

Brief on Rules of Origin

Preferential Rules of Origin have been under consideration by the WTO since the introduction of the duty-free, quota-free (DFQF) initiative into the 1996 Singapore Ministerial Declaration. However, although preferential Rules of Origin have been the subject of debate in the WTO for over 12 years, no consensus has been reached, possibly because different Members of the WTO expect Rules of Origin to serve different functions. The function of Rules of Origin which refer to the Duty-Free Quota-Free Market Access for Least-Developed Countries (LDCs) provisions are to reduce trade diversion and trade deflection to a minimum, which can be achieved by having Rules of Origin which are simple and transparent. LDCs are not able to take advantage of preferential market access provisions (and so be able to use trade as a vehicle for economic growth and poverty alleviation) if the Rules of Origin associated with the preference scheme are so strict as to preclude trade taking place.

The LDCs have been trying to introduce modalities on preferential Rules of Origin since the preparations for the Hong Kong Ministerial started and did manage to include language on Rules of Origin into the Hong Kong Ministerial Declaration. The Decision reached in Hong Kong, as contained in Annex F of the Ministerial Declaration, states, *inter alia*, that WTO Members agreed to: "*ensure that preferential rules of origin applicable to imports from LDCs are transparent and simple, and contribute to facilitating market access*".

Although useful, this language does not specify what the Rules of Origin should be nor does it address their impact on the utilisation of trade preferences. The LDC Group has considerable work to do to convince the rest of the WTO membership to agree to wording on Rules of Origin that ensures that actions on preferential Rules of Origin are both implementable at the multilateral level and are enforceable.

In order to initiate implementation of the commitment on Rules of Origin made by all Members in the Hong Kong Declaration, the LDC Group has put forward a proposal (TN/CTD/W/29 and TN/MA/W/74 and TN/AG/GEN/18 of 6th June 2006) to the NAMA and Agriculture committees and to the Committee on Trade and Development. The LDCs have submitted this proposal to these three committees in order to promote a focused debate on Rules of Origin between LDCs and preference-giving countries on the basis of a Rules of Origin and specific text rather than on declarations of principle and statements of intent.

The responses from preference-giving countries to the LDC proposal have not been encouraging.

Multilateral discussions between the LDC Group and preference-giving countries have been limited, mainly because preference-giving countries regard preference Rules of Origin as being unilateral and governed by the Enabling Clause rather than being part of the multilateral discussions. This reflects the view of preference-giving countries, expressed in the 1970 meeting of the OECD *ad-hoc* Group of the Trade Committee on Preferences held in Paris, that, as preferences were being granted unilaterally and non-contractually, the general principle had to be that donor countries were free to decide on the Rules of Origin which they thought were appropriate after hearing the views of the beneficiary countries. This decision was in direct contrast to the attempts being made at the same time by the UNCTAD Working Group on Rules of Origin to agree on a common set of rules of origin or GSP. After more than 30 years of discussing preferential Rules of Origin and after successive rounds of trade negotiations have substantially lowered the margin of preference available to LDCs, the preference-giving countries still maintain the principle that there cannot be multilateral preferential Rules of Origin.

Another challenge being faced by the LDC Group is the attempt by some preference-giving Members to take the discussions on preferential Rules of Origin out of the Special Session of the Committee on Trade and Development (CTDSS) and the Agriculture and NAMA Committees and into the Committee on Trade and Development. As developing country concerns with respect to a particular provision of a particular agreement are normally dealt with in the committee responsible for that agreement and not CTD, relegating the discussions on Rules of Origin to CTD will result in a de-linking of Rules of Origin from the DDA modalities.

A series of meetings were held in 2007 with Delegations of preference-giving countries, including the US, EU and Japan. However these meetings were used by the preference-giving countries as opportunities to explain to the LDC Group why the Rules of Origin used by these preference-giving countries were the best Rules of Origin that can be provided to LDCs and that they conformed to the Hong Kong Decision in that they were simple and transparent. The focus was on defence of the *status quo* rather than on taking account of the interests of LDCs and working together to resolve outstanding concerns of LDCs.

There also seems to be a perception by WTO members that LDCs do not know what they want or how they want to proceed. In his introduction to the Draft NAMA Modalities (Job(07/126) on 17th July 2007 the NAMA Chair, in paragraph 38, states that "*On the issue of improving rules of origin for duty-free, quota-free market access, neither the proponents nor the members more broadly have a precise idea on how to proceed*". This is despite the fact that the LDC Group presented a detailed proposal on Rules of Origin (TN/MA/W/74) to the NAMA Committee a year earlier.

The Chair, in paragraph 38, goes on to state that "*I would note that harmonizing preferential rules of origin may not be the optimal solution and that there are best practises among Members that could be readily adopted to enhance the effectiveness of these programs*". Nowhere has the LDC Group mentioned a desire to harmonise Rules of Origin so it is unclear as to why the Chair should consider it necessary to make this statement. The statement on the adoption of best practices is in line with the position of preference-giving countries, who all believe that their particular preferential Rules of Origin constitute best practice, rather than in line with the clearly stated objectives of the LDC Group.

As regards Rules of Origin at least, from the point of view of the LDCs the Revised NAMA Draft Modalities of 8th February 2008 are a slight improvement over the previous draft. Paragraph 15 of the Revised Draft states, among other things, that:

We reaffirm the need to help LDCs secure beneficial and meaningful integration into the multilateral trading system. In this regard, we recall the Decision on Measures in Favour of Least-Developed Countries contained in decision 36 of Annex F of the Hong Kong Ministerial Declaration (the "Decision"), and recommit:

- (a) to fully implement the Decision as agreed;*
- (b) to ensure that preferential rules of origin applicable to imports from LDCs will be transparent, simple and contribute to facilitating market access in respect of non-agricultural products. In this connection, we urge Members to use the model provided in document TN/MA/W/74, as appropriate, in the design of the rules of origin for their autonomous preference programs;*

The LDC proposals for preferential Rules of Origin are for an across the board Rule of Origin based on an, as yet unspecified¹, percentage criterion. The proposal for an across the board criterion was simply to avoid the negotiations of product specific rules of origin.

The LDCs have not been able to suggest what percentages would be appropriate as data to be used in the determination of these percentages is missing. However, through some field research being conducted by the DfID-financed Regional Trade Facilitation Programme and UNCTAD in the COMESA region, the level of percentages a sample of LDC producers could comply with will be assessed.

The use of a framework of an across-the-board percentage criterion for preferential Rules of Origin does not *a priori* preclude the adoption, in some sectors or HS chapters, of the use of other criteria such as change of tariff classification or specific working or processing requirements.

The draft LDCs model protocol attached as an annex to the LDC Proposal on Rules of Origin conforms with the Kyoto Convention and international practice in that it uses two main origin-conferring categories, these being:

¹ The fact that there has been no specified percentage criterion is deliberate. The LDC Group wanted to first get the concept of an across-the-board percentage criterion agreed and then move to the percentage, rather than get bogged down with a discussion on what percentages would be appropriate before principles were agreed.

- i) Wholly Produced - refers to agricultural and mining products which are collected, mined, grown, reared etc in the exporting country (e.g. mineral products; vegetable products; live animals; products obtained from live animals; etc if these products originate in the Member State concerned.) Annex D1 of the Kyoto Convention contains a definition of what constitutes wholly produced and most preferential Rules of Origin follow this definition
- ii) Substantive Transformation, defined by one or more of the following methods:
 - a. change of tariff classification;
 - b. value addition; or
 - c. specific manufacturing process.

There are difficulties in any method used to calculate substantive transformation but the method recommended for use in the LDC draft model protocol is the percentage criteria. The reason for recommending this method is to avoid a discussion on a line-by-line basis, as would be the case if substantive transformation was to be determined on the basis of change in tariff classification or specific manufacturing process.

The use of change of tariff classification to determine substantive transformation is usually regarded as the "easiest" method to use as all that needs to be done is to prove that a product has moved from one tariff heading (or sub-heading) to another after processing. However, because the Harmonised System is primarily a customs classification system rather than a way of defining substantive transformation, there are many instances in which a change in tariff classification does not constitute substantive transformation and also instances in which substantive transformation takes place but with no change in tariff classification. If change of tariff classification is to be used within the across-the board criterion of value addition then detailed discussions between the LDCs and the preference-giving countries on what constitutes substantive transformation will need to be held. These discussions will need to address how to treat goods where significant processing has taken place but where no change of tariff classification has been realised. This, by definition, would need to be done line-by-line (although in some cases substantive transformation could be agreed on by chapter head and sub-head) which will be further complicated and delayed by lobbying by interest groups in both the preference-giving countries and LDC Members.

If specific manufacturing process is also to be used this will also, by definition, need to be negotiated line-by-line.

Percentage criteria can be defined in a variety of ways but mainly they take the forms as follows:

- Value addition in terms of cost of labour and direct cost of processing added to the imported materials. This is the method used, for example, under the US GSP and AGOA).
- Value addition by subtraction of the value of imported material. This, for example, is the "build down" method used under the United States - Central America Free Trade Agreement (US-CAFTA).
- Allowance of a maximum amount of foreign inputs out of the ex-work price.
- Value addition in terms of cost of local material used in manufacturing the finished product. This, for example, is the "build up" method used under US-CAFTA.

Limitations in using the value-addition calculation method are:

- Value-addition may deter a manufacturer from investing in more efficient plant and machinery as this may reduce the cost of the manufacturing process which could result in the value added through processing to be reduced to below the value addition threshold which confers origin;
- Value-added percentages are easily affected by movements in exchange rates for finished products that have imported raw materials in that when a local currency appreciates, the percentage value added tends to decline, and vice versa;

- The level of percentage threshold may be arbitrarily set and may vary according;
- It is often difficult to calculate the value added if there are a number of products produced from the imported material, such as a manufacturing process using imported crude palm oil to produce a number of products such as refined cooking oil, soap and margarine;
- The costs of labour in developing countries is relatively cheap and in a value added calculation it may turn an asset into a penalty; and
- The calculations may be difficult and may entail some accountancy expertise generally not available in most small firms in LDCs.

However, despite these challenges, a percentage criterion has a number of advantages in that:

- It should be the quickest and easiest way to reach an agreement on Rules of Origin in that the Rules of Origin can be negotiated on a generic basis and not on a line-by-line basis;
- The percentage criterion method of calculation can be adjusted to minimise its shortcoming and could be drafted in such a way as to compensate for additional costs incurred in transportation charges on inputs by landlocked countries.
- The methodology used to calculate value addition is based on two formulas called build-down and built-up, using best practice from the US-CAFTA:

Method Based on Value of Non-Originating Materials ("Build-down Method")

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

Method Based on Value of Originating Materials ("Build-up Method")

$$RVC = \frac{VOM \times 100}{AV}$$

Where:

- RVC is the regional value content, expressed as a percentage;
- AV is the adjusted value;
- VNM is the value of non-originating materials that are acquired and used by the producer in the production of the good; VNM does not include the value of a material that is self-produced; and
- VOM is the value of originating materials acquired or self-produced, and used by the producer in the production of the good.

The formulas proposed take into account the special situations related to the transport costs of input materials to landlocked LDCs in that the calculations are based on adjustments made to the value of materials as contained in article 6 of the LDC Draft Protocol permitting either the deduction of the CIF costs to the regional port when a "build-down" method is used or the addition of inter-regional inland costs of transport when the "build up" method is used. This method of calculation of the value of materials used in manufacturing will greatly facilitate LDC compliance with the Rules of Origin of the preference giving country.