UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNCTAD

RULES OF ORIGIN AND ORIGIN PROCEDURES APPLICABLE TO EXPORTS FROM LEAST DEVELOPED COUNTRIES

UNCTAD series on assuring development gains from the international trading system and trade negotiations

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PREFACE

As the focal point of the United Nations for the integrated treatment of trade and development and interrelated issues, the UNCTAD secretariat supports member States in assuring development gains from international trade, the trading system and trade negotiations, with a view to their beneficial and fuller integration into the world economy and to the achievement of the United Nations Millennium Development Goals. Through intergovernmental deliberations and consensus-building, policy research and analysis, and technical cooperation and capacity-building support, UNCTAD's work on trade negotiations and commercial diplomacy aims at enhancing the human, institutional and regulatory capacities of developing countries to analyse, formulate and implement appropriate trade policies and strategies in multilateral, interregional and regional trade negotiations.

This paper is part of a new series called "Assuring Development Gains from the International Trading System and Trade Negotiations". The targeted readership is government officials involved in trade negotiations, trade and trade-related policymakers and other stakeholders involved in trade negotiations and policymaking, including non-governmental organizations, private sector representatives and the research community.

The objective of the series is to improve the understanding of key and emerging trade policy and negotiating issues facing developing countries in international trade, the trading system and trade negotiations. Authors are invited to express their personal views and the papers do not necessary reflect the view of the UNCTAD secretariat. The series seeks to provide an evidence-based analysis of technical issues involved, to draw implications for development and poverty reduction objectives, and to explore and assess policy options and approaches to international trade negotiations in goods, services and trade-related issues. It also seeks to contribute to the international policy debate on innovative ideas, and in turn, to realize a development dimension for the international trading system with a view to achieving the Millennium Development Goals.

The series is produced by a team led by Mina Mashayekhi, Head, Trade Negotiations and Commercial Diplomacy Branch, Division of International Trade in Goods and Services, and Commodities.

ABSTRACT

The objective of this report is to examine the rules of origin (RoO) for the least developed countries (LDCs), which is understood to mean both rule content and rule administration. This analysis will take as a given the current gap between LDCs that, on the whole, would understandably prefer to have a single value-added type of rule of origin for all their exports, and other members of the World Trade Organization (WTO), especially the Quad countries – Canada, countries in the European Union (EU), Japan and the United States of America – which generally seem content to maintain and/or expand their own national LDC rules of origin regimes. In light of these apparently irreconcilable differences, the primary focus of the analysis will be on alternate, second-best and practical options for all parties.

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CONTENTS

Note ... ii

Preface ... iii

Abstract ... iv

Acknowledgements ... v

List of Acronyms ... viii

CHAPTER I. INTRODUCTION ... 1

A. Background, Objectives and Assumptions ... 2

B. Preferential Rules of Origin in International Trade – an Overview ... 2

C. Methodologies for Determining Origin ... 3

1. "Wholly Obtained or Produced" Rules ... 3
2. Substantial Transformation Rules ... 3
   2.1. Tariff-Shift Rules ... 3
   2.2. Value Content Rules ... 4
   2.3. Specified Product or Process –Technical Rules ... 6
   2.4. Combinations and Alternatives ... 6
3. Cumulation ... 6
4. Non-Qualifying Operations ... 6
5. Administrative Considerations ... 7
   5.1. "Self-Certification" ... 7
   5.2. "Third-Party Certification" ... 7
6. International Disciplines on Rules of Origin ... 7

D. The Historical and International Context ... 8

E. International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto Convention) ... 10

F. Agreement on Rules of Origin ... 11

G. Initiatives Towards Harmonization of Rules of Origin ... 13

CHAPTER II. RULES OF ORIGIN IN MAJOR EXPORT MARKETS ... 15

A. United States – African Growth and Opportunity Act ... 16

B. The European Union – Generalized System of Preferences and Everything But Arms Initiative ... 16

C. Canada's Least Developed Countries Initiative ... 17

D. Japan's Least Developed Countries Programme ... 17

CHAPTER III. ORIGIN ADMINISTRATION – THE PRIVATE-SECTOR PERSPECTIVE ... 19

A. Origin Determination ... 20

B. Origin Analysis ... 23

C. Origin Documentation ... 24

D. Origin Imports and Origin Verifications ... 24

E. Origin Liability ... 28

CHAPTER IV. RECOMMENDATIONS ... 29

A. General Recommendations 30
1. Are Simplified Rules Achievable or Even Desirable? 30
2. Creating an Origin-Simplification Process 31

B. Practical Recommendations 32
1. Step 1 – The Most Important Rule Change Does Not Require New Rules of Origin: Expanded Cumulation 32
2. Step 2 – Create Uniformity Around Wholly Produced Rules of Origin and Minimal Operations 33
3. Step 3 – Regional Value Content Standardization? 33
4. Other Simplification Issues 34

C. Procedural Standards 34

D. Conclusions 35

REFERENCES 36

Boxes

Box 1. Common Declaration with Regard to Preferential Rules of Origin – Annex II 9
Box 2. The WCO Draft Action Plan 14
Box 3. WCF Certificate of Origin Task Force 14
Box 4. New EU GSP Rules of Origin 18
Box 5. Rules of Origin as a Source of Competitive Advantage 21
Box 6. NAFTA Rules of origin - Chapter 61 Articles of Apparel and Clothing Accessories, Knitted or Crocheted 23
Box 7. United States Code 25
Box 8. North American Free Trade Agreement (Nafta) - Audit (Verification) Manual 26

LIST OF ACRONYMS

AGOA	African Growth and Opportunity Act
EU	European Union
GATT	General Agreement on Tariffs and Trade
GPT	General Preferential Tariff
GSP	Generalized System of Preferences
HS	Harmonized Commodity Description and Coding System, Harmonized System
LDC	Least Developed Country
MFN	Most Favoured Nation
NAFTA	North American Free Trade Agreement
TPFD	Trade-Preferences-For-Development
WCO	World Customs Organization
WTO	World Trade Organization

I

INTRODUCTION

I. INTRODUCTION

A. Background, Objectives and Assumptions

At the Sixth WTO Ministerial Conference held in Hong Kong, China, in December 2005, member States agreed that developed and developing countries in a position to do so would, by 2008 or no later than the implementation of the Doha Round negotiations, provide duty-free and quota-free market access on a lasting basis for all products originating from LDCs in a manner that ensures stability, security and predictability (Annex F of the Hong Kong Ministerial Declaration). As a result, developing countries were permitted flexibility in coverage and implementation. All members who faced difficulties in supplying this degree of effective market access agreed to at least initially provide duty-free and quota-free market access for 97 percent of originating LDC exports defined at the tariff-line level. Members of WTO also agreed to “ensure” that the applicable rules of origin would be transparent and simple, and would facilitate market access.

Economic benefits of such undertakings are significant. A study by the International Food Policy Research projects that LDCs, along with eight other GSP countries, would realize a USD 7 billion rise in real income if all OECD countries extended them quota-free and duty-free for all their exports, and simpler and more transparent rules of origin are instrumental for realizing such gains.

The objective of this paper is to examine the rules of origin dimension, which is understood to mean both rule content and rule administration. This analysis will take as a given the current and historical gap between LDCs, which, on the whole, would understandably prefer to have a single value-added type of rule of origin for all their exports, and other WTO members, especially the Quad countries – Canada, EU countries, Japan and the United States of America – which generally speaking seem content to maintain and/or expand their own national LDC rules of origin regimes. In light of these apparently irreconcilable differences, the primary focus of the analysis will be onalternate, second-best and practical options for all parties.

There will be no attempt to duplicate existing rules of origin research, of which there is an extensive and expanding universe, although there will be appropriate recaps, references and links. There will be, however, a conscious attempt to make realistic, practical suggestions and recommendations in the spheres of public and private law. Finally, in order to be perfectly clear concerning first principles and underlying assumptions, the perspective of this study will naturally and necessarily reflect that of the author: in other words not from the approach of an economist or international trade policy specialist but from that of a technical trade and customs specialist and a rules-of-origin practitioner from the private sector. As such, the primary aim of this paper is to encourage trade policy practitioners, members of the private sector (exporters, importers and manufacturers) and their respective trade associations to discuss these matters in an open forum.

B. Preferential Rules of Origin in International Trade – an Overview

Preferential rules of origin, as they may appear in unilateral or reciprocal trade agreements, are essentially mechanisms for establishing the economic nationality of a product. In this regard, their nominal function is to prevent trade deflection wherein non-originating goods are shipped to a party to a free trade agreement with the lowest external tariffs and then re-exported to the party with higher tariffs in order to avoid paying these higher tariffs or products originating from non-beneficiaries of unilateral preferential schemes are transshipped through beneficiary countries. Although trade deflection is a legitimate concern, it is clear that the role and purpose of rules of origin have changed beyond the point required to simply prevent trade deflection. Likewise, the inherent discriminatory capacity of rules of origin allows parties to a free trade agreement or preference-granting countries to restrict duty-free entry of the exported products of the intended parties and other preferential benefits.

This discriminatory capacity is important because, while the developed countries have shown a willingness to grant improved market access to LDCs, they clearly have not shown the same willingness to grant such access to all countries. As such, the rules of origin, which provide the technical distinction between goods that truly originate in the selected beneficiary countries and those that do indeed originate in non-beneficiary countries, are essential to the viability of the

preference programmes. If such distinctions were not made, it is unlikely that the preference programmes could exist.

However, because of the capacity to discriminate, there is also a legitimate concern that rules of origin can be used for protectionist purposes. As described below, rules of origin specify limitations on the degree to which material inputs from third countries (i.e. countries other than an exporter) can be used to qualify for preferential treatment. If producers in the exporting country find it technically impossible or prohibitively expensive to meet the requirements of the rules, the tariff benefits ostensibly provided are in effect rescinded by the application of the rules of origin. Furthermore, because they can be highly technical, it is only in the application of the rules that this becomes apparent. Thus, the tariff preferences that look good on paper can, in practice, be of little value.

The policy challenge is thus to design rules of origin that do not generate for producers in the beneficiary countries costs that exceed the value of the preferences, while still maintaining the essential function of the rules that distinguishes between eligible and non-eligible goods.

In addition to the rules of origin themselves, there are other origin design and policy considerations, including origin negotiations (in the case of RTAs) and most importantly, origin administration. Origin administration itself implies a number of additional origin activities, such as certification, origin rulings and origin verification, and the challenge of how best to manage these diverse but related origin functions.

C. Methodologies for Determining Origin

The function of rules of origin is to provide criteria that distinguish between originating and non-originating goods. As outlined in greater detail below the “discriminatory” purposes of rules of origin are usually achieved in two ways: by requiring goods be “wholly obtained or produced” or by requiring that materials imported from outside the free trade area (other than goods wholly produced or obtained in the free-trade area or made from wholly produced or obtained goods) be substantially transformed.

1. “Wholly Obtained or Produced” Rules

Goods that are “obtained” or produced without any participation of materials from outside the exporting country are considered to be “wholly obtained”. These are generally products that are grown, harvested or extracted from the ground in the territory of a single country, as well as goods produced from such materials. While there are areas of the definition of “wholly obtained” that can become contentious (such as fish taken from the sea outside any territorial sea), in the vast majority of cases there is no controversy as to the application of this criterion.

2. Substantial Transformation Rules

For rules of origin purposes, substantial transformation criteria are defined in three ways: Tariff-Shift, Value Content, and Technical Rules. These methods of defining originating goods can be used individually and/or in combination with each other.

2.1. Tariff-Shift Rules

These rules require that a good (imported from a party outside the free trade agreement or a non-beneficiary to the preference scheme) that is incorporated into a product that is exported to a party must go through a specified change in tariff classification under the Harmonized Commodity Description and Coding System (Harmonized System or HS). The specified shift could be at the two-digit, four-digit, six-digit level, or at a more disaggregated level. In some instances, tariff-shift rules exclude the use of non-originating goods from specified subheadings, headings and chapters of the Harmonized System. The tariff-shift rules have many advantages including the near ubiquity of the Harmonized System in international trade and relative ease of origin verification. However, tariff classification under the Harmonized System is often more of an art than a science (i.e many products do not fit neatly into one classification) and requires a considerable amount of expertise. Furthermore, the Harmonized System is not designed for rules of origin purposes and constantly being updated – at least every four years – which means that Harmonized System-based tariff-shift rules must also be updated in a difficult process known as technical rectification, also requiring high levels of expertise in Harmonized System.

However, tariff-shift rules have the benefit of being the simplest to apply. One has simply to examine the bill of materials and determine whether or not the imported materials meet the tariff shift criteria. While this analysis may be complicated for those unfamiliar with tariff classification systems, it is a straightforward, objective criterion that merely requires the identification of the non-originating materials and their tariff classifications. When the non-originating materials are imported by the producer of the good whose origin is in question, their tariff classification is available on the customs declaration form from their importation. Thus, the advantages of these types of rules are their relative simplicity and objectivity.

The disadvantages of tariff-shift rules stem from their limited transparency, their rigidity and in some circumstances, their arbitrariness, as well as from all the difficulties relating to classification. It is important to bear in mind that the Harmonized System is not designed with the rules of origin definition in mind, grouping products together in chapters, headings and subheadings based on criteria that have nothing to do with establishing the origin of goods. As such, a tariff shift at the heading level, for example, can imply a transformation that is a technical impossibility in some parts of the nomenclature (no known technology enables the transformation of whales into sheep, for example). In others, however, a heading change may imply the simple assembly of advanced components. It is therefore impossible to know how burdensome a tariff-shift rule will be for producers without knowing something about the production process involved and the relative classifications of the important inputs. This leads to a lack of objective transparency, as only a study of the structure of a given industry allows one to understand the restrictiveness of this sort of rule.

This lack of transparency, combined with the fact that many countries (especially small or developing countries) export only a limited number of products, has led to the negotiation of origin regimes based on an across-the-board tariff-shift rule, generally at the heading level under RTAs. While this is efficient from a negotiating standpoint, it can result in effective requirements that vary widely across products. The rule then takes on an arbitrary quality, with no tangible justification for the restrictiveness implied, and may in the longer term represent barriers to export diversification.

Next, tariff-shift rules can be quite rigid. The use of non-originating materials that do not meet the required tariff-shift requirements categorically excludes a product from originating status, regardless of the importance of those materials in the good's production process. Consequently, many origin regimes have included tolerance or de minimis provisions. The effect of these provisions is to allow the use of non-originating materials that do not meet tariff-shift requirements set forth in the rules, provided that these materials do not represent an excessive proportion of the value of the good. These tolerance levels are generally set around 10 per cent, thus allowing up to that fraction of the value of a good (or of its weight, depending on the product and the tolerance provisions) to be accounted for by non-originating materials that do not satisfy the tariff-shift requirements.

Finally, and perhaps most importantly, the classification of goods is not always a simple exercise. When the classification of a good and its materials is not known, making that determination can be a significant problem, and errors in classification can lead to further complications. Additionally, the Harmonized System is revised every 4 to 5 years, with products regrouped into new or different headings and subheadings. This necessitates technical rectification of the rules in order to maintain consistency, which in turn means that some producers will have to learn new rules, although production processes that produced originating goods should continue.

2.2. Value Content Rules

These rules require that the prescribed minimum levels of value adding must be set in the country of export. This type of rule makes it very difficult to prove origin as it assumes certain levels of accounting skills and record keeping that is often scarce within developed country customs authorities and SMEs. The most user-friendly alternative to minimum value added is maximum levels of foreign content (an input value always recorded by customs in the country of export) in the finished good exported to a free trade agreement-trading partner.

Despite these difficulties, value-content rules are generally regarded as the most transparent, in that it is readily apparent that a given fraction of value added originates in the exporter/beneficiary. This assumed transparency has led to various policy recommendations, in particular, the proposed

reforms to the EU's rules which has been adopted and implemented since January 2011, relating to the Generalized System of Preferences (GSP), though these reforms have proven difficult to ratify. However it is not necessarily true that this sort of requirements is necessarily more transparent, as many substantial complications can be hidden in the intricacies of the calculation methods.

As mentioned above, the simplest calculation method is to specify the maximum share that non-originating materials may represent. This is simple when the customs valuation of the imported materials is available, along with the value of the final good. This still requires some definition as to how to treat a variety of costs that can be associated with the use of imported materials. These may include the costs of transporting these materials within the territory of the beneficiary, any tariffs or customs service charges paid when importing the materials, or the value of waste and scrap lost in the production of the good, among others. Some recent RTAs make specific provision for these issues, but the more important point is that the mere existence of these complications calls into question the assumed transparency of such rules.

A related issue to bear in mind is the vast proliferation of calculation methods that have arisen in various reciprocal preferential trading schemes. Exporters in a given country will face significant costs in attempting to manage multiple accounting processes simply to demonstrate origin if they wish to take advantage the preferential tariffs of multiple export markets. This barrier may be sufficient to discourage firms from entering new markets, and thus depress market diversification, which has been associated in the economic literature with firm success (Volpe and Carballo, 2008).

For example, programmes developed in the United States of America use at least five different calculation methods. Programmes such as GSP and other non-reciprocal programmes use the direct costs of processing, generally at a 35 per cent requirement. Signatories of the North American Free Trade Agreement (NAFTA) use the transaction cost and net cost methods, while the United States and Chile and parties to subsequent agreements use build-up and build-down methods, in addition to the NAFTA-era net cost method. To be fair, the transaction cost and build-down methods are almost identical, but this still leaves four different methods, none of which coincides with EU ex factory price calculations or any of the other GSP calculation methods employed by the developed countries.

To all of this are added additional complicating factors. For example, when using materials imported from another member of a free trade agreement, or from the grantor in a non-reciprocal scheme, in most cases these goods are cumulable, which means that they may be considered originating for purposes of determining the origin of goods in whose production they are used. However, this leads to the question of how to value such goods for purposes of subsequent value content calculations. If the materials were determined to be originating based on exceeding a value content threshold, does the totality of the value of the material count as originating when calculating the value content of subsequent goods (i.e. roll-up)? What about the situations whereby the imported material contains originating content, but not enough to qualify as originating – is the whole value of the material to count as non-originating (i.e. roll-down)? The criterion that seemed initially to be simple and transparent rapidly becomes quite complex.

Moreover, the effective burden of value content criteria can be affected by elements that are external to the usual origin considerations. Imagine the same production process taking place in two different countries, both sourcing the same materials from a third. If the two countries are identical in every regard except labour costs, the country with the higher labour costs will have an easier time meeting a value content threshold than the country with lower labour costs (in the cases of value content calculations that include these costs, such as the transaction value/build-down, net cost and most ex factory price-based calculations). Furthermore, depreciation in the exchange rate of one of the countries would raise the share of its imported non-originating materials, potentially transforming a production process that resulted in originating goods into one that resulted in non-originating goods, without any change in labour costs or sourcing of materials. The same effect can arise from changes in commodity prices or prices of any other non-originating input.

In short, while value content rules have different advantages and disadvantages from tariff-shift rules, it is not at all clear that they are in all cases superior, and in many cases may be less transparent rather than more so.

2.3. Specified Product or Process – Technical Rules

Technical rules are often associated with steel, textile and apparel goods. They specifically outline what process or input must be used in the making of an originating good. Although this substantial transformation criterion is easy to understand and verify, it usually is very restrictive in terms of alternate and or flexible sourcing of inputs.

These rules suffer from some of the same drawbacks as the tariff-shift rules in that they are not transparent; what is more, they are inflexible. The rules for apparel products can also be tortuous, requiring not only that fabric be cut, sewn and finished in a beneficiary country, but also that the fabric, yarn and sewing thread, as well as the fabric of visible linings and pocketing, be originating as well. The production-cost implications of meeting these requirements – let alone the costs of proving compliance – can result in situations where it is simply uneconomical to use tariff preferences.

2.4. Combinations and Alternatives

It is not uncommon for a rule of origin to use a combination of criteria types in its definition. For example, a rule may require that a product meet both a tariff shift and a value-content threshold. In other cases, tariff-shift rules may be combined with specified processes, a common practice in textiles and apparel. These rules tend to compound both the benefits and the difficulties of the different criteria used. Rules can be made more precise in terms of what is required, but the complexity of their application and verification also increases.

Additionally, many origin regimes, including the EU GSP rules, will provide more than one alternative method of qualification such as a tariff-shift requirement or a value-content requirement. In these cases, the trader may choose which alternative set of criteria to apply. This approach takes into consideration that producers of identical or very similar goods will differ in their production technologies and sourcing choices, as well as in their capacities to apply different rules. For example, firms that differ only in the sophistication of their accounting systems will likely have a different ease of application and demonstration of compliance with tariff-shift rules compared with value-content rules.

The provision of more than one alternative origin qualification criterion indicates that those who designed the rules considered these alternatives to be of roughly equal restrictiveness on average across firms, thus such rules will be considered co-equal. The principle of co-equality of rules and the provision of such alternatives will play an important role in making rules of origin more user-friendly.

3. Cumulation

As briefly mentioned above, all preferential schemes include some provision for the cumulation of originating materials. In its most basic sense, cumulation allows for goods originating in one country that is party/beneficiary to a preferential arrangement to be used in subsequent production in another country that is party/beneficiary to such an agreement and be treated as if the goods were produced in the latter for purposes of determining the origin of the subsequent production.

Cumulation is immensely important, especially for small and developing countries with limited domestic production resources. The burden of complying with any given rule of origin will depend directly on the availability of efficiently produced (i.e. at low cost) originating materials. In the absence of cumulation, smaller economies will be limited to using only available resources with which they have been endowed. Cumulation allows for the integration of partner-country resources into their production processes without disqualifying their goods from preferential tariff treatment. The larger the set of economies included in a cumulation zone, the less restrictive will be a given set of rules of origin, however defined, because producers will have a greater degree of sourcing options for cumulable materials.

4. Non-Qualifying Operations

Many origin regimes include provisions listing a series of production processes that do not confer originating status, regardless of the change in classification or value that they may add. These tend to include operations such as dilution in water, packaging for retail sale, or simple mixture of materials. Such provisions came into practice in an earlier era of origin regimes that tended to base their rules on across-the-board change-of-heading rules, where the nature of the tariff nomenclature was such that this explicit prohibition was necessary because the otherwise the

tariff-shift rules would have resulted in such operations conferring origin. In more recent agreements, as the product-specific rules of origin have been more carefully crafted product by product, the list of non-qualifying operations has become less important, and has even been omitted from some agreements.

5. Administrative Considerations

In the absence of vigorous multilateral obligations, preferential rules of origin have a tendency to reflect existing patterns of production because of the increasing origin literacy of special interest lobbies. It is not surprising, therefore, that the resulting economic impacts of restrictive rules of origin include origin protectionism and often require the use of regionally produced inputs or those produced in preference-granting countries. These negative impacts are explicitly illustrated by the findings of Estevadeordal and Suominen (2005) that restrictive rules of origin are related to reduced aggregate trade flows. Other effects of rules of origin are associated with administrative burdens. Origin administration by customs authorities and other public bodies and origin implementation in the private sector is a costly and time-consuming process. These costs are exacerbated by origin complexity within free trade agreements and origin diversity wherein producers, like LDC producers, must operate under numerous and divergent origin regimes. Furthermore, origin content complexity is further compounded by the absence of any comprehensive standards relating to origin procedures.

In other words, in addition to the requirements of the rules of origin themselves, there is also a host of issues related to the demonstration and verification of compliance. It is not enough that a good be originating – quality must be demonstrable and verifiable. The various preference schemes define different procedures for certification of origin, which conceptually can be divided into self-certification and third-party certification.

5.1. “Self-Certification”

“Self-certification” includes systems where any of the agents involved in the production and trade of the good are authorized to issue origin certificates, including the producer, the exporter and in some cases the importer. This system poses the least burden on trade, eliminating the need for intervention in the process by additional agents. However, this system is only effective in ensuring compliance with the rules if there is a robust capacity for verification by the customs or revenue authorities of the importing countries. If there is no credible likelihood that origin certificates will ever be verified, then there is no incentive to comply with the origin requirements, false certificates will be common and the original purpose of the rules of origin will be completely subverted.

Self-certification procedures are most common in United States preference programmes, where United States customs is competent in conducting the necessary risk analysis and verification to ensure that United States preferential imports tend to be originating. Problems may arise here, however, in United States reciprocal agreements where partner countries may not have the same institutional capacity.

5.2. “Third-Party Certification”

“Third-party certification” includes certification procedures that require either a government agency or an authorized private entity to issue origin certificates. These systems have exactly the reverse benefits and disadvantages. In this case, there is greater procedural effort required in each transaction, as every shipment (for the most part) must obtain a certificate from the third party. However, less verification capacity is needed, as much of this work is done on the front end.

One hybrid system is worth mentioning – authorized traders or trusted traders – wherein exporters can submit to verification up front in exchange for being authorized to subsequently certify their own exports under a third-party certification system. This is similar in concept to the concept of the authorized economic operator that applies in security matters and has the benefits of both certification systems, including greater ease of trade and greater likelihood of compliance. However, should there be significant up-front costs to becoming authorized, this could discourage small or infrequent exporters from seeking authorized status and thus limiting the associated benefits to larger and more regular traders.

6. International Disciplines on Rules of Origin

As outlined below, WTO is developing international disciplines in the area of non-preferential rules of origin under the Agreement on Rules of Origin. The

Agreement, however, does contain the Common Declaration with Regard to Preferential Rules of Origin – Annex II – presented in box 1.

D. The Historical and International Context

It is essential to briefly outline some of the historical roots and current state of play of rules of origin in international trade today. Given that there are common elements in all origin systems, the following review must touch upon non-preferential and reciprocal origin regimes despite the fact that the overall focus of this study is on non-reciprocal preferential origin programs.

It is clear from the following quotations that rules of origin and difficulties in defining what constitutes an originating product are issues that have troubled governments and traders for some time:

> *"But we should not imagine that England entirely eluded the clutches of the Dutch. Charles Wilson has pointed out that any quick-witted Dutchman could find ways around the Navigation Acts. Whereas the Act forbade any foreign vessels to bring to England goods that were not manufactured in the shipper's own country, it was agreed in 1667 that certain goods from the Dutch hinterland should be regarded as Dutch – that is, goods brought down the Rhine or bought in Leipzig or Frankfurt and warehoused in Amsterdam, including German linens – provided they were bleached at Haarlem." (Braudel, 1984).*

It seems as if English merchants learned from these experiences and passed on the lessons learned. An extract from the Second Reading Speech delivered by the Honourable Mr. M. Pratten, Minister for Trade and Customs, when introducing the Customs Bill 1925 at the Australian House of Representatives, is provided here after:

> *"An almost ludicrous state of affairs has arisen. Textile goods manufactured entirely on the Continent of Europe have been sent to England, and there dyed, measured, and wrapped, and have then come to this country under the terms of British preference. Machines in parts have been made on the Continent, and assembled and packed in England, and have come here under the terms of British. I am sorry to say that there is in England a type of Anglo-continental manufacturer, and he should be prevented from doing this sort of thing."*

One of the earliest efforts to standardize origin, or at least origin certification, was in 1923 at the Geneva-based discussions surrounding the International Convention relating to the Simplification of Customs Formalities. Here it was established that national governments could delegate or out-source origin certification to the appropriate organizations of their choice. Other than disciplines concerning origin markings in article IX, rules of origin remained essentially a non-issue during the early years of General Agreement on Tariffs and Trade (GATT). However, there must have been some commercial difficulties or complications with origin given that, in the early 1950s; the International Chamber of Commerce (ICC) did make proposals to harmonize rules of origin[1] (GATT/CP.6/36 – "Customs Treatment of Samples and Advertising Material, Documentary Requirements for the Importation of Goods, and Consular Formalities: Resolutions of the International Chamber of Commerce").

The first comprehensive attempts to regularize rules of origin were initiated during deliberations in UNCTAD around the introduction of GSP in the 1970s. The facilitative and development logic behind harmonized GSP rules of origin was as strong then as it is today but preference-giving countries did not choose this path. From this point forward, UNCTAD and its Working Group on rules of Origin played a pivotal role in maintaining and, wherever possible, updating the GSP rules of origin.[2]

1 GATT/CP.6/36 – "Customs Treatment of Samples and Advertising Material, Documentary Requirements for the Importation of Goods, and Consular Formalities: Resolutions of the International Chamber of Commerce."

2 See UNCTAD/ITD/GSP/34 for an outline of these activities between 1967 and 1995 and Inama (1995) for a detailed review of these activities.

Box 1. Common Declaration with Regard to Preferential Rules of Origin – Annex II

1. Recognizing that some Members apply preferential rules of origin, distinct from non-preferential rules of origin, the Members hereby agree as follows.
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 paragraph 1 of Article I of GATT[3] 1994.
3. The Members *agree* to ensure that:

(a) when they issue administrative determinations of general application, the requirements to be fulfilled are clearly defined. In particular:

(i) in cases where the criterion of change of tariff classification is applied, such a preferential rule of origin, and any exceptions to the rule, must clearly specify the subheadings or headings within the tariff nomenclature that are addressed by the rule;

(ii) in cases where the ad valorem percentage criterion is applied, the method for calculating this percentage shall also be indicated in the preferential rules of origin;

(iii) in cases where the criterion of manufacturing or processing operation is prescribed, the operation that confers preferential origin shall be precisely specified;

(b) their preferential rules of origin are based on a positive standard. Preferential rules of origin that state what does not confer preferential origin (negative standard) are permissible as part of a clarification of a positive standard or in individual cases where a positive determination of preferential origin is not necessary;

(c) their laws, regulations, judicial decisions and administrative rulings of general application relating to preferential rules of origin are published as if they were subject to, and in accordance with, the provisions of paragraph 1 of Article X of GATT 1994;

(d) upon request of an exporter, importer or any person with a justifiable cause, assessments of the preferential origin they would accord to a good are issued as soon as possible but no later than 150 days after a request for such an assessment provided that all necessary elements have been submitted. Requests for such assessments shall be accepted before trade in the good concerned begins and may be accepted at any later point in time. Such assessments shall remain valid for three years provided that the facts and conditions, including the preferential rules of origin, under which they have been made remain comparable. Provided that the parties concerned are informed in advance, such assessments will no longer be valid when a decision contrary to the assessment is made in a review as referred to in subparagraph (f). Such assessments shall be made publicly available subject to the provisions of subparagraph (g);

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

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

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

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

3 General Agreement on Tariffs and Trade.

E. International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto Convention)

The Kyoto Convention represents, in a sense, a "common language" (including certain definitions) and a detailed set of procedural standards and best practices for customs transactions including rules of origin.

The International Convention on the Simplification and Harmonization of Customs procedures (Kyoto Convention) entered into force in 1974 and was revised and updated to ensure that it meets the current demands of governments and international trade.

The WCO Council adopted the revised Kyoto Convention in June 1999 as the blueprint for "modern and efficient Customs procedures in the 21st century". Once implemented widely, it will provide international commerce with the predictability and efficiency that modern trade requires. The Revised Kyoto Convention elaborates several key governing principles, including:

- Transparency and predictability of Customs actions;
- Standardization and simplification of the goods declaration and supporting documents;
- Simplified procedures for authorized persons;
- Maximum use of information technology;
- Minimum necessary Customs control to ensure compliance with regulations;
- Use of risk management and audit based controls;
- Coordinated interventions with other border agencies;
- Partnership with the trade.

The Revised Kyoto Convention – entered into force on February 3, 2006 – promotes trade facilitation and effective controls through its legal provisions that detail the application of simple yet efficient procedures. The Revised Convention also contains new and obligatory rules for its application which all Contracting Parties must accept without reservation.

While the original Kyoto Convention contained an annex D.1 (concerning rules of origin), annex D.2 (concerning documentary evidence of origin) and annex D.3 (concerning the control of documentary evidence of origin), these annexes are essentially recreated in the Revised Kyoto Convention, annex K and respectively titled chapters 1, 2 and 3. They will be reviewed once the WTO work on the Agreement on Rules of Origin has been completed.

Although chapter 1 does not prescribe specific rules of origin for specific products, it does provide a useful introduction or briefing note of a wide range of fundamental origin principles and definitions, including the following:

1. "wholly produced";
2. "substantial transformation";
3. "cumulative origin";
4. operations that do not confer origin;
5. commentaries on the treatment of accessories, spare parts, unassembled and disassembled goods, packing, direct transport requirements, origin transparency and origin notification.

In addition, chapter 1 provides several ways through which substantial transformation requirements can be satisfied:

1. expressing substantial transformation through "[…] a change of tariff heading […]with lists of exceptions" (including known advantages and disadvantage)
2. expressing substantial transformation "by a list of manufacturing or processing operations which confer, or do not confer […] origin" (including known advantages and disadvantages)
3. expressing substantial transformation "by the ad valorem percentage rule […]"

These three fundamental ways of expressing substantial transformation are not only outlined in some detail, but the Kyoto Convention also provides the particular advantages and disadvantages of each methodology.

Chapters 2 and 3 are also unique in that they clearly and specifically address various aspects of origin certification (i.e. not required for temporary imports or small shipments, proposed certificate origin format and sanctions for fraudulent declarations) and control of documentary evidence of origin (i.e. reciprocal treatment, suggested times frames for responses to requests for additional information and confidentiality of records). These types of procedural

and administrative guidelines are unfortunately not found in the Agreement on Rules of Origin but should be included in the initial foundation of any efforts to standardize the administration of LDC origin.

F. Agreement on Rules of Origin

Most customs elements in a typical trade transaction are subject to multilateral obligations. Tariff coding at the six-digit level is guided by the Harmonized Commodity Description and Coding Systems (often referred to as "Harmonized System" or HS). Developed and maintained by WCO, the Harmonized System has become the de facto language for 98 per cent of all international trade. It is updated every four to six years.

Similarly, the standardization and harmonization of the customs value of imported goods is achieved through the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994, also known as the WTO Agreement on Customs Valuation. It is the responsibility of WCO to ensure that the technical disciplines of the Agreement are interpreted and applied in a consistent manner. It pursues this mandate through its Technical Committee on Customs Valuation, which manages a wide range of valuation capacity-building initiatives and provides the following technical support.

These levels of international uniformity, standardized regulatory structure and rationalized capacity-building have been, until very recently, entirely absent from the rules of origin universe. This absence led to the increased use and abuse of rules of origin as strategic trade policy instruments by the public and private sectors. It was apprehension about this behaviour that in turn led to the Uruguay Round Agreement on Rules of Origin. Admittedly, the Agreement does not specifically address preferential rules of origin, other than in the Common Declaration with Regard to Preferential Rules of Origin, but is specifically limited to non-preferential rules of origin:

> *[…] "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 1 of the GATT 1994". (Article 1).*

As outlined in the Agreement, this restricts any resulting origin obligations to purposes such as National treatment and MFN tariffs, Trade statistics, Origin marking requirements, Quantitative restrictions, Government procurement and Safeguard, anti-dumping and countervailing mechanisms.

It is not the intention of this study to supply a detailed review of this process, but several salient issues do require mentioning.

Firstly, it must be remembered and appreciated that the Agreement on Rules of Origin unleashed a harmonization work programme of breathtaking ambition and complexity. It began in July 1995 and was scheduled to be completed exactly three years later, in July 1998. Although the process is yet to be finalized, this delay should not be criticized. It took nearly 13 years for the Harmonized System to evolve from a four-digit system to a more detailed six-digit system. This was "simply" a process of updating an existing language whereas the Agreement creates a whole new meta-language for international trade, including rule content and origin architecture. Furthermore, it should be kept in mind that preferential rules of origin are structurally much easier to design than non-preferential rules of origin. In a preferential context, the only origin question that must be determined of an import from a beneficiary is the following: Does this product satisfy the specified rule of origin? A preferential context only requires a simple yes or no decision that normally does not require the much more difficult task of determining the country of origin of a product. This, however, is often the very challenge of non-preferential rules of origin. For example, goods are shipped from country A to B but, even though some value-adding activities did occur in A, the products cannot be considered as originating in A because they do not observe the specified or primary non-preferential rule of origin. In order to determine the country of origin, there must be additional or residual rules that allow interested parties to establish the country of origin.

Residual rules in turn raise questions as to how and what order they should be applied and even how to define what a country is. These relatively arcane and abstract considerations also give rise to a variety of practical difficulties. For example, if the operations performed on a product in the country of export do not observe the primary non-preferential rule of origin, the importer and/or the customs authorities in the country of import might have to collect product or process information from the country that supplied

the direct exporter with inputs. This process could prove to be problematic, given commercial confidentiality concerns that most traders have with regard to their goods.

The Agreement on Rules of Origin clearly requires that substantial transformation be defined on the basis of a change "[…] in tariff subheading or heading […]" (article 9). Furthermore, supplementary criteria for determining substantial transformation, such as ad valorem percentages and manufacturing operations, should only be considered "[…] where the exclusive use of the Harmonized System does not allow for the expression of substantial transformation […]".

Under the Agreement, the origin rules should be established for "[…] particular products or a product sector […]", which reveals an implicit and unproven assumption that one rules of origin can satisfy the all the needs of a particular subsector. As will be seen below, this is not likely to be the case.

Despite the Agreement's explicit restriction to the sphere of non-preferential rules of origin, several individuals and organizations, including UNCTAD, would like the Agreement to establish a benchmark of sorts for preferential rules of origin. There are several difficulties with this proposition, the most important of which is the differences in the application of cumulation in preferential versus non-preferential contexts. In non-preferential regimes, the unit of analysis is the country of provenance, with residual criteria that are applied when that country can not be considered the country of origin. In the preferential context, the question is not so much from which country a good is originating, but rather the binary decision of whether it is originating from within an artificially designated group of countries that have entered into a preferential agreement. This important difference in the scope of application of the rules makes any direct transfer from the multilateral, non-preferential harmonization exercise to the bilateral or regional, preferential context difficult.

Insofar as there are lessons to be drawn from the WTO's Harmonization Work Programme (HWP) for the detailed design of preferential origin regimes, there are two issues that stand out. First, the preference for tariff-shift rules in the programme indicates that it was the feeling of the negotiators of the Agreement that the benefits of this criterion (simplicity and objectivity of application) outweighed its disadvantages in most cases. To the degree that this estimation is correct, the implication for preferential rules is that tariff-shift rules should also be preferred when feasible.

Second, Estevadeordal, Harris and Suominen (2007) have put forward a potential mechanism for incorporating preferential rules into the multilateral system. This mechanism consists of using the harmonized non-preferential rules as a benchmark against which preferential rules could be measured, with the degree of deviation from the benchmark subject to a cap. The key concept here is that deviation is allowed, as it will be necessary to permit such deviations in order to accommodate the idiosyncrasies of each preferential zone.

Although these difficult negotiations in the harmonization work programme represent hard-won compromises and have achieved an amazing degree of agreement, they are still struggling with a few remaining obstacles, including remaining disagreements over product-specific rules, a common or single definition of origin for machinery (both value-added rules and tariff-shift and assembly rules are under consideration – in the end both may be applicable) and establishing agreement on the implications issue. This issue is a critical debate as it relates to the proper interpretation and application of article 9, 1 (a) of the Agreement, which states that the resulting non-preferential rules of origin "[…] should be applied equally for all purposes set out in article 1 […]".

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 treatment under Articles I, II, III, XI and XIII of GATT 1994; anti-dumping and countervailing duties under Article VI of GATT 1994; safeguard measures under Article XIX of GATT 1994; origin marking requirements under Article IX of GATT 1994; and any discriminatory quantitative restrictions or tariff quotas. They shall also include rules of origin used for government procurement and trade statistics. (article 1, paragraph 2).

Notwithstanding these explicit obligations, there is still significant debate as to whether or not the Agreement's harmonized non-preferential rules of origin should apply in each any every instance statistics, sanitary and phytosanitary standards, marks of origin and especially all forms of contingent protection, including anti-dumping and countervailing duty measures.

Another reason to prevent automatic assumptions concerning the potential applicability of the Agreement

to preferential scenarios is that it could be inferred that much of the consensus as to what constitutes substantial transformation was achieved between developed countries, given that most manufacturing operations take place within developed countries. This pattern, wherein rules of origin tend to reflect existing production patterns, is further re-enforced because developed countries do not encounter the same negotiating resource constraints that developing countries and LDCs face.

Finally, as mentioned above, the Agreement is more or less silent about origin administration and implementation issues (i.e. certification of origin, verification of origin, disputes, appeals or assessment details), many of which are much less important or even irrelevant in the non-preferential context, yet of significant importance in the preferential realm.

G. Initiatives Towards Harmonization of Rules of Origin

As extensively documented in trade policy literature, regionalism, in addition to the unilateral and multilateral liberalization routes, has aggressively carved a "third" approach trade liberalization. As of 2010, 371 RTAs have been notified the GATT/WTO, of which 193 are in force, with most of these notified since 1995.[4]

As regional trade agreements are poised to represent more than 50 per cent of international trade, it is clear that this relatively recent liberalization variation is not only here to stay but also imposes a wide variety of economic costs and inefficiencies of trade and traders: According to Baldwin (2006) "two facts form the point of departure: 1) Regionalism is here to stay; world trade is regulated by a motley assortment of unilateral, bilateral and multilateral trade agreements; 2) this motley assortment is not the best way to organize world trade. Moving to global free trade will require a multilateralization of regionalism".

In other words, the international trading community and policy makers around the world recognize that introducing some multilateral mechanisms and disciplines into regional trade agreements could produce real benefits to all parties.[5] This is a process that starts with monitoring and measuring as reflected in the WTO transparency mechanism for regional trade agreements that requires a host of supporting information and documentation, including "Product-specific preferential rules of origin as defined in the agreement [...]" (Annex, Section 2-d).

WCO members also have concerns about the current explosion of regional trade agreements that are lucidly expressed in their recent Policy Commission publication, "*Impact of Regional Trade Agreements"* (SP0237E1a: 29 May 2007):

> *"[...] WCO members and the business community in all WCO regions are faced with a growing number of preferential trade arrangements, often with widely different rules which can be both very complex and difficult to apply [...].*
>
> *[...] A new global approach is proposed to support WCO Members and trade interests in improving the understanding and proper application of preferential rules of origin for both existing and any future arrangements [...]" (emphasis added).*

In response to these challenges and opportunities, WCO has announced a draft action plan and undertaken to develop a package of specific measures based on the key areas outlined in box 2 and in box 3.

4 On the evolution of RTAs, see, for instance, WTO, The Changing Landscape of Regional Trade Agreements: 2006 Update.

5 See the WTO Conference on Multilateralizing Regionalism www.wto.org/english/tratop_e/region_e/conference_sept07_e.htm and www.cepr.org/meets/wkcn/2/2380/).

Box 2. The WCO Draft Action Plan

1. Development of a database of preferential arrangements as a key tool to support the work of Customs and possibly the business community in dealing with preferential trade agreements;
2. A detailed study of existing preferential arrangements to develop guidelines and standards for use by key actors in the negotiation and implementation of arrangements;
3. The introduction of capacity-building activities, targeted at Customs, policy makers and the private sector, in cooperation with other related international organizations involved in this area;
4. Greater use of risk analysis and increased administrative cooperation;
5. An increased profile for the WCO in rules of origin matters, particularly with regard to the central role Customs services play in the management of the rules.

The private sector and their trade associations are also concerned about origin complexity and multiplicity. For example, Chambers of Commerce have historically played an active and important role in supplying the international trade community with certificates of origin. The World Chambers Federation, a specialized division of ICC, has supported and further deepened this facilitative function with the recent publication of a comprehensive set of procedural origin guidelines in the *International Certificate of Origin Guidelines*.

The World Chambers Federation has also created the very robust and active Certificate of Origin Task Force, which investigates additional ways to harmonize origin procedures and build origin capacity. In its own words: (see box 3).

Box 3. WCF Certificate of Origin Task Force

A Chamber's role in the issuance and attestation of certificates of origin and other trade documents is both unique and vital to the facilitation of international trade, especially in an increasingly differentiated rule of origin trading environment that lacks international certification standards.

As such, there is an urgency to reinforce and enhance the unique position of Chambers of Commerce as the natural agent in the issuance and attestation of Certificates of Origin and to use the ICC WCF's global stature and platform to develop and or harmonize certification standards and procedures that will benefit traders and customs administrations.

The WCF Task Force achieves this through the following strategies:

1. Coordinated and vigorous lobbying of international and national governments and agencies through ICC structures.
2. Raising the credibility of Chambers' trade document functions through:
   (a) The setting up of an international Certificates of Origin certification procedure standards and guidelines for the issuance and attestation of Certificates of Origin.
   (b) The establishment of an international accreditation of Chambers' staff through an international CO Training Programme.
   (c) Helping Chambers in identification and use of advanced technologies in the delivery of Certificates of Origin and trade documents. (see http://www.iccwbo.org/wcf/co/id9418/index.html)

II

RULES OF ORIGIN IN MAJOR EXPORT MARKETS

II. RULES OF ORIGIN IN MAJOR EXPORT MARKETS

This section will briefly describe several developed country rules of origin schemes and highlight certain flaws in order to support concluding recommendations.

A. United States – African Growth and Opportunity Act

Although regional preference programmes such as the Caribbean Basin Initiative and similar Andean programmes have allowed apparel to enter the United States duty free, the United States-GSP rules have not included clothing or textiles. However, the African Growth and Opportunity Act (AGOA), allowed for the duty-free entry of these goods for sub-Saharan African countries.

Therefore, by definition, AGOA benefits do not apply to Asian LDCs. Recently the Haitian Hemispheric Opportunity through Partnership Encouragement Act, or HOPE, did introduce some AGOA-like benefits under specialized conditions. Major apparel producers such as Bangladesh and Cambodia have been excluded.

For most products imported under AGOA, the applicable rules of origin is a 35 percent value-added rule. Apparel products, however, are subject to different rules of origin: the origin of these goods is determined by the origin of their inputs (i.e. yarn and/or fabric). While apparel rules of origin generally requires that only U.S. and/or AGOA country inputs be used in production, lesser developed beneficiary sub-Saharan African countries can use third party inputs, subject to a cap.

As detailed in the United States Government Accountability Office (GAO) Trade Preference Program Review[6] released on April 11th, 2008 (above-mentioned), the utilization or fill-rate of tariff preference levels for the countries under AGOA that do not qualify for liberalized rules of origin that allow the use of non-United States and/or non-AGOA inputs is 1.8 per cent. For lesser developed beneficiary sub-Saharan African countries that can use third-party inputs – "lesser developed beneficiary sub-Saharan African countries" – the comparable fill-rate was over 43 per cent in 2006. It is clear that allowing the use of internationally competitive inputs from all sources in originating products increases preference utilization.

But if these liberalized rules of origin had been generally applied, the results would be dramatic:

> *"The most important condition is the stringent rule-of-origin, that is, the requirement that exporters source certain inputs from within Africa or the United States. Estimates suggest that the absence of these conditions would have magnified the impact nearly five-fold, resulting in an overall increase in non-oil exports of $0.54 billion, compared with the $100–$140 million increase that is expected in the presence of these restrictions.[7]"*

A United States International Trade Commission also examines the domestic benefits and compliance costs associated with apparel rules of origin that require the use of United States fabrics or, put differently, rules-of-origin-based foreign demand for textile products from the United States.

According to the study, the removal of textile and apparel preferential rules of origin would boost welfare by $818 million, but the effects of the reductions in compliance costs and foreign demand are markedly different. Foreign demand reductions would reduce United States welfare by $714 million because of reduced U.S. exports, but this is more than offset by the $1,532 million gained by cutting compliance costs in imported textiles and apparel.

B. The European Union – Generalized System of Preferences and Everything But Arms Initiative

The EU EBA (Everything But Arms) for LDCs

6 US GAO, U. S Trade Preference Programs Provide Important benefits, but a More Integrated Approach Would Better Ensure Programs Meet Shared Goals: Report to the Chairman, Committee on Finance, U.S. Senate, and the Chairman, Committee on Ways and Means, House of Representatives, March 2008.

7 Mattoo, A. et. Al. "The Africa Growth and Opportunity Act and its rules of origin: generosity undermined?" World Economy 26.

initiative represents a major advancement in terms of EU GSP product coverage in that all products are now covered including the duty- and quota-free treatment of agricultural goods that had enjoyed only partial preferences and were subject to caps or quantitative restrictions. This liberalization process the gradual elimination of applicable specific duties on certain agricultural products (i.e. bananas, rice and sugar).

Applicable rules of origin under Everything But Arms initiative are the GSP rules of origin, which have always been based on product-specific rules, which until recently included rather onerous rules on "wholly produced" for processed fish and fish preparations and double transformation rules for LDC apparel and textile products and highly differentiated and complex rules for food preparations. In this regard, EU introduced in January 2011 new GSP rules of origin following a long internal debate, which made important changes to these relatively restrictive rules. See box 4.

C. Canada's Least Developed Countries Initiative

On 1 January 2003, Canada unveiled its new LDC initiative, expanding duty-free and quota-free access to most imports except eggs, poultry and dairy goods. This initiative continued to allow full and global cumulation[8] privileges, and goods are considered to be originating if the value of the materials, parts or products originating in a non-beneficiary country, or in an undetermined location, used in the manufacture or production of the goods is no more than 60 per cent of the ex factory price of the goods as packed for shipment to Canada.

More importantly, Canada's new programme now includes textiles and apparel products under rules of origin that, under specified conditions, allow for the use of General Preferential Tariff (GPT) inputs (yarns/Apparel Rule 1 and fabrics/ Apparel Rule 2) to be used in the production of LDC-qualifying goods:

- Apparel Rule 1 (Origin Criteria "D"): originating apparel under this rule must be made from qualifying fabric that is cut in a LDC country or Canada and then assembled or knit to shape in the exporting LDC. Qualifying fabric must be produced in an LDC (or Canada) and be made from LDC, Canadian or GPT yarns. Neither of these yarns or fabrics may undergo any further processing outside a LDC or Canada.
- Apparel rule 2 (Origin Criteria "E"): originating apparel under this rule can be made from GPT-qualifying fabric on the condition that the value of any production materials (including packing) that originate outside an LDC where the goods are assembled is no more than 75 per cent of the ex factory price of the goods packed for shipment to Canada. Qualifying GPT fabric must be made of LDC, GPT or Canadian yarns. These fabrics may be cut in Canada or in the exporting LDC. Neither of these yarns or fabrics may undergo any further processing outside an LDC, a GPT country or Canada.

These rules of origin allow for the manufacturing of LDC originating goods that accurately reflect the yarn and fabric sourcing of many LDC producers who procure many of these inputs from China and India. As we shall see later, although liberal in their rule content, these provisions can present various origin administration and origin verification difficulties, including certain liabilities associated with self-certification.

D. Japan's Least Developed Countries Programme

Japan's GSP regime provides duty-free entry for LDC goods included under their programme. Originating LDC imports are not subject to the ceiling system that applies to GSP imports. In 2003, Japan enhanced GSP/LDC benefits by adding 200 agriculture and fisheries products, and further expanded product coverage in 2006 to meet the target of 97 per cent product coverage for duty-free and qutoa-free treatment for LDC exports as set out in the WTO Hong Kong Ministerial Declaration Consequently, Nearly all LDC-originating goods enjoy duty- and quota-free treatment. The following rules of origin are applicable:

1. *"Goods are considered as originating in a preference-receiving country if they are wholly obtained in that country;*

8 Global cumulation implies that all beneficiaries of the Canadian General Preferential Tariff may cumulate from each other, though still not from beneficiaries of other programmes.

Box 4. New EU GSP Rules of Origin

On 18 November 2010, the European Commission adopted a new regulation on the rules of origin for the EU GSP, effective as of 1 January 2011.[9] The new rules were aimed at simplifying and easing the EU GSP rules of origin, including expected introduction of a new system of proof of origin and administrative cooperation on 1 January 2017. The reform process began in 2003, and in October 2007 the Commission proposed the draft regulation which would have abolished the product specific rules and adopted one value-added method across-the-board. This proposal, however, met strong oppositions from stakeholders, and in November 2008 it submitted the revised regulation and reintroduced product-based rules. These rules adopted the origin-conferring methods such as change of tariff classification, specific working operation, and value-added criteria.

Origin-conferring requirements for the EU GSP are product specific, and they are contained in the "Product List". The current "Product List" has become notably simpler than the previous one for both agriculture and manufacture products. For instance, the current List contains about 290 product specific while the previous one had about 500. LDC specific rules of origin, which impose less stringent requirements, are included in the new rules of origin for many manufacture products, in contrast to the previous rules that applied identical criteria to both LDCs and non-LDCs. For agriculture products (i.e. products in HS Chapters 1 to 24), however, rules of origin are the same for the both categories of countries.

For LDCs, allowance for the use of non-originating materials for many manufacture products has been increased to 70 per cent. Allowance for the use of non-originating materials has also been increased for non-LDC developing countries. Increase of the allowance for some manufacture products (e.g. HS Chapters 34, 39, 40, 66, 71, 84 to 94) is significant, ranging between 20 to 40 per cent. In addition, for many agricultural products, a weight tolerance determination has replaced the previous value tolerance determination for non-originating materials and sugar. The conditions for wholly obtained fishery products have also relaxed several conditions on crews and ownership of vessels that the previous rules imposed. For LDCs, origin requirements for a large part of apparel products have become "single transformation" (i.e., use of imported fabric is allowed for apparel to be originating). For non-LDC beneficiaries, however, the "double transformation" requirement largely remains.

The new system of proof of origin and administrative cooperation will be gradually implemented and will become effective on 1 January 2017. Under this system, the GSP Form A certificate will be abolished, and instead, exporters which are registered electronically with their governments will make statements of origin and transmit them electronically. Importers will submit the statements to the customs authorities in the Community, and will be responsible for the evidence of origin. Beneficiary countries must comply with the administrative cooperation provisions of rules of origin and set up and manage a database of "Registered Exporters". For countries which cannot be ready for the new system by 2017, implementation will be delayed to 1 January 2020. Until 2017 (or 2020 for delayed countries), the current system (i.e. using Form A) will continue.

2. *In the case of the goods produced totally or partly from the materials or parts which are imported from other countries, or of unknown origin, such resulting goods are considered as originating in a preference-receiving country if those materials or parts used have undergone sufficient working or processing in that country. As a general rule, working or processing operations will be considered sufficient when the resulting goods are classified under a Harmonized System tariff heading (four digits) other than that covering each of the non-originating materials or parts used in the production. However, there are two exceptions to this rule. One is that some working or processing will not be considered sufficient when working or processing is actually so simple even if there is a change in the Harmonized System heading. The other is that some goods are required to satisfy the specific conditions in order to obtain originating status. (Product-specific rules outlined in the List of Processed Products for Which the Condition for Origin Country Acknowledgement is Specified: www.mofa.go.jp)."*

9 The EU is in the process of formulating its new GSP scheme applicable after 31 December 2011 when the current scheme expires. The reform is expected to include major changes in respect of country-eligibility criteria and coverage but not to address rules of origin. Thus, the newly introduced GSP rules of origin will continue to apply under the new GSP scheme.

ORIGIN ADMINISTRATION

THE PRIVATE-SECTOR PERSPECTIVE

III. ORIGIN ADMINISTRATION – THE PRIVATE-SECTOR PERSPECTIVE

There are many variations origin in the certification and verification under different preferential trade arrangements. These include certification: by customs authorities or parties recognized by the customs authorities as trusted traders; by certifying entities authorized by to do so by government authorities and self-certification by the manufacturer and/or exporter as found under NAFTA. Certification by the importer is a more recent origin variation. The specific advantages and disadvantages of these competing administrative procedures will be examined in some detail later in this study. However, even under regimes wherein origin is certified by parties other than the manufacturer/exporter, this certification is based on an origin declaration by the manufacturer/exporter. This origin declaration is in turn based on the manufacturer's own origin determination. Therefore, the focus here will be to review the set of private-sector origin activities that are common to all origin regimes – origin analysis, origin determination or declaration, and origin documentation, origin imports, origin verification and origin liability.

A. Origin Determination

Origin determination means determining whether intended or existing production of producers/exporters qualifies for preferential treatment. The importing purchasers can also look at this issue because they do not want to pay duties unnecessarily at the time of import. See box 5.

In most cases, however, the manufacturer or exporter is not so ingenious. The usual approach is that the manufacturer must determine the applicable regional trade agreement or preferential schemes, and the tariff classification of the product or products to be exported in order to determine the applicable rule of origin. This is not a trivial undertaking. Properly classifying products under the Harmonized System is not an easy process and usually requires a thorough understanding of the Harmonized System which can takes years to acquire. Furthermore, classification also depends on a full knowledge of a product, which, surprisingly, can often be difficult to come by. For example, very often an experienced clothing manufacturer might be attracted to characteristics of a particular fabric (i.e. texture, draping features) that will ensure plentiful and profitable sales of the finished garment. However, this fabric selection is regularly done without any understanding or even a desire to understand how these product specifications are achieved. Indeed, in many cases the fabric supplier does not want to share this type of product and/or manufacturing information with others.

The following quotations provide powerful testimony to the difficulties associated with product classification under the Harmonized System and valuation under the Agreement on Customs Valuation:

> *"As an interim measure, the Branch developed a spreadsheet-based process to capture the results of some of its verifications. In 2000–01 it conducted compliance verifications to check whether importers had classified and valued goods correctly. The Agency prepared a preliminary analysis of the results of 74 of these verifications that had looked at three high-risk commodities: textiles/apparel, steel and footwear. The analysis showed an error rate that ranged from 25 to 31 per cent for the classification of these commodities and from 19 to 27 per cent for valuation. Agency officials indicated that based on these results, potential trade data errors could reach more than $11 billion for these commodities. In 2001 we also noted high error rates of 29 per cent for classification and 15 per cent for valuation for all commodities. Accurate trade data are important for negotiating and monitoring trade agreements and are used by businesses to make domestic and foreign investment decisions."*

> *"The CCRA [Canada Customs and Revenue Agency] assessed the 53 verifications completed in phase I of the programme. The major objective was to determine how compliant importers were in providing correct trade data. It reported high error rates in classification (29 per cent), origin (18 per cent), and valuation (15 per cent). In some sectors the error rates were over 50 percent. More significant, 48 of 53 companies verified had made errors in classification. The Agency has not analysed the results of completed verifications since 1998 and cannot show whether compliance has improved or deteriorated since then." (Office of the Auditor General of Canada, 2003)".*

Box 5. Rules of Origin as a Source of Competitive Advantage

For a small minority of individuals and corporations, usually referred to as "early adopters", these origin activities are a source of competitive, if not comparative advantage as demonstrated by the "tariff engineering" of Steve & Barry's University Sportswear:

"This retailing duo has turned cheap skating into a sport. It allows them to sell hundreds of good-quality items – T-shirts, varsity jackets, button-down shirts, sweatpants, jeans, work boots, sneakers, backpacks, down jackets and tank tops among them – for just under $10. After doubling store count to 65 in 2004, the company is adding another 70 this year, averaging 60,000 square feet. Revenues have doubled in each of the past two years and, Shore and Prevor say, will do so again in 2005, when their chain should earn an estimated $50 million pretax on $700 million in sales."

Shore, 42, insists there is no secret sauce except low costs. The advertising budget is less than 1 per cent of revenue. Squeezing a few pennies out of an import duty is a big deal. So is getting an oversize build-out allowance from a mall owner.

Prevor, also 42, who calls himself a "tariff engineer," has mastered the patchwork of international agreements that make up U.S. apparel trade law. Example: Goods come in duty free from industrial parks designed to encourage Jordan-Israel relations, provided that at least 35 per cent of a product's value comes from the protected zone. So, for a $5 (wholesale) pair of shorts, $1.75 of its value must come from the sewing, cutting and indigenous components from Jordan and Israel; the rest of the garment – fabric, buttons, zipper – can be shipped in from elsewhere. Had those $5 shorts been made in China instead of Jordan, they would have cost $6.40. In 2004 Steve & Barry's sold 500,000 Jordanian shorts.

A similar tariff holiday applies to clothing from Swaziland, Lesotho, Malawi and Madagascar. Jeans manufactured in any of those countries with textiles shipped in from India cost Steve & Barry's $5 a pair. The company plans to sell 5 million jeans this year. If made in India for the same price, the 16 per cent duty would have come to $4 million.

It helps that the tariff schedules are insanely complicated. A man's nylon jacket coming from China typically carries a duty of 28 per cent, but Prevor orders a design that has the fabric equipped with water-resistant coating, reclassifying the garment as rainwear and dropping the duty to as little as 4 per cent. That's worth a few million dollars. Women's cotton khakis have a 17 per cent duty; if they're synthetic, 29 per cent. But Steve & Barry's khakis are more than 50 per cent ramie (a strong, stain-resistant natural fibre), dropping the duty to 3 per cent. For 5 million pairs of pants, that means a savings of $3.5 million." (Forbes.com – 7 April 2005).

The early-adopter advantage does not stop at the creative exploitation of existing rules of origin but usually also translates in to the enhanced ability to influence the rule of origin negotiation process – after all why stop at creating products around rules of origin when you can create rules of origin around the products you make or need to import?

The not-so-simple process of tariff classification is further complicated if it is determined that the applicable rule of origin defines substantial transformation by way of a tariff shift. Under a tariff-shift rule, the manufacturer must determine if inputs imported from a non-member of the regional trade agreement meets the required shift and/or the subject of any stated exclusions. In other words, origin determination under all definitions of substantial transformation, including tariff shift, usually start with a product's bill of materials which details what is the product and what materials were used to make it.

Consider the volume and complexity of tariff classifications that might have to be undertaken when trying to determine the NAFTA rule of origin of goods of 6101.10 to 6101.30 (which can be loosely described as men's and boy's knitted coats of fine animal hair, cotton or man-made fibres) that is also guided by Note 1 and 2, Chapter 61 provided in box 6.

The tariff classification and origin matrix can become even more complicated when the issue of which party's classification should predominate in any given origin context. For example, imagine that a manufacturer in country A imports a certain input from country B. This imported input is combined with domestic inputs that are wholly obtained from country A and then exported the finished good to country C under the terms and conditions of a bilateral free trade agreement between A and C. The applicable rule of origin for the finished product shipped from A to C is a specified tariff shift on inputs from non-members. The manufacturer in country A wants to ensure that the imported input from B makes the required tariff shift and applies for a tariff classification ruling from the customs authorities in his or her own country: the authorities confirm that the classification is under tariff item X. The exported product is classified under tariff item Y so the manufacturer feels confident about claiming origin on the finished good shipped to C. However, the customs authorities in country C disagree with the classification of the imported input into A: they feel it should be classified under tariff item Y and as a consequence, these deny the origin claim made at the time of entry. Under these circumstances there are only a few remedies available. Either the exporting manufacturer learns how to classify goods not only into his own jurisdiction but also how other regional trade agreement members classify them or the regional trade agreement creates a supranational tariff classification body or institution.

Classification under the Harmonized System for origin purposes can become particularly convoluted as a result of the modifications to the Harmonized System that occur approximately every four years as noted. This process can render useless existing tariff-shift rules and require that impacted rules be updated in a process referred to as technical rectification. Technical rectification can be an expensive and time-consuming operation.

Another potential origin entanglement associated with a tariff-shift definition of substantial transformation is associated with fungible goods. For purposes of illustrating this matter, fungible goods will be defined as goods that are interchangeable for commercial purposes and have essentially identical properties. For example, a pen producer purchases and imports blue ink from two sources: one source of blue ink come from a trading partner that shares a free trade agreement and the ink is originating and the other source of ink is from an MFN supplier. Manufacturers often purchase and keep fungible goods in their component part and/or raw materials inventory: having two suppliers of an interchangeable production part can improve price competition and security of supply (just-in-case as opposed to just-in-time). Sometimes the supply of a fungible product is necessary because of unavoidable circumstances such as labour unrest at a factory or a catastrophic fire at the supplier's facilities. Now imagine that 90 per cent of a manufacturer's raw material inventory would not negatively impact on the origin of their finished goods but the remaining 10 per cent, physically held in the same inventory, would prevent origin from being achieved on their finished production. In this situation, the manufacturer could not prove whether his or her finished product was made from the 90 per cent of the "qualifying" inventory or the 10 per cent of "non-qualifying" inventory. In other words, the originating ink and the non-originating ink are kept in the same ink storage vat. Under these conditions, origin on the exported product will be denied, given that undocumented origin, or origin one cannot prove, is simply deemed to be not originating: pens containing blue ink under these circumstances could not originate.

One remedy to this scenario is keeping the fungible originating and non-originating materials in separate raw materials inventories – an expensive proposition. Alternatively, the preferential rules of origin prescribe and outline approved inventory management techniques (i.e. LIFO, FIFO and averaging)[10] that would allow keeping originating and non-originating fungible materials in the same inventory as outlined in the Uniform Regulations under NAFTA.

Co-mingling is also a serious origin problem in finished goods inventories. For example, it is not unusual to for a clothing distributor to order a popular clothing item, say denim skirts with certain product specifications designated by the distributor's style number 100, from two or three different suppliers (suppliers A, B and C). All suppliers are producing

10 Last in first out (LIFO), first in first out (FIFO), and averaging over a defined time period (usually one year) are standard accounting approaches to inventory management, which as part of most generally accepted accounting practices are recognized as valid in origin determination in most origin regimes.

Box 6. NAFTA Rules of origin - Chapter 61 Articles of Apparel and Clothing Accessories, Knitted or Crocheted

Note 1: A change to any of the following headings or subheadings for visible lining fabrics:

51.11 through 51.12, 5208.31 through 5208.59, 5209.31 through 5209.59, 5210.31 through 5210.59, 5211.31 through 5211.59, 5212.13 through 5212.15, 5212.23 through 5212.25, 5407.42 through 5407.44, 5407.52 through 5407.54, 5407.61, 5407.72 through 5407.74, 5407.82 through 5407.84, 5407.92 through 5407.94, 5408.22 through 5408.24 (excluding tariff item 5408.22.aa, 5408.23.aa or 5408.24.aa), 5408.32 through 5408.34, 5512.19, 5512.29, 5512.99, 5513.21 through 5513.49, 5514.21 through 5515.99, 5516.12 through 5516.14, 5516.22 through 5516.24, 5516.32 through 5516.34, 5516.42 through 5516.44, 5516.92 through 5516.94, 6001.10, 6001.92, 6005.31 through 6005.44 or 6006.10 through 6006.44, from any heading outside that group.

Note 2: For purposes of determining the origin of a good of this Chapter, the rule applicable to that good shall only apply to the component that determines the tariff classification of the good and such component must satisfy the tariff change requirements set out in the rule for that good. If the rule requires that the good must also satisfy the tariff change requirements for visible lining fabrics listed in Note 1 to this Chapter, such requirement shall only apply to the visible lining fabric in the main body of the garment, excluding sleeves, which covers the largest surface area, and shall not apply to removable linings.

6101.10–6101.30

A change to subheading 6101.10 through 6101.30 from any other chapter, except from heading 51.06 through 51.13, 52.04 through 52.12, 53.07 through 53.08 or 53.10 through 53.11, Chapter 54 or heading 55.08 through 55.16 or 60.01 through 60.06, provided that:

(a) The good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the Parties;

(b) The visible lining fabric listed in Note 1 to Chapter 61 satisfies the tariff change requirements provided therein.

style 100. Suppliers A and B provide the distributor with sufficient origin information that the distributor is confident in making an origin declaration when exporting the goods but does not even bother collecting origin data from supplier C because without question the goods do not originate (i.e. perhaps supplier C is not a party to the regional trade agreement in question). The problem begins if all three suppliers' products, all properly marked style 100, including the corresponding product specifications, are placed into the exporter's distribution centre. Purchasing and logistics departments do not care about the origin of the denim skirts: they have to ship 1,000 dozen style 100s out by the end of day and all style 100s are kept in the same product bin. As outlined above, under these conditions, the exporter cannot prove or conclusively document the origin of exports of style 100 skirts: they would lose origin on all their production even though two thirds of them might qualify. This issue has caused significant financial and administrative grief to numerous parties, including sophisticated and trade-literate enterprises.

Finally, imagine that our hypothetical manufacturer is in fact an LDC manufacturer who must perform an origin analysis on his or her exported product, and in the corresponding Bill of Materials (BOM), against numerous non-reciprocal preferential rules of origin regimes (United States, EU, Japan, Brazil, India, Canada and so on).

B. Origin Analysis

Origin analysis refers to the everyday process when manufacturers, possibly confronting their own determination that their products do not qualify as originating for one or more preferential regimes, decide to explore numerous "what if" scenarios in an effort to achieve originating status. This could involve rechecking calculations, reviewing tariff classifications or even sourcing manufacturing inputs

from alternate suppliers and/or sources. In other words, manufacturers are sometimes forced to alter their purchases and/or production methods in order to achieve origin.

C. Origin Documentation

Once the manufacturers have determined that their products qualify as originating under one or more particular preferential origin regimes, the real origin work begins. In most cases, in order to declare origin, manufacturers must be able to prove or document their origin determination. In this sense, a manufacturer's declaration represents a major record-keeping undertaking, in that he declares that his goods are originating and that he has the proof of origin at his disposal, should authorities wish to verify them.

This undertaking includes two specific and separate dimensions. The first relates to records management. This is not an unsophisticated function: in developed countries many large corporations have been penalized for not retaining the proper origin information. This is not due to lack of overall shipping records, as many of firms utilize system-wide software that retains copious amounts of data on each transaction, but because the software was not designed or instructed to retain the origin information specified in the preferential agreement. Furthermore, these records must sometimes be maintained for up to five years. If these and related importer record requirements (see below 19 CFR 178e) represent difficulties to producers in developed countries, imagine the challenges to LDC manufacturers. See box 7.

The other dimension of origin documentation is that ultimately records management basically implies supplier management. This is due to the fact that, as discussed previously, in order to accurately determine origin a manufacturer must examine the bill of materials of the exported product because in most cases the origin and/or the value of each production material must be established. This necessitates detailed origin communications between the exporting manufacturer and some, or most, of his suppliers. In some cases, in order to provide his client with the proper information, the supplier himself must dissect his own BOM: this process can continue until the required information can be three to four levels of trade from the exporting manufacturer. What is more, the manufacturer's bill of materials and that of his suppliers are not static creatures but are changing sourcing all the time. In order to properly manage their origin function, the manufacturer must master the whole complex process and create an origin communication strategy. All this requires significant resources and administrative expertise, the costs of which may rapidly exceed the benefits of the tariff preferences they are intended to capture.

D. Origin Imports and Origin Verifications

The term "origin imports" pertains to the established process when some form of certified origin declaration, that is normally provided or at least initiated by the manufacturer or vendor, is used at time of entry by the importer of record, who is usually the purchaser of the goods. The certificate of origin accompanies other forms of import documentation and, in a preferential context, has the effect of lowering or eliminating the duties payable. However, for most customs authorities, the presentation of the certificate of origin at the time of entry does not imply that the correct origin of the goods has been established or accepted by customs but merely constitutes origin claimed by the importer. In most jurisdictions, origin is not actually confirmed until the certificate of origin has been actually verified.

The process and administrative prerequisites for origin verification is an entire field of study itself. If rules of origin are complicated and manufacturers produce goods under several different origin regimes, then it can hardly be surprising that origin verifications can be and usually are detailed and difficult undertakings for all parties. For example, it might take months for customs authorities to determine, in their opinion, the proper tariff classification of the exported product and/or the inputs that were used to make it. Even armed with this basic information, the interpretation of a rule of origin can still be challenging and likewise cause delays.

A more representation overview of the origin verification is the following introductory chapter to the *NAFTA Verification/Audit Manua*l that runs for several hundred pages. See box 8.

Box 7. United States Code

Title 19: Customs Duties

PART 10 — ARTICLES CONDITIONALLY FREE, SUBJECT TO A REDUCED RATE, ETC.

Subpart A — General Provisions

Generalized System of Preferences

§ 10.178a Special duty-free treatment for sub-Saharan African countries.

(e) Importer requirements. In order to make a claim for duty-free treatment under this section, the importer:

(1) Must have records that explain how the importer came to the conclusion that the article qualifies for duty-free treatment;

(2) Must have records that demonstrate that the importer is claiming that the article qualifies for duty-free treatment because it is the growth of a beneficiary sub-Saharan African country or because it is the product of a beneficiary sub-Saharan African country or because it is the manufacture of a beneficiary sub-Saharan African country. If the importer is claiming that the article is the growth of a beneficiary sub-Saharan African country, the importer must have records that indicate that the product was grown in that country, such as a record of receipt from a farmer whose crops are grown in that country. If the importer is claiming that the article is the product of, or the manufacture of, a beneficiary sub-Saharan African country, the importer must have records that indicate that the manufacturing or processing operations reflected in or applied to the article meet the country of origin rules set forth in §10.176(a) and paragraph (d) of this section. A properly completed GSP declaration in the form set forth in §10.173(a)(1) is one example of a record that would serve this purpose;

(3) Must establish and implement internal controls which provide for the periodic review of the accuracy of the declarations or other records referred to in paragraph (e)(2) of this section;

(4) Must have shipping papers that show how the article moved from the beneficiary sub-Saharan African country to the United States. If the imported article was shipped through a country other than a beneficiary sub-Saharan African country and the invoices and other documents from the beneficiary sub-Saharan African country do not show the United States as the final destination, the importer also must have documentation that demonstrates that the conditions set forth in §10.175(d)(1) through (3) were met;

(5) Must have records that demonstrate the cost or value of the materials produced in the United States and the cost or value of the materials produced in a beneficiary sub-Saharan African country or countries and the direct costs of processing operations incurred in the beneficiary sub-Saharan African country that were relied upon by the importer to determine that the article met the 35 per cent value content requirement set forth in §10.176(a) and paragraph (c) of this section. A properly completed GSP declaration in the form set forth in §10.173(a)(1) is one example of a record that would serve this purpose;

(6) Must be prepared to produce the records referred to in paragraphs (e)(1), (e)(2), (e)(4), and (e)(5) of this section within 30 days of a request from Customs and must be prepared to explain how those records and the internal controls referred to in paragraph (e)(3) of this section justify the importer’s claim for duty-free treatment.

Box 8. North American Free Trade Agreement (Nafta) - Audit (Verification) Manual

UNITED STATES CUSTOMS SERVICE

REGULATORY AUDIT DIVISION

NORTH AMERICAN FREE TRADE AGREEMENT

AUDIT (VERIFICATION) MANUAL TABLE OF CONTENTS

INTRODUCTION

With the entry in force of the North American Free Trade Agreement (NAFTA), the Parties have experienced a significant increase in the trade of goods and services between them. The three Customs Administrations have agreed that the rules of origin as set out in Chapter Four of the NAFTA and the NAFTA rules of origin Regulations (the Regulations), define the framework to be observed by exporters/producers in order to have their goods qualify as “originating goods”, and be eligible for a NAFTA preferential tariff treatment when imported into the territory of any of the other Parties to the Agreement.

As a result, it has become important for the Customs Administration of each Party to verify that the goods for which NAFTA preferential tariff treatment has been claimed comply with the rules of origin.

In this respect, the three Customs Administrations have considered that the establishment of verification guidelines is important and useful. The Customs Administrations of all Parties have consulted during the development of this manual and these guidelines include general, examination and reporting standards for NAFTA origin verifications.

This manual is intended to be used by: Origin Audits Unit of Revenue Canada (Canada); Direction of International Audit of the Ministry of Finance and Public Credit (Mexico); and, the offices of Regulatory Audit and Field Operations, U.S. Customs Service (United States). However, portions of this manual may also be used by other areas within each Customs Administration as deemed appropriate.

The main purpose of this document is to establish the recommended technical verification framework to be observed when conducting NAFTA verifications. The application of the provisions included therein should take into consideration the circumstances involved in each verification and be adapted accordingly. It is understood that this document will be updated on a continual basis.

This section of the NAFTA Verification Manual provides revisions to the November 1995 version to reflect changes in the Regulations which became effective on October 1, 1995.

EXECUTIVE SUMMARY

This manual considers all types of verifications, but focuses on the on-site audit process for exporter verifications where the regional value content requirement, tariff change requirement, or both, must be met. It should be noted that this manual provides verification procedures that are recommended by all Parties.

There are seven chapters contained in this manual. Included is an annex at the end of most chapters. The Annex contains information for the particular chapter that may differ among the Parties. The chapters within this U.S. version of the NAFTA Verification Manual includes information unique to the U.S. Information differing in Mexico and/or Canada, is included at the end of the chapter in the Annex. The highlights for each chapter are as follows:

Chapter 1, Purpose of the Manual and Legislative Framework, points out the need for this audit (verification) manual, and refers to the legal framework by which NAFTA verifications are conducted.

Chapter 2, Cooperation among the Parties, discusses the exchange of information and communication between Customs Administrations subject to NAFTA.

Box 8. North American Free Trade Agreement (Nafta) - Audit (Verification) Manual - *Continued*

Chapter 3, Auditing Standards, demonstrates how the Generally Accepted Auditing Standards have been incorporated into each Party's audit (verification) process.

***Chapter 4**,* Objectives of NAFTA Audits (Verifications), outlines the objectives of NAFTA exporter on-site verifications as well as the verification programme objectives for this type of verification.

Chapter 5, Scope of the NAFTA Audits (Verifications), describes the parameters of coverage for NAFTA exporter verifications including the verification period, coverage, importer identification and assessment/ liquidation period. This Chapter also includes recommended verification procedures that are identical and uniform for all Customs Administrations.

Chapter 6, Methodology for Rules of Origin Audits (Verifications), explains the verification process for NAFTA exporter verifications.

Chapter 7, NAFTA Working Groups, refers to the contact areas within the Customs Administration of each Party with respect to verification issues and their relationships with the NAFTA Working Groups.

LIST OF APPENDICES

A. Certificate of Origin CF-434

B. General Questionnaire CF-446

C. Election to Average Form for Vehicles CF-447

D. Sample Letter Proposing NAFTA Verification Visit

E.Sample Notification of NAFTA Verification of Goods to Known Importers of Record

F. Review of Policies, Procedures and Internal Controls Checklist

G. Final Written Determinations – Positive and Negative

H. Sample Notification of Verification Results to Known Importers

(1) Goods met NAFTA rule of origin requirements

(2) Goods did not meet NAFTA rule of origin requirements

I. Supplier Confirmation Letters

(1) for non-automotive parts suppliers

(2) for automotive parts suppliers

J. Supplier Verification Notification

K. Regulatory Audit Final Audit Reports

L. Goods Wholly Obtained or Produced Entirely in the Territory of One or More of the Parties

M. Goods Produced Entirely in the Territory of One or More of the Parties Exclusively from Originating Materials

N. Preference Criteria D

O. Light Duty Automotive Goods – Averaged

P. Light Duty Automotive Goods – Non-Averaged

Q. Heavy Duty Automotive Goods – Averaged

R. Heavy Duty Automotive Goods – Non-Averaged.

E. Origin Liability

What exactly are the implications if, as a result of an origin verification, the duty free originating status of an import is denied? In nearly all cases, the importer is legally responsible for making complete and accurate declarations concerning the goods they are importing and must account for any applicable duties and taxes. Moreover, given that in the overwhelming number of origin-related transactions, the importer is relying on the origin declaration of the exporter: if that certified origin declaration is intentionally or inadvertently wrong, the importer is the one who pays.

This imbalance of rights and responsibilities between exporters, who are not legally responsible for duties, and importers, who are usually not familiar with the all the details of how the goods they ordered were produced, represents one of the central difficulties in the realm of rules of origin. One solution that is often employed is for the importer or purchaser to impose contract clauses on the exporter that require him or her to pay for any duties if the certificate of origin is found to be defective. Although this can be effective for importers, in some instances it does have a distinct drawback for exporters: a bewildering array of company-specific terms and conditions that are all different from each other. This is an especially knotty origin problem that must be resolved in order to establish and increase confident trade in what one party has coined “the supply chain of trust”.

IV

RECOMMENDATIONS

IV. RECOMMENDATIONS

The need for more effective rules of origin for LDC exports has become a pressing issue. Decades of tariff liberalization, the proliferation of free trade agreements and MFA phase out have all significantly eroded the advantages and degree of preference offered by unilateral duty-free, quota-free programmes. Efforts by the LDC community to simplify and enhance the terms and conditions of the rules of origin they must operate under is not a myopic dependence on preferential tariffs but a call to do what can and should done. This will allow them and donors to then move onto other pressing challenges such as supply-side constraints and technical standards.

A. General Recommendations

In light of the above mentioned mutual benefits of increased and improved LDC exports, the following are a series of origin suggestions and recommendations to facilitate this process.

As outlined by Harris (2008) and others, the rules of origin issue for LDCs should not be seen simply as an issue of identifying and, wherever possible, harmonizing simple, non-restrictive rules of origin such as the Blair Commission for Africa call for a 10 per cent value-added rule. Although simplification and harmonization are required, overemphasis on this approach fails to fully take into consideration the development objectives of the WTO duty-free quota-free initiative, such as increased investment, domestic production and diversity of domestic production. This is because radically non-restrictive or liberal rules of origin do not necessitate the types of activity that promote production and could even decrease the demand for intermediate goods produced in developed countries. Therefore, it is clear that any rules-of-origin remedies for LDCs must address both objectives: LDC development and improved market access for LDC goods.

1. Are Simplified Rules Achievable or Even Desirable?

Often the call for enhancing and standardizing LDC programmes is accompanied by the call for simplified rules of origin or even a single rule of origin, because it is assumed that simple rules of origin will be simple to satisfy, implement and administer. This assumption is not entirely accurate and not unlike a flat-tax-type remedy for rules of origin – easy to explain but usually unfair in practice.

For example, the wholly produced rules of origin (leaving aside inherently political and complex fisheries issues) are often considered to be simple rules of origin. However, wholly produced origin declarations can be notoriously and even needlessly difficult to prove and document. Why? Because this rule requires supporting origin documentation for every single material found in a wholly produced good. Why bother keeping documentation on every input used when proving a tariff shift on a few critical components will achieve the same result? Furthermore, any rule that is difficult to prove is also likely to be difficult to verify. Therefore, the following recommendations, while not dogmatically anti-simplification by nature, will at least be guided by the maxim: seek – but distrust – simplicity.

Another assumption behind rule simplification proposals is that there can be or should be one type of rule (value added, tariff shift, specified process/input) for identifiable categories of goods (i.e. apparel, prepared foods, machinery). This assumption does not seem to adequately take into consideration the incredibly complex, dynamic and international nature of production. Production and value chains can lengthen and sometimes shorten with breathtaking speed: transforming a corporation, or a whole sector, once committed to tariff-shift rules, to regional value advocates, or vice versa, overnight. This is not to suggest that there is unanimity for a particular rule among members of a particular sector or subsectors. Owing to different design and sourcing strategies, even two producers of nearly identical goods may prefer to operate under completely different types of rules of origin.

That simplicity and flexibility lie in the eye of the beholder is illustrated by a quick overview of the apparel sector in Bangladesh. Starting in the late 1990s, the EU changed its LDC list rules of origin for apparel in that both knit and woven apparel required double transformation (i.e. fabric and clothing must be domestically produced) in order to qualify as originating goods for duty-free entry into the EU (which has been modified under the new EU GSP rules of origin as noted above). The old rule provided a powerful incentive for Bangladeshi entrepreneurs to invest in integrated or at least partially integrated knitwear

production: the spinning mill capacity tripled between 1995 and 2006. This is mostly because investment in knit capacity can start as low as a few million dollars, as opposed to the $15 million to $30 million required for a woven facility, and is easily and entirely expandable or scalable. The results of this origin-led industrial growth and diversification are spectacularly high levels of originating exports of knitwear to the EU: 85 per cent in 2005 and rising. Although recently there have been some increases in domestic woven capacity and corresponding increases in originating exports to the EU, these are mostly in niche markets, including higher-end jean production. Otherwise, like most apparel-producing countries around the world, domestic producers of woven apparel in Bangladesh must import the majority of their woven fabric needs and overall preference rates and volumes into the EU are much lower than for knitwear. Furthermore, the double-transformation requirement has given rise to a small but significant group of specialized knitwear producers in Bangladesh: high-end sweater manufacturers. Unlike a value-added rule of origin, double transformation rules can be observed, regardless of the value of inputs (i.e. fibres/yarns) and can prevent the ghettoization of production into low-value, low-margin apparel. The point is that because of unique product and production characteristics, which will be constantly altered and transformed through the process of innovation, different rules of origin may be required for similar and/or competitive goods in order to attain optimal results.

In addition, the EU previously considered "simplifying" its rules of origin by replacing all existing product specific or list rules with a value added rule of approximately 25-35 percent. Although this form of imposed simplicity could be of real benefit to many producers in Bangladesh, including manufacturers of woven apparel, it could (a) essentially eviscerate the industrial diversification and the knit capacity that the list rules intentionally and/or inadvertently created, (b) terminate sweater and similar production of higher-end goods and (c) eliminate the opportunity for an LDC country such as Cambodia from replicating the industrial growth and diversification achieved by Bangladesh. Simple rules of origin in a complex world can thus result in undesirable policy outcomes, real damage to countries and harm to individuals in LDCs.

Another known disadvantage to simple rules of origin is that they tend to be too vague in many situations and leave the trader or origin verification officer unsure about what to do in a wider variety of situations and uncertainty is the enemy of investment. However, are increasing the transaction costs and stupefying complexity the only alternatives? Not necessarily: in one of the more pleasant paradoxes of origin, it has been observed that the greater the degree of integration between two or more parties (i.e. NAFTA), the greater degree of specificity and complexity in the rules of origin. As outlined earlier, LDC trade does not feature this degree of competitive complexity or volume. Therefore, the solution for LDC harmonization cannot be found in macro-origin simplicity – one size fits all – or micro-origin complexity, but must lie somewhere between these two alternatives.

One of the most compelling reasons to create co-equal rules of origin is the impossibility of identifying which might be the best rule of origin for all LDCs – even on a sector basis. This is due to the simple fact that a rule of origin's restrictiveness is a direct function of any particular country's geographic endowments (i.e. natural resources including energy and proximity to major markets) and its particular level of development. Restrictiveness can even be found in the eye of the beholder, as different firms using different technologies can find different alternatives easier to use. The best alternative in this context is expanded cumulation coupled with co-equal rules or origin.

2. Creating an Origin-Simplification Process

At the same time, two undeniable facts must be recognized: (a) it has been clearly established that different rules of origin by different beneficiaries for the same LDCs are counterproductive and expensive and (b) Brazil, India, Canada, Japan, the EU, the United States and many others are not going take this sitting down – they will not relinquish their existing LDC rules of origin regimes. In light of the established benefits of LDC origin uniformity, as opposed to dogmatic simplicity, and the known improbability of donor countries abandoning their origin regimes, the following are a series of suggestions that combine origin content, origin procedures and the creation of an international origin process: a mechanism for coordinating and facilitating the evolution of standardized LDC regimes. This is not a single or simple harmonized rule of origin but a collaborative system

or mechanism to achieve a standardized LDC origin regime over time. If there is no process, how can harmonization potential be identified, negotiated or implemented?

In order to guarantee that the objectives of Annex F (36) are met, there should be a process whereby all parties meet on a regular basis to discuss the ways and means to facilitate LDC market access through improved rules of origin systems and coordination. Given the highly technical nature of this work, this origin-improving process should include the support of agencies and institutions, in addition to WTO, that have extensive rules of origin expertise including, but not limited to UNCTAD; WCO; the United Nations Economic Commission for Europe; the United Nations Centre for Facilitation of Procedures and Practices for Administration, Commerce and Transport; ICC and regional development banks, where appropriate.

B. Practical Recommendations

1. Step 1 – The Most Important Rule Change Does Not Require New Rules of Origin: Expanded Cumulation

The first issue to be examined is expanded cumulation. This recommendation draws almost exclusively on Harris (2008), who proposes that the dilemma between the development and liberalized rules of origin (as outlined in his quotation below) can be effectively resolved through the mechanism of expanded cumulation.

> *"The tension between market access and development goals in setting rules of origin is not a new problem. A European Commission document*[11] *expresses it well enough to merit quoting at length."*
>
> *"[..] certain [..] countries no longer [want] just to export cotton fibres with a low value added, but [want] to start selling fabrics and clothes. This approach would tend to favour an industrial view of development, with rules of origin requiring a high level of vertical integration. At the same time, certain [other] countries, specializing in labour-intensive industries, would like to be able to buy in semi-finished products so that they can make full use of the advantage that a generally lower level of wages gives them on international markets. Here, a trade-based approach to development, i.e. one that facilitates trade, would be more appropriate. For that, the rules of origin need to be less strict."*

Harris suggests a bold solution, expanded cumulation, for all unilateral trade-preferences-for-development (TPFD) regimes wherein all materials originating in any GSP beneficiary should be cumulable in any other GSP beneficiary, including the grantor of the unilateral trade preference.

The efficiency and self-regulating effectiveness of this remedy is best outlined by Harris's own explanation of a matter raised by GAO:

> *"A recent report by the United States Government Accountability Office (GAO) on United States trade preference programmes provides an anecdote of precisely this situation. A firm in Ghana was importing white T-shirts from Honduras and printing African designs on them, and exporting the printed T-shirts to the United States. These shirts, it turned out, were not eligible for preferences under the GSP because the T-shirts were not originating under GSP, despite the fact that they most likely were originating under the DR-CAFTA and would have entered the United States duty-free had they been exported directly to the United States from Honduras. This situation is troubling in several ways. First, the fact that the Ghanaian producers chose Honduran T-shirts in the first place indicates that these were the most competitive available, possibly even produced in a United States-owned plant in Honduras. The GSP origin rules, by not allowing the use of Honduran shirts, will thus most likely lead the Ghanaian producers to use shirts of lower quality or higher cost, at no benefit to the United States consumer. Indeed, the GAO report indicates that the producer intended to seek out suppliers in South Africa. This undermines the benefits of two United States TPFD programmes at the same time: the GSP by raising the production costs in Ghana, and the DR-CAFTA by limiting the export*

11 COM (2004) 461 Final, 7 July 2004, p.4

opportunities of the Honduran manufacturer. And every single material input, had it been exported directly to the United States, would have entered duty-free.

The "balance" between rules that promote investment in value-adding capacity ("industrial development") and employment-generating assembly ("trade-based development") that was sought in the EU communication cited above, can thus be found in sacrificing "strictness" in the rules applied to any given beneficiary country in favour of "strictness" applied to all beneficiaries taken together. In the Ghana-Honduras case, there is no need to change the rules for printed T-shirts under the GSP or AGOA. Instead, provision only need be made for cumulation across TPFD programmes. This would promote both kinds of development, though spread across beneficiary countries as they choose, and as their markets make possible, and not at the predetermined discretion of the grantor countries.

Compare this expanded cumulation approach to the effects of reforms that simply reduce the observed restrictiveness of the rules. In the latter case, greater use of materials imported from third countries is permitted. When the effective restrictiveness of the rules of origin is reduced through expanded cumulation, this is also true, but the grantors can control which third countries may participate. In the case of expanding cumulation to materials originating in any other TPFD beneficiary or PTA partner, the set of third countries in the cumulation zone is limited to those that have either been previously identified as eligible for preferences based on their level of development, or have completed negotiations of a reciprocal trade agreement with the grantor"(emphasis added).

Although expanded cumulation could complicate the origin certification process (a development that could be significantly tamed by harmonized origin administration as discussed below) it does feature unexpected compensating benefits for and between GSP/LDCs. The current structure of the GSP/LDC rules of origin does not encourage trade between developing countries: indeed, under most LDC regimes, imported developing country content in another developing country's exports could cause the product to be non-originating. This fact effectively diminishes efforts to liberalize trade between developing countries, whereas expanded cumulation would create incentives to liberalize South–South trade.

Another important effect of expanded cumulation is that it substantially reduces the importance of the rule specification. A change of heading requirement, say, is an impediment if the needed inputs of the same heading are not economically available within the beneficiary country or any other cumulable country. However, by expanding the set of cumulable countries, the likelihood of such inputs being economically available increases, and the rule ceases to be an impediment to developing country market access. Note that this formulation then benefits both the country producing the final product and the country that produced the cumulable inputs. It is also important to point out that these benefits can be captured without modification to the existing product-specific rules, and the effect is to reduce burden of any rule that is specified.

2. Step 2 – Create Uniformity Around Wholly Produced Rules of Origin and Minimal Operations

In terms of rule content, the first origin issues to be addressed would be to establish uniform rules of origin as they relate to wholly produced goods. However, these uniform rules would not be designed to replace existing LDC regimes, but rather to create a set of international meta-rules for LDC purposes that would stand above existing national programmes and be applied where agreed upon.

The above-mentioned organization or committee could also develop internationally agreed definitions and any related procedures including records and verification procedures for wholly produced or wholly obtained goods and definitions for those procedures that do not confer origin or minimal operations. These efforts would draw upon the existing work of the WTO Harmonized Work Programme and the Revised Kyoto Convention.

3. Step 3 – Regional Value Content Standardization?

The proposed origin-simplification process could develop internationally agreed definitions and any related procedures, including records and verification procedures, for a percentage or value-added criteria in cases where the finished LDC product is made

with imported inputs. There is near-consensus on this matter (i.e. the EU Everything But Arms interest in a percentage criterion and the existing across-the-board percentage criterion under the United States AGOA regime) and it should not be extremely difficult to achieve international standards for value rules of origin. However, the percentage criterion should be on the basis of maximum imported inputs based on the Agreement on Customs Valuation, as opposed to minimum value added, given the difficulties associated with the latter methodologies. As noted, minimum value-added percentage rules are particularly difficult for LDCs, which face human capital and resource restraints.

4. Other Simplification Issues

With a view to establishing regional and/or national original appeal tribunals the proposed origin-simplification process could also address the creation of an origin appeal tribunal on the above-mentioned origin elements and any other origin issues that evolve into international standards. Appeals encourage common standards and administration, and in doing so, also promote investment.

Additionally, the origin-simplification process could seek common standards on de minimis, roll-up/roll-down, treatment of sets and assortments, packing and packaging, and other cross-cutting issues of general application. Uniformity of treatment of these sorts of issues can greatly facilitate the application for beneficiaries seeking to access multiple preferential markets, as it creates a single language, even where the specific rules themselves are not harmonized. Furthermore, the origin-simplification process could directly promote private-sector capacity-building activities to educate the end-users of the preferential rules.

These activities should be supported by all countries supplying detailed utilization and verification data and all LDCs supplying detailed company information: this level-of-origin data will allow accurate targeting of the most applicable rule of origin from a LDC perspective.

C. Procedural Standards

Excessive and unnecessary origin compliance costs can significantly lower LDC utilization rates and benefits. Many, if not most, of these additional costs can be attributed to the administrative burden of complying with a bewildering array of LDC regimes and procedures. It is evident that that the absence of harmonized LDC origin procedures evolved because there has been no mechanism for coordinating and facilitating the evolution of standardized LDC procedures and/or administration. However, there is a strong case for creating international origin administration standards.

As with origin content, an origin-simplification mechanism such as the LDC Origin Committee is required not to create harmonized LDC procedural standards, but to act as a catalyst to spark the movement towards true international origin procedure standards. Many LDC observers speak of the missed opportunities and efficiencies when GSP/LDC initiatives have not been treated under a single programme or umbrella.

This LDC opportunity has been truly missed. Now international trade policy specialists and institutions are all but demanding increased origin uniformity, both in terms of origin content and origin procedures. An international or umbrella procedural standard for all preferential free trade agreements will contribute to reducing transaction costs as called for by WTO, WCO, ICC, numerous regional development banks and institutions, non-governmental organizations and countless trade specialists. This report recommends that the funding and expertise required for expanding on existing principles – such as those found in the Revised Kyoto Convention – and for crafting new international origin procedural standards should be initiated within the context of the duty-free, quota-free initiative. LDC exporters need this standardization the most and the process should start with them.

The process of creating international certification and origin standards has already begun, as witnessed by recent initiatives launched by WCO and ICC and the increased collaboration between the two parties. The establishment and enforcement of standardized origin procedures lessens the phenomena of regime discretion, which in turn encourages equal treatment between all exporters and importers. Finally, all such initiatives are in fact trade facilitation initiatives and as such, administration of rules of origin could be specifically dealt with in the current WTO trade facilitation negotiations where tariff classification and/or valuation matters are mentioned. Furthermore, all WTO trade facilitation calling for the use of e-commerce

solutions should apply equally to origin matters. E-origin solutions, including the recent appearance of Harmonized System software, can also be utilized to digitize some of the complexities associated with origin content.

One initiative, which only the private sector can undertake, could be extremely facilitative. This deals with the issue of origin liability. As outlined earlier, mistakes in LDC origin certification and/or LDC origin fraud are of increasing concern to importers because in most of these instances they are liable for any additional MFN duties that might become payable. Therefore, many importers are beginning to add their own unique contract clauses, regarding payment being conditional upon the supply of properly completed and valid certificates of origin or even making exporters directly liable for any additional duty payments. Such defensive contract clause management is entirely understandable from the importer's perspective. However, most of these origin conditions change from client to client and many are unnecessarily harsh. All of these result in higher – not lower – overall transaction costs.

In light of the above, it seems the only rational solution would be for ICC, along with other interested parties, including WCO, to investigate the creation of INCOTERMS for certificates of origin and related origin procedures. As with other INCOTERMS, they would strike a balance of rights and obligations between exporter/supplier and importer/first purchaser. This would encourage and improve the nature and level of origin dialogue between these two parties. Improved origin exchange between private-sector parties should lead to improved origin information and documentation being supplied to public authorities such as customs or certifying entities. Better quality information should facilitate the origin monitoring and origin verification responsibilities of these parties. Finally, origin disputes between exporter and importer could be resolved through established ICC alternative dispute resolution and arbitration procedures.

D. Conclusions

In sum, the path to improved LDC preference utilization and subsequent positive development outcomes lies in making useful reforms to the overall architecture of the various national programmes by expanding cumulation and standardizing definitions and procedures. Undue focus on the definition of the specific rules alone results in missing the forest for the trees. What is needed is a more harmonized approach to rules of origin, developing a better common language, as well as better integrated systems that create predictability and certainty in market access so as to promote investment in real productive capacity in the developing world.

Even this level of harmonization will involve overcoming individual national habits and preconceptions, but it is a necessary first step towards achieving greater simplification that can help meet the goals of the preferential trading system.

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