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CHALLENGES FACED BY LDCS IN COMPLYING WITH PREFERENTIAL RULES OF ORIGIN UNDER UNILATERAL PREFERENCE SCHEMES

Paper Presented by Uganda on Behalf of the LDCs Group

The following submission, dated 21 October 2014, is being circulated at the request of the Delegation of Uganda.

Background

At the last Committee on Rules of Origin (CRO) of 10 April 2014 the Chairman recalled that the last WTO Ministerial had adopted a Decision on Preferential Rules of Origin for LDCs (WT/L/917). Paragraph 1.10 of the Decision mandated the CRO to "annually review developments in preferential rules of origin applicable to imports from LDCs" and "report to the General Council".

The Chairman also proposed in addition and as a separate initiative, "to intensify efforts in the CRO to exchange information regarding existing preferential rules of origin for LDCs".

Uganda, on behalf of the LDCs welcomed the Chair's proposal and informed "the CRO that the LDC Group would prepare a paper outlining the challenges faced by LDCs in complying with existing rules of origin to facilitate discussions and foster exchange of information in the CRO".

The CRO agreed to engage in a transparency and out-reach exercise "where the Secretariat would prepare a background note describing the current state of notifications to be examined during a dedicated agenda item by CRO. An additional contribution to this dedicated agenda item would be the paper to be submitted by the LDCs about their specific challenges. While the results of the first proposal would be part of the CRO's report to the General Council and the LDC sub-committee, the results of the second would not.

This paper is the first contribution of Uganda on behalf of the LDCs under the above-mentioned agenda item. It is hoped that this first contribution will prove useful since the LDCs group is in the process of identifying further evidence and concrete cases that would serve as additional elements for further contributions to be discussed at the next CRO meetings.

1 BRINGING FORWARD THE ROO AGENDA FOR THE LDCS: CHALLENGES AND OPPORTUNITIES

1.1. The challenges of the LDCs in complying with the current rules of origin under the different DFQF schemes have been at the basis of the elaboration and evolution of the LDCs proposals on rules of origin[1] that ultimately culminated in the Bali Decision on preferential rules of origin. The opening of an agenda item in the CRO to exchange views and experiences is a welcome opportunity for the LDC group to share their lessons learned and the technical reasons that had led the LDC group to advocate for certain best practices in the area of RoO.

1.2. As contained in the Proposal on rules of origin circulated by the LDCs among WTO members[2] there is no better way to define the challenges faced by the LDCs in complying with RoO than the following excerpts from the EU internal assessment report carried out to evaluate the impact of a change in existing rules of origin:

1.3. **Rules[3] of origin are old and have not followed evolutions in world trade.** The present rules were initially drawn up in the 1970s and they have not materially changed much since, whereas the commercial world has. They were also based on the need to protect Community industry and on the premise that beneficiary countries should be encouraged to build up their own industries in order to comply. In most cases, this has not happened. Instead, there has been a trend towards the globalization of production, but rules of origin have not been adapted to this. At the same time, compliance costs are high and the paper-based procedures are outdated.

1.4. **....Lower preferential margins combined with high compliance costs make preferences unattractive**. As a result of successive rounds of trade agreements, preferential margins are much smaller than they used to be.

[1] See WTO document (TN/CTD/W/29 and TN/MA/W/74 and TN/AG/GEN/18 of 6 June 2006) to the NAMA and Agriculture Committees and to the Committee on Trade and Development.TN/CTD/W/30/Rev.2 and TN/MA/W/74/Rev.2 TN/AG/GEN/20/Rev.2 of 24 June 2011 and the last version before Bali WTO document TNC/C/63 of 31 May 2013.

[2] See WTO document TNC/C/63 of 31 May 2013.

[3] From *"Impact assessment on rules of origin for the Generalized System of Preference (GSP) European Commission, Brussels 25 October 2007 Taxud/GSP-RO/IA/1/07 (page 16).*

1.5. **...The dilemma of LDC**s is well illustrated by the information received from countries requesting derogations from rules of origin. Such countries have little or no domestic fabric production, which means they have to import it (so failing to comply with the "two stages of processing" rule) and add only between 27 per cent and maximum 40 per cent in value.

1.6. Since the launching of the Duty free Quota (DFQF) initiative in the 1996 Singapore Ministerial Declaration[4] rules of origin for LDCs started to be the subject of debate. The LDC Ministerial Declarations of Dhaka and Livingstone contained language referred to origin[5] without however expressly mentioning what kind of rules of origin was needed by the LDCs.

1.7. The Decision reached at the Hong Kong WTO Ministerial in 2005, as contained in Annex F of the Ministerial Declaration, states "*inter alia"* that WTO Members agreed to ensure that "*preferential rules of origin applicable to imports from LDCs are transparent and simple, and contribute to facilitating market access*".

1.8. Although useful, this language did not define what "transparent and simple" rules of origin might be, nor provided for or established a working group to define such concepts. In the immediate discussions, which followed the post - Hong Kong framework, preference giving countries reiterated the fact that since preferences are unilateral, then rules of origin under the DFQF cannot be discussed or negotiated. This was an exact replica of their position in the early '70s[6] to agree on a common set of rules of origin, when GSP rules of origin were discussed in the UNCTAD working-groups on rules of origin.

1.9. From a legal point such a stance is perfectly justifiable; however it would devoid of significance any attempt to hold meaningful discussions on how to improve the existing rules of origin for LDCs[7].

1.10. What is argued by the LDCs is that it is simply anachronistic to maintain unaltered the same rules of origin as if the world trading system was like the one in the '70s. After more than 40 years successive rounds of negotiations have substantially lowered the preferential margins[8], dramatic change in technologies and transport, information technology and communication occurred. The fragmentation of production and the global value chains approach have defeated any argument for a vertical integration of industrial sectors underpinning the need for strict rules of origin.

1.11. The Trade Facilitation Agreement (TFA) demands a series of reforms in the way customs procedures operates including rules of origin to facilitate trade. Yet, with some notable exception that will be discussed in this paper, the Rules of origin of some preference giving countries are the same as those of the '70 and the arguments heard to maintain the status quo are almost exactly those of the '70.

1.12. As illustrated in this paper there is no evidence that some set of rules of origin are transparent and simple, or that they have been trade and investment creating in LDCs.

1.13. In order to initiate implementation of the commitment on rules of origin contained in the Hong Kong Decision of 2005, the LDCs group started as early as 2006 to work on a draft that could serve as a concrete proposal to make progress on the issue of rules of origin for DFQF.

1.14. This initiative was aimed at setting the stage for a sensible debate on rules of origin between LDCs and preference-giving countries on the basis of a legal text, rather than on declarations of

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[4] Available at http://www.wto.org/english/thewto_e/minist_e/min96_e/wtodec_e.html.

[5] For instance paragraph 12 of the Livingstone Declaration provides as follows: *Incorporation of provisions in the modalities on realistic, flexible and simplified rules of origin, certification and inspection requirements and technical and safety standards.*

[6] At the OECD Ad Hoc Group of the Trade Committee on Preferences, held in Paris in 1970, preference-giving countries expressed the view that, as preferences were being granted unilaterally and non-contractually, the general principle had to be that donor countries were free to decide on the rules of origin which they thought were appropriate after hearing the views of the beneficiary countries.

[7] This does not mean that the LDCs aspire to a common set of rules of origin as discussed below.

[8] Preferential margin is commonly referred to as the difference between the MFN rate and the preferential rate granted under the GSP or other preferences.

principles and statements. Zambia, in its capacity of WTO LDC coordinator, submitted the first fully fledged proposal to operationalize the wording[9] of the Hong Kong Decision.

1.15. The responses from preference giving countries to such proposal were not satisfactory, nor the level of comprehension of the LDC proposal. A series of meetings were held in 2007 with delegations of preference-giving countries, including the US; EU; and Japan. However these meetings were not particularly productive, since the focus was on defending the "status quo" rather than on discussing possible ways to multilaterally achieve LDC rules of origin that are "*transparent and simple, and contribute to facilitating market access*".

1.16. There were also misguided perceptions that either LDCs did not know what they actually wanted, or did not know how to proceed[10]. This was despite the fact that the LDC Group presented a detailed proposal on rules of origin to the Negotiating Group on Market Access in 2006. There was also a misperception[11] that the main objective of the LDCs was to achieve the harmonization of preferential rules of origin. Although desirable, the LDC Group never argued for harmonizing rules of origin.

1.17. The statement of the NAMA chair of 2007, on the adoption of "*best practices",* was in line with the position of preference-giving countries, who all believe that their particular preferential rules of origin constituted a "best practice", rather than discussing or even acknowledging the mere existence of an articulated proposal of LDCs circulating among WTO members.

1.18 It was only after protracted negotiations, that the summary of the NAMA chair contained the following statement, which finally reflected the LDC proposal: *"ensure that preferential rules of origin applicable to imports from LDCs will be transparent, simple and contribute to facilitating market access, in respect of non-agricultural products. In this connection, we urge Members to use the model provided in document TN/MA/W/74, as appropriate, in the design of the Rules of Origin for their autonomous preference programs*[12]".

1.19. From 2008 till the Bali Decision of December 2013 the LDC proposal on rules of origin was mainly discussed in the context of an LDC package. Such package took the final form of a WTO document[13] presented by Nepal as Coordinator of the WTO LDC.

1.20. Between 2008 and 2013, the LDC proposal on rules of origin underwent other two revisions, the first one with Bangladesh being the coordinator of LDC WTO group[14], and the second one with Nepal who coordinated the LDCs WTO group until the Bali WTO Ministerial[9].

1.21. A major boost of confidence to the value of the LDCs proposal and a recognition of the extreme need to reform LDCs' rules of origin (which remained almost unchanged for the last 40 years), came from the changes in the Canadian rules of origin in 2003, and the EU reform on the rules of origin which entered into force in 2011[15].

1.22. In particular, the EU reform introduced drastic changes to the EU rules of origin in favour of both the LDCs and developing countries, as follows:

- Introduced a differentiation in favour of the LDCs that are benefitting of more lenient rules of origin than Developing countries in certain sectors;

[9] See WTO document (TN/CTD/W/29 and TN/MA/W/74 and TN/AG/GEN/18 of 6 June 2006) to the NAMA and Agriculture Committees and to the Committee on Trade and Development.

[10] In his introduction to the Draft NAMA Modalities (JOB(07)/126) on 17 July 2007 the NAMA Chair, in paragraph 38, stated that "On the issue of improving rules of origin for duty-free, quota-free market access, neither the proponents nor the Members more broadly have a precise idea on how to proceed".

[11] The Chair in Draft NAMA Modalities (JOB(07)/126) on 17 July 2007 paragraph 38 stated that "I would note that harmonizing preferential rules of origin may not be the optimal solution and that there are best practices among Members that could be readily adopted to enhance the effectiveness of these programs".

[12] See WTO document TN/MA/W/103/Rev.3, 6 December 2008.

[13] See WTO document TNC/C/63 of 31May 2013.

[14] See WTO documents TN/CTD/W/30/Rev.2; TN/MA/W/74/Rev.2; TN/AG/GEN/20/Rev.2.

[15] See Commission regulation No 1063/2010 of 18 November 2010 amending Regulation (EEC) No. 2454/93 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code See Inama, *Per aspera ad Astra, the reform of the EU GSP rules of origin*, Journal of World Trade, 2011.

- Allowed a single transformation process in textiles and clothing[16] - a request that the LDCs have been advocating for more than a decade;
- Raised the threshold of the use of non-originating materials, in many sectors from 40 per cent to 70 per cent for LDCs;
- Eased the cumulation rules[17].

1.23. The EU and Canada have been so far the only preference giving countries that have conducted a unilateral reform of their rules of origin for LDCs. Such reform triggered dramatic increases in the utilization rates of existing preferences and, most importantly, generated an overall increase of trade flows thanks to new investment and manufacturing operation located in LDCs. Other preference giving countries have yet to do so, while a number of developing countries have introduced DFQF schemes containing RoO that need to be assessed.

1.24. This paper builds upon the results achieved by the these two preference giving countries to show that a change in RoO reflecting global value chains generates a market response in terms of investment and trade flows. Obviously RoO do not operate in a vacuum and a number of other factors are concurring in the determination of such trade effects. Yet the response has been unequivocal and concrete evidence has been obtained from companies that decided to shift production to an LDC because of a change of a RoO.

1.25. The paper also illustrates the difficulties in meeting certain origin criteria that are based on percentage criterion. It provides examples of best practices and it discusses possible improvements and changes in the light of the Decision on preferential rules of origin.

1.26. Finally this paper lists a number of areas where further contributions from the LDCs will be submitted to the CRO.

2 THE TRANSVERSAL ISSUES

2.1 Debate among form and content of RoO

2.1. In spite of the written statement of the LDCs[18] that the LDC group is not seeking harmonization of preferential rules of origin it has often been reiterated during the discussions and negotiations leading to the Decision on preferential rules of origin that the LDCs were, *de facto*, seeking harmonization of rules of origin.

2.2. This paper is intended as a basis for a transparency and outreach exercise. Therefore, it is useful to clear some misunderstandings and to establish a comfortable climate for a fruitful exchange of views.

2.3. The LDCs recognize the well-known fact that there are a variety of forms of rules of origin used by preference giving countries to determine origin. No one of these forms is necessarily better than the other.

2.4. Experience has shown that what matters the most beside the "form" of a given rule of origin is the "substance" of such rule of origin.

2.5. The *"form"* is the way in which the rules are written using different methodologies (namely a change of tariff classification at heading level, at subheading level with or without exceptions, percentage criterion or specific working or processing and their different variants).

2.6. On one hand, the "form" is not usually linked to the "substance" of the RoO since, quite apart from the way a RoO is drafted, the rule may be restrictive or lenient. On the other hand,

[16] The EU reform was preceded by the Canada reform of their DFQF in favour of LDC and rules of origin in 2003 expanding product coverage to textiles and clothing and cumulation among all beneficiaries of the Canadian GSP schemes.

[17] The value of this provision was later severely diminished by the graduation of many GSP beneficiaries from cumulation in the case of the new EU GSP entered into force in 2014.

[18] See Paragraph 1.25 of WTO document TNC/C/W/63 of 31 May 2013 where it is stated: *"Although desirable, nowhere had and has the LDC Group argued for harmonizing Rules of Origin."*

there are "forms" of RoO where a number of lessons learned and best practices have been recorded.

2.7. The important lessons to be learned from these experiences are summarized below:

- No matter how RoO are designed or drafted, they should reflect global value chains. If not, trade will not be created and trade preferences will be underutilized. RoO should not be used as a disguised form of industrial policy aiming at requiring substantial transformation in LDCs going beyond what is commercially meaningful and viable.
- One should begin by considering the desired objective of a given set of RoO separately from the drafting methodology. A distinction has to be made between the "form" of a given RoO and its "substance". The "substance" is the degree of restrictiveness of a RoO with respect to an existing value chain context in which it is expected to operate (in this case, the beneficiaries are LDCs, many of which are landlocked and islands countries).

2.8. For decades, LDCs have complained that the RoO attached to these trade preferences were overly stringent, requiring, for example, a double processing stage[19] in the clothing sectors that does not tally with existing value chains. The restrictiveness of the RoO is the reason why many of the preferences have not been utilized[20]. The graphs contained in section 0showing drastic increases in the utilization rates following the change in the EU rules of origin for clothing moving from a double processing stage to a single processing stage in HS chapter 61 and 62 are telling examples worth more than 1,000 words.

2.9. This being said, there are a number of lessons learned and best practices that have progressively emerged on how to draft of a given rule of origin (the "form"), especially the percentage criterion that is still used by a number of preference giving countries.

2.2 The issue of cumulation

2.10. Cumulation is a practice that allows to consider products originating in other countries or working or processing carried out in other countries as being a domestic product or working of processing. Cumulation may be granted at regional level as adopted by the majority of GSP preference giving countries[21] or among all the beneficiaries[22].

2.11. As stated in the LDC proposal[23], the view point of LDCs is rather clear on the issue of cumulation: "Although laudable and highly desirable, cumulation is not a substitute for liberal rules of origin. With liberal rules of origin, the LDC producers may source their inputs worldwide from the most competitive producer at the best prices".

2.12. In short, cumulation is not a substitute for introducing rules of origin allowing global sourcing from the most competitive supplier. In a manufacturing world dominated by the existence of supply chains LDC companies and investors should be allowed to source their inputs from the most competitive supplier rather than be provided incentives through cumulation to restrict sourcing and indulge in trade diversion practices. The case of AJ Company illustrated in section 3.2.1 in Cambodia shows the merit and the limits of cumulation.

2.13. Cumulation is a viable tool for regional integration arrangements at high or advanced industrial stage like ASEAN where cumulation has been mostly utilized. In other regions like Sub-Saharan Africa or islands LDCs with low industrial base and high cost of freight, cumulation offers limited possibilities and cannot replace liberal rules of origin.

[19] Double processing stage requires that in order to obtain originating status beneficiary countries need to use fabrics that have been woven or kitted domestically.

[20] See Erosion of trade preferences in the Post Hong Kong (China) framework: From trade is better than aid to aid for trade: UNCTAD, 2008, Trade Preferences for LDCs: An early assessment of benefits and possible improvements. UNCTAD/ITCD/TSB/2003/8. December 2003. Market Access for Least Developed Countries. UNCTAD/DITC/TCND/4, May 2001.

[21] For instance the EU, Japan and the US are granting regional cumulation under their GSP schemes.

[22] For Instance Canada under its GSP grants cumulation among all beneficiaries.

[23] See WTO document TNC/C/63 of 31 May 2013.

3 THE TECHNICAL ISSUES

3.1. As mentioned above there are various forms of RoO and there is no unanimous evidence that one form is better than another one. This being said, the distinction among the "Form" and "Substance" of a given rule of origin has the merit to clearly define the areas where there are lessons learned and best practices that may be adopted.

3.2. The "form" of a given rules of origin is in fact a technical exercise that is rather objective and less prone to trade policy considerations that are rather preponderant when discussing the substance of a given rules of origin.

3.3. Under the section 3.1 below the lessons learned from drafting "the form" of rules of origin are discussed. These lessons learned, at the time of this writing, are mainly related to the percentage criterion.

3.4. Section 3.2 will illustrate how to improve the substance of a given rule of origin relating it to evidence arising from the utilization rates following the reform of the Canadian and EU GSP rules of origin. Such evidence will also be contrasted with the utilization figures of the US and Japan that have yet to introduce a reform in their rules of origin[24].

3.1 Improving the "form": Lessons learned from drafting the form of percentage criterion rules of origin

3.5. As discussed the "form" of a given rule of origin may be expressed or drafted according to different techniques such as change of tariff classification, with or without exceptions, specific working or processing or a percentage criterion. As discussed none of these "forms" may be necessarily better than the other one. However there are number of lessons learned from the LDC practice when using the percentage criterion. Focusing the analysis on the percentage criterion should not be read or understood that the LDCs believe that the percentage criterion is the preferred "form" of rule of origin.

3.6. Percentage criterion is a "form" of drafting rules of origin requiring to meet or not to exceed a given percentage calculated by using a numerator and a denominator. There are various forms of percentage criterion:

a) Value addition (35 per cent) calculated as a percentage of the cost of local originating material, labour and direct cost of processing out of the ex-factory price of the finished product. This is the method used, for example, under the US GSP and AGOA. This method is also used, albeit with other level percentages required and different definitions of the numerators and denominators by other preference giving countries like Australia; Canada; New Zealand and Eurasian Customs Union[25].
b) Value addition defined as subtraction of the value of imported material out of the ex-works (or "adjusted value" in US terminology). This, for example, is the "build down" method used under the United States - Central America Free Trade Agreement (US- CAFTA).
c) Allowance of a maximum amount of foreign inputs as a percentage of the ex-work price (EU current practice under EBA and many FTAs as well as Japan practice using the FOB price as a denominator[26]).

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[24] In the case of Japan some changes of rules of origin have been introduced. However a first assessment shows that the changes were of limited scope.

[25] The intrinsic limitations and scarce trade facilitation effects deriving from the use by preference giving countries of different calculations methods and different level of percentages are evident as early witnessed in an UNCTAD document: As earlier mentioned a preference-receiving country pointed out that insuperable obstacles were caused by the need to devise and operate an accounting system that differed in the definition of concept, application of accounts, precision, scope, and control from its internal legal requirements. The system must provide the costing information to satisfy the rules of the countries of destination, to check the shares of domestic and imported inputs in the unit cost of the exported goods, in some cases identifying the country of origin of the inputs and establishing direct and indirect processing costs.

[26] It has to be noted that both EU and Japan under the current GSP rules of origin do not use the percentage criterion as an across the board criteria. The Percentage criterion is only used in the context of certain product specific rules of origin contained in an extensive list detailing the product specific rules of origin. With respect to the ex-works price the FOB price includes inland transport to the port of embarkation.

3.7. Limitations in using the percentage criterions are well known and may be quickly summarized as follows:

a. Percentages calculations are easily affected by movements in exchange rates for finished products that have imported raw materials, in that, when a local currency appreciates, the percentage value added tends to decline, and vice-versa;
b. The level of percentage threshold may be arbitrarily set and it is difficult to set it up even with consultations with the private sector given the number of variables costs and products to take into account;
c. The costs of labour in developing countries is relatively cheap and in a value added calculation, it may turn an asset into a penalty; and
d. The calculations may be difficult entailing some accountancy expertise and a certain amount of discretion in assessing costs that may lead to dispute plus accountancy skills generally not available in most small firms in LDCs.

3.8. There are important differences in the formulation of the numerator and calculation of percentages. The major differences in the numerator reflect two approaches, one, which places a maximum limit on the use of, imported material like the EU and Japan and the other one which places a minimum limit of value added as in case of the US GSP represented by cost of local materials + direct cost of processing.

3.9. A third variation is a valued added calculation obtained by subtraction as in the build-down calculation of the US-Central America Free Trade Area and other FTAs.

3.10. Lesson learned in preferential rules of origin and in the net cost calculations in NAFTA has amply demonstrated that the formulation of percentage criterion calculations as value added or "domestic content" are complex. They entail detailed rules to define what are allowable and not-allowable costs that can be counted as numerator in a values added calculation.

3.11. These elements may be familiar only to accountants. As prices, costs and quantities change, recalculation will be necessary to ensure compliance. While some of these tasks may form part of the normal accounting procedures required for commercial purposes, some may not. In such cases therefore additional professional expertise may be required. The calculation of the numerator in a value added calculation is complex as it entails:

i. A distinction of costs, which could be computed as local value added;
ii. Itemization of such cost to the single unit of production. As a consequence it often requires accounting, and discretion may be used in assessing unit costs;
iii. Additionally, currency fluctuations in beneficiary countries may affect the value of the calculation.

3.12. The US has progressively restricted the use of such value added calculation that under NAFTA was referred to as net cost calculation to limited items in the automotive sector and the EU that initially planned to use such calculation in its reform of the GSP rules of origin has dropped it.

3.13. The following example illustrates how the application of the import content rule permits a more liberal system for determining the origin than the domestic content requirement.

Table 1

	Import content (max 50%)	Domestic content (direct cost of processing min 35%)
(a) Domestic materials	1.00	1.00
(b) Foreign materials (not substantially transformed)	4.00	4.00
(c) Direct cost of processing	2.00	2.00
(d) General expenses	1.50	1.50
(e) Profit	1.50	1.50
(f) Appraised value	10.00	10.00
(g) Import content/domestic content	40% (rule satisfied) (b/f) x 100	30% (rule not satisfied) [(a+c)/f] x100

3.14. As the example contained in Table 1 shows, a product in a regime of import content would qualify for preferential treatment because the cost of imported materials (US$4) is not more than 50 per cent of the appraised value (US$10). The same product from a beneficiary of the scheme would not qualify for preferences because the cost of domestic materials (US$1) plus the direct cost of processing (US$2) is less than 35 per cent of the appraised value (US$10).

3.15. In the light of the above mentioned lessons learned and best practices that are progressively adopted, the LDCs are of the view that a calculation methodology based on a value of materials calculation should be preferred when preference giving countries are using a percentage criterion. This methodology eliminates most of the shortcomings of a value added calculation. The value of material calculation is based on the WTO Customs Valuation Agreement anchoring the rules to a multilateral instrument in use by WTO Members.

3.16. This method of calculation is similar to the one used by the US in recent FTA agreements with Australia; Singapore; Chile; Central America; and other countries. The EU and Japan are also using a value of material calculation in their GSP scheme and in their FTAS.

3.2 The percentage criterion calculation proposed by the LDCs

3.17. The LDCs are therefore proposing that when preference giving countries are using a percentage calculation they use a methodology based on a value of material calculation

3.18. Such methodology used to calculate the percentage criterion may be based on two formulas defined as value on non-originating materials and value of originating materials, using best practices from the US, EU, Japan and Canada:

3.19. Method Based on Value of Non-Originating Materials: $LVC = \frac{EW - VNM}{EW} \times 100$

3.20. Method Based on Value of Originating Materials: $LVC = \frac{VOM}{EW} \times 100$

- VNM is the value of non-originating materials that are acquired and used by the producer in the production of the good; VNM does not include the value of a material that is self-produced; and
- VOM is the value of originating materials acquired or self-produced, and used by the producer in the production of the good.
- EW is the ex-works price
- LDC is the LDC value content

3.3 The issue of the level of percentages

3.21. Another intrinsic limitation of the percentage criterion is setting the level of percentage. The first criticism is derived from the fact that, even if determined through consultations with the private sector, setting an adequate level of percentage tends to be arbitrary as it may change from time to time due to variations in the cost of the inputs and currency fluctuations.

3.22. Moreover the level of the percentages may be different from product to product and the stringency or leniency of a given percentage depends on the calculation methodology.

3.23. Recent experience of preference giving countries has also been taken in account. In 2003 the Canadian Government introduced changes in rules of origin, setting a 60 per cent maximum import content allowance (instead of the 40 per cent permitted for other developing country GSP beneficiaries) for LDCs. This means that to qualify for the LDC duty-free treatment, at least 40 per cent of the ex-factory price of the goods packed for shipment to Canada must originate in one or more LDC beneficiary countries or Canada. In addition, 20 per cent of the 40 per cent qualifying content could originate from other developing countries that are beneficiaries of the Canadian GSP scheme. Special rules for textile and clothing were also introduced allowing the use of imported fabric from other beneficiaries of the Canadian GSP scheme, provided that they do not exceed 75 of the ex-factory price of the final goods.

3.24. In addition to findings resulting from field research, the EU Impact Assessment contained simulations exercises on the trade creation deriving from using different percentages of 50 per cent of local content and 30 per cent. The policy implication of the simulation exercise is that the trade creation results from the simulation exercise were far greater under 30 per cent level of percentage.

3.25. Hence, the final reform of the EU rules introduced, for a number of goods, a threshold of 30 per cent of local value content equivalent to a maximum allowance of foreign import of 70 per cent.

3.26. The introduction of a 70 per cent allowance of non-originating material as a default rule in many HS chapter of the EU Rules of origin[27] represents a watershed insofar as the most liberal percentage ever used by preference giving countries so far. The results and trade effects of such trade liberalization are illustrated in section 3.2

3.27. This table compares the existing level of percentages in major preference giving countries schemes.

Table 2: Summary comparative table of the Quad rules of origin percentage criteria for LDCs[28]

Country	Numerator	Denominator	Percentage Level	Cumulation
European Community (EBA)	Value of non-originating material	Ex-works price	Maximum amount of non-originating material 70%. Exception under Chapter 27 and Chapter 63: 25%, 40%, 50% where used in the single list.	(a) Cumulation with the European Union, Norway, Switzerland and Turkey; (b) Regional cumulation: ASEAN, Andean Community, SAARC, Mercosur; (c) Cumulation between ASEAN and SAARC; and (d) Extended Cumulation.
Japan	Value of non-originating materials	Value of the FOB price	Maximum amount of non-originating material 40% or 50% where used in the single list	Cumulation of Indonesia, Malaysia, the Philippines, Thailand and Viet Nam
Canada	Originating contents	Ex-factory price	Equal or greater than 40%	All GPT beneficiary countries are regarded as one single area. All LDCT beneficiary countries are regarded as one single area.
United States GSP[29]	Sum of the cost of value of material produced in the beneficiary developing country and the direct cost of processing	Appraised value of the article at the time of entry into the United States	Minimum of 35%	Regional cumulation for GSP-eligible members of Andean Group, ASEAN (Excluding Singapore and Brunei Darussalam), CARICOM, SADC and WAEMU.

[27] One may suggest that such liberal rule occurs in electronic and machinery sector where MFN rates of duty are low and the room for preferential margin is limited. As demonstrated by the case of bicycle where the MFN rate is as high as 12 per cent this suggestion does not stand a close scrutiny.

[28] It has to be stated the both the EU and Japan are using the percentage criterion together with other criterion such as the CTC and working or processing requirements

[29] US GSP: http://www.ustr.gov/trade-topics/trade-development/preference-programs/generalized-system-preference-gsp.

Country	Numerator	Denominator	Percentage Level	Cumulation
AGOA	Same as above	Same as above	Same as above[30]	Cumulation among AGOA-designated countries.

3.28. From the comparison table above it emerges quite clearly that the level of percentage required should not be considered in isolation since the extent of the cumulation, the different numerators and denominators used also play an effect on the stringency or leniency of a given percentage. The case of Canada is revealing since rather demanding requirement of 40 per cent is lessened by the opportunity of cumulation with all GPT beneficiaries including countries like China having a large manufacturing base that could supply inputs to neighbouring LDCs. This possibility however will be severely limited by the graduation policy of Canada taking into effect in 2015. According to this graduation policy Canada will be removing benefits from 72 higher-income and trade-competitive countries, effective 1 January 2015 including China and therefore no cumulation will be possible with the graduated countries. While the Government of Canada has expressed the intention to take action to ensure that the benefits of the Least Developed Country Tariff (LDCT) regime would not be reduced by changes to GPT country eligibility[31], no further action has been taken at time of this writing. Such graduation policy is not unique to Canada since also the EU has introduced in 2014 a new graduation policy that has affected around 54 countries[32]. Cambodia bicycle industry has been particularly affected by this graduation since it could no longer use bicycles gears made in Malaysia. A derogation has been later granted by the EU to obviate such situation.

3.29. Besides Canada, what may be observed from the above table is that even by taking into account the different level of numerators and denominator the level of percentages are the most generous in the case of the EU, followed by the US, even if the method of calculation is different, with Japan being the less generous.

3.30. This should not come as a surprise since the US has not changed its rules of origin since the time it enacted the first GSP in 1974 and Japan has introduced limited changes in its GSP rules of origin since their inception in the '70.

3.31. Table 3 compares the use of the different percentage criterion used by Japan and the EU. It is evident that in the case of the EU 40 HS chapters and 638 headings are benefitting a 70 per cent percentage rule while Japan does not allow such a percentage. In 38 chapters and 580 headings the EU allows the use of alternative rules of origin among a change in tariff heading and percentage criterion, a flexible approach while Japan does not provide for such possibility.

3.32. In 141 heading Japan requires the compliance with the rules of origin and percentage criterion while such cases are limited to 54 headings in the case of the EU.

3.33. It is evident that the EU has engaged in a meaningful reform that has generated a number of positive changes for the LDCs. Such reform and policy changes have yet to occur in the case of the US and Japan. Such difference is reflected in the results achieved by these respective countries in boosting LDC trade and increase utilization rates of the GSP Schemes as discussed in section 3.2.

[30] Two additional rules: (a) The cost or value of materials produced in the customs territory of the United States may be counted towards the 35 per cent requirement up to a maximum amount not to exceed 15 per cent of the article's appraised value; and (b) The cost or value of the materials used that are produced in one or more beneficiary sub-Saharan African countries shall be counted towards the 35 per cent requirement.

[31] See General Preferential Tariff Withdrawal Order (2013 GPT Review) P.C. 2013-967 27 September 2013.

[32] See for the name of these countries http://trade.ec.europa.eu/doclib/docs/2013/december/tradoc_152015.pdf.

Table 3

		Number of headings/ chapters where the percentage criterion as exclusive* RoO criteria	Number of headings/ chapters where the percentage criterion is used as additional**	Number of headings/ chapters where the percentage criterion is used as alternative*** RoO criteria with CTH	Number of headings/ chapters where the percentage criterion is used at 40% or less	Number of headings/ chapters where the percentage criterion is used at 50%	Number of headings/ chapters where the percentage criterion used is 70%	Number of headings/ chapters where the percentage criterion is used at 30% or 20%
EU	Headings	88	54	580	62	18	638	4
EU	Chapters	6	4	38	7	1	40	
Japan	Headings	0	141	0	112	29	0	
Japan	Chapters	0	5	0	4	1	0	

* only pc(*)
** another RoO and pc(*)
*** another RoO or pc(*)

In % total headings/chapters

Total Headings	1,224
Total Chapters	97

		Percentage of headings/ chapters where the percentage criterion is used as exclusive* RoO criteria.	Percentage of headings/ chapters where the percentage criterion is used as additional**	Percentage of headings/chapters where the percentage criterion is used as alternative*** RoO criteria with CTH	Percentage of headings/ chapters where the Percentage criterion is used at 40% or less	Percentage of headings/ chapters where the Percentage criterion is used at 50%	Percentage of headings/ chapters where the Percentage criterion is used at 70%	Percentage of headings/ chapters where the Percentage criterion is used at 30% or 20%
EU	Headings	7.19%	4.41%	47.39%	5.07%	1.47%	52.12%	0.33%
EU	Chapters	6.19%	4.12%	39.18%	7.22%	1.03%	41.24%	
Japan	Headings	0.00%	11.52%	0.00%	9.15%	2.37%	0.00%	
Japan	Chapters	0.00%	5.15%	0.00%	4.12%	1.03%	0.00%	

3.34. The LDC Group has assessed various literatures in the search for a level of percentage[33] that may reflect supply chains and be adequate to their industrial level. It has made use of a survey conducted among Eastern and Southern Africa and other evidence from recent studies conducted by researchers hired by preference giving countries. Another survey is currently being carried out in LDCs to gather additional evidence with the help of a questionnaire.

3.35. Such review of the literature has indicated that in the majority of cases the required percentages by the preference giving countries are not realistic when confronted with industrial reality. Recent examples of manufacturing like the iPod in China show that the local content is around 10 per cent.

3.36. On the basis of the above mentioned best practices and lessons learned the LDCs consider that a level of percentage of 15-25 per cent or even lower for certain category of products calculated according to the build-down formula mentioned above would guarantee that substantial transformation takes place and the genuine manufacturing operations have been carried in LDCs.

3.4 Treatment of costs of freight and insurance in the value of originating and non - originating inputs

3.37. The majority of LDCs have a very basic, in most cases, barely existent industrial base. It is clear that in such situation LDCs, especially land locked and islands countries are relying on inputs imported from third countries to manufacture their finished products.

3.38. As shown above in Table 2, Preference Giving countries are using different kind of numerators and denominators in the calculation methodology of the percentage rule.

3.39. The definition of the numerator and the denominator matters in the arithmetical calculation formula. There are a variety of experiences in the definition of the numerator and denominator. In principle they should allow a fair comparison reflecting on one side the cost (and profit) of the finished product and on the other side, the cost of the foreign materials used or the local content added. The addition or exclusion of certain costs such as cost of insurance and freight may alter the results of the calculation.

3.40. It is thus suggested that the "form" of percentage formulas used takes into account the special situations related to the transport costs of input materials to LDCs, especially Islands and landlocked LDCs or if not possible that such formulas take into account these factors by adjusting accordingly the level of percentage.

3.41. Such kind of rules of origin that are allowing adjustments to the cost of material by deducting or adding the cost of freight and insurance are already existing in US FTAs like US-CAFTA.

3.5 Improving the "substance" of a RoO: Evidence from utilization rates

3.42. The expected trade effects of trade preferences may be best summarized by the original objectives of the Generalized System of preferences, namely

a) To increase export earnings;
b) To promote manufacturing; and
c) To accelerate rates of economic growth.

[33] See for instance:, Impact assessment on rules of origin for the Generalized System of Preference(GSP) European Commission, Brussels 25 October 2007 Taxud/GSP-RO/IA/1/07, Evaluating the Consequences of Shift to a Value-added method for Determining Origin in EU PTAs", July 2006 (Letter of Contract No. 2005/103984, Framework Contract AMS/451 - LOT No. 11), Dr. Michiel Scheffer of Saxion Hogescholen, "Study on the application of value criteria for textile products in preferential rules of origin", October 2006 (Tender 06-H13). Contract Cadre FISH/2006/20, Specific Convention N° 3 "Rules of Origin in Preferential Trade Arrangements: New rules for the fishery sector, Trade Preferences for LDCs: An early assessment of benefits and possible improvement in the context of WTO negotiations. UNCTAD/ITCD/TSB/2003/8. December 2003, An assessment of the impact of Preferences Erosion and Rules of Origin in Eastern and Southern Africa, a survey of ESA exporters, UNCTAD and COMESA, f 2010.

3.43. As stated earlier simple and transparent rules of origin for LDCs are those rules of origin permitting a full utilization of trade preferences.

3.44. In fact the mere granting of tariff preferences or duty-free market access to exports originating in LDCs does not automatically ensure that beneficiary countries effectively utilize the trade preferences. Preferences are conditional upon the compliance with rules of origin requirements mainly consisting on a) compliance with origin criteria b) documentary evidence (certificate of origin form A or declaration by exporter/importer c) transport requirements in case the products have not been shipped directly.

3.45. As a result, even when a wide product coverage suggests potential benefits in terms of preferential market access to LDCs, the actual utilization of such preferences could be limited. A clear indicator of the effectiveness of trade preferences is the utilization rate. Such an indicator is the ratio of the amount of imports, which actually received trade preferences at the time of customs clearance in the preference giving country, to the amount of dutiable imports eligible for preferences. This is the most realistic measurement of the effectiveness of trade preferences.

3.46. To be accurate and reliable the utilization rate are based on the customs declaration made by the importer at the time of importation[34]. Higher or lower utilization rates are mainly the result of the stringency and/or complexity of rules of origin and ancillary requirements.

3.47. The importance of utilization rates should, however, not lead to overlook other factors in assessing the value of trade preferences and the measurement of the restrictiveness of a given rules of origin.

3.48. Records of high utilization rates, on average or for some product categories, do not always mean that market access at preferential rates and rules of origin exists and has been effective. High utilization rates may be easily obtained for very low amount of trade due to the fact that trade preferences and associated rules of origin have been incapable of generating trade and investment effects in LDCs. For instance, UNCTAD recorded that the United States had record very high utilization rates on textile and clothing products (94.8 per cent) since 2001[35]. However such high utilization rate was obtained in few tariff lines with minimal trade value since textile and clothing are in general excluded from the product coverage of the US GSP.

3.49. As analysed in sections 3.6 and 3.8, changes and reform of rules of origin may have a significant impact on trade and investment decision of companies located in LDCs or neighbouring countries that may be attracted by favourable rules of origin and market access condition to relocate in LDCs. Obviously rules of origin are just one of the many factors triggering investment decision and trade dynamics. However as shown in sections 3.6 and 3.8, there are marked differences in utilization rates and trade dynamics in preference giving countries that embarked on reform of their rules of origin like the EU and Canada and those like the US and Japan that have yet to do so.

3.50. The trade data and utilization rates used in this section of the paper are those notified by preference giving countries to the UNCTAD secretariat. In the case of the US the data has been extracted from the USITC website.

3.51. Given the preponderance of fuels in the exports and of the fact that raw agricultural products normally meet rules of origin requirement by being wholly obtained the trade data analysis focus on the remaining products

3.6 Trade effects of reforms of rules of origin in utilization rates (EU and Canada)

3.52. As discussed in section 1 Canada and the EU are the preference giving countries that have successfully engaged in a major reform of their rules of origin.

[34] Another technique used is to run questionnaire to exporters asking if they are using or have used trade preferences. This is the method used by various surveys carried out by the Asian Development Bank and JICA.

[35] Improved Market Access for Least Developed Countries, UNCTAD/DITC/TNCD/4, May 2001.

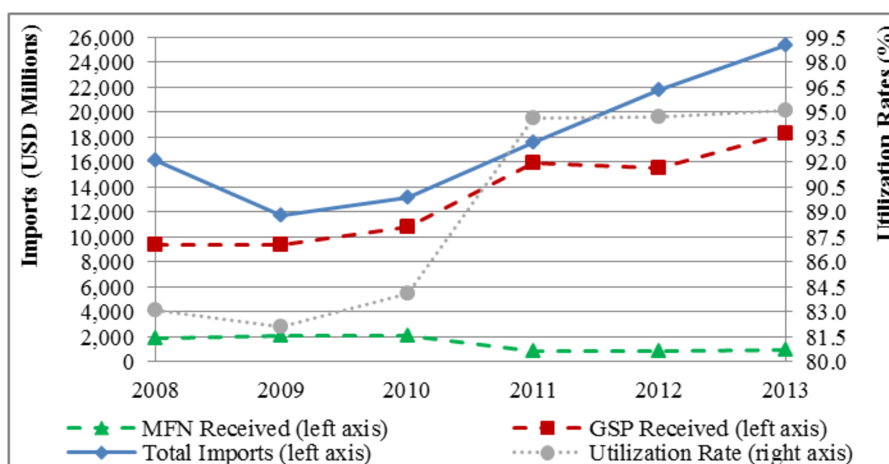
3.53. The newly created trading opportunities and the value of the reform were immediately seized by those LDCs that were better equipped and represent the most concrete example of how a change on rules of origin can trigger market responses in terms of access to value chains, productivity and job creation in LDCs.

3.54. Given the fact that fuels and raw agricultural products are in most cases wholly obtained products not meeting particular rules of origin difficulties, the analysis tends to exclude those products except where ,as in the case of the US, they play an important role in better appreciating the utilization of trade preferences.

3.7 The case of the reform of the EU and Canadian rules of origin: Trade effects and utilization rates

3.55. Figure 1 shows that when fuel and agricultural products are excluded the figures of total imports of the EU from LDCs shows a steady increase from 2010 to 2013 utilization rates follow a similar path raising from 89 per cent to 99 per cent.

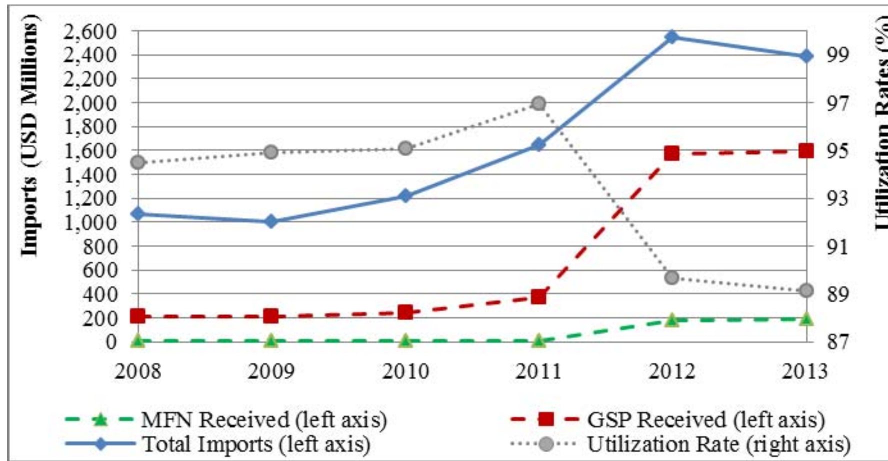
Figure 1[36]: EU Imports from LDCs and Utilization Rates - Non-Agricultural Products excluding Fuels



3.56. Figure 2 shows for Canada a similar pattern than the EU from 2008 overall imports have increased and the amount of GSP received trade also increased. Utilization rates jumped from 89 per cent to 95 per cent in the case of the EU while in the case of Canada there was a decline from 97 per cent in 2011 to 89 per cent in 2013.

[36] The trade data and utilization rates used in figures 1 to 17 are based on calculations drawn from notifications by preference giving countries to the UNCTAD secretariat.

Figure 2: Canadian Imports from LDCs and Utilization Rates - Non-Agricultural Products excluding Fuels



3.57. Given the export composition of LDCs the most dramatic effects of the rules of origin reforms concerned sectors and countries where LDCs had export potential and were affected by stringent rules of origin. The most important sector by far in terms of trade dynamics and increase of utilization is the clothing sector of HS 61 and 62.

3.58. The figures below provide evidence that the Canadian and EU reform of rules of origin undertaken respectively in 2003 and in 2011 have significantly impacted both utilization rates and the import values, the former reacting faster.

3.59. In the case of Canada imports from LDCs exponentially increased and the utilization rate immediately reached 100 per cent. The rise has been particularly strong, for garments of HS chapter 61, knitted and crocheted whose import values rose from approximately US$17.8 million to US$857 million between 2002 and 2011 to reach US$966 million in 2013. Figure 4 illustrates this same impact in Cambodia where imports of the same products increased from US$5.2 to US$456 million between 2002 and 2013.

Figure 3: Canadian imports from LDCs and GSP utilization rates - Art of apparel & clothing access, HS 61 knitted/crocheted and HS62 not knitted/crocheted

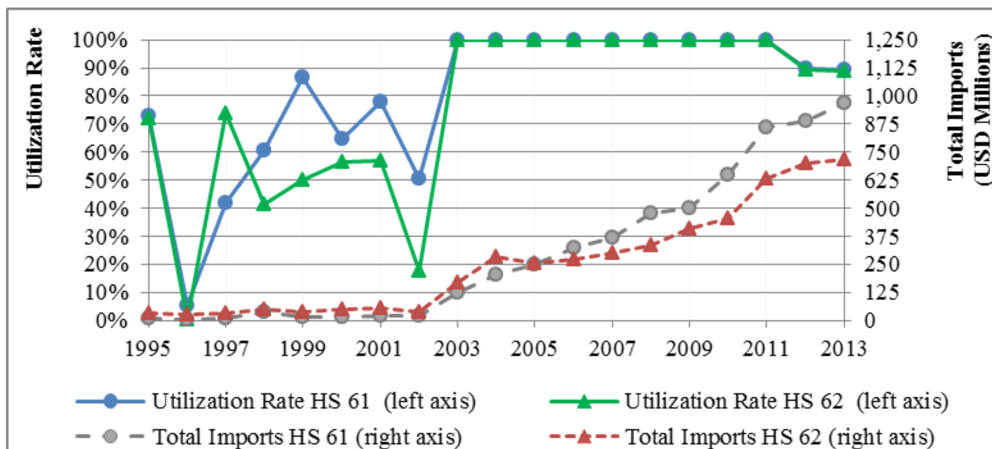
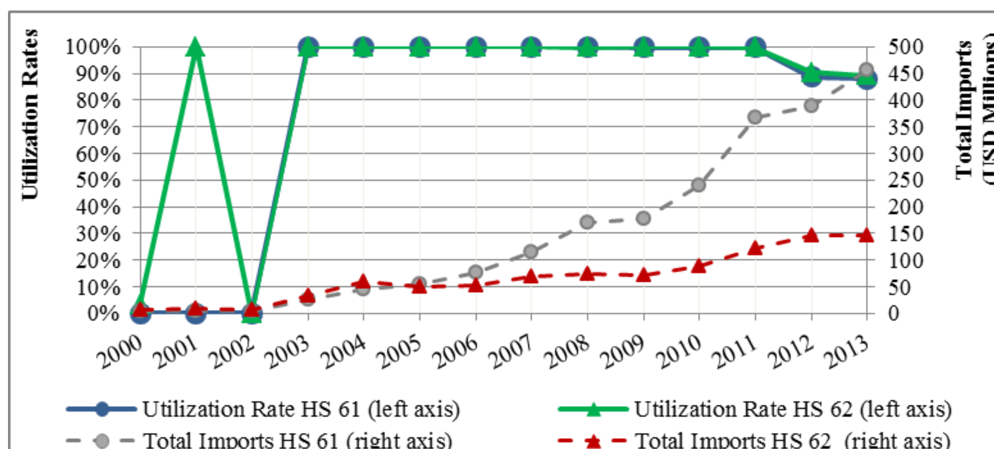


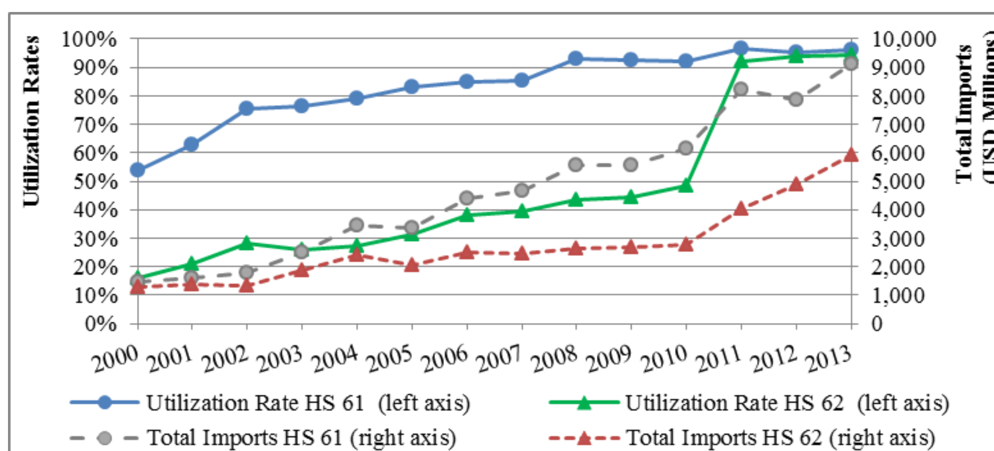
Figure 4: Canadian imports from Cambodia and GSP utilization rates - Art of apparel & clothing access, HS 61 knitted/crocheted and HS62 not knitted/crocheted



3.60. Despite the shorter time frame, similar observations can be made regarding the recent EU trade reform. Once again, both utilization rates and import values for garments (HS chapters 61-62), have been positively affected.

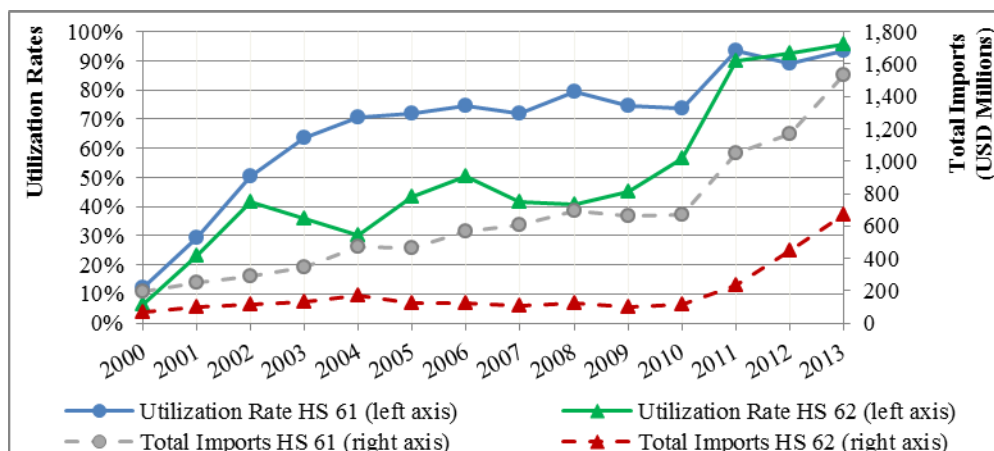
3.61. The impact is particularly striking in HS chapter 62, not knitted and crocheted garments, where the utilization rate by LDCs exporters raised from 49 per cent to 92 per cent between the end of 2010 and the end of 2011, the first year of entry into force of the EU reform (see Figure 5). Regarding Cambodian exports to the EU, utilization rate increased from 57 per cent to 90 per cent (see Figure 6). Simultaneously, LDCs exports to the EU market for same HS chapter, raised from US$2.8 to US$4 billion (+47 per cent) to reach US$5.9 billion in 2013. This surge in exports to the EU market between 2010 and 2011 is particularly strong for Cambodian products of chapter HS 62, with a rise in EU imports of 96 per cent.

Figure 5: EU imports from LDCs and GSP utilization rates - Art of apparel & clothing access, HS 61 knitted/crocheted and HS62 not knitted/crocheted



3.62. The rise in utilization rates of knitted or crocheted garments (HS chapter 61), has been moderated as the latter started from a much higher value than in the case of HS chapter 62. Indeed, on average, LDCs (Cambodian exporters) used the GSP preferences with a rate of 92 per cent (74 per cent) in 2010 and of 97 per cent (94 per cent) 2011. The rise in import values was nevertheless significant: US$2 billion (+33 per cent) for all LDCs and US$379 million for Cambodia (+56 per cent).

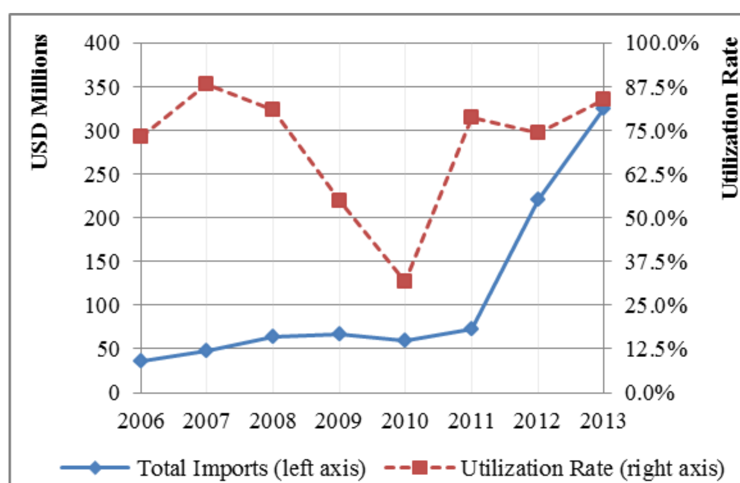
Figure 6: EU imports from Cambodia and GSP utilization rates - Art of apparel & clothing access, HS 61 knitted/crocheted and HS62 not knitted/crocheted



3.63. The reform on rules of origin introduced in 2010 and implemented in 2001 by the EU, has produced an impact beyond the traditional garment sector. In fact, the EU reform substantially liberalized the rules of origin not only for clothing but also in a variety of other sectors, allowing up to 70 per cent of non-originating materials for bicycles and easing ASEAN cumulation.

3.64. Figure 7 further shows that the utilization rate of bicycles exported to EU by Cambodia has increased in 2011 to around 80 per cent from the rate of 33 per cent of the previous year. Moreover, between 2010 and 2013, import values have been multiplied by a factor 5.4, increasing from US$60 to US$325 million (+442 per cent).

Figure 7: EU imports from Cambodia and GSP utilization rates - Bicycles



3.65. In the case of bicycles, it has to be mentioned that following changes introduced in the EU GSP schemes of 2014, Singapore and Malaysia inputs (mainly gears), cannot be used by Cambodia for ASEAN cumulation purposes. Similar changes in Canadian GSP rules of origin raised concerns and caused significant difficulties for the majority of bicycle industries based in Cambodia.

3.66. The Royal Government of Cambodia has requested a derogation to the EU Commission to continue to consider the ASEAN inputs from Malaysia and Singapore to be eligible for cumulation for a transitional period. Such request has been finally granted with a quota on the amount of bicycles that can use cumulation[37]

3.67. Once again, this is a clear demonstration of how changes in rules of origin have real effects on trade and business in LDCs.

The case of the AJ company in Cambodia

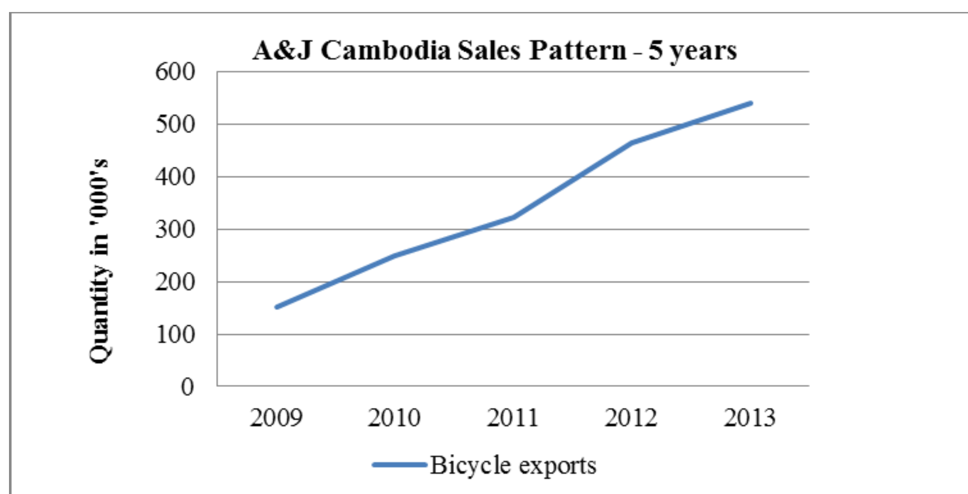
3.68. A&J (Cambodia) has been producing Bikes in Cambodia since 2006.

3.69. The Factory is located on 10 Hectares of Land and the investment is US$16 million. The total workforce in Cambodia is around 2,000 people. Annual Capacity is 720,000 Bicycles and has been raising.

3.70. Thanks to the new EU rules of origin A&J sales have dramatically increased as well as the unit value of the bike and the manufacturing operations in Cambodia. The reform of the EU rules of origin has allowed the company to operate in a much higher market than other LDCs.

3.71. In turn this has meant the need to develop special skills such as Aluminium welding including thin tube Welding, lightweight wheel building and specialist painting, areas which customers would usually look for in Taiwan that has been dominating this level of Bike production

3.72. Cambodia is the only LDC producing Mid to High end Bikes, and has the 2nd highest average export price in Asia. The specialist welding, painting and finishing skills necessary to produce such technically advanced Bicycles can currently only be found in Cambodia and Taiwan. At present A&J is in the process of overcoming the difficulties arising from the graduation of Malaysia from the EU GSP thanks to a derogation from the EU allowing the transitional use of Malaysia parts even if the country has graduated from the EU-GSP.



[37] See Commission implementing regulation (EU) No 822/2014 of 28 July 2014 on a derogation from Regulation (EEC) No. 2454/93 as regards the rules of origin under the scheme of generalised tariff preferences in respect of bicycles produced in Cambodia regarding the use under cumulation of bicycle parts originating in Malaysia.

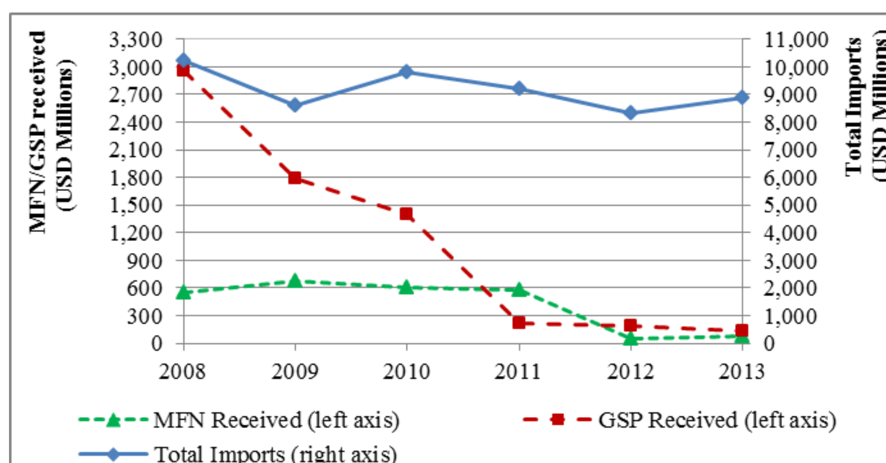
3.8 Utilization and trade effects in case of no reforms of rules of origin (US and Japan)

3.73. Given the difference of the kind of preferences granted to LDCs by the US[38], the analysis of the trade data has divided the LDCs in two groups: LDCs excluding AGOA beneficiaries that are granted GSP preferences and AGOA LDCs beneficiaries that are granted AGOA preferences.

3.74. Figure 8 shows the evolution of imports from LDCs excluding AGOA beneficiaries over time. Between 2008 and 2013, the total imports have decreased from US$10.2 to US$8.9 billion. Over the same period, imports receiving the GSP treatment and MFN treatment (while covered by the GSP scheme) have also significantly declined, respectively from US$3 billion to US$137 million and from US$550 to US$77 million[39]. This substantial decrease is mainly due to the graduation of Equatorial Guinea from the US GSP.

3.75. The most striking point is the value of imports either receiving GSP or MFN (while covered by the GSP) that under the GSP scheme are particularly low as compared to the total imports. This reflects the poor coverage of the GSP scheme and arguably that the existing rules of origin are not trade creating. In 2013, imports covered by the US GSP amounted only to US$213 million[40], which corresponds to a utility rate of about 2.6 per cent whereas the overall utilization rate was 64 per cent. Thus, not only the coverage is low but also the utilization rates are pointing to rules of origin as a deterrent for new trade dynamics.

Figure 8: US Total Imports from LDCs excluding AGOA beneficiaries



3.76. In Figure 9 excluding agricultural products and fuel the pattern is somewhat equivalent. Total imports from non-AGOA beneficiary LDCs increases over time, from US$6.5 billion in 2008 to US$8.4 billion in 2013, with significant reduction in GSP received, from US$204.7 to US$122 million (-40.4 per cent).

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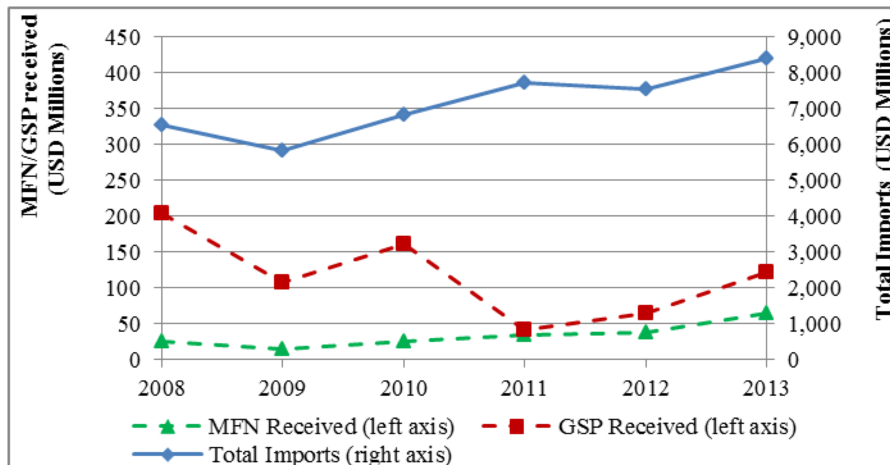
[38] In May 2000, the United States promulgated the African Growth and Opportunity Act (AGOA), whereby the United States GSP scheme was amended in favour of designated sub-Saharan African countries to expand the range of products, including textiles and clothing.

[39] In 2011, Equatorial Guinea graduated from the US-GSP scheme based on the income requirements. This mainly explains the sharp fall in imports receiving GSP and in the coverage between 2010 and 2011.

[40] The sum of imports receiving MFN and GSP treatment corresponds to the total imports that are covered by the agreement. In the case where all imports are dutiable, an identical value for imports receiving GSP and receiving MFN implies a utilization rate of 50 per cent.

Figure 9: US Total Imports from LDCs excluding AGOA beneficiaries - Non-Agricultural Products excluding Fuels



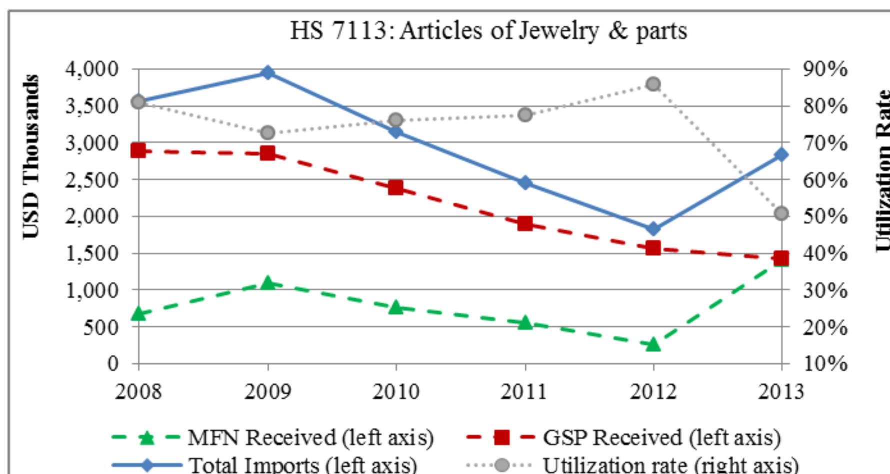
3.77. In the textile and clothing sector, the situation is not very different. The utilization rate declined from 73 per cent to 31 per cent. As for the utility rate, it is extremely low. With total imports of US$7.9 billion, including US$7.8 billion of dutiable imports, and only US$21.7 million (6.8+14.9) covered by the GSP scheme in 2013, the utility rate amounted to 0.28 per cent.

3.78. To sum up US imports from non-AGOA LDCs are notoriously highly concentrated in the textile and clothing sector. In 2013, imports in the textile and clothing sectors, representing 90% of the total imports, was covered at a rate of 0.27.

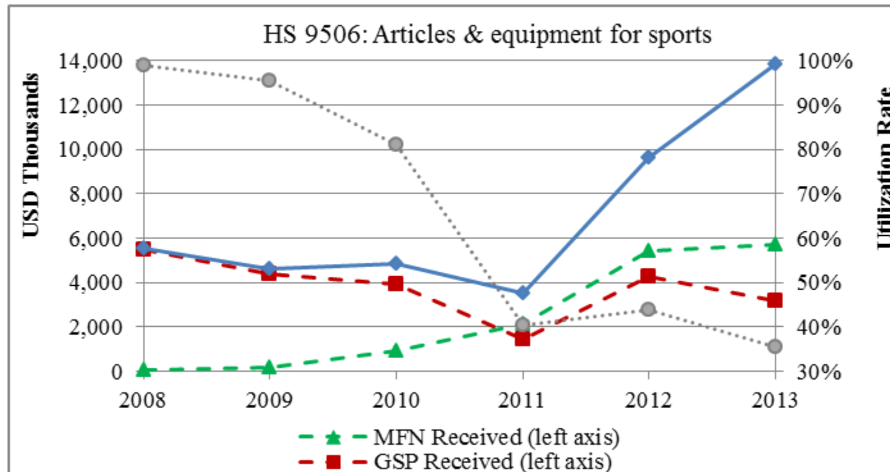
3.79. The most important issue to highlight in the context of this paper dealing with the adequacy of RoO is that: 1) the US rules of origin seems to have been so far unable to trigger a diversification of exports and the value of trade covered by the US GSP is abysmally low, and 2) it seems that in the industries other than textile and clothing that are mostly covered by the US GSP scheme, preferences are not fully utilized with relatively high values of imports receiving MFN treatment

3.80. Figure 10 are telling examples of the difficulties to comply with US GSP rules of origin even in the covered industrial sectors. It has to be noted that one of the difficulty of this exercise is that the volume of trade flows is extremely low and may show volatile fluctuations of the utilization rates. Such low volume and volatility may also be read as a sign of inadequacy of the existing rules of origin.

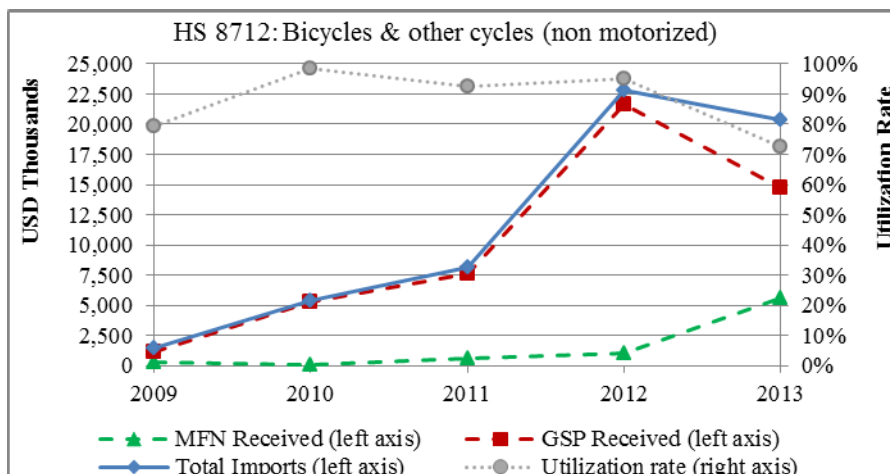
Figure 10: US Imports from LDCs excluding AGOA beneficiaries - Selected Products



3.81. The above figure shows the utilization of articles of jewellery exported from Nepal to the US. An initial high utilization rate on an average of 80 per cent declined to 50 per cent while US imports of the products rose in the same period. Perhaps some models of the jewellery did not meet rules of origin requirements.



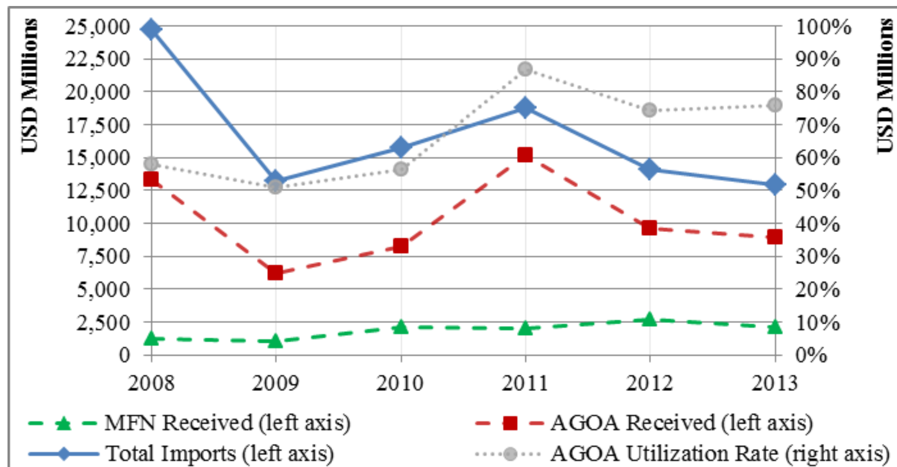
3.82. HS heading 9506 in the above figure shows the pattern of US imports of golf equipment from Bangladesh. Utilization rate after an initial high performance fell to a low of 30 per cent in 2013.



3.83. US imports of bicycles from Cambodia shows a rather high percentage rate and a similar pattern observed in the other two figures above: as total imports are growing, utilization is getting lower showing that there is problem of compliance with existing rules of origin. The exporter may find it easier to export without claiming trade preferences given the stringency of rules of origin.

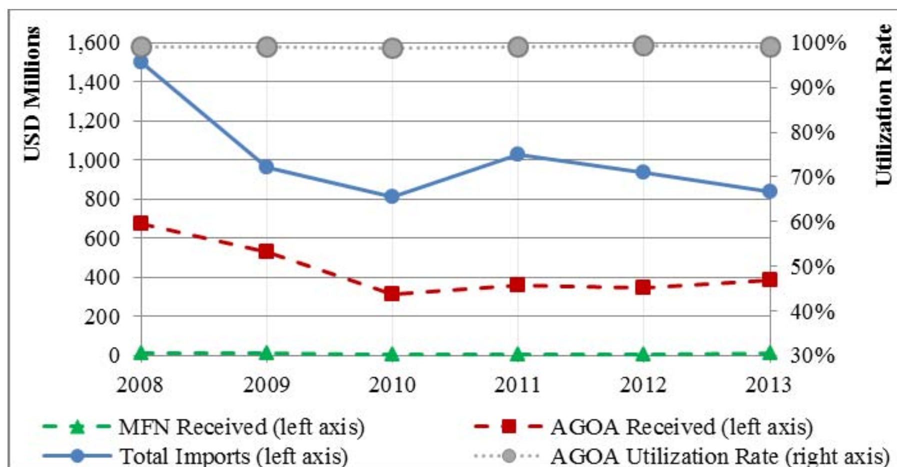
3.84. Figure 11 shows the overall performance of AGOA progressing from a utilization rate of 60 per cent in 2010 to 80 per cent in 2013. The volatile pattern of the AGOA received graph is probably due to the fluctuations of fuels imports from major LDCs suppliers.

Figure 11: US Total Imports from LDCs AGOA Beneficiaries



3.85. As shown in figure 12 once fuels and agricultural products are excluded the utilization rate of AGOA shows an impressive pattern of 100 per cent utilization.

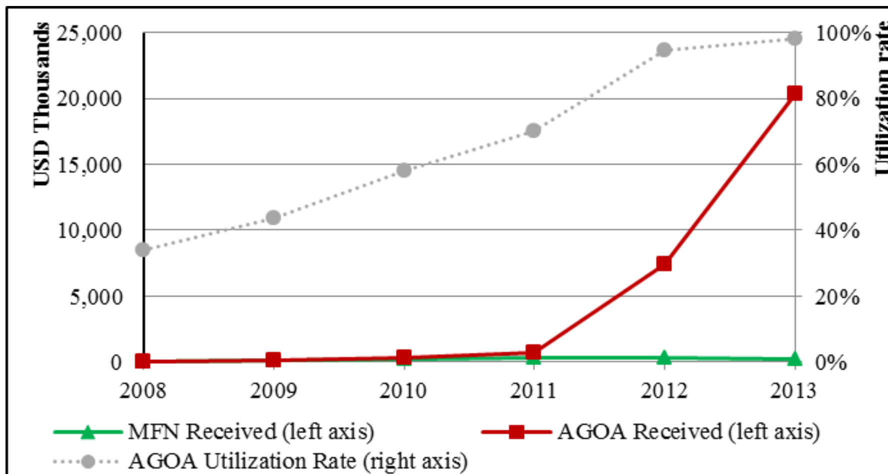
Figure 12: US Total Imports from LDCs AGOA Beneficiaries - Non-Agricultural Products excluding Fuels



3.86. Such impressive record is due to the extremely high concentration of exports in the clothing sector where special rules of origin apply that are allowing the use of third country fabric. In simple words under AGOA the US has adopted rules of origin that are similar to the ones introduced by the EU reform allowing a single transformation as origin conferring. Once again this figure is a telling example that lenient rules of origin with a sizable preferential margin are trade creating.

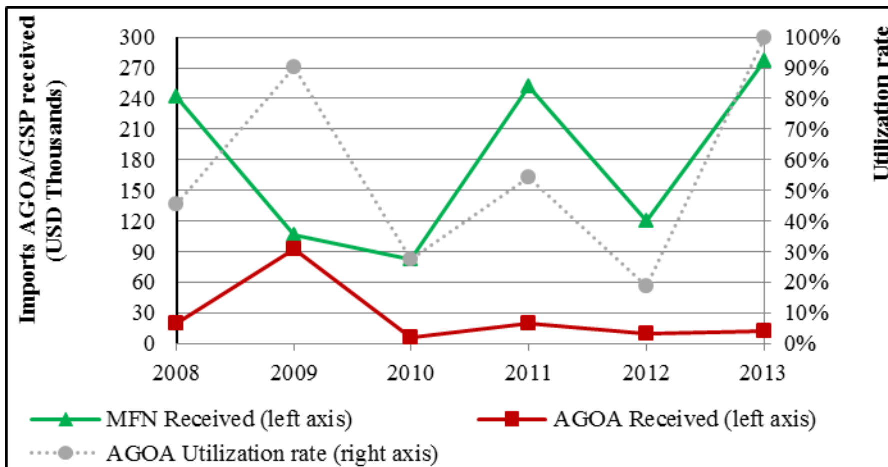
3.87. Besides clothing however there are few other successes of AGOA. Figure 13 shows US imports of leather shoes mainly imported from Ethiopia. Indeed utilization rate has progressed to almost full utilization, however it has to be noted that being Ethiopia a leather producer such shoes had little problem in meeting the 35 per cent value added requirement since most of its components were of Ethiopian origin.

Figure 13: US Total Imports from LDCs AGOA Beneficiaries - HS 64: Leather Footwear



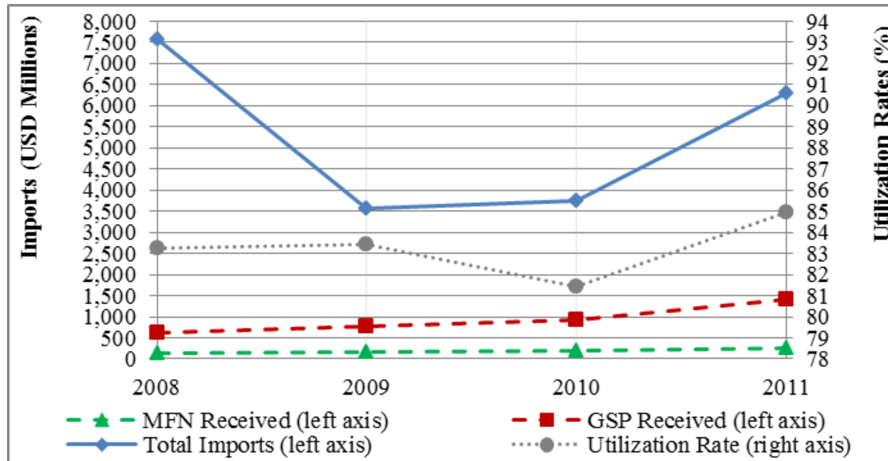
3.88. Figure 14 shows US imports under AGOA of basketwork of HS 4602 mainly imported from Rwanda. The extremely low value of these exports shows a volatile pattern of utilization rates.

Figure 14: US Imports from LDCs AGOA Beneficiaries - HS 4602: Basketwork, wickerwork of plaits etc. loofa articles



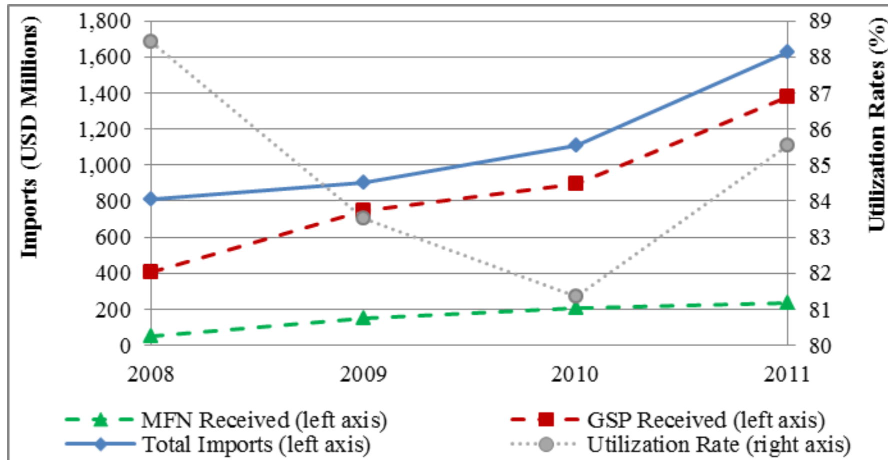
3.89. In the case of Japan there are some data limitations that have not permitted the analysis for a longer observation period than 2008-2011. During this period the overall trade performance of the LDCs under the GSP scheme of Japan seems to have followed a cyclical pattern with a decrease of overall imports following the financial crisis of 2009. Overall utilization rates are relatively high showing however a rather stagnant linear approach with an average figure between 84 per cent and 85 per cent.

Figure 15: Japanese Total Imports from LDCs and Utilization Rates



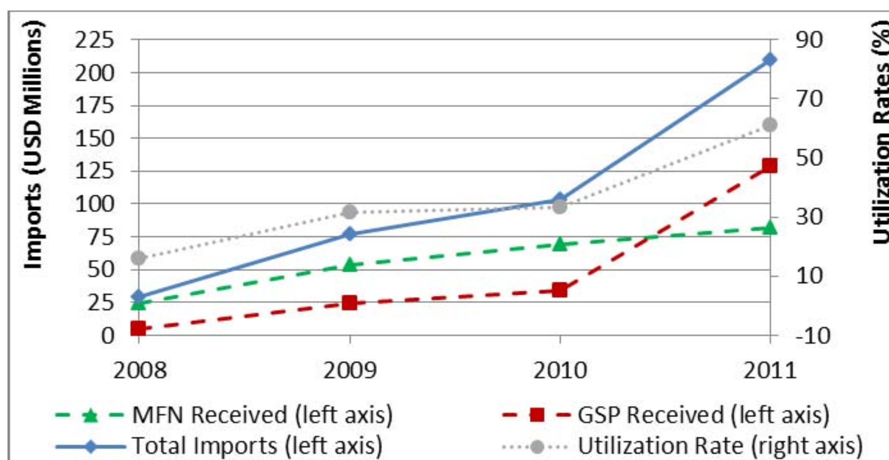
3.90. There are no significant differences in the pattern of utilization of the Japanese GSP scheme when Fuels and non-agricultural products are excluded. Utilization rates are ranging from 88 per cent to 86 per cent in 2011. These figures shows that even after the significant improvements in terms of coverage to the Japanese GSP scheme there has not been a significant modification in the trade patterns and utilization of the Japanese GSP.

Figure 16: Japanese Imports from LDCs and Utilization Rates - Non-Agricultural Products excluding Fuels



3.91. HS Chapter 61, Articles of apparel below is one of sectors where the utilization rate of the GSP scheme of Japan is significantly lower with respect to the average utilization rate although showing an increase in recent years. This is due to a product specific rule of origin in Chapter 61 that still demands a two stage process: knitting and crocheting of yarns and sewing of parts.

Figure 17: Japanese Imports from LDCs and Utilization Rates - HS 61: Articles of apparel & clothing accessories, knitted or crocheted



3.92. Efforts are currently underway to gather more recent data on the Utilization of the Japanese GSP to complete the analysis.

4 BUILDING ON THE DECISION ON PREFERENTIAL RULES OF ORIGIN FOR LDCS: SOME INITIAL SUGGESTED PRACTICES AND FUTURE CONTRIBUTIONS OF THE LDCS TO THE CRO

4.1 Background and way forward

4.1. The multilateral trading system has so far provided limited discipline to rules of origin, especially preferential rules of origin. This is in contrast with other similar basic customs laws such as customs valuation and customs classification where multilateral instruments provide effective disciplines since decades, namely the WTO Customs valuation agreement and the International Convention on Harmonized Commodity Description and Coding System for customs classification.

4.2. The WTO Agreement on Rules of Origin (ARO) was originally conceived to partially fill-in the existing gap. However its scope and coverage is limited to non-preferential rules of origin and even in such area, after 18 years, it has not been possible to conclude the Harmonization Work Program on non-preferential rules of origin.

4.3. Before the Decision on preferential rules of origin for LDCs the existing multilateral instruments to discipline preferential rules of origin were limited to the two annexes of Kyoto Conventions of 1974 and 2000 and the Common Declaration with regard to preferential rules of origin contained in the ARO. In spite of being mere guidelines contained in a Convention's Annexes, the content and recommendations contained in annexes to Kyoto Conventions have been the unique source of inspiration for the myriad of trade officials and negotiators who were facing the daunting task of drafting preferential rules of origin. This latter consideration applies in the context of unilateral or contractual rules of origin in FTAs.

4.4. Retrospectively, more detailed non-binding guidelines would have certainly assisted the multilateral trading system in drafting effective and predictable preferential rules of origin, especially in South-South trade agreements without necessarily tying negotiators' hands. Rules of origin are a very technical subject where it is possible to make substantial progress in drafting techniques, while leaving intact the policy space to negotiators and policy makers to determine their content.

4.5. The Common Declaration on rules of origin contained in ARO, although had some potential, generated less practical and concrete effects as compared to the Kyoto Conventions. This is probably due to the fact that much of its content did not contain any technical novelty on drafting rules of origin with respect to previous Kyoto conventions and the existing preferential rules of origin of WTO members. Where the Declaration provided for, and largely anticipated, some

provisions of the Trade Facilitation Agreement, namely on paragraphs (d) to (g)[41] on binding advance ruling information, judicial review, publication and confidentiality, there is not much trace of follow-up debates in the records of the Committee on Rules of Origin (CRO) to make operational these paragraphs.

4.6. Bearing the above mentioned precedents in mind, it may be reasonably argued that much of the value of the Decision depends not from its binding or non-binding nature but rather on its novelty in providing guidance on the technical ways of drafting rules of origin and the way forward that CRO members may wish to provide to its content.

4.7. When the Decision is assessed within such a perspective, it then provides a number of avenues for a possible way forward. In fact, there are a number of issues and novelties in the wording of the Decision where the multilateral trading system may gain considerable clarity and transparency on drafting preferential rules of origin for the LDCs.

4.2 Some initial suggested practices based on LDCs experience

4.2.1 Adopting a value of materials calculations when using the percentage criterion

4.8. Looking at the Decision it may observed that it considers in its paragraphs (namely 1.3 and 1.4 *ad valorem* percentage, 1.5 change of tariff classification and 1.6 specific working or manufacturing operations[42]), the three traditional methodologies on drafting rules of origin and adds to each one of those elements in comparison to the Kyoto Conventions and the Common Declaration on preferential rules of origin.

4.9. For instance, an issue where the international community may stand to gain is a clarification on the different methodologies that may be used to calculate the *ad valorem* percentage mentioned in the Decision.

4.10. As mentioned in section 0 *ad valorem* percentages may be calculated by: 1) adding local cost of materials, cost of labour and other incidentals incurred during the production of a finished good as a percentage of the ex-works price[43]; 2) calculating the *ad valorem* percentage by subtracting the value of non-originating materials from the ex-work price of the finished product; or 3) by determining a threshold on the use of originating or non-originating materials as a percentage of ex works price of a finished product.

4.11. According to the analysis carried out in section 0 the following suggestions could be considered:

[41] See Paragraph (d) and following paragraphs of the Common Declaration: (d) upon request of an exporter, importer or any person with a justifiable cause, assessments of the preferential origin they would accord to a good are issued as soon as possible but no later than 150 days after a request for such an assessment provided that all necessary elements have been submitted. Requests for such assessments shall be accepted before trade in the good concerned begins and may be accepted at any later point in time. Such assessments shall remain valid for three years provided that the facts and conditions, including the preferential rules of origin, under which they have been made, remain comparable. Provided that the parties concerned are informed in advance, such assessments will no longer be valid when a decision contrary to the assessment is made in a review as referred to in subparagraph (f). Such assessments shall be made publicly available subject to the provisions of subparagraph (g); (e) when introducing changes to their preferential rules of origin or new preferential rules of origin, they shall not apply such changes retroactively as defined in, and without prejudice to, their laws or regulations; (f) any administrative action which they take in relation to the determination of preferential origin is reviewable promptly by judicial, arbitral or administrative tribunals or procedures, independent of the authority issuing the determination, which can affect the modification or reversal of the determination; (g) all information that is by nature confidential or that is provided on a confidential basis for the purpose of the application of preferential rules of origin is treated as strictly confidential by the authorities concerned, which shall not disclose it without the specific permission of the person or government providing such information, except to the extent that it may be required to be disclosed in the context of judicial proceedings.

[42] This is another important difference in relation to Kyoto convention 2000 where the methodology based on working and processing operations was no longer included as possible recommended practice in drafting rules of origin.

[43] It has to be noted that there are different incoterms and practices used by WTO members like ex-factory price, ex-factory costs, FOB price, adjusted value etc.

- Suggested practice

  Preference - giving countries when using a percentage criterion for determining substantial transformation should use a value of materials methodology.

- Suggested practice

  A level of percentage of 15-25 per cent or lower for certain categories of products calculated according to the Build down formula mentioned under 0 should be considered appropriate when using a percentage criterion. The LDCs will further engage in research to identify appropriate level of percentages.

- Suggested practice

  Percentage criterion-based rules of origin should adequately take into account the costs of freight and insurance when determining the value of materials especially for landlocked and islands LDC.

4.3 Areas where LDC will submit their experience in next CRO meetings

4.3.1 Developing further the concept of CTC

4.12. Another interesting point in the Decision is the following: "*in the case of rules based on the change of tariff classification criterion, a substantial or sufficient transformation should generally allow the use of non-originating inputs as long as an article of a different heading or sub-heading was created from those inputs in an LDC.*"

4.13. However, it is notorious that the HS is not being designed for rules of origin purposes and that an across the board criterion of change of tariff classification may not reflect genuine substantial transformation in LDCs in all cases. This paper has not touched upon this subject. It may be beneficial to further discuss and, if possible, identify the product/sectors where a simple CTC could be used with or without CTC exceptions.

4.3.2 Setting appropriate levels of substantial transformation according to the different forms of Rules of origin

4.14. Paragraph 1.6 contains a number of useful statements where it refers to the "*limited production capacity of LDCs*". This statement could be related to the need of rules of origin for LDCs to facilitate their insertion into global value chains rather than induce them into import substitution of competitive available inputs for building their limited manufacturing capacity. In addition the recognition that the use of rules of origin based on a working or processing operation "*for chemical products has made such rules more transparent and easy to comply with*" provide a glaring example of what could be achieved by the international community if there is a sharing of the lessons learned.

4.3.3 Certification requirements

4.15. Paragraph 1.8 Section (b) of the Decision contains two important statements related to documentary requirements. Too often the issue of documentary evidence required to benefit from tariff preferences is overlooked when dealing with rules of origin. This is an area where multilateral guidelines and lessons learned are almost non-existent[44].

4.16. Two ground-breaking statements are contained in this part of the Decision:

1) *"non-manipulation or any other prescribed form for a certification of origin for products shipped from LDCs across other Members may be avoided"* - this apparent minor statement contains a significant trade facilitation proposal taking into account that such non-manipulation form is still a requirement under many non-reciprocal preferential arrangements for LDCs; this is especially important when considering that a large part of

[44] Some initial work was carried in the WCO Technical committee on rules of origin (TCRO).

LDCs are either landlocked or island countries and transhipment through other WTO members is either a geographical or a commercial reality;

2) "*with regard to certification of rules of origin, whenever possible, self-certification may be recognized*" - costs related to the certification requirements, mainly deriving from issuance of a certificate of origin by the certifying authorities in LDCs may be significant for the private sector. Yet, certifying authorities may still need to monitor and manage self-certification by exporters. This is an area where there are significant gains to be had from sharing experiences and establishing links and synergies with the related provision of the Trade Facilitation Agreement.

4.17. Certain preference giving countries have introduced reforms eliminating the non-manipulations requirements, other still maintain rather archaic methods hardly justifiable in view of the trade facilitation agreement.

4.18. Administration of rules of origin has a cost, both for the exporting and importing country and there are a variety of best practices and lessons learned.

4.19. The LDC WTO group will look into these issues with a view to prepare a contribution.