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# International Trade: Rules of Origin

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## Summary

Determining the country of origin of an imported product is important for properly assessing tariffs, enforcing trade remedies (such as antidumping and countervailing duties) or quantitative restrictions (tariff quotas), and statistical purposes. Other commercial trade policies are also linked with country of origin determinations, such as labeling and government procurement regulations.

Rules of origin (ROO), the methodology used to prove country of origin, can be very straightforward—as long as the parts of a product are manufactured and assembled in one country. However, when a finished product’s component parts originate in many countries, as is often the case in today’s global trading environment—determining origin can be a more complex process.

U.S. Customs and Border Protection (CBP) is the U.S. agency responsible for determining country of origin. CBP uses *non-preferential* ROO to determine the origin of goods imported from countries with which the United States has most-favored-nation (MFN) status. A key principle used in non-preferential ROO cases is “substantial transformation,” which means the country in which the product was last *substantially transformed*, or made into a “new and distinct” product. Since no U.S. laws specifically govern non-preferential ROO, these determinations are made by CBP primarily on a case-by-case basis using CBP’s own rules and precedents.

*Preferential* ROO are used to determine the eligibility of imports from U.S. free trade agreement (FTA) partners to receive FTA benefits, and whether goods from eligible developing countries qualify for tariff benefits under U.S. trade preference programs like the Generalized System of Preferences (GSP). Preferential ROO apply specifically to each FTA or preference, meaning that they vary from agreement to agreement and preference to preference.

CBP has periodically proposed implementing a more uniform system of determining non-preferential ROO. CBP’s last proposal was made in July 2008, when it suggested that a system implemented under North American Free Trade Agreement (NAFTA) ROO “has proven to be more objective and transparent and provide greater predictability in determining the country of origin of imported merchandise than the system of case-by-case adjudication they would replace.” The NAFTA scheme had already been used for several years to determine the origin of imports under NAFTA. The proposed ROO modifications received so many responses from the public that the deadline for public comment was extended twice. Changes in ROO requirements are opposed by some importers due to the costs involved in transitioning to new rules, or because they assert that some products they import might be at a disadvantage under different ROO methodology. According to a subsequent *Federal Register* notice, CBP implemented a portion of the proposed regulations applicable to a few specific products, including glass optical fiber, pipe fittings and flanges, and greeting cards.

This report deals with ROO in three parts. First, it describes the reasons that country of origin rules are important and describes U.S. laws and methods that provide direction in making ROO determinations. Second, it discusses some of the more controversial issues involving rules of origin, including the apparently subjective nature of some CBP origin determinations, and the effects of the global manufacturing process on ROO. Third, it concludes with some alternatives and options that Congress could consider that might assist in simplifying the process.

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## Introduction

Rules of origin (ROO), the methodology used to prove country of origin, are central components of U.S. trade policy. Such rules can be very straightforward when all of the parts of a product are manufactured and assembled primarily in one country.<sup>1</sup> However, when component parts of a finished product originate in many countries—as is often the case in global industries such as autos and electronics—determining origin can be a complex, sometimes subjective, and time-consuming process.

Determining a product's country of origin can have significant implications for an imported product's treatment with respect to U.S. trade programs and other government policies. For example, the United States restricts imports from certain countries, including Cuba, Iran, and North Korea, as part of larger foreign policy considerations. U.S. trade policy also seeks to promote economic growth in developing countries by offering trade preference programs, including the Generalized System of Preferences (GSP), and the African Growth and Opportunity Act (AGOA). Such policies require that officials make accurate country of origin determinations so that the benefits of the preferential tariff treatment are received and program goals are met.

Certain key characteristics of contemporary globalized manufacturing may also prove challenging to the ROO process and implementation. These characteristics include the growing complexity of global value chains and, consequently, the increasing demand for fast and efficient movement of intermediate goods across borders to assure competitive prices and profitability.<sup>2</sup> Some observers assert the combined effects of these characteristics have created a globalized manufacturing environment that is sufficiently intricate and flexible to make the application of ROO more complex and, at times, potentially misleading.

This report first provides a general overview of the implementation of the U.S. ROO system. It then discusses the advantages and disadvantages of U.S.-implemented ROO schemes. The report concludes with some policy options for Congress that proponents assert could improve the ROO process.

## Rules of Origin in U.S. Practice

The country of origin of an imported product is defined in U.S. trade laws and customs regulations as the country of manufacture, production, or growth of any article of foreign origin entering the customs territory of the United States.<sup>3</sup> There are two types of rules of origin (ROO):

- *Non-preferential* ROO are used to determine the origin of goods imported from countries with which the United States has most-favored-nation (MFN) status,<sup>4</sup>

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<sup>1</sup> Joseph, LaNassa, "Rules of Origin and the Uruguay Round's Effectiveness in Harmonizing and Regulating Them," *The American Journal of International Law*, 90:4 (October 1996), pp. 625-640.

<sup>2</sup> Pilar Ester Arroyo-Lopez and Gabriel R. Bitran, "Coordination of Supply-Chain Networks and the Emergence of Mini-maestros," *MIT Sloan School Working Paper 4674-08*, December 1, 2007.

<sup>3</sup> 19 C.F.R. §134.1. The customs territory of the United States is defined in General Note 2 of the Harmonized Tariff Schedule as the 50 states, the District of Columbia, and Puerto Rico. It does not extend to U.S. territories (e.g., the U.S. Virgin Islands and Guam).

<sup>4</sup> While the WTO uses the term "most-favored-nation" to describe nondiscriminatory trade treatment, U.S. law has (continued...)

and are the principal regulatory tools for accurate assessment of tariffs on imports, addressing country of origin labeling issues, qualifying goods for government procurement, and enforcing trade remedy actions and trade sanctions.

- *Preferential* ROO are used to determine the eligibility of imported goods from U.S. free trade agreement (FTA) partners and certain developing countries to receive duty-free benefits under U.S. trade preference programs (e.g., the Generalized System of Preferences and the African Growth and Opportunity Act), and other special import programs (e.g., goods entering from U.S. territories). Preferential ROO schemes vary from agreement to agreement and preference to preference.

U.S. laws and regulations on rules of origin conform to the World Trade Organization (WTO) Agreement on Rules of Origin, in which WTO members agreed not to use ROO to pursue trade policy objectives in a manner that would disrupt trade, and to apply them in a consistent, uniform, impartial, and reasonable manner.

No specific U.S. trade law provides an overall definition of “rules of origin” or “country of origin.” Instead, U.S. Customs and Border Protection (CBP)—the agency primarily responsible for determining country of origin (as it is for enforcing tariffs and other laws that apply to imported products)—relies on a body of court decisions, CBP regulations, and agency interpretations to confer origin on an imported product if the matter is in doubt.<sup>5</sup>

Although CBP is the primary enforcement agency for U.S. trade laws, the Customs Modernization Act (Title VI of P.L. 103-182) actually shifted much of the responsibility for complying with customs laws and regulations from CBP to the importer of record.<sup>6</sup> This means that the importer must understand customs procedures (including, for example, the applicability of a preferential ROO scheme to his or her product and country of origin), and apply “reasonable care” to enter, properly classify, and determine the value of merchandise so CBP can properly assess duties, collect accurate statistics, and determine whether all other applicable legal requirements have been met.<sup>7</sup> In cases where the country of origin is unclear, importers may seek advance ROO rulings from CBP in an effort to accelerate the import process.<sup>8</sup>

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since 1998 referred to this treatment as “normal trade relations” (NTR) status. See P.L. 105-206, §5003. This report uses the WTO terminology.

<sup>5</sup> Most CBP rulings from 1989 to the present are available in a searchable database known as the Customs Rulings Online Search System (CROSS), at <http://rulings.cbp.gov/>.

<sup>6</sup> Title VI of the North American Free Trade Agreement Implementation Act, P.L. 103-182, is also known as the “Mod Act.” For example, see 19 U.S.C. §1508, as amended.

<sup>7</sup> U.S. Customs and Border Protection, *What Every Member of the Trade Community Should Know about Recordkeeping*, Informed Compliance Series, January 2005. See also, U.S. Customs and Border Protection, *What Every Member of the Trade Community Should Know about Reasonable Care*, Informed Compliance Series, February 2004.

<sup>8</sup> U.S. Customs and Border Protection, *What Every Member of the Trade Community Should Know About: U.S. Customs and Border Protection Rulings Program*. Informed Compliance Series, December 2009. CBP decisions are binding, but may be appealed or challenged in court.

## Non-preferential Rules of Origin

As a member of the World Trade Organization (WTO), the United States must grant most-favored-nation (MFN) treatment to the products of other WTO member countries with respect to tariffs and other trade-related measures.<sup>9</sup> Non-preferential ROO ensure that imports from U.S. MFN trading partners receive the proper tariff treatment. Non-preferential ROO are also important for country of origin labeling, government procurement, enforcement of trade remedy actions, compilation of trade statistics, supply-chain security issues, and other laws.<sup>11</sup>

### Non-preferential ROO Criteria

Under non-preferential rules of origin, two major criteria apply. First, goods that are wholly the growth, product, or manufacture of one particular country are attributed to that country. This is known as the *wholly obtained* principle.

Second, if an imported product consists of components from more than one country, a principle known as *substantial transformation* is used to determine origin. In most cases, the origin of the good is determined to be *the last place in which it was substantially transformed into a new and distinct article of commerce* based on a change in name, character, or use.<sup>12</sup> Making the determination about what constitutes a change sufficient for a product to be considered *substantially transformed* is when an origin ruling can prove to be quite complex. When determining origin, CBP takes into account one or more of the following factors:

- the character, name, or use of the article;
- the nature of the article’s manufacturing process, as compared to the processes used to make the imported parts, components, or other materials used to make the product;
- the value added by the manufacturing process, including the cost of production, the amount of capital investment, or labor required, compared to the value imparted by other component parts; and,
- the essential character is established by the manufacturing process or by the essential character of the imported parts or materials.<sup>13</sup>

Origin determinations are fact-specific, but CBP acknowledges that there can be considerable uncertainty about what is deemed to be substantial transformation due to the “inherently subjective nature” which may be involved in CBP interpretations of these facts.<sup>14</sup>

<sup>9</sup> Cuba and North Korea are the only two countries not currently granted MFN status by the United States.

<sup>10</sup> As a World Trade Organization (WTO) member, the United States must grant immediate and unconditional most-favored-nation (MFN) treatment to the products of other members with respect to tariffs and other trade-related measures.

<sup>11</sup> United States International Trade Commission (USITC), *Country of Origin Marking: Review of Laws, Regulations, and Practices*, USITC Publication 2975, July 1996, pp. 2-4 (hereinafter COO Marking Report).

<sup>12</sup> The U.S. Supreme Court first applied the substantial transformation standard in *Anheuser-Busch Brewing Association v. United States*, 207 U.S.556. See also U.S. Customs and Border Protection, *What Every Member of the Trade Community Should Know about U.S. Rules of Origin*, Informed Compliance Series, May 2004, p. 9.

<sup>13</sup> COO Marking Report, pp. 2-5.

<sup>14</sup> The U.S. Customs Service proposed setting uniform rules of origin for imports in 1991 (56 *Federal Register* 48448), (continued...)

## WTO Non-preferential Harmonization Program

Participating countries in the Uruguay Round of multilateral trade talks (that also established the WTO in 1995) recognized the need for rules of origin to be objective, understandable, predictable, and transparent.<sup>15</sup> In the WTO Agreement on Rules of Origin, members agreed not to use rules of origin to pursue trade policy objectives in a manner that would disrupt trade, and to apply them in a consistent, uniform, impartial, and reasonable manner. However, the agreement also allows each WTO member to determine its own ROO regime.<sup>16</sup> All WTO members also agreed to notify other members about preferential ROO, including a listing of the preferential arrangements which they implement, along with all applicable administrative decisions and rulings.<sup>17</sup>

The WTO Agreement on Rules of Origin established a Harmonization Work Program (HWP) in an effort to develop uniform, cooperative, and coherent non-preferential rules of origin to be used by all WTO members.<sup>18</sup> The ongoing HWP issued a first draft of a consolidated negotiating text in 1998, and a technical review completed in 1999. These efforts secured a general agreement on an overall design for harmonized rules of origin, including definitions, general rules, and two appendices (one on definitions of wholly obtained goods and one on product-specific rules of origin).<sup>19</sup> Continuing negotiations are being carried out in the WTO Committee on Rules of Origin (CRO) under the WTO Council for Trade in Goods, and the World Customs Organization (WCO) Technical Committee on Rules of Origin (TCRO).<sup>20</sup>

In the Trade Act of 2002 (P.L. 107-210), one of the principal U.S. trade negotiating objectives was the conclusion of a WTO agreement on harmonized rules of origin.<sup>21</sup> According to the United States Trade Representative (USTR), reaching agreements on the technical aspects of the HWP have turned out to be more complex than initially envisioned, and negotiations continue in 2015.<sup>22</sup>

## CBP Proposals to Change Non-preferential ROO

CBP (formerly known as the U.S. Customs Service) has made several proposals since 1991 to simplify and standardize non-preferential ROO, generally by expanding the application of

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and again in 1994 (59 *Federal Register* 141). See also, U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Trade, *Rules of Origin*, Hearing, 104<sup>th</sup> Congress, 1<sup>st</sup> Session, July 11, 1995, Serial 104-27. A similar proposal was introduced on July 25, 2008 (73 *Federal Register* 43385).

<sup>15</sup> The WTO Agreement on Rules of Origin was adopted as part of the Uruguay Round of negotiations, and is accessible at [https://www.wto.org/english/docs\\_e/legal\\_e/legal\\_e.htm](https://www.wto.org/english/docs_e/legal_e/legal_e.htm).

<sup>16</sup> WTO, Agreement on Rules of Origin, Part II, Article 2, “Disciplines During the Transition Period.”

<sup>17</sup> *Ibid.*, Annex II (4).

<sup>18</sup> *Ibid.*, Part IV, Article 9.

<sup>19</sup> *Ibid.*

<sup>20</sup> World Customs Organization (WCO) home page, at <http://www.wcoomd.org/>.

<sup>21</sup> P.L. 107-210, Section 2102 (13).

<sup>22</sup> *Ibid.*; U.S. Trade Representative. *2015 Trade Policy Agenda and 2014 Annual Report of the President of the United States on the Trade Agreements Program*, March 2015, p. II-41, <https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2015/2015-Trade-Policy-Agenda-and-2014-Annual-Report>, (hereinafter USTR Trade Policy Agenda).

regulations set forth in 19 C.F.R. Part 102 (the “NAFTA Marking Rules”) to entries of goods under non-preferential rules of origin and for “free trade agreements already negotiated that use the substantial transformation test to determine whether products qualify for reduced tariffs.”<sup>23</sup> CBP mentioned that the NAFTA marking rules had already been implemented for all imports from Canada and Mexico, and for nearly all textile and apparel products since 1996 and, consequently, that the importing community and CBP have had extensive experience in applying these rules.<sup>24</sup> CBP noted that its experience in implementing NAFTA marking rules had shown that “by virtue of their greater specificity and transparency, codified rules result in determinations that are more objective and predictable than under the case-by-case adjudication method.”<sup>25</sup>

In addition, CBP stated its belief that “the proposed extension of the Part 102 rules to all trade will result in more objective, transparent, and predictable determinations, and will, therefore, facilitate the exercise of reasonable care by importers with respect to their obligations regarding identification of the proper country of origin of imported merchandise.”<sup>26</sup> A public comment period on the proposed rule ended on September 23, 2008.<sup>27</sup> The comment period was extended twice—first, until October 23, 2008 (73 F.R. 51963), and again (due to technical corrections in the underlying Code of Federal Regulations sections) on October 30, 2008 (73 F.R. 64575) until December 1, 2008.

Much of the public response opposed the 2008 CBP proposal. Many associations and businesses voiced general opposition to the proposed rule because they said the proposal could substantially increase costs of entry, place undue burdens on members of the trading community (especially on small businesses), and increase the complexity of the importing process. Others commented on the difficulty of applying these NAFTA marking rules to particular products such as computer software or pharmaceuticals.<sup>28</sup> Some industry organizations, including the National Association of Manufacturers, questioned the CBP assumption that implementing a tariff shift method could increase predictability and transparency.<sup>29</sup> Other associations commented that, if implemented, the regulation could cause an unintended major reversal of existing law that could harm some importers who have relied on the existing law for years.<sup>30</sup> In September 2011, CBP issued a final rule making the NAFTA marking rules applicable to some products subject to non-preferential ROO, namely pipe fittings and flanges, greeting cards, glass optical fiber, rice preparations, and some textile and apparel products. However CBP officials also announced that they did not adopt as a final rule the “portion of the notice that proposed amendments to the CBP regulations to

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<sup>23</sup> 73 F.R. 43385. The substantial transformation test is used in U.S. bilateral free trade agreements with Bahrain and Morocco.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> Joseph Tasker, Jr., *RE: Uniform Rules of Origin for Imported Merchandise*, Information Technology Association of America, December 1, 2008, <http://www.regulations.gov>, Docket No. USCBP-2007-0100.

<sup>29</sup> Catherine Robinson, *Notice of Proposed Rulemaking by U.S. Customs and Border Protection, Department of Homeland Security, "Uniform Rules of Origin for Imported Merchandise,"* National Association of Manufacturers, December 1, 2008.

<sup>30</sup> See comments of American Association of Exporters and Importers (AAEI), Business Alliance for Customs Modernization (BACM), Information Technology Association for America (ITAA), United States Council for International Business (USCIB), and others, <http://www.rulemaking.gov>, Docket ID USCBP-2007-0100.

establish uniform rules governing CBP determinations of the country of origin of imported merchandise.<sup>31</sup>

## Preferential Rules of Origin

Preferential rules of origin are used to verify that products are eligible for duty-free status under U.S. trade preference programs, such as the Generalized System of Preferences (GSP), the African Growth and Opportunity Act (AGOA), or free trade agreements (FTAs), such as the North American Free Trade Agreement (NAFTA) and the U.S.- South Korea Free Trade Agreement (KORUS FTA).<sup>32</sup>

As with non-preferential ROO, if goods are “wholly the product” of a beneficiary of preference program or free trade agreement, establishing origin is usually fairly straightforward. However, if a good was not entirely grown or manufactured in the targeted country or region, rules of origin specific to the trade preference or FTA apply. Preferential ROO vary from agreement to agreement and preference to preference. Most U.S. FTAs use three methods, or a combination thereof, to determine what products “originate” and thus actually qualify for the benefits of the agreement.

### “Tariff Shift” Test

In some agreements, a *tariff shift* method, or change in the Harmonized Tariff Schedule (HTS) tariff classification (as a result of production occurring entirely in one or more of the parties), may be used to determine whether or not the product qualifies for these benefits. The NAFTA is one example in which this methodology is used.<sup>33</sup> This methodology is favored by U.S. customs officials because they say that it provides an objective method for describing exactly the kind of substantial transformation that must occur to determine the origin of a product.<sup>34</sup>

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<sup>31</sup> U.S. Customs and Border Protection, “Rules of Origin for Imported Merchandise,” 76 *Federal Register* 54691, September 2, 2011.

<sup>32</sup> Application of preferential ROO includes the following U.S. preference programs and agreements: African Growth and Opportunity Act (AGOA); the Andean Trade Preference Act (ATPA); the Andean Trade Promotion and Drug Eradication Act (ATPDEA); the Automotive Products Trade Act (APTA); the Caribbean Basin Economic Recovery Act (CBERA); the Compact of Free Association Act (FAS); the Generalized System of Preferences (GSP); the Haitian Hemispheric Opportunity through Partnership Encouragement (HOPE) Act of 2006 (an amendment to CBERA); Insular Possessions of the United States; the North American Free Trade Agreement (NAFTA); products of the West Bank, the Gaza Strip, and associated Qualifying Industrial Zones; the United States-Caribbean Basin Trade Partnership Act (CBTPA); the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR); and United States bilateral FTAs with Israel, Jordan, Chile, Singapore, Australia, Morocco, Bahrain, Colombia, Panama, and South Korea. Although the ultimate goal of an FTA is duty-free access to the markets of each trading partner, tariffs on certain import-sensitive items may be phased out gradually over a specified time period.

<sup>33</sup> 19 C.F.R. §102. These rules are also known as the “NAFTA marking rules” and apply only to Canada and Mexico, except for 19 C.F.R. 102.21, which applies to rules of origin for textiles and apparel from all countries except Israel (rules for Israel are set forth in 19 C.F.R. 102.22).

<sup>34</sup> U.S. Customs and Border Protection, *How Do I Read Tariff Shift Rules? And Other Textile and Apparel Rules of Origin Questions You Were Afraid to Ask*, Seminar Presentation, October 2007.

## Examples of Tariff Shift Rules of Origin for Textiles and Apparel Products

### Fiber Forward

- **A change to heading 5101 through 5105 [wool fibers] from any other chapter.**
  - Wool fiber must be produced in the territory of the trading partners, and no foreign fibers may be used.

### Yarn Forward

- **A change to heading 5801 through 5811 [special woven fabrics] from any other Chapter, except from headings 5106 through 5113 [wool yarn and fabric], 5204 through 5212 [cotton yarn and fabric], 5308 [yarn of other vegetable fibers], or 5311 [woven fabrics of other vegetable textile fibers], Chapter 54 [man-made filaments and fabrics], or heading 5508 through 5516 [yarn and fabric of synthetic staple fibers].**
  - Yarn and fabric must be produced in the territory of the trading partners, but foreign fibers may be used.

### Fabric Forward

- **A change to heading 5901 [coated textile fabrics] from any other chapter, except from heading 5111 through 5113 [woven wool fabrics], 5208 through 5212 [woven cotton fabrics], 5307 through 5308 [woven fabrics of other vegetable yarns (coir yarn, paper yarn, etc)], 5407 through 5408 [woven man-made fiber filament fabrics], or 5512 through 5516 [woven man-made staple fabrics].**
  - Fabric must be produced in the territory of the trading partners, but foreign yarn and fibers may be used.

**Source:** Harmonized Tariff Schedule of the United States and U. S. Customs and Border Protection, “Textile and Apparel Preference Rules.”

For example, the “yarn forward” principle, related to preferential ROO for certain textile and apparel products, is a type of tariff shift test that requires textile and apparel products to originate in an FTA country from the yarn stage forward (fibers may come from anywhere). Notably, the specific term, “yarn forward” never actually appears in an FTA. Instead, the tariff shift presented in the ROO indicates the amount of processing required (substantial transformation) in an FTA country in order to confer originating status. Specific ROO for certain products, including textiles and apparel, generally appear in an annex to the FTA, and list various categories of goods by reference to their Harmonized Tariff Schedule (HTS) tariff lines.<sup>35</sup>

## Technical Test

With certain products, a *technical* test may be used that requires specific processing operations occur in the originating country.<sup>36</sup> Sometimes known as a critical process criterion, this test mandates that certain production or sourcing processes be performed that may (positive test) or may not (negative test) confer originating status.<sup>37</sup> For example, in the U.S.-South Korea Free

<sup>35</sup> The Harmonized Tariff Schedule (HTS) is an international classification scheme used to identify products and assign applicable tariffs. For the current United States Harmonized Tariff Schedule (USHTS) see <http://hts.usitc.gov/>.

<sup>36</sup> Moïshe, Hirsch, “International Trade Law, Political Economy and Rules of Origin—A Plea for a Reform of the WTO Regime on Rules of Origin,” *Journal of World Trade* (36) 2002, p. 171.

<sup>37</sup> Edwin Vermulst, “Rules of Origin as a Commercial Policy Instruments?,” in *Rules of Origin in International Trade: A Comparative Study*, ed. Edwin Vermulst, Paul Waer, Jacques Bourgeois, Ann Arbor: University of Michigan Press, (continued...)

Trade Agreement (KORUS), certain chemicals require that manufacturing processes such as purification, chemical reaction, controlled mixing and blending, changes in particle size, or other technical tests such as these, must take place in one or both FTA parties in order to confer origin.<sup>38</sup>

### **Examples of Technical Tests for Products of the Chemical or Allied Industries (HTS Chapters 28-38)**

**Rule 1: Chemical Reaction Origin:** A good in Chapters 28-38, except goods under heading 28.23, that results from a chemical reaction in the territory of one or both of the Parties shall be treated as an originating good.

**Note:** For purposes of this section, a “chemical reaction” is a process (including a biochemical process) that results in a molecule with a new structure by breaking intramolecular bonds and by forming new intramolecular bonds, or by altering the spatial arrangement of atoms in a molecule.

The following are not considered to be chemical reactions for the purposes of determining whether a good is an originating good:

- (a) dissolution in water or in another solvent;
- (b) the elimination of solvents including solvent water; or,
- (c) The addition or elimination of water of crystallization.

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**Rule 3:** A good in Chapters 30, 31, or 33, shall be treated as an originating good if the deliberate and controlled modification in particle size of the good, including micronizing by dissolving a polymer and subsequent precipitation, other than by merely crushing or pressing, resulting in a good having a defined particle size, defined particle size distribution, or defined surface area, which is relevant to the purposes of the resulting good and having different essential physical or chemical characteristics from the input materials, occurs in the territory of both of the Parties.

**Source:** United States - South Korea Free Trade Agreement, Annex 6-A, Specific Rules of Origin.

## **Local or Regional Value Content Test**

A *local content* or *regional value content (RVC)* test is required of many products imported into the United States under FTAs or preference programs. A local content test stipulates a product must contain a minimum percentage of domestic value-added determined by the origin of physical components or parts and labor and manufacturing processes that originated in the FTA partner or beneficiary developing country to receive the tariff benefit.<sup>39</sup>

The amount of local content required may vary among U.S. free trade agreements and preferences, and differ among product categories within an arrangement. In some cases, the local content requirement may be fulfilled on a regional basis. For example, in order for a product to qualify for duty-free treatment under the Generalized System of Preferences (GSP), the cost or value of the materials produced in that developing country (or produced *in one or more* members of an association of countries *treated as one country* under GSP), and the direct cost of the processing operations performed in that beneficiary country (or association of countries as described above), must be *at least 35% of the appraised value of the product*.<sup>40</sup>

(...continued)

1994, p. 450.

<sup>38</sup>For example, see United States-South Korea Free Trade Agreement (KORUS-FTA), Chapter Six, Rules of Origin.

<sup>39</sup> Ibid.

<sup>40</sup> U.S. International Trade Commission. *Harmonized Tariff Schedule of the United States*. General Note 4 (19 U.S.C. (continued...))

The previous example illustrates “cumulation,” or the way that ROO may allow for combining value-added inputs from a region or group of countries into a manufactured product that qualifies as an import under the terms of a regional FTAs or regionally-targeted preference program. Cumulation may help accomplish another major policy objective of regional trade programs: the stimulation of regional integration through deepened intra-regional trade.<sup>41</sup> In some preferential arrangements, a certain percentage of U.S. content may count toward meeting the regional content test.

In U.S. FTAs, three alternative methods are often used to calculate regional value content (RVC), which is often used to determine the origin of assembled products such as autos and auto parts. Manufacturers and importers are sometimes given more than one ROO option to calculate the RVC because one method of calculation may be more beneficial than the other for particular companies or industries. Three common types of RVC calculations are:

- **Build-down method:** calculates the RVC by subtracting the value of the non-originating merchandise (VNM) from the adjusted value (AV) of the finished product. The adjusted value includes all costs, profit, general expenses, parts and materials, labor, shipping, marketing, and packing. If the RVC (expressed as a percentage) of the product value is equal to or greater than the minimum percentage specified in the ROO, the product qualifies.
- **Build-up method:** calculates RVC by adding together the value of all of the regional inputs (e.g., costs, general expenses, parts, materials, labor, shipping, marketing, and packing). If the RVC (expressed as a percentage) of the product is equal to or greater than the minimum percentage specified in the ROO, the product qualifies.
- **Net cost method:** captures only the costs involved in manufacturing, including factory labor, materials, and direct overhead. Other costs, such as sales promotion, marketing, royalties, and profit, are excluded from the calculation. The use of a small, easily identifiable set of input costs is thought to make the net cost method easier to use in calculating RVC.<sup>42</sup>

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(...continued)

§1202).

<sup>41</sup> Dan Ciuriak and Derk Bienen, *Overcoming Low Preference Utilization in Preferential Trade Agreements: Presumption of Origin for Small Shipments*, BKP Development Research and Consulting, Trade and Development Discussion Paper no. 02/2014, June 2014.

<sup>42</sup> One example of an FTA using a net cost method for RVC calculations for originating products is NAFTA. According to the NAFTA Rules of Origin Requirements, (19 C.F.R. part 181, App.), "the net cost is the total cost of Good A (the aggregate of product costs, period costs, and other costs) per unit, minus the excluded costs (the aggregate of the sales promotion, marketing, and after-sales service costs, royalties, shipping and packing costs, and non-allowable interest costs) per unit. See Sections 6(11) and 6(22).

**Figure I. Regional Value Content Equations**

Build-Down Method	Build-Up Method	Net Cost Method
$RVC = \frac{AV - VNM}{AV} \times 100$	$RVC = \frac{VOM}{AV} \times 100$	$RVC = \frac{NC - VNM}{NC} \times 100$
<p><b>RVC</b> Regional value content of the good, expressed as a percentage</p> <p><b>AV</b> Adjusted value of the good</p> <p><b>VOM</b> Value of originating materials, other than indirect materials, acquired or self-produced and used by the producer in the production of the good. Originating materials may also include the costs of insurance, packing, transportation, duties and taxes (other than those waived or recoverable), and costs for waste and spoilage.</p> <p><b>VNM</b> Value of non-originating materials, other than indirect materials, acquired or used by the producer in the production of the good. VNM does not include the value of the material that is self-produced. The costs of insurance, packing, transportation, duties and taxes (other than those waived or recoverable), and costs for waste and spoilage may be deducted from VNM.</p> <p><b>NC</b> Net cost of the good. Net cost excludes costs for sales, marketing, royalties, profit, shipping, and all other after-sales product costs.</p>		

**Source:** Various U.S. FTA rules of origin chapters.

## Rules of Origin Issues

Due to their obscure and technical nature, rules of origin frameworks are generally not in the forefront of the continuing debates on trade liberalization or globalization. Nevertheless, the role of ROOs (both preferential and non-preferential) is central to the international trading system and trade negotiations.

Preferential rules of origin are arguably essential to ensure that the benefits of an FTA are provided to those countries that have negotiated and entered into the agreement.<sup>43</sup> Without preferential ROO, it would be possible for imports from non-FTA countries to enter the FTA partner with the lowest external tariff, and then sell the good throughout the region under the FTA rate. This could force a convergence of external tariffs and possibly a competitive devaluation of external tariffs in the region.<sup>44</sup> For similar reasons, ROO are also important when providing unilateral trade preferences to ensure that only goods from eligible countries receive the benefits.

Some policy observers, however, assert that the worldwide proliferation of trade agreements creates inefficiencies in the trading system because there are so many complex ROO frameworks. Others express concern that current U.S. systems for determining country of origin may run counter to overall U.S. trade policy. Still other observers say that negotiation of specific ROO allows countries to shield import-sensitive segments of industries by instituting ROO that either do not include a particular product, or make the ROO so difficult that the product does not qualify. Some observers assert that ROO interpretation is complex and subjective. Other experts

<sup>43</sup> Moishe Hirsch, "The Politics of Rules of Origin," *International Law Forum, Hebrew University of Jerusalem*, June 2013.

<sup>44</sup> *Ibid.*, p. 3.

maintain that, in a global manufacturing environment, there should be other means of determining country of origin. Finally, some experts wonder if ROO definitions could produce results that could be counter to certain policy objectives.

## Proliferation of Preferential ROO

Some economists argue that the proliferation of bilateral and regional trade agreements—each with their own preferential ROO scheme—adds new complexities for importers and manufacturers; thus potentially inserting economic inefficiencies into the international trading system. Since preferential rules of origin are specific to each free trade agreement or preference program, assembling the proper documentation can be a complex and costly process. Some in the business community mention that the administrative costs associated with navigating the increasingly complex patchwork of regulations involved in establishing origin can outweigh the benefits of FTAs.<sup>45</sup>

Some economists also assert that the worldwide proliferation of FTAs have led to an inefficient “spaghetti bowl” approach to trade policy with individual ROO requirements.<sup>46</sup> The lack of transparency of preferential ROO (and their apparent use as instruments of protectionism) is also a matter of concern for some critics. An often-repeated example of this is the “triple-transformation rule” for apparel products within the North American Free Trade Agreement (NAFTA). This rule requires that the raw materials (fiber), the cloth, and the garment itself all be processed within the FTA region to be NAFTA-eligible.<sup>47</sup>

Other observers say FTAs provide importers with greater flexibility in sourcing goods, and provide exporters with greater access to foreign markets where the same FTA ROO requirements would apply on entry into the FTA partner’s market. Importers always have the option of entering products under MFN status (in which case non-preferential rules of origin would apply) if they determine this is the most cost-effective method of entry. Therefore, FTAs could be seen as providing importers with additional options in choosing suppliers, as well as modes of entry (i.e., under preferential or non-preferential ROO). Importers can weigh the costs of compliance (combined with the more favorable FTA tariff rate) against importing goods from suppliers outside the FTA.<sup>48</sup>

For example, a study of trade flows under NAFTA ROO illustrated that when the MFN tariff on a product is equal or more favorable than the NAFTA tariff, importers will typically choose to import under the MFN rate to avoid the additional compliance costs. However, when importers determine that the NAFTA rate (plus additional transaction costs) is more favorable, they choose

<sup>45</sup> Ollilla, Jorma and Sutherland, Peter. “Business is Fearful as Doha Nears the Precipice,” *Financial Times*, April 23, 2006. See also, Ikenson, Daniel J. *Leading the Way: How U.S. Trade Policy Can Overcome Doha’s Failings*, Cato Institute, Trade Policy Analysis No. 33, June 19, 2006, p. 13, at <http://www.freetrade.org/node/28>.

<sup>46</sup> Bhagwati, Jagdish and Krueger, Anne O. “U.S. Trade Policy: the Infatuation with Free Trade Agreements,” in *The Dangerous Drift to Preferential Trade Agreements*, AEI Press, 1995. Dan Ciuriak and Derk Bienen, *Overcoming Low Preference Utilization in Preferential Trade Agreements: Presumption of Origin for Small Shipments*, BKP Development Research and Consulting, Trade and Development Discussion Paper no. 02/2014, June 2014.

<sup>47</sup> Krueger, Anne O. “Are Preferential Trading Arrangements Trade-Liberalizing or Protectionist?,” *The Journal of Economic Perspectives* 13:4 (Autumn 1999), p. 112. Cadot, O. and de Melo, J. 2007. Why OECD Countries Should Reform Rules of Origin. Center for Economic Policy Research (CEPR) Discussion Paper (6172).

<sup>48</sup> Kunimoto, Robert and Sawchuck, Gary. *NAFTA Rules of Origin*. Government of Canada. Policy Research Initiative Discussion Paper, June 2005, pp. 6-7.

to import goods under NAFTA.<sup>49</sup> Importers may, in some cases, decide not to enter goods under an FTA, but the availability of such preferences gives them greater flexibility to purchase and import products in the most cost-effective manner available. The fact remains, however, that the utilization of trade preferences under preferential rules of origin is sometimes costly, and may also inhibit the use of preferences.

The key challenges of constructing ROO in preferential trading relationships are twofold: finding the balance between the effectiveness and the efficiency of ROO, and simplifying and making ROO more transparent.

## **Influence of Domestic Industries**

Because some preferential ROO in FTAs are negotiated product by product and industry by industry, some critics allege that there is “enormous scope for well-organized industries to essentially insulate themselves from the effects of the FTA by devising suitable ROO,” thus diminishing the FTA’s trade liberalizing effects overall.<sup>50</sup> Thus, more restrictive (and often more complex) ROO may be crafted to compensate domestic manufacturers that stand to lose protection as a result of an FTA or preference.<sup>51</sup> Others contend that such measures are often successful in softening the opposition from import-competing groups, thus enhancing the political feasibility of subsequent FTA implementation (after congressional approval).<sup>52</sup>

Some studies indicate that more restrictive rules of origin, such as higher local content requirements, may encourage producers of finished goods in an FTA region to shift from lower-cost suppliers of intermediate goods outside an FTA to higher-cost suppliers within an FTA region (often U.S. suppliers) to qualify for more favorable FTA tariff benefits. Thus, more restrictive ROO can be used to provide “protection” to these regional suppliers and maintain existing protection against outsiders, to the extent that they provide sufficient incentive for FTA producers to buy more inputs inside the region.<sup>53</sup> Therefore, more restrictive local or regional content requirements can spread the benefits of an FTA to manufacturers of intermediate products in the region.

The following example illustrates the interest the U.S. automobile sector demonstrated in influencing ROO during negotiations on the NAFTA:

All three [U.S.] automakers had an interest in a reasonably high rule of origin to make it more difficult for European and Japanese competitors to locate assembly plants in Canada or Mexico and thereby ship finished automobiles to the United States duty-free. But GM differed from Chrysler.... Because of [its] joint venture with Isuzu in Canada, GM favored a lower rule of origin, around 60 percent [regional content requirement]. For reasons that reflected their own patterns of production and competitive position, Ford and Chrysler preferred a higher rule, approximately 70 percent. Auto parts makers had every incentive to

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<sup>49</sup> Ibid.

<sup>50</sup> Krishna, Kala. “Understanding Rules of Origin,” European Financial Management Association (EFMA) Meetings, Helsinki (2003), p. 1.

<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

<sup>53</sup> Chase, Kerry A. “Industry Lobbying and Rules of Origin in Free Trade Agreements,” International Studies Association 48<sup>th</sup> Annual Convention, Chicago, Illinois, February 28-March 3, 2007.

push for as high as a percentage as possible, since high percentages protected them from foreign competitors.<sup>54</sup>

## ROO Interpretation

Country of origin rulings can be complex, especially when questions on what processes or procedures are sufficient for a product to be “substantially transformed” come into play. A major reason for this complexity is that, especially in situations involving non-preferential (MFN) origin rules, officials must often make these determinations on a “case-by-case” basis. Some importers have criticized CBP because they assert that some of these determinations are subjective and inconsistent. U.S. exporters sometimes argue that ROO determinations by officials in other countries are arbitrary and lack transparency.

In the United States, importers may request a binding ruling in advance of importing the good from the CBP Office of Regulations and Rulings. CBP also provides a Customs Rulings Online Search System (CROSS) that importers can search for a ruling on a product similar to theirs for additional guidance.<sup>55</sup>

In December 2014, WTO members concluded the WTO Agreement on Trade Facilitation, in which they agreed to issue advance rulings on ROO and other trade matters “in a reasonable time-bound manner,” and to “promptly publish . . . laws, regulations, and administrative rulings” of general application relating to rules of origin.<sup>56</sup> It is believed that increased transparency of ROO interpretation worldwide will provide greater assurance for exporters from the United States and other countries that the origin of their products will be handled in a consistent manner.

## Global Manufacturing and Rules of Origin

In an international trading environment in which components of goods originate in many countries and assembly can occur anywhere in the world, some observers suggest that single-country origin determinations are misleading.

Rapid advancements in science and technology since World War II have contributed to a major transformation of modern manufacturing. New manufacturing techniques have made it possible for lesser-skilled workers to manufacture higher quality products with little waste or loss. In addition, the development of faster and more efficient communications and transportation technology has made it possible to reliably construct and ship components, parts and materials from multiple locations to the site of final assembly, making the manufacturing process more

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<sup>54</sup> Mayer, Frederick W. *Interpreting NAFTA: The Science and Art of Political Analysis*. New York: Columbia University Press, 1998, pp. 157-158. Numerous automakers have subsequently taken advantage of the benefits afforded by NAFTA and built state-of-the-art auto plants in Mexico, including Nissan, Honda, Volkswagen, and Mazda.

<sup>55</sup> 19 C.F.R. 177. A ruling may be requested by “any person who, as an importer or exporter of merchandise, or otherwise has a direct and demonstrable interest in the question or questions presented in the ruling request, or by the authorized agent of such person.” CBP guidance for requesting advance rulings can be found in U.S. Customs and Border Protection, *What Every Member of the Trade Community Should Know About: U.S. Customs and Border Protection Rulings Program*, Informed Compliance Publication, December 2009, <http://www.cbp.gov>. The Customs Rulings Online Search System (CROSS) is found at <http://rulings.cbp.gov/>.

<sup>56</sup> WTO, Preparatory Committee on Trade Facilitation, *Agreement on Trade Facilitation*, WT/L/931, July 15, 2014, <http://www.wto.org>.

complex and intricate. As a result, an increasing variety of a product's parts and components come from many different nations, and, especially with more complex merchandise, manufacture and assembly may also be conducted in several different countries.<sup>57</sup>

World trade and production are increasingly structured around "global value chains" (GVCs), defined as "the full range of activities that firms and workers do to bring a product from its conception to its end use and beyond."<sup>58</sup> A value chain typically includes design, production, marketing, distribution, support, and delivery to the final consumer.<sup>59</sup> Beyond increased competition among manufacturers, there has also been a restructuring of the overall manufacturing process toward subcontracting or "outsourcing" production to globally-integrated contract manufacturers. "Full-package" production companies in China and other countries have the capacity to link multiple specialized producers in many countries into specialized networks that manufacture all components and assemble final products. These producers are sufficiently integrated to control all manufacturing, logistics, and final delivery of the end-use products.<sup>60</sup>

These characteristics of modern manufacturing have significant implications for international trade, including the following:

- The "nationality" of the retailer or brand, the "nationalities" of the specialized producers, and "nationalities" of the ultimate manufacturers or assemblers of a product are often different. Most goods (and increasingly services) are "made in the world."
- Countries increasingly specialize in tasks and business functions rather than in manufacture of specific products, and countries compete on economic roles within the value chain rather than in the production of end-use goods.<sup>61</sup>
- Although major U.S. manufacturing firms are actively involved in the overall management of their GVCs, some industries, such as retailers, may know less about where or how a product was made;
- Frequently, a relatively small percentage of the product's total value was created in the attributed country of origin; and,
- GVCs exist across many industry sectors, including electronics, motor vehicles, chemical products, agriculture and food products, fashion, and business and financial services.

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<sup>57</sup> Pilar Ester Arroyo-Lopez and Gabriel R. Bitran, "Coordination of Supply-Chain Networks and the Emergence of Mini-maestros," *MIT Sloan School Working Paper 4674-08*, December 1, 2007.

<sup>58</sup> Koen De Backer and Sebastien Miroudot, *Mapping Global Value Chains*, Organization for Economic Policy and Development (OECD), OECD Trade Policy Papers No. 159, 2013.

<sup>59</sup> Ibid.

<sup>60</sup> Pilar Ester Arroyo-Lopez and Gabriel R. Bitran, "Coordination of Supply-Chain Networks and the Emergence of Mini-maestros," *MIT Sloan School Working Paper 4674-08*, December 1, 2007.

<sup>61</sup> Koen De Backer and Sebastien Miroudot, *Mapping Global Value Chains*, Organization for Economic Policy and Development (OECD), OECD Trade Policy Papers No. 159, 2013.

## The Case of the Apple iPhone

A 2011 analysis of the manufacture of an Apple iPhone 4 provides a very clear case study of how electronics and other products are produced in the global manufacturing environment. Most of Apple's iPhones are assembled in China by Foxconn,<sup>62</sup> a Taiwanese contract manufacturer that handles all sourcing and logistics. The gross export value of the product (factory gate price) of the product was \$194.04.<sup>63</sup> Value-added (e.g., parts, electrical components, design, assembly, software development) came from the following countries:

- \$80.05 of the value-added inputs originated in Korea;
- \$24.63 originated in the United States;
- \$16.08 came from Germany;
- \$3.25 came from France;
- \$0.70 came from Japan;
- \$6.54 of the total value-added was contributed by China; and,
- \$62.19 was undetermined (rest of world, ROW).<sup>64</sup>

Even though China's contribution to the iPhone's value was relatively small, the product is considered a product of China according to CBP regulations, because the product was last "substantially transformed" in China.<sup>65</sup>

## Effects on Rules of Origin

As described above, in the increasingly global manufacturing environment, the assembly point of the manufactured product and of its individual components may differ. These rapidly accelerating changes in the manufacturing process can lead to additional complexities in ROO determinations because officials must ascribe origin to a single country for import purposes.

In turn, these complexities may lead to apparent inconsistencies. For example, in some cases, CBP officials may decide that the assembly process (including the value-added by labor costs) is sufficient to confer origin, as it is the "last place of substantial transformation."<sup>66</sup> In other cases,

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<sup>62</sup> Foxconn is the trade name of Hon Hai Precision Industry Co., Ltd. Reportedly, Apple is gradually shifting the supply chain for some of its products away from Foxconn to Pegatron Corp., another Taiwanese firm (see Eva Dou, "Apple Shifts Supply Chain Away from Foxconn to Pegatron," *Wall Street Journal*, May 20, 2013).

<sup>63</sup> Gary Gereffi and Joonkoo Lee, "Why the World Suddenly Cares About Global Supply Chains," *Journal of Supply Chain Management*, vol. 48, no. 3 (July 2012).

<sup>64</sup> Gary Gereffi and Joonkoo Lee, "Why the World Suddenly Cares About Global Supply Chains," *Journal of Supply Chain Management*, vol. 48, no. 3 (July 2012).

<sup>65</sup> CBP Regulations (19 C.F.R. §134.1(b)), define "country of origin" as "the country of manufacture, production, or growth of any article of foreign origin entering the United States. Further work or material added to an article in another country must effect a substantial transformation in order to render such other country the 'country of origin' within the meaning of [the marking laws and regulations]." For country of origin marking purposes, a substantial transformation of an article occurs when it is used in manufacture, which results in an article having a name, character, or use differing from that of the article before the processing. However, if the manufacturing or combining process is merely a minor one that leaves the identity of the article intact, a substantial transformation has not occurred.

<sup>66</sup> In Customs Ruling HQ HO127620, *Country of Origin of a Flashlight and Replacement Part*, CBP determined that a military-grade flashlight and a replacement part were of U.S origin for purposes of the "Buy American Act" even (continued...)

officials have determined that the final assembly process and labor costs incurred are actually not sufficient to confer this essential character.<sup>67</sup>

However, since CBP has the legal flexibility to be able to consider “the totality of the circumstances and makes such decisions on a case-by-case basis,” the agency is able to fully consider the extent and technical nature of the processing that occurs in each country, thus taking into account the “resources expended on product design and development, extent and nature of post-assembly inspection procedures, and worker skill required during the actual manufacturing process” when making country of origin determinations.<sup>68</sup> Therefore, the flexibility to analyze individual components and manufacturing processes could lead to more precise country of origin determinations, despite the complex nature of global manufacturing.

## Conclusion and Options for Congress

Rules of origin are central components of trade policy. Preferential rules of origin are especially important for ensuring that only goods qualified to receive benefits under an FTA or preference receive those benefits. ROO may also be constructed to ensure that import-competing U.S. producers are not adversely affected by an FTA, thus possibly assuring a degree of public support for the measure. Non-preferential rules are essential for making sure that goods coming from countries that enjoy MFN status with the United States are assessed the proper tariffs, and are also key to supporting other U.S. trade laws, such as country of origin labeling.

At present, CBP makes non-preferential country of origin determinations primarily based on an established body of regulatory and legal precedents. For many imports, determining origin is relatively straightforward. However, if the matter is in doubt, the origin question is decided on a case-by-case basis with input, records, and samples provided by the importer of record.

Although origin rulings are fact-specific, there is sometimes uncertainty over what will be deemed as substantial transformation. Businesses sometimes criticize CBP and the current process as lacking clarity, consistency, and predictability.<sup>69</sup> Additionally, given the expanding use of preferential ROO as the United States potentially enters into additional FTAs, determining country of origin (or waiting for rulings from CBP) may prove to be a significant burden on importers, especially on smaller firms.

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(...continued)

though many of the parts were of foreign origin, including the lenses, circuit boards, lens reflectors, rubber gaskets, and plastic bodies. CBP found that the various imported components “lose their identities ... are substantially transformed as a result of the operations in the United States and become an integral part of a new article possessing a new name, character, and use.” In addition, CBP found that the assembly process and a light-emitting-diode (LED assembly) of U.S. origin represented a majority of the costs involved in making the product. See Customs Rulings Online Search System (CROSS), at <http://rulings.cbp.gov>.

<sup>67</sup> In Customs Ruling HQ H021398 *Country of Origin of Ball Seals*, CBP determined that two types of ball seals made of five parts (three of U.S. origin and two sourced in China) that were shipped to China for a final assembly process were of U.S. origin for purposes of the “Buy American Act” because “the U.S.-origin components impart the essential character to the assembled seals” and that “the Chinese operations are simple assembly operations that involve a small number of components and do not appear to require a considerable amount of time, skill, or attention to detail.” See Customs Rulings Online Search System (CROSS), at <http://rulings.cbp.gov>.

<sup>68</sup> Ibid.

<sup>69</sup> COO Marking Report, pp. 2-5.

With regard to non-preferential rules, the United States has agreed to an ongoing Harmonization Work Program (HWP) under the auspices of the WTO Committee on Rules of Origin and the World Customs Organization. According to the USTR, however, reaching agreements on the technical aspects of the HWP are more complex than initially envisioned, and negotiations are expected to continue.<sup>70</sup> Congress could, through legislation or other means, encourage the Administration to exercise leadership in this area with a view toward reaching a resolution to these negotiations. In fact, one of the principal negotiating objectives set forth in the Trade Act of 2002 was the conclusion of an agreement on rules of origin.<sup>71</sup>

Some observers assert that preferential ROO are inefficient and lack transparency. However, negotiators sometimes make incremental changes. For example, since October 2009, NAFTA partners have implemented four sets of changes to the NAFTA rules of origin. The fourth set of changes, agreed in January 2011, covered products whose annual trilateral trade exceeds \$90 million.<sup>72</sup> Therefore, it is possible for preferential ROO to be simplified through mutual agreement of the parties even after an FTA is implemented. If Congress desires to provide greater preferential access to the U.S. market (and gain reciprocal access to the markets of trading partners), it could urge U.S. negotiators to liberalize ROO, and to examine the costs and benefits of applying a uniform set of preferential ROO with respect to future FTA negotiations.

Since the processes of globalization are likely to continue making origin determinations more complex, Congress might also consider providing CBP with additional legislative guidance, especially in the area of non-preferential rules. However, such efforts may adversely affect importers and manufactures that benefit from the current system. In addition, even though the determination process may be complex and lengthy, CBP has the flexibility to examine the complete manufacturing process, including design, sources of intermediate components, labor costs, and assembly processes in order to make its country of origin determination.

Some trade policy analysts have called for the liberalization or revision of industry-specific preferential rules of origin. Others advocate the abolition of rules of origin entirely, because they inject a large amount of inefficiency in the world trading system, and because they can effectively serve as a form of protection for import-competing industries. Some trade policy analysts argue for the multilateral elimination of tariffs, which, they say, would eliminate the need for ROO entirely.<sup>73</sup> However, the end of tariffs would automatically lead to the end of all preference programs for developing countries, as well as the tariff preference benefits of FTAs. In addition, eliminating ROO entirely could pose issues for other trade policy objectives such as collecting trade statistics, country of origin labeling, implementing trade sanctions, enforcing trade remedies, and other trade policy objectives.

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<sup>70</sup> Ibid.; USTR Trade Policy Agenda.

<sup>71</sup> P.L. 107-210, §2102 (13).

<sup>72</sup> United States Trade Representative, *2011 Trade Policy Agenda and 2010 Annual Report*, January 2011, p. 123.

<sup>73</sup> Ibid.

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