



## GATT Article XXIV and Asymmetric Rules of Origin

Could it work for EPAs?

2008

As of 1 January 2011:

**giz** Deutsche Gesellschaft  
für Internationale  
Zusammenarbeit (GIZ) GmbH

**gtz**

commissioned by



Federal Ministry  
for Economic Cooperation  
and Development

**Publisher:**

Deutsche Gesellschaft für  
Technische Zusammenarbeit (GTZ) GmbH  
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**This study has been commissioned by GTZ on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ), Germany. The views expressed in this study are those of the authors only and should not be attributed to BMZ and GTZ.**

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## List of Abbreviations

ACP	African, Caribbean and Pacific Countries
AoS	WTO Agreement on Safeguards
ARO	Agreement on Rules of Origin (GATT 1994)
CARICOM	Caribbean Community
CBD	Convention on Biological Diversity
CEPA	CARIFORUM-EC Economic Partnership Agreement
BTA	Bilateral Trade Agreements
DDA	Doha Development Agenda
EPA	Economic Partnership Agreement
EC	European Community
EU	European Union
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GI	Geographical Indication(s)
IPRs	Intellectual Property Rights
LDC	Least-Developed Country
MFN	Most Favoured Nation
MRA	Mutual Recognition Agreement
NAFTA	North American Free Trade Agreement
NT	National Treatment
OECD	Organisation for Economic Co-operation and Development
ORC	Other Regulations of Commerce
PTA	Preferential Trade Agreements
RP	Reference Paper (also: WTO Reference Paper on Basic Telecommunications)
RTA	Regional Trade Agreement
SMEs	Small and Medium-Sized Enterprises
SPS	(Agreement on) Sanitary and Phytosanitary Measures
SSM	Special Safeguard Mechanism

SVEs	Small, Vulnerable Economies
TA & CB	Technical Assistance and Capacity Building
TBT	(Agreement on) Technical Barriers to Trade
TDCA	South Africa Trade, Development and Cooperation Agreement
TRIPS	(Agreement on) Trade-Related Intellectual Property Rights
UPOV	International Union for the Protection of New Varieties of Plants (Union internationale pour la protection des obtentions végétales)
WCT	WIPO Copyright Treaty
WPDR	Working Party on Domestic Regulation (WTO)
WPPT	WIPO Performances and Phonograms Treaty
WIPO	World Intellectual Property Organization
WTO	World Trade Organization



## 1 Introduction

Rules of origin are criteria used to determine the 'economic nationality' of products. Determining the economic nationality of products is a prerequisite for market access to preferential markets especially in globalised manufacturing processes where products are made of input materials from various sources. Preferential trade agreements require that preferences are made available only to the parties to the trade arrangement and not to 'free riding' third parties. Rules of origin are therefore decisive components in trade agreement as they define the effective reach of RTAs by ensuring that the privileges of free trade are exclusive to members to the RTA and do not extend to 'free riding' third parties through transshipment and trade deflection.

Because they determine the effective extent of market access, rules of origin are an important factor in the "depth" of free trade agreements. This matters because WTO rules, namely GATT Article XXIV, require a certain coverage of trade to allow for parties to preferential agreements to actually grant each other these preferences, *i.e.*, to deviate from the otherwise applicable MFN principle.

When considering possible asymmetries in favour of the ACP parties to the EPAs it would appear conceivable to consider not only asymmetric market access commitments (in particular tariff concessions), but also asymmetric rules of origin that make it easier for ACP producers than for EU producers to obtain origin (and hence benefit from the trade preferences). The EU could, for example, be asked to fulfill a higher percentage of value-added than ACP countries. This paper assesses the issue of conformity of such asymmetric rules of origin in EPAs with WTO rules, in particular GATT Article XXIV.

## 2 Starting Point: Possible Asymmetric Rules of Origin for EPAs

Rules of origin, as indicated, determine the 'economic nationality' of a product with respect to a particular trade regime, for example a free trade agreement (hereinafter FTA). In FTAs and other negotiated bilateral or regional trade agreements rules of origin are often agreed upon, not set unilaterally by the parties.

Usually the parties agree on one set of rules of origin for all. It is equally conceivable, however, to agree on different rules of origin for the same goods depending on the country of exportation, or the party concerned. This has been specifically proposed for the Economic Partnership Agreements (hereinafter referred to as EPAs), for instance by the Joint Parliamentary Assembly.<sup>1</sup> The thrust of such proposals is to agree on less strict rules of origin for exports from African, Caribbean and Pacific countries (hereinafter referred to as ACP) to the EU than vice versa to make it easier for ACP exporters to source components from third countries without jeopardizing the status of 'originating product' for the final good to be exported to EU markets.

In principle any variation of asymmetric rules of origin is conceivable and any of the 'classical elements' of rules of origin discussed below can be made stricter or looser, in combination or alone and fine-tuned with respect to the particular product to which they apply, respectively.

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<sup>1</sup>Report on Economic Partnership Agreements: Problems and Prospects adopted by the ACP-EU Joint Parliamentary Assembly on 14 February 2004.

If the stricter rule of origin, for instance, demands specific acts of transformation or a change in tariff heading, the looser rule could offer, in addition and as an alternative, a value-added criterion (e.g., 20 per cent), thereby offering producers in the privileged FTA party the possibility to generate an originating good even if they do not meet the transformation/change of tariff heading requirement, while producers in the other party do not have that choice. A strict transformation requirement (e.g., two steps for textiles, i.e. yarn to fabric, fabric to garment) applicable to the non-privileged side could be loosened to a less strict requirement (one step only, e.g., fabric to garment) for producers from the privileged FTA party. Or a value-added requirement of, say, 30 per cent on the non-privileged side could be met with a value-added requirement of 20 per cent from the privileged side.

Since no specific proposals on asymmetric rules of origin appear to yet have approached agreement in the EPA negotiations, this paper will address the issue in principle. It will be useful and necessary to revisit the issue with a close look at specifics once these and the surrounding factors, such as product coverage, become more discernible, since the evaluation of the matter under GATT Article XXIV will depend on these factors joint effect.

For purposes of this analysis, the following schematic assumptions about a possible EPA system of asymmetric rules of origin will be taken as points of reference:

- The rules of origin sides differ only moderately between the two sides (e.g., value-added requirement of 30 per cent for EU producers, 20 per cent for ACP producers).
- The stricter rules (on the EU side) conform more or less to normal practice in FTAs, i.e., are not unusually strict. The looser rules of origin (on the ACP side) are thus less strict than average rules of origin in FTAs.

Before explaining at which junctures of the analysis these assumptions may matter, the following section provides a very brief general overview of rules of origin in preferential trade agreements.

### **3 Rules of Origin in Preferential Trade Agreements**

#### **3.1 The Function and Effect of Rules of Origin**

Rules of origin are criteria used to determine the country of origin, or 'economic nationality,' of a certain product. Most countries, as well as the WTO system, differentiate between two types, or sets, of rules of origin: preferential and non-preferential rules of origin.

- Preferential rules of origin are used in bilateral or regional trade agreements (hereinafter jointly referred to as RTAs) to implement tariff policies through distinguishing between products that originate in a preference receiving country (party to the RTA) and thereby qualify for a preferential treatment, and products that originate in third countries and therefore do not qualify for such a treatment.<sup>2</sup> Rules of origin therefore define the effective reach of RTAs by ensuring that the privileges

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<sup>2</sup> Paragraph 2 of Annex II to the Agreement on Rules of Origin (Common Declaration with Regard to Preferential Rules of Origin).

of free trade are exclusive to members to the RTA and do not extend to 'free riding' third parties through transshipment.

- Non-preferential rules of origin are used to make a distinction between domestic and foreign products for purposes of implementation of non-tariff barriers to trade including quantitative restrictions, trade remedies and government procurement policies.

### 3.2 Overview: Determination of Origin

The World Customs Organization's Kyoto Convention<sup>3</sup> sets forth the basic criteria and recommended practices for the determination of origin on the basis of which countries administer their own legislative frameworks for rules of origin. Most national systems broadly follow the Kyoto Convention's approach, which itself is a reflection of established international practice in this regard.

The essential elements of classical rules of origin can be sketched as follows.

#### 3.2.1 Basic Distinction: Wholly Obtained v. (Sufficient) Transformation

Goods acquire origin if the input material or the product is either 'wholly obtained' or if the non-originating components of the product undergo sufficient transformation.

**Wholly obtained** products are products composed of input or raw material that originate in the same country where the production process is completed (or – if cumulation of origin is allowed – in the parties to the preferential trade agreement). The product, in other words, is entirely 'homegrown'. Classical examples of wholly obtained goods include live animals, agricultural products such as vegetables and fruits and minerals extracted from the soil or seabed.

Most production processes, in particular in manufacturing, however, use imported components from third countries. In this case local origin is conferred to the imported, originally non-originating goods when **sufficient transformation** of the non-originating components takes place. The following three main criteria are used, individually or in combination, in RTAs to determine whether sufficient transformation took place:

- Change in tariff heading requires that the manufacturing process results in a product that falls under a tariff heading (normally a four digit HS number) different than that of the non-originating components.
- Value added criteria appear in various forms. One is the *local content* method requiring that a certain percentage of local value is added to the non-originating components. Another is the *import content* method imposing a ceiling on the use of

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<sup>3</sup> Chapter 1 of Annex K to the International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto Convention) of 18 May 1973.

imported non-originating components by setting a maximum allowable percentage of these components.<sup>4</sup>

- Processing operations, also referred to as technical operations, requires that the product undergo certain processing or production operations such as cutting, knitting, dyeing and assembling in order to acquire origin.

If the product was produced in more than one country, the product acquires the origin of the country in which the last sufficient transformation took place.

### 3.2.2 Negative Distinction: Minimal Operations

Many agreements, including trade agreements concluded by the EC provide that certain processes or operations are considered insufficient to confer originating status on products. The Community Customs Code as well as EC agreements refer to these as 'minimal operations.' They include, for instance, packaging, labeling, cooling, preserving, simple mixing or assembling of product components.

### 3.2.3 Cumulation of Origin

Cumulation of origin allows for the use of imported materials from countries parties to an RTA in the production process without the risk of losing the preferential 'originating' status of the final product. Imported inputs from RTA partner countries do not count as foreign inputs and, therefore, are not subject to the 'sufficient transformation' requirement usually required for imported components before they can benefit from RTA preferences. As a consequence, cumulation of origin provides an incentive to source components from within the RTA.

Cumulation rules differ between agreements. They aim to reflect the specific interests of the parties to the RTA. There are three types of cumulation of origin reflecting the level of economic integration between partner countries to an RTA:

Bilateral cumulation occurs primarily in bilateral trade agreements (hereinafter referred to as BTAs) such as for example the EC's Association Agreements. It allows one member of the BTA to use imported materials from the other member to the BTA in the production process without losing the preferential status of the final products, provided that the imported materials acquired originating status in the export country because they are either wholly obtained or sufficiently transformed.

Diagonal cumulation often occurs in RTAs that have more than two parties; they are equally conceivable – as is the case, for example, of the emerging Pan-Euro-Mediterranean system of cumulation – in economic areas based on a web of bilateral treaties. Diagonal cumulation allows for the use of imported materials from any member to the RTA (almost as if these inputs came from the producing country itself) in the production of goods, which then acquire originating status in the country of the final processing, provided that the final processing is more than a minimal operation. These input materials that originate in countries parties to

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<sup>4</sup> E. Vermulst, Rules of Origin as Commercial Policy Instruments? in E. Vermulst, J. Bourgeois, and P. Waer (eds), *Rules Of Origin in International Trade: A Comparative Study* (University Michigan Press: 1994), p 436.

regional cumulation do not count as foreign inputs for purposes of any value added, specific transformation or change in tariff heading rule.

Full cumulation differs from diagonal cumulation in that it does not require that input materials from RTA partners first acquire originating status before they are used in further production in another RTA partner. Full cumulation considers all production steps performed within the RTA space as one and measures them against a single rule of origin.

## 4 WTO Disciplines on Rules of Origin in Preferential Trade Agreements

### 4.1 No Relevant Specific WTO Rules on Preferential Rules of Origin

The WTO package of agreements contains, as one of the Annexes to the GATT 1994, the Agreement on Rules of Origin (ARO). The ARO, however, primarily addresses *non-preferential* rules of origin, i.e. those that WTO Members apply to trade between them under general WTO rules, in the absence of a preferential trade relationship.<sup>5</sup> For these non-preferential rules of origin the ARO provides essentially for a work programme towards the development of harmonized rules within the WTO. In addition, the ARO provides some general, high-level principles that apply while the work programme is under way.

*Preferential* rules of origin, arguably not directly a WTO matter, are only addressed in the form of an Annex. Annex II to the ARO contains the “Common Declaration with Regard to Preferential Rules of Origin” (hereinafter referred to as the Declaration). Paragraph 2 of the Declaration defines preferential rules of origin as:

*“those laws, regulations and administrative determinations of general application applied by any Member to determine whether goods qualify for preferential treatment under contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of paragraph 1 of Article I of the GATT 1994”.*<sup>6</sup>

The WTO disciplines (ARO and Declaration) do not establish any significant ‘hard’ criteria for preferential rules of origin, leaving this to the Members acting autonomously or as FTA partners. In the Declaration WTO Members only agree to observe certain general obligations when drafting and implementing their national preferential rules of origin including such matters as transparency, the obligation to ensure that the criteria for establishing origin are clearly defined, that the rules of origin are based on a positive standard (*i.e.*: set the criterion

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<sup>5</sup> Article 1 of the Agreement on Rules of Origin defines rules of origin as laws, regulations and administrative determinations applied to determine the country of origin for goods for purposes other than granting of tariff preferences. Article 1 of the Agreement further mentions areas of application of non-preferential rules of origin including the determination of MFN qualification, the implementation of certain commercial policy instruments such as anti-dumping and countervailing rules in addition to safeguard measures, the application of labelling and marking requirements, the application of quantitative restriction, implementation of government procurement policies and the collection of statistics.

<sup>6</sup> Paragraph 2 of Annex II to the Agreement on Rules of Origin.

that does establish origin and not the criterion that does not) and that rules of origin decisions are subject to judicial review.<sup>7</sup>

The Agreement on Rules of Origin thus neither offers relevant legal parameters nor guidance for the purpose of this paper. It is notable, in particular, that Annex II (the Declaration) on preferential rule of origin does *not* contain certain elements that are found in Article 2 of the Agreement, referring to non-preferential rules of origin, in particular the requirement that rules of origin ‘are not used as instruments to pursue trade objectives directly or indirectly’ (Article 2 paragraph (b)). This is not surprising, as rules of origin in RTAs usually serve precisely that function – and are thus allowed to do so. This would appear to include asymmetric rules of origin in preferential agreements provided these agreements as a whole, including their rules of origin, satisfy the WTO rules on such agreements, namely Article XXIV of the GATT in the case of trade in goods.

It remains thus to consider whether WTO rules on RTAs, most notably Article XXIV of the GATT, provide any conditions for, or limitations on, the use of rules of origin generally and asymmetric ones in particular.

#### **4.2 General Rules on Regional Trade Agreements for the EPAs: The Enabling Clause and GATT Article XXIV**

The GATT/WTO system provides for two distinct sets of rules for RTAs. The older, general rule is contained in GATT Article XXIV, which imposes certain conditions on RTAs, namely the internal and external trade requirements, in exchange for the exemption from certain GATT rules, most importantly the MFN principle in GATT Article I. GATT Article XXIV does not differentiate between types or classes of WTO Members.

The so-called “Enabling Clause” largely eliminates these conditions for preferential trade agreements (only) between developing countries (so-called South-South RTAs). As the EPAs, however, involve the European Community and its Member States, the Enabling Clause does not apply. It follows that it can neither justify, nor prohibit, certain rules of origin in EPAs, asymmetric or not. This leaves GATT Article XXIV as the yardstick for the question before us.

#### **4.3 The Applicability of GATT Article XXIV Disciplines on Rules of Origin**

##### **4.3.1 Very Brief Sketch: The Essence of GATT Article XXIV**

GATT Article XXIV recognizes the desirability of forming close economic integration in the form of customs unions and free trade areas (RTAs) as a means of increasing the freedom of trade between parties to the RTA<sup>8</sup> and thereby contributing to the expansion of world trade.<sup>9</sup> While recognising the desirability of RTAs to develop and facilitate trade among parties to the

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<sup>7</sup> Paragraph 3, *ibid.*,

<sup>8</sup> GATT Article XXIV:4

<sup>9</sup> Preamble of the GATT 1994 Understanding on the Interpretation of Article XXIV.

RTA for purposes of trade creation, Article XXIV:4 recognizes the potential adverse effects of RTAs on raising barriers to trade with third parties including in the form of trade diversion.

Reflecting the need to balance risks and opportunities, GATT Article XXIV rules therefore make the right to form RTAs conditional upon meeting the following requirements:<sup>10</sup>

**External trade requirement: tariff and non-tariff barriers not more restrictive than before.**

GATT Article XXIV:5(b) stipulates that:

*“duties and other regulations of commerce maintained in each of the constituent territories and applicable at the formation of such free trade area or the adoption of such interim agreement to the trade of contracting parties shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free trade area”.*<sup>11</sup>

It is worth noting that in the case *Turkey – Textiles* the WTO Appellate Body had to interpret the almost parallel provision on customs unions in Article XXIV:5 (a), which provides that the duties and other regulations of commerce “on the whole” shall not be higher or more restrictive than before. The Appellate Body concluded that in order for customs unions to satisfy the requirements of Article XXIV, members of the union are obliged to ensure that their tariffs and non-tariff barriers vis-à-vis third countries “shall not on the whole be (...) more restrictive than the general incidence” of the regulation of commerce in place prior to the formation of the RTA.<sup>12</sup> It agreed with the Panel that this assessment required an economic analysis of the actual practices before and after, rather than a look at whether WTO ceilings (limits such as bound tariffs and other WTO “rights”) are being changed.

It must be noted, however, that subparagraph (b) omits the phrase “on the whole” with respect to FTAs, suggesting that no such overall weighing is required. This appears logical as FTAs, in contrast to customs unions, do not require the harmonization of the members’ external trade policies vis-à-vis third parties, and hence cannot in themselves explain or justify any additional external trade barriers.<sup>13</sup> It would appear, thus, that FTA partners are generally not allowed to raise barriers to trade with third parties as a result of the formation of the FTA.

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<sup>10</sup> In addition to the conditionality for concluding RTAs mentioned in Article XXIV:5, paragraph 1 of the Understanding on XXIV states that conformity of RTAs with GATT Article XXIV must satisfy paragraph 5, 6, 7 and 8 of the Article. Paragraph 6 of the Article stipulates that the provisions of GATT Article XXVIII on the modification of schedules shall apply if members of the RTA raise their applied tariffs vis-à-vis third parties. Paragraph 7 sets a notification requirement of RTAs to the WTO members. The obligations under paragraph 5 and 8 of the Article are further analysed here.

<sup>11</sup> A similar wording is contained in paragraph 5(a) of the Article in relation to customs unions.

<sup>12</sup> WTO Appellate Body Report, *Turkey-Restrictions on Imports of Textiles and Clothing Products*, WT/DS34/AB/R, 1999, paragraph 54.

<sup>13</sup> It is not the aim to conclude here that no such overall weighing is appropriate *at all* in evaluating FTAs under Article XXIV. One could imagine this to be a possibility when, for instance, SPS and TBT practices emerge as a result of the formation of an FTA where no such practices existed before, thereby making trade more difficult, but as a result of more developed practices in full conformity with the TBT and SPS agreements. It would be interesting to see how this interpretative challenge would be addressed by Panels and/or the Appellate Body.

### **Internal trade requirement: liberalization of substantially all trade.**

Paragraph 5 of GATT Article XXIV is complemented in relevant part by paragraph 8, which defines customs unions and FTAs for purposes of the provision and thereby establishes requirements for the liberalization of 'internal' trade between the partners of the RTA.

Paragraph 8(a) of Article XXIV reads in relevant part as follows:

*“a customs union shall be understood to mean the substitution of a single customs territory or two or more customs territories, so that*

*(1) “duties and other restrictive regulation of commerce (...) are eliminated with respect to substantially all trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories”.*

In regard to FTAs, paragraph 8(b) of the Article in parallel provides as follows:

*“a free trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (...) are eliminated on substantially all the trade between the constituent territories in products originating in such territories”.*

Paragraph 8 of Article XXIV thus requires parties to RTAs to eliminate tariffs and non-tariff barriers in regard to “substantially all [the] trade” between them. An RTA that falls short of that does not benefit from the exception provided in Article XXIV:5. This would mean, most importantly, that all preferences granted between RTA partners would be in plain and unjustified violation of the MFN principle in Article I of the GATT.

It is important to note that Paragraph 8 thus requires a far reaching *minimum* degree of internal liberalization between the RTA parties. From the perspective of MFN this may appear counter-intuitive at first sight, as more preferential liberalization between FTA partners *prima facie* means less MFN treatment for others. But since this comes in exchange for integration of the two economies concerned and hence increased bilateral trade, and thus internal competition, the GATT concluded that it is within the logic of the RTA exemption to require full or far-reaching internal liberalization, and hence integration of the economies concerned, in exchange for the exemption from the MFN requirement.

GATT/WTO practice and jurisprudence does not provide reliable or usable standard for the “substantially all trade” criteria. In *Turkey-Textiles*, the Appellate Body did address the complexity of the term “substantially all trade” as follows:

*“neither the GATT Contracting Parties nor the WTO Members have ever reached an agreement on the interpretation of the term 'substantially' in this provision. It is clear, though, that 'substantially all the trade' is not the same as all the trade, and also that 'substantially all the trade' is something considerably more than merely some of the trade. We note also that the terms of sub-paragraph 8(a)(i) provide that members of a customs union may maintain, where necessary, in their internal trade, certain restrictive regulations of commerce that are otherwise permitted under Articles XI through XV and under Article XX of the GATT 1994. Thus, we agree with the Panel that the terms of sub-paragraph 8(a)(i) offer 'some flexibility' to the constituent members of a customs*

*union when liberalizing their internal trade in accordance with this sub-paragraph. Yet we caution that the degree of 'flexibility' that sub-paragraph 8(a)(i) allows is limited by the requirement that 'duties and other restrictive regulations of commerce' be 'eliminated with respect to substantially all' internal trade."<sup>14</sup>*

The current WTO jurisprudence thus provides no more than a vague frame of outer limits. It does not have to be 100 percent of trade, but must be much more than just *some* trade. Given this lack of clear guidance on the abstract level, a case-by-case approach is inevitable.

#### **4.3.2 Asymmetric Rules of Origin and the External Trade Requirement**

##### **(i) The Application of GATT Article XXIV:5 to Rules of Origin**

The first threshold issue to be addressed at this point is the question whether the rules of origin applicable within an RTA are at all subject to disciplines under GATT Article XXIV:5. This would be the case if they qualified as "other regulations of commerce" in the sense of that provision. The same question will arise with respect to the internal trade requirement in paragraph 8, which uses the same phrase. Given the separate functions of these two provisions, the external trade requirement (paragraph 5) vs. the internal trade requirement (paragraph 8), it is appropriate to look at both provisions separately in turn.

Rules of origin are rather obviously regulations that apply to commerce, and hence *prima facie* appear to fall under the requirement of GATT Article XXIV.5. However, given that rules of origin within an RTA by definition *apply* as a matter of law only to internal trade between the RTA partners, not to external trade between them and third parties, it seems questionable whether they should be considered at all under this provision. It has been consequently argued that they should not.<sup>15</sup>

There are, however, good reasons to assume that they should. As both the Panel and the Appellate Body have underlined in *Turkey – Textiles*, Article XXIV:5 necessitates not so much a legal than an economic test when considering whether the post-RTA situation is more restrictive on external trade (between the FTA parties and third parties) than the pre-RTA situation.<sup>16</sup>

As *Rivas*<sup>17</sup> notes, there can indeed be situations where rules of origin in RTA can have a detrimental knock-on effect on external trade that could, arguably, qualify as additional restrictions in the sense of Article XXIV:5. He points to the case of rules of origin for textiles in the Canada-US FTA that required only one step to be performed (fibre to yarn *or* yarn to fabric *or* fabric to garment) in the US or Canada in order for the product to qualify for duty-

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<sup>14</sup> Appellate Body Report, *Turkey-Textiles*, above at n 13, paragraph 48.

<sup>15</sup> J.H Mathis, *Regional Trade Agreements in the GATT/WTO: Article XXIV and the Internal Trade* (Asser Press, The Hague: 2002), p 253.

<sup>16</sup> In 1979, the GATT Council adopted the Decision on Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries (the "Enabling Clause") to waive Article I of the GATT for certain arrangements, with respect to, *inter alia*, regional or global arrangements entered into amongst less-developed countries for the reduction or elimination of tariffs.

<sup>17</sup> J.A. Rivas, Do Rules of Origin in Free Trade Agreements Comply with Article XXIV GATT? in L. Bartels and F. Ortino *Regional trade Agreements and the WTO Legal System* (Oxford University Press, Oxford), pp158-170.

free access to the other party. When the US-Canada agreement was replaced by NAFTA, the rule was tightened to henceforth require two production steps. This led US producers with exports to Canada to shift their sourcing from Chilean fabric producers to Mexican fabric producers. As a result, *Rivas* suggests, the NAFTA rules of origin on textiles should be classified as new restrictions on external trade in violation of GATT Article XXIV:5.

It appears however, that the negative effect of the NAFTA rules of origin on Chile was generated not only by the rule of origin alone (the two steps requirement), but by its combination with a cumulation rule that allowed the US and Mexico to perform the required steps jointly. Only that led to the exclusion of Chilean producers. Had cumulation not been applied, the US producers would have to have sourced their fabrics from US producers (or produced them themselves from yarn), which would not have affected negatively or positively the competitive situation of Chilean producers *vis-à-vis* Mexican producers. Since production of fabric in the US is presumably too expensive, garment producers would likely have opted to forgo the FTA preferences and pay duties. This could have left Chilean producers unaffected; they would have continued to sell to US producers as before, despite the stricter rule of origin.

Rules of origin can have an effect on sourcing decisions of producers, as they try to make use of trade preferences, and hence may affect the export opportunities of third country producers. In the example, this happened when originally loose rules of origin in an existing FTA were tightened when a third member joined the existing FTA and cumulation was allowed.

It appears that these two factors (strict rules and cumulation) should be distinguished for purposes of the analysis under GATT Article XXIV:5. Both analysed in isolation reveal that, in fact, both should indeed not be considered as relevant *potentially restrictive* regulations of commerce with respect to the *external trade requirement* in Article XXIV:5.

This follows from the following considerations: A strict rule of origin affects the reach of the trade preference not more and not less. The stricter the rule, the higher the price for its fulfilment, and hence the less trade will effectively be covered by the preference. The effect of certain constellations of strict rules of origin on third country input suppliers to certain industries, are therefore nothing other than a reflex of the trade preferences themselves (the preferential duties). These, however, are simply, and only, a necessary element of the FTA itself, recognized by Article XXIV as an exception to the MFN principle.

A similar logic applies to the second factor, namely cumulation. *Rivas'* reading would in fact lead to the conclusion that provided an FTA (or two) pre-exist and are later connected by cumulation rules, the resulting disadvantage for third country suppliers would qualify as a new restrictive regulation of commerce that would violate GATT Article XXIV:5 (b). But again, and in fact, it is simply a variation of exactly that trade diversion effect that Article XXIV aims to tolerate in exchange for trade creation, namely the effect that trade within the new FTA zone is privileged *vis-à-vis* external trade with third countries. It should be noted in passing that this is what the EC is currently doing in a number of its FTA theatres, such as the

EuroMed zone where bilateral FTAs (the Association Agreements) are successively connected by cumulation rules under the Palermo Protocol.<sup>18</sup>

It seems, therefore, that rules of origin in FTAs, while undoubtedly regulations of commerce, by definition cannot affect external trade in a way that Article XXIV:5 aims to proscribe, because they affect only internal trade between RTA partners. Effects on external trade, while potentially important, are indirect and a necessary and logical consequence of the liberalization of trade among RTA partners, and hence sanctioned by Article XXIV.

It follows that asymmetrical rules of origin equally only affect internal trade, and hence do not raise issues under GATT Article XXIV:5.

## **(ii) Alternative: Rules of origin as potentially restrictive regulations of commerce under Article XXIV:5**

Assuming *in the alternative* that rules of origin, through their negative effects on third country suppliers, were in fact covered as potentially restrictive regulations of external commerce in the sense of Article XXIV:5, as *Rivas* suggests, the question whether asymmetric rules of origin could raise issues under this provision would, obviously, arise.

It appears, however, that no schematic answer is possible in this respect. Whether or not asymmetric or, in fact, symmetric rules of origin in FTAs raise new barriers to the external trade of EPA partners in the sense of GATT Article XXIV:5 would depend on an economic “before & after” analysis on a product-by-product level, and hence depend on the precise rules applicable. It would further, and in addition, depend on the cumulation rules applied.

That said, certain general conclusions can be drawn with respect to EPAs. On the EU side (*i.e.* with respect to post-EPAs rules of origin applicable to EU producers exporting their products under preferences to ACP countries), the new rules of origin, however phrased, cannot affect a pre-established situation where third country inputs to EU production benefit from a preference in exports to ACP countries that is now withdrawn, as was the case in the example above (Canada-US-Mexico-Chile). This is because prior to the conclusion of EPAs, EU exports to ACP countries did not benefit from any preferences, so any post-EPAs preference, even if combined with a rule of origin, cannot lead to disadvantages to third countries. Any indirect effect, such as EU producers now switching to EU or ACP suppliers in order to make use of the new preferences, is a necessary and unavoidable reflection of *any* preferential rule of origin.

On the ACP side, it is conceivable that certain of the newly agreed EPA rules of origin may have some tightening effect (and hence knock-on effect on third country suppliers) over previously applicable Cotonou/Lomé 4 rules of origin. However, it would seem odd indeed to

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<sup>18</sup> *Rivas*' sample case displays a third peculiarity, however, which is the tightening of a previously more liberal rule of origin in a pre-existing FTA, which happens to occur at the occasion of an extension of that FTA. This means that trade between two of the three FTA partners was previously more liberal and now becomes more restricted, to the detriment of a third party. This peculiar situation may indeed raise concerns under Article XXIV:5. However, even in this case doubts are in order. Since FTAs do not benefit from the qualification for customs unions that considers restrictiveness “on the whole” rather than item by item, this would require FTAs to only move upwards towards more liberalization for each and every aspect, rather than allow them to adjust to new partners in a more comprehensive way. It is at least questionable whether Article XXIV:5(b) in fact aims to generate this effect.

measure a new FTA situation that aims to achieve WTO compatibility without the need for a waiver against a “more WTO incompatible,” or artificial, situation of unilateral preferences. Even if ACP trade to the EU in one product or another became subject to stricter rules of origin than before, it appears that this could not be considered in violation of Article XXIV:5.

Irrespective of the (odd) possibility of such effects, however, it is clear that the *asymmetry of rules of origin in favour of ACP producers* could conceivably only generate benefits, not detriments, to non-ACP third party producers, as their inputs benefit from easier access to the EU market.

In conclusion, it appears difficult to conceive of possible violations of Article XXIV:5 by any rules of origin in EPAs *even if* the possibility of such violations through rules of origin in general is assumed. Irrespective of this, however, the *asymmetry* of rules of origin in favour of ACP producers cannot raise any additional issues not raised by the rules as they apply to specific products.

### **4.3.3 Asymmetric Rules of Origin and the Internal Trade Requirement**

#### **(i) The Application of GATT Article XXIV:8 Disciplines to Rules of Origin**

While it is questionable whether rules of origin should be classified as relevant regulations of commerce with respect to *external* trade under GATT Article XXIV:5, it is clear that the rules of origin do, in fact, relate directly to the internal trade between the RTA partners.

One might argue, however, that rules of origin do not fall under the rules applying to the inner-RTA trade in the sense of paragraph 8 as they *define* rather than *regulate* that internal trade. Because the notion of what is (originating) trade between the RTA partners depends on what the rules of origin say, one might suggest that these rules themselves cannot be considered as affecting the “substantially all trade between the constituent parties” criterion. Only once the scope of originating trade is determined, which necessarily presupposes the application of *some* notion of product origin, can it be analysed whether or not substantially all of that trade is liberalized or not.

This arguably logical construction, however, does not appear to lead to reasonable results in view of the object and purpose of the provision. This is because it would leave the definition of origin entirely within the discretion of RTA partners and thereby, potentially creating a serious risk of abuse. RTA partners could, for example, agree on extremely strict, *de facto* impossible-to-fulfil rules of origin on all but a few products, thereby creating a *de facto* sectoral trade agreement for these few products, which is exactly what Article XXIV aims to prevent through the “substantially all trade” requirement. Support for this conclusion is found in Para. 8 (a)(i) and (b), at the end, respectively. Both provisions make reference to “products originating in [the parties to a RTA]”, thus appear to presuppose that there is some degree of objectivity involved and that the definition of what is originating is *not* left entirely to the two parties. It must thus be assumed that rules of origin in RTAs are, in fact, to be considered “other regulations of commerce” in the sense of GATT Article XXIV:8.

#### **(ii) Which Rule of Origin to Evaluate the Rules of Origin?**

This, however, raises the question against which rule of origin the “originating” trade within the RTA is defined so that the RTAs rules of origin themselves can be probed as to whether

they restrict internal trade below the level of “substantially all trade.” There is no clear answer to this question, as no set of “normal” rules of origin for RTAs exists that could serve as a reliable backdrop. In the absence of such a set the only standard to rely on would be the general practice of RTA participant countries.

In order to take any meaningful measurement one would thus have to distinguish, even if only imprecise assumptions are possible, between “normal” rules of origin and stricter or looser than normal rules of origin. These would then have to be combined with the RTA’s product coverage, depth of tariff preferences and absence of other relevant restrictive regulations in order to determine whether overall “substantially all [internal] trade” has been liberalized. The overall picture would decide. The measure, as put by the Appellate Body, would be somewhere significantly above the level of just *some* trade.

### **(iii) Applying the “Substantially all Trade” Criterion to Rules of Origin**

“Normal” rules of origin, combined with a sufficient coverage of products on which tariffs and other restrictions have been eliminated, would thus meet the requirements of Article XXIV:8 (b). Slightly stricter than normal rules of origin, combined however with greater product coverage, could equally qualify. So could, arguable, relatively relaxed rules of origin combined with slightly more restrictive product coverage.

Conversely, just sufficient product coverage, combined, however, with overly restrictive rules of origin, might thus fail to meet the test. Similarly, even relaxed rules of origin may not “rescue” a grossly insufficient product coverage. And so forth.

It is obvious that this is rather “imprecise science,” to say the least. However, given that the reach of “substantially all trade” has so far not been defined in any authoritative way neither by the WTO Members nor the dispute settlement organs, rough approximation is the maximum that can be achieved. With this caveat in mind, the following four conclusions could be made:

- Rules of origin combined with product coverage, tariff levels, and restrictiveness of other regulations form an overall level of liberalization, which is to be evaluated under the “substantially all trade” criterion of Article XXIV:8.
- Rules of origin must allow most actually originating goods (“substantially all the trade”) benefit from liberalization. Precise parameters for measuring this do not currently exist. WTO disciplines thus effectively provide only a protection against extremes, or abuse.
- The legality of individual rules of origin, including peaks of overly restrictive rules on certain products, is not in question unless these affect the overall coverage to an extent that “tilts the balance.”

- “Normal” rules of origin, meaning rules of origin that overall reflect normal FTA practice, if combined with equally normal duty-free product coverage<sup>19</sup> should thus be assumed to satisfy the requirements of Article XXIV:8 (b).

#### **(iv) The Legality of Asymmetric Rules of Origin Legal under Article XXIV:8**

##### **(1) Reciprocity and (A)Symmetry in GATT Article XXIX**

Members and commentators alike have suggested that GATT Article XXIV addresses, covers and legitimizes (only) reciprocal trade agreements. This tenor is so pervasive that it is almost surprising to note that the terms “reciprocity” or “reciprocal” do not appear anywhere in the Article.

The idea of reciprocity, however, can arguably be found in several provisions, such as the notion in paragraph 4 that an FTA shall aim to facilitate trade “between the constituent territories” and, in particular, the “substantially all trade” criterion in paragraph 8. Wherever the threshold lies, it is clear that a trade relation in which exports from one party to the other are not covered at all would miss on average half of the bilateral trade, and hence not satisfy the criterion.

Reciprocity presupposes a trade-off, an exchange of values between the participating parties. Since trade under normal circumstances implies a win-win situation, we must assume that reciprocity is present where both parties walk away happy with what they got for what they paid. Prices, however, are necessarily subjective, as different buyers and sellers value the same goods differently.

The same is true for trade concessions between countries. Trade concessions are thus reciprocal if the trading partners give and receive trade concessions in a way that makes the exchange mutually beneficial and overall satisfying. A trade agreement is reciprocal if it makes sufficient economic sense for both parties.

Whatever the concept’s status and content, however, it is clear that reciprocity does not, and has never, implied *symmetry* of concessions. The explicitly “reciprocal”<sup>20</sup> trade liberalization within the WTO consists of vastly diverse sets of concessions in goods, services and other areas, thus posing a picture of distinctly asymmetrical factors and degrees of liberalization. It is thus surprising to note that some commentators and some Members appear to find a requirement of “symmetry” in FTAs in Article XXIV of the GATT.

In fact, such a requirement cannot be found in this provision. The idea of asymmetrical concessions, even more so of asymmetrical rules of origin, thus does not *prima facie* and in and of itself raise issues under Article XXIV.

Only through comparatively more lenient rules of origin, and arguably other relaxations, to the benefit of the less developed side may actual reciprocity in terms of economic benefits

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<sup>19</sup> Various WTO Members and commentators have ventured to provide various percentages of duty free product coverage. Numbers mentioned tend to range around 85% to 90%. None of these numbers has authoritative value.

<sup>20</sup> C.M.O Ochieng, The EU-ACP Economic Partnership agreements and the ‘Development’ Question: Constraints and Opportunities Posed by Article XXIV and Special and Differential Treatment Provisions of the WTO in *Journal of International Economic Law*, 10(2): 2007, pp 374-377.

and trade coverage be achieved. Strictly “symmetric” North-South RTAs are likely not to provide reciprocal benefits. This may be particularly true for rules of origin as these tend to carry higher compliance costs for less sophisticated producers. This applies both to matters of procedure including documentation of production processes and inputs, monitoring and other procedures, and to the actual ability to manage input sourcing effectively on the world market. Symmetric rules of origin in EPAs may thus effectively give a “non-reciprocal” advantage to EU producers over ACP producers.

## **(2) Applying Article XXIV:8 to Asymmetric Rules of Origin**

As for the notion of reciprocity itself, the measure for asymmetric rules of origin, and for their asymmetry, is to be found directly in the “substantially all trade” requirement in Art. XXIV:8. As noted above, no precise or authoritative percentages or other numbers are available to clarify this criterion.

Given that asymmetry *as such* is not problematic, at least as long as the trade-off is reciprocal, it appears logical to suggest that in principle FTA parties would be free to distribute the burden of reaching “substantially all” of the trade between them as they see fit. Assuming *arguendo* a requirement of 80 percent coverage of the overall trade, trade in one direction, assuming equal volumes, could be covered at 70 percent if 90 percent of the trade in the other direction is covered.

To be on the safe side, however, it seems advisable to suggest as a working hypothesis that the “substantially all trade” measure be applied *per RTA party*. Assuming again *arguendo* a required level of 80 per cent, imports into each party from the other parties would thus individually have to reach that level of coverage of liberalization. Thus means that asymmetry would have to play above that level, e.g., by one party liberalizing 83 percent and the other 92 percent of all imports from RTA partners.

Applying this to the EPA situation before us, it would appear that the following conclusions can be drawn:

- If rules of origin and duty free coverage for EU imports into the ACP countries are “normal”, thus reach average FTA standard, the “substantially all trade” requirement would be met for that side.
- Assuming the same duty free coverage but more favourable, “easier” rules of origin for ACP imports to the EU, coverage would logically be even higher and thus equally satisfy the “substantially all trade” requirement for that side.

## **(3) Cross-Check: Asymmetric Rules of Origin and the MFN Principle**

It is worth considering briefly, in this context, the effect of the above conclusions on the operation of the principle that the disciplines of GATT Article XXIV aims to protect, namely the MFN principle. Article XXIV, while creating an exception to MFN, aims to do so only for certain cases, namely RTAs that satisfy the “substantially all trade” principle. Consider the following two situations:

- Situation 1: Rules of origin in an RTA are (1) on an overall “normal” level and (2) are identical for all RTA partners (thus symmetric).

- Situation 2: All things are identical to Situation 1, except that the rules of origin on one side are more generous (the rules of origin are thus asymmetric).

We note that Situation 2 actually gradually *improves* the conditions for MFN producers over Situation 1, as they now have better opportunities than under Situation 1 to benefit from the RTA preferences because they can more easily provide inputs to the producers on the privileged side. It follows that if Situation 1 is compatible with GATT Article XXIV, Situation 2, which is “better” from an MFN perspective, should logically be equally compatible. It would run against the object and purpose of Article XXIV to outlaw Situation 2 while Situation 1 is considered legal.

This would be the situation in the case of asymmetric EPA rules of origin where the rules of origin for EU products are “normal” while those for ACP products are more generous. If the rules applicable to the EU producers were applied to both EU and ACP products, Article XXIV of the GATT would be satisfied, provided that together with tariffs and other regulations of commerce they liberalize “substantially all trade” – this corresponds to Situation 1 above. If those rules are now relaxed for ACP producers, the situation improves for MFN producers from countries not parties to the EPA, as they can now more easily provide inputs to ACP producers – corresponding to Situation 2 above. As Article XXIV disciplines operate for their protection, it would not be logical for the provision to prevent such asymmetry.

The MFN principle thus supports the findings above, because asymmetric rules of origin, compared to symmetric rules of origin on the level of the stricter side, benefit MFN producers.

## 5 Conclusions

The WTO legal parameters that determine the legality of asymmetric rules of origin in EPAs are to be found in the general rule of GATT Article XXIV.

It is disputed whether rules of origin in Free Trade Agreements fall *at all* under the disciplines of Article XXIV:5 (b), the “external trade requirement.” It appears that they do not, therefore, both symmetric and asymmetric rules of origin cannot be held GATT illegal under this provision. Even if it is assumed that the provision applies, it appears unlikely that EPA rules of origin would be found to be illegal under this provision; a detailed economic analysis would have to confirm that for each product in question.

Rules of origin do, however, fall as “other regulations of commerce” under the “internal trade requirement” in Article XXIV:8 (b), namely the requirement that “substantially all the trade” between parties to an RTA shall be liberalized in a qualifying FTA. Because no authoritative interpretation of that criterion exists, however, it is a highly speculative exercise to try to analyze which rules of origin in combination with which liberalization measures would, or would not, meet the criterion. Tentative approximations, however, are legitimate. These reveal that as long as the EPA rules of origin remain within normal FTA practice or are more liberal, Article XXIV:8 would be satisfied.

The asymmetry of rules of origin as such does not violate Article XXIV. While a general notion of *reciprocity* does appear to apply to RTAs under Article XXIV, the notion of *symmetry* is alien to both this provision and the idea and practice of reciprocity itself. Reciprocity assumes a win-win tradeoff of trade commitments, which can be diverse and

different for RTA partners. More favourable rules of origin for economically weaker parties may in fact be necessary to make the tradeoff reciprocal in the first place.

Asymmetric rules of origin in EPAs are thus acceptable if their application overall satisfies the coverage of “substantially all trade” between the respective ACP countries and the EU parties and the existence of a general tradeoff, hence reciprocity, is not in question. This will safely be the case if the rules of origin applicable to EU exports are “normal” while those applicable to ACP exports are more liberal than “normal.” This is confirmed by the fact that more liberal than normal rules of origin not only cover more internal trade, and hence work favourably towards the “substantially all trade” requirement, but also lessen the RTAs negative effect on MFN producers, as these have relatively more opportunities to benefit from the EPA preferences. The same conclusions as for (substantively) more liberal rules of origin apply to more liberal procedural rules of origin which make it easier for ACP businesses to fulfill the origin requirements.

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