

## TEACHING CHINA GATT

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*How would China fare in its first World Trade Organization (WTO) dispute? That question has been of interest to international trade law practitioners and scholars ever since China acceded to the WTO on 11 December 2001, and indeed even before then, in the years leading up to its accession. The answer now exists. China lost, and lost rather thoroughly, in the 2009 Auto Parts case concerning the imposition of 25 percent charge on imported auto parts by China. However, its loss is a lesson to China, and indeed all WTO Members, about important GATT principles, and indeed about the Golden Rule. Further, for China, and the world, the Auto Parts litigation leads to broader and deeper questions about the nature and extent of economic and political reforms.*

*After a brief discussion of the facts leading to the dispute and the principles of international trade law applicable, the article examines the Panel and Appellate Body rulings and China's arguments. The author concludes by making three comments: First, China can take heart from its small victory in proving it did not violate the promises it made when acceding to the WTO. Second, the dispute serves as an important lesson for China on the Golden Rule of international trade. Third, the dispute plays only a small role in the bigger scheme concerning the grip on political power held by the Chinese Communist Party in China.*

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The author is grateful to his Research Assistant, Mr. Ben Sharp (J.D. Candidate 2009, University of Kansas), for his indispensable help on this work. A modified version of this article initially appeared as part of the *WTO Case Review 2009* in volume 27 of the *Arizona Journal of International and Comparative Law* (2010) (co-authored with Professor David Gantz, University of Arizona). The author is grateful to the *Arizona Journal*, and Mr. Shashank Kumar of *Trade, Law and Development*. All views and errors are attributable to the author.

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## I. THE END OF THE HONEYMOON

A. *Overview*

It was a fight over cars and car parts that marked the end of China's honeymoon period at the World Trade Organization (WTO), those blissful few years when its major trading partners were willing to forgive its trespasses because this largest of developing countries had just joined the club. The United States was not alone in bringing the *Auto Parts* case against China, the first WTO litigation brought against China since it acceded to the WTO on 11 December 2005.<sup>1</sup> (Previous Chinese involvement was

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<sup>1</sup> The formal citation to the case is *China – Measures Affecting Imports of Automobile Parts* (complaints by European Communities, United States, and Canada), WT/DS/339/AB/R, WT/DS/340/R, and WT/DS/342/AB/R (adopted 12 January, 2009).

Argentina, Australia, Brazil, Japan, Mexico, Thailand, and (notably) Taiwan (Chinese Taipei) participated as third parties in all three Panel proceedings, and at the Appellate Body stage. Taiwan attended the oral hearing, and provided no written submission. There is no coverage in the Appellate Body report of what Taiwan thought about the case. Some

limited to a third party role.) Canada and the European Communities (EC) also filed a claim against China. No longer was China a voluntary third-party participant. Now, it was compelled to defend its trade rules and policies before an independent international adjudicator.

More than history was at stake. Commercially, China is the third largest economy in the world (measured by Gross Domestic Product (GDP)), after the United States and Japan, and besting Germany in 2007.<sup>2</sup> After the United States, China boasts of the second largest consumer auto market in the world.<sup>3</sup> Likewise, following America, China is the second largest producer of autos and auto parts in the world.<sup>4</sup> Yet, in the two countries the fortunes of this strategic sector are headed in opposite directions. Car sales of new passenger vehicles in the United States (both total and retail) have

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of the third parties have major auto and auto parts interests in respect of China, as exporters to China, foreign direct investors in China, or both.

At the request of all three complainants, the same Panel heard all three cases, and at the request of the United States, this Panel issued a single Report with slightly different conclusions and recommendations for each complainant. Also at the request of the Americans, the Appellate Body set out its conclusions and recommendations separately for each complainant (in Paragraphs 253-254), thus issuing three reports, although the main body (Paragraphs 1-252) is presented as a unity. See *China Auto Parts* Appellate Body Report, *infra*, at ¶¶ 1 fn. 1, 9, 12; *China Auto Parts* Panel Report, *infra*, at ¶ 2.7. Canada, the European Communities, and the United States also participated as third parties in the actions brought by the other Members. Given the significant interests of all three in the Chinese auto market, their collaboration is not surprising. For example, car manufacturers from Europe account for 20-25 percent of all auto production in China. See *China Probed Over Car Parts Tariffs*, FINANCIAL TIMES, 27 October, 2006, at 2.

Interestingly, the Appellate Body received an unsolicited *amicus curiae* brief, but (after giving the complainants, respondent, and third parties the chance to express their opinion) did not find it necessary to rely on it to decide the case. See *China Auto Parts* Appellate Body Report, *infra*, at ¶ 11.

<sup>2</sup> See Geoff Dyer, *Chinese Data Put Economy in Third Place*, FINANCIAL TIMES, 15 January, 2009, at 1. Of course, some healthy skepticism is appropriate in respect of statistics put out by the Chinese Communist Party. See Geoff Dyer, *Economists at Odds Over Reliability of Beijing Data*, FINANCIAL TIMES, 15 January, 2009, at 3.

<sup>3</sup> See John Reed & Bernard Simon, *The Thrill is Gone*, FINANCIAL TIMES, 3 February, 2009, at 9; Jonathan Lynn, *UPDATE 2 – China Loses WTO Appeal in Car Parts Dispute*, REUTERS, 15 December, 2008, available at [www.reuters.com](http://www.reuters.com). See also Kathleen E. McLaughlin, *China Poised to be 2<sup>nd</sup> Largest Car Market by End of 2006*, *Government Economist Says*, 23 International Trade Reporter (BNA) 1566 (2 November, 2006) (quoting Xu Changming, Senior Economist, State Information Center, State Council of China, stating “[t]he era of common household car ownership in China is drawing near”).

<sup>4</sup> See *China Probed Over Car Parts Tariffs*, FINANCIAL TIMES, 27 October, 2006, at 2.

trended downwards since 2000 (from just under 18 million to below 12 million vehicles per year between 2000 and 2009, respectively).<sup>5</sup> Job loss and wage decline in the American auto industry are a decades-long phenomena. Conversely, the auto industry has been an engine of Chinese economic development. The market share of Chinese-owned vehicle producers (such as Chery) has risen relative to that of joint ventures between Chinese and foreign companies, and imported cars account for less than 5 percent of all auto sales in China.<sup>6</sup> China aims to win 10 percent of the global car market by *circa* 2016.<sup>7</sup> (A worrying sign for China is the effect of recession on its prized auto industry: in early 2009, the market for used cars was growing faster than for new cars, adding to protectionist pressures within the country.<sup>8</sup>) These commercial facts have their own political ramifications, *i.e.*, the *Auto Parts* case is a historic dispute set in the broad context of the political economy and development of China.

This article explores China's first loss at the WTO. Lose it did, at both the Panel and Appellate Body stage, on all the claims that mattered. The 25 percent charge China imposed on imported auto parts ran afoul of the Golden Rule of international trade law, national treatment. Part II sets out the facts of the case, and Part III provides essential information about the principles of international trade law that were at stake. Part IV examines the Panel rulings. Part V surveys the key issues on appeal, and holdings of the Appellate Body. Parts VI and VII analyze the arguments China made and lost on appeal. Part VIII offers three comments about the case. First, China can take heart from a small victory it achieved in the case, namely, in proving it did not violate the promises it made when acceding to the WTO. Second, the case is a useful tutorial for China about the Golden Rule of trade, which stems from Article III of the General Agreement on Tariffs and Trade (GATT)<sup>9</sup>. Third, and perhaps most importantly, the case plays

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<sup>5</sup> See John Reed & Bernard Simon, *The Thrill is Gone*, FINANCIAL TIMES, 3 February, 2009, at 9.

<sup>6</sup> See Daniel Pruzin, *WTO Panel Upholds U.S., EU, Canada in Final Ruling in China Auto Parts Case*, 25 International Trade Reporter (BNA) 448-449 (27 March, 2008) (reporting on 2006 data).

<sup>7</sup> See *China Probed Over Car Parts Tariffs*, FINANCIAL TIMES, 27 October, 2006, at 2.

<sup>8</sup> See Patti Waldmeir & John Reed, *China Used-Car Dealers in Top Gear*, FINANCIAL TIMES, 5 February, 2009, at 6.

<sup>9</sup> General Agreement on Tariffs and Trade 1994, 15 April, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay round, 1867 U.N.T.S. 187, 33 I.L.M. 1153 (1994).

only a small role in a much grander drama on stage in China concerning the grip on political power held by the Chinese Communist Party (CCP).

### B. *Part of a Larger Development Drama*

More broadly, development is the underlying narrative in the story of China's first defeat at the WTO. A common feature of developing countries (and, *a fortiori*, least developed countries) is their lack of legal capacity to participate fully and effectively in the international trade arena. As the world's largest developing country, China is a land of pockets of garish wealth and stunning skylines amidst a desert of mild to extreme poverty and life-threatening pollution. Its legal capacity in international trade is a microcosm of this macrocosm.

There exists a small, growing cadre of brilliant trade lawyers, typically educated outside China and now working in Beijing and Shanghai. The vast majority of lawyers, and worryingly, judges, have precious little appreciation for the policies, much less the intricacies, of the GATT–WTO regime. Thus, the *Auto Parts* dispute provides the first case study in the development of China's legal capacity to bring and defend claims on the world stage. Why did China not settle the case, after it failed to give a convincing justification for its controversial measures?<sup>10</sup> Why did it press on

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<sup>10</sup> See Daniel Pruzin, *WTO Talks with China on Auto Parts Dispute Ends with No Sign of Resolution*, 23 International Trade Reporter (BNA) 762 (18 May, 2006). The first WTO action brought against China was by the United States, which contended China taxed imported semi-conductors in a discriminatory fashion. China settled that action by agreeing to end the discriminatory treatment. See *id.* In the *Auto Parts* case, China's cut on auto tariffs to 10 percent (from a range with a high point of 16.4 percent), and its cut on autos to 25 percent (from 28 percent) effective 1 July, 2006, seemed a clumsy effort to solve the case that failed to address the underlying claims of discriminatory treatment, and in any event were necessary for China to fulfill its WTO accession commitments. See Kathleen E. McLaughlin & Christopher S. Rugaber, *China to Reduce Import Tariffs on Autos, Some Parts Effective July 1*, 23 International Trade Reporter (BNA) 947 (22 June, 2006); Daniel Pruzin & Christopher S. Rugaber, *U.S., EU Initiate WTO Dispute Complaints Against Chinese Restrictions on Auto Parts*, 23 International Trade Reporter (BNA) 530-531 (6 April, 2006); *China to Cut Car Import Duties*, FINANCIAL TIMES, 16 June, 2006, at 5.

China also blocked the first request for the establishment of a panel in the *Auto Parts* case, did not accept the slate of panelists (requiring WTO Director-General Pascal Lamy to appoint them), and reacted angrily to the eventual formation of a panel, all signs, perhaps, which adduce a pugnacious approach, in contrast to the semi-conductor case. See Daniel Pruzin, *U.S., EU, Canada Ask Lamy to Appoint Panel Members in China Auto Parts Case*, 24

with an appeal, after the widely reported preliminary and final panel rulings clearly condemned its controversial trade measures?<sup>11</sup> How did China argue the case, given that it was aware of the strong claims against it since 2004?<sup>12</sup> Why were China's arguments largely unpersuasive? What legal lessons are there for China as it develops in the area of international trade adjudication? These and related issues will be asked and debated on for generations to come, and rightly so, if China aspires to develop its trade law capacity. Assuming China indeed has this aspiration, it might also be asked why (despite the requests of the complainants) China refused to allow public access to the WTO proceedings?<sup>13</sup>

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International Trade Reporter (BNA) 134 (25 January, 2007); Kathleen E. McLaughlin, *China Ministry Complains About WTO Case on Auto Part Tariffs, Cites Shrinking Duties*, 23 International Trade Reporter (BNA) 1566-1567 (2 November, 2006); Daniel Pruzin, *U.S., EU, Canada to Renew Requests at WTO for Panels to Rule on China Car Parts Tariffs*, 23 International Trade Reporter (BNA) 1507 (19 October, 2006); Daniel Pruzin, *China Blocks U.S., EU, Canadian Requests for WTO Panel Review of Auto Parts Tariffs*, 23 International Trade Reporter (BNA) 1436-1437 (5 October, 2006).

<sup>11</sup> See Frances Williams, *WTO Panel Finds Against China in Import Tariff Dispute*, FINANCIAL TIMES, 19-20 July, 2008, at 2; Rossella Brevetti, *WTO Panel Issues Ruling Upholding U.S. Complaint on China Auto Part Import Duties*, 25 International Trade Reporter (BNA) 1100 (24 July, 2008); Daniel Pruzin, *WTO Panel Upholds U.S., EU, Canada in Final Ruling in China Auto Parts Case*, 25 International Trade Reporter (BNA) 448-449 (27 March, 2008); Daniel Pruzin, *WTO Issues Preliminary Ruling Condemning China on Auto Parts Tariffs in U.S., EU Case*, 25 International Trade Reporter (BNA) 270 (21 February, 2008).

<sup>12</sup> Daniel Pruzin & Christopher S. Rugaber, *U.S., EU Initiate WTO Dispute Complaints Against Chinese Restrictions on Auto Parts*, 23 International Trade Reporter (BNA) 530-531 (6 April, 2006).

<sup>13</sup> See Daniel Pruzin, *WTO Panel Chairman Sets Dates for Decision on China Auto Tariffs*, 24 International Trade Reporter (BNA) 308 (1 March, 2007) (noting the contrast between the policy of the complainants to make WTO adjudication more transparent, hence their request to open the panel proceedings in the *Auto Parts* case, and the political sensitivity of China about its first case).

The transparency of China's international trade law regime – like that of many developing countries – has been a long-standing concern of the United States and other developed countries. The ostensibly straightforward task of obtaining accurate information about Chinese laws – what they are and how they are applied – often proves not to be simple. See, e.g., Daniel Pruzin, *U.S. to Press China for Answers on Alleged Barriers to Goods Trade*, 23 International Trade Reporter (BNA) 1636-1637 (16 November, 2006) (reporting on the difficulty in obtaining data from China on barriers to trading rights of foreign firms, export quotas and export duties on coking coal (used to make steel), value added tax (VAT) rebates for steel, investment incentives for the purchase of domestic industrial machinery, and policies on SOEs).

Not surprisingly, *The Economist* summarized the wide context and repercussions of China's first loss, not only for China, but also for foreign countries and their industries:

[O]n a symbolic and practical level, the case could be a turning-point for many industries in China: the start of a new era in which they are attacked by litigation.

...

The WTO decision also draws attention to China's increasingly fractious trade relationships, which are the source of a growing number of anti-dumping actions.... Most importantly, it shows China's potential vulnerability before the WTO.

... [T]he Chinese government has not just intervened on behalf of partsmakers. It has erected barriers to protect many other industries, for example by imposing elaborate registration and certification requirements for imported food, cosmetics, chemicals, and pharmaceuticals. These do not apply to local firms, which is just the kind of preferential treatment that could fall foul of WTO rules.

China was eager to join the WTO on the basis that membership of a large, multilateral organization would enhance its ability to compete with other big countries. But its odd, state-dominated economy makes it particularly sensitive to verdicts of this kind.<sup>14</sup>

A related matter is the role exports play in Chinese economic growth, which, in two words is "huge" and "unsustainable."

As even China's Premier, Wen Jiabao, has admitted, it is "unstable, unbalanced, uncoordinated, and unsustainable" for China to continue to rely on exports, rather than domestic consumption, as the dominant component of its growth in GDP.<sup>15</sup> In the United States, personal consumption was 67 percent of GDP for the last quarter of the 20<sup>th</sup> century, and 72 percent between 2000 and 2008. In China, domestic consumption has fallen from 45 percent of GDP in the mid-1990s to 35 percent of GDP in 2009. China must increase its wage levels, so that its citizens have more disposable income to spend. (Wages in China account for 40 percent of GDP, whereas in the Group of Seven (G-7) industrialised nations the comparable figure is 52 percent.) But, how can China boost wage levels without damaging its international competitive advantage by

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<sup>14</sup> *Inevitable Collision*, THE ECONOMIST, 23 February 2008, at 82-83 (commenting on the impact of the Panel decision).

<sup>15</sup> *Quoted in David Pilling, China Should Raise Wages to Stimulate Demand*, FINANCIAL TIMES, 5 February 2009, at 9. The statistics in this paragraph are taken from this source.

driving up its own labor costs? Even if wage levels rise, why would average Chinese citizens spend on consumer items when they must save for their and their children's education and health care, and for their pensions, as the state no longer provides a comprehensive safety net? Amidst these challenges, how can China continue to privatize state owned enterprises (SOEs), end export subsidies, allow its currency to float freely in foreign exchange markets, and open major sectors – like autos and auto parts – to free trade?

The historic *Auto Parts* case is a multi-layered story in an environment of colossal challenges for China and the world. The case is about the development of legal capacity in the one developing country about which every other country cares. It is about a sector on which the fortunes of tens of millions of Chinese and foreigners ride. It is about the structure of the Chinese economy and the role the CCP plays in directing domestic and foreign factors of production. The *Auto Parts* case may even be about – in a tiny way – the beginning of the end of the six decades of political dominance by the CCP.

## II. THE ADVERSE MEASURES<sup>16</sup>

Underlying the actions brought against China by the United States, Canada, and EC was the same factual predicate. China imposed measures that adversely affected exports of automobile parts into the Chinese market.<sup>17</sup> In controversy were three legal instruments issued by the CCP government:

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<sup>16</sup> This discussion is drawn from Appellate Body Report, *China – Measures Affecting Imports of Automobile Parts* (complaints by EC, US, Canada), WT/DS/339/AB/R, WT/DS/340/R, and WT/DS/342/AB/R (adopted 12 January, 2009) ¶¶ 1-13, 109-126 (hereinafter *China Auto Parts* Appellate Body Report); Panel Report, *China – Measures Affecting Imports of Automobile Parts* (complaints by EC, US, Canada), WT/DS/339/AB/R, WT/DS/340/R, and WT/DS/342/AB/R ¶¶ 1.1-2.7 (adopted as modified by the Appellate Body 12 January, 2009) (hereinafter *China Auto Parts* Panel); World Trade Organization, *Update of WTO Dispute Settlement Cases*, WT/DS/OV/33 (3 June, 2008), at 54-56.

<sup>17</sup> Among the Chinese auto component makers are Weichai Power Co. Ltd. and Changchun FAW – Sihuan Automobile Co. Ltd. Some American component makers, like Delphi Corp. and Visteon Corp., also produce parts in China. Insofar as car manufacturers import some components, rather than purchase from domestic suppliers, these firms are among the ones potentially affected by the Appellate Body decision discussed herein. See Jonathan Lynn, *UPDATE 2 – China Loses WTO Appeal in Car Parts Dispute*, REUTERS, 15



1. Policy Order 8 –  
*Policy on Development of the Automotive Industry*, Order Number 8 of the National Development and Reform Commission, effective 21 May 2004.
2. Decree 125 –  
*Administrative Rules on Importation of Automobile Parts Characterized as Complete Vehicles*, Decree Number 125 of the People’s Republic of China, effective 1 April 2005.
3. Announcement 4 –  
*Rules on Verification of Imported Automobile Parts Characterized as Complete Vehicles*, Public Announcement Number 4 of 2005 of the Customs General Administration of the People’s Republic of China, effective 1 April 2005.

Policy Order 8 establishes the legal basis for Decree 125 and Announcement 4. Under that Order, the Customs General Administration (CGA) works with other relevant Chinese governmental departments (such as the Ministries of Commerce and Finance, the National Development and Reform Commission (NDRC), and the Verification Centre) to promulgate specific rules about the imports of autos and auto parts. Decree 125 implemented those rules. Essentially, the rules deal with the supervision and administration of parts that are imported and subsequently assembled into

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December, 2008, *available at*: [www.reuters.com](http://www.reuters.com). Without doubt, exporters of autos and auto parts in the complainant countries are affected, and their representatives at the meeting of the WTO Dispute Settlement Body (DSB) urged China to implement the Appellate Body decision as quickly as possible given the “current perilous state of the automobile industry.” Daniel Pruzin, *Citing Carmaker’s Woes, U.S., EU Urge China to Implement Quickly WTO Auto Parts Ruling*, 26 *International Trade Reporter (BNA)* 77 (15 January, 2009).

To be sure, several foreign car manufacturers (*e.g.*, Honda, General Motors, Toyota, and Volkswagen AG) are wont to rely on components produced in China (and they account for 80 percent or more of the value of the models the foreign firms build in China), because the local parts are cheaper than imports (and the quality of local parts has improved), notwithstanding the added tariff cost associated with imports. In other words, these companies do not all complain about high Chinese tariffs, which leads to the inference that the *Auto Parts* dispute is perhaps more political than economic in nature. *See UPDATE 1 – China Commerce Ministry Regrets WTO Car Parts Ruling*, REUTERS, 16 December, 2008, *available at*: [www.reuters.com](http://www.reuters.com); Richard McGregor & Geoff Dyer, *Trade Friction Puts Heat on China*, FINANCIAL TIMES, 1-2 April, 2006, at 4.

certain models of cars. The rules also set the criteria to characterize whether imported auto parts should be treated as a complete vehicle. Announcement 4 gives further details on the procedures and criteria set out in Order 8.

Taken together, the measures may be referred to as “China’s 2004 Automobile Policy.”<sup>18</sup> Briefly stated, the Policy imposes a 25 percent charge on imported auto parts used in the manufacture or assembly of certain models of motor vehicles in China, and sold in the Chinese domestic market. But, the imposition occurs only if those imported parts are characterized as – or, stated differently, if they have the essential character of – a completed vehicle based on criteria prescribed in the Policy.<sup>19</sup> Further, the charge is levied only after the parts are imported and assembled in China into a finished vehicle. The criteria are a set of thresholds concerning the type or value of imported auto parts used to produce specific models of vehicles. More precisely, as the Appellate Body explained:

The measures set out ... the criteria that determine when imported parts used in a particular vehicle model must be deemed to have the “essential character” of complete vehicles and are thus subject to the 25 per cent charge. These criteria are expressed in terms of particular combinations or configurations of imported auto parts or the value of imported parts used in the production of a particular vehicle model. The use in the production of a vehicle model of specified combinations of “major parts” or “assemblies” that are imported requires characterization of *all* parts imported for use in that vehicle model as complete vehicles. [Note that the noun “assembly” as a synonym for “major part” should not be confused with the verb “assemble” in the sense of putting together parts to make a finished car.] Various combinations of assemblies will meet the criteria, for example: a vehicle body (including cabin) assembly and an engine assembly; or five or more assemblies other than the vehicle body (including cabin) and engine assemblies. The use, in a specific vehicle model, of imported parts with a total price that accounts for at least 60 per cent of the total price of the complete vehicle also requires characterization of *all* imported parts for use

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<sup>18</sup> See Amy Tsui, *WTO Affirms Chinese Measures, Treatment of Imports of Auto Parts Violate Obligations*, 25 International Trade Reporter (BNA) 1779 (18 December, 2008).

<sup>19</sup> Both the Panel and Appellate Body intentionally used the term “charge,” rather than “duty” or “tariff.” China’s 2004 Automobile Policy employs the latter two terms, but the Panel and Appellate Body preferred the word “charge” because it was neutral as to whether the “charge” fell under Article II or Article III of the General Agreement on Tariffs and Trade (GATT). See *China Auto Parts* Appellate Body Report, ¶ 109 fn. 127.

in that vehicle model as complete vehicles. Imports of CKD and SKD kits [completely-knocked down vehicle kits and semi-knocked down vehicle kits, respectively, discussed below] are also characterized as complete vehicles.<sup>20</sup>

Broadly speaking, this passage reveals two thresholds that will lead to characterization of imported auto parts as a completed vehicle:

1. Volume threshold –

Employing certain key imported major parts (*i.e.*, assemblies), or a designated combination of imported major parts, to make a vehicle, which effectively summed to 60 percent or more of the content of the vehicle.<sup>21</sup>

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<sup>20</sup> *China Auto Parts* Appellate Body Report, ¶ 114 (citations omitted, emphasis in original). In a footnote, the Appellate Body explained the term “assembly” under Decree 125 included “the vehicle body (including cabin) assembly, the engine assembly, the transmission assembly, the driving axle assembly, the driven axle assembly, the frame assembly, the steering system, and the braking system.” As indicated, the term corresponds loosely to the major parts of a vehicle. In a separate footnote, the Appellate Body summarized Decree 125 as containing

[t]he following combinations of “assemblies” ...: (i) imports of a vehicle body (including cabin) assembly and an engine assembly for the purpose of assembling vehicles; (ii) imports of a vehicle body (including cabin) assembly or an engine assembly, plus at least three other assemblies, for the purpose of assembling vehicles; and (iii) imports of at least five assemblies other than the body (including cabin) and engine assemblies for the purpose of assembling vehicles. ... In turn, the determination of whether auto parts used to produce an assembly will be deemed an “imported assembly” and therefore count towards the thresholds ... is made based on criteria specified in ... Decree 125. These criteria include: (i) a complete set of parts imported to assemble the assembly; (ii) “key parts” or “sub-assemblies” that reach or exceed specified quantities referred to in Annexes 1 and 2 to Decree 125; and (iii) the total price of the imported parts accounts for at least 60 per cent of the total price of that assembly.

*China Auto Parts* Appellate Body Report, ¶ 114 fn. 147.

<sup>21</sup> See Daniel Pruzin & Christopher S. Rugaber, *U.S., EU Initiate WTO Dispute Complaints Against Chinese Restrictions on Auto Parts*, 23 *International Trade Reporter (BNA)* 530-531 (6 April, 2006). This account states the volume threshold as in excess of 60 percent.

2. Value threshold –

Employing imported parts in a vehicle that account for 60 percent or more of the total price of that vehicle.<sup>22</sup>

If the imported parts used in a particular vehicle meet or exceed the relevant threshold, then all of the imported parts used to assemble that model of vehicle are characterized as complete vehicles. As the Appellate Body explained:

When the imported parts used in the production of a specific vehicle model meet the criteria under the measures at issue, then the 25 per cent charge and the requirements under the measures apply in respect of *all* imported parts assembled into the relevant vehicle model. [That is, the charge affects every imported part assembled into a completed vehicle, even a part that was not considered when determining whether the vehicle model in question met the volume or value threshold.] It is immaterial whether the auto parts that are “characterized as complete vehicles” were imported in multiple shipments – that is at various times, in various shipments, from various suppliers and/or from various countries – or in a single shipment. It is also immaterial whether the automobile manufacturer imported the parts itself or obtained the imported parts in the domestic market through a third party supplier such as an auto part manufacturer or other auto part supplier. However, if the automobile manufacturer purchases imported parts from such an independent third party supplier, the automobile manufacturer may deduct from the 25 per cent charge that is due the value of any customs duties that the third party supplier paid on the importation of those parts, provided that the automobile manufacturer can furnish proof of the payment of such import duties. If optional parts that are imported are installed on a relevant vehicle model, the manufacturer must report those optional parts to the Verification Centre, make declarations at the time of the actual installation of the optional parts and pay the 25 per cent charge on such optional parts.<sup>23</sup>

In effect, China rolls up all imported parts together, and presumes, irrebutably, the imported parts impart the essential character of a completed vehicle. In turn, all imported parts used for the vehicle model are subject to the 25 percent charge. China imposes the charge following the assembly of the vehicles.

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<sup>22</sup> The value threshold, originally scheduled to take effect on 1 July, 2006, entered into force on 1 July, 2008, because of the administrative complexity in implementing it. *See China Auto Parts*, Appellate Body Report, ¶ 195 fn. 275.

<sup>23</sup> *China Auto Parts* Appellate Body Report, ¶ 121 (citations omitted, emphasis in original).

The 25 percent figure is no accident. It equals the average applied and bound tariff rate China lists as in its Schedule of Concessions as applicable to complete motor vehicles.<sup>24</sup> The 25 percent Most-Favoured Nation (MFN) duty rate is higher than the average rate China applies to auto parts, and has bound, which is 10 percent. As for imported auto parts that China does not characterize as complete vehicles, they are subject to the duty rate in China's Schedule for parts, *i.e.*, an average of 10 percent. Manifestly, China's 2004 Automobile Policy was an effort, *inter alia*, "to discourage foreign car makers from importing vehicles in large parts to circumvent the higher tariff."<sup>25</sup>

In sum, under the 2004 Automobile Policy, imported automobile parts used for the production in China of a vehicle for sale in China are subject to a charge. That charge equals the tariff for a completed imported vehicle, that is, 25 percent, and the automobile manufacturer (not the importer) is legally liable for paying the charge.<sup>26</sup> The charge is levied only if those parts are imported and used in the production and assembly of a vehicle in excess of certain thresholds. The thresholds – which are based on the volume and value criteria laid out in the Policy – define whether imported parts used in a particular vehicle model have the essential character of, and thus qualify as, a completed vehicle. If the imported parts have the essential character of a completed vehicle, then China slaps a 25 percent tariff on those parts, and indeed all imported parts used to make that model of vehicle.

China also applies the 25 percent charge – *i.e.*, the tariff for a complete vehicle – on a CKD and SKD kit.<sup>27</sup> These kits are a sub-set of all the

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<sup>24</sup> This document is Schedule CLII – People's Republic of China (Part I – Schedule of Concessions and Commitments on Goods), attached as Annex 8 to China's *Accession Protocol*, WT/ACC/CHN/49/Add.1.

<sup>25</sup> UPDATE 1 – China Commerce Ministry Regrets WTO Car Parts Ruling, REUTERS, 16 December, 2008, available at: [www.reuters.com](http://www.reuters.com). See also Daniel Pruzin, *China Outlines Defense in WTO Dispute Over Auto Parts Tariffs*, 24 International Trade Reporter (BNA) 621 (3 May, 2007) (summarizing China's argument about the prevention of circumvention by treating disassembled auto parts that have the essential character of a car as a complete vehicle, and thereby subjecting the shipment to the 25 percent vehicle tariff, not the 10 percent parts tariff).

<sup>26</sup> If a manufacturer buys imported parts from an independent supplier, then the manufacturer may deduct from the 25 percent charge it owed the value of any customs duties the supplier paid on those parts, as long as the manufacturer has proof of such payment. See *China Auto Parts Appellate Body Report*, ¶ 174 fn. 235.

<sup>27</sup> See *China Auto Parts Appellate Body Report*, ¶ 4 fn. 19.

products covered by China's 2004 Automobile Policy.<sup>28</sup> Yet, its Policy does not provide any definition of a "CKD" or "SKD" kit. Filling this definitional void, the Panel stated it considered these kits to refer to all, or nearly all, of the auto parts necessary to assemble a complete vehicle, which must be packaged and shipped in a single shipment and, following importation, which must go through a process of assembly to become a completed vehicle.<sup>29</sup> The distinction between the two kits concerns

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<sup>28</sup> See *China Auto Parts* Appellate Body Report, ¶ 210.

<sup>29</sup> The Appellate Body explained in further detail the procedural steps an automobile manufacturer must follow. In summary, before beginning production of a new vehicle model that will incorporate imported parts and be sold in the Chinese market, the manufacturer performs a self-evaluation as to whether the imported parts to be used in that model have the essential character of a complete vehicle, and thus qualify as such and trigger the 25 percent charge. It submits the results to the NDRC and Ministry of Commerce. If the self-evaluation yields an affirmative result, then the manufacturer arranges for the Chinese government to list the vehicle model in question in a Public Bulletin. If the result is negative, then the Chinese government – specifically, the Verification Centre – conducts a verification examination to ensure the proposed vehicle model meets the thresholds established by the criteria in the 2004 Automobile Policy. If the Centre verifies the self-evaluation results, then the manufacturer is not subject to the 25 percent charge.

Once listed in the Public Bulletin, the manufacturer applies to the CGA to register the vehicle model. Assuming approval of the registration application, CGA requires the manufacturer to post a duty bond (a financial guarantee that final duties ultimately assessed will be paid) that corresponds to the 10 percent tariff rate on auto parts multiplied by the projected monthly importations of auto parts. At this point, the manufacturer may start importing parts for use in its new vehicle model. When the manufacturer imports the parts that are characterized as complete vehicles, it must specify on the relevant customs documentation that the parts are "characterized as complete vehicles." Thereafter, the manufacturer is free to use the parts, though it must submit information (according to prescribed deadlines) to the CGA about all completed vehicles it made so that a "Verification Report" can be issued (by the Verification Centre).

Once that Report is issued, the relevant district customs office classifies the auto parts as complete vehicles, and assesses the 25 percent charge. The manufacturer makes a duty declaration on the tenth working day of each month for all complete vehicles of the relevant model that it assembled during the preceding month. The office collects the charge.

There are four principal qualifications to these procedures. First, an automobile manufacturer may apply for a re-verification of a vehicle model, if it changes the configuration or combination of imported parts it uses to manufacture that model, and it believes the change will affect the determination that the vehicle meets the essential character criteria. The Verification Centre is responsible for Re-Verification Reports. Second, if an automobile manufacturer does not use imported auto parts that it had declared as a complete vehicle, then it is eligible for the 10 percent auto parts duty rate.

assembly. A CKD kit contains auto parts imported together in an unassembled state. Subsequently, the parts are assembled to make a complete vehicle. An SKD kit also has auto parts imported together. But, some of the components in an SKD kit have been assembled prior to importation.

The auto parts subject to the 25 percent charge fall into four categories of the Harmonized Commodity Description and Coding System (Harmonized System, or HS):

1. Complete motor vehicles (headings 87.02-87.04).<sup>30</sup>
2. Certain intermediate categories of auto parts, specifically chassis fitted with engines (heading 87.06), and bodies for motor vehicles (heading 87.07).
3. Other intermediate categories of auto parts, specifically parts and components of motor vehicles that fall under a particular HS heading (heading 87.08).<sup>31</sup>
4. Parts and accessories of motor vehicles that fall under a variety of HS Chapters other than Chapter 87, such as engines (Chapter 84) (specifically, parts under headings 84.07-84.09, 84.83, 85.01, 85.03, 85.06, 85.11-85.12, and 85.39).

Thus, for example, suppose imported parts exceed the applicable volume or value threshold. Then, the Chinese government imposes, on all imported parts used in the relevant vehicle model, a charge amounting to 25 percent *ad valorem*, which is in addition to the normal MFN rate applicable to the parts. The Chinese government does not impose the same charge on domestically produced parts. Thus, the 2004 Automobile Policy imposes

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Third, if a Chinese auto or auto parts manufacturer substantially processes imported auto parts (other than an entire imported assembly or sub-assembly, *i.e.*, it incorporates imported parts into an assembly or sub-assembly), then the imported parts are treated as a domestic parts, and not subject to the 25 percent charge. Fourth, an automobile manufacturer importing a CKD or SKD may declare and pay duties on the kits at the time of importation, and thereby obtain an exemption from certain aspects of the 2004 Automobile Policy that establish the 25 percent charge. *See China Auto Parts Appellate Body Report ¶¶ 114-126.*

<sup>30</sup> This category is the one to which the average applied Chinese tariff is 25 percent. There are variations at the HS 8 digit level, but the 25 percent figure is the average.

<sup>31</sup> This and the fourth categories are the ones for which China has an average applied tariff rate of 10 percent.

different charges on vehicles made in China depending on the domestic content of the parts used in the production process. The Policy penalizes a manufacturer of vehicles in China for using imported auto parts in a vehicle destined for sale in China. Conversely, it gives producers an advantage if they use domestically made parts.

### III. RELEVANT GATT PRINCIPLES

As just explained, China bound its tariff on auto parts at MFN rates considerably lower than its tariff bindings for complete vehicles – 10 versus 25 percent. Yet, if an imported part is incorporated into a vehicle made and sold in China, and that vehicle contains imported parts in excess of a government-defined threshold, then the tariff imposed on the part is at the higher level, *i.e.*, that of a finished vehicle. In effect, China bumped up the tariff on the imported part to the level of a finished good. Note, then, that China's Schedule displays tariff escalation – the bound tariff rates are higher for complete motor vehicles than for components. The typical purpose of tariff escalation is to encourage the location of high value-added economic activity within the territory of the importing country.

Contrary to the tariff binding principles in GATT Article II:1, the bump up means China, assesses on the disfavoured imported auto parts, a charge that is in excess of the charges set forth and bound in its Schedule of Tariff Concessions for these imports. Article II:1 states:<sup>32</sup>

- (a) Each contracting party shall accord to the commerce of the other contracting parties treatment no less favourable than that provided for in the appropriate Part of the appropriate Schedule annexed to this Agreement.
- (b) The products described in Part I of the Schedule relating to any contracting party, which are the products of territories of other contracting parties, shall, on their importation into the territory to which the Schedule relates, and subject to the terms, conditions or qualifications set forth in that Schedule, be exempt from *ordinary customs duties* in excess of those set forth and provided for therein. Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with the importation in excess of those imposed on the date of this Agreement or

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<sup>32</sup> Unless otherwise noted, all GATT and WTO rules are quoted from RAJ BHALA, INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE – DOCUMENTS SUPPLEMENT (3d ed. 2008).



those directly and mandatorily required to be imposed thereafter by legislation in force in the importing territory on that date.<sup>33</sup>

The extra charge also raises a problem under national treatment principles.

Those principles are set out in GATT Article III. The national treatment problems arise because the charge applies only to imports, not like domestic products. Article III:1-2 and 4 state:

1. The contracting parties recognize that internal taxes and other *internal charges*, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.\*

2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other *internal charges* of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other *internal charges* to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.\*

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4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded *treatment no less favourable* than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.<sup>34</sup>

Indicated by the asterisk (\*) in Articles III:1-2, the Interpretative Note, *Ad Article III* (sometimes referred to as the *Ad Note*) provides:

Any internal tax or other *internal charge*, or any law, regulation or requirement of the kind referred to in paragraph 1 which applies to an imported product and to the like domestic product and is collected or

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<sup>33</sup> Emphasis supplied.

<sup>34</sup> Emphasis supplied.

enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal tax or other *internal charge*, or a law, regulation or requirement of the kind referred to in paragraph 1, and is accordingly subject to the provisions of Article III.

*Paragraph 1*

The application of paragraph 1 to internal taxes imposed by local governments and authorities within the territory of a contracting party is subject to the provisions of the final paragraph of Article XXIV. The term “reasonable measures” in the last-mentioned paragraph would not require, for example, the repeal of existing national legislation authorizing local governments to impose internal taxes which, although technically inconsistent with the letter of Article III, are not in fact inconsistent with its spirit, if such repeal would result in a serious financial hardship for the local governments or authorities concerned. With regard to taxation by local governments or authorities which is inconsistent with both the letter and spirit of Article III, the term “reasonable measures” would permit a contracting party to eliminate the inconsistent taxation gradually over a transition period, if abrupt action would create serious administrative and financial difficulties.

*Paragraph 2*

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.<sup>35</sup>

Further, the bump up is a way China discourages vehicle producers located in that country from using too many imported parts, and encourages them to source their inputs from suppliers in China. That is because China’s 2004 Automobile Policy specifies domestic content thresholds (using value or volume metrics).

This kind of encouragement is a prohibited subsidy, a Red Light import substitution subsidy, under Article 3:1(b) of the WTO *Agreement on Subsidies and Countervailing Measures (SCM Agreement)*.<sup>36</sup> That is, the “subsidy” (under Article 1) is government revenue that China foregoes by imposing a lesser

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<sup>35</sup> Emphasis supplied.

<sup>36</sup> Agreement on Subsidies and Countervailing Measures, 15 April, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay round, 1867 U.N.T.S. 14.

tariff on imported auto parts if a final, assembled vehicle contains the requisite level of local content. The subsidy is “specific” (under Article 2) to the auto industry. This specific subsidy is for import substitution under Article 3:1(b), which states:

3.1. Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

(a) subsidies contingent, in law or in fact,<sup>37</sup> whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;

(b) subsidies contingent, whether solely or as one of several other conditions, *upon the use of domestic over imported goods*.<sup>38</sup>

Avoidance of the extra charges is contingent on the use of domestic over imported goods. That, in turn, helps keep Chinese factories in business and workers employed – all at the expense of Canadian, European, and American car parts companies and their work forces.

The 2004 Automobile Policy also biases the pattern of foreign direct investment (FDI) into China, raising concerns among the complainants that they ran afoul of the WTO *Agreement on Trade-Related Investment Measures (TRIMs)*<sup>39</sup>. The Policy confers an advantage on enterprises that use in the production of vehicles domestic rather than imported parts. This advantage may induce firms to establish parts manufacturing operations in China. By locating their plants in China, rather than exporting auto parts from outside China, they avoid imposition of the full vehicle duty rate on the parts.

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<sup>37</sup> A footnote to this phrase explains that *de jure* or *de facto* contingency exists: when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

<sup>38</sup> Emphasis supplied.

<sup>39</sup> Agreement on Trade-Related Investment Measures, 15 April, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay round, 1868 U.N.T.S. 186.

IV. LESSONS FROM THE PANEL<sup>40</sup>

In their separate actions before the Panel, the EC, Canada, and the United States made a large number of claims. Each complainant, averred China's 2004 Automobile Policy, violated all or some of the following multilateral trade obligations:

1. GATT Articles II:1(a)-(b) (concerning tariff bindings), III:1-2 and III:4 (concerning national treatment for fiscal and non-fiscal measures, respectively), III:5 (concerning domestic content requirements), and XI:1 (concerning quantitative restrictions).<sup>41</sup>
2. Articles 2:1-2:2 of the WTO *TRIMs Agreement* (concerning national treatment and quantitative restrictions, and referring to GATT Articles III and XI), along with the related Illustrative List (in Annex 1 thereto, particularly Paragraphs 1(a) and 2(a), concerning domestic sourcing and import substitution, and referencing GATT Articles III:4 and XI:1).<sup>42</sup>
3. Articles 3:1(b) and 3:2 of the WTO *SCM Agreement* (concerning prohibited or "Red Light," specifically import-substitution, subsidies).<sup>43</sup>
4. Certain provisions in the WTO accession documents agreed to by China that lay out commitments China made to join the WTO, particularly Part I, Paragraphs 7.2-3 of the *Protocol of Accession*, and Paragraphs 93, 203 and 342 of the *Working Party Report on the Accession of China* (in conjunction with Part I, Paragraph 1.2 of the *Accession Protocol*).<sup>44</sup>

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<sup>40</sup> This discussion is drawn from *China Auto Parts* Appellate Body Report ¶¶ 1-13, 108-126; World Trade Organization, *Update of WTO Dispute Settlement Cases*, WT/DS/OV/33 (3 June, 2008), at 54-56.

<sup>41</sup> These provisions are discussed in RAJ BHALA, *MODERN GATT LAW* chs. 4-6 (national treatment) and 11 (tariff bindings) (2005), as well as RAJ BHALA, *INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE* chs. 12 (tariff bindings) and 13 (national treatment) (3d ed. 2008).

<sup>42</sup> The *TRIMs Agreement* is treated in RAJ BHALA, *INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE* ch. 13, pt. II.C (3d ed. 2008).

<sup>43</sup> The *SCM Agreement* is treated in RAJ BHALA, *INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE* ch. 34 (3d ed. 2008).

<sup>44</sup> Canada pled an additional violation, namely, Article 2(b)-(d) of the WTO *Agreement on Rules of Origin*. See generally Raj Bhala, *Enter the Dragon: An Essay on China's WTO Accession Saga*, 15 AM. U. INT'L L. REV. 1469-1538 (2000) (assessing China's accession commitments

The complaining WTO Members also asserted that the Automobile Policy nullified or impaired benefits accruing to them under the aforementioned agreements.

In the first decision by any WTO adjudicatory body against China, the *Auto Parts* Panel rendered a strong verdict against China's Automobile Policy on the most potent arguments of the complainants. In particular:<sup>45</sup>

1. *National Treatment (Fiscal Measures) Violation* –

The complainants alleged the 25 percent levy imposed under China's 2004 Automobile Policy was an "internal charge" incongruous with GATT Article III:2 (first sentence). China applied the internal charge to imported auto parts, but not to like domestic auto parts. That is, the internal charge China imposed on imported parts was in excess of that imposed on domestic parts. China's response was that the 25 percent levy was an ordinary customs duty (OCD) within the meaning of Article II:1(b) (first sentence), not an "internal charge" subject to Article III:2 (first sentence). The Panel agreed with the complainants.

2. *National Treatment (Non-Fiscal Measures) Violation* –

The complainants argued that by imposing the 25 percent levy, China violated GATT Article III:4, because it treated imported auto parts less favourably than like domestic auto parts. The less favourable treatment arose because China imposed additional administrative requirements, and additional charges, on automobile manufacturers that used imported auto parts in excess of thresholds specified in the 2004 Automobile Policy. The result was a disincentive for producers to use imported parts. China's response again was that the 25 percent levy was an OCD under Article II:1(b) (first sentence), not an internal measure governed by Article III:4. The Panel agreed with the complainants.

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based on the 15 November, 1999 bilateral agreement between the United States and China).

<sup>45</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 3-5, 7, 128-133, 183-184, 187.

### 3. *Alternative Tariff Bindings Violation* –

As an alternative contention, the complainants said China breached GATT Article II:1(a)-(b). The charge on imported auto parts imposed under China's 2004 Automobile Policy – if considered an OCD – exceeded the bound tariff rates set out in China's Schedule of Concessions. That Schedule is annexed to its *Protocol of Accession*, hence there was a violation of it and the *Accession Working Party Report*. China countered that the Policy did not run afoul of Article II, but rather gave effect to the proper interpretation of the term “motor vehicles” in its Schedule. As an alternative to its findings under Article III:1-2, the Panel held the Policy established an OCD within the scope of Article II:1(b) (first sentence). Under its Policy, China imposed duties in excess of the relevant tariff bindings in China's Schedule, which were incongruous with Article II:1(a)-(b).

### 4. *Special Finding on Auto Kits* –

On the assumption the 25 percent charge is characterized as an OCD, the complainants charged China violated GATT Article II:1(b) (first sentence) in its treatment of the CKD and SKD kits. The Panel disagreed, handing China its only substantive victory in the case. That is, the Panel said China legitimately could classify a CKD and SKD kit as a completed “motor vehicle” under its Schedule of Concessions, impose a 25 percent charge, and not breach its Article II:1(b) (first sentence) tariff binding for finished cars.<sup>46</sup> But, the Panel held Chinese treatment of these kits was inconsistent with Paragraph 93 of China's *Accession Working Party Report*. In that Paragraph, China pledged not to apply a tariff rate above 10 percent to imports of CKD and SKD kits. The Paragraph states:

Certain members of the Working Party expressed particular concerns about tariff treatment in the auto sector. In response to questions about the tariff treatment for kits for motor vehicles, the representative of China confirmed that

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<sup>46</sup> This specific conclusion was not appealed. The application of GRI 2(a), discussed *infra*, to the term “motor vehicles” in China's Schedule of Concessions, provided China with the legal basis for its classification of the kits.

China had no tariff lines for completely knocked-down kits for motor vehicles or semi-knocked down kits for motor vehicles. *If China created such tariff lines, the tariff rates would be no more than 10 per cent.* The Working Party took note of this commitment.<sup>47</sup>

To reach its conclusion, the Panel held that by implementing the 2004 Automobile Policy, China had created new tariff lines for CKD and SKD kits at the HS-10 digit level.

5. *Failure of the Administrative Necessity Defense* –

The complainants urged that the violation of Article III:4, or in the alternative Article II:1(a)-(b), could not be excused under the administrative necessity exception of Article XX(d), which China had invoked. China invoked this exception because it said 2004 Automobile Policy ensures “substance over form” in its administration of customs law. That is because the Policy allows Chinese customs officials to classify as a complete motor vehicle groups of auto parts that have the essential character of a complete vehicle, regardless of how an importer structures importation of the parts. In other words, the Policy prevents the circumvention of China’s tariff headings for complete motor vehicles. (This argument, of course, is about substantial completeness, a problem dealt with in United States customs law by the five-factor *Daisy Heddon* Test in United States customs law, and under World Customs Organization (WCO) standards by the *General Rule of Interpretation (GRI) 2(a)*, known as the “Doctrine of the Entireties.”<sup>48</sup> China’s point was that it properly applied *GRI 2(a)* by treating a disassembled set of parts that has the essential character of a car – *i.e.*, is a substantially complete car – as a complete vehicle. Indeed, if it did not do so, said China, then importers would be able to circumvent its 25 percent MFN tariff on cars.) However, the Panel rejected China’s argument about tariff circumvention, partially because of the increasing

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<sup>47</sup> Quoted in *China Auto Parts* Appellate Body Report, ¶ 212 (emphasis supplied).

<sup>48</sup> See RAJ BHALA, *INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE* 534, (3d ed. 2008). The *Daisy-Heddon* test was developed in *Daisy-Heddon, Div. Victor Comptometer Corp. v. United States*, 600 F.2d 799 (CCPA 1979), and is summarized and applied in *Simod America Corp. v. United States*, 872 F. 2d 1572 (1989). See *INTERNATIONAL TRADE LAW, id.* at 538-544.

standardization of auto parts, which means that many parts can be used interchangeably among different car models, allowing manufacturers to realize economies of scale by making families of vehicle models that share platforms and components, and for which 60-70 percent of parts are common to the models. The Panel agreed China failed to prove that its violations of its GATT obligations satisfied the two-step test under the Article XX(d) exception.

Still other major claims against China arose under GATT Articles III:5 and XI:1, Article 2 of the *TRIMs Agreement* (including Paragraph 1(a) of Annex 1 thereto), and Article 3:1(b) and 3:2 of the *SCM Agreement*, Part I, Paragraphs 7:2-3 of China's *Accession Protocol* and Paragraph 203 of its *Accession Working Party Report*. On all these claims, the Panel exercised judicial economy.

## V. LESSONS FROM THE APPELLATE BODY, IN BRIEF<sup>49</sup>

### A. Key Issues and Holdings

Not surprisingly, but perhaps not wisely, China appealed the verdicts of the Panel. Before the Appellate Body, the key issues were as follows:<sup>50</sup>

#### 1. *Internal Charge or OCD?*

Is the 25 percent charge an internal charge under GATT Article III:2 (first sentence), rather than an OCD under Article II:1(b) (first

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<sup>49</sup> This discussion is drawn from *China Auto Parts* Appellate Body Report ¶¶ 1-13, 108-126, 253; World Trade Organization, *Update of WTO Dispute Settlement Cases*, WT/DS/OV/33 (3 June, 2008), at 54-56.

<sup>50</sup> *China Auto Parts* Appellate Body Report, ¶ 108.

Also at issue on appeal was whether the Panel violated Article 11 of the WTO *Understanding on Rules and Procedures Governing the Settlement of Disputes* (*Dispute Settlement Understanding*, or *DSU*) concerning its ruling about the United States and Canada mounting a *prima facie* case. The Appellate Body exercised judicial economy on this issue. See *China Auto Parts* Appellate Body Report, ¶ 108(d)(ii), 246.

At the Panel Stage, China unsuccessfully argued its 2004 Automobile Policy does not itself impose a duty or fee, but rather defines the circumstances under which China classifies imported parts under a different tariff provision. The Panel held the Policy does establish a charge, and China did not appeal the finding.



sentence)?<sup>51</sup> China argued the Panel erred in ruling this charge is properly characterized as an “internal charge” subject to the national treatment rule, rather than an OCD governed by the tariff binding rule. Briefly, the Appellate Body upheld the Panel finding, *i.e.*, the Appellate Body agreed the charge is an “internal charge” under Article III:2 (first sentence), not an OCD under Article II:1(b) (first sentence).<sup>52</sup>

## 2. *National Treatment (Fiscal Measures) Violation?*

Is the 25 percent charge illegal under GATT Article III:2 (first sentence)?<sup>53</sup> China urged the Panel was wrong in holding the charge exceeded impositions levied on like domestic products. Briefly, the Appellate Body upheld the Panel. In respect of imported auto parts in general, it held that China’s 2004 Automobile Policy violates Article III:2 (first sentence) because it subjects imported parts to an internal charge not applied to like domestic auto parts.<sup>54</sup>

## 3. *National Treatment (Non-Fiscal Measures) Violation?*

Is the 2004 Automobile Policy, through which China imposes the 25 percent charge, illegal under GATT Article III:4?<sup>55</sup> China claimed the Panel was mistaken in finding its Policy treated imported auto parts less favourably than like domestic merchandise. The Appellate Body thought China was mistaken, ruling with respect to auto parts

<sup>51</sup> See *China Auto Parts* Appellate Body Report, ¶ 108(a).

<sup>52</sup> See *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS339/AB/R (European Communities), ¶ 253(a); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS340/AB/R (United States), ¶ 253(a); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS342/AB/R (Canada), ¶ 253(a).

<sup>53</sup> See *China Auto Parts* Appellate Body Report, ¶ 108(b)(i).

<sup>54</sup> See *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS339/AB/R (European Communities), ¶ 253(b); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS340/AB/R (United States), ¶ 253(b); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS342/AB/R (Canada), ¶ 253(b).

<sup>55</sup> See *China Auto Parts* Appellate Body Report, ¶ 108(b)(ii).

in general, the Policy accords less favourable treatment to imported parts than to like domestic parts, and thus violates Article III:4.<sup>56</sup>

#### 4. *Tariff Bindings Violation?*

Is the 2004 Automobile Policy, through which China imposes the 25 percent charge, illegal under GATT Article II:1(a)-(b)?<sup>57</sup> That is, assuming as an *arguendo* the Appellate Body reverses the finding of the Panel that the charge is an “internal charge” under Article III:2 (first sentence), and classifies it as an OCD under Article II:1(b) (first sentence), then was the Panel wrong in its alternative ruling that the Policy violates the Article II:1(a)-(b) tariff binding provisions? China faulted this alternative ruling. The Appellate Body exercised judicial economy, finding it unnecessary to issue a ruling on the question.<sup>58</sup>

#### 5. *Accession Commitment Violation?*

Is the 2004 Automobile Policy inconsistent with the conditional commitment China made in Paragraph 93 of its *Accession Working Party Report* not to apply a tariff rate above 10 percent to imports of CKD and SKD kits?<sup>59</sup> In specific, did the Panel err in construing the Policy as imposing a charge on CKD and SKD kits, and was it mistaken to rule that China did not meet its Paragraph 93

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<sup>56</sup> See *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS339/AB/R (European Communities), ¶ 253(c); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS340/AB/R (United States), ¶ 253(c); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS342/AB/R (Canada), ¶ 253(c).

<sup>57</sup> See *China Auto Parts* Appellate Body Report, ¶ 108(c).

<sup>58</sup> See *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS339/AB/R (European Communities), ¶ 253(d); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS340/AB/R (United States), ¶ 253(d); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS342/AB/R (Canada), ¶ 253(d).

<sup>59</sup> The complainants did not appeal the finding of the Panel that China acted consistently with GATT Article II:1(b) in classifying the kits as a complete motor vehicle and imposing a 25 percent charge on them. See *China Auto Parts* Appellate Body Report, ¶ 211.

commitment? This holding rested on two other findings, namely, the Policy (1) was deemed to have created tariff lines for CKD and SKD kits, and (2) established separate tariff lines at the HS-10 digit level for these kits. Accordingly, these findings were at issue on appeal. Briefly, the Appellate Body sided with China, holding that the Policy did not impose a charge on CKD and SKD kits, and China did meet its accession commitments with respect to the kits.<sup>60</sup>

On all but the final issue, which itself was at the periphery of the case, China lost its appeal. Given the meticulous work of the Panel, premised on a considerable amount of GATT Panel and Appellate Body jurisprudence, the loss was predictable. It was all the more predictable because of China's appellate argumentation. China's overwhelming reliance, not well-grounded in facts, was on the claim that the 25 percent charge was governed by GATT Article II, not Article III. Put differently, China gambled the same argument it made and lost at the Panel stage would somehow persuade the Appellate Body.

China did not appeal the finding of the Panel that its 2004 Automobile Policy failed to qualify for administrative necessity under GATT Article XX(d).<sup>61</sup> That decision is mildly puzzling. With the gamble China took on its argument-in-chief, it raised the stakes on itself when it removed its only viable fallback option, namely, the administrative necessity defense.

### *B. The Threshold Question: Internal Charge or OCD?*<sup>62</sup>

A trade measure cannot simultaneously qualify as an "internal charge" under GATT Article III and an "OCD" under Article II. The measure either is imposed after the border (*i.e.*, post-entry), in which case it is in the first category and governed by the national treatment rules, or it is imposed at the border (*i.e.*, pre-entry), in which case it is in the second category and governed by the tariff binding rules. Put simply, a measure is either an

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<sup>60</sup> See *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS340/AB/R (United States), ¶ 253(e); *China Auto Parts* Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS342/AB/R (Canada), ¶ 253(e).

<sup>61</sup> See *China Auto Parts* Appellate Body Report, ¶ 198 fn. 282.

<sup>62</sup> This discussion is drawn from *China Auto Parts* Appellate Body Report, ¶¶ 127-182.

internal tax, or a tariff, but not both. Even China accepted this elementary distinction.<sup>63</sup>

Thus, logically, the Appellate Body started with the question of what the 25 percent charge is, and thereby what rules of GATT govern it. Indeed, it spent considerable time and effort doing so. Why did the Appellate Body agree with the Panel, and hold that the 25 percent charge is best characterized as a “internal charge” under GATT Article III:2 (first sentence)?<sup>64</sup>

The answer, in brief, is that the Panel performed its task of defining and delineating carefully. Following the dictates of treaty interpretation in Articles 31-32 of the Vienna Convention on the Law of Treaties<sup>65</sup>, the Panel looked to the ordinary meaning of the terms “internal charge” and “OCD.” It also looked to the context in which each term is situated. For “internal charge,” that context is the phrase “imported into the territory” in Article III:2 (first sentence), and the Interpretative Note, *Ad Article III, Paragraph 2* (also called the “*Ad Note*”). For “OCD,” the context was the phrase “on their importation” in the first sentence of Article II:1(b), and the phrase “on or in connection with the importation” in the second sentence of Article II:1(b). Also informing the meaning of the two terms was the accretion of GATT and WTO jurisprudence, starting as far back as 1952 with the GATT Panel Report, *Belgium – Family Allowances*,<sup>66</sup> and the 1990 GATT Panel Report in *EEC – Parts and Components*.<sup>67</sup>

On these bases, in respect of “OCD,” the Panel concluded logically as follows:

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<sup>63</sup> See *China Auto Parts* Appellate Body Report, ¶ 184.

<sup>64</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 181-182.

<sup>65</sup> Vienna Convention on the Law of Treaties, 1969 1155 U.N.T.S. 331 (1969), reprinted in 8 I.L.M. 679 (1969) (hereinafter *Vienna Convention*).

<sup>66</sup> See GATT Panel Report, *Belgium – Family Allowances (Allocations Familiales)*, II B.I.S.D. (1<sup>st</sup> Supp.) 59 (1953, adopted 7 November, 1952). This case is excerpted and discussed in RAJ BHALA, INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE ch. 11 (3d ed. 2008).

<sup>67</sup> See GATT Panel Report, *European Economic Community – Regulation on Imports of Parts and Components*, B.I.S.D. (37<sup>th</sup> Supp.) 132 (adopted 16 May, 1990).

[T]he ordinary meaning of “on their importation” in Article II:1(b), first sentence, of the GATT 1994, considered in its context and in light of the object and purpose of the GATT 1994, contains a *strict and precise temporal element* which cannot be ignored. This means that the obligation to pay ordinary customs duties is linked to the product at the moment it enters the territory of another Member.... It is at this moment, and this moment only, that the obligation to pay such charge accrues. ... And it is based on the condition of the good at this moment that any contemporaneous or subsequent act by the importing country to enforce, assess or reassess, impose or collect ordinary customs duties should be carried out. (emphasis in original; footnotes omitted)

In contrast to ordinary customs duties, the obligation to pay internal charges does not accrue because of the importation of the product at the very moment it enters the territory of another Member but because of the internal factors (*e.g.*, because the product was re-sold internally or because the product was used internally), which occurs once the product has been *imported* into the territory of another member. The status of the *imported* good, which does not necessarily correspond to its status at the moment of *importation*, seems to be the relevant basis to assess this internal charge. (emphasis in original)<sup>68</sup>

Succinctly put, the Panel said:

[I]f the obligation to pay a charge does not accrue based on the product at the moment of its importation, it cannot be an “ordinary customs duty” within the meaning of Article II:1(b), first sentence of the GATT 1994: it is, instead, an “internal charge” under Article III:2 of the GATT 1994, which obligation to pay accrues based on internal factors.<sup>69</sup>

In contrast, in respect of “internal charge,” the Appellate Body summarized the Panel understanding as follows:

161. Like the Panel, we consider that the adjectives “internal” and “imported” suggest that the charges falling within the scope of Article III are charges that are imposed on goods that have already been “imported,” and that the obligation to pay them is triggered by an “internal” factor, something that takes place *within* the customs territory. Further, the second sentence of Article III:2 expressly refers to the principles set forth in Article III:1. The Appellate Body has stated that Article III:1 articulates a general principle, that informs all of Article III, that internal measures

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<sup>68</sup> *China Auto Parts* Panel Report, ¶¶ 7.184-7.185, quoted in *China Auto Parts* Appellate Body Report, ¶ 129.

<sup>69</sup> *China Auto Parts* Panel Report, ¶ 7.204, quoted in *China Auto Parts* Appellate Body Report, ¶ 131.

should not be applied so as to afford protection to domestic production. [The Appellate Body cited its Report in *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, 18 (adopted 1 November 1996) (*Japan – Alcoholic Beverages II*).<sup>70</sup>] ...

162. ... [I]n examining the scope of application of Article III:2, in relation to Article II:1(b), first sentence, the time at which a charge is collected or paid is not decisive. In the case of Article III:2, this is explicitly stated in the GATT 1994 itself, where the *Ad Note* to Article III specifies that when an internal charge is “collected or enforced in the case of the imported product at the time or point of importation,” such a charge “is nevertheless to be regarded” as an internal charge. What is important, however, is that the *obligation* to pay a charge must accrue due to an internal event, such as the distribution, sale, use or transportation of the imported product.

163. This leads us, like the Panel, to the view that a key indicator of whether a charge constitutes an “internal charge” within the meaning of Article III:2 of the GATT 1994 is “whether the obligation to pay such charge accrues because of an *internal* factor (*e.g.*, because the product was *re-sold* internally or because the product was *used* internally), in the sense that such ‘internal factor’ occurs *after the importation* of the product of one Member into the territory of another Member.” ...<sup>71</sup>

The work of the Panel serves as an excellent tutorial – for China and indeed all WTO Members – on the different scope of application between the tariff binding and national treatment obligations in GATT, and it is no surprise the Appellate Body admired its analytical approach.

The boundaries between these obligations must be respected, if their distinct objects and purposes are to be served.<sup>72</sup> Binding tariffs under Article II preserves the value of negotiated reductions in duties. Non-discriminatory treatment, with respect to both internal taxes and regulatory measures, under Article III is essential to avoid the devilish protectionist temptation to favour like domestic products over imported merchandise. Together, the distinct disciplines promote the objective of the Agreement Establishing the World Trade Organization (WTO Agreement)<sup>73</sup>, namely, to

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<sup>70</sup> This case is excerpted and discussed in RAJ BHALA, *INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE* ch. 13 (3d ed. 2008).

<sup>71</sup> *China Auto Parts* Appellate Body Report ¶¶ 161-163 (citations omitted, emphases original).

<sup>72</sup> See *China Auto Parts* Appellate Body Report, ¶ 130 fn. 190.

<sup>73</sup> Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, *THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE*

promote the security and predictability of reciprocal, mutually advantageous trade-liberalizing arrangements.

In lawyer-like fashion, the Panel then turned to the task of applying these GATT principles to the facts of the case. Briefly, the Panel was struck by four key facts about the operation of the China's 2004 Automobile Policy:

1. The obligation to pay the charge becomes ripe internally, that is, after the auto parts have entered the customs territory of China, and have been assembled into motor vehicles in China.
2. The 25 percent charge is imposed on automobile manufacturers, not on importers.
3. The charge is not levied on specific imported parts at the moment of importation. Rather, it is levied on specific imports based on what other imported or domestic parts are used together with those specific imports in assembling a vehicle model.
4. Identical imported parts, which are imported simultaneously in the same container and vessel, can be subject to a different charge rate, depending on whether the vehicle model into which these parts are subsequently assembled satisfies the thresholds in the criteria set out in the Policy.

These four facts (supplemented by others, as explained below) led the Panel inexorably to the conclusion that the 25 percent charge is an internal one under GATT Article III:2 (first sentence).

Notably, China misunderstood or obscured what the Panel did and did not infer from these facts, particularly the first one. China suggested that the Panel had held that:

[T]he mere fact that the assembly of parts into a completed vehicle will necessarily occur *after* the parts have entered the customs territory means that a charge assessed on this basis is an internal charge.<sup>74</sup>

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NEGOTIATIONS 4 (1999), 1867 U.N.T.S. 154, 33 I.L.M. 1144 (1994). This Agreement is available on the WTO website ([www.wto.org](http://www.wto.org)) and reprinted in a variety of sources, including RAJ BHALA, INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE – DOCUMENTS SUPPLEMENT, Document # 8 at 209-220 (3d ed. 2008).

<sup>74</sup> *China Auto Parts* Appellate Body Report, ¶ 179 (emphasis in original).

The Appellate Body rejected this understanding.<sup>75</sup> The Panel simply looked at when and where the obligation to pay the charge accrues, and weighed it with other facts. The small comfort for China was that the Panel excluded from this finding the charge on CKD and SKD kits, and found the charge on the kits was an OCD under the first sentence of Article II:1(b).

#### VI. LEARNING FROM LOSING ARGUMENTS: CHINA'S UNSUCCESSFUL CLAIMS OF PANEL ERROR

China's appellate argument was that the Panel failed to take into account *GRI 2(a)* – the Doctrine of the Entireties, as it is known in United States customs law – which states:

Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished, provided that, as presented, the incomplete or unfinished article has the essential character of the complete or finished article. It shall also be taken to include a reference to that article complete or finished (or falling to be classified as complete or finished by virtue of this Rule), presented unassembled or disassembled.<sup>76</sup>

China asserted this Rule enables customs authorities to classify unassembled auto parts as a complete motor vehicle, even in the situation in which the parts arrive in multiple shipments and the parts are assembled after importation.<sup>77</sup> As for the text of Article II:1(b) (first sentence), China said it requires customs authorities to determine what the “product” in question is, and then – following HS Rules – classify the product and apply the correct OCD to it.

Specifically, China accused the Panel of three mistakes. First, the Panel ought not to have separated the (1) threshold question of whether the 25 percent charge is an OCD from (2) question of whether China is authorized to apply *GRI 2(a)* to multiple entries of auto parts. The 25 percent charge is inextricably linked to valid classification procedures under HS Rules. The Panel should have examined the two questions simultaneously, not sequentially.

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<sup>75</sup> *See id.*

<sup>76</sup> *Quoted in China Auto Parts Appellate Body Report*, ¶ 134 fn. 197.

<sup>77</sup> *See China Auto Parts Appellate Body Report*, ¶¶ 134-135.



Second, the Panel wrongly refused to characterize the 25 percent charge as an “OCD” under Article II:1(b) (first sentence). China urged it is impossible to decide whether its charge is an OCD without taking proper account of the term “product” in that Article, in light of the classification rules of the HS, like *GRI 2(a)*. China conceded Article II:1(b) (first sentence) emphasizes the moment of importation as pertinent to ascertaining whether a charge is an “OCD.” But, no less relevant is the “condition”, or “status,” of the product at the moment it enters the importing country. *GRI 2(a)* is needed to determine whether the condition or status of a completely unassembled motor vehicle at that moment permits, or not, the parts to be classified as a complete vehicle. In essence, the Panel erred by neglecting to use the HS Rule to interpret the significant GATT terms.

Third, China claimed, the Panel erroneously dubbed the 25 percent charge an “internal charge” under GATT Article III:2 (first sentence). China insisted that the fact that auto parts are assembled into a completed vehicle after importation does not mean the 25 percent charge is governed by that provision. In other words, China faulted the Panel for making too much of the time and place of assembly – after importation, post-border. All three claims of Panel error were related, and to some degree China’s style of argumentation – as recounted by the Appellate Body – lacks the clarity and precision expected of a sophisticated presentation.

#### *A. Wrongful Separation of Issues*

China’s argument about the first error it contended the Panel made was a *post hoc* rationalization for the 25 percent charge. Conceptually, its argument made no sense. As the United States, Canada, and the EU all rightly pointed out, to accept China’s position would be to “blur,” or “confuse,” the threshold issue of what provision of GATT governs the controversial 25 percent charge with the distinct question of whether the charge is consistent with that provision.<sup>78</sup> China puts the “cart before the horse” by presuming the charge is an OCD, when that is the first question in need of analysis.<sup>79</sup>

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<sup>78</sup> *China Auto Parts* Appellate Body Report, ¶ 136.

<sup>79</sup> *China Auto Parts* Appellate Body Report, ¶ 136.

Unsurprisingly, the Appellate Body sided with the Panel and complainants:

In its appeal, China challenges the Panel's decision to analyze the threshold issue separately from the issue of the consistency of the measures with Article II:1(b) of the GATT 1994. Yet, as the Appellate Body has previously observed, the "fundamental structure and logic" of a covered agreement may require panels to determine *whether* a measure falls within the scope of a particular provision or covered agreement *before* proceeding to assess the consistency of the measure with the substantive obligations imposed under that provision or covered agreement. [The Appellate Body cited its Reports in *Canada – Certain Measures Affecting the Automotive Industry*, WT/DS139/AB/R, WT/DS142/AB/R ¶ 151 (adopted 19 June 2000) (*Canada – Autos*) (quoting Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R ¶ 119 (adopted 6 November 1998) (*U.S. – Shrimp*)), and *United States – Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, I, 3, 20 (adopted 20 May 1996 (*US – Gasoline*)).<sup>80</sup>] We consider this to be just such a case, particularly in the light of the Panel's observation – with which China expressly agrees – that "a charge cannot be at the same time an 'ordinary customs duty' under Article II:1(b) of the GATT 1994 and an 'internal tax or other internal charge' under Article III:2 of the GATT." If, as the Panel considered, the charge imposed on automobile manufacturers could fall within the scope of either the first sentence of Article II:1(b) *or* Article III:2, then the Panel had to begin its analysis by ascertaining *which* of these provisions applied in the circumstances of this dispute.<sup>81</sup>

In sum, the Appellate Body approved of the sequential methodology of the Panel to treat the threshold issue of "what GATT rule applies?" before considering "did the 25 percent charge violate the rule?"<sup>82</sup>

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<sup>80</sup> The *Auto Pact* case is excerpted and discussed in RAJ BHALA, INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE ch. 11 (3d ed. 2008). The *Shrimp* and *Gasoline* cases are excerpted and discussed in *id.*, ch. 43.

<sup>81</sup> *China Auto Parts* Appellate Body Report, ¶ 139 (emphasis in original).

<sup>82</sup> Neither side in the case, at either the Panel or Appellate stage, argued the 25 percent charge qualified for the phrase of GATT Article II:1(b) (second sentence) as "all other duties and charges [ODC] of any kind imposed on or in connection with the importation" of the product in question. In other words, the dispute was whether the 25 percent charge fell within the first sentence of Article II:1(b) as an OCD, not whether it was an ODC under the second sentence. Likewise, there was no dispute as to the delineation between an OCD and ODC. The Appellate Body said that in deciding whether a particular charge falls under Article III:2 as an "internal charge," or under Article II:1(b) (first sentence) as an "OCD," it would be helpful to examine the meaning of "ODC." That would produce a complete understanding of the architecture of Articles II and III. But, the Panel's choice

### B. Using the GRI as Context to Interpret GATT

As to the second error China contended the Panel made, here, too, the Appellate Body looked approvingly at the work of the Panel, and quoted generously from it. There is a strict, precise temporal element to Article II:1(b) (first sentence). That is clear from the terms surrounding “ODC” that indicate an “ODC” is imposed on “products, on their importation.”<sup>83</sup> If a charge does not accrue at the moment of importation, it is not an ODC. China cited an Appellate Body precedent, *EC – Chicken Cuts*, in which the Appellate Body agreed it is permissible to examine the HS as context for interpretation of a GATT–WTO text, even though the HS is not technically part of the accords annexed to the *WTO Agreement* (i.e., it is not a covered agreement).<sup>84</sup>

In *EC – Chicken Cuts*, the Appellate Body considered the issue of whether the Harmonized System could constitute context for the interpretation of a term in the European Communities’ Schedule of Concessions. The Appellate Body pointed out that, although the Harmonized System is not formally part of the *WTO Agreement*, there is nonetheless a close link between that System and the covered agreements. The Appellate Body explained that:

... prior to, during, as well as after the Uruguay Round negotiations, there was broad consensus among the GATT Contracting Parties to *use* the Harmonized System as the basis for their WTO Schedules, notably with respect to agricultural products. In our view, this consensus constitutes an “agreement” between WTO Members “relating to” the *WTO Agreement* that was “made in connection with the conclusion of” that *Agreement*, within the meaning of Article 31(2)(a) of the *Vienna Convention*. As such, this agreement is “context” under Article 31(2)(a) for the purpose of interpreting the WTO agreements, of which the EC Schedule is an integral part. In this light, we consider that

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not to study ODC neither affected the outcome of the case (because China said no products at issue in the case were affected by an ODC), nor was it reversible error. *See China Auto Parts* Appellate Body Report, ¶ 140.

<sup>83</sup> *See China Auto Parts* Appellate Body Report, ¶ 153 (quoting GATT Article II:1(b)).

<sup>84</sup> *See* Appellate Body Report, *European Communities – Customs Classification of Frozen Boneless Chicken Cuts*, WT/DS269/AB/R, WT/DS286/AB/R (adopted 27 September 2005). This case is discussed in Raj Bhala & David Gantz, *WTO Case Review 2005*, 23 ARIZ. J. INT’L & COMP. L. 107-345 (2006).

the Harmonized System is relevant for purposes of interpreting tariff commitments in the WTO Members' Schedules. (emphasis in original)<sup>85</sup>

However, the complainants astutely observed that China made too much of this precedent. It relates to the use of the HS only to interpret a term in a Schedule of Concessions, not a term in a GATT–WTO rule.

The Appellate Body agreed with the view of the complainants on *EC – Chicken Cuts*:

The negotiators of the *WTO Agreement* used the Harmonized System as the basis for negotiating Members' Schedules of Concessions, and included express references to the Harmonized System in certain covered agreements for purposes of defining product coverage of those agreements or specific provisions thereof. It follows that the Harmonized System is context for purposes of interpreting the covered agreements, in particular for the classification of products under Schedules of Concessions and for defining the product coverage of certain covered agreements. This is what the Appellate Body found in *EC – Chicken Cuts*. Yet this does not answer the question of whether the Harmonized System is context that is relevant to the determination of whether a charge is an ordinary customs duty or an internal charge.<sup>86</sup>

As to the latter question, the Appellate Body looked to the direction of Article 31(2) of the *Vienna Convention*, which states:

The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

- (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
- (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.<sup>87</sup>

The Appellate Body explained that context must be relevant to the interpretative question at issue.

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<sup>85</sup> *China Auto Parts* Appellate Body Report, ¶ 146.

<sup>86</sup> *China Auto Parts* Appellate Body Report, ¶ 148 (citation omitted).

<sup>87</sup> Quoted in *China Auto Parts* Appellate Body Report, ¶ 150.

As the Schedule of Concessions of every WTO Member is constructed using the HS, the rules of the HS are relevant context for discerning the meaning of a term in a Schedule. Thus, if the question in the case at hand was whether China could classify auto parts as complete motor vehicles, then it would be necessary to interpret China's Schedule. Yet, that is not the question. The key matter – to which the HS rules are not pertinent – is defining “OCD” and “internal charge” under GATT Articles II:(1)(b) and III:2 (first sentence), respectively.

155. ... The Harmonized System categorizes products, and the characteristics of particular products are relevant to how they are categorized. We recognize, as China argues, that classification, and hence the tariff rate applied, might, in some circumstances, vary depending on the condition of goods at the moment of importation. Since different categories of products are subject to different bound and applied tariff rates, the classification of a given product may affect the amount of the duty imposed. Accordingly, classification issues have some bearing on the question of whether a Member applying such a duty is in conformity with its obligation, under Article II:1(b), not to impose duties in excess of the bound rate set out in the Member's Schedule for the product concerned. Yet this issue (whether a duty applied to a *product* by virtue of its classification is consistent with Article II:1(b)) is separate from the issue of whether a *charge* falls under the first sentence of Article II:1(b) at all (as opposed to under Article III:2). It is not evident to us how classification rules are relevant to the latter issue. While it is true, as China argues, that the “classification of the product necessarily precedes the determination of which ‘ordinary customs duty’ applies,” it is not the case that classification of the product (even if properly done) necessarily precedes a determination of *whether* the charge that applies is an ordinary customs duty.

...

158. Yet we fail to see how the Panel erred in not relying on GIR 2(a) in resolving the threshold issue of whether the charge imposed under the measures at issue is an ordinary customs duty or an internal charge. The *right* of a WTO Member to impose a customs duty, and the *obligation* of an importer to pay such a duty, accrue at the very moment the product enters the customs territory of that Member and by virtue of the event of importation. In contrast, the classification rules according to which customs authorities determine under which tariff heading the “product” concerned falls, depending on its “status” or “condition,” are not relevant to the nature of the “duty” itself because they do not determine the *moment* at which the *obligation* to pay accrues, but only the *amount* of that duty. Similarly, as all of the participants agree, the moment at which a charge is *collected* or *paid* is not determinative of whether it is an ordinary customs duty or an internal charge. Ordinary customs duties may be collected *after* the moment of

importation, and internal charges may be collected at the moment of importation. For a charge to constitute an ordinary customs duty, however, the *obligation* to pay it must accrue at the moment and by virtue of or, in the words of Article II:1(b), “on,” importation.

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163. ... We also observe that the Harmonized System does not serve as relevant context for the interpretation of the term “internal charges” in Article III:2.

164. In sum, we see the Harmonized System as context that is most relevant to issues of classification of products. The Harmonized System complements Members’ Schedules and confirms the general principle that [as the Appellate Body stated in *EC – Chicken Cuts*] it is “the ‘objective characteristics’ of the product in question when presented for classification at the border” that determine their classification and, consequently, the applicable customs duty. The Harmonized System, and the product categories that it contains, cannot trump the criteria contained in Article II:1(b) and Article III:2, which distinguish a border measure from an internal charge under the GATT 1994. Among WTO Members, it is these GATT provisions that prevail, and that define the relevant characteristics of ordinary customs duties for WTO purposes. Thus, even if the Harmonized System and GIR 2(a) would allow auto parts imported in multiple shipments to be classified as complete vehicles based on subsequent common assembly, as China suggests, this would not *per se* affect the criteria that define an ordinary customs duty under Article II:1(b). ...

...

166. ... [A] determination of whether a particular charge falls under Article II:1(b) or Article III:2 of the GATT 1994 must be based on a proper interpretation of these two provisions. The Harmonized System does not provide context that is relevant to the threshold question or to the assessment of the respective scope of application of “ordinary customs duties” in the first sentence of Article II:1(b) and “internal charges” in Article III:2 of the GATT 1994 that must be undertaken in answering that question. It follows that the Panel did not err in interpreting the term “ordinary customs duties” in the first sentence of Article II:1(b) of the GATT 1994 without relying on the rules of the Harmonized System, in general, or GIR 2(a), in particular.<sup>88</sup>

The above-quoted paragraphs may be distilled as follows: The essence of China’s appellate argument was that China correctly classified the “product” – a completed vehicle – under *GRI* 2(a), thus its 25 percent

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<sup>88</sup> *China Auto Parts* Appellate Body Report, ¶¶ 155, 158, 163-164, 166 (citations omitted, emphases original).

charge must be an “OCD” under Article II:1(b) (first sentence). But, “must be” and “is” are not the same. It is specious to conflate tariff classification under HS Rules, and the related matter of respect for tariff bindings under Article II:1(b) (first sentence), with the characterization of a charge as an “OCD” under that Article. Just because classification is done properly (a completed vehicle despite disassembled parts), and a charge imposed (25 percent), does not make that charge an OCD. As for the HS Rules, they are context most relevant to product classification, but they are not context that supersedes the language of GATT.

To this finding and rationale the Appellate Body added a consequential justification, one suggested by the Panel.<sup>89</sup> Suppose China’s arguments were accepted: a 25 percent charge imposed on auto parts following, and as a result of, their assembly into a completed vehicle, constitutes an OCD. The consequence would be that whether any charge is an OCD would depend on circumstances that transpire after the border, rather than solely on the moment of (and by virtue of) importation. The distinction between border and post-border would collapse, because what happens after importation would affect characterization of a charge at the border. Stated differently, the scope of “OCD” and Article II:1(b) (first sentence) would expand, but the scope of “internal charges” and Article III:2 (first sentence) would contract. The latter consequence would enervate the highly important national treatment discipline, and upset the balanced structure so carefully arranged by the GATT drafters and elaborated on through GATT and WTO adjudication.

### *C. Not Really an Internal Charge*

Obviously, with the Appellate Body upholding the decision of the Panel that China’s 25 percent levy was not an “OCD” under GATT Article II:1(b) (first sentence), the proper categorization was an “internal charge” under Article III:2 (first sentence). That categorization – said China – was the third error made by the Panel. The Appellate Body did not agree, and found no fault with the work of the Panel.

The Panel rightly scrutinized all relevant characteristics of the 25 percent charge, particularly its design and operation. That scrutiny enabled

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<sup>89</sup> See *China Auto Parts* Appellate Body Report, ¶ 165.

the Panel to identify the “center of gravity” of the charge based on its “core” or “leading” features, an essential task because some aspects may point to a conclusion that this charge is an “OCD,” while others suggest it is an “internal charge.” The Panel also correctly examined the circumstances under which China imposed the 25 percent charge. In brief, the Panel correctly followed the teaching of the Appellate Body in *India – Additional Import Duties*, a case concerning whether a measure was governed by Article II:2(a) or the *Ad Note* to Article III.<sup>90</sup>

As summarized by the Appellate Body, the characteristics of the 25 percent charge that impressed the Panel, and persuaded it that the charge was not an “OCD” governed by Article II:1(b) (first sentence):

172. ... The Panel identified the following characteristics of the charge as having particular significance for legal characterization purposes: (i) the obligation to pay the charge accrues internally after auto parts have entered the customs territory of China and have been assembled/produced into motor vehicles; (ii) the charge is imposed on automobile manufacturers rather than on importers in general; (iii) the charge is imposed based on how the imported auto parts are *used*, that is, *not* based on the auto parts as they enter, but instead based on what other parts from other countries and/or other importers and/or domestic parts are subsequently used, together with those imported parts, in assembling a vehicle model; and (iv) the fact that identical auto parts imported at the same time in the same container or vessel can be subject to different charge rates depending on which vehicle model they are assembled into.

173. We agree with the Panel as to the legal significance of these features of the measures at issue. Furthermore, there are additional characteristics of the charge imposed under the measures that the Panel recognized, and that support its characterization of that charge as an internal charge falling within the scope of Article III:2 of the GATT 1994. Foremost among these is the fact that it is not the declaration made at the time of importation, but rather the declaration of duty payment made subsequent to the assembly/production of complete motor vehicles, that determines whether the charge will be applied.

174. That the declaration made at the time of importation does not control or necessarily affect whether the charge under the measures will ultimately

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<sup>90</sup> See Appellate Body Report, *India – Additional Import and Extra-Additional Duties on Imports from the United States*, WT/DS360/AB/R (adopted 17 November, 2008). This case is reviewed in Raj Bhala & David Gantz, *WTO Case Review 2008*, 26 ARIZ. J. INT'L & COMP. L. (2009).



be applied to specific imported parts is illustrated most prominently in the scenario where an automobile manufacturer does not import parts directly, but instead purchases them from an independent third party supplier within China. In such circumstances, the third party supplier imports and declares those auto parts at the border and pays a 10 per cent duty. Yet those same parts may subsequently be subject to the 25 per cent charge – imposed after assembly – if they are sold to an automobile manufacturer and assembled into a vehicle model that meets the thresholds set out in the measures at issue.

175. In addition, there are at least two circumstances in which imported auto parts that are not characterized as complete vehicles or declared as such at the moment of importation will nonetheless be subject to the charge under the measures at issue following vehicle assembly: (i) when imported auto parts are installed on a vehicle as *options* (that is, such parts were not mentioned in the self-evaluation or Verification Report because they are not installed on the baseline models of the particular vehicle model in question), the manufacturer must report the options to the Verification Centre and make declarations for purposes of paying the charge at the time of the actual installation of the optional parts; and (ii) when, following re-verification due to an increase in the combinations or value of imported parts vis-à-vis domestic parts, a vehicle model that previously did not meet the criteria under the measures at issue is determined to meet those criteria, the imported parts used in the production/assembly of that model must be declared after assembly, and will then be subject to the charge.

176. There are also at least two circumstances in which auto parts that are characterized as complete vehicles and declared as such at the time of importation will *not* attract the 25 per cent charge under the measures at issue, namely: (i) when imported parts that are characterized as complete vehicles in the declaration made at the time of importation are not assembled/produced into complete vehicles within 12 months, they must be declared within 30 days of the expiration of the 12-month period and will be subject to a 10 per cent charge, rather than the 25 per cent charge that would otherwise apply under the measures at issue; and (ii) when, following re-verification due to a decrease in the combinations or value of imported parts vis-à-vis domestic parts, a vehicle model that previously met the criteria under the measures at issue is determined no longer to meet those criteria, the imported parts used in the assembly/production of that model will not be subject to the charge under the measures at issue.<sup>91</sup>

Even a quick read of these characteristics indicates the facts weighed heavily against China's argument of Panel error. Were there any

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<sup>91</sup> *China Auto Parts Appellate Body Report*, ¶¶ 172-176.

countervailing facts supporting the proposition that the 25 percent charge was an “OCD”?

Indeed, there were four characteristics China stressed:

(i) the measures at issue use language typically reserved for references to “ordinary customs duties;” (ii) China’s explanation of the policy purpose of the measures, and that the charge imposed thereunder “objectively relate[s] to the administration and enforcement of China’s tariff provisions for motor vehicles;” (iii) China’s view that parts imported directly by an automobile manufacturer remain subject to customs control until after assembly/production of the relevant vehicle model; and (iv) the measures at issue and the charge imposed thereunder are administered primarily by China’s customs authorities.<sup>92</sup>

Here, again, even a glance at these characteristics reveals the weakness of the Chinese argument. None of them individually, or taken in aggregate, are persuasive enough to offset the features pointing toward classifying the 25 percent charge under Article III:2 (first sentence).

The first feature is a matter of labeling by China. A WTO Member can manipulate rubrics to suit its ends, but the job of a panel or the Appellate Body is to see through formalistic labels and look to underlying substantive reality. That is clear from Appellate Body precedent in *Softwood Lumber IV*.<sup>93</sup> The second feature is China’s perspective. Legislative intent is difficult to discern, especially by external adjudicators, and is not conclusive. That is apparent from the Appellate Body decision in the *Byrd Amendment* case.<sup>94</sup> The third feature actually cuts against China’s argument. Imported auto parts are not physically confined or otherwise restricted by customs authorities, and can be used freely in China’s internal market. That is, importation of these parts under the financial guarantee of a bond hardly amounts to “ongoing customs control.” The fourth feature is a matter of

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<sup>92</sup> *China Auto Parts* Appellate Body Report, ¶ 177.

<sup>93</sup> See Appellate Body Report, *United States – Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada*, WT/DS257/AB/R ¶ 56 (adopted 17 February, 2004). This decision is reviewed in Raj Bhala & David Gantz, *WTO Case Review 2004*, 22 ARIZ. J. INT’L & COMP. L. 99-249 (2005).

<sup>94</sup> See *United States – Continued Dumping and Subsidy Offset Act of 2000*, WT/DS217/AB/R, WT/DS/234/AB/R ¶ 259 (adopted 27 January, 2003). This decision is reviewed in RAJ BHALA, MODERN GATT LAW ch. 29 sec. X (2005), and in Raj Bhala & David Gantz, *WTO Case Review 2003*, 21 ARIZ. J. INT’L & COMP. L. 317-439 (2004).

China's internal administrative edifice. Decisive weight about interpreting a provision of GATT cannot be given to a point, like governmental structure, which is wholly under the control of a WTO Member. That is manifest in the 1990 *EEC – Parts and Components* GATT Panel Report.<sup>95</sup> The fourth feature cited by China also is not the whole truth. Other organs of the CCP – the Ministries of Commerce and Finance, and the NDRC, and the Verification Centre – have official roles in the administration of the 25 percent charge.

## VII. LEARNING FROM VIOLATIONS: WHAT CHINA GOT WRONG

### A. National Treatment

With the 25 percent charge clearly characterized as an “internal charge,” the next question concerned its consistency with the governing provision, GATT Article III:2 (first sentence). China made the job of the Appellate Body easy.<sup>96</sup> At no point in the case did China contend the imported and domestic auto parts were not like products. Further, China admitted that if the charge was an internal one, then it violated Article III:2 (first sentence). Indubitably, the 25 percent charge was in excess of levies imposed on like domestic products. In other words, once China lost the debate to slot the charge as an “OCD” under Article II:1(b) (first sentence), it lost the debate about compliance with national treatment and fiscal measures.<sup>97</sup>

There is, of course, a second national treatment obligation. GATT Article III:4 covers all non-fiscal measures. The United States, Canada, and EU all successfully persuaded the Panel that the China's 2004 Automobile Policy was an internal one within the ambit of this obligation, and was incongruous with it. That success carried through to the Appellate Body. The focus of this debate was on the regulatory requirements in the Policy that require all vehicle manufacturers in China to register, and provide a listing and detailed records to Chinese customs authorities if they use imported auto parts.

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<sup>95</sup> The key relevant parts of the decision are ¶¶ 5.6-5.7, and the case is cited *supra*.

<sup>96</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 183-186.

<sup>97</sup> As explained below, the Article III:2 finding of the Appellate Body, like that of the Panel, excluded the imposition of the 25 percent charge on CKD and SKD kits. See *China Auto Parts* Appellate Body Report, ¶ 186 fn. 259.

China's losing argument on Article III:4 was essentially the same as on Article III:2 (first sentence): the 2004 Auto Policy imposes an "OCD," so the correct rule to apply is Article II:1(b) (first sentence). Additionally, the administrative procedures for implementing the Policy are associated with the imposition of an OCD, and should be viewed as customs measures to implement the classification rules of the HS, not internal rules governed by Article III:4. Not surprisingly, with little effort, the Appellate Body rejected the Chinese argument in Article III:4 context, as it had in the Article III:2 (first sentence) context.<sup>98</sup> Manifestly, China had too much confidence in its characterization that the 25 percent charge, and the measures by which China administered the charge, were governed by Article II:1(b) (first sentence). Once China lost that debate, most of its case crumbled.

To be sure, China put up one argument on which the Appellate Body paused.<sup>99</sup> China said the Panel was wrong to find that the 2004 Automobile Policy influences the choice by an automobile manufacturer between domestic and imported auto parts, and thus affect the internal use of imported parts. China said the influence is created by the differential tariff structure, namely, a 10 percent bound duty on parts, and a 25 percent bound rate for completed vehicles. The Panel wrongly premised an Article III:4 violation on an inherent feature of China's Schedule of Concessions. There is nothing illegal about discriminating against imported auto parts merely through the imposition of a customs duty validly imposed under GATT rules, *i.e.*, those rules countenance one kind of discrimination – tariffs.

Unfortunately for China, it again misunderstood or obfuscated what the Panel had ruled.<sup>100</sup> The difference in bound rates for auto parts and completed vehicles in China's Schedule was not the discrimination concerning internal use of imported auto parts on which the Panel relied to find a violation of GATT Article III:4. Rather, the Panel looked to the measures at issue, especially the incentives created for car manufacturers by the volume thresholds (*i.e.*, the use of designated assemblies or combinations of assemblies) and value thresholds (*i.e.*, the 60 percent test). Those thresholds determine whether China characterizes imported auto parts as complete vehicles. For an automobile manufacturer to avoid the 25

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<sup>98</sup> See *China Auto Parts* Appellate Body Report, ¶ 189.

<sup>99</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 190-197.

<sup>100</sup> See *China Auto Parts* Appellate Body Report, ¶ 192.

percent charge for a completed vehicle (and instead qualify for a 10 percent duty on parts), it must ensure the imported parts it uses to assemble a vehicle model are below the thresholds. Moreover, if a manufacturer exceeds the thresholds, then the 25 percent charge applies to all imported parts it uses in the vehicle model in question. Further, if a manufacturer exceeds the thresholds, then it is subject to tracking and reporting requirements, and attendant delays, concerning auto parts imported in multiple shipments.

Quite obviously, these realities are incentives for a manufacturer to limit its use of imported relative to domestic parts, and they “‘affect’ the *conditions of competition* for imported auto parts on the Chinese internal market.”<sup>101</sup> The Panel was on solid ground, citing the *U.S. – FSC (Article 21:5 – EC)* decision of the Appellate Body, which explained that an incentive for a manufacturer not to use imported inputs affects the internal use of imported products, and thus violates Article III:4. That decision, plus long-standing jurisprudence under this Article, emphasizes the importance of not tilting the competitive playing field against foreign *vis-à-vis* like domestic products. That lesson may be especially important for a Communist country like China claiming it no longer is a non-market economy (NME).

### B. *Tariff Bindings*

The United States, Canada, and EC convinced the Panel to reach an alternative finding, namely, if the 25 percent charge were an “OCD,” then China violated GATT Article II:1(a)-(b) by exceeding the bound rates for auto parts in its Schedule of Concessions.<sup>102</sup> Why did the Panel agree to embark on the alternative analysis in the first place? It looked out to the demands of the parties, and up to the Appellate Body. The complainants and China disagreed on whether the charge violated this Article, so an issue was joined. There was the specter (perhaps remote) that the Appellate Body might overturn its finding under Article III:2 (first sentence), as the line between an “OCD” and an “internal charge” is not always bright.<sup>103</sup>

The Panel sided with the complainants, stating:

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<sup>101</sup> *China Auto Parts* Appellate Body Report, ¶ 195 (emphasis supplied).

<sup>102</sup> See *China Auto Parts* Appellate Body Report, ¶ 198.

<sup>103</sup> See *China Auto Parts* Appellate Body Report, ¶ 198 fn. 283.

... the tariff provisions for motor vehicles (87.02-87.05) of China's Schedule of Concessions do not include in their scope auto parts imported in multiple shipments based on their assembly into a motor vehicle. Accordingly, to the extent the measures could be considered as falling within the scope of Article II of the GATT 1994, China's measures have the effect of imposing ordinary customs duties on imported auto parts in excess of the concessions contained in the tariff headings for auto parts under its Schedule, inconsistently with its obligations under Article II:1(a) and (b) of the GATT 1994.<sup>104</sup>

The Panel premised this alternative finding on more than just the interpretation of "motor vehicles" in China's Schedule of Concessions. The criteria China applied to determine whether imports parts have the essential character of a completed vehicle also indicate China accords less favourable treatment to imported auto parts than it promises in its Schedule.

China's appeal raised serious systemic concerns, and the United States and EC expressly stated as much.<sup>105</sup> These two complainants sought a complete examination by the Appellate Body of the alternative finding of the Panel, so as to leave no doubt about the inconsistency of China's 25 percent charge under GATT Article II. China posited two different scenarios. First, trotting out its old argument, China urged the Appellate Body to reverse the Panel, and hold the 25 percent charge is an "OCD" under GATT Article II:1(b) (first sentence). If the Appellate Body does so, then it will see the charge is based on a valid classification of imported auto parts under *GRI* 2(a) as a completed vehicle – hence, the charge is not a duty in excess of China's tariff binding. This scenario, of course, did not materialize. Second, on the assumption that the Appellate Body upheld the conclusion of the Panel that the 25 percent charge was an internal one governed by Article III:2 (first sentence), China called upon the Appellate Body to declare the alternative finding of the Panel to be moot and of no legal effect. Seeing no reason to do so, the Appellate Body rejected that call.<sup>106</sup> In sum, leaving the Panel's alternative finding alone, the Appellate Body did the bidding of neither the complainants nor China.

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<sup>104</sup> Quoted in *China Auto Parts* Appellate Body Report, ¶ 199.

<sup>105</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 204-208.

<sup>106</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 203, 209.

## VIII. THREE PERSPECTIVES

A. *China Kept its Accession Promise*

Promises made by a country to get into the WTO are not political campaign promises. Rather, they have legal consequences. They create an obligation enforceable under GATT–WTO law, specifically through the *DSU*.<sup>107</sup> That is true for a pledge set out in the *Working Party Report* on the accession of that Member, and for one set out in the *Protocol of Accession*. As the Diagram below indicates, the *Accession Protocol* itself states it is an integral part of the *WTO Agreement*. For example, this link is made in Part I, Article 1.2, of China’s *Accession Protocol*. In turn, a *Working Party Report* incorporates into the *Accession Protocol* any commitment an acceding country makes in that *Report*. In China’s case, Paragraph 342 of the *Working Party Report* incorporates China’s promises in that *Report*, including Paragraph 93 concerning the 10 percent tariff on CKD and SKD kits.

Consequently, when faced with the issue of whether a Member has broken a promise it made to join the WTO, a WTO adjudicator can – indeed, must – apply the Article 31-32 *Vienna Convention* rules on treaty interpretation to *Working Party Reports* and *Accession Protocols*. That is exactly what the Panel and Appellate Body did in the *Auto Parts* case. The Panel held that China broke its promise not to apply a tariff rate in excess of 10 percent on CKD and SKD units.<sup>108</sup> China appealed on three grounds.

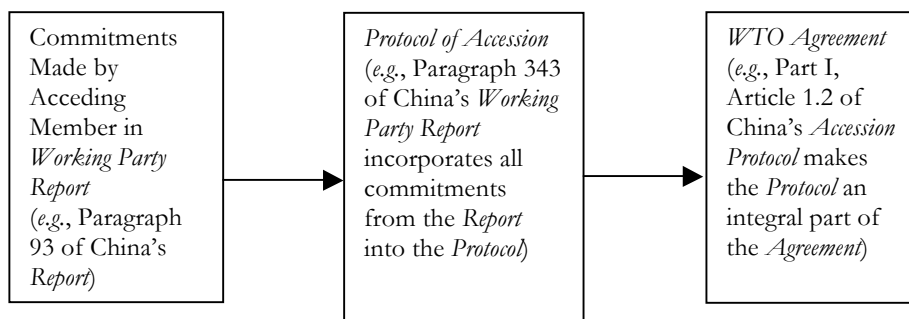


Figure 1: Legal Linkages among WTO Accession Commitments and the WTO Agreement

<sup>107</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 213-214.

<sup>108</sup> See *China Auto Parts* Appellate Body Report, ¶ 215.

First, China said the Panel was wrong to characterize its 2004 Automobile Policy as imposing a “charge” or “duty” on an automobile manufacturer importing a CKD or SKD unit that declares the kit, and pays duties, at the border.<sup>109</sup> In fact, the Policy excludes the kits from both administrative procedures (*e.g.*, declarations, bonding requirements, tracking, reporting, and verifications) and the 25 percent charge. True, the kits attract a 25 percent duty – but that is the MFN rate in China’s Schedule of Concessions for completed vehicles, not the 25 percent charge under the Policy. In brief, the Policy entirely excludes the kits, and the basis for imposing the duty is Chinese customs law. So, it was illogical for the Panel to say China’s Policy as applied to the kits violated its accession commitments.

The Panel ruled that China misread or misunderstood its own Policy. The Panel examined carefully the relevant language in it (especially Articles 2(1)-(2) and 21 of Decree 125). An auto manufacturer importing a CKD or SKD kit has the option to exclude them from the administrative procedures attendant with the Policy, declare the kit at the border, and pay a 25 percent charge on the kit as a completed vehicle. A manufacturer exercising this option is not relieved from the obligation to pay the charge, but rather the red-tape associated with paying the charge later, after it assembles the vehicle at a post-border location. This option is why the Panel excluded CKD and SKD kits from its ruling under GATT Article III:2 (first sentence). If an importer chooses to declare and pay duties on a kit at the border, then the 25 percent charge it pays is a result of the operation of the Policy, not an internal charge subject to the national treatment rule. Additionally, held the Panel, the Chinese Policy created new tariff lines, at the HS 10-digit level, for CKD and SKD kits. The 25 percent charge on the kits is associated with those new lines.

The logical consequence of this reasoning was that China violated its Paragraph 93 accession commitment. Under its 2004 Automobile Policy, China imposed a tariff on CKD and SKD units higher than 10 percent. Existing WTO Members negotiating with China for its accession specifically anticipated China, once it joined the WTO, might try to treat the kits as completed vehicles. Doing so, they feared, would impede access to China’s internal market – the 15 percentage point differential is a hefty cost

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<sup>109</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 216-245.



for automobile manufacturers importing the kits. Thus, China was asked – and agreed – to hold the line at 10 percent.

The Appellate Body did not accept the finding and rationale of the Panel.<sup>110</sup> Reviewing the same language in the 2004 Automobile Policy, the Appellate Body said China had established (especially in Decree 125) a special, seamless regime of administrative procedures and the 25 percent charge covering imported auto parts characterized as a complete vehicle. The procedures and the charge were inseparable. A CKD and SKD kit that is declared for and paid at the border is exempt from that regime. The 25 percent tariff China levies on the kit is – as China argued – a consequence not of the special regime, but rather arises under normal customs law. That is the MFN tariff on a finished car under China’s Schedule governed by GATT Article II:1(b). The Appellate Body also faulted the Panel for not properly scrutinizing the key characteristics of the 25 percent charge in the context of CKD and SKD imports.<sup>111</sup> That failure was an asymmetry in the Panel Report. The Panel did study these characteristics in its threshold analysis under GATT Articles II:1(b) (first sentence) and III:2(b) (first sentence).

The “bottom line” was that China did not violate its Paragraph 93 accession commitment about a 10 percent cap on tariffs applied to SKD and CKD kits. The finding of the Panel that China broke its promise rested on an erroneous reading by the Panel that the 25 percent charge on imported kits arises under China’s 2004 Automobile Policy. It does not. China’s Policy is a seamless web. A declaration of a kit as a complete vehicle

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<sup>110</sup> See *China Auto Parts* Appellate Body Report, ¶¶ 235-245.

Interestingly, the Appellate Body rejected an American argument that construction by a WTO panel of municipal law is a factual determination that is not subject to review under DSU Article 17:6. Citing its Reports in *U.S. – Section 211 Omnibus Appropriations Act of 1998*, WT/DS176/AB/R ¶ 105 (adopted 1 February, 2002), and *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R ¶¶ 65-66, 68 (adopted 16 January 1998), the Appellate Body pointed out municipal law is not only evidence of facts, but also of compliance (or the lack thereof) with international legal obligations. Thus, if a panel interprets municipal law to determine whether a Member has complied with its WTO obligations, then the finding of the panel is a legal one, subject to Appellate Body review. See *id.*, ¶¶ 224-226. The *Section 211* case is discussed in Raj Bhala & David Gantz, *WTO Case Review 2002*, 20 ARIZ. J. INT’L & COMP. L. 143-289 (2003). The *India Patent* case is excerpted and discussed in RAJ BHALA, INTERNATIONAL TRADE LAW: INTERDISCIPLINARY THEORY AND PRACTICE ch. 49 (3d ed. 2008).

<sup>111</sup> See *China Auto Parts* Appellate Body Report, ¶ 243.

at the border exempts the declarer from both the administrative procedures and 25 percent charge arising under the Policy. The declaration subjects the kits to payment of a 25 percent duty under China's Schedule. In effect, Paragraph 93 is irrelevant to such kits. The charge on the kits is nothing more than an OCD – the MFN duty – governed by Article II:1(b) (first sentence). Here, China kept its promise.<sup>112</sup>

### B. *China (Hopefully) Learnt the Golden Rule*

The drafters of GATT showed considerable foresight in making as a pillar of their document the national treatment principle. They knew well that if a government is prone to discriminate, then it is highly likely to prefer its domestic producers against foreign competitors. GATT Article III is nothing less than the international trade law equivalent of the Golden Rule. One version, in the Judeo-Christian tradition, is found in the Old Testament:

*Do to no one what you yourself dislike. Give to the hungry some of your bread, and to the naked some of your clothing. Seek counsel from every wise man. At all times bless the Lord God, and ask him to make all your paths straight and to grant success to all your endeavors and plans.*<sup>113</sup>

The New Testament expression is in the Gospel according to Matthew:

<sup>34</sup>When the Pharisees heard that he [Jesus] had silenced the Sadducees, they gathered together, <sup>35</sup>and one of them [a scholar of the law] tested him by asking, <sup>36</sup>"Teacher, which commandment in the law is the greatest?" <sup>37</sup>He said to him, "You shall have the Lord, your God, with all your heart, with all your soul, and with all your mind. <sup>38</sup>This is the greatest and the first commandment. <sup>39</sup>The second is like it: *You shall love your neighbour as yourself.* <sup>40</sup>The whole law and the prophets depend on these two commandments."<sup>114</sup>

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<sup>112</sup> The Appellate Body exercised judicial economy as to whether China's 2004 Automobile Policy created new tariff lines, at the HS 10-digit level, for those kits, or could be deemed as having done so. See *China Auto Parts* Appellate Body Report, ¶ 252.

<sup>113</sup> BOOK OF TOBIT, 4:15a-19 (emphasis supplied).

<sup>114</sup> THE GOSPEL ACCORDING TO MATTHEW, 23:34-40 (emphasis supplied). See also CATECHISM OF THE CATHOLIC CHURCH ¶ 2055 at 499 (Washington, D.C., United States Catholic Conference, Inc. – Libreria Editrice Vaticana, 2<sup>nd</sup> ed. 1997) (quoting the two Great Commandments from Matthew 22:37-40, and discussing them in relation to the Ten Commandments).

By no means, of course, is the Golden Rule uniquely Christian. It is expressed (directly or indirectly) in the sacred texts of other religions and philosophies.

The advocates for inclusion of China in the WTO urged that by becoming a Member, the international rule of law would circumscribe China's trade behavior. The GATT Golden Rule would be an international legal obligation incumbent on China to eschew viewing its domestically produced merchandise better than foreign competitors. That shift might help China emerge from a Middle Kingdom mentality, a Maoist-era semi-isolationist sense, into a responsible stakeholder on the world stage.<sup>115</sup>

The *Auto Parts* case was China's first lesson via adverse litigation as to what the Golden Rule of trade means in practice as well as theory. No doubt an elite cadre of CCP trade professionals in Beijing knew the logic and details of GATT Article III even before China acceded to the WTO on 11 December 2005. No doubt, too, this cadre is slowly increasing as China develops, spreading beyond the roughly 63 million CCP members and Beijing to non-Party members and other major cities. But, even in a small country, let alone the most populous nation, appreciation for why national treatment matters is not (and probably never will be) universal. Moreover, even advanced developed countries make mistakes on national treatment. The loss the United States suffered in the *Section 337* case is just one example.

That said, was China smart to fight the *Auto Parts* case? The facts and the law were against it from the outset. Then-United States Trade Representative (USTR) Rob Portman said exactly that when the case was launched:

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<sup>115</sup> While the then U.S. Deputy Secretary of State, Robert Zoellick coined this appellation in a speech he delivered in New York on 21 September 2005. His remark was that the U.S. should "step up efforts to make China a responsible stakeholder in the international system."

Thus, in the context of Doha Round talks, Chinese Foreign Ministry spokesman Liu Jianchao declared in December 2008 that "China will continue to play a constructive and active role as a responsible country, and work with all sides to promote the negotiations to achieve a comprehensive and balanced result on the basis of existing achievements." *Foreign Ministry: China To "Actively" Join Doha Round*, XINHUA (ENGLISH), 4 December, 2008, available at: <http://english.sina.com>.

It's a classic example of discrimination. China maintains regulatory policies that impose discriminatory tariffs and encourage its automakers to use Chinese parts, at the expense of auto parts from the United States and other countries. These regulations discourage U.S. exports and create an incentive for auto parts makers to relocate to China.<sup>116</sup>

Hence, it was a case China was nearly destined to lose. The answer to this question is “yes” only if China secretly hoped to lose, and then use the Appellate Body Report to bludgeon recalcitrant hard-liners to change their ways and begin treating foreign auto imports fairly. This response – while privately admitted by trade officials from time to time representing other countries – is sheer conjecture in the Chinese context. The point, then, may be that China ought to review carefully the cases it chooses to defend versus settle, if it hopes to avoid running up a string of losses. After all, there is no shortage of potential cases China may find itself defending in the years to come.<sup>117</sup>

### C. *But, More is at Stake*

The *China Auto Parts* case is a minor part in a far larger drama at play inside China. The context in which China's 2004 Automobile Policy is set, which is obviously not a WTO matter, is the grip – dare it be dubbed “iron” or “tenacious” – on political power certain elements within the CCP insist on keeping.<sup>118</sup> A sagging economy amidst global recession, significant wage declines and job losses, and consequent industrial unrest would undermine the claim (again, made by some, not all, CCP members) that the CCP alone can guide China to higher heights of economic prosperity and social peace. Thus, the *Financial Times* wrote:

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<sup>116</sup> Quoted in Daniel Pruzin & Christopher S. Rugaber, *U.S., EU Initiate WTO Dispute Complaints Against Chinese Restrictions on Auto Parts*, 23 *International Trade Reporter* (BNA) 530-531 (6 April 2006)

<sup>117</sup> See, e.g., UNITED STATES TRADE REPRESENTATIVE, 2008 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE (December 2008), available at: [www.ustr.gov](http://www.ustr.gov) (chronicling many areas of apparent non-compliance, as summarized in Table II at pp. 11-14).

<sup>118</sup> Lest this comment be wrongly misread as premised on a disposition hostile toward China or the CCP, rather than as being offered in the spirit of friendly, constructive suggestions, it may be worth referring to Raj Bhala, *Virtues, the Chinese Yuan, and the American Trade Empire*, 38 *HONG KONG LAW JOURNAL* part I, 183-253 (May 2008). As the late Professor Edward Said rightly remarked, it is the job of the scholar to speak the truth to power. See EDWARD W. SAID, *REPRESENTATIONS OF THE INTELLECTUAL* xvi (1994).

... Beijing is feeling defensive: concerned above all else to ensure that a sharp slump in growth does not trigger regime-threatening unrest. *All Chinese policies can almost always be traced back to this primal fear.*<sup>119</sup>

The CCP is scared in part because it is well aware of what most average Chinese understand intuitively: despite the large absolute size of China's GDP, in *per capita* purchasing power parity terms, China ranks a pathetic 122<sup>nd</sup> in the world, behind Egypt, El Salvador, and Armenia.<sup>120</sup>

Yet, in the long run, what the CCP is not mindful of – through willful blindness or intentional suppression – is what will doom its monopoly on power. Thousands of Chinese intellectuals, and distinguished leaders like the Dalai Lama, have signed *Charter '08* which (*inter alia*) calls for non-violent change toward modern democratic institutions and practices that safeguard basic human dignity and fundamental freedoms, including the freedom of conscience and speech.<sup>121</sup> To some elements within the CCP, the drafters and signatories of the *Charter* are enemies of the state to be ignored, or better yet quashed, rather than Chinese patriots seeking peaceful change toward an economic, political, and social climate enjoyed in every other major country except China.

Do the signatories of *Charter '08* speak for the people, including the 20 million rural migrant Chinese laborers (15 percent of the total of that cohort) who have lost their jobs in the coastal manufacturing centers and returned to the interior?<sup>122</sup> The short answer is “yes.” Based on its erroneous Marxist premise about human nature – that man is fundamentally an economic creature – the official ideology of the CCP holds that as long as the CCP can provide the conditions for rapid growth in *per capita* GDP, reduce poverty, and rectify rural-urban imbalances, no rational Chinese citizen would want anything more out of life. Throughout history, poor

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<sup>119</sup> *Chinese Leadership Besieged by Caution*, FINANCIAL TIMES, 3 February, 2009, at 10 (emphasis supplied).

<sup>120</sup> See Geoff Dyer, *Chinese Data Put Economy in Third Place*, FINANCIAL TIMES, 15 January, 2009, at 1.

<sup>121</sup> *China's Charter '08* is published in a variety of sources, including 56 *New York Review of Books* issue 1 (15 January, 2008), available at: [www.nybooks.com/articles/22210](http://www.nybooks.com/articles/22210) (Perry Link, trans.) (last visited 22 July, 2009).

<sup>122</sup> See David Pilling, *China Should Raise Wages to Stimulate Demand*, FINANCIAL TIMES, 5 February 2009, at 9; Jamil Anderlini & Geoff Dyer, *Downturn Has Sent 20m Rural Chinese Home*, FINANCIAL TIMES, 3 February, 2009, at 1.

people have shown themselves to be more than *homo economicus*. China need look no further than its southern neighbor, and no further back than 60 years. Mahatma Gandhi led a movement that, at its root, was about the dignity of every person – no matter how destitute or socially outcast. Thus, without doubt, on the points raised in *Charter '08*, this ideology is on the wrong side of history. That was a point made by President Barack H. Obama, in his Inaugural Address, when he stated:

To the Muslim world, we seek a new way forward, based on mutual interest and mutual respect. To those leaders around the globe who seek to sow conflict, or blame their society's ills on the West - know that your people will judge you on what you can build, not what you destroy. *To those who cling to power through corruption and deceit and the silencing of dissent, know that you are on the wrong side of history; but that we will extend a hand if you are willing to unclench your fist.*<sup>123</sup>

Regrettably, the CCP actually censored parts of the new President's speech, particularly in Chinese-language translations.<sup>124</sup> Trade protectionism through measures in key sectors like autos might extend the rule of the CCP – but not forever.

Likewise, no amount of fiscal stimulation will extend in perpetuity the monopoly on power of the CCP. In 2008, China's auto sector posted the lowest rate of growth – 6.7 percent – in a decade. Thus, in November 2008, the CCP announced a \$586 billion economic stimulus package, which contained three components to assist China's auto industry:<sup>125</sup>

1. A cut in the sales tax on small cars (vehicles with engines of 1.6 liters or less) from 10 to 5 percent.
2. Investment of \$1.5 billion to upgrade technology.
3. Expenditures of \$750,000 to help farmers shift away from three-wheeled gas-powered vehicles that pollute heavily.

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<sup>123</sup> President Barack H. Obama, Inaugural Address (20 January, 2009) *available at*: <http://news.bbc.co.uk>.

<sup>124</sup> See Michael Bristow, *Obama Speech Censored in China*, BBC NEWS, 21 January 2009, *available at*: <http://news.bbc.co.uk>. See also *It Never Stays Long*, THE ECONOMIST, 17 January, 2009, at 60 (remarking “the failure of the Beijing Olympics to bring any of the promised (or more accurately, hoped-for) changes in China's policy was probably the biggest disappointment of 2008).

<sup>125</sup> See Kathleen E. McLaughlin, *Chinese Government Announces Auto Industry Aid Under Stimulus*, 26 International Trade Reporter (BNA) 99 (22 January, 2009).

All three initiatives are laudable, and all three are environmentally friendly, as they will help boost fuel efficiency and reduce pollution. To give the benefit of the doubt, they are the result of dedicated CCP officials sincerely concerned about the present and future livelihoods of their people. But, neither these kinds of initiatives, nor the legal record the CCP achieves in WTO adjudication, really matters in proportion to the ideals of *Charter '08* – and, in all probability, the CCP knows that.