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Briefing Report to the Honorable Lloyd M. Bentsen, Chairman, Committee on Finance, U.S. Senate

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INTERNATIONAL TRADE

Rule of Origin for the U.S.-Canada Free Trade Area

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General Accounting Office
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National Security and
International Affairs Division

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November 16, 1987

The Honorable Lloyd M. Bentsen
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

One aspect of negotiations for the proposed U.S.-Canada Free Trade Area Agreement was the formulation of a rule of origin acceptable to both nations. This rule would establish criteria a product must meet to be considered "Made In" the United States or Canada and thus be entitled to the trade preferences of the Agreement. Rules of origin in general have become increasingly important as nations trade a growing number of products that embody parts, components, or raw materials originating in other nations. This internationalization of production has made it difficult to assign origin unambiguously and to administer important trade policy measures directed at the products of specific nations. Given the extensive volume of trade between the United States and Canada, as well as their trade with other partners, selection of an appropriate rule of origin has been a major concern. As you requested, we examined the rule of origin developed for the proposed Agreement. On September 23, 1987, we briefed your representatives on our findings and provided them with a background paper. This report provides more detailed information.

The draft Agreement's rule of origin is based on a proposal drawn up by the U.S. Department of the Treasury. In general, the proposed rule confers U.S. or Canadian origin on a product containing foreign source parts, components, or materials when sufficient additional manufacturing occurs within the United States or Canada, respectively, to change the tariff heading under which the product is classified. The rule specifies which tariff heading changes are sufficient for origin to be conferred and which are not. The rule also provides that in certain circumstances where assembly of an article from foreign parts does not result in a change of tariff heading, origin

may be conferred if the assembly adds at least 50 percent to the total value of the final article.

Basing origin determinations on tariff classifications would be a change from the current U.S. rule, based on the substantial transformation concept, which confers origin when manufacturing "substantially transforms" a product so as to produce a "new and different article of commerce." The current rule requires case-by-case decisionmaking and considerable subjective judgement on the part of Customs officials, and was not acceptable to Canada. The proposed rule may involve less subjectivity than the current U.S. rule; however, its adoption is contingent on the planned U.S. conversion to the internationally standardized system of tariff classifications and nomenclature.

As requested, we did not obtain formal agency comments on this report. However, officials from Treasury and the International Trade Commission reviewed a draft of the report and generally concurred with our assessment.

Our work is discussed in greater detail in appendix I.

Unless you publicly announce its contents earlier, no further distribution of this report will be made until 2 days from its issue date. At that time, we will provide copies to other interested parties. If you have questions on the information provided, please contact me on (202) 275-4812.

Sincerely yours,

Allan I. Mendelowitz

Allan I. Mendelowitz
Senior Associate Director

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ABBREVIATIONS

CTH	Change of Tariff Heading
FTA	Free Trade Area
ST	Substantial Transformation

APPENDIX I

RULE OF ORIGIN FOR THE U.S.-CANADA FREE TRADE AREA

A major issue involved in the negotiations for the proposed U.S.-Canada Free Trade Area (FTA) has been the formulation of a rule of origin acceptable to both nations. This rule would establish the criteria that a product must meet to be considered "Made In" the United States or Canada, if the product does not wholly originate in either, so that it may be entitled to the trade preferences of the FTA.

In general, the proposed rule developed by the Department of the Treasury for the U.S.-Canada FTA confers U.S. or Canadian origin on a product containing foreign source parts, components, or materials when sufficient additional manufacturing occurs within the United States or Canada, respectively, to change the tariff heading under which the product is classified.[1] For products that are assembled from components, the proposed rule incorporates a value added test for local content of 50 percent.

Basing origin on a change of tariff heading (CTH) rule may represent some improvement over the current U.S. rule, which confers origin when manufacturing "substantially transforms" a product so as to produce a "new and different article of commerce" with a name, character, or use distinct from that of its components. The substantial transformation (ST) rule requires considerable subjective judgement on the part of Customs officials and was not acceptable to Canada. The benefit of the CTH rule is that decisions as to whether ST has occurred have already been made and written into the rule, so that it should be far more mechanical in application than the current rule. However, certain problems may arise in implementing the proposed CTH rule.

BACKGROUND

The primary purpose of the rule of origin is to ensure that significant economic activity takes place in a country before an importer can claim that country as the source of the product. The rule of origin, therefore, seeks to prevent cases where products gain favorable customs or tariff treatment after being slightly altered or simply repackaged in the importing nation. These practices are referred to as trade deflection where shipping or production patterns are deliberately arranged to mask the

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[1] A product undergoes a change of tariff heading when it has been changed sufficiently to meet the classification criteria of the tariff schedule for a different article of commerce.

real country of origin or to claim the benefits of preferential programs.

Thus, the rule of origin has become increasingly important with the growth in international trade and in the number of products that embody parts, components, or raw materials originating in another nation. This situation has been compounded over the last decade as numerous trade programs have been instituted that are country-specific (i.e., quotas, voluntary restraint agreements, or preference programs like the Generalized System of Preferences or Caribbean Basin Initiative). As the rule of origin has become increasingly more important, so too has countering the problem of trade deflection and ensuring that congressional intent in providing country-specific trade benefits is met.

The rule of origin became an issue in the negotiations for the U.S.-Canada FTA because of the problems associated with the current U.S. standard--substantial transformation. Its primary problem is its subjectivity, which requires a case-by-case decision as to whether substantial transformation has occurred. This subjectivity, and consequent unpredictability, has tended to promote litigation. While a sizeable body of precedent has accumulated, a Treasury official responsible for these matters felt that court interpretations have tended to confuse the issue. (To counter this, the U.S. Customs Service in recent years has also required substantial processing in addition to substantial transformation in some cases.)

Treasury's proposed rule, therefore, was developed to remove subjectivity and improve the functioning of the rule of origin. In a case such as the U.S.-Canada FTA, where such an enormous volume of trade is involved, it was important that the rule accurately place the legal origin of a product. Further, a Treasury official told us that experience with the ST rule of origin in the U.S.-Israel FTA has demonstrated the need for a more predictable standard and for easier enforcement in order to prevent trade deflection.

The proposed CTH rule was circulated for comment in both the United States and Canada. In the United States, it was reviewed by appropriate executive branch agencies, the International Trade Commission, Commerce's industry advisory committees, and the Joint Industry Group (a private sector association).

APPENDIX I

CONTENT OF PROPOSED RULE

The proposed rule of origin is still based on the concept that significant economic activity that leads to a substantial transformation of the product must occur to confer origin. However, it explicitly defines ST on a product basis as a change in tariff heading under the Harmonized System[2] for tariff nomenclature. Thus, when an article undergoes sufficient processing to change its tariff heading in the importing country, it may automatically have origin conferred in that country. The exception is where it has been predetermined in the Agreement that a particular CTH would not involve a substantial transformation of the product. Changes to certain tariff headings and subheadings are, therefore, identified under this rule as not conferring origin. The proposed rule also provides, under some circumstances, that articles assembled from foreign parts may qualify for a change of origin even though there has been no CTH. Here, a value added test of 50 percent must be met to ensure the significance of domestic content.

The benefit of using a CTH standard is that it can be applied more mechanically than the ST rule. In most cases, a CTH would automatically confer origin. Since the new rule relies on established principles of tariff classification, which provide guidance on what comprises a new and different article through descriptions of product categories, it is expected to be easier for Customs to administer and for industry to use in its production planning.

At the same time, one of the problems in using a CTH rule is that the tariff nomenclature was not designed with origin rules in mind. Any assembly, whether economically significant or not, will generally produce a change of tariff heading at some level of classification. Under the proposed rule, however, not all assembly confers origin; an additional, significant step in the processing or manufacturing of a product must have taken place, rather than simple combining or packaging. This is why certain tariff headings and subheadings have been set aside wherein a CTH would not confer origin because there has been no substantial transformation. This modification of the CTH standard reflects the fact that the

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[2] The Harmonized Commodity Description and Coding System is commonly referred to as the Harmonized System. It will facilitate the international standardization of tariff and statistical nomenclatures (i.e., classification systems). Legislation to ratify the Harmonized System Convention is now pending before the U.S. Congress and the Canadian Parliament.

significance of the assembly performed is not uniformly demonstrated by changes in tariff heading. As a result, a CTH at a particular classification level (e.g., a 4-digit heading or 6-digit subheading) in one product sector might not confer origin, while a change at that level would be sufficient for other product sectors.

For example, under the new rule a 4-digit level change of tariff heading may be sufficient to confer origin, as with a change to heading 1806 (chocolate and other food preparations containing cocoa) from any other heading. However, within heading 1806, only a change to subheadings 1806.31 (filled chocolate in blocks, slabs, or bars) or 1806.90 (other miscellaneous chocolate and food preparations not in blocks, slabs, or bars) would confer origin; changes to all other 6-digit subheadings have been set aside and would not confer origin.

In this regard, the proposed rule differs from the European Community's use of change of tariff heading for its rule of origin. The EC rule provides that a change in heading at the 4-digit level automatically confers origin, but then provides lengthy lists of exceptions where additional requirements must be met before origin is conferred. There are also exceptions that permit products to obtain a change in origin without a change of heading at the 4-digit level. The proposed U.S. rule, however, defines the required level of change (e.g., 4-digit or 6-digit) depending on the product, and these definitions have already been determined and written into the rule of origin.

Under the proposed rule of origin for the U.S.-Canada FTA, in certain instances where assembly of an article from foreign parts does not result in a CTH, a value added test of 50 percent is triggered. This occurs when (a) the article was imported in unassembled or disassembled form (such as a kit) and classified under the tariff category for the assembled article or (b) the article is classified under tariff subheadings which provide for both the article and its parts. Then, if the value of the materials obtained or produced in either the United States or Canada, plus the direct cost of assembly operations, constitute at least 50 percent of the value of the article, ST is considered to have occurred and origin is conferred.

The definition of value added has been modified in the proposed rule of origin compared with certain trade preference programs. The proposed rule focuses on production cost rather than on sales price, thus eliminating such costs as advertising, sales promotion, profit, and administrative overhead costs. According to Treasury, it was for this reason that the value added threshold, originally proposed at 35 percent as in the Generalized System of Preferences

and Caribbean Basin Initiative programs[3], was later revised upward to 50 percent.

POTENTIAL IMPLEMENTATION PROBLEMS

Implementation of the new CTH rule of origin for the U.S.-Canada FTA will likely face some problems. The most obvious one is its newness for both Customs officials and businessmen. However, Treasury believes that the rule of origin is written so that industry can use information it already has, including the Canadian import form needed to get goods into Canada or the export form needed to move goods out of the country. It would be necessary to get additional information regarding the import value of components only if a firm did not import the components itself.

Despite the more mechanistic nature of the CTH rule, Customs still has a relatively complicated task, potentially requiring two classification decisions when a product using components imported into Canada claims exemption from tariffs under the FTA Agreement. If Customs questions the exporter certification that the product meets all U.S. legal requirements for tariff preference, then the original Canadian classification decision must be double-checked in making a second classification decision for U.S. entry. Treasury states, however, that verifying classification will still be easier than verifying the direct costs of processing, as required in current practice. There will also be mutual enforcement of the rule of origin by both sides. Thus, if a Canadian exporter gives false information to U.S. Customs, Canadian authorities will take action against the firm in Canada; U.S. authorities would take action against U.S. firms that falsely informed Canadian Customs.

Implementing the new rule of origin in the U.S.-Canada FTA may create greater short term uncertainties due to the unfamiliarity of U.S. Customs and industry with the rule and the Harmonized System. However, it should create an easier and more predictable process in the long term. Use of CTH represents a mid-ground between ST (least predictable) and a process-based system (most predictable), as proposed in the U.S. International Trade Commission's May 1987 report, Standardization of Rules of Origin, USITC Publication 1976.

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[3] Value added in the Generalized System of Preferences is based on the transaction value. Due to problems Customs experienced in implementing it, the definition of value added was modified in the Caribbean Basin Initiative to exclude profit and some overhead. The modification of value added in the U.S.-Canada FTA has gone further to include only production costs.

In the opinion of an ITC official, there was not enough time before the FTA agreement deadline for such a process-based system to be fully considered. However, the proposed CTH rule does not preclude a subsequent move to a process-based system, either bilaterally or multilaterally, in the event that the process basis gains wider acceptance.

The process-based rule of origin proposed by the International Trade Commission would enumerate for each product sector (and for some individual products) those industrial processes considered sufficiently significant to confer origin. The Commission believes that such a system would be clear, predictable, and conducive to consistent application with a minimum of subjective interpretation. Origin would automatically be conferred without regard to the value contribution made or to other extraneous standards. Whether a given process should be deemed to confer origin would have been decided in the original creation of the process list, permitting advance knowledge by industry in its production planning of the potential origin treatment of goods not wholly made in one country. It would also do so without the need for constant recourse to Customs officials or the courts. However, a process-based rule would also have to be constantly updated as new technologies and processes evolved. Some believe this would make such a rule difficult to administer.

Consideration of whether the CTH rule of origin is the most appropriate standard for the U.S.-Canada FTA may be irrelevant if the Harmonized System for tariff nomenclature, the basis of the proposed rule, is not adopted by the United States and Canada. Legislation to do so is currently pending consideration before the U.S. Congress as part of the 1987 omnibus trade bills. Canada has also not yet ratified the Harmonized System, but has indicated that it intends to do so before the end of the year.

OBJECTIVES, SCOPE AND METHODOLOGY

Our objective was to identify and assess the rule of origin developed for the U.S.-Canada FTA Agreement. We interviewed officials of the Treasury Department, U.S. International Trade Commission, and Office of the U.S. Trade Representative concerning the rules of origin for the U.S.-Canada FTA. The Commission's reports Standardization of Rules of Origin and The Impact of Rules of Origin on U.S. Imports and Exports (USITC Publication 1695, May 1985) provided an important source of background information about rules of origin and we relied upon them in our work.

Officials from Treasury and the International Trade Commission reviewed and commented on a draft of this report. They generally concurred with our assessment and their comments were reflected in this report as appropriate. Our review was performed from August to October 1987 in accordance with generally accepted government auditing standards.

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