

What are Rules of Origin (ROOs)?

1. ROOs are laws, regulations and administrative practices used to identify the country of origin of internationally traded goods. The “nationality” of most products is ambiguous because intermediate trade in inputs means that the value-added in the production of goods is split between two or more countries. Increased globalisation of production has raised both complexity of origin issues and the profile of ROOs on the trade agenda.

2. ROOs have a number of functions, but in the context of preferences for developing countries, the most important is to prevent trade deflection; in other words, to attempt to limit the benefits of preferences offered by the “donor” country to designated “recipient” countries. A second, and related function, is to foster industrial development within recipient countries.

How is the Origin of a Product Determined?

3. In broad terms, origin is determined by use of one of the following tests:

- A product originates from a country where it is harvested or extracted from the soil, or if manufactured exclusively from materials and labour in that country;
- If the product results from materials and labour from more than one country, it originates from the country in which it has last undergone a “substantial transformation”.

4. The “substantial transformation” concept is used as the general principle for the determination of basic origin in US law, which goes on to define a transformation as being “substantial” where it yields an article that is “new and different”. In itself, however, this clearly does little or nothing to pin-down the issue, and so origin of individual products is determined on a case by case basis.

5. In practice, one of three rules is used to determine origin. Transformations are deemed to be substantial where the processing:

- results in the good being classified under a different tariff heading from the imported materials (Change of Tariff Heading or CTH rule).
- involves a minimum level of value being added, or a minimum proportion of components sourced in that country (value-added or content rule).
- involves the completion of a pre-determined process seen as essential for the manufacture of the good (specific process rule).

What is Trade Deflection?

6. Trade deflection refers to a situation where a country not in receipt of preferences essentially circumvents the MFN tariff of a preference donor by transshipping its exports through a country in receipt of preferences, adding little or no value in the recipient country.

7. Imagine a (hypothetical) situation where

- the EU imposes a 20% MFN tariff on motor cars,
- decides to offer a group of developing countries (e.g. the ACPs) duty free access on cars.
- Suppose further that one of the ACPs, Jamaica, charges a 5% tariff on the import of motor cars.

8. Trade deflection arises where a third country (e.g. Malaysia) gains access to the EU market via the ACP (Jamaica), by first exporting to Jamaica, paying the 5% tariff and then selling on to the EU market from Jamaica and gaining duty free access. The result is that the Malaysian company pays a 5% tariff to enter the EU market rather than 20%.

9. The ROO prevents trade deflection by specifying some rule such that only cars “made” in an ACP country can benefit from duty free access.

10. An important point to note here is that the problem of deflection should only arise where the recipient’s (Jamaica’s) tariff is lower than that of the donor (EU). Where this is not the case, the ROO is presumably performing some other function(s). For example, if Jamaica imposed a MFN tariff on motor cars of 20% or more, there would be no gain for Malaysian car producers by selling to the EU via the Jamaican market.

11. Given that most EU industrial tariffs are very low, and very often lower than those of preference recipients, it would seem that prevention of pure trade deflection is not the primary function of most EU ROOs in the industrial sector. One possible exception to this was EU (and US) protection of clothing and textiles through MFA quotas, which ended at the beginning of 2005.

How can ROOs foster Industrialisation in Developing Countries?

12. Even where pure trade deflection is not an issue, it is argued that strict ROOs provide an incentive for exporters of final products to source inputs, materials and labour within the preference recipient, rather than third countries. It also provides an incentive for inward investment within the preference recipient. In this way, ROOs can help the development of vertically integrated production structures within developing countries.

13. Weak ROOs on the other hand, are like to increase the possibility of “backdoor” utilization of preferences by countries outside the scheme, with, only very low quality activities (including via inward FDI) being attracted to the beneficiary.

What are the Problems with ROOs?

14. There are a number of problems arising from the operation of ROOs in practice.

- ROOs represent a trade barrier in their own right by imposing conformity assessment costs ie the costs of demonstrating that the ROO has been complied with.
- ROOs impose compliance costs (i.e. the costs of actually meeting the ROO). They can distort decisions on sourcing of inputs, production and investment location.
- ROOs are susceptible to manipulation by domestic industries (or industries in donor countries) keen to protect their markets.

15. Although there is relatively little hard empirical evidence on ROOs, one study¹ estimated that for firms wishing to take advantage of preferences under the EFTA-EC FTA, the administrative and technical work need to achieve compliance with the ROO added around 5% to the costs of production.

Is it better to have a strict ROO or a liberal ROO?

16. There is no simple answer to this question. Too strict a ROO will mean that the exporters in the recipient country cannot comply with the ROO or can only do so at prohibitive cost and therefore loses the benefit of the preference. Too liberal a ROO and the benefit of the preference accrues to some third party. The optimal ROO strikes a balance between the costs imposed on the recipient on the one hand and providing incentives to add value in the recipient on the other. But the optimal ROO will vary according to the specific product and country in question.

What is Cumulation?

17. Cumulation refers to the degree to which inputs (processes and/or materials) wholly or partly originating from one preferential trading partner are allowed to count towards satisfying a ROO governing processes carried out in another preferential partner. A cumulation rule adds flexibility by allowing inputs originating in two or more parties to a single agreement, or even parties of different agreements, to be counted together to determine origin.

18. In general, the higher the degree of available cumulation, i.e. the greater the number of trading partners whose inputs can count towards satisfying the ROO, the more liberal is the ROO (i.e. the easier it is to satisfy). Exporters will be less constrained in their choice of inputs, will be less likely to choose inefficient input sources in order to qualify for preferences and hence will be more competitive.

¹ J Herrin "Rules of Origin and Differences between Tariff Levels between EFTA and the EC" EFTA Occasional Paper 13.

Is a Wider Cumulation Rule Better than a Narrower one (e.g. Global versus Regional Cumulation)

19. The arguments here are similar to arguments for and against liberal ROOs. In principle, a very narrow cumulation rule, i.e. one confined to a single or limited group of countries will provide the greatest incentives to add value within that country or region. But it will also impose the greatest costs and the greatest risks that the ROO will not be met or only met at prohibitively high costs, and so the preference will not be utilized.

20. Moreover, restricting cumulation to existing Regional groupings places an artificial constraint on sourcing patterns. There is no guarantee that such regional groupings include the most, or even any, efficient source of components or materials.

21. Wider cumulation rules give greater freedom to exporters in sourcing decisions. But they increase the possibility of unintended utilization of preferences by countries outside the scheme, and the risk that only very low quality activities (including via inward FDI) would be attracted to the beneficiary. However, easing rules would at least attract FDI to countries where final assembly finishing processes could take place competitively.

Is There Any Evidence on Cumulation?

22. Although very limited, most available evidence suggests that narrow cumulation rules have not succeeded in their aim of promoting industrialization within a single or narrow group of countries.

23. A study² of developing countries views of EU ROOs, suggested that they themselves wish to see a relaxation of ROOs and cumulation provisions. ROOs have traditionally aimed at promoting the development of a vertically integrated production chain within individual developing countries. However, it was argued that such a model has been overtaken by trends in global sourcing.

24. Current cumulation rules may require sourcing from areas where raw materials and components exist in limited and sometimes uncompetitive quantities. Even allowing cumulation regionally, or even globally (within a given preference scheme) makes it difficult to compete. Restrictions imposed on the use of imported material and components were excessive and largely counterproductive when viewed against the actual industrial capacity of most beneficiaries. Increased use of component parts from third countries which have economies of scale, is the only way a beneficiary can compete on world markets. Moreover, because of the nature of today's manufacturing processes, many components are only available (competitively) from the more developed developing nations, in Asia, or from developed countries.

25. In an assessment of the impact of the EBA initiative Brenton³ found that for almost all LDCs eligible for both EBA and Cotonou preferences, there was almost no

² The Usage of the EU Trade Preferences (GSP and Lome), Cerrex Limited Jan 2002.

³ Paul Brenton: "Integrating the Least Developed Countries into the World Trading System: The Current Impact of EU Preferences under Everything But Arms". 2003

take-up of EBA. The main reason for this may be that despite the similarities between the ROOs under the two schemes, EBA imposes very limited regional cumulation rules, whereas Cotonou allows full cumulation across all Cotonou.beneficiaries

26. More generally, Brenton argues that strict ROOs and narrow cumulation provisions discriminate against small countries for whom possibilities for local sourcing are more limited; and since most LDCs are small economies, they are particularly problematic. Even regional cumulation rules prevent sourcing from low cost locations in in Asia and are often supplemented by value-added rules, which limits the extent to which cumulation can be used in practice. Over the longer term, there is no evidence that strict ROOs have helped simulate development of integrated production structures in developing countries.

27. In another piece of research, this time looking at the performance of AGOA, Brenton⁴ notes that the stricter ROOs imposed on S Africa and Mauritius compared with other AGOA beneficiaries appears to have contributed to relatively low utilization rates. He also notes that flexibility of sourcing is crucial to maintaining competitiveness, which again points to the importance of a wider rather than narrower cumulation rule

⁴ Paul Brenton: “The Initial and Potential Impact of Preferential Access to the US Market under the African Growth and Opportunit Act” 2004.d