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# **RULES OF ORIGIN NEGOTIATION**

Prepared and presented by  
Alan Morley

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## Rules of Origin

- A mechanism to ensure that the benefits of a trade agreement are conferred on the participating countries, in return for the trade concessions they have made – a “quid pro quo”.
- Intended to insure that the goods of non-participating countries are denied access to the benefits of the agreement.
- Can be designed to tailor precisely the scope and extent of the application of the negotiated trade concessions.



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## Rules of Origin

- Negotiation inputs
  - Economic analyses
  - Identification of strategic industrial development and trade objectives
  - Analysis of trade flows – import and export statistics
  - Assessment of opportunities and threats
  - Identification of issues of administrability



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## Rules of Origin

- Negotiation issues
  - Their trade patterns
    - What, and with whom?
  - Their industry sectors
    - Strengths and weaknesses
  - Their third country import trade flows
    - Flow-through threats
  - Potential competitive pressures



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## Rules of Origin

- Negotiation opportunities
  - Our trade patterns
    - What, and with whom?
  - Our industry sectors (current and potential)
    - Development opportunities
    - Industrial development strategy
  - Our third country import trade flows
    - Relationship to our industrial processes, particularly in export-focused sectors



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## Rules of Origin

- Mechanisms
  - Wholly originating
  - Tariff shift
  - Value-added
  - Specified processes



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## Wholly Originating

- (a) a mineral good extracted in the territory of one or more of the participating countries;
- (b) a vegetable or other good harvested in the territory of one or more of the participating countries;
- (c) a live animal born and raised in the territory of one or more of the participating countries;
- (d) a good obtained from hunting, trapping or fishing in the territory of one or more of the participating countries;
- (e) fish, shellfish or other marine life taken from the sea by a vessel registered or recorded with a participating country and flying its flag;
- (f) a good produced on board a factory ship from a good referred to in paragraph (e), where the factory ship is registered or recorded with the same participating country as the vessel that took that good and flies that country's flag;



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## Wholly Originating

- *(g)* a good taken by a participating country or a person of a participating country from or beneath the seabed outside the territorial waters of that country, where a participating country has the right to exploit that seabed;
- *(h)* a good taken from outer space, where the good is obtained by a participating country or a person of a participating country and is not processed outside the territories of the participating countries;
- *(i)* waste and scrap derived from
  - (i) production in the territory of one or more of the participating countries, or
  - (ii) used goods collected in the territory of one or more of the participating countries, where those goods are fit only for the recovery of raw materials;
- *(j)* a good produced in the territory of one or more of the participating countries exclusively from a good referred to in any of paragraphs *(a)* <sup>8</sup> through *(i)*, or from the derivatives of such a good, at any stage of



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## Wholly Originating

- International standard
  - COMESA: Rule 3
  - NAFTA: Part II

**BUT**

- Check for potential issues!
  - For example, an itinerant fishing industry dependent upon ships flying another country's flag.



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## Tariff Shift

- Advantages
  - Common reference point (HS Nomenclature)
  - Works well for sectors other than manufacturing
    - Example: NAFTA rules on textile products
- Disadvantages
  - Usable only to 6 digit level (a somewhat blunt instrument)
  - Manufacturing: classification of parts and components
  - Tariff shifts arising through “technical” reclassifications
    - Example: Functional units and composite machines



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## Value-added

- Works well to specify a desired level of further processing, but COMPLICATED to apply effectively.
- There can be unintended results
- Materials Issues
  - Intermediate Materials
  - Indirect materials
  - Packaging
  - Accessories, spare parts, tools
  - Fungible goods



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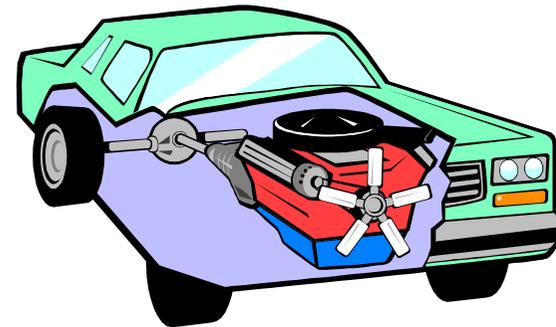
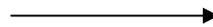
## Value-added

- Intermediate Materials
  - Designation of self-produced articles in a vertically-integrated manufacturing process as discretely identifiable “intermediate materials” for purposes of determination of origin.
  - Provides a mechanism to treat self-produced intermediate materials on the same basis as intermediate materials sourced from another supplier, for purposes of “rolling up” the value of processing to meet a value-added test.



## Value-added

- Intermediate Materials – Scenario A
  - 50% value-added test – engine out-sourced



- 60% territorial value
- 40% foreign content
- Engine qualifies as “originating”

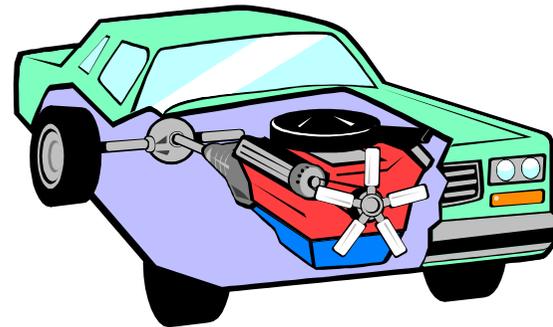
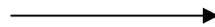
100% of the engine value is recognized as “qualifying value”

- Total vehicle territorial value added 51% -- qualifies



## Value-added

- Intermediate Materials – Scenario B
  - 50% value-added test – engine self-produced



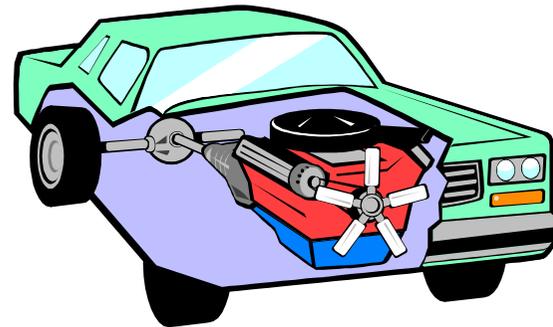
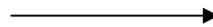
- 60% territorial value
- 40% foreign content
- Qualifying value calculated for the vehicle as a whole
  - Total vehicle territorial value added 45% -- fails to qualify

only 60% of the engine value is recognized as “qualifying value”



## Value-added

- Intermediate Materials – Scenario C
  - 50% value-added test – engine self-produced but designated as an “intermediate material”



- 60% territorial value
- 40% foreign content
- Engine qualifies as “originating”

100% of the engine value is recognized as “qualifying value”

- Total vehicle territorial value added 51% -- qualifies



## Value-added

- Indirect Materials
  - Articles that enter into the cost of production of a good, but are not incorporated into the good:
    - Lubricating oil
    - Fuel
    - Catalysts
  - NAFTA :

“For purposes of determining whether a good is an originating good, an indirect material that is used in the production of the good shall be considered to be an originating material, regardless of where that indirect material is produced.”
  - COMESA :

“Electrical power, fuel, plant, machinery and tools used in the production of goods shall always be regarded as wholly produced within the Common Market when determining the origin of the goods.”



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## Value-added

- Packing and Packaging
- Accessories, spare parts, tools
  - Include them or not?
  - Conditions or qualifications?
  
  - NAFTA
    - Part IV; paragraphs 12-15 (packing)
    - Part IV; paragraphs 17-20 (accessories, spare parts, tools)
  
  - COMESA
    - Rule 9 (treatment of packing)
    - Rule 6 (accessories, spare parts, tools)



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## Value-added

- Fungible goods (goods that are physically indistinguishable from each other) used as production inputs:
  - Require physical segregation or allow commingled inventories?
  - Inventory management methods
    - FIFO
    - LIFO
    - Averaging
  - NAFTA
    - Part IV paragraph 16
  - COMESA
    - Rule 7



## Specified operations

- Qualifying operations
  - Agreement to allow certain operations to qualify notwithstanding the result of tariff shift or value-added tests
    - Feathers – no tariff shift possible even if processed
    - Unassembled/incomplete goods (are classified as if assembled/complete under HS interpretative rule 2a)
- Non-qualifying operations
  - Agreement to disqualify certain operations notwithstanding the apparent satisfaction of tariff shift or value-added tests
    - Dilution
    - Frivolous processes
  - NAFTA: Part VI paragraph 17
  - COMESA: Rule 5



## Administrability Issues (1)

- Generally Accepted Accounting Principles (GAAP)
  - Whose accounting principles will govern administration?
- De minimis
  - Treatment of material inputs below a defined threshold value proportion of the value of the finished good.
- Averaging
  - Value-added tests on a per-item basis only, or averaged across a production period?
- Accumulation
  - Territorial processes by only one producer considered, or by all territorial contributors taken together?



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## Administrability Issues (2)

- Audit access
  - Defined opportunity to conduct origin audits of producers and exporters in other participating countries
  - Notification requirements
  - Restrictions
  - Requirement to share results with other governments
  - Opportunity to question or contest findings
- Exchange of Rulings
  - Defined requirement to issue rulings to importers and exporters
  - Requirement to publish / exchange rulings
  - Opportunity to question or contest rulings



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## Consequential Impact Issues

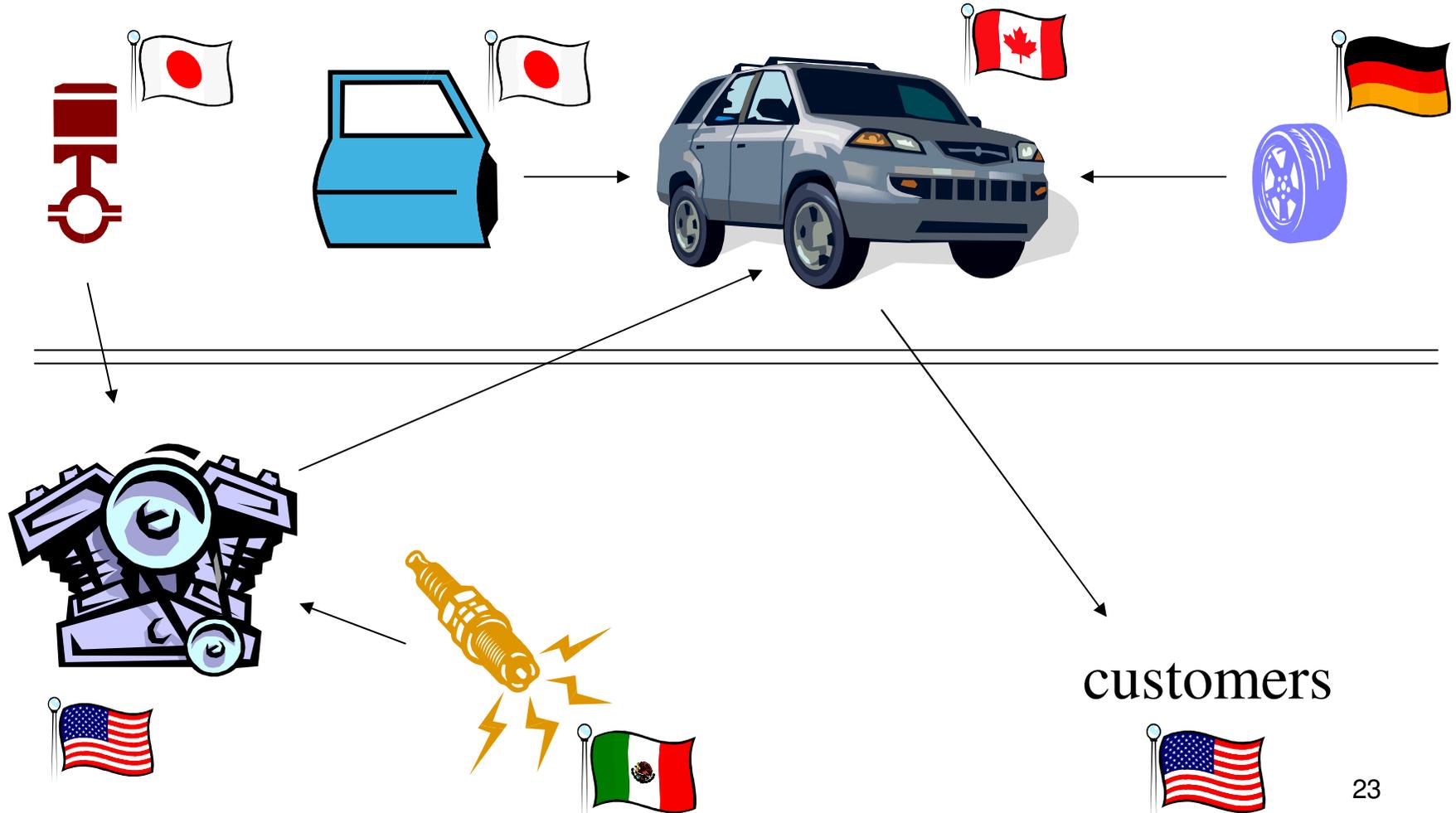
- Phase-in to reduce immediate effect (to give producers time to adapt)
  - Example, a progressive increase over time, rather than immediate implementation, of value-added thresholds
- Transshipment restrictions
  - In earlier times, a mechanism to control trade with colonies
  - A mechanism to disallow 3<sup>rd</sup> country processing en route



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## A Case Study of Unexpected Consequences





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## Canada-US bilateral free trade agreement (1989)

- 50% value-added test for motor vehicles
- Designation of intermediate materials allowed
- Canadian perspective:
  - Favorable result for vertically-integrated manufacturers
  - Encouraged final vehicle production in Canadian factories
  - Preserved preferential treatment of Japanese automobile manufacturers that had established factories in Canada
  - A good result!



## Unexpected Consequences

- After the bilateral free trade agreement was implemented, the US government applied pressure on Japanese automobile company factories in Canada to relocate in the US.
  - US Customs conducted audits seeking to “disqualify” designated intermediate materials
    - To reduce their value-added contribution to the finished vehicle from 100% to 0%
    - To disqualify the finished vehicle when imported into the US from Canada
  - In the absence of specific definitions in the bilateral agreement rules of origin, US Customs auditors applied a “restrictively literal” interpretation of US regulations and policies regarding origin.
    - Example: the “non-originating” engine block



## US Actions

- US Customs audit of a Japanese automobile manufacturer's engine factory in the US state of Ohio "disqualified" the engines to be sent to Canada for incorporation into the automobiles produced by that manufacturer in its Canadian factory for export to the US.
- The "disqualified" engines were ruled to be entirely of non-qualifying value in calculating the value-added content of the automobiles.
- The automobiles were thereby unable to qualify to use the free trade agreement upon import into the US.



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## Canadian reactions

- Canadian Customs conducted an audit of the engine factory in Ohio and “qualified” the engines for import into Canada under the free trade agreement.
- The Canadian Customs audit was completed and the results were published before the US Customs audit finding was published.
- The Japanese automobile manufacturer took the Canadian Customs audit ruling to Washington and negotiated an interim settlement with the US government.
- Canada sought a permanent solution to the problem through the NAFTA negotiations.



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## Impact on the NAFTA negotiations (1)

- Designation of “intermediate materials” removed from “light-duty motor vehicle” manufacturing.
  - qualification dependant upon the territorial value content of the entire vehicle taken as a whole.
- Value-added test for motor vehicles increased from 50% to 62.5%, but phased in over a number of years.
- Note that the addition of Mexico to the NAFTA agreement qualified Mexican auto parts production as originating goods – a favorable factor for Canadian automobile manufacturers using Mexican auto parts as inputs.



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## Impact on the NAFTA negotiations (2)

- A detailed set of interpretive regulations on rules of origin (including an extensive series of specific case examples) was agreed to by Canada, the US and Mexico, and incorporated by the three countries into their legislation upon the implementation of NAFTA (1994).
- Results:
  - From a Canadian perspective, the NAFTA value-added test for automobile manufacturing was not as favorable as the bilateral agreement had been, but the achievement of greater certainty in the US application of the rules was an important gain.
  - The Japanese automobile factories are still operating in Canada.



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## The lesson of this tale - - -

- Rules of Origin can be used as a powerful tool to tailor the scope and coverage of a trade agreement to support economic, industrial and trade development strategies.
- If not carefully constructed, Rules of Origin could lead to an unintended result.
- Rules of Origin must be precisely defined to avoid any potential misunderstandings.
- Rules of Origin are of little value if they cannot be correctly and effectively administered.



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