations the crucial point to be examined was the possible implication of product-specific rules of origin on the existing production chains of the SADC region. A double processing requirement may be matching certain vertically oriented production facilities. In cases in which production is mainly concentrated on a one-stage process, the application of product-specific rules of origin requiring double processing may be problematic because the producer will either have to change the source of inputs, or invest in new machinery, or forego the tariff preferences.

The next step analyzed was the impact of different rules of origin in this particular sector utilizing the input/output matrix of imports and exports. For instance, if a SADC country was importing substantial quantities of woven fabrics from Asia and exporting garments to other SADC countries, there was a *prima facie* indication that this country will have some difficulties in meeting a double processing requirement. Obviously this analysis has to be completed and contrasted with local production data.

TABLE 5.9. *Extract from SACU proposed list of product-specific rules of origin*

HS code	Description of product	Rules conferring origin within the meaning of para. 1(b) and (c) of rule 2
Ch. 60	Knitted or crocheted fabrics	Manufacture from: • Natural fibers; • Manmade staple fibers, not carded or combed or otherwise processed for spinning; or • Chemical materials or textile pulp.
Ch. 61	Articles of apparel and clothing accessories, knitted or crocheted: • Obtained by sewing together or otherwise assembling two or more pieces of knitted or crocheted fabric whicht have been either cut to form or obtained directly to form; • Other.	Manufacture from yarn Manufacture from: • Natural fibers; • Manmade staple fibers, not carded or combed or otherwise processed for spinning; or • Chemical materials or textile pulp.
ex Ch. 62	Articles of apparel and clothing accessories, not knitted or crocheted, except for:	Manufacture from yarn
ex 6202, *ex 6204,* *ex 6206,* *ex 6209* *and* *ex 6211*	Women's, girls' and babies' clothing and clothing accessories for babies, embroidered	Manufacture from yarn, or Manufacture from unembroidered fabric provided the value of the unembroidered fabric used does not exceed 40 percent of the ex-works price of the product

In any case, the methodology applied was a first step toward the identification of rules of origin tailored to the manufacturing capacities of the region. A series of tables were produced matching the input/output tables obtained by breaking down the HS with different rules utilized as a basis for analyzing the specific country tables:

(1) simple CTH, as currently contained in the Trade Protocol;
(2) SACU product-specific rules as specified.

Not surprisingly, the results of the methodology indicated that the majority of SADC members including Mauritius for some tariff lines were importing fabric from outside the region and most specifically from Asian countries to manufacture garments for export to the SACU market. In spite of this evidence, the negotiations of product-specific rules, especially on textiles and garments, under the SADC protocol turned out to be one of the most difficult exercises.

5.4.3.3. *The ASEAN-China Free-Trade Experience*

An analysis based on the methodology was carried out in the context of the negotiations of product-specific rules of origin of the ASEAN-China FTA, in which the volume and variety of the intraregional trade and intraindustry trade could further test the suitability of such methodology. Two sets of tables were elaborated. The first set contained the most exported tariff lines of China to ASEAN for the last three years. The second table contained the most imported tariff lines from the world. An input/output matrix elaborated from the HS was then applied to these tables to establish the linkages between imported inputs and exported outputs.

Subheading 847330 of the HS classifies parts and accessories of computers. This single subheading turned out to classify the most imported and most exported item in 2002 among ASEAN countries and China. The trade flows of this subheading may capture the fact that there are a lot of assembly operations of parts or subcomponents of computers between China and ASEAN.

These trade flows may also reveal an intraindustry trade in which China imports part of computers from ASEAN countries to assemble subcomponents classified in same heading and exported to ASEAN.

Naturally, this indication would need to be corroborated by meeting with the concerned electronic industries to verify this initial assumption. However, assuming that this intraindustry trend is confirmed following discussions with domestic industry, a rule could be drafted in the following manner:

(A) A change to heading 8473 from any other heading.[145]

This rule would practically mean that all assembly operations performed in China to manufacture subcomponents from parts imported from ASEAN will not be considered as originating in China because the finished product is classified in the same heading.

Certainly cumulation could play its role if the parts imported from ASEAN are of ASEAN origin. If this is not the case, alternative drafting could be

[145] This rule is excerpted from the U.S.-Singapore FTA.

considered by, for instance, utilizing a percentage criterion based on clear percentages and rules to calculate such as:

(B) no required change in tariff classification to heading 8473, provided there is a regional value content of not less than:

(1) 35 percent based on the build-up method, or
(2) 45 percent based on the build-down method.[146]

Then correct methodologies to calculate the *ad valorem* percentages under the build-up or build-down methods will have to be identified through consultations with the domestic industries.

Another example was HS subheading 841430 classifying compressors; this product was found to be the fifth most exported product exported to ASEAN by China in 2002.

The input/output matrix identified that at the same time HS subheading 8414 90 – parts of compressors – rank as the 36th most imported product from the United States and Japan. According to this finding, it may be possible to identify a pattern in which some parts of the compressors exported to ASEAN contain parts imported from outside the region. Assuming that this finding is confirmed during consultations with domestic industries, assembling the compressors rules could be drafted as follows: A change to HS subheading 841430 from any other subheading, except from HS subheading 8414.90 may entail that the compressors exported to ASEAN utilizing parts imported from Japan and the United States will not comply with rules of origin requirements.

These simple examples show that, with analytical research, consultations with private sectors, and technical skills in drafting transparent rules of origin that match the industrial capacity and trade flows of partners to FTAs is not an impossible task

5.4.3.4. *Negotiating Product-Specific Rules of Origin in the Context of the Economic Partnership Agreements*

Although EPA negotiations with the all-ACP Group were launched in September 2002, both the EC and the ACP underestimated the complexity and time needed to negotiate EPAs, especially for African countries. As the deadline was approaching in the last quarter of 2007, both the EC and five of the six ACP groupings (excluding the Caribbean, which negotiated and signed a full

[146] This example is excerpted from the U.S.-Singapore FTA. For the parameters of the calculation of the build-down and build-up method, see Section 5.4.2.

EPA covering goods and services in December 2007) agreed to work toward the signing of an interim EPA that allowed the trading relationships between the EC and the ACP countries concerned to be in compliance with WTO provisions (specifically Article XXIV of GATT).

As shown in Table 3.7, not all the regions managed to initial an interim EPA.

These interim agreements are committing both sides to continue negotiating a full EPA to be signed by the end of 2008 and mid-2009 in the case of countries signing the East Africa Community (EAC) text.

Various studies and meetings were launched to determine what could be the best rules of origin to be used in the context of EPAs. Some of this literature has been discussed in Chapter 4. However, the majority of the regions have been unable to present and defend a technically valuable and defensible proposal. Some of the regions wanted to introduce the concept of asymmetrical rules of origin; other regions were insisting on a CTSH across the board. Maintenance of cumulation among all ACP countries was another overvalued negotiating objective of the ACP.

The ACP Group of countries originally agreed that rules of origin to be used in EPAs were to be common across the ACP Group, as opposed to each of the six envisaged EPAs being negotiated having their own rules of origin. However, at the ACP Council of Ministers meeting held in Fiji in 2007, it was agreed that time was getting short so each regional negotiating group should start to negotiate its own rules of origin. In order not to arrive at a situation whereby each negotiating region would have fundamentally different rules of origin it was also agreed that the ACP secretariat should prepare a template for use by the regional negotiators in negotiating rules of origin.

Previous to the ministerial meeting, the ACP secretariat hosted a workshop on rules of origin at the ACP House on 19–20 October 2006 at which representatives from all the six ACP EPA negotiating regions and a number of experts on rules of origin were present. At that meeting the following was agreed:

- Rules of origin must be placed at the heart of the EPA negotiations instead of being considered as a purely technical issue, because without adequate rules of origin, there can be no real preferences.
- Simple and nonrestrictive rules of origin should be formulated so as to strengthen regional integration and encourage the use of preferences.
- Regarding the origin criteria to be used, it would be preferable to adopt a global cross-cutting rule, rather than specific product-based rules that would involve interest groups that could make their formulation and implementation very difficult.

- The value-added method is very simple at the conceptual level, but very complex to implement because it requires a good accounting system that may sometimes be lacking in some ACP countries.
- It may be interesting to use the materials percentage criterion, which is somewhat simpler than the value-added one.
- Special attention must be given to key sectors such as textiles and fisheries.
- Everything must be done to avoid, as much as possible, different rules of origin in the six negotiating regions.
- The rules of origin model that was originally developed and presented constituted a very good base that can be used to launch the negotiations, but it remained a generic model. It needed to be further developed to become a prototypical model to guarantee that the six ACP negotiating entities adopt a single approach.
- The prototypical model should take into account, as much as possible, the recommendations formulated by the group of experts on rules of origin at the end of their third meeting.
- Rules of origin for marine fishery products should be examined with due regard for issues of sustainability, the capacity of coastal states to manage their resources, and investment guarantees in the sector.
- Regarding fishery products, a possible solution would be to adopt different criteria for primary products and processed products.

The ACP secretariat devised a template that was designed to assist the six ACP negotiating regions to negotiate rules of origin that build on the Cotonou rules of origin and that, if followed, would have promoted consistency between the rules of origin negotiated by the six regions and the EC.

One of the main recommendations of the meeting of the group of experts was that everything should be done to try to ensure that the six different regions did not negotiate six different rules of origin with the EC. If this happened, this would have delayed the current attempts to strengthen and deepen regional integration, especially in Africa.

It is for this reason that the group of experts agreed to develop a draft model protocol on rules of origin that, if agreed on by the six ACP negotiating regions, could be used as the basis of negotiations on rules of origin with the EC. Although the negotiations would be done at the level of the regions, the ACP secretariat aimed at playing a coordinating role to ensure that all regions were kept informed of progress made in the negotiations in all other regions.

A first version of the draft model protocol was presented during the fifth meeting of the ACP experts on rules of origin in February 2007. The first version of the draft model protocol recommended the use of an across-the-board

value-addition criteria. The reason for recommending this method was mainly based on the fact that there was very little time in which rules of origin for EPAs could be negotiated. It was considered that the adoption of an across-the-board criterion could represent a shortcut because there was no time to negotiate on a line-by-line basis product-specific rules of origin.

During the discussions among experts at the fifth meeting, held in Brussels on February 2007, it was agreed that the draft protocol presented at the meeting should be revised to take into account the group of experts' observations, which may be summarized as follows:

- both the CTC and value-added criteria should be used to define rules of origin for the EPAs;
- the draft ESA protocol should be the source document for revising the ACP-wide proposal;
- The issues related to certification and administrative procedures should be incorporated into the revised draft ACP-wide protocol.

On the basis of this previous work, a revised draft model protocol was presented to the ACP group of experts during July 2007, drafted on the following assumptions:

- The introduction of a CTC criterion meant the negotiation of product-specific rules of origin as set out in the draft Eastern and Southern Africa (ESA) protocol.
- However, it was not necessary to negotiate a full set of product-specific rules of origin exhaustively covering all products, because the ACP regions either do not show significant trade in some of the HS headings or the EC tariff rate is MFN duty free in others. Attention may be therefore focused on the product-specific rule of origin in which significant trade flows have been reported. To this end a template was attached to the draft model protocol containing exhaustive information on the current Cotonou rules of origin, the preferential margin, the amount of trade flows recorded for that specific heading or chapter from the different ACP regions, and a proposed simplified product-specific rule of origin.
- The product-specific rules of origin contained in the template were designed to liberalize the current Cotonou product-specific rules of origin, using, as suggested by the group of experts, different drafting techniques, and the experience gained in other contexts.
- The template was designed to be used as a flexible negotiating tool that, once cleaned, could become the protocol containing product-specific rules of origin for each ACP region.

- As far as the certification and administration procedures and in view of the comments made to the proposed EC Draft Convention, it considered adopting as a transitional measure, the existing Cotonou procedures with minor amendments as contained in the ESA protocol. The transitional period should be used to asses the impact of introducing a new system as suggested in the proposed EC convention or other alternatives.

The draft model protocol provided for two main originating products categories:

(i) Wholly produced referred to agricultural and mining products that are collected, mined, grown, reared, etc., in the exporting country (e.g., mineral products; vegetable products; live animals; products obtained from live animals; etc., if these products originate in the member-state concerned.) Annex D1 of the Kyoto Convention contains a definition of what constitutes wholly produced, and most preferential rules of origin follow this definition.
(ii) Substantive transformation, which can be achieved by one or a combination of the following as specified at the product-specific level in the attached template:
   a. CTC;
   b. value addition expressed as value of materials;
   c. specific manufacturing process.

For a CTC, because the HS is primarily a customs classification system rather than a way of defining substantive transformation, there are many instances in which a change of tariff classification does not constitute substantive transformation and also instances in which substantive transformation takes place but with no change in tariff classification. To overcome such technical difficulties and avoid an excessive complication of the product-specific rules origin entering on a CTSH or change of tariff subheading split (CTSHS) drafting exercise, use was made, borrowed from the Cotonou rules of origin, of the expression "manufacture from any heading."

Such an expression means, as contained in the explanatory notes to the template and in the previous explanatory notes to the Cotonou rules of origin, that where a rule uses the expression "Manufacture from materials of any heading" then materials of any heading(s) (even materials of the same description and heading as the product) may be used including obviously the subheadings, subject, however, to any specific limitations that may also be contained in the rule.

This rule is a liberal version of the CTSH rule (at the six-digit level) but allows origin-conferring status to certain manufacturing operations that may occur even within a subheading.

In these extreme cases the safeguard that such operations are to be regarded as substantial transformations is represented by the recourse to the list of minimal processing or working requirements.

The use of "manufacture from any heading" has permitted in a number of cases the adoption of a very liberal approach without further complicating the drafting of product-specific rules or origin. Some would, however, object to such an approach on technical grounds. In other cases a simple CTH approach was adopted with no or little exception in order to maintain the liberal nature of the product-specific rules.

In some cases the definition of specific manufacturing process was used to make the rules easily understandable to operators, especially in the textile and clothing sector that represent a key area for many ACP exporters including relevant processes such as dyeing and bleaching.

Value addition was used mainly in the machinery and electronic chapters (84 to 96). In this area the important points to be noted were two: The first related to the basis for the calculations of the nominator and denominator proposed that were different from those used in the present Cotonou regime. The methodology used to calculate value addition was based on two formulas called build-down and build-up, as follows, borrowed from the CAFTA experience:

Method Based on Value of Nonoriginating Materials ("Build-down Method")

$$\text{RVC} = \frac{\text{AV} - \text{VNM} \times 100}{\text{AV}}$$

Method Based on Value of Originating Materials ("Build-up Method")

$$\text{RVC} = \frac{\text{VOM} \times 100}{\text{AV}}$$

where:

- RVC is the regional value content, expressed as a percentage;
- AV is the adjusted value;
- VNM is the value of nonoriginating materials that are acquired and used by the producer in the production of the good; VNM does not include the value of a material that is self-produced; and
- VOM is the value of originating materials acquired or self-produced, and used by the producer in the production of the good.

The changes that were introduced aimed at taking into account the special situations related to the transport costs of input materials to the ACP countries. Basically the calculation method adopted was based on adjustments made to the value of materials as contained in Article 6 of the draft protocol permitting, on the one hand, the deduction of the CIF costs when a "build-down" method is used to the nearest regional port and the additions of interregional inland costs of transport when the "build-up" method is used. This method of calculation of the value of materials used in manufacturing could greatly facilitate ACP compliance with the EC rules of origin.

The second issues concern the level of percentages, which was provisionally fixed at 20 percent for the build-up method and 30 percent for the build-down method. Further work was needed to asses how realistically these thresholds were taking into account the manufacturing capacity of ACP countries.

As a rule of thumb, the following underlying approaches were used in drafting more liberal and simpler product-specific rules of origin in specific sectors, drawing at times from the extensive technical work carried out by the Technical Committee on Rules of Origin (TCRO) of the WCO and the CRO of the WTO:

- In the processed agricultural sector, the Cotonou rules restricted the use of imported primary materials to manufacture processed agricultural product ex: to manufacture cheese, imported milk cannot be used or there a series of limitations on use of materials of Chapter 17 (sugar) in the manufacturing of beverages. These limitations were eliminated by adopting a simple CTH allowing the use of such primary imported materials;
- In the chemical sector, Chapters 28 to 40, general chapter rules were proposed to recognize that a series of operations such as a chemical reaction, change in particle size, and purification as origin-conferring operations;
- In the leather products, dyeing, tanning, and retanning were considered origin-conferring operations;
- In the textiles and clothing, a single stage of transformation was considered origin conferring, replacing the previous requirements of double transformation. In addition, dyeing and printing were also considered origin-conferring-operations as well as embroidery;
- In the machinery and electronic sector of Chapters 84 to 91, tentative thresholds of 20 percent for the build-up method and 30 percent for the build-down method have been set.
- In the course of the fall 2007 a series of field visits to manufacturers with questionnaires were planned to be carried out in the ACP region to assess the most realistic thresholds in various sectors when percentage requirements were used.

However, these latest attempts to come up with an ACP-wide approach to the rules of origin, although explored, did not translate into negotiating positions, probably because time was short and regions were divided on some issues. Meanwhile, the reform of EC rules of origin proceeds slowly mainly because of internal divergence of views within the EC Commission.

At the end of 2007, shortness of time prevailed, and the Cotonou rules were used, with the changes described in Chapter 3, in the interim EPAs.

In spite of the lost opportunities, the door is still open to continue negotiations of rules of origin with the EC. Leaving aside the debate about across-the-board or product-specific approaches or other drafting techniques, the methodology just outlined in Section 5.4.3 has been applied to identify (a) products for which rules of origin could play a role and (b) possible product-specific rules for these products respecting the industrial capacity of ACP countries.

Taking the ESA region as an example, at an aggregate level the sectors of the most exported goods to the EC where ESA countries are likely to encounter difficulties are the garments and fishery sectors. The difficulties in the garment sector affect a number of exports of Mauritius and Madagascar and are linked to the double processing requirement of the EC rules of origin. The fishery sector is affected by stringent rules or origin linked to the requirements examined in Chapter 3.

The exercise also aimed at identifying additional products for which some individual ESA countries may be encountering difficulties with the current EC rules of origin. Three sets of tables were prepared. The first set reported the most exported products at subheading level for individual ESA countries to the EC for the most recent year (2004). The second one reported the same information containing the most exported products to the world. The third set of tables reported most imported products from the world at subheading level.

From an examination of this set of tables it emerged that the most exported products of Kenya, at that time still negotiating within the ESA Group, to the EC are classified in 27 tariff lines with a trade volume exceeding $1 billion. The most important products are fresh flowers, fresh vegetables, coffee, and tea. These products generally do not report significant origin difficulties for Kenya because they are grown and harvested in Kenya.

However, a look at the most imported inputs reveals that $15 million worth tea was imported in 2004. This tea could have been imported for local consumption, but it may also be the case that it has been mixed with a local variety to obtain a better mixture for export. This practice may have some effects on origin requirement. The EC rules of origin requirement for tea is manufacture from any heading including the heading in which the product is classified. This means that imported tea could be freely mixed with Kenyan tea to obtain mixtures of tea to be exported to the EC. It follows that in this specific

product the current EC Pan-European rules of origin are not representing a difficulty.

Import statistics also show imports of sugar and other mixtures of odoriferous substances used in food or drinks preparations. If these products are used in the manufacturing of fruit juices, which are shown as the eight most exported products to the EC, there might be potential problems with rules of origin because the EC rules for heading 2009 requires that all the fruit, nuts, or vegetables of Chapters 7 and 8 and any sugars of Chapter 17 used must already be originating. In this case a more liberal rule had to be defined.

In the case of Mauritius, besides textiles, garments, and fishery products, export statistics show that TV sets of heading 852520 for an amount of $88 million rank as the fourth most exported product to the EC in 2004. Looking at the import statistics, subheading 852520 classifying the same product ranks as the second most imported product from world with an overall trade amount of $284 million. Once the most exported products of Mauritius to the world is considered, the same product ranks in third place with an amount of $265 million. It appears from this analysis that some assembly operations of TV sets may be carried in Mauritius within heading 852520. It remains to be seen if these assembly operations carried in Mauritius are enough to comply with the EC rule of origin that requires for heading 8525 no more than 40 percent of imported inputs of the ex-works price and that the value of nonoriginating material parts does not exceeds the values of all the originating materials. An alternative rule provides a maximum amount of 25 percent of imported inputs of the ex-works price of the finished products.

Table 5.10 contains a complete draft template of rules origin that could be used as a reference by ESA and SADC in their negotiations with the EC compiled according to the methodology described in this section. For ease of reference the template contain the rules of origin under Cotonou and the average preferential margin.

TABLE 5.10. *Comparison table among Cotonou rules, ESA, and SADC proposed rules on selected most exported products to the EC, including possible alternative common rules*

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade[a] 000	Possible alternative rules
0201	Meat and edible meat, fresh or chilled	4.07	16.8	12.8	Manufacture from materials of any heading except meat of bovine animals, frozen of heading no. 0202	none	44.273	Possible options a) Manufacture from live animals i.e slaughtering is an origin-conferring operation b) fattening for a certain period could be considered as origin conferring
03	FISH AND CRUSTACEANS, MOLLUSCS AND OTHER AQUATIC INVERTEBRATES	0.0	10.82	10.82	Manufacture in which all the material of Chapter 3 used are wholly obtained	352.795 All the materials of Chapter 3 used must be wholly obtained	544.460	Suggested rules: see definition of wholly obtained products for fishery products Possible options: a) Filleting fish is an origin-conferring operations b) drying and salting fish is an origin-conferring operation c) heavy salting of fish is an origin-conferring operation d) producing fish flour or pellets is an origin-conferring operation
08	EDIBLE FRUIT AND NUTS; PEEL OF CITRUS OR MELONS	2.27	13.56	11.52		43.783 Manufacture in which all the fruit and nuts of Chapter 8 used must be wholly obtained	794.735 Manufacture in which all the fruit and nuts used are wholly obtained	
					Manufacture in which: - all the fruit and nuts used are wholly obtained, and - the value of all the materials of Chapter 17 used does not exceed 30 percent of the value of the ex-works price of the product			Manufacture in which all the fruit and nuts used are wholly obtained,
09	Coffee, tea, maté and spices; except for				Manufacture in which all the	407.380	47.011	

Note: This table is for reference use only. ESA and SADC differ in providing product-specific rules or origin at chapter and heading levels. This table shows a comparison of selected chapters and headings where trade from SADC and ESA regions are most concentrated.
"Same Rule" means that the same product-specific rules under Cotonou could continue to be used. More refinements may be necessary.
[a] SADC trade includes South Africa.

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
					materials of Chapter 9 used are wholly obtained	Manufacture from materials classified in a heading other than that of the product	Manufacture in which all the materials of Chapter 9 used are wholly obtained	Same rule as Cotonou
0901	Coffee, whether or not roasted or decaffeinated; coffee husks and skins; coffee substitutes containing coffee in any proportion	0.0	6.05	6.05	Manufacture from materials of any heading	261.912	39.101 Manufacture from materials of any heading	Same rule as Cotonou
0902 0910	Tea, whether or not flavoured Manufacture from materials of any heading ex 0910 Mixtures of spice	0.0	0.80	0.80	Manufacture from materials of any heading Manufacture from materials of any heading	111.595	7.845 Manufacture in which the value of all the materials used does not exceed 50 percent of the value of the ex-works price of the product	Same rule as Cotonou
16	**PREPARATIONS OF MEAT, OF FISH OR OF CRUSTACEANS, MOLLUSCS OR OTHER AQUATIC INVERTEBRATES**	.				281.277 Manufacture from materials classified in a heading other than that of the product	1.606 Manufacture - from animals of Chapter 1, and/or - in which all the materials of Chapter 3 used are wholly obtained	CTH
16	Preparations of meat, of fish or of crustaceans, molluscs or other aquatic invertebrates							
1604	Prepared or preserved fish	0.0	17.83	17.83	Manufacture from animals of Chapter 1. All the materials of Chapter 3 must be wholly obtained material	280.996	None Manufacture from materials of any heading, except that of the product	
1701	Cane or beet sugar and chemically pure sucrose, in solid for	0.0	15.13	15.13	Manufacture from materials of any heading, except that of the product	468.948	15345 Manufacture in which the value of all the materials of Chapter 17 used does not exceed 30 percent of the ex-works price of the product	Refining sugar could considered as origin-conferring operations
20	**PREPARATIONS OF VEGETABLES, FRUIT, NUTS OR OTHER PARTS OF PLANTS**	**N.A.**	**0-41 20.8**	**N.A.**	Manufacture in which all the fruit, nuts or vegetables used are wholly obtained	83.143 Manufacture from materials classified in a heading other than that of the product	122.016 Manufacture from materials of any heading, except that of the product	Manufacture from materials of any heading, except that of the product

Note: CTH means change of trade heading.

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade '000	Possible alternative rules
ex 2008	Nuts, not containing added sugar or spirits	0.0	19.95	19.95	Manufacture in which the value of all the originating nuts and oil seeds of headings 0801, 0802 and 1202 to 1207 used exceeds 60 percent of the ex-works price of the product	44.168	89.348	Manufacture from materials of any heading, except that of the product
	- Peanut butter; mixtures based on cereals; palm hearts; maize (corn)				Manufacture from materials of any heading, except that of the product			
	- Other except for fruit and nuts cooked otherwise than by steaming or boiling in water, not containing added sugar, frozen				Manufacture: - from materials of any heading, except that of the product, and - in which the value of all the materials of Chapter 17 used does not exceed 30 percent of the ex-works price of the product			
ex 2009	Fruit juices (including grape must) and vegetable juices, unfermented and not containing added spirit, whether or not containing added sugar or other sweetening matter	0.0	24.46	24.46	Manufacture: - from materials of any heading, except that of the product, and - in which the value of all the materials of Chapter 17 used does not exceed 30 percent of the ex-works price of the product	12.194	32.575	Manufacture from materials of any heading, except that of the product
24	**TOBACCO AND MANUFACTURE TOBACCO SUBSTITUTES EXCEPT FOR:**				Manufacture in which all the materials of Chapter 24 used are wholly obtained	256.823 Manufacture from materials classified in a heading other than that of the product	107656 Manufacture from materials of any heading, except that of the product	
2401	Unmanufactured tobacco/ tobacco refuse	59.8	43-85 69.4	9.6	Manufacture in which all the materials of Chapter 24 used are wholly obtained	255.207 Manufacture in which all the materials of Chapter 24 used must be wholly produced	107.656	Manufacture from materials of any heading, except that of the product
48	**PAPER AND PAPERBOARD; ARTICLES OF PAPER PULP, OF PAPER OR OF PAPERBOARD**	**0**	**0-13 9.3**	**9.3**	Manufacture from materials of any heading, except that of the product	1.569 Manufacture from materials classified in a	121.069 Manufacture from materials of any heading, except that of the product	

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
						heading other than that of the product		
4802	Uncoated paper..., for writing... in rolls or sheets/ hand-made paper...				Manufacture from paper-making materials of Chapter 47	none	33.033	CTH
4804	Uncoated craft paper and paperboard, in rolls or sheets (excl. 48.02+03)	0	9.9 9	9	Manufacture from paper-making materials of Chapter 47	none	87411	CTH
52	**COTTON**					100.877 Manufacture from materials classified in a heading other than that of the product	17.199 Manufacture from materials of any heading, except that of the product	
	Cotton, not carded or combed				Manufacture from materials of any heading except that of the products	66.332	9.468	Same rule as Cotonou
61	**ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, KNITTED OR CROCHETED**					453.877 Manufacture from materials classified in a heading other than that of the product, except from materials of heading 61.17	5.918 Manufacture from materials of any chapter, except that of the product, provided that the value of the nonoriginating fabric used does not exceed 60 percent of the ex-works price of the product. For products only cut (or knit to shape) and sewn, both the cutting (or knitting to shape) and sewing or an assembly in an other way must be completely made in the parties (11)	
Chapter 61	Knitted or crocheted fabrics – Obtained by sewing together or otherwise assembling, two or more pieces of knitted or crocheted fabric which have been either cut to form or obtained directly to form – Other				Manufacture from: Manufacture from yarn • natural fibers, • manmade staple fibers not carded or combed or otherwise processed for spinning, or			Manufacture from yarn or manufacture by assembling two or more pieces of knitted or crocheted fabric which have been either cut to form or obtained directly to form

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
					• chemical materials or textile pulp			
62	**ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, NOT KNITTED OR CROCHETED**	0.0	12.00	12.00	Manufacture from yarn	104.100 Manufacture from materials classified in a heading other than that of the product, except from materials from heading 62.17	32.080 Manufacture from materials of any chapter, except that of the product, provided that the value of the nonoriginating fabric used does not exceed 60 percent of the ex-works price of the product. For products only cut (or knit to shape) and sewn, both the cutting (or knitting to shape) and sewing or an assembly in an other way must be completely made in the parties (11)	Manufacture from fabric or manufacture by assembling two or more pieces of woven fabric which have been either cut to form or obtained directly to form
ex 6202, ex 6204, ex 6206, ex 6209 and ex 6211	Women's, girls' and babies' clothing and clothing accessories for babies, embroidered				Manufacture from yarn (2) or Manufacture from unembroidered fabric, provided that the value of the unembroidered fabric used does not exceed 40 percent of the ex-works price of the product			
ex 6210 and ex 6216	Fire-resistant equipment of fabric covered with foil of aluminised polyester				Manufacture from yarn (2) or Manufacture from uncoated fabric, provided that the value of the uncoated fabric used does not exceed 40 percent of the ex-works price of the product			
6213 and 6214	Handkerchiefs, shawls, scarves, mufflers, mantillas, veils and the like – Embroidered				Manufacture from unbleached single yarn Manufacture from unbleached single yarn (1) (2) or Manufacture from unembroidered fabric, provided that the value of the unembroidered fabric used does not			Manufacture from fabric accompanied by printing or dying or embroidery and at least two preparatory or finishing operations

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
					exceed 40 percent of the ex-works price of the product			
	-Other				Manufacture from unbleached single yarn (1) (2) or Making up, followed by printing accompanied by at least two preparatory or finishing operations (such as scouring, bleaching, mercerising, heat setting, raising, calendering, shrink resistance processing, permanent finishing, decatising, impregnating, mending and burling), provided that the value of all the unprinted goods of headings 6213 and 6214 used does not exceed 47.5 percent of the ex-works price of the product			
72	**IRON AND STEEL**					63.823 Manufacture from materials classified in a heading other than that of the product	1.688.529 Manufacture from materials of any heading, except that of the product	Manufacture within which all the materials used are classified in a heading other than that of the product
7202	Ferro alloys	0	3.9	3.9	Manufacture from materials of heading no. 7201, 7202, 7203, 7204 or 7205	59.144	1.078.475	
7208 to 7216	Flat-rolled products, bars and rods, angles, shapes and sections of iron or nonalloy steel	0.6	4.9	4.3	Manufacture from ingots or other primary forms of heading no. 7206	2.965	148.415 Manufacture from ingots, other primary forms or semifinished products of heading 7206 or 7207	CTH or cladding or plating operations
7217	Wire of iron or nonalloy steel	0.3	5.3	5	Manufacture from semifinished materials of heading no. 7207	none	41432 Manufacture from semifinished materials of heading 7207	CTH except 72.13 through 72.15
ex 7218, 7219 to 7222	Semifinished products, flat-rolled products, bars and rods, angles and sections of stainless steel	N.A.	N.A.	N.A.	Manufacture from ingots or other primary forms of heading no. 7218	277.303 Manufacture from ingots or other primary forms of heading 72.18	295.519 Manufacture from ingots or other primary forms of heading 7218	CTH

In the case of headings 72.21 and 72.22, further refinement is needed at the subheading level to take into account certain specific working or processing.

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
73	**ARTICLES OF IRON AND STEEL**				Manufacture from materials of any heading, except that of the product	1.761 Manufacture from materials classified in a heading other than that of the product	20.718 Manufacture from materials of any heading, except that of the product	CTH
7308	Structures (excluding prefabricated buildings of heading no. 9406) and parts of structures (for example, bridges and bridge sections, lock-gates, towers, lattice masts, roofs, roofing frameworks, doors and windows and their frames and thresholds for doors, shutters, balustrades, pillars and columns), of iron or steel plates, rods, angles, shapes, sections, tubes and the like, prepared for use in structures, of iron or steel	0	4.1	4.1	Manufacture in which all the materials used are classified within a heading other than that of the product. However, welded angles, shapes and sections of heading no. 7301 may not be used		20.586 Manufacture from materials of any heading, except that of the product. However, welded angles, shapes and sections of heading 7301 may not be used	CTH or manufacture from any heading
84	**NUCLEAR REACTORS, BOILERS, MACHINERY AND MECHANICAL APPLIANCES; PARTS THEREOF EXCEPT FOR:**				Manufacture: – from materials of any heading, except that of the product, and – in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product OR Manufacture in which the value of all the materials used does not exceed 30 percent of the ex-works price of the product	10.637	1.773.296 Manufacture from materials of any heading, except that of the product	
8407	Spark-ignition reciprocating or rotary internal combustion piston engines	0	5.7	5.7	Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	497 Manufacture from materials classified in a heading other than that of the product	149.430	CTH
8408	Compression-ignition internal combustion piston engines (diesel or semidiesel engines)	0	4.4	4.4	Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	610 Manufacture from materials classified in a heading other than that of the product	111.344	CTH

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
8409	Parts suitable for use solely or principally with the engines of heading no. 8407 or 8408	0	3.3	3.3	Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	1.335 Manufacture from materials classified in a heading other than that of the product, except from materials of headings 84.07 and 84.08	71.476	CTH
8411	Turbo-jets, turbo-propellers and other gas turbines				Manufacture: – from materials of any heading, except that of the product, and – in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	373	33.238	CTSH
8473	Parts suitable for use solely or principally with machines of 84.69-72	0	4.3	4.3	Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	None Manufacture from materials classified in a heading other than that of the product, except from materials of headings 84.69 to 84.72	26.376	Manufacture from any heading
8474	Machinery for sorting, screening, agglomerating, forming foundry moulds	0	5.2	5.2	Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	None Manufacture from materials of any heading, including other materials classified in headings listed in column A	21.794	Manufacture from any heading
8483	Transmission shafts, cranks, clutches, shaft couplings(universal joints	0	2.1	2.1	Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	Manufacture from materials classified in a heading other than that of the product		
85	**ELECTRICAL MACHINERY AND EQUIPMENT AND PARTS THEREOF; SOUND RECORDERS AND REPRODUCERS, TELEVISION IMAGE AND SOUND RECORDERS AND REPRODUCERS, AND PARTS AND ACCESSORIES OF SUCH ARTICLES, EXCEPT FOR**				Manufacture: – from materials of any heading, except that of the product, and – in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product Manufacture in which the value of all the materials used does not exceed 30 percent of the ex-works price of the product	8.538 Manufacture from materials classified in a heading other than that of the product	229.960 Manufacture from materials of any heading, except that of the product	

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
ex 8511	All types of electrical ingnition, generators, cut-outs etc.	N.A.	N.A.	N.A.	Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, • where the value of all the nonoriginating materials used does not exceed the value of the originating materials used, or • Manufacture in which the value of all the materials used does not exceed 25 percent of the ex-works price of the product	None	21.011	
8525	Transmission apparatus for radio-telephony, radio-telegraphy, radio-broadcasting or television, whether or not incorporating reception apparatus or sound recording or reproducing apparatus; television cameras	0	3.6	3.6	Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, • where the value of all the nonoriginating materials used does not exceed the value of the originating materials used, or • Manufacture in which the value of all the materials used does not exceed 25 percent of the ex-works price of the product	92937	826	CTH
8527	Reception apparatus for radiotelephony, radio-telegraphy or radio-broadcasting, whether or not	0	10.7	10.7	Manufacture: • in which the value of all the	None	46.018	CTH

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
	combined, in the same housing, with sound recording or reproducing apparatus or a clock				materials used does not exceed 40 percent of the ex-works price of the product, • where, within the above limit, the materials classified within heading no. 8529 are only used up to a value of 5 percent of the ex-works price of the product, • where the value of all the nonoriginating materials used does not exceed the value of the originating materials used, and • all the transistors of heading no. 8541 used are originating products			
8535 and 8536	Electrical apparatus for switching or protecting electrical circuits, or for making connections to or in electrical circuits	0	4.6	4.6	Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, and • where, within the above limit, the materials classified within heading no. 8538 are only used up to a value of 10 percent the ex-works price of the produc or Manufacture • in which the value of all the materials used does not exceed 25 percent of the ex-works price of the product	1317	232	CTH
8537	Boards, panels (including numerical control panels), consoles, desks, cabinets and other bases, equipped with two or more apparatus of heading no. 8535 or 8536, for electric control or the distribution of electricity, including those incorporating instruments or apparatus of Chapter 90, other than switching apparatus of heading no. 8517	0	4.2	4.2	Manufacture: • in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product, and	None	1681	CTH

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
ex 8541	Diodes, transistors and similar semiconductor devices, except wafers not yet cut into chips				• where, within the above limit, the materials classified within heading no. 8538 are only used up to a value of 10 percent the ex-works price of the product or • Manufacture in which the value of all the materials used does not exceed 30 percent of the ex-works price of the product Manufacture: – from materials of any heading, except that of the product, and – in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product Manufacture in which the value of all the materials used does not exceed 25 percent of the ex-works price of the product	None	87134	Diffusion or assembly process
8542	Electronic integrated circuits and microassemblies – Monolithic integrated circuits	0	12.9	12.9	Manufacture in which: – the value of all the materials used does not exceed 40 percent of the ex-works price of the product, and – within the above limit, the value of all the materials of headings 8541 and 8542 used does not exceed 10 percent of the ex-works price of the product or The operation of diffusion (in which integrated circuits are formed on a semi-conductor substrate by the selective introduction of an appropriate dopant), whether or not assembled and/or tested in a country other than those specified in Articles 3 and 4 or Manufacture in which the value of all the materials used does not exceed 25 percent of the ex-works price of the product	2301	None	Diffusion or assembly process

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules: ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status	ESA trade 000	SADC trade 000	Possible alternative rules
	– Other				Manufacture in which: – the value of all the materials used does not exceed 40 percent of the ex-works price of the product, and – within the above limit, the value of all the materials of headings 8541 and 8542 used does not exceed 10 percent of the ex-works price of the product Manufacture in which the value of all the materials used does not exceed 25 percent of the ex-works price of the product			
8544	Insulated (including enameled or anodised) wire, cable (including co-axial cable) and other insulated electric conductors, whether or not fitted with connectors; optical fibre cables, made up of individually sheathed fibres, whether or not assembled with electric conductors or fitted with connectors	0	6.3	6.3	Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	53	Manufacture in which the value of all the materials used does not exceed 55 percent of the ex-works price of the product. However metallic conductors of heading 8544 may not be used 70.117	Manufacture from any heading
8548	Electrical parts of machinery or apparatus, not specified or included elsewhere in this Chapter	0	4.2	4.2	Manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	Manufacture from materials classified in a heading other than that of the product, except from materials of headings 85.01 to 85.47		
87						1728	1127962	
8703	MOTOR CARS AND OTHER MOTOR VEHICLES	0	9.7	9.7	Manufacture: – in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	Manufacture from materials classified in a heading other than that of the product	Manufacture (14) in which the value of all the materials used does not exceed 60 percent of the ex-works price of the product	CTH
8704	MOTOR VEHICLES FOR THE TRANSPORT OF GOODS	0	13	13	Manufacture: – in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product – in which the value of all the materials used does not exceed 30 percent of the ex-works price of the product	Manufacture from materials of any heading, including other materials classified in headings listed in column A		CTH

(*continued*)

TABLE 5.10 (*continued*)

HS code	Description	Current Cotonou rules				ESA trade 000	SADC trade 000	Possible alternative rules
		ACP tariff	MFN tariff	Pref. margin	Working or processing carried out on nonoriginating materials that confers original status			
8708	PARTS AND ACCESSORIES OF THE MOTOR VEHICLES OF HEADINGS 87.01 TO 87.05	0	3.7	3.7	Manufacture: – in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product	Manufacture from materials classified in a heading other than that of the product		Manufacture from base metal goods prepared for finishing or CTH (to be further refined as a subheading level)
9401	Seats whether or not convertible into beds, and parts thereof	0	5.6	5.6	Manufacture from materials of any heading, except that of the product or Manufacture from cotton cloth already made up in a form ready for use with materials of heading 9401 or 9403, provided that: – the value of the cloth does not exceed 25 percent of the ex-works price of the product, and – all the other materials used are originating and are classified in a heading other than heading 9401 or 9403 or Manufacture in which the value of all the	88	376.274	Manufacture in which there is a regional value content of not less than: (1) 20 percent based on the build-up method, or (2) 30 percent based on the build-down method

6

The Administration of Rules of Origin

An important element of the rules of origin is their administration. Rules of origin are one of the three basic customs law: The Harmonized System (HS) for customs classification, customs valuation, and rules of origin. These customs laws are designed to assist the customs officers in responding to basic questions: Where do I classify these goods? How much are they worth? Where are they coming from?

In day-to-day business life, rules of origin are part of the border routine and they need to be administered in an efficient manner to facilitate customs clearance and not to cause hindrance to trade.

The administration of rules of origin is usually centered on three stages: (1) the issuance of the documentary evidence proving origin, that is, the certificate of origin, (2) direct consignment conditions and related documentary evidence, and (3) verification and postclearance recovery procedures.

There are not multilateral rules on administering rules of origin. On the one hand, the World Trade Organization (WTO) Agreement on rules of origin is conspicuously silent in this regard. On the other hand, the Kyoto Convention provides only guidelines. Meanwhile, the flourishing of free-trade areas (FTAs) Agreements entails the negotiations of rules of origin as well as their administrative requirements with almost total lack of multilateral discipline.

Many of these FTAs are replacing former unilateral preferences. The Central American Free-Trade Area (CAFTA) has replaced former unilateral preferences granted by the United States, and the Economic Partnership Agreements (EPAs) that the EC is negotiating with African, Caribbean, and Pacific (ACP) countries are replacing former unilateral trade preferences granted under the Cotonou Partnership Agreement (CPA) and former Lomé Conventions.

The switch from unilateral to reciprocal trade preferences means that rules of origin administration and their enforcement will become another important aspect of customs administration in developing countries. In addition to

maintaining their traditional role of issuing certificate of origin for export under EC or U.S. rules, for instance, customs administrations in developing countries will also have to administer rules of origin at the time of importation in their own country. FTAs and EPAs in fact will mean that imports from the EC or from the United States into African countries and least-developed countries (LDCs) will be entitled to preferential rates of duty.

Hence there is a need to make sure that preferences are granted to genuine EC or U.S. originating goods and not to products that have been transshipped through the EC or the U.S. or are objects of minimal and insufficient processes in the EC or US.

In many developing countries, tariff revenue still accounts for a significant share of the budget. In addition, the fragile industrial structure of many developing countries may be highly sensitive to surges in trade flows of competing goods entering at preferential rates. These two factors suggest that administering rules of origin on the import side could become one of the next challenges for developing countries' customs administrations.

In the absence of multilateral rules in this area, this chapter first discusses the experience of the Generalized System of Preferences (GSP) rules of origin. This was an area that first registered efforts to harmonize some of the procedures related to administration or rules of origin. This chapter further examines the experience of the two major "models" of rules of origin from the EC and the United States that are showing different evolutions in administering rules of origin. Some of the leading cases on rules of origin under the respective jurisdictions of the EC are reviewed.

6.1. The Administration of GSP Rules of Origin

The administration of GSP rules of origin follow the pattern of the substantive GSP rules: Although efforts were made, harmonization results were limited. As in other sets of rules of origin, the main elements of administration of GSP rules of origin are (1) issuance of certificate of origin, (2) direct consignment and related evidence, and (3) verifications.

6.1.1. Issuance of Certificate of Origin Form A or Declaration by Exporter or Importer

The claim for GSP treatment must be supported by appropriate documentary evidence as to origin and consignment. Details are given in the following paragraphs. For consignments of small value, including postal consignments, simplified documentary requirements are applied by many preference-giving countries.

Originally, Form A was designed in United Nations Conference on Trade and Development (UNCTAD) working groups to serve as a common certificate of origin. However, there was considerable divergence because at the outset countries such as the United States, Australia, and New Zealand opted for a declaration by the exporter and accepted GSP Form A as an alternative. Lately the United States has switched to an importer-based declaration of origin.

Presently GSP Form A is still officially used by the following preference-giving countries: the EC, Japan, Norway, Switzerland, and Turkey. The situation of Russia is unclear. All other preference-giving countries have progressively moved out to other forms of certification.

GSP Form A means that these countries must have a system of customs cooperation based on certifying authorities issuing GSP Form A.

Some GSP schemes contain provisions regarding the issue and acceptance of documentary evidence of origin. These may be divided into provisions applicable in preference-receiving countries and those that are applicable in preference-giving countries. They are summarized in the following paragraphs.

Provisions Applicable in Preference-Receiving Countries

(a) Application for Certificates of Origin Form A

A certificate of origin should be issued only upon written application from the exporter or his authorized representative. It is recommended that Form B (declaration by the exporter) be used for that purpose. The exporter or his representative should submit with his request any appropriate supporting documents proving that the products to be exported qualify for the issue of a certificate of origin.

(b) Issue of Certificate of Origin Form A

It is the responsibility of the competent governmental authority or other body of the exporting preference-receiving country to ensure that the certificates and applications are duly completed. Each certificate should bear a serial number (whether or not printed) by which it can be identified. The serial number is to be placed in the top right-hand box of Form A.

(c) Issue of Duplicate Certificates of Origin Form A

The EC, Japan, Norway, and Switzerland provide for the issue or acceptance of duplicates of certificates of origin Form A in order to ensure that exporters in preference-receiving countries may, in the event of theft, loss or destruction of a certificate, nevertheless obtain GSP treatment. The duplicate Form A issued in this way should be endorsed with one of the following words: "DUPLICATE" or "DUPLICATA," printed in box 4. The duplicate, which should bear the

date of issue and the serial number of the original certificate, will take effect as from the date.

(d) Issue of Provisional Certificates of Origin Form A
Japan provides for the issue of provisional certificates of origin in cases where the goods are sent to a third country for the display at exhibitions, fairs, etc., so that the final destination of products exported from a preference-receiving country is not known.

(e) Certificates of Origin Form A Issued Retrospectively
Although certificates of origin are generally issued at the time of exportation of the products in question, Canada, the EC, Norway, and Switzerland accept certificates of origin Form A (or in the case of Canada, an "Exporter's Statement of Origin") issued retrospectively. This may the case when a certificate was not requested at the time the products were exported, because of error, involuntary omissions, or any other special circumstances. Japan accepts certificates issued retrospectively when there are unavoidable reasons including no request for a certificate was made at the time for exportation. Certificates of origin Form A issued retrospectively should bear the endorsement "ISSUED RETROSPECTIVELY" or "DELIVER A POSTERIORI," printed in ink, in box 4.

Provisions Applicable in Preference-Giving Countries
(a) Time Limit for Presentation or Certificates of Origin Form A
The EC, Switzerland, and Norway require Form A to be produced to the customs office where the goods are presented for clearance within 10 months from the date of issue. In the case of Japan the time limit is one year with the possibility of an extension in exceptional cases. Canada has a four-year limit to submit Form A or the "Exporter's Statement of Origin."

(b) Presentation of Certificates of Origin Form A after Expiry of the Time Limits
The EC and Switzerland have specified that certificates of origin (Form A) may be accepted after expiry of the time limits provided the failure to observe the time limits results from *force majeure* or exceptional circumstances. In addition, the competent customs authorities of the preference-giving importing countries may accept such certificates provided the products have been presented to them before expiry of the time limits. In the case of *Japan*, the time limit may be extended in exceptional cases if the authorities are satisfied that it was not practicable to produce the certificate within the time limit.

(c) Discrepancies Between Statements Made in Certificates of Origin Form A and those in Other Documents

The discovery of slight discrepancies between the statements made in the certificate and those made in the documents presented to the customs for the purpose of carrying out the formalities for importing the products will not *ipso facto* render the certificate null and void, provided it is duly established that the certificate corresponds to the products.

(d) Issue and Acceptance of Replacement Certificates of Origin Form A by the EC, Norway, and Switzerland

These countries accept replacement certificates of origin Form A issued by the customs authorities or any other of these countries on the basis of a certificate of Form A issued by the competent authorities of the exporting preference-receiving country, provided that most transit conditions have been fulfilled. Replacement certificates may be issued by the customs authorities of these countries on the basis of a written request by the re-exporter. The replacement certificate shall indicate the country in which the products are considered as originating, and be endorsed "Replacement certificate" or "Certificat de remplacement" as well as date of issue and serial number of the original certificate in box 4. A photocopy of the original certificate Form A may be attached to the replacement certificate.

6.1.2. Direct Consignment

The rule that originating products must be transported directly from the exporting preference-receiving country to the preference-giving country is an important feature common to all GSP origin rules except those of Australia. Its purpose is to enable the customs administration of the preference-giving country of importation to be satisfied that the imported products are identical with the products that left the exporting preference-receiving country, that is, they were not manipulated, substituted, further processed, or entered into commerce in any intervening third country. Consignment conditions, as prescribed by individual preference-giving countries, are listed as shown below.

Conditions Applied by Some Preference-Giving Countries.

Countries	Conditions
Canada, EC, Japan, New Zealand, Norway, and Switzerland	These countries recognize as transportation: (a) Products transported without passing through the territory of another country. (b) Products transported through the territories of countries other than the exporting preference-receiving country,

	with or without transshipment or warehousing within those countries, provided that the products have remained under customs control in the country of transit or warehousing and have not entered into commerce or have been delivered for home use there, and have not undergone operations other than unloading, reloading and any other operation required to keep them in good condition.

Additional Provisions Applied by Particular Countries

In addition, for the countries indicated the following provisions apply:

Canada, EC, Switzerland	Splitting up loads in intervening countries is allowed.
EC	Transport through third countries must be justified for geographical reasons or exclusively on account of transport requirements. Because the EC is a customs union, products that have been transported direct from a preference-receiving country to the EC are regarded as having met the consignment requirement once they have arrived at any point of entry in the customs territory of the EC. Therefore, products may, after arrival in one member-state, enter into trade there and subsequently be shipped to another member-state without thereby losing entitlement to GSP treatment. Products manufactured within one of the regional groupings may be consigned to the EC from any country that is a member of that grouping.
EC and preference-giving countries of European Economic Area (EEA) (Norway and Switzerland)	Products may be transported through any of these countries and subsequently reexported to any of these countries in full or in part, provided that the products have remained under the surveillance of the customs authorities of the country of transit or warehousing and have not been delivered for home use or have not undergone operations other than unloading, reloading, and any operation intended to keep them in goods condition there.
Japan	Transport through third countries must be justified for geographical reasons or exclusively on account of transport requirements. Japan accepts, in general, only unloading, reloading, transshipment, and temporary storage under the surveillance of the customs authorities in the transit country. Temporary storage is permissible if the goods remain under the surveillance of the customs authorities in the transit country and are thereafter exported to Japan by the same exporter of the same preference-receiving country.

United States	Products must be destined for the United States at the time that they depart from the country of production. Special rules[1] apply for shipments through a free-trade zone in a preference-receiving country.
Australia	No consignment rule is applied.

[1] The special rules are as follows:

(a) The merchandise must not enter into the commerce of the country maintaining the free-trade zone;

(b) The eligible article must not undergo any operation other than:
- sorting, grading or testing;
- packing, unpacking, changes of packing, decanting, or repacking into other containers;
- affixing marks, labels, or other like distinguishing signs or articles or their packing, if incidental to operations allowed under these special provisions; or
- operations necessary to ensure the preservation of merchandise in its condition as introduced into the free-trade zone;

(c) Merchandise may be purchased and resold, other than at retail, for export within the free-trade zone. For the purposes of these special provisions, a free-trade zone is a pre-determined area or region declared or secured by or under government authority, where certain operations may be performed with respect to articles, without such articles having entered into the commerce of the country maintaining the free-trade zone.

Evidence of Direct Consignment

In the case of exports to the EC, Japan, Norway, and Switzerland, evidence that the requirements of the direct transportation have been fulfilled must, for products passing through the territory of a third country, be supplied to the customs authorities in the importing countries by the presentation of:

(a) a thorough bill of lading drawn up in the exporting preference-giving country covering the passage through the country or countries of transit; or

(b) certificate by the customs authorities of the country or countries of transit:
- giving an exact description of the products;
- stating the dates of unloading and reloading of the products or of their embarkation or disembarkation, identifying the ships used;
- certifying the conditions under which the products remained in the transit country or countries; or

(c) failing these, any substantiating documents deemed necessary (for example, copy of the order for the products, supplier's invoice, bills of lading establishing the route by which the products traveled).

Goods originally consigned to a specific European Free-Trade Area (EFTA) preference-giving country (Norway and Switzerland) and retraded to a EFTA preference-giving country or to the EC will still receive preferential tariff treatment in the final country of destination even if Form A does not show the country concerned as the final destination. The EC applies the same rule with respect to EFTA preference-giving countries. However, the customs authorities of the country of transit (either a EFTA or an EC country) shall issue a

new certificate of origin Form A based on the original Form A issued by the exporting preference-receiving country. This new certificate shall have in box for the text "replacement certificate" or "certificat de replacement."

Canada requires a thorough bill of lading addressed to a consignee in a specified port in Canada. The importer may be required to produce documentary evidence in cases of transit through intermediate countries.

Regarding exports to the United States, the importer may be required to submit appropriate shipping papers, invoices, or other documents as evidence that the articles were imported directly. The district director of U.S. Customs may waive the submission of evidence of direct shipment when he is otherwise satisfied that the merchandise clearly qualifies for GSP treatment. In the case of transit shipment, the invoices, bills of lading, and other documents connected with shipment must show the United States as the final destination.

6.1.3. Arrangements for Administrative Cooperation

The implementation of the GSP demands close cooperation and mutual assistance between the customs authorities in the preference-giving countries and the authorities concerned in the preference-receiving countries so as to ensure the observance of the provisions and requirements under the various schemes, including the effective control and verification of origin and consignment of products.

As part of this mutual cooperation, preference-giving countries require certain information from the preference-receiving countries concerning the authorities/bodies competent to issue certificates of origin Form A, as follows:

Information	Countries
Names and addresses of certifying authorities/bodies	All preference-giving countries except United States, Australia and New Zealand, for which such notification is not obligatory.
Specimen of stamps	As above.
Specimen of signatures	No preference-giving country requires specimen of signatures.

Verification and Control

Requests for verification of certificates of origin (Form A) are, as a rule, directed by the authorities of preference-giving importing countries to the relevant issuing authorities/bodies in the preference-receiving exporting country. Selection of certificates for verification is made by the relevant customs authorities in the preference-giving importing country where they have doubts as to the

authenticity of the document, or as to the accuracy of the information regarding the origin of the products in question, or on a random basis.

For the purposes of such requests for verification, the competent customs authorities in the preference-giving importing country are required to return certificate Form A to the responsible authorities/body in the exporting preference-receiving country giving, where appropriate, the reasons of form or substance for an enquiry. The commercial invoice, if available, or a copy thereof, should be attached to certificate Form A, and customs authorities will forward any information that has been obtained that suggests that the particulars given on certificate or form are inaccurate.

When a request for verification has been made, such verification has to be carried out and its result communicated within a maximum of six months from the date at which the request from the competent authority of the preference-giving importing country has been received by the competent authority/body in the exporting preference-receiving country. In cases of replacement certificates of Form A, issued by the customs authorities of the EC, Norway, or Switzerland, the time limit is extended to eight months. The result must be such as to establish whether the certificate of origin Form A in question is authentic, whether it applies to the products actually exported, and whether these products were in fact eligible to benefit from preferential tariff treatment, stating the reasons for which applicable rules of origin in this case are met. If, in cases of reasonable doubt, there is no reply within the six months prescribed, or if the reply does not contain sufficient information to determine the authenticity of the form or of the true origin of the product, a second communication will be sent to the issuing authority/body. If thereafter the results are not provided as soon as possible (in any case within four months) to the requesting authorities, or if the results do not permit the determination of the authenticity of the document or the true origin of the products in question, the requesting authorities will refuse any GSP benefit except in the case of *force majeure* or in exceptional circumstances.

For the purpose of subsequent verification, copies of the certificates issued as well as any export document referring to them, if appropriate, must be kept for at least three years by the competent authority/body in the preference-receiving exporting country. Most preference-giving countries have rules setting out detailed provisions, as previously described.

6.2. The Experience of the United States on Administering Origin

Before the FTA with Canada, later replaced with North American Free-Trade Agreement (NAFTA), the experience of the United States with preferential origin administration was mainly related to the GSP, Caribbean Basin Initiative

(CBI), and the trade agreement with Israel. NAFTA changed the U.S. perspective with regard to rules of origin, given the trade volume involved and the different interests at stake. NAFTA, however, represented a peak, and a number of lessons were learned during implementation that informed the attitude of U.S. trade negotiators and the regulations in the post-NAFTA framework. These lessons learned from the NAFTA experience may be best summarized in Table 6.1, comparing NAFTA with other recent FTAs. The table clearly shows that NAFTA is the only agreement in which the primary responsibility for compliance with rules of origin resides with the exporter. In all other FTAs, the primary responsibility is now shifted to the importer. This change implied a switch from a system based on the existence of certifying authorities, customs cooperation, and certificate of origin to an importer declaration. This change had several implications for the U.S. partners to the FTAs Agreements. Among the various implications, it has been observed that in an importer-based system the burden of proving origin in case of doubt or verification of customs authorities falls on the importer and his/her abilities to secure information about the origin of the goods from the exporter or manufacturer. Such ability however may be dependent on business realities related to the trade volumes and the number of transactions between the importer and the exporter. Providing and showing documentary evidence related to origin may rather tedious and time-consuming exercises involving, at times, confidential aspects that, for instance, a Chilean exporter may endure to maintain business relations with his U.S. importer for its exports to the lucrative U.S. market. The same may be less obvious in the case of a Chilean importer requesting origin information to a large exporter or manufacturer based in a U.S. market where the Chilean importer may represent a small or rather insignificant share of its overall export sales turnover. The pros and cons of adopting an administration system based on certifying authorities, an importer-based system, or a combination of the two, is open. Much of this debate is contained in subsection 6.3.9, illustrating the different options of the Green Paper of the EC commission of the reform of EC rules of origin. In the following subsection, the more salient features of the African Growth and Opportunity Act (AGOA) as well as NAFTA administration are discussed as well the more modern version of an importer-based administration.

6.2.1. Customs Procedures and Enforcement under AGOA for Textiles and Clothing Products

To benefit from the special concession on rules of origin allowing the utilization of imported fabric from their countries, the countries have to be designated by

TABLE 6.1. *Comparison of certification requirements and relative legislation among different FTAs*

Provision	NAFTA	Singapore FTA	Chile FTA	GSP	Australia FTA
General					
Agreement	NAFTA Implementation Act	U.S.-Singapore FTA Implementation Act	U.S.-Chile FTA Implementation Act	Generalized System of Preferences	U.S.-Australia FTA Implementation Act
U.S. Code	19 U.S.C. 3301–3473	19 U.S.C. 3805 note	19 U.S.C. 3805 note	19 U.S.C. 2461–2467	19 U.S.C. 3805 Note
CFR	19 CFR 181 and Rules of Origin Regs	Regs in early Draft Stage	70 FR 10868, March 7, 2005 (19 CFR 10 Subpart H)	19 CFR 10.171, 10.178	Regs in Early Draft Stage
Harmonized Tariff Schedule (HTS) U.S. General Note	GN 12	GN 25	GN 26	GN 4	GN 28
Primary responsibility for compliance	Exporter	Importer	Importer	Importer	Importer
Special Program Indicator	CA or MX	SG or 9999.00.84 (ISI)	CL	A, A+, A*	AU
Expiration	No	No	No	2006 (likely to be renewed)	No

Source: U.S. Customs and Border Protection (CBP).

the U.S. Trade Representative (USTR) after demonstrating that they have an effective visa system in place to verify that apparel and textile goods are in fact produced in a beneficiary sub-Saharan African (SSA) country in accordance with the required rules of origin. The USTR is publishing a *Federal Register* notice when it designates a country(ies) as eligible for AGOA apparel/textile benefits.[2]

In particular, to be declared eligible for textile/apparel provisions, SSA countries must do the following[3]:

(a) Adopt an effective visa system and a domestic law and enforcement procedure to prevent illegal transshipment and the use of counterfeit documents relating to the importation of the eligible apparel products into the United States;
(b) Enact legislation or issue regulations in order to permit the U.S. Customs Service to investigate thoroughly allegations of transshipment;
(c) Agree to report on the total exports and imports of covered articles in the country;
(d) Cooperate with the United States to prevent circumvention;
(e) Agree to require all producers and exporters of covered articles in the country to maintain complete records of the production and the export of covered articles, including materials used in the production, for at least two years after the production or export;
(f) Agree to provide documentation to the U.S. Customs establishing the country of origin of covered articles. This includes the production record, information relating to the place of production, the number and identification of the types of machinery used in production, the number of workers employed in production, and certification from both the manufacturer and the exporter. These records should be retained for five years.

The USTR directed the Commissioner of Customs to require that importers provide an appropriate export visa from a designated beneficiary SSA country when the country claims preferential treatment of textile and apparel products under the Act.[4]

A shipment shall be visaed by stamping an original circular visa in blue ink only on the front of the original commercial invoice. The original visa shall not be stamped on duplicate copies of the invoice. The original of the invoice with the original visa stamp shall be required for obtaining preferential

[2] The information concerning country eligibility is available at http://www.ustr.gov.
[3] Section 113 (a)(1) of the Act.
[4] See *Visa Requirements under the AGOA*, vol. 66, Federal Register 7837; 25 January 2001.

tariff treatment. Duplicates of the invoice and/or visa may not be used for this purpose. Each visa stamp shall include (a) the visa number, including the preferential groupings the apparels qualify for, a country code, and a numerical serial number identifying the shipment; (b) the date of visa issuance; (c) the authorized signature of an authorized official of the beneficiary countries; and (d) the quantity of goods being shipped.

A visa shall not be accepted and preferential tariff treatment shall not be permitted if the visa number, date of issuance, authorized signature, correct grouping, quantity or the unit of quantity is missing, incorrect or illegible, or has been crossed out or altered in any way.

If the visa is not acceptable, a new visa must be obtained from an authorized official of the eligible country, or a designate, before preferential tariff treatment can be claimed. Waivers are not permitted.

If the visa invoice is deemed invalid, the U.S. Customs Service will not return the original document after entry, but will provide a certified copy of it for use in obtaining a new correct original visaed invoice.

The AGOA also provides for transshipment penalties for exporters.[5] If the president determines, on the basis of sufficient evidence, that an exporter has engaged in unlawful transshipment, he shall deny for a period of five years all AGOA benefits to such exporter or any successor entity. The president delegated the authority to make these determinations to the Committee for the Implementation of Textile Agreements (CITA).

6.2.2. *The Administration of NAFTA Rules of Origin*

Any importer claiming preferential treatment of certain textiles and apparel shall comply with customs procedures and requirements similar to the relevant procedures and requirements under Chapter 5 of NAFTA.[6]

The NAFTA system is based on three pillars: (1) a certificate of origin completed and signed by the exporter of the goods, (2) obligations of the importer when making an origin declaration, and (3) maintenance of records concerning origin and verifications.

The role of the certificate of origin is central to the NAFTA rules of origin as pointed out in the U.S. Customs and Border Protection (CBP) directive no. 3810–014A of 26 July 2005:

[5] Section 113(b) (4) of the Act states that "Trans-shipment has occurred when preferential treatment for a textile or apparel article under this Act has been claimed on the basis of material false information concerning the country of origin, manufacture, processing, or assembly of the article or any of its components."

[6] Chapter 5 of NAFTA is available at http://www.mac.doc.gov/nafta/ch05.htm.

2.1 The Certificate is the fundamental document required to support a claim for NAFTA benefits. The Certificate confers legal rights and obligations. Completion of a Certificate is an affirmation that the signatory has made a careful inquiry into the terms of the NAFTA, has determined that the goods covered by the Certificate originate as defined by the NAFTA, and maintains the relevant records.

2.2 The Certificate must be signed by the exporter, or by the exporter's authorized agent having knowledge of the relevant facts. Producers who are not exporters may choose to prepare a Certificate and provide it to the exporter, but there is no requirement that they do so and in no case will this relieve exporters of their obligation to prepare a Certificate.

2.3 A Certificate is required for each importation on which NAFTA preference is claimed and covers only those goods specified on the Certificate. The Certificate need not accompany each shipment, but must be presented to U.S. Customs and Border Protection (CBP) upon request.

2.4 The Certificate must be in the possession of the importer at the time preferential treatment is claimed. However, Port Directors may, in writing, waive this requirement in accordance with 19 Code of Federal Regulations 181.22(d)(i) if otherwise satisfied that the good qualifies for preferential treatment under the NAFTA.

The rules concerning the issuance of a certificate of origin are contained in Article 501, paragraph 3 of NAFTA:

> Each Party shall provide that:
> (a) an exporter in its territory shall complete and sign a Certificate of Origin for any exportation of a good for which an importer may claim preferential tariff treatment upon importation of the good into the territory of another Party; and
> (b) where an exporter in its territory is not the producer of the good, such exporter may complete and sign a Certificate on the basis of
> (i) its knowledge of whether the good qualifies as an originating good,
> (ii) reasonable reliance upon the producer's written representation that the good qualifies as an originating good, or
> (iii) a completed and signed Certificate for the good voluntarily provided to the exporter by the producer.

Article 502 of NAFTA provides for obligations regarding import procedures related to origin:

> Except as otherwise provided in this Chapter, each Party, with respect to an importer in its territory that claims preferential tariff treatment for a good imported into its territory from the territory of another Party, shall provide that:
> (a) the importer shall make a written declaration, based on a valid Certificate of Origin, that the good qualifies as an originating good;
> (b) the importer shall have the Certificate in its possession at the time such declaration is made;

(c) the importer shall provide, upon the request of that Party's customs administration, a copy of the Certificate;
(d) if the importer fails to comply with any requirement set out in this Chapter, that Party may deny preferential tariff treatment to the good;
(e) the importer, where the importer has reason to believe that a Certificate on which a declaration was based contains information that is not correct, shall promptly make a corrected declaration and pay any duties owing; and
(f) the importer, who voluntarily makes a corrected declaration pursuant to subparagraph (e), shall not be subject to penalties for the making of an incorrect declaration.

Such obligations on the part of the exporter and the importer are reinforced by the requirements of keeping the records for five years as specified in Article 505 of NAFTA:

1. Each Party shall provide that:
   (a) an exporter or a producer in its territory that completes and signs a Certificate of Origin shall maintain in its territory, for a period of five years from the date the Certificate was signed or for such longer period as such Party may specify, all records relating to the origin of a good for which preferential tariff treatment was claimed in the territory of another Party, including records associated with
      (i) the purchase of, cost of, value of, and payment for, the good that is exported from its territory, and
      (ii) the purchase of, cost of, value of, and payment for, all materials, including indirect materials, used in the production of the good that is exported from its territory, and
      (iii) the production of the good in the form in which the good is exported from its territory; and
   (b) an importer claiming preferential tariff treatment for a good imported into the Party's territory shall maintain in that territory, for a period of five years from the date of importation of the good or for such longer period as the Party may specify, a copy of the Certificate and all other required documentation relating to the importation of the good.

Finally, Article 506 of NAFTA set up detailed procedures for origin verifications:

1. For purposes of determining whether a good imported into its territory from the territory of another Party qualifies as an originating good, a Party may, through its customs administration, conduct a verification solely by means of:
   (a) written questionnaires to an exporter or a producer in the territory of another Party;
   (b) visits to the premises of an exporter or a producer in the territory of another Party to review the records and observe the facilities used in the production of the good; or
   (c) such other procedure as the Parties may agree . . . *(omissis)*

The U.S. implemented legislation, reproduced in the following section, which substantially reflects the NAFTA treaty provisions. Under NAFTA, it is clear the declaration made by the importer is based on the NAFTA certificate of origin.

> **§ 181.21 Filing of claim for preferential tariff treatment upon importation**
> In connection with a claim for preferential tariff treatment for a good under the NAFTA, the U.S. importer shall make a written declaration that the good qualifies for such treatment. The written declaration may be made by including on the entry summary, or equivalent documentation, the symbol "CA" for a good of Canada, or the symbol "MX" for a good of Mexico, as a prefix to the subheading of the HTSUS under which each qualifying good is classified.
>
> (*Omissis*) . . . the declaration shall be based on a complete and properly executed original Certificate of Origin, or copy there of, which is in the possession of the importer and which covers the good being imported.
>
> **§ 181.22 Maintenance of records and submission of Certificate by importer**.
> (a) *Maintenance of records*. Each importer claiming preferential tariff treatment for a good imported into the United States shall maintain in the United States, for five years after the date of entry of the good, all documentation relating to the importation of the good. Such documentation shall include a copy of the Certificate of Origin and any other relevant records as specified in § 163.1(a) of this chapter.
> (b) *Submission of Certificate*. An importer who claims preferential tariff treatment on a good under § 181.21 of this part shall provide, at the request of the port director, a copy of each Certificate of Origin pertaining to the good which is in the possession of the importer. A Certificate of Origin submitted to Customs under this paragraph or under § 181.32(b)(3) of this part:
> 1. Shall be on Customs Form 434, including privately-printed copies thereof, or on such other forms as approved by the Canadian or Mexican customs administration, or, as an alternative to Customs Form 434 or such other approved form, in an approved computerized format or such other medium or format as is approved by the Office of Field Operations, U.S. Customs Service, Washington, DC 20229. An alternative format must contain the same information and certification set forth on Customs Form 434; 194057T.

6.2.3. From NAFTA to the U.S.-Chile Agreement

The preceding NAFTA text should be compared with the U.S.-Chile regulations reproduced in this section to measure the differences and the evolution of the administration of rules of origin from a system based on the certificate of origin and verification procedures carried out in the exporting partner to an importer-based system. As shown in the Table 6.1, NAFTA is the only

preferential trade regime providing for the former system. All subsequent FTAs entered by the United States have consistently adopted, as far as the United States is concerned, an importer-based approach and in-country verifications. The importer-based system does not completely eliminate the existence of a certificate of origin as contained in the following provision:

Article 4.12 of the U.S.- Chile agreement: Claims of Origin

1. Each Party shall require that an importer claiming preferential tariff treatment for a good:
   (a) make a written declaration in the importation document that the good qualifies as originating;
   (b) be prepared to submit, on the request of the importing Party's customs authority, a certificate of origin or information demonstrating that the good qualifies as originating;
   (c) promptly make a corrected declaration and pay any duties owing where the importer has reason to believe that the certificate or other information on which the declaration was based is incorrect.

In addition, Article 4.13 of the U.S.-Chile FTA expressly provides for rules for issuance of certificate of origin by the importer or the exporter. However, the truth is contained in the provision reproduced in the following section, making clear that the final responsibility of an origin declaration resides with the importer who cannot rely on a certificate of origin issued by the exporter. It follows that the value of the certificate of origin issued by the exporter has a limited value and is far from being the centerpiece of origin administration as in NAFTA.

Article 4.14: Obligations Relating to Importations

1. Each Party shall provide that the importer is responsible for submitting a certificate of origin or other information demonstrating that the good qualifies as originating, for the truthfulness of the information and data contained therein, for submitting any supporting documents requested by the Party's customs authority, and for the truthfulness of the information contained in those documents.
2. Each Party shall provide that the fact that the importer has issued a certificate of origin based on information provided by the exporter or the producer shall not relieve the importer of the responsibility referred to in paragraph 1.

Finally, an importer-based system does not eliminate the need for verifications. However, such verifications are conducted in-country. The U.S.-Chile agreement does not provide in fact for visits of customs authorities of one party to the other party. Verifications are carried out in-country and on the declarations made by the importers.

The U.S. implemented legislation does not even mention the words certificate of origin and makes clear that a certification made by the exporter or producer will not relieve the importer of his/her own responsibilities.

U.S. CHILE

§ 10.412 Importer obligations.

(a) *General*. An importer who makes a declaration under § 10.410(a) is responsible for the truthfulness of the declaration and of all the information and data contained in the certification, for submitting any supporting documents requested by CBP, and for the truthfulness of the information contained in those documents.

(b) *Compliance*. In order to make a claim for preferential treatment under § 10.410 of this subpart, the importer:

  (1) Must have records that explain how the importer came to the conclusion that the good qualifies for preferential treatment. Those records must include documents that support a claim that the article in question qualifies for preferential treatment because it meets the applicable rules of origin set forth in General Note 26, HTSUS, and in this subpart. Those records may include a properly completed certification as set forth in § 10.411 of this subpart; and

  (2) May be required to demonstrate that the conditions set forth in § 10.463 of this subpart were met if the imported article was shipped through an intermediate country.

(c) *Information provided by exporter or producer*. The fact that the importer has issued a certification based on information provided by the exporter or producer will not relieve the importer of the responsibility referred to in paragraph (a) of this section. A U.S. importer who voluntarily makes a corrected declaration will not be subject to penalties for having made an incorrect declaration (*see* § 10.481 of this subpart).

(d) *Internal controls*. In accordance with Part 163 of this chapter, importers are expected to establish and implement internal controls which provide for the periodic review of the accuracy of the certifications or other records referred to in paragraph (b)(1) of this section.

§ 10.413 Validity of certification.

A certification that is completed, signed and dated in accordance with the requirements listed in § 10.411 will be accepted by CBP as valid for four years from the date on which the certification was signed. If the port director determines that a certification is illegible or defective or has not been completed in accordance with § 10.411, the importer will be given a period of not less than five business days to submit a corrected certification.

The extent of the obligations of the importer with respect to the NAFTA could also be measured by comparing the requirements under NAFTA Section 181.22 and the corresponding section concerning the U.S.-Chile reproduced below. The latter provisions expressly require keeping a number of specific records and documents that are not requested in NAFTA.

§ 10.415 **Maintenance of records**.
(a) *General*. An importer claiming preferential treatment for a good imported into the United States must maintain in the United States, for five years after the date of importation of the good, a certification (or a copy thereof) that the good qualifies as originating, and any records and documents that the importer has relating to the origin of the good, including records and documents associated with: (1) The purchase of, cost of, value of, and payment for, the good; (2) Where appropriate, the purchase of, cost of, value of, and payment for, all materials, including recovered goods and indirect materials, used in the production of the good; and, (3) Where appropriate, the production of the good in the form in which the good was exported.
(b) *Method of maintenance*. The records referred to in paragraph (a) of this section must be maintained by importers as provided in § 163.5 of this chapter.

The CBP guidelines[7] made clear that the U.S.-Chile Free-Trade Agreement (U.S.-CFTA) places the burden of substantiating the validity of the claim for preferential tariff treatment on the importer. An importer may make a claim based on knowledge or information in his/her possession that the good qualifies as an originating good. CBP may verify the validity of the claim and will direct inquiries for verification by means of CBP Form 28, Request for Information, to the importer.

Furthermore, when requested by CBP, the importer shall provide additional documentation beyond the certification such as additional cost and manufacturing information. Such information may include information concerning the regional value content (RVC) calculation used in the claim for preference such as the build-up or build-down methods as outlined in General Note 26, HTS. This includes, but is not limited to, records concerning the purchase of, cost of, value of, and payment for the good and the purchase of, cost of, value of, and payment for all materials used in the production of the good, and the production of the good in its exported form.

§ 10.416 **Effect of noncompliance; failure to provide documentation regarding transshipment**.
(a) *Effect of noncompliance*. If the importer fails to comply with any requirement under this subpart, including submission of a certification of origin under § 10.411(a) or submission of a corrected certification under § 10.413, the port director may deny preferential tariff treatment to the imported good. (b) *Failure to provide documentation regarding transshipment*. Where the requirements for preferential tariff treatment set forth elsewhere in this subpart are met, the port director nevertheless may deny preferential tariff treatment to an

[7] Such guidelines are available at http://www.cbp.gov/linkhandler/cgov/trade/trade_programs/international_agreements/free_trade/us_cfta/chile_trade_agreement.ctt/chile_trade_agreement.doc.

> originating good if the good is shipped through or transshipped in a country other than Chile or the United States, and the importer of the good does not provide, at the request of the port director, copies of documents demonstrating to the satisfaction of the port director that the requirements set forth in § 10.46 were met.

Most recently, the CPB guidelines[8] made clear a number of provisions contained in the U.S.-CFTA:

> U.S.-CFTA provides that "...an importer may satisfy a request under Article 4.12(1)(b) by providing a certificate of origin that sets forth a valid basis for a claim that a good is originating. Each Party shall provide that a certificate of origin need not be in a prescribed format, and that the certificate may be submitted electronically."
>
> All references to a "certificate of origin" in this document, do not refer to an "official form" issued by CBP, such as the CF434 under the NAFTA. A certificate of origin may take many forms, such as a statement on company letterhead, a statement on a commercial invoice or supporting documentation which demonstrates that the imported good qualifies for preferential treatment. Any format utilized must contain the data elements outlined in Attachment A.
>
> At the request of CBP the importer shall submit a certificate of origin or supporting documentation to demonstrate that the imported goods qualify for preferential tariff treatment. The certification is not required to be on file at the time the claim is made. However, the importer is responsible for retaining supporting documentation, which may be requested by CBP, as to the good's eligibility for preferential treatment at the time the claim was made. The certificate of origin shall be submitted in English or Spanish. If submitted in Spanish, CBP may request an English translation.
>
> An importer may submit a certificate of origin completed or generated by an exporter or producer or may issue the certificate of origin based on information submitted by the exporter or producer that the good qualifies as originating; however, the importer must exercise reasonable care when certifying to the accuracy and truthfulness of the information submitted to CBP. The fact that the importer has issued a certificate of origin based on information provided by the exporter or producer or submits a certificate of origin executed by the exporter or producer shall not relieve the importer of the responsibility to exercise reasonable care.

6.3. The EC Experience in Administering Rules of Origin

The progressive adoption of the Pan-European rules of origin has meant a consistent effort to harmonize rules of origin and related procedures; however,

[8] Available at http://www.cbp.gov/linkhandler/cgov/trade/trade_programs/international_agreements/free_trade/us_cfta/chile_trade_agreement.ctt/chile_trade_agreement.doc.

a number of variations remain. The differences concerning certification of origin and methods of administrative cooperation mainly relate to

- the appropriate form to be used as proof of origin (certificate of origin Form A, only for GSP purposes; movement certificate EUR.I,EUR-MED for other preferential agreements);
- the issuance of the certificate of origin for cumulation purposes (EUR.I form, EUR-MED Form, GSP form, invoice declarations, suppliers declaration);
- the simplified procedure for the issuance of certificates of origin.

All reciprocal preferential agreements utilize the EUR.I or EUR-MED form as the certificate of origin. The issuance of this certificate and the ancillary rules are almost identical for all agreements, with the exception of some differences explained in the following section. In the context of the GSP, the form to be used is the certificate of origin Form A, because its format was multilaterally agreed within UNCTAD at the time of the GSP's inception. In some cases, the procedure for the issuance of the certificate of origin Form A is similar to that for the issuance of form EUR.I. The main differences concern

- the issuing authority for form EUR.I or EUR-MED (always a customs office);
- the issuing authority for the certificate of origin Form A (the customs authorities or other governmental authorities designated by the beneficiary countries);
- number of boxes to be completed;
- duration of the certificate's validity after its issuance;
- a number of ancillary provisions related to simplified provisions

The certificate of origin Form A should be used only in the context of GSP preferences. However, the overlapping of trade preferences may induce some exporters in countries, which were beneficiaries of preferential trade arrangements such as the CPA and EPAs at present, and some of the Mediterranean Agreements, to use Form A instead of Form EUR.I. In these cases an exporter using Form A instead of form EUR.I may lose some benefits. In fact, on presentation of GSP Form A, the EC customs authorities will be obliged to apply GSP rules of origin, product coverage, and tariff rates, even if products, originating in ACP or Mediterranean countries, would have been entitled to better terms of trade if Form EUR.I had been presented.

This occurrence is mainly the result of these countries still being on the list of GSP beneficiaries, even though they are often granted better trade concessions under the bilateral agreements. There were, however, exceptional cases for which presentation of GSP Form A may be justified. These cases were limited to the existence of tariff quotas within the bilateral agreements. Once the tariff quotas have been reached and the most-favored-nation (MFN) duty has been reintroduced, the exporter may still benefit from a GSP tariff reduction if the product is covered by the scheme. How and if this could still be valid today may be object of further study.

At the time of introduction of the Everything But Arms (EBA) initiative, many exporters in LDCs were and still are using Form EUR.I instead of Form A, as required to benefit from the EBA initiative. This is mainly because these exporters from ACP LDCs have been using Form EUR.I for exports to the EC during the past decades under the requirement of the CPA and previous Lomé Conventions. However, the introduction of the EBA initiative in 2001 provided for some products better preferences than those granted under the Cotonou regime. Moreover, at the time of this writing, the Cotonou regime lapsed, and unless the LDCs have entered an EPA they must switch to GSP Form A.

Otherwise they may stand to lose the market access provided by the EBA initiative. However, in the case in which they have signed interim EPAs and if cumulation has been used within the region, it may be useful to present Form EUR.I because cumulation is of a limited nature and scope under the GSP rules of origin of the EBA initiative.

The Pan-Euro-Mediterranean cumulation introduced in 2006 is the last evolution of the Pan-European rules of origin model. This cumulation introduced, along with the traditional EUR.I certificate, the EUR-MED certificate and a rather complex system of administration that will be analyzed in the following section.

The reason for such a complex administration is the differences in the agreements between the EC, its EEA partners, and Switzerland on the one hand and, on the other hand, the agreements between these countries and Mediterranean partners.

There are still differences in the cumulation that is full in the EEA and with Switzerland and Turkey and diagonal between these countries and the Mediterranean countries with the exception of the full cumulation between the EC and Tunisia, Morocco, and Algeria.

There are also differences on the issues of drawback among the different agreements that further demand some differentiation, including those listed in the following section.

Prohibition of drawback is always applicable in trade, whether bilateral or diagonal, between the EC, Turkey, Switzerland, Norway, Iceland, and the Faeroe Islands and in the agreement between the EC and Israel.

However, drawback is still possible in purely bilateral trade between the EC and Morocco, Algeria, Tunisia, Egypt, West Bank and Gaza Strip, Jordan, Lebanon, and Syria.

The following example[9] may further clarify this difference:

Example of the possibility of drawback in bilateral trade:

Aluminum originating from the United Arab Emirates is imported into Egypt where aluminum screws (HS 7616) are manufactured. The final product originating in Egypt is exported to the Community.

Since Egyptian originating status is obtained on the basis of sufficient working and processing and not on the basis of cumulation with materials originating in one of the countries referred to in Articles 3 and 4, Egyptian customs authorities can grant drawback for non-originating materials used in the manufacture of the originating products when it is exported to the Community.

However, the screws cannot be used in the Community for the purpose of pan-Euro-Mediterranean cumulation. In this example the screws originating in Egypt can only be exported to the Community with a movement certificate EUR.1 or an invoice declaration.

Morocco, Algeria, Tunisia, Egypt, the West Bank and Gaza Strip, Jordan, Lebanon, and Syria can apply partial drawback. The application of partial drawback does not exclude goods from diagonal cumulation.

EUR.I and EUR-MED Forms are issued by the customs authorities of the exporting country following a written application. This application should be made on a form titled "Application for the issuance of movement certificate form EUR.I, EUR-MED." The EUR.I and now EUR-MED is a common feature to all preferential agreements of the EC.

EUR.I and EUR-MED Forms must be printed in one or more of the EC official languages. Each certificate must measure 210 × 297 mm. A tolerance of up to plus 8 mm or minus 5 mm in length may be allowed. The paper must be white, sized for writing, not containing mechanical pulp, and weighing not less than 60 g/m^2. It must have a printed green guilloche pattern background, making any falsification by mechanical or chemical means apparent to the eye. Non-EC countries may print their own certificates or have them printed by approved printers. In the latter case, each certificate must include a reference to such approval. Each certificate must bear the name and address of the printer

[9] These examples are excerpted from, *Explanatory notes concerning the Pan-Euro-Mediterranean protocols on rules of origin*, Official Journal of the European Union C 16/8 of 21.1.2006.

or a mark by which the printer can be identified. It must also bear a serial number, printed or not, by which it can be identified.

6.3.1. *Procedure for the Issuance of Certificates of Origin EUR.I and EUR-MED*[10]

The Pan-European rules of origin started to be implemented in the Europe agreements with Eastern European countries that at that time were not member of the EC.

The enlargement of the EC and the parallel evolution of the Barcelona process meant that, from 1998 to date, Euro-Mediterranean association agreements with Algeria, Tunisia, Morocco, Israel, Jordan, Lebanon, the Palestinian Authority, Syria, and Egypt have entered into force.

A system of cumulation of origin between all Mediterranean countries, the EC, the EFTA countries (Iceland, Liechtenstein, Norway, and Switzerland), the Faeroe Islands, Andorra, San Marino, and Turkey has been created (Pan-Euro-Mediterranean cumulation).

The Pan-Euro-Mediterranean protocol on rules of origin was developed in a working group with all partner countries concerned. This protocol was endorsed by the Euro-Med Trade Ministerial meeting in Palermo on 7 July 2003.

Pan-Euro-Mediterranean cumulation does not contain substantially different innovation or change of directions from the traditional EC rules of origin policy or administration.

It introduced, however, some new features or concepts that entailed some changes in the rules especially related to the Pan-Euro-Mediterranean cumulation. In particular a new form, EC-MED, has been created and ancillary administrative rules have been established to discipline what is now defined as variable geometry and the differences in cumulation. According to this concept, cumulation can be applied among three countries of the zone as soon as FTAs containing identical rules of origin between the countries concerned are in place. The system can thus be applied between a limited group of countries, without the full network of FTAs having been completed (so-called "variable geometry").

Article 17 of the EC/Switzerland Agreement provides the following for the procedure for the issuance of certificate of origin EUR.I and EUR-MED respectively:

[10] The examples and some of the material in this section are drawn from "A *User's Handbook to the Rules of Preferential Origin used in trade between the European Community, other European Countries, and the countries participating to the Euro-Mediterranean Partnership*."

1. *A movement certificate EUR.1 or EUR-MED shall be issued by the customs authorities of the exporting country on application having been made in writing by the exporter or, under the exporter's responsibility, by his authorised representative.*
2. *For this purpose, the exporter or his authorised representative shall fill out both the movement certificate EUR.1 or EUR-MED and the application form, specimens of which appear in the Annexes III a and b. These forms shall be completed in one of the languages in which this Agreement is drawn up and in accordance with the provisions of the domestic law of the exporting country. If they are handwritten, they shall be completed in ink in printed characters. The description of the products must be given in the box reserved for this purpose without leaving any blank lines. Where the box is not completely filled, a horizontal line must be drawn below the last line of the description, the empty space being crossed through.*
3. *The exporter applying for the issue of a movement certificate EUR.1 or EUR-MED shall be prepared to submit at any time, at the request of the customs authorities of the exporting country where the movement certificate EUR.1 or EUR-MED is issued, all appropriate documents proving the originating status of the products concerned as well as the fulfilment of the other requirements of this Protocol.*

***Issuance of certificate** EUR.1 **(emphasis added) paragraph 4 of article 17 of** EU/**Swiss agreement**.*

4. *Without prejudice to paragraph 5, a movement certificate EUR.1 shall be issued by the customs authorities of a Member State of the Community or of Switzerland in the following cases:*
   - *if the products concerned can be considered as products originating in the Community, in Switzerland or in one of the other countries referred to in Articles 3(1)* (EU; EEA and Turkey) *and 4(1)* (EU; EEA and Turkey) *with which cumulation is applicable, without application of cumulation with materials originating in one of the countries referred to in Articles 3(2)* (Med Countries) *and 4(2)* (Med Countries)*, and fulfil the other requirements of this Protocol;*
   - *if the products concerned can be considered as products originating in one of the countries referred to in Articles 3(2)* (Med Countries) *and 4(2)* (Med Countries) *with which cumulation is applicable, without application of cumulation with materials originating in one of the countries referred to in Articles 3 and 4 and fulfil the other requirements of this Protocol, provided a certificate EUR-MED or an invoice declaration EUR-MED has been issued in the country of origin.*

Because different cumulation systems and drawback provisions apply within the Pan-European-Mediterranean cumulation, different conditions have been established for the issuance of EUR.I and EUR-MED certificates. Because the cumulation of working or processing falls outside the context of the Pan-Euro-Mediterranean cumulation of origin, products obtaining origin on the basis of the full cumulation are excluded from the Pan-Euro-Med trade.

The *User's Handbook to the Rules of Preferential Origin* used in trade between the EC, other European countries, and the countries participating to the Euro-Mediterranean Partnership[11] (hereinafter referred to as "the handbook") recommend the practice described in the following section.[12]

6.3.2. *Optional Use of Form EUR and EUR-MED and Mandatory Use of Form EUR.I or EUR-MED*

As mentioned earlier, the certification of origin is rather complex but it constitutes one of the most important elements of the Pan-Euro-Mediterranean system of cumulation. The adoption of this complex system has been necessary to administer differences in the variable geometry, full cumulation, and the prohibition of drawback.

In some cases the exporter has the option to request the issuance of the movement certificate EUR.I or EUR-MED. A movement certificate EUR.I or EUR-MED can be issued when the products concerned are either originating in the exporting country or in any of the other countries of the EUR-MED zone on the condition that cumulation with the Faeroe Islands or any of the Mediterranean countries other than Turkey has not been applied.

In particular movement certificate EUR.I can be issued when the conditions for the Pan-Euro-Med trade are met, that is:

- the product originates from any of the countries of the zone;
- "no-drawback" rule is respected;
- full cumulation is not applied.

However, movement certificate EUR.I must be issued when the conditions for the diagonal, Pan-Euro-Med trade are not fulfilled, such as,

- the product originates from any of the countries of the zone, and
- full cumulation is applied, or
- drawback is granted.

When the EUR.I movement certificate has been issued, products concerned must stay on market of the importing country and cannot be reexported under

[11] See, *supra* note 8.

[12] Specimen of the forms EUR.I, EUR-MED, and other forms mentioned in this section, can be found in any Euro-Mediterranean Agreement, see for instance, Protocol on Rules of Origin to the Euro-Mediterranean Agreement of Egypt and EC, OJ 304, 30 September 2004 and *Explanatory notes concerning the Pan-Euro-Mediterranean protocols on rules of origin*, Official Journal of the European Union C 16/8 of 21.1.2006.

preferences to other countries of the zone (bilateral EC – Mediterranean Partner Countries trade).

1. *Example of the use of Eur.I movement certificate when cumulation applied but no cumulation with the Mediterranean partner*:
   Sugar (HS 1701) originating in the EC is imported into Switzerland where it is processed into sweets (HS 1704). The value of the EC originating sugar exceeds 30 percent of the ex-works price.
   The Swiss originating product is exported to Turkey.
   Since the originating status is obtained in Switzerland on the basis of cumulation without application of cumulation with a Mediterranean partner and because the three countries are linked by free trade agreements, the Swiss customs authorities may issue a EUR.I certificate for the exportation to Turkey.
   However, in this example a movement certificate EUR-MED can be issued by the Swiss administration also if the sweets could be used in Turkey in the context of cumulation with any of the other countries referred to in Articles 3 and 4, for example if the sweets are to be reexported from Turkey to Tunisia. Therefore if the Swiss exporter duly applied to his customs administration for a EUR-MED certificate, his application should be accepted and a movement certificate EUR-MED issued. The movement certificate EUR-MED in box 7 shall contain the statement 'Cumulation applied with the EC.'
2. *Example of the use of EUR.I movement certificate when no cumulation applied*:
   Embroidered curtains (HS 6303) are manufactured in Lebanon from nonoriginating single yarn. The final product is exported to the Community.
   Because the originating status is obtained in Lebanon on the basis of sufficient working and processing and cumulation was not applied with any of the Pan-Euro-Mediterranean countries, the Lebanese customs authorities may issue a movement certificate EUR.I for the exportation to the Community.
   However, the use of a movement certificate EUR-MED in this example is also possible provided the prohibition of drawback in Lebanon was respected. This would allow the reexportation of the curtains to any of the other countries referred to in Articles 3 and 4.
   Therefore, likewise in the first example, if the Lebanese exporter duly applied to his Customs administration for a EUR-MED certificate, his application should be accepted and a movement certificate EUR-MED issued. The movement certificate EUR-MED in box 7 shall contain the statement 'No cumulation applied.'

Movement certificate EUR.I must be issued when conditions for diagonal, Pan-Euro-Mediterranean cumulation of origin are not satisfied. This happens when the prohibition of drawback is not respected in bilateral trade between any of the two countries of the Euro-Mediterranean zone or when cumulation of working or processing with Morocco, Tunisia, or Algeria took place.

There are differences in cumulation and drawback from the EC, EEA, Switzerland, and Turkey and the Pan-Euro-Mediterranean cumulations. It follows that a movement certificate EUR-MED can be issued when the conditions for the diagonal, Pan-Euro-Med cumulation are fulfilled, namely:

- the product originates from any of the countries of the zone;
- "no-drawback" rule is respected;
- full cumulation is not applied.

However, the movement certificate EUR-MED must be issued when the preceding conditions for the diagonal, Pan-Euro-Med cumulation have been fulfilled and if cumulation with any of the Mediterranean countries has been applied. This is because the network of the FTAs with the Mediterranean partners is not complete, so it is necessary to trace back the countries participating in the acquisition of the originating status of the basis of cumulation.

When the EUR-MED movement certificate has been issued, products concerned can be reexported under preferences from the importing country to any other country of the zone with which the Pan-Euro-Med cumulation is applicable (diagonal Pan-Euro-Med trade).

When the movement certificate EUR-MED is issued, box 7 has to be filled. In cases in which the product obtained its originating status on the basis of cumulation, the names of the countries from that materials originated have to be listed. In cases in which the originating product is wholly obtained or when nonoriginating materials used in the manufacturing were sufficiently processed, the box "Cumulation not applied" has to be ticked.

***Mandatory use of the movement certificate** EUR-MED*[13]
A movement certificate EUR-MED must be issued when the products concerned are originating either in the exporting country or in any of the other countries referred to in articles 3 and 4 and cumulation with Faroe Islands or any of the Mediterranean countries other than Turkey has been applied.

EXAMPLES

1. *Example of cumulation with materials originating in one of the Mediterranean countries.*
   Fabrics originating in Egypt (HS 5112) are imported into Norway where man's trousers (HS 6103) are manufactured. The originating status is obtained in Norway based on cumulation applied with Egyptianmaterials and therefore when the final product is exported to the Community, Norwegian customs administration must issue a movement certificate EUR-MED containing the statement 'Cumulation applied with Egypt.'

[13] These examples are excerpted from *Explanatory notes concerning the Pan-Euro-Mediterranean protocols on rules of origin*, Official Journal of the European Union C 16/8 of 21.1.2006.

2. *Example of cumulation applied in one of the Mediterranean countries.* Norwegian wooden boards cut to size (HS 4407) are imported into Morocco where the wooden boxes are manufactured (HS 4415). The Moroccan originating status is obtained on the basis of cumulation in a country that is a signatory country of Barcelona Declaration and therefore when the final product is exported to the Community, Moroccan customs administration must issue a movement certificate EURMED containing the statement 'Cumulation applied with Norway.'

6.3.3. *Simplified Procedures for the Issuance of Certificates of Origin: Approved Exporters*

The new Protocol to the Swiss Agreement adopted under the Pan-European rules of origin contains provision for a simplified procedure to prove origin (Article 22):

1. *An invoice declaration or an invoice declaration EUR-MED as referred to in Article 16(1)(c) may be made out:*
   (a) *by an approved exporter within the meaning of Article 23, or*
   (b) *by any exporter for any consignment consisting of one or more packages containing originating products whose total value does not exceed EUR 6,000.*
2. *Without prejudice to paragraph 3, an invoice declaration may be made out in the following cases:*
   - *if the products concerned can be considered as products originating in the Community, in Switzerland or in one of the other countries referred to in Articles 3(1) and 4(1) with that cumulation is applicable, without application of cumulation with materials originating in one of the countries referred to in Articles 3(2) and 4(2), and fulfil the other requirements of this Protocol;*
   - *if the products concerned can be considered as products originating in one of the countries referred to in Articles 3(2) and 4(2) with that cumulation is applicable, without application of cumulation with materials originating in one of the countries referred to in Articles 3 and 4 and fulfil the other requirements of this Protocol, provided a certificate EUR-MED or an invoice declaration EUR-MED has been issued in the country of origin.*
3. *An invoice declaration EUR-MED may be made out if the products concerned can be considered as products originating in the Community, in Switzerland or in one of the other countries referred to in Articles 3 and 4 with which cumulation is applicable, fulfil the requirements of this Protocol and:*
   - *cumulation was applied with materials originating in one of the countries referred to in Articles 3(2) and 4(2), or*
   - *the products may be used as materials in the context of cumulation for the manufacture of products for export to one of the countries referred to in Articles 3(2) and 4(2), or*
   - *the products may be re-exported from the country of destination to one of the other countries referred to in Articles 3(2) and 4(2).*

4. *An invoice declaration EUR-MED shall contain one of the following statements in English*:
   - *if origin has been obtained by application of cumulation with materials originating in one or more of the countries referred to in Articles 3 and 4*: 83
     'CUMULATION APPLIED WITH . . . . . ' (name of the country/countries)
   - *if origin has been obtained without the application of cumulation with materials originating in one or more of the countries referred to in Articles 3 and 4*: *'NO CUMULATION APPLIED.'*
5. *The exporter making out an invoice declaration or an invoice declaration EUR-MED shall be prepared to submit at any time, at the request of the customs authorities of the exporting country, all appropriate documents proving the originating status of the products concerned as well as the fulfilment of the other requirements of this Protocol.*
6. *An invoice declaration or an invoice declaration EUR-MED shall be made out by the exporter by typing, stamping or printing on the invoice, the delivery note or another commercial document, the declaration, the texts of that appear in Annexes IV a and b, using one of the linguistic versions set out in that Annex and in accordance with the provisions of the domestic law of the exporting country. If the declaration is handwritten, it shall be written in ink in printed characters.*
7. *Invoice declarations and invoice declarations EUR-MED shall bear the original signature of the exporter in manuscript. However, an approved exporter within the meaning of Article 23 shall not be required to sign such declarations provided that he gives the customs authorities of the exporting country a written undertaking that he accepts full responsibility for any invoice declaration that identifies him as if it had been signed in manuscript by him.*
8. *An invoice declaration or an invoice declaration EUR-MED may be made out by the exporter when the products to which it relates are exported, or after exportation on condition that it is presented in the importing country no longer than two years after the importation of the products to which it relates.*

The Handbook recommends the following procedures when one is completing an invoice declaration or an invoice declaration EUR-MED:

(a) The wording of the declaration must conform to the wording set out in the annexes to the to the Protocol;
(b) For consignments comprising goods originating in more than one country of the Pan-Euro-Mediterranean cumulation zone, the names or official abbreviations of the countries concerned, or a reference to a specific indication in the invoice must be entered in the wording of the invoice declaration or the invoice declarations EUR-MED. (See the answer to Question 3 in the explanation to Article 17 and the Explanatory Note to the same Article for a list of the abbreviations);
(c) The name or official abbreviation for every country concerned should be entered on the invoice for each item listed;

(d) Declarations may be made on photocopies of invoices provided they bear the signature of the exporter, just as required on the original invoices. Approved exporters who are authorized not to sign original invoice declarations or invoice declarations EUR-MED need not sign such declarations made on photocopied invoices;
(e) An invoice declaration or an invoice declaration EUR-MED may be made out on the reverse side of an invoice;
(f) An invoice declaration or an invoice declaration EUR-MED may be made on a separate sheet of the invoice provided that the sheet is obviously part of the invoice;
(g) If an importer makes out the invoice declaration or the invoice declaration EUR-MED on a label that is subsequently attached to the invoice there should be no doubt that the label has been affixed by the exporter and his stamp or signature should cover both the label and the invoice;
(h) An invoice declaration or an invoice declaration EUR-MED given on a delivery note or other commercial document must identify the exporter.
(i) In case of an invoice declaration EUR-MED the necessary statement: 'Cumulation applied with. . . . (name of the country/countries)' or 'No cumulation applied' has to be made.

Approved Exporter

Article 23 of the EC/ Swiss agreement provides for the following:

"1. *The customs authorities of the exporting country may authorise any exporter, hereinafter referred to as 'approved exporter', who makes frequent shipments of products under this Agreement to make out invoice declarations or invoice declarations EUR-MED irrespective of the value of the products concerned. An exporter seeking such authorisation must offer to the satisfaction of the customs authorities all guarantees necessary to verify the originating status of the products as well as the fulfilment of the other requirements of this Protocol.*
2. *The customs authorities may grant the status of approved exporter subject to any conditions that they consider appropriate.*
3. *The customs authorities shall grant to the approved exporter a customs authorisation number which shall appear on the invoice declaration or on the invoice declaration EUR-MED.*
4. *The customs authorities shall monitor the use of the authorisation by the approved exporter.*
5. *The customs authorities may withdraw the authorisation at any time. They shall do so where the approved exporter no longer offers the guarantees referred to in paragraph 1, no longer fulfils the conditions referred to in paragraph 2 or otherwise makes an incorrect use of the authorisation.*

Under this procedure Form EUR.I or EUR-MED is replaced with an invoice declaration arrangement, issued by an "approved exporter."

Article 25 of the Explanatory notes concerning the Pan-Euro-Mediterranean protocols on rules of origin[14] provides for the following:

> The term 'exporter' may refer to persons or undertakings exporting from the territory of one of the contracting parties, regardless of whether they are producers or traders, as long as they comply with all the other provisions of this Protocol. Customs clearance agents may not be granted approved exporter status within the meaning of this Protocol. When examining this, the customs authorities should consider the following points:
> - whether the exporter exports regularly: here, rather than focusing on a given number of consignments or a particular sum, the customs authorities should look into how regularly the operator carries out such operations;
> - whether the exporter is at all times in a position to supply evidence of origin for the goods to be exported. In this connection it is necessary to consider whether the exporter knows the current rules of origin and is in possession of all the documents proving origin. In the case of producers, the authorities must make sure that the undertaking's stock accounts allow identification of the origin of goods and, in the case of new undertakings, that the system they have installed will permit such identification. For operators who are traders only, examination should focus more specifically on their usual trade flows;
> - whether, in the light of his past exporting record, the exporter offers sufficient guarantees concerning the originating status of the goods and the ability to meet all resulting obligations.
>
> Once an authorisation has been issued, exporters must:
> - undertake to issue invoice declarations or invoice declarations EUR-MED only for goods for that they hold all the necessary proof or accounting elements at the time of issue;
> - assume full responsibility for the way the authorisation is used, particularly for incorrect origin statements or other misuse of the authorisation;
> - assume responsibility for ensuring the person in the undertaking responsible for completing invoice declarations or invoice declarations EUR-MED knows and understands the rules of origin;
> - undertake to keep all documentary proofs of origin for a period of at least three years from the date that the declaration or invoice declaration was made;
> - undertake to produce proof of origin to the customs authorities at any time, and allow inspections by those authorities at any time.
>
> The customs authorities must carry out regular controls on authorised exporters. These controls must ensure the continued compliance of the use of the authorisation and may be carried out at intervals determined, if possible, on the basis of risk analysis criteria.
>
> The customs authorities must notify the Commission of the European Communities of the national numbering system used for designating authorised exporters. The Commission of the European Communities will then pass on the information to the customs authorities of the other countries.

[14] See, Official Journal of the European Union C 16/8 of 21.1.2006.

An approved exporter must have satisfied the customs authorities of his suitability before being granted that status. However, to retain approved exporter status, the trader must undertake to fulfill the following conditions and obligations.

6.3.4. Supplier Declarations

The system of supplier declarations does not feature in the EC-Switzerland Agreement but it remains in Article 27(a) of the EC-Morocco Agreement:

Article 27a[15]

Supplier's declaration

1. When a movement certificate EUR.1 is issued, or an invoice declaration is made out, in the Community or Morocco for originating products, in the manufacture of which goods coming from Algeria, Morocco, Tunisia or the Community which have undergone working or processing in these countries without having obtained preferential originating status, have been used, account shall be taken of the supplier's declaration given for these goods in accordance with this Article.
2. The supplier's declaration referred to in paragraph 1 shall serve as evidence of the working or processing undergone in Algeria, Morocco, Tunisia or the Community by the goods concerned for the purpose of determining whether the products in the manufacture of which these goods are used, may be considered as products originating in the Community or Morocco and fulfil the other requirements of this Protocol.
3. A separate supplier's declaration shall, except in cases provided in paragraph 4, be made out by the supplier for each consignment of goods in the form prescribed in Annex V on a sheet of paper annexed to the invoice, the delivery note or any other commercial document describing the goods concerned in sufficient detail to enable them to be identified.
4. Where a supplier regularly supplies a particular customer with goods for which the working or processing undergone in Algeria, Morocco, Tunisia or the Community is expected to remain constant for considerable periods of time, he may provide a single supplier's declaration to cover subsequent consignments of those goods, hereinafter referred to as a 'longterm supplier's declaration'.

   A long-term supplier's declaration may normally be valid for a period of up to one year from the date of making out the declaration. The customs authorities of the country where the declaration is made out lay down the conditions under which longer periods may be used.

   The long-term supplier's declaration shall be made out by the supplier in the form prescribed in Annex VI and shall describe the goods concerned in sufficient detail to enable them to be identified. It shall be provided to the customer concerned before he is supplied with the first consignment of goods covered by this declaration or together with his first consignment.

[15] See, Official Journal of the European Union L 336/15 of 21.12.2005.

The supplier shall inform his customer immediately if the longterm supplier's declaration is no longer applicable to the goods supplied.

5. The supplier's declaration referred to in paragraphs 3 and 4 shall be typed or printed using one of the languages in which the Agreement is drawn up, in accordance with the provisions of the national law of the country where it is made out, and shall bear the original signature of the supplier in manuscript.

   The declaration may also be handwritten; in such a case, it shall be written in ink in printed characters.

6. The supplier making out a declaration must be prepared to submit at any time, at the request of the customs authorities of the country where the declaration is made out, all appropriate documents proving that the information given on this declaration is correct.

To facilitate the administration of certificate of origin Form EUR.I or making out an invoice declaration, a system of supplier declarations and forms to check supplier's declaration was established by Council Regulation 1207/2001[16] under the Pan-European rules of origin. This system has been maintained in the EC-Morocco Agreement.

The main purpose of the supplier declaration is to facilitate the issuance of certificate of origin or for making out invoice declaration. The supplier shall make a declaration according to the format contained in Annexes V and VI. This declaration must be made on the commercial invoice relating to a specific consignment or any other commercial document that describes the goods concerned in sufficient details to enable them to be identified.

Under certain conditions, a long-term supplier declaration may be made for a period not exceeding one year. Supplier declarations should bear the signature of the supplier in script. However, although the invoice is drawn up by a computer, the declaration may not be signed in script if the supplier gave a written undertaking that he will accept responsibility of the supplier declarations that identifies him as if it had been signed in script by him.

6.3.5. *Documentary Evidence for the Issuance of Certificates of Origin*

Documentary evidence is required for the issuance of certificate of origin as pointed out in paragraph 3 of Article 17 of the EC-Switzerland Agreement. The meaning of the expression "appropriate documents" in that paragraph is clarified in the Protocol on Rules of Origin of the EC-Switzerland Agreement

[16] Council Regulation (EC) No. 1207/2001 on procedures to facilitate the issue of movement certificates EUR.I, the making-out of invoice declarations and forms EUR.2 and the issue of certain approved exporter authorizations under the provisions governing preferential trade between the European Community and certain countries and repealing Regulation (EEC) no. 3351/83, OJ. L165 (2002).

by Article 27, which states that the appropriate documents to prove origin "may consist *inter alia* of the following":

> *The documents referred to in Articles 17(3) and 22(5) used for the purpose of proving that products covered by a movement certificate EUR.1 or EUR-MED or an invoice declaration or invoice declaration EUR-MED can be considered as products originating in the Community, in Switzerland or in one of the other countries referred to in Articles 3 and 4 and fulfil the other requirements of this Protocol may consist inter alia of the following:*
>
> *(a) direct evidence of the processes carried out by the exporter or supplier to obtain the goods concerned, contained for example in his accounts or internal bookkeeping;*
>
> *(b) documents proving the originating status of materials used, issued or made out in the Community or in Switzerland where these documents are used in accordance with domestic law;*
>
> *(c) documents proving the working or processing of materials in the Community or in Switzerland, issued or made out in the Community or in Switzerland, where these documents are used in accordance with domestic law;*
>
> *(d) movement certificates EUR.1 or EUR-MED or invoice declarations or invoice declarations EUR-MED proving the originating status of materials used, issued or made out in the Community or in Switzerland in accordance with this Protocol, or in one of the other countries referred to in Articles 3 and 4, in accordance with rules of origin that are identical to the rules in this Protocol.*
>
> *(e) appropriate evidence concerning working or processing undergone outside the Community or Switzerland by application of Article 12, proving that the requirements of that Article have been satisfied.*

Validity of Forms EUR.I and EUR-MED and Preservation of Proof of Origin and Supporting Documents

Form EUR.I or EUR-MED must usually be submitted within four months of its date of issue by the customs authorities of the exporting country to the customs authorities of the importing country where the products are entered.

Article 29 of the EC-Switzerland Agreement provides for the following:

> 1. *The exporter applying for the issue of a movement certificate EUR.1 or EUR-MED shall keep for at least three years the documents referred to in Article 17(3).*
> 2. *The exporter making out an invoice declaration or invoice declaration EUR-MED shall keep for at least three years a copy of this invoice declaration as well as the documents referred to in Article 22(5).*
> 3. *The customs authorities of the exporting country issuing a movement certificate EUR.1 or EUR-MED shall keep for at least three years the application form referred to in Article 17(2).*

4. *The customs authorities of the importing country shall keep for at least three years the movement certificates EUR.1 and EUR-MED and the invoice declarations and invoice declarations EUR-MED submitted to them.*

In the case of verification or for related reasons, the documentation is necessary to refer back to the supporting documents that have justified the issuance of a certificate of origin EUR.I or EUR-MED or invoice declaration. Therefore, for a period of three years, both the exporter and the customs authorities are obliged to retain the documents relating to exports, that is, the applications for EUR.I or EUR-MED certificates and the certificates themselves, invoice declarations, or invoice declarations EUR-MED. Even though for trade purposes EUR.I or EUR-MED certificates have a validity period of four months, they must nevertheless be retained for three years in case of subsequent verification requests.

6.3.6. *Verification of Proofs of Origin*

Detailed provisions for this important part of the administration of rules of origin are contained in Article 33 of the EC-Switzerland Agreement:

1. *Subsequent verifications of proofs of origin shall be carried out at random or whenever the customs authorities of the importing country have reasonable doubts as to the authenticity of such documents, the originating status of the products concerned or the fulfilment of the other requirements of this Protocol.*
2. *For the purposes of implementing the provisions of paragraph 1, the customs authorities of the importing country shall return the movement certificate EUR.1 or EUR-MED and the invoice, if it has been submitted, the invoice declaration or the invoice declaration EUR-MED, or a copy of these documents, to the customs authorities of the exporting country giving, where appropriate, the reasons for the enquiry. Any documents and information obtained suggesting that the information given on the proof of origin is incorrect shall be forwarded in support of the request for verification.*
3. *The verification shall be carried out by the customs authorities of the exporting country. For this purpose, they shall have the right to call for any evidence and to carry out any inspection of the exporter's accounts or any other check considered appropriate.*
4. *If the customs authorities of the importing country decide to suspend the granting of preferential treatment to the products concerned while awaiting the results of the verification, release of the products shall be offered to the importer subject to any precautionary measures judged necessary.*
5. *The customs authorities requesting the verification shall be informed of the results of this verification as soon as possible. These results must indicate clearly whether the documents are authentic and whether the products concerned can be considered as products originating in the Community, in Switzerland or in one of the other countries referred to in Articles 3 and 4 and fulfil the other requirements of this Protocol.*

6. *If in cases of reasonable doubt there is no reply within ten months of the date of the verification request or if the reply does not contain sufficient information to determine the authenticity of the document in question or the real origin of the products, the requesting customs authorities shall, except in exceptional circumstances, refuse entitlement to the preferences.*

In all FTA Agreements concluded by the EC with partner countries, there is reciprocal obligation of the customs authorities countries to assist each other in managing the origin rules.[17] Article 33 lists the expectations from customs authorities and how they should conduct verifications.

The customs authorities of the importing country may request verification of the authenticity of the proofs of origin and of the originating status of the products concerned from the customs authorities of the exporting country. The reasons for such verification requests could stem from doubts about the true origin of the goods or, in the case of goods covered by EUR.I or EUR-MED, doubts about the stamp used to authenticate the document. Random verifications are also permitted under this Article. The explanatory notes provide that no country shall be obliged to answer a request for subsequent verification received more than three years after the date of issue of a movement certificate EUR.I or EUR-MED or the date of making out an invoice declaration or an invoice declaration EUR-MED. Pending the results of a verification request, the customs of the importing country may decide to suspend granting preferential tariff treatment in respect of the goods under investigation and to any further consignments of similar goods from the same exporter. However, they will offer to release the goods subject to whatever precautionary measures they deem necessary, such as demanding payment from the importer of a deposit equal to the full duty payable on the goods or an undertaking guaranteed by a bank to pay the duty.

If, in cases of reasonable doubt, a reply to the verification request has not been received within 10 months, or does not contain sufficient information to verify that the certificate is authentic or the declared origin is correct, the customs will refuse preference.

[17] In the case of the EC-Switzerland Agreement such cooperation is spelled out in Article 32: 1. *The customs authorities of the Member States of the Community and of Switzerland shall provide each other, through the Commission of the European Communities, with specimen impressions of stamps used in their customs offices for the issue of movement certificates EUR.1 and EUR-MED, and with the addresses of the customs authorities responsible for verifying those certificates, invoice declarations and invoice declarations EUR-MED.2. In order to ensure the proper application of this Protocol, the Community and Switzerland shall assist each other, through the competent customs administrations, in checking the authenticity of the movement certificates EUR.1 and EUR-MED, the invoice declarations and the invoice declarations EUR-MED and the correctness of the information given in these documents.*

The explanatory notes concerning the Pan-Euro-Mediterranean Protocols on rules of origin[18] provide for the following parameters and guidance on the issue of verification:

> Article 33 – Refusal of preferential treatment without verification
>
> This covers cases in which the proof of origin is considered inapplicable, *inter alia* for the following reasons:
> - the goods to that the movement certificate EUR.1 or EUR-MED refers are not eligible for preferential treatment;
> - the goods description box (Box 8 on EUR.1 or EUR-MED) is not filled in or refers to goods other than those presented;
> - the proof of origin has been issued by a country which does not belong to the preferential system even if the goods originate in a country belonging to the system (e.g. EUR.1 or EUR-MED issued in Ukraine for products originating in Syria) or the proof of origin has been issued by a country with which cumulation is not applicable (e.g. EUR.1 or EURMED issued in Syria for goods exported to Norway when the free trade agreement between these two countries does not exist);
> - one of the mandatory boxes on the movement certificate EUR.1 or EUR-MED bears traces of nonauthenticated erasures or alterations (e.g. the boxes describing the goods or stating the number of packages, the country of destination, or the country of origin);
> - the time-limit on the movement certificate EUR.1 or EUR-MED has expired for reasons other than those covered by the regulations (e.g. exceptional circumstances), except where the goods were presented before expiry of the time-limit;
> - the proof of origin is produced subsequently for goods that were initially imported fraudulently;
> - Box 4 on the movement certificate EUR. 1 or EUR-MED names a country not party to the agreement under which preferential treatment is being sought;
> - Box 4 on the movement certificate EUR.1 or EUR-MED names a country with which cumulation is not applicable (e.g. EUR.1 or EUR-MED issued in the EC for products of Faroese origin imported to Morocco when the free trade agreement between Morocco and the Faeroe Islands does not exist).

In these cases the explanatory notes provide that the action to be taken is as follows:

> The proof of origin should be marked 'INAPPLICABLE' and retained by the customs authorities to that it was presented in order to prevent any further attempt to use it. Where it is appropriate to do so, the Customs authorities of the importing country shall inform the Customs authorities of the country of exportation about the refusal without delay.

[18] See, Official Journal of the European Union C 16/8 of 21.1.2006.

Article 33 of the explanatory notes provides further clarifications on the term "Reasonable doubt." The following cases, by way of example, come into the category of reasonable doubts:

- the document has not been signed by the exporter (except for declarations on the basis of invoices or commercial documents drawn up by approved exporters where such a possibility is provided for);
- the movement certificate EUR.I or EUR-MED has not been signed or dated by the issuing authority;
- the markings on the goods or packaging or the other accompanying documents refer to an origin other than that given on the movement certificate EUR.I or EUR-MED;
- the particulars entered on the movement certificate EUR.I or EUR-MED show that there has been insufficient working to confer origin;
- the stamp used to endorse the document does not match that which has been notified.

In these cases the explanatory notes recommend the following actions:

The document is sent to the issuing authorities for postclearance verification, with a statement of the reasons for the request for verification. Pending the results of this verification, all appropriate steps judged necessary by the customs authorities shall be taken to secure payment of any applicable duties.

The customs authorities may also refuse preferential origin without requesting verification of the proofs of origin presented. Among the reasons for such action are the following examples:

(a) the goods to which the proof of origin relates are not eligible for preference;
(b) the description box has not been completed;
(c) the goods described in the proof of origin do not match those presented;
(d) the proof of origin has been presented after the expiry of its period of validity and there are no grounds justifying its acceptance exceptionally;
(e) the proof of origin has had words erased or has in some way been tampered with;
(f) a country not party to the agreement or a country with that cumulation is not applicable has been cited in box 4 of the EUR.I or EUR-MED certificate.

6.3.7. *Issuance of Certificate of Origin for Cumulation under the Pan-European Rules of Origin, GSP, Regional Cumulation, and Cotonou Partnership Agreement*

6.3.7.1. *Procedure for the Issuance of Certificates of Origin for Cumulation under EC GSP Rules of Origin*

Among the preferential arrangements examined, there are differences concerning the issuance of the certificate of origin for cumulation purposes. Under the EC regional and bilateral cumulation rules, certificate of origin Form A for the finished product benefiting from cumulation is issued on the basis of the

Form A certificate issued previously in the other member-countries in respect of the originating materials and/or parts utilized in the manufacturing processes of the finished product (Article 72a, paragraph 5, of the Community Customs Code [CCC]).

Example: An exporter in country C wishes to export a finished product that contains imported inputs originating in countries A and B of the same regional grouping. The exporter will have to submit to the competent authority two Form A certificates relating respectively to the inputs originating in country A and in country B and issued by the competent authorities in each of those countries. From these two certificates, the competent authority in country C will then issue the final Form A certificate relating to the finished product to be exported.

To date, three regional groups benefit from regional cumulation under GSP rules:

- the Association of Southeast Asian Nations (ASEAN) (Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam);
- the Central American Common Market (CACM) (Costa Rica, Honduras, Guatemala, Nicaragua, and El Salvador)[19] and the Andean Group (Bolivia, Colombia, Ecuador, Peru, and Venezuela) as one group;
- the South Asian Association for Regional Cooperation (SAARC) (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka).

Ancillary rules for the allocation of origin, transshipment, and administrative procedures are detailed enough to ensure the proper customs cooperation in the issuance of GSP Form A. Paragraph 1 of Article 72a lays down the rules according to which the country of origin of the final product shall be determined:

> *When goods originating in a country which is a member of a regional group are worked or processed in another country of the same regional group, they shall have the origin of the country of the regional group where the last working or processing was carried out provided that*:
> *(a) the value-added*[20] *there is greater than the highest customs value of the products used originating in any of the other countries of the regional group, and*
> *(b) the working or processing carried out there exceeds that set out in article 70 (insufficient working or processing) and, in the case of textile products, also those operations referred to at annex 16.*

The allocation of origin in the EC GSP context proved to be a delicate issue, especially as regards ASEAN. In fact, the previous scheme, which was in force

[19] See Commission Communication 95/C 343/09 for CACM countries, O.J. C 343 (1995).

[20] "Value-added" means the ex-works price minus the customs value of each of the products incorporated that originated in another country of the regional group.

until 1994, applied various limitations and quotas concerning GSP treatment of products originating in ASEAN countries. Thus origin allocation was a determining factor in the correct application of the quota system to the individual ASEAN countries. With the introduction of the EBA initiative in 2001 the allocation of origin still plays a fundamental role especially in ASEAN. In fact Laos and Cambodia benefit from duty-free entry for textiles and clothing whereas neighboring ASEAN countries are either graduated or benefit only from reduction of the MFN rate.

6.3.7.2. Procedure for Issuance of Certificates of Origin for Cumulation under the Former Cotonou Partnership Agreement

At the time of this writing, the CPA has expired. This section is maintained in order to keep an institutional memory on how full cumulation among all ACP countries has been maintained for more than two decades. Under the former Cotonou rules and requirements for cumulation purposes, the procedure is different from the one adopted under the GSP. In particular, the requirement to issue a specific certificate of origin for intermediate inputs or working or processing carried out in another ACP state has been replaced with a supplier declaration system.

Where the cumulation option on donor country content has been used in the manufacturing process of the finished ACP product, "the competent Customs authorities in the ACP State requested to issue the certificate for products in the manufacture of which materials coming from other ACP States, the Community or the OCT[21] are used, shall take into consideration the declaration, (. . .) given by the exporter in the State or OCT from which it came, either on a commercial invoice applicable to these materials, or on a supporting document to that invoice."[22]

These declarations must be made on the commercial documents related to the shipment. The text of the declaration is contained in specific forms attached to the Protocol on Rules of Origin. There are two kinds of declarations. The first

[21] The overseas countries and territories (OCTs) referred to in the Lomé IV Convention include the overseas countries of the Kingdom of the Netherlands (Aruba and the Netherlands Antilles), those of the French Republic (New Caledonia and Dependencies, Wallis and Futuna Islands, French Polynesia, and the French Southern and Antarctic Territories), the Territorial Collectivities of the French Republic (Mayotte and St. Pierre and Miquelon), the OCT of the United Kingdom of Great Britain and Northern Islands (Anguilla, Cayman Islands, Falkland Islands, Sandwich Islands and their Dependencies, Turks and Caicos Islands, British Virgin Islands, Montserrat, Pitcairn, St. Helena and Dependencies, British Antarctic Territory and British Indian Ocean Territory), and the overseas country of the Kingdom of Denmark (Greenland).

[22] See Article 23 of Protocol 1 to the Lomé IV Convention.

concerns products that have already acquired originating status in the exporting state on their own, independent of the further working or processing that may take place in the importing ACP states. The second relates to products that have not acquired originating status. These need some working or processing in the importing ACP states to be considered as originating products under the Convention.

Some examples help clarify the use of these forms:

- An exporter in ACP country A buys vegetables grown and harvested in ACP country B. He plans to export tinned vegetables to the EC. When applying for Form EUR.I he will have to submit a supplier's declaration as contained in Annex VI because the products he intends to export to the EC already originate (in this case they are wholly obtained) in the ACP state of origin under the terms of the Convention;
- An ACP exporter intends to export cotton jackets to the EC. Cotton jackets are subject to the Single List requirements. To manufacture jackets, he imports fabrics from ACP country A and manufactures them starting from the imported fabric. However, the imported fabric from country A is not considered as originating because it is made out of imported yarn instead of starting, as required by the Single List, from natural fiber. In the case of rubberized textile fabrics, this is classified in heading 5906. Therefore the declaration to be made by the supplier will be the one concerning products that have not acquired originating status.

The purpose of these declarations was to ensure that the provision regarding cumulation and donor country in the Convention was not circumvented by importing materials from third countries that were not members of the Convention, it being claimed that these inputs are of ACP or EC origin. It also allowed the customs authorities of the ACP exporting state, where Form EUR.I is to be issued, to be in a position to better enforce and apply the provisions of the Convention. Verification of supplier declarations could be carried out at random or whenever the customs authorities of the importing state had reasonable doubts about the authenticity of the declaration made. In the latter case, the customs authorities of the importing state could request those of the exporting state to issue an information certificate (a model of which is also contained in an annex to the Protocol). Alternatively, the customs authorities of the importing state could request the final exporter to produce an information certificate issued by the customs authorities of the exporting state.

6.3.8. *The Procedure and Decision Making in the Case of A Posteriori Recovery or Remission of Customs Duties and Origin Verification in the EC*

Under Community Law, the customs revenues collected by EC member-states are remitted to the EC Institutions, which utilize them as community-owned resources. The EC member-states customs authorities no longer have exclusive powers of implementing and administrating customs legislation and duties. These powers are presently shared among the member-states and the EC Commission.

In the case in which certificates of origin have been declared invalid following verification or investigation, a postclearance procedure for the recovery of unpaid customs duties is normally undertaken. In these cases, the importer is liable to repay the amount of duties uncollected for all certificates of origin declared invalid. The postclearance recovery is initiated either by the EC member-states or by request of the EC Commission.

Postclearance entry may be waived in specific cases. The CCC has been amended[23] following the recognition that it was necessary for the particular case of preferential arrangements, to define the concepts of error by the customs authorities and of the good faith of the person liable for payment. The view of the EC authorities was that the importer should not be held responsible for a malfunction of the system that is due to an error made by the authorities of a third country. The issue of an incorrect certificate by such authorities should not, however, be considered an error if the certificate is based on an application by the exporter that contains incorrect information. The incorrect nature of the information provided by the exporter in his application must be assessed based on all the factual elements that are contained in that application. The person liable for payment can plead his good faith where he can demonstrate that he has taken due care, except when a notice stating that there are grounds for doubt has been published in the *Official Journal of the European Communities*.

Accordingly, Article 220(2)(b) of the EC Customs Code provides that postclearance recovery may be waived when:

> *. . . the amount of duty legally owed was not entered in the accounts as a result of an error on the part of the customs authorities that could not reasonably have been detected by the person liable for payment, the latter for his part having acted in*

[23] See Regulation No 2700/2000 of the European Parliament and of the Council of 16 November 2000 amending Council Regulation (EEC) No 2913/92 establishing the Community Customs Code – OJ L311/17, 12 Dec. 2000.

good faith and complied with all the provisions laid down by the legislation in force as regards the customs declaration.

Where the preferential status of the goods is established on the basis of a system of administrative cooperation involving the authorities of a third country, the issue of a certificate by those authorities, should it prove to be incorrect, shall constitute an error that could not reasonably have been detected within the meaning of the first subparagraph.

The issue of an incorrect certificate shall not, however, constitute an error where the certificate is based on an incorrect account of the facts provided by the exporter, except where, in particular, it is evident that the issuing authorities were aware or should have been aware that the goods did not satisfy the conditions laid down for entitlement to the preferential treatment.

The person liable may plead good faith when he can demonstrate that, during the period of the trading operations concerned, he has taken due care to ensure that all the conditions for the preferential treatment have been fulfilled.

The person liable may not, however, plead good faith if the European Commission has published a notice in the Official Journal of the European Communities, stating that there are grounds for doubt concerning the proper application of the preferential arrangements by the beneficiary country.

6.3.8.1. *The Procedure for Nonrecovery of Customs Duties after Clearance*

Nonrecovery of customs duties is not necessarily the result of an application by an interested party. It is for the national customs authorities to decide not to recover duties when the conditions laid down for each of the cases listed exhaustively in Article 869 of Regulation No. 2454/93 are met. Article 869 states the following:

The customs authorities shall themselves decide not to enter uncollected duties in the accounts:

(a) in cases in which preferential tariff treatment has been applied in the context of a tariff quota, a tariff ceiling or other arrangements when entitlement to this treatment had been ended at the time of acceptance of the customs declaration without that fact having been published in the Official Journal of the European Communities before the release for free circulation of the goods in question or, where such fact is not published, having been made known in an appropriate manner in the Member State concerned, the person liable for payment for his part having acted in good faith and complied with all the provisions laid down by the legislation in force as regards the customs declaration;

(b) in cases in which they consider that the conditions laid down in Article 220(2)(b) of the Code are fulfilled, except those in that the dossier must be transmitted to the Commission pursuant to Article 871. However, where Article 871(2), second indent, is applicable, the customs authorities may not adopt a decision waiving entry in the accounts of the duties in question until the end of a procedure initiated in accordance with Articles 871 to 876.

However, where the competent authorities either consider that the conditions laid down in Article 220(2)(b) of the [Customs] Code are fulfilled or are in doubt as to the precise scope of the criteria of that provision with regard to a particular case, those authorities shall submit the case to the Commission, and the file submitted must contain all the information required for a full examination (first paragraph of Article 871 of Regulation no. 2454/93). Within 15 days of receipt of the file, the Commission must forward a copy to the member-states (first paragraph of Article 872). Then, after consulting a group of experts composed of representatives of all the member-states, meeting within the framework of the Customs Committee to consider the case in question, the Commission shall decide whether the circumstances under consideration are, or are not, such that the duties in question need not be entered in the accounts (first paragraph of Article 873).

That decision must be taken within six months of the date on which the file submitted by the member-state is received by the Commission (second paragraph of Article 873) and the member-state concerned must be notified of the decision as soon as possible (first paragraph of Article 874).

It should be noted that the procedural rules for nonrecovery described in the preceding paragraphs, like those applicable to the remission of customs duties, were amended following the entry into force of Regulation no. 1677/98. The new rules were applied in the context of Case T-147/99 (*Miller*).

Thus Regulation no. 1677/98 inserts *inter alia* a new Article 872a, which provides:

> Where, at any time in the procedure provided for in Articles 872 and 873 [of Regulation No 2454/93], the Commission intends to take a decision unfavourable towards the person concerned by the case presented, it shall communicate its objections to him/her in writing, together with all the documents on which it bases those objections. The person concerned by the case submitted to the Commission shall express his/her point of view in writing within a period of one month from the date on which the objections were sent. If he/she does not give a point of view within that period, he/she shall be deemed to have waived the right to express a position. The period of six months prescribed in Article 873 of Regulation No 2454/93 is replaced by a period of nine months.

6.3.9. *The Future of the EC Rules of Origin: The Green Paper on the Future of Rules of Origin in Preferential Arrangements and Recent Developments*

In January 2004, the Commission published a Green Paper on the future of rules of origin in preferential trade arrangements. The objective of the Green

Paper was to open a debate among EC institutions, civil society, and partner countries on the possible options for reform and changes in the area of rules of origin and their administration. The Commission invited comments from all interested parties that had to be submitted through a questionnaire available on the Internet in March/April 2004. At present, the Commission is still considering how to revise the rules of origin, and a number of studies have been launched. However, after more than 4 years since the launching of the Green Paper, there is still no conclusive way forward on how EC rules of origin will be in the near future. At the same time and as examined in Chapter 3 in relation to EPAs some of the concerns of the Green Paper have already matured in a change of some established practices in the EPA's Protocols on rules of origin.

The starting point of the Green Paper was the current state of EC legislation and case law on preferential origin and customs debt, which in the eyes of the Commission was not perceived as satisfactory. In particular, the Commission pointed out the following salient points as examples of a "status quo" that needs reform:

- under EC law on remission, repayment, and nonrecovery of customs debt, an importer acting "in good faith" may be exempted from payment of the customs debt if the commercial risk involved is considered "abnormal"; an example is when an importer is confronted with an error made by the competent authorities in certifying or checking preferential origin or finds himself in a special situation involving no negligence on his part;

  In such situation, the EC budget bears the corresponding financial loss and this situation constitutes a threat to the balance of preferences and to fair trade and competition.

  The result is a perverse system in which one party suffers the economic and financial effects of negligence by the other party.

The Commission move was also motivated by the desire that arrangements be fairly and properly implemented, in the interests of both the EC and its trading partners. In practice, fraud and failure to meet the conditions for granting preferential treatment may not only mean a loss of revenue for the EC, but will also damage its legitimate economic interests and those of its partners, by distorting competition.

To enhance the protection of the EC interests, a number of actions were listed in the Green Paper to improve the administration of the rules of origin:

- Greater capacity for the EC to prevent and react to problems of fraud or incorrect application of preferential origin rules. To be effective, this

protection may imply, at EC level, a clear breakdown of tasks and responsibilities between the Commission and the administrations of the member-states, in charge of controlling compliance with rules of origin, by the economic operators as well as by the countries benefiting from preferences. It may also imply enhanced cooperation and harmonization of controls to perform, together with the allocation of the means necessary to this end.

- A clause suspending preferences in the event of fraud or other irregularities and/or lack of administrative cooperation, which is progressively incorporated into the preferential agreements on a reciprocal basis. This instrument will be used where repeated problems adversely affect both the proper application of the arrangements and compliance with their objectives. It will have a preventive or deterrent effect on those inclined to abuse the arrangements or neglect to supervise them. As examined in Chapter 3, this clause is now inserted in all interim EPAs.
- A clause assigning financial liability to any contracting party that has failed to implement a preferential agreement correctly and consequently caused injury to the other party. This clause should be considered not as an instrument of retaliation available to one of the parties but as an essential factor in ensuring that all parties implement the agreements fairly.

Apart from these policy guidelines, the Green Paper focused on the various alternatives and options to introduce changes to the EC system traditionally based on certifying authorities. Thus the key questions of the Green Paper were focused on the issue of implementation of rules of origin and how to improve or change the current EC system based on certifying authorities. The options center around the following key issues:

- certification of preferential origin in the country of export,
- declaration of preferential origin by the importer,
- verification.

Certification of preferential origin on export

This option is based on the system currently in operation. The following section presents some additional options to introduce variations and/or make the current system more efficient.

Improve the current system for establishing proof of origin

- Develop training and information projects on the principles and practicalities of the rules of origin, issue of certificates, and the corresponding checks on the originating status of the products or the authorization and

checks on the practices of approved exporters authorized to make invoice declarations.
- Step up monitoring as well as administrative cooperation and mutual assistance, including joint enquiries on the spot.
- Step up capacity to identify and react to fraud situations and poor application of the rules.
- Make the authorities of the beneficiary countries take responsibility by introducing preference suspension and, if necessary, financial liability clauses to be triggered in the event of failure to obey the rules or a lack of administrative cooperation.

Introduce certification by the exporter only

- Give the exporter alone the task of certifying the originating status of the products, as a factor in his commercial relationship with the importer, without prejudice to any checks conducted by the competent authorities to ensure the origin rules are complied with.
- A standard form of certificate would incorporate all the details needed (with a view to subsequent checks) to identify the exporter, the goods, and the conditions of production on which their originating status is based; the exporter would fill in the form and send it (electronically, perhaps) to the importer.

Introduce an intermediate system of "approved" or "registered" exporters

- Abolish all certification by the authorities and entrust the task to exporters identified for this purpose by the country of export.
- Choose between two formulas: "approval," entailing an audit (mainly of the firm's management structure, financial health and length of time in business) and prior authorization plus monitoring of practice, and "registration," limited to listing exporters likely to certify preferential origin, with a view to facilitating subsequent checking.

This seems to be the system that was envisaged in the draft convention examined in Section 6.3.10.

Declaration of preferential origin on import and the responsibility of the importer

The series of options outlined in the following section aims at strengthening the disciplines by imposing additional responsibility on the importer's liability.

Strengthening the disciplines on debt and debt recovery

- Without changing the current systems of certification and administrative cooperation, abolish all reference to equity and legitimate expectations by the debtor with regard to the recovery of debt incurred as a result of a refusal to grant preference, or, alternatively,
- spell out the conditions to be met by the importer/debtor (particularly as regards his relations with the exporter) to qualify for a waiver of post-clearance recovery or remission/repayment.

Assuming the authorities of the country of export remain responsible for certifying origin

- Impose additional commitments and obligations on the importer applying for preference (special declaration promising to comply with the rules of origin, an "origin clause" in the contract with the exporter, etc.).
- Amend/reinforce the Customs Code implementing provisions regarding customs declarations and/or the preferential origin rules (systematically requiring a specific declaration by the importer).

Assuming the exporter alone (whether or not he is registered or approved) bears responsibility for certifying origin

- Ensure the importer's liability for the declaration of preferential origin based on a direct, exclusive commercial relationship with the exporter.
- Spell out the importer's commitment when declaring preferential origin, on his own responsibility, on the basis of the certificate and information received from the exporter. Make it obligatory to keep such information and to supply additional information on request in case of doubt about the origin of the products.
- Provide for a mechanism to reverse the burden of proof of preferential origin, offering the country of import the option of refusing preference if the origin of the product cannot be confirmed following checks or failing cooperation by the country of export.

Verification of preferential origin

These series of options contained in the Green Paper aim at strengthening the procedures for monitoring preferential origin of the goods.

Stepping up checks on the importer

- Develop mechanisms and criteria at the EC level to target controls on declarations of preferential origin and direct enquiries relating to the importer and, if necessary, the exporter. Step up checks on import using these mechanisms. Make sure that the importer's liability is invoked.

- Step up checks on the exporter assuming the authorities of the country of export remain responsible for certifying origin.
- Make current procedures for postclearance checks and administrative cooperation work.

Assuming the exporter (whether or not he is registered or approved) bears sole responsibility for certifying origin.

Importing country carries out checks directly

- Provide for the legal bases and procedures allowing direct checks on the exporter by the country of import, by means of a questionnaire or on the premises, as is done in the NAFTA.

Country of export provides country of import with assistance

- Mutual assistance and specific cooperation mechanisms to enable the country of import to have the country of export check the origin of the products exported and, if necessary, be involved in these operations.
- Checks carried out in this way should enable the authorities to establish that products declared to be of preferential origin really are. Failing positive and satisfactory confirmation, the country of import could refuse preference based on the information at its disposal.
- The assistance and control procedures to be introduced and the scope for traders to appeal should be subject to a more detailed description than exists at present.

6.3.10. Recent Developments Following the Green Paper

A proposal for a Convention to regulate rules of origin in the context of the EPAs with the ACP countries circulated in mid-2007 marked a first step toward the implementation of some of the options indicated in the Green Paper. Some of the elements of the convention featured in the interim EPAs and the proposal for the new GSP rules of origin.

The Convention marked a shift from the traditional administration of rules of origin in a number of areas:

- It placed cooperation and burden sharing on administering origin requirements as the pillar of the architecture of the Convention. Established a Joint EC-ACP Origin Committee to administer and implement different aspects of the Convention and provided different forms of cooperation among the competent authorities in charge of control and verification.

- Moved away from the central role of the certifying authorities, and reform the role played by Customs by leaving open the option to adopt other governmental authorities for administering control and verification of rules origin.
- Established a system of registered exporters to be administered by such competent authorities.

According to this proposal the new configuration of the administration of rules of origin raises a number of comments. The Convention clearly distinguished two kinds of exporters: registered and nonregistered.

The rule applicable to nonregistered exporters is contained in Article 16 of the Convention, which reads *"Non-registered exporters shall inform the competent authorities of the beneficiary country of any statement on origin made out for their exports under the scheme."* This article leaves unanswered a basic question: Could the importing authorities accept a statement of origin issued by a nonregistered exporter? Looking at the architecture of the Convention, this is probably not the case because it is quite clearly centered on the establishment of a registry of exporters that will be the base for origin verification. In addition paragraph 1 (c) of Article 24 titled "refusal of preferential treatments" expressly provides that:

> *The customs authorities of the importing country shall refuse entitlement to the scheme, without having to request any additional evidence or send a request for verification to the exporting country where*:
>
> *(c) the statement on origin in possession of the importer, that covers a consignment exceeding EUR 6 000, has not been made out by an exporter registered in the exporting country*;

It follows that only the registered exporters are entitled to issue a statement of origin that could be issued on different means such a specimen indicated in the Convention or on other commercial documents including electronic means. This statement of origin has to be submitted by the importer at the time of importation, and it is the responsibility of the importer to verify that the exporter is registered.

Article 20 establishes a series of obligations in maintaining and managing a database on registered exporters:

1. *The competent authorities of the exporting country shall maintain and manage an up-to-date electronic record of registered exporters located therein.*
2. *The record shall contain the following information*:
   (a) Name and full address of Registered Exporter;
   (b) Number of Registered Exporter;

(c) Product coverage;
(d) Period of validity.
For the purpose of verification, the Commission, the customs authorities of the Member States and of the Regions' States shall obtain, by appropriate means including electronic means, an access to the record of registered exporters.

3. *The competent authorities of the countries must notify each other of the national numbering system used for designating registered exporters. The number shall begin with the ISO-alpha code of the country concerned*.
4. *Exporters who no longer meet the conditions for exporting goods under the scheme shall inform the competent authorities in the exporting country and be immediately removed from the record of registered exporters in the exporting country concerned*.
5. *Without prejudice to the system of penalties applicable in the exporting country, exporters who draw up, or cause to be drawn up, a statement on origin or any supporting document that contains incorrect information for the purpose of obtaining a preferential treatment for products, shall be sanctioned by a temporary or definitive withdrawal from the record of registered exporters in the exporting country concerned, depending on the seriousness of the irregularity or fraud committed. Where the exporter is a legal person, the withdrawal shall also concern its manager or managers*.

The architecture of the Convention based on the existence and maintenance of such a database may have significant implementation implications, especially for ACP countries. The existence of the database is linked to the obligation of the competent authorities to carry our periodic checks on its own database.

The preliminary analysis of the Convention shows a marked shift toward shared responsibilities of the competent authorities in the EC and ACP states, in which each administration has the responsibility, on the export side, to maintain its own database of registered exporters and, on the import side to be able to access the same database to check the statement of origin. These implementation requirements may have a number of consequences and implementation costs when the disparities of equipment and expertise in national administrations among EC member-states and ACP are taken into account:

- The limited expertise and availability in ACP countries of electronic means to establish and maintain such database.
- The discretionary power of the competent authorities to approve registered exporters may lead to corruption and abuse.
- The lack of equipment/ ability of the ACP competent authorities to register ACP exporters may turn into a non tariff barrier.
- The ability and expertise of the ACP competent authorities to verify and check the compliance of origin requirements of EC imports.

One possible way to ascertain the advantages and disadvantages of such a system is to test its feasibility on some ACP countries.

6.3.11. Origin Administration and Customs Cooperation in the EC

Each EC national customs authority has established its own risk assessment software to monitor, *inter alia*, the risks arising from the managing of the preferential agreements and origin declaration.

Although the aim here is not to discuss in details such a system, some general comments may assist in understanding the EC experience.

Import and export transactions in EC member-states are carried out by electronic means. However, paperwork and documentary evidence is not totally eliminated because certificate of origin Form EUR.I, invoice declarations, and so on still exist in parallel to the electronic means and risks assessment software.

Significant facilitation and time saving are nevertheless realized by the introduction of electronic means because documentary evidence and physical inspection of the goods are carried out in only a minority of cases. The monitoring of import declaration is based on a different level of control of import declarations, which could be summarized as follows:

- The goods and customs are cleared and released to the importer with no *a posteriori* verification and no request to show documentary evidence;
- The goods are released but documentary evidence is requested and examined by the customs authorities;
- The goods are not released and are subject to physical inspection and documentary evidence is examined.

At present, in the EC, there are no common parameters for risk assessment software. It follows that each member-state has developed its own system according to risk assessment, taking into account national parameters. Such a system invariably provides for feedback responses, and its accuracy and effectiveness may depend on the quality and intensity of the interaction between the user and the system.

At the EC-wide level, Council Regulation 515/97[24] (hereinafter "the regulation") is a fundamental piece of Community legislation laying down the modalities on mutual assistance between customs administrations of

[24] Council Regulation (EC) No 515/97 on mutual assistance between the administrative authorities of the member-states and cooperation between the latter and the Commission to ensure the correct application of the law on customs and agricultural matters – OJ L82 (1997).

member-states and the Commission and between the Community and third countries.

The declared purpose of the regulation is to establish clear rules and mechanisms among the EC member-states administration authorities and with the Commission to guarantee the proper application of customs and agriculture laws and regulations, in particular by preventing and investigating breaches of those regulations.

At the same time, the regulation set up a computerized Customs Information System (CIS) at community level to secure the rapid and systematic exchange of information among EC member-states and the Commission.

The regulation is composed of seven major titles, of which four contain the modalities for assistance, namely:

Title I:	Assistance on request
Title II:	Spontaneous assistance
Title III:	Relations with the Commission
Title IV:	Relations with third countries
Title V:	CIS

Under the modality of assistance on request, the requested authority shall transmit under Article 9:

> *any information that may enable it to ensure compliance with the provisions of customs or agricultural legislation, and in particular those concerning*:
> - *the application of customs duties and charges having equivalent effect together with agricultural levies and other charges provided for under the common agricultural policy or the special arrangements applicable to certain goods resulting from the processing of agricultural products*,
> - *operations forming part of the system of financing by the European Agricultural Guidance and Guarantee Fund*.
>
> *In order to obtain the information sought, the requested authority or the administrative authority to which it has recourse shall proceed as though acting on its own account or at the request of another authority in its own country*.

Moreover, the applicant authority may ask the requested authority to arrange for a special watch on persons, places, movements of goods, and means of transport where there are reasonable grounds for believing that there is a breach of customs legislation.

The requested administrative authorities shall provide copies of any available information in its possession and shall carry out the appropriate administrative

enquiries. Paragraph 2 of Article 9 set the modalities for joint administrative enquiries.

> 2. *By agreement between the applicant authority and the requested authority, officials appointed by the applicant authority may be present at the administrative enquiries referred to in paragraph 1*
>
> *Administrative enquiries shall at all times be carried out by staff of the requested authority. The applicant authority's staff may not, of their own initiative, assume powers of inspection conferred on officials of the requested authority. They shall, however, have access to the same premises and the same documents as the latter, through their intermediary and for the sole purpose of the administrative enquiry being carried out.*
>
> *Insofar as national provisions on criminal proceedings reserve certain acts to officials specifically designated by national law, the applicant authority's staff shall not take part in such acts. In any event, they shall not participate in particular in searches of premises or the formal questioning of persons under criminal law. They shall, however, have access to the information thus obtained subject to the conditions laid down in Article 3.*

Modalities for spontaneous assistance are laid down in Articles 13–16 of the Regulation where it is stated that each competent authority shall provide and send to other authorities all related information concerning operations, which constitute, or appear to them to constitute, breaches of customs legislation.

Title III regulates the relations between the competent authorities in the EC member-states and the Commission. In particular, Article 17 provides that:

> 1. *The competent authorities of each Member State shall communicate to the commission as soon as it is available to them*:
>
> *(a) any information they consider relevant concerning*:
>
> - *goods that have been or are suspected of having been the object of breaches of customs or agricultural legislation,*
> - *methods or practices used or suspected of having been used to breach customs or agricultural legislation,*
> - *requests for assistance, action taken and information exchanged in application of Articles 4 to 16 that are capable of revealing fraudulent tendencies in the field of customs and agriculture.*
>
> *(b) any information on shortcomings or gaps in customs and agricultural legislation that become apparent or may be deduced from the application of that legislation.*
>
> 2. *The Commission shall communicate to the competent authorities in each Member State, as soon as it becomes available, any information that would help them to enforce customs or agricultural legislation.*

In addition, the Commission itself may request assistance to the competent authorities of the member-states according to the modalities just mentioned.

Paragraph 4 of Article 17 establishes a clear competence of the Commission to initiate investigation to which Commission officers may participate:

> *. . . where the Commission considers that irregularities have taken place in one or more Member States, it shall inform the Member State or States concerned thereof and that State or those Sates shall at the earliest opportunity carry out an enquiry, at which Commission officials may be present under the conditions laid down in Articles 9 (2) and 11 of this Regulation.*

Title IV of the regulations deals with relations with third countries and modalities for administrative cooperation as contained in Article 19 of Title IV. Such administrative cooperation is subject to two basic conditions:

1. *the existence of a legal undertaking where the third country committed to provide assistance to gather proof of irregular nature of operations which appear to constitute breaches of customs legislation*;
2. *agreement of the competent authorities to provide information to the third countries.*

In the case of third countries, the legal undertaking is normally represented by a protocol establishing mutual assistance between administrative authorities in customs matters normally annexed to the agreement establishing a FTA, as in the case of Mexico and Chile and other third countries having entered such trade relation with the EC. In other cases, the agreement on customs cooperation may be a stand-alone piece of legislation like the agreement entered with India on customs cooperation and mutual administrative assistance in customs matters.[25]

The establishment of a community CIS is dealt with in Title V of the Regulation. As stated in paragraph 2 of Article 23 of the Regulation:

> *2. The aim of the CIS, in accordance with the provisions of this Regulation, shall be to assist in preventing, investigating and prosecuting operations that are in breach of customs or agricultural legislation, by increasing, through more rapid dissemination of information, the effectiveness of the cooperation and control procedures of the competent authorities referred to in this Regulation.*

[25] Council Decision of 30 March 2004 concerning the conclusion of the Agreement between the EC and the Republic of India on customs cooperation and mutual administrative assistance in customs matters, OJ.L304 (2004).

The CIS consists of a central database facility, and it is accessible by terminals in each member-state and at the Commission. It comprises exclusively data necessary to fulfill its aim as stated in Article 23 (2), including personal data, in the following categories:

(a) *commodities*;
(b) *means of transport*;
(c) *businesses*;
(d) *persons*;
(e) *fraud trends*;
(f) *availability of expertise*.

Direct access to data included in the CIS is reserved exclusively for the national authorities designated by EC member-states and the departments designated by the Commission. The CIS may be used for the purpose of sighting and reporting discrete surveillance or specific checks. A series of provisions in Title V aims to protect personal data and provide personal data protection and supervision.

The functioning of the mutual assistance and the CIS is managed by a committee chaired by the Commission and made up of representatives of member-states. This committee is examining all matters related to mutual assistance, in particular:

- *"the general working of the mutual assistance arrangements provided for in this Regulation,*
- *the adoption of practical arrangements for forwarding the information,*
- *the information sent to the commission pursuant to see if anything can be learnt from it, decide on the measures required to put an end to practices found to be in breach of customs or agricultural legislation and, where appropriate, suggest amendments to existing Community provisions or the drafting of additional ones,*
- *the preparation of enquiries carried out by the Member States and coordinated by the Commission and Community missions,*
- *measures taken to safeguard the confidentiality of information, in particular personal data, exchanged under this Regulation,*
- *the implementation and proper operation of the CIS and all the technical and operational measures required to ensure the security of the system,*
- *the necessity of storing information in the CIS,*
- *the measures taken to safeguard the confidentiality of information entered in the CIS under this Regulation, particularly personal data, and to ensure compliance with the obligations of those responsible for processing,*
- *implementation and monitoring of origin requirements by national customs authorities."*

6.3.12. *Experience of OLAF on Origin Investigation*

The roles and functions of OLAF

The core activity of Office Européen de Lutte Anti-Fraude (OLAF) established in 1999 is the conduct and coordination of antifraud operations to protect the EC budget and the investigation of fraud and illegal activities within the European institutions. Thus, OLAF has not been created with the specific function of fighting customs fraud or conducting origin verification. In fact, the field of OLAF activities is substantially larger, including fraud related to agricultural subsidies, structural funds, aid projects, and other areas.

In the specific customs field, it has to be recalled that the Customs Union and the common commercial policy fall within the exclusive responsibility of the Community (Articles 23 and 131 of the EC Treaty). The Commission accordingly has the power to take action against operations that constitute or appear to constitute breaches of the customs legislation. Regulation (EC) No. 515/97[26] is the basic regulation containing provisions on mutual assistance between member-states and between member-states and the Commission. OLAF is responsible for the application of this regulation.

On the basis of implementing regulations[27] and international agreements, OLAF has the highest responsibility for organizing an effective cooperation at all levels to ensure a good application of customs regulations. To that end, it exchanges information, coordinates actions undertaken in the member-states, takes part in checks and inspections in the member-states and nonmember countries, and carries out on-the-spot checks.

All customs investigations concern exchange of goods between the EC and nonmember countries (import, export, transit, warehousing, processing) on the basis of information on established or suspected breaches of customs legislation.

Information exchange with member-states and OLAF responsibilities

The principal means of cooperation with the member-states is through the Mutual Assistance Agreement and AFIS/CIS (Antifraud/Customs Information System).

OLAF reports that there are more than 3,000 active users on more than 800 AFIS terminals who exchange an average of 2,500 messages per day. OLAF

[26] Council Regulation (EC) No 515/97 of 13.3.1997 on mutual assistance between the administrative authorities of the member-states and cooperation between the latter and the Commission to ensure the correct application of the law on customs and agricultural matters (OJ L 082, 22.3.1997 p. 1).

[27] In particular, Regulation 515/97 and Regulation 2185/96.

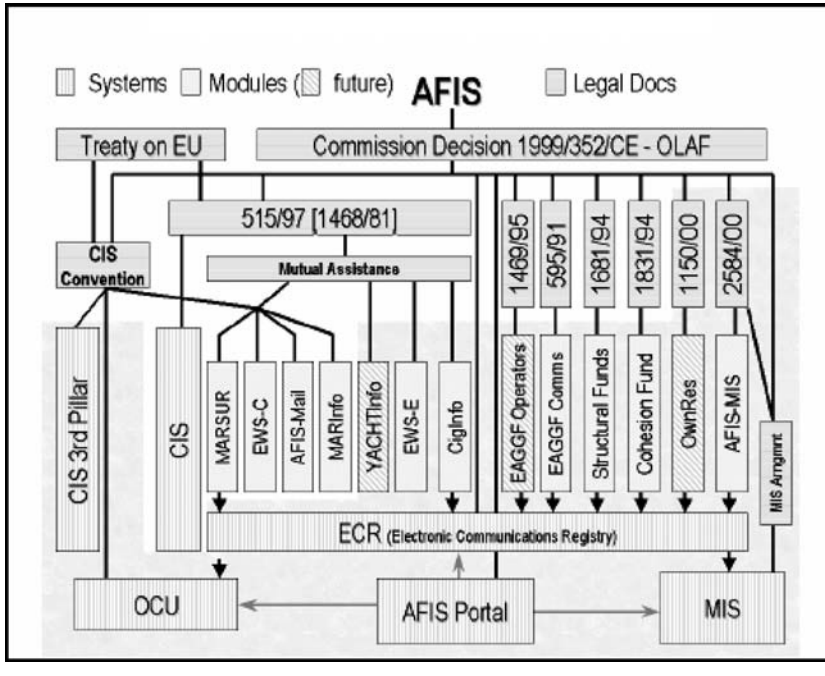


FIGURE 6.1. The legal basis as implemented through AFIS (Antifraud Information System)

is committed to improving AFIS and has awarded several new contracts for this purpose. OLAF has made progress with the development of the CIS in cooperation with the member-states, several of whom have seconded technical experts to OLAF to help with this task.

Figure 6.1 illustrates the breadth of OLAF's responsibilities and how the different legal acts are implemented in a common information-technology architecture. This is the architecture of the AFIS that implements Council Regulation (EC) 515/97 on mutual assistance in the customs area and the CIS Convention. OLAF also collects and analyzes fraud-related data through the *Electronic Communications Registry*, which enables secure exchange of text between member-states and OLAF.

Customs-related activities are governed by Council Regulation (EC) 515/97. This provides for the CIS, *Maritime Surveillance* (MARSUR), *Early Warning System for Customs* (EWS-C), *Maritime Information* (MARInfo, YACHT-Info), *Early Warning System for Excise* (EWS-E), and Information on *Cigarette Seizures* (CigInfo). It also constitutes the legal basis of *AFIS Mail*, which allows secure exchange of text between AFIS partners.

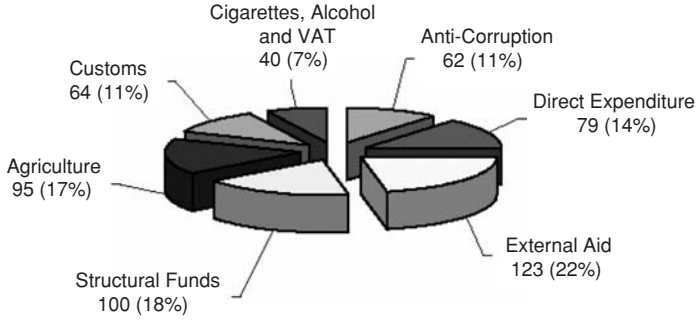


FIGURE 6.2. New case records from the reporting period by OLAF sector. *Source:* Olaf Report 2003

Within the context of Council Regulation 515/97, a number of Commission Regulations and Committee decisions provide for the exchange of structured information in a range of areas. These constitute the legal basis for the AFIS modules that are used by the member-states for reporting to the Commission. These modules include the Agriculture Funds Module (EAGGF Communications), the EAGGF Operators Module (in development), the Structural Funds Module, and the Cohesion Funds Module. Finally, the Mutual Information System (MIS) deals specifically with meat exports to Russia, an area of very high risk to EC funds. It is based on the MIS Administrative Arrangement between OLAF and the Russian Federation. More than 7,000 messages were exchanged during the first year of operation.

The CIS Convention foresees the creation and operation of a Central CIS to cover the Third Pillar competencies (e.g., drugs, money laundering, etc). The Operations Control Unit (OCU) is established at regular intervals to run specific antifraud exercises involving member-states and third countries. Such exercises are increasingly "virtual," meaning that there is no physical central control room staffed by all participants. Whereas the OCU involves third pillar operations, these use parts of the AFIS infrastructure 3rd pillar CIS) without intervention by OLAF.

OLAF is collaborating with the member-states to simplify and clarify the legal bases for the member-states' exchange of information in the various EC policy sectors.

In 2003, there were considerable fluctuations between OLAF sectors compared with those in 2002.[28] As shown in Figure 6.2, the proportion of customs

[28] See "Report of the European Anti Fraud Office – Third Activity report for the year ending June 2002."

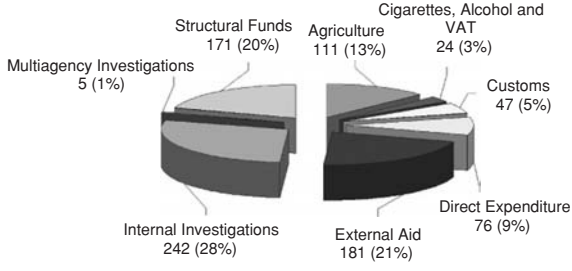


FIGURE 6.3. New case record from the reporting period by OLAF sector. (*Source*: OLAF Report 2005)

case records fell from 20 percent in 2002 to 11 percent in 2003, whereas the proportion of Direct Expenditure and External Aid case records rose from 32 percent last year to 36 percent. The Structural Funds sector also experienced an increase from 15 percent to 18 percent, as did Agriculture (from 14 percent to 17 percent). The proportion of Anticorruption and Cigarettes, Alcohol, and VAT cases remained stable at 11 percent and 7 percent, respectively.[29]

As shown in Figure 6.3 in 2005 the customs share of opened cases reconfirmed the trend previously reported, indicating a lower frequency in respect to previous years. In 2005, customs recorded a share of 5 percent downward from the previous share of 11 percent of 2003.

As shown in Figure 6.4, according to the 2005 OLAF report cases involving false declarations of origin have substantially become the top offense because, out of 70 cases, 41 involved false origin declarations. According to these figures, false origin declarations accounted for a third of all customs fraud.

Some specific cases of origin verification and fraud

In general, fraud origin cases are more likely to occur in AD measures, which are in force because AD duties might be as high as 30 percent whereas the average customs duty is lower in the preferential sector. The traditional cases referred to textiles and clothing and fish products.

In the specific sector of fish, origin fraud and value fraud continue to occur. Both types of fraud are a consequence of the high level of customs duties for fish products (some in excess of 20 percent). This situation encouraged dishonest operators either to declare that the products originate in states where

[29] Numbers referring to earlier years may deviate slightly from those reported here due to data revision.

Type of Fraud	Active	Follow-up	Non Case	Grand Total
False description of goods	7			7
False origin declaration	19	1		20
False quantity declaration	2			2
False supporting documents	1			1
Other false declaration	2			2
Other fraud	16			16
Other transit fraud	1			1
Non Cases			*11*	*11*
Grand Total	**48**	**1**	**11**	**60**

FIGURE 6.4. Customs investigations by type of fraud. (*Source*: OLAF Report 2005)

the rates that apply are more favorable or to undervalue the products in order to decrease the level of duties owed. Community health requirements have also led certain operators to bypass the rules and at the same time commit origin fraud.

OLAF reported in 2003 that the number of investigations notified by the member-states in the sector of textiles and clothing products has decreased, apparently for two reasons: the progressive liberalization of the systems of textile quotas, and earlier and better prevention, which is due in part to OLAF's development of agreements with certain countries (for example, Vietnam, Laos, and Cambodia) for better administrative co-operation.

The following case studies excerpted from the 2005 OLAF report[30] illustrates some of traditional cases of false declaration of origin to obtain preferential access in the garment sector and false declaration to evade application of antidumping (AD) duties.

Case study: Textiles from the Caribbean
In March 2005 a Caribbean Customs authority invalidated all EUR.I movement certificates issued for more than 21 million pieces of knitted textiles (mainly jerseys, pullovers, and cardigans) exported to the European Community in the three previous years. This was the result of a Community mission carried out in this country by a team composed of OLAF officials and representatives from the customs authorities of the Member-states affected by the relevant textile imports and assisted by the national authorities.

[30] See http://ec.europa.eu/anti_fraud/reports/olaf/2005/en.pdf.

OLAF opened an external investigation in March 2004 following information received from a Member State questioning the authenticity of the EUR.I certificates submitted on importation into the Community. The importers used these certificates as proof of origin with a view to benefiting from the preferential treatment (0 percent duty rate) granted by the European Union within the framework of the Cotonou Agreement to products originating in the country. Goods have to satisfy the relevant preferential origin rule. In the case of the textile goods concerned, the preferential origin rule requires the manufacture to be from yarn.

OLAF carried out extensive research in preparation of the joint verification mission. The research revealed that the alleged Caribbean manufacturers had sourced only very small quantities of yarn. These could not possibly have sufficed for the production of the huge quantities of ready-made garments exported to the Community. Indeed, the subsequent investigation concluded that most of the goods exported to the Community were either manufactured in the country from pieces of imported knitted fabric already cut to form or were re-exports of finished garments originating from Asia. The Asian goods were supplied by a network of companies belonging to a multinational textile group that also operated the companies in the Caribbean. The latter had applied to local Customs for the issuance of the EUR.I certificates. They had falsely declared that the goods exported had been manufactured from yarn. In January 2005, immediately after the quantitative restrictions applying to Asian textile supplied to the European markets were lifted, the Caribbean companies ceased their business activities. OLAF received the full assistance and support of the national authorities in the course of this investigation.

To date, the member-states concerned have initiated recovery proceedings of more than €20 million of customs duties evaded by falsely declaring the goods at importation into the Community as originating in the country in question. Member-state authorities are facing appeals lodged by several importers at the request of the multinational textile group 82.

Case study: Color televisions from Asia

A European trade association alleged in September 2001 that colour televisions (CTVs) originating from two Asian countries were being fraudulently declared as originating in another country to avoid paying anti dumping duties on importation to the EU. The allegations were confirmed by the results of an anti-dumping investigation by the Trade Directorate General of the Commission. The latter confirmed the allegations of the false declaration of origin for the CTVs. OLAF opened its own investigation. All available information was communicated to Member States' customs investigation services in September 2002.

OLAF requested the assistance of the third country's authorities in December 2002. An initial preparatory visit to the Asian manufacturer took place in February 2003. A verification mission took place in January 2004, led by OLAF, in which four Member State customs investigation services and the local authorities also participated. These investigations established that the company concerned did indeed export CTVs of falsified origin to the Community. All relevant reports

and data were forwarded to Member States' customs services for follow up action including recovery of anti-dumping duties. Civil debt recovery procedures for an estimated €18 million in anti-dumping duties have already been notified to the importers in 8 Member States. Appeals against the debt recovery are underway in a number of Member States.

Case study: Ring-binder mechanisms
A European trade association alleged that ring-binder mechanisms (RBMs) originating in Asia were fraudulently declared as originating in a particular country to avoid the payment of EU anti-dumping duties. OLAF opened an investigation. The allegations were confirmed by the results of an anti-dumping investigation by the Directorate General for Trade of the Commission published in June 2004 which confirmed the circumvention of anti dumping duties. Subsequently, the OLAF investigation was extended to cover a third country following the receipt of new information to the effect that this country had also been used to circumvent the anti-dumping duties.

OLAF opened its own investigation and communicated all available information to Member States' customs investigation services. OLAF requested the assistance of the national authorities in Asia in July 2004. Community verification missions took place in November and December 2004 led by OLAF. Three Member State customs investigation services and the local national authorities participated. These investigations established that the company concerned did indeed export RBMs of falsely declared origin to the Community.

The companies in all three countries are linked. All relevant reports and data for both cases have been forwarded to Member States' customs services for the necessary follow up action including recovery of anti-dumping duties. Civil debt recovery procedures for an estimated €6 million in anti-dumping duties have already been notified to the importers in six Member States and criminal investigations are underway in a number of Member States.

6.3.13. *An Overview of EC Judicial Remedies in Matters Related to Origin and Verification Requirements*

The question of the origin of goods has been brought before the Court on various occasions. Some leading cases in this area demonstrate the economic consequences of a correct determination of the origin of goods.

In the *Yoshida* case,[31] the facts did not strictly relate to imports of products from third countries but rather to the Dutch authorities' refusal to issue a certificate of Community origin for certain slide fasteners manufactured in the Community. The manufacturer, a Japanese company based in the Netherlands, challenged this refusal, and the case was referred to the European Court of Justice (ECJ) under Article 177.

[31] Case 114/78, Yoshida, [1979] ECR 151.

In particular, the manufacturer challenged the validity of Regulation 2067/77, which laid down a product-specific rule to determine the origin of slide fasteners. This Regulation was one of a series of product-specific regulations for determining the origin of goods for nonpreferential trade. It has to be noted that the circumstances of the case clearly indicated that Regulation 2067/77 was a measure of commercial policy directed specifically against products of Japanese origin.[32]

The Regulation provided that for originating status to be conferred on the final product, the manufacturing of the slider had to be carried out in the Community. Yoshida produced most of the parts of which fasteners are composed in the EC, except for the sliders, which were produced in Japan. The Court analyzed Regulation 2067/77 in the light of Article 3 of Regulation 802/68[33] to ascertain whether the specific requirements laid down by the Commission were justifiable. It did not accept the specific Commission requirement that the slider had to be manufactured in the Community, because there was no economic rationale for it. In particular, the Court concluded that:

> *[t]he requirement that virtually all components of a product must be of Community origin, even those of little value that are of no use in themselves unless they are incorporated into a whole, would amount to a repudiation of the very objective of the rules on the determination of origin. The Commission has therefore by that very fact exceeded its power under Article 14 (3) of Regulation 802/68.*

In the *Brother* case,[34] a sophisticated origin question was raised under Article 177 of the EC original treaty in the context of a postclearance recovery of AD duties. In particular, the German authorities considered that certain typewriters declared as being of Taiwanese origin were to be regarded as of Japanese origin and therefore fell within the scope of Regulation 1698/85 imposing AD duties on imports of typewriters originating in Japan. The German authorities therefore requested Brother to pay the corresponding amount of AD duties. The question before the Court related to the interpretation of Article 5 of Regulation 802/68 to ascertain whether the typewriters were to be considered as being of Taiwanese or Japanese origin. The vague terms of the regulation as examined in Section 5.4 provided the only guidance in assessing origin of this article, because there was no product-specific regulation concerning typewriters.

It is important to note the lack of specific and objective rules for determining the origin of a product in nonpreferential trade at the time of the

[32] See the opinion of the Advocate General in the same case for a summary of the previous circumstances.

[33] Council Regulation 802/68, O.J. L 148 (1968).

[34] Case C-26/88, Brother, [1989] ECR 4253. See also Subsection 3.5.1.

case.[35] Brother can be said to have been relatively lucky in being able to challenge the postclearance recovery decision adopted by the German authorities. In fact, it could be difficult, if not impossible, to challenge a decision concerning origin of goods made either through administrative provisions of national customs authorities or decisions made by the Origin Committee. Such decisions, sometimes informally communicated to the individuals concerned, are by their very nature difficult to bring to Court under Article 173 or Article 177. From an importer's point of view, it may be a relief to bring an action before the Court when the determination of origin constituted an almost blatant abuse, as in the *Yoshida* case.

In another case, *Trend-Moden Textile Handels*,[36] an issue related to the origin of goods was also raised. In this case, the argument was related not to the determination of origin but to the documentary evidence needed to prove the origin of the goods in question.

Trend-Moden, a German company, imported textiles from the Netherlands into Germany without paying customs duties because the goods were put into free circulation in the Netherlands. However, after an inspection by the German customs authorities, it was required to pay customs duties because it could not produce the prescribed form T2, as required by Regulation 222/77 under the internal Community transit procedure.

The question put to the Court was whether form T2 was the only acceptable proof for demonstrating the Community status of the goods or whether alternative documentary evidence, as suggested by the importer, was acceptable. In the light of Community efforts to facilitate the transport of goods within the EC, the answer given by the Court was that, in principle, only a form T2 declaration can confer Community status on goods.

The relative importance of this case may be fully appreciated by contrasting it with the elimination of the physical borders between the EC member-states at that time. It was a common belief among exporters from third countries that they can easily bypass national standards or regulations not yet harmonized at the Community level simply by transshipping goods via another member State (i.e., putting them into free circulation in the member-state and having them transshipped to the final destination). On the contrary, however, it seems that as long as Community transit was governed by forms T1 and T2, and these were considered the only means of proof of originating status, the national customs authorities were in a position to determine the origin of the goods

[35] See Vermulst and Waer, *European Community Rules of Origin as Commercial Policy Instruments?*, (1990) Michigan Journal of International Law, 201–275. See also S. Inama and E. Vermulst "Customs and Trade Laws of the European Community," Kluwer (1999).

[36] Case C-117/88, Trend-Moden Textile Handels, [1990] ECR 631.

in question[37] and apply the corresponding treatment or national regulations according to their real origin when legislation was not yet harmonized at the Community level.

An important economic aspect from the point of view of an economic overview relating to the question of origin is the postclearance recovery of duty, which may result from the discovery by national customs authorities of a false declaration of origin. Apart from the issues of criminal law and penalties discussed in Part III, this point has been raised several times in the ECJ,[38] especially when the issue of origin related to the granting of preferential duty according to the various trade agreements entered into by the Community with various third countries.

In *Administration des Douanes/Soulange Chiffre*, the question related to a simple although relevant detail in the issuance of the origin certificate, Form A, by the Indian customs authorities. In fact the certificates of origin, GSP Form A, issued by the Indian customs authorities, contained as country of destination of the goods the Socialist Republic of Czechoslovakia and the Popular Republic of Poland. The French customs refused to accept such certificates for customs clearance in France because they did not indicate the EC as final destination. They maintained that this indication was the only means of establishing that the origin of the goods, according to EC GSP rules of origin, had been correctly fulfilled by the exporting country. On the other hand, the French importer claimed that the GSP Form A was issued having as final destination Poland and Czechoslovakia because the original transaction was conducted in the framework of a countertrade deal. This fact, however, did not exclude the issuance of an *a posteriori* certificate by the Indian customs authorities. This possibility contained in the GSP rules of origin was warranted by the exceptional character of the countertrade transaction. The Court, while excluding the validity of the original certificate, admitted the possibility of the issuance of an *a posteriori GSP* Form A pursuant to the EC rules of origin.

An interesting case on rules of origin and postclearance recovery of duties implying different legal and procedural aspects was addressed by the Court.[39]

[37] It seems that the EC institutions are already aware of this problem. See Regulation No 339/93 on checks for conformity with the rules on product safety in the case of products imported from third countries, particularly, preambles 4 and 6.

[38] Case 368/92, Administration des Douanes/Solange Chiffre, [1994] ECR 605. See also Case C-12/92, Huygen [1993] ECR I-6381; Case 218/83, Les Rapides Savoyardes [1984] ECR 3105; and Case C-432/92, Anastasiov [1994] ECR 3087.

[39] Joined Cases C-153/94 and 204/94, *The Queen v. Commissioners of Customs and Excise*, ex parte Faroe Seafood C. Ltd and Others, [1996] ECR I-2465.

The facts of the case concerned EUR.I certificates issued by Faeroese customs officials and subsequently invalidated by the United Kingdom customs, following an investigation conducted jointly by the Commission and the customs authorities of the United Kingdom and Denmark. The findings of the investigation revealed that the relevant rules of origin concerning fishery vessels, that is, the composition of the crew of the vessels that caught the fish, had not been fulfilled because the percentage of the third-country crew on board the fishing vessels had not been respected. Second two factories had mixed shrimp, some originating in the Faeroe Islands and others in third countries.

Following the findings of the investigation, the United Kingdom customs authorities declared invalid the certificates of origin, Form EUR.I, issued by the Faeroese customs authorities and proceeded to the postclearance recovery of the duties. The Faeroese customs authorities, however, maintained that the certificate, Form EUR.I, was issued according to EC rules of origin and was fully valid. In particular they contested, not the facts ascertained by the investigation, but the application and interpretation made by the investigation team of the Community rules of origin. In this context, the United Kingdom court posed a series of questions to the ECJ. Some of the questions related to certain principles concerning procedural rules and interpretation of EC rules of origin.

One of the issues addressed by the United Kingdom Court was whether the United Kingdom customs was entitled to proceed to a postclearance recovery of duties, when the Faeroese authorities disputed the findings of the investigation, maintaining that the certificates were fully valid and in force. In addition, the Faeroese customs authorities pointed out that the Origin Committee established by virtue of Regulation 802/68 was not consulted on the question.

The Court first held that when an *a posteriori* investigation is conducted and its findings conclude that the certificates of origin were wrongly issued by the competent authorities, the appropriate duties have to be collected. The fact that the Faeroese customs authorities maintained the validity of the certificate of origin was further examined by the Court in the light of its previous case law on customs cooperation for the verification of certificates of origin. Although the Court held that this latter cooperation is shared between importing and exporting customs authorities, it introduced a qualification on the nature of the trade preferences.

In particular the Court held that "the need for the Customs Authorities of the Member States to recognize the assessments made by the customs authorities of the exporting country does not arise in the same way where the preferential system is established not by an international agreement binding the Community

to a nonmember country on the basis of reciprocal obligations, but by a unilateral Community measure."[40] Given the diversified trade arrangements of the EC, this distinction means that origin determination by customs authorities under the GSP and, to a certain extent, the former Lomé Convention has a different value than that made by customs authorities of countries having reciprocal FTA agreements. This seems to echo the differentiation made in the S.R. *Industries* case.[41] The Court further held that there is no obligation on member-states' customs authorities to submit such origin litigation to the Origin Committee because this Committee had as its main task the definition of rules of origin through collaboration among the Commission and member-states.

The Court also examined, in addition to other relevant issues, the principles of good faith and legitimate expectations of the importers when making origin declarations. In fact, a waiver to the recovery of customs duties may be granted subject to Article 5, paragraph 2, of Regulation 1697/79.[42] In particular, this article provided that three cumulative conditions had to be fulfilled to waive the postclearance recovery of customs duty, namely that noncollection must have been due to an error by the authorities, that the person liable must have acted in good faith, or, in other words, that he must not have been reasonably able to detect the error of the authorities and he must have complied with all the provisions laid down by the legislation in force, so far as his customs declaration is concerned. The Court then examined when these three conditions are fulfilled as follows:

(A) Error of competent customs authorities

The Court examined what could be considered "a mistake of competent authorities." It held that the legitimate expectation of the person liable to attract the protection provided for in Article 5 (Regulation 1697/79) applied only if it was the competent authorities themselves who created the basis for those expectations. "Thus any errors attributable to acts of the competent authorities confer entitlement to the waiver of post-clearance recovery of customs duties." This is not the case when competent authorities are misled by an incorrect declaration furnished by the exporters.

[40] See Judgement of the Court on Joint Cases 153/94 and 204/94, previous footnote, [1996] ECR I-2522.

[41] Case 385/85, S.R. *Industries v. Administration des douanes*, [1986] ECR 2929.

[42] O.J. L 197 (1979). That Regulation was repealed following consolidation by Article 251 of Regulation 2913/92 cited supra.

(B) Whether the error on the part of the competent authorities could have been detected by the person liable

The Court first recalled previous cases[43] in which it held that the condition in question implies that the national court must enquire whether the person liable might not reasonably have been able to detect the error made by the competent authorities, having regard to the nature of the error, the professional experience of the traders concerned and the degree of care that they exercised. Although the Court left to the national court the assessment of the particular circumstances of the case, it gave quite a detailed indication of its own evaluation of the specific circumstances favorable to the Faeroese exporters.

(C) Whether all the provisions laid down by the legislation in force concerning customs declarations had been complied with

The Court held "that the person making the declaration must supply the competent customs authorities with all the necessary information as required by the Community rules (. . .) However, this obligation may not go beyond production of the information that the person making the declaration may reasonably be expected to possess and obtain, with result that it is sufficient for such information, even if incorrect, to have been provided in good faith."

More recently, a landmark case has led EC authorities to seriously reconsider the issue of origin verification and revise administrative procedures.

This case concerned the importation into the Community of colour televisions (CTVs) assembled in Turkey. They were produced by various Turkish companies that used in their manufacture, besides components of Turkish origin, components of Community origin and components from third countries (generally from Korea, Japan, Hong Kong, and Singapore).

According to the EC/Turkish Association Council, goods exported from Turkey to the EC were given a preferential treatment only if a compensatory levy was collected on the third-country inputs used in the manufacturing of the finished products. The joint EC/Turkish Association Council took decisions 2/72 and 3/73 establishing precise rules relating to the procedure for the collection of the compensatory levies to be collected on the imported components.

Between 1991 and 1994, CTVs manufactured in Turkey were imported into the Community under A.TR.1 certificates and thus qualified for the exemption from customs duties provided for by the Association Agreement and the Additional Protocol.

[43] Case C 371/90, *Beirafrio v. Alfandega do Ronto* [1992] ECR 2715, case C 187/91, Belovo [1992] ECR 4937.

Following a number of complaints and notifications of irregularities, the Commission undertook a fact-finding mission to Turkey in 1993 in which two representatives of the Commission and five representatives from the Belgian, French, Dutch, German, and United Kingdom customs services took part. In the course of the mission, it was ascertained that the Turkish authorities were validating A.TR.1 certificates without any compensatory levy being collected.

The Commission concluded in the mission report that the certificates were invalid because they related in fact to CTVs manufactured in Turkey in that the components originating in third countries had not been released for free circulation or made subject to a compensatory levy and, accordingly, they could not be released for free circulation on importation into the Community.

Accordingly, by letters of 2 March and 21 April 1994, it instructed the member-states concerned to seek payment of the customs duties laid down by the Common Customs Tariff (that is, 14 percent of the total value of the television sets at the time of their importation into the Community) from the companies that had imported the television sets from Turkey at the material time, taking account of the three-year time limit for recovery. However, the Commission authorized the member-states who wished to do so to waive or postpone the recovery of duties until it had made a final appraisal of the result of the fact-finding mission.

Finally, the Commission confirmed, by a letter of 25 November 1994, that it was necessary to proceed without delay to recover customs duties on imports of CTVs made under A.TR.1 certificates issued before 15 January 1994, taking into account the three-year time limit for recovery.

All importers submitted a request for waiving the postclearance recovery of duties. However, the Commission decided that such requests were unfounded.

In fact, the Commission observed that, according to settled case law, the legitimate expectations of a trader warrant protection only if the competent authorities themselves created the basis for those expectations. They went on to state in the contested decisions that the Turkish exporters had declared in section 13 of the A.TR.1 certificates that the goods described therein met the conditions for obtaining that certificate. That was not the case, because, as was discovered during the fact-finding mission in Turkey, the television sets manufactured in Turkey contained components from third countries that had not been released for free circulation or made subject to a compensatory levy in accordance with Article 3(1) of the Additional Protocol.

The Commission accordingly took the view that the competent Turkish authorities were misled by the inaccurate statements made by the exporters. No positive error could thus be attributed to those authorities, and therefore the fact that the Turkish authorities had issued the contested certificates based

on statements made by the exporters was not sufficient to justify a legitimate expectation on the part of the importers as to the validity of those certificates.

The Commission also observed that the legislation at issue was well known and relatively simple as regards the conditions for issue of an A.TR.1 certificate and that the importers could not, therefore, have been unaware of it. It also pointed out that a diligent trader should have had doubts about the validity of the A.TR.1 certificates. In the light of those findings, the Commission found that the conditions for remission and/or nonrecovery of the customs duties were not met.

The importers contested the decision of the Commission not to grant waiver of postclearance recoveries. The Court started its reasoning by recognizing that as held in *Mecanarte*, paragraphs 23 and 24, the legitimate expectations of the person liable to pay qualify only for the protection provided for in Article 5(2) of Regulation no. 1697/79 only if it was the competent authorities themselves who created the basis for the expectations of the person liable. Thus, only errors attributable to acts of the competent authorities, which could not reasonably have been detected by the person liable to pay, create entitlement to the waiver of postclearance recovery of customs duties. That condition cannot be regarded as fulfilled where the competent authorities have been misled, in particular as to the origin of the goods, by incorrect declarations made by the person liable, the validity of which those authorities do not have to check or assess. In such circumstances, the Court has consistently held that it is the person liable to pay who must bear the risks arising from a commercial document that is found to be false when subsequently checked.

On the other hand, those provisions do not prevent the person liable to pay from relying on other matters in support of his application for remission under Article 13(1) of Regulation no. 1430/79. The error of the competent authorities may itself have been made possible by inadequate monitoring by the Commission of the implementation of the provisions of the Association Agreement. As is clear from previous case law, such circumstances may constitute a special situation within the meaning of Article 13(1) of Regulation no. 1430/79.

Because it has been established that the fact that the Turkish customs authorities were misled by the Turkish exporters does not, in itself, rule out the existence of a special situation within the meaning of Article 13(1) of Regulation no. 1430/79, the court went on to determine whether the circumstances of the case constituted such a situation.

Accordingly, the Court first observed that, for more than 20 years, the Turkish authorities did not transpose legislation on the compensatory levy laid down in Article 3(1) of the Additional Protocol and Decision No 2/72. Because the legislation was not transposed, the Turkish customs authorities could not

legitimately issue A.TR.1 certificates for goods, such as CTVs, containing components from third countries that were not in free circulation in Turkey.

Second, from 1991 until 1993 the Turkish authorities introduced measures that either did not comply with the provisions of the Association Agreement or the Additional Protocol or did not allow the correct implementation of those provisions as regards the exportation of goods (including CTVs) to the Community.

The Court also found that a number of applicants provided plausible evidence to show that those authorities were (or at least should have been) aware of the presence in the CTVs of components from third countries imported under that scheme, in particular on the basis of information given in the export declarations and the A.TR.1 certificates and by virtue of their task of supervising the implementation of the export incentive scheme.

That is borne out by the fact that, as the Commission report stated, it was based on customs import and export documents that the fact-finding mission was able to establish that components from third countries were imported free of duty and the finished products exported under the export incentive scheme. *A fortiori*, the Turkish customs authorities, which endorsed those documents, could have made the same finding. The fact that they did not have import declarations, as the Commission stated, merely confirmed in the eyes of the Court the inadequacy of their methods.

The Court also found that the fact that those two decisions of the Association Council were not published was particularly serious. The Court found it surprising that the Commission accused the applicants of not being cognizant of the provisions concerning the compensatory levy when some of those provisions were not published. For instance, because Decision no. 2/72 was not published, community and noncommunity traders could not be deemed to know that the Association Council for the compensatory levy had fixed a rate. In any event, because Decisions no. 2/72 and no. 3/72 were of a general legislative nature, their publication in the Official Journal was, as a matter of principle, an essential precondition for their having a binding effect on their addressees.

Furthermore, even if the applicants knew that a rate had been fixed for the compensatory levy, they could not know, merely by reading the conditions set out on the reverse of the A.TR.1 certificate, that the Turkish customs authorities were making an error in issuing such a certificate for the goods at issue. The customs authorities could validly issue A.TR.1 certificates without collecting a compensatory levy if the components of the television sets concerned were of Turkish or Community origin or, if from third countries, had been released for free circulation in Turkey.

Moreover, to detect the error made by the Turkish customs authorities, it was necessary not only to have thorough knowledge of the general legislation concerning preferential treatment, but also to know that the Republic of Turkey had not transposed that legislation. It was only by knowing that the Turkish customs legislation contained no provisions concerning the collection of a compensatory levy that importers could know that they needed to ascertain that the components from third countries that had been included in the television sets had been released for free circulation in Turkey. The Court found that not only the Commission itself – despite having been entrusted with the role of monitoring the implementation of the Association Agreement and the Additional Protocol – waited more than 20 years before ascertaining that the Turkish authorities had not transposed the legislation on the compensatory levy, but it took more than five years and the organization of the fact-finding mission on the spot for it to ascertain the state of the Turkish legislation on the importation of components from third countries.

That legislation was, moreover, very complex. First, the Turkish authorities had set up the export incentive scheme, and, second, the Court finally held that the serious deficiencies attributable to the contracting parties had the effect of placing the applicants in a special position in relation to other traders carrying out the same activity. The deficiencies undoubtedly helped to bring about irregularities that led to customs duties being entered in the accounts postclearance with respect to the applicants. Moreover, in the circumstances of the present case, there was no obvious negligence or deception on the part of the applicants.

Consequently the Court held that the Commission made a manifest error of assessment in finding in the contested decisions that the conditions for remission of customs duties laid down in Article 13(1) of Regulation no. 1430/79 or, as appropriate, in Article 239 of the Customs Code were not met.

A rather unique case deals with the issue of derogation under the former Lomé Convention. Case C-430/92, *Kingdom of the Netherlands v. Commission*,[44] concerns a Commission decision[45] refusing a request from the Netherlands Antilles for a derogation from the definition of originating products[46]

[44] [1995] ECR I-5197.

[45] Commission Decision C(92)2655 final, of 6 November 1992.

[46] See Council Decision 91/482/EEC, O.J. L 263(1991), on the association of overseas countries and territories with the European Economic Community (OCT Decision). The rules on definition the concept of originating products are to be found in Annex II to the OCT decision. Article 30 of Annex II provides for the possibility of derogations and, in particular, paragraph 8 states that: "*(a) The Council and the Commission shall take all the necessary measures to ensure that a decision is taken promptly and in any case not later than 60 working days after receipt of the*

with respect to prerecorded video cassettes falling within CN code 8524. The Netherlands government argued that the decision had to be declared void, because the Commission's refusal of the Netherlands Antilles' request for a derogation had been given after the time limit of 60 working days had expired. Consequently, the request had to be considered as accepted.

According to the facts of the case, the request was submitted by the Government of the Netherlands Antilles to the chairman of the Committee on Origin (who received it on 1 June 1992), through the offices of the Permanent Representative of the Netherlands to the Communities. The request concerned prerecorded video cassettes produced in Curacao from material imported from Korea, Japan, and the United States, and exported subsequently to the Community and the United States. The request was submitted by means of the standard application form, duly completed, and referred to the benefits of the proposed investment for the economy of the Antilles and to the reasons why the rules on origin could not be met by the finished product.

Following that request, the Commission promptly sent to the Committee on Origin a note expressing its reservations concerning, *inter alia*, the sensitivity of the product in question and the fact that the work to be performed in the Netherlands Antilles appeared to be a relatively minor operation.

On 31 July 1992, the Commission wrote to the Netherlands Government asking to provide the Community with further explanation on some matters before a decision could be made on the request for derogation. The Commission also stated that the 60-working-day time limit would commence from the date on which it received adequate information on those matters, contending that the time limit begins to run only from the moment when requests for derogation comprise all the information necessary to enable the Community to consider them.

In the opinion of Advocate General Gulmann, it was clear that the Commission could not demand further information simply to gain time for a decision to be taken. The Commission must be expected to decide as quickly as possible whether it needs additional information. In this case, the circumstances referred to in the Commission's letter of 31 July 1992 did not provide a sufficient basis for an extension of the time limit. He further noted that 60-day time limit was introduced precisely to ensure that requests for derogation from the rules

request by the Chairman of the Committee on origin. In this context, Decision 90/523/EEC shall apply mutatis mutandis *to the OCT*; (b) If a decision is not taken within the time-limit referred to in subparagraph (a), the request shall be considered as accepted." See Inama and Vermulst "Customs and Trade Laws of the European Community," Kluwer (1999).

of origin are dealt with rapidly and efficiently by the Community authorities, and to provide legal certainty.

The additional information the Commission required mainly concerned three problems:

1. The Commission mentioned the possibility for the Netherlands Antilles to import the materials needed in the manufacturing process from the Community (no more from third countries), so that the final products would comply with the normal rules of origin and a derogation would not be necessary at all.[47] This specific problem was already indicated in the request itself, in which the government of Netherlands Antilles had clearly explained that the necessary raw materials might be imported from the Community but that they were of lower quality or dearer, or both, than corresponding goods from third countries. Consequently, application of the rules on cumulation of origin could not solve the problem either qualitatively or economically.
2. The request did not provide any indication that the company concerned would take the necessary steps to fulfill, at least in the long term, the normal rules of origin, thus overcoming the need for a derogation.
3. The kind of products in question could cause an injury to an established Community industry, and in particular put at risk intellectual property rights of Community nationals or companies. Thus the Commission asked the Government of Netherlands Antilles to provide the Community intellectual property rights involved with some kind of protection.

The wording of the relevant provision[48] indicates that it is sufficient, to start the 60-day period running, for the request to have been received by the chairman of the Committee, provided, however, that it satisfies the formal requirements (fullest possible information, covering in particular the points listed previously).

The Netherlands representative on the Committee on Origin made a statement on 1 October 1992, from which it appeared that the Netherlands Government considered the request as accepted, because the Commission had not taken a decision before the expiry of the 60-day period (from 1 June to 21 August).

By a decision dated 6 November 1992, the Commission refused the request. In December 1992, the Kingdom of Netherlands (not exactly the OCT state

[47] The Commission expressly refers to Article 30 (4) of the OCT rules of origin (see Article 31, paragraph 4 of Protocol 1), which requires that such opportunities should be taken to avoid the need for derogations.

[48] Article 30 of Annex II to the OCT Decision. See also Article 31 of Protocol 1.

concerned, which is not entitled to apply for the annulment of an EC Commission decision), brought an action under the first paragraph of Article 173 of the EC Treaty seeking the annulment of the contested decision. The Court decided that the interpretation favorable to the Kingdom of Netherlands was "the only one capable of guaranteeing rapid settlement of the situation by ensuring that requests are accepted or rejected within the time-limit." "In this case the reasons given for the contested measure do not establish that the request failed to satisfy the formal requirements, but indicate that, after the Commission commenced its consideration of the merits of the request, it had doubts as to whether it was justified and sought additional information. (. . .). Since that step on the part of the Commission was not capable of interrupting the 60-working-day time-limit, the request submitted by the government of the Netherlands Antilles must be regarded, in accordance with Article 30 (8)(a), as impliedly accepted on the expiry of that time-limit. (. . .) Accordingly the contested decision is unlawful, because the Commission was no longer empowered *ratione temporis* to reject the request following its implied acceptance, and it must therefore be annulled."

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