

## EC's Wonderland: an overview of the pan-European harmonised origin protocols

*'Every thing's got a moral, if only you can find it'*<sup>1</sup>

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### 1. INTRODUCTION

It is no exaggeration that the European Union<sup>3</sup> is one of the most enthusiastic users in the world of free-trade areas and customs unions. On the continent of Europe, the EU currently is a partner in free-trade areas with ten Central European countries,<sup>4</sup> two Mediterranean island states,<sup>5</sup> and the EFTA Member States.<sup>6</sup> The latter—with the exception of Switzerland—together with the EU also make up the European Economic Area (EEA). The European Union and Turkey form a customs union.<sup>7</sup> The EU has been supportive of economic integration among its partners, such as the Central European Free-Trade Area and the Czech-Slovak customs union. Just outside Europe, the EU's Mediterranean policy involves free-trade areas with most South and East Mediterranean partners.<sup>8</sup> Further afield, free-trade areas are being negotiated with South Africa and Mexico, and are on the drawing board with Mercosur and Chile. Last, the EU offers unilateral preferences to Overseas Countries and Territories (OCT), certain former Yugoslav republics, the Faroe Islands, the Africa Caribbean Pacific (ACP) group, and in the context of the Generalised Scheme of Preferences.

In the first years of the 1990s these different trade liberalisation arrangements contained a bouquet of varying and disconnected sets of preferential origin rules. In cases where the origin criteria<sup>9</sup> were similar, often no provisions for cumulation were foreseen, and the general rules were often more a reflection of EU thinking at the time of their adoption with a corresponding diversity in general origin rules.<sup>10</sup>

This situation was unavoidable: the original origin protocols with the EFTA countries dated from 1972<sup>11</sup> and 1973;<sup>12</sup> the EEA agreement entered into force in 1994; and the 'Europe Agreements' with the associated Central European countries were negotiated at different points of time in the first half of the 1990s. No preferential origin rules apply with

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1 Lewis Carroll, *Alice in Wonderland*, Chapter IX, Oxford University Press, 1989 at 79.

2 [www.vvg-law.com](http://www.vvg-law.com). The authors wish to thank Ms Aycan Mütevellioglu, Wim Keizer, Mária Szító, Edwin Vermulst, Paul Waer and Professor Norio Komuro for their valuable help on earlier drafts. The authors remain, however, solely responsible for the contents. For further discussions on rules of origin see Vermulst, Waer and Bourgeois, *Rules of Origin in International Trade—A Comparative Study*, University of Michigan Press 1994 and, in the European context, Norio Komuro, 'Pan European Rules of Origin', in 1997 *Revue des Affaires Européennes*.

3 In this paper the denomination 'European Union' or 'EU' is used to include the European Community.

4 Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

5 Cyprus and Malta.

6 Iceland, Liechtenstein, Norway, and Switzerland.

7 See section 8 below.

8 The Maghreb countries (Algeria, Morocco, and Tunisia), the Mashreq countries (Egypt, Jordan, Lebanon, and Syria), Israel and Palestine.

9 In the remainder of this article, 'origin criteria' denotes product-specific rules in the annexes to the origin protocols, whereas 'general origin rules' is used where the rules in the main text of those protocols or instruments is intended.

10 Please refer to the Annex for a listing of the references.

11 Austria, Sweden, Switzerland, and Iceland. See footnote 24.

12 Norway and Finland. See footnote 24.

respect to Turkey in view of the customs union since 31 December 1995, except for (non-processed) agricultural products and coal and steel products.<sup>13</sup>

Although unavoidable, this situation was also far from ideal. Notably the origin rules in the original protocols attached to the association agreements with the Central European countries were soon criticised as being overly restrictive. To begin with, the origin criteria themselves were not easy to meet—a problem compounded by the fact that most of the associated Central European countries are relatively small, making it difficult to source parts locally. In the original texts, cumulation possibilities were limited: among Hungary, Poland and Czechoslovakia (later the Czech and Slovak republics) on the one hand, and among the Baltic States on the other. The difficulties for economic operators to avail themselves of the trade preferences in the agreements at the time may be shown by Example A.

**Example A: hypothetical assembly of air conditioners in Poland using parts from other countries as treated under the *old* protocol**

The preferential origin criterion for air conditioners in the EU-Poland association agreement requires: '[m]anufacture in which the value of all the [non-originating] materials used does not exceed 40% of the ex-works price of the product.'<sup>14</sup>

Suppose that a Korean manufacturer assembles air conditioners in Poland and that the ex-works price of the air conditioners can be broken down as follows:

— Korean parts:	30 %
— Romanian parts:	20 %
— Polish parts, labour and other costs, and profit:	<u>50 %</u>
— Total:	100 %

Under the original origin protocols 50% was originating—which, however, is not enough since it leaves 50% non-originating.<sup>15</sup>

Had the producer sourced parts from Hungary, the Czech republic or Slovakia instead of Romania, then diagonal cumulation would have applied and the non-originating content would have been 30%. In conclusion, even though both Poland and Romania concluded free-trade agreements with the European Union, in the above example the air conditioners assembled in Poland would not enjoy tariff preferences under the EU-Poland association agreement.

Furthermore, operators were faced with practical difficulties such as in the area of evidence as a result of different origin requirements. These factors called for the need for a harmonised system of preferential origin rules.

Apart from the disappointing take-up of preferences under the free-trade agreements concluded with the Central European countries, there was also the perception that increased trade among the Union's Central European partners might be a factor promoting stability in the region. These factors led the European Commission to propose to the Edinburgh European Council of December 1992 that the EU 'encourage regional economic co-operation through cumulation under the rules of origin for all products from associated central and east European countries and EFTA.'<sup>16</sup> In a follow-up communication prepared for the Copenhagen European Council, the Commission suggested that the necessary negotiations with the EFTA and Central European countries be initiated.<sup>17</sup>

13 See section 7, *infra*.

14 EC Official Journal [OJ] (1994) L 359/2.

15 The old protocols did allow for bilateral cumulation.

16 *Towards a closer association with the countries of Central and Eastern Europe—Report by the Commission to the European Council of Edinburgh, 11-12 December 1992*, December 2, 1992, doc. SEC (92) 2301 final, p. 5.

17 *Towards a closer association with the countries of Central and Eastern Europe—Communication by the Commission to the Council, in view of the meeting of the European Council in Copenhagen, 21-22 June 1993* at 11.

The Copenhagen European Council of 21 and 22 June 1993 requested the European Commission to study the impact of changes of rules of origin on trade between the European Community, the EFTA countries and Central Europe. One year later the Commission issued a discussion paper in which it laid down a strategy for the harmonisation of the preferential origin rules in Europe.

The Commission in its paper argued that extended cumulation provisions would have many advantages:

- improved Community and EFTA market access for products from the Central European (and EFTA countries);
- increased economic co-operation between the Community, the Central European and EFTA countries;
- improved sourcing possibilities for materials and products;
- improved possibilities to realise economies of scale by organising activities on a Europe-wide scale.<sup>18</sup>

Concomitantly with increased cumulation provisions, materials originating in third countries would be able to enter the Community market easier.<sup>19</sup>

The Commission championed a three-stage approach for harmonising origin rules. In the first stage the applicable origin protocols were to be streamlined among the Visegrád countries (the Czech republic, Hungary, Poland, Slovakia, Slovenia), and Bulgaria and Romania were to be added at a later stage.<sup>20</sup> In addition, in this stage full cumulation with Switzerland was to be considered.

In the second stage diagonal cumulation was to be introduced between the EU/EFTA group and Central Europe. On the other hand, the no-drawback rule was to be introduced in the agreements with Central Europe.

The third stage would be the introduction of full cumulation.

The conclusions adopted during the Essen European Council of 9-10 December 1994 essentially adopted these proposals. However, on the issue of full cumulation the European Council noted that

‘[b]efore the introduction of full cumulation into all Europe agreements as a third stage at the end of the process, whose difficulties should not be underestimated, the Council will take its decision on the basis of a thorough evaluation of the sectorial and regional consequences on European industry of introducing full cumulation, taking into account the effects of the first two stages.’

In practice the first and second stages have been merged and the Commission has negotiated harmonised protocols allowing full diagonal cumulation among the EU, the associated Central

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18 1994 *Communication from the Commission to the Council concerning the unification of rules of origin in preferential trade between the Community, the Central and East European countries and the EFTA countries* at 6.

19 As witnessed by the no-drawback rule, the reality of such desire is sometimes different in practice. See Section 6 below.

20 See, e.g., Joint Declaration No 10 to the 1993 EC-Bulgaria’ Interim Agreement:

‘The Community and Bulgaria confirm their readiness to consider at a later stage in the Association Council the possibility of regional cumulation with Poland, Hungary and Czechoslovakia, and with Romania, in the light of progress made in fulfilling the appropriate technical and administrative conditions.’

European countries, the EEA countries and Switzerland.<sup>21, 22</sup> Currently, full cumulation (the third stage) is tentatively on the drawing boards but the date of its introduction is still uncertain.

This paper provides an overview of the system of origin rules in the harmonised protocols and argues that generally, the Protocols offer opportunities for economic operators interested in trade across the European continent. First the different sets of trade liberalisation schemes are briefly discussed (Section 2). Subsequently the system of the harmonised protocols (Section 3) and cumulation are discussed (Section 4). Section 5 treats the origin criteria. Last, comments are made on the no-drawback provision, the position of Turkey and evidence of origin.

## 2. TRADE-LIBERALISING INITIATIVES IN EUROPE

A free-trade area is defined in Article XXIV:8(b) of GATT 1994 as

‘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.’

The limitation to ‘products originating in such territories’ implies that preferential rules of origin are necessary in order to determine whether a product actually can benefit from the free-trade area. Thus, a protocol of preferential origin rules is adopted as part of each free-trade agreement concluded by the European Union.

The free-trade (or preferential trade) arrangements applied by the EU (whether or not based on Article XXIV) fall broadly in the following categories:

- 1) *Central Europe*: in the case of the association agreements concluded with Bulgaria, the Czech republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia (hereinafter: the associated Central Eastern European countries) the preferential rules of origin are laid down in Protocol No 4 to the respective association agreements.<sup>23</sup> The Czech Republic, Estonia, Hungary, Poland and Slovenia are currently negotiating accession to the EU;
- 2) *the EFTA countries*: the European Community had concluded free-trade agreements with each of the Member States of the European Free Trade Association (EFTA) as early as the beginning of the 1970’s;<sup>24</sup>
- 3) *the EEA partners*: in the 1980s the creation of a free-trade area covering the EFTA countries and the EU was proposed. This project resulted in the EEA, in force from 1 January 1994.<sup>25</sup> However, pursuant to a referendum, Switzerland decided not to ratify the EEA. Consequently, the EU-Swiss free trade agreement, as amended, remains relevant. The Swiss

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21 Before the harmonised protocols were drafted, the Czech and Slovak association agreements (OJ (1994) L 360/2 and OJ (1994) L 359/2, respectively) replaced the earlier agreement for Czechoslovakia. The wording on cumulation in those new agreements was improved somewhat, prompting an analogous revision of the protocols with Hungary (OJ (1995) L 201/39) and Poland (OJ (1996) L 208/33). These protocols were replaced in 1997 by the harmonised protocols.

22 Turkey recently negotiated corresponding protocols with the partner countries concerned.

23 Protocol No 3 in case of the agreements with the Baltic states.

24 Then: Austria, Finland, Iceland, Norway, Sweden and Switzerland. The original agreements are published in OJ (1972) L 300/2 (Austria); OJ (1973) L 328/2 (Finland); OJ (1972) L 301/2 (Iceland); OJ (1973) L 171/2 (Norway); OJ (1972) L 300/97 (Sweden); OJ (1972) L 300/189 (Switzerland).

25 OJ (1994) L 1.

and EU authorities are seeking to minimise the consequences of Switzerland's refusal to ratify by harmonising the agreement as much as possible to EU law.

The subsequent EU Membership of Austria, Finland and Sweden reduced the EEA ranks to the EU, Iceland and Norway; however, after it adapted its customs union with Switzerland, tiny Liechtenstein joined the EEA.<sup>26</sup>

The relevant protocol of the EEA agreement is No 4;

- 4) *Cyprus* and *Malta* each have an accession (free-trade) agreement with the EU. Cyprus is currently negotiating EU Membership;
- 5) *the Mediterranean countries*: the new generation free-trade agreements under negotiation or conclusion with the Mediterranean countries contain revised protocols on origin. The agreements with Morocco, Tunisia and Algeria will or do contain full cumulation provisions relating to these countries. There are (long-term) plans to extend this system to other Mediterranean countries, but the extent of this largely depends on the political situation in the Middle East;
- 6) *the 71 African, Caribbean, and Pacific (ACP) countries*, with which the European Union has concluded the Lomé IV agreement. Protocol I to that agreement defines the applicable preferential rules of origin. Lomé IV does not really qualify as a free-trade area, since it does not provide for reciprocal trade liberalisation but focuses on market access for ACP products in the European Union; and
- 7) for completeness' sake, we should mention that the Community maintains a number of unilateral preferential systems, each of which relies on a special set of rules of origin in order to determine the eligibility for preferential treatment. The most important of these is the Community's *Generalised Scheme of Preferences*.<sup>27</sup>

Last, we mention *CEFTA* here even though the European Union is not a Member to it. The CEFTA grouping, founded in 1992 and now consisting of Hungary, Poland, the Czech republic, Slovakia, Slovenia, Romania and Bulgaria has adopted origin rules for their internal trade similar to those in the harmonised protocols (this was a condition laid down in the cumulation provisions of the harmonised protocols).

In general, substantive preferential origin criteria are at least as restrictive as non-preferential origin criteria.<sup>28</sup> They may even be stricter. The European Court of Justice has explicitly ruled that this is in conformity with EU law.<sup>29,30</sup>

26 Article 2(2) of the EEA origin protocol provides that 'the territory of the Principality of Liechtenstein shall, until 1 January 2000, be excluded from that of the EEA, for the purpose of determining the origin of the products referred to in Tables I and II of Protocol 3 and such products shall be considered to be originating in the EEA only if they have been either wholly obtained or sufficiently worked or processed in the territories of the other Contracting Parties.'

27 The latest version of the GSP rules of origin is published in OJ (1997) L 9, amended by OJ (1999) L10/1. Under the current rules, cumulation of origin is allowed with Norway and Switzerland.

Other rules of origin cover preferential trade with the EU's Overseas Countries and Territories (OCTs), certain republics of the former Yugoslavia, and the Faroe Islands.

28 Except for cumulation rules, which allow derogations not foreseen under non-preferential rules.

29 Case 385/85, *S.R. Industries vs Administration des douanes*, [1986] ECR 2929. Also discussed by Waer, *op. cit.* at 156.

30 There is no need for preferential origin rules within the European Union, since it is a customs union. Article 9(1) of the EU Treaty (Article 23(1) in the post-Amsterdam renumbered version) provides that:

'The Community shall be based upon a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect, and the adoption of a common customs tariff in their relations with third countries.'

This means in practical terms that the EU operates as one customs territory for the purposes of goods from third

### 3. THE SYSTEM OF THE HARMONISED PROTOCOLS

#### 3.1 Two types of harmonised protocols

In fact, there are two types of harmonised protocols. First, there are the new protocols to the bilateral free-trade agreements between the EU and Iceland, Norway<sup>31</sup> and Switzerland, and to the free-trade (association) agreements with Central Europe. These are all *mutatis mutandis* similar. The second type is the EEA origin protocol, necessitated because of the different origin concept in the EEA (*vide infra*). In practice, however, all protocols form one cumulation system.

In the following we discuss this origin system.

#### 3.2 Basic principles

The first main rule is laid down in Article 2 of the harmonised protocol: products *wholly obtained* in the EU/partner country/EEA shall be considered as originating there. Article 5<sup>32</sup> defines which products are considered as *wholly obtained*; these are mainly mining, agricultural and fisheries products.<sup>33</sup>

Especially in the field of industrial products, most products will not be wholly obtained. In that case Article 2 requires that such materials have undergone *sufficient working or processing* in either the Community or the partner country.

Non-originating materials have undergone sufficient working or processing if the origin criteria in Annex II to the Protocols are fulfilled.<sup>34</sup> Annex II lists the origin criteria for each heading in the Harmonised System (HS) nomenclature. Such origin criteria can look as in Example B.

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countries. Once products from third countries are customs cleared in the EU, they are in *free circulation* and can move from one EU Member State to the other without restriction.

31 The background to the continuing existence of the bilateral agreements between the EU and Norway and Iceland is that some agricultural (fisheries) products are not included in the EEA. There are plans for extending the EEA also to those products; once this happens, the *raison d'être* for the bilateral agreements with these countries disappears. It may be presumed that than also the bilateral origin protocols with these countries lose their purpose.

32 Article 4 of the EEA protocol.

33 Wholly obtained are the following products obtained in the EU or in the partner country concerned:

- (a) mineral products extracted from their soil or from their sea bed;
- (b) vegetable products harvested there;
- (c) live animals born and raised there;
- (d) products from live animals raised there;
- (e) products obtained by hunting or fishing conducted there;
- (f) products of sea fishing and other products taken from the sea outside the territorial waters of the Community or the partner country by their vessels;
- (g) products made aboard their factory ships exclusively from products referred to in subparagraph (f);
- (h) used articles collected there fit only for the recovery of raw materials, including used tyres fit only for retreading or for use as waste;
- (i) waste and scrap resulting from manufacturing operations conducted there;
- (j) products extracted from marine soil or subsoil outside their territorial waters, provided that they have sole rights to work that soil or subsoil;
- (k) goods produced there exclusively from the products specified in (a) to (j).

34 In the old protocols, the main rule was a change of tariff heading (CTH) criterion to which, however, very many exceptions were allowed. Such a general rule is no longer included since the complete Harmonised System is covered by Annex II to the protocols.

**Example B: preferential origin criteria for radios**

HS heading No (1)	Description of product (2)	Working or processing carried out on non-originating materials that confers originating status	
		(3)	or (4)
8527	Reception apparatus for radio-telephony, radio-telegraphy or radio broadcasting ( <i>etc.</i> )	Manufacture: — in which the value of all the materials used does not exceed 40% of the ex-works price of the product; [and] — where the value of all the non-originating materials used does not exceed the value of the originating materials used	Manufacture in which the value of all the materials used does not exceed 25% of the ex-works price of the product.

In Example B, the radios must fulfil *either* the criteria in column (3) *or* the criterion in column (4). Such a choice is not provided in all cases. For example, the criterion for air conditioners is relatively straightforward (Example C).

**Example C: preferential origin criterion for air conditioners**

HS heading No (1)	Description of product (2)	Working or processing carried out on non-originating materials that confers originating status	
		(3)	or (4)
8415	Air conditioning machines, comprising a motor driven fan and elements for changing the temperature and humidity, including those machines in which the humidity cannot be separately regulated	Manufacture in which the value of all the materials used does not exceed 40% of the ex-works price of the product	

Article 7<sup>35</sup> contains a general exception to the sufficient working or processing criterion: certain operations do not confer origin under the *sufficient working or processing* rule even if the conditions are fulfilled. These operations (hereinafter referred to as ‘*de minimis* operations’) could be broadly summarised as maintenance and simple assembly operations.<sup>36</sup>

<sup>35</sup> Article 6 in the EEA protocol.

<sup>36</sup> These operations are the following:

- (a) operations to ensure the preservation of products in good condition during transport and storage (ventilation, spreading out, drying, chilling, placing in salt, sulphur dioxide or other aqueous solutions, removal of damaged parts, and like operations);
- (b) simple operations consisting of removal of dust, sifting or screening, sorting, classifying, matching (including the making-up of sets of articles), washing, painting, cutting up;
- (c) (i) changes of packaging and breaking up and assembly of packages;  
(ii) simple placing in bottles, flasks, bags, cases, boxes, fixing on cards or boards, *etc.*, and all other simple packaging operations;
- (d) affixing marks, labels and other like distinguishing signs on products or their packaging;
- (e) simple mixing of products, whether or not of different kinds, where one or more components of the mixture do not meet the conditions laid down in this Protocol to enable them to be considered as originating in the Community or the partner country;
- (f) simple assembly of parts to constitute a complete product;
- (g) a combination of two or more operations specified in subparagraphs (a) to (f);
- (h) slaughter of animals.

It is, of course, possible for such operations to be part of more extensive working or processing and as such to count as *sufficient working or processing* if the proper conditions are met.

### 3.3 Tolerance clause

The harmonised protocols introduce a general 10 percent tolerance clause:<sup>37</sup> non-originating materials which, according to the origin criterion concerned, should not be used, may nevertheless be used under the following conditions:

- (a) their total value does not exceed 10 percent of the ex-works price of the product; *and*
- (b) any of the percentages given in the list for the maximum value of non-originating materials are not exceeded through the application of this exception.<sup>38</sup>

The 10 percent test serves as a *de minimis* test. Its operation is shown in Example D.

#### Example D: application of the tolerance clause for large aluminium electrolytic capacitors assembled in the Czech Republic

The preferential origin criterion for large aluminium electrolytic capacitors (heading 8532) in the harmonised origin protocols requires:

‘[m]anufacture in which:

- all the [non-originating] materials used are classified within a heading other than that of the product; [and]
- the value of all the [non-originating] materials used does not exceed 40% of the ex-works price of the product;

*or*

[m]anufacture in which the value of all the [non-originating] materials used does not exceed 30% of the ex-works price of the product.’

Suppose a Japanese manufacturer in the Czech Republic assembles such capacitors with the following breakdown of the ex-works price:

— Japanese parts, classifiable under HS heading 8532:	9 %
— Japanese parts not classifiable in HS heading 8532:	30 %
— Polish parts:	10 %
— EU parts:	10 %
— Czech parts, labour, manufacturing costs, profit:	<u>41 %</u>
— Total:	100 %

The second origin criterion cannot be used because the Japanese parts represent in total 39% of the ex-works price. The 10% allowance does not apply since the 30% percentage in the origin criteria would be exceeded by it.

The first origin criterion option would normally also not apply, because non-originating parts are imported which are classified under the same HS heading as the completed capacitor. Here, however, the 10% allowance allows application of the criterion because the Japanese 8532 parts amount to 9% of the ex-works price only.

It should be noted that for the application of anti-dumping duties, the EU will apply its *non-preferential*

<sup>37</sup> Article 6(2); Article 5(2) of the EEA protocol. Such 10 percent tolerance clause was already part of the protocols concluded with the EEA (OJ (1994) L 1/57) and the EFTA countries (OJ (1994) L 204/66, 94 and 154). By way of comparison, the EU’s GSP rules of origin allow only a derogation of up to 5% (OJ (1999) L 10/1 at 2).

<sup>38</sup> As an extra restriction, the 10 percent tolerance rule does not apply for textile or clothing products.

<sup>39</sup> *But see* Advocate-General Van Gerven, in his opinion to the *Brother II* Judgment (Case 26/88, [1989] ECR 4253), discussed by Waer in *Rules of Origin in International Trade, A Comparative Study* by Vermulst and Waer, *op. cit.* at 124-125. The Advocate-General takes the opinion that ‘it is only the *last*, which from an economic point of view need not necessarily be the most important of . . . the operations, which confers origin.’

origin rules. Hence, while these capacitors have obtained preferential Czech origin and will not be subject to the normal EU customs tariff, the usual rules on last substantial transformation—often expressed and understood as a 45% value-added and 35% value of parts test—will determine the non-preferential origin. Under the non-preferential rules there is no cumulation. Under the above fact pattern the Japanese manufacturer should therefore be careful because since no 45% value-added is reached it is likely that the Japanese parts represent the highest portion of the parts value and the non-preferential origin is Japanese.<sup>39</sup> In such scenario, anti-dumping duties would (currently) be due.

### 3.4 Treatment of units and sets; other aspects relating to the cost determination

The unit for the determination of origin is the same as used for customs classification. That means that for products consisting of a group or assembly of articles, the whole group is the unit to be taken into account.<sup>40</sup>

For sets as defined by General Rule 3 to the HS<sup>41</sup> the non-originating parts may not constitute over 15 percent of the ex-works price of the set.

Accessories, spare parts and tools dispatched with a piece of equipment, machine, apparatus or vehicle, which are part of the normal equipment and included in the price thereof or which are not separately invoiced, are regarded as one with the piece of piece of equipment, machine, apparatus or vehicle in question.<sup>42</sup> It follows that, under this provision, accessories, spare parts and tools are to be regarded as one whole for origin purposes only when the following conditions are fulfilled:

- the accessories/parts/tools must be dispatched together with the goods;
- they must be part of the normal equipment; and
- they should be included in the price thereof *or* not separately invoiced.

Under this provision, for example, spare tyres and normal tools and similar accessories imported with the car would be part of the vehicle if its origin must be determined. An example of this rule is provided in Example E.

#### **Example E: assembly of gas turbines in Hungary**

The preferential origin criterion for gas turbines (HS heading 8411) in the harmonised origin protocols requires:

<sup>40</sup> Article 8 of the protocols, Article 7 of the EEA protocol. The recently added Article 70a to *Commission Regulation (EEC) No 2454/93 of 2 July 1993 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code* clarified the same point in the GSP context in virtually identical wording (OJ (1999) L 10/1 at 2).

<sup>41</sup> General Rule 3 to the Harmonised System provides as follows:

‘When by application of rule 2(b) or for any other reason, goods are, *prima facie*, classifiable under two or more headings, classification shall be effected as follows:

- (a) the heading which provides the most specific description shall be preferred to headings providing a more general description. However, when two or more headings each refer to part only of the materials or substances contained in mixed or composite goods or to part only of the items in a set put up for retail sale, those headings are to be regarded as equally specific in relation to those goods, even if one of them gives a more complete or precise description of the goods;
- (b) mixtures, composite goods consisting of different materials or made up of different components, and goods put up in sets for retail sale, which cannot be classified by reference to 3(a), shall be classified as if they consisted of the material or component which gives them their essential character in so far as this criterion is applicable;
- (c) when goods cannot be classified by reference to 3(a) or (b), they shall be classified under the heading which occurs last in numerical order among those which equally merit consideration.’

<sup>42</sup> Article 9 (Article 8 of the EEA protocol).

‘[m]anufacture in which:  
 — all the [non-originating] materials used are classified within a heading other than that of the product; [and]  
 — the value of all the [non-originating] materials used does not exceed 40% of the ex-works price of the product;  
 or  
 [m]anufacture in which the value of all the [non-originating] materials used does not exceed 25% of the ex-works price of the product.’

Let us suppose that a producer manufactures gas turbines in Hungary with the following cost breakdown of the ex-works price of the ‘bald’ machine:

— Japanese parts, classifiable under HS sub-heading 8411 91:	€ 2,600
— EU-origin part:	€ 2,400
— Hungarian parts, assembly, labour and other manufacturing costs, profit:	€ 5,000
Hence the ex-works price of the ‘bald’ machine is	€ 10,000

The total production cost of an optional part is 1,000 €. The option is fully EU origin.

*Case 1:* the gas turbine and the option are exported from Hungary to the EU separately. EU customs will consider that, under the EU-Hungarian harmonised origin protocol, the first possible origin criterion cannot confer origin because the non-originating (Japanese) parts are partly classified under the same heading as the finished product: HS heading 8411. Even with the general 10% allowance, the Japanese portion is too large.

Since the Japanese parts represent  $2,600 \div 10,000 = 26\%$  of the ex-works value, the second origin option is also incapable to confer origin. The gas turbine will not enjoy tariff preferences.

*Case 2:* the exporter ships the option with the gas turbine in one package and invoices it as a normal part of the gas turbine. The ex-works price for the gas turbine (including option) is now € 11,000; of that  $5,000 + 2,400 + 1,000 = € 8,400$  is Hungarian/EU origin and € 2,600 non-originating. The non-originating part has now decreased to  $2,600 \div 11,000 = 23.6\%$ . As a consequence, the gas turbine originates in Hungary by virtue of the alternative origin criterion.

As a last matter, the harmonised protocols provide that it is not necessary to determine the origin of certain ‘neutral elements’ used in the production of the goods concerned. This concerns the following inputs:

- energy and fuel;
- the plant and equipment;
- machines and tools;
- goods which do not enter and which are not intended to enter into the final composition of the product.<sup>43</sup>

These factors should therefore be counted as originating.<sup>44</sup>

### 3.5 Arrangements relating to territoriality and outward processing

Several rules relating to territoriality limit the applicability of the preferential rules of origin. First, if goods originating in the Community or in a partner country are exported to a third country and subsequently re-exported back to the EU or that partner country, they lose originating status, unless it can be demonstrated to customs that:

- the goods returned are the same goods as those exported; and
- they have not undergone any operation beyond that necessary to preserve them in good condition while in that country or while being exported.<sup>45</sup>

<sup>43</sup> Article 11 (Article 10 of the EEA protocol).

<sup>44</sup> Compare Recommended Practice 5 in Annex D.1 of the Kyoto Convention of 18 May 1973, recognised by the EU (OJ (1975) L 100/1).

<sup>45</sup> Article 12 (Article 11 of the EEA protocol).

It is noteworthy that no provision has been made for exports to other partner countries. Imagine, for example, that radios are produced in the European Union having EU origin in accordance with the harmonised protocols. If these radios are exported to Hungary they will enter that country enjoying tariff preferences. If the radios are subsequently re-exported from Hungary to the Czech republic, however, they would lose originating status unless the importer can prove to the satisfaction of the Czech customs authorities that the conditions mentioned above have been fulfilled.

In practice it will often be at most a minor hurdle since importers should normally be able to prove the conditions mentioned above. Exporters may be able to acquire an additional EUR.1 certificate *a posteriori* on the basis of Article 17.<sup>46</sup> Moreover, provision is made for the possibility of direct transport and transshipment under customs control. In any event, any additional burden of proof will be overcome when the third stage of the harmonisation process is fulfilled and one pan-European origin area comes into existence.

The 1999 amendments to the harmonised protocols provide for an additional exception to the territoriality rules.<sup>47</sup> The new Article 12(3) allows for some processing abroad (outward processing or similar arrangements), provided

- the exported materials originate in the EU or the partner country or underwent more than *de minimis* operations before being exported;
- it must be demonstrated to the customs authorities that the re-imported goods have been obtained by working or processing the exported materials;
- by availing of this option, the total value added acquired outside the EU or the partner country concerned should not exceed 10 percent of the ex-works price of the product for which originating status is claimed.

In principle working or processing undertaken abroad under these arrangements will not count for the purpose of the origin criteria. There is an exception to this: if an origin criterion sets a maximum value for all non-originating materials, this value may not be exceeded by the total of the non-originating materials incorporated in the country of assembly and the total *added value* (not materials!) acquired during the outward processing operations.

The sting of the revised Article 12 is in the tail: paragraph 6 lays down that the outward processing exception is only valid if the product satisfies the origin criteria. A further restriction on the exception is that the outward processing option may not be used if the origin criterion is met only because of the 10 percent tolerance clause (see section 3.3, *supra*). A last and further important restriction is in paragraph (7): the outward processing option may not be used for textile or clothing products—which is probably a popular area of application of outward processing.

#### 4. CUMULATION

##### 4.1 **Bilateral, diagonal and full cumulation**

Cumulation provisions can be divided in bilateral cumulation, diagonal cumulation and full cumulation. Bilateral and diagonal cumulation is accepted in all agreements discussed in this overview. Full cumulation is currently only part of the EEA protocol.<sup>48</sup> It appears that the

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46 This would seem to be the implicit view of the European Commission (compare the notice in OJ (1999) L 90/6 at 7).

47 Article 12, as amended in *e.g.* OJ (1999) L 35/32 (for the EU-Czech protocol).

48 Note that in the *bilateral* relations between the EU on the one hand and Norway and Iceland on the other there exists *bilateral* cumulation (Article 3, OJ (1997) L 195), while in the relations between these countries in

European Commission in the long term considers extending full cumulation to the Central European associated countries and to Switzerland. Of course, for some Central European Member States this may happen within a few years as a result of their attaining EU Membership.

#### 4.2 Bilateral and diagonal cumulation

In the original version of the harmonised protocols separate provisions were adopted for bilateral and diagonal cumulation.

Bilateral cumulation implies that parts from the Community<sup>49</sup> may be counted as parts from the beneficiary country (and *vice versa*). In the original text of the harmonised protocols materials originating in a partner country were considered as materials originating in the EU when incorporated into a product there, even if their working or processing was not sufficient; however, the working and processing had to be more than *de minimis* operations. In plain English: a producer in the EU could use materials originating in a partner country in his product. These materials would in the process obtain EU-origin, provided the working or processing in the EU was more than the *de minimis* operations defined in Article 7 of the harmonised protocols. This system worked similarly vice versa with EU-origin materials used in the partner country.

Diagonal cumulation means that parts from a third beneficiary country may under certain circumstances be counted as partner country (or EU) parts. Under the rules in force before the harmonised protocols, diagonal cumulation existed among the Czech republic, Hungary, Poland and Slovakia, and among the Baltic States. This system was expanded through the harmonised protocols to cover all partner countries and since recently, to some extent, Turkey.<sup>50</sup>

The main principle is that materials originating in partner countries (Bulgaria, the Czech republic, Estonia, Hungary, Iceland, Latvia, Lithuania, Norway, Poland, Romania, Slovakia, Slovenia, Switzerland, Liechtenstein and—beyond the limitation of Annex V to the harmonised protocols—Turkey) may be counted as originating. It is not necessary that the materials first undergo sufficient working or processing.

For example, if a Polish-based producer of radios destined for the EU purchases radio parts from Hungary, these parts may be counted as Polish origin if they are used in the radios. Consequently, producers have less difficulty in sourcing parts in other partner countries and still fulfil the origin criteria.

The second main principle was that (sticking to the radio example) the radios only obtained Polish origin if the Polish value-added exceeded the value of the materials from each of the partner countries (before cumulation). If this was not so, then the products obtained the origin of the country representing the highest value of originating materials.<sup>51</sup>

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the framework of the EEA *full* cumulation exists (OJ (1997) L 21). As noted in footnote 31, *supra*, the background of the continuous existence of the free-trade agreements between the EU and Norway and Iceland is the exclusion of certain agricultural (fisheries) products from the scope of the EEA.

49 On the basis of the Joint Declarations attached to the harmonised protocols, industrial products (HS Chapters 25 to 97) originating in Andorra are considered to be of EU-origin. All products from San Marino are considered to be originating in the EU as well. The Spanish territory of Ceuta and Melilla is, however, not part of the Community (Article 36 of the harmonised protocols).

50 For the position of Turkey see *infra* at section 8.

51 The old text of the harmonised protocols provided in Article 4(2) that, for the purpose of the highest value test, 'no account shall be taken of materials originating in the other [partner] countries . . . which have undergone sufficient working or processing in the Community or [name partner country]'. This effectively

Although the original text of the cumulation provisions in the harmonised protocols was already an improvement over the somewhat opaque wording featuring in the original protocols with Hungary, Czecho-Slovakia and Poland, it was recently amended and substantially shortened.<sup>52</sup> The provisions on bilateral and diagonal cumulation are now merged. In the amended text, Article 3 ('Cumulation in the European Community') is almost similar in wording to Article 4 ('Cumulation in [partner country]'). The first paragraph of the cumulation provision now provides that:

'Without prejudice to the provision of Article 2(1),<sup>53</sup> products shall be considered as originating in the [partner country or EU] if such products are obtained there, incorporating materials originating in the Community, Bulgaria, Poland, Hungary, the Czech Republic, the Slovak Republic, Romania, Lithuania, Latvia, Estonia, Slovenia, Iceland, Norway, Switzerland (including Liechtenstein)<sup>54</sup> or Turkey<sup>55</sup> in accordance with the provisions of the Protocol on rules of origin annexed to the Agreements between the [partner country or EU] and each of these countries, provided that the working or processing carried out in the [partner country or EU] goes beyond that referred to in Article 7 of this Protocol. It shall not be necessary that such materials have undergone sufficient working or processing.'

The second paragraph of Article 3 adds that:

'Where the working or processing carried out in [partner country or EU]<sup>56</sup> does not go beyond the operation referred to in Article 7, the producer obtained shall be considered as originating in [partner country or EU] only where the value added there is greater than the value of the materials used originating in any one of the other countries referred to in paragraph 1. If this is not so, the producer obtained shall be considered as originating in the country which accounts for the highest value of originating materials used in the manufacture in [partner country or EU].'

The second paragraph of Article 4 exactly mirrors this rule for the partner country concerned.

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implied a roll-up test for parts assembled in the country of assembly of the final product from materials from other beneficiary countries. For example, if an assembly was manufactured in the Czech Republic from Hungarian parts and it fulfilled its origin criterion, it obtained Czech origin. If subsequently it was used in the Czech Republic for the production of a radio, it would still be considered as Czech-origin for the purpose of the highest-value test.

Presumably, the latest text of the cumulation provision does not change this for the cases where the highest-value test is applied. Articles 3(2) and 4(2) provide in this respect that, for the purpose of the highest-value test, 'the product obtained shall be considered as originating in the country which accounts for the highest value of *originating* materials used in the manufacture in [the country of assembly]' (Emphasis added).

52 Please refer to the Annex for an overview of the state of publication of the amendments.

53 In Article 3(1) the reference is to Article 2(1), in Article 4(1) to Article 2(2).

54 Footnote in original: 'The Principality of Liechtenstein has a customs union with Switzerland, and is a Contracting Party to the Agreement on the European Economic Area.'

55 Footnote in original: 'Cumulation as provided for in this Article does not apply to materials originating in Turkey which are mentioned in the list at Annex V to this Protocol.'

56 The amendment of the EU-Hungarian protocol erroneously mentions here Lithuania instead of Hungary (OJ (1997) L 49/34).

It would appear that the revision is not just textual, but implies a slight change in substance as well. The original Article 4(2)<sup>57</sup> of the harmonised protocols provided that, if the value-added in the country of assembly was less than the value of parts of any other partner country, the product would obtain the origin of the latter. In the new text (Articles 3(2) and 4(2)) this rule is limited to situations where the working or processing in the last country is *de minimis* operations. This would appear to be a slight relaxation which, however, will probably be of limited importance since most preferential tariffs among the EU and its partner countries are quite modest.

On the other hand did the bilateral cumulation provisions in the old text of the harmonised protocols—logically—not contain a highest share rule such as now laid down in Articles 3(2) and 4(2). The slight simplification noted above is thus offset by the introduction of the highest value rule in the bilateral cumulation context.

To stick with radios, the working of the new rules is shown in Example F.

#### Example F: Diagonal cumulation

The origin criterion for radios in the harmonised protocols was quoted in Example B, *supra*.

Suppose the ex-works price of radios produced in the Czech republic for export to the EU is composed as follows:

— Hungarian parts:	30 %
— Japanese parts:	35 %
— EU parts:	10 %
— Czech value added, including local parts:	25 %
— Total:	100 %

Under the cumulation rules the EU and Hungarian parts may be counted as originating.

However, since the Hungarian parts count for more than the Czech value-added, under the old rules the radios would obtain Hungarian origin, even though assembly takes place in the Czech republic.

Suppose that the Hungarian parts consisted of an assembly itself including 20% Czech materials, but which according to the origin criterion for radio assemblies obtained Hungarian origin. In such cases, the parts would have to be counted as fully Hungarian for the allocation of origin. In other words, for the allocation of origin the parts themselves are not broken down (roll-up test).

Under the new amendment, the Hungarian parts will be counted as originating. *Provided* the working and processing in the Czech republic is more than *de minimis* operations, however, the finished product will *not* switch to Hungarian origin, but retain Czech origin. The highest-value rule would only come into play if the operations in the Czech Republic would be *de minimis*; again, the Hungarian parts count as fully originating in Hungary, even though they include Czech parts.

The next main rule provides that diagonal cumulation is only applicable to the extent that the countries involved apply identical origin rules. *I.e.*, the countries of Central Europe, Switzerland, Iceland and Norway must conclude among them rules of origin identical to the harmonised protocols. To a large extent such rules have indeed been adopted. The European Commission has published a notice clarifying which cumulation combinations are now possible.<sup>58</sup>

At the moment of writing not all of the 1999 amendments to the cumulation rules have been published, although it is expected that this will happen in the near future.

<sup>57</sup> Article 3(2) of the EEA protocol.

<sup>58</sup> Please refer to the Annex to this paper.

### 4.3 Full cumulation

Full cumulation means that the partner countries concerned and the EU form one territory for the purpose of the origin determination. Such full cumulation is currently only recognised in the EEA context. This implies that *any* working or processing in an EEA country is taken into account for the determination of origin.

The difference between diagonal and full cumulation is shown by Example G.

**Example G: hypothetical assembly of hydraulic turbines in Germany using parts from other EEA countries as treated under the EEA**

The preferential origin criterion for hydraulic turbines [classifiable under HS 8410, and hence subject to the general rule of chapter 84] requires:

‘[m]anufacture in which:

- all the [non-originating] materials used are classified within a heading other than that of the product; [and]
- the value of all the [non-originating] materials used does not exceed 40% of the ex-works price of the product;

or

[m]anufacture in which the value of all the [non-originating] materials used does not exceed 30% of the ex-works price of the product.’

Let us suppose that a producer manufactures a hydraulic turbine in Germany with the following breakdown of the ex-works price:

— Japanese parts:	15 %
— assembly assembled in Norway:	30 %
— EU origin parts, labour and other costs:	<u>55 %</u>
— Total:	100 %

Suppose the Norwegian assembly [for example a regulator] is itself classifiable within HS heading 8410 [namely: 8410 90] and that the cost break-down of its ex-works price is as follows:

— Japanese parts (classifiable under HS heading 8410):	40 %
— Norwegian parts, labour and cost:	<u>60 %</u>
— Total:	100 %

Had the EEA been based on *diagonal cumulation* of Norway and the EU, then the first question would have been whether the assembly has obtained Norwegian origin. Using the relevant origin criterion, it would not have, since more than 30% of it originates in Japan while the 40% criterion is not applicable since the Japanese parts are classifiable under the same HS heading. It follows that the hydraulic turbine would not count as originating since the non-originating parts would count for 15 + 30 = 45 %, while the assembly is classified under the same heading as the hydraulic turbine. Consequently, had the EEA been based on diagonal cumulation, then the hydraulic turbine would not have enjoyed tariff preferences when exported to another EEA country.

The EEA is based, however, on *full cumulation* and the EEA thus counts as one territory. This means that all working and processing in the EEA will be added. The origin assessment will therefore be calculated as follows:

— Japanese parts:	15 % of the ex-works price;
— Japanese part of the Norwegian subassembly: 40 % x 30 % =	12 % of the ex-works price;
— Norway: 60% x 30% =	18 % of the ex-works price;
— EU origin parts, labour and other costs:	55% of the ex-works price.

In summary, 18 % + 55 % = 73 % is EEA origin, and 15 % + 12 % = 27 % in Japan. The hydraulic turbine will thus be below the 30 % threshold and count as originating.

As Example G shows, under *full cumulation* working in the EEA on non-originating parts is also counted and a tracing test is used.

#### 4.4 WTO consistency of the cumulation rules

Cumulation of origin only plays a role with preferential rules of origin and these are excluded from the scope of the WTO Agreement on Rules of Origin. However, this does not automatically mean that WTO régimes do not have a bearing upon such cumulation rules.

The precise function of free-trade areas and customs unions is to affect the normal (MFN-based) flows of trade. Article XXIV:4 of GATT 1994 provides a recognition of

‘increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements . . . [T]he purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories.’

This raises the question whether the harmonised protocols facilitate trade, or constitute a barrier to it.

As a first observation it must be remarked that, while the purpose of free-trade areas may be to increase trade, any distinction between *increasing* trade and *deflecting* it seems somewhat artificial. The mere reduction of customs duties among the members of the free-trade area will *ipso facto* lead to a certain trade deflection. For example, an assembler of radios based in the European Union may find it more attractive to source parts from Poland rather than from Japan because the former are imported without customs tariffs. The actual growth of global trade caused by free-trade areas will be fairly limited, especially in comparison with the trade-deflection caused by such arrangements.

This holds true especially for the preferential arrangements in force between the EU and its European partner countries, which agreements contain fairly complicated and purpose-driven rules of origin. If preferential rules of origin were merely a technical instrument aimed at defining the scope of the agreements, there would be little reason to have such a wide variety of preferential origin rules.

This criticism is not new. As long ago as 1974 the *Report of the GATT Working Party on the EEC Agreement with Egypt* noted that some GATT Members

‘found the rules of origin in the present Agreement, like those in similar agreements examined in earlier working parties, almost excruciatingly complex and difficult to explain. It was difficult to imagine why the parties would put themselves to so much trouble to draw up rules that hopefully would not represent increased barriers to third parties’ trade.’<sup>59</sup>

As a second point, it would seem that in general bilateral cumulation promotes sourcing from the Community, notably in cases where opportunities for diagonal cumulation are limited.

The real test for GATT-compatibility could tentatively be formulated as follows: do economic operators change their sourcing patterns by purchasing more expensive parts merely to fulfil the origin criteria? If such cases could be proven, then it could be argued

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<sup>59</sup> *Guide to GATT law and practice* (Vol. 2), WTO, Geneva 1995 at 802.

Of course, the EU is not the only entity using complicated sets of rules of origin in free-trade context. As one example, NAFTA’s origin rules are illustrative.

that, in their effects, the cumulation provisions of the harmonise protocols *prima facie* violate Article XXIV.

The sheer evidentiary difficulty of the matter makes it hard to prove that the origin protocols violate WTO law: how does one prove that a substantial number of operators could have sourced their materials cheaper elsewhere without the trade arrangement concerned? This may be the reason why in the past, apart from some criticisms in Article XXIV Working Parties, little action has been undertaken in the GATT/WTO context on the issue.

## 5. THE SUBSTANTIVE ORIGIN CRITERIA

In the old protocols the main origin criterion was change of tariff heading (CTH) at four-digit Harmonised System heading level. However, each of the protocols contained an (identical) list of exemptions, so that especially for industrial products the main criterion was rarely applicable. Instead, the exceptions in many cases provided for a (partial) import content criterion.

In the new protocols there no longer is a main criterion; Annex II now covers the whole HS and provides for each HS heading the origin rule.<sup>60</sup> As shown above, there is for many products a choice between two origin criteria.

The first test (column 3 of Annex II), can be a technical test, a CTH test, and/or an import content test. The import content test is normally set at maximally 40 percent.

Where a second (column 4 of Annex II) criterion is provided, it is at all times an import content test. The maximum allowed percentage of import value can be 25, 30 or 40 percent, depending on the HS heading.

The severity of the tests appears to depend mainly on the degree of sensitivity of the product concerned and this may lead to considerable trade deflection. For example, where a second test is provided for consumer electronics, it normally requires a maximum of 25 or 30 percent import content.

For example, while the (single) test for power supply units for computers (HS heading ex 8504) merely requires a maximum import content of 40 percent, the criteria for radios (quoted *supra* at Example B) are much more difficult to fulfil. Since the printed circuit board (PCB) may often represent a large part of the ex-works value of a radio, the alternative 25 percent import content criterion effectively requires production of the PCB in a partner country or the EU. Even under the first criterion for radios it will be difficult to source the transistors from a non-partner country and still obtain origin.

## 6. THE NO-DRAWBACK PROVISION

A relatively hidden but rather serious concession (from the point of view of the partner countries) that had to be made by the partner countries to the EU was the inclusion of a no-drawback rule. Laid down in Article 15 of the harmonised protocols<sup>61</sup> this was a novelty for the Central European countries, although such a rule already featured in the protocols concluded by the Community with the EFTA countries.<sup>62</sup> Paragraph 1 of Article 15 provides that:

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60 Note that some slight changes were made to the criteria by the 1999 amendments. These concern HS headings 2207, Chapter 57, and headings 7006 and 7601.

61 The corresponding provision in the EEA protocol is Article 14.

62 See, for example, Article 23 and the related Explanatory note 11 of the Agreement between the EU and

‘Non-originating materials used in the manufacture of products originating in the Community, [partner country] or in one of the other countries referred to in Article 4 for which a proof of origin is issued or made out in accordance with the provisions of Title V shall not be subject in the Community or [partner country] to drawback of, or exemption from, customs duties of whatever kind.’

Such prohibition applies to:

‘any arrangement for refund, remission or non-payment, partial or complete, of customs duties or charges having an equivalent effect, applicable in the Community or [partner country] to materials used in the manufacture and to products covered by paragraph 1(b) above, where such refund, remission or non-payment applies, expressly or in effect, when products obtained from the said materials are exported and not when they are retained for home use there.’

On the face of it, this rule makes sense: exporting producers in country A are not given a competitive cost advantage when exporting their goods to each other’s markets (country B) as compared with local producers (in country B) selling in the local market (in country B). In this connection, the 1994 Commission paper provides the following example:

‘Alternators destined for the EC market are manufactured in Poland from components in Taiwan. Without a no-drawback rule, no customs duty is paid on the components in Poland. Neither is any customs duty paid in the EC, for the alternators are considered to originate in Poland within the meaning of the Europe Agreement. If the alternators had been manufactured in the EC and put onto the EC market, the Taiwanese components would have been subject to a 5.6% customs duty. Similarly, Polish manufacturers would have to pay customs duties on components imported from Asia and used in the manufacture of a product destined for the Polish market, whereas an EC manufacturer would avoid paying duties for the same components when the manufactured product was exported to Poland.’<sup>63</sup>

While this example is of course technically correct, the practical implication is more far-reaching. Namely, in practice the provision will mainly be felt by manufacturers who had set up an assembly operation in Central Europe with the EU as main export destination.<sup>64</sup> For such producers the no-drawback rule ensured that foreign components became relatively more expensive since import duties became due on them as compared with components sourced locally or in the EU.<sup>65</sup> Hence, while the Central European countries gained more

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Norway, OJ (1993) L 171/2.

<sup>63</sup> 1994 Commission paper, *op.cit.* footnote 17 at page 4, footnote 1.

<sup>64</sup> Since the liberalization of Central Europe, (foreign) producers/investors tend to prefer such countries as the manufacturing location over the relatively more expensive EU. Also, the no-drawback rule is irrelevant for the sales on the local market since in such situations no drawback can be obtained in any event. Clearly, the remaining target group is the (foreign) producers/investors in Central Europe with product destination EU. As noted by Norio Komuro, *op. cit.*: ‘The no-drawback rules might seriously affect the sourcing of electronic parts from Japan, Korea and newly industrialized economies (NIES) countries.’

<sup>65</sup> An old example may illustrate the practical working of the no-drawback rule. At the time when the EU and Turkey were not yet a customs union (but had a free trade agreement in place) certain foreign producers were

market access to the EU, the concession against such free trade was that sourcing of components should shift to the EU. The previously equal competition that existed between EU (or local) components and third country components was changed into a competition between duty-paid third country components and duty-free EU (or local) components. While in theory this meant that both the EU and partner countries benefit from the rule, it implied in practice that high-tech components not available in Central and Eastern Europe had to be sourced in the EU. In this light it is no surprise that at the time of the negotiations Hungary and Poland contested the no-drawback provision.<sup>66</sup> On the other hand it is only fair to note that the no-drawback provision contained the possibility for an exemption.<sup>67</sup> This duration of this exemption was recently extended to 31 December 2000.<sup>68</sup>

It should furthermore be noted that, due to the existence of this no-drawback rule, it could under specific circumstances be more favourable to claim the drawback of the duty on a component, rather than to enjoy the duty-free access of the finished product, as is shown in Example H.

**Example H: non-take up of preferential origin could be more favourable than foregoing drawback**

A producer in Hungary imports parts of flat panel display devices (HS sub-heading 8531 90) into Hungary. The Hungarian MFN import duty on these parts is 25%. Suppose that the [non-originating] parts for the flat panel cost € 60. This producer then assembles the flat panel display devices (HS sub-heading 8531 80) and exports these to the EU. Suppose that the total assembly costs [without import duty on the parts] represent € 140. The flat panel device then costs € 200 without duty on the parts, and € 215 with duty on the parts. The MFN import duty on the finished product [the flat panel display devices] in the EU is 0.8%. The producer in Hungary then has a choice: he can either opt for the preferential origin and save the 0.8% duty on the finished product, *or* he can forego the preferential origin and save the import duty on the parts under the drawback rule. A summary table shows that this latter option is more cost-efficient:

	Option 1: Forego drawback, pay import duty on component; save duty on finished product	Option 2: Use drawback, save import duty on component; pay duty on finished product
Parts for flat panel	60	60
Import duty on parts into Hungary (25 %)	15	—
Costs flat panel	215	200
Import duty on flat		

assembling colour televisions in Turkey. These televisions were made from (partly) imported components (mainly colour picture tubes) on which, as it appeared, no customs duties had been paid on import into Turkey. However, the finished products were destined for export to the EU and the EC-Turkey additional and financial protocol to the EC-Turkey Agreement contained detailed rules, under which such compensating duty on the value of the components was due upon entry of the finished product into the EU. (See Article 2(2), 2(3) and 3 of the Additional Protocol and Financial Protocol, signed on 23 November 1970, annexed to the Agreement establishing an Association between the European Economic Community and Turkey. OJ (1972) L 293 (special English version OJ (1973) C 113).). Since these compensatory levies had not yet been charged on the value of the picture tubes upon entry of the televisions into the EU, the European Commission's Directorate-General XIX for Budgets urged in a letter of 2 March 1994 the collection of customs duties on colour televisions assembled in Turkey.

<sup>66</sup> The rule held up the ratification of the Hungarian and Polish harmonised protocol. However, the Hungarian and Polish Governments yielded to the EU after high-level negotiations. This does not mean that other Central European governments did not have misgivings about the rule.

<sup>67</sup> Article 15 (6) of the harmonized protocols, for example in OJ (1996) L 343.

<sup>68</sup> See for example Article 1(5) of the 1999 amendments (references in the Annex to this paper).

panel into EC (0.8 %)	—	1.6
Total costs	215	201.6

Finally it is noted that in the context of recent anti-subsidy proceedings the existence of drawback schemes is sometimes targeted by the EU as a countervailable subsidy.<sup>69</sup> This way, foreign producers are caught in a ‘catch 22’ situation: in the context of a free-trade agreement they will face a ‘no-drawback’ rule, while if they utilise drawback in the absence of such free trade agreement they may face an anti-subsidy proceeding. Heads the EU wins, tails a partner country loses. In this regard it remains to be seen how the EU would react against a potential allegation that its inward-processing regime constitutes a countervailable subsidy.

## 7. TURKEY

### 7.1 Nature of the relation

The arrangements between the EU and Turkey stand somewhat apart from the system of rules of origin described above. The EC concluded an association agreement with Turkey as early as 1963.<sup>70</sup> Nowadays a customs union exists between the EU and Turkey, and Turkey has already applied for membership to the EU in 1987.<sup>71</sup>

The customs union entered into force on 31 December 1995.<sup>72</sup> It covers in principle all industrial goods (including textile products)<sup>73</sup> and certain agricultural goods. Agricultural products listed in Annex II to the EC Treaty are covered by a separate free trade regime.<sup>74</sup> Coal and steel products falling within the scope of the European Coal and Steel Community Treaty are excluded from the scope of the EU-Turkey association agreement and, consequently, from the customs union.<sup>75</sup> For such latter products the Community adopted a specific free-trade agreement with Turkey including a special protocol of preferential rules of origin in the coal and steel sector.<sup>76</sup>

69 See for example PTY from India and Korea, OJ (1998) C 264/2.

70 Council Decision of 23 December 1963 concluding the Agreement establishing an Association between the European Economic Community and Turkey, OJ (1964) L 217; English version published in OJ (1973) C 113. This agreement is commonly referred to as the ‘Ankara Agreement.’

71 This application was made in accordance with Article 28 of the Ankara Agreement which provides that:

‘As soon as the operation of this Agreement has advanced far enough to justify envisaging full acceptance by Turkey of the obligations arising out of the Treaty establishing the Community, the Contracting Parties shall examine the possibility of the accession of Turkey to the Community.’

The application for membership is still valid. The most recent legal development in the EC-Turkish customs union and the application for membership is the proposal for a Council Regulation regarding the implementation of measures to intensify the EC-Turkey customs union, published in OJ (1998) C 408.

72 Article 65(1) of Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union, published in OJ (1996) L 35/1.

73 With respect to the integration of textile products in customs union see Decision No 2/98 of the EC-Turkey Association Council of 23 February 1998, published in OJ (1998) L 86.

74 Chapter II of Decision No 1/95, *supra* footnote 72, as implemented by Decision No 1/98 of the EC-Turkey Association Council of 25 February 1998 on the trade regime for agricultural products, published in OJ (1998) L 86/1. Protocol 3 of this latter Decision contains the applicable rules of origin for agricultural products with respect to trade between the EU and Turkey.

75 Article 26 of the association agreement, OJ (1964) 217, English special edition OJ (1973) C 113.

76 Protocol 1 to the agreement between the European Coal and Steel Community and Turkey on trade in products covered by the ECSC, OJ (1996) L 227/1.

## 7.2 Application of origin rules

Since the EU and Turkey form a *customs union*, no rules of origin should normally apply for the trade within this union. As per Article 3 (1) of Decision No 1/95, the customs union directly applies to (industrial) goods (and certain agricultural products):

‘— produced in the Community or Turkey, including those wholly or partially obtained or produced from products coming from third countries which are in free circulation in the Community or in Turkey, [and]  
— coming from third countries and in free circulation in the Community or in Turkey.’

For the concept of free circulation, Article 3 (2) clarifies that—similar to products circulating within the EU as a customs union—products:

‘ . . . from third countries shall be considered to be in free circulation in the Community or in Turkey if the import formalities have been complied with and any customs duties or charges having equivalent effect which are payable have been levied in the Community or in Turkey, and if they have not benefited from a total or partial reimbursement of such duties or charges.’

In other words, the concept of origin *within* the EU-Turkey customs union cannot in theory play a role for the products for which the customs union applies.<sup>77</sup>

## 7.3 Turkey and the EU’s preferential trade agreements

With respect to trade with third countries, Turkey has concluded, or is in the process of concluding, preferential trade agreements with the same partner countries as the EU, in parallel with the EU’s preferential trade Agreements.<sup>78</sup> Upon completion of certain necessary administrative formalities, Turkey will very soon fully participate in the system of the pan-European cumulation.<sup>79</sup> This system will apply retrospectively as from 1 January 1999 and will also include ECSC products.

## 7.4 The absence of no-drawback in the customs union

The Customs Union between the EU and Turkey is based on the concept of ‘free movement of goods’. Therefore the concept of ‘no-drawback’ does not apply in the trade between these

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<sup>77</sup> Article 3(3) of the said Decision defines the customs territory of the customs union to comprise the customs territory of the Community and the customs territory of Turkey. Article 15 of Decision 1/95 provides that for certain products, agreed by the Association Council, Turkey may retain higher duties than the EU customs tariff. Turkey may collect the difference in such duties.

<sup>78</sup> Annex 10 of Decision 1/95 lists the preferential agreements and the autonomous regimes referred to in Article 16. A statement by Turkey on Article 16 announces that ‘[i]n relation to Article 16, Turkey states that priority will be given to the following preferential agreements: Bulgaria, Hungary, Poland, Romania, Slovakia, Czech Republic, Israel, Estonia, Latvia and Lithuania, Morocco, Tunisia, Egypt’ (OJ (1996) L 35/17). In practice Turkey has already concluded agreements with the EFTA countries, Israel and almost all East European countries except Poland. The Agreement with Poland is likely to be completed in the first half of 1999. Turkey has also already initiated negotiations with Tunisia, Morocco, Algeria, and Egypt.

<sup>79</sup> At the time of writing these formalities are in the process of being completed.

parties for goods that are in free circulation as per the above-mentioned Article 3 (2) of Decision 1/95.<sup>80</sup>

## 7.5 Procedural aspects

Decision No 1/96 of the EC-Turkey Association Council lays down detailed rules for the application of Decision 1/95, notably in the field of procedure and evidence.<sup>81</sup> Products in free circulation in the customs union are to be accompanied by movement certificate A.TR. Non-processed agricultural products subject to preferential origin rules as per protocol 3 of Council Decision 1/98 are to be accompanied by an EUR.1, certificate which counts as proof of origin.<sup>82</sup> With respect to trade in ECSC products between the EU and Turkey,<sup>83</sup> a EUR.1 certificate is issued as proof of origin as well.

## 8. EVIDENCE OF ORIGIN; PROCEDURAL ASPECTS

### 8.1 Proof of origin

Title V of the harmonised protocols concerns proof of origin. The provisions concerned have been redrafted and considerably liberalised. This has happened in parallel with the redrafting of similar proof requirements in the context of the GSP rules of origin.<sup>84</sup>

Under the old rules, the only acceptable proof of preferential origin consisted of a certificate EUR.1. The customs authorities of the exporter's country issue such certificates. Economic operators have to supply all the relevant information enabling customs to determine that the certificate is rightfully issued. Under certain circumstances EUR.1 certificates may be issued retrospectively. An EUR.1 certificate is in principle valid for four months.

A novelty in the harmonised protocols (and—in a more limited form—in the revised GSP origin rules) is the possibility to prove preferential origin instead of a certificate EUR.1, with the following declaration to be given on the invoice:<sup>85</sup>

'The exporter of the products covered by this document (customs authorisation No . . .) declares that, except where otherwise clearly indicated, these products are of . . . preferential origin.'

In order to use this possibility, it is necessary that the exporter is approved, or that the consignment consists of one or more packages whose total value does not exceed € 6,000.

In order to be approved, exporters must seek an authorisation from customs. Authorisations are given to exporters which make frequent shipments under the free-trade

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80 The above example in footnote 65 concerning the colour televisions could therefore no longer occur these days with respect to the current relation between the EU and Turkey. In fact, even before the customs union was effected the Turkish customs authorities had started collecting the countervailing duties on third country products exported to the EU, or on products incorporating foreign components and manufactured in Turkey.

81 Title III of Decision 1/96 addresses the procedural aspects of the movement certificate A.TR.

82 Council Decision No 1/98 of the EC-Turkey Association Council of 25 February 1998 on the trade regime for agricultural products, published in OJ (1998) L 86.

83 See footnote 76 and accompanying text above.

84 See for the new GSP rules of origin concerned OJ (1997) L 9/1 at 12.

85 Or on any other document sufficiently identifying the goods concerned.

agreement concerned and who offer all the guarantees to verify the originating status of products. Customs may impose conditions and must monitor the authorisation.<sup>86</sup>

Articles 25 and further of the protocols contain some smaller exceptions and sundry rules on proof of origin. First, Article 25 lays down that for importation by instalments a single proof of origin is to be submitted. The product scope of this rule is defined in that provision.

Article 26 provides for an exemption of proof of origin for small packages sent between private persons and travellers' luggage and similar personal imports. These exceptions are limited by maximum allowances of € 500 for small packages and € 1,200 for travellers' personal luggage.<sup>87</sup>

Articles 27 through 35 contain sundry provisions dealing with administrative co-operation between customs authorities.<sup>88</sup>

## 8.2 Binding origin information

As part of the EU's obligations under the WTO Agreement on Rules of Origin<sup>89</sup> the Union had to introduce in its customs legislation a procedure for requesting binding origin information. The EU recently did so by amending Regulations 2913/92 and 2454/93.<sup>90</sup> Although not obligated by the Agreement on Rules of Origin, it extended the procedure to preferential rules of origin. Consequently, economic operators wishing to avail of the opportunities offered by the harmonised protocols may also request binding origin information on preferential origin.

Under the binding information procedure economic operators can ask customs for a binding ruling as to the origin of products.<sup>91</sup> Such ruling may in principle be invoked against other customs authorities in the EC. The applicant (defined as any person having 'valid reasons' for requesting a ruling) must submit an application to customs where he is located, or where the imports will be taking place. The application must contain the details listed in Article 6 of Regulation 2454/93.

The holder of binding origin information may invoke it before any customs authorities. The customs authority that issued the binding origin information may require the holder to inform other customs authorities thereof.

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<sup>86</sup> A Joint Declaration attached to the harmonised protocols provides for a transition period which is now of historical interest only.

For some practical details, see the notice in OJ (1999) C 90/6.

<sup>87</sup> We note that as a minor amendment, the applicable customs declaration form was altered in the 1999 amendments (Article 26(1) of the protocols, as amended by the 1999 amendments).

<sup>88</sup> These have been slightly changed by the 1999 amendments (see the Annex to this paper for references).

<sup>89</sup> Article 2(h) (and, *mutatis mutandis*, Article 3(f)) thereof provide that:

'upon the request of an exporter, importer or any person with a justifiable cause, assessment of the origin they would accord to a good are issued as soon as possible but not later than 150 days after a request for such an assessment provided that all necessary elements have been submitted. Requests for such assessments shall be accepted before trade in the good concerned begins and may be accepted at any later point in time. Such assessments shall remain valid for three years provided that the facts and conditions, including the rules of origin, under which they have been made remain comparable. Provided that the parties concerned are informed in advance, such assessments will no longer be valid when a decision contrary to the assessment is made in a review as referred to in subparagraph (j). Such assessments shall be made publicly available subject to the provisions of subparagraph (k).'

<sup>90</sup> OJ (1997) L 9 and OJ (1997) L 17/1. Regulation 2913/92 contains the Community Customs Code; Regulation 2454/93 the Implementing Community Customs Code.

<sup>91</sup> Or classification. This aspect, however, lies outside the purview of this overview.

9. CONCLUSIONS

The harmonised protocols are an improvement over the trading system as it existed until then. Preferential rules of origin were, until these protocols, a major restriction on the take-up of tariff preferences granted by the free-trade agreements concluded by the Community. The harmonised protocols are considerably more logical and, by allowing alternative origin criteria for many products, offer better sourcing opportunities than the original texts. Moreover, the improved cumulation provisions now make it easier for foreign companies to source parts in Central Europe and the EU and still claim tariff preferences. With the conclusion of a customs union between the EU and Turkey, and the conclusion by Turkey of parallel free-trade agreements with the partner countries, the scope for cumulation has been enlarged for economic operators.

Some critical remarks may be made, though. Although the redrafted wording on cumulation in the 1999 amendments is a further improvement, there appears to be space for further advancement. Notably, the applicable origin rules could be further simplified by advancing to full cumulation. For some partner countries (notably the so-called 'first wave' accession candidates) the issue may be resolved in the not-so-distant future when they attain full EU Membership; but the harmonised protocols will probably remain relevant for other candidate countries for many years.

The introduction of outward processing facilities in the 1999 amendments is, frankly speaking, less than what could have been granted. Outward processing is popular especially in the textiles (garments) trade. Excluding the textile sector from the scope of the new Article 12(3) curtails the usefulness of this provision somewhat.

A further interesting issue is the compatibility of the current system with WTO rules. The question whether the free-trade arrangements between the EU and its European partners deflect trade or create it has been touched upon. This question is complex. This paper is not the place for passing judgement on that matter; suffice it to say that there may be an issue here.

In view of the trade deflection issue noted earlier, the no-drawback rule is difficult to defend. It ensures that in a tit-for-tat trade liberalisation process the freeing up of the EU market did and does not come without concessions. And this may be the moral we found in this story: nothing in this world comes for free, especially in the world of free trade.

### Annex: references on origin rules in the harmonised protocols and published amendments thereto

This annex reflects the state of publication as per mid-March 1999.

Harmonised protocol concluded by the EU with	Publication reference
Bulgaria	OJ (1997) L 134
Czech Republic	OJ (1996) L 343
EEA	OJ (1997) L 21
Estonia	OJ (1997) L 111
Hungary	OJ (1997) L 92
Latvia	OJ (1997) L 111
Lithuania	OJ (1997) L 136
Norway, Iceland, Switzerland en Liechtenstein	OJ (1997) L 195
Poland	OJ (1997) L 221
Romania	OJ (1997) L 54
Slovak Republic	OJ (1997) L 212
Slovenia	OJ (1996) L 344

Origin protocol concluded by the EU with Turkey	Publication reference
Coal and steel products	OJ (1996) L 227/1
Unprocessed agricultural products	OJ (1998) L 86/1

Amendments to the harmonised protocols with	Publication reference
Bulgaria	OJ (1999) L 38/48
Czech Republic	OJ (1999) L 35/32
EEA	Not yet published
Estonia	Not yet published
Hungary	OJ (1999) L 49/33
Latvia	OJ (1999) L6/10
Lithuania	OJ (1999) L 45/39
Norway, Iceland, Switzerland en Liechtenstein	Not yet published
Poland	OJ (1999) L77/34
Romania	OJ (1999) L 35/11
Slovak Republic	Not yet published
Slovenia	OJ (1999) L 51/89

Notices
OJ (1997) C 84/3 (on cumulation), updated in OJ (1997) C 291/10
OJ (1997) C 141/5 (Explanatory notes), updated in OJ (1999) C 90/6