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ITS ORIGIN, NATURE AND  
DIRECTIONS FOR REFORM

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# **Country of Origin Rules: Its Origin, Nature, and Directions for Reform\***

by

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## **Abstract**

In a world of increasing specialisation and division of labour, the designation of one country of origin to a product is becoming increasingly out of touch with the reality and is getting more and more costly in terms of the investment and trade diversion effect country of origin rules(COR) cause. This paper proposes an extension of the Lloyd(1993) proposal and formalizes it into a Multiple Country of Origin Rule and recommends it on the basis of the more accurate information content it provides and the greater economic efficiency it results.

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## 1. Introduction

Designation of the country of origin to a product serves one of two purposes: an informative purpose and an administrative purpose. Information about the country of origin is sought by consumers, importers, and other interested parties who may regard the country of origin to be related to quality or to have an effect on market demand for a good. Designation of the country of origin is needed if products of different countries are treated differently for tariff or quota purposes. The country of origin rule is a necessary complement to discriminatory commercial policies<sup>1</sup>.

In a world of increasing specialisation and division of labour a product nowadays is more often than not the joint output of many countries<sup>2</sup>. However, there is in practice only one country of origin for one product. Because of the proliferation of discriminatory commercial policies<sup>3</sup> manufacturers have an incentive to arrange their production in such a way that their products qualify to assume the country of origin with the most favourable treatment by importing countries.

There is, however, no objective, scientific way of determining the country of origin of a global product, by which I mean a good produced in a multitude of countries. Indeed, the country of origin rule varies from country to country, from product to product, and, for a given product and a given importing country, even from time to time. Because of the virtually unlimited discretion bureaucrats have over the country of origin rule, the country of origin rule has become an excellent vehicle for the conducting of discriminatory industrial policies. To wit:

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<sup>1</sup> The opening sentence of Vermulst(1992) reads: “The *raison d’etre* for rules of origin is the existence of differentiated restrictions on international trade.”(p. 61)

<sup>2</sup> Vernon(1996) cited UNCTAD and wrote, “manufacturing firms that were units in a multinational network accounted in 1989 for 72 per cent of the manufacturing output of the United States, for 48 per cent of the manufacturing output of the Netherlands, and for 32 per cent of the output of Japan.”(p.630)

<sup>3</sup> According to Lau(1996) “From the inception of the GATT in 1947 to the inception of the WTO on 1 January 1995, 98 Regional Trade Agreements were notified to GATT under Article XXIV(and 11 preferential agreements were notified or covered by the 1979 Enabling Clause.)”(p.15)

Already the European Community(EC)(after February 1992 the European Union) has used origin rules as instruments of commercial policy in its Single Market as a way to force investment and protect critical high-tech industries. The United States followed in the North American Free Trade Agreement(NAFTA), using rules of origin not only to prevent the use of Mexico as an export platform into the U.S. market by Japan and other countries, but also to stimulate investment and encourage sourcing from the NAFTA partners.(Jensen-Moran, 1996, p. 240)

There is no doubt the country of origin rule is an extremely powerful force that forges the directions of FDI and trade flows. Yet it is precisely because of its potency it is an independent source of uncertainty and economic waste. Historically, investors have found the values of their investment wiped out overnight by a change of the country of origin rule(COR). Compliance with requirements for the designation of the most favoured country of origin may become more important than sourcing materials and supplies from the most efficient suppliers.

From the economic point of view, the large distortionary effect of COR stems from the *totally* different treatment a product enjoys when there is a *marginal* variation in domestic content that is sufficient to change the country of origin designation. In such circumstances, the temptation of bringing about the marginal difference in domestic content to warrant preferential treatment is irresistible. Because there is no end to the possible variations in domestic content requirements for a COR designation, the COR is an important independent cause of uncertainty facing investors.

## **2. A Multiple Countries of Origin(MCO) Rule Based on Value Added**

To reduce the distortionary effects of COR we propose that we dispense with the artificial designation of a single “country of origin” on what is truly a global product. This is essentially the proposal made by Lloyd(1993) but we shall extend the

concept to cover both tariffs and quantitative restrictions, rather than just for Free Trade Areas with discriminatory tariffs on non-member countries, the subject of Lloyd's original paper. In a nutshell, we propose to institute the designation of multiple countries of origin(MCO) based on value added produced at different stages in different countries.

The MCO requires that tariff be paid only once in the country of final consumption. Intermediate goods imported for processing and exported later are exempted from tax. Suppose a product X has three stages of production in countries A, B, and C respectively. Suppose the final product is eventually imported and consumed in country D. Let the unit price of the imported good be  $p$  at the point of importation and it is equal to  $a + b + c$ , where  $a$ ,  $b$ ,  $c$  are respectively the value added in A, B, C. The proposed arrangement is for country B and country C not to impose any tariff on  $a$  and  $b$  respectively. That is to say, goods imported for re-export are not subject to tariffs. Now let country D impose differential tariffs on import X from A, B, and C at  $t_a$ ,  $t_b$ , and  $t_c$  respectively. Then it is proposed that instead of designating X as originating from A, B, *or* C we should treat it as originating from A, B, *and* C and impose a total tariff of  $t_a a + t_b b + t_c c$ . In the case that there are only two rates of tariff, at  $t_f (=0)$  and  $t_{nf}$  for the free trade region and the non-free-trade region respectively, and assuming that both A and B belong to the non-free-trade region while C belongs to the free trade region, the effective tariff on the good will be  $t_{nf}(a+b)$ . This is exactly Lloyd's (1993) proposal. We would, however, maintain that for information purposes  $a$ ,  $b$ , and  $c$  should still be identified as the corresponding values added from A, B, and C respectively--a Multiple Country of Origin(MOC) Rule as we call it. In consideration of administrative simplicity, we would recommend that only three principal countries of origin be made known to importers and consumers in order of importance. This subject will be discussed further in the next Section.

We now propose an extension of Lloyd's framework to products subject to quantitative restriction as well. Again using the previous example, suppose that a different quota restriction applies to the same product X depending on whether it originates from A, B, or C. Suppose  $P$  is the unit price of X upon its being imported

into D, which imposes the quantitative restriction. If P comprises values added  $a + b + c$ , corresponding to the value added by A, B, and C respectively. Then the proposal is that we treat a unit of X imported into D as consisting of  $a/P$  unit being imported from A,  $b/P$  unit from B, and  $c/P$  unit from C. Clearly, these subunits add up to one unit. The recalculated number of units of hypothetical imports is the same as the actual number of units of the import. In other words the physical number of units of X imported is consistent with the quota imposed by country D as originally intended. The importing country achieves the degree of protection it wants. The only difference is that the quota is now shared among the exporting countries on a *pro rata* basis.

It may be noted that, as proposed, the consumption of the quota for country A, B, and C respectively will be against the quota imposed on good X, and not against the quota imposed on the respective intermediate goods. More specifically take the illustrative example of the car industry. Suppose country D does not impose any quota restriction on steel. To the extent that steel is imported by B and eventually transformed in countries B and C into a part of a car imported by D, country C, as the final exporter of the good, will need to *buy* the necessary *automobile* quota for A as a car exporter as well as the necessary *automobile* quota for B and for C. Alternatively, we may assume that country D sets automobile quotas for A, B, and C and auctions these quotas in the open market. Importers will need to buy the necessary quotas in the open market as they import directly or indirectly from different countries.

It should be noted that in the above example, we had assumed that D does not impose any quota restriction on steel. Suppose D does impose a quota restriction on steel. Then the proposal is that the importer of cars would not need any quota for steel as such as long as it is using the quota for cars. This ensures that there is no double counting. On the other hand, if D imports steel directly from A, it will need to use the quota for steel as applied to country A. An additional remark is that in the algebraic example, X could itself be an intermediate good or a final good<sup>4</sup>.

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<sup>4</sup> It is true that in a world characterized by much trade between the parent company and its subsidiaries the reported value added accorded to different countries may be distorted by transfer pricing. While the proposed MCO rule is far from perfect it is nevertheless a big improvement



### **3. A MCO Rule For More Accurate Representation of Data**

The proposed MCO rule provides an objective way of describing the origin of a good. Consumers can, through the use of a *Global Product Label*, read the names of, say, three countries of origin in order of percentage content. This not only conveys more accurate information compared to a single “Made in Country X” label, but it will also reduce protectionist sentiments. It will clearly foster a feeling of living in a “global village,” and a sense of cooperative harmony. Implementation of the proposal will alleviate such complaints as recently reported in the *Asian Wall Street Journal* (June 26, 1997), wherein Japanese watchmakers protest the label of “Made in Japan” on watches exported by Hong Kong watchmakers that use the movements imported from Japan.

The MCO concept will help alleviate the kind of trade disputes such as recently arising between the United States and China, with each side disputing the magnitude of the trade surplus(deficit). Without affecting the total trade balance of a country, which may continue to be interpreted as total merchandise exports minus total merchandise imports, bilateral trade accounts will be modified to read Value Added Exported to the Trade Partner Minus Value Added Imported from the Trade Partner. Such accounts will no doubt be more costly to compile, and the cost of collecting very accurate information may indeed be high.

### **4. Practical Considerations**

Meaningful application of the proposed MCO principle does not require great precision in data collection. Practical considerations means that very precise data may be difficult to collect and verify, such as reported price data in the case of transfer pricing. But the additional cost of collecting reasonably accurate information, however, may not be as high as one may think. Even though the cost of setting up a system of information collection may be significant, the cost of running the system

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from the present regime even if the information reported is not precise or is not totally accurate.

need not be very high. Importers of intermediate goods have incentive to declare (evidence must, of course, be presented<sup>5</sup>) and to certify the reexport of such goods as embodied in exported goods, because this will allow them to be exempted from tariffs. The problem may appear to be more serious with products that are produced in many stages in many countries. The complexity, however, is not insurmountable. The fact is, no matter how many inputs and how many countries are involved, specialisation means that each firm is responsible for clearly defined stages of output and is responsible only for identifying his own value added. The complexity should be similar to that arising from the value added tax. Indeed, to the extent that the value added tax is already quite common, the additional complexity appears to be small.

It is admitted that in the case of multiple stages of production in many countries and sourcing of materials from different countries precise application of the MCO principle to preferential quantitative restrictions may be very complicated. Practical considerations suggest that we may have to set up an "other countries" category along with the three top value-added countries for any product.

#### **4. Conclusions**

Given the ongoing international division of labour, the idea of one single country of origin is becoming increasingly out of date and out of touch with reality. The fact that it continues to prevail is largely a reflection of the continuing inclination of bureaucrats to use rules of origin as a convenient discretionary complement to discriminatory commercial policies and as a tool to be used both to achieve internal industrial policy objectives and to serve as a bargaining chip in international trade negotiations. However, the cost of arbitrary rules of origin is increasing rapidly as global specialisation and division of labour intensify. International investors find rules of origin an important source of uncertainty and a reason to plan their production in globally inefficient manners --which is not helped by the lack of transparency when a

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<sup>5</sup> There may be some inaccuracy, it is up to the manufacturer as to how a batch of intermediate goods is attributed to different products.

COR is changed or when interpretation of an existing COR is necessary(Lau, 1996). This leads to higher costs that ultimately hurt the interest of both consumers and producers. Worse still, overall industrial investment is likely to be less than otherwise. As a result employment is reduced.

In this short paper we have outlined how the concept of multiple country of origin can be put into practice. We recognize that it is naive to believe that discriminatory commercial policies and protectionism can be replaced by global free trade within the foreseeable future. To the extent that such policies are required by the politics of individual countries, they should be as explicit as possible. By nature a single country of origin rule is arbitrary, non-scientific, and necessarily a cause of uncertainty and dispute. It is high time that it be replaced by a more objective and scientific rule that provides more accurate information about products produced and traded globally and also removes this source of uncertainty once and for all.

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