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## Preferential Rules of Origin – A Conceptual Outline

*The European Community's preferential trading agreements with third countries all contain origin rules, which lay down a number of detailed criteria that must be met in order for goods to qualify for preferential customs treatment. These "preferential rules of origin" are currently under discussion by policy-makers<sup>1</sup> and economists developing guidelines for policy-makers. However, no such discussion is apparent in the more recent academic literature. It appears that scientific debate so far has not analysed in depth the basic legal concepts and instruments contained in preferential trading agreements. The following article attempts to identify these instruments and draft a conceptual overview.*

Globalisation brought the rise of multinational corporations and the production of goods in multiple stages using input (or parts) produced in different places around the world. The growth of international trade in goods that are manufactured in more than one single country has called attention to the rules related to the determination of the "origin" of the traded products, the "rules of origin" (ROO). Governments apply these ROO as the criteria to determine the "nationality" of products, which as a rule will have an impact on the customs rate to be paid upon importation.<sup>2</sup>

Governments do so in principle for two reasons. First, to distinguish foreign from domestic goods, when imports are not being granted national treatment. Second, to define the foreign origin of a product, because foreign goods may be subject to different customs duties or measures depending on their origin, be they preferential or other measures.

The main reason for the existence of ROO is the existence of differentiated restrictions in international trade. In an entirely open world economy there would not be a demand for rules of origin because it would be irrelevant where goods originated.<sup>3</sup> However, as long as the restrictions in international trade factually exist, rules of origin will remain an important trade policy mechanism.

According to the definitions used in current customs legislation, each good can originate in only one territory.<sup>4</sup> Once the origin of a good is known, the importing country can apply country-specific or trade-area specific trade preferences or restrictions to the imported good,<sup>5</sup> account for the good in its compila-

tion of economic statistics on trade flows and ensure that the good is conspicuously marked with its country of origin.<sup>6</sup>

Rules of origin are used:<sup>7</sup>

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

<sup>1</sup> For example, cumulation of origin was discussed intensively under the Spanish Presidency of the European Union at the Ministerial Seminar on Trade & Euromed Meeting in Toledo, 18.-19.03.2002.

<sup>2</sup> Rod Falvey, Geoff Reed: Rules of Origin as Commercial Policy Instruments, Research Paper 2000/18, Centre for Research on Globalisation and Labour Markets, University of Nottingham 2000.

<sup>3</sup> Cf. Edwin Vermulst: Rules of Origin as Commercial Policy Instruments - Revisited, in: Journal of World Trade, Vol. 26, No. 6, 1992, pp. 61 f.

<sup>4</sup> For example, US and EC tariff schedules which do not allow for multiple origin.

<sup>5</sup> For example, duty-free entry of goods originating in the partner country of a preferential trading agreement, quantitative restrictions on goods originating in countries subject to quotas, or anti-dumping duties on goods from specific companies that originate in specified countries.

<sup>6</sup> Joseph A. LaNasa: 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, Working Paper, Harvard Law School 1995.

<sup>7</sup> Cf. World Trade Organisation, Technical Information on rules of origin, [http://www.wto.org/english/tratop\\_e/roi\\_e/roi\\_e.htm](http://www.wto.org/english/tratop_e/roi_e/roi_e.htm).

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### Non-Preferential Rules of Origin

Rules of origin can be divided into two categories: preferential and non-preferential rules of origin. Non-preferential rules define the origin of a good for the purpose of such matters as MFN treatment,<sup>8</sup> trade statistics and import quotas. Non-preferential ROO must be applied objectively and in a non-discriminatory way since the origin of goods is essentially a matter of fact.<sup>9</sup> They are usually laid down in the customs codes<sup>10</sup> of the respective customs territories.<sup>11</sup>

In the Community the non-preferential rules provide for origin to be established in two ways. Goods are either “wholly obtained or produced”<sup>12</sup> in one country, or they are the product of two or more countries. In the latter case these goods are deemed to originate in the country where they underwent “their last, substantial, economically justified working or processing in an undertaking equipped for that purpose and resulting in the manufacture of a new product or representing an important stage of manufacture”.<sup>13</sup> In most cases this criterion is not further defined. However, there are some cases, for example textiles, where there are specific rules interpreting the last substantial transformation process.<sup>14</sup> Community law and practice complies with international standards.<sup>15,16</sup>

### Preferential Rules of Origin

Preferential ROO are usually defined by members of regional free trade areas or other countries that have

signed up to preferential trade agreements.<sup>17</sup> Preferential ROO can also be preferential tariff measures adopted unilaterally in respect of certain countries, groups of countries or territories. Because they are unilaterally granted, such tariff preferences constitute an exception from the MFN principle of Art. II GATT. Hence such measures have to comply with WTO/GATT provisions regarding the General System of Preferences<sup>18</sup> and regarding Measures in Favour of Least Developed Countries.

Preferential trade agreements as well as the provisions allowing for unilateral preferential tariff measures usually contain a sophisticated and detailed body of rules and regulations in order to ensure that only goods which genuinely originate in one of the member countries enjoy the low tariffs or other benefits laid down in the agreement.<sup>19</sup> In contrast to non-preferential ROO, which are only of statistical importance once the good has been identified as “foreign” and the relevant duties have been paid, preferential ROO play a key role when granting preferential treatment, which is usually the synonym for zero tariffs instead of MFN tariffs. Therefore preferential ROO are often more restrictive than the non-preferential ones.<sup>20</sup>

The Community Customs Code explicitly exempts “preferential tariff measures contained in agreements which the Community has concluded with certain countries or groups of countries and which provide for the granting of preferential tariff treatment”<sup>21</sup> and “preferential tariff measures adopted unilaterally by the Community in respect of certain countries, groups of countries or territories”<sup>22</sup> from the scope of application of non-preferential ROO.<sup>23</sup> Hence preferential tariff measures are subject to preferential ROO, which lay down the conditions governing acquisition of origin that goods must fulfil in order to benefit from the preferential treatment. The preferential ROO are determined in the respective preferential trading agreements.<sup>24</sup> In the case of unilateral preferential tariff

<sup>8</sup> I.e. whether goods shall be subject to the “normal”, non-preferential customs tariffs.

<sup>9</sup> Only the non-preferential rules of origin are covered by the WTO Agreement on Rules of Origin, which requires WTO members to ensure that their rules of origin are transparent; that they do not have restricting, distorting or disruptive effects on international trade; that they are administered in a consistent, uniform, impartial and reasonable manner; and that they are based on a positive standard; cf. [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/agrm8\\_e.htm#origin](http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm8_e.htm#origin).

<sup>10</sup> As for the EC cf. articles 22ff of the Council Regulation (EEC) No. 2913/92 of 12 October 1992 establishing the Community Customs Code, OJ 1992 L pp. 1-50 as amended by Regulation (EC) No. 2700/2000 of 16 November, OJ L 311 12.12.2000 p. 17; also Commission Regulation (EEC) No. 2454/93 of 2 July 1993 laying down provisions for the implementation of Council Regulation (EEC) No. 2913/92 establishing the Community Customs Code as amended by Commission Regulation (EC) No. 993/2001 of 4 May 2001, OJ 2001 L 141 pp. 1-128.

<sup>11</sup> Note that unilaterally granted tariff preferences are also laid down in the respective customs codes; e.g. the exceptions under the EC’s General System of Preferences (GSP) scheme and the US Qualified Industrial Zone Initiative.

<sup>12</sup> Cf. Regulation (EEC) 2913/92, Art. 23.

<sup>13</sup> Cf. *ibid.*, Art. 24.

<sup>14</sup> As for textiles cf. Regulation (EEC) No 2454/93, Art. 35 ff.

<sup>15</sup> Cf. HM Government, Department of Trade and Industry, [www.dti.gov.uk/worldtrade/rules.htm](http://www.dti.gov.uk/worldtrade/rules.htm).

<sup>16</sup> For a detailed analysis of non-preferential ROO see Edwin Vermeulst, *op. cit.*, pp. 61 ff.

<sup>17</sup> Note that in the literature the term “arrangement” instead of “agreement” is sometimes used.

<sup>18</sup> Decision of the GATT/WTO member states: Generalised Non Reciprocal and Non Discriminatory Preferences Beneficial to Developing Countries, GATT BISD 18 Supp. 24 (1972).

<sup>19</sup> In the context of unilaterally granted preferences to developing countries, ROO ensure that only those goods which genuinely originate in the developing countries enjoy the low tariffs or other benefits unilaterally granted.

<sup>20</sup> Joseph A. LaNasa, *op. cit.*

<sup>21</sup> Cf. Regulation (EEC) 2913/92, Art. 20 lit. d.

<sup>22</sup> Cf. *ibid.* Art. 20 lit. e; for further recent information on the GSP scheme of the European Community see <http://www.eurunion.org/legislat/gsp/legislat.htm>.

<sup>23</sup> *Ibid.* Art. 22 lit. a.

<sup>24</sup> *Ibid.* Art. 27 lit. a.

measures they are determined in the respective regulations in which these preferences are granted.<sup>25</sup>

The EC's preferential ROO are also clearly more stringent than the non-preferential ones.<sup>26</sup> The ECJ stated in the context of unilaterally granted tariff preferences that they "may ... be necessary to attain the objective of the generalised tariff preferences of ensuring that the preferences benefit only industries which are established in developing countries and which carry out the main manufacturing process in those countries."<sup>27</sup> The reasoning in this decision should also be valid in the context of a preferential trade agreement, i.e. that only industries which are established in the EC's FTA partner countries and which carry out the main manufacturing process in those countries should benefit from the preference.

The Community's preferential trading agreements all contain origin rules, which lay down several detailed criteria that must be met in order for goods to qualify for preference.<sup>28</sup> For analytical convenience the following will therefore concentrate on the rules and regulations of preferential rules of origin in FTA,<sup>29</sup> because the detailed and structured body of ROO in preferential trading agreements facilitates the analysis of the conceptual outline.

#### Conceptual Outline

The rapid, recent spread of free trade agreements<sup>30</sup> that, *inter alia*, liberalise trade through the creation of regional free trade areas has focused increasing attention on preferential ROO and their importance. In theory, trade liberalising reciprocal preferential agreements result in net trade creation. Nevertheless, in practice the use of preferential ROO may also result in collateral effects on trade and investment.<sup>31</sup>

Because of these collateral effects, economists have recently developed interest in the field of rules of origin. This interest has been prompted by the falling importance of MFN tariffs and their replacement by other trade policy interventions<sup>32</sup> and the expansion of preferential trade agreements. Economists argue

that the manner in which ROO are defined and applied within these arrangements plays a significant role in determining the degree of preference and of protection that they confer. Trade may be significantly changed as a consequence.<sup>33</sup>

The economic analysis of preferential ROO is still relatively limited and often fails to distinguish preferential ROO precisely from non-preferential ones.<sup>34</sup> The literature has, however, already identified two different instruments provided by preferential ROO to control the degree of preference – one of them is varying the severity of the required transformation and the other is allowing different degrees of cumulation.<sup>35</sup> However, the analysis of the conceptual overview still fails to differentiate clearly between these two instruments, which are determined in the provisions regulating the determination of origin and the cumulation of origin. These instruments are sometimes supported by the prohibition of duty relief.<sup>36</sup>

#### Determination of Origin

The general criterion for the determination of origin of a good is the level of required transformation which has taken place in the respective country of origin. This level of required transformation can also be expressed in the percentage of the value added to a good in the respective country.

When a product is wholly obtained in a single country, or when a product is produced from raw materials that are wholly obtained in the producing country, it is relatively easy to determine its nationality, i.e. its national origin. In this case 100% of the value of the product is "added" in this country. Therefore usually no specific transformation levels are required when a product is "wholly obtained"<sup>37</sup> in or "wholly the growth, product, or manufacture" of a member country of a preferential trade agreement.<sup>38</sup>

Difficulties arise in determining the origin of goods that are produced in more than one country and/or

<sup>25</sup> Ibid. Art. 27. lit. b.

<sup>26</sup> Cf. Edwin Vermulst, op. cit., p. 82.

<sup>27</sup> ECJ, Judgment of 08/10/1986, Case 385/85, S.R. Industries v. Administration des Douanes, (1986) ECR 2929.

<sup>28</sup> Cf. HM Government, op. cit.

<sup>29</sup> Reference to preferential measures which are unilaterally granted will be explicitly mentioned.

<sup>30</sup> Reciprocal trading agreements like FTA provide the same trade preferences to goods from any and all member countries. The best example of a reciprocal trading agreement is the creation of a free trade area. Non-reciprocal trading agreements provide a preference to goods from the beneficiary country, but not to goods from the country "donating" the preference.

<sup>31</sup> Joseph A. LaNasa, op. cit.

<sup>32</sup> Such as anti-dumping, countervailing and anti-subsidy measures.

<sup>33</sup> Rod Falvey, Geoff Reed, op. cit., p. 2.

<sup>34</sup> Exceptions are Joseph A. LaNasa, op. cit., and Edwin Vermulst, op. cit.

<sup>35</sup> Joseph A. LaNasa, op. cit.; also Edwin Vermulst, op. cit., pp. 61 f.

<sup>36</sup> For example, the prohibition of duty drawback and the inward-processing relief regimes.

<sup>37</sup> Cf. Euro-Mediterranean Interim Association Agreement on trade and cooperation between the European Community and the Palestine Liberation Organization (EC-Palestine Authority Association Agreement), Protocol 3 (Rules of Origin), Art. 4, OJ 1987 L 187 pp. 3 f.

<sup>38</sup> Cf. Agreement on the Establishment of a Free Trade Area between the Government of Israel and the Government of the United States of America (US-Israel FTA), Annex 3 (Rules of Origin), para 1 lit. a.

consist of intermediate goods that originate in more than one country. Regarding the origin of a good it is therefore determined that the product has its origin where it was “substantially transformed”<sup>39</sup> or “sufficiently worked or processed”.<sup>40</sup> Situations are still possible – especially when processing inferior goods – in which simple assembly and packing operations would meet the required level of transformation. Hence preferential ROO also provide provisions to prevent simple assembly and packing operations from conferring origin to products.<sup>41</sup>

In practice three different methods or criteria exist for setting the level of required transformation in order to accomplish the determination of origin of products which are manufactured in or assembled in and/or consist of intermediate goods originating in two or more countries.<sup>42</sup> The following methods are often applied singly or in combination:<sup>43</sup>

- value added test: this requires that the last production process creates a certain percentage of value added to the final product;<sup>44</sup>
- change in tariff heading test: origin is conferred if the activity in the exporting country results in a product that is classified under a different tariff heading of the customs tariff classification than its intermediate inputs;
- technical test: certain production activities are laid down that may (positive test) or may not (negative test) confer originating status.<sup>45</sup>

In order to fully understand the importance of the determination of origin, it should be recalled that mem-

ber countries of a preferential trade agreement usually expect it to be trade-creating and welfare-improving, both for the trading “bloc” as a whole as well as for its individual member countries.<sup>46</sup> The determination of origin provides an instrument to support these goals in both an internal and an external context.

#### **Internal Context**

In a preferential trade agreement tariff rates among members are often zero, whereas external tariff rates set by members on imports from non-members are not necessarily equalised. Therefore each and every member maintains its own external tariffs, which are likely to differ among member countries. Given this difference in tariffs, and in the absence of transport and other costs, it can be expected that trade in a product would most likely go through the country with the lowest external tariff.<sup>47</sup> In this constellation the Determination of the Origin in the ROO usually prevents trade deflection by establishing criteria that ensure an adequate degree of transformation in the preference-receiving member countries to justify allowing a good to benefit from the preference.<sup>48</sup> Hence the provisions regarding the determination of origin aim at preventing members from acquiring additional customs revenues at the cost of their partner countries in the preferential trade area.

Also, situations may arise in which high transport and storage costs occur for intermediate goods, whereas these costs are comparatively low for the finished product. In this constellation, provisions regarding the determination of origin prevent producers in FTA partner countries from obtaining artificial comparative advantages in the integrated market through unilateral measures by the country in which these producers are based, i.e. by those countries lowering their MFN duties on imported goods.

To some extent the determination of origin in ROO can therefore also be seen as an instrument that prevents member countries from creating excessive comparative advantages and which ensures that producers in all FTA members have access to production sources from outside the FTA on more or less the same, fair and equal basis<sup>49</sup> when producing products for the integrated market.

<sup>39</sup> Cf. US-Israel FTA, Annex 3 (Rules of Origin), para 4 which forseees a minimum percentage of 35 % local value added to confer origin.

<sup>40</sup> EC-Israel Euromed Association Agreement, Protocol 4 (Rules of Origin), Art. 5 OJ 2000 L 70, p.51 f.

<sup>41</sup> For example cf. Euro-Mediterranean Agreement establishing an association between the European Communities and their Member States and the State of Israel (EC-Israel Euromed Association Agreement), Protocol 4 (Rules of Origin), Art. 6 OJ 2000 L 70, p.52; or US-Israel FTA, Annex 3 (Rules of Origin), para 2, [http://199.88.185.106/tcc/data/commerce\\_html/TCC\\_Documents/IsraelFreeTrade.html](http://199.88.185.106/tcc/data/commerce_html/TCC_Documents/IsraelFreeTrade.html).

<sup>42</sup> Rod Falvey, Geoff Reed, op. cit., p.1; also Edwin Vermulst, op. cit., pp. 61-102; Edwin Vermulst, Paul Waer, Jacques Bourgeois (eds.): Rules of Origin in International Trade: A Comparative Study, Ann Arbor 1994, The University of Michigan Press.

<sup>43</sup> Cf. EC-Israel Euromed Association Agreement, Protocol 4 (Rules of Origin), Annex I and II, in which all three criteria can be identified, e.g. change in tariff heading test and value added test for HS Heading 87 09 Work trucks and technical test for HS Heading 2504 Natural crystalline graphite.

<sup>44</sup> Cf. US-Israel FTA, Annex 3 (Rules of Origin), para 1 lit. c.

<sup>45</sup> For further details about the various tests and their advantages and disadvantages see Edwin Vermulst, op. cit., pp. 63-75; also Rod Falvey, Geoff Reed, op. cit., FN 1-4, and Joseph A. LaNasa, op. cit.

<sup>46</sup> For a survey on the economic theory of regional integration arrangements cf. Dean A. DeRosa: Regional Integration Arrangements, Static Economic Theory, Quantitative Findings and Policy Guidelines, Worldbank, Policy Research Working Paper 2007; <http://ourworld.compuserve.com/homepages/adrintl/w.htm>.

<sup>47</sup> Jiandong Ju, Kala Krishna: Firm Behaviour and Market Access in a Free Trade Area with Rules of Origin, NBER Working Paper No. 6857, 1998, p.1.

<sup>48</sup> Joseph A. LaNasa, op. cit.

**Example 1**

**Rules of Origin and Determination of Origin (customs revenues)**

Assume three countries: the home country H, the partner country P and the rest of the world (ROW). Assume that the MFN tariffs of these countries are all 20%. Good 'a' is wholly obtained, i.e. 100% value added, in country H and in ROW. Suppose that – prior to the conclusion and implementation of an FTA between countries H and P – country P imported good 'a' from country H and from ROW. Prior to the implementation of the preferential trade agreement, the imports from both H and ROW face the same 20% MFN tariff when entering P.

1. Countries H and P sign and implement a bilateral free trade agreement (the H-P FTA) in order to promote regional integration. This FTA allows for duty-free access of good 'a', if the FTA's ROO are met.
2. Assume that the ROO within this FTA only demand that good 'a' is imported directly from country H to country P, but do not foresee any determination of origin.
3. Assume that country H lowers its MFN tariffs to 10% after the implementation of the FTA, whereas the MFN tariffs of country P remain at 20%.
4. In this constellation and in the absence of transport and storage costs it is most likely that extra-regional trade, i.e. exports from ROW to countries H and P of good 'a' would avoid the 20% MFN tariff of country P. Trade would most likely go through country H with the lower 10% MFN tariff. Exports from ROW would then enter country P duty-free under "quasi-country H" origin. Hence country P would lose revenues from tariffs to country H, whenever such trade occurred. Country H would gain tariff revenues at country P's cost.
5. For analytical convenience now allow for strictest determination of origin in the ROO (i.e. origin conferred with 100% local value added only). Goods that are wholly obtained in country H and have "true-country H" origin will still have duty-free access to country P, whereas the determination of origin prevents goods from ROW entering country P duty-free under "quasi-country H" origin. Trade deflection will no longer occur. Exports from ROW to country P will no longer go through country H and country H will not gain tariff revenues at country P's cost.

Strictest determination of origin (100% value added) would most likely suppress efficient trade in situations in which the region is not able to produce all the intermediate goods which are needed for the autonomous production of the finished good. Therefore in practice the determination of the level of transformation required to confer origin varies in order to enable inputs of intermediate goods originating in third countries.

**External Context**

Preferential ROO also exist in order to prevent imports from third countries taking advantage of concessions which have been made by the parties to the preferential agreement. The ECJ stated for unilaterally granted tariff preferences under the GSP framework that "only industries which are established in developing countries and which carry out the main manufacturing process in those countries" should benefit from the preference.<sup>49</sup> For EC trade policy it can be concluded that it generally limits the scope of preferences to the country to which the trade concession is

unilaterally granted or with which the trade concession is agreed upon.

**Prohibition of Duty Relief**

In this context the prohibition of duty relief should be mentioned, which can also be found in the preferential ROO of some preferential trade agreements. The most common forms of duty relief are the duty drawback and the inward-processing relief regimes. Duty drawback links the recovery of import duty on intermediate goods to the subsequent export of finished goods that are (partially) produced from these intermediate goods. Inward processing relief is similar to duty drawback. It provides for the remission of import duties on production materials based on the export of the finished goods. However, while drawback allows for the recovery of duties already paid, under inward processing relief import duty payment may be avoided completely.

Clauses providing for the prohibition of duty relief usually lay down that non-originating materials used in the manufacture of exported products originating in

<sup>49</sup> Cf. the EC practice which often requires only 60% or less as criterion for the determination of origin, which allows for the input of foreign intermediate goods but still provides that a major part of the value of the product is added within the preferential trade area.

<sup>50</sup> ECJ, Judgment of 08/10/1986, Case 385/85, S.R. Industries v. Administration des Douanes, (1986) ECR 2929.

**Example 2**

**Rules of Origin and Determination of Origin (comparative advantages)**

Assume three countries: the home country H, the partner country P and the rest of the world (ROW). Assume that the MFN tariffs of these countries are all 20%. Suppose that countries H and P import the intermediate good 'b'. Producers in countries H and P use this intermediate good 'b' for the production of the finished product 'c'. The input of intermediate good 'b' creates 50% of the value added to the finished product 'c'. Countries H and P both produce intermediate good 'b', but not in sufficient quantities to autonomously meet the demand on their domestic market. Prior to the implementation of the preferential trade agreement the imports of the intermediate good 'b' and of the finished product 'c' from all countries face the same 20% MFN tariff when entering country H and country P.

1. Countries H and P sign and implement a bilateral free trade agreement (the H-P FTA) in order to promote regional integration. This FTA allows for duty-free access of the intermediate good 'b' and of the finished product 'c', if the FTA's ROO are met.
2. Assume that the ROO within this FTA only demand that the intermediate good 'b' or the finished product 'c' are imported directly from country H to country P, but do not foresee any determination of origin.
3. Assume that country H lowers its MFN tariffs to 10% after the implementation of the FTA, whereas the MFN tariffs of country P remain at 20%.
4. In this constellation and in the absence of transport and storage costs, the result for trade in the intermediate good 'b' would be as described in Example 1. Though country P would lose tariff revenues in this constellation, producers of product 'c' still would have access to extra-regional imports of the intermediate good 'b' at the same cost, i.e. world market price plus 10% customs tariff of country H.
5. Now allow for transport and storage costs for the intermediate good 'b' which exceed the 10% tariff difference. These costs would most likely prevent extra-regional trade in good 'b'<sup>1</sup> avoiding the higher 20% MFN tariff of country P. Though trade in the intermediate good 'b' would most likely not go through country H with the lower tariff, country P's producers of the finished product 'c' would – due to the unilateral MFN tariff reduction of country H – face higher production costs than their intra-regional competitors in country H, i.e. 5% higher<sup>2</sup> material costs.
6. This artificial comparative advantage would be crucial in scenarios where intra-regional trade in the finished product 'c' faces transport and storage costs which are lower than the advantage created. Assuming that these costs were less than 5%, and that country P would not lower the MFN tariffs, producers in country P would not only face the disadvantage on the intra-regional market, but also on their home market.
7. For analytical convenience now allow for strictest determination of origin in the ROO (i.e. origin conferred with 100% local value added only). Finished products that are produced from intermediate goods wholly obtained in country H and that therefore have "only-country H" origin will still have duty-free access to country P. In this constellation the determination of origin prevents finished goods that are produced in country H with input from ROW from entering country P.<sup>3</sup> Trade deflection can no longer occur. Country H cannot create artificial comparative advantages for its producers by simply lowering the MFN tariff.

<sup>1</sup> I.e. exports from ROW to countries H and P.

<sup>2</sup> If good 'b' created 50% of the added value of product 'c' and if there is a world market price for good 'b', then a 10 % MFN tariff difference would result in 5% higher material costs.

<sup>3</sup> Since such extreme determination of origin would also suppress efficient trade in practice, the degree of the level of transformation required varies in practice in order to enable necessary inputs of intermediate goods originating from outside the preferential trade area.

an FTA member may not be subject to drawback of, or exemption from, customs duties of whatever kind between the partners of the FTA.<sup>51</sup>

Therefore it can be concluded that the prohibition of duty relief prevents members of a preferential trade agreement from creating artificial competitive advantages for their domestic producers in the form of hidden export subsidies<sup>52</sup> by reducing their tariffs on third country intermediate inputs for their producers' intra-

regional exports within the integrated market, while keeping the tariff up for the home markets.

<sup>51</sup> Cf. EC-Israel Euromed Association Agreement, Protocol 4 (Rules of Origin), Art. 16 f. or EC-Palestine Authority Euromed Association Agreement, Protocol 3 (Rules of Origin), Art. 14 f.

<sup>52</sup> Note that in the WTO context it is stated that "substitution drawback systems can constitute an export subsidy to the extent that they result in an excess drawback of the import charges levied initially on the imported inputs for which the drawback is being claimed"; cf. Agreement on Subsidies and Countervailing measures, Annex III, Article I.

**Example 3**

**Rules of Origin and Determination of Origin (external context)**

Assume three countries: the home country H, the partner country P and the rest of the world (ROW). Assume that the MFN tariffs of all three countries are 20%. The finished product 'd' is wholly obtained, i.e. 100% value added, in country P and in ROW only, but not in country H. Suppose that country P imported the finished product 'd' from ROW. Prior to the implementation of the preferential trade agreement, the imports of the finished product 'd' from ROW meet the same 20% MFN tariff when entering countries H and P.

1. Countries H and P sign and implement a bilateral free trade agreement (the H-P FTA) in order to promote regional integration. This FTA allows for duty-free access of the finished product 'd' if the FTA's ROO are met.
2. Assume that the ROO within this FTA only demand that the finished product 'd' is imported directly from country H to country P, but do not foresee any determination of origin. Assume that country H lowers its MFN tariffs to 0% after the implementation of the FTA, whereas the MFN tariffs of country P remain at 20%. (Country H could either act deliberately by using the tariff reduction as a trade-off in its own bilateral trade relationships to ROW for any reason whatsoever at country P's cost or simply negligently overlook a loophole in its customs legislation.)
3. In this constellation and in the absence of transport and storage costs it is most likely that extra-regional trade, i.e. exports from ROW to countries H and P of the finished product 'd' would avoid the 20% MFN tariff of country P. Trade would most likely go through country H with the zero tariff. Exports from ROW would then enter country P duty-free under "quasi-country H" origin. Hence country P would lose revenues from tariffs to country H whenever such trade occurred.
4. For analytical convenience now allow for strictest determination of origin in the ROO (i.e. origin conferred with 100% local value added only). Since it does not produce the finished product 'd', country H's position remains neutral. The determination of the origin prevents the finished product 'd' from ROW entering country P duty-free under "quasi-country H" origin. Trade deflection can no longer occur. If exports from ROW to country P go through country H they will be subject to country P's MFN tariff.

**Cumulation of Origin**

As can be seen from the above, the determination of origin and the prohibition of duty relief of ROO are important in constellations in which goods are imported to the preferential trade area from third countries. If the same determination of origin were to be applied to intra-regional trade as to imports from third countries, the welfare and trade-creating potential of any preferential trade agreement would be seriously restricted.

In this constellation, and assuming that the 100% origin determination were applied, the advantage of such agreements would be limited to the mere exchange of raw materials and intermediate goods wholly obtained in the FTA member countries, since finished goods from member countries which contain inputs from other member countries would not receive any preference. It goes without saying that if one of the parties employs materials or processing from the other party to a bilateral preferential agreement or from more than one party to a multilateral network of preferential agreements, it would be economic nonsense for such inputs to be denied a preference.

It has also been shown that sufficient transformation performed by producers in the exporting country

is vital in order to confer the exporting country's origin on a good. To exempt intra-regional trade from the effects of the determination of origin, especially in cases in which producers situated in one member country use intermediate imports from the other member country in their production, preferential trade agreements provide for the "cumulation of origin".

Cumulation of origin is an important preferential exception within the ROO's concept of determination of origin. Though some forms of cumulation of origin, e.g. "bilateral cumulation" or "diagonal cumulation" have been identified and recently discussed in the literature,<sup>53</sup> academic debate still lacks a common definition of the concept of cumulation of origin.

For the purpose of this paper cumulation of origin shall be defined as a preference granted between partners of a preferential trade agreement under which they stipulate that under certain conditions, materials originating in a country other than the exporting (FTA-partner) country shall be treated as if they originated in

<sup>53</sup> Cf. definitions regarding "bilateral cumulation" and "diagonal cumulation", in: The Sussex European Institute: Study on the economic impact of extending the pan-European system of cumulation of origin to the Mediterranean partners part of the Barcelona process, Final Report, University of Sussex, pp. 6 f.



**Example 4**

**Rules of Origin and Prohibition of Duty Relief**

Assume three countries: the home country H, the partner country P and the rest of the world (ROW). Assume that the MFN tariffs of these countries are all 20 %. Suppose that countries H and P imported intermediate good 'e'. Producers in countries H and P use this intermediate good 'e' for the production of finished product 'f'. The input of intermediate good 'e' creates 50% of the value added to the finished product 'f'. Countries H and P both do not produce intermediate good 'e'. Prior to the implementation of the preferential trade agreement the imports of the intermediate good 'e' and of the finished product 'f' from all countries meet the same 20% MFN tariff when entering country H and country P.

1. Countries H and P sign and implement a bilateral free trade agreement (the H-P FTA) in order to promote regional integration. This FTA allows for duty-free access of the finished product 'f', if the FTA's ROO are met. Assume that the determination of origin in these ROO demand that 50% of the value added of the finished product 'f' is obtained locally and that all finished products 'f' produced in country H meet this criterion of determination of origin. Assume that the ROO do not provide any form of prohibition of duty relief.
2. For analytical convenience now assume that country H grants a "full" duty drawback on the non-originating intermediate goods 'e' used in the manufacture of exported finished products 'f' originating in country H's territory, i.e. allows for the recovery of the 20% MFN import duties collected on the intermediate good 'e' to the subsequent export of the finished product 'f' to country P, whereas country P does not grant such a drawback.
3. In this constellation and in the absence of transport and storage costs, country P's producers of the finished product 'f' would – due to the unilateral duty drawback of country H – face higher production costs when producing for their domestic market than their country H based intra-regional competitors when exporting to country P's market, i.e. 5% higher<sup>1</sup> material costs. At the same time producers in country H that produce the finished product 'f' for the domestic market of the country would not be granted any tariff reduction. Country H would still gain tariff revenues from keeping the tariff up for the production for its domestic market. Assuming country P did not lower the MFN tariffs, this artificial comparative advantage could seriously distort intra-regional trade, since it would produce the same results as export subsidies granted within the integrated market.
4. Now allow for prohibition of duty drawback in the preferential trade agreement. Country H can no longer create artificial comparative advantages for its producers.

<sup>1</sup> If good 'e' created 50% of the added value of product 'f' and if there is a world market price for good 'e', then a 10 % MFN tariff difference would result in 5% higher material costs.

the exporting (FTA-partner) country when the origin is determined within the context of the FTA.

The rules which determine origin within bilateral trade agreements usually also provide for cumulation of origin. This means that materials originating in one country, i.e. the input-providing importing country, are considered as materials originating in the other country, i.e. the input-using exporting country. Therefore it is not necessary that intermediate goods deemed as originating in one FTA partner country undergo sufficient working or processing in the other FTA partner country in order to gain duty-free access when re-importing finished goods containing these intermediate goods.<sup>54</sup>

In general it can be stated that the provisions regarding cumulation of origin are designed to encourage regional integration within a preferential trade area. As shown in Example 5 for bilateral constellations, cumulation of origin encourages the use of ma-

terials and processing within a preferential area while the determination of origin sets a common standard for treating third country non-preferential inputs.

**Conclusion**

As long as the restrictions in international trade factually exist, ROO, be they preferential or non-preferential, will remain an important trade policy mechanism. Great economic powers like the United States and the EC<sup>55</sup> have indeed concluded a multitude of preferential trading agreements.<sup>56</sup>

<sup>54</sup> In a trilateral context this means that from the point of view of a non-input-providing importing country materials originating in an input-providing third country shall be considered as materials originating in the exporting country. In a plurilateral context this means that from the point of view of a non-input-providing importing country materials originating in several input-providing third countries shall be considered as materials originating in the exporting country.

<sup>55</sup> According to Edwin Vermeulst op. cit., p. 80, Japan is an exception from this development because of its geographical distance.

<sup>56</sup> Ibid.

**Example 5**

**Rules of Origin and Cumulation of Origin**

Assume three countries: countries H and P and the rest of the world (ROW). For analytical convenience in the discussion we consider that the MFN tariffs of these countries are the same and we refer to strictest determination of origin (i.e. origin conferred with 100% local value added), though of course in reality MFN tariffs might differ and the rules of origin require a level of sufficient working or processing which is less than 100%.

1. Suppose that – prior to the conclusion and implementation of the FTA – country P imported the finished product ‘g’ from country H. The finished product ‘g’ is sold on the domestic markets of country H and country P. 35% of the value added of that good comprise intermediate imports, which country H does not produce. These intermediate imports could originate in country P, but also in the ROW.
2. Country H and P sign a bilateral free trade agreement (the H-P FTA) in order to promote regional integration. This FTA allows for duty-free access of the finished product ‘g’ if the FTA’s ROO are met. If the ROO within this FTA only foresee the determination of origin but do not provide any possibility of cumulation between the FTA partners, then intermediate products of both FTA partner countries would be treated in the same way as products from the ROW. In this constellation there would be no incentives for the producers in one FTA-partner country to use intermediate inputs originating in the other FTA-partner country (assuming that there is a world market price for the intermediate imports). The finished product ‘g’ would not meet the origin-criteria (100%) of the FTA, so the good would be subject to tariffs when exported from country H to country P.
3. Now allow for cumulation, i.e. suppose that the partners of the preferential trade agreement have agreed that materials originating in country H shall be considered as materials originating in the partner country P (and vice versa) and that it shall not be necessary for such materials to have undergone sufficient working or processing in order to gain duty-free access. In this constellation cumulation sets aside the effects of the determination of origin, and provides that producers of the one FTA partner country are able to meet the origin criteria when using intermediate imports from the other FTA partners. Therefore the finished product ‘g’ enters country P without being subject to tariffs.

There has recently been a surge of interest in these preferential trading agreements.<sup>57</sup> In the EC, much of this is linked to the creation of the European Economic Area (EEA) as well as to the creation of several Free Trade Areas within the EC association agreements with the Central and Eastern European Countries (CEEC)<sup>58</sup> and within the EC-Euromed association agreements with the Southern Mediterranean countries.<sup>59</sup>

These preferential trading agreements all contain preferential ROO, which lay down several detailed criteria that must be met in order for goods to qualify for preference. Members of preferential trade agreements use these rules of origin to control the degree of preference by varying the severity of the determination of origin and by allowing different degrees of cumulation of origin. These instruments can be supported by provisions which lay down the prohibition of duty relief.

With the spread of preferential trading arrangements, preferential ROO have also grown in im-

portance.<sup>60</sup> Because of their potential for trade and welfare creating effects as well as collateral effects on trade flows, the preferential ROO are currently under discussion by policy-makers and economists developing guidelines for the policy-makers.

The investigative part of this paper has shown that determination of origin, the cumulation of origin and the prohibition of duty relief are the main instruments to be found in the provisions regulating preferential ROO. Though these instruments are closely related to each other, each of them performs different tasks in the overall context of preferential ROO.

The collateral effects of these instruments still warrant closer scrutiny. However, the trade and welfare-enhancing potential, especially of determination and cumulation of origin, can already at this stage be clearly discerned. There is much to indicate that it would be useful to further develop these concepts. Above, we have attempted to outline a basis which could be useful for further analysis and development.

<sup>57</sup> Jiandong Ju, Kala Krishna, op. cit.

<sup>58</sup> Cf. EC Association Agreements with Poland OJ 1993 L 348 p. 1, Hungary OJ 1993 L 347 p. 1, Czech Republic OJ 1994 L 360 p.1, Slovakia OJ 1994 L 359 p.1, Slovenia OJ 1999 L 51 p.3, Romania OJ 1994 L 357 p.1, Bulgaria OJ 1994 L 358 p.1, Estonia OJ 1998 L 68 p.1, Latvia OJ 1998 L 26 p.1, and Lithuania OJ 1998 L 51 p.1.

<sup>59</sup> Cf. EC Euromed Association Agreements with Tunisia OJ 1998 L 97 p.2, Morocco OJ 2000 L 70 p.2, Israel OJ 2000 L 70 p.2 and Palestinian Authority OJ 1997 L 187 p.3.

<sup>60</sup> Rod Falvey, Geoff Reed, op. cit, p. 16.