

Rules of origin are used to determine the country of origin of a product for purposes of international trade. There are two common type of rules of origin depending upon application, the preferential and non-preferential rules of origin (19 CFR 102). The exact rules vary from country to country.

Non-preferential rules of origin are used to determine the country of origin for certain purposes. These purposes *may* be for quotas, anti-dumping, anti-circumvention, statistics or origin labeling.

When a product is wholly obtained and produced in a single country, it is relatively easy to determine its origin. Difficulties arise in determining the origin of a product that is manufactured in, assembled in, or uses materials originating in more than one country.

At least four different methods or criteria exist for determining the origin of goods that are manufactured in, assembled in, or use materials originating in more than one country:

1. Using the concept of substantial transformation as a rule;
2. Using an ad valorem percentage test;
3. Listing specific manufacturing or processing operations which confer or do not confer origin upon the goods; and
4. Requiring a specified change in tariff classification.

Whichever method is employed to determine origin, each seeks to prevent simple assembly and packaging operations from conferring origin. This section of the article will evaluate the different methods according to their effectiveness in determining the origin of a good and in preventing circumvention, their clarity, their certainty, their transparency and the predictability or consistency of origin of determinations which use that method.

A. Substantial Transformation

The traditional substantial transformation rule states that a good originates in the last country where it emerged from a given process with a "distinctive name, character or use." The substantial transformation of a good requires more than just a change in the article; it requires an article be transformed into a "new and different article" "having a distinctive name, character or use."

The traditional substantial transformation rule captures the heart of the meaning of the rules of origin in a simple, concise way. For a product to be from a particular state, it must be substantially transformed there. To prevent a product from having multiple countries of origin, the good is a product of the country where it last underwent substantial transformation. The standard's flexibility allows it to evolve to meet technological change; however, this flexibility can result in inconsistent origin determinations that undermine the certainty required for strategic planning by businesses.

Moreover, the standard's flexibility provides an opportunity for it to be "captured" by lobbying groups, *i.e.*, for the standard to be used in a results-oriented manner designed to accommodate political pressure for more trade restrictive effects. For example, the rule can easily be converted into a search for the most significant processing, instead of the last substantial transformation. This type of search requires the exporter, importer, or producer to furnish a great deal of factual information to prove substantial processing. This fact-intensive, time-consuming inquiry raises the cost of determining origin, makes the rule even more restrictive and complex than it otherwise would be, and contradicts the spirit and purpose of the last substantial transformation rule.

For example, in 1984, the United States Custom Service adopted a two-part test for determining the origin of textile goods that result from processes or materials from more than one country. This "revised" substantial transformation test was more restrictive than the traditional substantial transformation test because it required the creation of a new and different article and substantial manufacturing or processing operations. The revised test nominally was changed to prevent companies from circumventing textile quotas by passing goods through an intermediate country to confer that country's origin on the good.

The substantial transformation rule provides the custom authorities and the courts with a great deal of flexibility to adapt the rule to particular circumstances to avoid circumvention. As the amount of restrictions or duties on imports increases for unfavorable origin determinations, more companies will try to manipulate the rules of origin to avoid unfavorable determinations. This often forces the courts to stretch the common law developed around substantial transformation to prevent circumvention and ensure that the standard's basic purpose is met. In other words, as the rules on substantial transformation become more precise and defined, it becomes easier to circumvent the purpose of the law while formally complying with its language. The flexibility of the substantial transformation standard provides countries with the ability to look beyond the form of the transaction to see if a substantial transformation actually occurred.

However, the ambiguity of the standard and its flexible decision-making can lead to unpredictable, seemingly arbitrary results, especially when substantial transformation rule is applied differently for different purposes. The United States has attempted to deal with this lack of certainty by compiling lists of criteria. However, instead of having the abstract concept of substantial transformation become more definite through concrete application to factual situations, the selective, inconsistent use of the criteria has led to more uncertainty and confusion.

Some of the seemingly inconsistent and arbitrary determinations result from the fact that the rules are applied for different purposes. Courts and agencies may expend more effort on determining the true origin of a good for trade preferential or restrictive purposes than for marking purposes, and therefore the inconsistency may not be a sign of results-oriented policy-making. In other words, the seemingly fragmented and inconsistent application of the substantial transformation standard may be proof that the substantial transformation is working effectively, in that its abstractness gives it the flexibility to

specifically address the facts of each situation and prevent circumvention. However, to some commentators, by varying the degree of transformation required according to how the origin determination will be used, the "only consistency [in defining substantial transformation in the United States] is a policy that results in either higher duties or in fewer imports."

While the flexibility of the process leaves it open to political pressure and capture by lobbying groups who want overly restrictive applications of the standard for protectionist purposes, this problem exists with every method of determining origin, just at a different stage in the determination process. With more defined methods of determining origin, the capture and manipulation occurs when the definitions are being developed or by having the definitions rewritten or re-interpreted. Moreover, the rules are defined for these other methods in the definitional stage where there is no adversarial relationship, no neutral decision-maker, no representation of the major viewpoints, and no factual situation to which the principle can be applied, unlike many of the applications of the substantial transformation standard. Therefore, a greater danger of capture and protectionism may exist with the more defined methods because of the lack of court oversight and the lack of the adversarial representation.

In summary, the substantial transformation standard has many advantages, including its flexibility, evolution over time, and development through application to specific facts in an adversarial situation where interested parties are represented. However, these advantages are also the root of its disadvantages: its inconsistent applications, its discretionary nature, and the costs of making an origin determination under it. The adoption or rejection of substantial transformation as a method of determining origin depends on which principle one values more: flexibility or certainty. While profit-maximizing firms need more objective, predictable and easier to use rules, the substantial transformation standard should be used as the motivating principle behind the development and continued refinement of more precise, defined rules of origin, because it captures the purpose of origin determinations in a simple, concise manner.

B. Value-Added Percentage Test

The value-added test defines the degree of transformation required to confer origin on the good in terms of a minimum percentage of value that must come from the originating country or of maximum amount of value that can come from the use of imported parts and materials. If the floor percentage is not reached or the ceiling percentage exceeded, the last production process will not confer origin. If the determination is for non-preferential purposes, then origin will be conferred on a prior country; if it is for preferential purposes, then no further origin determination is necessary unless the prior country is also a beneficiary country under a preferential trading agreement with the importing country.

While the value-added method is often praised for its simplicity and precision, in practice it is very far from that because it generates substantial compliance costs and uncertainty

for companies. The value-added test is a very unsatisfactory method of determining origin.

The value-added test generates substantial compliance costs for companies. It can be very costly and difficult to comply with its administrative requirements, especially if the rules require tracing the value of specific parts and materials. Firms often will find it cheaper not to comply with the value-added test, forgoing the trade preferences and paying the most-favored-nation tariff, when the product results from complex manufacturing operations or when the product does not otherwise face high tariff or non-tariff barriers. To comply with a value-added rule requiring tracing, a manufacturer of a complex product would need a highly sophisticated inventory and accounting system to adequately ensure that particular goods contain specific local components at specific values.

The value-added test also generates substantial uncertainty for companies. Because the test ignores exchange rate risk and fluctuations in the price of raw materials, the status of goods can change daily as the currency values fluctuate or as the price of raw materials fluctuates, unless the firm is able to obtain a binding advance ruling from the country's customs authorities. Additionally, the origin of identical goods may vary with each importing country, depending on the exchange rate relationship between the importing country's currency and that of the processing country. Furthermore, because the value-added test is a bright line test, it often results in seemingly arbitrary results for borderline cases. For example, if the rules require 50% local value-added to confer origin, then a good with 49% local value added will be denied origin while a good with 50% local value added will be considered to originate there. When a firm seeks a certain origin, it may seek to manipulate the prices of the good and its imports to ensure the desired origin determination. This threat of transfer pricing is especially prevalent with transactions among related parties. For example, related parties could under-price the imported materials so that the final good has enough local value-added to qualify for local origin. To limit or prevent this manipulation of "value-added", the rules of origin could force the related parties to show that the price is similar to prices reached in an arm's-length transaction, whether by showing that the price is similar to the price of identical materials or goods sold to third parties, as long as third parties have purchased a substantial number of those materials or goods, or by comparing it to the price of similar materials or goods sold in arm's-length transactions, or it could force them to use a "net cost" method of determining value-added. For example, in the NAFTA, the producer or exporter must use the "net cost" method when there is no transaction value (price) for the good or when the good is sold to a related party and related parties have purchased over 85% of the producers' identical or similar goods during the preceding six months.

Moreover, the value added test leads to inconsistent results for similar products, because countries calculate the amount of value-added in different manners. For example, the value-added test may result in inconsistent determinations of origin of identical goods in different countries because different countries include different amounts of the transportation costs in the "sales prices" for the good, thereby creating different sales prices for the same good. The later the article is valued in the transport stage, the harder it becomes for the article to meet the local value-added content requirements, because the

transport costs increase the value of the denominator, unless the delivery costs are also added to the numerator as originating costs. Further, even if countries valued all parts of the good at the same stage in the transport cycle, they would still have different origin determinations because countries include different costs in its local value-added calculations.

The value-added test penalizes low cost production operations, though they may be more efficient than high cost facilities. The value-added test penalizes labor-intensive facilities in countries with cheap labor costs, capital-intensive facilities in countries with cheap capital costs, and resource-intensive facilities in countries with cheap resource costs. Because there is a greater difference in the cost of labor than the cost of capital since capital is more mobile than labor or raw materials, the value-added test discriminates against lesser developed countries whose primary comparative advantage is cheap labor and cheap materials.

As with any defined test, a value-added test is subject to industry capture during its formulation stage. For example, in the North American Free Trade Agreement, American automobile manufacturers pressured the negotiators into accepting overly restrictive special rules of origin for automobiles, ones that had a higher regional value content requirement for automobiles than for other goods under the North American Free Trade Agreement. Furthermore, to purportedly prevent roll-up, NAFTA requires that the producer trace the value of imported automotive parts throughout the production chain to improve the accuracy of the content calculation, thereby imposing substantial additional compliance costs and administrative burdens on the manufacturer. The combination of higher regional value content requirement with the tracing provisions forces automotive companies to manufacture the drive trains and engines of the vehicles within the free trade area if they want the good to qualify for preferential treatment, or, if they want to avoid the rules of origin, to source their assembly plant in the final market country, *i.e.*, the United States.

In summary, due to differences in calculation methods, the fluctuations in values, and the compliance costs, the value-added test is not a satisfactory method of determining origin.

C. Specified Processes

The specified process tests of origin, also referred to as technical tests, prescribe certain production or sourcing processes that may (positive test) or may not (negative test) confer originating status.

The specified process test serves as a useful supplemental test because it is easily tailored to meet a specific situation in a clear, precise manner. However, it is not a satisfactory primary test of origin because it would be extremely difficult, if not impossible, to define a process test for the enormous array of products made, and to continually update these rules for new products and technological advances in production. Second, such a process of defining origin would be highly susceptible to capture by industry lobbying groups, because the drafters and administrators of the rule would have to rely upon industry for

information, and, because the test would be in technical terms, its content would be hidden from public view. For example, Commission Regulation 288/89, on determining the origin of integrated circuits, stated that origin is conferred on a good whenever it undergoes diffusion. However, diffusion is always followed by assembly and testing, processes that are more labor-intensive and that may add more value than diffusion. This product-specific technical rule was adopted because European Community producers of integrated circuits performed the diffusion process in the European Communities and then had the testing and assembly done in third countries while Japanese producers of integrated circuits had them tested and assembled in the European Communities. Therefore, this regulation conferred EC origin on goods produced by EC manufacturers while denying EC origin on goods produced by Japanese manufacturers, thereby allowing the integrated circuits produced by the EC companies to trade on better terms than those produced by the Japanese.

Third, it is a rigid test whose form could be met while subverting the underlying concept of requiring a substantial transformation to confer origin. Meeting this problem with anti-circumvention provisions would re-introduce the fact-intensive inquiries and their corresponding uncertainty that the technical and other defined tests seek to avoid.

Finally, negative technical tests leave large gray area, in that they only delineate which processes do not confer origin. For example, Commission Regulation 2071/89, on determining the origin of photocopiers, stated that the incorporation of an optical system into a photocopying apparatus will not confer origin, but did not explain which operations would confer origin. This regulation was designed specifically to deny United States origin to copiers assembled in the United States by Ricoh, a Japanese corporation. These copiers contained imported Japanese optical systems, and therefore were viewed as "Japanese" copiers by the origin test. Because anti-dumping duties had been imposed on Ricoh copiers from Japan, these copiers, which were assembled in the United States, were now subject to these duties.

D. Change in Tariff Classification

The change in tariff classification method determines the origin of a good by specifying the change in tariff classification of the Harmonized System of Tariff Nomenclature ("Harmonized System") required to confer origin on a good. Because the Harmonized System has been adopted by countries representing 90% of the world's trade, it provides a uniform, hierarchical nomenclature to be used in defining origin determinations for all products in international trade.

The Harmonized System's systematic, hierarchical framework and its nearly universal acceptance among trading nations permit the drafters of rules of origin tremendous flexibility to define classification changes in a precise manner that sustains exceptions and special rules without sacrificing objectivity, certainty, or identity.

The Harmonized System is divided into twenty-one Sections, each representing a broad industrial grouping; ninety-six Chapters, each representing a more narrow industrial

sector; and one thousand two hundred and forty-one headings, each representing a narrow industrial section.

The headings in a chapter generally are ordered by the degree of processing. The farther into the chapter the heading is, the more processing that good has undertaken. Therefore, unless the rules of origin specify otherwise, any change in the level of classification of the product at the heading level should be sufficient to confer origin on that product in the country where that change last occurred; hence, this method of determining origin is often called the "change in tariff heading method." The Harmonized System's hierarchical framework, its division by industry, and its systematic arrangement of headings by increasing degrees of technical sophistication and economic effort provide an easy to use and easy to adapt underlying structure for origin determinations.

While the Harmonized System reflects the most sophisticated and refined tariff classification system, it is just that -- it's a system primarily designed for the dual purposes of commodity classification and compilation of statistics. Because it was not designed to be used for origin determinations, changes in classification are not always an appropriate or effective test for determining origin. Therefore, an origin scheme based on change in tariff classification must be supplemented by a list of exceptions that describe when a sufficient transformation has occurred despite the lack of a change in tariff classification, when a change in classification is not sufficient, and which processes are not sufficient to confer origin even though they lead to a change in tariff classification. These supplemental tests, which rely upon process and value-added tests as supplemental tests for origin, reintroduce the problems associated with those systems into the change in tariff classification system, albeit on a lesser scale than if these tests were the primary tests. As with any process system, both the required changes and the exceptions lists must be updated to reflect new products and technological advances.

The change in tariff classification method of determining origin is conceptually simple and easy to apply, once the product is classified. Because the Harmonized System is already used to classify 90% of the goods in international trade, custom authorities, exporters, importers, and manufacturers are comfortable and familiar with it. However, the classification of the product can give rise to problems, because products are not always classified in a uniform manner, despite the substantial efforts of the Harmonized System Committee to ensure that they are. While it may appear that the change in tariff classification test which uses the Harmonized System as its underlying nomenclature will result in uniform determinations of origin because all of the countries are using an internationally harmonized nomenclature, this may not be the case because each country is free to classify the good as it sees fit, unless a system of binding dispute resolution open to both individual and member country complainants is developed.