Chapter 9

RULES OF ORIGIN

OVERVIEW OF RULES

Rules of origin are used to determine the "nationality" of goods traded in international commerce. Yet there is no internationally agreed upon rules of origin. Each countries or each jurisdiction that administers a regional trade agreement—the NAFTA and the EU, for example—have presently established their own rules of origin. Rules of origin are divided into two categories: 1) rules relating to preferential treatment, and (2) those relating to non-preferential treatment. The former is divisible into rules on general preferential treatment for developing countries and those relating to regional trade agreements (see Figure 9-1).

Figure 9-1

- Rules relating to non-preferential treatment
- Rules relating to preferential treatment
  - Rules on general preferential treatment (GSP) (for developing countries)
  - Rules relating to regional trade agreements

Rules of origin relating to non-preferential treatment will be used as follows, except for the application of preferential tariffs: (1) for selecting items in enforcing trade-related measures that specify exporting countries (e.g. quantitative restrictions); (2) for compiling trade statistics; and (3) for determining the country of origin in marking the origin of certain goods. (Some countries have purpose-oriented sets of rules whose contents are different; several kinds of rules of origin in one country may therefore exist.)

In contrast, preferential rules of origin are used for giving preferential treatment to imported goods. These rules are applied to determine whether particular products are exported from countries that are given preferential treatment based on the generalized system of preferences when developed countries import the products. In addition, in regional groupings such as the NAFTA and the EEA, preferential rules of origin are used for giving preferential treatment to goods, which originate in the region.

With respect to trade policy, rules of origin should play a neutral role. However, they sometimes are used for protectionist ends: origin rules that are too restrictive or that are enforced arbitrarily can expand improperly the coverage of trade restrictions.

In general, rules of origin have not been adequately addressed at the international level. For many years, the GATT contained no specific provisions on rules of origin other than Article IX, which deals with marking requirements (i.e. “marks of origin”). Rules of origin are only covered by the GATT's general provisions, such as Article I (MFN treatment) and Article XXIV:5, the latter of which requires that free trade areas shall not increase restrictions on trade with Members who are not part of the free trade area or parties to the customs union. Aside from the GATT, the International Convention on Simplification and Harmonization of Customs Procedures (the Kyoto Convention), concluded under the aegis of the Customs Cooperation Council (commonly called “WCO”, abbreviated from “World Customs Organization”), contains an Annex on rules of origin. Although binding on parties that accept it, the range of permitted options is so wide that the Annex imposes no effective restrictions. The ability of the Annex to serve as a set of international rules is thus severely limited from the outset.

The imposition of rules of origin should properly be a technical and neutral matter. But because no common international standards exist, rules are increasingly being formulated and administered in an arbitrary fashion in an attempt to achieve protectionist policy objectives. To remedy the trade problems

this has caused, countries are now in the process of formulating harmonized non-preferential rules of origin under the terms outlined in the Agreement on Rules of Origin, an Annex to the WTO Agreement.

LEGAL FRAMEWORK

Summary of the Agreement on Rules of Origin

The Agreement reached in the Uruguay Round provides a programme for the harmonization of rules of origin for application to all non-preferential commercial policy instruments, including most-favoured-nation treatment, anti-dumping and countervailing duties, marking requirements under Article IX of the GATT, and government procurement. It also establishes disciplines that individual countries must observe in instituting or operating rules of origin and provides for the framework for the harmonization of rules and dispute settlement procedures.

(a) Principles

Rules of origin:

- must apply equally for all purposes of non-preferential treatment;
- must be objective, understandable, and predictable;
- must not be used directly or indirectly as instruments to pursue trade objectives;
- must not, in and of themselves, have a restrictive, distorting, or disruptive influence on international trade; etc.

(b) Framework of Harmonization Programme

- The WTO undertakes the harmonization programme in conjunction with the WCO (the WTO Committee on Rules of Origin and the WCO Technical Committee on Rules of Origin).
- The Technical Committee is required to submit its results on the technical aspects of the operation and status of the Agreement. The

WTO Committee will review the results from the perspective of overall coherence.

(c) Schedule of Harmonization Programme

- The harmonization programme shall begin as soon as possible after the Agreement takes effect, and will be completed within three years of initiation (this programme is still ongoing, as mentioned in the section below, “Harmonization of the Rules of Origin Relating to Non-Preferential Treatment”)
- Harmonization shall, in principle, follow the chapters and sections of the Harmonized System nomenclature, and the WTO Committee shall request the interpretations and opinions resulting from the harmonization work conducted by the Technical Committee, which is required to submit its results within specific time frames (the work conducted by the Technical Committee has already been completed, as mentioned in the section below).
- The WTO Committee shall regularly review the work of the Technical Committee and, when all work has been completed, will consider the results in term of their overall coherence.
- The WTO Ministerial Conference will adopt the results as an integral part of the Agreement.

(d) Disciplines Applicable to Preferential Rules of Origin (Annex II)

The Agreement exempts the rules of origin used in the application of preferential tariffs from harmonization. The Agreement does set down a number of disciplines in Annex II that are applicable to preferential regimes. Thus, according to the Agreement, preferential rules of origin:

- should clearly define requirements for conferring origin;
- should be based on a positive standard;
- should be published in accordance with GATT Article X:1; and
- should not be applied retroactively.

HARMONIZATION OF THE RULES OF ORIGIN RELATING TO NON-PREFERENTIAL TREATMENT

Work on the harmonization of rules of origin formally began in July 1995. At present, negotiators are considering (1) rules of origin in the context of individual items and (2) general provisions containing general rules (overall architecture) that will be applied widely to various items. Although the Agreement on Rules of Origin specified a deadline of three years for the harmonization programme (i.e. July 1998), this programme is still ongoing.

By referring to the HS Code, negotiators are considering rules of origin relating to individual items, based on the following three standards, i.e. (1) "Wholly Obtained Criteria", which applies to goods that are domestically produced only in a specific country; (ii) "Minimal Operation Criteria", for simple processing that is negligible in origin determination; and (3) "Substantial Transformation Criteria" in which more than two countries are involved in the production of goods and their origin will be conferred upon the country where the last substantial transformation has been carried out. In light of the Substantial Transformation Criteria, the Agreement allows negotiators to introduce a "Change in Tariff Classification Criteria" and, as a supplementary criteria for the Substantial Transformation Criteria, the "*Ad Valorem* Criteria" and the "Manufacturing or Processing Operations Criteria" in order to determine whether the Substantial Transformation has occurred.

The procedures call for the WCO to perform technical studies for individual items. When the WCO reaches a consensus on an item, it is referred to the WTO for endorsement, and is only considered formally agreed upon after this endorsement is obtained. Should the technical arguments be exhausted and the WCO still be unable to reach a consensus, the item is referred to the WTO for decision. The WTO then becomes the forum for consideration, studying the item in light of the sensitivities and concerns of individual countries. The technical studies undertaken by the WCO have been completed as of the 17th meeting held in May 1999. The items on which the WCO could not reach consensus are being discussed by the WTO.

Debate is now taking place on whether WTO studies of regulations on individual items should discuss each individual item found in the HS Code or whether they should discuss common problems for categories of items. This

issue is now under study. (There are 469 total issues, 349 of which are concerned with categories 25-97.)

For the rules of origin for individual items noted in Annex III of the Agreement, categories 1-97 were to have their first review between September 1999 and September 2000. Almost all of the categories were discussed. Running parallel to this was a study of general rules that would be applied across the board to all items. The WTO Rules of Origin Committee met eight times during 2000.

As of this writing, WTO approval and formal agreement had been reached on only about 1,750 HS subheadings (out of a total of 5,113 HS subheadings). The WTO is now undergoing intensive study to complete the programme as soon as possible.

ECONOMIC IMPLICATIONS

Rules of origin are an important factor in determining the tariffs to be imposed on specific goods and whether quantitative and other trade restrictive measures may be applied to imported goods. Consequently, the manner in which these rules are formulated and applied may have an enormous impact on the flow of trade and investment. A country's manipulation of origin rules can substantially affect direct investment, parts procurement, and other business activities of companies seeking to establish origin in that country.

Furthermore, at a time when increasing numbers of companies are globalizing their parts procurement and production networks, the significant differences in national rules of origin can work to disrupt the free flow of trade. Unnecessary complications and confusion arise when the same product may have several different countries of origin depending on the country for which it is destined. Needless to say, this greatly diminishes the exporter's predictability of trade. In addition, a change in the rules of origin of a particular country may force globalized producers to add certain manufacturing processes in that country, with substantial resulting costs.

Properly formulated and applied, rules of origin should have a neutral effect on trade. Arbitrary formulation and application, however, will result in a country expanding its trade restrictive measures, and an increase in the likelihood that such measures will distort trade as mentioned in the section below, “Amending the Rules of Origin for Textile Products”. Reducing tariffs in

broad sectors in the Uruguay Round and strengthening disciplines to anti-dumping sectors and others, rules of origin may be used as hidden trade restrictive measures. Establishing fair and common international rule in this area is an urgent issue.

PROBLEMS OF TRADE POLICIES AND MEASURES IN INDIVIDUAL COUNTRIES

Well-organized rules of origin have been adopted mostly by developed countries. These same countries also account for most cases of arbitrary application.

With the implementation of the Agreement, the WTO and the WCO began the process of harmonizing non-preferential rules of origin. The completion of this harmonizing process should resolve the majority of the problems that may arise under such non-preferential rules of origin. In cooperation with other countries, Japan should continue to contribute positively to the developmental process on harmonizing non-preferential rules of origin.

The actions of the WTO and the WCO in seeking to harmonize the non-preferential rules of origin will not, however, solve all potential problems. For instance, preferential origin rules are excluded from the harmonization programme. Moreover, the current abuse and lack of uniformity of such rules will remain unabated during the transition period leading up to harmonization. Presently in relation to preferential rules of origin, each Member is required to notify the WTO about the contents of these rules in accordance with the Agreement. In addition, the Trade Policies Review Body and the Committee on Regional Trade Agreements are considering issues relating to these rules of origin. In this regard, Japan has pointed out that the rules of origin within the NAFTA in particular may become too restrictive.

Matters relating to NAFTA are dealt with separately in Chapter 15.

1. UNITED STATES

Lack of Consistency and Clarity

Non-preferential rules of origin in the United States can be divided into three categories according to their purposes: (1) rules for origin marking; (2) rules for the enforcement of quantitative restrictions on importation in the context of textile products; and (3) rules that are applied widely in enforcing trade-related measures such as application of tariffs and import quotas (but excepting that of textile products). Further, US preferential rules of origin are divided into (4) general preferential rules of origin that confer preferential treatment on good originating in developing countries and (5) NAFTA rules of origin and rules of origin marking. It is therefore said that the US rules of origin constitute a complicated legal regime.

There are two kinds of rules of origin about marking in the United States, the contents of which are different: those established by the US Tariff Act, and those established by the Federal Trade Commission (rules framed by the latter organization were designed for protecting the right of consumers). It is possible that the two kinds of rules could be contributing to the confusion among exporters. Further, the rules mentioned in (3) above have been developed through customs interpretation and case law. In general, courts and the US Customs Service establish the origin of a product processed in two or more countries based on where the product was “substantially transformed” into a new and different article of commerce. Since US Customs and the courts decide whether a certain product has undergone a “substantial transformation” on a case-by-case basis, origin determinations have been extremely unpredictable.

The United States itself has recognized that its current case-by-case approach lacks predictability. Desiring to increase objectivity and certainty, the government of the United States in January 1994 proposed amendments to its rules of origin to be applied to imports that unified all rules of origin relating to non-preferential treatment. Two exceptions were the FTC’s rules of origin on marking requirements and textile products. The US government stated that the amendments were intended to codify customs rules of origin in order to provide rules that are more objective and transparent. The amended rules would determine origin based on a change in tariff classification. The United States deserves praise for its efforts in attempting to bring clarity to its rules of origin. However, implementation of this rule has been put off in view of the harmonization programme for non-preferential rules of origin undertaken by the WTO.

According to the rules of origin marking prescribed in the US Tariff Act, marking of origin on watch and clocks must be stated on components parts of watches/clocks (i.e. movements, batteries, cases, bands). In addition, the ways of marking are elaborately explained in the act. Such rules will force manufactures of watches/clocks to shoulder severe burdens in the context of production control. As a result, Japan urged the U.S. to limit such marking requirement and leave the choice of marking methods at the discretion of manufacturers through deregulation dialogue between Japan and the U.S., and so forth.

Problems regarding non-preferential rules of origin of the United States are expected to be solved through the harmonization process. However, appropriate actions based on GATT and the relevant provisions of the WTO Agreement will be also necessary, and Japan should continue to monitor whether such rules are administered in a consistent and impartial manner.

Amending the Rules of Origin for Textile Products

Amendments to the rules of origin for textile products (Section 334 of the Uruguay Round Agreement Act) took effect in the United States in October 1995. The new rules of origin applied to all textile products imported and cleared through United States Customs after 1 July 1996. The key points in the amendments are:

- For clothing, origin was previously conferred on the country in which cutting was performed, but under the new rules will be conferred on the country in which sewing was performed.
- For weaves, origin was previously conferred if dip dyeing, printing, and two other ancillary processes took place (the “2 + 2” rule), but under the new rules will be conferred on the country where the weaving took place regardless of any other processing.

In accordance with the WTO dispute-settlement procedures, the EU requested bilateral consultations under Article XXII of the GATT with the United States over this issue in June 1997. The EU had been importing silk weaves from China and cotton weaves from Turkey and Egypt, processing them into scarves and other objects, and exporting them to the United States as EU products. Under the new rules, they would not be allowed to bear “made in EU” designations, and would fall under the US quotas for the countries in which they

were woven. However, the consultation—in which Japan, Hong Kong, Switzerland, and Thailand intended to participate—was solved because an agreement between the United States and the EU was finally reached just before the beginning of the first consultation. The key points in the agreement are:

- If the work on harmonizing rules of origin within the framework of the WTO is to be completed by the deadline set by the Agreement on Rules of Origin (i.e. July 1998), the results of this work must correspond with the amended rules of origin within two months after the completion of such work.
- If the work is not to be completed by the deadline mentioned above, the United States must take necessary legal measures, which will reinstitute the rules of origin relating to textiles before their amendments.
- As a provisional measure to be taken by the July deadline, the United States does not require the EU to mark “made in (the name of a country that weaves textiles)” on imported textiles (e.g. silk scarves dyed and printed within the territory of the EU).
- The United States exempt some printed cotton fabrics from textile visa requirements in respect of Egypt, Turkey, Thailand and Indonesia.
- The United States exempts some printed man-made fibre fabrics from quota coverage in respect of Malaysia, Indonesia, and Thailand.
- If the United States fails to take the above-mentioned measures, the EU then has a right to request, again, consultation under Article XXII of the GATT.

In November 1998, the EU—arguing that, after the deadline, a bill introduced by the US Congress still did not reflect the previous agreement made between the EU and the United States—requested another consultation under Article XXII. At the first formal consultation, held on 15 January 1999, the EU advanced arguments on the compatibility of the US measures and rules of origin with the WTO Agreement. In this consultation, because the United States avoided immediate answers on some issues, the parties could not resolve the dispute. It should be noted that Japan and other countries (Pakistan, India, Hong Kong, and Switzerland) participated in the consultations.

Negotiations between the two countries produced a US/EU agreement that was formally notified to the WTO in July 2000, bringing an end to dispute settlement procedures under the GATT Article XXII. The United States amended Section 334 of the Uruguay Round Implementation Act to create Section 405 of the Trade and Development Act of 2000, which was promulgated on 18 May 2000. This resulted in the return to US rules of origin that existed prior to the Article XXII consultations. Japan is pleased that these measures have been brought into conformance with Article 2 of the Rules of Origin Agreement.

2. EUROPEAN UNION

Under the EU regulations, a product processed in two or more countries originates in "the country in which the last substantial process or operation . . . was performed . . . resulting in the manufacture of a new product or representing an important stage of manufacture".

Rules of Origin for Photocopiers

In July 1989, the EU introduced new rules of origin applicable to photocopiers. According to the new rules, certain processes would not, in and of themselves, confer origin on the country wherein those operations took place. However, by failing to define the criteria by which a product's origin is determined, such "negative lists" create enormous predictability problems for exporters. The use of such negative standards is expressly prohibited under Article 2(f) of the Agreement. Japan should take every opportunity to highlight the problem and the EU is urged to abolish this practice, which is a clear violation of Article 2(f) of the Agreement on Rules of Origin.

Rules of Origin for Semiconductors

The manufacture of semiconductors includes two processes: diffusion and assembly. In February 1989, the EU changed its practice of conferring origin on semiconductors based on the place of assembly. It began conferring origin based on the place of diffusion, stating that diffusion is the more sophisticated of the two processes. To obtain EU origin after this policy shift, Japanese and US

subsidiaries with only assembly operations in the European Union were forced to make additional investments in the region.

Japan considers that the change apparently was based on the EU intention to promote investment in the European Union and to protect the EU manufacturers that perform assembly processes abroad, both of which are trade policy objectives.

Rules of origin for semiconductors are to be harmonized through the program now being carried out by the WTO and the WCO. To avoid the introduction of such measures similar to that described above, the harmonization programme should be completed as quickly as possible, and efforts should be continued.