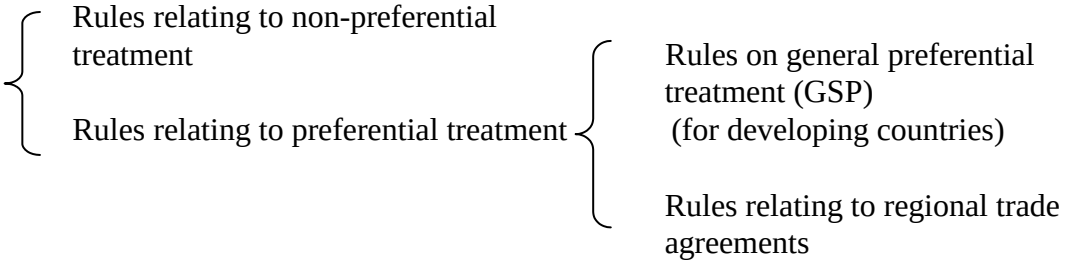
Chapter 9

RULES OF ORIGIN

1. OVERVIEW OF RULES

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

Figure 9-1
Types of Rules of Origin



Rules of origin relating to non-preferential treatment are, except for the application of preferential tariffs, used as follows: (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 upon importation by developed countries to determine whether particular products are exported from countries that are subject to preferential treatment under the generalized system of preferences. In addition, in regional groupings such as the NAFTA and the EEA, preferential rules of origin are used for giving preferential treatment to goods, originating within 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 the "World Customs Organization" or "WCO"), contains an Annex on rules of origin. In 1999, the WCO amended the Kyoto Convention for the first time in around 25 years; Japan accepted the amendments in 2001. The Specific Annex on rules of origin in the amended Kyoto Convention, however, was only subjected to the minimum necessary review on the grounds that a further review would be undertaken once the WTO completed its work on harmonization of rules of origin. As acceptance of Specific Annexes, including the one on rules of origin, is voluntary, the Annexes have little binding power as international rules.

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 to achieve protectionist policy objectives. To remedy the trade problems this has caused, countries are in the process of formulating harmonized non-preferential rules of origin under the terms outlined in the Agreement on Rules of Origin, based on the Uruguay Round Agreement on Rules of Origin.

2. LEGAL FRAMEWORK

Summary of the Agreement on Rules of Origin

The Agreement reached in the Uruguay Round provides a programme for harmonizing rules of origin and applying them 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 harmonizing 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 policy objectives; and
- 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 WCO 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 be completed within three years of initiation. (This programme is still ongoing, as mentioned in the section on "Harmonization of the Rules of Origin Relating to Non-Preferential Treatment," below.)
- 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 WCO Technical Committee. The WCO Technical Committee is required to submit its results within specific time frames. (The work conducted by the WCO Technical Committee has already been completed, as discussed in the section below.)
- The WTO Committee shall regularly review the work of the WCO Technical Committee and, when all work has been completed, will consider the results in terms 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, however, 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.

3. 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.

Using the HS Code, negotiators are considering rules of origin relating to individual items, based on the following three standards: (1) "Wholly Obtained Criteria", which applies to goods that are domestically produced only in a specific country; (2) "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 occurred. In light of the Substantial Transformation Criteria, the Agreement allows negotiators to introduce a "Change in Tariff Classification Criteria" and, as 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 on individual items. When the WCO reaches a consensus on an item, it is referred to the WTO for endorsement, and is considered formally agreed upon only 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 since the 17th meeting held in May 1999. The items on which the WCO could not reach consensus are being discussed by the WTO.

Discussions on rules of origin under the WTO are taking place not on individual HS items, but by issues based on common problems with respect to each HS Chapter. (There are 486 total issues,) At the writing of this report, agreement has been reached covering approximately 70% of the total issues.

Since July 2002, the General Council, which supervises the Committee for Rules of Origin, has taken the lead in discussing the 94 core unresolved issues. The 94 core issues include issues which Japan considers important and Japan will need to assume an active part in the discussions. Japan is particularly interested in the following two issues, which will have a vast impact on the harmonization of rules of origin:

Regarding rules about machinery, the Chairperson of the Committee on Rules of Origin proposed double-rule: importing countries may choose either "added-value criteria or change in tariff classification, as a compromise at a meeting in 2006 to solve the conflict. Since then, discussion about the proposal continued but a conclusion has not yet been reached. The Chairperson reported the situation to the General Council in July 2007 and agreed to seek guidance from the General Council while suspending the discussion about the implications of the Harmonized Rules of Origin on other WTO agreements and the double rule for machinery. Meanwhile discussions about general provisions and technical matters to be considered will continue.

(1) Implications of Harmonized Rules of Origin on other WTO Agreements

It is unclear how harmonized rules will affect other WTO agreements and many Members, therefore, are unable to be flexible on individual issues in the process of the harmonization work programme. Discussions occurred to develop a uniform understanding on the impact that Harmonized Rules of Origin will have on other WTO agreements, but the fact is as said above.

(2) Adoption of Value-Added Rule

The discussions consider the potential for adopting value-added rules as one measures to be used in determining "last substantial transformation," the criteria for many items, particularly in the machinery sector. This raises the potential for origin to be changed due to changes in foreign exchange rates, materials costs, labor costs, etc., which would be problematic in terms of predictability, transparency and consistency required in the preamble to the Rules of Origin Agreement. Japan objects to the adoption of the rules, but the fact remains as stated above.

With the implementation of the Agreement, the WTO and the WCO began 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 for harmonizing non-preferential rules of origin. However, there remains concern over preferential legislation, applying the current rules during the transition period leading up to harmonization and over preferential rules of origin which are excluded from the harmonization process. The latter is of particular concern given the recent trend towards negotiating free trade agreements. With respect to preferential rules of origin, each Member is required to notify its rules to the WTO and maintain their consistency with Annex II of the Agreement. In addition, the Trade Policy Review Body and the Committee on Regional Trade Agreements reviews rules of origin issues to ensure compliance. (*See* "Part I: Problems of Trade Policies and Measures in Individual Countries and Regions" in regard to the regulations of respective countries and the issues these present.)

4. ECONOMIC ASPECTS AND SIGNIFICANCE

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 can 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.

Recently, given an increased push by several countries to pursue FTA's throughout the world, concern is mounting over the so-called 'spaghetti bowl phenomenon' where varying rules of origin and varying tariff schedules based on origin criss-cross around the world as noodles in a bowl. In light of this, Japan should strive for reciprocal consistency of rules of origin in FTA negotiations. However, we have to note that the differences in national rules of origin are attributed to the fact that negotiations were based on the problems particular to each concerned party. It is also

notable that the rules of origin defined in each country reflect conditions for receiving preferential treatment and are not the same as the ones defined in countries which receive non-preferential treatment. Under this situation, discussions initiated by the chemical industry in APEC to seek a common understanding on desirable product-specific rules of origin on chemical products may be notable.

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 increase the likelihood that such measures will distort trade (*see* "US–Textile Products", below). As a result of reducing tariffs in broad sectors during several Rounds and strengthening disciplines in anti-dumping sectors and others, rules of origin may be used as hidden trade restrictive measures. Establishing fair, neutral and common international rules in this area is an urgent issue.