

# INTERNATIONAL AND REGIONAL TRADE LAW: THE LAW OF THE WORLD TRADE ORGANIZATION



## **Unit III: The Rules of Origin**

**J.H.H. Weiler**

University Professor, NYU

Joseph Straus Professor of Law and European Union Jean Monnet Chair

NYU School of Law

**Sungjoon Cho**

Professor of Law

Chicago-Kent College of Law

**Isabel Feichtner**

Assistant Professor for Law and Economics

Goethe University, Frankfurt

AND

**Julian Arato**

Assistant Professor of Law

Brooklyn Law School

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### **Supplementary Reading**

For a more complete overview over rules of origin and their relevance in international trade law we suggest the following reading:

*Peter van den Bossche, The Law and Policy of the World Trade Organization, 2013, 418-462.*

*Raj Bhala, Modern GATT Law. A Treatise on the General Agreement on Tariffs and Trade, 2013, 1383-1407.*

*Michael J. Trebilcock et al., The Regulation of International Trade, 4th ed. 2013, 258-287.*

*John H. Jackson et al., Legal Problems of International Economic Relation, 6th ed. 2013, 442-452.*

# 1. Introduction

## Technical Information on Rules of Origin (WTO Website)

[http://www.wto.org/english/tratop\\_e/roi\\_e/roi\\_info\\_e.htm](http://www.wto.org/english/tratop_e/roi_e/roi_info_e.htm)

### Definition

Rules of origin are the criteria needed to determine the national source of a product. Their importance is derived from the fact that duties and restrictions in several cases depend upon the source of imports.

There is wide variation in the practice of governments with regard to the rules of origin. While the requirement of substantial transformation is universally recognized, some governments apply the criterion of change of tariff classification, others the ad valorem percentage criterion and yet others the criterion of manufacturing or processing operation. In a globalizing world it has become even more important that a degree of harmonization is achieved in these practices of Members in implementing such a requirement.

### Where are rules of origin used?

Rules of origin are used:

- to implement measures and instruments of commercial policy such as anti-dumping duties and safeguard measures;
- to determine whether imported products shall receive most-favoured-nation (MFN) treatment or preferential treatment;
- for the purpose of trade statistics;
- for the application of labelling and marking requirements; and
- for government procurement.

### No specific provision in GATT

GATT has no specific rules governing the determination of the country of origin of goods in international commerce. Each contracting party was free to determine its own origin rules, and could even maintain several different rules of origin depending on the purpose of the particular regulation. The draftsmen of the General Agreement stated that the rules of origin should be left:

“...within the province of each importing country to determine, in accordance with the provisions of its law, for the purpose of applying the most-favoured-nation provisions (and for other GATT purposes), whether goods do in fact originate in a particular country”.

Article VIII:1(c) of the General Agreement, dealing with fees and formalities connected with importation and exportation, states that “the contracting parties also recognize the need for

minimizing the incidence and complexity of import and export formalities and for decreasing and simplifying import and export documentation requirements” and the Interpretative Note 2 to this Article states that it would be consistent if, “on the importation of products from the territory of a contracting party into the territory of another contracting party, the production of certificates of origin should only be required to the extent that is strictly indispensable”.

### **Interest in the harmonization of rules of origin**

It is accepted by all countries that harmonization of rules of origin i.e., the definition of rules of origin that will be applied by all countries and that will be the same whatever the purpose for which they are applied - would facilitate the flow of international trade. In fact, misuse of rules of origin may transform them into a trade policy instrument *per se* instead of just acting as a device to support a trade policy instrument. Given the variety of rules of origin, however, such harmonization is a complex exercise.

In 1981, the GATT Secretariat prepared a note on rules of origin and, in November 1982, Ministers agreed to study the rules of origin used by GATT Contracting Parties. Not much more work was done on rules of origin until well into the Uruguay Round negotiations. In the late 1980s developments in three important areas served to focus more attention on the problems posed by rules of origin:

### **Increased number of preferential trading arrangements**

First, an increased use of preferential trading arrangements, including regional arrangements, with their various rules of origin;

### **Increase in the number of origin disputes**

Second, an increased number of origin disputes growing out of quota arrangements such as the Multifibre Arrangement and the “voluntary” steel export restraints; and

### **Increased use of anti-dumping laws**

Lastly, an increased use of anti-dumping laws, and subsequent claims of circumvention of anti-dumping duties through the use of third country facilities.

## **The UR Agreement**

### **Introduction**

The increased number and importance of rules of origin led the Uruguay Round negotiators to tackle the issue during the negotiations.

### **Aims of the Agreement**

### **Harmonization**

The Agreement on Rules of Origin aims at harmonization of non-preferential rules of origin, and to ensure that such rules do not themselves create unnecessary obstacles to trade. The Agreement

sets out a work programme for the harmonization of rules of origin to be undertaken after the entry into force of the World Trade Organization (WTO), in conjunction with the World Customs Organization (WCO).

### **General principles**

Until the completion of the three-year harmonization work programme, Members are expected to ensure that their rules of origin are transparent; that they are administered in a consistent, uniform, impartial and reasonable manner; and that they are based on a positive standard.

### **Coverage: all non-preferential rules of origin**

Article 1 of the Agreement defines rules of origin as those laws, regulations and administrative determinations of general application applied to determine the country of origin of goods except those related to the granting of tariff preferences. Thus, the Agreement covers only rules of origin used in non-preferential commercial policy instruments, such as MFN treatment, anti-dumping and countervailing duties, safeguard measures, origin marking requirements and any discriminatory quantitative restrictions or tariff quotas, as well as those used for trade statistics and government procurement. It is, however, provided that the determinations made for purposes of defining domestic industry or “like products of domestic industry” shall not be affected by the Agreement.

### **Institutions**

#### **WTO Committee on Rules of Origin**

The Agreement establishes a Committee on Rules of Origin within the framework of the WTO, open to all WTO Members. It is to meet at least once a year and is to review the implementation and operation of the Agreements (Article 4:1).

#### **WCO Technical Committee**

A Technical Committee on Rules of Origin is created under the auspices of the World Customs Organization (formerly the Customs Cooperation Council). Its main functions are (a) to carry out the harmonization work; and (b) to deal with any matter concerning technical problems related to rules of origin. It is to meet at least once a year. Membership is open to all WTO Members; other WCO members and the WTO Secretariat may attend as observers (Article 4:2 and Annex I).

#### **The Harmonization Work Programme (HWP)**

Article 9:2 provided that the HWP be completed within three years of initiation. Its agreed deadline was July 1998. While substantial progress was made in that time in the implementation of the HWP, it could not be completed due to the complexity of issues. In July 1998 the General Council approved a decision whereby Members have committed themselves to make their best endeavours to complete the Programme by a new target date, November 1999.

The work is being conducted both in the WTO Committee on Rules of Origin (CRO) in Geneva and in the WCO Technical Committee (TCRO) in Brussels. The TCRO is to work, on a product-sector basis of the HS nomenclature, on the following matters:

## **Definitions of goods being wholly obtained**

To provide harmonized definitions of the goods that are to be considered as being wholly obtained in one country, and of minimal operations or processes that do not by themselves confer origin to a good;

## **Last substantial transformation**

### **Change of tariff heading**

To elaborate, on the bases of the criteria of substantial transformation, the use of the change of tariff classification when developing harmonized rules of origin for particular products or sectors, including the minimum change within the nomenclature that meets this criterion.

### **Supplementary criteria**

To elaborate supplementary criteria, on the basis of the criterion of substantial transformation, in a manner supplementary or exclusive of other requirements, such as ad valorem percentages (with the indication of its method of calculation) or processing operations (with the precise specification of the operation).

The CRO considers the input of the TCRO with the aim of endorsing the TCRO's interpretations and opinions, and, if necessary, refining or elaborating on the work of the TCRO and/or developing new approaches. Upon completion of all the work in the TCRO, the CRO is to consider the results in terms of their overall coherence (Article 9:3).

## **Overall architectural design**

The CRO and the TCRO have established an overall architectural design within which the harmonization work programme is to be finalized. This encompasses

— general rules, laid down in eight Articles provisionally entitled: Scope of Application; the Harmonized System; Definitions; Determination of Origin; Residual Rules of Origin; Minimal Operations or Processes; Special Provisions; and De Minimis;

— three Appendices:

Appendix 1: Wholly obtained goods;

Appendix 2: Product rules - substantial transformation; and

Appendix 3: Minimal operations or processes.

## **Results of the Harmonization Work Programme**

The results of the harmonization programme are to be approved by the Ministerial Conference and will then become an annex to the Agreement. When doing this, the Ministerial Conference is also to give consideration to arrangements for the settlement of disputes relating to customs classification and to establish a time-frame for the entry into force of the new annex.

## **Disciplines during the transition period**

During the transition period (i.e. until the entry into force of the new harmonized rules) Members are required to ensure that:

- (a) rules of origin, including the specifications related to the substantial transformation test, are clearly defined;
- (b) rules of origin are not used as a trade policy instrument;
- (c) rules of origin do not themselves create restrictive, distorting or disruptive effects on international trade and do not require the fulfilment of conditions not related to manufacturing or processing of the product in question;
- (d) rules of origin applied to trade are not more stringent than those applied to determine whether a good is domestic, and do not discriminate between Members (the GATT MFN principle). However, with respect to rules of origin applied for government procurement, Members are not obliged to assume additional obligations other than those already assumed under the GATT 1994 (the national treatment exception for government procurement contained in GATT Article III:8).
- (e) rules of origin are administered in a consistent, uniform, impartial and reasonable manner;
- (f) rules of origin are based on a positive standard. Negative standards are permissible either as part of a clarification of a positive standard or in individual cases where a positive determination or origin is not necessary;
- (g) rules of origin are published promptly;
- (h) upon request, assessments of origin are issued as soon as possible but no later than 150 days after such request, they are to be made publicly available; confidential information is not to be disclosed except if required in the context of judicial proceedings. Assessments of origin remain valid for three years provided the facts and conditions remain comparable, unless a decision contrary to such assessment is made in a review referred to in (j). This advance information on origin is considered as a great innovation of the Agreement;
- (i) new rules of origin or modifications thereof do not apply retroactively;
- (j) any administrative action in relation to the determination of origin is reviewable promptly by judicial, arbitral or administrative tribunals or procedures independent of the authority issuing the determination; such findings can modify or even reverse the determination;
- (k) confidential information is not disclosed without the specific permission of the person providing such information, except to the extent that this may be required in the context of judicial proceedings.

### **Disciplines after the transition period**

As from the conclusion of the HWP, non-preferential rules of origin will be harmonized and Members will be bound to apply only one rule of origin for all purposes covered by Article 1. The principles contained in (d) through (k) above will continue to apply — i.e. transparency, non-discrimination (also including rules of origin applied for government procurement), and the possibility of reviewing any administrative actions concerning determination of origin (Article 3).



## **Consultation and dispute settlement**

The WTO provisions on consultation and settlement of disputes apply to the Agreement.

## **Preferential rules of origin**

Annex II of the Agreement on Rules of Origin provides that the Agreement's general principles and requirements for non-preferential rules of origin in regard to transparency, positive standards, administrative assessments, judicial review, non-retroactivity of changes and confidentiality shall apply also to preferential rules of origin.

## **Notifications Non-preferential rules of origin**

Article 5:1 of the Agreement requires each Member to provide to the Secretariat, within 90 days after the date of entry into force of the WTO Agreement for it, its currently applicable rules of origin, judicial decisions and administrative rulings of general application relating to rules of origin. The Secretariat circulates to all Members lists of the information received and available to them.

At its meeting of 4 April 1995, the Committee agreed that any notifications made in a language other than a WTO working language should be accompanied by a summary in a WTO working language (G/RO/1).

## **Preferential rules of origin**

Paragraph 4 of Annex II of the Agreement on Rules of Origin provides that Members shall provide to the Secretariat promptly their preferential rules of origin, including a listing of the preferential arrangements to which they apply, judicial decisions, and administrative rulings of general application relating to their preferential rules of origin as soon as possible to the Secretariat. The Secretariat circulates lists of the information received and available to Members.

At its meeting of 4 April 1995, the Committee agreed that any notification made in a language other than a WTO working language, should be accompanied by a summary in a WTO working language (G/RO/1).

*Note: So far the Harmonized Work Programme has not been completed and approved by the Ministerial Conference.*

## 2. Methodology

Excerpts from:

Joseph A. LaNasa III ("Jody"), 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, Jean Monnet Working Paper, 1/96

<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 good 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 country is also a beneficiary country under a preferential trading agreement with the importing country.

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 be 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 tariff 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.

(...)

## Notes

[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 substantially 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 Palmetier, *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 Palmetier, *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] *Palmer, 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

\*\*\*

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. Examples of (Preferential) Rules of Origin

This section features two examples of preferential rules of origin adopted by the United States. The first example concerns the U.S. rules of origin on clocks and watches (and parts thereof) under Chapter 91 of the U.S. Harmonized Tariff (HS) system. Compare the first rule applied to WTO members to the second one applied to NAFTA members. You will find an additional requirement (“regional value content”) imposed in case of NAFTA rules of origin. This additional rule aims to prevent the so-called “trade deflection.” Suppose that a Korean manufacturer substantially transformed Chinese watch parts (9114) into a wrist watch with precious metal (9101) in Korea. According to the “last substantial transformation rule,” this watch is made in Korea under the U.S. HS system. However, the NAFTA rules of origin complicate these original rules. For example, suppose that a Canadian manufacturer substantially transformed Chinese watch parts (9114) into a wrist watch with precious metal (9101) in Canada. In this case, the watch is made in Canada, and therefore duty free when entering into the U.S. territory under NAFTA, only if the regional value content (value added in Canada) exceeds 50 or 60 percent. Otherwise, it would still be made in China and therefore subject to normal WTO tariffs.

The second example, excepted from the U.S. – Jordan FTA, demonstrates the notorious complexity of the U.S. rules of origin in textile and apparel products. These nearly unintelligible rules of origin tend to deter potential U.S. businesses from taking advantage of preferential tariffs under the U.S. – Jordan FTA. These rules attest to the protectionist nature of preferential rules of origin in general, and those in the textile and apparel sector in particular. Other peculiar rules of origin in the same sector, such as the yard-forward rule or fabric-forward rule, serve the same purpose.

**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:

\* \* \*

## NAFTA SPECIFIC RULES OF ORIGIN (ANNEX 401)

### Section A - General Interpretative Note

For purposes of interpreting the rules of origin set out in this Annex:

(...)

(c) a requirement of a change in tariff classification applies only to non-originating materials

(...)

### 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*)

\* \* \*

**Rules of Origin: An Excerpt from the U.S.-Jordan FTA**  
(emphasis added)

9. Textile and apparel products

(a) General rule. A textile or apparel product shall be considered to be wholly the growth, product or manufacture of a Party, or a new or different article of commerce that has been grown, produced, or manufactured in a Party; only if

(i) the product is wholly obtained or produced in a Party;

(ii) the product is a yarn, thread, twine, cordage, rope, cable, or braiding, and,

(1) the constituent staple fibers are *spun in that Party*, or

(2) the continuous filament is *extruded in that Party*;

(iii) the product is a fabric, including a fabric classified under chapter 59 of the Harmonized Commodity Description and Coding System, and the constituent fibers, filaments, or yarns are *woven, knitted, needled, tufted, felted, entangled, or transformed by any other fabric-making process in that Party*; or

(iv) the product is any other textile or apparel product that is wholly assembled in that Party from its component pieces.

(b) Special rules.

(i) Notwithstanding subparagraph (a)(iv), and except as provided in subparagraphs (b)(iii) and (b)(iv), whether this Agreement shall apply to a good that is classified under one of the following HTS headings or subheadings shall be determined under subparagraphs (i), (ii), or (iii) of subparagraph (a), as appropriate: 5609, 5807, 5811, 6209.20.50.40, 6213, 6214, 6301, 6302, 6304, 6305, 6306, 6307.10, 6307.90, 6308, or 9404.90.

(ii) Notwithstanding subparagraph (a)(iv), and except as provided in subparagraphs (b)(iii) and (b)(iv), this Agreement shall apply to a textile or apparel product which is knit to shape in a Party.

(iii) Notwithstanding subparagraph (a)(iv), this Agreement shall apply to goods classified under HTS heading 6117.10, 6213.00, 6214.00, 6302.22, 6302.29, 6302.52, 6302.53, 6302.59, 6302.92, 6302.93, 6302.99, 6303.92, 6303.99, 6304.19, 6304.93, 6304.99,

9404.90.85, or 9404.90.95, except for goods classified under such headings as of cotton or of wool or consisting of fiber blends containing 16 percent or more by weight of cotton, *if the fabric in the goods is both dyed and printed, when such dyeing and printing is accompanied by 2 or more of the following finishing operations: bleaching, shrinking, fulling, napping, decatizing, permanent stiffening, weighting, permanent embossing, or moireing.*

(iv) Notwithstanding subparagraph (a)(iii), this Agreement shall apply to fabric classified under the HTS as of silk, cotton, man-made fiber, or vegetable fiber *if the fabric is both dyed and printed in a Party, and such dyeing and printing is accompanied by 2 or more of the following finishing operations: bleaching, shrinking, fulling, napping, decatizing, permanent stiffening, weighting, permanent embossing, or moireing.*

(...)

**UNITED STATES – RULES OF ORIGIN  
FOR TEXTILES AND APPAREL PRODUCTS**

*Report of the Panel*

(...)

**VI. FINDINGS**

**A. MEASURES AT ISSUE**

6.1 The measures at issue in this dispute are:

- (a) Section 334 of the US Uruguay Round Agreements Act<sup>1</sup> (hereafter "section 334"), which entered into force on 1 July 1996,

(...)

6.3 Section 334 and section 405 lay down rules of origin, *inter alia*, for fabrics and certain made-up non-apparel articles assembled in a single country from single country fabric. The latter category of goods, also referred to in this Report as "flat goods", include goods of export interest to India, notably bedding articles (bed linen, quilts, comforters, blankets, etc.) and home furnishing articles (wall hangings, table linens, etc.).

6.4 Section 334 provides, in relevant part, that fabrics and made-up non-apparel articles falling under 16 specified HTS 4-digit headings<sup>2</sup> – essentially flat goods – are considered to originate in the country where the fabric is woven, knitted or otherwise formed, regardless of any further finishing operations which may have been performed in respect of the fabrics or articles

<sup>1</sup> Pub. Law 103-465, 108 Stat 4809, enacted on 8 December 1994, and codified at 19 U.S.C. § 3592. For the text of section 334, see, *supra*, para. 2.2.

<sup>2</sup> For a list of the goods concerned, see *supra*, para. 2.3. India notes that one of the 16 HTS headings refers to goods which are deemed to originate where the yarn was produced. India's first written submission, para. 36.

concerned.<sup>3</sup> The parties have in some instances referred to this rule of origin as the "fabric forward" rule. We prefer to use the term "fabric formation" rule.

(...)

#### D. INDIA'S CLAIMS IN RESPECT OF SECTION 334 AND SECTION 405

6.26 In this Section, the Panel will assess India's claims in respect of the statutory provisions at issue in this dispute, *i.e.*, section 334 and section 405. In the next Section, the Panel will assess India's claims in respect of the customs regulations implementing these statutory provisions.

##### 1. India's claims under Article 2(b) of the *RO Agreement*

6.27 India claims that both section 334 and section 405 are inconsistent with Article 2(b) of the *RO Agreement*. The Panel will examine these claims in turn. Before doing so, however, it is necessary to address the parties' interpretation of Article 2(b).

###### (a) Article 2(b) of the *RO Agreement*

6.28 Article 2(b) provides as follows:

"Until the work programme for the harmonization of rules of origin set out in Part IV is completed, Members shall ensure that:

[...]

(b) notwithstanding the measure or instrument of commercial policy to which they are linked, their rules of origin are not used as instruments to pursue trade objectives directly or indirectly[.]"

6.29 **India** considers that the operative clause of Article 2(b) is the obligation that rules of origin must not be used "as instruments to pursue trade objectives". (...) According to India, for the purposes of this dispute, it is not necessary to develop a general definition of the term "trade objectives". In India's view, it is sufficient for the Panel to find that trade objectives include the objective of protecting the domestic industry against import competition or of favouring imports from one country over imports from another. India maintains that any rule of origin that is used as an instrument to protect a domestic industry or to favour imports from one country over imports from another country is an instrument to pursue "trade objectives" as that term is used in Article 2(b).

(...)

6.31 India contends that the object and purpose of the *RO Agreement* also supports its interpretive approach. Specifically, India notes that the seventh recital of the preamble states that Members desire, through the *RO Agreement*, "[...] to ensure that rules of origin are prepared and applied in an impartial, transparent, predictable, consistent and neutral manner". India also notes that, according to its preamble, the *RO Agreement* is "to further the objectives of the GATT 1994". According to the preamble of the GATT 1994, the GATT 1994 is to expand the production and exchange of goods through the reduction of tariffs and other barriers to trade. In India's view, one of the fundamental purposes of the *RO Agreement* thus is to ensure that the barriers to trade Members agreed to reduce in the framework of the GATT 1994 are not indirectly re-established through the use of rules of origin protecting domestic industries.

<sup>3</sup> United States' reply to Panel question No. 7.



6.32 Finally, with respect to how to assess whether a rule of origin is being used as an instrument to pursue a trade objective, India submits that one way is to assess whether the rule of origin in question achieves the same results as a measure or instrument of commercial policy. India also considers it useful to examine the design, architecture, and structure of the relevant rule of origin. India recalls that the Appellate Body has noted that "[a]lthough it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the *design*, the *architecture*, and the revealing *structure* of a measure".<sup>4</sup>

6.33 The **United States** agrees with India that the operative clause in Article 2(b) is the obligation that rules of origin are not to be used "as instruments to pursue trade objectives". (...) However, the United States submits that India's interpretation of a "trade objective" is overly broad. The United States argues that if "trade objective" is understood to be any objective related to trade, rules of origin could not be used to pursue transparency or predictability, two trade-related goals. According to the United States, such an interpretation would be at odds with both the object and purpose of the *RO Agreement* and the context of Article 2(b).

6.34 As for India's contention that the protection of a domestic industry and the favouring of imports from one Member over imports from another would constitute "trade objectives" within the meaning of Article 2(b), the United States accepts India's contention that protection of a domestic industry is an "impermissible" trade objective for the purposes of Article 2(b). Concerning the other objective identified by India as a "trade objective" – the favouring of imports from one Member over imports from another – the United States cautions that rules of origin might have the practical effect of favouring one Member over another and that such rules could not, on that basis alone, be considered to pursue a "trade objective".<sup>5</sup> Apart from this, the United States does not raise concerns with respect to the second trade objective referred to by India. In fact, the United States suggests that "discrimination" in favour of one Member could be considered to be a "trade objective".<sup>6</sup>

6.35 Regarding the issue of how it can be assessed whether a rule of origin is being used as an instrument to pursue a trade objective, unlike India, the United States does not consider that it is necessary or relevant to analyse whether the design, structure and architecture of a contested rule of origin measure reveals an "impermissible" trade objective.

6.36 The **Panel** agrees with the parties that the operative part of Article 2(b) is the phrase "rules of origin are not [to be] used as instruments to pursue trade objectives directly or indirectly". It is clear from this phrase that in order to establish a violation of Article 2(b), a Member needs to demonstrate that another Member is using rules of origin for a specified purpose, *viz.*, to pursue trade objectives. (...)

6.40 In seeking to determine whether the objectives of "protecting the domestic industry against import competition" and "favouring imports from one Member over imports from another" are "trade objectives" within the meaning of Article 2(b), the Panel begins by noting that, as a textual matter, these objectives are clearly related to trade. In that sense, they could certainly be covered by the ordinary meaning of the term "trade objectives", which, as India has identified, is "goals" or "aims" related to trade.<sup>7</sup>

(...)

<sup>4</sup>Appellate Body Report, *Japan – Taxes on Alcoholic Beverages* ("Japan – Alcoholic Beverages II"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, DSR 1996:I, 97, at 120 (emphasis added by India).

<sup>5</sup>United States' reply to Panel question No. 6; United States' second written submission, para. 31.

<sup>6</sup>United States' second written submission, para. 29.

<sup>7</sup>*Supra*, para. 6.29.

6.43 Finally, we believe that interpreting the term "trade objectives" as suggested by India is consistent with the objective of Article 2(b). In our view, Article 2(b) is intended to ensure that rules of origin are used to implement and support trade policy instruments, rather than to substitute for, or to supplement, the intended effect of trade policy instruments. Allowing Members to use rules of origin to pursue the objectives of "protecting the domestic industry against import competition" or "favouring imports from one Member over imports from another" would be to substitute for, or supplement, the intended effect of a trade policy instrument and, hence, be contrary to the objective of Article 2(b).

6.44 Taken together, the foregoing considerations lead us to the conclusion that the objectives identified by India – *i.e.*, the objectives of "protecting the domestic industry against import competition" and of "favouring imports from one Member over imports from another" – may, in principle, be considered to constitute "trade objectives" in pursuit of which rules of origin may not be used.

6.45 Bearing in mind the above conclusions, we now turn to examine whether section 334 is inconsistent with Article 2(b), as claimed by India.

(b) Consistency of section 334 with Article 2(b) of the *RO Agreement*

6.46 **India** argues that an examination of the design, architecture, and structure of section 334 shows that it is used as an instrument to pursue the objective of protecting the domestic textiles and apparel industry. India submits that section 334 confers origin on the basis of criteria that are unrelated to the value added operations or the change in the nature of the product. Instead, the criteria are those that are commonly used in the application of commercial policy instruments.

6.47 India considers that the new rules of origin moved the United States away from those used by its major trading partners such as the European Communities and Canada. To India's knowledge, no other country determines origin on the basis of the place where the greige fabric was formed, if that fabric was further processed and made into a flat good, thereby reflecting the importance of cutting and sewing to produce a finished product. India notes that greige fabric, and even dyed and printed greige fabric, can be put to a variety of uses. India points out that, in contrast, once the fabric is cut and sewn into a pillowcase, no one can use that fabric for anything other than a pillow case.

6.48 India argues that the fact that the "fabric forward" rule set out in section 334 is used for a wide variety of non-apparel flat textile articles, such as bedding articles (quilts, comforters, mattresses, blankets), home furnishings (wall hangings, table linens) and fashion accessories such as scarves, shows that the section 334 rules are being used as instruments to pursue trade objectives. India notes in this respect that, for home textiles, bedding articles, furnishings, and miscellaneous made up articles, the section 334 rules work a significant change in the determination of the country of origin. India notes that under the "fabric forward" rule, these products are deemed to originate in the country where their constituent fabric is formed (woven or knitted) in the greige state and no account is taken of any subsequent value-added operations such as the dyeing, printing or finishing of the fabric, the cutting of the fabric into components, the assembly of those components into finished articles or any other operations. India offers the example of down-filled comforters, which are classified under HTS subheading 9404.90 and subject to the fabric forward rule. According to India, this means that if the down-filled comforter was cut, sewn and assembled in country A and had a value of US \$200, it would be nevertheless determined as a product of country B if the greige fabric used in its manufacture, which cost only a few dollars, was woven in country B.

6.49 India submits that the clearly protectionist objective of section 334 can be demonstrated by its effect on the determination of origin for the products subject to section 334. India points out that

the effect of section 334, especially its fabric forward provision, was that a range of textiles and clothing products imported into the United States were subjected to the strict quotas of the developing countries whereas previously they had been under no quota or a more generous quota. In India's view, the fabric forward rule increases the quantities of textile imports that are conferred the origin of the countries that are under quota.<sup>8</sup> India argues that this strengthens the impact of the United States' quota regime under the *Agreement on Textiles and Clothing* which – as the United States admits – was put in place to protect the domestic industry. According to India, the fabric forward rule is thus clearly being used to pursue a trade objective.

(...)

6.58 The **United States** notes that India makes three arguments with respect to its claim that section 334 is inconsistent with Article 2(b): (1) the objective of the United States in formulating its rules of origin was to protect its domestic industry; (2) the Panel should look to the measures or instruments of commercial policy listed in Article 1.2 of the *RO Agreement* and assess whether the United States' rule of origin "achieves the same results"; and (3) "the design, architecture and structure" of section 334 "demonstrate that it was adopted to protect the domestic textile industry".<sup>9</sup>

6.59 With respect to the *objectives* of the United States in formulating section 334, the United States argues that section 334 rules of origin do not have as their objective the protection of domestic industry. The United States notes that the SAA is clear on what the objectives of section 334 were: (i) to prevent quota circumvention and address illegal transshipment, to advance harmonization, and (ii) to more accurately reflect where the most significant production activity occurs.<sup>10</sup> (...)

6.72 The **Panel** begins by recalling India's claim that the United States is using the fabric formation rule set forth in section 334 as an instrument to pursue the objective of protecting its domestic textile industry. This is clear, in India's view, from the features, or design, of the fabric formation rule as well as from its effect.

6.73 We first address the features, or design, of the fabric formation rule. India seeks to cast doubt on the validity of this rule. Specifically, India asserts that no other country uses a fabric formation rule for flat textile goods. Since we have not been provided with information on the rules of origin employed by Members other than the United States, we are not in a position to determine whether Indian's assertion is correct. However, we note *en passant* that, within the framework of the harmonization work programme, a significant number of those Members expressing a view on the issue have indicated support for a fabric formation rule for flat textile goods.<sup>11</sup> In any event, even if the United States was using an unusual rule of origin, that would be irrelevant. There is no requirement in Article 2 of the *RO Agreement* to use a particular type of rule. Instead, as pointed out earlier<sup>12</sup>, Article 2 simply provides broad parameters for the use of rules of origin.

6.74 India also appears to question the rationality of a fabric formation rule. India argues, first of all, that a fabric formation rule does not reflect the importance of cutting and sewing to the making of a final article. India notes in this regard that, whereas greige fabric has a variety of uses, once the fabric is cut and sewn into a pillow case, the fabric can only be used as a pillow case. The United States, on the other hand, states that its rules of origin are based on where the most important assembly or manufacturing process takes place and that, in its judgment, fabric

<sup>8</sup> In its second oral statement, India went further and said that the fabric forward rule "by definition" increases the quantities of textile imports that are conferred the origin of the countries that are under quota. India's second oral statement, para. 8.

<sup>9</sup> The United States refers to paras. 46-49 of India's first written submission.

<sup>10</sup> The United States considers that these objectives are entirely consistent with and supportive of the objectives of the *RO Agreement* itself.

<sup>11</sup> Document G/RO/52, p. 69.

<sup>12</sup> *Supra*, para. 6.25.

formation is the most important step in manufacturing flat goods. We are not aware of any basis in Article 2 of the *RO Agreement* on which to resolve the parties' disagreement regarding what is the most important manufacturing process. The silence of Article 2 on this issue suggests that Members are, subject to the disciplines contained in Article 2(b) and (c), free to make this determination as they deem fit.<sup>13</sup> At any rate, we do not find the United States' view that the flat goods in question (*e.g.*, bedsheets) are basically fabric to be on its face unreasonable.<sup>14</sup> Indeed, as we have noted, the fabric formation rule commands substantial support within the framework of the harmonization work programme. In these circumstances, we are not persuaded that the fabric formation rule is inherently unsound.

(...)

6.76 In sum, India has not persuaded us that the mere fact that the United States is using a fabric formation rule requires us to conclude that it is doing so in order to protect its domestic textile industry.

6.77 We now turn to examine whether the effect of the fabric formation rule demonstrates that the United States is using section 334 to protect its textile industry. India contends that the application of the fabric formation rule as of mid-1996 meant that a range of flat goods "were subjected to the strict quotas of the developing countries whereas previously they had been under no quota or a more generous quota".<sup>15</sup> Similarly, India asserts that the fabric formation rule, "by definition", increases the quantities of textile imports that would be conferred the origin of the countries that are under quota.<sup>16</sup> India argues that this "strengthens the impact"<sup>17</sup> of the United States' quota regime and renders it "more restrictive"<sup>18</sup>.

6.78 It is clear that applying a fabric formation rule will result in flat articles subject to that rule being conferred the origin of the fabric-forming country. Also, *if* the relevant fabric-forming country is under quota in the United States for the article concerned, the article will be subjected to that country's quota. However, the Panel was not provided with any evidence and/or data regarding:

- which countries are under quota in the United States with respect to the articles in question;
- the quota levels of those countries;
- the quota utilization by those countries;
- which countries are important suppliers of relevant fabric (*e.g.*, cotton); and
- the price and quality of the fabric made by those countries and their production capacity.

6.79 In these circumstances, *i.e.*, without specific information on the design of the United States' quota system, the market in the relevant final and intermediate goods and the relationship between the two, it is very difficult to assess the correctness, weight and implications of India's factual assertions.<sup>19</sup>

<sup>13</sup> Of course, the disciplines in Articles 2(b) and (c) may bar a Member from using particular rules of origin in a given case. Indeed, this is precisely what we need to examine in this case.

<sup>14</sup> United States' reply to Panel question No. 14.

<sup>15</sup> India's first oral statement, para. 22.

<sup>16</sup> India's second oral statement, para. 8.

<sup>17</sup> *Ibid.*

<sup>18</sup> India's reply to Panel question No. 72.

<sup>19</sup> The Panel does not believe that it would have been difficult for the parties to have provided this information. For instance, some of it is available from notifications to the WTO Textiles Monitoring Body

(...)

6.83 In conclusion, we consider that the evidence and argument adduced by India do not support the conclusion that the fabric formation rule necessarily, or in fact, brings more imports of made-up articles under quota in the United States.

6.84 In any event, if India had established to our satisfaction that, under the fabric formation rule, more imports would be under quota in the United States, this would only prove that there would be more restrained imports than under the pre-section 334 rules of origin. This circumstance would not prove, however, that the fabric formation rule is being used as an instrument to protect the United States' textile industry rather than as an instrument to implement United States' textile quotas and other commercial policy instruments. Article 2(b) is intended to preclude Members from using rules of origin to substitute for, or supplement, the intended effect of a trade policy instrument. Accordingly, where a rule of origin is linked, *inter alia*, to a quota, the rule of origin should not add to the protection already afforded by the quota.<sup>20</sup> India's argument is that if a rule of origin makes a quota regime more restrictive, the quota regime automatically becomes too restrictive in the sense that it would add to the protective effect of the quota regime, thus indicating the use of rules of origin in pursuit of the trade objective of protecting the domestic textile industry. But, India's argument focuses on the direction of a change in rules of origin, not the end point of the change. That is to say, India ignores the distinction between the use of rules of origin to implement and support a quota regime and the use of rules of origin to supplement the protective effect of the quota regime. Using rules of origin which render a quota regime more restrictive may be consistent with using rules of origin to implement and support such a regime.

6.85 Moreover, we note that the mere fact of making the quota system more restrictive could not, *ipso facto*, condemn the fabric formation rule. A restrictive fabric formation rule may have been adopted in pursuit of legitimate objectives.

6.86 One of the objectives claimed by the United States in using the fabric formation rule is "to more accurately reflect where the most significant production activity occurs".<sup>21</sup> Since we have already found that the fabric formation rule is not an unsound rule for the United States to apply to the made-up articles in question, we see no justification for determining that the stated United States objective of reflecting where the most important manufacturing process takes place is a pretext for protecting the United States' textile industry.<sup>22</sup>

(...)

6.93 We note in this regard that India has adduced other evidence which it considers demonstrates that the "real" objective of the fabric formation rule is to afford protection to the United States'

("TMB"). Without that information and arguments of the parties on its legal significance, the Panel is unable to draw any conclusion.

<sup>20</sup> We think a rule of origin which has the effect of discouraging the full utilization of a quota could be one example of a rule of origin which affords extra protection to the Member maintaining the quota in question.

<sup>21</sup> United States' first written submission, para. 29; United States' replies to Panel questions Nos. 14 and 19.

<sup>22</sup> Merely that the United States changed its substantive rules of origin in 1996 for some of the made-up articles in question does not, in our view, suggest that the fabric formation rule is not intended to "more accurately reflect where the most significant production activity occurs". It seems pertinent to note, in this regard, that the pre-section 334 rules, found at 12 C.F.R. 130, originated with the Administration, specifically the United States Customs Service, whereas section 334 was prescribed by Congress. India's first written submission, paras. 14 and 16. Nor do we think that the "clarification of section 334", enshrined in section 405, undermines the United States' assertion that the fabric formation rule is not intended to "more accurately reflect where the most significant production activity occurs". We note that, with respect to this clarification, the United States has stated that it was persuaded by the European Communities that, for the goods at issue, the most important manufacturing process would be better reflected by a DP2 rule. United States' reply to Panel question No. 76.

textile industry by making the relevant quotas "more restrictive". These elements include the legislative history of section 334, notably the House and Senate reports<sup>23</sup>; post-enactment statements by two United States senators<sup>24</sup>; a statement by a United States textile importer association<sup>25</sup>; and publications by academics and a practising lawyer<sup>26</sup>. It should be noted that these elements are not part of section 334 itself, nor can they be said to "objectively manifest"<sup>27</sup> the objective of the fabric formation rule. Under the test established by the Appellate Body in *Chile - Alcoholic Beverages*<sup>28</sup>, we are not to base our inquiry into the objective of the fabric formation rule on such elements.<sup>29</sup> In any event, we have carefully reviewed each of these elements. We do not consider that, individually or taken together, they are sufficient to support the conclusion that the United States is using the fabric formation rule to afford protection to its textile industry, over and above the protection it already enjoys as a result of the United States' quota regime. With respect to the legislative history, India has provided no support for its assertion that the House and Senate reports reveal that section 334 was intended by the United States Congress as an instrument to pursue trade objectives.<sup>30</sup> With respect to the post-enactment statements by two United States senators, India states that the senators in question referred to section 334 as a "very significant change in rules of origin".<sup>31</sup> However, such a characterization would not demonstrate that section 334 is "protectionist"<sup>32</sup>. Finally, with respect to the opinions expressed by a United States' textile importer association, academics and a practising lawyer, we do not think they are particularly probative.<sup>33</sup> Indeed, the Panel was struck by the paucity of public and critical comment on the legislative changes.

6.94 In sum, India has not persuaded us that the fabric formation rule does not pursue any legitimate objectives, or that any such objectives are a sham. Therefore, even assuming that the fabric formation rule rendered relevant United States textile quotas more restrictive, India has failed to establish that any restrictive effects of the fabric formation rule are not incidental to the pursuit of legitimate objectives.

6.95 (...) For these reasons, we find that India has not demonstrated that the fabric formation rule as it applies to fabrics is inconsistent with Article 2(b).

6.96 In the light of the above, we find that India has failed to establish that section 334 is being used as an instrument to pursue the objective of protecting the United States' textile industry.<sup>34</sup>

<sup>23</sup> India's first written submission, para. 57.

<sup>24</sup> *Ibid.*, paras. 66-68.

<sup>25</sup> *Ibid.*, para. 64.

<sup>26</sup> *Ibid.*, para. 65.

<sup>27</sup> Appellate Body Report, *Chile - Alcoholic Beverages*, *supra*, para. 71.

<sup>28</sup> *Supra*, para. 6.37.

<sup>29</sup> We also note that, as a matter of United States law, the legislative history, for instance, is less authoritative than the SAA. United States' reply to Panel question No. 31.

<sup>30</sup> India's first written submission, para. 57.

<sup>31</sup> India's first written submission, para. 66; exhibit INDIA-3.

<sup>32</sup> India's first written submission, para. 66.

<sup>33</sup> We note that the comments by the United States textile importer association were made at the time of the Congressional deliberations on what later became section 405 and sought to convince United States legislators to revisit the fabric formation rule in section 334. Exhibit INDIA-11, p. 14. The academic publication referred to by India is authored by members of an association which has prepared a report on obstacles to textile trade for the European Commission. Exhibit INDIA-12, opening footnote. The other publication referred to by India is by a private lawyer who, according to the United States, often represents importers. United States' second oral statement, para. 22.

<sup>34</sup> In response to question 55(b) from the Panel, India briefly addressed some of the other purposes for which section 334 is used, that is to say, purposes other than the administration of quantitative restrictions. However, India's response does not establish that, when used for one of these purposes, section 334 is used to pursue a trade objective. With respect to origin marking, the mere fact that the fabric formation rule in section 334 may mean that some goods have to be marked as originating in a different country and that this may, in

Accordingly, we conclude that India has failed to establish that section 334 is inconsistent with Article 2(b).

(...)

some cases, affect the marketability of these goods, would not, in and of itself, warrant the conclusion that the fabric formation rule is designed to protect the United States' textile industry. Also, the example mentioned by India, silk scarves, is not subject to the fabric formation rule, but to the DP2 rule provided for in section 405. With respect to the purpose of gathering trade statistics, we are not persuaded by India's argument that the fabric formation rule is intended to protect the United States' textile industry because it skews import statistics. India's argument is based on its disagreement with the United States as to where finished fabrics and flat goods should be deemed to originate, an argument which we have already dealt with.

## **Optional Reading**

*Moshe Hirsch*, International Trade Law, Political Economy and Rules of Origin: A Plea for a Reform of the WTO Regime on Rules of Origin, 36 *Journal of World Trade* (2002) 171.





## Accumulation / Cumulation

What is “accumulation”/“cumulation”?

The concept of “accumulation”/“cumulation” or sometimes also called “cumulative rules of origin” allows countries which are part of a preferential trade agreement to share production and jointly comply with the relevant rules of origin provisions, i.e. a producer of one contracting party of a free trade zone is allowed to use input materials from another contracting party without losing the originating status of that input for the purpose of the applicable rules of origin. Otherwise said, the concept of accumulation/cumulation or cumulative rules of origin allows products of one country of a free trade zone to be further processed or added to products in another country of that zone as if they had originated in the latter country. In this way, production may be aggregated with other countries’ inputs without losing originating status offering additional opportunities to source input materials. This essentially widens the definition of originating products and provides flexibility to develop economic relations between countries within a free trade zone. Hence, with the concept of accumulation/cumulation in a free trade agreement, the use of input materials and manufacturing processes within that zone is encouraged. This promotes economic integration amongst member countries of a free trade zone.

Accumulation/cumulation is a deviation from one of the core concepts of origin legislations. The basic rules of origin specify that only products which are either produced entirely in a specific country (wholly obtained) or which are sufficiently transformed according to the relevant origin rules may be regarded as originating in that country. The concept of accumulation/cumulation extends this principle in so far as accumulation/cumulation offers the possibility to use products originating in a partner country or in partner countries of a preferential trade area as originating materials for the manufacture of an originating product. The higher the degree of accumulation/cumulation is, i.e. the greater is the number of potential trading partners whose inputs can count towards satisfying the origin rules, the more liberal are the rules and the easier it is to satisfy them. With wider accumulation/cumulation possibilities exporters will be less constrained in their choice of inputs and inefficient input sourcing in order to qualify for preferences is less likely and producers will be more competitive.

On the other hand, narrow accumulation/cumulation possibilities provide greater incentives to add value within the free trade zone, but also impose greater costs to producers with the risk that the origin rules will not be met or will only be met at prohibitively high costs that the preferences will not be utilized.

Wider cumulation provisions offer greater freedom in sourcing decisions to exporters. While wider cumulation rules make countries more competitive in manufacturing processes and thus more attractive for foreign direct investments, wider cumulation rules may, however, increase the possibility of unintended utilization of preferences by countries which do not participate in a preferential area.

Three types of “accumulation”/“cumulation”

In principle three types of accumulation/cumulation can be distinguished, although they are not specified as such in legal texts. Those are:

Provisions on accumulation/cumulation are found in virtually all origin legislation models. The most common concept is bilateral cumulation.

WTO consistency of the cumulation rules

From the outset, the question is whether the formation of a free trade area is considered to facilitate trade or constitute a barrier to trade and what role play rules of origin and more precisely the rules for cumulation/accumulation. It goes without saying that a free trade zone generally promotes inner trade zone which can change sourcing patterns. It is however difficult to prove that origin legislations violate the WTO law and little action had been undertaken in the GATT/WTO context to challenge the WTO consistency of rules of origin and amongst those the rules for cumulation/accumulation schemes.

Rules for cumulation/accumulation schemes are not specifically mentioned in the Common Declaration With Regard To Preferential Rules of Origin of the WTO Agreement on Rules of Origin. Nevertheless the WTO regime as such has no bearing upon the cumulation/accumulation rules. Especially [Article XXIV, paragraph 4 of GATT 1947](#) stipulates that the purpose of a customs union or a free trade area should contribute to facilitating trade between the constituent territories and not raise barriers for the trade with other countries. Thus, the question is whether or not cumulation/accumulation rules affect trade patterns and if yes, then how.

The analysis shows that the cumulation/accumulation schemes affect trade patterns. But the views on how they do it are divided. Proponents of cumulation/accumulation schemes argue that cumulation/accumulation schemes would reduce trade barriers and thus facilitate trade among economies participating in preferential regimes. Critics argue that cumulation/accumulation schemes extend preferences of individual preferential arrangements to other non-participating parties without any legal basis and in this way they may discriminate third parties.

The most inclusive legislation on accumulation/cumulation is found in the European origin legislation (Pan-Euro cumulation system and Euro-Med cumulation system). The European General System of Preferences (GSP) for developing countries and the Economic Partnership Agreements (EPAs) which are about to be

concluded between the EU and the ACP countries (African, Caribbean and Pacific countries) will also have comprehensive accumulation/cumulation possibilities for the promotion of regional integration between developing countries with diagonal cumulation offering a better economic integration of the members of a regional group of beneficiary countries.

The European origin legislations mostly offer the possibility of "diagonal cumulation" to its free trade partner countries, meaning the possibility to cumulate with originating inputs. The economies in the countries of Eastern Europe were in this way connected to the core European economies of the EU member states, Turkey and EFTA countries. Diagonal cumulation is also foreseen for the European partner countries in the Balkans and the Mediterranean rim (Euro-Med) and the Mediterranean countries are gradually integrated into the diagonal cumulation system offered by the Euro-Med cumulation. Diagonal cumulation also offers a better economic integration for members of a regional group of beneficiary countries in the European GSP system.

The NAFTA origin legislation also offers the possibility of cumulation, called "accumulation". The NAFTA accumulation is in fact a full cumulation concept for the calculation of the regional value content requirement. However, compared to the European concept of cumulation, the NAFTA accumulation allows the use of origin conferring manufacturing stages solely for the calculation of the regional value content which is only one element of the origin determination. All other requirements set out in the product specific origin rules, such as tariff classification changes required for non-originating materials must be fulfilled anyway. This means that the NAFTA accumulation offers less room of manoeuvre for widening the definition of originating products compared to bilateral/diagonal cumulation concepts offering originating input from other partner countries.

It has to be acknowledged that the concept of accumulation/cumulation will deliver its full potential for product specific rules based on value added requirements or for specific rules of origin based on manufacturing operations (i.e. in the textile sector where different manufacturing stages are required, such as spinning and weaving or weaving and sewing or other finishing operations). The accumulation/cumulation concept within rules of origin based on a tariff shift model has a limited impact for the development of economic relations within a free trade zone and the NAFTA accumulation system has to be seen under this angle.

The ASEAN origin legislation offers "regional accumulation" that allows only originating materials to benefit from regional accumulation (goods which have obtained originating status according to the ASEAN model). In short, this means that materials originating in one member state of the ASEAN origin legislation shall be considered as originating materials in the other state.

#### Administration of different types of accumulation/cumulation

Full cumulation models require a sophisticated system to trace back the different manufacturing processes made by the various producers in the different countries. A producer may only be sure to comply with the specific origin rules when he knows what kind of origin conferring contributions were provided by previous manufactureres (the use of originating or non-originating input in the case of cumulation with originating inputs or the totality of the share of origin contributions in the manufacturing chain for the overall assessment of total or full cumulation).

The traceability for originating inputs is easier to provide in bilateral/diagonal cumulation than in full cumulation. Under bilateral/diagonal cumulation the origin of a good is indicated in the customs declaration (the customs declaration shows whether or not the inputs were imported under preferences and the respective proof of origin submitted for customs clearance is indicated in the import declaration).

Inputs used under full cumulation may be imported without preferences with the consequence that origin relevant inputs for the use of full cumulation must be indicated separately (i.e. with the suppliers' declaration). Therefore, an information system must be established between the economic operators in the preferential zone to ensure that the information on previous origin conferring manufacturing operations provided by former producers will be delivered to the further producers in the manufacturing chain (in the European origin systems there is a special form, so-called "suppliers' declaration" which can be used to forward origin relevant information of previous manufacturing processes, i.e. manufacturing processes and added value inputs made in previous manufacturing stages which may be counted as origin conferring elements of former manufacturing processes).

Accumulation/cumulation systems always need a legal administrative framework by means of appropriate administrative co-operation in the countries of the preferential zone in order to trace back the originating status of inputs benefitting from accumulation/cumulation and to administer and control the origin of such inputs.

The legal wording of the provisions for cumulation/accumulation is varying heavily in the various rules of origin models of the different preferential trade arrangements. It is perhaps one of the origin topics which is worded in the most heterogeneous way, despite the fact that there are only two distinctive types of cumulation/accumulation possibilities. In certain origin jurisdictions, cumulation/accumulation is stipulated in a specific article (called specifically cumulation/accumulation or cumulative rule of origin or cumulative treatment), whereas in other cases it is paraphrased in a general manner (sometimes found in the definitions or in the general requirements for origin determination, i.e. the requirement of "wholly obtained" and "sufficient transformation" requirement).

Hereafter, there are three explanations on the types of cumulation found in the European, the NAFTA and the ASEAN contexts:

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**WTO: 2016 NEWS ITEMS**

22 April 2016

**RULES OF ORIGIN**

**WTO members gear up for implementing Nairobi agreement on preferential rules of origin**

WTO members held their first discussions on 22 April regarding implementation of the Ministerial Decision on Preferential Rules of Origin for Least Developed Countries (LDCs). The Ministerial Decision was one of the key outcomes of the WTO's 10th Ministerial Conference in Nairobi last December.

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The provisions set out under the [Nairobi Decision](#) aim to facilitate least-developed countries' export of goods to both developed and developing countries under unilateral preferential trade arrangements in favour of LDCs. Key beneficiaries will be countries of the LDC Group, the proponent for the Nairobi Decision.

The Nairobi Decision builds on the earlier 2013 Bali Ministerial Decision on preferential rules of origin by providing more detailed directions on specific issues, such as methods for determining when a product qualifies as "made in an LDC", and when inputs from other sources can be "cumulated" – or combined together – into the consideration of origin. The provisions also call on preference-granting members to consider simplifying documentary and procedural requirements related to origin as well as other measures to further streamline customs procedures.

At a meeting of the WTO's committee on rules of origin, the chairman, Christian Wegener (Denmark), reminded delegations that the Nairobi Decision contains an obligation for members to inform the committee about efforts they are making to implement the decision. Members thus need to start preparing this submission.

The chairman noted that, for developed countries, a notification on implementation is due by the end of 2016, while for developing countries with preferential schemes, the notification is due when they decide to start implementing the Nairobi Decision, in line with the flexibilities set out in paragraph 4.1 of the Decision.

"Because of the broad scope of the Decision and its provisions, I would urge all members to start preparing their communication as early as possible, so that all efforts are made to ensure a smooth implementation of the Decision," Mr Wegener said.

Speaking on behalf of the LDC Group, Benin raised several issues to move the discussions forward, including questions set out in a [written submission](#) to the committee meeting. Benin said it was important to have information on the present status of notifications on preferential rules of origin and how the preference-granting members would abide by their commitments. Benin also noted that an obligation already exists to provide trade and tariff data to the WTO but that some members have provided incomplete data or no data at all. The data will be used by the WTO Secretariat to calculate preference utilization rates, in accordance with modalities to be agreed upon by the committee.

Switzerland, the United States, China, Canada, the EU, Japan and Chile all outlined efforts currently under way or already completed to bring their practices in line with the Nairobi Decision. The EU said it always notified all regulations on rules of origin in the context of its Generalized System of Preferences (GSP) programmes and that it submits relevant import data on a regular basis. The US said it considered its preferential rules of origin well-positioned in terms of consistency with the Nairobi Decision as well as the notification requirements contained therein. China added that effective implementation of the Nairobi Decision will help LDCs increase their exports and integrate into global value chains.

**Jargon buster**

Place the cursor over a term to see its definition:

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## Background

Rules of origin are the criteria used to determine where a product was made. Products that are deemed under such rules to be made in LDCs would qualify for preferential market access schemes for LDCs.

The 2013 [Bali Decision](#) set out, for the first time, a set of multilaterally agreed guidelines to help make it easier for LDC exports to qualify for preferential market access. The Bali Decision recognizes that each country granting trade preferences to LDCs has its own method of determining rules of origin, and it invites members to draw upon the elements contained in the Decision when they develop or build on their individual rules of origin arrangements applicable for LDCs.

The Decision also requires that members notify their preferential rules of origin for LDCs to the WTO to enhance transparency, make the rules better understood, and promote an exchange of experiences as well as mainstreaming of best practices. The WTO's relevant bodies shall also annually review these rules of origin.

A briefing note on preferential rules of origin and other issues of interest to LDCs addressed at the Nairobi Ministerial Conference is available [here](#).

Further information on the WTO's work regarding rules of origin can be found at [www.wto.org/origin](http://www.wto.org/origin).

Details on the LDC Group and others in the WTO can be found [here](#).

The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.

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