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LEAST-DEVELOPED COUNTRIES' PROPOSAL ON RULES OF ORIGIN

Communication from Zambia on behalf of the LDC Group

The following communication, dated 31 May 2006, has been received from the Delegation of Zambia on behalf of the LDC Group.

There is no evidence that strict rules of origin over the past 30 years have done anything to stimulate the development of integrated production structures in developing countries. In fact such arguments have become redundant in the light of technological changes and global trade liberalisation which have led to the fragmentation of production processes and the development of global networks of sourcing. Globalisation and the splitting up of the production chain does not allow the luxury of being able to establish integrated production structures within countries. Strict rules of origin act to constrain the ability of firms to integrate into these global and regional production networks and in effect act to dampen the location of any value-added activities. In the modern world economy flexibility in the sourcing of inputs is a key element in international competitiveness. Thus, it is quite feasible that restrictive rules of origin rather than stimulating economic development will raise costs of production by constraining access to cheap inputs and undermine the ability of local firms to compete in overseas markets.

From "Rules of Origin, Trade and Customs" by Brenton and Imagawa (page 36)

INTRODUCTION

1. Rules of Origin have been under consideration by the WTO since almost its inception in 1995 and consensus on Rules of Origin has yet to be arrived at. The main reason for this lack of consensus could well be that 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.
2. LDCs have, for a long time, argued that, despite being accorded preferential market access through the various agreements, they have not been able to take advantage of these opportunities

because of the associated, often stringent, rules of origin. It is against this background that LDCs have been advancing the position that rules of origin need to be simplified.

3. Paragraph 47 of the Hong Kong Ministerial Declaration (WT/MIN(05)/DEC) contains the following:

Building upon the commitment in the Doha Ministerial Declaration, developed-country Members, and developing-country Members declaring themselves in a position to do so, agree to implement duty-free and quota-free market access for products originating from LDCs as provided for in Annex F to this document. Furthermore, in accordance with our commitment in the Doha Ministerial Declaration, Members shall take additional measures to provide effective market access, both at the border and otherwise, including simplified and transparent rules of origin so as to facilitate exports from LDCs.

4. The Hong Kong Ministerial Declaration, therefore, commits developed-country Members of the WTO, and developing countries declaring themselves in a position to do so to provide preferential market access to Least-Developed Countries.

5. Rules of Origin are required in any preferential trading arrangement, with the minimum requirement being to minimise trade deflection¹ by ensuring that the product to be exported into the customs territory granting the preference is produced (however that is defined) in the customs territory the preference is granted to. Although Rules of Origin can have development objectives and can also be used as a means of protection, the Hong Kong Ministerial Declaration specifically states that the Rules of Origin, in this situation, should be simple and transparent and should facilitate exports from LDCs.

6. Rules of Origin are important in that they can affect the sourcing and investment decisions of companies and can, at the same time, distort the relative prospects of similar firms within a country. The adoption of restrictive Rules of Origin are more likely to constrain than to stimulate regional economic development and can act to undermine preferential trade agreements.

ORIGIN-CONFERRING CATEGORIES

7. There are two main origin-conferring categories, these being:

- (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 which can be achieved by one or all of the following (as defined in Annex D1 of the Kyoto Convention):

¹ Trade deflection is taken to mean the export of products originating in a third country which does not have preferential access into a first country being re-routed through a second country which does have preferential access. This re-routing could take the form of simple transshipment or could involve a simple operation, such as repackaging the goods.

- (a) change of tariff classification;
- (b) percentage value added (build-down method);
- (c) local content (build-up method);
- (d) specific manufacturing process.

Change of Tariff Classification

8. A change of tariff classification refers to a change in the Harmonised System (HS) tariff classification once a good undergoes a substantial transformation. Origin is granted if the exported product has a different tariff classification to any of the inputs used in its production. The benefit of using the change of tariff classification is that it is unambiguous and easy to understand. In terms of documentary requirements, it requires that producers keep records of the tariff classifications of all inputs and the final product. Change of tariff classification is usually defined at the 6-digit level (change of tariff sub-head – CTSH).

Value Addition

9. Value-added is defined as the difference between the cost of the finished product and the cost of all the materials used in the production of the finished product. In calculating value addition the denominator is the ex-works price, which, in the case of the Cotonou Rules of Origin, for example, is the price paid for the manufactured product, ex-works, minus any internal taxes which are, or may be, repaid when the product is exported. The numerator would be the value of the materials used to produce the manufactured product and this could be calculated using either the free-on-board (f.o.b.) or cost-insurance-freight (c.i.f.) values. Each method of calculating value addition will give a different value of non-originating materials. Preferential Trade Agreements using the value addition criterion in determining source of origin have a value-added threshold of a defined percentage that has to be met if origin is to be conferred.

10. The value-added criterion has a number of limitations. Value-addition may deter a manufacturer from investing in more efficient plant and machinery as this will most probably 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.

11. A further limitation is the fact that value-added percentages are easily affected by movements in exchange rates for finished products that have imported raw materials. When a local currency appreciates, the percentage value added tends to decline, and vice versa. The first column in the table below gives an example of a manufacturer importing half the value of his inputs, and a value addition of 35 per cent, so, in this case, the manufacturer meets the threshold for the value-addition criterion of the country in which his country has a preferential trading arrangement with. The second column assumes that there has been a currency devaluation of 100 per cent in the country of the exporter. Despite the fact that there has been no change in technology or change in volume of inputs, the value addition reduces to below 35 per cent so, in this case, the export would not qualify for preferential treatment and would be charged the full MFN duty by the importing country, despite the fact that the importing country is providing preferential treatment to the exporting country.

		Local currency	100% depreciation	Local currency
Cost of materials		1000		1500
	Local	500	500	
	Imported	500	1000	
Direct labour		250		250
Depreciation of machinery		40		40
Factory overheads		250		250
Ex-factory cost		1540		2040
Value Added =	$(1540-1000)/1540$	35.06	$(2040-1500)/2040$	26.47

12. It is often difficult to calculate the value added if there are a number of products produced from the imported material. For example, some LDCs import crude palm oil and from this refined cooking oil, soap, margarine and other finished products are manufactured. Under these circumstances there are various ways to calculate the input cost of the crude palm oil. Even in instances where cost accounting methods are used, the calculations, which are done by the exporter, are open to dispute and query by the importer.

Specific Manufacturing Process

13. In some Rules of Origin, substantial transformation is defined on the basis of a list of processing or manufacturing operations which have to be carried out on specific non-originating materials in order to confer origin to the resulting product. In some instances specific manufacturing processes are used in conjunction with other origin-conferring criteria, such as value addition criteria. Specific manufacturing processing rules usually apply to specific sectors, such as the textile industry, and restrict firms' choices of production methods and of product. Requirements are usually very detailed and specific and are often extremely complex, with the end result being that it becomes difficult for products to qualify.

CUMULATION

14. Cumulation allows producers to import materials from a specific country or regional group of countries without undermining the origin of the product.

DE MINIMIS (TOLERANCE)

15. Most Rules of Origin allow for a certain percentage of non-originating materials to be used without affecting the origin of the final product. The tolerance rule can act to make it easier for products with non-originating inputs to qualify for preferences.

PROBLEMS ASSOCIATED WITH RULES OF ORIGIN

16. There is a sizeable literature on Rules of Origin and the uptake of preferences and, from this literature, the following points arise:

- There is a direct cost associated with the completion of Rules of Origin of about 3 per cent to 5 per cent which reduce exports under preferential schemes;
- Rules of Origin can make it more difficult to achieve economies of scale since input requirements may vary according to destination markets of the final products;

- Rules of Origin are an incentive to purchase intermediates in the country conceding the preference, and this can be a source of a trade diversion if there is a more efficient producer of intermediates elsewhere;
- Rules of Origin can be used as a means of protection for the importing country, with some studies showing that the larger the difference in tariffs, the more restrictive the associated Rules of Origin; and
- Rules of Origin usually do not recognise constantly changing industrial configurations brought about through globalisation and can retard the effective utilisation of trade preferences and may impede rather than facilitate preferential market access.

17. However, despite these drawbacks and difficulties, it is necessary to agree on a set of Rules of Origin if a preferential trading arrangement such as the one agreed to by the WTO Members for LDCs as defined in Annex F of the Hong Kong Ministerial Declaration is to be implemented. The challenge facing WTO Members is to define a set of Rules of Origin which will assist LDCs to take advantage of the improved market access conditions they have been provided with so that LDCs are able to translate this improved market access into improved living standards of their populations through economic growth brought about by increased trade, while minimising trade deflection.

Annex 1

Summary of the Different Approaches to Determining Origin			
Rule	Advantages	Disadvantages	Key Issues
Change of Tariff Classification (in the Harmonised System)	<ul style="list-style-type: none"> ▪ Consistency with non-preferential rules of origin. ▪ Once defined, the rule is clear, unambiguous and easy to understand by both operators and enforcers. ▪ Relatively straightforward to implement. 	<ul style="list-style-type: none"> ▪ Harmonised System not designed for conferring origin, as a result there are often many individual product specific rules, which can be influenced by domestic industries ▪ Documentary requirements maybe difficult to comply with. ▪ Can be conflicts over the classification of goods which can introduce uncertainty over market access 	<ul style="list-style-type: none"> ▪ Level of classification at which change required – the higher the level the more restrictive. ▪ Can be positive (which imported inputs can be used) or negative (defining cases where change of classification will not confer origin) test^a – negative test more restrictive.
Value Added	<ul style="list-style-type: none"> ▪ Clear, simple to specify and unambiguous. ▪ Allows for general rather than product specific rules 	<ul style="list-style-type: none"> ▪ Complex to apply – requires firms to have sophisticated accounting systems. ▪ Uncertainty due to sensitivity to changes in exchange rates, wages, commodity prices etc. 	<ul style="list-style-type: none"> ▪ The level of value added required to confer origin ▪ The valuation method for imported materials – methods which assign a higher value (eg CIF) will be more restrictive on the use of imported inputs
Specific Manufacturing Process	<ul style="list-style-type: none"> ▪ Once defined, clear and unambiguous ▪ Provides for certainty if rules can be complied with 	<ul style="list-style-type: none"> ▪ Documentary requirements can be burdensome and difficult to comply with. Leads to product specific rules. ▪ Domestic industries can influence the specification of the rules. 	<ul style="list-style-type: none"> ▪ The formulation of the specific processes required – the more procedures required the more restrictive. ▪ Should test be negative (processes or inputs which cannot be used) or a positive test (what can be used) – negative test more restrictive.

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

Source of Table: “Rules of Origin, Trade and Customs” by Paul Brenton and Hiroshi Imagawa

**Duty-Free Quota-Free Market Access Provisions
For Least-Developed Countries**

Annex F of the WTO Hong Kong Ministerial Decisions

Rules of Origin

GENERAL PROVISIONS

Article 1

For the purposes of this Agreement:

- (a) "LDCs" means the countries classified within this category by the United Nations General Assembly.
- (b) "manufacture" means any kind of working or processing including assembly or specific operations;
- (c) "material" means any ingredient, raw material, component or part, etc., used in the manufacture of the product;
- (d) "product" means the product being manufactured, even if it is intended for later use in another manufacturing operation;
- (e) "goods" means both materials and products;
- (f) "customs value" means the value as determined in accordance with the 1994 Agreement on implementation of Article VII of the General Agreement on Tariffs and Trade (WTO Agreement on customs valuation);
- (g) "ex-works price" means the price paid for the product ex works to the manufacturer in the LDC in whose undertaking the last working or processing is carried out, provided the price includes the value of all the materials used, minus any internal taxes which are, or may be, repaid when the product obtained is exported;
- (h) "value of materials" means the customs value at the time of importation of the non-originating materials used, or, if this is not known and cannot be ascertained, the first ascertainable price paid for the materials in the LDC except that such value may be adjusted to exclude any costs, charges or expenses incurred for transportation, insurance and related services incident to the international shipment of the merchandise from the country of exportation to the place of importation;
- (i) "value of originating materials" means the value of such materials as defined in sub-paragraph (h) applied mutatis mutandis;
- (j) "value-added" means the difference between the ex-works cost of the finished product and the [f.o.b.][c.i.f.] value of the materials imported from outside the LDC and used in the production;

- (k) "chapters", "headings" and "sub-headings" mean the chapters, headings (four-digit codes) and sub-headings (six-digit codes) used in the nomenclature which makes up the Harmonised Commodity Description and Coding System, or HS;
- (l) "classified" refers to the classification of a product or material under a particular heading; and
- (m) "consignment" means products which are either sent simultaneously from one exporter to one consignee or covered by a single transport document covering their shipment from the exporter to the consignee or, in the absence of such a document, by a single invoice.

GENERAL REQUIREMENTS

Article 2

1. The following products shall be considered as originating in the LDCs:
 - (a) products wholly obtained in the LDCs within the meaning of Article 3 of this Agreement; and
 - (b) products obtained in the LDCs incorporating materials which have not been wholly obtained there, provided that such materials have undergone sufficient substantial transformation in the LDCs within the meaning of Article 4 of this Agreement.
2. For the purpose of implementing paragraph 1, all LDCs shall be considered as being one territory.
3. Originating products made up of materials wholly obtained or sufficiently worked or processed in two or more LDCs shall be considered as products originating in the LDC where the last working or processing took place, provided the working or processing carried out there goes beyond that referred to in Article 5 below.

WHOLLY OBTAINED PRODUCTS

Article 3

1. The following shall be considered as wholly obtained in the LDCs:
 - (a) mineral and other naturally occurring products extracted from their soil or from their seabed;
 - (b) vegetable products harvested there;
 - (c) live animals born and raised there;
 - (d) products from live animals raised there;

- (e) products obtained by hunting or fishing conducted there;
- (f) products of sea fishing and other products taken from the sea outside the territorial waters by their vessels;
- (g) products made aboard their factory ships exclusively from products referred to in sub-paragraph (f);
- (h) used articles collected there fit only for the recovery of raw materials, including used tyres fit only for re-treading or for use as waste;
- (i) waste and scrap resulting from manufacturing operations conducted there;
- (j) products extracted from marine soil or subsoil outside their territorial waters provided that they have sole rights to work that soil or subsoil;
- (k) goods produced there exclusively from the products specified in sub-paragraphs (a) to (j).

2. The terms "their vessels" and "their factory ships" in paragraph 1(f) and (g) shall apply only to vessels and factory ships which are registered or recorded in a LDC or in the country into which the exports of wholly produced products from LDCs are made.

3. Notwithstanding the provisions of paragraph 2, the preference giving country shall recognise, upon request of a LDC, that vessels chartered or leased by the LDC be treated as "their vessels" to undertake fisheries activities in its exclusive economic zone.

SUBSTANTIAL TRANSFORMATION

Article 4

1. For the purposes of these Rules of Origin, products which are not wholly obtained are considered to be sufficiently worked or processed in a LDC when the LDC value content is calculated on the basis of the build-down method (value added criteria) or the build-up method (local content criteria) described below.

- (a) For the build-down (value added) method, the LDC value content of a good may be calculated on the basis of the formula:

$$LVC = \frac{P - VNM}{P} \times 100$$

Where:

LVC is the LDC value content of the good, expressed as a percentage.

P is the ex-works price of the good.

VNM is the value of non originating materials that are acquired and used by the producer in the production of the good, but does not include the value of a material that is self-produced.

- (b) For the build-up (local content) method, the regional value content of a good may be calculated on the basis of the formula:

$$\text{LVC} = \frac{\text{VOM}}{\text{P}} \times 100$$

Where:

LVC is the regional value content of the good, expressed as a percentage.

P is the ex-works price of the good.

VOM is the value of originating materials that are acquired or self-produced, and used by the producer in the production of the good.

2. A finished good is sufficiently worked or processed when:
- (i) In the case where the build-down method is used the LDC content expressed as a percentage is equal to (x) percent.
 - (ii) In the case where the build-up method is used the LDC content expressed as a percentage is equal to (y) percent.
 - (iii) In the case where adjustments are to be made to calculate the value of non-originating materials used in the production of a good when the built-down method is used paragraph 3(c) below will apply .
3. Value of materials.
- (a) For the purpose of calculating the LDC value content of a good, the value of a material is:
 - (i) in the case of a material that is imported by the producer of the good, the value of the material;
 - (ii) in the case of a material acquired or self-produced as defined in paragraph 4 in the territory in which the good is produced, the value, determined in accordance with the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994.
 - (b) The following expenses, if not included in the value of an originating material calculated under sub-paragraph 3(a) above, may be added to the value of the originating material:
 - (i) the costs of freight, insurance, packing and all other costs incurred in transporting the material within or between the territory of one or more of the LDCs or neighbouring countries as defined under Article 7 to the location of the producer;
 - (ii) duties, taxes and customs brokerage fees on the material paid in the territory of one or more of the LDCs or neighbouring countries as defined in Article 7 other than duties or taxes that are waived, refunded, refundable or otherwise recoverable, including credit against duty or tax paid or payable;

- (iii) the cost of waste and spoilage resulting from the use of the material in the production of the good, less the value of renewable scrap or by-products.
- (c) The following expenses, if included in the value of a non-originating material calculated under sub-division 3(a) above, are deducted from the value of the non-originating material:
 - (i) the costs of freight, insurance, packing and all other costs incurred in transporting the material to the location of the producer;
 - (ii) duties, taxes and customs brokerage fees on the material paid in the territory of one or more LDC or neighbouring countries as defined under Article 7, other than duties or taxes that are waived, refunded, refundable or otherwise recoverable, including credit against duty or tax paid or payable;
 - (iii) the cost of waste and spoilage resulting from the use of the material in the production of the good, less the value of renewable scrap or by products;
 - (iv) the cost of originating materials used in the production of the non- originating material;
 - (v) in the case where the deductions mentioned above under (i) to (iv) are not made and the value of a non-originating material is calculated on a c.i.f basis the required percentage under the build-down method will be increased by (z) percentage.

4. If a product, which has acquired originating status by fulfilling the conditions set out above, is used in the manufacture of another product, the conditions applicable to the product in which it is incorporated do not apply to it and no account shall be taken of the non-originating materials which may have been used in its manufacture.]

INSUFFICIENT WORKING OR PROCESSING OPERATIONS

Article 5

1. The following operations shall be considered as insufficient working or processing to confer the status of originating products, whether or not the requirements of Article 4 are satisfied:
- (a) operations to ensure the preservation of products in good condition during transport and storage (ventilation, spreading out, drying, chilling, placing in salt, sulphur dioxide or other aqueous solutions, removal of damaged parts, and like operations);
 - (b) simple operations consisting of removal of dust, sifting or screening, sorting, classifying, matching (including the making-up of sets of articles), washing, painting, cutting up;
 - (c) changes of packaging and breaking up and assembly of packages or simple placing in bottles, flasks, bags, cases, boxes, fixing on cards or boards, etc., and all other simple packaging operations;

- (d) affixing marks, labels and other like distinguishing signs on products or their packaging;
- (e) simple mixing of products, whether or not of different kinds, where one or more components of the mixtures do not meet the conditions laid down in this Agreement to enable them to be considered as originating in a LDC;
- (f) simple assembly of parts to constitute a complete product;
- (g) a combination of two or more operations specified in sub-paragraphs (a) to (f); and
- (h) slaughter of animals.

2. All the operations carried out in the LDCs shall be considered together when determining whether the working or processing undergone by that product is to be regarded as insufficient within the meaning of paragraph 1.

TERRITORIALITY

Article 6

1. The conditions for acquiring originating status must be fulfilled without interruption in the LDCs.
2. The acquisition of originating status shall not be affected by working or processing done outside the LDCs on materials exported from the LDCs and subsequently re-imported there, provided:
 - (a) the said materials are wholly obtained in the LDCs or have undergone working or processing beyond the operations referred to in Article 5 prior to being exported; and
 - (b) it can be demonstrated to the satisfaction of the customs authorities of the preference giving countries that:
 - (i) the re-imported goods have been obtained by working or processing the exported materials; and
 - (ii) the total added value acquired outside LDCs by applying the provisions of this Article does not exceed (a) percent of the ex-works price of the end product for which originating status is claimed.

CUMULATION

Article 7

Cumulation with preference giving countries

1. Materials originating in the preference giving countries shall be considered as materials originating in the LDCs when incorporated into a product produced in the LDCs. It shall not be necessary that such materials have undergone sufficient working or processing, provided they have undergone working or processing going beyond that referred to in Article 5.

Diagonal regional cumulation

2. Products originating in any of the countries that are partners with a LDC of a regional group and used in further manufacture in a LDC shall be treated as if they originated in the LDC of further manufacture.

3. Notwithstanding paragraph 2, products further manufactured in a LDC shall be considered as originating in a LDC only where the LDC content there is greater than the value of the materials used that originate in any one of the other countries that are members of the regional grouping.

4. LDC content is calculated according to the method contained in sub-paragraph 1(a) of Article 4 (built down method) and the value of originating materials is calculated according to sub-paragraph 3(a) of Article 4.

5. The cumulation provided for in this paragraph may be applied only provided that:

- (a) a preferential trade agreement is in place between a LDC and other members of the same regional trading arrangement;
- (b) originating material and products of other members of the regional group and incorporated into a product further manufactured in a LDC have acquired originating status by the application of rules contained in this Agreement.

Cumulation with neighbouring countries

6. At the request of a LDC, materials originating in a neighbouring developing country not a member of a regional trade agreement which is not a LDC shall be considered as materials originating in the LDC when incorporated into a product obtained there. It shall not be necessary that such materials have undergone sufficient working or processing, provided that the working or processing carried out in the LDC exceeds the operations listed in Article 5.

UNIT OF QUALIFICATION

Article 8

1. The unit of qualification for the application of the provisions of this Agreement shall be the particular product which is considered as the basic unit when determining classification using the nomenclature of the Harmonised System. Accordingly, it follows that:

- when a product composed of a group or assembly of articles is classified under the terms of the Harmonised System in a single heading, the whole constitutes the unit of qualification; and
- when a consignment consists of a number of identical products classified under the same heading of the Harmonised System, each product must be taken individually when applying the provisions of this Agreement.

2. [Where packaging is included with the product for classification purposes, it shall be included for the purposes of determining origin.]

3. Accessories, spare parts and tools dispatched with a piece of equipment, machine, apparatus or vehicle, which are part of the normal equipment and included in the price thereof or which are not separately invoiced, shall be regarded as one with the piece of equipment, machine, apparatus or vehicle in question.

4. Sets, as defined in General Rule 3 of the Harmonised System, shall be regarded as originating when all component products are originating. Nevertheless, when a set is composed of originating and non-originating products, the set as a whole shall be regarded as originating, provided that the value of the non-originating products does not exceed (b) per cent of the ex-works price of the set.

5. In order to determine whether a product originates, it shall not be necessary to determine the origin of the following which might be used in its manufacture:

- (a) energy and fuel;
 - (b) plant and equipment;
 - (c) machines and tools;
 - (d) goods which do not enter and which are not intended to enter into the final composition of the product.
-