Preferential rules of origin are applied by countries that offer certain trade partners zero-duty or reduced-duty access for their imports as a means of determining the eligibility of products to receive such preferential access. These rules of origin are required to prevent trade deflection or simple transshipment, whereby products from nonpreferred countries are redirected through a free trade partner to avoid the payment of customs duties. They are meant to ensure that only goods originating in participating countries enjoy duty preferences. Rules of origin are thus integral to preferential trade agreements such as bilateral and regional free trade agreements and to the nonreciprocal preferences that industrial countries offer to developing countries.

The nature of rules of origin and their application can have profound implications for trade flows and for the work of customs authorities. Rules of origin can be designed in such a way as to restrict trade and therefore can be used, and are being used, as instruments of trade policy. The proliferation of free trade agreements throughout the world, with the accompanying preferential rules of origin, is increasing the burden on customs services in many countries, with implications for the ease of trade. Perhaps surprisingly, given their potential to influence trade flows, preferential rules of origin are one area of trade policy that has been subject to very little discipline during the almost 50 years of the multilateral rules-based system now governed by the World Trade Organization (WTO).

Defining Origin

When a product is produced in a single stage or is wholly obtained in one country, such that there are no imported components, the country origin of the product is relatively easy to establish. This applies mainly to “natural products” and to goods made entirely from them. Proof that the product was produced or obtained in the preferential trade partner is normally sufficient. For all other cases in which two or more countries have taken part in the production of the good, the rules of origin define the methods for ascertaining in which country the particular product has undergone sufficient working or processing or has been
subjected to a substantial transformation. (In general, these terms can be used interchangeably.) A substantial transformation is one that conveys to the product its essential character. Unfortunately, there is no simple and standard rule of origin for identifying the “nationality” of a product.

Although rules relating to products that are wholly obtained are usually relatively straightforward, this is not always the case. A good example of how rules for products that appear to be in their natural state, and are therefore apparently wholly obtained, can become complex and restrictive is the case of fish—typically, a sensitive sector in many countries. There is no apparent import content of fish caught in the sea or ocean, yet the European Union (EU) rules for fish caught outside a country’s territorial waters but within the exclusive economic zone of a country can be very complex and difficult to satisfy and to prove compliance with. To receive preferential access to the EU under the generalized system of preferences (GSP), all of the following conditions relating to the vessel that catches the fish and the crew that sails on it must be satisfied:

• The vessel must be registered in the beneficiary country or in the EU.
• The vessel must sail under the flag of the beneficiary or of a member state of the EU.
• The vessel must be at least 60 percent owned by nationals of the beneficiary country or the EU or by companies with a head office in either the beneficiary country or in an EU state, and the chairman and a majority of the board members must be nationals of the beneficiary country or the EU.
• The master and the officers must be nationals of the beneficiary country or of an EU member, and at least 75 percent of the crew must be nationals of the beneficiary country or of an EU country.

Under the EU’s Cotonou Agreement, which gives preferential access to the EU market to African, Caribbean, and Pacific (ACP) countries, the rules of origin for fish are slightly different and a little more liberal than those for GSP countries:

• The vessel must be registered in the EU or in any ACP state.
• The vessel must sail under the flag of any ACP or EU country.
• The vessel must be at least 50 percent owned by nationals of any ACP or EU state, and the chairman and the majority of the board members must be nationals of any of those countries.
• Under certain conditions, the EU will accept vessels chartered or leased by the ACP state under the Cotonou Agreement.
• Under Cotonou, the master, the officers, and 50 percent of the crew must be nationals of any ACP state or the EU.

So, identifying the nationality of fish can be a demanding task! More important, these rules have important economic implications for countries that wish to attract foreign direct investment (FDI) into their fisheries sectors and for small island economies that may have great difficulty in meeting the crew and officer requirements.

Methods for Determining Substantial Transformation

The three main criteria for determining origin are change of tariff classification, value added, and specific manufacturing process. We discuss each in turn.

Change of tariff classification. Origin is granted if the exported product falls into a different part of the tariff classification from any imported inputs that are used in its production. Application of this “tariff-shift” method has been facilitated by the widespread adoption of the Harmonized System (HS), under which most of the world’s more than 190 countries are now classifying goods according to the same harmonized categories. The level of classification of the HS at which change is required remains an issue, however. Typically, it is specified that the change should take place at the heading level (that is, at the four-digit level of the HS). Examples of simple HS headings are “beer made from malt” (HS 2203) and “umbrellas and sun umbrellas” (HS 6601). But headings can be more sophisticated:

Machinery, plant or laboratory equipment, whether or not electrically heated (excluding furnaces, ovens and other equipment of heading 8514), for the treatment of materials by a process involving a change of temperature such as heating, cooking, roasting, distilling, rectifying, sterilizing, pasteurising, steaming, drying, evaporating, vaporizing, condensing or cooling, other than machinery or plant of a kind used for domestic purposes; instantaneous or storage water heaters, non-electric. (HS 8419)

The HS, however, was not designed specifically as a vehicle for determining country of origin; its purpose is to provide a unified commodity classification for definition of tariff schedules and for statistical purposes. Thus, in particular cases it can be argued that a change of tariff heading will not identify substantial transformation, whereas in other cases, substantial transformation may occur without change of tariff heading. As a result, schemes utilizing the criterion of change of tariff heading usually provide for a
wide range of exceptions that need to satisfy other criteria for determining country of origin.

The change of tariff classification may be used to define both a positive test of origin, by stating the tariff classification of imported inputs that can be used in the production of the exported good (for example, those under a different heading), and a negative test, by stating cases in which change of tariff classification will not confer origin. For example, the North American Free Trade Agreement (NAFTA) rule of origin for tomato ketchup states that a change to ketchup (HS 210320) from imported inputs of any chapter except subheading 200290 (tomato paste) will confer origin. In other words, any ketchup made from imported fresh tomatoes will confer origin, but ketchup made from tomato paste imported from outside the area will not qualify for preferential treatment, even though the basic change of tariff classification requirement has been satisfied. In the EU’s preferential rules of origin, bread, biscuits, and pastry products (HS 1905) can be made from any imported products except those in chapter 11, which include flour—the basic input to these products.

The WTO Agreement on Rules of Origin stipulates that preferential and nonpreferential rules of origin should be based on a positive standard, but it allows the use of negative standards (a definition of what does not confer origin) if they “clarify a positive standard.” The latter condition is so vague as to have had very little effect, and EU and NAFTA rules of origin, for example, are rife with negative standards.

Thus, although in principle the change of tariff classification can provide a simple, uniform method of determining origin, in practice, instead of a general rule, there are often many individual rules. Nevertheless, the rule on change of tariff classification, once defined, is clear, unambiguous, and easy for traders to learn, and it is relatively straightforward to implement. In terms of documentation, it requires that traders keep records showing the tariff classification of the final product and of all the imported inputs. This may not be a demanding requirement if the exporter directly imports the inputs, but it may be more difficult if inputs are purchased from intermediaries in the domestic market.

Value added. When the value added to a product in a particular country exceeds a specified percentage, the goods are defined as originating in that country. This criterion can be defined in two ways: as the minimum percentage of the value of the product that must be added in the country of origin, or as the maximum percentage of imported inputs in total inputs or in the value of the product.

As in the case of change of tariff classification, the value added rule has the advantage of being clear, simple, and unambiguous as stated. In application, however, it can become complex and uncertain. First, there is the issue of the valuation of materials, which may be based on several prices: ex works (from factory); free on board (FOB); cost, insurance, and freight (CIF); or into factory. Each method yields a different (in this instance, ascending) value of nonoriginating materials. Second, the application of this method can be costly for firms that will require sophisticated accounting systems and the ability to resolve often-complex accounting questions. Finally, under the value added method, origin is sensitive to changes in the factors that determine production cost differentials across countries, such as exchange rates, wages, and commodity prices. For example, operations that confer origin in one location may not do so in another because of differences in wage costs, and an operation that confers origin today may not do so tomorrow if exchange rates change.

Specific manufacturing process. This criterion delineates for each product or product group certain manufacturing or processing operations that define origin (positive test) and manufacturing or processing procedures that do not confer origin (negative test). The rules may require the use of certain originating inputs or prohibit the use of certain nonoriginating inputs. For example, EU rules of origin for clothing products stipulate manufacture from yarn, while the rule for sodium perborate requires manufacture from disodium tetraborate pentahydrate.

The main advantage of specific manufacturing process rules is that, once defined, they are clear and unambiguous so that, from the outset, producers are able to clearly ascertain whether their product is originating or not. There are, however, a number of drawbacks to this system, including obsolescence (as a consequence of changes in technology) and documentary requirements, such as an up-to-date inventory of production processes, which may be burdensome and difficult to comply with.

Table 8.1 summarizes the main advantages and disadvantages of these various methods of determining sufficient processing or substantial transformation. No one rule dominates others as a mechanism for formally identifying the nationality of all products, and each has its advantages and disadvantages. It is clear, however, that different rules of origin can lead to different determinations of origin.

Producers who are eligible for preferential access to different markets under different schemes with different rules of origin may find that their product qualifies under some schemes but not others. For example, a company in a developing country may find that the product it produces qualifies for preferential access to the EU market under the EU’s GSP scheme but that the same product does not satisfy the rules of origin of the U.S. GSP scheme.
Table 8.1. Summary of Methods for Determining Origin

<table>
<thead>
<tr>
<th>Rule</th>
<th>Advantages</th>
<th>Disadvantages</th>
<th>Key issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change of tariff classification in the Harmonized System</td>
<td>Consistency with nonpreferential rules of origin. Once defined, rule is clear, unambiguous, and easy to learn. Relatively straightforward to implement.</td>
<td>Harmonized System not designed for conferring origin; as a result, there are often many individual product-specific rules, which can be influenced by domestic industries. Documentary requirements may be difficult to comply with. Conflicts over the classification of goods can introduce uncertainty about market access.</td>
<td>Level of classification at which change required; the higher the level, the more restrictive. Test may be positive (e.g., which imported inputs may be used) or negative (e.g., definition of cases where change of classification will not confer origin); negative test more restrictive.a</td>
</tr>
<tr>
<td>Value added</td>
<td>Clear, simple to specify, and unambiguous. Allows for general rather than product-specific rules.</td>
<td>Complex to apply; requires firms to have sophisticated accounting systems. Uncertainty resulting from sensitivity to changes in exchange rates, wages, commodity prices, and so on.</td>
<td>Level of value added required to confer origin. Valuation method for imported materials: methods that assign a higher value (e.g., CIF) will be more restrictive with respect to use of imported inputs.</td>
</tr>
<tr>
<td>Specific manufacturing process</td>
<td>Once defined, clear and unambiguous. Provides for certainty if rules can be complied with.</td>
<td>Documentary requirements can be burdensome and difficult to comply with. Leads to product-specific rules. Domestic industries can influence the specification of the rules. Can quickly become obsolete due to technological progress and therefore require frequent modification.</td>
<td>Formulation of the specific processes required; the more procedures required, the more restrictive. Use of negative test (processes or inputs which cannot be used) or positive test (what can be used); negative test more restrictive.</td>
</tr>
</tbody>
</table>

Source: Author’s compilation.

Note: CIF, cost, insurance, and freight.

a. A positive determination of origin typically takes the form of “change from any other heading,” as opposed to a negative determination of origin, such as “change from any other heading except for the headings of chapter XX.” It is worth noting that change of tariff classification, particularly with a negative determination of origin, can be specified to have an effect identical to that of a specific manufacturing process.

Best-Practice Suggestions for the Design of Rules of Origin

Although it is difficult to derive specific recommendations with regard to the best-practice approach to the design of rules of origin, certain general propositions can be advanced that apply to both preferential and nonpreferential rules:

- The rules of origin should be simple, precise, easy to understand, transparent, predictable, and stable. They should avoid or minimize scope for interpretation and administrative discretion.
- The rules should be designed to have the least trade-distorting impact and should not become disguised nontariff barriers to trade. Protectionist lobbying should not compromise the specification of the rules of origin.
- As much as possible, the rules should be consistent across products and across agreements. The greater are the inconsistencies, the greater will be the complexity of the system of rules of origin, both for companies and for officials administering the various trade schemes.

Rules of Origin and Trade Preferences

Preferred rules of origin define the conditions that a product must satisfy to be deemed as originating in a country that is eligible for preferential access to a partner’s market—not simply transshipped from a nonqualifying country or subject to only minimal processing. In practice, the greater the level of work that is required by the rules of origin, the more difficult it is to satisfy those rules, and the more restrictive the rules are in constraining market access relative to what is required simply to prevent trade deflection. This is particularly true for small, less diversified developing economies. The higher the amount of domestic value added that is required by a value added rule, the more difficult compliance will be, since there will be less scope for the use of imported parts and materials. A rule of origin that prevents the use of imported flour in the production of pastry products such as biscuits, for example, will be very restrictive for countries that do not have a competitive milling industry. With regard to requirements relating to sufficient processing, change of tariff classification is the most frequently
used criterion in current preferential trade agreements, and it features in both EU agreements and NAFTA. WTO research (WTO 2002) shows that of 87 free trade agreements (FTAs) and other preferential trade agreements investigated, 83 used change of tariff classification in the determination of origin. Most agreements specify that the change should take place at the heading level (that is, at the four-digit level), but in many agreements, especially those involving the EU and NAFTA, the tariff-shift requirement varies by product. For example, Estevadeordal and Suominen (2003) show that, although in NAFTA about 40 percent of tariff lines requires change of tariff heading, most tariff lines (54 percent) are subject to the more restrictive requirement of change of chapter (two-digit level). For a small number of products, only a change of subheading (six-digit level) is required.

Although change of tariff heading is used in most preferential trading agreements, it is seldom the only method applied. It is also important to note that in some agreements, such as those involving the EU, change of tariff classification is applied to some products, but the value added and specific manufacturing process methods are used for others. In NAFTA, rules of origin tend to require at least change of tariff classification, but the level at which change is required varies across products. This typically leads to considerable complication for customs officials in determining origin in preferential agreements. By contrast, many agreements between developing countries tend to specify general rules of origin and eschew the detailed product-by-product approach adopted by the EU and NAFTA.

Furthermore, in EU agreements and in NAFTA for certain products, rules are stipulated that require satisfaction of more than one method to confer origin. This is clearly more restrictive than a requirement to satisfy a single method. For example, in NAFTA’s rules of origin, the requirement for passenger motor vehicles (HS 870321) reads, “A change to subheading 8703.21 from any other heading provided there is a regional value content of not less than 50 percent under the net cost method.”

In some agreements for certain products, two or more methods will be stipulated, and satisfaction of any one of the methods will be sufficient to confer origin. For example, in the EU rules of origin, the requirements for wooden office furniture (HS 940330) are “manufacture in which all the materials used is classified within a heading other than that of the product” or “manufacture in which the value of all the materials used does not exceed 40 percent of the ex-works price of the product.” The provision of alternative means of satisfying origin requirements gives exporters, especially small firms, greater flexibility and will facilitate trade under preferential trade agreements.

With respect to value added requirements, the WTO views a threshold for domestic content of between 40 and 60 percent as the norm, with a typical average import requirement of between 60 and 40 percent. The EU agreements identify various thresholds on import content, ranging from 30 to 50 percent. NAFTA has a domestic content requirement of either 50 or 60 percent, according to the method used to value the product. A value added requirement of 50 percent can be very demanding in the globalized world of today, in which production has become split among (perhaps many) countries.

A further feature of globalization is that, for such products as clothing, computers, and telecommunication equipment, much of the value added lies in the intermediate products. High value added requirements therefore become particularly difficult for developing countries to satisfy, since it is the final, labor-intensive stage that they host. In this way, restrictive rules of origin act to constrain specialization at the country level. The available evidence suggests that for many products, value added in low-income countries is substantially less than 30 percent. When the final stage of production involves labor-intensive activities applied to relatively high-value imported inputs, it is more difficult for low-wage countries to satisfy a particular value added requirement than it is for higher-wage countries.

In general, these percentage value rules are rarely applied as the sole test of origin and are typically employed with the change of tariff classification. Exceptions among agreements are the Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), the South Pacific Trade and Economic Co-operation Agreement (SPARTECA), and the Association of Southeast Asian Nations (ASEAN) Free Trade Agreement (AFTA), which have percentage requirements without any additional need for change of tariff heading. All three agreements do require that the last process of manufacture be undertaken in the exporting country.

As noted earlier, under the value added method, origin is sensitive to changes in factors such as exchange rates, wages, and commodity prices. The value added method thus tends to penalize low-labor-cost locations, which will find it more difficult than higher-cost locations to add the necessary value. It is likely to cause particular problems of compliance for companies in developing countries that lack the sophisticated accounting systems necessary under this method.

Rules based on specific manufacturing processes are widely used (in 74 of the 83 preferential trade agreements analyzed by the WTO), often in conjunction with the change of tariff classification criterion, the value added criterion, or both. They are a particular feature in the textiles
and clothing sectors. Some examples of the application of the rules follow:

- A producer imports cotton fabric (HS5208), which is then dyed, cut, and made up into cotton shirts (HS6105). The value of the imported materials amounts to 65 percent of the value of the shirts. In this case, origin would come under a change of tariff heading rule, but not under a value added rule, which requires an import content of not more than 60 percent or a domestic content of more than 40 percent. A specific manufacturing process requirement that the products have been manufactured from yarn (the production stage before fabric) would mean that the product would not be originating.

- A doll (HS9502) is made from imported plastics and imported ready-made garments and footwear. The value of the imported materials amounts to 50 percent of the value of the doll. In this case, the doll would be originating under a value added rule requiring an import content of no more than 60 percent; it would not be originating under the change of tariff heading because garments and accessories for dolls are classified under the same tariff heading as dolls.

Most preferential trade agreements also specify types of operations that are deemed to be insufficient in working or processing to confer origin. Typically, they include (a) simple packaging operations, such as bottling, placing in boxes, bags, and cases, and simple attachment on cards and boards; (b) simple mixing of products and simple assembly of parts; and (c) operations to ensure the preservation of products during transport and storage. The requirements act to ensure that these basic operations do not confer origin even if the basic rule of origin, such as change of tariff heading, has been satisfied.

Several other typical features of the rules of origin of preferential trade schemes can influence whether origin is conferred on a product and can hence determine the effect of the scheme on trade flows. These are cumulation, tolerance rules, and absorption. The treatment of duty drawback and of outward processing outside the free trade partners or preferential trade partners can also be important.

**Cumulation**

The basic rules of origin define the processing that has to be done in the individual beneficiary or partner to confer origin. Cumulation allows producers to import materials from a specific country or regional group of countries without undermining the origin of the final product. In effect, the imported materials from the identified countries are treated as being of domestic origin in the country requesting preferential access. There are three types of cumulation: bilateral, diagonal (or partial), and full.

The most basic form, *bilateral cumulation*, applies to materials provided by either of two partners of a preferential trade agreement. In this case, originating inputs (i.e., materials) that have been produced in accordance with the relevant rules of origin and imported from the partner, qualify as originating materials when used in a country’s exports to that partner. For example, under the EU’s GSP scheme, the rule of origin for cotton shirts states that origin is conferred to a beneficiary country if the shirt is manufactured from yarn. Nonoriginating yarn may be imported, but the weaving into fabric, the cutting, and the making up into a shirt must take place in the beneficiary. The EU’s GSP scheme allows for bilateral cumulation so that fabric that originates in the EU (that is, fabric produced in accordance with the rule of origin for fabric—in this case, produced from the stage of fibers) can be treated as originating in the beneficiary country. Thus, originating fabrics can be imported from the EU and used in the production of shirts for export that will qualify for preferential access to the EU. The EU, however, is often not the least-cost supplier of inputs, and so the benefits of this type of cumulation can be limited. If the extra cost of using EU-sourced inputs rather than the lowest-cost inputs from elsewhere exceeds the available benefit from preferential access, cumulation will have no effect, and there will be no improvement in market access.

*Diagonal cumulation* takes place on a regional basis. Qualifying materials from anywhere in the specified region can be used without undermining preferential access. In other words, parts and materials from anywhere in the region that qualify as originating can be used in the manufacture of a final product, which can then be exported with preferences to the partner country’s market. Diagonal cumulation is widely used in EU agreements but is not applied by NAFTA. In Europe, a pan-European system of rules of origin with diagonal cumulation has been developed to govern EU free trade agreements with countries of the European Free Trade Association (EFTA) and with countries in Central and Eastern Europe. Diagonal cumulation is allowed under the EU’s GSP scheme, but within a limited set of regional groups that have pursued their own regional trade agreements. For example, diagonal cumulation can take place within four regional groupings: ASEAN, the Central American Common Market (CACM), the Andean Community, and the South Asian Association for Regional Cooperation (SAARC).
Diagonal cumulation allows originating materials from regional partners to be further processed in another country in the group and treated as though the materials originated in the country where the processing is undertaken. This flexibility in sourcing is, however, constrained by the further requirement that the value added in the final stage of production exceed the highest customs value of any of the inputs used from countries in the regional grouping. Thus, for example, with diagonal cumulation, shirt producers in Cambodia can use fabrics from Indonesia (provided that they are originating—that is, produced from the fiber stage) and still receive duty-free access to the EU, but the value added in Cambodia must exceed the value of the imported fabric from Indonesia. Similarly, producers in Nepal can import originating fabric from India and still qualify for preferential access to the EU if the value added in Nepal is sufficient.

As demonstrated in a report by the United Nations Conference on Trade and Development (UNCTAD) and the Commonwealth Secretariat (2001), the value added requirement can render regional cumulation of little value. For example, value added in the making up of clothing in Bangladesh ranges from between 25 and 35 percent of the value of the product, so the import content of the fabrics that come from India is around 65 to 75 percent. In this case, the value added requirement placed on regional cumulation is not met, and origin of the made-up clothing is conferred not on Bangladesh, but on India. Regional cumulation still allows clothing that is produced in Bangladesh from Indian fabrics preferential access to the EU, but not at the zero rate for which Bangladesh is eligible. Rather, the rate for which India is eligible—a 20 percent reduction from the most favored nation (MFN) rate—is applied. Thus, instead of the zero duty, which is in principle available to Bangladesh under the Everything But Arms regulation, a tariff of more than 9 percent would be levied on these exports from Bangladesh to the EU.

In full cumulation, any processing activities carried out in any participating country in a regional group can be counted as qualifying content, regardless of whether the processing is sufficient to confer originating status on the materials themselves. Full cumulation allows for greater fragmentation of production processes among the members of the regional group and so stimulates increased economic linkages and trade within the region.

Under full cumulation, all the processing carried out in participating countries is assessed in deciding whether there has been substantial transformation. Full cumulation therefore encourages deeper integration among participating countries. Full cumulation is rare. It is currently applied in the EU agreements with the EFTA countries; with Algeria, Morocco, and Tunisia; and, under the Cotonou Agreement, with the ACP countries. It is also available in the GSP schemes of Japan and the United States; among countries within specified groupings; and, on a global basis, among all developing-country beneficiaries in the schemes of Australia, Canada, and New Zealand, as well as the ANZCERTA and SPARTECA regional agreements.

Under full cumulation, it may be easier for more developed, higher-labor-cost countries to outsource labor-intensive, low-technology production stages to less developed, lower-wage partners while maintaining the preferential status of the good produced in low-cost locations. Diagonal cumulation, by requiring that more stages of production or higher value added be undertaken in the lower-cost country, may make it more difficult for the products produced by outsourcing to qualify for preferential access. The documentary requirements of full cumulation may be more onerous than those required under diagonal cumulation. Detailed information from suppliers of inputs may be required under full cumulation, whereas the certificates of origin that accompany imported materials may suffice to show conformity under diagonal cumulation. For this reason, it is desirable that traders be offered a choice between diagonal or full cumulation.

To illustrate the alternatives, a clothing product made in one country from fabric produced in a regional partner and made from nonoriginating yarn would be eligible for duty-free access to the EU under full cumulation but not under diagonal cumulation, since the fabric would not be deemed to be originating. (The rule of origin for the fabric requires manufacture from fibers.) Or, country A provides parts (say, chassis for bicycles) to country B, where they are processed (painted and prepared) and sent to country C for final assembly, using locally produced parts (tires and seat), before being exported to country D. Countries B, C, and D participate in the same FTA; country A is not a member. The value of the final product (the bicycle) exported from country C to country D consists of 25 percent parts from country A, 25 percent value added in country B, and 50 percent parts from and value added in country C. The value of parts from country A makes up 50 percent of the value of the intermediate product exported from country B to country C. If there were a 40 percent maximum import content for all products, the bicycle exported from country C to country D would qualify for preferential access under full cumulation. (Only the 25 percent of parts from country A is nonoriginating.) It would not, however, qualify under diagonal cumulation because the value of originating materials in the product exported by country B exceeds 40 percent. This intermediate product would not be treated as originating, and...
the total of nonoriginating materials in the final product would now be calculated as 50 percent of the final price of the bicycle (the value from both country A and country B).

Tolerance Rules

Tolerance, or de minimis, rules allow a certain percentage of nonoriginating materials to be used without affecting the origin of the final product. The tolerance rule can make it easier for products with nonoriginating inputs to qualify for preferences under the change of tariff heading rule and the specific manufacturing process rule. This provision does not affect the value added rules. The tolerance rule does not act to lower the limitation on the value of imported materials; the nonoriginating materials will always be counted in calculating import value content.

In NAFTA, nonoriginating materials can be used even if the rule on sufficient processing is not fulfilled, provided that the value of these materials does not exceed 7 percent of the value of the final product. Under the EU’s GSP scheme, the threshold is 10 percent, but under the Cotonou Agreement between the EU and the ACP countries, the tolerance rule allows 15 percent of nonoriginating materials that would otherwise not be accepted. For example, in the case of the doll described earlier, in which the value of dolls’ clothing accessories denied origin to the final product under the change of heading rule (since the accessories are classified under the same heading), origin would be conferred under the EU GSP if the value of the dolls’ clothing and accessories is less than 10 percent of the value of the doll.

The tolerance rules applied to the textiles and clothing sector are often different and are generally less favorable than the general rules on tolerance. In many cases, the rule is applied in terms of the maximum weight rather than the value of the nonoriginating materials that are tolerated, and in cases in which the value threshold is maintained, it is set at a lower level than in the general rule.

Absorption (Roll-Up) Principle

According to the absorption principle, parts or materials that have acquired originating status by satisfying the relevant rules of origin can be treated as being of domestic origin in any further processing and transformation. This is of particular relevance to the value added test. For example, in the production of a particular part, origin is conferred because imported materials constitute 20 percent of the final price of the part and are less than the maximum, say, 30 percent required by an import content rule of origin. This part will then be treated as 100 percent originating when incorporated into a final product. The 20 percent import content of the part is not taken into account when assessing the import content of the final product. The converse of this is that if the part does not satisfy the relevant rule of origin, it is deemed to be 100 percent nonoriginating (“roll-down”). Ideally, if the part or the materials fail to satisfy the relevant rule of origin, the portion of value added domestically should still be counted in the determination of the origin of the final product.

Duty Drawback and Outward Processing

Provisions relating to duty drawback can lead to the repayment of duties on nonoriginating inputs used in the production of a final product that is exported to a free trade or preferential trade partner. Some agreements contain explicit no-drawback rules that will affect decisions relating to the sourcing of inputs by firms exporting within the trade area, reducing the incentives for the use of imported inputs from nonparticipating countries and encouraging the use of originating inputs from participating ones. Increasingly important are rules concerning territoriality and the treatment of outward processing by companies based within the free trade area that is undertaken in countries that are not members of the agreement. These rules determine whether processing outside the area undermines the originating status of the final product exported from one partner to another.

Rules of Origin in Existing Preferential Trade Agreements

Preferential rules in EU and U.S. agreements. All three methods of determining origin are employed in agreements involving the EU and NAFTA. A key feature of the EU and NAFTA models of rules of origin is that these rules are specified at a very detailed level on a product-by-product basis and can be very complex—they often run to well over 200 pages! The rules for clothing products under NAFTA provide an example of very complex and restrictive rules of origin. The following summarizes the rules for men’s or boys’ overcoats made of wool (HS620111), which are typical of the nature of the rules for a wide range of clothing products:

A change to subheading 620111 from any other chapter, except from heading 5106 through 5113, 5204 through 5212, 5307 through 5308 or 5310 through 5311, Chapter 54 or heading 5508 through 5516, 5801 through 5802 or 6001 through 6006, provided that the good is both cut and sewn or otherwise assembled in the territory of one or more of the Parties.

The basic rule of origin stipulates change of chapter but then provides a list of headings and chapters from which
imported inputs cannot be used. In effect, the overcoat must be manufactured from the stage of wool fibers forward, since neither imported woolen yarn (HS5106–5110) nor imported woolen fabric (HS5111–5113) can be used. However, the rule also states that neither imported cotton thread (HS5204) nor imported thread of man-made fibers (HS54) can be used to sew the coat together. This rule in itself is very restrictive, and the rule for this product is further complicated by requirements relating to the visible lining:

Except for fabrics classified in 54082210, 54082311, 54082321, and 54082410, the fabrics identified in the following sub-headings and headings, when used as visible lining material in certain men’s and women’s suits, suit-type jackets, skirts, overcoats, car coats, anoraks, windbreakers, and similar articles, must be formed from yarn and finished in the territory of a party: 5111 through 5112, 520831 through 520859, 520931 through 520959, 521031 through 521059, 521131 through 521159, 521213 through 521215, 521223 through 521225, 540742 through 540744, 540752 through 540754, 540761, 540772 through 540774, 540782 through 540784, 540792 through 540794, 540822 through 540824 (excluding tariff item 540822aa, 540823aa or 540824aa), 540832 through 540834, 551219, 551229, 551299, 551321 through 551349, 551421 through 551599, 551612 through 551614, 551622 through 551624, 551632 through 551634, 551642 through 551644, 551692 through 551694, 600110, 600192, 600531 through 600544 or 600610 through 600644.

This stipulates that the visible lining used must be produced from yarn and finished in either party. The rule may well have been introduced to constrain the effect of the tolerance rule, which would normally allow 7 percent of the weight of the article to be of nonoriginating materials. In overcoats and suits, the lining is probably less than 7 percent of the total weight. Finally, it is interesting to note that the rules of origin also provide very specific exemptions to the rules of origin for materials that are in short supply or are not produced in the United States—reflecting firm-specific lobbying to mitigate the restrictiveness of the original NAFTA rules of origin. The most specific example is where apparel is deemed to be originating if assembled from imported inputs of “fabrics of subheading 511111 or 511119, if hand-woven, with a loom width of less than 76 cm, woven in the United Kingdom in accordance with the rules and regulations of the Harris Tweed Association, Ltd., and so certified by the Association.” The task facing importers, and the relevant customs officials, in checking consistency with such rules is clearly not a simple one!

Preferential rules in other agreements. This detailed, product-specific approach to rules of origin of the EU and NAFTA can be contrasted with most of the agreements involving developing countries, such as AFTA, the Common Market for Eastern and Southern Africa (COMESA), and the Southern Cone Common Market (Mercosur, Mercado Común del Sur), where rules are typically general and there are no, or very few, product-specific rules of origin. This suggests that domestic industry did not play a significant role in the specification of these rules. Some agreements, such as AFTA, rely solely on the value added method. The COMESA rules of origin require satisfaction of a value criterion (either the CIF value of imports must not exceed 60 percent of the value of all materials used, or domestic value added should be at least 35 percent of the ex-factory cost of the goods) or a change of tariff heading.\footnote{What are the merits of these different approaches to the specification of preferential rules of origin? Detailed product-by-product rules can leave very little scope for interpretation. Indeed some argue that a product-by-product approach based on input from domestic producers is the best way of dealing with the specification of rules of origin. But, as the examples of fish and clothing show, product-specific rules can become very complex and restrictive. The more complex and the more technical the rules become, the greater is the scope for the participation of domestic industries in setting restrictive rules of origin (see Hoekman 1993). Indeed, “the formulation of product specific rules of origin is, by its nature, very much out of the practical control of generalists, which is to say government officials at the policy level, and very much in the practical control of specialists, which is to say the representatives of concerned industries” (Palmeter 2003, 159). Other interests, such as consumers of the relevant product, are effectively excluded from discussion concerning the rules of origin.

Those who lobby hardest for trade policy interventions are not altruistic, and their objectives with regard to rules of origin are likely to be to restrict competition from imports and to expand their own exports within a free trade area at the expense of third-country suppliers. Such objectives can be more effectively pursued when policy is determined in an environment that lacks transparency and openness, as can easily occur when rules of origin are determined product by product.

From a trade policy perspective, the restrictiveness of a value added rule, in terms of its impact on trade, is clearer and more apparent than is the case for the change of tariff classification and specific manufacturing process rules. It is relatively straightforward to compare alternative proposals concerning a value added rule. The extent of protection engendered by complex and technical rules of origin that differ across products is much more difficult to detect. This asymmetry of information is one reason why those groups
seeking protection will push for complex rules of origin and why the change of tariff classification and specific manufacturing process rules may be more susceptible to capture by protectionist domestic interest groups (see Hirsch 2002). Adopting a product-by-product approach to rules of origin will tend to lead to rules that are more restrictive than is necessary to prevent trade deflection—to protectionist rules of origin—and that can lead to an overly complex system that is difficult for traders to implement and that adds considerably to the burden on customs services.

More general rules of origin can allow greater scope for interpretation, as noted by Izam (2003). In Asia, there are some suggestions of underutilization of AFTA preferences, reflecting uncertainties concerning the rules of origin. It appears that differing interpretations of the rules in ASEAN countries lead to inconsistent application of the rules within the region. This suggests the need for more effective coordination between customs and other relevant authorities in partner countries, with the aim of clarifying existing rules and regulations rather than applying more restrictive rules of origin. It is also important that alternative rules be considered so that producers are allowed some flexibility in proving origin. Giving producers the option of satisfying either a value added rule or a change of tariff classification rule is likely to be trade facilitating.

There is substantial variation in the permitted amount of nonoriginating import content under value added requirements in different agreements. In the Canada–Chile agreement, for example, products are typically subject to a change of tariff classification (where the level of change required varies by product) and a domestic value added requirement that varies between 25 and 60 percent, according to the product and the method of valuation used. In the U.S.–Chile agreement, where the rules are similar to those of NAFTA but not identical for all products, the required domestic content is between 35 and 55 percent. Under the Canada–Chile agreement for those products, whereas other products may satisfy U.S. but not Canadian rules of origin requirements.

Most free trade and nonreciprocal trade preference schemes contain provisions for cumulation, but there is considerable variation in its nature. For example, the EU allows for diagonal cumulation in the Pan-European Area of Cumulation, encompassing the EFTA, Central and Eastern European, and Balkan countries, whereas under the Cotonou Agreement, there is full cumulation among African and Caribbean countries. Similarly, for tolerance rules, which are widely applied in agreements that are not based on the sole use of the value added method, there are considerable differences across agreements, even those involving the same country. Under the EU–Mexico Free Trade Agreement, nonoriginating materials can constitute up to 10 percent of the value of the final product, while under the agreement between the EU and South Africa, the level of tolerance is set at 15 percent. Different rules of tolerance are often established for certain sectors, especially textiles and clothing.

Measures of the restrictiveness of different origin regimes. Estevadeordal (2000) introduced an ordinal index (the R-index) to capture the overall restrictiveness of a set of rules of origin. The index is derived from data at the tariff line level and is based on an observation rule, with the following two assumptions:

- For a change of tariff classification (CTC), change at the chapter level is more difficult to satisfy than a change at the heading level; a change at the heading level is stricter than at the subheading level; and a change at the subheading level is more stringent than at the tariff-line or item level.
- Additional criteria usually imply a more restrictive rule. When a CTC is accompanied by a value added requirement, a specific technical process, or both, the rule is more difficult to meet. Allowances (tolerance) and cumulation, by contrast, will tend to diminish the restrictiveness of a given rule.

Higher values are assigned more demanding rules, with a maximum value of 7. Figure 8.1 provides a simple summary of the outcome of applying this index to a number of free trade agreements by using information presented in Estevadeordal and Suominen (2006). The index shows that agreements involving the United States and the EU tend to have more restrictive rules of origin than do agreements among developing countries, such as COMESA and the Economic Community of West African States (ECOWAS). Agreements involving the EU and the United States tend to
have complex product-specific rules of origin, whereas the COMESA and ECOWAS agreements have simpler rules that are common across products.

Although agreements between developing countries often have less restrictive rules of origin on paper, in practice their implementation can be highly restrictive. For example, to be able to use the ECOWAS trade liberalization scheme, companies must obtain, for each and every product that they wish to export, approval from their national ministry and then from ECOWAS. This is in addition to the requirement of a certificate of origin for each shipment. The whole process apparently takes between four to six months. Indeed, exporters registering for the first time are advised to state the names of future products to be exported under the scheme. If not, they will have to apply again for each new product they wish to export!

**Economic Implications of Rules of Origin**

The specification and implementation of rules of origin can be a major determinant of the impact of free trade and preferential trade agreements. In practice, rules of origin are controversial because the available evidence suggests that the utilization of preferences tends to be less than full. That is, substantial proportions of actual exports that are eligible for preferences do not enter the partner’s market with zero or reduced duties but actually pay the MFN tariff. Sapir (1998) shows that 79 percent of EU dutiable imports from GSP beneficiaries in 1994 qualified for preferential access to the EU market, yet only 38 percent actually entered the EU market with a duty less than the MFN rate. The reasons for this difference are the effects of rules of origin and tariff quotas for particular products, which set limits on the amount of imports that can receive beneficial access to the EU market. The gap also reflects the treatment of textiles and clothing products, which accounted for more than 70 percent of EU imports from countries covered by the GSP but for which the utilization rate (the ratio of imports receiving preferences to eligible imports) was only 31 percent.

**Rules of Origin and the Utilization of Trade Preferences**

Under the EU’s Everything But Arms Agreement for the least developed countries, which offers duty-free access for all products, almost all of Cambodia’s exports to the EU are eligible for zero duty preferences, yet in 2001, only 36 percent of those exports obtained duty-free access. Brenton (2003) shows that this failure to utilize preferences meant that, on average, Cambodia’s exports to the EU paid a tariff equivalent to 7.7 percent of the value of total exports. Again, the main suspect for this underutilization of trade preferences is the rules of origin, particularly since Cambodia specializes in the production of clothing products, for which EU rules of origin are very restrictive, requiring production from yarn. Brenton and Manchin (2003) show that large amounts of EU imports from Eastern European countries of clothing products made from EU-produced fabrics still enter the EU market under an alternative customs regime—outward processing—even though there is no fiscal incentive to do so, since EU tariffs have been removed under free trade agreements. This probably reflects the costs and uncertainties in proving origin that would be necessary under the normal preferential customs procedures. Estevadeordal and Miller (2002) demonstrate that, in the transition from the U.S.–Canada free trade agreement to NAFTA, rules of origin for certain sectors, such as textiles, became more restrictive and that, as a result, the utilization of the available preferences declined.

Compliance with rules of origin entails costs that can affect the sourcing and investment decisions of companies. If the optimal input mix for a firm involves the use of imported inputs that are proscribed by the rules of origin of a free trade agreement in which the country participates, then the rules of origin will reduce the value of the available preferences. The firm will have to shift from the lowest-cost source of inputs to a higher-cost source in the domestic economy, reducing the benefits of exporting under a lower

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**Figure 8.1.** Restrictiveness (R-Index) of Rules of Origin in Free Trade Agreements

Source: Derived from Estevadeordal and Suominen 2006.

Note: AFTA, ASEAN Free Trade Agreement; ASEAN, Association of Southeast Asian Nations; CACM, Central American Common Market; COMESA, Common Market for Eastern and Southern Africa; ECOWAS, Economic Community of West African States; EU, European Union; NAFTA, North American Free Trade Agreement; SADC, Southern African Development Community. For derivation of the R-index, see the discussion in the text.
tariff. In the extreme, if the cost difference exceeds the size of the tariff preference, the firm will prefer to source internationally and pay the MFN tariff. The ability to cumulate inputs from a partner under bilateral, diagonal, or full cumulation will tend, in increasing order, to open the possibilities for identifying low-cost sources of inputs that do not compromise the qualifying nature of the final product. Nevertheless, if the lowest-cost supplier is not a member of the area of cumulation, the benefits of the preferential scheme will always be less than indicated by the size of the preferential tariff.

Rules of origin can also distort the relative prospects of similar firms within a country. For example, a clothing producer in Moldova may have established an efficient manufacturing process on the basis of importing fabrics from Turkey. A less efficient producer that uses imported EU fabrics may be able to expand production on the basis of preferential access to the EU market under the GSP (with bilateral cumulation). The more efficient firm may not be able to expand, since its product does not qualify for preferences because of the use of nonqualifying fabrics and there may be substantial costs in changing suppliers of fabrics.

These problems will be exacerbated in sectors in which economies of scale are important. Producers that supply both preferential and nonpreferential trade partners, or that face different rules of origin in different preferential partners, will have to produce with a different input mix for different markets if they are to receive preferential access. This may undermine the benefits from lower average costs that would arise if total production were to be based on a single set of material inputs and a single production process.

Rules of origin may be an important factor in determining the investment decisions of multinational firms. Such firms often rely on imported inputs from broad international networks that are vital for supporting firm-specific advantages such as a technological edge in the production of certain inputs. More generally, if the nature and application of a given set of rules of origin increase the uncertainty concerning the extent to which preferential access will actually be provided, the level of investment will be less than if such uncertainty were reduced.

For companies, there is not only the issue of complying with the rules on sufficient processing but also the cost of obtaining the certificate of origin, including any delays that arise in obtaining it. The costs of proving origin include satisfying a number of administrative procedures, so as to be able to provide the required documentation, and maintaining systems that accurately account for imported inputs from different sources, in order to prove consistency with the rules. The ability to prove origin may well require the use of what are, for small companies in developing and transition economies, sophisticated and expensive accounting procedures. Without such procedures, it is difficult for companies to show precisely the geographic breakdown of the inputs they have used.

An important feature of most preferential trade schemes is the requirement of direct consignment or direct transport. It stipulates that goods for which preferences are requested are shipped directly to the destination market. If they are in transit through another country, documentary evidence may be requested to show that the goods remained under the supervision of the customs authorities of the country of transit, that they did not enter the domestic market there, and that they did not undergo operations other than unloading and reloading. In practice, it may be very difficult to obtain the necessary documentation from foreign customs offices.

Finally, it is important to note that customs authorities are typically responsible for implementing the system of rules of origin. Customs usually has the responsibility for checking the certificate of origin and may also be involved in issuing origin certificates for local exporters. Rules of origin, although an essential element of preferential trade agreements, add considerable complexity to the trading system for traders, customs officials, and trade policy officials.

Implementation of preferential trade agreements increases the burden on customs. Limited resources and weak administrative capacity in many developing countries mean that these trade agreements have inevitable repercussions for trade facilitation. At the very least, when designing trade agreements, issues of administrative capacity in customs need to be taken into account. Complicated systems of rules of origin increase the complexity of customs procedures and the burden on origin-certifying institutions.

In general, rules of origin that are clear, straightforward, transparent, and predictable and that require little or no administrative discretion will place less of a burden on customs than will complex rules. The use of general rather than product-specific rules appears to be most appropriate for preferential rules of origin applied by and to developing countries. Less complicated rules of origin stimulate trade between regional partners by reducing the transaction costs of undertaking such trade, in comparison with more complex and restrictive rules of origin.

WTO members have recognized that rules of origin are an important factor affecting the ability of exporters to exploit market access opportunities. At the sixth WTO ministerial meeting, held in Hong Kong SAR, China, in December 2005, ministers declared that "developed-country Members, and developing-country Members declaring
themselves in a position to do so, agree to implement duty-free and quota-free market access for products originating from [least-developed countries (LDCs)] and that “members shall take additional measures to provide effective market access, both at the border and otherwise, including simplified and transparent rules of origin so as to facilitate exports from LDCs.”

Quantifying the Costs Associated with Rules of Origin

The costs of complying with rules of origin can be decomposed into distortionary costs (caused by changes in the production structure to enable compliance) and administrative costs (to prove origin). Information on these costs is limited. Early studies suggested that the costs of providing the appropriate documentation to prove origin could be about 3 percent or more of the value of the export shipment for companies in developed countries (Herin 1986).

Recently, efforts have been made to derive cost estimates for various product-specific rules of origin by linking the index of the restrictiveness of rules of origin developed by Estevadeordal (2000) to rates of utilization of preferences, after controlling for the size of the preferential margin. Cadot et al. (2006) find utilization rates of preferences to be positively related to preferential margins and negatively related to the restrictiveness of the rules of origin, as proxied by the R-index. They then proceed to use the R-index and the information on utilization of preferences to carry out nonparametric estimation of the upper and lower bounds of the costs of complying with the rules of origin. By revealed preference, when utilization rates are 100 percent, the preference margin provides an upper bound for compliance costs. When utilization rates are zero, the preference margin provides a lower bound of the costs of complying with the rules of origin. For intermediate rates of utilization, the average rate of preference is taken to capture the costs of compliance. The trade-weighted average of compliance costs is found to be 6.8 percent for NAFTA and 8 percent for EU rules of origin.

Cadot et al. (2006) also use the information on utilization rates to break down the estimate of compliance costs into the costs attributable to the costs of administration and those attributable to the distortionary element. They assume that low values of the R-index will tend to be associated with low administrative costs. (For example, the requirement to satisfy only change of tariff heading will require little paperwork.) Hence, preference margins for high utilization rates and a low value of the R-index will set an upper bound on the distortionary element of the compliance costs. The authors conclude that administrative costs for NAFTA are around 2 percent and those for EU rules, about 6.8 percent, which reflects the more demanding certification procedures of EU schemes.

Finally, Estevadeordal and Suominen (2006) include the R-index in a standard gravity model of bilateral trade flows. Their econometric analysis leads them to conclude that restrictive, product-specific rules of origin undermine overall trade between the partners in a free trade agreement and that provisions such as cumulation and tolerance rules, which increase the flexibility of application of a given set of processing requirements, act to boost intraregional trade. By applying this approach at the sectoral level, they find support for the hypothesis that the restrictiveness of rules of origin for final goods stimulates trade in intermediate products between preferential partners.

It is useful to complement these econometric studies with case studies, and there is one product-specific case that clearly highlights how restrictive rules of origin can constrain the ability of beneficiaries to exploit trade preferences (Brenton 2006). Both the EU and the United States have schemes that offer duty-free access to low-income countries in Africa. A key sector is clothing. Most of today’s developed countries and newly industrialized countries have used the clothing sector as a gateway to industrial development. The sector has very low entry barriers: it is labor intensive, the technology is relatively simple, start-up costs are comparatively low, and scale economies are negligible. The industry generates employment for large magnitudes of unskilled labor. Finally, the clothing sector is still subject to high tariffs in rich countries, so that there are large margins of preference for low-income countries in Africa.

Exports of apparel from African least-developed countries to the EU and to the United States were almost equal in 2000, but, by 2005, the value of exports to the United States was more than three times greater than the value of exports to the EU. The key factor explaining this increase is the rules of origin. EU rules stipulate production from yarn. This means that a double-transformation process must take place in the beneficiary; the yarn is woven into fabric, and then the fabric is cut and made up into apparel. The rules prohibit the use of imported fabric, although cumulation provisions allow for the use of inputs produced in other ACP countries. To obtain preferences, apparel producers must use local, EU, or ACP fabrics; they may not use fabrics from the main fabric-producing countries in Asia and still qualify for EU preferences. This is a binding restriction, since few countries in Africa have competitive fabric industries. The rules of origin under the U.S. African Growth and Opportunity Act (AGOA) allow African clothing exporters to use fabrics from any country
(the so-called third-country fabric rule). The EU rules do not allow producers in African least-developed countries the flexibility they currently have under the U.S. scheme to source fabrics globally.

De Melo and Portugal-Pérez (2008), controlling for other relevant factors, find that, although Sub-Saharan African countries were offered similar preferential margins of around 10 percent in both EU and U.S. markets under Everything But Arms (EBA) and AGOA, the U.S. third-country fabric rule was associated with an increase in apparel exports from the seven main African exporters of about 300 percent. The removal of tariffs on imports of apparel from Sub-Saharan African countries was estimated to have led to a 96 percent increase in exports.

It is worth remembering that the EU has granted preferences to African countries for apparel, subject to these strict rules of origin, for more than 20 years under the Lomé and Cotonou Agreements and now EBA. These strict rules, however, have done little to encourage the development of an efficient fabric industry in Africa and are likely to have severely constrained the impact of preferences in stimulating the apparel industry. (See Brenton and Özden 2009 for a more detailed analysis of the impact of the EBA and AGOA on apparel exports from African least-developed countries and the role of the rules of origin.)

The specific justification for constraining access to third-country fabrics through the use of restrictive rules of origin is to encourage the expansion of fabric production in Africa, consistent with the view that vertical integration in Africa is crucial to survival in a world in which competitors in Asia are no longer constrained by quotas. However, the basis for this view is not well founded (see Stevens and Kennan 2004), since restrictive rules of origin will not lead to the emergence of competitive textile producers in Africa and will actually undermine the prospects of the sector. Textile capacity will only emerge if production of apparel continues. Lack of access to competitively produced fabrics undermines the viability of the apparel sector, so that there will be no demand for locally produced yarns and fabrics. Substantial improvements in infrastructure, especially in power and transport, together with a better climate for investment, are essential requirements for significant investments in textile production.

The European Commission now appears to have accepted the need for less restrictive rules of origin for clothing in its negotiations on economic partnership agreements (EPAs) with countries in Africa, the Caribbean, and the Pacific. For the interim EPAs that have been signed with African countries, the rules of origin for clothing have been relaxed to allow African exporters to use imported fabrics from any country and to qualify for preferential access to the EU market.

**Rules of Origin and Economic Development**

Can and should rules of origin be used as tools for stimulating economic development within a regional grouping? The draft ministerial text for the Cancún meeting of WTO members as part of the Doha Development Round of trade negotiations proposes, under provisions for special and differential treatment, that “developing and least-developed country Members shall have the right to adopt preferential rules of origin designed to achieve trade policy objectives relating to their rapid economic development, particularly through generating regional trade.” Strict rules of origin are viewed by some as a mechanism for encouraging the development of integrated production structures within developing countries to maximize the impact on employment and to ensure that it is not just low value added activities that are undertaken.

There are problems with this view. First, such rules discriminate against small countries where the possibilities for local sourcing are limited or nonexistent. Since most developing countries are small, they are particularly disadvantaged by restrictive rules of origin relative to larger countries. Second, there is no evidence that the application of strict rules of origin over the past 30 years has done anything to stimulate the development of integrated production structures in developing countries. In fact, such arguments have become redundant in the light of technological changes and global trade liberalizations that have led to the fragmentation of production processes and the development of global networks of sourcing. Globalization and the splitting up of the production chain do not allow the luxury of establishing integrated production structures within countries. Strict rules of origin act to constrain the ability of firms to integrate into global and regional production networks and, in effect, act to dampen the location of any value added activities. In the modern world economy, flexibility in the sourcing of inputs is a key element in international competitiveness. Thus, it is most likely that restrictive rules of origin, rather than stimulating economic development, will raise costs of production by constraining access to cheap inputs and will undermine the ability of local firms to compete in overseas markets.

Flatters (2002) and Flatters and Kirk (2003), documenting the evolution of the rules of origin in the South African Development Community (SADC), show that the adoption of restrictive rules of origin is more likely to constrain than to stimulate regional economic development. This
example provides a salutary lesson on how sectoral interests and misperceptions of the role and impact of rules of origin can undermine regional trade agreements.

SADC initially agreed to simple, general, and consistent rules of origin similar to those of the neighboring and overlapping COMESA. The initial rules required a change of tariff heading, a minimum of 35 percent of value added within the region, or a maximum import content of 60 percent of the value of total inputs. Simple packaging and the like were defined to be insufficient to confer origin. Subsequently, however, these rules were revised, and there are now more restrictive sector- and product-specific rules, with the change of tariff heading requirement being supplanted by detailed technical process requirements and rules with much higher domestic value added and lower permitted import content. The rules became much more similar to those of the EU and of NAFTA, reflecting, in part, the influence of the recently negotiated EU–South Africa agreement and the rules of origin governing EU preferences for ACP countries:

The EU–South Africa rules were often invoked by special interests in South Africa as models for SADC. Such claims were too often accepted at face value and not recognized as self-interested pleading for protection by already heavily protected domestic producers. There were few questions about the appropriateness of the underlying economic model (whatever it might be) for SADC. (Flatters and Kirk 2003, 7)

Flatters (2002) points out that, in the SADC case, it has been argued that the weakness of customs administrations in the region makes it likely that low-cost products from Asia could enter through porous borders and then claim tariff preferences when exported to another member state. It is then suggested that restrictive rules of origin are required to prevent this from happening. There is no reason, however, to expect that weak customs administrations would be better able to enforce strict rules of origin than less restrictive rules. In fact, in many cases, the rules of origin are so strict that no producers in the region can satisfy them and therefore no discretion on the part of customs is required; preferences are not granted, and the preferential trade agreement has no impact. A better approach is to adopt economically sensible rules of origin and a program for improving administrative capacities in customs. Clearly designed safeguard measures can also be adopted to deal with surges of imports entering via porous borders and then claim tariff preferences when exported to another member state. (Flatters and Kirk 2003, 7)

Conclusions

The nature of rules of origin typically reflects the purpose that is set for them, the transparency of the process by which they are determined, and the composition of the group involved in that process. Within preferential trade areas, complex and restrictive rules of origin act to stunt the development of certain industries by preventing competition for final producers within a country from suppliers in partner countries and to stimulate intra-area exports of intermediate products by diverting demand away from third-country suppliers. Such rules typically emerge when the process by which they are determined lacks transparency and openness and is dominated by input from domestic industry. If the purpose of preferential rules of origin is simply to prevent trade deflection, then a simple and less restrictive set of rules of origin implemented through general rather than product-specific rules is appropriate. In the current globalized world market, less restrictive rules are more likely to stimulate trade and investment in the partner region by giving producers as much flexibility as possible in sourcing their inputs without compromising the ability to prevent transshipment of goods from third countries that are not members of the agreement. If the objective of the trade agreement is to foster trade and development, it is best achieved through simple and liberal rules of origin, rather than by using rules of origin as opaque measures of trade protection. The analysis in this chapter leads to the following broad conclusions:

1. Rules of origin that vary across products and agreements add considerably to the complexity and costs of participating in and administering trade agreements. The incidence of such costs falls particularly heavily on small and medium-size firms and on firms in low-income countries. Complex systems of rules of origin add to the burdens on customs and may compromise progress on trade facilitation.

2. Restrictive rules of origin constrain international specialization and discriminate against small, low-income countries, where the possibilities for local sourcing are limited.
3. Simple, consistent, and predictable rules of origin are more likely to foster the growth of trade and development. Specifying generally applicable rules of origin, with a limited number of clearly defined and justified exceptions, is appropriate if the objective is to stimulate integration and minimize the burdens on firms and customs in complying with and administering the rules.

4. Producers should be accorded flexibility in meeting origin rules, for example, by specifying that either a change of tariff requirement or a value added rule can be satisfied.

5. Preferences granted by developed countries would be more effective in stimulating exports from developing countries if they were governed by less restrictive rules of origin. Ideally, these schemes should have common rules of origin. Producers in developing countries should be able to gain preferential access to all developed-country markets if their product satisfies a single origin test.

6. Restrictive rules of origin should not be used as tools for achieving economic development objectives; they are likely to be counterproductive. The potential benefits of trade agreements among developing countries can be substantially undermined if those agreements contain restrictive rules of origin.

Notes

This chapter is based on Brenton and Imagawa (2005). 

1. Countries also apply another set of often different nonpreferential rules of origin in applying basic trade policy measures such as tariffs, quantitative restrictions, antidumping measures and countervailing duties, and safeguard measures, as well as to fulfill requirements relating to country-of-origin marking and public procurement and for statistical purposes.

2. The Harmonized System comprises 96 chapters (two-digit level), 1,241 headings (four-digit level), and about 5,000 subheadings (six-digit level).

3. The apparent reason for this rule in NAFTA is to protect producers of tomato paste in Mexico from competition from producers in Chile; see Palmeter (2003).

4. The EU rule of origin for sodium perborate also allows satisfaction of a maximum import content rule of 40 percent.

5. This yarn-forward rule is common in EU agreements for all clothing products. The United States typically applies an even stricter process rule requiring that the clothing be made from fibers, which means that the processes of spinning fiber into yarn and weaving yarn into fabric, as well as making up fabric into clothing, have to be undertaken in the exporting country to confer origin on the product.

6. For both bilateral and regional cumulation, there can be an additional requirement that the processing carried out be more than “insufficient working or processing.” This addition, which is typical in EU agreements but not in those of other countries, requires that more than packing, mixing, cleaning and preserving, and simple assembly of parts take place.

7. The COMESA agreement also specifies that a range of goods deemed to be of particular importance to economic development need only satisfy a 25 percent domestic value added criterion.

8. For many years, UNCTAD has been highlighting the relatively low levels of utilization of preferences granted by developed countries to developing countries. For a recent discussion of utilization rates of GSP schemes and rules of origin, see Inama (2002).

9. Economists have generally given little attention to rules of origin within the voluminous literature on free trade areas. The key initial contributions on rules of origin are Krueger (1997) and Krishna and Krueger (1995); these authors demonstrate how rules of origin can act as “hidden protectionism” and can induce a switch in demand in free trade partners from low-cost external inputs to higher-cost partner inputs to ensure that final products actually receive duty-free access. Falvey and Reed (1998) show how rules of origin can be used to protect a domestic industry from unwanted competition from a partner, even in conditions where trade deflection is unlikely. 

10. Herin (1986) also found that as a result of the costs to EFTA producers of proving origin, one-quarter of EFTA exports to the EU paid the applied MFN duties.

References


