

# TRADE HOT TOPICS

# Commonwealth

Issue No.28

## Rules of Origin: The Way Ahead

### Lessons from the USA-EC-India Textiles Dispute

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*'Rules of Origin are very, very complex. You don't want to know about them. They are terrible things to deal with'.*

Canadian Trade Minister before the Canadian Parliament.

#### INTRODUCTION

The successive trade rounds under the GATT/WTO have resulted in substantial reduction in the level of tariffs, especially in the developed countries. In the post-Uruguay Round period, the applied and bound tariff levels are shown in Table 1.

**Table1. Average Applied and Bound Rates (Percent)**

	Developed		Developing	
	Applied	Bound	Applied	Bound
All Merchandise	2.6	3.7	13.3	13.0
Manufactures	2.5	3.5	13.3	13.3
Textiles & Clothing	8.4	11.0	21.2	25.5

Source: WTO

It is evident from the data in the Table 1 that tariffs which used to be the principal instrument for trade control has significantly lost its importance in the developed countries. There are, however, sectors, both agricultural and industrial, where the average level of tariff protection conceals significantly higher protection level. Textiles and clothing is one such sector.

The Rules of Origin (ROO) whose basic function is to determine where a particular product has originated geographically have been found by many experts as a trade policy instrument which they should not be. One possible explanation behind such usage is what Bhagwati has termed as the 'Law of Constant Protectionism'.<sup>2</sup>

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<sup>2</sup> Bhagwati, Jagdish (1988) Protectionism, MIT Press, P. 53

According to this law, if one form of protectionism is brought down, e.g., tariff, another form will substitute it. The net effect is displacement, though not any overall rise in the protection level. The growing realization that ROO may act as a trade barrier rather than facilitate trade transactions, has also come about because of the increasing number of regional trading arrangements (RTAs). All preferential trading regimes require extensive and precise rules of origin to ensure that only goods originating in the partner countries are allowed to enter the importing country at preferential rates of duties. Due to the multiplicity of RTAs, the twin dangers of trade diversion and complexity of origin rules are currently being highlighted. There is a third reason as well. Increasing use of anti-dumping measures requires clear rules for the determination of origin of goods.

## ROO AND GATT/WTO

Though ROO is fundamental to trade, especially the customs administration, the GATT legal regime on this has been lax. Though there are specific references to ROO, such as Articles I and XXIV, there is no precise definition. The issue has been mostly dealt with in the World Customs Organisation. The laxity in the GATT legal regime allowed the member-states to draft their own rules and apply differently, sometimes with specific trade objectives in mind. The first GATT effort towards bringing some uniformity in this complex web of ROOs was made in the Uruguay Round when the Agreement on Rules of Origin was negotiated.<sup>3</sup>

The Preamble of the Agreement on Rules of Origin provides, inter alia,

*Recognising* that clear and predictable rules of origin and their application facilitate the flow of trade;

*Desiring* to ensure that rules of origin do not nullify or impair the rights of members under GATT 1994;

*Recognising* that it is desirable to provide transparency of laws, regulations, and practices regarding rules of origin;

*Designing* to ensure that rules of origin are prepared and applied in an impartial, transparent, predictable, consistent and neutral manner;

*Recognizing* the availability of a consultation mechanism and procedures for the speedy, effective and equitable resolution of disputes arising under this Agreement.

It is important to carefully note the objectives of the Agreement, as indicated in the preamble. It seeks to ensure that the rules themselves should not obstruct trade, should be clear and predictable, applied in a neutral manner, i.e., non-discriminatory way. As such, ROO should not act as a trade barrier but serve only as determinant of origin.

The Agreement on ROO has three distinct features. First, it makes a clear distinction between non-referential and preferential ROOs. Non-preferential ROOs apply to MFN trade, i.e., for the determination of origin in the framework of GATT trade policy instruments such as anti-dumping duties, quantitative restrictions, safeguards, application of rules of origin to marks of origin, trade statistics and government procurement. Preferential ROOs apply to preferential tariff regimes, such as GSP, RTAs, etc. The Agreement brings only the non-preferential ROOs under the WTO discipline. Second, the Agreement has the objective of harmonizing the national ROOs through detailed technical work carried out in the World Customs Organisation. Third, 'the harmonized set of rules of origin has to be used for all MFN purposes ...'.<sup>4</sup>

On the restriction of the Agreement to non-preferential arrangement, Hockman and Kostecki observed:

'Rules of Origin have been problematic mostly in the context of preferential trade agreements; exactly the arena where WTO rules do not apply. This was no oversight, and reflects the fact that many countries did not want to see constraints imposed on their policy freedom with regard to regional integration or the mechanics of trade preferences for developing countries.'<sup>5</sup>

The disputes that EU and India had with USA on textiles show that even non-preferential rules of origin are quite problematic.

It is also necessary at this stage to consider the related issue of the marks of origin. Marks of origin show where the product/produce has originated as information to prospective buyers. Marketing literature indicates that

<sup>3</sup> WTO (1994), The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts.

<sup>4</sup> UNCTAD (1998), Globalization And The International Trading System: Issues Relating to Rules of Origin (UNCTAD/ITCD/TSB/2), PP 10-11.

<sup>5</sup> Hockman and Kostecki (1995), The Political Economy of the World Trading System, Oxford University Press, P. 104.

buyers associate several attributes such as quality, ethnicity etc. with the place where the product has come from.<sup>6</sup> This information has, therefore, strong commercial importance. Legally, GATT permits WTO members to maintain laws relating to marks of origin on imported products to protect buyers from false and misleading information under GATT Article IX. However, marks of origin should not be discriminatory or unreasonably burdensome. Further, these are not to work to the detriment of products with distinctive regional or geographic names (GATT Article IX: 6).

It is also observed 'that country-of-origin marking requirements that single out foreign goods may be found to violate GATT's national treatment provisions'.<sup>7</sup>

## THE EU-US DISPUTE

Trade in textiles was regulated under various agreements through a rigorous quota regime. In the Uruguay Round, the Agreement on Textiles and Clothing was negotiated which would result in a 10 year phase-out by 2005 of the quota regime and integration of the textiles and clothing with the WTO regime.

The rules of origin followed by USA up to 1 July 1996, for the determination of origin for textiles were:<sup>8</sup>

1. Dyeing of fabric and printing, when accompanied by two or more of the following operations: bleaching, shrinking, fulling, napping, decatizing, permanent stiffening, weighting, permanent embossing or moireing.<sup>9</sup>
2. Spinning fibres into yarn.
3. Weaving, knitting or otherwise forming fabric.
4. Cutting of fabric into parts and the assembly of those parts into the completed article.
5. Substantial assembly by sewing and/or tailoring of all cut pieces of apparel articles which have been cut from fabric in another country into a completed garment.

The alternative to the four operations rule was substantial transformation, resulting in a change in tariff heading. Consequent upon the ATC becoming effective, USA introduced changes in its rules of origin regarding textiles and clothing. The new rules de-recognized the four operations rule. The origin now vests on the country where the fabric was woven or sewn. For a final product, the assembly became the determining factor.

Section 334 of the Uruguay Round Agreement Act (URAA) provides that a product is to be considered as originating in a country if:

- A. the product is wholly obtained or produced in that country.
- B. the product is a yarn, thread, twine, cordage, rope, cable or braiding and
  - i) the constituent staple fibres are spun in that country; or
  - ii) the continuous filament is extruded in that country.
- C. the product is a fabric, including a fabric classified under the Chapter 59 of the HTs and the constituent fibres, filaments or yarns are woven, knitted, needled, tufted, felted, entangled or transformed by any other fabric-making process in that country ...; or
- D. the product is any other textile or apparel product that is wholly assembled in that country ... from its component pieces'.

...

(3) Multicountry rule – If the origin of a good cannot be determined under paragraph (1) or (2), then that good shall be considered to originate in, and be the growth, product or manufacture of:

- (a) the country in which the most important assembly or manufacturing process occurs, or
- (b) if the origin of the product cannot be determined under subparagraph a, the last country in which important assembly or manufacturing occurs.

<sup>6</sup> There is a large international marketing literature on this. See for example, Bhattacharyya (1992), *Export Marketing: Strategies for Success*, Global Business Press, New Delhi, Ch. 3.

<sup>7</sup> Matsushita, Schoenbaum and Mavroidis, (2003), 'The World Trade Organization: Law, Practice and Policy', P. 119. See also footnote note 51 and the references therein.

<sup>8</sup> US Customs notification 19 CFR 12.130.

<sup>9</sup> This is commonly known as four operations rule

These new rules created problems for the EU exporters of clothing. Under the previous four operations rule, the EU exporters could claim origin by undertaking four recognized operations, even if the fabric was from a non-EU country. Under the new rules, origin of the fabric determined the origin of clothing. The immediate impact was that the EU clothing exports indirectly got included under the ATC quota regime in those cases where the fabrics were sourced from a country whose exports were subject to quota restraints. A second problem was that as origin changed, the right to label the products, as made in Italy or any other EU member states also disappeared. This reduced the marketability of the final product.

]The EU brought the issue to the conciliation process under WTO's Dispute Settlement system. The WTO Agreement on Textiles and Clothing provides in Article 4.2:

'Members agree that the introduction of changes, such as changes in practices, rules, procedures and categorization of textiles and clothing products ... should not upset the balance of rights and obligations between the Members concerned - - - adversely affect the access available to a Member, impede the full utilization of such access, or disrupt trade under this Agreement.

- - - -

Members agree that the Member initiating such changes shall inform and, whenever possible, initiate consultations with the affected Member or Members prior to the implementation of such changes, with a view to reaching a mutually acceptable solution ...<sup>10</sup>

There were two *process-verbal* agreements between the EU and the USA. USA agreed to amend the relevant legislation to undo the damage caused by the 1996 rules to the EU exports to USA. The final outcome was that Section 405 of the Trade and Development Act of 2000, entitled 'clarification of Section 334 of the Uruguay Round Agreement Act', was adopted.

Section 405 was, therefore, adopted essentially to take care of the EU objections. "To settle the dispute, the United States agreed to amend Section 334, creating two exceptions to Section 334's fabric formation rules."<sup>11</sup>

Section 405 provides, inter alia,

...

- B. Notwithstanding paragraph (1) (c), fabrics classified under HTS as of silk, cotton, man-made fibre, or vegetable fibre shall be considered to originate in, and be the growth, product, or manufacture of, the country, territory or possession in which the fabric is both dyed and printed when accompanied by two or more of the finishing operations: .....
- C. Notwithstanding paragraph (1) (D), goods classified under HTS headings (.....), except for goods classified under such headings as of cotton or of wool or consisting of fibre blends containing 16 percent or more by weight of cotton, shall be considered to originate in, and be the growth, product, or manufacture of, the country territory, or possession in which the fabric is both dyed and printed when accompanied by two or more of the following finishing operations: ...?.

What the amendments meant are the following:

- i) The four operations rule was reintroduced, except for fabrics made of wool.
- ii) for silk, cotton, man-made and vegetable fibre fabric, origin would be conferred by dyeing and printing and two or more finishing operations.
- iii) For certain textiles products, excepted from the assembly rule, origin would be conferred on the identical bases, with exceptions.<sup>12</sup>

The amendments through Section 405 satisfied the EU as a result of which no dispute settlement panel was set up.

<sup>10</sup> WTO (1994), The Legal Texts.

<sup>11</sup> United States – Rules of Origin for Textiles and Apparel Products, WTO, WT/DS 243, P.8.

<sup>12</sup> WT/DS 243/R

## INDIA-USA DISPUTE

India sought consultations with USA pursuant to Article 4 of the understanding on rules and procedures governing settlement of disputes, Art XXII:I of GATT and Article 7 of the Agreement on Rules of Origin concerning the USA rules of origin on textiles and clothing, Consultations were held during February-March 2002 which failed to come to an agreement.<sup>13</sup>

As a result, India requested establishment of a panel which was set up in June 2002 with the following terms of reference:

‘To examine in the light of the relevant provisions of the covered agreements cited by India in document WT/DS 243/5/Rev. 1, the matter referred to the DSB by India in that document and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements.’<sup>14</sup>

Bangladesh, China, the European Communities, Pakistan and the Philippines reserved their third party rights to participate.

The major points made by India were that rules of origin, set out in Section 334 and as modified by Section 405 and the relevant customs notifications

- a) are being used by the United States as instruments to pursue trade objectives, thereby violating Article 2(b) of the RO Agreement. Section 334 is being used as an instrument to protect the United States’ textile and apparel industry. Section 405 is being used as an instrument to favour imports of the products of concern to the European Communities;
- b) create restrictive, distorting and disruptive effects on international trade and are, therefore, inconsistent with the United States’ obligations under Article 2(c), first sentence, of the RO Agreement;
- c) require the fulfillment of a certain condition not related to manufacturing or processing and pose unduly strict requirements and are, therefore, inconsistent with Article 2(c), second sentence, of the RO Agreement; and
- d) with respect to section 405, discriminate between Members, and in particular, discriminate in favour of the European Communities and are, therefore, inconsistent with the United States’ obligations under Article 2(d) of the RO Agreement.<sup>15</sup>

Due to these reasons, India considered the US rules of origin for textiles and apparel products to be inconsistent with paragraphs (b), (c), (d) and (e) of Article 2 of the Agreement on Rules of Origin.

Leaving aside complex legal points and textual interpretations, the major economic issue raised was the possible use of rules of origin as a trade policy instrument, specifically to provide protection to domestic industry. The desire to use this instrument to subdue the competitive effect of MFA dismantling is prima facie clear. The restrictiveness in trade flows in this case is coming out of the quota regime of ATC due to which India had argued that it had suffered disadvantage. Specifically, India cited its export of greige fabric to Sri Lanka for manufacture into bed linen. India had argued that Section 334 caused a major setback to this trade, because the products were considered as Indian and not of Sri Lanka, as a result of which Indian quota got exhausted.

In addition to the issue of providing protection, India also raised the issue of trade distortion. The main argument was that complex origin rules by themselves can disrupt trade. One interesting point raised by India in connection with the quota regime is the issue of circumvention. The statement of Administrative Action (SAA) lists four objectives for Section 334. These are: i) to reflect the important role assembly plays in the manufacture of apparel products; ii) to combat transshipment; iii) to harmonize US rules with those of major trading partners and iv) to advance the ARO goal of harmonization. According to India, what is allowed is prevention of fraudulent circumvention and not legal circumvention. For prevention of circumvention, India observed that Article 5.2 of ATC is the relevant provision and Section 334 does not assist the USA in combating transshipment.

India also argued that since section 405 was a product of bilateral settlement between EU and USA, this is discriminatory to India, as it unduly favours the EU and, therefore, violates Article 2(b) and 2(d). Basically, the point was that settlement took into account products of export interest only to the EU.

<sup>13</sup> WTO, WT/DS 243/5 Rev. 1

<sup>14</sup> WTO, US – Rules of Origin Textiles and Apparel Product, WT/DS 243/6.

<sup>15</sup> WTO, WT/DS/243 R., P. 69

## US RESPONSE

USA responded to all these points, in addition to its own as to why India's contention was not valid. Legally, it raised the point that as a complainant, it was India's responsibility to provide the burden of proof which India had not done.

USA maintained that ARO allows changes in the rules of origin during the transition period and the changes made are, in the ordinary meaning of Article 2, consistent with the ARO. It argued that 'a finding that the US regime is inconsistent with Article 2 leads to an impossible result under the ARO: that the United States should have no rules of origin and instead simply make case by case determination of origin or that the WTO dispute settlement system can assign origin determination for specific products'.<sup>16</sup>

USA argued that Section 334 does not have the objective of protecting domestic industry, as the statement of Administrative Action (SAA) reveals.

'USA has a regime in place for the purpose of protecting its domestic industry during the transition ATC period, i.e., a quota regime ... (which) provides effective protection for the domestic industry. Indeed this is why this dispute exists ...'<sup>17</sup>

USA also argued that even if Section 405 was the result of bilateral consultations, the Section was not discriminatory as it is applied to all WTO members on an MFN basis. The concept of de facto advantage was not applicable in this case.

Coming to the economic issues, USA argued that effects on trade which can be expected of any change in rules of origin, could not be equated with trade distortion. Further, restrictive, distorting or disruptive effects on trade cannot be determined by examining effect on one single Member's trade.<sup>18</sup>

On the issue of providing protection to domestic textiles trade, USA argued that 'Section 334 has facilitated an enormous increase in trade and textiles product, to the US market. Accordingly, a conclusion that Section 334 was enacted to protect the US textile industry and is, therefore, a trade objective in the context of Article 2(b) would not be based on any legal or factual foundation'.<sup>19</sup>

## FINDINGS

The Panel issued the interim report in April 2003 which became the final report since neither party gave comments or sought meeting with the Panel. The Report was released by the WTO on 20 June, 2003.

The Panel concluded:

- a) India has failed to establish that Section 334 of the Uruguay Round Agreements Act is inconsistent with Articles 2(b) or 2(c) of the RO Agreement;
- b) India has failed to establish that Section 405 of the Trade and Development Act is inconsistent with Articles 2(b), 2(c) or 2(d) of the RO Agreement; and
- c) India has failed to establish that the customs regulations contained in 19 C.F.R. § 102.21 are inconsistent with Articles 2(b), 2(c) or 2(d) of the RO Agreement.<sup>20</sup>

The arguments which led the Panel to come to these conclusions are too complex and would take space not available here and, therefore, will not be summarized. However, few observations of the Panel merit reference here.

1. Article 2 of the ARO provides a fair amount of discretion to members, as to the determination criteria which confer origin, changing those criteria overtime, or applying different criteria to different goods. (PP. 71-72)
2. The objectives identified by India, i.e., the objective of protecting domestic industry against import competition and favouring imports from one member over imports from another may, in principle, be considered to constitute trade objectives in pursuit of which ROO may not be used. (PP 73-74)

<sup>16</sup> WTO, WT/DS 243, P. 5, Executive Summary of 1st submission of US.

<sup>17</sup> WTO, WT/DS 243, P. 5, Executive Summary of 2nd submission of US

<sup>18</sup> WTO, WT/DS 243, P. 5, Executive Summary of 2nd submission of US

<sup>19</sup> Op. cit., P. 6

<sup>20</sup> T/DS/243/R, Part 1, P. 124. All subsequent page numbers refer to the same Report.

3. India seeks to cast doubt on the validity of the fabric formation rule as set forth in Section 334 as it is used to pursue a trade objective. The Panel observed that there is no requirement in Article 2 of ROA to use a particular type of rule (P. 81). As to India's point on the rationality of the rule, the Panel said; 'the silence of Article 2 on the issue suggests that Members are, subject to the discipline contained in Article 2(b) and 2(c), free to make determination as they deem fit' (P. 82). As to India's point that the fabric formation rule does not take into account subsequent value-added operations, the Panel observed that there is 'no requirement in Article 2 that Members need to confer origin on the country where a significant, or even the most significant economic contribution to a final good has been made' (P. 82).
4. *On India's contention on the effect of the fabric formation rule on the quota regime, the Panel observed that no factual evidence was provided and a priori conclusions could not be drawn on this alleged effect. '... The evidence and argument adduced by India do not support the conclusion that the fabric formation rule necessarily or in fact, brings more imports of made-up articles under quota in the United States' (P.84)..... Moreover... the mere fact of making the quota system more restrictive could not, ipso facto, condemn the fabric formation rule. A restrictive fabric formation rule may have been adopted in pursuit of legitimate objectives.'* (P. 84)
5. 'Even if we were to accept India's contention that the concept of circumvention does not include legal quota avoidance strategies, this would not detract from the fact that the United States has offered a plausible explanation of how the fabric formation rule promotes the objective of preventing illegal quota circumvention. ... we do not consider that there is an inherent link between the possible objective of preventing circumvention – defined here as the prevention of quota avoidance through legal means – and the objective of protecting the United States' textiles industry, such that the two objectives could invariably be viewed as one and the same. (P. 85)
6. As to India's claim that section 405 is inconsistent with Article 2(b) as it favours imports from the European Communities, the Panel observed that since the 'section 305 applies equally to qualifying goods from all Members, we do not see how section 405 is being used as an instrument to pursue the objective of favouring EC imports ...' ... setting a bilateral trade dispute does not imply an intention on the part of the disputing parties to disfavour members who are not parties to a settlement agreement'. (P. 91)
7. On the trade restrictive effect of the fabric formation rule in Section 334, the Panel was not convinced of the factual evidence – provided by India. 'The mere assertion by an Indian exporters' association, that, as a result of the fabric formation rule provided for in section 334, "exports of grey fabrics from India to Sri Lanka suffered a major set back", is insufficient to establish that the level of exports of Indian greige fabrics to Sri Lanka has decreased or there exists a causal link between the fabric formation rule in Section 334 and the alleged decrease in India's exports of greige fabric'. The Panel also observed that data on more than only one country are required to study the restrictive effects on international trade. (PP. 100-101).

## CONCLUSIONS

India's decision to take USA to the Dispute Settlement Board possibly arose out of the concern that the unilateral determination of rules of origin during the transition period might bring unexpected and undesirable consequences to its export interests. The long delay in the work programme of the Committee on ROO strengthened this threat perception. Had India won the case, that would have set restraints on such future actions by other member-states. India has already felt the adverse impact of the NAFTA rules of origin, especially the triple transformation rule, on India's exports of T&C to USA.

But arguably, still more critical was the perception that the fabric formation rule, as followed by USA, would be detrimental to India's interests from a long term point of view and, therefore, its legal status needed to be questioned. This was more so, because in the Committee on ROO, a large number of countries have indicated their preference for such a rule.

India is a large exporter of textiles and clothing, with almost one-third of its total exports originate in this sector and its concern to ensure that hidden non-tariff barriers in the form of restrictive ROO conditionalities do not proliferate is understandable. As the NAFTA experience as well as almost total collapse of India's grey fabric exports to Sri Lanka reveal, ROO can effectively deny market access to textiles and clothing exports from India, especially till the time the ATC quotas are in place.

However, the dispute, despite all its legal complexities, does not have much substantive long term implications for two reasons. First, the dispute arose out of the quota regime of the ATC which will become inoperative by 2005,

with the complete integration of the T&C trade. Second, non-preferential rules of origin will have to be harmonized under the work programme of the Doha Development Agenda. That cannot be indefinitely postponed, even if there are delays as of now.

The short-term importance of the dispute arises out of this second reason. There are strong non-convergent views in the Committee on Rules of Origin. It is possible that this dispute by bringing on the surface some of the implications of national rules of origin may influence the views of the negotiators in the Committee on Rules of Origin.

From the legal stand point, two points are important. First, this as well as some other current disputes tend to substantiate the view that since under the WTO's dispute settlement system, the WTO rules can be consequentially enforced only if there are formal challenges, the body of case law may get developed in a skewed form, depending upon the interests of important members who are willing to use the DSM to push the envelop in their own interest. Second, the Panel Report brought into sharp focus the importance of trade data, in addition to the legal interpretation of the Agreements in arriving at findings. The Panel has observed with reference to at least two claims made by India on the inadequacy of empirical evidence submitted. This shows that trade economists along trade lawyers should be involved in preparing a country's substantive and legal position. Finally, from a systemic standpoint, the rapid rise in the number of disputes being brought to WTO, despite this being a sign of the robustness of the mechanism, calls for a review of the current system, to ensure that it does not collapse because of its own success.

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