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Efforts to Establish Multilateral Rules

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

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

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

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

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

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

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

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

[2] See United Kingdom Finance Act of 1919.
[3] See Tariff Act of 1890, Chapter 1244, paragraph 6, 26 Stat. 567, 613 (1891).
[4] See PCT/174, pp. 3–4.
[5] See, for instance, the 1951 report on "Customs Treatment of Samples and Advertising Material, Documentary Requirements for the Importation of Goods, and Consular Formalities: Resolutions of the International Chamber of Commerce" (GATT/CP.6/36, adopted 24 October 1951, II/210) and the 1952 report on "Documentary Requirements for Imports, Consular Formalities, Valuation for Customs Purposes, Nationality of Imported Goods and Formalities connected with Quantitative Restrictions" (G/28, adopted 7 November 1952, 15/100).

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

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

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

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

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

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

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

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

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

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

Substantial Transformation or Sufficient Working or Processing

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

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

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

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

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

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

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

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

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

A. CHANGE OF TARIFF HEADING

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

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

- Advantages

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

- Disadvantages

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

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

B. LISTS OF MANUFACTURING OR PROCESSING OPERATIONS

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

- Advantages

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

- Disadvantages

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

C. AD VALOREM PERCENTAGE RULE

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

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

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

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

This method may be applied

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

- Advantages

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

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

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

- Disadvantages

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

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

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

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

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

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

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

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

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

1.2. The UNCTAD Working Group on Rules of Origin

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

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

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

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

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

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

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

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

[12] Ibid., para. 7.

[13] Ibid., para. 7.

[14] Ibid., para. 7.

[15] Ibid., para. 8.