

China – Measures Affecting Imports of Automobile Parts

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Abstract: This paper reviews the WTO Appellate Body Report on *China – Measures Affecting Imports of Automobile Parts* (WT/DS342/AB/R, 15 December 2008). This dispute concerns a set of regulatory measures imposing a 25% ‘charge’ on imported automobile parts used in the manufacture of motor vehicles in China. The main legal question in this case consisted of the nature of this charge as either a border charge subject to China’s tariff concessions or an internal charge, subject to the basic nondiscrimination requirement of GATT Article III. In our report, we examine the reasoning of the Appellate Body relating to the difference between these two types of charges. We discuss the role and relevance of this distinction in the GATT/WTO legal system in general, and for the purposes of resolving this dispute in particular. We also address the important systemic question relating to the review of a Member’s domestic laws for purposes of determining their GATT/WTO consistency. This was an important issue in this case, as China claimed that the Panel misunderstood the meaning of the relevant Decree and requested the Appellate Body to review the Panel’s erroneous reading of this Decree. We discuss the Appellate Body’s reasoning relating to the review of domestic laws by Panels and the Appellate Body and express concern over the distinction drawn by the Appellate Body between legal and factual elements of relevance in the interpretation of such laws.

The ‘economic bone’ in this case is less straightforward to split than the legal one. In legal terms, the Appellate Body’s decision is a time-consistent one, but, in economic terms, it is not clear if it is also a welfare-optimal one. The main reason is that many questions relevant to the case were left unaddressed by the Appellate Body. Due to the lack of factual evidence to substantiate its allegations, the Panel’s ruling remains rather speculative on certain accounts. For this purpose, we engage in our own examination of the facts, using mainly a unique dataset of

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Chinese firm-level data. We analyze issues of ownership in China's car industry, the growth of the import-competing Chinese industry over time, the elasticity of the demand for cars, and duty pass-through, etc. The purpose is to verify more closely who 'benefits' and who 'loses' from the Chinese import duty so as to understand the economic incentives involved. In this respect, we attempt to determine whether the economics support the conclusion that China pursued a beggar-thy-neighbor policy in the car-part industry.

1. The dispute

1.1 *The measure at issue*

This dispute concerns a set of regulatory measures imposing a 25% 'charge' on imported automobile parts used in the manufacture of motor vehicles in China. The charge is due if the imported auto parts have the character of a 'complete vehicle', something that is determined by the Chinese authorities based on criteria prescribed under three instruments enacted by the Chinese government.¹

The criteria for such a determination 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'² that are imported requires characterization of *all* parts imported for use in that vehicle model as 'complete vehicles'.

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% of the total price of the complete vehicle also requires characterization of *all* imported parts for use in that vehicle model as complete vehicles. Imports of

¹ These instruments are:

- Policy on Development of the Automotive Industry (Order of the National Development and Reform Commission (No. 8)) ('Policy Order 8'), which entered into force on 21 May 2004;
- Administrative Rules on Importation of Automobile Parts Characterized as Complete Vehicles (Decree of the People's Republic of China, No. 125) ('Decree 125'), which entered into force on 1 April 2005;
- Rules on Verification of Imported Automobile Parts Characterized as Complete Vehicles (Public Announcement of the Customs General Administration of the People's Republic of China, No. 4 of 2005) ('Announcement 4'), which entered into force on 1 April 2005.

² An 'assembly' is defined in Article 4 of Decree 125 to include 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. The Panel found that an 'assembly' corresponds roughly to the major parts of a vehicle (Panel Reports, *China – Measures Affecting Imports of Automobile Parts* (WT/DS342/R) (hereinafter Panel Reports), paras. 7.88 and 7.89).

Completely Knocked Down (CKD) and Semi-Knocked Down (SKD) kits³ are also characterized as imports of complete vehicles.

In other words, the measures at issue set up a regulatory regime and impose a charge with respect to imported auto parts used in the production or assembly of certain models of motor vehicles that are sold in the Chinese domestic market. They prescribe thresholds regarding the type or value of imported auto parts used to assemble specific vehicle models. If the imported parts used in a given vehicle model meet or exceed these thresholds, then *all* of the imported parts used to assemble that model are characterized as complete vehicles and are subject to the charge under the measures at issue.

The charge is imposed following assembly of the vehicles. The measures set out a number of procedural and administrative steps designed to determine whether the charge applies and ensure tracking and reporting of the imported auto parts, along with payment of the charge, in respect of the relevant auto parts. The amount of the charge imposed corresponds to the tariff rate applicable to complete vehicles, that is 25 %. Imported auto parts that are not ‘characterized as complete vehicles’ under the measures at issue are subject to duties at the tariff rates for auto parts in China’s Schedule of Concessions, that is 10 % on average.

The system is based on the principle of ‘self-evaluation’ to be performed by the automobile manufacturer prior to beginning production of a new vehicle model that will incorporate imported parts and that will be sold in China. In case of a positive self-evaluation, the manufacturer will apply to the Ministry of Commerce for an import license for the parts to be used in the vehicle model. The automobile manufacturer must provide a duty bond,⁴ the amount of which is calculated on the basis of the projected quantity and value of the auto parts that will be imported each month. In practice, the amount corresponds to the applicable tariff rate for auto parts (10 % on average) applied to the projected monthly importations of auto parts. The automobile manufacturer may then begin to import parts to be used in the production of its new vehicle model. When the auto parts characterized as complete vehicles for use in a registered vehicle model are then actually imported into China, they are subject to the duty bond as well as to ongoing tracking and reporting requirements imposed on the manufacturer importing those parts. The parts are not, however, subject to any ongoing physical confinement or any other restriction by customs authorities on their use in the internal market.

³ Although CKD and SKD kits are specifically mentioned in Article 21(1) of Decree 125, they are not defined under the challenged measures. The Panel found that, for purposes of this dispute, CKD and SKD kits refer to all or nearly all of the auto parts and components necessary to assemble a complete vehicle, which must be packaged and shipped in a single shipment, and which must go through the assembly process to become a complete vehicle once they have been imported into the importing country (see, Panel Reports, paras. 7.644–7.647).

⁴ Panel Reports, paras. 7.51–7.52. Third-party auto suppliers and auto-part manufacturers are not covered by this requirement, as they are subject to normal customs procedures and thus pay the import duty at the tariff rate applicable to auto parts at the time of importation (Panel Reports, para. 7.51).

Article 13 of China's Decree 125 states that auto manufacturers importing auto parts characterized as complete vehicles must declare their importation of such auto parts and *pay duties* to the district customs office. Article 13 thus refers to the obligation not only to declare the importation of auto parts, but also to pay duties. However, actual payment of the duty/charge under the measures does not occur until the Verification Centre has completed the verification that the imported parts actually possessed the essential character of 'complete vehicles'. This occurs after the manufacturers have finished the assembly of auto parts into complete vehicles.⁵ It is this 'duty' that is to be paid by the manufacturers following verification that constitutes the 'charge' under the measure which is being challenged by the complainants.

1.2 *The complainants' claims and China's defense*

The United States, Canada, and the European Communities (the 'complainants') claimed that the charge imposed under the measures was an 'internal charge' that was inconsistent with Article III:2 of the GATT 1994 because it applied to imported auto parts, while no similar charge applied to like domestic parts. In addition, they argued that the additional administrative requirements on automobile manufacturers that use imported auto parts in excess of specified thresholds violated China's obligations under Article III:4 of the GATT 1994. According to the complainants, these requirements provided an incentive to prefer domestic auto parts. By using domestic parts, the manufacturers would be able to avoid all of the reporting and verification requirements.

In the alternative, if the measures were considered to impose customs duties, as argued by China, the complainants claimed that such a 'duty' (25 %) was in excess of the relevant tariff bindings in China's Schedule of Concessions for automobile parts (10 %) and was therefore inconsistent with Article II:1(a) and (b) of the GATT 1994.

The complainants also argued that the charge imposed by the measures equally applied to imports of certain unassembled or partially assembled motor vehicles, that is completely CKD and SKD kits.⁶ The complainants claimed that China's tariff treatment of such kits under the measures was inconsistent with Article II:1(a) and (b) of the GATT 1994, as it exceeded the 10 % import duty rate set for

⁵ Once production of the relevant vehicle model begins, the automobile manufacturer must submit a verification application to the relevant authorities. Following verification by the authorities, the automobile manufacturer must make a declaration of duty payable, and submit additional documentation in respect of all relevant complete vehicles assembled from when production of the vehicle model began. The authorities then proceed to classify the auto parts as complete vehicles and to collect the 'duty' and VAT for all imported auto parts used in assembling those complete vehicles.

⁶ The Panel explained that, although the measures at issue do not define CKD and SKD kits, it considered CKD and SKD kits under the measures to refer to all or nearly all of the auto parts and components necessary to assemble a complete vehicle, which must be packaged and shipped in a single shipment, and which must go through the assembly process to become a complete vehicle once they have been imported into the importing country (Panel Reports, paras. 7.644–7.647).

imported parts. Two of the complainants, the United States and Canada, claimed that the measures were also inconsistent with paragraph 93 of China's Accession Working Party Report, in which China promised to set at 10% the level of the duties due in respect of the importation of such kits, in case it would create a separate tariff line for kits.⁷

China responded that the charge under the measures was an ordinary customs duty, within the meaning of Article II:1(b), and not an internal measure subject to Article III. China argued that the measures were not inconsistent with Article II of the GATT 1994 because they give effect to a proper interpretation of 'motor vehicles' in China's Schedule of Concessions. China explained that the measures ensured 'substance over form' in the administration of China's national customs law in that they allow customs authorities to classify, as complete motor vehicles, groups of auto parts and components that have the essential character of a complete vehicle, irrespective of how an importer chooses to structure the importation of these parts. China contended that the measures thereby prevent the 'circumvention' of China's tariff headings for motor vehicles. China argued that the treatment of the CKD or SKD kits was in line with its tariff binding for complete vehicles and thus consistent with GATT Article II. In China's view, it was consistent with China's obligation under its Schedule and Article II:1(b) of the GATT 1994 to treat CKD and SKD kit imports as complete vehicles in light of the principle that a complete set of parts 'presented unassembled or disassembled' (e.g., in a kit) is classified as the complete article, not as parts of that article.

China argued that, insofar as the measures were found to be inconsistent with either Article II or Article III, they were justified under Article XX(d) of the GATT 1994. China expressed the view that the measures were necessary to address circumvention of the obligation to pay 25% duties on complete vehicles through the shipment of auto parts at 10% when those parts were later assembled into a complete vehicle.

2. The Panel's findings

The Panel found that the charge imposed by China was an internal charge that was inconsistent with GATT Article III and that could not be justified under GATT Article XX. In the alternative, and assuming the charge was considered to be a customs duty, the Panel found that the charge violated China's tariff commitments under GATT Article II.

⁷ Paragraph 93 of China's WPR states as follows: '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 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%. The Working Party took note of this commitment.'

With regard to the CKD and SKD kits, however, the Panel was of the view that the ‘duties’ imposed by the measure were not internal charges, but customs duties covered by GATT Article II. The Panel found that the duties imposed on kits were consistent with China’s tariff commitments for complete vehicles under GATT Article II. However, the Panel considered that China had violated the commitment made at the time of its accession to the WTO that it would not impose duties of more than 10% on such kits in the event it created a new tariff line for kits. We briefly expand on the Panel’s reasoning below.

China’s charge on imported auto parts is an internal charge covered by GATT Article III

The Panel first considered as a threshold matter whether, as contended by the complainants, the charge imposed on automobile manufacturers under the measures at issue constituted an ‘internal charge’ under Article III:2, or, as contended by China, an ‘ordinary customs duty’ under Article II:1(b).⁸ The Panel observed 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’.⁹

The Panel found that ‘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 resold internally or because the product was used internally), which occur 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.’¹⁰ In sum, according to the Panel:

[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.¹¹

The Panel applied its interpretation to the measures at issue to conclude that they imposed an internal charge rather than an ordinary customs duty. The Panel considered the following facts relevant:

- that the obligation to pay the charge accrues internally after the auto parts have been assembled into motor vehicles within China;¹²

8 Panel Reports, para. 7.105.

9 Ibid.

10 Ibid., para. 7.185.

11 Ibid., para. 7.204.

12 Ibid., para. 7.205.

- that the charge is imposed on automobile manufacturers rather than on importers in general;
- that the imposition of the charge on specific imported parts is based on which *other* imported or domestic parts are used together with those imported parts in assembling a vehicle model, rather than upon the specific parts at the moment of importation;¹³
- that identical imported parts imported at the same time in the same container or vessel can be subject to different charge rates depending on whether or not the vehicle model into which they are later assembled meets the criteria set out in the measures.¹⁴

On this basis, the Panel concluded that the 25 % charge imposed on automobile manufacturers was an internal charge within the meaning of Article III:2 of the GATT 1994.¹⁵ It held that the Chinese regulatory measures were inconsistent with GATT Article III:2, first sentence, because they subjected imported auto parts to an internal charge in excess of that applied to like domestic auto parts.¹⁶ In addition, The Panel was of the view that the measures were inconsistent with GATT Article III:4 because imported auto parts were accorded less favorable treatment than like domestic auto parts, mainly due to the disincentive created in respect of imported auto parts by the administrative requirements relating to the use of imported parts.¹⁷

Despite the fact that the Panel thus resolved the issue before it, the Panel went on to make alternative findings under GATT Article II, assuming *arguendo* that the measures would be considered as ‘ordinary customs duties’ within the scope of the first sentence of Article II:1(b). The Panel concluded that, insofar as this was a correct assumption, the measures were inconsistent with China’s tariff binding commitments in respect of auto parts and were thus inconsistent with Article II:1(a) and (b) of the GATT 1994.¹⁸

The Panel also concluded that the measures at issue were not justified under Article XX(d) of the GATT 1994.¹⁹ In the course of its analysis under Article XX(d) of the GATT 1994, the Panel rejected China’s arguments relating to tariff ‘circumvention’²⁰ and made certain observations regarding the operation of the automotive industry in general. The Panel considered that ‘the language of Policy Order 8, which is a legal authority giving rise to the implementing measures at issue (Decree 125 and Announcement 4), as well as the circumstances leading up to the introduction of the measures as explained by China cast doubt on China’s

13 Ibid., para. 7.207.

14 Ibid.

15 Ibid., para. 7.212. The Panel excluded from the scope of this finding the ‘charge’ imposed on CKD and SKD kits imported under Article 2(2) of Decree 125, which it considered to be an ordinary customs duty.

16 Ibid., para. 7.223.

17 Ibid., para. 7.272.

18 Ibid., para. 7.523.

19 Ibid., para. 7.365.

20 Ibid., para. 7.346. China did not appeal the Panel’s finding under Article XX(d).

claim that the measures are “designed” to address the evasion or circumvention of higher tariff rates that apply to motor vehicles under China’s tariff schedule’.²¹ In response to the question of circumvention, the Panel explained that ‘to circumvent one tariff duty for another as claimed by China, an importer at least needs to have the intent to do so’.²² It considered that, to the extent the action China submits as inconsistent under its tariff schedule includes the importation and assembly of auto parts without any intention to avoid the higher tariff duties imposed on motor vehicles, China has not explained why and how such an action is inconsistent with its tariff schedule.

The Panel concluded that Chinese law provided an incentive to export parts rather than complete cars and that there was therefore nothing ‘wrong’ with exporters acting on that incentive. According to the Panel, ‘China has neither provided evidence showing such practices by importers, nor proved to our satisfaction why such actions are inconsistent with importers’ obligations under China’s tariff schedule.’²³ Insofar as ‘circumvention’ refers to fraudulent declarations, the Panel considered that this issue was adequately dealt with under Chinese law as it is in most domestic legal systems. The Panel thus found that China had not discharged its burden to prove that the measures ‘secure compliance’ with its tariff schedule.²⁴ Neither could the measure be considered as ‘necessary’ to secure compliance, according to the Panel. The Panel was of the view that the scope of the measures was too broad to be viewed as necessary for the prevention of such an action, since it encompassed even a situation where automobile manufacturers/importers use imported auto parts for their assembly into motor vehicles in the normal course of their business operations without any intention to avoid the higher tariff duties imposed on motor vehicles, let alone any intention to falsely declare or document the specific content of importation. In the Panel’s view, this type of measure went well beyond what was necessary to enforce China’s tariff provisions for motor vehicles.²⁵

With regard to CKD and SKD kits, the Panel found that the measures were not inconsistent with Article II:1(b) of the GATT 1994,²⁶ since China’s tariff commitment of 25 % for complete cars can be read to include these types of kits. However, the Panel upheld the argument that the measures were inconsistent with China’s commitment under paragraph 93 of China’s Accession Working Party

21 *Ibid.*, para. 7.312. The Panel noted that the title of Policy Order 8 – ‘the Policy on Development of the Automotive Industry’ – refers to the development of China’s automotive industry, not enforcement of China’s tariff provisions for motor vehicles or vehicle parts. Further, as submitted by the complainants, the text of the preamble of Policy Order 8 also shows that the main reason for introducing the Policy is to further develop China’s automotive industry (*Ibid.*, para. 7.306).

22 *Ibid.*, para. 7.326

23 *Ibid.*, para. 7.337.

24 *Ibid.*, para. 7.346.

25 *Ibid.*, para. 7.361.

26 *Ibid.*, para. 7.736.

Report, since China had *de facto* created a new tariff line for such kits and imposed duties at a level above the level indicated in the WPR.²⁷

3. China's appeal and the Appellate Body's findings

China appealed the Panel's characterization of the nature of the 'charge' imposed under the measures at issue. In China's view, the Panel reached its finding on the basis of an erroneous interpretation of the first sentence of Article II:1(b) of the GATT 1994, which failed to take into account the context provided by the rules of the Harmonized Commodity Description and Coding System (the 'Harmonized System'). China asserted that Rule 2(a) of the General Rules for the Interpretation of the Harmonized System (GIR 2(a))²⁸ enables national customs authorities to classify unassembled auto parts as a complete motor vehicle, including in the situation where auto parts that are related through their subsequent common assembly arrive in multiple shipments. China was of the view that a correct approach would have led the Panel to the conclusion that the charge in question was an ordinary customs duty subject to the tariff bindings in respect of complete vehicles of GATT Article II and China's tariff schedule.

The Appellate Body basically rejects all of China's arguments on appeal, with the exception of the arguments relating to the Panel's treatment of CKD and SKD kits.

Distinguishing between customs duties and internal charges

The Appellate Body agrees with the analytical approach of the Panel to determine as a threshold matter whether the charge imposed by the measure was an internal measure or rather a border measure/customs duty, noting the Panel's view 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'.²⁹

In response to China's argument about the relevance of the correct classification of the product under the rules of the harmonized system, the Appellate Body clarifies that it is of the view that the question was not whether China could treat car parts as complete vehicles. Rather, in its view the relevant question concerns the nature of the measure as either an internal charge or a customs duty. Therefore,

²⁷ *Ibid.*, para. 7.758. The Panel exercised judicial economy with respect to the claims under the *TRIMs Agreement*, Article III:5 of the GATT 1994, and Articles 3.1(b) and 3.2 of the *SCM Agreement*.

²⁸ The text of GIR 2(a) provides:

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.

²⁹ Appellate Body Report, para. 139.

the Appellate Body finds, the Harmonized System rules and commentaries do not constitute relevant context that should have been considered by the Panel.³⁰ The Appellate Body considers that classification issues have some bearing on the question of whether a Member applying a customs 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).³¹

The Appellate Body then states its view in respect of the difference between ordinary customs duties and internal charges. According to the Appellate Body, for a charge to constitute an ordinary customs duty in the sense of GATT Article II, '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'.³²

In contrast, the Appellate Body³³ is of the view that the charges falling within the scope of GATT 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'.³⁴ The time at which a charge is collected or paid is not decisive. 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.

The Appellate Body thus reaches the following conclusion in paragraphs 163 and 165 of its report:

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.'³⁵ 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.

...

In our view accepting that a charge imposed on auto parts following, and as a consequence of, their assembly into a complete motor vehicle can constitute an ordinary customs duty would significantly limit the scope of 'internal charges' that fall within the scope of Article III:2 of the GATT 1994. We also share the

30 Ibid., para. 152.

31 Ibid., para. 155.

32 Ibid., para. 158.

33 Ibid., para. 161.

34 Panel Reports, paras. 7.128 and 7.129.

35 Ibid., para. 7.132 (original emphasis).

concerns expressed by the Panel to the effect that the security and predictability of tariff concessions would be undermined if ordinary customs duties could be applied based on factors and events that occur internally, rather than at the moment and by virtue of importation, and that this, in turn, would upset the carefully negotiated and balanced structure of key GATT rights and obligations, including the different disciplines imposed on ordinary customs duties and internal charges.

Characterization of China's 25% charge on imported parts as an 'internal charge'

The Appellate Body considers that 'the same measure may exhibit some characteristics that suggest it is a measure falling within the scope of Article II:1(b), and others suggesting it is a measure falling within the scope of Article III:2', but that one must identify the features that 'are the most central to that measure itself, and which are to be accorded the most significance for purposes of characterizing the relevant charge'.³⁶

The Appellate Body agrees with the Panel that the characteristics of the charge it had identified – and to which we referred above in the context of the Panel's decision – were of 'particular significance for legal characterization purposes'.³⁷ It adds to the factors identified by the Panel 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.³⁸ This, according to the Appellate Body, may lead to the charge being applied to imported parts not originally declared as complete vehicles as well as the nonapplication, following reverification, of the charge in respect of parts originally declared as complete vehicles.

The Appellate Body rejects China's arguments based on the terms used in Chinese law ('duties') to describe the charges as being determinative. The Appellate Body confirmed its earlier expressed view that the way in which a Member's domestic law characterizes its own measures, although useful, cannot be dispositive of the characterization of such measures under WTO law.

In sum, the Appellate Body agrees with the Panel that the 25% charge imposed on imported auto parts under the conditions set forth in the challenged measures is an internal charge subject to the obligations of GATT Article III.³⁹

Since China accepted that, if the Appellate Body were to uphold the Panel's finding that the charge imposed under the measures is an internal charge falling

³⁶ Appellate Body Report, para. 171.

³⁷ *Ibid.*, para. 172.

³⁸ *Ibid.*, para. 173. The Appellate Body refers to the scenario where an automobile manufacturer does not import parts directly, but instead purchases them from an independent third-party supplier within China who paid 10% import duty on the imported parts, while the manufacturer may be liable to pay 25% duties depending on the amount of imported parts used in the assembly of the vehicle (*Ibid.*, para. 174).

³⁹ *Ibid.*, para. 182.

within the scope of Article III:2, it must also uphold the Panel's finding that the charge is inconsistent with China's obligations under the first sentence of Article III:2 of the GATT 1994, the Appellate Body agrees with the Panel that the charge violates GATT Article III.2.⁴⁰

The Appellate Body also agrees with the Panel that the measures create an incentive to prefer domestic auto parts and thus distort competitive opportunities for imported products in a manner inconsistent with GATT Article III.4. According to the Appellate Body, the administrative procedures and associated delays imposed on automobile manufacturers using imported parts, which could be avoided entirely if a manufacturer were to use exclusively domestic auto parts, provide incentives that negatively 'affect' the conditions of competition for imported auto parts on the Chinese internal market.⁴¹

Given the fact that it had upheld the Panel's finding under GATT Article III, the Appellate Body saw no reason to examine the Panel's alternative findings under Article II, even though some of the complainants (EC and Canada) considered that it would be useful and systemically important for the Appellate Body to do so. Nor did the Appellate Body see any reason to accede to China's request to declare such alternative findings 'moot and of no legal effect'.⁴²

Treatment of CKD kits under the challenged measure

The Appellate Body then turns to the Panel's finding that China's imposition of the 25% charge on CKD and SKD kits is a violation of China's accession commitments under paragraph 93 of its WPR. We recall that the Panel had found that the 'exemption' created by the Decree 125 for kits that were declared as complete vehicles and subject to ordinary customs procedures implied that they were subject to the 25% charge of the measure but not subject to the administrative aspects of the measure. According to the Panel, the 25% charge imposed on such kits was therefore not an internal charge, but rather a customs duty.

China argues that the Panel misread the 'exemption' for kits as set forth in the measure. China explains that the provision of the challenged Chinese Decree 125 relating to CKD and SKD kits exempts such kits from the measures altogether, and thus also from the charge.

The Appellate Body first rejects the suggestion that the Panel's understanding of the Chinese Decree and of the scope of the exemption is a factual determination that it cannot review. The Appellate Body considers that it can review the interpretation of the Panel as to the meaning of China's municipal law. According to the Appellate Body, 'When a panel examines the municipal law of a WTO Member for purposes of determining whether the Member has complied with its

40 Ibid., para. 184.

41 Ibid., paras. 195–196.

42 Ibid., para. 209.

WTO obligations, that determination is a legal characterization by a panel, and is therefore subject to appellate review under Article 17.6 of the DSU'.⁴³

The Appellate Body examines Article 2 of the Decree and expresses some 'difficulty understanding how the Panel could read Article 2(2) to mean that CKD and SKD kits that are declared and paid for at the border, prior to assembly, and that are not subject to verification or other procedural steps under the measures at issue, can nonetheless be subject to the charge under the measures at issue'.⁴⁴ In the view of the Appellate Body, the 'duties' referred to in Article 2(2), which are to be declared and paid upon importation, are not 'duties' or charges imposed under Decree 125. Consequently, it finds that the Panel's construction of Article 2(2), read together with Article 21(1), 'amounts in our view to legal error'.⁴⁵

The Appellate Body faults the Panel for not explaining how the same charge of 25 % could be, in one context, an internal charge, while in the context of the CKD and SKD kits it allegedly constitutes a border duty, if indeed this distinction is to be treated as a threshold issue.⁴⁶

The Appellate Body also reverses the Panel's subsequent finding that the measures at issue are inconsistent with China's conditional commitment in paragraph 93 of its Accession Working Party Report, as this finding was premised upon the erroneous view that the measures impose a charge that is an ordinary customs duty on CKD and SKD kits imported under Article 2(2) of Decree 125. The Appellate Body does not see how the charge imposed under the measures at issue could, as an internal charge within the meaning of Article III:2, somehow have violated China's commitment regarding its tariff treatment of CKD and SKD kits in paragraph 93 of its Accession Working Party Report.⁴⁷

4. Legal analysis

4.1 *Border measure or internal charge – a fine line*

The main legal issue to be resolved in this case was the question whether the charge imposed by China on imported auto parts was to be characterized as a customs duty (i.e., a border charge) *on the importation of* auto parts, or rather as an internal charge *on imported* auto parts (i.e., an internal measure). Under GATT, different rules apply to these different types of charges.

Ordinary customs duties, as well as all other duties and charges imposed on the importation of goods, are covered by the tariff commitments set forth in a Member's schedule of concessions. GATT Article II provides that no ordinary customs duties are to be levied 'on the importation' of products above the bound

43 Ibid., para. 225.

44 Ibid., para. 235.

45 Ibid., para. 238.

46 Ibid., para. 243.

47 Ibid., para. 245.

tariff rate. In addition, it provides that products shall be exempt from all other duties or charges of any kind ‘imposed on or in connection with importation’. GATT Article II is the basic market-access provision that determines the maximum price of the entry ticket to be paid in order to obtain market access in a given Member country. GATT Article XI is the corollary of Article II, as it prohibits any ‘restrictions or prohibitions other than duties, taxes or charges ... on importation’. GATT Article XI thus confirms that duties and charges as circumscribed by GATT Article II are the only type of border measure allowed for under GATT.

In contrast, the only obligation that Members have in respect of ‘internal taxes or other internal charges of any kind’ is to ensure that imported products that have paid their entry ticket into the market are treated no differently from like domestic products. That is basically what GATT Article III stands for. It imposes a requirement that internal taxes, and more generally any measures affecting the internal sale, purchase, transportation, distribution or use of products, ‘should not be applied to imported or domestic products so as to afford protection to domestic production’. This is translated into two practical obligations: (1) in respect of internal taxes or charges, not to impose internal taxes or other internal charges of any kind in excess of those applied on like domestic products; and (2) in respect of any other internal measures, to ensure that imported products are treated no less favourably than like domestic products. GATT Article III thus acts as an ‘anti-circumvention’ provision, as it intends to prevent a Member from retreating from its market-access commitments by imposing internal charges or introducing internal measures more generally in a manner that distorts competitive opportunities to the detriment of imported products. The Panel in the case discussed in our report correctly summarized the role played by both provisions in the system in the following manner:

As the Appellate Body clarified, a basic object and purpose of the GATT 1994, as reflected in Article II of the GATT, is ‘to preserve the value of tariff concessions negotiated by a Member with its trading partners and bound in that Member’s Schedule’.⁴⁸ At the same time, the broad purpose of Article III is ‘to avoid protectionism in the application of internal tax and regulatory measures’.⁴⁹ While serving their own objects and purposes, these two provisions are also interrelated such that the disciplines contained in these two provisions aim to ensure ‘the

⁴⁸ Appellate Body Report, *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items* (WT/DS56/AB/R, adopted 22 April 1998), para. 47.

⁴⁹ Appellate Body Report, *Japan – Taxes on Alcoholic Beverages* (WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996), DSR 1996:I, pages 16–17; 109–110 (original footnotes omitted). See also Appellate Body Report, *United States – Tax Treatment for ‘Foreign Sales Corporations’ – Recourse to Article 21.5 of the DSU by the European Communities* (WT/DS108/AB/RW, adopted 29 January 2002), para. 204. The GATT Panel in *Italy – Agricultural Machinery* also provides insight on the object and purpose of Article III, stating that ‘the intention of the drafters of the Agreement was clearly to treat the imported products in the same way as the like domestic products once they had been cleared through customs. Otherwise indirect protection could be given’ (GATT Panel Report, *Italian Discrimination Against Imported Agricultural Machinery* (adopted 23 October 1958), para. 11).

security and predictability of the reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade.⁵⁰ To achieve this overall object and purpose of the WTO Agreement, Members are obliged to respect the boundaries between Article III and Article II of the GATT 1994.⁵¹

However, the distinction between import duties/border charges, on the one hand, and internal charges, on the other hand, is not always an easy one to make. Both GATT Article II on import duties/charges and GATT Article III on internal taxes and charges contain references to the possibility that additional charges may lawfully be imposed or collected at the border, even though their imposition would exceed the bound rate.

GATT Article II.2 provides that nothing in Article II on border charges shall prevent a Member from imposing at any time ‘on the importation’ of any product ‘a charge equivalent to an internal tax imposed consistently with’ the non-discrimination obligation of GATT Article III.2 on like domestic products. Similarly, the *Ad Note* to GATT Article III states that any internal charge that applies to an imported product and to the like domestic product and is ‘collected or enforced in the case of the imported product at the time of importation, is nevertheless to be regarded as an internal tax or other internal charge’ and is thus subject to the provisions of GATT Article III. Both provisions thus warn against simplistic conclusions about the nature of a measure from the mere fact that certain payments are imposed at the border or at the time of importation.

In the case discussed in this report, the Appellate Body had to determine whether the charge imposed by China on imported auto parts was an internal charge covered by GATT Article III or an ordinary customs duty/border charge covered by GATT Article II. The approach followed by the Panel and the Appellate Body in answering this question is in line with the approach adopted in prior GATT/WTO case law relating to the different nature of border measures and internal measures.

In older GATT cases like *Belgian Family Allowances*⁵² or *EEC–Parts and Components*,⁵³ Panels have concluded that if the event that gives rise to the liability

50 Appellate Body Report, *European Communities – Customs Classification of Frozen Boneless Chicken Cuts* (WT/DS269/AB/R, WT/DS286/AB/R, adopted 27 September 2005), para. 243.

51 Panel Reports, para. 7.201.

52 In this case the 1952 GATT Panel reached the following conclusion:

After examining the legal provisions regarding the methods of collection of that charge, the Panel came to the conclusion that the 7.5% levy was collected only on products purchased by public bodies for their own use and not on imports as such, and that the levy was charged, not at the time of importation, but when the purchase price was paid by the public body. In those circumstances, it would appear that the levy was to be treated as an ‘internal charge’ within the meaning of paragraph 2 of Article III of the General Agreement, and not as an import charge within the meaning of paragraph 2 of Article II. GATT Panel Report, *Belgian Family Allowances (allocations familiales)* (‘*Belgium–Family Allowances*’), G/32, adopted 7 November 1952, BISD 1S/59.

53 GATT Panel Report, *European Economic Community – Regulation on Imports of Parts and Components* (‘*EEC–Parts and Components*’), adopted 16 May 1990, BISD 37S/132.

to make the payment is an internal event that takes place following importation, such as their assembly, and if the charge is thus imposed on ‘imported products’ – i.e., products that have been imported already – the charge is of an internal nature, even when this charge is collected at the border. Similarly, the WTO Panel on *Argentina–Hides and Leather*, found that the prepayment at the border of a Value-Added Tax (VAT) was an internal measure because the measure applied to ‘definitive import transactions, but only if the products imported were subsequently re-sold in the internal Argentinean market’.⁵⁴ The Panel referred to *Ad Note to GATT Article III* to conclude that ‘the fact that [the payment] is collected at the time and point of importation does not preclude it from qualifying as an internal tax measure’.⁵⁵

In contrast, if the charge is ‘on’ or ‘connected with’ importation – i.e., in respect of a product that is being imported – and the liability to pay the charge arises as a consequence of importation, it will be considered as a border charge covered by GATT Article II.⁵⁶ As noted by the GATT Panel in *EEC – Measures on Animal Feed Proteins*, recalling the GATT negotiating history, ‘The Sub-Committee at the Havana Conference considered (Havana Reports pp. 62–63, paragraphs 42–43, E/CONF.2/C.3/A/W.30 page 2) that “certain charges ... were import duties and not internal taxes because ... (a) they are collected at the time of, and as a condition to, the entry of the goods into the importing country, and (b) they apply exclusively to imported products without being related in any way to similar charges collected internally on like domestic products”’.⁵⁷

The same approach to border measures as measures that condition access to the market and impose a condition on entry into the market is found in the WTO case law in respect of GATT Article XI prohibiting restrictions ‘on importation’. The Panel on *India–Autos* considered the ordinary meaning of the phrase ‘restriction ... on importation’ as being a restriction ‘with regard to’ or ‘in connection with’ the importation of the product.⁵⁸

⁵⁴ Panel Report, *Argentina – Measures Affecting the Export of Bovine Hides and Import of Finished Leather* (WT/DS155/R, adopted 16 February 2001), para. 11.145 (emphasis added, original footnote omitted).

⁵⁵ Panel Report, *Argentina–Hides and Leather*, para. 11.145.

⁵⁶ For example, the GATT Panel on *EEC–Parts and Components* came to the following conclusion: ‘The text of Articles I, II, III and the Note to Article III refers to charges ‘imposed on importation’, ‘collected ... at the time or point of importation’ and applied ‘to an imported product and to the like domestic product’. The relevant fact, according to the text of these provisions, is not the policy purpose attributed to the charge but rather whether the charge is due on importation or at the time or point of importation or whether it is collected internally. This reading of Articles II and III is supported by their drafting history and by previous panel reports (e.g. BISD 1S/60; 2S/49, 67)’. GATT Panel report, *EEC–Parts and Components*, para. 5.6.

⁵⁷ GATT Panel Report, *EEC – Measures on Animal Feed Proteins*, L/4599, adopted on 14 March 1978, 2S/49, para. 4.16.

⁵⁸ Panel Report, *India – Measures Affecting the Automotive Sector* (WT/DS146/R, WT/DS175/R, adopted 5 April 2002), para. 7.257.

The Chinese case discussed in this report shows some resemblance to the GATT case on *EEC–Parts and Components*, relating to so-called ‘screwdriver’ operations used to circumvent antidumping duties on finished products. In that GATT case, the (then) EEC expressed the view that the antidumping duties it had imposed on finished products were being circumvented by the sale of parts and components of such products to importers related to or associated with the exporters found to have been dumping their products into the EC market. The EEC considered that ‘in order to prevent circumvention, it is necessary to provide for the collection of an antidumping duty on products thus assembled or produced’ in the event one could link the assembled products to the products covered by the antidumping duties.⁵⁹ The measure imposed by the EEC to fight what it considered to be circumvention of the antidumping duties consisted of imposing the same antidumping duties on the finished products assembled in the EEC on the basis of the parts and components exported by exporters that were subject to antidumping duties on the finished products.

The GATT Panel noted that the anti-circumvention duties are levied, according to the EEC regulation, ‘on products that are introduced into the commerce of the Community after having been assembled or produced in the Community’. The duties are thus imposed, as the EEC explained before the Panel, not on imported parts or materials, but on the finished products assembled or produced in the EEC. Their imposition is not conditional upon the importation of a product or at the time or point of importation.⁶⁰ The GATT Panel found that the internal assembly of the parts into the finished product subject to the antidumping duty triggered the duty liability and thus that the measures imposed by the EEC were internal measures subject to GATT Article III.⁶¹

In so doing, the GATT Panel rejected arguments by the EEC relating to the policy objective of the charges (to combat circumvention of antidumping duties) or their qualification under domestic law of the EEC as antidumping duties – i.e., border measures. Such arguments were not considered to be relevant to the determination of the nature of the charge, which was either a duty imposed on or in connection with importation within the meaning of Article II or an internal tax within the meaning of Article III.2.⁶²

⁵⁹ Article 13 of Council Regulation (EEC) No. 2423/88 as discussed in GATT Panel report, *EEC–Parts and Components*, paras. 2.2–2.7.

⁶⁰ GATT Panel Report, *EEC–Parts and Components*, para. 5.5

⁶¹ The Panel equally rejected the defense that such an anti-circumvention provision was necessary to secure compliance with its GATT-consistent antidumping laws, since the challenged general antidumping Regulation of the EEC did not establish obligations that require enforcement; it merely established a legal framework for the authorities of the EEC. Therefore, in the view of the GATT Panel, the anti-circumvention duties do not serve to enforce the payment of antidumping duties and cannot be justified under GATT Article XX (d). GATT Panel Report, *EEC–Parts and Components*, para. 5.18.

⁶² According to the GATT Panel, ‘the fact that the EEC treats imported parts and materials subject to anti-circumvention duties as not being “in free circulation” therefore cannot, in the view of the Panel,

On the nature of the charge imposed by China, the Panel and Appellate Body reach a conclusion similar to that of the GATT Panel on *EEC–Parts and Components*. According to the Appellate Body, for a charge to constitute an ordinary customs duty in the sense of GATT Article II, ‘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’.⁶³ In contrast, the Appellate Body is of the view, like the Panel, that the adjectives ‘internal’ and ‘imported’ suggest that the charges falling within the scope of GATT 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’⁶⁴:

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.’⁶⁵

In general, this approach relating to the distinction between border measures and internal charges makes sense – border measures determine the amount that needs to be paid in order to be allowed into a market, while internal charges are triggered by the internal sale, offering for sale, purchase, use, or any other internal event that occurs subsequent to importation. In this case, it was the use of the imported auto parts in a certain combination with other auto parts of foreign origin that led to the imposition of an additional levy to be paid *by the manufacturer of motor vehicles*. Duty liability under the Chinese measure rests with the manufacturer of the vehicle, not the importer of the parts. If the car parts were ultimately not used to manufacture a car that China considered to be an imported vehicle based on the percentage of imported auto parts, the charge was not due, even if the manufacturer had originally informed the authorities to the contrary. It thus seems very clear that it is the use of the parts in a particular combination, once imported, that determines whether the charge is due. In our view, it is correct to conclude, as did the Panel and the Appellate Body, that this charge is not imposed ‘on the importation’ of the parts but is an internal charge. Arguably, China’s measure could be qualified as a ‘reverse border adjustment’ – China does not impose an additional charge in order to impose the same internal charge levied on domestic products equally on imported products (the normal type of border adjustment measure provided for in *Ad Note* GATT Article III and GATT Article

support the conclusion that the anti-circumvention duties are being levied “in connection with importation” within the meaning of Article II:1(b)’, GATT Panel Report, *EEC–Parts and Components*, para. 5.7.

63 Appellate Body Report, para. 158.

64 *Ibid.*, para. 161.

65 *Ibid.*, para. 163.

II.2); rather, China imposes the additional charge in order to adjust for a customs duty on cars that was not paid by the importer of the car parts considered as a complete vehicle. In other words, it seems that the internal charge is seen as a means of adjusting for the failure to comply with a border charge (i.e., the customs duty on cars). No GATT provision expressly provides for this type of adjustment and thus, arguably, such an adjustment is simply a GATT-inconsistent internal charge.

Nevertheless, it seems justified in a case like this one to wonder whether all this discussion about the right ‘qualification’ of the charge mattered much. Both the Panel and the Appellate Body base their analysis on the fact that Article II refers to charges ‘on importation’ of a product, while Article III relates to charges imposed on ‘imported’ products. In line with past GATT/WTO jurisprudence, the Panel considered 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’,⁶⁶ and the Appellate Body silently seems to agree with this commonly held view.

However, as became clear in the case of *India–Additional Duties*, the language of GATT Article II.2 casts doubt on this commonly held view that there is such a strict separation. This case suggests that a charge that is imposed at the border and is equivalent to an internal tax may nevertheless be seen as an unjustified border charge that violates GATT Article II, as an internal tax that fails to meet the conditions of GATT Article III, or both.⁶⁷ GATT Article II.2 provides that nothing in that Article relating to border measures shall prevent a Member from imposing ‘on the importation’ of any product a charge equivalent to an internal tax when this charge is imposed consistently with GATT Article III.2. This seems to provide a safe haven for a charge ‘on importation’ – i.e., a border charge – if it is equivalent to an internal charge. The nature of the charge would be that of a border charge covered by GATT Article II – why else would there be a need for this type of justification under Article II.2? If it were an internal charge, simply collected at the border, GATT Article II would not apply and there would be no need for this type of safe haven. And what is GATT Article II.2 actually saying – that a border charge (‘on importation’) can be justified as an internal charge so long as there exists a domestic equivalent for this charge and the charge complies with the

⁶⁶ Panel Report, para. 7.105.

⁶⁷ The Appellate Body Report, *India – Additional and Extra-Additional Duties on Imports from the United States* (WT/DS360/AB/R, adopted 17 November 2008), found that Indian ‘Additional Duty would not be justified under Article II:2(a) of the GATT 1994 insofar as it results in the imposition of charges on imports of alcoholic beverages in excess of the excise duties applied on like domestic products. Consequently, this would render the Additional Duty inconsistent with Article II:1(b) to the extent that it results in the imposition of duties on alcoholic beverages in excess of those set forth in India’s Schedule of Concession’. Appellate Body Report, *India–Additional Duties*, para. 214. In other words, it seems that the Appellate Body was saying that a charge imposed at the border which is not consistent with the non-discrimination requirement of Article III.2, even if it perhaps has the character of an internal charge, would be inconsistent with Article II.1(b) on border measures.

nondiscrimination requirement of GATT Article III? This type of approach seems to argue against a strict and clean separation between border measures and internal charges based on certain essential characteristics of the measure.

Maybe a more pragmatic approach would be to say that measures that are imposed at the border should *prima facie* be considered to be border measures subject to GATT Article II. One should not assume that they are actually internal measures simply collected or enforced at the border, unless such charges are clearly linked to a domestic tax equivalent. Such was not the case here, and no argument to this effect was made by China. There obviously was no domestic counterpart to the 25% charge imposed on imported products. China clearly considered the charge to be an import duty, and the Chinese customs authorities were the ones collecting the charge.

It seems that the Panel could have reached the same conclusion of violation simply by accepting that China imposed a duty on imported parts that exceeded the tariff binding on auto parts as set forth in China's Schedule. The only relevant question before the Panel at that stage would be whether China was justified in imposing duties at the level reserved for complete vehicles on parts simply because they were later assembled into a 'complete vehicle' as defined by the Chinese authorities.

The answer to this question has to be 'no': all imported parts will one day be assembled into a complete vehicle and may thus become cars, but what is being imported are parts, not cars.⁶⁸ Whether considered as an internal charge or as a customs duty, it is clear that China would be found to have violated its GATT obligations. Maybe the Panel could have done as the 1992 GATT Panel on the *Canadian Liquor Board* case did: it concluded that 'the question whether the restrictions violated Article III.4 [on internal measures] or Article XI:1 [on border restrictions other than duties] of the General Agreement was ... of no practical consequence in the present case'.⁶⁹

4.2 *Reviewing the meaning of domestic legislation – a matter of fact or law?*

Article 17.6 DSU provides that an appeal 'shall be limited to issues of law covered in the panel report and legal interpretations developed by the panel'. In other words, a challenge to a Panel's finding before the Appellate Body is limited to

68 The exception could consist of parts 'presented as complete vehicles' under the General Rules for the Interpretation of the Harmonized System, namely, GIR 2(a), which provides:

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.

However, as explained through lengthy argumentation by the Panel, this does not justify China's imposition of duties for complete vehicles on parts which it has determined as having the essential character of a complete vehicle based on their subsequent assembly. Panel Report, Section D.

69 GATT Panel Report, *Canada – Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*, DS 17/R, adopted 18 February 1992, 39 S/75–76, para. 5.6.

matters of law, and in principle it is not for the Appellate Body to review factual determinations made by the Panel.

The only indirect way of making the Appellate Body review factual determinations is through Article 11 DSU, which requires a Panel to make an ‘objective assessment of the matter’ before it. Article 11 DSU thus provides a way of challenging the Panel’s analysis of the evidence or its general approach to establishing the facts. This appeal raised the question whether a Panel’s interpretation of the meaning of municipal law is a legal interpretation by the Panel or a factual determination that, in the absence of an Article 11 DSU claim, cannot be reviewed by the Appellate Body.

In particular, the Panel had interpreted a provision in the challenged Chinese Decree 125 relating to the exemption for CKD and SKD kits to mean that such kits were subject to the charge under the Decree but not subject to the administrative requirements of this Decree. China appealed the findings of the Panel regarding CKD and SKD kits. It did not deny that CKD and SKD kits were subject to a 25 % duty, but argued that this duty was not a duty imposed by the challenged Decree. China claimed that the Panel misread the Decree’s exemption for CKD and SKD kits as being only a partial exemption. It thus requested the Appellate Body to examine the Decree and to review the Panel’s erroneous reading of this Decree. The United States on the other hand argued that a Panel’s ‘constructions of municipal law are factual determinations in WTO dispute settlement’ and that the Appellate Body may not review such findings *de novo*, but must accord them ‘the same deference as other types of factual findings made by Panels in WTO dispute settlement proceedings’.⁷⁰

The Appellate Body, referring to its report on *US–Section 211 Appropriations Act*, rejected the US argument and considered that ‘When a panel examines the municipal law of a WTO Member for purposes of determining whether the Member has complied with its WTO obligations, that determination is a legal characterization by a panel, and is therefore subject to appellate review under Article 17.6 of the DSU.’⁷¹ It then added the following qualification of this right to review a Panel’s interpretation of a Member’s municipal law, which we find particularly intriguing:

The Appellate Body has reviewed the meaning of a Member’s municipal law, on its face, to determine whether the legal characterization by the panel was in error, in particular when the claim before the panel concerned whether a specific instrument of municipal law was, as such, inconsistent with a Member’s obligations.⁷² **We recognize that there may be instances in which a panel’s assessment of municipal law will go beyond the text of an instrument on its face, in which case**

⁷⁰ Appellate Body Report, para. 224.

⁷¹ *Ibid.*, para. 225.

⁷² [footnote original] See, for instance, Appellate Body Report, *United States – Section 211 Omnibus Appropriations Act of 1998* (WT/DS176/AB/R, adopted 1 February 2002), para. 106.

further examination may be required, and may involve factual elements.⁷³ With respect to such elements, the Appellate Body will not lightly interfere with a panel's finding on appeal.⁷⁴

On the point of principle – whether a Panel's interpretation of the meaning of municipal law is a factual determination or rather a legal interpretation subject to Appellate Body review – the Appellate Body's ruling in this case is in line with earlier findings to this effect in *India–Patents (US)* and *US–Section 211 Appropriations Act*. Although we are of the view that this proposition is debatable,⁷⁵ we wish to focus our commentary on the new twist given by the Appellate Body to its authority to review a Panel's interpretation of the meaning of municipal law.⁷⁶

In the case discussed in this report, the Appellate Body qualified its 'right to review' a Panel's determination of the meaning of municipal law and stated that it would 'not lightly interfere with a panel's finding' when the Panel's assessment of

73 [footnote original] The Appellate Body Report, *United States – Sunset Review of Anti-Dumping Duties on Corrosion-Resistant Carbon Steel Flat Products from Japan* (WT/DS244/AB/R, adopted 9 January 2004), stated that '[i]f the meaning and content of the measure are clear on its face then the consistency of the measure can be assessed on that basis alone. If, however, the meaning ... is not evident on its face, further examination is required' (Appellate Body Report, *US–Corrosion-Resistant Steel Sunset Review*, para. 168). See also Appellate Body Report, *United States – Countervailing Duties on Certain Corrosion-Resistant Carbon Steel Flat Products from Germany* (WT/DS213/AB/R, adopted 19 December 2002), paras. 156 and 157.

74 Appellate Body Report, para. 225. Following its review of the Decree, the Appellate Body concluded that the Panel's construction of Article 2(2) of the Chinese Decree that the kits were exempted from the administrative aspects of the measure but still subject to the charge imposed by the Decree 'amounts in our view to legal error' (Appellate Body Report, para. 238).

75 In our view, there are two different questions at play: First, what does the measure – i.e., the municipal law in question – mean, and what does it require authorities to do? This seems to be a determination of what in fact is required under the law, as interpreted by the domestic courts, etc. A second question is whether what is required by municipal law may correctly be qualified as a violation of the obligations set forth in the international agreement. That second question is clearly a legal assessment, as it involves the application of the international law, as interpreted on the basis of the principles of the Vienna Convention on the Law of Treaties, to the facts as determined by the Panel when determining the meaning of the municipal law. Of course, as with any 'measure', a review that concerns only the second question is limited, as the review of the Panel's application of the law to the facts is based on the assumption that the Panel correctly determined what the facts are. But maybe that limitation was precisely what Article 17.6 DSU intended to impose on the Appellate Body. The arguments offered by the Appellate Body for a more expansive review authority are not very convincing, as the determination of the implications of a Member's municipal law are not more 'legal interpretations' than is the determination of the implications of any other measure. It seems that the Appellate Body is simply keen to review a Panel's interpretation of the meaning of municipal law, while with regard to other types of 'measures', it feels comfortable hiding behind the argument that it is not reviewing the factual determinations of the Panel unless an Article 11 DSU claim has been made. In any case, the Appellate Body construed a way out of the limitation imposed by Article 17.6 DSU through the use of Article 11 DSU ('objective assessment of the matter') as the avenue to bring factual determinations before the Appellate Body. The Appellate Body could have used the same avenue to address a Panel's interpretation of the meaning of municipal law.

76 For an interesting discussion of the question of the treatment of national law in WTO law, see S. Bhuiyan (2007), *National Law in WTO Law, Effectiveness and Good Governance in the World Trading System*, Cambridge University Press, pp. 207–243.

municipal law goes ‘beyond the text of an instrument on its face’ and thus involves ‘factual elements’.

It is not clear to us what exactly the Appellate Body was trying to say in the bolded part of the above-quoted paragraph. It seems that the Appellate Body was suggesting that, if the determination of the Panel is based on the text of the municipal law without consideration of the application of the law or its interpretation by the domestic courts, then the Panel’s reading of the meaning of the municipal law is subject to review by the Appellate Body. However, if the Panel relies on the application of the law or on domestic court rulings to determine the meaning of the law as such, then the Panel’s determination rests on ‘factual elements’ that the Appellate Body would not ‘lightly interfere with’. Hence, the Appellate Body would view this interpretation as a factual matter, not subject to review, unless through Article 11 DSU.

The Appellate Body’s reasoning appears to deny that, from the standpoint of international law, ‘municipal laws are merely facts’.⁷⁷ That is why in the past the WTO Appellate Body has stated that the consistency of a Member’s domestic laws must be assessed on the basis of the text of the law, its consistent application in practice, if applicable, and possibly the pronouncements of domestic courts on the meaning of such laws, as well as the opinions of legal experts and the writings of recognized scholars:

A responding Member’s law will be treated as WTO-consistent until proven otherwise. The party asserting that another party’s municipal law, as such, is inconsistent with relevant treaty obligations bears the burden of introducing evidence as to the scope and meaning of such law to substantiate that assertion. Such evidence will typically be produced in the form of the text of the relevant legislation or legal instruments, which may be supported, as appropriate, by evidence of the consistent application of such laws, the pronouncements of domestic courts on the meaning of such laws, the opinions of legal experts and the writings of recognized scholars. The nature and extent of the evidence required to satisfy the burden of proof will vary from case to case.⁷⁸

⁷⁷ Permanent Court of International Justice, *Certain German Interests in Polish Upper Silesia*, [1926], PCIJ Rep., Series A, No. 7, p. 19, as referred to with approval in Appellate Body Report, *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products* (WT/DS50/AB/R, adopted 16 January 1998), para. 65. Also see GATT Panel Report, *US–Tobacco*, para. 75. This statement by the PCIJ is often quoted without much consideration of what seems to have been meant by it. Basically, it seems that the PCIJ meant to say that an international tribunal does not have to take ‘judicial notice’ of a country’s municipal law but may require proof of the meaning of municipal law and review evidence relating to the meaning of the law. It also implies that an international tribunal is to examine the meaning of municipal law in the domestic factual context – i.e., in the light of its application by the administrative authorities, the interpretation offered by domestic courts, etc. See I. Brownlie (2008), *Principles of Public International Law*, 7th Edition, Oxford University Press, pp. 38–39.

⁷⁸ Appellate Body Report, *US–Carbon Steel*, para. 157 (footnote omitted); Appellate Body Report, *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes* (WT/DS302/AB/R, adopted 19 May 2005), para. 111 and Appellate Body Report, *United States – Measures Affecting*

In *Dominican Republic–Import and Sale of Cigarettes*, the Appellate Body clearly rejected an attempt by the complainant to impose an analysis of its ‘as such’ claim based on the text of the legislation in isolation.⁷⁹

This was also the approach followed by the WTO Panel on *US–Section 301*, which examined a section of US law, first to determine its meaning in order to subsequently assess whether the challenged section of US law was consistent with the obligations of the US under the WTO Agreements. This Panel correctly considered that it was not to:

interpret US law ‘as such’, the way we would, say, interpret provisions of the covered agreements. We are, instead, called upon to establish the meaning of Sections 301–310 as factual elements and to check whether these factual elements constitute conduct by the US contrary to its WTO obligations.⁸⁰

The GATT Panel on *US–Tobacco* similarly considered that an examination of a Member’s law required it to refrain from engaging in an independent interpretation of domestic laws and to treat the interpretation of such laws as questions of fact.⁸¹

In other words, the Appellate Body’s distinction between certain textual ‘legal’ elements and other nontextual ‘factual’ elements in the case discussed in this report is at odds with the way public international law, as well as established GATT/WTO case law, views the interpretation of municipal law. In addition, it seems that the Appellate Body forgot that in the case of *India–Patents (US)* – to which it expressly refers in support of its position that it can review a Panel’s interpretation of domestic law – the Panel and Appellate Body did not simply examine the text of the Indian law in isolation. Rather, there was a considerable amount of evidence available in that case regarding the proper interpretation of the express terms of the Indian Patents Act, all of which was taken into consideration by the Panel and the Appellate Body in its review of the Panel’s determination.

Therefore, it would seem proper for the Appellate Body to consider either that any determination by the Panel regarding the meaning of municipal law is a factual determination that is not subject to appeal (other than through Article 11 DSU), and thus to reverse its prior rulings in this respect; or to accept, as it seems to have done in the past, that the interpretation of municipal law in order to determine the law’s consistency with the WTO Agreements is a legal interpretation that is subject to review by the Appellate Body, irrespective of the kind of evidence used by the Panel to determine the meaning of the law. A bit of both is not possible, and statements like the one made in this case do not clarify matters; quite to the

the Cross-Border Supply of Gambling and Betting Services (WT/DS285/AB/R, adopted 20 April 2005), para. 138.

⁷⁹ Appellate Body Report, *Dominican Republic–Import and Sale of Cigarettes*, paras. 112–115.

⁸⁰ Panel Report, *United States – Sections 301–310 of the Trade Act of 1974* (WT/DS152/R, adopted 27 January 2000), para. 7.18.

⁸¹ GATT Panel Report, *US–Tobacco*, para. 75.

contrary. The distinction that the Appellate Body seems to make between cases in which the Panel simply bases its understanding of the municipal law on the text of the law as such, without resort to the application of the law, and other cases in which ‘factual elements’ are incorporated in the analysis is, in our view, misguided.

Such statements, which seem intended only for the Appellate Body in a later case to refer to when it does not feel like reviewing a Panel’s interpretation of a Member’s municipal law, do not provide the system with ‘security’ or ‘predictability’. To the contrary, they create doubt and uncertainty as to the scope of the Appellate Body’s review authority in important cases involving the interpretation of municipal law.

5. Economic analysis

5.1 *Incentives for abuse on both sides*

It is clear from the above that the ‘legal bone’ in the case is relatively straightforward in the sense that the Panel’s rulings and the Appellate body’s decisions are very much in line with earlier rulings and decisionmaking and can therefore be considered as time-consistent. From a legal point of view this case can even be described as highly ‘predictable’ in the light of similarity with earlier dispute cases. The time consistency by the Panel and the Appellate body reduces uncertainty and enhances transparency in decisionmaking, which is important for trade.

From an economic point of view, time-consistency tends to rank second to the objective of welfare. The ultimate question to an economist is how policy affects the welfare of the parties involved and whether or not a policy is welfare-improving from a unilateral or from a multi-lateral perspective. However, in practice this is a much more difficult objective to verify than time-consistency of policy, but this should not prevent us from striving for better outcomes than a mere pragmatic approach.

Ideally, WTO rules should be in place to make certain that world welfare is maximized; this can be attained by drafting and applying rules to ensure that countries do not pursue their unilateral welfare-maximizing policies at the expense of other countries, which would be a ‘beggar-thy-neighbor’ policy where one country’s gain would be another country’s loss. From an economic point of view, what determines who is ‘wrong’ or who is ‘right’ in a trade-policy conflict is often the beggar-thy-neighbor policy content of the action undertaken. Policies where one country gains at the expense of another are unlikely to yield stability, which may hurt trade, and they are therefore undesirable. Extrapolated to this dispute case under scrutiny, some insight into who ‘gains’ and who ‘loses’ from the higher duty imposed on imported car parts could have helped the Panel to make an even more informed decision. From this perspective several important questions were

not raised in the course of the dispute and consequently no factual evidence was gathered on them.

Economists feel particularly uncomfortable if no factual evidence is gathered to substantiate the allegations made on both sides of the fence, with China accusing foreign suppliers of ‘*circumventing*’ import duties (GATT Article XX), and importers accusing China of pursuing an ‘*industrial policy*’ aimed at favoring the domestic car industry (Article III:2 of the GATT).

Without sufficient factual evidence, the Panel cannot but remain rather speculative on certain accounts. For instance, the Panel asserted that the import duty of 25 % on car parts, decided on in 2004 and taking effect in 2005, is an internal charge (Article III:2) favoring the import-competing Chinese industry of motor parts. But for this to be true, it would have been relevant to investigate whether such an import-competing industry existed and whether it was benefited during the time that the Chinese applied their elevated import duty on parts. In the absence of such an industry, car assemblers in China would not be in a position to source from an alternative domestic supplier and would be forced to pay the higher import duty on car parts, squeezing their profits. This would not be in their interest, and that would leave us wondering why China would introduce such a measure. Follow-up questions that come to mind are: Who are the car assemblers in China? To what extent are they foreign firms or domestic firms? In other words, ownership matters in order to determine who carries the burden of the duties. Most importantly also: Who buys the assembled cars? Is it domestic Chinese consumers or foreign ones, and to what extent is the import duty passed through to the consumer in the form of higher prices? That in turn will depend on the demand elasticity for assembled cars, which is often correlated with overcapacity in the industry.

But before we enter a more systematic treatment of some of the questions above, we can ask ourselves why China imposed a higher tariff on the imports of motor vehicles than on motor parts before 2004 in the first place. It is true that, in the past, many great nations have pursued similar tariff structures for the purpose of building their own manufacturing industries using the dual tariff structure as a tool of industrial policy.⁸² A country that makes the imports of complete motor vehicles relatively more expensive than imports of parts provides an incentive in favor of the shipments of parts and invites new investment in assembly activities. Additional investment in car assembly can occur through domestic entry or foreign investors keen on ‘jumping’ the high import duty on complete motors. One underlying reason for China to pursue such a policy could be that assembly activities generate technology spillovers and know-how that China would like to internalize rather than simply import from abroad. Additionally, it may also reflect a concern for creating domestic Chinese employment, since assembly is usually a labor-intensive activity. While China has not been violating any rules by setting its dual tariff structure on motor vehicles versus car parts at the time of entry into the

82 M. Irish (2004), *The Auto Pact: Investment, Labour and the WTO*, Kluwer Law International.

WTO in 2001, it is undeniable that this gave rise to certain incentives for foreign suppliers, namely to ship more parts instead of complete motor vehicles. Hence, we expect the beneficiaries of the dual tariff schedule imposed to be the foreign suppliers of parts and the losers to be the foreign importers of complete motor vehicles. But an adversely affected importer of complete motor vehicles, faced with a high import tariff of 25 %, can try to circumvent the duty by taking his complete motor vehicle apart, shipping the parts to China, and paying 10 % import duties, thus saving 15 % in duties. Economically speaking, the incentive to circumvent China's dual tariff structure was definitely present before 2004, and there is nothing in the case analysis to suggest that this did not actually occur. Indeed, history tells us that *circumvention* of high import duties through a strategy of disassembling products into parts is a distinct possibility and a strategy pursued by importers of final goods adversely affected by import duties.

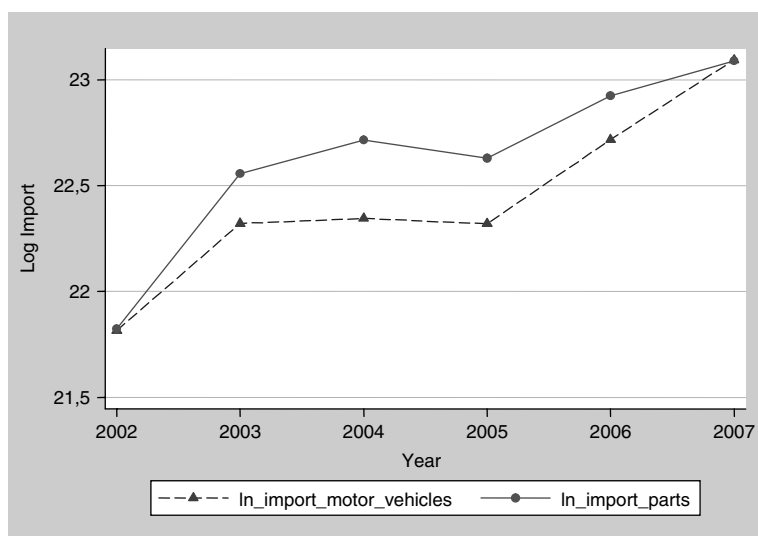
A well-described example of this occurred during the 1980s when Japan was heavily targeted by European antidumping duties on its imports of consumer electronics into Europe. The Japanese tried to avoid the import duties by 'jumping' the duties by setting up assembly plants in Europe so that *they* could start shipping to Europe parts on which *they* did not have to pay duties; the parts were then further assembled inside the EU into consumer electronics and sold on the European market. The EU tried to put a stop to this through the 'screwdriver' cases by levying import duties on the parts similar to import duties on final consumer electronics. Academically, the causality between antidumping duties and Japanese 'antidumping' jumping is well documented⁸³ but from a legal point of view the import duties were not WTO-consistent, since they discriminated foreign parts against domestic parts and were considered an internal charge.

Is this what has been going on in China? Has there been an increase in the imports of car parts? Has there been an inflow of FDI during the time of the dual tariff structure, accompanying the increase in imported parts, which could be a sign of circumvention? If the objective of the Chinese government was to create its own car assembly industry by using trade policy as an industrial policy, did they succeed in doing that? Did the Chinese car-manufacturing sector grow during that time?

For a WTO Panel, it should be relatively easy to get access to this kind of data, if only because it can ask the parties involved in a dispute to supply the relevant information. While the questions above are not directly related to the object of the dispute, for an economist 'initial conditions' are important. There can be little doubt that the imposition of the dual tariff structure, with 25 % duties on imports of motor vehicles but only 10 % on the imports of parts, created certain incentives

83 A. Blonigen (2002), 'Tariff-jumping antidumping duties', *Journal of International Economics*, 57(1); J. Haaland and I. Wootton (1998), 'Antidumping jumping: reciprocal antidumping and industrial location', *Weltwirtschaftliches Archiv*, 134(2).

Figure 1. Imports of complete motor vehicles and car parts



Source: UN Comtrade, imports reported in dollars.

and dynamics in the car industry in China that laid out the foundations or ‘initial conditions’ in the light of which this dispute case should be considered.

Without access to firms’ private information, we can only turn to the available public information in an attempt to get a better understanding of some of the allegations made in the dispute case.⁸⁴

We start in Figure 1 by examining the evolution of imports into China of complete motor vehicles as well as car parts to verify if the incentives that we believe to arise under China’s trade policy are somehow reflected in the trade figures. Figure 1 shows that in 2002, right after China’s entry into WTO, the imports of car parts equaled the imports of complete motor vehicles. But shortly after that, the imports of parts into China increasingly exceeded that of complete motor vehicles. This seems to suggest that the imposition of a dual tariff structure may indeed have created incentives for relatively more car parts being imported relative to complete vehicles. But after 2004, the gap between imports of parts and imports of complete motor vehicles narrowed, and they became equal to each other again in 2007. This seems to suggest that the measures after 2004 had taken effect. After an initial boost in the imports of car parts coinciding with an initially slower growth in imports of motor vehicles, imports in both types of activities converged again in 2007, possibly due to the circumvention policy on car parts that China pursued by that time, which again made imports of parts relatively less attractive.

⁸⁴ The product level trade data set we use is UN Comtrade for imports and exports of complete motor vehicles (HS codes 8702, 8703, 8704) and motor vehicle parts (HS codes 8706, 8707, 8708).

Table 1. Inflow of foreign direct investment in Chinese car manufacturing

Year	In million US\$
2000	1089.9
2001	1017.6
2002	1226.6
2003	2003.4
2004	3352.5
2005	3404.9
2006	2140.9

Source: Ministry of Commerce of PR China.

In that same period, we also observe a substantial inflow of Foreign Direct Investment (FDI) in the car-manufacturing sector in China (in million USD). Table 1 shows that FDI especially increased before the years 2004 and 2005, but stabilized afterwards in the period that China imposed the circumvention duty that, under certain conditions, implied a similar duty treatment for parts as for complete motor vehicles. FDI inflows were highest in 2004 and 2005 but decreased again substantially in 2006. This seems to be consistent with the hypothesis that before 2005 there was a lot of tariff-jumping FDI taking place, and after the introduction of a high tariff on car parts, that kind of FDI inflow stopped.

At first glance, these facts could be consistent with a story of duty circumvention by foreign suppliers of car parts. But in order to assert that circumvention has taken place, there is a missing piece of the puzzle – i.e., *circumvention* assumes that the *same* suppliers previously shipping complete motor vehicles are the *same* ones setting up assembly plants in China and afterwards switching to shipping parts.

In this dispute case, no evidence was collected to verify that the ownership of the importing firms was the same as that of the FDI firms, thus distinguishing the EU screwdriver cases mentioned earlier, where the same Japanese firms were involved in first shipping complete goods and afterwards setting up plants in Europe and shipping parts instead of motor vehicles. The facts observed – i.e., increase in the shipment of parts relative to complete motor vehicles and inward investment – could just reflect different firms entering the car-manufacturing industry attracted by the incentives provided by the dual tariff structure.

Clear evidence on circumvention would have to show that the same firms previously supplying the Chinese market with complete cars were engaging in inward FDI in China and altering their shipments to China into parts rather than complete cars in response to the dual Chinese tariff structure in the initial years after 2001.

An alternative interpretation of the facts is that China deliberately used its tariff policy as part of an industrial policy. China may have used trade policy for the purpose of building its own car industry. The tariff-jumping FDI triggered by

the dual tariff structure may have been anticipated and intended in order for the technology embedded in the assembly of cars to spill over from foreign investors to domestic car assemblers once foreign firms had invested in China. Academically speaking, the effectiveness of such an industrial policy is questionable, since the empirical results on FDI spillovers are ambiguous and inconclusive. At best, horizontal spillovers of FDI amongst firms engaged in the same type of activity are found to be weak. Similar types of firms act more as rivals and try to prevent knowledge spillovers to horizontal competitors. The only robust result emerging from the spillover literature is the presence of vertical spillovers, i.e. between a foreign multinational and its indigenous suppliers,⁸⁵ which could have given China a reason, in a second phase of its industrial policy, to pull up the import duty on car parts for the purpose of fostering local suppliers and to encourage vertical spillovers between the downstream FDI that had jumped the original tariff on complete vehicles and the local suppliers.

It is not unimaginable that China, through the phasing of its trade policy, tried to create its own car industry.⁸⁶ Introducing a high tariff wall on the imports of complete motor vehicles in a first stage favors domestic assembly of cars and stimulates foreign and domestic entry of car assemblers. Once the car assembly activity is well developed and foreign investors with their technology are in place, a higher tariff on the imports of car parts could constitute a second stage in China's industrial policy, where it aims to stimulate the domestic upstream production of car parts. Imposing a higher tariff on imports of parts favors 'local sourcing' to the benefit of the domestic import-competing car-parts industry but to the detriment of 'foreign sourcing' of parts, which brings us to the current dispute-settlement case under analysis. By pulling up the tariff on imported parts to 25 %, imports of car parts will be adversely affected and car manufacturers inside China eager to save on costs are likely to switch suppliers and source from local suppliers (if present) that are not subject to the import duty.

The use of trade policy to build import-competing industries is a development strategy sometimes referred to as the 'infant-industry' argument for trade protection. However, by now we know that strategy is a fallacy. Baldwin showed that using trade policy is welfare-inferior to free trade.⁸⁷ A better way to build a domestic manufacturing industry is through the capital market that should provide the necessary financing and loans to facilitate the construction of new industries. This is far less distortive and is welfare-superior to trade policy to achieve that purpose. Of course, for the Baldwin argument to hold, capital markets should function properly. In China, however, there is evidence to suggest that credit markets do not

85 Beata Smarzynska Javorcik (2004), 'Does foreign direct investment increase the productivity of domestic firms? In search of spillovers', *The American Economic Review*, 94(3): 605–627.

86 In the original Panel Report, the Chinese delegation spoke of an industrial policy strategy.

87 Robert E. Baldwin (1969), 'The case against infant-industry tariff protection'; *The Journal of Political Economy*, 77(3): 295–305.

function properly and are far less efficient than in most developed countries,⁸⁸ which may well explain China's incentive to revert to a relatively old way of constructing an import-substitution industry using trade policy.

The discussion above reveals that the incentive structure in this dispute case is 'open ended' in the sense that the rules in place undeniably give foreign suppliers an incentive to 'circumvent' the initial duty on complete vehicles (which is the Chinese stance in the dispute), although this remains unverified. At the same time, the Chinese government may also 'abuse' the higher tariff on car parts as a second phase in its industrial policy aimed at fostering its import-competing car-parts industry, which favors 'local sourcing' over foreign sourcing (which is the EU, US, and Canadian stance in the dispute) in the hope of benefiting from vertical spillovers coming especially from the foreign investors that previously jumped the high tariff walls on complete motor vehicles in the first phase of the industrial policy. This is a well-known development strategy used in the past by other countries, but it can be regarded as welfare-inferior to other domestic policies.

5.2 Four relevant questions related to the case

There are at least four relevant economic questions that were not addressed in the dispute case but that may have yielded a clearer understanding of the beggarthy-neighbor policy content of China's trade policy.

Who bears the cost of the additional import duty?

A first relevant question would be whether the assembled motor vehicles in China were used for domestic sales to Chinese consumers or were meant for export destinations and consumers outside China. This is relevant in terms of who bears the ultimate extra cost of the surcharge on imported motor parts. If assembled cars are mainly for Chinese consumers, Chinese consumers are likely to pay a higher price for their cars as a result of the higher import duty on parts and Chinese trade policy would be carried domestically. If, however, the assembled cars are mainly exported, it is consumers in export markets that are likely to pay the additional price, but only if demand overseas is not too elastic, which is the second relevant economic question treated below. But let us first look at whether assembled cars are sold for exports or domestically.

Figure 2 below is derived from firm-level data⁸⁹ and gives us a peek at the importance of domestic sales versus exports of complete motor vehicles (2a) and car

⁸⁸ Sandra Poncet, Walter Steingress, and Hylke Vandenbussche (2008). 'Financial constraints in China: firm-level evidence'; CORE DP 2008/79; Alessandra Guariglia and Sandra Poncet (2008), 'Could financial distortions be no impediment to economic growth after all? Evidence from China', *Journal of Comparative Economics*, 36(4): 633–657.

⁸⁹ The firm-level data set we used is Oriana with variables on 200,000 firms in which we identify the firms in the car manufacturing sector and in car parts. Oriana does not use a product classification but a sector level classification NAICS. The correspondence with the HS codes suggest that the complete motor vehicles producers are in NAICS (2002) codes 336111, 336112, 336120, and 336214 while the car parts firms belong to NAICS (2002) 336211, 336312, 336322, 336330, 336340, 336350, and 336399. One of

Figure 2a. Complete motor vehicles

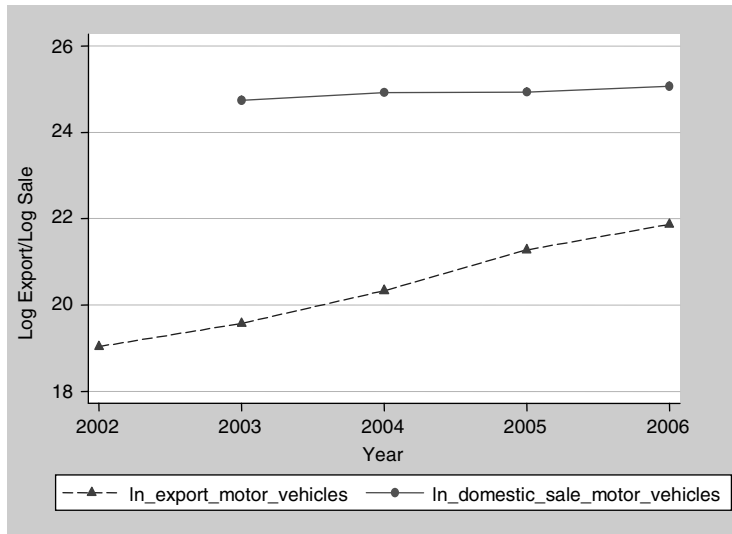
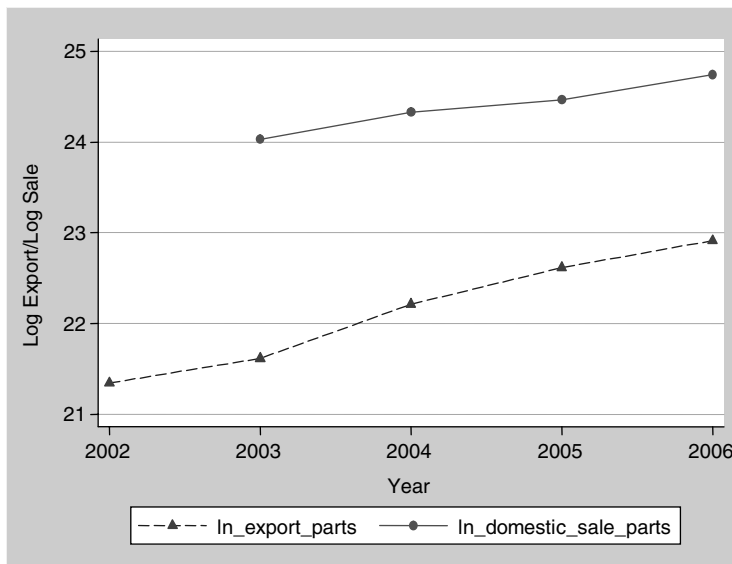


Figure 2b. Car parts



Source: Oriana firm-level data.

the serious limitations that we face is that we only have good quality data for 2003 to 2006. Another limitation is that firm-level data set does not have imports at the firm level. The exports values are firm-level, but are not split up by destination countries or by product.

parts (2b). It appears that most complete motor vehicles are sold to domestic customers and a much smaller number is shipped for exports. While domestic sales remained relatively stable over time, exports continued to rise between 2004 and 2006. The only mention of exports in the dispute case under scrutiny is footnote 14,⁹⁰ which states that exports are *exempted* from import duties, which may explain why they continued to rise. Figures 2a and 2b suggest that the import duties on complete car vehicles or car parts would mainly affect Chinese customers, given that domestic sales are more important than exports.

How elastic is the final demand for cars?

A second relevant question is whether or not the final demand for assembled motor vehicles is elastic. The demand elasticity determines the negative slope of the demand curve and reflects how consumers move away from buying a motor vehicle when the prices go up. This elasticity is indicative of the extent to which an increase in costs resulting from an extra charge on inputs used in the production process can be passed through to the consumer. Put differently, the demand elasticity captures how sensitive prices for assembled motor vehicles are. Car manufacturers may pass the higher import duty on to consumers by charging a higher price, but if demand is very elastic, this would imply a large drop in the sales of cars, and therefore car producers may prefer to absorb the duty even though it implies a squeeze in their profits. To estimate the elasticity of demand directly is not possible for us, due to lack of data on quantities sold and prices charged, but we can look at car manufacturers' profits over the years to see what happens there. Figure 3 shows that profits of both car manufacturers and car-parts producers in China were on a slide before the introduction of the new tariff structure, with profits for manufacturers of complete motor vehicles much higher than those for car-parts manufacturers. But after 2005, when the new tariff structure went into effect, profits for both types of firms rose again, suggesting that the tariffs benefited both. This is indicative that the additional costs from the import tariffs were passed through at least in part to consumers, resulting in price increases that did not affect sales too much, leaving the car sector with higher profits than before.

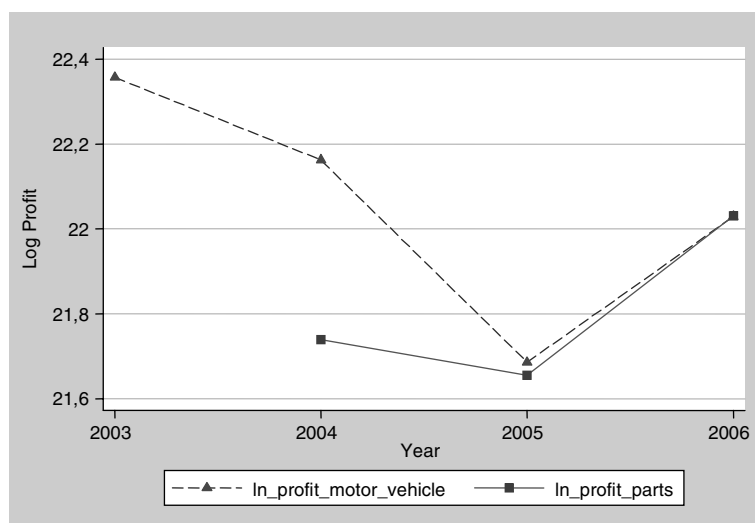
Is there an import-competing Chinese car-parts industry?

The third question is on the existence of an import-competing domestic Chinese motor-parts industry and whether it benefited from the higher tariff on car parts. If there is such an industry, to what extent did the import duty of 25 % benefit them?

This is an important question, since the Panel's conviction of China on the basis of Article III:4 assumes there is. Violation of Art III:4 implies that a country uses trade policy to favor its local industry, since the underlying reasoning is that, when car assemblers in China are faced with more expensive foreign parts, they are likely to switch to domestically produced parts that have become relatively cheaper

90 Appellate Body Report.

Figure 3. Profits of motor vehicle assemblers in China



Source: Oriana firm-level data.

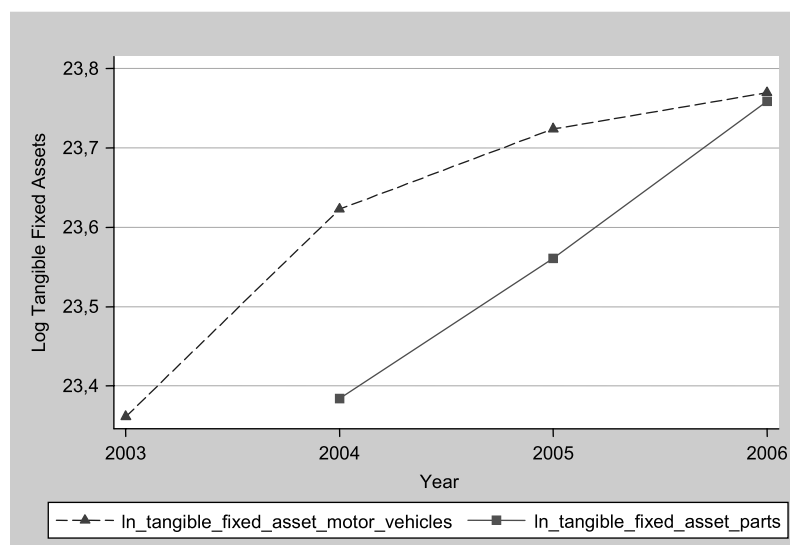
because the duty does not apply to them. The existence and size of an import-competing Chinese industry of parts is therefore important, since this would shed more light on how substantiated the claim is that the high import duty on foreign parts favors domestic parts suppliers.

We collected firm-level information on the group of firms in car manufacturing and the group of firms in China reporting ‘car parts’ as their main activity.⁹¹ One of the variables of interest is firm-level investment in car assembly and parts. Figure 4 shows the evolution of fixed tangible assets of firms in China in the car sector, which is generally regarded as a good proxy for investment. While both complete motors and car parts attracted investment, the growth in investment is more spectacular in the car-parts industry between 2004 and 2006, the period where the circumvention duty of the Chinese authorities applied. The investment in machinery, land, buildings, etc., grew so fast that the car-parts industry by 2006 had reached a similar level of assets as that of the motor-vehicles sector.

This sparse evidence already suggests two important facts that substantiate the claim made by the WTO Panel that the local industry was favored by China’s trade policy. It shows, first, that an import-competing industry for car parts existed at the time, and, second, that it seems to have grown substantially over time at a higher pace than the car-assembly industry during the period the circumvention duty applied.

91 See footnote 75 for more information.

Figure 4. Investment in the Chinese car sector



Source: Oriana.

Who owns the car manufacturing industry in China?

A fourth relevant question is about ownership. To the extent that the entire car-parts industry is Chinese, the effects of a change in import duties on car parts would fall on Chinese shareholders. However, if there is a substantial amount of foreign ownership in that sector, the effect of an import duty on car parts would also be shared by them.

Ownership information is typically very hard to come by. While our firm-level data set has some information on ownership, it is time-invariant and is far from perfect. From Table 2 we observe that, based on our micro data, the foreign ownership in both the complete-motor-vehicle sector and in the car-parts sector lies around 20%.

Furthermore, it can be noted that in the more downstream industry of complete motor vehicles, the number of firms is around 287, making this a relatively concentrated sector. Concentrated sectors generally are less subject to competition, and firms have more market power.

This is important for pass-through issues, as we know that more concentrated sectors are more likely to pass on adverse cost shocks to consumers. The total number of firms in the more upstream activity of the car parts is around 5,800 different producers, making this sector much less concentrated. Typically, competition in less concentrated sectors is stronger and market power lower. The pass-through to consumers is therefore likely to be more limited in car parts than in complete motor vehicles.

Table 2. Number of firms in the car sector in China

Ownership type	Number of firms	
	Complete motor vehicles	Motor vehicle body and parts
Domestic	227	4,640
Foreign	60	1,236
Total	287	5,876

Notes: 'Foreign' includes: 'Foreign Invested Stock Limited Company', 'Sino-Foreign Cooperative Venture', 'Sino-Foreign Joint Venture', 'Wholly Foreign Owned Enterprise', 'HK, Macau or Taiwan Joint Cooperative Venture', 'HK, Macau or Taiwan Joint Venture', 'Wholly HK, Macau or Taiwan Invested Stock Limited Company', or 'Wholly HK, Macau or Taiwan Owned Enterprise'. The rest of the firms are defined as 'Domestic'.

Source: Oriana.

Table 3. Nationality of foreign firms

Ownership country	Number of firms	
	Complete motor vehicle	Motor vehicle body or parts
China	26	48
US	7	25
Germany	3	16
France	3	7
Great Britain	2	3
Sweden	2	1
Italy	0	3
Canada	1	1
Japan	12	21
Korea	2	1
Hong Kong	3	17
Taiwan	1	2
Singapore	2	7

Notes: The sample used in this table includes firms that have information on their ownership AND have foreign owners. One firm can be owned by owners from different countries or regions.

Source: Oriana.

In terms of the nationality of the firms, we present in Table 3 the information available to us. The number of firms for which country of ownership could be retrieved is relatively small, but it gives us an idea of the proportions. Foreign ownership is relatively more common in the complete-motor-vehicle sector than in the more upstream car-parts industry. The largest group of foreign owners is the Asian countries (Japan, Korea, Hong Kong, Taiwan, and Singapore), followed by

the EU, followed by North America (US and Canada). The presence of foreign firms in the Chinese car sector could reflect an outsourcing strategy where the purpose of foreign firms is to ship the goods they produce back to their country of origin. Or their presence could reflect ‘horizontal FDI’ for the purpose of serving the domestic Chinese market. In the first case, they would be far less affected by China’s trade policy due to the exemption of exports (footnote 14 in the dispute case), i.e. goods produced for export markets are exempted from the high 25 % duty on imports of car parts.

This can be verified in Figure 2, where exports continued to rise when domestic sales stabilized. In the second case, where FDI is of the ‘horizontal type’ for serving the domestic Chinese market, the import duties can adversely affect foreign firms’ operations in China, depending on the pass-through to the Chinese customer.

Our gathering of factual evidence can only be regarded as indicative due to limitations in data, time, and manpower. Our main purpose was to raise questions rather than to pretend to answer them in full. But the many questions that the case leaves unaddressed suggest that the ‘economic bone’ is less straightforward to split than the legal one. If anything, the empirical facts that we gathered suggest that in the end the Panel most likely was right in ruling out the ‘circumvention’ hypothesis and embracing the ‘industrial policy’ hypothesis.

While the occurrence of ‘circumvention’ cannot be completely ruled out for reasons explained above, the facts pointing in the direction of China’s use of trade policy as a tool of industrial policy are plentiful. The phasing of trade policy by China is almost a textbook case of an ‘import substitution policy’ pursued by other countries in the past. At the time of WTO entry, China first set a high tariff on the imports of motor vehicles to build manufacturing capacity in the upstream activity of car assembly, resulting in inward FDI and discouraging imports of complete vehicles. A couple of years down the road from WTO entry, China altered its trade policy by imposing a circumvention duty that raised the tariff on the imports of more upstream car parts, which are intermediates in the assembly of cars. This discouraged the imports of both car parts and complete vehicles and enhanced a spectacular increase in the investment in and capacity of the domestic Chinese car-parts industry. Furthermore, the exemption of exports from paying import duties on parts suggests that China combined its import-substitution policy with a well-known policy described by: ‘import protection as export promotion’.⁹² In a model where import protection raises the market size for a representative domestic producer, domestic sales for the domestic firm increase. This allows the firm to lower its average

⁹² Paul Krugman (1984), ‘Import protection as export promotion: international competition in the presence of oligopoly and economies of scale’, in Henry Kierzkowski (ed.), *Monopolistic Competition and International Trade*, Oxford: Oxford University Press.

cost curve and makes it more competitive, resulting in more exports. Hence, the Krugman model pointed out that import protection may actually stimulate exports.

While too little factual evidence is currently presented to formally accuse China of pursuing these ‘beggar-thy-neighbor’ policies, all we can say is that some of the facts, such as the spectacular growth in the Chinese car-parts industry after the 25% duty on parts was introduced, are consistent with it.

From an economic point of view, it is interesting to note that ‘old’ policy recipes appear to survive despite the fact that we know that trade policies can only be second best compared to other domestic instruments. Building industries behind tariff walls is less effective than investing in properly functioning capital markets.⁹³ Recent evidence also questions the ability to use import protection to raise exports when firms are heterogeneous.⁹⁴

93 Baldwin, ‘The case against infant-industry tariff protection’.

94 H. Kasahara and B. Lapham (2008), Productivity and the decision to import and export: theory and evidence’, CESifo working paper no. 2240; J. Konings and H. Vandenbussche (2009), ‘Antidumping protection hurts exporters: firm-level evidence from France’, CEPR discussion paper no. 5678.