TRAINING MODULE
ON RULES OF ORIGIN
NOTE

This Training Module is published under the auspices of TradeMark Southern Africa and is designed to contribute to the negotiating capacity of relevant stakeholders involved in the shaping of the Tripartite Free Trade Area (TFTA).

The training material provided is tailored to advise the negotiating tasks of the TFTA role players, including government officials as well as private sector and civil society representatives.

The Module is intended for educational and divulgence purposes only. As such, it does not reflect or state the official positions of the TFTA Members. Having no legal value, no claim can be made to the Publisher in relation to the legal content, which in no instance replaces or substitutes the official texts being reviewed.

PREFACE

This Module concerns the discipline of rules of origin as dealt with in the Common Market for Eastern and Southern Africa (COMESA), the Eastern African Community (EAC) and the Southern African Development Community (SADC) Treaties as well in the Draft TFTA Text.

The legal provisions on rules of origin of the three Regional Economic Communities (RECs) and the Draft TFTA Text have drawn from the existing models of rules of origin in the European Union (EU) and in the United States (US), as well as from the multilateral practices existing under the Kyoto Conventions and the World Trade Organization (WTO) Agreement on Rules of Origin (ARO).

In this scenario, the legal texts of COMESA, the EAC and SADC, along with the Draft TFTA Text, are examined in the light of the existing models of rules of origin in force in the European Communities (EC) and US as well as the current status of the Harmonised Work Programme under the WTO’s ARO.

Throughout the Module, selected excerpts from the rules of origin in the EU and US are provided, as well as examples drawn from the negotiations of the Harmonised Work Programme under the ARO and, wherever relevant, other leading cases from the TFTA Region and its trading partners.

This Module has been drafted by Mr Stefano Inama, Trade Lawyer, United Nations Conference on Trade and Development (UNCTAD). The Module draws from the book “Rules of origin in international trade”¹ and the experience gained in negotiations on rules of origin in Eastern and Southern Africa and in other, different regional and multilateral contexts.

Special thanks are extended to Mwansa Musonda of the COMESA Secretariat, Geoffrey Osoro of the EAC Secretariat and Paul Kalenga of the SADC Secretariat for providing the relevant legal texts and advice during the drafting.

What you will learn

Following this Training Module, you will:

> Learn about the international discipline of rules of origin under the WTO and in the COMESA, EAC, SADC legal provisions, as well as in the current formulation of the Draft TFTA Text;

> Master the terminology related to rules of origin as well as the legal requirements pertaining to this trade remedy;

> Understand how to draft rules of origin drawing from the existing legislation at multilateral, regional and national levels and to list the factors that shall be assessed in the drafting of particular rules of origin; and

> Become acquainted with the basic calculations of rules of origin and references to legal sources that will enable you to further engage in better understanding rules of origin and their administration in the light of the evolution in jurisprudence and negotiations.

# TABLE OF CONTENTS

Introduction: Rules of Origin in International Trade – Main Trade Policy Issues ............................................. 4

1. The Rules of Origin in COMESA, EAC, SADC and the Draft TFTA Text ................................................................. 8
   1.1 Introduction .................................................................................................................................................................. 8
   1.1.1 COMESA ....................................................................................................................................................... 8
   1.1.2 EAC ............................................................................................................................................................... 9
   1.1.3 SADC ......................................................................................................................................................... 10
   1.1.4 The Proposed TFTA Rules of Origin ........................................................................................................... 11

2. Rules of Origin under the WTO ARO and Other Multilateral Disciplines ............................................................... 13
   2.1 Rules of Origin in International Trade: Their Rationale ....................................................................................... 13
   2.2 Non-preferential Rules of Origin: The WTO Harmonisation Work Programme ............................................. 14
      2.2.1 Principal Features of the Harmonisation Work Programme on Non-preferential Rules of Origin ............... 14
      2.2.2 Method of Work Adopted by the TCRO: The Technical Implications of Using a Change of Tariff Classification as Main Criteria for Drafting Rules of Origin ......................................... 15
      2.2.3 The Treatment of Assembly Operations in the Textile and Machinery Sectors ...................................... 19
      2.2.4 Conclusive Remarks on the Issue of Harmonisation on Rules of Origin .................................................. 22

   3.1 The Concept of Rules of Origin: The Main Differences Between Non-Preferential and Preferential Rules of Origin ........................................................................................................................................... 23
   3.2 Preferential Rules of Origin ..................................................................................................................................... 24
      3.2.1 Unilateral Preferential Rules of Origin ............................................................................................................ 25
      3.2.2 Contractual Rules of Origin in FTAs ............................................................................................................. 26
   3.3 Cumulation ......................................................................................................................................................... 29
      3.3.1 Contractual Rules of Origin and Cumulation ............................................................................................... 31

4. Lessons Learnt in Drafting Rules of Origin ............................................................................................................... 33
      4.1.1 Origin Criteria: Technical Options and Implications ...................................................................................... 33
      4.1.2 The Wholly Obtained Criterion .................................................................................................................... 33
   4.2 Origin Criteria: The Definition of Substantial Transformation ............................................................................... 34
      4.2.1 Change of Tariff Heading ........................................................................................................................... 36
      4.2.2 The Percentage Criterion ........................................................................................................................... 38
      4.2.3 Specific Working and Processing ............................................................................................................... 42
   4.3 Lessons Learnt from Drafting Rules of Origin under FTAs: Technical Issues and Methodologies .................... 44
      4.3.1 Defining the Index of Technical Soundness .................................................................................................. 46
      4.3.2 Compiling a Complete, Structured Draft Containing all Elements of Rules of Origin ............................. 49

Annex 1: Exercise ......................................................................................................................................................... 52
   Examination of Different Texts of Rules of Origin ................................................................................................. 52
   Chapter Rule 1 ......................................................................................................................................................... 52
LIST OF TABLES

Table 1: Suggested origin criteria for certain animals ................................................................. 16
Table 2: Suggested origin criteria for coffee in various forms ...................................................... 17
Table 3: Steel products .................................................................................................................. 18
Table 4: Suggested adjustments to the HS structure ................................................................. 19
Table 5: Classification of finished goods and parts .................................................................. 20
Table 6: Example of a split chapter ............................................................................................. 21
Table 7: Existing regimes of rules of origin ................................................................................. 24
Table 8: Cumulation and donor country content .......................................................................... 30
Table 9: Drafting differences ....................................................................................................... 37
Table 10: The percentage criterion ............................................................................................. 38
Table 11: Example of domestic content rule .............................................................................. 41
Table 12: Utilisation of trade preferences by Asian FTAs .......................................................... 44
Introduction: Rules of Origin in International Trade – Main Trade Policy Issues

Origin rules were first introduced in international trade to enable national customs offices to determine the country of origin of goods imported into their territory, so that tariffs could be applied correctly and statistical data could be collected. In theory, if every country were to apply Most Favoured Nation (MFN) treatment to imported products, the origin of these products would clearly not matter. In practice, countries have always used origin rules to distinguish foreign products from domestic products, among other reasons, when they do not wish to apply national treatment to imported goods. Moreover, origin determination is becoming more important due to the proliferation and overlapping of regional trade agreements and unilateral preferential arrangements, which extend further than the MFN treatment of products ‘originating’ in partner or selected countries.

Over the last couple of years, and especially after the conclusion of the Uruguay Round negotiations, the application of origin rules has widened its scope. Today these rules are also used as the main evidence to support laws and regulations within the framework of WTO trade policy instruments such as trade preferences in unilateral and contractual preferential trade arrangements, anti-dumping and countervailing duties, quantitative restrictions, export restraints, government procurement and safeguard measures.

Globalisation and fragmentation of production is currently the main factor complicating the issue of origin determination. The complexity of origin rules has increased as a consequence of advances in the technology of manufacturing processes, which have resulted in greater specialisation. The number of component suppliers operating in different countries has increased. More and more imported inputs are involved in the production of the final good. This means that weighting the relative importance of the various factors of production has become essential in the drafting of origin rules. As a consequence, it is increasingly difficult to identify one simple criterion as the most suitable to determine the country of origin of the good.

At the same time that globalisation is complicating the determination of the origin of a product, origin determination is becoming more important due to the proliferation and overlapping of regional trade agreements and unilateral preferential arrangements, which extend further than the MFN treatment of products ‘originating’ in partner or selected countries. There are not only more such arrangements, but to an increasing extent they interconnect, in that one country may be a member of several sub-regional agreements and at the same time a beneficiary of unilateral preferences. This is exactly the case for many TFTA Member States.

Compliance with rules of origin, including the requirements for supporting documentation, is invariably cited by enterprises as one of the most irritating trade policy measures affecting their daily operations.

Although the impact and relevance of the implications of non-preferential rules are more complex to detect when compared to preferential rules, they have increasingly assumed critical importance in the ‘fight for market entry’. Their impact becomes evident when they are associated with discrimination measures. In such cases, rules of origin imply a ‘negative benefit’, i.e. they identify products which are subject to some sort of ‘penalty’, such as quota restraints, over tariff quota rates or countervailing or anti-dumping duties.

Trade remedies and anti-dumping duties are becoming one of the main instruments for controlling trade, and origin considerations have become an important factor in the application of anti-dumping measures. The major trading countries have implemented legislation aimed at preventing the circumvention of anti-dumping duties, which are seen to be accomplished by exporting parts for assembly by a ‘screwdriver’ plant in the importing country, or by shifting production to another country. In such cases the question of origin can be linked to the origin of the firm. In anti-dumping cases there is also the question of which firms constitute the domestic industry. The fact that, in some cases, the criteria applied may result in anti-dumping action being applied to protect a foreign firm, located in the importing country, from injury caused by dumping from domestic firms producing abroad, illustrates the complexity of this issue. Although, during the Uruguay Round, negotiations were undertaken on the issue of anti-circumvention measures, members failed to reach agreement and the issue of anti-circumvention became merely the object of a common declaration.

While a harmonised set of non-preferential rules of origin is still under negotiation, changes in the domestic legislation of major trade partners have already given rise to considerable controversy. In addition, the ARO enlarges the utilisation of origin determination to new areas such as mark of origin, trade statistics and government procurement.2

---

2 See paragraph 2 of Article I Definition and Coverage of the Agreement on Rules of Origin where it refers to “Rules of origin ... shall include origin marking requirements under Art. IX of GATT 1999” and “they shall also include rules of origin used for government procurement and trade statistics”.

As noted above, rules of origin are conceived to further certain basic trade policy objectives. However, when criteria established with these objectives in mind are transposed to other areas, trade problems can arise. For example, the subordination of marks of origin to rules of origin has already given rise to trade disputes. Although technically, according to the criteria for rules of origin, a product may originate in the country where the value added was achieved, the designation of origin as the country of manufacture of the basic material (rather than its conception and design) can negate the comparative advantage that may be derived from the reputation of the designing country.

**Implication of Mark of Origin**

During the early round of negotiation of the Technical Committee on Rules of Origin, the Swiss Delegation proposed that the assembly of watches from parts should confer origin since this process involves a series of complex operations requiring specialised services. The comparative rule of origin adopted by Switzerland under its Generalised System of Preferences (GSP) scheme requires, in general, that the foreign inputs used in the manufacturing of the watch do not exceed 40% of its ex-works value and that the value of the non-originating inputs does not exceed the value of the domestic input. The Swiss Delegation argued that customs origin is not necessarily to be regarded as sufficient criterion when it comes to marking goods with the name of the country of production, since members may need to add further information to meet specific criteria such as the Swiss legislation for national geographical indication for watches and their parts. The Delegation argued that such criteria are covered under Article 22 of the WTO Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement and Article IX, para. 6, of the General Agreement on Tariffs and Trade (GATT) 1996 and that this kind of geographical indication may go beyond the simple ‘customs origin’ concept. Other delegations, especially those from the Asian region, were of the opinion that origin should be conferred to the country which manufactured the clock movement (the electronic or mechanical component). They argued that the essential character 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 non-preferential rules of origin would allow Swiss watchmakers to import Japanese or third country clock movements and retain origin, while for Generalised System of Preference (GSP) purposes, the third country watchmakers would be faced by much stricter rules, making it difficult for their products to qualify for GSP benefits. Moreover, the Swiss proposal to link the origin marking to the geographical indication under Article 22 of the WTO Agreement on TRIPS may have obvious trade policy and marketing implications. Accordingly, parts of watches, watch cases and watch movements imported from third countries and assembled and tested in Switzerland would obtain Swiss origin protected by the geographical indication of Article 22 of the WTO TRIPS Agreement. Third countries’ manufacturers are invited to provide parts of watches with the assembly and testing being undertaken by Swiss laboratories in order that the watches obtain Swiss origin and protection of the origin marking.

When trade flow statistics are derived from rules of origin which have been designed with other policy objectives in mind, serious implications may occur as in the case of US–China trade relations. Rules designed to facilitate trade or to prevent trans-shipment when reflected in trade statistics may create bizarre results which can over- or underestimate trade flows and give rise to different perceptions as to the balance of bilateral trade between countries, with consequent political implications.

Another characteristic of rules of origin is their technical nature that renders them as an attractive subject for study. Overall, it is relevant to point out that the degree of technicality and the sophisticated and complex linkages which seem to govern industries which are currently exploiting globalisation opportunities are increasingly becoming evident in the area of rules of origin. Although rules of origin were the object of the ARO, this instrument fell short of exhaustively addressing all the issues and implications which can and are arising in this field.

Different approaches may be adopted in examining the issue of rules of origin. The traditional issues connected with origin determination deal essentially with the technical assessment of the best possible way to determine origin, shortcomings of the various methods and evaluation of the degree of restrictiveness or liberality. However, rules of origin also reveal the chains of production and strategies utilised by enterprises to exploit comparative advantages in the manufacturing of finished and intermediate products. To sum up, if one utilises the 'revealing' components of rules of origin to a finished product, it is increasingly likely that one will be able, through an operation of reverse engineering, to appreciate the dialogue, the constraints, and the interaction between the multilateral trading system and globalisation.
The Substantial Economic Benefit Criteria, Globalisation and Trade Statistics

A recent press report outline a relevant case where the combined issues of origin criteria, globalisation of production and trade statistics came into play.

A Barbie doll is sold in a US shop in a box labelled ‘made in China’, at a price of US$9.99. The report writer was able to establish that through multi-country processing, utilising different intermediate inputs, China was the country of origin of the Barbie doll. The US customs held the same view. However, of the US$9.99 retail price, the ‘substantial economic benefit’ for China is just 35 cents. A cost analysis, tracing back through the making of Barbie doll revealed the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail price</td>
<td>US$9.99</td>
</tr>
<tr>
<td>Shipping, ground transportation, marketing, wholesale, retail and profit</td>
<td>US$7.99</td>
</tr>
<tr>
<td>Export value from China</td>
<td>US$2.00</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overhead and management (Hong Kong)</td>
<td>US$1.00</td>
</tr>
<tr>
<td>Intermediate materials (nylon hair (Japan), vinyl plastic (Taiwan), packaging (US), oil to produce vinyl plastic (Saudi Arabia), other (China)</td>
<td>US$0.65</td>
</tr>
<tr>
<td>Labour (China)</td>
<td>US$0.35</td>
</tr>
</tbody>
</table>

Since China is the country of origin, it is charged with an export value of US$2.00 in terms of trade statistics, but the economic benefit deriving from this is just 35 cents. According to US customs, toys imported from China in 1995 totalled 5.4 billion – about one sixth of the total 36.2 billion US trade deficit. China, however, contends that these US trade figures are distorted since they do not take into account economic realities or the value added in multi country production chain, the holding corporation, Mattel, is estimated to make US$1.00 profit and most of the US$9.99 cost of producing the Barbie doll is estimated to be accumulated in the United States. This finding seems to contradict the fear of job losses, often raised in US 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 the suitability of using rules of origin for trade statistics calculations.

On the basis of these findings, some analysts started to flag the idea of investigating the origin of the company rather than the origin of goods produced. Yet, given the current trend towards mergers, acquisitions and joint ventures, this may prove equally difficult in the long run.

Given their industry-driven approach, one might argue that the World Customs Organization (WCO) and WTO Harmonised Work Programme negotiations on non-preferential rules of origin looks at the distribution of industrial capacity among the participating countries. These negotiations focused on the manufacturing processes of domestic industries.

Countries with a large industrial base may be interested in adopting rules of origin matching the capacity of their domestic industries, while those with small industry bases may be interested in benefitting from investments, even if they are initially limited to assembly operations.

A restrictive or complex rule of origin, demanding sophisticated processing, may have the effect of concentrating ‘origin’ in fewer countries. Conversely, lenient rules allowing origin to be conferred by simple processing or assembly operations may scatter origin among different countries. The weighting and implications of the rules will eventually reflect the policy objectives of the countries concerned and will have to be evaluated in the light of the instruments of the international trading system. In recent negotiations on non-preferential rules of origin, the ‘substantial transformation’ concept, which in the past was strictly adhered to when elaborating preferential rules of origin, has been interpreted in a more liberal manner.

Until the beginning of the 1990s, preferential rules of origin numbered just a handful, mainly regulating some autonomous tariff preferentials like the GSP schemes. Only the EU, due to the Free Trade Areas (FTAs) network with the remaining European Free Trade Association (EFTA) countries, had developed a comprehensive policy on rules of origin.

---

In the years that followed, and especially after the US-Canada Free Trade Area and later the North American Free Trade Area (NAFTA) concluded rules of origin under FTAs, the number of rules of origin has proliferated. Such proliferation is following in the path of the flourishing growth in Regional Trade Agreements (RTAs). In fact, every time that RTAs are entered into, rules of origin have to be part of the agreement.

There are no binding multilateral rules on preferential rules of origin, nor are there efforts to harmonise them. It follows that there are not only different rules of origin in the case of the GSP schemes and as a result of the number of RTAs concluded between developed countries, but increasingly because of RTAs between developed and developing countries and among developing countries. As a result, there is an increased diversification in terms of the content and nature of preferential rules of origin.

The techniques and experience of the main users of rules of origin, namely the United States and the EU, have heavily influenced the drafting of the rules of origin in South–South agreements. This holds especially true when one of the partners in the South–South agreement has previously entered into an RTA with the US or EU. In these cases, experience has shown that the model inherited by the partner in the North will shape the content of the rules of origin of the RTA between the countries of the South.

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 trans-shipped through one of 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 an 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 this way, importers and producers would eventually undertake minimal transformation and finally they would re-export the goods to the countries with the higher tariffs. To sum up, this would be equivalent to a tariff circumvention operation.

In recent years, and especially following the NAFTA experience, rules of origin in FTAs have been used as a trade policy instrument to make the tariff preference dependent on the utilisation of regional inputs. A classic example is the case of the yarn-forward rules, where garments made in Mexico may benefit from a tariff preference only if US textile material is utilised.

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, since producers from the integrated area will favour intermediate inputs originating there, in spite of their higher cost in comparison with inputs from countries outside the FTA. Thus, the higher the preferential margin associated with origin compliance and the less costly the compliance with rules of origin and related administration costs, the greater trade diversion will be.

This Module thoroughly examines the subject of rules of origin, tracing the various developments taking place at multilateral level during the negotiation of non-preferential rules of origin pursuant to the WTO ARO, as well as those on preferential rules taking place in the context of FTAs.
1. The Rules of Origin in COMESA, EAC, SADC and the Draft TFTA Text

1.1 Introduction

This part of the Module covers the main features of the rules of origin contained in the three RECs and in the Draft TFTA Text, with some comments. The main issue of debate focuses on the relevant aspects and articles of the three RECs in terms of the contention that rules of origin are closely related to the definition of 'substantial transformation'. This does not mean that there are no other relevant issues that should be addressed in rationalising rules of origin, such as documentary evidence and administration of certificates of origin. However, the scope of the present training does not cover such aspects and these could be dealt with in a future module.

1.1.1 COMESA

The rules of origin of COMESA comprise a number of different origin criteria as contained in the COMESA Protocol on Rules of Origin.


"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 State wholly or partially from materials imported from outside the Member State or of undetermined origin by a process of production which effects a substantial transformation of those materials such that:

i. The [cost, insurance and freight (CIF)] value of those materials does not exceed 60 percent of the total cost of the materials used in the production of the goods; or

ii. The value added resulting from the process of production accounts for at least 35 percent of the ex factory cost of the goods; or

iii. The goods are classified or become classifiable under a tariff heading other than the tariff heading under which they were imported; or

iv. The goods are 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."

According to the COMESA Protocol on Rules of Origin, the COMESA Procedures Manual on the implementation of the COMESA Protocol on Rules of Origin provides for five different criteria for rules of origin:

"The COMESA Rules of Origin have five independent criteria, and goods are considered as originating in a Member State if they meet any of the five.

The criteria are as follows:

i. The goods should be wholly produced in a Member State; or

ii. The goods should be produced in the Member States and the CIF value of any foreign materials should not exceed 60% of the total cost of all materials used in their production; or

iii. The goods should be produced in the Member States and attain a value added of at least 35% of the ex factory cost of the goods; or

iv. The goods should be produced in the Member States and should be classifiable under a tariff heading other than the tariff heading of the non-originating materials used in their production;

v. The goods should be designated by the Council of Ministers as “goods of particular importance to the economic development of the Member States” and should contain not less than 25% value added, notwithstanding the provisions of paragraph (iii) above.”

5 Revised 2002 version.
In the course of the years of operation of the COMESA rules of origin, a number of disputes have arisen on the interpretation thereof, especially the 35% valued added requirement.\(^6\)

At the same time, COMESA has developed a series of product-specific rules of origin. The legal relationship and the status of these product-specific rules in relation to the rules of origin as contained in the COMESA protocol is not entirely clear.\(^7\)

\[1.1.2 \text{ EAC}\]

“Goods shall be accepted as originating in a Partner State when they are consigned directly from a Partner State to a consignee in another Partner State and where:

a) They have been wholly produced as provided for in rule 5 of these rules; or

b) They have been produced in a Partner State wholly or partially from materials imported from outside the Partner State, or of undetermined origin by a process of production which effects a substantial transformation of those materials such that:

i. The CIF value of those materials does not exceed sixty percent of the total cost of the materials used in the production of the goods; or

ii. The value added resulting from the process of production accounts for at least thirty five percent of the ex factory cost of the goods as specified in the First Schedule to these rules; or

iii. The goods are classified or become classifiable under a tariff heading other than the tariff heading under which they were imported as specified in the Second Schedule to these Rules.”

The EAC rules of origin appear similar to those of COMESA, but in reality there are a series of differences. The most relevant differences are the following:\(^8\)

1. There is no mention in the EAC rules that “goods of particular importance to the economic development of the Member States” are deserving of special status; and

2. It appears that the product-specific rules of origin were developed at the same time as the EAC Protocol rules of origin and, albeit with some similarities, there are significant differences with the COMESA product-specific rules.

As a confirmation of differences between the EAC, COMESA and SADC on the use of the Change in Tariff Heading (CTH), an analysis was conducted on CTH common to COMESA, EAC and SADC. In this analysis, a series of technical difficulties were encountered in identifying where the three RECs have adopted a simple CTH with no exceptions. These difficulties are further explained below with a few examples excerpted from some of the easiest chapters.

The EAC product-specific rules of origin, up to Chapter 28 (organic chemicals), are mostly based on the wholly obtained criteria, or when a CTH is used it is not a simple CTH but a CTH with exceptions. Thus for Chapters 1 to 28 it is not possible to find a simple CTH common to all three RECs. Chapters 28 and 29 are examples were a simple CTH is used across all three RECs and could be used as a common product-specific rule under the TFTA.

\(^6\) See report of the 19th Meeting of COMESA Council of Ministers where the following disputes were reported: Rules of origin dispute regarding refined palm oil from Kenya to Zambia. Zambia questioned whether the oil meets the 35% value added criterion under which it is exported; rules of origin dispute regarding air-conditioners from Egypt to Zambia. Zambia questioned whether the air-conditioners meet the 45% value added criterion. In 2004, Rwanda questioned Egypt whether the pick-up vans meet the 45% value added criterion under which they were exported. It took till 2008 to settle the dispute between Zambia and Kenya on palm oil (see COMESA Joint Ministers of Trade, Industry and Finance Report. Addis Ababa, April 2008).

\(^7\) In fact, there is no legal text linking to product-specific rules to the rules contained in the COMESA protocol.

\(^8\) The differences mostly relate to additional exceptions of some HS headings.
<table>
<thead>
<tr>
<th>Description</th>
<th>Simple CTH common to the 3 RECs at chapter level</th>
<th>Common only at heading level</th>
<th>EAC exceptions to simple CTH</th>
<th>COMESA exceptions to simple CTH</th>
<th>SADC exceptions to simple CTH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 30, pharmaceuticals</td>
<td>None</td>
<td>30.01, 30.02 and 30.03</td>
<td>Exception of 30.04 and 30.05</td>
<td>Exception of 30.04, 30.05 and 30.06</td>
<td>No exceptions</td>
</tr>
<tr>
<td>Chapter 31, fertilizers</td>
<td>None</td>
<td>All headings except 31.05</td>
<td>Exception of 31.05</td>
<td>No exceptions</td>
<td>No exceptions</td>
</tr>
<tr>
<td>Chapter 32, tannins and dyeing extracts</td>
<td>All headings except 32.13 and 32.14</td>
<td>Exception of 32.14</td>
<td>Exception of 32.14</td>
<td>No exceptions</td>
<td></td>
</tr>
<tr>
<td>Chapter 33, essential oils</td>
<td>None</td>
<td>All headings except 3303, 33.06 and 33.07</td>
<td>Exception of 33.06</td>
<td>Exception of 33.03, 33.06 and 33.07</td>
<td>No exceptions</td>
</tr>
<tr>
<td>Chapter 34, soap</td>
<td>All chapter 34</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

However, as shown above, starting from Chapter 30 (pharmaceuticals) there are a series of difficulties since, while the simple CTH has been used at Chapter level, there are a number of exceptions made at heading level under EAC and COMESA (heading 30.04 and 30.05), while no exceptions are made for SADC. At the same time, there are a number of headings where the simple CTH remains the basic rule common to all three RECs (for instance 30.01).

In order to maintain the commonalities, it would be necessary to single out in each Chapter the headings where the simple CTH is common among the three RECs (in this case for example heading 30.01) and leave out the exceptions. This exercise would result in a rather long list of headings where there the three RECs have adopted a common simple CTH. This is equivalent to a line-by-line approach and may raise questions or ambitions of harmonisation or negotiation over the excluded headings where there is no common simple CTH, but the CTH is used with exceptions.

The alternative would be to put on the negotiating table the headings where there are exceptions (for example 30.04 and 30.05 where SADC will have to agree with COMESA and EAC to single out the above-mentioned headings from the CTH).

This exercise would be tantamount to a harmonisation effort, resulting in a rather long list of headings where the three RECs will have to agree to use a given CTH and will ultimately result in a line-by-line negotiation.

---

### 1.1.3 SADC

The original SADC Protocol provided for rules of origin that were quite similar to those of COMESA. However, when the implementation of the SADC Trade Protocol started and negotiations on rules were tabled, it became evident that some Member States felt it appropriate to focus on a product-specific approach.

---

**Sufficiently Worked or Processed Products**

“(a) For the purpose of this Rule, products, which are not wholly produced, are considered to be sufficiently worked or processed when the conditions set out in the list in Appendix I of this Annex are fulfilled.

(b) The conditions referred to in sub-paragraph (a) indicate, for all products covered by this Protocol, the working and 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 this 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…”
The Article above makes reference to the list of product-specific rules that define at Chapter or heading level the requirements to be met to comply with rules of origin. The only exceptions to the list were the more lenient rules for clothing in Chapters 61 and 62 to be applied to the SADC least developed countries (LDCs) – often referred to as MMTZ (Malawi, Mozambique, Tanzania and Zambia). Even these lenient rules of origin were subject to quotas and administration procedures.

1.1.4 The Proposed TFTA Rules of Origin

At the Tripartite Sub-committee on Customs and Trade meeting, held in Mombasa from 24–25 July 2009, it was agreed that the TFTA rules of origin should:

"i) Not restrict trade;
ii) Be simple, flexible and easy for customs administrations to administer as well as businesses to comply with at a reasonable cost;
iii) Not to be more stringent than existing rules under the regional trading arrangements of the RECs and [Economic Partnership Agreements (EPAs)];
iv) Promote trade and enhance global competitiveness; and
v) Enable diagonal cumulation."

In the Annex prepared during the same Sub-committee meeting, a value of material calculation was retained as an across the board percentage criteria for determining origin, including two alternative criteria based on the amount of originating and non-originating materials. The value of material calculations has been found easier to administer than a value added calculation, since it is less complex and therefore less demanding in terms of compliance cost for business.

**Article 5: Origin Criteria – Sufficiently Worked or Processed Products**

“For the purposes of this Annex, products which are not wholly obtained are considered to be sufficiently worked or processed in the Tripartite Member States when:

• The value of non-originating materials used in the production of the good does not exceed 70% of the ex works price of the good; or
• The value of the originating materials used in the production of the good is at least equal to 30% of the ex works price of the good.

Notwithstanding paragraph 1 above, for the purposes of this Annex, products which are not wholly obtained in a Member State and contained in the list in Appendix I are considered to be sufficiently worked or processed only when the conditions set out in the list are fulfilled. Those conditions indicate, for all products covered by the list, the change of tariff classification or working or processing which must be carried out on non-originating materials used in manufacturing and apply only in relation to such materials.”

Moreover, this value of materials calculation takes into account the special situations related to the cost of input materials to the COMESA/EAC/SADC Countries. Basically the calculation method adopted is based on adjustments made to the value of materials permitting, on the one hand, the deduction of the CIF costs when non-originating materials are used in the manufacturing of a finished product and, on the other, the addition of inter-regional inland costs of transport when originating materials are used as outlined in Article 6 of the Draft TFTA Protocol on rules of origin below.
Article 6: Value of Materials

1. For purposes of Article 5, the value of a material shall be:
   a) For a material imported by the producer of the good, the value, determined in accordance with the GATT Agreement on Customs Valuation adjusted in accordance with the provisions of Articles 8 and 15 of the Agreement on Customs Valuation;
   b) For a material acquired in the territory where the good is produced, the value, determined in accordance with the GATT Agreement on Customs Valuation in the same manner as for imported goods, with such reasonable modifications as may be required due to the absence of an importation; or
   c) For a material that is self-produced;
      i. All the expenses incurred in the production of the material, including general expenses; and
      ii. An amount for profit equivalent to the profit added in the normal course of trade.

2. For originating materials, the following expenses, where not included under paragraph 1, 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 Tripartite State territory or between the territories of two or more Tripartite Member States 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 Member States, 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.

3. For non-originating materials, the following expenses, where included under Article 5, 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 to a Tripartite Member State or between the territories of two or more Tripartite Member States 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 Tripartite Member States, 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 Tripartite Member State.”
2. Rules of Origin under the WTO ARO and Other Multilateral Disciplines

2.1 Rules of Origin in International Trade: Their Rationale

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. At the outset, the granting of these tariff preferences was conditional upon the compliance with rules of origin requirements, often based on a value added criteria.

A notable exception to this principle, deriving from a different historical background, is the United States’ rules of origin which were first associated with origin marking and not with the granting of preferential tariff treatment. As discussed below, this latter difference has had direct consequences in the evolution of the origin concept in US legislation.

The issue of rules of origin (as opposed to origin markings to which GATT Article IX is devoted – probably as a result of US influence) did not gain 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 sub-committee 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 favoured nation (MFN) provision whether goods do in fact originate in a particular country”. Only later in 1951 and 1952 were the first attempts made (without success) to address the question of harmonisation of rules of origin.

The scant attention devoted to the issue of rules of origin in the original GATT is likely to have derived from the preoccupation of the drafters with establishing the unconditional MFN principle contained in Article I. In an MFN world there is no need to examine the origin of the goods. This implied that, as a general concept, origin entered into world trade with a discriminatory bias: you need to ascertain origin whenever a discriminatory measure is in place. During the years of GATT 1947 operation, rules of origin, used by Contracting Parties in the context of GATT instruments, and preferential rules of origin relating to the granting of tariff concessions according to treaties on arrangements concluded under Article XXIV, were sporadically the subject of debates.

Besides these early GATT discussions, one of the first attempts to establish a harmonised preferential set of rules of origin arose during a discussion held at UNCTAD in connection with the Generalised System of Preferences (GSP). In fact, UNCTAD Member States, when discussing the establishment of the GSP, realised the need to examine ‘origin’ at the multilateral and systemic level. However, the preferential character 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 negotiations, preference-giving countries opted to retain their own origin systems and extend them with some adjustments to the GSP.

---

9 See United Kingdom Finance Act of 1919.
10 See Tariff Act of 1890, Chapter 1244, paragraph 6, 26 Stat. 567, 613 (1891).
11 See EPCT/174, pages 3 and 4.
13 This consideration, however, does not fully explain why an origin determination was not considered necessary in the framework of Article VI of GATT on anti-dumping, although an explicit reference is made to the cost of production in the country of origin in paragraph I B ii of the Article.
Efforts to codify and strengthen a general concept of origin in the absence of multilateral disciplines took place at the multilateral level during the Kyoto Convention in 1973. However, Annex D I of the Convention containing such guidelines was not sufficiently detailed, and left Member States with the freedom to choose different and alternative methods to determine origin. The low level of harmonisation achieved, combined with the fact that few countries ratified this Annex, meant that the Annex became little more than a general guidance used in determining origin at national level.

These scant results achieved at the multilateral level to harmonise rules of origin or even to determine 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 Harmonised Commodity Description and Coding System negotiated under the auspices of the Customs Co-operation Council in 1988. Thus, until the Uruguay Round Agreement, rules of origin remained the only one of the three basic customs laws operating at national level, which was not subject to multilateral discipline.

2.2 Non-preferential Rules of Origin: The WTO Harmonisation Work Programme

The Uruguay Round Agreement on Rules of Origin (ARO) broke new ground in three respects: firstly, it brought non-preferential rules of origin into WTO discipline; secondly, it aimed to harmonise these rules through the detailed Harmonisation Work Programme involving the WCO; and, thirdly, the resulting harmonised set of non-preferential rules of origin is intended to be applicable for all trade policy purposes.

The core text of the ARO deals exclusively with non-preferential rules of origin, while as far as preferential rules of origin are concerned, the ARO limits itself to the Common Declaration with regard to Preferential Rules of Origin. The Declaration reiterates the call for transparency, predictability and user-friendliness in the application of preferential rules of origin. In comparison with the specific work programme for harmonising non-preferential rules of origin and the clear commitments contained therein, the text of the Declaration does not contain binding language.

2.2.1 Principal Features of the Harmonisation Work Programme on Non-preferential Rules of Origin

Part IV of the Agreement on Rules of Origin, entitled “Harmonisation of rules of origin”, deals specifically with, inter alia, the work programme for establishing a set of harmonised non-preferential rules of origin. While under Article 4 of the Agreement, the WTO Committee on Rules of Origin (CRO) was established, the actual elaboration of the harmonised rules was to be carried out by a Technical Committee “under the auspices of the Customs Cooperation Council” (now WCO) (see Article 4, para. 2). According to Article 9, para. 2(c), with reference to the work programme, the Technical Committee on Rules of Origin (TCRO) should first develop harmonised definitions of:

(i) Wholly obtained and minimal operations or processes;
(ii) Substantial transformation – change in tariff classification; and
(iii) Other supplementary criteria, upon completion of the work under sub-paragraph (ii) and on the basis of the criterion of the substantial transformation.

It is of paramount importance to note that the ARO clearly stipulated that the TCRO had to elaborate on the criteria of substantial transformation using the change in tariff classification. In addition, the work of

---

15 International Convention on the Simplification and Harmonisation of Customs Procedures, adopted in 1974 by the Customs Cooperation Council at its 41st and 42nd sessions held in Kyoto. In substance, Annex D I did not provide for ready-to-use rules of origin. While the criterion for products ‘wholly provided 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 than the fact that the three different ways in which the substantial transformation may be interpreted were listed: change of tariff heading, ad valorem percentage rules. For a list of manufacturing or processing operations, see Asakura H. The Harmonised System and Rules of Origin. In Journal of World Trade, August 1993, Vol. 27, No. 4.

16 In fact, after the entry into force of the Customs Valuation Code, negotiated under the Tokyo Round in 1979, and of the International Convention on the Harmonised Commodity Description and Coding System, negotiated under the auspices of the Customs Cooperation Council in 1988, rules of origin remained the only one of the three basic customs laws operating at the national level and not regulated or harmonised at the multilateral level. The Kyoto Convention contained, in its annexes, general guidelines on rules of origin criteria, but did not comprehensively regulate the matter.
the TCRO was divided on a product basis taking into account the Chapters or sections of the Harmonised System (HS) nomenclature.\(^{17}\)

Article 9, para. 2(c)(iii), provides for the Technical Committee to consider and elaborate upon supplementary criteria to be used “when, upon completion of the work under sub-paragraph (ii) (i.e. the work based on the change of tariff heading 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”. Such supplementary criteria might be “\textit{ad valorem} percentages and/or manufacturing or processing operations”. With this complicated wording, the ARO and its work programme adopts the change of tariff classification as the main criterion, and the across the board percentage criterion and specific working or processing operations are retained only as supplementary criteria.

The Harmonisation Work Programme (HWP) was officially launched on 20 July 1995 and was scheduled for completion by 20 July 1998. However, while the bulk of the technical work has been completed final agreement on the shape of the harmonised rules of origin has yet to be reached.

The first stage of the process concerned the development, by the Technical Committee, of harmonised definitions for ‘wholly obtained’ goods and ‘minimal operations’ that do not by themselves confer origin. The second stage involved the determination of the appropriate harmonisation criterion to be applied to individual products. During the third and last stage, the task of the Technical Committee was to consider the use of supplementary criteria or the exclusive use of other criteria in those instances in which a change in tariff classification is inappropriate as a sole criterion. In this process, the WTO CRO is supposed to consider the interpretations and opinions of the Technical Committee with a view to endorsing them.

As regards the status of the work, substantial progress has been made, but it has been slow. Most of the technical work on the harmonisation of rules of origin for specific products and sectors has been completed. The definitions of ‘wholly obtained’ products and ‘minimal operations or processes’ have been virtually completed, although further refinement is needed. What remains largely unresolved is the overall structure of the harmonised rules of origin. In particular, the stumbling block is the possible implications that the final set of harmonised rules may have on other WTO agreements, most notably the ADA.

### 2.2.2 Method of Work Adopted by the TCRO: The Technical Implications of Using a Change of Tariff Classification as Main Criteria for Drafting Rules of Origin

The text of 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 on the basis of the change of tariff classification criterion. Some examples, together with the dynamics of the initial outcome of the negotiations, are reported below in order to highlight lessons learned and sharpen technical abilities in the future.

The TCRO spent a considerable amount of time harmonising the definitions of wholly obtained products and of minimal operations and processes, which were subsequently reduced to a minimum. After making progress on these definitions, the TCRO turned to the elaboration of specific rules of origin on a product-by-product basis, starting with the least troublesome HS Chapter, namely Chapter 25 (on salt, sulphur, earths and stone). As was widely expected, the exclusive use of HS nomenclature to determine the origin of goods was one of the first major problems which the TCRO faced, given that the HS was originally intended only as a means for 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.\(^{18}\) Goods in the HS are first grouped into 21 sections and then into 96 two-digit chapters, which, in principle, are established by industrial sector. Chapters are divided into four-digit headings and six-digit subheadings. Headings are placed within a Chapter in the order of the degree of processing required.\(^{18}\) These features make the HS a suitable device for applying the concept of ‘substantial transformation’ in determining the country of origin through the ‘change in tariff heading’ (CTH) method. In principle, a final product is considered to have undergone sufficient manufacturing or processing if its tariff classification is different from that of the

\(^{17}\) The Harmonised Commodity Description and Coding System (HS) is a uniform nomenclature employed in the customs tariffs and trade statistical nomenclature of nearly 180 countries covering over 90% of world trade.


\(^{19}\) 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), semi-finished 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).
non-originating materials used for its manufacture: thus the product acquires the origin of the country in which it is manufactured (i.e. ‘substantially transformed’). This rule is referred to as the CTH or change in tariff subheading (CTSH) rule.

Let us suppose that a producer manufactures a chair from imported sawn wood. The chair cannot be considered as wholly obtained in one country because the producer has used imported sawn wood. Therefore it is essential to know if the sawn wood (the imported material) can be considered to have undergone sufficient manufacturing or processing according to the above-mentioned definition. Since the product obtained, a chair, is classified under HS heading 94.03 at the four-digit level (which is different from heading 44.07 where sawn wood is classified), we can determine that the sawn wood has been ‘substantially transformed’ and that the chair qualifies as an originating product. In fact, following the CTH rule, the final product is classified under an HS heading which differs from that under which the imported inputs are classified (i.e. the numbers of the headings of the foreign inputs and those of the finished products are different). In our example, the non-originating foreign inputs (sawn wood) would therefore be considered to have been sufficiently worked or processed and the final product (a chair) would therefore be considered to have originated in the producer’s country.

The structure of the HS varies from Chapter to Chapter and Section to Section, depending upon the nature of goods being classified. While 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. In other Chapters, however, especially the agricultural ones, it is difficult to apply. A typical example is Chapter 1, which covers different kinds of live animals in terms of which no degree of processing can occur. In these cases, where a ‘change of chapter’ (CC) rule is not applicable, the Technical Committee has developed a particular language which clearly explains the path to be followed to identify the country of origin of the good (see table below).

Table 1: Suggested origin criteria for certain animals

<table>
<thead>
<tr>
<th>HS Code Number</th>
<th>Description of goods</th>
<th>Origin criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 1 Live animals</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| 01.01 | Live horses, asses, mules and hinnies | Options proposed by delegations:  
1. The country of origin of the goods of this heading shall be the country in which the animal was born  
2. The country of origin of the goods of this heading shall be the country in which the animal was raised  
3. The country of origin of the goods of this heading shall be the country in which the animal was fattened for at least six months; or the country in which the animal was born  
4. The country of origin of the goods of this heading shall be the country in which the animal was fattened for at least six months; or the country in which the animal was born and raised |
| Chapter 2 Meat and edible meat offal |                                                    |                                                                                  |
| 02.05 | Meat of horses, asses, mules or hinnies, fresh chilled or frozen | Options proposed by delegations:  
1. The country of origin of the goods of this heading shall be the country in which the animal was born  
2. CC  
3. 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 three months  
4. The country of origin of the goods of this heading shall be the country in which the animal was fattened for at least six months; or the country in which the animal was born and raised |
| Chapter 5 Products of animal origin, not elsewhere specified or included |                                                    |                                                                                  |
| 05.03 | Horsehair and horsehair waste, whether or not put up as a layer with or without supporting material | CC |

Source: WCO document 42.146 E.
The various solutions offered by delegations during the discussions in the Technical Committee can be easily analysed, bearing in mind that “live animals born and raised in one country” are included in the list of the harmonised definitions of wholly obtained products. As regards heading 01.01, option 1 implicitly states that raising imported horses cannot be regarded as a substantial transformation. Option 2 perfectly echoes the above-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 increases 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. The only slight, but meaningful difference can be found in option 2, according to which a change of Chapter is required: this means that in order to obtain originating “meat of horses...” of heading 02.05, it is necessary 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, since 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 to 05.11 of different animal origin. The CTH role is not applicable in this case, because there is no other product in Chapter 5 from which, for example, horshair could be obtained; therefore, a change of chapter is required.

In the case of coffee (Chapter 9 of the HS), further discussion was carried out by the Technical Committee, since agreement could not be reached on the issues of decaffeination and roasting of coffee (see table below). On the one hand, coffee which has not been roasted or decaffeinated, has the origin of the country in which the plant grew (i.e. was wholly obtained); on the other hand, if coffee undergoes decaffeination or roasting, the applicable rule of origin depends on whether or not one or both of these processes is considered an origin-conferring event. In the case of subheading 0901.12, coffee not roasted has undergone decaffeination. While some delegations held the view that decaffeination is not substantial transformation and consequently should not be taken into account in determining the origin of the goods, for other delegations, changes in the chemical structure of the input material meant that decaffeination should be considered as resulting in a new product, so that the origin of the goods is the country where this last substantial transformation process has taken place. In this 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 shows a third option, roasted, decaffeinated coffee cannot originate from roasted, non-decaffeinated coffee. In this case, the goods acquire the origin of the country in which the process of roasting has taken place.

### Table 2: Suggested origin criteria for coffee in various forms

<table>
<thead>
<tr>
<th>HS code number</th>
<th>Description of goods</th>
<th>Origin criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Chapter 9 Coffee, tea, maté and spices</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>09.01 Coffee, whether or not roasted or decaffeinated...</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Coffee, not roasted</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0901.11 Not decaffeinated</td>
<td>The country of origin of the goods of this subheading shall be the country in which the plant grew</td>
<td></td>
</tr>
<tr>
<td>0901.12 Decaffeinated</td>
<td>Options proposed by delegations: 1. The country of origin of the goods of this subheading shall be the country in which the plant grew 2. CTSH</td>
<td></td>
</tr>
<tr>
<td><strong>Coffee, roasted</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0901.21 Not decaffeinated</td>
<td>Options proposed by delegations: 1. The country of origin of the goods of this subheading shall be the country in which the plant grew 2. CTSH</td>
<td></td>
</tr>
<tr>
<td>0901.22 Decaffeinated</td>
<td>Options proposed by delegations: 1. The country of origin of the goods of this subheading shall be the country in which the plant grew 2. CTSH 3. CTSH, except from subheading 0901.21</td>
<td></td>
</tr>
</tbody>
</table>

**Source:** WCO Document 42.146 E.
Apart from having identified the individual products and product sectors to which the wholly obtained CTH (or CTSH) or CC criteria would be sufficient for determining the country of origin, the TCRO proceeded with a more sophisticated adaptation of the HS to cover cases where the exclusive use of the HS nomenclature may give rise to difficulties in determining origin or where the HS is not structured in a manner which recognises certain manufacturing processes as origin-conferring events. In a 1995 document, the WCO Secretariat clearly enumerated the instances in which this need was likely to arise and proposed the following solutions:

a) Cases of products or product sectors in which an unspecified change in subheading or heading is not sufficient to express substantial transformation. The Technical Committee may come up with a rule under which the non-originating 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 3);

Table 3: Steel products

<table>
<thead>
<tr>
<th>HS code number</th>
<th>Description of goods</th>
<th>Origin criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>72.13</td>
<td>Bars and rods, hot-rolled in irregularly wound coils of iron or non-alloy steel</td>
<td>CTH, except for heading 72.14</td>
</tr>
<tr>
<td>72.14</td>
<td>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</td>
<td>CTH, except for heading 72.13</td>
</tr>
</tbody>
</table>

Source: WCO Document 42.273 E.

b) 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. The Technical Committee may, in these cases, split those subheadings or headings using the designation ‘ex’. The basic rule of origin will be the CTH or CTSH rule respectively; and

c) Cases where 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.

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 Technical Committee may consider as entailing substantial transformation. As mentioned above, the product-by-product analysis started from what was initially considered the least troublesome Chapter. In this context, as a rule at Chapter level, the TCRO had in principle endorsed the following terminology 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 hold the view that the process of calcination of mineral substances is an origin-conferring process. For example, as shown in Table 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, in order to adjust the HS structure for origin purposes

---


21 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 programme, to split the subheadings or headings in question to provide more specific descriptions of the products that accommodate the needs of origin determination.
and recognise calcination as an origin-conferring process, it is necessary to create two split headings: one for calcined kaolin, whose origin is conferred, through a CTSH rule, on the country where the imported kaolin undergoes calcination, and another one, “other than calcined kaolin”, to which the general rule applies.

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.

Table 4: Suggested adjustments to the HS structure

<table>
<thead>
<tr>
<th>HS code number</th>
<th>Description of goods</th>
<th>Origin criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 25</td>
<td>Salt, sulphur, earths and stone, plastering materials, lime and cement</td>
<td>Options proposed by delegations:</td>
</tr>
<tr>
<td>25.07</td>
<td>Kaolin and other kaolinic clays, whether or not calcined</td>
<td>1. Chapter rule</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. WO</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Proposals as indicated at the splits below</td>
</tr>
<tr>
<td>ex 25.07 (a)</td>
<td>Calcined*</td>
<td>CTHS</td>
</tr>
<tr>
<td>ex 25.07 (b)</td>
<td>Other*</td>
<td>Options proposed by delegations:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1. Chapter rule</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. CC</td>
</tr>
<tr>
<td>25.18</td>
<td>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)</td>
<td>Proposals as indicated for subheadings:</td>
</tr>
<tr>
<td>25.18.10</td>
<td>Dolomite not calcined</td>
<td>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</td>
</tr>
<tr>
<td>25.18.20</td>
<td>Calcined dolomite</td>
<td>CTSH</td>
</tr>
</tbody>
</table>

Source: WCO Document 42.535 E.

* When a split heading or subheading is proposed, the description is underlined to show that it is not HS text.

2.2.3 The Treatment of Assembly Operations in the Textile and Machinery Sectors

A major problem encountered by the Technical Committee in elaborating the harmonised set of origin rules utilising the HS, is the treatment of incomplete or unassembled articles. In fact, the HS provides six general rules for this interpretation, laying down the principle 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 which refers to a particular article to cover not only the complete or finished article, but also the 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 due to the requirements for, 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 (i.e. an assembly of parts so far advanced that they already have the essential character of the complete machine). A good example is given by the general explanatory note to Chapter 87 on vehicles, which states that:
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) A motor vehicle, not yet fitted with the wheels or tyres and battery;
b) A motor vehicle not equipped with its engine or with its interior fittings; or
c) A bicycle without saddle and tyres.

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 Technical Committee has come to the common understanding that the assembly of a good from parts results in substantial transformation and the conferral of origin. This principle is subject to exceptions under various circumstances for particular goods. 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 which 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 semi-trailers of 87.16 from parts of 8716.90). However, in some cases parts are classified under the heading with the vehicles produced and thus undergo no change of classification when used for production of the article (such as baby carriages of 87.15).

Table 5: Classification of finished goods and parts

<table>
<thead>
<tr>
<th>HS code number</th>
<th>Description of goods</th>
<th>Origin criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 87</td>
<td>Vehicles other than railway or tramway rolling stock, and parts and accessories thereof</td>
<td>Options proposed by delegations:</td>
</tr>
</tbody>
</table>
| 87.02          | Motor vehicles for transport of ten or more persons, including the driver | 1. CTH  
2. CTH, except for heading 87.06 (chassis fitted with engines, for the motor vehicles of headings nos. 87.01 to 87.05)  
3. 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 60% of the ex works price of the product  
4. At least 60% value added |
| 87.15          | Baby carriages and parts thereof | Options proposed by delegations: |
| ex 87.15 (a)   | Baby carriages* | CTH  
S |
| ex 87.15 (b)   | Parts of baby carriages* | CTH |

Source: WCO Document 41.643 E.

* When a split heading or subheading is proposed, the description is underlined to show that it is not HS text.
The issue of assembly of parts is also extremely relevant in the context of textile products, which represent one of the most sensitive sectors for origin determination. For goods listed in Chapter 61 (Articles of apparel and clothing accessories, knitted or crocheted), alternative proposals are still under discussion in the Technical Committee. One of the questions concerns the process of assembly of an article of headings 61.01 to 61.05 from parts knitted or crocheted to shape and, in particular, whether this process can be regarded as an origin-conferring event (see Table 6). In order to determine the origin of these goods, the compilation of Chapter notes has been deemed necessary.

### Table 6: Example of a split chapter

<table>
<thead>
<tr>
<th>HS code number</th>
<th>Description of goods</th>
<th>Origin criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 61</td>
<td>Articles of apparel and clothing accessories, knitted or crocheted</td>
<td>As indicated at split Chapter level</td>
</tr>
<tr>
<td>ex Chapter 61 (a) (ex 61.01 to 61.17)</td>
<td>Goods including parts and accessories, knitted or crocheted to shape*</td>
<td>The country of origin of the goods of this split Chapter is the country where these goods have been knitted or crocheted to shape</td>
</tr>
<tr>
<td>ex Chapter 61 (b) (ex 61.01 to 61.15)</td>
<td>Goods of heading 61.01 to 61.15 assembled from parts knitted or crocheted to shape*</td>
<td>Options proposed by delegations: 1. Change to goods of this split Chapter, provided that the goods are assembled in a single country in accordance with Chapter note 1/option 1 2. 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 3. 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</td>
</tr>
</tbody>
</table>

* When a split heading or subheading is proposed, the description is underlined to show that it is not HS text.

### CHAPTER NOTES:

1/Option 1:

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 buttons and/or other fasteners, pockets, trimmings, cuffs, plackets, labels, [collars] or other accessories; making button holes, hemming.

1/Option 2:

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 to shape 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 and/or making up the following, for example) (attaching to garments or accessories): buttons and/or other fasteners; patch pockets, foot straps, trimmings, ornaments, cuffs, plackets, belt loops, epaulettes, labels, (collars), (lining, padding, pockets, other than patch pockets, waist bands, garment accessories, facings, self-belts, pleats); making button holes, hemming, (pressing, stone or acid washing).

1/Option 3:

a) For the purposes of this Chapter, and subject to paragraph (b), ‘both cut or knitted or crocheted to shape and sewn or otherwise assembled in the country claiming origin’ means that all of the assembly operations, along with 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 buttons and other fasteners, pockets, patch pockets, foot straps, trimmings, ornaments, cuffs, plackets, belt loops, epaulettes, labels, collars, paddings and waist bands.
With regard to option 1 in Table 6, for some delegations the assembly of an article in one country from parts knitted or crocheted to shape was 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 such as 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.

Delegations supporting options 2 and 3 hold 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 that 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 are both knitted or crocheted to shape and sewn or otherwise assembled, or the single country where the parts are knitted or crocheted, whether or not they are assembled in the same country.

2.2.4 Conclusive Remarks on the Issue of Harmonisation on Rules of Origin

Undoubtedly, the harmonisation of non-preferential rules of origin will be considered a new milestone in ensuring a transparent and predictable regulatory framework in the international trading system. The Technical Committee negotiations have mainly been driven by certain industries seeking to have their manufacturing process recognised 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 the recognition of certain working or processing operations as substantial transformation does not always tally with the structure of the HS. Attempts have therefore been made to adapt the HS by means of ‘ex subheadings’, Chapter notes, etc. 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.

From a preferential rules of origin perspective, the following points deserve to be highlighted:

a) Generally speaking, the layout or architectural format is similar. Origin determination focuses on three general concepts, namely wholly obtained, minimal working or processing, and product-specific rules;

b) The way the change of tariff classification criterion has been used to determine a harmonised set of rules of origin is close to the model used by NAFTA and the NAFTA model rules of origin. In the case of the EU rules of origin and the majority of RTAs among developing countries, the simple CTH at the four-digit level has always been utilised. In the majority of RTAs that are not inspired by the NAFTA model there are no rules expressed in changes of tariff subheadings. In the harmonised set of non-preferential rules of origin the priority allocated to the change of tariff classification criterion has made the utilisation of other criteria difficult; and

c) The almost exclusive use of the change of tariff classification, pursuant to Article 9 of the Agreement on Rules of Origin and strenuously supported by some delegations, 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, requiring high levels of expertise in the HS structure and rules. Some delegations are still proposing that in some cases ad valorem rules on specific working or processing may be used.
3. Preferential Rules of Origin

3.1 The Concept of Rules of Origin: The Main Differences Between Non-Preferential and Preferential Rules of Origin

Whenever one country starts differentiating its trade policies between its partners, rules of origin play an instrumental role in ensuring that the benefits of this differentiation are confined to the targeted countries. As explained above, rules of origin can be non-preferential or preferential.

Preferential rules of origin are those which apply in the context of preferential tariff regimes. Within the second category, one can differentiate between three kinds of rules:

a) Unilateral and non-contractual, such as the GSP rules of origin;

b) Unilateral and contractual, such as those contained in the Former Cotonou Convention and the Caribbean Basin Initiative; or

c) Contractual rules of origin negotiated within the context of Free Trade Areas, such as the North American Free Trade Area (NAFTA), the Tripartite Free Trade Area (TFTA) and the Economic Partnership Agreements (EPAs).

Another clear difference between the two types of rules of origin stems from the different trade policy purposes which they serve. The main task of preferential rules of origin is to ensure that tariff preferences are granted exclusively to goods originating in the beneficiary countries, to the exclusion of others. Thus, if the origin criterion is not met, the goods are simply not entitled to preferential treatment.

On the other hand, non-preferential rules of origin are aimed at assigning origin to all goods imported into a specific country. Therefore customs authorities at the point of entry of the imported goods must, in principle, always be in a position to determine the origin of the goods. If the main origin criteria are not satisfied, other residual rules have to be applied to determine the origin. The issue of residual rules of origin has been one of the thorniest matters of contention in the framework of the WTO Harmonisation Work Programme on non-preferential rules of origin.

From the inception of the concept of rules of origin, both preferential and non-preferential rules of origin have varied considerably, not only from one country to another, but sometimes within a country, depending on the specific trade policy instrument they serve. For instance, at the very start of the GSP, preference-giving countries decided to implement their national schemes on a unilateral basis. The autonomous character of each GSP scheme resulted, inter alia, in different sets of preferential rules of origin that have to be complied with in order to qualify for the GSP tariff treatment. The technical nature and the diversity of rules of origin have brought additional complexity to the GSP schemes and their utilisation.

For this reason, the UNCTAD Working Group on Rules of Origin was established by the second session of the Special Committee on Preferences, to harmonise, simplify and improve the rules. For over 20 years, discussions have concentrated on the best ways and means to attain these aims. While results have been achieved in some areas, one of the major issues that was discussed remained undecided, namely whether the possible harmonisation of GSP rules of origin should be based on the process criterion or the percentage criterion.

---

22 The Common Declaration with regard to Preferential Rules of Origin, in its Article 2, para. 2, defines preferential rules of origin as follows: “For the purposes of this Common Declaration, preferential rules of origin shall be defined as those laws, regulations and administrative determinations of general application applied by any Member to determine whether goods qualify for preferential treatment under contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of Article I:1 of the GATT 1994.”

23 For a more detailed analysis of the issue of harmonisation, see documents TD/BSCP/AC, “Harmonisation, simplification and improvement of the rules of origin”; and UNCTAD/ITD/GSP/31, “Compendium of the work and analysis conducted by the UNCTAD working groups and sessional committees on GSP rules of origin, Part I”. 
Table 7 represents an overview of the existing regimes of rules of origin.\footnote{For easy reference to the sources of the various regimes of rules of origin, see the following UNCTAD documents: Handbook on the scheme of Canada (TAP/247/Rev.3), Handbook on the scheme of New Zealand (TAP/258/Rev.3), Handbook on the scheme of Australia (TAP/259/Rev.2), Handbook on the scheme of Japan 1997-1998, Handbook on the scheme of the European Community (ITCD/TSB/Misc.25), Handbook on the scheme of Switzerland (TSB/Misc.28), Handbook on the scheme of Norway (TSB/Misc.29), Digest of GSP rules of origin (TAP/133/Rev.7).}

**Table 7: Existing regimes of rules of origin**

<table>
<thead>
<tr>
<th>Country/group of countries</th>
<th>Origin criteria</th>
<th>Requirements</th>
<th>Numerator</th>
<th>Denominator</th>
<th>Percentage level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Percentage</td>
<td>Minimal local content requirement</td>
<td>Value of labour and/or materials of the preference-receiving country, other preference-receiving countries and Australia</td>
<td>Ex factory price or ex work cost</td>
<td>Minimum 50%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Percentage</td>
<td>Minimal local content requirement</td>
<td>Value of material or parts the product of any DC/LDC or New Zealand</td>
<td>Ex factory price or ex work cost</td>
<td>Minimum 50%</td>
</tr>
<tr>
<td>Canada</td>
<td>Percentage</td>
<td>Maximum percentage of imported inputs</td>
<td>Value of imported inputs, special rules on textiles and clothing apply</td>
<td>Ex factory price</td>
<td>Maximum 40% or 60% for LDCs</td>
</tr>
<tr>
<td>United States</td>
<td>Percentage</td>
<td>Minimal local content requirement</td>
<td>Cost of materials produced in the preference-receiving country plus the direct cost of processing carried out there</td>
<td>Ex factory price or appraised value by US Customs</td>
<td>Minimum 35%</td>
</tr>
<tr>
<td>European Union, Norway, Switzerland and Japan</td>
<td>Process</td>
<td>Product-specific rules of origin covered by the Single List: CTH, CTH with exceptions technical tests and/or maximum percentage of imported inputs</td>
<td>Customs value of imported inputs or the earliest ascertainable price paid in the case of materials of unknown, undetermined origin</td>
<td>Ex works price, in the case of Japan: free on board (FOB) price</td>
<td>Maximum 5%, 40% or 50%, or 70% where used in the Single List</td>
</tr>
</tbody>
</table>

As may be noted from Table 7, preference-giving countries’ rules of origin are broadly divided into two main categories: a) Canada, United States, Australia, New Zealand, Central and Eastern European countries use the percentage criterion; and b) the European Union, Norway, Switzerland and Japan use a variety of methods. 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. Among those using the process criterion, the rules of origin are almost completely harmonised between European Free Trade Association (EFTA) preference-giving countries and the European Union, while differences persist between the Single List requirements of these two groups of countries and Japan. It has to be noted that the process criterion makes use of percentages in the requirements laid down in the Single List. This mainly concerns machinery and consumer goods where the specific Single List rules require that the value of the imported inputs should not exceed a certain percentage of the ex works or FOB prices of the finished products.

### 3.2 Preferential Rules of Origin

There is little doubt that the rules of origin issue has recently gained renewed attention following the flourishing of regional agreements. In the ’90s the NAFTA negotiations on rules of origin received attention at presidential level.
As already mentioned, one of the main differences which may be observed among the various categories of preferential rules of origin is related to trade instruments and the context in which they are established. Thus, we have to distinguish between unilateral preferential rules of origin and contractual rules of origin.

In the context of preferential rules of origin of a contractual nature, i.e. in the case of free trade agreements, rules of origin serve to regulate the trade patterns of the Members. Strict rules of origin in an FTA may affect upstream, side stream or downstream third country producers of inputs. Conversely, excessively flexible origin rules may encourage sourcing of inputs outside the FTA through the territory of the Member with the most liberal trade regime, and thereby frustrate its desired integration objective. These issues have been the subject of confrontations during NAFTA negotiations. The progressive adoption of a Pan-European model of rules of origin contained in the panoply of FTAs and preferential arrangements, of which the EC is a partner, is another sign of past initiatives in this area.

These preferential rules of origin reflect policy objectives. The most obvious is to avoid the deflection of trade in an FTA, however, they often seem designed to respond to industrial policy objectives of domestic industries. Unilateral rules of origin such as those included in the GSP and Lomé Convention may be intended to ensure that beneficiaries derive real benefit in terms of value added and investment. In spite of this laudable objective, the rules of origin contained in the GSP schemes and Cotonou have been indicated as one of the major stumbling blocks of the utilisation and use of trade preferences by beneficiaries. Cumulative rules of origin can be aimed at encouraging trade among members of a grouping of developing countries or among developing countries in general. However, the technicalities and economic realities frustrate this objective.

3.2.1 Unilateral Preferential Rules of Origin

Unilateral preferential rules of origin are those contained in unilateral preferential trade arrangements like the GSP, Caribbean Basin Initiative (CBI) and the Andean Trade Preference Act (ATPA). This definition may also be extended to cover rules of origin contained in non-reciprocal but contractual agreements like the former Cotonou Convention and other similar non-reciprocal agreements concluded by the EC. In fact, the main difference between reciprocal agreements is that the Protocols on rules of origin, usually attached to these non-reciprocal agreements, are not ‘negotiated’ according to their unilateral character. The existence of rules of origin in all these agreements is explained by the desire of preference-giving countries to limit the tariff advantages granted under these agreements to products that are genuinely manufactured or obtained in beneficiary countries. Thus, the tariff preferences granted under these respective agreements and the GSP are made subject to the compliance with strict rules of origin requirements. The granting of unilateral tariff preferences is subject to declared policy objectives which, in the case of the GSP, are as follows:

- Increase industrialisation;
- Accelerate rate of economic growth; and
- Increase export earnings.

The trade effects of tariff preferences are expected to be gained by the reduction of duty or duty free access to products of beneficiary countries which make them more competitive price wise in comparison with products from non-beneficiary countries. These expected trade effects may, however, be limited or frustrated by an excessive stringency of the rules of origin requirements attached to the granting of the preferential tariff treatment. The greater the preferential margin the rules of origin are and the more liberal and less burdensome for the local industries, the greater the effect that may be expected from the trade preferences. On the other hand, excessively stringent rules of origin, tied with a minor preferential margin, will lead to less beneficial trade effects. The stringency of preferential rules of origin has been cited as one of the explanations for the insufficient utilisation of trade preferences. Moreover, they do not seem to match the industrial capacity of beneficiary countries, especially LDCs.

As pointed out by a preference-receiving country,25 insuperable obstacles were caused by the need to devise and operate an accounting system which differed in the definition of concept, application of accounts, precision, scope and control from its internal legal requirements. The system must provide the costing information to satisfy the rules of the countries of destination, to enable them to check the shares of domestic and imported inputs in the unit cost of the exported goods and, in some cases, allowing them to identify

---

the country of origin of the inputs and establish direct and indirect processing costs. This has often required (and still requires) data processing techniques which are not commonly use, especially in small and medium-sized enterprises. It was also found that the willingness of enterprises to change, or to adopt new, different accounting systems depends on the volume of export, the share of such exports in total sales, and the cost involved. In addition, the expenditure incurred in operating a parallel accounting system may outweigh the benefit of tariff preferences, e.g. where the preferential margin is less than 5%.

3.2.2 Contractual Rules of Origin in FTAs

Rules of origin are clearly at the very core of regional economic integration schemes because they ensure that the preferential market access will only be granted to goods that have actually been 'substantially transformed' within the area and not to goods that are produced elsewhere and simply trans-shipped through one of the partner countries that participate in the scheme. 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.

The main reason for the existence of rules of origin in free trade areas (FTAs) derives from the pre-occupation with trade deflection. In an FTA, each country maintains its own external tariff and commercial policy vis-à-vis the outside trading partners. To the extent that the tariffs and commercial policy are different for third countries there is always the incentive to import a good through the country with the most liberal import regime and tariffs. Importers/producers will eventually undertake minimal transformation and will finally re-export the goods to country(ies) with the higher tariffs. To sum up, this is a tariff circumvention operation. Trade deflection does not carry a negative economic effect per sé. In fact, it may, from an economic point of view, be considered equivalent to a reduction in the tariffs of the high tariff country and thus indeed be positive for its economic efficiency.

However, trade deflection is considered a negative phenomenon since it does not correspond with the objectives of FTA contracting parties. Pushed to its extreme, trade deflection could go beyond the original intention of the contracting parties by transforming the original FTA into a custom union where the external tariffs will be determined by the country applying the lower tariffs.

The traditional ‘remedy’ for trade deflection is stringent rules of origin. However, the more stringent the rules of origin, the more prevalent trade diversion is likely to become, since producers from the integrated area will favour intermediate inputs originating in the area in spite of their higher cost in comparison with inputs from countries outside the FTA. Thus, the higher the preferential margin associated with origin compliance and the less costly the compliance with rules of origin and related administration costs, the greater the likelihood of trade diversion.

In order to determine the possible effects of rules of origin in an 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 FTA categories:

(1) Among developed countries (i.e. the US–Canada original FTA or the European Economic Area (EEA) Agreement);

(2) Among developed and developing countries (i.e. NAFTA, Euro-Med, Interim Economic Partnership Agreement (IEPA)); and

(3) Among developing countries (i.e. SADC, COMESA, TFTA).

A fourth variable to be taken into consideration is the extent and kind of cumulation adopted within the partners of the FTA.

---

26 Ibid. p. 22.
27 Ibid. p. 5. A preference-receiving country showed, as an example, that in the case of the US, out of a total of $788.9 million of Mexican exports which could have benefitted from GSP in 1983, and for which in principle there was no limitation apart from the presentation of origin certificates, 58.7% (462.2 million) comprised goods whose preference margin was less than 5%. For such goods, the main reason for the non-use 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% of exports, with a preference margin exceeding 5%, largely represented cases where the goods had failed to satisfy the origin rules.
Rules of origin adopted in the context of FTAs like the original US–Canada and the EEA are, besides the control of trade deflection, mostly guided by the inspiring principle of integration, specialisation of the domestic industries and preference of domestic intermediate inputs over imported ones. Obviously, the more sophisticated the level of industrial development, the more that rules of origin may be restrictive towards third country inputs, without considerably reducing the trade creation effects.

The complex situation which may arise from the trade-off to be made between trade deflection, trade creation and trade diversion and the technical complexities of rules of origin is illustrated by the Honda case in North America discussed below.

The much publicised fears of loss of North American jobs during the NAFTA negotiation was partly based on the consideration that North American industries would relocate to low cost Mexico to obtain preferential access and compete with domestic industries in North America. In general, when forming an FTA with a developing country, developed countries which already possess a strong industrial basis fear the trade deflecting effects of liberal rules of origin more than they value – as exporters – their potential trade creating effect. It is this fear that prompted US domestic producers to press for finely tuned rules of origin in, for instance, the automobile,28 textiles and toy manufacturing industries. The yarn-forwarding rule adopted in the textile sector results in the exclusion of low cost intermediate materials from East Asia for the manufacturing of NAFTA originating textiles, unless natural fibres have been imported. This exclusion may ultimately provide incentives for the development of a capital intensive industry in Mexico, reducing the NAFTA trade creation.

Potential US textile companies wishing to relocate to Mexico have to invest greater amounts of capital in order to comply with NAFTA origin requirements, since to take advantage of labour costs and NAFTA preferential rates they have the following choices: (i) import US cotton yarn with loss of comparative advantage, or (ii) start the manufacturing process from imported natural fibres or to imports of fabrics from North America29 (i.e. increasing the trade diversion) or require Mexican and Canadian textiles producers to buy yarn from US textiles mills before being allowed to sell the clothing to US consumers duty-free. The combination of both the yarn forwarding rules and the high tariffs facing textile imports imply that the North American producers have an incentive to use US made fabrics rather than competitive fabrics from Asia. Ultimately, the utilisation of restrictive rules of origin may be an implicit device for extending tariff protection (or other protective devices) on domestic intermediates to partner countries.

<table>
<thead>
<tr>
<th>Box 1: Honda case30</th>
</tr>
</thead>
<tbody>
<tr>
<td>The much debated and publicised Honda case may be considered the epiphany of technical complexities of rules of origin, globalisation and relocation of industries and the policy and industry decisions underlying them. Ultimately, the Honda case, which arose in the context of the US–Canada FTA became the test case for the importance given to rules of origin in the following NAFTA negotiations.</td>
</tr>
<tr>
<td>From a technical point of view, and in the eyes 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 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 is particularly related to the increasing globalisation of production and the increasing practice by companies, especially in the automobile sector, to subcontract the manufacturing of sub-assemblies according to just-in-time agreements with suppliers. Under the US–Canada FTA origin of automobiles and the components were subject to a CTH test plus a requirement of a minimum of 50% local content. Parts or components of an automobile (intermediate products) were also subject to the same rules. That is to say that if a subcomponent of the automobile, suppose the engine as in the Honda case, meets the CTH requirement plus the 50% local content requirement in the US, it can be considered of American origin. Then, when it is used to complete the automobile manufactured in Canada, the value of the engine as a whole (100%) will be counted as North American content (and not only the 50% of US origin local content) and its whole value will be added to the local content acquired in Canada to fulfil the 50% local content requirement for the complete automobile. This rule was called roll up. Vice versa, when the subcomponent did not acquire originating status, the whole value of the component would be counted as foreign (roll-down rule).</td>
</tr>
</tbody>
</table>


In the Honda case, Honda Canada and the Canadian Customs for some time treated the Honda engine manufactured in the US as originating, and imported it duty free into Canada. When the engines were subsequently assembled into the Honda Civic, their full value was counted as of North American content to reach the minimum 50% local content requirement to be re-exported to the US duty free.

This trend continued until 1992 when a US Customs investigation determined that the Honda Civic manufactured in Canada and exported to the US did not meet the 50% requirement because it contained too many Japanese parts. Honda Canada was then asked to pay a retroactive bill of US$17 million for the 2.5% ad valorem tariff evaded on the Honda Civic re-exported to the US.

More specifically, US Customs ruled that engines manufactured in the Ohio plant did not qualify as North American, and according to the roll-down rule, their whole value could not be counted as local content when calculating the required 50% local content for the Honda Civic. As a consequence, the complete Honda Civic manufactured in Canada was not considered as North American, since it did not meet the 50% domestic content and had to pay duties as if they were exported directly from Japan. Furthermore, the US Customs interpretation did not allow certain ‘processing costs and indirect cost’ incurred in the US to be counted as local content. The determination of allowable costs and the accounting method to impute such cost to local content has been a traditional and classic pitfall of the percentage criterion.

Such technical details stirred various political considerations. First, at that time, the US authorities were arguing with the European Economic Community (EEC) that Honda Accords made in Ohio were of American origin and therefore should not be counted as Japanese cars against the quota that the French authorities maintained on Japanese car imports. Second, Honda’s reputation and image of being naturalised as American was shaken following the finding of the inquiries of US Customs which charged Honda Japan to practice price setting to its Honda Canada related suppliers (some of them were 100% Japanese owned), and *inter alia* to be engaged in transfer price manipulation. Third, the issue rose to a political debate where US policymakers started to weight and review all aspects of the value of transplants operations in the US and how they contribute to or compete with US vehicle manufacturers.

On the other hand, some of the Canadian policymakers considered the US Customs ruling as a means to divert Japanese investment from Canada to the US. Above all, political consequences, the core of the heated debate at technical level, started, as admitted by senior US official, by a flaw, or as others may argue, by a loophole occurring in the drafting of the FTA rules of origin, namely the rollup rule. Using this rule to his extreme, a senior US official admitted that by utilising the breaking-up of the car in as many subassemblies as possible, it was feasible to obtain a 100% American car on paper, with less than 50% local content in reality.31

Most likely, the original drafters of the NAFTA rules undervalued the practices of multinational corporations and the possibilities offered by the globalisation of production which has overtaken the traditional concept of origin and the classic method of origin determination. Some of the technical problems in the origin determination connected with the Honda Case were only thought as a theoretical imagination of some customs officials few years ago. Yet, the realities of the technological process and economic interdependence made it real. 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 rollup and roll down rules did not gain a second lease of life in the NAFTA rules. The domestic content requirement for cars was fixed, after lengthy negotiations, at 62.5% to be progressively implemented.

It may therefore be concluded that rules of origin in FTAs may have limited the expected economic benefits of regional integration, or may have caused distortions in favour of the partner able to negotiate rules of origin which match the capacity of domestic industries. However, in practice, these considerations have to be further qualified by at least two factors, namely the intrinsic difficulty of evaluating the economic effects of an FTA, together with the impact of different sets of rules of origin, and the extent of the pressures exerted by lobbies during the negotiation on rules of origin already discussed.

---

3.3 Cumulation

Normally, rules of origin in the context of autonomous or unilateral contractual preferences are to be fulfilled within the customs territory of a single beneficiary country. However, some preference-giving countries considered that this requirement was not adequate for the existing realities in developing countries, especially in view of the regional trade initiatives among them. First, isolated and stringent requirements to fulfil rules of origin may demand excessive ‘verticalisation’ of production, which does not exist in developing countries. Second, an excessive demand for fulfilling multi-stage or value-added operations would frustrate trade creation effects expected in a regional trade area.

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; and
3. Bilateral cumulation or donor country content.

As far as quantitative aspects are concerned, the concept of cumulation is linked to geographical extension of the cumulation, i.e. all beneficiary countries under the GSP scheme of New Zealand, or only limited to African, Caribbean and Pacific (ACP), and a few other countries in the context of the Lomé Convention.

The most delicate and complex differences on cumulation belong to the distinction between full and partial cumulation. This distinction, besides in the context of unilateral preferences, also applies to contractual preferential rules of origin and has decisive economic effects on the functioning and utilisation of trade preferences.

Generally speaking, full cumulation of origin allows for more scattered and divided labour operations among the beneficiary countries since, in order to fulfil the origin criteria, the distribution of manufacturing may be carried out according to business exigencies within the Members of the regional grouping, i.e. working or processing may start in A, continue in B and finish in B according to a cost-benefit analysis.

This perspective seems to match the globalisation and interdependence of production where developed countries may be attracted to subcontract low-tech or labour intensive production processes in low cost countries. Partial cumulation does not particularly favour this approach since it requires higher valued added or more complicated manufacturing processes. On the other hand, and in view of preference-giving countries, the partial cumulation approach may attract more capital intensive investments, accompanied by improved technical know-how and labour skill.

A deeper economic consideration of the impact of full or partial cumulation is that full cumulation allows for the employment of low wage, low skilled labour, which some may argue is a potentially negative factor since these workers are often being paid less than the average wages and save less than the average workers. Reality, however, suggests that, in spite of the argument of preference-giving countries proposing a long-term objective of industrial policy through the adoption of restrictive rules of origin, labour-intensive, lighter industries tend to compete most effectively with similar industries 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 the compliance with rules of origin by expanding the geographical coverage. In the latter case, cumulation may have the result of strengthening the potential inhibitive use of third country materials outside the contracting parties as further explained below.

Through its different sets of rules of origin, the EC, as other main trading partners, has traditionally utilised a variety of options in the cumulative rules of origin. Sometimes it advanced them according to its trade policy objectives. Among the most important example of this variety, the following table may provide valuable examples of the existing diversification of cumulative origin systems:
Table 8: Cumulation and donor country content

<table>
<thead>
<tr>
<th>Country</th>
<th>Cumulation</th>
<th>Donor country content</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP</td>
<td>Partial regional cumulation</td>
<td>Yes</td>
</tr>
<tr>
<td>IEPA</td>
<td>Full and diagonal regional cumulation</td>
<td>Yes (diagonal)</td>
</tr>
<tr>
<td>Cotonou Convention</td>
<td>Full cumulation</td>
<td>Yes (full)</td>
</tr>
<tr>
<td>US</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP</td>
<td>Full regional cumulation</td>
<td>No</td>
</tr>
<tr>
<td>CBI</td>
<td>Full regional cumulation</td>
<td>Yes (limited)</td>
</tr>
<tr>
<td>NAFTA</td>
<td>Diagonal cumulation</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP</td>
<td>Regional cumulation</td>
<td>Yes (limited)</td>
</tr>
<tr>
<td>Canada</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP</td>
<td>Full and among all beneficiaries</td>
<td>Yes (full)</td>
</tr>
</tbody>
</table>

Box 2: GSP Rules

1. Partial cumulation under GSP rules

EC rules of origin require that the manufacturing process for apparel not knitted or crocheted (HS62), when imported inputs are used, has to start from imported yarn. With diagonal regional cumulation, however, preference-receiving country C may utilise imported fabrics from country B, a Member of the same regional grouping, and the finished jacket will be considered an originating product. This is because the imported fabric is counted under the cumulation rules as a domestic input and not as an imported input. However, this only applies when the fabric manufactured in country B is already originating, i.e. it is wholly obtained (manufactured from domestic cotton fibres) or has been manufactured from imported natural fibres, but not imported yarn according to EC requirements. This production chain may be visualised as follows:

Country A  Country B  Country C  Country D
Natural fibre ✐ Natural fibres to fabrics = originating ➦ Fabrics to apparel = originating ➦ Donor country

Thus, if the fabrics are produced in country D from imported natural fibres and the apparel is made in country C, the final apparel will be considered as originating.

2. Full cumulation – ACP rules

As in the case of GSP, EU rules of origin in case of ACP countries still require that the manufacturing process, when imported inputs are used, has to start from imported yarn. Since, under the EC rules, the ACP countries are considered as one single customs territory for rules of origin purposes, it is sufficient that such requirement is fulfilled within the area. Thus, the intermediate materials imported from another member of the ACP group do not need to be already originating. In this case the full cumulation the production chain is as follows:

Country A  Country B  Country C  Country D
Yarn ➦ Yarn to fabrics ➦ Fabrics to apparel = originating ➦ Donor country

Apart from other considerations, the above example shows that a full cumulation system may save one step of the manufacturing process. In fact, according to the partial cumulation system, in order to comply with the same rules of origin, beneficiary countries are obliged to import materials at a lower manufacturing stage (cotton fibres) or fulfil the specific processing operations laid down for fabrics instead of yarn as in the case of full cumulation. Thus, under the GSP, yarn spinning facilities must be established, in principle, within the regional grouping.

---

32 On a qualitative assessment, the full and diagonal cumulation is present in the IEPA as under the Cotonou Convention, and has been maintained as the quantitative aspect, although it is made subject to the signing of administrative cooperation requirements among parties involved in the cumulation.


34 Unless the finished fabric incorporates cotton thread. In this latter case, manufacturing from yarn is allowed. See supra note.

35 Country A = Third country
Country B = Preference-receiving regional partner
Country C = Exporting preference-receiving
Country D = Donor country

36 Same as footnote 54.
From the above it is clear that the EU, like other preference-giving countries, grants regional cumulation to certain regional groupings such as the Association of South East Asian Nations (ASEAN), the Andean Group and the Central American Common Market (CACM). Under regional cumulation, products or inputs which originate in Members Countries of the regional association are considered as domestic input and not as foreign input. However, there is a difference between the regional cumulation granted by the EU and that offered by Japan and the United States.

In fact, under their regional cumulation schemes, Japan and the United States consider all ASEAN countries as one single customs territory (except that the US worked Singapore and Brunei out of its GSP). 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 EU, only the parts which acquire origin in one Member State of the regional association will be counted as domestic content. Thus, only the products which already originate in other countries of the association, according to the EU GSP rules of origin, could be counted as local content when utilised for further manufacturing, or can be incorporated in the finished product manufactured in the final Member State.37

3.3.1  Contractual Rules of Origin and Cumulation

In general, cumulative origin systems utilised in the context of FTAs may strengthen or exacerbate the trade effects outlined in the preceding sections dealing with cumulative systems in unilateral preferences, and the fate of intermediate components as in the Honda case. In Honda case, the partial cumulation system was obviously one of the factors which contributed to the difficulty of the technical details at stake.

The main difference between partial and full cumulation in unilateral trade preferences also applies in the case of contractual trade preferences. However, the progressive and comprehensive expansion of regional economic integration schemes, such as the one gradually undertaken by the main trading partners like the US and the EC with the rest of the world, call into play additional factors which throw new light on the cumulation issue in FTAs. For example, think of the gradual unfolding of the Free Trade of Americas Initiative and the EC–FTAs agreement to better seize the magnitude of these new developments.37

As some of the implications of the rules of origin in North America have been examined above, the following analysis examines the implications of Economic Partnership Agreements (EPAs). In the post Cotonou scenario, the EU launched the establishment of EPAs aimed at establishing a series of FTAs with different African regions.

EPAs which aim, inter alia, to progressively establish FTAs, contain extensive protocols on rules of origin providing for diagonal and full cumulation among the signatories, with a possible extension to other ACP Countries, conditional upon the signing of a customs cooperation agreement.

Unless the ACP EC Countries undertake a deep trade liberalisation process, the EU could be at the centre of a web of bilateral FTAs. In this situation, the EU may become a potential hub for investors, who may set up factories in the EU to benefit from preferential access to all non-EC Member Countries and their markets. Unless non-EU Member Countries negotiate FTAs, they could be relegated to a ‘spoke’ role, since reverse operations could not be possible and only the comparative limited home market of the ‘spoke’, in addition to the EC market, will be available to factories located in ACP Countries. For this reason, the TFTA Member Countries started the initiative to liberalise regional trade. However the EC considers such trade liberalisation on intra-regional trade, as undertaken by the TFTA and the Central European Free Trade Agreement (CEFTA), the second pillar of the establishment of the Euro-Mediterranean FTA.38

If trade liberalisation is undertaken between third Country Members, the rules of origin adopted among these ACP Members should at least initially be more liberal than those adopted by the EU Members. A practical example to illustrate this point is in order. If we assume three countries, A and B being ACP Member States and C an EU Member, one may envisage the following scenario:

37 For an overview and consideration of the EC policy toward preferential rules of origin, see the communication from the Commission to the Council concerning the unification of rules of origin in preferential trade between the Community, the central and east European countries and the EFTA countries, 30 November 1994, SC(94) [1987] (final). See also the content of the Barcelona Declaration for Mediterranean countries.

(i) In the absence of trade liberalisation efforts between A and B, the diagonal cumulation between A and B will be frustrated by the tariff protection applied in their trade relations (beside the hub and spokes argument made before). This holds extremely true when one considers that many of the FTAs among ACPs are still not effectively utilised. Thus, production specialisation and resources optimisation among A and B in order to increase their exports to the EU, will be limited or nil since their main target will remain the EU market where both A and B continue to compete as before. This situation is exacerbated when higher tariffs are applied on intermediate products in A and B than in the EU. Effective rates of protection and tariffs may differ between the EU and these ACP countries, giving rise to the transfer of tariff protection;

(ii) If an FTA between A and C has more restrictive rules of origin than that between A, B and the EU, these latter origin rules may neutralise the expected trade effects of free trade between A and B and the application of diagonal cumulation contained in their EPAs. In fact, under these circumstances, A and B are likely to continue to compete in the EU market, as they were in absence of their FTAs, and both will struggle to comply with the rules of the origin requirements contained in their EPAs. In addition, since their trade and the size of the EU market is usually much bigger in comparison with the trade and size of the market of its neighbours, A and B have little, if any, incentive to develop joint investments to comply with their bilateral rules of origin that are more restrictive of those applied in their trade with the EU. Ultimately, diversion of efforts will be geared towards the EU market; and

(iii) Only where rules of origin between A and B are more liberal than those applied between them and the EU, producers have incentive to trade and redistribute manufacturing activities between them, in order to more fully utilise the mutual trade preferences and export possibilities to the EU. Two additional comments of caution in adopting this kind of approach derive from other variables which have to be taken into account:

a) Even in the latter case, the greater the tariff disparities among A and B, the more the determination of production location may be influenced; and

b) The advantages of more liberal rules of origin between A and B may indirectly favour EU exports of intermediate products to A, to be further processed according to liberal rules of origin, and re-exported to B. This possibility, which may be remote in certain circumstances, also has to be taken into account.
4. Lessons Learnt in Drafting Rules of Origin


4.1.1 Origin Criteria: Technical Options and Implications

The definition of the origin of goods is generally based on two criteria: (i) the wholly obtained criterion, and (ii) the substantial transformation criterion. The first criterion is to be used when the imported product was wholly produced in one country from raw materials originating in the same country. If this criterion is not applicable, because more than one country was involved in the manufacture of the final product, other criteria must be resorted to in order to obtain a definite origin outcome.

Traditionally, three methods were identified and used in determining the substantial transformation principle. In most cases, however, a combination of them was used:

1. The change of tariff classification;
2. The percentage of value added criterion; and
3. The specific working or processing criterion.

Experience has shown that none of these methods are entirely satisfactory and applicable, but that each has advantages and disadvantages. In the following sections, a series of examples are drawn from different contexts to further illustrate the advantages and disadvantages of the different techniques used.

Many of these examples are excerpted from negotiations that took place in UNCTAD at the very start of the GSP when preference-giving countries decided to implement their national schemes on a unilateral basis. The autonomous character of each GSP scheme resulted, inter alia, in different sets of preferential rules of origin that have to be complied with in order to qualify for the GSP tariff treatment. The technical nature and diversity of rules of origin brought additional complexity to the GSP schemes and their utilisation.

For this reason, the UNCTAD Working Group on Rules of Origin was established by the second session of the Special Committee on Preferences to harmonise, simplify and improve the rules. For over 20 years, discussions concentrated on the best ways and means to attain these aims. It is somewhat surprising that, in spite of the technological and scientific progress achieved in the last four decades, some technical issues are still valid and the goal of harmonising rules of origin, albeit in the area of non-preferential rules of origin, remain a distant objective. Be this as it may, some of the Working Group’s technical findings can provide TFTA negotiators with some enlightening messages and lessons learnt.

4.1.2 The Wholly Obtained Criterion

The Special Committee permitted the Working Group to identify the main features of the wholly obtained criterion at its first session in March 1970 in order to evaluate the rules of origin applied in individual preferential schemes by some preference-giving countries before the entry into force of the GSP. The wholly obtained criterion was intended to cover two types of goods, namely:

(i) Goods which were natural products of a particular country, such as manufactured 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.

It was considered that, since the various origin systems did not differ much with regard to the wholly obtained criterion, the definition of the wholly obtained criterion for GSP purposes might not present insurmountable difficulties. There was consensus among preference-giving countries that the following products had to be considered as wholly produced: unmanufactured raw materials (e.g. mineral products extracted from the soil in the country of origin); and petroleum and other minerals extracted from the continental shelf or from other parts of the seabed outside the territorial waters in the narrow sense (provided that the country claiming origin exercised exclusive rights to exploit the seabed in question).
Certain agricultural products were also generally considered to be wholly obtained goods, i.e. 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. A problem was raised regarding products obtained from live animals in 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 from a hen in country X had to be imported from country Y, or whether the hen had to be an animal born or at least raised in country X itself.

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 EC rules for imports from the ACP states required that the vessel be at least half-owned by nationals of the country or by a company, the head office of which was situated in the country and which had nationals of the country as its managing director or directors, chairman of its board, or governors. Moreover, the majority of the board members 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, the vessel’s officers and at least 75% of its crew had to be nationals of the country. According to EFTA rules, a vessel was regarded as that of a Member State if it was registered in the State and flew its flag. In this regard, special attention was given to the question of goods produced on board factory ships from products of sea fishing and other products taken from the sea, since a number of developing countries had established joint ventures for the exploitation of sea resources.

Some rules contained special regulations for the treatment of used articles, waste and scraps. EFTA rules treated used articles only fit for the recovery of materials and collected from users within the EFTA, and scrap and waste resulting from manufacturing operations within the EFTA, as wholly produced articles. All EC rules accepted scraps and waste from manufacturing operations and disused articles as wholly produced, provided they had been collected within the country concerned and could be used only for the recovery of raw materials.

A definition of the extent and nature of the use of goods in a specific country in order to treat it as the country of origin was considered necessary, in particular in the case of used machinery which 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 could also be required. Such a requirement could help to avoid abuse of the scheme of preferences by way of delivering virtually new articles from a developing country via the beneficiary country. Moreover, it was considered to be in the interest of industrialisation in exporting developing countries to rather be restrictive when formulating such a special clause.

The analysis of existing preferential schemes revealed that EFTA Countries uses a complementary provision, the basic material list, which treats particular raw materials and some manufactured materials as goods from the EFTA, whatever their origin. The reason for the 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 is only used within the EFTA and never for GSP purposes.

The US applied a similar provision on imports from insular possessions under preferential terms. Under this rule, materials which could be imported into the US duty free were not considered of foreign origin. 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. These developing countries urged other preference-giving countries to incorporate similar provisions in their schemes. Some developed countries proposed to establish 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.

4.2 Origin Criteria: The Definition of Substantial Transformation

The first systemic discussion on the ‘substantial transformation’ criterion was held under the auspices of UNCTAD. 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.
An analysis of the various rules of origin commonly applied by donor countries showed that the substantial transformation criterion had been specified in different ways, so that there were several criteria in use 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; and
c) Percentage of value added.

The first criterion identified the rules which conferred the origin in the case of completion of a specific process deemed to be sufficient to give the product in question its essential character. In order to assess whether or not a specific process could be regarded as being sufficient, two main methods were in use, namely i) the list of qualifying processes and ii) the use of the Brussels Tariff Nomenclature (BTN)\(^39\). These methods were also used in combination.

The first method requires the compilation of a relatively long list indicating the approved qualifying processes in such detail as may be necessary for every product falling in the scope of preferences. In the second method, the rules of origin were based on the change in tariff heading of the BTN; this method permitted "a short and accurate definition of the materials" that could be used. The most important shortcoming, just evidenced by the analysis of the various rules applied by preference-giving countries, was that the BTN was not designed to determine origin (as is the case of the HS), and in some cases the change in tariff heading was either not sufficient to complete a substantial transformation, or the substantial transformation could also take place without a change in the tariff heading. This shortcoming required a list of supplementary regulations to indicate those processes for which special rules were deemed necessary.

The second definition, i.e. the criterion of final transformation process, was based on the criteria identified in the non-preferential rules of origin of the EC, as contained in regulation 802/68: "products 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".\(^40\)

The third definition 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/area in the manufacturing process.

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 the origin of goods in a scheme of preference of a non-contractual nature. This opposition was justified by the fact that the customs official of preference-giving countries had been using specific criteria and administrative procedures since the inception of the preferential arrangements, and changes in these rules would mean an increase in the cost of administering the rules of origin.

It is very important to note that, at that time, neither the US 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).

Thus, as seen above in paragraph 1, preferential rules of origin are still broadly divided into two main categories: (a) the US, Canada, Australia, New Zealand and the Central and Eastern European Countries use the percentage criterion; and (b) the EC, EFTA countries and Japan use a series of product-specific rules of origin.

---

\(^39\) The BTN was the precursor of the HS.

\(^40\) O.J. L 1481/65, 1968. This text has been replaced by Commission Regulation 2454/93.
4.2.1 Change of Tariff Heading

In carrying out the tasks assigned to the Working Group, the first criterion analysed was the process criterion, and in particular the lists of qualifying and non-qualifying processes applied by individual preference-giving countries. It has to be recalled that, since the BRN was not designed to determine origin (as is the case of the HS), most schemes added certain qualifying and non-qualifying processes to the rules in the form of two lists. List A specified processes which, although resulting in a change in tariff heading 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 which do not confer origin status on the products obtained, despite the fact that there was no change in tariff heading. 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 non-originating material worked or processed did not exceed a given percentage of the value of the goods obtained.

Since the introduction of the Harmonised System (HS) in 1988, preference-giving countries utilising the process criterion have implemented these rules of origin requirements on the basis of the new customs nomenclature. However, even the Harmonised System was not expressly designed for origin rule purposes and the basic rule of change of tariff heading does 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 exempted from the basic CTH rule and subject to separate and specific rules. The list, commonly referred to as the 'Single List' contains various formulations of the requirements to be met. Most of its content in terms of specific requirements was a combination of the previous List A and List B.

According to the CTH criterion, imported inputs and materials used in the manufacturing process of a finished product must undergo a change of HS heading or subheading to be considered an originating product. Since the 1970s, the EC and Japan used the CTH as a basic origin criterion in their preferential origin systems. To a certain extent, the EC also used them as a criterion for non-preferential rules of origin.

The advantages of the CTH are commonly recognised in its conceptual simplicity, its lack of discretion and, depending on the formulation of the rules, its ease of application. In addition, the CTH is based on the common framework constituted by HS, which is the customs nomenclature currently applied worldwide. On the other hand, and as mentioned above, one of the main disadvantages of the CTH comes from the fact that the HS was designed as a nomenclature for customs classification and not for rules of origin. This entails that in certain cases, even minimal working or processing may imply a CTH.

In the case of the EC's preferential rules of origin, this problem was solved by adopting List A and List B, as discussed above, as exceptions to the CTH rules. These lists were subsequently merged into the Single List of specific requirements (OF the 96 HS Chapters, about 84 can be found on the Single List). Thus, the basic CTH rule is applied as a general rule, unless some specific rules are applicable to certain products. Given the extensive coverage of the Single List rule, one might however wondered if the CTH is the exception and the Single List the basic rule.

As mentioned above, the disadvantages of the CTH mainly derive from its conceptual design which is not totally suitable for origin purposes. In the EC practice, supplementary criteria such as percentage criteria and specific working or processing have been added to the CTH to compensate for this gap. Another drawback of the CTH test is that it requires in-depth knowledge of the HS, not only on the part of exporting country administrations (not necessarily customs experts), but also on the part of producers/exporters with respect to both the finished products and the raw material.

Moreover, preference-giving countries had not been able to agree on a common phraseology to describe origin requirements in using the change of tariff heading. 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 exceed a given percentage of the value of the goods obtained. As can be seen from the following example from List A, preference-giving countries had used different wording to express the value of and describe component requirements.
Table 9: Drafting differences

<table>
<thead>
<tr>
<th>Products with BTN heading description</th>
<th>Working/processing not conferring the ‘originating’ products status</th>
<th>Preference-giving countries concerned</th>
</tr>
</thead>
<tbody>
<tr>
<td>11.04 Flours of the fruits falling under any heading in Chapter 8</td>
<td>Manufactured from fruits in Chapter 8</td>
<td>EEC</td>
</tr>
<tr>
<td></td>
<td>Manufactured from fruits falling under Chapter 8</td>
<td>Norway</td>
</tr>
<tr>
<td></td>
<td>Manufactured from the fruit</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>19.05 Prepared foods obtained by the swelling or roasting of cereals products (puffed rice, corn flakes and similar products)</td>
<td>Manufactured from various products</td>
<td>EEC, Switzerland</td>
</tr>
<tr>
<td></td>
<td>Manufactured from any products</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>32.06 Colour lakes</td>
<td>Any manufactured from materials of headings no. 32.04 and 32.05</td>
<td>EEC, Finland, Norway, Sweden</td>
</tr>
<tr>
<td></td>
<td>Manufactured from products of nos. 32.04 or 32.05</td>
<td>Austria</td>
</tr>
<tr>
<td></td>
<td>Any manufactured from products of headings no. 32.04 or 32.05</td>
<td>Denmark</td>
</tr>
<tr>
<td></td>
<td>Manufactured from materials of headings no. 32.04 or 32.05</td>
<td>United Kingdom</td>
</tr>
<tr>
<td></td>
<td>Manufactured from products falling under headings no. 32.04 or 32.05</td>
<td>Japan</td>
</tr>
<tr>
<td></td>
<td>Manufactured from products of headings no. 32.04 or 32.05</td>
<td>Switzerland</td>
</tr>
<tr>
<td>20.02 Vegetables prepared or preserved by other means than vinegar or acetic acid</td>
<td>Manufactured from ‘originating’ products falling under Chapter 7</td>
<td>Japan</td>
</tr>
<tr>
<td></td>
<td>Manufactured from ‘originating’ products of Chapter 7</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>45.03 Articles of natural cork</td>
<td>Manufactured from products of heading no. 45.01</td>
<td>EEC, Denmark, Finland, Norway, Sweden, Switzerland</td>
</tr>
<tr>
<td></td>
<td>Manufactured from products of no. 45.01</td>
<td>Austria</td>
</tr>
<tr>
<td></td>
<td>Manufactured from products falling under heading no. 45.01</td>
<td>Japan</td>
</tr>
<tr>
<td></td>
<td>Manufactured from materials of heading no. 45.01</td>
<td>United Kingdom</td>
</tr>
</tbody>
</table>

The data refer to GSP schemes of 1972. At that time, Austria, Denmark, Finland, Sweden and the UK were not EEC Members and had adopted independent GSP schemes.

The CTH became fashionable in the world trading system following its adoption as the main criterion for the NAFTA rules of origin. Before NAFTA, the US and Canada based their administration on a mixture of percentage criterion, substantial transformation and, where required, specific working or processing.

The NAFTA adoption of CTH was very different from that of the EC. In the EC rules, the CTH was meant to be a change of tariff heading at four-digit level, coupled with the Single List of exceptions to the CTH rule. In the NAFTA rules of origin, the CTH criterion lies at the foundation of the rules, and it is used at widely varying levels such as Chapter level (two digits), heading level (four digits), subheading level (six digits) and national tariff line level (8 digits). In some cases, ex headings or subheadings are created from the HS to suit the special origin requirement of NAFTA. In other cases, the CTH requirement is accompanied by value added criteria.

The result of this approach, and the consequent rules which emerged from the negotiations, are at first glance extremely complicated, since they require a deep knowledge of the HS and the national tariff lines into which some HS subheadings are further subdivided. Further, percentage criteria still apply in a number of cases.

The NAFTA drafters were of the opinion that the extensive use of the HS leaves little room for discretion. This is debatable, since a good part of the HS Committee, established at the WCO, is charged with the complex task of settling classification disputes among custom administrations. However, the HS has the intrinsic advantage of transferring the experience gained through its utilisation in matters of customs classification, explanatory notes and updating system to the rules of origin.
4.2.2 The Percentage Criterion

The value added or local content criterion has largely been used as the main criterion in the context of preferential trade arrangements like the GSP schemes of the US, Canada, New Zealand, or other arrangements like CBI, Caribbean–Canada Trade Agreement (CARIBCAN), ATPA, etc. The EC, EFTA, Japan preference origin system has mainly been used as supplementary criteria. Table 10 summarises the main version of the percentage criterion utilised in the GSP schemes. Mutatis mutandis, some of these versions are utilised in other origin systems which are either preferential or non-preferential.

Table 10: The percentage criterion

<table>
<thead>
<tr>
<th>Country/ group of countries</th>
<th>Rules</th>
<th>Ancillary/ exclusive</th>
<th>Requirements</th>
<th>Numerator</th>
<th>Denominator</th>
<th>% level</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>To be eligible for duty free treatment under GSP, an article must originate in, and be imported directly from the beneficiary 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 to at least 35% of the appraised value of the article at the time of its entry into the US</td>
<td>Exclusive</td>
<td>Minimum local content requirement</td>
<td>Cost of materials produced in the preference-receiving country, plus the direct cost of processing carried out there</td>
<td>Ex factory price or appraised value by US customs</td>
<td>Minimum 35%</td>
</tr>
<tr>
<td>Australia</td>
<td>Goods must comply with two requirements: a) the final manufacturing process 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 labour and/or materials of one or more developing countries (for the purposes of this requirement any Australian content may be counted as developing country content)</td>
<td>Exclusive</td>
<td>Minimum local content requirement</td>
<td>Labour and materials from the preference-receiving country, other preference-receiving countries and Australia</td>
<td>Ex factory or ex work cost</td>
<td>Minimum 50%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>At least half of the factory or work cost of the finished products is represented in each article by the value of material from any developing country or New Zealand, and/or other items with factory or works cost incurred in any developing country or New Zealand</td>
<td>Exclusive</td>
<td>Minimum local content requirement</td>
<td>Value of materials or parts of the product of any developing country or New Zealand</td>
<td>Ex factory or ex work cost</td>
<td>Minimum 50%</td>
</tr>
<tr>
<td>Canada</td>
<td>If the value of the import content amounts to not more than 40% or, in the case of LDCs, not more than 60% of the ex factory price of the goods as packed for shipment to Canada</td>
<td>Exclusive, except textile and clothing products</td>
<td>Maximum import content</td>
<td>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</td>
<td>Ex factory price of goods as packed for shipment to Canada</td>
<td>Not more than 40%, or 60% for LDCs</td>
</tr>
<tr>
<td>EU</td>
<td>E.g. Chapter 82.07: “The value of all the materials used does not exceed 40% of the ex work price of the product”</td>
<td>Ancillary</td>
<td>Maximum percentage of imported inputs</td>
<td>Customs value of imported inputs, or the earliest ascertainable price paid in the case of materials of unknown, undetermined origin</td>
<td>Ex factory price</td>
<td>Maximum 40%, 50% or 70%</td>
</tr>
</tbody>
</table>
The most important and most visible difference between the percentage and the CTH criteria is the extensive use of the HS system in the CTH requirement criterion and the comparative transparency, i.e. the use of plain language, in the case of the percentage criterion.

Basically, there are two approaches to the percentage criterion: a) in the case of the ‘domestic content’ or ‘value added’ form, the minimum proportion of materials, parts or components originating in the exporting preference-receiving country and the costs of processing incurred in that country must be used in the manufacturing of a finished product; and b) with regard to the ‘import content version’, a maximum proportion of non-originating materials should not be exceeded, i.e. third party (or of undetermined origin) materials or components can be used up to a maximum percentage of the value of the finished product.

According to the domestic content determination of origin, as used by Australia, New Zealand and the United States, both local materials and labour are included in calculating the minimum domestic content requirement. However, there were various definitions on how to calculate and allocate these elements towards the minimum percentage requirement. Allowable costs are defined differently. The Australian rules refer to “labour and materials of the preference-receiving country”. The New Zealand rules refer to the value of “materials and parts originating in” a preference-receiving country and “of other items of ex factory or ex works cost”.

The definition of costs which may be calculated towards the domestic content, may be different depending on the definition of allowable costs. The Australian rules allowed for costs directly attributed to the manufacturing of the finished product, for example, factory operatives, foremen and managers. On the other hand, costs attributed to the advertising or sale of the product were excluded. In particular, the expression “materials of a preference-receiving country” was interpreted as materials which had already acquired originating status in the preference-receiving country through fulfilment 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 consisting of qualifying area content, provided that the last manufacturing process 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 contains 30% area content, then 30% of the expenditure on that material will be included as qualifying content for the final good; and

b) Totally without area content, if it does not meet the “last process of manufacture” requirement for the preference-receiving country.

In addition, the United States reference to “cost or value of materials produced in the preference-receiving country” was defined in more detail. It referred to materials which 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; and

d) Taxes and/or duties imposed on materials, provided that 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; and

iii. Freight, insurance, packing and all other costs incurred in transporting the materials to the manufacturer’s plant.
In addition, according to the United States rules, intermediate materials which were “substantially transformed [...] into a new and different article of commerce” may also be 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 United States rules. In fact, in this case, the definition of substantial transformation referred to a judge’s ruling according to the jurisprudence of the US Federal Circuit Courts.

The words “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 labour costs 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;

b) Dies, moulds, tools and depreciation on machinery and equipment allocable to the specific merchandise; and

c) Costs of inspecting and testing the specific merchandise.

Items not included in the meaning of ‘direct costs of processing operations’ are those which are not directly attributable to the merchandise under consideration or that are not manufacturing ‘costs’ of the product. These include, but are not limited to:

a) Profit; and

b) General business expenses that are either not allocable to the specific merchandise, or not related to the growth, production, manufacture or assembly of the merchandise, such as administrative salaries, casualty and liability insurance, advertising and salespeople’s salaries, commissions or expenses.

There are other costs related to the manufacture of the goods, the status of which was not made clear under the United States rules, for example, costs of packaging, power and fuel, machinery (other than “dies, moulds and tooling”), whose costs are included only if they relate specifically to the particular finished product.

As far as the ‘import content’ approach is concerned, the calculation is based on the customs value of the imported materials. The rules laid down by the 1994 Agreement on Implementation of Article VII of GATT (WTO Agreement on Customs Valuation) are of great help in determining a common assessment of the customs value of imported materials, parts and components. The application of the above-mentioned rules by preference-receiving countries ensures a consistent approach to the valuation of imported materials, parts and components into their territories and thus improves the operation of the concept of import content.

Comparison between domestic and import content

The percentage criterion version that uses ‘import content’ as numerator appears readily comprehensible and requires little specialist knowledge.41 In this regard it appears simpler than the process criterion. On the other hand, where the percentage criterion uses the ‘domestic content’ or ‘value added’ form as numerator, some versions might require expert account advice to ensure compliance with the fine distinctions drawn between allowable and unallowable costs.

Drawing a general comparison between the CTH and the percentage criterion, it may seem reasonable to suggest that so far as newcomers to the origin requirements are concerned, the formulation and presentation of the CTH criterion rules might initially be expected to produce a deterrent effect. This could be serious in the event that newcomers have no experience in the HS, or are only familiar with percentage criterion rules. If a reliable source of information and advice is however available, as often should be the case, difficulties could readily be overcome and familiarity with the criterion established. The ability to provide such information and guidance in developing countries is thus important; it will of course vary from country to country.

So far as administrative effort is concerned, i.e. in relation to the establishment of compliance, with the criteria and subsequent monitoring thereof to ensure continuing compliance. The percentage criterion might

41 See UNCTAD Document TD/B/C.S/141, para. 23.
in practice be more burdensome, since 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. In contrast, the process criterion seems to require less monitoring, except in those cases where goods are exempted from the basic CTH rule, and percentage rules apply or when the HS is revised.

As far as a comparison between the import and domestic content is concerned, it may be observed that the ‘domestic content’ concept consists of two elements: a) the definition of labour and materials which may be counted towards the fulfilment of the percentage required; and b) direct cost of processing.

On the other hand, the import content is based on only one element, materials, either imported or of undetermined origin, while the denominator may rely on customs valuations which have been agreed at multilateral level. Thus, the import content approach possesses the advantage of immediate simplicity and transparency.

As discussed above, it was not easy to determine the distinctions between allowable and non-allowable labour costs which may be imputed to domestic content. Furthermore, where lines were drawn, they appeared to be arbitrary.

Apart from the problems caused by the lack of harmonisation of the definition of ‘domestic cost’, which could be allocated to domestic content, the varied and incomplete definitions not only created substantial administrative burdens for traders in preference-receiving countries, but also doubts as to whether their calculations were valid and accurate. In this regard, it should be borne in mind that the cost of both labour 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, import content can 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 where variations in labour costs must also be taken into account. Additionally, the domestic content approach was found to have the disadvantages as discussed below.

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 which could not arise under the import content concept. This might, for example, happen in the case of the United States GSP rules of origin where domestic content is defined taking into account the concept of ‘direct processing costs’. In fact, it is theoretically possible that a wholly produced article will not meet the 35% origin requirement, i.e. when the indirect costs exceed 65% of the appraised value of the good imported into the US. Using the concept of ‘direct processing costs’ in connection with the domestic content, the numerator might reduce the scope for using imported materials and components. For example, a product may have 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% requirement requested by the US 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.

### Table 11: Example of domestic content rule

<table>
<thead>
<tr>
<th></th>
<th>CASE 1</th>
<th>CASE 2</th>
<th>CASE 3</th>
<th>CASE 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appraised value</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Indirect cost</td>
<td>66</td>
<td>50</td>
<td>40</td>
<td>25</td>
</tr>
<tr>
<td>Minimum value of originating materials</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td>35</td>
</tr>
<tr>
<td>Maximum import content</td>
<td>Cannot meet the 35% rule, even if wholly produced</td>
<td>15</td>
<td>25</td>
<td>40</td>
</tr>
</tbody>
</table>

The examples in Table 11 show that in three out of the four cases only 15%, 25% and 40% 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 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% domestic processing cost rule.

ii) At a more detailed level, the domestic content approach requires an accounting analysis of records of both labour and materials used in manufacturing, and that the direct cost of processing operations is kept up to date. Such an analysis and record would be more detailed and burdensome than those required under the import content concept where 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 materials 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 therefore be lighter.

### 4.2.3 Specific Working and Processing

As was the case with problem with the definitions linked to the CTH being easily solved by using a well-known, accepted nomenclature classification of products, there is also the need to provide some kind of definition of the process that products must have undergone, therefore a definition of the processes that confer the origin to the goods. From a theoretical point of view, the best solution would be to define the exact process for each single product. But this raised the question that in many instances this would mean splitting up the headings for the final products into an extremely large number of subheadings. In practice, the definition would generally have to refer to all products under each heading.

UNCTAD experienced that, with the BTN taken as a basis for discussion, there nevertheless existed some BTN headings which comprised goods differing so considerably from each other than there would be no practical possibility of defining only one process of production for all of them. For example, a single heading might cover goods which can best be described as raw materials as well as goods which were highly manufactured.

The same may happen in the case of the HS. For example, under heading 30.03, which comprises medicines of all kinds, from simple mixtures of plants to the most sophisticated mixtures of equally sophisticated chemical products, the HS splits up the heading which allows for the description of manufacturing processes which are both economically reasonable and intelligible. Providing different process criteria for each subheading may cause an exceptional proliferation of different and very complex rules of origin.

In some cases, direct reference to a process, such as printing or rolling, might be a simple solution for many products, as it is possible to apply such references to even some whole headings. As an example, the printing process might be mentioned for goods falling in headings 49.01, 49.02, etc. (books, newspapers, etc.). The EEC applied a similar system in its GSP rules of origin in the 1970s.

However, even such definitions may need some refinement. For example, the expression ‘rolling’ seems to be unambiguous as a description for the manufacturing of metal sheets. But cold-rolled steel sheets have undergone many stages of rolling. First, the steel ingots have been rolled down into slabs or sheet bars. Then hot-rolled steel plates are produced, a procedure which means rolling in many steps down to a desired thickness. Cold rolling is a new stage which may again be performed in many steps, depending on the desired final thickness. A manufacturer who has performed only the last rolling of an already cold rolled steel sheet, has undoubtedly fulfilled a rolling process. 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 can also be applied to other procedures such as printing (e.g. the printing of only a few pages of a book), painting, etc. However, the precautionary measure mentioned above, namely to state the starting materials, might be enough even without a reference to the rolling procedure. For the time being, the only practical way to make steel sheets from ingots is the rolling procedure.

An UNCTAD study conducted in 1973 entitled The GSP: Proposals for improvement and harmonisation of...
the rules of origin analysed rules of origin contained in List A and List B of the GSP scheme with a different perspective. The study first considered that it is usually expected that each economically justified process adds a certain value to the processed goods. It, however, noted that many of the processes required in List A were multi-stage operations which did not provide that origin status was conferred by one single production process (e.g. making garments from yarn compared to the use of textile fabrics as starting material, which would not confer origin status on the finished garment, and processes required for garments under BTN headings 61.01–61.04), or else they implied de facto that the finished articles must be wholly produced in the preference-receiving countries concerned. These multi-stage rules were criticised by the preference-receiving countries as going “far beyond the conceivable limits of substantial transformation”. The study illustrated the implications of such provisions in the GSP rules of origin, in force at that time, through some technical examples.

The study considered that, in principle, processes requiring multi-stage operations may be justified by the fact that, in quite a number of cases, a manufacturing process can cause a change in tariff heading, without resulting in sufficient transformation of the starting material. Since the BTN (and the HS) was not devised for purposes of determining origin, it sometimes classified goods which had undergone only a very simple manufacturing process under another tariff heading than their starting materials. For example, cotton yarn, not put up for retail sale, fell under BTN heading 55.05, while the same yarn, put up for retail sale, fell under BTN heading 55.06. It is quite understandable that the process involved in this change in tariff heading could not be deemed sufficient for conferring origin status to the cotton yarn put up for sale.

Multi-stage processing, however, usually involves much more than simply the exclusion of a manufacturing or finishing operation. In the study’s technical examples it was shown that the multi-stage processing, specified in List A, generally required a percentage of unusually high value added in the course of production, which made it extremely difficult for preference-receiving countries to benefit from the GSP.

In examining the percentage requirements in List A, it was noted that, in many cases, the processes in List A conferred origin status only if the value of the non-originating material did not exceed a certain percentage of the finished article. In this case the concept of value added was therefore used as a complementary provision.

Such provision was 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), therefore 239 tariff lines in total. Thus, of the 409 processes specified for BTN Chapters 25–99 in List A, 58.4% involved a percentage requirement.

Of these 239 processes involving a percentage requirement, 99 (or 41.4%) specified a non-originating percentage of 40% of the value of the finished products, i.e. requiring that 150% of the value of the imported material be added in the course of manufacturing in the preference-receiving country. Eighty processes (33.5%) specified a non-originating percentage of 50%, i.e. requiring 100% of value to be added in the country of origin. One process specified a non-originating percentage of 70% from imported raw materials, therefore requiring only 42.9% of value added. Thirteen processes (5.4%) used a combined formula specifying 40% or 50% of non-originating elements for various parts of the finished article.

According to the requirements specified in the GSP rules, several multi-stage operations are required in the production of textiles. For example, the GSP rules of origin in the early 1970s required that cotton yarn (BTN 55.05), in order to obtain origin, had to be manufactured from cotton, not carded or combed, or from cotton liners, or from cotton waste not carded or combed (the required process was “manufacture from materials of heading 55.01 or 55.03”). According to average value attributable to the specific processing factor, the spinning factor usually raised the value of the starting material by 75%. For 100 units of raw cotton, the yarn had a face value of 175, and the percentage of value added required thus on average amounted to 75%.

---

44 The same problem was solved through the adoption of the HS; in fact both cotton yarn put up for sale and the cotton yarn not put up for sale fall under the same heading (52.04). The first is classified under subheading 5204.11 and the second under 5204.20.


46 In the case of copper powder and flakes (BTN heading 74.06), a manufacturing process conferred origin status only if the value of the non-originating products used did not exceed 50% of the value of the finished product. In other words, another 100% had to be added, in the course of production, to the value of the non-originating products.

47 Account was taken of processes covering more than one tariff heading in all these calculations.

48 In the EC GSP rules of origin the materials described in the text, as classified in HS Chapter 62, obtain origin if they are manufactured from yarn.
For “other woven fabrics of cotton” (BTN 55.09), the process prescribed was “manufacture from materials of headings 55.01, 55.03 and 55.04”. Since the use of non-originating yarn was not permitted as raw material, the starting material for the production of fabrics must again be raw cotton. Since it was assumed that the average value attributable to the weaving process was equivalent to 140%, 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%.

4.3 Lessons Learnt from Drafting Rules of Origin under FTAs: Technical Issues and Methodologies

As discussed in Section 4.1, rules of origin under unilateral arrangements should match and reflect the industrial capacity of the countries receiving trade preferences. These rules of origin should serve the multilaterally agreed principle of the GSP, i.e. increase export earnings, promote industrialisation and accelerate rates of economic growth.

In the case of reciprocal trade preferences in FTAs, the rules of origin are, at best, the result of intensive negotiations between the FTA Parties, resulting in a balanced (although one may argue, at times unbalanced) negotiated outcome. At worse, they are the result of an unfounded belief that rules of origin could be a catalyst for regional integration, or a policy recipe to add value to exports of raw commodities. Even worse, it can sometimes be attributed to an unwarranted conviction that there is a need for ‘strong’ rules of origin. Thus, the level of leniency or stringency when drafting rules of origin should be understood as a function of different vectors, such as the magnitude of trade flows, the preferential margin, manufacturing capacity, availability or unavailability of local and regional inputs and the import or export sensitivity of a given sector, in the context of a preferential agreement.

The measuring or negotiating of rules of origin extracted from the regional trade flows, the ability of customs administration to administer the rules, and the private sector’s commercial interest in complying with the rules, may lead to an agreement between government officials, but have little or no impact on the economies of the FTA Parties.

It is recognised that the utilisation of trade preferences by Asian FTAs is low, as depicted in Table 12. Findings in the COMESA utilisation rates point in the same direction.

Table 12: Utilisation of trade preferences by Asian FTAs

<table>
<thead>
<tr>
<th>Country</th>
<th>Use by exporters</th>
<th>Intend to use</th>
<th>No intention to use</th>
<th>Use by importers</th>
<th>Intend to use</th>
<th>No intention to use</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN</td>
<td>27%</td>
<td>27%</td>
<td>46%</td>
<td>23%</td>
<td>27%</td>
<td>50%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>43%</td>
<td>22%</td>
<td>35%</td>
<td>33%</td>
<td>34%</td>
<td>33%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>26%</td>
<td>19%</td>
<td>55%</td>
<td>20%</td>
<td>34%</td>
<td>59%</td>
</tr>
<tr>
<td>Philippines</td>
<td>14%</td>
<td>29%</td>
<td>57%</td>
<td>8%</td>
<td>21%</td>
<td>71%</td>
</tr>
<tr>
<td>Singapore</td>
<td>46%</td>
<td>17%</td>
<td>37%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>26%</td>
<td>31%</td>
<td>43%</td>
<td>28%</td>
<td>29%</td>
<td>43%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>12%</td>
<td>35%</td>
<td>53%</td>
<td>14%</td>
<td>28%</td>
<td>58%</td>
</tr>
</tbody>
</table>

Source: Survey of Japanese-affiliated firms in ASEAN, India, and Oceania.

Note: ‘Use’ refers to the share of affiliates that are already using FTAs, ‘intend to use’ refers to the share of affiliates that are not using, but are considering the use of FTAs, and ‘no intention to use’ refers to the share of affiliates that are not using and are not going to use FTAs. The figures in Singaporean imports are not available since the general tariff rates are already zero or quite low in Singapore.

In assessing the good and bad of rules of origin, two basic parameters may be used:

1. Index of restrictiveness; and
2. Index of technical soundness.
Index of Restrictiveness

Such degree is related to the degree of stringency or leniency of a given rule of origin in respect of the industrial capacity of the country or countries where the rule of origin is operational.

This parameter may not be measured in abstract, as it is dependent on the industrial capacity, trade flows and trade policy objectives of the preferential trade arrangement and the country concerned. The evaluation of this parameter, i.e. whether a certain rule is good or bad for a certain preferential arrangement, is linked with trade policy interests and is dependent from the level of industrial capacity of the region or country where the rules of origin are operational, as well as the preferential margin. This index is not neutral, but varies based on the perspective of the parties to an FTA agreement, or of a preference-giving country in the case of unilateral trade preferences.

Index of Technical Soundness

This index must be determined against the accuracy of given rules of origin in providing an origin outcome in the simplest and more predictable manner, as well as by its easiness in administering it, taking into account the capacity of customs administrations.

A number of lessons have been learnt from the international community, providing guidance on the technical soundness of a given rule. There are also several objective technical considerations and internationally agreed tools, like the HS and the customs valuation agreements, that are delimiting the boundaries of the degree of technical soundness.

One of the common misconceptions is mixing the concepts underlying the two indexes. In fact, the restrictiveness of a given set of rules of origin is an independent factor from the way in which the rules are drafted. The following technical instruments are available in drafting a given rule of origin, namely: a requirement of a change of tariff heading or subheading, coupled or not with exceptions, a requirement of a certain value added or regional value content to be complied with, or the performances of a specific working or processing requirement.

Below are some examples of similar substantive requirements in the clothing sector which require double processing, expressed according to different drafting techniques. In this case, the NAFTA basic rules of change of tariff subheading from any other Chapter, excerpted below, may appear quite liberal. A closer look at the materials classified in the excepted headings however reveals that one may only use imported raw cotton to make knitted or crocheted products under Chapter 61 (triple transformation or double transformation, depending on the kind of garments). Moreover, these rules, based on change of tariff classification, also contain a specific requirement for visible lining.

Change of Tariff Heading – NAFTA Model with Exception as Shown Below

A change at subheading level through all of Chapter 61 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 or 60.01 through 60.02, 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.

Specific working or processing requirement according to the EU model

<table>
<thead>
<tr>
<th>HS Chapter</th>
<th>Description of the product</th>
<th>Origin requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 62</td>
<td>Articles of apparel and clothing accessories not knitted or crocheted</td>
<td>Manufacture from yarn</td>
</tr>
</tbody>
</table>

In this case, the rule is quite straightforward insofar as it expressly calls for working or processing requirements to confer originating status on finished products manufactured with third country inputs. These requirements mean that the rules of origin are drafted through various techniques, such as specific working or processing operation or a change of tariff classification according to the NAFTA model.

In spite of these different drafting techniques, the requirement to carry out multiple processing phases is almost similar, albeit in the NAFTA case the spinning process is also required. Thus the way in which the rules of origin are drafted should not be confused with the measurement of restrictiveness of a given rule.
4.3.1 Defining the Index of Technical Soundness

Rules of origin are increasingly the object of fierce negotiations, since they are often the main cause of low utilisation of autonomous trade preferences and FTAs. In fact, the mere existence of trade preferences does not automatically imply that the tariff preference is granted at the time of customs clearance. Tariff preferences are conditional upon compliance with rules of origin and its ancillary requirements such as documentary evidence and consignment requirements.

There are more or less refined techniques of drafting adequate rules origin. But, once again, experience has shown that given the complexity of rules of origin, several misunderstandings may occur when drafting rules of origin. These misunderstandings may easily have devastating effects once these rules, which may not reflect commercial realities and manufacturing capacity, have to be administered and applied in the field.

Most recently, it was proposals that rules origin which require a mere 10% value added, be adopted. Some studies argue that sensible rules of origin under economic partnership agreements should be across-the-board, simple change of tariff heading for all products. There have also been a number of suggestions that suitable rules of origin could either be the CTH requirement at four-digit level, or a 35% value addition based on CIF input costs.

Alternative rules of origin for the same product are currently in use in the Pan-European rules origin and the NAFTA or similar rules. These are designed to assist producers/exporters to comply and understand rules of origin requirements. However, it has to be observed that the substantive requirements under these alternative rules are essentially co-equal in terms of its stringency.

This might however not be the case when producers/exporters have a choice between the four-digit level CTH and a 35% value addition. Depending on the product concerned, the exporter/producer will pick the CTH when it is easy to comply with, and vice versa. This absence of logic will defeat the objective of rules of origin, namely to allow compliance for products that are genuinely manufactured in a LDC and to avoid trade deflection.

The merits and limits of the change of tariff classification

Simple, across-the-board CTH rules will surely allow trade deflection in a number of cases as shown in the examples below. It is however widely known among practitioners that the adoption of a four-digit level CTH imply that insufficient processing sometimes involve a change in HS heading. In spite of this evidence, the urban legend of an across-the-board CTH or CTSH still exists in some circles.

However, it has to be noted that in the case of the EU, the basic CTH was coupled with exceptions, while the NAFTA and the HWP rules, which are based on the HS, are at times defined at six-digit levels with exceptions. The CTH may be very useful in drafting rules of origin, but it is far from perfect for use as across-the-board origin criteria.

The HS was designed for customs classification purposes, not rules of origin, yet it has been used extensively in drafting rules of origin under the EU and NAFTA, and more recently the Harmonisation Work Programme (HWP) under the WTO Agreement on Rules of Origin. As mentioned in Chapter 2 however, one has to keep in mind non-preferential rules of origin adopted on the basis of the HS does not imply a simple change of tariff heading at four-digit level applying to all products.

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 or unknown origin materials are used, there must be a change in HS heading. The following examples may further clarify the implication of simple CTH.
Example 1: Cocoa and cocoa preparations

<table>
<thead>
<tr>
<th>HS heading no.</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>18.01</td>
<td>Cocoa beans</td>
</tr>
<tr>
<td>18.02</td>
<td>Cocoa shells</td>
</tr>
<tr>
<td>18.03</td>
<td>Cocoa paste</td>
</tr>
<tr>
<td>18.04</td>
<td>Cocoa butter</td>
</tr>
<tr>
<td>18.05</td>
<td>Cocoa powder</td>
</tr>
<tr>
<td>18.06</td>
<td>Chocolate, etc.</td>
</tr>
</tbody>
</table>

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 a manufacturing process, including refining; while 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 to making cocoa butter and 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
- Sheets

This example shows the manufacturing chain of steel products like 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.

However, some substantial processes like cladding, plating, or coating bars and sheets are not recognised as substantial transformations, while others such as the rolling process of is a substantial transformation in certain cases (reflected in the HS) and not in others. Some examples of these inconsistencies can be found below.

Heading 72.12 classify flat-rolled products of iron or non-alloy steel of a width of less than 600 mm, clad, plated, or coated, while heading 72.10 classify flat-rolled products of iron or non-alloy steel, of a width of 600 mm or more, clad, plated or coated. If a product is rolled from a width of 500 mm to 400 mm, the rolling is not origin conferring because the product will remain under heading 72.12. However, if the rolling reduces the width from 600 mm to 500 mm, it is origin conferring because the product will move from heading 72.10 to 72.12.

Example 3

Watch movement HS 91.04
Clock case HS 91.12
Watch HS 91.03

Assembly of watches is an origin conferring operation according to a CTH, but testing is not.

Example 4

Fresh vegetables HS 0701.09
Dried vegetables HS 07.12

Is drying of vegetables a substantial transformation?
Example 5: Normal case: cotton jackets

The below are the main processes in order to make cotton jackets:

- To get a raw cotton (fibre) \[\text{HS 52.01}\]
- To make cotton yarn \[\text{HS 52.05}\]
- To make cotton fabrics \[\text{HS 52.08}\]
- To make cotton jackets \[\text{HS 62.03}\]

Example 6: Special case: knitted wear

- Raw wool \[\text{HS 51.01}\]
- Woollen yarn \[\text{HS 51.09}\]
- Knitted sweater \[\text{HS 61.10}\]

It should be noted that a mere adoption of the CTH criteria will eliminate double or triple transformation requirements. On the other hand, essential processes such as dying, washing and printing are excluded from origin conferring.

Example 7: Diamonds

- Rough/unworked
- Cut/worked \[\text{HS 71.02}\]

In sharp contrast with examples 5 and 6, there are some instances in which a process or manufacturing does not involve a change in HS heading, but can well be regarded as the process or manufacturing which has undergone a substantial transformation as illustrated above.

Example 8

With regard toys (HS heading 95.43), some producers in developing countries found it impossible to comply with the rule of origin based on the change in tariff heading criterion. In fact, some countries found it necessary to import some parts under heading 95.43, so the finished toys cannot obtain origin.

Problems with adopting simple CTH in the machinery and electronics sector

As already pointed out, the HS identifies three broad categories of parts: a) parts for general use; b) parts suitable for use solely or principally for machines under a particular heading; and c) finished goods which will be used as parts or components for other goods.

For some goods, therefore, the assembly of parts to produce the finished good will result in a change of heading (e.g. manufacturing of motor vehicles under heading 87.01–87.05 from parts under heading 85.08), while it will result in a change of subheading for others (e.g. trailers and semi-trailers under heading 87.16 from parts under heading 87.16.90). However, in some cases, parts are classified under the heading for the vehicles produced, without subheadings, and thus undergo no change of classification when used for the production of an article such as baby carriages under heading 87.15.

Thus, when using the simple CTH requirement, depending on the structure of the HS, a very complex assembly may be denied origin, while a simple assembly of parts may be considered as origin conferring, even if it is a screwdriver operation.

The traditional remedy to address these intrinsic limitations of the change of tariff classification is the provision of adjustment provisions in the form of product-specific lists and the listing of simple operations such as cutting, sorting, placing in bottles, changing packing and affixing marks, which do not confer the status of originating products. However, since it is impossible to enumerate a list of simple operations, this exercise resulted in a long list of product-specific rules with stringent requirements.
4.3.2 Compiling a Complete, Structured Draft Containing all Elements of Rules of Origin

Drafting a protocol on rules of origin requires a number of elements and provisions that may be summarised as follows:

- Definitions of terminology;
- General requirements;
- Wholly obtained products including the definition of vessels;
- Substantial transformation: definition of appropriate methodology;
- Insufficient working or processing operations;
- Tolerance rules;
- Cumulation;
- Allocation of origin in cumulation; and
- Definition of administrative rules concerning proof of origin and related trade facilitation aspects.

According to the revised Kyoto Convention, and practically almost all sets of rules of origin, there are two categories of products, as discussed below.

Wholly obtained products

Wholly obtained products are products for 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 seabed;
- 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 there;
- f) Products of sea fishing and other marine products taken from the sea by its vessels;\(^49\)
- g) Products exclusively made on-board its factory ships 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.”

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. The pros and cons of the different approaches that may be adopted to define substantial transformation have been highlighted throughout this Module.

Drafting a percentage criterion requirement

In the case where a percentage criterion is adopted it may be considered to adopt a criterion based on value of materials rather than on a value added criterion. This criterion may be adopted across the board for all products but there might be a need to consider, in limited cases, product specific rules of origin where the application of the percentage criterion may not be considered suitable or viable.

\(^{49}\) This definition has to be spelled out in order to avoid restrictions as in the EU case.
Rationale

The UNCTAD Working Groups and evidence drawn from questionnaires submitted to exporters and producers, found a tendency, if not consensus, among exporters/manufacturers to prefer the adoption of a maximum imported inputs allowance rather than a minimum value added requirement. There are two reasons for this preference:

1) The percentage calculation of the value of the imported input is easier to calculate and the value of the imported input can be supported by suppliers’ invoices. The term ‘value of imported material’, rather than being left vague and subject to the discretion of customs authorities, can be anchored to the customs value as determined in accordance with the Agreement on Implementation of Article VII of the GATT 1994; and

2) The calculation of the value added is complex as it entails:
   i) A distinction of costs, which could be calculated as local value added;
   ii) The itemisation of such cost to the single unit of production, which often requires accounting, while discretion may be used in assessing unit costs. Additionally, currency fluctuations in beneficiary countries may affect the value of the calculation; and
   iii) Low labour costs in developing countries may result in low value added and instead of being a factor of competitiveness, may turn out to penalise producers.

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 places a maximum limit on the use of imported material, and the other places a minimum limit on the domestic content contribution of the preference-receiving country.

Some preference-giving countries apply interpretative definitions in both approaches. Where ‘imported material’ is used as numerator, the method of its valuation is defined. Where ‘domestic content’ is used, the elements it may comprise are, to varying degrees, defined so as to identify those that may be included in the calculation of the numerator and those that may not. Definitions used for denominators are ‘ex work cost’, ‘ex factory price’, ‘ex factory or ex work cost’ and ‘ex factory price or value as appraised by the US authorities’.

The nature of each formulation of the percentage criterion affects the administrative effort required to introduce and maintain compliance therewith. It also affects the substance of the criterion. As regards administrative efforts, manufacturers and exporters in preference-receiving countries need to establish records in sufficient detail to meet the differing requirements of each formulation. These vary especially in the case of some ‘domestic content’ formulations, where the division drawn between acceptable and unacceptable elements of the numerator is set out in detail.

These elements may only be familiar to accountants, as the recalculation of prices, costs and change in quantities will be necessary to ensure compliance. While some of these tasks may form part of the normal accounting procedures required for commercial purposes, some may not. In such cases, additional professional expertise may be required.

As a rule of thumb, the larger the denominator in the case of a value added criterion, the more stringent the requirement of certain percentages of valued added may be. While in the case of import content criteria, the larger the denominator, the more lenient the limitation on the use of imported inputs may be.

The formulation of denominators calls for figures which appear to be readily accessible and determinable. The exception is the current formulation used by the US under the GSP scheme, which is the ex factory price or value as appraised by the US Import Authority. This may affect compliance with the rules, as the appraised value may not be available until after the import of the goods, with possible disadvantage to the traders concerned.

It has been suggested 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. It could therefore be easier to obtain preferential treatment for products manufactured in plants which are relatively near the point of export, and a variation in the degree of liberality of the rule of origin would ensue.
Inequities may also arise in connection with factory cost and factory price. For example, more efficient manufacturers will produce items at a lower unit cost and may find the percentage criterion more restrictive with regards to the proportion of imported materials that may be used. It thus seems impossible to achieve complete equity on the basis of a percentage criterion in this respect because of continuous variations in costs and prices.

In the case of the CIF price, land-locked and island countries may be severely affected by transport and insurance costs, as the value of imported inputs will be exceeding the value of similar inputs used in another country that is not landlocked.

Bearing in mind the above observation, it has been argued that the use of the FOB price would assist all exporters in a preference-receiving country, irrespective of their location and efficiency, to meet a percentage requirement based on import content. The advantages the FOB price may have over the other formulations include:

- It is the most frequently quoted price level and is used in international trade. It is thus readily available for use in establishing origin without additional effort or expense;
- The administrative overheads for manufacturers are therefore reduced to a minimum, comparing favourably with both factory cost and factory price, where detailed definitions have to be observed; and
- It includes some important elements which are excluded by other formulations and which may be regarded as ‘originating elements’, for example local transport and insurance, packing and handling costs.

At present only Japan is using FOB prices under its current GSP. The EU is currently using the definition of ex works price: “ex works price means the price paid for the product ex works to the manufacturer in the community or in ACP States in whose undertaking the last working or processing is carried out, provided the price includes the value of all the materials used, minus any internal taxes which are, or may be, repaid when the product obtained is exported”.

In the US, as pointed out above, the concept of appraised value is still used with its related difficulties. In the case of the US–Central American Free Trade Agreement (CAFTA) Agreement, the denominator is based on the concept of adjusted which is defined as “For the purposes of this note, the term ‘adjusted value’ means the value determined under Articles 1–8, Article 15 and the corresponding interpretive notes of the Agreement on Implementation of Article VII of the GATT (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”.
Annex 1: Exercise

Examination of Different Texts of Rules of Origin

Question 1: Is the rule of origin below technically sound? Is it easy to understand and administer? Is it restrictive or lenient? Does it require special knowledge?

A change to subheadings 6202.91 through 6202.93 from any other Chapter, except from headings 5106 through 51.13, 52.04 through 52.12, 53.07 through 53.08, or 53.10 through 53.11, Chapter 54, or headings 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 NAFTA parties, and

b) The visible lining fabric listed in Chapter Rule 1 (see below) for Chapter 62 satisfies the tariff change requirements provided therein.

Chapter Rule 1

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 items 5408.22.10, 5408.23.11, 5408.23.21 and 5408.24.10),
- 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,
- 6005.31 through 6005.44 or 6006.10 through 6006.44, from any other heading outside that group
Question 2: Can you compare the rules below with those above? What does it change in terms of requirements?
A change to subheadings 6202.91 through 6202.93 from any other chapter.

Question 3: Is the following rules of origin text clear and predictable? Are the rules of origin contained therein easy to administer? What are the possible implications?

a) For the purposes of Rule 2(b), a product shall be deemed to be originating if:
   i. Not less than 40% 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-ASEAN–China Free Trade Area (ACFTA)), does not exceed 60% of the FOB value of the product so produced or obtained, provided that the final manufacturing process 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% ACFTA content is calculated as follows:

\[
\text{Value of } + \text{Value of materials of undetermined materials, non-ACFTA origin} \times 100 \% < 60\%
\]

FOB price

Therefore, the ACFTA content: 100\% – non-ACFTA material = at least 40\%

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 to be a material whose country of origin, as determined under these rules, is the same country as the country in which the material is used in production.

Question 4: Suppose you have to determine origin with a product cost sheet for a chair of heading 9401, and the applicable rules of origin are as detailed below with cumulation applicable. The country of last manufacturing is in a TFTA Member State. Deductions or addition of cost of transport are allowed. Which of the following would be your calculations?

i. The CIF value of those materials does not exceed 60\% of the total cost of the materials used in the production of the goods.

ii. The value added resulting from the process of production accounts for at least 35\% of the ex factory cost of the goods.

iii. The goods are classified or become classifiable under a tariff heading other than the tariff heading under which they were imported.

iv. Method based on value of non-originating materials with deduction of transports costs.

\[
\text{VNM} = \text{VNM} \times 100 \Rightarrow 70\%
\]

EWP
v. Method based on value of originating materials with deduction of transports costs.

\[ \text{VOM} = \frac{\text{VOM}}{\text{EWP}} \]

Where EWP is the ex works price as below. VNM is the value of non-originating materials and VOM is the value of originating materials. The finished product in the TFTA Member State is a chair under HS heading 94.01.

Manufacturing cost sheet:
- Local timber 150
- From other TFTA Member State Z 80 (110 after addition of intraregional transport)
- Malaysian origin 900 (after deduction of CIF) = 750

Other costs:
- Glue (imported from Brazil): 5, after deduction of CIF: 4
- Varnish (imported from Germany): 8, after deduction of CIF: 6

Factory overheads:
- Rent and rates: 50
- Depreciation of machinery: 30
- Direct labour: 170
- Ex factory cost: 1,380 + 14 of profit = 1,394 EW price

Calculations:
- Value added (35%)?
- Import material content (60%)?
- CTH?
- VNM (70%)?
- VOM (30%)?
## LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACP</td>
<td>African, Caribbean and Pacific</td>
</tr>
<tr>
<td>ACFTA</td>
<td>ASEAN–China Free Trade Area</td>
</tr>
<tr>
<td>ARO</td>
<td>Agreement on Rules of Origin</td>
</tr>
<tr>
<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
</tr>
<tr>
<td>ATPA</td>
<td>Andean Trade Preference Act</td>
</tr>
<tr>
<td>BTN</td>
<td>Brussels Tariff Nomenclature</td>
</tr>
<tr>
<td>CACM</td>
<td>Central American Common Market</td>
</tr>
<tr>
<td>CAFTA</td>
<td>Central American Free Trade Agreement</td>
</tr>
<tr>
<td>CARIBCAN</td>
<td>Caribbean–Canada Trade Agreement</td>
</tr>
<tr>
<td>CBI</td>
<td>Caribbean Basin Initiative</td>
</tr>
<tr>
<td>CC</td>
<td>Change of Chapter</td>
</tr>
<tr>
<td>CEFTA</td>
<td>Central European Free Trade Agreement</td>
</tr>
<tr>
<td>CIF</td>
<td>Cost, insurance and freight</td>
</tr>
<tr>
<td>COMESA</td>
<td>Common Market for Eastern and Southern Africa</td>
</tr>
<tr>
<td>CRO</td>
<td>Committee on Rules of Origin</td>
</tr>
<tr>
<td>CTH</td>
<td>Change in Tariff Heading</td>
</tr>
<tr>
<td>CTSH</td>
<td>Change in Tariff Subheading</td>
</tr>
<tr>
<td>DC</td>
<td>Developed Countries</td>
</tr>
<tr>
<td>EAC</td>
<td>Eastern African Community</td>
</tr>
<tr>
<td>EC</td>
<td>European Communities</td>
</tr>
<tr>
<td>EEA</td>
<td>European Economic Area</td>
</tr>
<tr>
<td>EEC</td>
<td>European Economic Community</td>
</tr>
<tr>
<td>EFTA</td>
<td>European Free Trade Association</td>
</tr>
<tr>
<td>EPA</td>
<td>Economic Partnership Agreement</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EWP</td>
<td>Ex works price</td>
</tr>
<tr>
<td>FOB</td>
<td>Free on Board</td>
</tr>
<tr>
<td>FTA</td>
<td>Free Trade Area</td>
</tr>
<tr>
<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
</tr>
<tr>
<td>GSP</td>
<td>Generalised System of Preferences</td>
</tr>
<tr>
<td>HS</td>
<td>Harmonised System</td>
</tr>
<tr>
<td>HWP</td>
<td>Harmonisation Work Programme</td>
</tr>
<tr>
<td>IC</td>
<td>Intergovernmental Committee</td>
</tr>
<tr>
<td>IEPA</td>
<td>Interim Economic Partnership Agreement</td>
</tr>
<tr>
<td>LDC</td>
<td>Least Developed Countries</td>
</tr>
<tr>
<td>MFN</td>
<td>Most Favoured Nation</td>
</tr>
<tr>
<td>MMTZ</td>
<td>Malawi, Mozambique, Tanzania and Zambia</td>
</tr>
<tr>
<td>NAFTA</td>
<td>North American Free Trade Area</td>
</tr>
<tr>
<td>REC</td>
<td>Regional Economic Community</td>
</tr>
<tr>
<td>RTA</td>
<td>Regional Trade Arrangements</td>
</tr>
<tr>
<td>SADC</td>
<td>Southern African Development Community</td>
</tr>
<tr>
<td>TCRO</td>
<td>Technical Committee on Rules of Origin</td>
</tr>
<tr>
<td>TFTA</td>
<td>Tripartite Free Trade Area</td>
</tr>
<tr>
<td>TRIPS</td>
<td>Trade Related Aspects of Intellectual Property Rights</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>VNM</td>
<td>Value of non-originating materials</td>
</tr>
<tr>
<td>VOM</td>
<td>Value of originating materials</td>
</tr>
<tr>
<td>WCO</td>
<td>World Customs Organization</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
</tbody>
</table>
TradeMark Southern Africa

Physical:  1st and 2nd Floor, Building 41, CSIR Campus, 627 Meiring Naude Road, Brummeria, Pretoria, 0001, South Africa
Postal:  PO Box 107, Persequor Park, Pretoria, 0020, South Africa
Tel:  +27 12 349 7500
Fax:  +27 12 349 7513
E-mail:  info@trademarksa.org