GLOBALIZATION AND
THE INTERNATIONAL TRADING SYSTEM

Issues relating to rules of origin
# CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraphs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>1 - 11</td>
</tr>
<tr>
<td>1. Rules of origin in international trade: Efforts to establish</td>
<td>12 - 18</td>
</tr>
<tr>
<td>multilateral rules</td>
<td></td>
</tr>
<tr>
<td>1.1 Non-preferential rules of origin: Circumvention and</td>
<td>19 - 27</td>
</tr>
<tr>
<td>anti-dumping duties</td>
<td></td>
</tr>
<tr>
<td>1.2 The Uruguay Round Agreement on Rules of Origin</td>
<td>28 - 30</td>
</tr>
<tr>
<td>1.2.1 Harmonized rules of origin: Issues involved</td>
<td>31 - 36</td>
</tr>
<tr>
<td>1.2.2 Marks of origin</td>
<td>37 - 45</td>
</tr>
<tr>
<td>2. Preferential rules of origin</td>
<td>46 - 48</td>
</tr>
<tr>
<td>2.1 Unilateral preferential rules of origin</td>
<td>49 - 53</td>
</tr>
<tr>
<td>2.2 Contractual rules of origin in free trade areas</td>
<td>54 - 64</td>
</tr>
<tr>
<td>2.3 Cumulation</td>
<td>65 - 73</td>
</tr>
<tr>
<td>2.4 Contractual rules of origin and cumulative systems</td>
<td>74 - 81</td>
</tr>
<tr>
<td>Conclusions</td>
<td>82 - 88</td>
</tr>
</tbody>
</table>
Note

The present study is part of a series of publications on globalization and international trade published by the Division on International Trade in Goods and Services, and Commodities. It has been drafted by Mr. Stefano Inama, UNCTAD Project Manager, with comments and suggestions from Mr. Murray Gibbs, Head of the Trade Analysis and Systemic Issues Branch, Mr. Xiaobing Tang, Economic Affairs Officer of the Development of Trade Capacities Section, and Mr. Edwin Vermulst, partner in the Vermulst & Waer law firm.
Introduction

1. Paragraph 91 of the final document of the ninth session of UNCTAD states that:

   “UNCTAD's main role in the field of trade in goods and services should be to help maximize the positive impact of globalization and liberalization on sustainable development by assisting in the effective integration of developing countries, particularly LDCs, and certain developing countries with structurally weak and vulnerable economies, into the international trading system so as to promote their development. Specific interests of the economies in transition should also be taken into account.”

2. To carry out this mandate effectively, it is necessary to have a clear idea of the relationship between the process of globalization and the international trading system, and how this relationship can affect the development process.

3. Traditional trade policy instruments were designed to deal with a situation where production was seen as an activity which essentially took place within national frontiers, although, obviously, raw materials were imported and semi-finished products exported. These instruments were applied to influence or control the price or quantity of goods that entered a country. Liberalization under GATT was achieved primarily by progressively tightening the prohibition on quantitative measures and reduced tariffs through multilateral negotiations based on reciprocity.

4. Advances in information, communications and management technology make it possible for enterprises to globalize their production. They have adopted new "modes" of penetrating markets in addition to trade, foreign direct investment, international subcontracting, licensing of technology, mergers and acquisitions, international joint ventures and inter-firm agreements (strategic alliances). The composition of trade has shifted to high-tech products, mutual trade in like products and trade in services.

5. Governments have shifted their priorities, abandoning import substitution policies for those intended to increase their competitiveness in the global market. Such policies have involved supporting "their" firms' global operations, even when this leads to an increase in outward investment and transfer of employment to lower-cost countries. These are considered to be inevitable elements of national competitiveness, which is perceived as depending to a large extent on the overall global competitiveness of national firms. At the same time, most countries are attempting to improve their physical, legal and administrative infrastructure as well as fiscal incentives to attract foreign investors.

6. As a consequence, globalization has modified the impact of trade policy instruments, some of which have become relatively less important as means of influencing the volume and direction of trade and investment flows. On the other hand, other instruments may have become more significant in this respect. Globalization has also created pressures for a "level playing field" for the global operations of enterprises, through the tightening of multilateral trade disciplines, their extension to all countries and the negotiation of multilateral disciplines in new policy areas, including those covering industrial and even social policy. In addition, it has generated initiatives for the proliferation of regional agreements aimed at achieving deeper integration than that possible at the multilateral level, to enable enterprises to set up regional production networks.
Globalization and the Uruguay Round

7. The negotiating objectives of the major trading countries in the Uruguay Round were largely to provide a world environment more conducive to promoting the globalization process. Multilateral disciplines were established which facilitated globalized production. For example, in the area of subsidies the Uruguay Round "deepened" the rules to cover elements of industrial policy, notably industrial subsidies. Disciplines were tightened or extended to facilitate globalization of production in key sectors, particularly local-content requirements trade-related investment measures (TRIMs). Intellectual property rights were incorporated within the multilateral trade rules. The new framework for trade in services (covering investment, movement of persons, communications, transportation, professional qualifications, etc.) provides a means of negotiating liberalization and enforceable disciplines in areas of crucial interest to the global operations of enterprises, i.e. covering many of the "modes" mentioned above. The linking of all these disciplines to the dispute settlement mechanism and the eventual threat of trade sanctions gave them an unprecedented degree of credibility. The outcome of the Singapore Ministerial Conference (SMC), which included an agreement on free trade in information technology products and on additional liberalization of financial and basic telecommunications services, demonstrates the continued priority given to this objective by the major developed trading countries.

8. However, while the Uruguay Round Agreements introduced a greater degree of precision and predictability in their application, the WTO still permits a series of instruments to restrict and control trade, notably "contingency protection" measures such as anti-dumping and countervailing duties and emergency safeguard measures. Also, it introduced new forms of safeguards in the agriculture and textile sectors. It allows governments a wide margin in the use of certain industrial subsidies (i.e. subsidies for research and development, conformity with environmental regulations, and dealing with regional disparities within countries). While the new system for trade in agricultural products provides more transparency and security of access, it has not significantly reduced protection in this sector and may have the undesired effect of encouraging bilateral deals and managed trade. These instruments constitute the arsenal of weapons which can be used (a) by governments in competition with other governments to attract investment, (b) by governments in competition with other governments to enhance the competitiveness of "their" firms, and (c) by firms in competition with other firms, including other "national" firms.

Globalization and "origin"

9. The design and application of rules of origin have become more problematic when faced with the realities of globalization, as the origin of a product has become more difficult to determine, and rules of origin can be applied to influence a firm's behaviour so as to achieve the desired trade effects. For example, non-preferential rules (e.g. for anti-dumping actions) can be designed so as to target certain countries or enterprises. Preferential rules such as those applied by regional agreements can also be designed to have a particular impact on certain input sectors, such as textiles and automobile parts. Such rules when reflected in marks of origin also have a trade impact.
10. In their continuous search for efficiency and competitiveness, some companies which have already moved ahead on the path of globalization have already shifted their strategy from a simple diversification of site of production and management of manufacturing assets to a more complex array of services going beyond the mere production of goods. The increased reliance on brand name and the management of servicing of finished products undertaken by these companies bypass some of the traditional obstacles to trade. For these companies, brand names and marks of origin with a global reputation for quality and superior technology are progressively becoming the most important strategy. Global companies may thus start to produce goods and services tailored to global supranational tastes, sourcing their inputs worldwide and securing the manufacturing facilities with the products having the most comparative advantages. Traditional trade barriers may be either eliminated or obliterated by a combination of intellectual management of services, brand names and corporate strategy.

11. One possible barometer which may be used in examining the interaction between globalization and the international trading system is rules of origin. This traditional instrument of the international trading system has recently been demonstrated to be a valuable yardstick for measuring industrial relations and company behaviour, and a source for identifying the strategy of global companies in sourcing their inputs worldwide. Specific cases occurred during international trade disputes may serve to make clear the confrontations which may arise in the utilization of traditional trade instruments and their impact on new ones. For these reasons, “origin” was chosen as the first subject for study in the present series.

1. Rules of origin in international trade: Efforts to establish multilateral rules

12. 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 compliance with rules of origin requirements often based on a value-added criterion.

13. 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 difference has had direct consequences in the evolution of the origin concept in United States legislation.

14. The issue of rules of origin (as opposed to origin markings, to which GATT Article IX is devoted, probably because of United States influence) did not attract much attention in the negotiation of the original General Agreement on Tariffs and Trade. On the contrary, during the second session of the Preparatory Committee in 1947, a subcommittee considered that “it is to be clear that it is within the province of each importing member to determine, in accordance with the provisions of its law, for the purpose of applying the most-favoured-nation (MFN) provision

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1 See United Kingdom Finance Act of 1919.
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 harmonization of rules of origin.

15. The scant attention devoted to the issue of rules of origin in the original GATT was probably due to 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 goods. This implied that, as a general concept, origin entered into world trade with a discriminatory bias: origin needs to be ascertained whenever a discriminatory measure is in place. During the years of operation of GATT 1947, rules of origin used by Contracting Parties in the context of GATT instruments and preferential rules of origin related to the granting of tariff concessions in accordance with treaties on arrangements concluded under Article XXIV were sporadically the subject of debate.

16. Besides these early discussions in GATT, one of the first attempts to establish an harmonized preferential set of rules of origin was made during the discussion in UNCTAD in connection with the Generalized System of Preferences (GSP). In point of fact, UNCTAD member States when discussing the establishment of the GSP realized the need to examine “origin” at the multilateral and systemic level. However, the preferential nature of the rules, their policy objectives and the unilateral nature of the GSP did not permit the elaboration of a single set of GSP rules of origin. At the end of the first negotiations, preference-giving countries opted to retain their own origin systems and extend them with some adjustments to the GSP.

17. Efforts to codify and strengthen a general concept of origin in the absence of multilateral disciplines were made at the multilateral level during the Kyoto Convention negotiations in 1973. However, Annex D I of the Convention, containing guidelines, was not sufficiently detailed and

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3. See EPCT/174, pp. 3-4.
5. 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.
7. International Convention on the Simplification and Harmonization of Custom Procedures, adopted in 1974 by the Customs Cooperation Council at its 41st and 42nd sessions, held in Kyoto. In substance, Annex 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 other than by listing the three different ways in which the substantial transformation may be interpreted: change of tariff heading, ad valorem percentage rules and specific manufacturing or processing operations, see H. Asakura, “The Harmonized System and rules of origin”, Journal of World Trade, vol., 27, no. 4, August 1993.
left member States freedom to choose different and alternative methods of determining origin. The low level of harmonization achieved, combined with the fact that few countries ratified this annex, meant that the annex became little more than general guidance used in determining origin at national level.

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

1.1 Non-preferential rules of origin: Circumvention and anti-dumping duties

19. The first cases where the absence of multilateral disciplines on non-preferential rules of origin started to attract the attention of policy makers and analysts occurred in the 1980s in connection with the enforcement of anti-dumping duties and other trade contingency or protectionist measures.

20. The emergence of anti-dumping law as one of most important trade policy instruments during the 1980s and 1990s has largely been responsible for the growing attention to the use of rules of origin as commercial policy instruments which could influence the interaction between the internationalization of production and its location. Imposition of anti-dumping duties coinciding with increasing globalization of production created the first tangible relocation cases of certain companies in strategic markets such the European Community (EC) and the United States. Claims by EC and United States domestic industries regarding the establishment of screwdriver factories on their territories led the two jurisdictions to adopt anti-circumvention legislation in the 1980s.8

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CIRCUMVENTION BY TRANSPLANT OPERATIONS

The 1988 EC regulation on anti-dumping contained an anti-circumvention provision which allowed the imposition of anti-dumping duties on products that were introduced into the commerce of the Community after having been assembled or produced in the Community, if the following conditions were met:

- “assembly or production is carried out by a party which is related or associated to any of the manufacturers whose exports of the like product are subject to a definitive anti-dumping duty;
- the assembly or production operation was started or substantially increased after the opening of the anti-dumping investigation;
- the value of parts or materials used in the assembly or production operation and originating in the country of exportation of the product subject to the anti-dumping duty exceeds the value of all parts or materials used by at least 50 per cent;

In applying this provision, account shall be taken of the circumstances of each case and, inter alia, of the variable costs incurred in the assembly or production operation and of the research and development carried out and the technology applied within the Community.”

Under this provision, seven proceedings concerning assembly operations in the EC were initiated from 1987 to 1989. They concerned Japanese transplant operations for the assembly of electronic typewriters, electronic scales, photocopiers, ball bearings, excavators, etc.

The provision was successfully challenged by the Japanese Government through a GATT panel regulation. The GATT panel examined whether anti-circumvention measures could be justified under GATT Article XX (s), which provides that:

“[n]othing in this Agreement shall be construed to prevent the adoption or enforcement by any Contracting Party of measures ... d) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement...”

The panel examined whether anti-circumvention measures could be considered necessary in order to secure compliance with the regulations imposing a definitive anti-dumping duty on the importation of the finished product (“law or regulations”). In this respect, the EC argued that the term “secure compliance with” should be broadly construed to cover not only the enforcement of laws and regulations per se but also the prevention of actions which have the effect of undermining the objectives of laws and regulations. The panel did not accept this broad interpretation. It noted that the text of GATT Article XX (d) does not refer to “objectives” of laws or regulations but only to laws or regulations.

It therefore clearly follows from this GATT panel decision that GATT Article XX (d) cannot be invoked as a general legal basis for adopting anti-circumvention measures which would deviate from the conditions set forth in Article VI (concerning anti-dumping). It is thus clear that any anti-circumvention measures can be adopted only in full compliance with the GATT conditions for imposing anti-dumping duties, i.e. establishment of findings of dumping and material injury and a causal relation between the two.

In the Uruguay Round negotiations, no agreement was reached on anti-circumvention measures. In fact, the Marrakesh Final Act only referred this matter “to the Committee on anti-dumping practices” established under that Agreement for resolution. This legal vacuum has been filled by a new and amended version of the original anti-circumvention provision in the most recent EC anti-dumping legislation.10

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9 See GATT document L/6657 of 22 March 1990, “EEC regulation on imports of parts and components”.

10 See Articles 13(1) and (2) of Council Regulation 284/96 of 22 December 1995, on protection against dumped imports from countries not members of the European Communities [1996 O.J. L.56/1]. For an initial first evaluation of the WTO consistency of this anti-circumvention provision, see Vermulst and Waer, op. cit. and Holmes, “Anti-circumvention under the European Union’s new anti-dumping rules”, Journal of World Trade, vol. 93, no. 3, June 1995.
21. Anti-dumping proceedings are normally initiated at the request of a complainant domestic industry against products originating in a certain country. Thus, a normal anti-dumping procedure requires that, besides other findings relating to dumping and injury, the investigating authorities determine the origin of the product exported from the third country. However, this is not always consistently done by the investigating authorities.\(^{11}\)

22. On the other hand, one may expect that the origin of the product of the domestic industry which filed the complaint will be examined as well. However, proof of domestic industry origin is generally not required of the complainant on the part of the domestic industries. Article 4 of the Uruguay Round Agreement on Anti-Dumping (definition of domestic industry) does not require that, in order to file a complaint, domestic producers manufacture originating products.\(^{12}\) Hence, a double standard is applied where origin is examined as regards exports of allegedly dumped products but not as regards the local industry which files the complaint. On the other hand, domestic industries complain about dumping of products from country A while simultaneously are importing parts to manufacture the same product. In certain anti-dumping proceedings instituted by the EC during the 1980s, this question arose in realistic terms. Especially in the photocopiers case and others,\(^{13}\) the EC investigating authorities found out that under Community rules of origin, certain models of photocopying machines consisted of parts imported from Japan. However, since the factory in question was planning to increase the Community content, the issue was dropped.

23. In particular, the clearest sign of the interaction between rules of origin and globalization was and still is provided by the unresolved issue of the appropriateness of anti-circumvention measures in the context of anti-dumping legislation. Various cases of textile quotas circumvention have also been recorded in anti-dumping cases.

24. The anti-circumvention provision contained in the 1980s EC Anti-Dumping Regulation was consequently successfully challenged by Japan in the GATT, (see box 1).

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\(^{11}\) The WTO Agreement on Anti-Dumping does not indicate this requirement clearly in its Article 9(2). In a specific anti-dumping case involving small screen colour televisions from the Republic of Korea, the EC Commission opted for the country of production rather than the country of origin. See O.J. L.324/1 [1990] (provisional); O.J. L.107/56 [1990] (definitive). An illustration of this case is provided in Vermulst and Waer, op. cit.

\(^{12}\) See Article 4 of the WTO Agreement on Anti-Dumping on definition of domestic industry.

\(^{13}\) In the photocopiers, outboard motors, video cassette recorders, small screen colour televisions, DRAMs and EPROMs cases, the EC Commission had to examine the position of certain EC producers and the position of manufacturing bases in the EC owned by or having links with producers under investigation for injurious dumping. In particular, during the photocopiers case investigation, the Commission had to examine the position of Rank Xerox, which was one of the complainants. The origin determination carried out by the Commission revealed that at least in one factory most parts of the photocopiers originated in Japan and to a lesser degree in the Community. Nevertheless, and taking into consideration factors not related to origin determination such as “long standing manufacturers in the Community”, etc., the Commission accepted Rank Xerox as domestic producer. For a deeper analysis see P. Waer “Rules of Origin in International Trade”, in E. Vermulst, P. Waer and J. Bourgeois (eds.), Ann Arbor University of Michigan Press, 1994. For the specific investigations see “Outboard motors from Japan” [1983] O.J. L152/18 (provisional); Plain paper photocopiers from Japan [1987] O.J. L54/12 (definitive); Video cassette recorders from Japan and Korea [1988 O.J. L 240/5 (provisional); Small screen colour televisions from Korea [1990] O.J. L 107/56 (definitive); Dynamic random access memories from Japan [1990] O.J. L 193/1 (definitive); Erasable programmable read-only memories from Japan [1991] O.J. L 65/1 (definitive). In the US context, see, for instance, Brother Industries v. US, No. 91-11-00794 (slip. op 92-152) [1992], where the US Court of International Trade reversed a determination of the Department of Commerce that Brother lacked standing to file an anti-dumping complaint. On this latter case, see Palmeter in Vermulst, Waer and Bourgeois, op. cit.
25. The specific issue of circumvention may take the following forms: (i) relocation of assembly factories to the importing country; (ii) relocation of factories to third markets; and (iii) exportation of disassembled articles to be assembled in the importing country (really a variant of (i)). One must consider the different approaches of the complainants and defendants in order to follow the rationale for anti-circumvention. The complainants usually argue that the relocation of a factory to the home market of the complainant or to a third country has as its main purpose the avoidance of anti-dumping duties and that the working or processing operations carried out there are only minor and not origin-conferring. Thus, they argue that anti-dumping duties should also be imposed on products manufactured in the third country or in the home market because they retain the initial origin status of the third country’s products subjected to anti-dumping duties (see box 2). For their part, the exporters tend to argue that the relocation is a genuine foreign direct investment, a simple step in the globalization of production, and that the amount of value added and/or working or processing carried out in the third country or home market is sufficient for acquiring origin.

26. From a legal point of view, the basic problem of anti-circumvention measures is the absence of multilateral agreed rules and the resulting unilateral discretionary practices of the investigating authorities. Neither the United States nor the EC, the main users of such measures, had codified detailed non-preferential rules of origin, and moreover they sometimes applied different tests of origin depending on the trade instruments within which the origin determination had been carried out.

27. For example, in United States practice, the origin of semiconductors determined by the Commerce Department in the context of anti-dumping proceedings was different from that determined by the United States Customs Service. Codification of non-preferential rules was rare or totally absent in EC legislation. Thus, the EC Commission investigations used to rely on a rule of thumb of a 45 per cent value-added test. This, however, did not prevent the EC authorities from developing ad hoc rules on assembly products where the circumstances of the case so required, as was arguably the case for ball bearings, photocopiers and semiconductors.

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14 This latter form of circumvention is not further examined here since it is not related to rules of origin but rather to interpretative rules of the Harmonized System. See, for instance, the comments made on the Eisbein Case (Case C.35/93, Dr. Eisbein GMBH v. Hauptzollamt Stuttgart [1994], European Court of Justice Report, 1-2655) in Vermulst and Waer, op. cit., where Eisbein, a German factory which imported disassembled typewriters, argued that these kits should be classified as “parts” and not be object of the anti-dumping duty charged against the finished typewriters.

15 See Palmeter “Rules of origin in the United States” in Vermulst, Waer and Bourgeois, op. cit., p. 74, and the following decision where Customs concluded that assembling and testing conferred origin on a semiconductor: C.S.D. 80-227, 14 Cust. b & Dec. 1133 (1980). In the following case, the Commerce Department decided that, for anti-dumping purposes, assembling and testing did not confer origin: Erasable Programmable Read Only Memories (EPROMs) from Japan; Final determination of sales at less than fair value, 51, Fed. Reg. 39680, 39692 (1986). This, however, did not prevent the EC authorities from developing ad hoc rules on assembly products where the circumstances of the case so required, as was arguably the case for ball bearings, photocopiers and semiconductors.


Box 2

CIRCUMVENTION THROUGH THIRD-COUNTRY ASSEMBLY OPERATIONS

(a) Change of origin during anti-dumping procedures

In an anti-dumping case concerning typewriters from Taiwan Province of China, the EC Commission terminated investigation proceedings it had initiated on the ground that the production processes carried out there were not sufficient to confer Taiwan Province of China origin. The practical consequence of these findings was that the products assembled in Taiwan Province of China continued to have Japanese origin and therefore de facto were subjected to the anti-dumping duties imposed with respect to such products originating in Japan. Subsequently, the customs authorities in some member States even took the position that anti-dumping duties should be levied retroactively on prior imports of typewriters from Taiwan Province of China. This ultimately gave rise to the Brother case, where the customs authorities in Germany, after an on-the-spot investigation at Brother premises, again determined that the typewriters in question could not be considered as originating in Taiwan Province of China but in Japan, and that the anti-dumping duty applied against imports of Japanese typewriters was applied to the typewriters exported from Taiwan Province of China with retroactive effect. The consequence was that the German customs authorities ordered Brother to pay over DM three million in anti-dumping duties. Brother appealed against this decision on the ground that most of the parts came from Japan, they were mounted and assembled in Taiwan Province of China in a fully equipped factory into ready-for-use typewriters.

(b) Origin-specific determination

The absence of multilateral discipline on rules of origin allowed both the United States and the EC to issue ad hoc origin determinations concerning origin disputes with regard to third-country production. In some cases these decisions led to international criticism and to bizarre or contradictory regulations. In the late 1980s, an investigation conducted on the spot by the EC Commission at the Ricoh photocopier plant in California concluded that such photocopiers should be denied United States origin and should continue to be of Japanese origin. Subsequently, the Commission enacted a specific regulation on the origin of photocopiers, which although couched in general terms was essentially tailored to the Ricoh situation. As a direct consequence of this origin determination, anti-dumping duties imposed on direct import of Ricoh photocopiers from Japan were extended to Ricoh exports from California to the EC despite the fact that these photocopiers presumably included substantial United States value added.

This photocopier decision drew criticism from some of the Community’s main trading partners. At that time, the United States and Japan argued that these regulations were protectionist because they determined the nature of manufacturing operations carried out by European producers in the Community rather than providing objective criteria for determining origin and/or because they indirectly promoted manufacturing in Europe policies.

For instance, in the Integrated Circuits Regulation, the Commission ruled that diffusion rather than assembly was origin-conferring, despite the facts that diffusion is always followed by assembly and testing, that assembly and testing are more labour-intensive than diffusion, and that the value added in the assembly and testing process can be as high as, and sometimes even higher than, the value added in the diffusion process. The Regulation tended to work to the advantage of major European companies such as Siemens which (at the time of adoption) carried out the diffusion process in the EC and testing and assembly in third countries, to the disadvantage of Japanese producers which assembled and tested integrated circuits in the EC.

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20 For a detailed analysis of the various issues involved in these cases, see Vermulst and Waer (in note 16 above).
23 See note 15.
The Integrated Circuits Regulation came at both a convenient and an embarrassing time for the pending anti-dumping proceedings concerning DRAMs24 and EPROMs25 from Japan. Until the adoption of the Regulation, some member States’ customs authorities had held that the process of assembly and testing constituted the last substantial transformation. Such an attitude could have been disastrous for the outcome of the anti-dumping proceedings initiated because it would have led to the inescapable conclusion that the only Community industry which existed was Japanese-owned!

The later United States objections to the EC’s determination to consider diffusion as the last substantial process or operation for determining the origin of integrated circuits seem inconsistent in the light of the fact that the United States Commerce Department, for the purposes of applying the anti-dumping law, has explicitly held that diffusion rather than assembly constitutes the last substantial transformation, thereby overruling the established practice of the United States Customs Service, which for its own purposes had previously rules that assembly and testing conferred origin.

1.2 The Uruguay Round Agreement on Rules of Origin

28. As discussed above, the absence of clear and binding multilateral discipline in the field of rules of origin has been one of the reasons for opening the way to the utilization of rules of origin as trade policy instrument. The growing concern over the trade policy implications of rules of origin ultimately generated the efforts which matured in the long-awaited multilateral discipline.26 In comparison with past multilateral negotiations on this subject, the Uruguay Round Agreement on Rules of Origin broke new ground in several respects. First, it clearly defines the difference between, and the field of application of, non-preferential and preferential rules of origin systems. According to the Agreement, non-preferential rules of origin are commonly understood to apply to MFN trade,27 i.e. for the determination of origin in the framework of GATT trade policy instruments such as anti-dumping duties, quantitative restrictions, safeguards, application of the rules of origin to marks of origin, trade statistics and government procurement. Conversely, preferential rules of origin are those which apply in the context of preferential tariff regimes,28 such as the GSP, free trade areas and regional integration agreements. The Agreement brings

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24 See note 15.

25 See note 15.


27 The Uruguay Round Agreement on Rules of Origin in its Article 1 (paragraphs 1 and 2) defines as follows the scope of application of non-preferential rules of origin: “Paragraph 1 - for the purposes of Parts I to IV of this Agreement, rules of origin shall be defined as those laws, regulations and administrative determinations of general application applied by any Member to determine the country of origin of goods provided such rules of origin are not related to contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of Article I:1 of the GATT 1994”; “Paragraph 2 - Rules of origin referred to in paragraph 1 shall include all rules of origin used in non-preferential commercial policy instruments, such as in the application of most-favoured-nation under Articles I, II, III and XI and XIII of the GATT 1994; anti-dumping and countervailing duties under Article IV of the GATT 1994; safeguard measures under Article XIX of the GATT 1994; origin marking requirements under Article IX of the GATT 1994; and any discriminatory quantitative restrictions or tariff quotas. They shall also include rules of origin used for government procurement and trade statistics” (GATT document MTN/FA, 15 April 1994, II-AIA-11).

28 The Common Declaration with Regard to Preferential Rules of Origin, in its Article 2, defines preferential rules of origin as follows: “Paragraph 2 - 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”. (GATT document MTN/FA, 15 April 1994).
into WTO discipline non-preferential rules of origin. Second, it aims at harmonizing them through a detailed procedure involving the World Customs Organization (WCO). Third, and perhaps most important, the harmonized set of rules of origin has to be used for all MFN purposes as described above.

29. In spite of these relevant achievements, the Agreement failed to regulate preferential rules of origin. In this area, the members limited themselves to a Common Declaration with regard to the latter. In comparison with the specific programme for harmonizing the non-preferential rules of origin and the clear commitments undertaken by parties with respect to these, the Common Declaration contains “best endeavours” commitments. Its main practical outcome seems to be the establishment of an advance origin ruling procedure.29

30. The Agreement provides for the elaboration of the harmonized set of non-preferential rules of origin by the WTO Committee on Rules of Origin and the Technical Committee on Rules of Origin established within the WCO. This latter committee is charged with the technical elaboration of the harmonized rules. According to the timetable in the Agreement, this work was to be completed in October 1997. However, given the technicalities and the complexity of the negotiations, delays may be expected. At present, the work undertaken under the Agreement has allowed a complete first reading of all Harmonized System headings.

Box 3

THE HARMONIZATION PROGRAMME

Part IV of the Agreement on Rules of Origin, entitled “Harmonization of Rules of Origin”, deals specifically with, inter alia, the work programme for establishing a set of harmonized rules of origin. While under Article 4 of the Agreement, a Committee on Rules of Origin is established, and the actual elaboration of the harmonized rules is to be carried out by a Technical Committee “under the auspices of the Customs Cooperation Council” (now the World Customs Organization) (Article 4, paragraph 2). Under Article 9, paragraph 2 (c), with reference to the work programme, the Technical Committee should first develop harmonized definitions of “(i) Wholly obtained and Minimal Operation Processes”; “(ii) Substantial Transformation - Change in Tariff Classification” (and “upon completion of the work under subparagraph (ii) ...” it should “consider and elaborate upon...”); “(iii) Substantial Transformation - Supplementary Criteria”.

First, it is of paramount importance to note that the Agreement clearly provides that the Technical Committee will elaborate upon, on the basis of the substantial transformation criterion, “the Use of change in tariff sub-heading or heading”. Additionally, the work of the Technical Committee will be divided “on a product basis taking into account the chapters or sections of the HS nomenclature”.

Article 9, paragraph 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 subparagraph (ii) (i.e. the work based on the change of tariff heading criteria) for each product sector or individual product category ... the exclusive Use of HS nomenclature does not allow for the expression of substantial transformation”. Such supplementary criteria might be “ad valorem percentages and/or manufacturing or processing operations”.

Through this complicated working, the Agreement and its work programme solve the unsettled question of the basis on which the harmonization of GSP rules of origin has to be carried out, i.e. (i) change of tariff heading; (ii) adopting an across-the-board value-added criterion; and (iii) specific working or processing. In fact, the provisions of the Agreement place the change of tariff heading at the very foundation of the harmonization process of the non-preferential rules of origin.

29 See paragraph 3(D) of Annex II of the Common Declaration with Regard to Preferential Rules of Origin of the Agreement.
The value-added criterion (referred to as “ad valorem percentages”) comes into play only as a supplementary criterion in defining “substantial transformation” and only when the exclusive use of the HS nomenclature is not satisfactory for complying with “substantial transformation”.

1.2.1 Harmonized rules of origin: Issues involved

31. Trade policy considerations are not openly discussed during the negotiations. However, the possible implications and the trade policy effects of the harmonized set of rules of origin are already the subject of debate. Some early implications have in fact already arisen in some of the “new areas” covered by the harmonized set, such as mark of origin and rules of origin and trade statistics. There are also various observations which may be made on the basis of the preliminary results so far achieved.

32. Since the whole concept of origin is to allocate the origin of a product to a specific country, negotiations were first faced with the definition of the terms “country” and “territorial sea” for the purpose of rules of origin. This apparently simple and legalistic question rapidly becomes a more difficult one when deciding if Customs unions should be included within the definition of “country”. In such a case, the EC would be counted as a single country for the purpose of origin and any trade measure such as quotas and anti-dumping duties.

33. The definition of country of origin has also been the subject of intensive debate regarding its extension to territorial waters and the origin of fish caught by foreign vessels. Many developing counties objected to a definition which linked country of origin only to the country in which a vessel was registered since many of them depended on chartered vessels for their fishing exploitation. If registration or dual registration were not allowed, most of the fish caught in the territorial seas of a developing country would be regarded as originating in third countries.

34. Environmental concern and recycling industries considerations have entered into the negotiations when the origin of waste and scrap, parts recovered from waste and scrap and Used articles have been discussed. The question revolves around the country to which origin should be allocated: the country which produces the waste and scrap, has produced the article from which parts have been collected or where the article has been used, or the country which reutilizes these goods? Depending on origin allocation, developing countries’ concerns may be classified into different categories. Allocating origin to the collecting of parts could be a potential incentive to locate recycling or hazardous industries in developing countries. Other concerns may be linked to the fact that used articles may be competing with domestic products in developing countries. Overall, there might be a different perception of what is considered to be waste and scrap or Used articles in an industrialized country and in a least developed country. As an example, the average commercial life of a computer in industrialized countries is estimated at two or three years, whereas in a developing country context a computer of that age may still have a substantial commercial value.

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35. In general, it may be observed that at product-specific level, the preliminary outcome of negotiations has been, given their technical nature, mostly industry-driven, and most unresolved issues are unresolved because of the different views held by domestic industries on what kind of processing should be treated as “substantial transformation”. Most domestic industries have tended to defend their case by arguing that the working or processing they carry out on their premises is a substantial transformation and deserves origin. Moreover, there may be genuine technical problems in determining origin or difficulty in understanding processing using new technology. These considerations, however, are not sufficient to fully explain, for example, why drying and seasoning of imported raw meat should be origin-conferring. Nor are they sufficient to explain why placing of tea in tea bags, fattening of cattle, grinding of pepper, roasting coffee, etc. should be considered substantial transformation when, although in the different context of preferential rules of origin but utilizing the same concept of substantial transformation, these same processing operations were considered minimal.

36. Overall, an initial evaluation of the preliminary results of the negotiations indicates that simple operations as described above have been elevated to the rank of “substantial transformation”. In many instances, and especially in the agriculture and processed foodstuffs sectors, where developing countries are expected to have a comparative advantage, origin may be moved to another country by relatively simple processing. This tendency has to be evaluated carefully against the background of the trade instrument which origin is designed to serve. For example, foodstuffs and agricultural products may be linked with measures related to the Agreement on Agriculture or the Agreement on the Application of Sanitary and Phytosanitary Measures, or marks of origin; electronic products with anti-dumping; textile products with quotas, and so forth. As the negotiations are mainly industry-driven, the final outcome of the Agreement will probably be a worldwide origin map, whereby origin allocation may be conferred on a certain manufacturing or processing operation which could be concentrated in different countries or regions, depending on the rule adopted. For instance, depending on whether a particular rule of origin is lenient or stringent or reflects the industrial capacity of a country, the origin of a product may finally be concentrated in one country or scattered in several countries. If a lenient rule of origin, such as one regarding manufacturing shoe from shoes parts, is adopted, the origin of shoes will depend on where the assembly operations are carried out. These operations will probably be carried out in many different countries, since producers may select the countries where assembly is cheaper without losing origin and mark of origin. Such rules seem to be more suitable to the globalization of production. Conversely, if origin rules are more stringent so as to exclude that kind of assembly, and require that origin depend on other manufacturing operations such as the making of shoe uppers, the worldwide production of shoes will be more concentrated in fewer countries. Depending on the realities of production chains and industrial strategy, domestic industries may press for rules of origin which will reflect their capacity and sourcing of intermediate inputs. The final outcome of the rules may very well look similar to the network of worldwide manufacturing operations of the firms lobbying. Eventually, the trade effects of the final rules will affect the interaction with international trading system rules such as quotas, anti-dumping and mark of origin. If safeguards and anti-dumping are triggered by imports originating in third countries, a lenient set of rules of origin will lessen the concentration of production and exports, making the injury test more difficult. If protective action is taken against an exporting country, it may be tempted to circumvent it by switching its assembly plant to a third country.

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32 For a comparison of the negotiation positions of different countries, see the WTO document on HS Chapter 64 (shoes) and WTO document G/RO/W/13/Rev.3, 12 May 1997, p. 385, “Integrated negotiating text for the Harmonization Work Programme”.
1.2.2 Marks of origin

37. Besides these direct implications of the Agreement on Rules of Origin, it is worth noting at this stage the extension of the area of application of the concept of customs origin to marks of origin and trade statistics.

38. The linkage between customs origin and mark of origin derives as mentioned earlier, from United States practice. The requirement to mark goods imported into the United States with their country of origin dates back to 1890, and has been reiterated since then. The purpose of this requirement was to inform consumers of a product’s country of origin, but it could also have the indirect effect of favouring domestic products over competing foreign goods. Thus, as in many “buy national” campaigns periodically launched in certain countries, marks of origin may function as non-tariff barriers.

39. Moreover, switching the country of origin and its mark of origin may have important and decisive consequences, as follows:

(i) Changing the country of origin of a product may result in its originating in a country subjected to quotas, restrictions or anti-dumping duties;

(ii) Importers that made a false declaration of origin may be subject to ex post recovery of duties, fines and criminal proceedings.

Box 4

IMPLICATIONS OF MARK OF ORIGIN

During the early negotiations 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 specialized services. The comparative rule of origin adopted by Switzerland under its GSP scheme requires, in general, that the foreign inputs used in the manufacture of a watch not exceed 40 per cent of its ex-works value and that the value of the non-originating inputs not exceed the value of the domestic input. Also, the Swiss delegation argued that customs origin is not necessarily to be regarded as a sufficient criterion when it comes to marking the goods with the name of the country of production since member States may require additional criteria, such as in the case of Swiss legislation a national geographical indication for watches and their parts. The delegate argued further that the national legislation of his country was to be considered a geographical indication under Article 22 of the WTO Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPs) and Article IX, paragraph 6, of GATT 1996, and that this kind of geographical indication might go beyond the simple “customs origin” concept. Other delegations, especially those from the Asian region, were of the opinion that origin should be conferred on the country that manufactured the clock movement. They argued that the essential function of a watch is to measure intervals of time. This measurement is performed by the clock movement, and not by the assembly and testing operations.

As a possible result, the Swiss proposal on non-preferential rules of origin would allow Swiss watchmakers to import Japanese or third-country clock movements and retain origin, while third-country watchmakers for GSP purposes would face much stricter rules making it difficult for their products to qualify for GSP benefits. Moreover, the Swiss proposal to link origin marking to the geographical indication under Article 22 of the WTO TRIPs Agreement may have obvious trade policy and marketing implications.

Given the historical background, the question of mark of origin in the United States has been the subject of several dispute decisions involving the United States courts, Customs and importers of foreign goods. Usually, most disputes arose in sensitive sectors such as foodstuffs, textiles, steel products and footwear, where labelling, import sensitivity and consumer health considerations may have had a bearing on the final outcome. A general analysis of these disputes gives rise to the following points:

(i) The difficulty, given the globalization of production, in origin determination. From an importer’s point of view, this difficulty is exacerbated by the fact that a wrong declaration of origin or incorrect labelling of origin may give rise to heavy penalties;

(ii) Marking and customs origin are becoming increasingly insufficient criteria to determine which countries have derived substantial economic benefit from the sale of a product;

(iii) Mark of origin may have a far-reaching effect on consumers’ choice in certain categories of products such as foodstuffs, pharmaceuticals and fashion goods.

41. A recent trade dispute in WTO between the United States and the EC on rules and marks of origin may best summarize the implications of a change in rules of origin and open the way to further considerations regarding the impact on rules of origin and trade statistics.

42. In July 1996, new legislation on textile origin was promulgated in the United States. The new rules of origin for textile articles introduced several changes in relation to past practice and United States legislation. Those changes are summarized in the table below.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Apparel</td>
<td>Cutting</td>
<td>Assembly</td>
</tr>
<tr>
<td>Fabrics</td>
<td>Dyeing of fabric and printing if accompanied by two or more finishing operations</td>
<td>Weaving from yarn</td>
</tr>
</tbody>
</table>

The implications of these changes did not take long to produce results.

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34 One type of controversy encountered in the determination of the country of origin under the marking regulations is illustrated by the decision in Koru North America v. United States. In this case, vessels caught hoki fish outside New Zealand’s territorial waters. The vessels were chartered to a New Zealand corporation, but were flying the flags of New Zealand, the Soviet Union and Japan. They were caught, gutted and frozen on the catching vessels within New Zealand’s Exclusive Economic Zone. The fish were then landed and consolidated for shipment in New Zealand, and shipped to the Republic of Korea, where they were shipped to the United States. The importer claimed that the hoki fillets’ country of origin was New Zealand, while the Custom Service argued that the origin of the fish was New Zealand, the Soviet Union, and Japan. The court determined, however, that the hoki fillets were substantially transformed in the Republic of Korea, and were therefore products of that country. In the textiles sector, a report in the Financial Times of 10 April 1997 indicated that a major US retailer was to be charged with millions of dollars of custom duties owed on allegedly mislabelled Chinese products.

35 The US legislation on rules of origin for textiles products has been the subject of relatively frequent changes. See, for earlier changes, Palmeter, “Rules of origin in the United States” (cited in note 15 above). The latest changes were included in section 334 of US Department of Treasury, Customs Services, Rules of Origin for Textile and Apparel Products”. Federal Register, vol. 60, no. 171, September 1995.
43. A complaint\textsuperscript{36} to the EC Commission was made as early as October 1996 by the Italian Association of Textile Producers against the changes in the United States textile rules. Since it contained sufficient evidence the matter was subsequently taken by the Commission to the WTO, where consultations with the United States authorities will start in due course.\textsuperscript{37} The fact at issue is that under the new rules Community-originating status is not granted for scarves which have been dyed, printed and finished in the Community on loom-state fabrics produced in third countries. A significant aspect of the complaint related to the requirement that the products in question be labelled as originating in the country which produced the fabric, with obvious consequences for United States consumers, who may not positively identify Community products.

44. Although it may be difficult to quantify, it is obvious that in the upper-textile market of haute-couture brand name and mark of origin have a considerable influence on consumer choice, a fact which may justify the concern of producers of finished products. Although the globalization of production has rendered outdated the notion that a product is wholly produced and obtained in a particular country, consumers may still identify certain quality products with specific geographical regions or countries. Moreover, the non-inclusion of design and style in expenditure on advertising and research which may be incurred in the fashion textile industry, together with ownership of the manufacturing plant, may not be in line with the “substantial transformation” concept.

45. These changes to United States legislation may cause changes to origin of products subjected to quotas, such as textile and steel products. The decision on where the origin of a product is allocated among countries subject to the quota system may have a highly disruptive effect on production chains and relations among different industries. In Asia, the cutting of fabric into garments, a former origin-conferring operation, used to take place in countries where quotas were underutilized or in countries which had no quotas, while the assembly operations were performed in low-cost countries such as China. The new rules imply a change in origin allocation, switching origin to countries such as China, where most assembly operations are performed. This may ultimately result in new limitations if these countries’ exports are subject to quotas which they are fully utilized. China is not a member of the WTO and thus its textiles and clothing exports do not benefit from the Agreement on Textiles and Clothing. Thus, the changes in origin rules may affect the pattern of production and investment in a whole region, which may take considerable time and financing to adjust.\textsuperscript{38}

\textsuperscript{36} See O.J. C.351 of 22 November 1996.


\textsuperscript{38} For a more illustrative analysis of the interaction between origin and quotas on textile products, see document CR/XXV/SLV/6 of 20 May 1997 of the International and Textile Clothing Bureau, presented to the Council of Representatives, XXV session, San Salvador, 10-13 June 1997.
THE SUBSTANTIAL ECONOMIC BENEFIT CRITERIA, GLOBALIZATION AND TRADE STATISTICS

A recent press report\(^39\) outlined a relevant case which combined the issues of origin criteria, globalization of production and trade statistics.

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail price</td>
<td>$ 9.99</td>
</tr>
<tr>
<td>Shipping, ground transportation, marketing, wholesaling, retailing and profit</td>
<td>$ 7.99</td>
</tr>
<tr>
<td>Export value from China</td>
<td>$ 2.00</td>
</tr>
</tbody>
</table>

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

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

Since China is the country of origin, it is charged an export value of $ 2.00 in trade statistics, while the economic benefit deriving from it is just 35 cents. According to the US Customs, toys imported from China in 1995 totalled $ 5.4 billion, about one-sixth of the $ 36.2 billion of the total United States trade deficit. China, however, contends that these US trade figures are distorted since they take into account neither economic realities nor the value-added operation carried out in Hong Kong and other intermediate processing or shipping operations. Thus, in 1995 the US Commerce Department put the US trade deficit at $ 3.8 billion, while China said it was $ 8.6 billion.\(^40\)

In this multi-country production chain, the Usmaettel holding corporation is estimated to make $ 1.00 profit on each Barbie doll and most of the Barbie doll cost of $ 9.99 is estimated to be accumulated in the United States. This finding seems to contradict the fear of job losses often raised in some 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 its suitability for trade statistics calculations. On the basis of these findings, some analysts have started to put forward the idea of investigating the origin of the company rather than the origin of the goods produced. However, given the current trend of mergers, acquisitions and joint ventures, this may prove as difficult as in the case of goods.

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\(^40\) On this issue, see Ma Xinoye and Zheng Han-Da, “China and the United States: Rules of origin and trade discrepancies”, *Journal of World Trade*, 1996.
2. Preferential rules of origin

46. There can be little doubt that the rules of origin issue has recently attracted renewed attention following the spate of regional agreements. The North American Free Trade Agreement (NAFTA) negotiations on rules of origin received attention at presidential level. One of the main distinctions which may be made among the various categories of preferential rules of origin is related, as usual, 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.

47. 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 member States. Strict rules of origin in a free trade area may affect upstream, side-stream or downstream third-country producers of inputs. Conversely, excessively flexible rules of origin may encourage sourcing of inputs outside the free trade area through the territory of the member State with the most liberal trade regime, and frustrate its desired integration objective. These issues were the subject of confrontations during the NAFTA negotiations, and are already high on the agenda of the trade negotiations of the FTAA (Free Trade Area of the Americas) Agreement. The progressive adoption of a Pan-European model of rules of origin contained in the panoply of free trade areas and preferential arrangements in which the EC is a partner is another sign of the ongoing initiatives in this area.

48. These preferential rules of origin reflect policy objectives. The most obvious is to avoid the deflection of trade in a free trade area; 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 Lomé Convention have been increasingly indicated as one of the major stumbling blocks to the 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, their technicalities may frustrate this objective.

2.1 Unilateral preferential rules of origin

49. Unilateral preferential rules of origin are those contained in unilateral preferential trade arrangements such as the GSP, the Caribbean Basin Initiative and Andean preferences. This definition may be extended to cover rules of origin contained in non-reciprocal but contractual agreements such as the Lomé Convention and similar non-reciprocal agreements concluded by the European Union. In fact, the main difference from reciprocal agreements is that the Protocols on Rules of Origin usually attached to these non-reciprocal agreements are not “negotiated”, given 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 them to products genuinely manufactured or obtained in beneficiary countries. Thus, the tariff preferences granted under these agreements and the GSP are made subject to 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:
50. The trade effects of tariff preferences are expected to be obtained by the reduction of duty or duty-free access on products from beneficiary countries, which make them more price competitive 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.

51. The greater the preferential margin and more liberal and not burdensome for the local industries rules of origin are, the greater the effects that may be expected from the trade preferences. On the other hand, excessively stringent rules of origin tied to a minor preferential margin will lead to fewer trade effects. The stringency of preferential rules of origin has been cited as one of the explanations for the insufficient utilization of trade preferences. Moreover, they do not seem to match the industrial capacity of beneficiary countries, especially least developed countries.

52. As pointed out by a preference-receiving country, 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, and to check the shares of domestic and imported inputs in the unit cost of the exported goods, in some cases identifying the country of origin of the inputs and establishing direct and indirect processing costs. This often required (and still requires) data-processing techniques which are not in common use, especially in small and medium-size enterprises. Also, it was found that the willingness of enterprises to change or adopt accounting systems different from normal systems depends on the volume of exports, the share of such exports in total sales, and the cost involved.

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 per cent.

53. In 1995, at a meeting of an intergovernmental group of experts on rules of origin for the GSP, preference-giving countries showed a certain degree of willingness to examine the issue of harmonization of GSP rules of origin in order to facilitate GSP utilization.

41 See UNCTAD document TD/B/C.5/WG(X)/2, p. 6.
42 Ibid. p. 22.
43 Ibid. p. 5. A preference-receiving country showed, as an example, that in the case of the United States, out of a total of $788.9 million of Mexican exports which could have benefited from GSP in 1983, and for which in principle there was no limitation apart from the presentation of origin certificates, 58.7 per cent ($462.2 million) comprised goods whose preference margin was less than 5 per cent. 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 per cent of exports, with a preference margin exceeding 5 per cent, largely represented cases where the goods had failed to satisfy the origin rules.
2.2 Contractual rules of origin in free trade areas

54. Rules of origin are clearly at the very core of regional economic integration schemes because they ensure that preferential market access will be granted only to goods that have actually been “substantially transformed” within the area, and not to goods that are produced elsewhere and simply transshipped through one of the countries participating in the scheme. In the absence of rules of origin it would not be possible to discriminate against imports from third countries, so that the significance of regional integration would be drastically diminished.

55. The main reason for the existence of rules of origin in free trade areas (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, there is always the incentive to import a good through the country with the most liberal import regime and tariffs. In that case, importers/producers will eventually operate minimal transformation and finally they will re-export the goods towards the country(ies) with the higher tariffs. To sum up, it would be equivalent to a tariff circumvention operation.

56. Trade deflection does not have per se a negative economic effect; in fact, it may from an economic point of view be considered equivalent to a reduction in the tariffs of a high-tariff country and thus indeed positive for its economic efficiency. It is, however, regarded as a negative phenomenon since it does not correspond to the objectives of FTAs’ contracting parties. Taken to its extreme, trade deflection could go beyond the original intention of the contracting parties by transforming the original FTA into a customs union where the external tariffs will be determined by the country applying the lower tariffs.

57. The traditional “remedy” for trade deflection is stringent rules of origin. 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, trade diversion will be greater, the higher the preferential margin associated with origin compliance and the less costly the compliance with rules of origin and related administration costs.

58. However, in order to determine the possible effects of rules of origin in a FTA, it is first necessary to examine the general level of industrial and economic development of the countries involved. It is possible to determine three categories of FTAs:

(i) among developed countries (i.e. the US/Canada original FTA or the European Economic Area (EEA) Agreement);

(ii) among developed and developing countries (i.e. NAFTA, Euro-Mediterranean)

(iii) among developing countries (i.e. Southern African Development Community)

59. A fourth variable to be taken into consideration is the extent and kind of cumulation adopted within the FTA partners.
60. Rules of origin adopted in the context of FTAs as in the original United States/Canada FTA and the EEA Agreement, are mostly guided by the principle of integration, specialization of domestic industries and preference for domestic intermediate inputs over imported ones as well as by the control of trade deflection. Obviously, the more sophisticated the level of industrial development, the more rules of origin may be restrictive as regards third-country inputs without substantially reducing the trade creation effects.

61. The complex situation which may arise from the trade-off between trade deflection, trade creation and trade diversion and the technical complexities of rules of origin may be illustrated by the Honda case in North America (see box 6).

62. The much publicized fears of loss of North American jobs during the NAFTA negotiations were partly based on the belief that North American industries would relocate in low-cost Mexico to obtain preferential access and compete with domestic industries in North America. In general, when forming a free trade area with a developing country, developed countries which already have 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. This fear prompted United States domestic producers to press for finely tuned rules of origin in, for instance, the automobile, textile and toy-manufacturing industries. For example, the yarn-forwarding rule adopted in the textile area results in the exclusion of low-cost intermediate materials from East Asia for the manufacturing of NAFTA originating textiles unless natural fibres were imported. This exclusion may ultimately provide incentives for the development of a capital-intensive industry in Mexico, reducing NAFTA trade creation. United States textiles companies potentially wishing to relocate in Mexico have to invest a greater amount 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) to import US cotton yarn with loss of comparative advantage; (ii) to start the manufacturing process from imported natural fibres or from imports of fabrics from North America (i.e. increasing the trade diversion); or (iii) require Mexican and Canadian textiles producers to buy yarn from US textile mills before being allowed to sell the clothing to US consumers duty-free. The combination of the yarn-forwarding rules and the high tariffs facing textile imports implies that the North American producers have an incentive to use US-made fabrics rather than competitive fabrics from Asia.

63. Ultimately, the utilization of restrictive rules of origin may be an implicit device for extending tariff protection (or other protective devices) of domestic intermediates to partner countries.

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THE HONDA CASE

The much-debated and publicized Honda case may be regarded as the classic illustration of the technical complexities of rules of origin, globalization and relocation of industries and the policy and industry decisions underlying them. Ultimately, the Honda case, which arose in the context of the United States/Canada FTA, became the test case for the importance attached to rules of origin in the subsequent NAFTA negotiations.

From a technical point of view and in the opinion of those familiar with rules of origin, the issue at stake had to do with some of the traditional problems linked to origin determination: inadequacy of the change of tariff heading (CTH) rule in specific cases, definition of allowable costs under the percentage criterion and origin determination of intermediate input or components, the latter aspect being particularly related to the increasing globalization of production and the increasing practice by companies, especially in the automobile sector of subcontracting the manufacturing of sub-assemblies according to just-in-time agreements with suppliers. Under the United States/Canada FTA, the origin of automobiles and their components was subject to a CTH test plus a requirement for a minimum of 50 per cent local content. Parts or components of an automobile (intermediate products) were also subject to the same rules. Thus, if a subcomponent of an automobile - for example, the engine as in the Honda case - meets the CTH requirement plus the 50 per cent local content requirement in the United States, it can be considered to be of American origin. Then, when it is used to complete the automobile manufactured in Canada the value of the engine as a whole (100 per cent) will be counted as North American content (and not only the 50 per cent of US original local content), and its whole value will be added to the local content acquired in Canada to fulfil the 50 per cent local content requirement for the complete automobile. This rule is called the “roll up rule”. Controversely, when the subcomponent did not acquire originating status the whole value of the component would be counted as foreign (roll-down rule).

In the Honda case, Honda of Canada and the Canadian Customs for a certain period of time treated the engines manufactured in the United States as originating and imported them duty-free into Canada. When the engines were subsequently assembled into the Honda Civic their full value was counted as being of North American content in order to reach the minimum 50 per cent local content requirement to be re-exported to the United States duty-free. This trend continued until 1992 when a US Customs investigation determined that the Honda Civic manufactured in Canada and exported to the United States did not meet the 50 per cent requirement because it contained too many Japanese parts. Honda was then asked to pay a retroactive bill of US$ 17 million for the 2.5 per cent ad valorem tariff evaded on the Honda Civics re-exported to the United States. More specifically, the US Customs ruled that engines manufactured in the Ohio plant did not qualify as North American. Then, according to the roll-down rule, their whole value could not be counted as local content when calculating the required 50 per cent local content for the Honda Civic. As a consequence, the complete Honda Civic manufacture in Canada was not considered North American since the automobiles no longer met the 50 per cent domestic content requirement, and had to pay duties as if they were exported direct from Japan.

In particular, the engine was considered not to have US origin following the US Customs interpretation which did not allow certain “processing costs and indirect cost” incurred in the United States to be counted as local content. The determination of allowable costs and the accounting method to impute such costs to local content have been a traditional and classic pitfall of the percentage criterion.

These technical details gave rise to various political considerations. First, at that time, the US authorities were arguing with the EEC that Honda Accords made in Ohio were of American origin and that they should therefore not be counted as Japanese cars against the quota that the French authorities maintained on Japanese car imports. Second, Honda’s reputation and naturalized American image were affected following the finding by the US Customs investigation, which accused Honda Japan of price-setting with regards to its Honda Canada related suppliers (some of them were 100 per cent Japanese-owned) and transfer-price manipulation. Third, the issue became the subject of a political debate in which US policy makers started to weigh and review all aspects of the value of transplant operations in the United States and how they helped or competed with US automobile.

Some Canadian policy makers, on the other hand, regarded the US Customs ruling as a means of diverting Japanese investment from Canada to the United States. The core of the problem, which was heatedly debated at the technical level, lay, as admitted by a senior US official, in a flaw or (as others argue) a loophole in the drafting of the FTA rules of origin, namely in the roll-up rule. Taking this rule to its extreme, a senior US official admitted that it was possible, through breaking up the car into as many subassemblies as possible, to obtain a 100 per cent American car on paper with less than 50 per cent local content in reality. Most likely, the original drafters of the NAFTA rules could not imagine, or perhaps underestimated, the practices of multinational corporations and the possibilities offered by the globalization of production which have finally overtaken the traditional concept of origin and the classic method of origin determination. A number of the technical problems in origin determination connected with the Honda case were only a few years ago regarded as existing solely in the imagination of some customs officials. The realities of technological progress and economic interdependence made them real, however. As one executive said, “we have arrived in the era not only of multinational enterprises but of multinational goods”. It goes without saying that the roll-up and roll-down rules did not acquire a new lease of life in the NAFTA rules. The domestic content requirement for cars was fixed, after lengthy negotiations, at 62.5 per cent, to be implemented progressively.

64. It may therefore be concluded that rules of origin in an FTA may greatly limit the expected economic benefits of regional integration, or may cause distortions in favour of the partner which has been able to negotiate rules of origin which match the capacity of domestic industries. In practice, however, these conclusions have to be further qualified by at least two factors: on the one hand, the intrinsic difficulty of evaluating the economic effects of an FTA, together with the impact of different sets of rules of origin; and on the other hand, the extent of the pressures exerted by lobbies during the negotiation of rules of origin discussed above.

2.3 Cumulation

65. Normally, rules of origin in the context of autonomous or unilateral contractual preferences are to be complied with within the customs territory of a single beneficiary country. However, some preference-giving countries considered that this requirement per se was not adequate to the existing realities in developing countries, especially in view of the regional trade initiatives taking place among them. First, isolated and stringent requirements to comply with rules of origin may demand excessive “verticalization” of production which does not exist in developing countries. Second, an excessive requirement carrying out for multi-stage operations or value-added operations would frustrate trade creation effects expected in a regional trade area.

66. Three kinds of cumulation are used, as far as qualitative aspects are concerned, in autonomous or unilateral contractual trade preferences:

(i) full cumulation;
(ii) diagonal or partial cumulation;
(iii) bilateral cumulation or donor country content.

67. As far as quantitative aspects are concerned, the concept of cumulation is linked to geographical extension of the cumulation, e.g. all beneficiary countries under New Zealand’s GSP scheme, or limited to African, Caribbean and Pacific countries and few other countries in the context of the Lomé Convention.

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

69. Generally speaking, full cumulation of origin allows 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 globalization and interdependence of production, whereby developed countries may be attracted to farming out low-tech or labour-intensive production processes in low-cost countries. Partial cumulation does not particularly favour this approach since it requires higher value added or more complicated manufacturing processes. On the other hand, and in view of preference-giving countries, partial cumulation may be able to attract more capital-intensive investments accompanied by improved technical know-how and labour skills.

70. Deeper economic consideration of the impact of full or partial cumulation suggests that full cumulation allows the massive employment of low-wage, low-skill labour, which some may argue to be a potentially negative factor since these workers often receive less than the average wages and save less than the average workers. Reality suggests, however, in spite of the argument of preference-giving countries suggesting a long-term objective of industrial policy through the adoption of restrictive rules of origin, that labour-intensive lighter industries tend to compete most effectively with similar industry in developed countries. Thus, the argument for full cumulation is strengthened.

71. In evaluating the effects of the different cumulative systems, one fundamental distinction must be made between cumulative systems in unilateral trade preferences and contractual ones. In the first case, whatever form of cumulation is granted, it aims in principle to facilitate compliance with rules of origin by expanding geographical coverage. In the second case, cumulation may have result in strengthening the potential inhibitive use of third-country materials outside the contracting parties, as explained below.

72. Through its different sets of rules of origin, the EC, like the other main trading partners, has traditionally utilized a variety of options in the cumulative rules of origin. Sometimes it has graduated them according to its trade policy objectives. The table below provides examples of the existing diversification of cumulative origin systems.
<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>CUMULATION</th>
<th>DONOR COUNTRY CONTENT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EUROPEAN UNION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP</td>
<td>Partial regional cumulation</td>
<td>Yes</td>
</tr>
<tr>
<td>Europe Agreement</td>
<td>Diagonal cumulation</td>
<td>Yes (diagonal)</td>
</tr>
<tr>
<td>Lomé Convention</td>
<td>Full cumulation</td>
<td>Yes (full)</td>
</tr>
<tr>
<td>Old Mediterranean Cooperation Agreement</td>
<td>Diagonal (full cumulation between Algeria, Tunisia and Morocco)</td>
<td>Yes (partial)</td>
</tr>
<tr>
<td>New Euro-Mediterranean Agreement</td>
<td>As above</td>
<td>As above</td>
</tr>
<tr>
<td><strong>UNITED STATES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP</td>
<td>Regional full cumulation</td>
<td>No</td>
</tr>
<tr>
<td>CBI</td>
<td>Regional full cumulation</td>
<td>Yes (limited)</td>
</tr>
<tr>
<td>NAFTA</td>
<td>Diagonal cumulation</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>JAPAN</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP</td>
<td>Regional cumulation</td>
<td>Yes (limited)</td>
</tr>
<tr>
<td><strong>CANADA</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP</td>
<td>Full and among all beneficiaries</td>
<td>Yes (full)</td>
</tr>
</tbody>
</table>

73. As may be seen from the above table, like other preference-giving countries, the EU 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 that originate in other countries which are members of the regional association are regarded as domestic input and not as foreign input. However, there is a difference between the regional cumulation granted by the EU and the one 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 United States has graduated Singapore and Brunei out of its GSP programme). 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 those 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 utilized for further manufacturing or be incorporated into the finished product manufactured in the final member State.
Box 7

**GSP RULES**

1. **Partial cumulation under GSP rules**

   EC rules of origin require that the manufacturing process for apparel not knitted or crocheted (HS 62), when imported inputs are used, start from imported yarn. With diagonal regional cumulation, however, preference-receiving country C may utilize imported fabrics from country B - a member of the same regional grouping - and the finished jacket will be considered as 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 applies only 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 without yarn according to EC requirements. This production chain may be visualized as follows:

   - **Country A** = third country.
   - **Country B** = preference-receiving regional partner.
   - **Country C** = exporting preference-receiving.
   - **Country D** = 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 the GSP, EU rules of origin in the case of ACP countries still require that the manufacturing process, when imported inputs are used, start from imported yarn. Since under the EC rules the ACP countries regarded as one single customs territory for rules of origin purposes, it is sufficient that this 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 the case of full cumulation, the production chain is as follows:

   - **Country A**
   - **Country B**
   - **Country C**
   - **Country D**

   Apart from other considerations, the above example shows that a full cumulation system may save one step in 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 carry out the specific processing operations laid down from 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.

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50 Unless the finished fabric incorporates cotton thread. In this latter case, manufacturing from yarn is allowed. See note 49.

51 Country A = third country.
Country B = preference-receiving regional partner.
Country C = exporting preference-receiving.
Country D = donor country.

52 See note 51.
2.4 Contractual rules of origin and cumulative systems

74. In general, cumulative origin systems utilized in the context of free trade areas 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 this latter case, the partial cumulation system used in the United States/Canada FTA was obviously one of the factors that contributed to the difficulty of the technical details at issue.

75. 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 like the one gradually undertaken by the main trading partners such as the United States and the EC with the rest of the world bring into play additional factors which throw new light on the cumulation issue in FTAs in addition to the traditional topics mentioned above. By way of illustration, it is sufficient to recall the gradual development of the Free Trade Agreement of the Americas and the EC/FTAs agreements with Central and Eastern European countries, as well as the new Euro-Mediterranean Policy, in order to better grasp the magnitude of these new developments.\(^{53}\)

76. Since some of the implications of rules of origin in North America have been examined above, the following analysis is centred on an examination of the implications of the newly launched Pan-European rules of origin. In the Middle East and Central and Eastern Europe, following the entry into force of the Europe Agreement with the Visegrad countries the EC has entered into the same kind of agreements with the Baltic States, Bulgaria, Romania and Slovenia. Following the Barcelona Declaration and the launching of the new Euro-Mediterranean Policy, the EC aims to establish by 2010 an Euro-Mediterranean Free Trade Area. A first step towards this latter objective is to progressively establish a series of Euro-Mediterranean Association Agreements with each of the Mediterranean countries and the EC. The FTAs with Tunisia, Morocco and Israel have already been concluded, while negotiations are continuing with the remaining Mediterranean countries, namely Algeria, Egypt, Lebanon and the Syrian Arab Republic.

77. Obviously, all these agreements which aim *inter alia* to progressively establish FTAs contain extensive protocols on rules of origin which have to be cumulated with the previous set of rules of origin adopted by the EC through unilateral preferences and the rules contained in former FTAs negotiated with the remaining countries of the European Free Trade Association (EFTA) countries. These latter agreements were replaced by the European Economic Area (EEA) which also contains its protocol on rules of origin. Since most of the rules of origin systems contained in this proliferation of FTAs and unilateral preferences were only similar among them but contained substantial differences, the progressive harmonization of these rules was recently stated by the EC to be one of the priority issues in this field. This is especially true when one considers the administrative formalities and paperwork connected with origin rules which are

\(^{53}\) For an overview and consideration of the EC policy on 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 Barcelona Declaration for Mediterranean Countries.
required when a substantial amount of transactions are carried out in an FTA. Suffice it to recall that an early EFTA study\(^{54}\) on the cost of complying with rules of origin procedures in EC/EFTA relations was sufficient reason for many producers to forgo origin compliance and pay normal MFN duties unless the preferential margin was considerable.

78. The recently launched EC harmonization policy is based on progressive harmonization steps that start from the implementation of full cumulation of origin within the EEA considered as a single entity and the extension of diagonal cumulation among all Central and Eastern European Countries (CEEC). A third step will entail the extension of diagonal cumulation between the CEEC countries and the Mediterranean countries. During the first phase, diagonal cumulation will also be allowed between Mediterranean countries that have already entered into an Euro-Mediterranean Association Agreement. Undoubtedly, the progressive adoption of a Pan-European set of harmonized preferential rules of origin will contribute to the simplification of origin rules in the current tangle of origin requirements and will foster the spreading of production among the partners involved. Additionally, decisive savings are expected to be made by companies through the easing of administrative procedures which may result from the harmonization and simplification efforts. However, the additional benefits which may accompany these efforts, including the expected effect of regional globalization of production, will also depend on trade relations and the rules of origin adopted by the non-EC countries involved.

79. This latter aspect is likely to be a decisive factor for investors and transnational corporations where they have to examine, together with all the other variables, where and when to better distribute sub-assemblies and components factories or other manufacturing operations.\(^{55}\)

80. Unless the non-EC countries undertake a trade liberalization process among themselves, the EC could be at the centre of a web of bilateral FTAs. In such a situation, the EC might become a potential hub for investors that may locate their factories in the EC, benefiting from preferential access to all non-EC member countries and their markets. Unless non-EC member countries negotiate FTAs among themselves they could be relegated to a “spoke” role since reverse operation would not be possible and only the comparatively limited home market of the “spoke”, in addition to the EC market, would be available to factories located in non-EC member countries. The liberalization of regional trade initiative has been undertaken by countries belonging to the Central European Free Trade Agreement (CEFTA) and is regarded by the EC as the second pillar of the establishment of the Euro-Mediterranean Free Trade Area.\(^{56}\)


81. If trade liberalization is undertaken among third-country members, rules of origin adopted by these non-EC members should be at least initially more liberal than those adopted by the EC members. A practical example to illustrate this point is in order. If we assume three countries - A and B, non-EC members, and C, an EC member - may be envisaged the following scenario:

(i) In the absence of trade liberalization efforts between A and B, the diagonal cumulation between those two countries will be frustrated by the tariff protection applied in their trade relations (this being in addition to the “hub and spokes” argument above). This holds particularly true when one considers that many of the FTA non-EC members are still retaining high tariffs even after the Uruguay Round. Thus, specialization of production and optimization of resources among A and B to increase their exports to the EC will be limited or nil since their main target will remain the EC market where they both continue to compete as before. Finally, this situation is exacerbated when higher tariffs are applied to intermediate products in A and B than in the EC. Effective rates of protection and tariffs may differ between the EC and these latter countries, thus giving rise to the transfer of tariff protection as examined above in the NAFTA case. To stress the potential impact of this latter point, it has to be mentioned that the new set of rules to be adopted under the Pan-European rules of origin contains a prohibition on a drawback clause.

(ii) If an FTA between A and C is negotiated which has more restrictive rules of origin than the ones applying between A, B and the EC, the effects of the latter rules of origin may neutralize the expected trade effects of free trade between A and B and the application of diagonal cumulation contained in their FTAs under the Pan-European rules of origin. In fact, under these circumstances, A and B are as likely to continue to compete in the EC market as they would be in the absence of their FTAs, and both will struggle to comply with the rules of origin requirement contained in their Agreements with the EC. In addition, since their trade and the size of the EC market are usually much greater than the trade and size of the market of their 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 than those applied in their trade with the EC. Ultimately, diversion of efforts will be geared towards the EC market.

(iii) Thus, only where rules of origin between A and B are more liberal than those applied between themselves and the EC do producers have an inducement to trade among themselves and redistribute manufacturing activities among themselves in order to utilize more fully the mutual trade preferences and their possibilities for exports to the EC. Two additional cautions about adopting this kind of approach derive from other variables which have to be taken into account:

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

(ii) The advantages of more liberal rules of origin applying between A and B may indirectly favour EC 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, has in certain circumstances also to be taken into account.
Conclusions

82. At multilateral level, globalization has two powerful allies in the MFN and national treatment principle. As previously mentioned, in a world of MFN treatment, rules of origin will lose most of their importance. However, given the undeniable link between globalization and the traditional instruments of trade policy, such as anti-dumping, quotas, FTAs and trade preferences, rules of origin will continue to play a substantial role in international trade.

83. After years of absence of multilateral disciplines on rules of origin, the Uruguay Round Agreement on Rules of Origin has made up for some of the time lost. However, this agreement covers only non-preferential rules of origin concerning trade in goods. Wide areas such as rules of origin in autonomous or contractual preferential agreements remain, as far as the multilateral system is concerned, under “soft law” regulations and not guided by common disciplines. Trade diversion caused by stringent rules of origin in FTAs is becoming increasingly important as regional integration arrangements are gradually expanding at vertical “North-South” and horizontal “South-South” levels. In the former category of FTAs, rules of origin are most of the time the reflection of the industrial interests of stronger economies unless they are diluted by cumulative arrangements accompanied by multilateral or regional liberalization by the weaker economies. However, developing countries belonging to this generation of FTAs take pains to assess the technicalities and subtleties of the rules. In some instances, certain developing countries have shown more resistance in liberalizing their trade at regional South level than with their partners of the North. Whatever the overall policy reasons may be, this attitude fosters the trade diversion effects of rules of origin tailored to the larger economy and generates a “hub and spokes” situation.

84. In addition to these traditional issues in which rules of origin are fostering or restricting the sourcing of inputs and sub-assemblies, other areas may become more important. As shown by the industrial strategy of the largest companies, there is a tendency through mergers and acquisitions to manage the intellectual value of a company by means of brand names which are directly related to marks of origin. Global companies are attracted by the assets of national companies with an established brand name and clientele which may encounter financial difficulties because of their restricted market and insufficient internationalization. By acquiring the established brand, global companies through their superior ability are able to redistribute the production and sourcing chains of these former national champions while maintaining the brand name.

85. In this connection, marks of origin which the Uruguay Round Agreement on Rules of Origin links with custom origin might have a decisive role. In addition, it will be more difficult, notwithstanding the establishment of customs origin criteria, to determine which country and which nationals will derive the substantial economic benefits of the production of a specific product.

86. The linkage made by the Agreement between origin and trade statistics may be another revealing factor in the production chains in the world economy today. International trade statistics, are nowadays widely regarded as unreliable as far as origin is concerned. If the linkage established can be enforced, there might be a global restructuring of trade statistics as they are today, with consequent implications for the management for the international trading system.
87. The coverage of rules of origin has been also extended to cover public procurement. In this area, origin rules may play their old role as minimum local content requirements.

88. Although not described in terms of “rules of origin”, the General Agreement on Trade in Services contains elements which would identify the origin of services, or more precisely, the origin of service suppliers. These have not yet been tested in negotiations or in trade disputes.