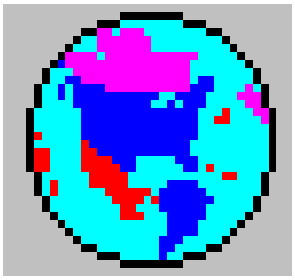
THE LAW OF
REGIONAL ECONOMIC INTEGRATION
IN THE AMERICAN HEMISPHERE



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Unit IX

Rules of Origin

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Guiding Questions

1. Why are the "rules of origin" important? Think about situations relating to the imposition of quota or anti-dumping duties. Also think about situations in the Free Trade Area and Customs Union. In the ever-growing situation of "global sourcing" (e.g., 20% US + 30% Mexican + 30% Chinese components + 20% Nigerian) does this concept still retain its raison d'être?

2. Compare different methods determining the origins such as "substantial transformation" and "value-added percentage" test. What are their merits and demerits? Look carefully at a real example of rules of origin in the course material.

3. Pay attention to some special rules of origins applicable to automobiles and textiles in NAFTA context. See also mini-customs union about certain products like automatic data processing goods and color cathode-ray television picture tubes.

I. Introduction

1-1. Overview

http://www.sice.oas.org/summary/nafta/nafta4.asp

Chapter Four: Rules of Origin

Rules of origin are an essential part of any free-trade agreement. They provide the basis for customs officials to determine whether goods are entitled to the more liberal tariff treatment provided for in the Agreement. In essence, the rules of origin ensure that only goods that have been the subject of substantial economic activity within the free trade area are eligible for the more liberal tariff conditions created by the NAFTA.

Chapter four sets out the rules for determining whether a good imported from another NAFTA Party is an "originating" good. If a good qualifies as an originating good under this chapter, it is eligible for: preferential tariff treatment under Article 302; preferential treatment with regard to customs user fees under Article 310; preferential tariff and quota treatment under annexes 300-A (automotive), annex 300-B (Textiles) and Article 801 and annex 801.1 (bilateral emergency action); and preferential treatment accorded to "goods of a Party" under the NAFTA, including with regard to quantitative restrictions and country of origin marking under chapter three, because the definition of "goods of a Party" under Article 201 includes originating goods.

Article 401 sets out the four basic rules for determining whether a good originates: if they are wholly obtained or produced in the NAFTA region; if they are produced entirely from originating materials, i.e., materials which originate in their own right under the rules of origin; if the non-originating materials used in their production undergo the specified change in tariff classification set out for that good in annex 401 and, where required, contain the required level of North American content; or where goods and their parts are classified in the same tariff heading, which is not further subdivided into subheadings, or subheading, goods originate if they satisfy a regional value-content requirement.

Annex 401 sets out the applicable change in tariff classification for each good and identifies those goods that may also be required to satisfy a regional value-content requirement. For many goods, the annex provides two alternative rules under which a good may qualify as an originating good a rule based solely on a change in tariff classification, and a rule based on the combination of a change in tariff classification and a regional value-content requirement. For example, certain machinery and equipment qualify if their parts are made in the region. Alternatively, if the parts are imported, the good may still qualify if production results in a change from a parts' subheading to a finished good subheading and the good contains the required level of North American content. In addition, annex 401 specifies that certain goods, such as engine parts, may originate

without undergoing a change in tariff classification if they satisfy a regional value-content requirement.

Article 402 sets out the methods for calculating the regional value content for those goods that are required to meet this test. For most goods, there are two options: the transaction-value method and the net-cost method. Under the transaction-value method, the value of non originating materials used by the producer in the production of a good is subtracted from the transaction value of the good (i.e., the price actually paid or payable), and then divided by the price to determine the content level. The required content level under the transaction value is 60 percent, although certain chemical products must meet a 65 percent level. Under the net-cost method, the following costs are subtracted from the total cost of a good to determine the net cost of the good: royalties, shipping and packing, marketing, sales promotion and after-market services, and interest costs in excess of 700 basis points above government borrowing rates for comparable maturities. Once the net cost is calculated, the regional value content is determined by subtracting the value of non-originating materials used by the producer from the net cost and then dividing by the net cost to obtain the regional value content. The required content level under the net cost method is 50 percent, with two exceptions. It is 55 percent for footwear, and, as indicated below, it increases over time for automotive products.

Article 403 sets out three methods for calculating the net cost of a good. In addition, the uniform regulations called for in Article 511 set out provisions regarding the reasonable allocation of costs for purposes of calculating the net cost of a good. Although most producers have the option of using either method, the net cost method must be used for certain products such as automotive goods and footwear, as well as when the transaction value is not acceptable under the GATT Customs Valuation Code or when a producer sells more than 85 percent of its production to related persons.

Article 403 establishes the special rules for calculating the regional value-content of automotive goods under the net-cost method. The tracing requirement applies to the calculation of the value of non-originating materials. It requires each producer to report the value of specified parts imported from outside of North America to the next producer in the production chain and the second producer to include that value in its calculation of the value of non-originating materials in its good.

For cars, light vehicles and their original equipment pans, tracing applies to the value of non-North American parts imported under the tariff provisions identified in annex 403.1. For example, the tariff provisions listed in that annex include the sub-heading for brakes and their parts. If a brake producer imports a non-North American brake part to manufacture brakes that are sold to a car assembler, the brake producer reports the value of the brake part the assembler. The assembler, in turn, includes the value of that non-North American part in its calculation of the value of non-originating materials in its good.

In the case of other motor vehicles and their engines and transmissions, those parts identified in annex 403.2 are required to be traced when calculating the value content. To provide automotive producers with greater flexibility, Article 403 also sets out special

averaging provisions for parts and vehicle and producers. Parts producers have a number of choices for averaging their calculation for parts that are classified under the same specified tariff provisions. Vehicle producers are allowed to average their regional value content for their fiscal year over: the same model line produced in a plant; the same class of vehicles produced in a plant; or the same model line produced in the territory of a NAFTA Party.

Under Article 403, the regional value content level of automotive goods rises in two steps over eight years from 50 percent to 62.5 percent for cars, light trucks and their engines and transmissions, and from 50 percent to 60 percent for other motor vehicles and parts. Producers who invest in new plants will be able to qualify their vehicles for preferential tariff treatment at a 50 percent content level for five years after the production of the first prototype if they have not previously produced that type of vehicle in the NAFTA region. A vehicle produced in a re-fitted plant will be able to qualify for tariff preferences at a 50 percent content level for two years if it is a different type of vehicle than produced before the plant was refitted.

Article 404 allows producers to accumulate their production, including with producers located in other NAFTA Parties, when determining whether a good satisfies a specified change in tariff classification or meets a regional value-content level. Under the de-minimis rule contained in Article 405, goods will not be precluded from enjoying preferential treatment if they contain a small level of non-originating materials that fail to meet the requirements of annex 401. This rule allows a good to originate if non-originating materials used in its production do not undergo the required change in tariff classification, as long as the value of those materials does not exceed 7 percent of the transaction value or the total cost of the good. In addition, a good is not required to meet a regional value-content requirement if the value of all non-originating materials is less than 7 percent of the transaction value or total cost. The rule may not be used for specified non-originating materials used to produce specified goods, for example milk used to make dairy products .

The special de-minimis rule for textile and apparel goods requires that the weight of non-originating fibres and yarns used in the production of the principal component of the textile or apparel good be less than 7 percent of the weight of that component in order to qualify for preferential tariff treatment under this provision.

Article 406 allows producers to use any of the inventory control methods set out in the uniform regulations for determining the origin of fungible good de-minimis s or materials where non-originating and originating materials or goods are stored together. This provision allows producers to avoid the costs of duplicating facilities for storing originating and non originating materials and goods separately in their general inventory.

Articles 407, 408, 409 and 410 set out the rules for treating accessories, spare parts and tools, indirect materials used in production (e.g., lubricants, safety equipment and fuel), packaging and packing materials and containers when determining whether a good originates under a tariff classification change test or a value-content test.

Article 411 stipulates that goods which undergo further production or other processing outside the NAFTA region shall not be considered to be originating goods.

Article 412 provides that goods do not originate if their production involves mere dilution with water or another substance that does not materially alter the characteristics of the good, or if they qualify because of a production or pricing practice that can be demonstrated on the basis of a preponderance of evidence to have been undertaken by the producer with the objective of circumventing the rules of a origin.

Article 413 sets out a number of interpretative provisions for applying the above rules.

Article 414 requires the Parties to consult regularly to ensure that the provisions of chapter four are administered effectively, uniformly and consistently with the objectives of the NAFTA, and to co-operate in the administration of the rules of origin as set out under chapter five (customs procedures). This provision also provides that any NAFTA Party may propose modifications to the rules of origin.

1-2. Legal Text (Edited Version)

Chapter Four: Rules of Origin

Article 401: Originating Goods

Except as otherwise provided in this Chapter, a good shall originate in the territory of a Party where:

a) the good is wholly obtained or produced entirely in the territory of one or more of the Parties, as defined in Article 415;

b) each of the non-originating materials used in the production of the good undergoes an applicable change in tariff classification set out in Annex 401 as a result of production occurring entirely in the territory of one or more of the Parties, or the good otherwise satisfies the applicable requirements of that Annex where no change in tariff classification is required, and the good satisfies all other applicable requirements of this Chapter;

c) the good is produced entirely in the territory of one or more of the Parties exclusively from originating materials; or

d) except for a good provided for in Chapters 61 through 63 of the Harmonized System, the good is produced entirely in the territory of one or more of the Parties but one or more of the non-originating materials provided for as parts under the Harmonized System that are used in the production of the good does not undergo a change in tariff classification because

(i) the good was imported into the territory of a Party in an unassembled or a disassembled form but was classified as an assembled good pursuant to General Rule of Interpretation 2(a) of the Harmonized System, or

(ii) the heading for the good provides for and specifically describes both the good itself and its parts and is not further subdivided into subheadings, or the subheading for the good provides for and specifically describes both the good itself and its parts,

provided that the regional value content of the good, determined in accordance with Article 402, is not less than 60 percent where the transaction value method is used, or is not less than 50 percent where the net cost method is used, and that the good satisfies all other applicable requirements of this Chapter.

Article 402: Regional Value Content

1. Except as provided in paragraph 5, each Party shall provide that the regional value content of a good shall be calculated, at the choice of the exporter or producer of the good, on the basis of either the transaction value method set out in paragraph 2 or the net cost method set out in paragraph 3.

2. Each Party shall provide that an exporter or producer may calculate the regional value content of a good on the basis of the following transaction value method:

$$RVC = \frac{TV - VNM}{TV} \times 100$$

where RVC is the regional value content, expressed as a percentage;
TV is the transaction value of the good adjusted to a F.O.B. basis; and
VNM is the value of non-originating materials used by the producer in the production of the good.

3. Each Party shall provide that an exporter or producer may calculate the regional value content of a good on the basis of the following net cost method:

$$RVC = \frac{NC - VNM}{NC} \times 100$$

where

RVC
is the regional value content, expressed as a percentage;
NC
is the net cost of the good; and
VNM
is the value of non-originating materials used by the producer in the production of the good.

4. Except as provided in Article 403(1) and for a motor vehicle identified in Article 403(2) or a component identified in Annex 403.2, the value of non-originating materials used by the producer in the production of a good shall not, for purposes of calculating the regional value content of the good under paragraph 2 or 3, include the value of nonoriginating materials used to produce originating materials that are subsequently used in the production of the good.

5. Each Party shall provide that an exporter or producer shall calculate the regional value content of a good solely on the basis of the net cost method set out in paragraph 3 where:

a) there is no transaction value for the good;

b) the transaction value of the good is unacceptable under Article 1 of the Customs Valuation Code;

c) the good is sold by the producer to a related person and the volume, by units of quantity, of sales of identical or similar goods to related persons during the six-month period immediately preceding the month in which the good is sold exceeds 85 percent of the producer's total sales of such goods during that period;

d) the good is

(i) a motor vehicle provided for in heading 87.01 or 87.02, subheading 8703.21 through 8703.90, or heading 87.04, 87.05 or 87.06,

(ii) identified in Annex 403.1 or 403.2 and is for use in a motor vehicle provided for in heading 87.01 or 87.02, subheading 8703.21 through 8703.90, or heading 87.04, 87.05 or 87.06,

(iii) provided for in subheading 6401.10 through 6406.10, or

(iv) provided for in tariff item 8469.10.aa (word processing machines);

e) the exporter or producer chooses to accumulate the regional value content of the good in accordance with Article 404; or

f) the good is designated as an intermediate material under paragraph 10 and is subject to a regional value-content requirement.

6. If an exporter or producer of a good calculates the regional value-content of the good on the basis of the transaction value method set out in paragraph 2 and a Party subsequently notifies the exporter or producer, during the course of a verification pursuant to Chapter Five (Customs Procedures), that the transaction value of the good, or the value of any material used in the production of the good, is required to be adjusted or is unacceptable under Article 1 of the Customs Valuation Code, the exporter or producer may then also calculate the regional value content of the good on the basis of the net cost method set out in paragraph 3.

7. Nothing in paragraph 6 shall be construed to prevent any review or appeal available under Article 510 (Review and Appeal) of an adjustment to or a rejection of:

a) the transaction value of a good; or

b) the value of any material used in the production of a good.

8. For purposes of calculating the net cost of a good under paragraph 3, the producer of the good may:

a) calculate the total cost incurred with respect to all goods produced by that producer, subtract any sales promotion, marketing and aftersales service costs, royalties, shipping and packing costs, and non-allowable interest costs that are included in the total cost of all such goods, and then reasonably allocate the resulting net cost of those goods to the good,

b) calculate the total cost incurred with respect to all goods produced by that producer, reasonably allocate the total cost to the good, and then subtract any sales promotion, marketing and aftersales service costs, royalties, shipping and packing costs and non allowable interest costs that are included in the portion of the total cost allocated to the good, or

c) reasonably allocate each cost that forms part of the total cost incurred with respect to the good so that the aggregate of these costs does not include any sales promotion, marketing and aftersales service costs, royalties, shipping and packing costs, and non-allowable interest costs, provided that the allocation of all such costs is consistent with the provisions regarding the reasonable allocation of costs set out in the Uniform Regulations, established under Article 511 (Customs Procedures Uniform Regulations).

9. Except as provided in paragraph 11, the value of a material used in the production of a good shall:

a) be the transaction value of the material determined in accordance with Article 1 of the Customs Valuation Code; or

b) in the event that there is no transaction value or the transaction value of the material is unacceptable under Article 1 of the Customs Valuation Code, be determined in accordance with Articles 2 through 7 of the Customs Valuation Code; and

c) where not included under subparagraph (a) or (b), include

(i) freight, insurance, packing and all other costs incurred in transporting the material to the location of the producer,

(ii) duties, taxes and customs brokerage fees on the material paid in the territory of one or more of the Parties, and

(iii) the cost of waste and spoilage resulting from the use of the material in the production of the good, less the value of renewable scrap or byproduct.

10. Except as provided in Article 403(1), any self-produced material, other than a componenet identified in Annex 403.2, that is used in the production of a good may be designated by the producer of the good as an intermediate material for the purpose of calculating the regional value content of the good under paragraph 2 or 3, provided that where the intermediate material is subject to a regional value-content requirement used in the production of that intermediate material may itself be designated by the producer as an intermediate material.

11. The value of an intermediate material shall be:

a) the total cost incurred with respect to all goods produced by the producer of the good that can be reasonably allocated to that intermediate material; or

b) the aggregate of each cost that forms part of the total cost incurred with respect to that intermediate material that can be reasonably allocated to that intermediate material.

12. The value of an indirect material shall be based on the Generally Accepted Accounting Principles applicable in the territory of the Party in which the good is produced.

(…)

Article 404: Accumulation

1. For purposes of determining whether a good is an originating good, the production of the good in the territory of one or more of the Parties by one or more producers shall, at the choice of the exporter or producer of the good for which preferential tariff treatment is claimed, be considered to have been performed in the territory of any of the Parties by that exporter or producer, provided that:

a) all non-originating materials used in the production of the good undergo an applicable tariff classification change set out in Annex 401, and the good satisfies any

applicable regional value-content requirement, entirely in the territory of one or more of the Parties; and

b) the good satisfies all other applicable requirements of this Chapter.

2. For purposes of Article 402(10), the production of a producer that chooses to accumulate its production with that of other producers under paragraph 1 shall be considered to be the production of a single producer.
(…)

Article 407: Accessories, Spare Parts and Tools

Accessories, spare parts or tools delivered with the good that form part of the good's standard accessories, spare parts, or tools, shall be considered as originating if the good originates and shall be disregarded in determining whether all the non-originating materials used in the production of the good undergo the applicable change in tariff classification set out in Annex 401, provided that:

a) the accessories, spare parts or tools are not invoiced separately from the good;

b) the quantities and value of the accessories, spare parts or tools are customary for the good; and

c) if the good is subject to a regional value-content requirement, the value of the accessories, spare parts or tools shall be taken into account as originating or non-originating materials, as the case may be, in calculating the regional value content of the good.

Article 408: Indirect Materials

An indirect material shall be considered to be an originating material without regard to where it is produced.

Article 409: Packaging Materials and Containers for Retail Sale

Packaging materials and containers in which a good is packaged for retail sale shall, if classified with the good, be disregarded in determining whether all the nonoriginating materials used in the production of the good undergo the applicable change in tariff classification set out in Annex 401, and, if the good is subject to a regional valuecontent requirement, the value of such packaging materials and containers shall be taken into account as originating or non originating materials, as the case may be, in calculating the regional value content of the good.

Article 410: Packing Materials and Containers for Shipment

Packing materials and containers in which the good is packed for shipment shall be disregarded in determining whether:

a) the nonoriginating materials used in the production of the good undergo an applicable change in tariff classification set out in Annex 401; and

b) the good satisfies a regional value content requirement.

Article 411: Trans-shipment

A good shall not be considered to be an originating good by reason of having undergone production that satisfies the requirements of Article 401 if, subsequent to that production, the good undergoes further production or any other operation outside the territories of the Parties, other than unloading, reloading or any other operation necessary to preserve it in good condition or to transport the good to the territory of a Party.

Article 412: Non-Qualifying Operations

A good shall not be considered to be an originating good merely by reason of:

a) mere dilution with water or another substance that does not materially alter the characteristics of the good; or

(b) any production or pricing practice in respect of which it may be demonstrated, on the basis of a preponderance of evidence, that the object was to circumvent this Chapter.

(…)

1-3. Mini-Customs Union in the NAFTA

Article 308: Most-Favored-Nation Rates of Duty on Certain Goods

1. Annex 308.1 applies to certain automatic data processing goods and their parts.

2. Annex 308.2 applies to certain color television tubes.

3. Each Party shall accord most-favored-nation duty-free treatment to any local area network apparatus imported into its territory, and shall consult in accordance with Annex 308.3.

Annex 308.1

Most-Favored-Nation Rates of Duty on Certain Automatic Data Processing Goods and Their Parts

Section A - General Provisions

1. Each Party shall reduce its most-favored-nation rate of duty applicable to a good provided for under the tariff provisions set out in Tables 308.1.1 and 308.1.2 in Section B to the rate set out therein, to the lowest rate agreed by any Party in the Uruguay Round of Multilateral Trade Negotiations, or to such reduced rate as the Parties may agree, in accordance with the schedule set out in Section B, or with such accelerated schedule as the Parties may agree.

2. Notwithstanding Chapter Four (Rules of Origin), when the most-favored-nation rate of duty applicable to a good provided for under the tariff provisions set out in Table 308.1.1 in Section B conforms with the rate established under paragraph 1, each Party shall consider the good, when imported into its territory from the territory of another Party, to be an originating good.

3. A Party may reduce in advance of the schedule set out in Table 308.1.1 or Table 308.1.2 in Section B, or of such accelerated schedule as the Parties may agree, its most-favored-nation rate of duty applicable to any good provided for under the tariff provisions set out therein, to the lowest rate agreed by any Party in the Uruguay Round of Multilateral Trade Negotiations, or the rate set out in Table 308.1.1 or 308.1.2, or to such reduced rate as the Parties may agree.

4. For greater certainty, most-favored-nation rate of duty does not include any other concessionary rate of duty.

Annex 308.2

Most-Favored-Nation Rates of Duty on Certain Color Cathode-Ray Television Picture Tubes

1. Any Party considering the reduction of its most-favored-nation rate of customs duty for goods provided for in item 8540.11.aa (color cathode-ray television picture tubes, including video monitor cathode-ray tubes, with a diagonal exceeding 14 inches) or 8540.11.cc (color cathode-ray television picture tubes for high definition television, with a diagonal exceeding 14 inches) during the first 10 years after the date of entry into force of this Agreement shall consult with the other Parties in advance of such reduction.

2. If any other Party objects in writing to such reduction, other than a reduction in the Uruguay Round of Multilateral Trade Negotiations, and the Party proceeds with the reduction, any objecting Party may raise its applicable rate of duty on originating goods provided for in the corresponding tariff item set out in its Schedule to Annex 302.2, up to the applicable rate of duty as if such good had been placed in staging category C for purpose of tariff elimination.

Annex 308.3

Most-Favored-Nation Duty-Free Treatment of Local Area Network Apparatus

To facilitate the operation of Article 308(3), the Parties shall consult regarding the tariff classification of local area network apparatus and shall endeavor to agree, no later than January 1, 1994, on the classification of such goods in each Party's tariff schedule.

(…)

II. Basic Features of Rules of Origin

2-1. Dark Side of the Rules of Origin

Excerpts from "International Trade Law, Political Economy and Rules of Origin: A Plea for a Reform of the WTO Regime on Rules of Origin" by Moshe Hirsch (*unpublished manuscript, on file with the author*)

(…)

III. The Functions of Rules of Origin (ROO): A Political Economy Perspective

The above political economy analysis argues that an international effort to reduce protectionism must involve the operation of reciprocal trade regimes. The underlying rationale for this approach is to avoid "free riding": the benefits of free trade are *not* to be accorded to all states. Trade concessions are to be granted only to products manufactured in states that undertake and implement similar concessions to products of other contracting states. Existing trade barriers *vis-a-vis* non-contracting parties are to be maintained.

The operation of such "discriminatory" regimes necessitates a *differentiating mechanism* to identify products manufactured in contracting states (which are eligible for preferred treatment), to the exclusion of products manufactured in non-contracting states. In addition, where a contracting party does not comply with its obligations under the agreed trade regime, effective retaliatory measures are of significant importance to maintaining the regime's credibility in the long run. Efficient retaliatory machinery presupposes the existence of a differentiating mechanism to make a distinction between products manufactured in 'cooperative' and 'noncooperative' parties.

To sum up, the principal function of ROO in the international trading system is to serve as a differentiating mechanism to distinguish between various products in accordance with their place of production.[1] This mechanism is indispensable for the operation of reciprocal trade regimes that are designed to promote trade liberalization. Thus, ROO function as "gate-keepers" in discriminatory trade regimes.[2]

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[1] ROO function as a differentiating mechanism in preferential arrangements, but it should be noted that these arrangements may operate in both directions: providing for either trade preferences (e.g., tariff reduction) or restrictive measures (e.g., quantitative restrictions). Though the role of determining whether a particular product qualifies for a certain trade preference is more noticeable, the rationale underlying both roles is the same.

[2] ROO have an additional and distinctive role in free trade areas (FTAs). ROO are essential to maintaining FTAs with different external tariffs towards non-FTA members. In the absence of ROO, imported products from non-FTA countries would enter through the country with the lowest tariff and be re-exported to the other FTA members. After a certain period, such a pattern of trade flow is expected to exert pressure upon the states with the higher tariff rate to lower their tariff rate, nearing that of the state with lowest duty. Such a process is likely to put pressure on the FTA members to adopt the same external tariff rates, i.e., to form a custom union. The operation of ROO averts this undesirable development by not allowing products manufactured in non-FTA countries to enjoy duty-free movement among the FTA members. See on this feature, Kala Krishna and Anne Krugger, 'Implementing Free Trade Areas: Rules of Origin and Hidden

The determination of origin does not present special difficulties when the product is wholly produced in one state. Unfortunately, with the increasing trend that has been labeled as the "global factory",[3] most final products in contemporary international commerce involve factors of production from more than one country; well-known examples are computers and automobiles. In such cases, rules of origin are designed to identify which of the states involved is the "originating state". The general principle widely accepted in international trade law is that the state where the "last substantial process", or "sufficient working or processing", has been carried out -- is the originating state.[4]

The principle of the "last substantial process" is vague and leaves wide discretion to national customs authorities. This feature generates an undesirable situation of uncertainty and undermines predictability for traders. Three additional tests are employed to define more precisely the general principle: (i) *a domestic content test*, requiring a minimum percentage of local value-added in the originating state (or setting the maximum percentage of value originating in non-member states); (ii) *a technical test*, prescribing that the product must undergo specific processing operations in the originating state; and (iii) *a change in tariff classification*, requiring the product to change its tariff heading under the Harmonized Commodity Description System (Harmonized System) in the originating state.[5] These techniques will be further discussed below.

IV. ROO as a Strategic Trade Instrument

As analyzed above, ROO are primarily designed to facilitate trade liberalization through reciprocal arrangements. This method is widely implemented through the conclusion of preferential agreements[6] that are intended to allow trade concessions only to the contracting parties, while *maintaining* existing barriers towards non-contracting parties. It is important to note here that ROO are certainly not designed to *raise* trade barriers towards third states, beyond those barriers existing prior to the establishment of the reciprocal

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Protection', in Jim Levinson, Alan V. Deardroff, and Robert M. Stern, eds., *New Directions in International Trade* 149, 150-151 (University of Michigan Press, Ann Arbor, 1995).

3 On this trend, see Jacques H. J. Bourgeois, 'Rules of Origin: An Introduction', in Edwin Verlmust, Paul Waer and Jacques Bourgois eds., *Rules of Origin in International Trade* 1, 4-5 (University of Michigan Press, Ann Arbor, 1994).

4 The term 'last substantial process' is often used in non-preferential contexts (e.g., the WTO Agreement on Rules of Origin) and the term 'sufficient working or processing' is widely used in preferential agreements; see, e.g., with regard to EC preferential agreements, Paul Waer, 'European Community Rules of Origin', in Edwin Verlmust, Paul Waer, and Jacques Bourgois eds., *Rules of Origin in International Trade* 85, 146 (University of Michigan Press, Ann Arbor, 1994).

5 See on these tests in detail, John H. Jackson, *The World Trading System* 167-169 (2nd ed., MIT Press, Cambridge, 1997); Edwin A. Verlmust, 'Rules of Origin as Commercial Policy Instruments – Revisited', 26 (6) *Journal of World Trade* 61, 63-74 (Dec. 1992); Joseph A. LaNasa III, 'Rules of Origin and the Uruguay Round's Effectiveness in Harmonizing and Regulating Them', 90 *American Journal of International Law* 625, 629-636 (1996).

6 It should be emphasized here that global agreements (like the WTO agreements) are also considered as 'preferential arrangements' in this sense, since trade preferences included in such agreements are accorded only to products manufactured in the contracting states.

regime.[7] As for the trade flow between the contracting parties themselves, ROO are not intended to affect the volume of trade in favor of one of the partners to a preferential regime.[8]

In reality, however, ROO often fall prey to protectionist pressures.[9] ROO are increasingly employed as an instrument to attain two principal (and complementary) goals:

(1) Increasing trade barriers towards non-contracting states; and,
(2) Attracting investment into the markets of the contracting parties.

1.Increasing trade barriers towards non-contracting states: The main objective here is to increase the consumption of local factors (materials and labor) through restriction of access of third parties' suppliers into the preferential market, beyond the level existing prior to the reciprocal arrangement. The apparent motive of this move is the desire to "compensate" local manufacturers for losses that are expected to arise following the implementation of trade liberalization towards the other contracting parties.

Setting more restrictive ROO generates an enhanced incentive for local producers to employ factors of production originating in the territories of the contracting states, [10] at the expense of foreign suppliers. [11] We have to remind ourselves that, generally, as more local materials and processes are employed in the manufacturing of a product, the likelihood of

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[7] This issue is also one of the essential preconditions to the establishment of FTAs or custom unions under Article XXIV(4) of the GATT; see, e.g., Jackson, *supra* note, at 65-67; on the economic rationale for Article XXIV, see Jagdish Bhagwati, 'Regionalism and Multilateralism: An Overview', in *New Dimensions in Regional Integration* 22, 25-28 (Jaime de Melo and Arvind Panagariya, eds., Cambridge University Press, Cambridge, 1995).

[8] See, e.g., E. Ivan Kingston, 'The Economics of Rules of Origin', in Edwin Verlmust, Paul Waer and Jacques Bourgois eds., *Rules of Origin in International Trade* 7 (University of Michigan Press, Ann Arbor, 1994).

[9] See, e.g., the statement made by Lawrence: "The major abuses perpetrated by the emerging regional arrangements relate to their use of rules of origin and antidumping provisions." Robert Z. Lawrence, 'Regionalism and the WTO: Should the Rules be Changed?', in Jeffrey J. Schott, ed., *The World Trading System: Challenges Ahead* 41, 52 (Institute of International Economics, Washington DC, 1996).

[10] The terms "local" and "domestic" refer here to the territories of the contracting states, and "foreign" refers to the territories of non-contracting states. This terminology is based on the assumption that the preferential arrangements include rules of either "bilateral cumulation" or "multilateral cumulation". Cumulation rules allow each party to the arrangement to use factors of production originating in the territories of the other contracting parties without infringing upon the ROO. See, e.g., Article 404 of the North American Free Trade Agreement (NAFTA), 32 *International Legal Materials* 289 (1993). In the absence of such cumulation rules, the above effects of ROO operate only with regard to the territory of each contracting party.
For a detailed analysis of various techniques of cumulation , see Moshe Hirsch, *Asymmetric Factor Endowments, Progressive Rules of Origin, and Commercial Cooperation in the Middle East* 15-22 (Working Paper, Kohl Center for European Studies, The Hebrew University, 1998). On the cumulation rules in the EC preferential agreements, see Hans-Joachim Priess and Ralph Pethke, 'The Pan European Rules of Origin: The Beginning of a New Era in European Free Trade', 34 *Common Market Law Review* 772, 782-786 (1997); Nicholas A. Zaimis, *EC Rules of Origin* 175-214 (Chancery Law Publishing, London, 1992).

[11] On this impact of ROO, and its inefficient consequences (in terms of reallocation of resources) in detail, see Moshe Hirsch, 'The Asymmetric Incidence of Rules of Origin: Will Progressive and Cumulation Rules Resolve the Problem?', 32 (4) *Journal of World Trade* 41, 44-45 (1998).

meeting the origin requirements increases. Thus, the inclusion of more stringent ROO in a preferential agreement generates a greater incentive for producers to use more local materials and intermediate components.[12]

2.Attracting investments into the contracting parties' markets: Manufacturers outside the preferential area who face more stringent origin requirements may either purchase more "local" factors (see above), or change their investment strategy and shift their production lines into the preferential market. The transfer of production into the territories of contracting states often enables the "foreign" producer to comply with the new ROO requirements. As ROO become more restrictive, the greater is the incentive for foreign producers to transfer their production processes into the preferential market area.

As discussed below, ROO are occasionally employed as a strategic instrument to increase local sourcing and attract investments. Three principal factors explain which settings are more susceptible to strategic use of ROO.

The variables affecting the strategic use of ROO:

The extent of the incentive to increase local sourcing and attract investors by restrictive ROO is dependent upon three principal variables:

1.The extent of the gap between trade preferences accorded under the alternative trade arrangements: Foreign producers assess the gap between the trade concessions granted under the alternative arrangements available to them. The alternative trade arrangements may take the form of state legislation, bilateral or regional FTA, or global preferential arrangement. If, for instance, the importing state's unilateral legislation provides for a zero-tariff rate for imported products manufactured in all states, the incentive to change either sourcing or investment patterns (in order to comply with the alternative arrangement) is very low.[13] If, on the other hand, the importing state's legislation provides for a 100% tariff rate, and the reciprocal agreement provides for a zero-tariff rate, the incentive for foreign suppliers to change patterns of sourcing or investment is much greater.

2. The size of the preferential market: Generally, the larger the preferential market (in terms of purchasing power), the greater the incentive for foreign suppliers to bear

[12] The above negative effects of ROO upon foreign suppliers are similar to those that are generally generated to third parties by the establishment of preferential arrangements in general. This is the well-known effect of "trade diversion" in favor of preferential arrangements' parties. It should be emphasized that the *extent of the diversion* in favor of the contracting parties *is dependent, inter alia, on the level of restrictiveness of the ROO* included in a particular preferential arrangement. Thus, excessive ROO increase the negative impacts of preferential agreements for manufacturers located in the territories of third parties. For an analysis of the economic effects of preferential arrangements for third parties, see James C. Ingram and Robert M. Dunn, *International Economics* 163-169 (3rd ed., Wiley & Sons, 1993); Jagdish Bhagwati and Arvind Panagariya, *The Economics of Preferential Trade Agreements* 7 *et seq*. (The AEI Press, Washington DC, 1996). For the impact of preferential trade arrangements on the world trading system, see Michael J. Trebilcock and Robert House, *The Regulation of International Trade* 129-134 (2nd. Ed., Routledge, London, 1999).

[13] In such a case, however, other NTBs may still be relevant.

additional costs involved in changing sourcing or investment patterns to comply with the new ROO.

3.The gap between production costs under the alternative patterns of production: Foreign producers assess the gap between the production costs involving factors originating outside of the preferential area and production costs with factors from within preferential area. The same assessment is made when a foreign producer considers whether to shift its production line to the territories of the contracting states or not. [14] Generally, the smaller the gap between production costs, the greater the incentive to employ more factors from the preferential area or to transfer the production process into that area.[15]

In light of the important role of variables (1) and (2), it is no surprise that the parties that are most widely reported to employ ROO as a strategic instrument are the NAFTA and the EC member states. These major economic blocs are prominent in terms of both the remarkable size of their markets and the extent of trade concessions offered by them to manufacturers. Numerous cases of employing ROO as an instrument of protectionism are documented in international trade literature and we shall briefly mention here only a few cases regarding the practices of these economic blocs.

The ROO of NAFTA were shaped with the intention of increasing local sourcing with respect to tomatoes and textiles. The ROO regarding tomato catsup in NAFTA are more stringent than those included in the former Canada–U.S. FTA. The apparent aim of this change was to increase the share of Mexican tomato producers in the U.S. market, at the expense of their competitors from Chile.[16] The ROO regarding textiles and apparel in NAFTA are more restrictive, with the intention of encouraging Canadian and Mexican textile manufacturers to use costlier U.S. fabrics, instead of less expensive Asian ones.[17]

The EC Commission changed the ROO applying to photocopiers in 1989 with the apparent intention "to target" the Ricoh producers in the U.S. Exports from the Ricoh plant in the U.S. significantly increased following the imposition of anti-dumping duties by the Community on imported photocopiers from Japan. The new ROO essentially described the operations carried out by the Ricoh producer in the U.S., and provided that such operations

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[14] These calculations should also take into account the costs of transferring production in the case of shifting the production line into the preferential area, and transportation costs in the case of production outside the preferential area.

[15] Here it is also necessary to examine the *administrative* costs involved in compliance with ROO (e.g., the costs of providing appropriate documentation to determine origin). Krishna and Krugger, *supra* note, at 157 n.16; Waer, *supra* note, at 158; Stephenson and James, 'Rules of Origin and the Asia-Pacific Economic Cooperation', 29 (2) *Journal of World Trade* 77, 89 (1995).

[16] David Palmeter, 'Rules of Origin in Regional Trade Agreements', in Paul Demaret, Jean-Francois Bellis, and Gonzalo Garcia Jimenez, eds., *Regionalism and Multilateralism After the Uruguay Round* 341, 343-345 (European Inter-University Press, Brussels, 1997).

[17] Joseph A. LaNasa III, 'Rules of Origin Under the North American Free Trade Agreement: A Substantial Transformation into Objectively Transparent Protectionism', 34 *Harvard International Law Journal* 381, 397-399 (1993).

do *not* confer U.S. origin. Consequently, photocopiers produced in the U.S. were considered as originating in Japan, and they were subject to anti-dumping duties. [18]

As for changing investment strategies, ROO proved themselves an effective tool to attract foreign investments in the practice of the EC and NAFTA. The ROO of the EC regarding semiconductors became more stringent in 1989, apparently at the behest of the European semiconductor producers. Following this change, investment in the semiconductor manufacturing facilities in the EC dramatically increased.[19]

The ROO of NAFTA regarding color televisions were planned to attract television tube production into the NAFTA area. As described by Jensen-Moran: "The notion behind the NAFTA rule was to rationalize North American production by attracting television tube production – the source of the highest-paid jobs in the industry – in North America, while allowing assembly elsewhere".[20] Indeed, these ROO attracted major foreign investments in the North American tube industry.[21]

The above-mentioned reports of employing ROO as a tool of protectionism are supported by the results of a recent statistical research project. The research project examined the interaction between trade liberalization and the level of restrictiveness of ROO in NAFTA. The extent of liberalization (or, conversely, protectionism) was measured by the length of the tariff phase-out programs prescribed by the agreement, i.e., the number of years that each party is bound to fully eliminate its tariffs with the other NAFTA members.[22] The statistical results revealed that the degree of tariff liberalization among the NAFTA members is highly and significantly correlated with the degree of restrictiveness of ROO: sectors with more restrictive ROO are also the ones with longer phase-out periods for tariff liberalization.[23]

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[18] Verlmust, *supra* note, at 66-67; Anna Murphy, *The European Community and the International Trading System* 50-51 (Vol. II, Center for European Policy Studies, Brussels, 1990).

[19] Murphy, *supra* note, at 49-50; Jeri Jensen-Moran, 'Trade Battles as Investment Wars: The Coming Rules of Origin Debate', 19 *The Washingtonian Quarterly* 239, 242-243 (1995); Rene Schowk, *US-EC Relations in the Post-Cold War Era: Conflict or Partnership* 101-102 (Westview Press, Boulder, 1991); Norio Komuro, 'International Harmonization of Rules of Origin', in Philip Ruttley, Iain MacVay and Carol George, eds., *The WTO and International Trade Regulation* 86 (Cameron May Publishers, London, 1998).

[20] Jensen-Moran, *supra* note, at 244.

[21] See the impressive figures cited in Jensen-Moran, *ibid*, at 245.

[22] Antoni Estevadeordal, 'Negotiating Preferential Market Access: The Case of the North American Free Trade Agreement', 34(1) *Journal of World Trade* 141, 151 (2000).

[23] Ibid. at 160-161. The author concludes at p. 161: "In other words, borrowing the language of the endogenous protection literature, one could conclude that the same forces that push for tariff protection also push for more restrictive ROO".

2-2. Methodology

Excerpts from “An Evaluation of the Uses and Importance of Rules of Origin, and the Effectiveness of the Uruguay Round's Agreement on Rules of Origin in Harmonizing and Regulating Them” by Joseph A. LaNasa III ("Jody")

http://www.jeanmonnetprogram.org/papers/96/9601ind.html

(…)

IV. Methods of Determining Origin

When a product is wholly obtained and produced in a single country, it is relatively easy to determine its origin. [13] Difficulties arise in determining the origin of a product that is manufactured in, assembled in, or uses materials originating in more than one country.

At least four different methods or criteria exist for determining the origin of goods that are manufactured in, assembled in, or use materials originating in more than one country:

1. Using the concept of substantial transformation as a rule;

2. Using an ad valorem percentage test;

3. Listing specific manufacturing or processing operations which confer or do not confer origin upon the goods; and

4. Requiring a specified change in tariff classification.

Whichever method is employed to determine origin, each seeks to prevent simple assembly and packaging operations from conferring origin. This section of the article will evaluate the different methods according to their effectiveness in determining the origin of a goal and in preventing circumvention, their clarity, their certainty, their transparency and the predictability or consistency of origin of determinations which use that method.

A. Substantial Transformation

The traditional substantial transformation rule states that a good originates in the last country where it emerged from a given process with a "distinctive name, character or use." [14] The substantial transformation of a good requires more than just a change in the article; it requires an article be transformed into a "new and different article" "having a distinctive name, character or use." [15]

The traditional substantial transformation rule captures the heart of the meaning of the rules of origin in a simple, concise way. For a product to be from a particular state, it must be substantially transformed there. To prevent a product from having multiple countries of origin, the good is a product of the country where it last underwent substantial transformation. The standard's flexibility allows it to evolve to meet technological change;

however, this flexibility can result in inconsistent origin determinations that undermine the certainty required for strategic planning by businesses.

Moreover, the standard's flexibility provides an opportunity for it to be "captured" by lobbying groups, i.e., for the standard to be used in a results-oriented manner designed to accommodate political pressure for more trade restrictive effects. For example, the rule can easily be converted into a search for the most significant processing, instead of the last substantial transformation. This type of search requires the exporter, importer, or producer to furnish a great deal of factual information to prove substantial processing. This fact-intensive, time-consuming inquiry raises the cost of determining origin, makes the rule even more restrictive and complex than it otherwise would be, and contradicts the spirit and purpose of the last substantial transformation rule.

For example, in 1984, the United States Custom Service adopted a two-part test for determining the origin of textile goods that result from processes or materials from more than one country. [16] This "revised" substantial transformation test was more restrictive than the traditional substantial transformation test because it required the creation of a new and different article and substantial manufacturing or processing operations. [17] The revised test nominally was changed to prevent companies from circumventing textile quotas by passing goods through an intermediate country to confer that country's origin on the good.

The substantial transformation rule provides the custom authorities and the courts with a great deal of flexibility to adapt the rule to particular circumstances to avoid circumvention. As the amount of restrictions or duties on imports increases for unfavorable origin determinations, more companies will try to manipulate the rules of origin to avoid unfavorable determinations. This often forces the courts to stretch the common law developed around substantial transformation to prevent circumvention and ensure that the standard's basic purpose is met. In other words, as the rules on substantial transformation become more precise and defined, it becomes easier to circumvent the purpose of the law while formally complying with its language. The flexibility of the substantial transformation standard provides countries with the
ability to look beyond the form of the transaction to see if a substantial transformation actually occurred.

However, the ambiguity of the standard and its flexible decision-making can lead to unpredictable, seemingly arbitrary results, especially when substantial transformation rule is applied differently for different purposes. [18] The United States has attempted to deal with this lack of certainty by compiling lists of criteria. [19] However, instead of having the abstract concept of substantial transformation become more definite through concrete application to factual situations, [20] the selective, inconsistent use of the criteria has led to more uncertainty and confusion. [21]

Some of the seemingly inconsistent and arbitrary determinations result from the fact that the rules are applied for different purposes. Courts and agencies may expend more effort on determining the true origin of a good for trade preferential or restrictive purposes than for

marking purposes, and therefore the inconsistency may not be a sign of results-oriented policy-making. In other words, the seemingly fragmented and inconsistent application of the substantial transformation standard may be proof that the substantial transformation is working effectively, in that its abstractness gives it the flexibility to specifically address the facts of each situation and prevent circumvention. However, to some commentators, by varying the degree of transformation required according to how the origin determination will be used, the "only consistency [in defining substantial transformation in the United States] is a policy that results in either higher duties or in fewer imports." [22]

While the flexibility of the process leaves it open to political pressure and capture by lobbying groups who want overly restrictive applications of the standard for protectionist purposes, this problem exists with every method of determining origin, just at a different stage in the determination process. With more defined methods of determining origin, the capture and manipulation occurs when the definitions are being developed or by having the definitions rewritten or re-interpreted. Moreover, the rules are defined for these other methods in the
definitional stage where there is no adversarial relationship, no neutral decision-maker, no representation of the major viewpoints, and no factual situation to which the principle can be applied, unlike many of the applications of the substantial transformation standard. Therefore, a greater danger of capture and protectionism may exist with the more defined methods because of the lack of court oversight and the lack of the adversarial representation.

In summary, the substantial transformation standard has many advantages, including its flexibility, evolution over time, and development through application to specific facts in an adversarial situation where interested parties are represented. However, these advantages are also the root of its disadvantages: its inconsistent applications, its discretionary nature, and the costs of making an origin determination under it. The adoption or rejection of substantial transformation as a method of determining origin depends on which principle one values more: flexibility or certainty. While profit-maximizing firms need more objective, predictable and easier to use rules, the substantial transformation standard should be used as the motivating principle behind the development and continued refinement of more precise, defined rules of origin, because it captures the purpose of origin determinations in a simple, concise manner.

B. Value-Added Percentage Test

The value-added test defines the degree of transformation required to confer origin on the good in terms of a minimum percentage of value that must come from the originating country or of maximum amount of value that can come from the use of imported parts and materials. [23] If the floor percentage is not reached or the ceiling percentage exceeded, the last production process will not confer origin. If the determination is for non-preferential purposes, then origin will be conferred on a prior country; if it is for preferential purposes, then no further origin determination is necessary unless the prior county is also a beneficiary country under a preferential trading agreement with the importing county.

While the value-added method is often praised for its simplicity and precision, [24] in practice it is very far from that because it generates substantial compliance costs and uncertainty for companies. [25] The value-added test is a very unsatisfactory method of determining origin.

The value-added test generates substantial compliance costs for companies. It can be very costly and difficult to comply with its administrative requirements, especially if the rules require tracing the value of specific parts and materials. Firms often will find it cheaper not to comply with the value-added test, forgoing the trade preferences and paying the most-favored-nation tariff, when the product results from complex manufacturing operations or when the product does not otherwise face high tariff or non-tariff barriers. [26] To comply with a value-added rule requiring tracing, a manufacturer of a complex product would need a highly sophisticated inventory and accounting system to adequately ensure that particular goods contain specific local components at specific values.

The value-added test also generates substantial uncertainty for companies. Because the test ignores exchange rate risk and fluctuations in the price of raw materials, the status of goods can change daily as the currency values fluctuate or as the price of raw materials fluctuates, unless the firm is able to obtain a binding advance ruling from the country's customs authorities. [27] Additionally, the origin of identical goods may vary with each importing country, depending on the exchange rate relationship between the importing country's currency and that of the processing country. Furthermore, because the value-added test is a bright line test, it often results in seemingly arbitrary results for borderline cases. For example, if the rules require 50% local value-added to confer origin, then a good with 49% local value added will be denied origin while a good with 50% local value added will considered to originate there. When a firm seeks a certain origin, it may seek to manipulate the prices of the
good and its imports to ensure the desired origin determination. This threat of transfer pricing is especially prevalent with transactions among related parties. For example, related parties could underprice the imported materials so that the final good has enough local value-added to qualify for local origin. To limit or prevent this manipulation of "value-added", the rules of origin could force the related parties to show that the price is similar to prices reached in an arm's-length transaction, whether by showing that the price is similar to the price of identical materials or goods sold to third parties, as long as third parties have purchased a substantial number of those materials or goods, or by comparing it to the price of similar materials or goods sold in arm's-length transactions, or it could force them to use a "net cost" method of determining value-added. [28] For example, in the NAFTA, the producer or exporter must use the "net cost" method when there is no transaction value (price) for the good or when the good is sold to a related party and related parties have purchased over 85% of the producers' identical or similar goods during the preceding six months. [29]

Moreover, the value added test leads to inconsistent results for similar products, because countries calculate the amount of value-added in different manners. [30] For example, the value-added test may result in inconsistent determinations of origin of identical goods in

different countries because different countries include different amounts of the transportation costs in the "sales prices" for the good, thereby creating different sales prices for the same good. [31] The later the article is valued in the transport stage, the harder it becomes for the article to meet the local value-added content requirements, because the transport costs increase the value of the denominator, unless the delivery costs are also added to the numerator as originating costs. Further, even if countries valued all parts of the good at the same stage in the transport cycle, they would still have different origin determinations because
countries include different costs in its local value-added calculations. [32]

The value-added test penalizes low cost production operations, though they may be more efficient than high cost facilities. The value-added test penalizes labor-intensive facilities in countries with cheap labor costs, capital-intensive facilities in countries with cheap capital costs, and resource-intensive facilities in countries with cheap resource costs. Because there is a greater difference in the cost of labor than the cost of capital since capital is more mobile than labor or raw materials, the value-added test discriminates against lesser developed countries whose primary comparative advantage is cheap labor and cheap materials. [33]

As with any defined test, a value-added test is subject to industry capture during its formulation stage. For example, in the North American Free Trade Agreement, American automobile manufacturers pressured the negotiators into accepting overly restrictive special rules of origin for automobiles, [34] ones that had a higher regional value content requirement for automobiles than for other goods under the North American Free Trade Agreement. [35] Furthermore, to purportedly prevent roll-up, [36] NAFTA requires that the producer trace the value of imported automotive parts throughout the production chain [37] to improve the accuracy of the content calculation, thereby imposing substantial additional compliance costs and administrative burdens on the manufacturer. The combination of higher regional value content requirement with the tracing provisions forces automotive companies to manufacture the drive trains and engines of the vehicles within the free trade area if they want the good to qualify for preferential treatment, or, if they want to avoid the rules of origin, to source their assembly plant in the final market country, i.e., the United States. [38]

In summary, due to differences in calculation methods, the fluctuations in values, and the compliance costs, the value-added test is not a satisfactory method of determining origin.

C. Specified Processes

The specified process tests of origin, also referred to as technical tests, prescribe certain production or sourcing processes that may (positive test) or may not (negative test) confer originating status. [39]

The specified process test serves as a useful supplemental test because it is easily tailored to meet a specific situation in a clear, precise manner. However, it is not a satisfactory

primary test of origin because it would be extremely difficult, if not impossible, to define a process test for the enormous array of products made, and to continually update these rules for new products and technological advances in production. Second, such a process of defining origin would be highly susceptible to capture by industry lobbying groups, because the drafters and administrators of the rule would have to rely upon industry for information, and, because the test would be in technical terms, its content would be hidden from public view. For example, Commission Regulation 288/89, on determining the origin of integrated circuits, stated that origin is conferred on a good whenever it undergoes diffusion. However, diffusion is always followed by assembly and testing, processes that are more labor-intensive and that may add more value than diffusion. [40] This product-specific technical rule was adopted because European Community producers of integrated circuits performed the diffusion process in the European Communities and then had the testing and assembly done in third countries while Japanese producers of integrated circuits had them tested and assembled in the European Communities. [41] Therefore, this regulation conferred EC origin on goods produced by EC manufacturers while denying EC origin on goods produced by Japanese manufacturers, thereby allowing the integrated circuits produced by the EC companies to trade on better terms than those produced by the Japanese. [42]

Third, it is a rigid test whose form could be met while subverting the underlying concept of requiring a substantial transformation to confer origin. Meeting this problem with anti-circumvention provisions would re-introduce the fact-intensive inquiries and their corresponding uncertainty that the technical and other defined tests seek to avoid.

Finally, negative technical tests leave large gray area, in that they only delineate which processes do not confer origin. For example, Commission Regulation 2071/89, on determining the origin of photocopiers, stated that the incorporation of an optical system into a photocopying apparatus will not confer origin, but did not explain which operations would confer origin. [43] This regulation was designed specifically to deny United States origin to copiers assembled in the United States by Ricoh, a Japanese corporation. [44] These copiers contained imported Japanese optical systems, and therefore were viewed as "Japanese" copiers by the origin test. Because anti-dumping duties had been imposed on Ricoh copiers from Japan, these copiers, which were assembled in the United States, were now subject to these duties.

D. Change in Tariff Classification

The change in tariff classification method determines the origin of a good by specifying the change in tariff classification of the Harmonized System of Tariff Nomenclature ("Harmonized System") [45] required to confer origin on a good. [46] Because the Harmonized System has been adopted by countries representing 90% of the world's trade, it provides a uniform, hierarchical nomenclature to be used in defining origin determinations for all products [47] in international trade.

The Harmonized System's systematic, hierarchical framework and its nearly universal acceptance among trading nations permit the drafters of rules of origin tremendous

flexibility to define classification changes in a precise manner that sustains exceptions and special rules without sacrificing objectivity, certainty, or identity. [48]

The Harmonized System is divided into twenty-one Sections, each representing a broad industrial grouping; ninety-six Chapters, each representing a more narrow industrial sector; and one thousand two hundred and forty-one headings, each representing a narrow industrial section. [49]

The headings in a chapter generally are ordered by the degree of processing. The farther into the chapter the heading is, the more processing that good has undertaken. [50] Therefore, unless the rules of origin specify otherwise, any change in the level of classification of the product at the heading level should be sufficient to confer origin on that product in the country where that change last occurred; hence, this method of determining origin is often called the "change in tarrif heading method." [51] The Harmonized System's hierarchical framework, its division by industry, and its systematic arrangement of headings by increasing degrees of technical sophistication and economic effort provide an easy to use and easy to adapt underlying structure for origin determinations.

While the Harmonized System reflects the most sophisticated and refined tariff classification system, it is just that -- it's a system primarily designed for the dual purposes of commodity classification and compilation of statistics. [52] Because it was not designed to be used for origin determinations, changes in classification are not always an appropriate or effective test for determining origin. Therefore, an origin scheme based on change in tariff classification must be supplemented by a list of exceptions that describe when a sufficient transformation has occurred despite the lack of a change in tariff classification, [53] when a change in classification is not sufficient, [54] and which processes are not sufficient to confer origin even though they lead to a change in tariff classification. [55] These supplemental tests, which rely upon process and value-added tests as supplemental tests for origin, reintroduce the problems associated with those systems into the change in tariff classification system, albeit on a lesser scale than if these tests were the primary tests. As with any process system, both the required changes and the exceptions lists must be updated to reflect new products and technological advances.

The change in tariff classification method of determining origin is conceptually simple and easy to apply, once the product is classified. [56] Because the Harmonized System is already used to classify 90% of the goods in international trade, custom authorities, exporters, importers, and manufacturers are comfortable and familiar with it. However, the classification of the product can give rise to problems, because products are not always classified in a uniform manner, despite the substantial efforts of the Harmonized System Committee to ensure that they are. [57] While it may appear that the change in tariff classification test which uses the Harmonized System as its underlying nomenclature will result in uniform determinations of origin because all of the countries are using an internationally harmonized nomenclature, this may not be the case because each country is free to classify the good as it sees fit, unless a system of binding dispute resolution open to both individual and member country complainants is developed.

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Note

[13] Origin complications may arise with wholly obtained products when dealing with products extracted from territorial waters and from the seabed. For example, fishery products are considered wholly obtained in a country as long as they are obtained on a vessel of that country. Because some origin definitions vary in terms of defining what constitutes that country's vessels, this rule may lead to the anomalous result of fish being caught in the waters of country A by a vessel from country B being considered fish of country B, even though they were "obtained" in country A's waters.

[14] Anheuser-Busch Ass'n v. United States, 207 U.S. 556, 562 (1908). See also Hartranft v. Wiegman, 121 U.S. 609, 615 (1887) (explaining that a good is substantial transformed when it is "manufactured into a new and different article, having a distinctive name, character or use from that" of the original article or good). The United States determines the origin of goods for non-preferential purposes by the rule of substantial transformation, a standard created by the courts and codified in administrative regulations.

The European Communities use a similar default rule. Council Regulation 802/68, which establishes the criteria to be used for determining the origin of imported goods when no other rule of origin is applicable, states, in part, that a product originates in the country in which the last substantial process or operation that is economically justified was performed, having been carried out in an undertaking equipped for the purpose, and resulting in the manufacture of a new product or representing an important stage of manufacture. Council Regulation 802/68, Art. 5.

[15] See Anheuser-Busch, 207 U.S. at 562. See also United States v. Gibson-Thomsen Co., 27 C.C.P.A. 267 (1940) (holding that under the marking statute, when imported wood toothbrush handles and imported wood hairbrush blocks are combined in the United States with bristles to form a brush, the brush originates in the United States because "each [part] lost its identity in a tariff sense, and [became] an integral part of a new article having a new name, character and use").

[16] Textiles and textile products country of origin, 19 C.F.R. §12.130. The Custom Service based these regulations on its interpretation of Uniroyal Inc. v. United States, 542 F. Supp. 1026 (1982). Country of Origin Rules Regarding Imported Textiles and Textile Products, T.D. 90-17, 24 Customs Service Bulletin 3, 6 (March 14, 1990). Uniroyal held that a product originates in the country where it gained its identity or essence by means of processing operations performed in that country. Therefore, in Uniroyal under the marking statute, the attachment of imported leather uppers to domestic outer soles was not a substantial transformation of a shoe, because the upper maintained its identity, in that the upper was the essence a completed shoe.

For application of a similar test in a non-textile context, see Superior Wire v. United States, 669 F. Supp. 472 (Ct. Int'l Trade 1987), aff'd, 867 F.2d 1409 (Fed. Cir. 1989) (holding that wire produced in Canada from wire rod manufactured in Spain is of Spanish origin because the Canadian processing was not substantial in terms of complexity or cost).

[17] 19 C.F.R. §12.130(b) (stating that a "textile or textile product will be considered to have undergone a substantial transformation if it has been transformed by substantial manufacturing or processing operations into a new and different article of commerce"). The regulation then lists a series of manufacturing or processing operations that will "usually" result in "a new and different article", id. at §1230(d)(1), lists a series of factors to be considered

to determine if the good underwent substantial processing, id. at §1230(d)(2), a list of processes that will "usually" result in conferring origin on that good, id. at §1230(e)(1), and a list of processes that will "usually" not result in conferring origin on that good, id. at §1230(e)(2).

[18] The United States applies the standard differently for different purposes. See Koru North American v. United States, 701 F. Supp. 229, 133 (Ct. Int'l Trade 1988) (stating that in ascertaining origin, the court must look to "the purpose of the particular statute involved"); National Juice Products Ass'n v. United States, 628 F. Supp. 978, 988-89, n.14 (noting that "although the language of the test applied under the statutes [tariff preferences, duty drawback, and country of origin marking] is similar, the results may differ where differences in statutory language and purposes are pertinent"). See also N. David Palmeter, Rules of Origin or Rules of Restriction? A Commentary on a New Form of Protectionism, 11 Fordham Int'l L. J. 1, 4 (1987) [hereinafter Palmeter, Protectionism] (arguing that the United States interprets its rules of origin differently for different purposes and providing the example that "threading is substantial transformation if it means GSP benefits will be denied but not if it means that a quota will be inapplicable").

When a court held that courts should not "depart from policy-neutral rules governing substantial transformation in order to achieve wider import restrictions [via a voluntary restraint agreement on steel imports from Japan] in particular cases," Ferrostaal Metals Corp. v. United States, 664 F. Supp. 535, 538 (Ct. Int'l Trade 1987), the United States Congress overturned it, rejecting the principle that the uniform application of a standard for all purposes, by giving the President the power to impose the VRA quota on steel that has been substantially transformed in a non-VRA country as long as the steel was originally melted and poured in a VRA country. Omnibus Trade and Competitiveness Act of 1988, Pub. L. 100418, §1322 (amending 198 U.S.C. §2253).

[19] The criteria include the distinction between producer and consumer goods, the amount of value-added, the complexity of the processing operation, and changes in tariff classification. See C. Edward Galfand, Comment, Heeding the Call for a Predictable Rule of Origin, 11 U. Pa. J. Int'l Bus. L. 469, 480 (1989).

[20] "The search for relevant meaning is often satisfied not by a futile attempt at abstract definition but by pricking a line through concrete applications. Meaning frequently is built up by assured recognition of what does not come within a concept the content of which is in controversy." Bazley v. Commissioner, 331 U.S. 737 (1947) (J. Frankfurter) (explaining why the Supreme Court will not affirmatively define what a recapitalization under the Internal Revenue Code, but rather will just look at the facts of the transaction and compare them to the underlying purpose of a reorganization, of which a recapitalization is one type).

[21] For example, one criterion, the transformation of a good usable solely by producers into a consumer goods, has been held to be both determinative and indeterminative of origin. Compare Torrington Co. v. United States, 764 F.2d 1563 (Fed. Cir. 1985) (transformation determinative); Midwood Industries, Inc. v. United States, 313 F. Supp. 951 (Cust. Ct. 1970) (transformation determinative) with National Juice Products Ass'n v. United States, 628 F. Supp. 978 (Ct. Int'l. Trade 1986) (transformation not determinative); Uniroyal, Inc. v. United States, 542 F. Supp. 1026 (Ct. Int'l. Trade 1982) (no origin conferred despite transformation).

[22] Palmeter, Protectionism, supra note 20, at 4.

[23] See Vermulst, Revisited, supra note 3, at 63-64. The European Community uses the domestic content method as a test for non-preferential purposes and the United States uses it for preferential purposes. The import content method is used by the European Communities as a test for preferential purposes. The value-added test also can be articulated as requiring

that a minimum percentage of the value of the parts come from the originating country. Id. The value of the parts test is used by the European Community in some product-specific origin regulations as a subsidiary test when the 45% value-added primary test is not met. See Commission Regulation 861/71 on determining the origin of tape recorders, art. 2 (1971); Commission Regulation 2632/70 on determining the origin of radio and television receivers, art. 2 (1970). It may be unduly restrictive of origin because it ignores local assembly and overhead costs.

[24] See Michael P. Maxwell, Formulating Rules of Origin for Imported Merchandise: Transforming the Substantial Transformation Test, 23 Geo. Wash. J. Int'l L. & Econ. 669, 671-72 (1990) (calling for a rule of origin based on value-added criteria).

[25] See Joseph LaNasa, Rules of Origin under the North American Free Trade Agreement: A Substantial Transformation into Objectively Transparent Protectionism, 34 Harv. Int'l. L.J. 381, 392 (Spring 1993) (arguing that most of the origin determination controversies under the Canadian-United States Free Trade Agreement involved the value-added test).

[26] See id. at 391-92, n.48-49; Jan Herin, Rules of Origin and Differences Between Tariff levels in EFTA and in the EC, Occasional Paper no. 13 (European Free Trade Association 1986) (25% of trade between EFTA and the EC is on a non-preferential basis because of the high costs of satisfying the change in tariff classification and the value-added rules of origin). See also Ralph H. Sheppard, NAFTA Rules of Origin from the Importers' Perspective: What the Agreement Should Contain, Mex. Trade and L. Rep., Rules of Origin Vol. 1 No. 2, Nov. 1, 1991 (stating that the need to certify content in specific shipment in order to comply with value-added requirements lead many businesses to forgo benefits due to the inordinate accounting or inventory costs).

[27] Of course, the fluctuation problem could be minimized through the use of weighted monthly, quarterly, or annual averages.

[28] The net cost method requires the firm to trace the cost of each item or material used in producing the good.

[29] NAFTA art. 402(5)(a,c). The exporter or producer also must use the net cost method when the transaction value is unacceptable under Article I of the GATT Customs Valuation Code, when it elects to accumulate the regional value content of a good or when it elects to designate a self-produced material containing no other intermediate materials as an intermediate material. Id. at art. 402(5)(b, e-f).

[30] See Vermulst, Revisited, supra note 3, at 65-71. The local value-added of a good can be calculated by either deducting the cost of non-originating parts from the sales price or by adding up all items of local value-added. This value is then placed over a denominator representing the price of the good, which yields the percentage of local value-added. If the import content rule is being used, subtract the resulting percentage from 100% to see if the import content ceiling is surpassed. While these two calculation methods in theory should lead to the same result, in practice they do not because of the lack of harmonization of calculation methods. Id.

[31] Id. at 65. Goods can be valued, in ascending order, at the ex-works price (the price as it leaves the factory), free on board (FOB) price (the price at the border of the exporting country), cost insurance and freight (CIF) price (the price at the border of the importing country) or the delivered into-factory price. For example, the European Communities uses the ex-works price. Any other costs must be deducted from the price. This greatly complicates the valuation process by requiring additional calculations and documentation of the costs of these other items. On the other hand, the United States often uses the appraised

value of the good as it enters the United States. Because this value often will just be the transaction price in transactions between non-related parties, this method does not entail doing any additional calculations. Id.

[32] See Vermulst, Revisited, supra note 3, table 4 at 71 (showing that the same product will have a different domestic content ratios in the United States, the European Communities, Australia, Canada and Japan).

[33] While the problem of punishing low cost producers also arises with other methods of determining origin, because in practice, all origin rules impose value-added constraints since all origin rules require value-adding processing, the problem is most acute with an explicit value-added test. However, with substantial transformation as the test, the problem of discriminating against low-cost producers arises, if the agency or court compares processing costs to see if a substantial transformation occurred.

[34] See LaNasa, supra note 25, at 400-01 (arguing that the enormous clout of the American car manufacturers resulted in rules of origin for automobiles that discriminated against foreign car companies, an argument supported by the fact that General Motors received preferential treatment in its joint venture with Suzuki on the treatment of the origin of the CAMI).

[35] Compare NAFTA, art. 403(6) (requiring a regional value content equal to or greater than 62.5% for light trucks and passenger vehicles using the net cost method) with id. at art. 401(b) (requiring just a specified change in tariff classification for most goods) with id. at annex 401.1, §6401.10 - 6401.10 (requiring that footwear meet the specified tariff classification change and that it have a regional value content equal to or greater than 55% under the net cost method).

[36] Roll-up occurs when imported parts are substantially transformed in a preference-receiving country into an intermediate part whose whole value then counts towards fulfilling the value-added requirement for the final good. For example, under the Canadian-United States Free Trade Agreement, an intermediate part was considered wholly a domestic part if it had regional value content equal to or greater than 50%. If it had a regional value content less than 50%, then the roll-down occurred, i.e., the part was considered wholly an imported part.

Under the Canada-United States Free Trade Agreement, the controversy over roll-up exploded into an international controversy. Honda assembled cars (Civics) in Canada with engines assembled in Ohio that used Japanese parts. Canada and Honda claimed that the engines had a direct cost of 66%, thereby entitling them to roll-up. With their value rolled-up, the assembled cars met the CFTA's regional value content requirement for cars and therefore were entitled to preferential treatment. The United States argued that the engines were not entitled to roll-up because Canada and Honda had included indirect costs in their computation of direct costs and that a proper calculation of direct costs revealed that the engines had less than 50% regional content and therefore their value must be roll-downed. Without being able to count the value of the engines, the Honda cars assembled in Canada no longer could not meet the CFTA's regional value content requirement for automobiles and therefore were not entitled to preferential treatment. The United States' interpretation of direct costs of assembly excluded costs that were reasonably allocated to the assembly costs, overhead costs and general expenses of doing business. The United States claimed that the dispute was purely a technical matter. The Canadians claimed that the decision was a political one motivated by American desires to bash Japan and to force Japanese companies to relocate their assembly operations to the United States. See Frederic Cantin and Andreas Lowenfeld: Rules of Origin, The Canada-U.S. FTA and the Honda Case, 87 Am. J. Int'l L. 375 (July 1993).

[37] NAFTA, at art. 403(1-2) (requiring tracing of the value of a specified list of automotive parts), annex 403.1-.2 (listing the automotive parts and materials whose value must be traced). The administrative burden is lessened somewhat by allowing the producer to use an annual averaging method. Id. at art. 403(4-5).

[38] See LaNasa, supra note 25, at 400-402.

[39] See Vermulst, Revisited, supra note 3, at 74. The United States uses them for preferential and non-preferential purposes, often in combination with a value-added test. The European Communities use them for many of their non-preferential product-specific origin regulations. Id.

[40] Edwin Vermulst and Paul Waer, European Community Rules of Origin as Commercial Policy Instruments, 24:3 J.W.T. 55, 66.

[41] Id. at 66.

[42] In the European Communities, certain product-specific regulations that purport to apply the "last substantial process" test can be viewed as nothing more than protectionist interpretations designed to benefit European Communities industry and restrict market access of Japanese producers. Id. at 94 (citing the zipper, integrated circuits and photocopier regulations).

[43] Commission Regulation 2071/89 on determining the origin of photocopying apparatus incorporating an optical system or of the contact type, art. 1 (1989).

[44] See Vermulst and Waer, supra note 40, at 66-67.

[45] The Harmonized System was implemented by the International Convention on the Harmonized Commodity and Description Coding System on January 1, 1988. It was developed by and is administered by the Customs Co-operation Council. While one hundred twenty-one countries have adopted it for customs tariffs and trade statistical purposes, only seventy-one nations have contracted to the International Convention, as of June 1, 1993. See Hironori Asakura, The Harmonized System and Rules of Origin, 27 J.W.T. 4, 8 (Aug. 1993) [hereinafter Harmonized System]. Because the one hundred twenty-one countries account for 90% of world trade, the Harmonized System is one of the most basic and widely applied international trade laws.

[46] See, e.g., Origin Agreement, supra note 4, at art. 9(2)(c)(ii) (calling for global harmonization of non-preferential rules of origin defined primarily in terms of change in tariff classification using the Harmonized System as the underlying nomenclature); North American Free Trade Agreement, art. 401(b) (providing for determinations of origin by specified change in tariff heading), art. 413(a) ("the basis for tariff classification in Article 401 is the Harmonized System"), Annex 401.1 (using the Harmonized System as the tariff classification system used to define the required change in headings).

[47] If the product itself has not been classified, the products placed into a basket of unclassified goods. A question may arise as to in which basket it should be included.

[48] In contrast, when the substantial transformation standard was used to create exceptions or special rules, it produced "unguided formlessness" in which a diverse series of criteria were applied in an illogical or inconsistent manner. See Galfand, supra note 19, at 492 ("Whereas flexibility in the substantial transformation criteria equates to unguided formlessness, the objective and mechanically precise character of the Harmonized System renders it capable of sustaining exceptions and special rules without losing its identity.").

[49] Asakura, supra note 45, at 9. For example:

Section I
Live animals and animal products
Section II
Vegetable products
Chapter 6
Live Trees & Other Plants; Bulbs, Roots & the Like; Cut Flowers & Ornamental Foliage
Chapter 7
Edible Vegetables & Certain Roots & Tubers
Chapter 9
Coffee, Tea, Mate & Spices
Chapter 10
Cereals

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Section IV
Prepared Foodstuffs; Beverages, Spirits & Vinegar; Tobacco & Manufactured Tobacco Substitutes
Section V
Mineral Products
Section VI
Chemical products
Chapter 28
Inorganic Chemicals
Chapter 29
Organic Chemicals
Chapter 30
Pharmaceutical Products
Chapter 31
Fertilizers

Id.

[50] For example:

Chapter 72 Iron & Steel

72.01
Pig Iron
72.04
Ingot
72.06
Semi-Finished Products
72.08 - 72.12
Flat-Rolled Products
72.13 - 72.15
Bars and Rods
72.16
Angles, Shapes & Sections
72.17
Wire

This example is taken from id. at 12.

[51] Many of the headings are further sub-divided into subheadings, which are further subdivided into two-dash subheadings. Id. at 9. Sometimes, the required change in tariff classification occurs at the subheading or the chapter level. For example, in the agricultural chapters, many of the headings specify different kinds of agricultural products which have undergone minimal processing. Id. at 17 (describing how in Chapter 7, which deals with edible vegetables and certain roots and tubers, the headings progress from fresh or chilled vegetables (7.01 - 7.09) to frozen vegetables, whether uncooked, steamed or boiled vegetables (7.10), to provisionally preserved vegetables unsuited for immediate consumption (7.11) to dried vegetables (7.12, 7.19) to roots and tubers (7.19)). There, a product will be substantially transformed if the change occurs at the chapter level. For example, the North American Free Trade Agreement dealt with the vegetable problem by stating that items in headings 7.01 - 7.14 originate in the country where they were transformed from an item classified in a different chapter. See NAFTA, Annex 401.1. See also Asakura, supra note 45, at 17 (describing the eighteen times that NAFTA requires a change at the chapter level instead of at the heading level for at least some of the headings contained in that chapter).

[52] See, e.g., Vermulst, Revisited, supra note 3, at 73.

There is no need to develop a new classification system designed specifically for origin determinations, given that the Harmonized System has already developed a rather accurate, predicable, universally adopted, and well-managed classification system.

[53] See, e.g., NAFTA, art. 401(d)(i) (good originates in the preferential territory if it "is produced entirely in the territory of one or more of the Parties but one or more of the non-originating parts used in the production of the good does not undergo a change in tariff classification because the good was imported into the territory of a Party in an unassembled or a disassembled form but was classified as an assembled good pursuant to General Rule of Interpretation 2(a) of the Harmonized System").

[54] See, e.g., Origin Agreement, supra note 4, at art. 9(2)(c)(iii) (stating that the harmonized rules of origin may use supplementary criteria); NAFTA art. 402 (setting out the regional value content test which is used as a supplementary test to the change in tariff classification test).

[55] See Origin Agreement, supra note 4, at art. 9(2)(c)(i) (stating that the harmonized rules of origin will contain a list of minimal operations or processes that do not by themselves confer origin on a good); NAFTA, at art. 412 (listing non-qualifying operations).

These processes may include simple packing and preservation operations, simple mixing of products of the same or different kind, and simple assembly of parts into complete articles. These disqualifying provisions can be controversial because they may exclude processes, such as mixing and assembly, that may add a great deal of value. However, this problem can be resolved by adopting exceptions to the exceptions, i.e., by specifying the mixing and assembly processes that will confer origin, notwithstanding the general rule that mixing and assembly do not confer origin.

[56] However, disputes over tariff classification, such as whether a vehicle is a truck or a van, do occur, because this classification system, like any classification system, is sometimes imprecise and subject to political considerations. N. David Palmeter, The U.S. Rules of Origin Proposal to GATT: Monotheism or Polytheism?, 24:2 J.W.T. 25, 28 (April 1990).

[57] The Harmonized System Committee seeks to ensure uniform international application of the system by making classification decisions and settling international classification disputes between member countries. It also assists with the problem of fitting millions of goods into the 1241 four-digit headings by publishing the Harmonized System's General Rules for Interpretation, its detailed Legal Notes, and the extensive complementary publications such as the Custom Co-operation Council's Explanatory Notes. These sources of information on interpretation and help with application help ensure more uniform, accurate and predictable classifications.

(…)

III. A Real Example of Rules of Origin

3-1. Harmonized Tariff Schedule of the United States (WTO)

Chapter 91: Clocks and Watches and Parts Thereof

9101 Wrist watches, pocket watches and other watches, including stop watches, with case of precious metal or of metal clad with precious metal: Wrist watches, electrically operated, whether or not incorporating a stop watch facility:

9101.11 With mechanical display only:

* * *

9102 Wrist watches, pocket watches and other watches, including stop watches, other than those of heading 9101: Wrist watches, electrically operated, whether or not incorporating a stop watch facility:

9102.11 With mechanical display only: Having no jewels or only one jewel in the movement: With strap, band or bracelet of textile material or of base metal, whether or not gold- or silver-plated:

* * *

9107.00 Time switches with clock or watch movement or with synchronous motor:

9107.00.40 Valued not over $5 each.

* * *

9114 Other clock or watch parts:

* * *

3-2. NAFTA Annex 401

Chapter 91: Clocks and Watches and Parts Thereof

91.01-91.07 A change to heading 91.01 through 91.07 from any other chapter; or

A change to headings 91.01 through 91.07 from heading 91.14, whether or not there is also a change from any other chapter, provided there is a **regional value content** of not less than:

(a) 60 percent where the **transaction value** method is used, or

(b) 50 percent where the **net cost** method is used. *(emphasis added)*

* * *

IV. Comparative Insight (Rules of Origin in Other Trade Regimes)

4-1. WTO

Excerpts from “An Evaluation of the Uses and Importance of Rules of Origin, and the Effectiveness of the Uruguay Round's Agreement on Rules of Origin in Harmonizing and Regulating Them” by Joseph A. LaNasa III ("Jody")

http://www.jeanmonnetprogram.org/papers/96/9601ind.html

(…)

VI. The Origin Agreement

The Origin Agreement seeks to harmonize all the non-preferential rules of origin used by signatory countries into a single set of international rules. Under the Origin Agreement, each country is free to adopt its own preferential rules of origin, or to adopt different preferential rules of origin for its different preferential agreements. [71]

The Origin Agreement anticipates a two stage harmonization process. First, the Origin Agreement anticipates a three-year transitional period, [72] during which time the harmonized rules will be drafted and adopted. The proposed harmonized rules will be drafted by the Technical Committee on Rules of Origin, with the Committee on Rules of Origin considering its results "with a view to endorsing such interpretations and opinions." [73] The Origin Agreement does not specify whether consensus decisions, majority voting, or supermajority voting will apply. [74] However, by drafting the rules in a multilateral context where all countries are represented and where the adopted rules will be used for all non-preferential purposes, the ability of any one country to draft the rules in politically motivated ways will be limited. For example, if the United States sought to protect its domestic car industry by having the harmonized rule of origin for automobiles be unduly restrictive, those same American companies would be injured when they sought to export their automobiles to other countries. Once the harmonization work program is completed, a GATT Ministerial conference will establish the results of the harmonization program as an Annex to the Origin Agreement, along with a time frame for its entry into force. [75]

Three criteria will be used to define origin under the harmonized rules. First, the Technical Committee will develop a detailed harmonized definition for determining when goods are wholly obtained in one country. [76] Second, the Technical Committee will develop a harmonized list of minimal operations or processes that do not by themselves confer origin to a good. [77] Finally and most importantly, the Technical Committee will define when the last substantial transformation of a good produced in more than one country occurrs, primarily through use of the change in tariff classification method at the heading or sub-heading level, using the Harmonized System as the underlying nomenclature, and, when supplemental tests are necessary, through the use of the value added and specified processing methods of determining origin. [78] The Origin Agreement states that origin will be conferred where the last substantial transformation occurred, not where the most

significant occurred. This rule increases certainty in application and simplifies the determination of origin because the custom authorities can disregard previous operations.

Both during and after the transitional period, the member countries are forbidden from using negative rules, unless they are used to clarify a positive standard or when a positive determination is not necessary. [79] This provision will make the rules of origin more specific and clear, because negative provisions only state what will not constitute a substantial transformation, not what will constitute a substantial transformation. This provision is aimed at the criticized European Communities practice of issuing product-specific origin regulations that use negative rules, such as European Communities Regulation 2071/89, which was allegedly changed to confer Japanese origin on photocopiers produced by Ricoh (a Japanese company) in the United States in order to apply anti-dumping duties imposed on Japanese photocopiers on these United States assembled copiers.

The Origin Agreement provides for an advance publication and ruling procedure to be implemented in each signatory country, starting immediately, for all origin determinations. [80] Signatory countries must publish the rules of origin and any applications of the rules. [81] Any changes in the rules can not be applied retroactively. [82] Upon the request of any interested person, [83] the member country must issue and publish a binding assessment of origin within 150 days of a request containing all the necessary elements. [84] This assessment must clearly and precisely state what requirements must be met to confer origin. [85] Any confidential information submitted by the parties shall remain strictly confidential, unless the person or government providing it specifically permits its disclosure or unless
judicial proceedings require disclosure. [86] The assessment request can be made in advance of trading in the good and once made, will be valid for three years in all comparable situations. [87] This advance ruling procedure will allow firms to rationally plan its sourcing and production processes with knowledge of the final good's origin and corresponding treatment. [88]

Additionally, because the assessments will be published, interested parties will be able to make more cogent arguments for favorable rulings, using these prior rulings as precedents, because these prior rulings will be binding on the custom authorities for three years in all "comparable" situations. This process, which improves on the American system of inconsistent review of determinations of origin, will create a more fact-specific, common law-like context for origin determinations that will lead to fairer, more objective determinations as the rules are explained through application to specific factual situations. Because the determinations are binding in comparable situations, are published, and are subject to review, there will be implicit pressure on the custom authorities to explain their reasoning, thereby increasing the transparency and consistency of the process.

Starting immediately, any administrative action taken with regard to the determination of origin for either preferential and non-preferential purposes is reviewable promptly by an independent authority. [89] This independent review may be made by a judicial, administrative, or arbitral tribunal which has the power to modify or reverse the

determination. [90] The prompt review by an independent body will lead to a system closer to one based on the rule of law. It will serve to increase the transparency, neutrality, consistency, and legitimacy of origin determinations, because an independent body will be deciding the correctness of its application after hearing presentations from both sides.

Despite numerous advances over existing systems of origin determination and harmonization of rules and decision-making processes, the Origin Agreement will not lead to harmonized determinations. During the transition period, each member country will apply its own non-preferential rules, subject to limitation that "notwithstanding the measure or instrument of commercial policy to which they are linked, the rules of origin are not to be used as instruments to pursue trade objectives directly or indirectly." [91] This provision implies that the member countries should not use the rules of origin as commercial policy instruments, but rather as a technical, definitional device. The question arises as to whether applying different rules for different purposes means that the country is using the rules of origin as a trade policy instrument or whether different commercial policy tools need different rules of origin to effectively implement them. If the latter is true, the exclusion of preferential rules of origin from the harmonization implies a recognition by the drafters that some commercial policy instruments, i.e., preferential trade agreements, may require special rules of origin to control the degree of preference and prevent trade deflection. But the question arises as to why some instruments require special rules of origin while the other instruments can apply the same rule. If voluntary restraint agreements are also exempted from the harmonization program, then the key differentiating factor between those tools which must use the harmonized rules and those which are free to design their own rules of origin may be that in voluntary agreements, such as preferential trading agreements and voluntary restraint agreements, the parties are free to design their own rules of origin, but whenever the trade restriction is being applied unilaterally, the country should be forced to use the harmonized rules of origin so that the rules of origin are not being used as a hidden policy tool. After the transitional period ends, each member country is free to disagree with how it interprets the harmonized non-preferential rules. Both during and after the transitional period, the member countries will be applying their own preferential rules.

After the transitional period ends, the same non-preferential rules of origin will be applied for all non-preferential purposes by the signatory countries. Because these harmonized rules will be defined primarily in terms of change in tariff classification and secondarily in terms of specified value-added requirements and specified technical processes, they will replace the use of the vague, discretionary concepts such as substantial transformation or last substantial process with the use of more mechanical, clearer tests that will enable profit-maximizing firms to better plan their production, purchasing, and investment strategies. [92] However, even though these rules represent a substantial advance over the existing system of multiple rules of origin which are applied differently for different purposes, application of these harmonized rules will not ensure harmonized origin determinations.

The Common Declaration with Regard to Preferential Rules of Origin, an annex to the Agreement (the "Declaration"), imposes a number of procedural safeguards similar to

those discussed above, in hope of creating a more transparent, rule of law-like system for applications of preferential rules of origin. It requires that the rules be published. [93] It states that when issuing administrative determinations of origin, the requirements to confer origin be precisely and specifically stated, that requests by interested parties for an assessment of origin be made within 150 days, that such assessment be valid for three years, that the assessments be published, that they be subject to review by an independent body, and that the confidentiality of information submitted be protected. [94] However, it imposes few substantive limits on the preferential rules. It prohibits the use of negative standards of origin except to clarify a positive standard or when a positive determination is not necessary, and it
prohibits the retroactive application of changes in preferential rules of origin. [95]

(…)

Note

[71] Origin Agreement, supra note 4, at art. l(l) (expressly excluding rules of origin "related to contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of [most-favored nation status]"). While there was some discussion about harmonizing all rules of origin, the more restrictive approach of only harmonizing non-preferential rules of origin was adopted, partially because that was what the European Communities preferred and partially because the United States began using preferential rules of origin in restrictive manner. See Navarro, supra note 64, at 10. Attached to the Origin Agreement as Annex II is a Common Declaration with regard to Preferential Rules of Origin. This Annex seeks to provide more transparency and foster the development of a rule of law around the application of the preferential rules through the adoption of suggested procedural reforms.

For an explanation of why countries may want to adopt different rules of origin for preferential trade agreements and even vary the rules between the different agreements, see Section II of this article.

[72] Id. at art. 9(2)(a). The transitional period will last until the harmonization program is completed. The Origin Agreement hopes that the transitional period lasts no longer than three years. Id. at art. 9(2)(a).

[73] Id. at art. 9(3); 9(2)(b). While Article 9(2)(b) states that both the Technical Committee and the Committee on Origin will draft the proposed rules, Article 4 implies that the Technical Committee will do almost all of the work because Article 4(2) states that "the Technical Committee shall carry out the technical work called for in Part IV [Harmonization of Rules of Origin]"; Article 9(2) states that the Technical Committee "shall develop harmonized definitions" and Article 9(3) states that the Committee's role is to periodically consider the interpretations and opinions of the Technical Committee . . . with a view to endorsing such interpretations and opinions." The Technical Committee, which was established by Article 4(2) of the Origin Agreement, will operate under the auspices of the Customs Co-operation Council. Id. at Art. 4(2). Each member to the Origin Agreement has the right to be represented on it, id. at Annex 1, and to be represented on the Committee, id. at art. 4(l). Additionally, trade organization representatives are allowed to attend meetings of the Technical Committee as observers. Id. at Annex I(6)

[74] If a majority voting system is applied, then the decisions should be binding with no reservations allowed in order to fully implement global harmonization of the nonpreferential rules of origin.

[75] Id. at art. 9(4)

[76] Id. at art. 9(l)(b); 9(2)(c)(i).

[77] Id.

[78] Id. at art. 9(l)(b); 9(2)(c)(ii).

[79] Id. at art. 2(f).

[80] Id. at art. 2(h) (providing for advance ruling procedure during transitional period); art. 3(f) (providing for the same advance ruling procedure after transitional period); Annex 11 (providing for same advance ruling procedure for preferential rules of origin).

[81] Id. at art. 2(g) ("laws, regulations, judicial and administrative rulings of general application relating to the rules of origin are published").

[82] Id. at art. 2(i).

[83] E.g., id. at art. 2(h) ("upon the request of an exporter, importer or any person with a justifiable cause").

[84] E.g., id. at art. 2(h).

[85] E.g., id. at art. 2(a) (stating that the administrative determinations must "clearly specify the subheadings or headings" when using the criterion of change in tariff classification; must indicate the method of calculating the percentage when using the percentage criterion; and must "precisely specify" the prescribed operation when using technical criterion).

[86] E.g., id.

[87] E.g., id.

[88] The advance ruling provisions in many ways codify the United States procedural approach, which allows judicial review of origin determinations and which allows advance rulings. In making these advance rulings, the Treasury Department will often publish prospective rulings for comment, and then publish the final ruling.

This provision in the Agreement represents a substantial advance over existing practices of the European Community. See Vermulst, Revisited, supra note 3, at 76. In the European Community, the Committee on Origin was willing to give advance rulings on origin determinations, but only a member state or the Commission had the authority to bring a request for such an advance ruling. Council Regulation 802/68 on the common definition of the origin of goods, art. 13 (O.J. L139/6 (as amended 1971) (stating that the Committee on Origin will consider questions regarding application of the Origin regulation if brought by

the Chairman or by a representative of a member state). Once a ruling was issued, it was reviewable only in member-state courts after that state has applied the determination to the good. This left firms seeking to reverse adverse origin determinations through judicial review only with the time-consuming, expensive option of seeking review in several different member state courts with the hope for a reference to the European Court of Justice and the risk of inconsistent judgments by the national courts if no reference was issued. See Vermulst, Revisited, supra note 4, at 76 (citing the Yoshida litigation in 1978 and the ongoing Brother litigation as examples of these problems and risks). Recently an informal advance ruling procedure has evolved where an exporter would voluntarily submit information to the

Commission and the Origin Committee in hope of receiving an informal consensus decision on its products' origin. Id. at 75-76.

[89] Origin Agreement, supra note 4, at art. 2(j); art. 3(h); Annex II(3)(f).

[90] Id.

[91] Id. at art. 9(2)(b). See also id. at art. 9(d) (stating that the rules of origin "should not themselves create restrictive, distorting or disruptive effects on international trade.")

[92] This increased certainty will result in a loss of flexibility as national custom administrators will not be able to adapt the rules to changes in technological or manufacturing processes or to circumvention of the rules. Instead, any changes in the harmonized rules to accommodate technological change or unforeseen abuses will have to occur multilaterally in the Technical Committee.

[93] Origin Agreement, supra note 4, at Annex II(3)(c).

[94] Id. at Annex II(3)(a,d,f).

[95] Id. at Annex II(3)(e).

(…)

4-2. MERCOSUR

http://www.sice.oas.org/trade/mrcsr/mrcsr8.asp

SOUTHERN COMMON MARKET (MERCOSUR) AGREEMENT

ANNEX II: GENERAL RULES OF ORIGIN

Chapter I: General Rules for Classification of Origin

Article 1

The following shall be classified as originating in the States Parties:

(a) Products manufactured wholly in the territory of any of the Parties, when only materials originating in the States Parties are used in their manufacture;

(b) Products included in the chapters or headings of the tariff nomenclature of the Latin Arnerican Integration Association referred to in Annex 1 of resolution 78 of the Committee of Representatives of that Association, simply by virtue of the fact that they are produced in their respective territories.

The following shall be classified as produced in the territory of a State Party:

(i) Mineral, plant and animal products, including hunting and fishing products, extracted, harvested or gathered, born and raised in its territory or in its territorial waters or exclusive economic zone;
(ii) Marine products extracted outside its territorial waters and exclusive economic zone by vessels flying its flag or leased by companies established in its territory; and
(iii) Products resulting from operations or processes carried out in its territory by which they acquire the final form in which they will be marketed, except when such processes or operations simply involve assembly, packaging, division into lots or volumes, selection and classification, marking, the putting together of assortments of goods or other equivalent operations or processes;

(c) Products in whose manufacture materials not originating in the States Parties are used, when such products are changed by a process carried out in the territory of one of the States Parties which results in their reclassification in the tariff nomenclature of the Latin American Integration Association under a heading different from that of such materials, except in cases where the States Parties determine that the requirement of Article 2 of this Annex must also be met.

However, products resulting from operations or processes carried out in the territory of a State Party, by which they acquire the final form in which they will be marketed, shall not be classified as originating in the States Parties when such operations or processes use only materials or inputs not originating in their respective countries and simply involve assembly, division into lots or volumes, selection, classification, marking, the putting together of assortments of goods or other similar operations or processes;

(d) Until 31 December 1994, products resulting from assembly operations carried out in the territory of a State Party using materials originating in the States Parties and third countries, when the value of those materials is not less than 40 per cent of the f.o.b. export value of the final product; and

(e) Products which, in addition to being produced in their territory, meet the specific requirements established in Annex 2 of Resolution 78 of the Committee of Representatives of the Latin American Integration Association.

Article 2

In cases where the requirement of Article 1 (c) cannot be met because the process carried out does not involve a change in nomenclature heading, it shall suffice that the c.i.f. value of the third country materials at the port of destination or the maritime port does not exceed 50 per cent of the f.o.b. export value of the goods in question.

In considering materials originating in third countries for States Parties with no outlet to the sea, warehouses and free zones granted by the other States Parties when the rnaterials arrive by sea shall be treated as the port of destination.

Article 3

The States Parties may establish, by mutual consent, specific requirements of origin which shall prevail over general classification criteria.

Article 4

In determining the specific requirements of origin referred to in Article 3 and in reviewing those already established, State Parties shall take the following elements, individually or jointly, as a basis:

I. Materials and other inputs used in production:

(a) Raw materials:
(i) Preponderant raw material or that which essentially characterizes the product; and
(ii) Main raw materials.
(b) Parts or components:

(i) Part or component which essentially characterizes the product;
(ii) Main parts or components; and
(iii) Percentage of parts or components in relation to total weight.

(c) Other inputs.

II. Type of processing used.

III. Maximum proportion of the value of materials imported from third countries in relation to the total value of the product arrived at using the valuation procedure agreed to in each case.

(…)

Article 7

For the purpose of meeting requirements of origin, materials and other inputs originating in the territory of any State Party and used by a State Party in the manufacture of a given product shall be classified as originating in the territory of this latter State Party.

Article 8

The criterion of maximum use of materials or other inputs originating in States Parties may not be taken into account in establishing requirements which involve the imposition of materials or other inputs of those States Parties when, in their view, such materials or inputs do not meet adequate supply, quality or price standards or are not adapted to the industrial processes or technologies used.

Article 9

In order for originating goods to benefit from preferential treatment, they must have been shipped directly from the exporting country to the importing country. For these purposes, the following shall be deemed direct shipment:

(a) Goods not shipped through the territory of a country that is not a party to the Treaty;
(b) Goods shipped in transit through one or more countries that are not parties to the Treaty, with or without transshipment or temporary storage, under the supervision of the competent customs authority in such countries, provided that:

(i) Transit is justified by geographical reasons or transport considerations;
(ii) The goods are not intended for trade or use in the country of transit; and
iii) The goods are not subjected, during shipment and storage, to any operation other than loading, unloading or handling to keep them in good condition or ensure their conservation.

Article 10

For the purposes of these general rules, it shall be understood that:

(a) Products coming from free zones located within the geographical boundaries of any of the States Parties shall meet the requirements envisaged in these general rules;
(b) The term "materials" shall include raw materials, intermediate products and parts and components used in the manufacture of goods.

(…)

Additional Resources and References (Optional Reading)

Jimmie V. Reyna, *A Preliminary Review of the Operation and Effect of the NAFTA Rules of Origin*, 1 U.S.-MEX. L.J. 127 (1993).