RULES OF ORIGIN AND SERVICES: CONCEPTUAL ISSUES

Note by the Secretariat

1. This note responds to a request made at the GNS during the meeting of 10-25 July that the secretariat prepare a background note to assist participants in identifying issues that may need to be addressed when considering matters relating to rules of origin for services. The objective of this note is to provide an overview of some of the conceptual and practical issues that arise in this context.

2. The note is structured as follows. First, it addresses the question why rules of origin may be needed in the context of a services agreement. Second, it briefly reviews existing origin rules applied to trade in merchandise, and the draft agreement on rules of origin negotiated in the Uruguay Round Negotiating Group on Non-tariff Measures. Given the need for providers of certain services to establish a commercial presence to sell their services internationally, the third part discusses existing rules and procedures for determining the origin of producers (i.e. as opposed to products), focusing in particular on criteria that are used to distinguish domestic from foreign producers. The fourth part explores the relevance and applicability of existing rules of origin to international service transactions. This is followed by a brief summary of the existing literature on the costs and benefits of local content based rules of origin for products or producers. The final part of the note offers some concluding remarks and suggests a number of issues that might be considered by participants.

I. POSSIBLE RATIONALES FOR RULES OF ORIGIN

3. In this note, a rule of origin should be understood to be a criterion that is used to determine the "nationality" of a product or a producer. There are a number of possible rationales for rules of origin. They may be needed with regard to the collection of statistics on trade and investment flows, or to administer health, sanitary, and technical regulations. Alternatively, there might be need to establish that an entity originates in specific country. For example, this is necessary when controlling exports or when determining acquired rights under bilateral or multilateral agreements. In the latter case, a "complainant" country may need to argue that an action by another country has nullified or impaired benefits obtained under an agreement. This requires, inter alia, that it can be
shown that the action has negatively affected a firm or industry that produces (originates) in the complainant country. More generally, an origin rule may be necessary to determine which government or agency has jurisdiction (i.e. the right or obligation to tax, regulate, administer laws, etc.). For example, if the principle of home country control for financial service providers is agreed to, it will presumably be necessary that countries follow uniform procedures to determine origin.

4. In most instances the raison d'être of an origin rule is a desire to discriminate between sources of supply of a specific product. Such discrimination may be preferential or it may be non-preferential. The most commonly observed type of preferential discrimination is to impose lower tariffs on products originating in certain countries compared to tariffs on products originating in other countries. This need usually arises in the context of a trade agreement with less than universal membership or a system of tariff preferences. A need for non-preferential discrimination arises if countries decide to restrict imports (exports) from (to) certain countries. Rules of origin are then required to monitor and enforce the product- and country-specific trade restrictions that are maintained. Such discriminatory restrictions may take the form of countervailing duties, anti-dumping actions, "buy national" regulations, product-specific export restraint agreements or quotas negotiated with (or imposed upon) various trading partners (steel, textiles, automobiles, etc.), and controls or bans on exports by domestic producers to specific countries (e.g. enforcement of economic sanctions). It should be recognized that whenever a rule of origin is defined for a product, implicitly this also determines when products are of domestic origin (i.e. all those products not of foreign origin). Although it is sometimes maintained that if all countries followed a policy of m.f.n. there would be no need for rules of origin,

1 Some of the preferential schemes applied by the United States and the European Community provide representative examples of policies maintained by many countries that require rules of origin. Such schemes include the Generalized System of Preferences, the Caribbean Basin Initiative (U.S.), the Lomé agreement (EC), products originating from insular possessions of the U.S. and from countries with which free trade agreements have been negotiated (U.S.-Canada, U.S.-Israel, EC-EFTA), products to which m.f.n. obligations apply, goods that have been exported for processing and are re-imported, products eligible for duty drawbacks, imported products that have been tested and certified in the source country as meeting national standards under auspices of the GATT Standards Code, and non-applicability of "buy national" legislation for imported products that originate in countries that are signatories of the GATT Government Procurement Code.

2 See, e.g., McGovern (1986), Palmetter (1990) or Vermulst and Waer (1990). Considerations relating to non-preferential rules of origin have become particularly acute in recent years. Until the mid-1980s concerns relating to origin primarily resulted from systems of tariff preferences (see, e.g., Nusbaumer, 1979 and the references cited therein).

3 For example, Jackson (1989, p. 142).
is not the case. In addition to statistical needs and the defence of rights under bilateral or multilateral agreements, the issue of determining whether a product or a producer is of domestic or foreign origin has become increasingly important as the result of the ongoing internationalization of production. This is illustrated by recent problems relating to the definition of "domestic" industry in the context of anti-dumping and other unfair trade actions (discussed below). However, it is certainly the case that the need for origin criteria becomes less if countries follow m.f.n.

**Rules of Origin in a Services Agreement**

5. In the absence of any discussion in the GNS, it is not clear why rules of origin might need to be addressed in the context of a services agreement. In principle, considerations similar to those mentioned above may also arise when dealing with trade in services. Thus, collection of statistics, enforcement of technical regulations and standards, invocation of "escape clauses," identification of producers or products originating in countries that are not party to an agreement, determining jurisdiction and regulatory responsibility, etc. may also require rules of origin. Furthermore, to the extent that sector-specific exemptions are sought with respect to the m.f.n. obligation, origin rules will be required if the parties involved are concerned with the possibility of trade diversion. Finally, a need to address the issue of rules of origin in the GATS context may be due to a perceived need to impose disciplines on the design and use of such rules by Parties to an agreement. Experience with rules of origin in merchandise trade indicates that origin requirements differ substantially and may have trade inhibiting effects. It may be deemed appropriate, therefore, to attempt to agree on certain disciplines in this area.

6. Procedures to be followed when determining the origin of a service or service provider are not specified in the draft General Agreement on Trade in Services (MTN.TNC/W/35/Rev.1). For example, rules of origin are not addressed explicitly in Article XXXIV (Definition of Terms), which is limited to defining natural and juridical persons of a Party. Criteria that are mentioned are nationality, jurisdiction under which an entity is legally constituted, ownership and control. These concepts are discussed at greater length below. It may be helpful to mention a number of the articles of the draft agreement where a need for rules of origin could arise. These include: Article I (Scope and Definition); Article II (MFN); Article V (Economic Integration); Article VII (Harmonization and Recognition); Article X (Safeguards); Article XII (Balance of Payments); Article XV (Subsidies); Article XVI (Market Access); Article XVII (National Treatment); Article XXIII (Dispute Settlement and Enforcement); Article XXX (Non-application); and Article XXXI (Denial of Benefits). In most instances, a need for origin rules may arise either to decide whether

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4See MTN.TNC/W/35/Rev.1, pp. 328-78. The following list should be seen as illustrative, and no claim is made for comprehensiveness.
an entity is covered by the agreement, or to determine which entities are "domestic".

II. RULES OF ORIGIN FOR MERCHANDISE TRADE: AN OVERVIEW

7. The text of the General Agreement on Tariffs and Trade does not specify a rule of origin for purposes of the agreement. Instead, it is left up to each contracting party to decide on the rules to determine the origin of merchandise entering its territory. Indeed, countries may and do, employ multiple rules of origin, depending on the purpose of the policy, on the products involved, etc. Of the various Tokyo Round codes, only the Agreement on Government Procurement contains an explicit reference to rules of origin, requiring that the same rules are to apply as those that are applied in the normal course of trade for the products concerned (Art. II:3).

The Kyoto Convention

8. Although the Contracting Parties explored the possibility of harmonizing their rules of origin in the early 1950s - in response to an International Chamber of Commerce resolution urging the adoption of uniform origin rules - no agreement was possible. Currently, the only multilateral convention dealing with rules of origin is the 1974 International Convention on the Simplification and Harmonization of Customs Procedures (known as the Kyoto Convention), negotiated under auspices of - and administered by - the Customs Cooperation Council in Brussels. The Convention provides a list of ten types of products that should be considered to originate in a country because they are wholly produced or obtained there; that is, contain no imported materials. These are largely natural resource-based products extracted or obtained from the territory of the country concerned. Where two or more countries are involved in the production of a product, the Convention states that the origin of the product is the one in which the last "substantial transformation" took place, i.e., the country in which the last substantial manufacturing or processing occurred, deemed sufficient to give the product its essential character. The substantial transformation criterion has been used by the United States,

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5BISD, Second Supplement, 1954, pp. 53-57; BISD, Third Supplement, 1955, pp. 94-103. For a compilation of origin criteria applied by countries, see Customs Cooperation Council (1986).

6Despite the significant flexibility the Kyoto Convention gives to signatories regarding their choice of origin system, membership remains quite limited. Only a limited number of countries have signed the convention. Although the U.S. partially ratified the convention, it has not accepted the provisions regarding rules of origin.
since the early 20th century (Palmeter, 1990, p. 27), and is also the basis for the EC system of non-preferential rules of origin.

9. Substantial transformation is a rather vague concept. To be made operational it may need to be augmented by a more precise criterion or test. The Convention provides a number of alternatives that signatories may employ in this regard. These include: (1) requiring a change in tariff heading in a specified nomenclature (currently the Harmonized System); (2) determining a list of specific processing operations which do or do not confer upon the products involved the origin of the country in which the operations were carried out; (3) requiring that the value of the materials utilized in transforming the product exceeds a specified percentage of the value of the transformed product; or (4) requiring that the percentage of value added in the country of processing reaches a specified level. In the last two cases the precise percentage is left for each country to decide.

10. Whatever specific test is employed by a country, a general goal is to prevent simple assembly operations and "cosmetic" processing of a product (such as packaging) from conferring origin. However, in practice it is often quite difficult to distinguish in a consistent and neutral manner transformations that are substantial from those that are not. The vagueness of the Kyoto Convention and the lack of GATT discipline allows countries a great deal of discretion. The consensus appears to be that there is no ideal system of origin, as arguments can be found in the literature in favour and against each rule that is used in practice. Arguably, whatever rule is used, transparency and predictability will be maximized if it is applied uniformly and consistently. In practice, however, few countries apply a uniform rule of origin. Indeed, the plethora of existing rules may suggest that many countries are not convinced that a uniform rule is preferable.

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7 Set out in Reg. 802/68. For a discussion, see McGovern (1986) and Vermulst and Waer (1990). This definition follows what was proposed in the early 1950s by a GATT Working Group on origin rules.

8 In practice, content requirements may also be phrased in terms of physical units, e.g., physical units of a component sourced from a country should exceed a specified proportion of the total number of components that are used. Note that value added includes the value of the factor inputs (labour, capital) employed in transforming a product. It differs therefore from the value of materials used in transforming a product.

9 E.g., Palmeter (1987, 1990) is in favour of substantial transformation rule that is interpreted in the sense of sufficient processing to result in a new, distinct product. Maxwell (1990), in contrast, favours a value added criterion. Vermulst and Waer (1990) appear to favour a rule that specifies the technical manufacturing or processing operations/techniques that must be employed. The Uruguay Round draft agreement on rules of origin proposes to make the change in tariff heading the prime criterion.
Cumulation

11. The impact of a rule of origin depends on the specific criterion that is used and on the degree of uniformity with which the rule is applied. It should be noted that if the origin rule is applied in the context of a preferential trade policy, an additional important factor is whether the rule is cumulative. Suppose a product is imported that has been processed in at least two countries. An origin system is cumulative if the importing country only requires that "sufficient" processing of the product has occurred in the countries to which the preferential agreement applies. That is, it allows the exporting country of the "final" product to add the value added in other beneficiary countries to that added by itself. A non-cumulative system of origin requires that the degree of processing in each country must be substantial enough to constitute origin. Thus, if a value added criterion is used (e.g., 40 percent), each country along the chain of production must have increased the value of the transformed product by at least 40 percent. Non-cumulative rules of origin are clearly much more restrictive than cumulative ones.

The draft Uruguay Round text on rules of origin for goods

12. An objective of the draft agreement on rules of origin is to foster the harmonization of the rules of origin used by signatories. The primary criterion for determining origin is to be change in tariff heading. The draft requires a work programme to be undertaken by a Technical Committee, in conjunction with the Customs Cooperation Council. The goal of this programme is to develop a classification system regarding the changes in tariff (sub)heading based on the Harmonized System that constitute a substantial transformation. In cases where the HS nomenclature does not allow for the expression of substantial transformation, the Technical Committee is to provide guidance regarding the use of supplementary tests such as ad valorem percentages and/or manufacturing or processing operations. Language in brackets reveals that no consensus emerged concerning whether the resulting harmonized rules should be applied in a uniform manner to all commercial policy instruments, and whether the rules are without prejudice to determinations made for purposes of defining "domestic industry" or "like products" in the context of actions under Article VI of the GATT. As is discussed further below, the emphasis on "substantial transformation" as reflected in a predetermined change in tariff heading significantly reduces the relevance of the draft agreement for the services negotiations.


11 This appears to follow EC practice, where a value added test tends to be used as an additional criterion in instances where the substantial transformation rule cannot be applied. See Vermulst and Waer (1990).
II. DETERMINING THE ORIGIN OF PRODUCERS

13. Until recently, issues pertaining to rules of origin arose almost exclusively in connection with trade in tangible products. Increasingly, however, the origin of producers has become a policy issue. In particular, questions relating to the origin of producers have emerged in the context of: (1) anti-dumping and related trade policy actions; and (2) foreign direct investment.

Origin issues in anti-dumping and safeguard actions

14. In anti-dumping actions, origin-related issues arise that go beyond the need to identify the origin of dumped imports. In particular, the domestic industry producing the like product must be identified. Defining what constitutes a domestic industry is likely to be very important in the services context. Recent experience with anti-dumping suggests that this is not an issue that is easily settled using objective criteria. The problem is that firms increasingly source inputs from all over the world, so that if origin criteria that focus on the value added in production by local firms are used, many such firms may not be considered to be domestic.

15. Some countries have relatively unambiguous rules for determining what constitutes a domestic industry. For example, Australian anti-dumping law requires that to be considered domestic, locally-established producers must add at least 25 percent value in their production. Other countries have not addressed this issue in their legislation, and decide which locally-established firms are part of the domestic industry on a somewhat ad hoc basis, using a variety of rules. The focus of anti-dumping investigations is rather narrow, all that is required being a decision whether locally-established firms are related to firms accused of dumping, or simply serve as distributors of the dumped product. Criteria therefore revolve around ownership or control of the firms involved, or may be based on the magnitude of locally-added value. Neither criterion is straightforward to employ, and a number of recent cases illustrate that resulting decisions may be rather arbitrary.

Origin of corporations in international law and existing treaties

12 A recent EC anti-dumping case pertaining to Japanese exports of photocopiers is illustrative. All the complainants had links of either a corporate or a commercial nature with the exporting firms that were accused of dumping. In some cases the EC firms acted as distributors for Japanese products, in others Japanese firms had substantial ownership stakes.

13 See e.g., Vermulst and Waer (1990), or Messerlin and Noguchi (1991).
16. Most countries allow foreign-owned or based firms to engage in inward foreign direct investment. Frequently, such investment flows are subjected to conditions (such as restrictions on sourcing of inputs, local content requirements, etc.). They may also occur under the auspices of specific bilateral agreements, such as bilateral investment treaties, friendship, commerce and navigation treaties (FCNs) or tax treaties. To the extent that treaties exist, there is a need to distinguish firms that originate in countries with which agreements have been reached from those where this is not the case. In general, any time conditions (or incentives) exist that differ across firms, there will be a need for rules to determine the origin of firms. Such rules may be employed in addition to rules of origin for products. For example, corporations may be subject to local content requirements. Indeed, it is possible that local content requirements may be used as a criterion of origin for producers, i.e., the origin of intermediate inputs may determine the origin of producers.

17. The origin of producers (corporations) is usually decided on the basis of one or more of the following criteria: (1) place of incorporation; (2) nationality of control; (3) nationality of ownership; (4) principal place of business; (5) location of headquarters or centre of management/decision making; (6) origin of value added; and (7) origin of material and/or intangible inputs. The first five of these criteria are related in that the focus is on the nationality of the producer/firm as reflected in the geographic location of assets or activity. The last two criteria focus on the product that is produced/sold and are frequently based on product content.

18. Under international law, the nationality of a company is determined for most purposes by the country of incorporation. This is a simple and unambiguous criterion, one that was most recently reaffirmed by the International Court of Justice in the Barcelona Traction case in 1970 (Fatouros, 1987). However, the criterion of incorporation has been deemed to be inadequate for certain purposes. For example, it may accord nationality to corporations that are incorporated in a country for tax avoidance or related purposes, but do no business (have no assets) in that country. This perceived inadequacy is reflected in many bilateral and plurilateral agreements. Thus, Article 58 of the Treaty of Rome specifies that to be considered an EC company, not only must it be incorporated in a member state, but it should also have its headquarters/central administration or principle place of business within the EC. The U.S.-Canada Free Trade Agreement makes ownership or control, not incorporation, the basis for determining whether firms originate in the U.S. or Canada. Bilateral investment treaties (BITs) negotiated between certain OECD countries and developing countries may include ownership or control as the primary or as additional factors for determining the origin of a corporation. The BITs of countries such as France, Germany and the United Kingdom rely primarily on the incorporation criterion, "referring to control or substantial

14 See Malmgren et al. (1990) for a discussion.
interest only in specific contexts, such as the grant of national treatment to investments by nationals of a party" (Fatouros, 1987, p. 302). The U.S. BITs use a combination of incorporation and substantial interest (Kunzer, 1983), while other countries such as Switzerland focus only on control.

19. Establishing the nationality of the entities by employing an ownership, substantial interest or control test is often a very difficult matter. Even if it can be done it may be as inappropriate as a decision to determine nationality or origin on the basis of the location of incorporation. For example, a firm incorporated in country x (a signatory to the GATS) but controlled in country y (a non-signatory) may sell products that embody mostly inputs sourced from country z (a signatory). This is one reason why countries may also focus on the content of the products that are produced and/or sold by a firm in its territory when determining the origin of the firm. A practical example where this currently occurs is in the context of anti-dumping (and related anti-circumvention) investigations (see above).

IV. EXISTING APPROACHES AND SERVICES

20. Existing rules of origin for traded goods normally focus on processing activities. What is important is not only where value was added (processing occurred), but also how much value was added to a specific product (whether substantial transformation occurred). Many tradable services either constitute processing activities or add value to goods by distributing and marketing them. Thus, the experience with origin rules relating to merchandise trade may be of some relevance to the services negotiations. The same applies to existing rules determining the origin of producers, whether applied in the context of foreign direct investment or unfair trade actions.

21. Clearly, however, certain criteria that are used to determine origin cannot be applied in the services context. In particular, the substantial transformation test, and change in tariff heading will not be workable. First, insufficient information is available regarding the structure of production for most services, and, more fundamentally, it can be argued that most traded services will be "substantial transformations" of whatever inputs are used, simply because the service will not have existed before it was sold. That is, the non-storability of services frequently makes these traditional merchandise trade approaches irrelevant. The same applies to physical content requirements (number of domestic units, weight, etc.), as services tend to be intangible and indivisible.

22. The only approaches that appear feasible to apply to services are origin criteria based on nationality or value added. A nationality-based origin rule, such as location of incorporation, is perhaps the simplest and most transparent procedure, and can be used to determine the origin of both products and providers. While a value added criterion can also be used for both purposes, it is much more complex to implement. Indeed, in the services context it is likely to lead to greater arbitrariness and offer more discretion to investigating authorities, simply because the
invisibility of the production process will usually inhibit an objective
determination how much value was added in a specific location. Of course,
it might be argued that incorporation by itself is not enough, as it may
not prevent "free-riding" by non-signatories to a services agreement. If
this is felt to be a potential problem, criteria such as control, substan-
tial interest, or value added might be employed as additional or supple-
mentary tests. Great care must then be taken that such additional criteria
be clearly defined. Again, they may easily result in arbitrary decisions,
and governments should consider whether the benefits of such procedures
outweigh their costs.

V. SOME ECONOMIC CONSIDERATIONS

23. Origin rules are invariably adopted to pursue specific government
policies, usually trade preferences (barriers) for (against) certain
countries. Two cases can be distinguished, depending on whether rules of
origin are necessary (i.e., indispensable) to achieve a given policy
target. If this is the case, the impact of the rules of origin used may be
of secondary importance, as they are merely part and parcel of the policy
that is being pursued. Nonetheless, they are of relevance insofar as they
affect the realization of the objective of the underlying policy. For
example, certain rules may prevent the purported policy goal from being
attained. In other instances rules of origin are not necessary in that
alternative instruments might be used to achieve the policy goal. Many
origin systems based on local content requirements are simply ways of
protecting domestic producers of intermediate inputs from import competi-
tion. Alternative instruments that might achieve this goal at less cost
include tariffs on imports, production subsidies, and other forms of
(adjustment) assistance for the domestic industry.

24. In general, there is a need to take into account the incentive effects
of the rules that are imposed. Numerous analyses of preferential tariff
schemes such as the GSP and free trade agreements have documented the trade
restrictive effects of the rules of origin that are used. For example,
in an empirical analysis of trade between the EC and individual EFTA
countries - each of which is in principle allowed duty free access to the
EC - Herin (1986) found that the costs associated with satisfying the rules
of origin imposed by the EC were high enough to induce 25 percent of EFTA
exports to enter the EC by paying the relevant m.f.n. tariff. The costs of
origin rules may therefore be quite high, and may act to directly inhibit
the attainment of an underlying policy goal (free trade in the EC-EFTA
case, greater imports from developing countries in the case of GSP schemes,
or providing preferential market access to signatories of a GATS in the
services context). Such costs are likely to be even higher if the imposi-
tion of origin criteria is not necessary to achieve a particular policy

15 In the case of GSP schemes these pertain especially to cumulation
issues. See McQueen (1982), Nusbaumer (1979), or UNCTAD (1985).
target. The prime example of this is a local content scheme that is intended to protect a domestic producer of intermediates.

25. The impact of rules of origin (especially those based on local content criteria) on economic efficiency and welfare has been analyzed at length in the theoretical and policy-oriented economic literature. A general theme of this literature is that there is a need to investigate whether the specific origin rule that is employed is efficient (i.e. attains the policy goal at least cost). In practice, the origin rules that are employed may not even be consistent with the underlying policy goal. Another theme is that policymakers should consider the economy-wide implications of alternative origin rules. For example, while local content requirements protect domestic intermediate goods producers, this raises the costs of production for final good producers. From a national welfare viewpoint, restrictions on local content are unlikely to be beneficial, especially if account is taken of political economy considerations. The social costs of content rules are very non-transparent, and they are likely to be more difficult to remove than other forms of protection because the groups that gain may easily gain more than would be the case under alternative instruments. Again, an implication is that if origin rules are to be included in an agreement, criteria based on incorporation/nationality might be superior to those based on value added.

VI. CONCLUDING REMARKS

26. A number of possible rationales for rules of origin for service products and providers were identified in this note. For purposes of negotiations, the primary rationale for giving consideration to the issue is that some discipline may need to be imposed so as to give assurance that origin rules cannot be used as a means of circumventing the articles of the Agreement or initial commitments.

27. In designing rules of origin for services, a number of arguments were presented that suggest that criteria based on nationality of natural persons, and incorporation of legal persons (service providers), will be superior to criteria based on value added. As with other issue areas that may require further consideration in the GATS (e.g. safeguards, subsidies), origin criteria are likely to be an issue for future consideration.

28. It could be argued that a primary issue facing participants in the GNS is to determine the minimum discipline that should be provided by rules of origin necessary for the Agreement to be viable. Another important issue is

18 The political economy of local content regulations is discussed in Findlay and Wellisz (1986). See also Vousden (1987).
whether attempts should be made to agree on uniform (harmonized) origin rules, i.e., similar rules for products and producers, individuals and legal persons.
Selected Bibliography on Rules of Origin


