CHINA’S FIRST LOSS

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1. China’s Development and the Historic Case

A. Introduction

It was a fight over cars and car parts that marked the end of China’s honeymoon period in the World Trade Organization (WTO), that blissful few years when its major trading partners were willing to forgive its trespasses because this largest of developing countries had just joined the club. As the bilateral U.S. trade deficit rose to more than $201 billion in 2005, the U.S. government and many members of Congress sought to achieve more balance in Sino-American trade relations. There have been a significant number of trade disputes with China, including over failure to implement obligations China made when acceding to the WTO, Chinese subsidies to industrial producers, lax tax law enforcement by Chinese authorities, and unfair, if not illegal, Chinese exchange rate policy. Among these allegations, certain discriminatory charges by China on imported auto parts made an easy target.

The United States was not alone in bringing the Auto Parts case against China. The European Communities (EC) and Canada also filed suit against China. No longer was China a voluntary third-party participant. Now, it was compelled to defend its trade rules and policies before an independent international adjudicator.

More than history was at stake. Commercially, China is the third largest economy in the world (measured by Gross Domestic Product (GDP)), after the United States and Japan, and besting Germany in 2007. After the United States, China boasts the second largest consumer auto market in the world. Likewise, following America, China is the second largest producer of autos and auto parts in the world. Yet, in the two countries the fortunes of this strategic sector are headed in opposite directions.

Car sales of new passenger vehicles in the United States (both total and retail) have trended downwards since 2000 (from just under 18 to below 12 million vehicles per year between 2000 and 2009, respectively). Job loss and wage decline in the American auto industry are a decades-long phenomenon. Conversely, the auto industry has been an

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1 China – Measures Affecting Imports of Automobile Parts (complained by European Communities, United States, and Canada), WT/DS/339/AB/R, WT/DS/340/R, and WT/DS/342/AB/R (adopted 12 January 2009). Argentina, Australia, Brazil, Japan, Mexico, Thailand, and (notably) Taiwan (Chinese Taipei) participated as third parties in all three Panel proceedings, and at the Appellate Body stage.

2 In 2005, the bilateral trade deficit of the European Union (EU) with China rose to $74 billion.

3 Since its accession to the WTO, China has participated in 54 cases as a third party, prior to the initiation of the Auto Parts case.


7 See John Reed & Bernard Simon, The Thrill is Gone, FINANCIAL TIMES, 3 February 2009, at 9
engine of Chinese industrialization and economic development. Annual vehicle output of China increased from less than 2 million vehicles in the late 1990s to 9.5 million in 2008. In terms of production volume, in 2008, China surpassed Korea, France, Germany, and the United States, trailing only Japan. China aims to win 10 percent of the global car market by about 2016. Unlike Korea or Japan, China’s automotive industry has developed extensively through foreign direct investment (FDI). This FDI has come in the form of joint ventures (JVs) and alliances between international automobile manufacturers and Chinese partners. The market share of Chinese-owned vehicle producers (such as Chery) has risen relative to that of joint ventures between Chinese and foreign companies, and imported cars account for less than 5 percent of all auto sales in China.

Despite this success, a worrying sign for China is the effect of global economic recession on its prized auto industry: in early 2009, the market for used cars was growing faster than for new cars, adding to protectionist pressures within the country. In 2008, China’s auto sector posted the lowest rate of growth – 6.7 percent – in a decade. Thus, in November 2008, the Chinese Communist Party (CCP) Government announced a $586 billion economic stimulus package, which contained three components to assist the country’s auto industry:

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

These commercial facts have their own political ramifications, i.e., the Auto Parts case is an historic one set in the broad context of the political economy and development of China.

This chapter explores China’s first loss in the WTO. Lose it did, at both the Panel and Appellate Body stage, on most of the claims that mattered. The 25 percent charge China imposed on imported auto parts ran afoul of the Golden Rule of international trade law, national treatment. Part 2 sets out the facts of the case. Part 3 examines the Panel rulings. Parts 4 and 5 survey the key issues on appeal and holdings of the Appellate Body, and analyze the appellate arguments China made and lost.

Parts 6 and 7 put the case in the wider context of China’s legal and political development. This Part offers three perspectives. First, China can take heart from a small victory it achieved in the case, namely, in proving it did not violate the promises it made when acceding to the WTO. Second, the case is a useful tutorial for China about the Golden Rule of trade, which stems from Article III of the General Agreement on Tariffs and Trade (GATT). Third, and perhaps most importantly, the case may play a certain role in a much grander drama on stage in China concerning its future policy makings in the

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10 See Patti Waldmeir & John Reed, China Used-Car Dealers in Top Gear, FINANCIAL TIMES, 5 February 2009, at 6.
11 See Kathleen E. McLaughlin, Chinese Government Announces Auto Industry Aid Under Stimulus, 26 International Trade Reporter (BNA) 99 (22 January 2009).
face of protectionist pressures and the systemic reform for partnership and shareholding in world trading system.

B. The Broad Context

As intimated above, the Auto Parts case ought not to be viewed narrowly as a one-off technical legal event. Rather, it ought to be seen in a broad context. Development is the underlying narrative in the story of China’s first defeat in the WTO. A common feature of developing countries (and, a fortiori, least developed countries) is their lack of legal capacity to participate fully and effectively in the international trade arena. As the world’s largest developing country, China is a land of pockets of garish wealth and stunning skylines amidst a desert of mild to extreme poverty and life-threatening pollution. Its legal capacity in international trade is a microcosm of this macrocosm.

There exists a small, growing cadre of brilliant trade lawyers, typically educated outside China and now working in Beijing and Shanghai. The vast majority of lawyers, and worryingly, judges, have precious little appreciation for the policies, much less intricacies, of the GATT–WTO regime. Thus, the Auto Parts dispute provides the first case study in the development of China’s legal capacity to bring and defend claims on the world stage. Why did China not settle the case, after it failed to give a convincing justification for its controversial measures? Why did it press on with an appeal, after the widely-reported preliminary and final panel rulings clearly condemned its controversial trade measures? How did China argue the case, given that it was aware of the strong

\[12\] See Daniel Pruzin, *WTO Talks with China on Auto Parts Dispute Ends with No Sign of Resolution*, 23 International Trade Reporter (BNA) 762 (18 May 2006). In the Auto Parts case, China’s cut on auto tariffs to 10 percent (from a range with a high point of 16.4 percent), and its cut on autos to 25 percent (from 28 percent) effective 1 July 2006, seemed a clumsy effort to solve the case that failed to address the underlying claims of discriminatory treatment, and in any event were necessary for China to fulfill its WTO accession commitments. See Kathleen E. McLaughlin & Christopher S. Rugaber, *China to Reduce Import Tariffs on Autos, Some Parts Effective July 1*, 23 International Trade Reporter (BNA) 947 (22 June 2006); *China to Cut Car Import Duties*, FINANCIAL TIMES, 16 June 2006, at 5; Daniel Pruzin & Christopher S. Rugaber, *U.S., EU Initiate WTO Dispute Complaints Against Chinese Restrictions on Auto Parts*, 23 International Trade Reporter (BNA) 530-531 (6 April 2006).

China also blocked the first request for the establishment of a panel in the Auto Parts case, did not accept the slate of panelists (requiring WTO Director-General Pascal Lamy to appoint them), and reacted angrily to the eventual formation of a panel, all signs, perhaps, which adduce a pugnacious approach, in contrast to the semi-conductor case. See Daniel Pruzin, *U.S., EU, Canada Ask Lamy to Appoint Panel Members in China Auto Parts Case*, 24 International Trade Reporter (BNA) 134 (25 January 2007); Kathleen E. McLaughlin, *China Ministry Complains About WTO Case on Auto Part Tariffs, Cites Shrinking Duties*, 23 International Trade Reporter (BNA) 1566-1567 (2 November 2006); Daniel Pruzin, *U.S., EU, Canada to Renew Requests at WTO for Panels to Rule on China Car Parts Tariffs*, 23 International Trade Reporter (BNA) 1507 (19 October 2006); Daniel Pruzin, *China Blocks U.S., EU, Canadian Requests for WTO Panel Review of Auto Parts Tariffs*, 23 International Trade Reporter (BNA) 1436-1437 (5 October 2006).

claims against it since 2004? Why were China’s arguments largely unpersuasive? What legal lessons are there for China as it develops in the area of international trade adjudication? These and related topics will be asked and debated for generations to come, and rightly so, if China aspires to develop its trade law capacity. Assuming China indeed has this aspiration, it might also be queried why (despite the requests of the complainants) China refused to allow public access to the WTO proceedings? 

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

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

\[T\]he WTO decision also draws attention to China’s increasingly fractious trade relationships, which are the source of a growing number of anti-dumping actions. Most importantly, it shows China’s potential vulnerability before the WTO.

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

A related matter is the role exports play in Chinese economic growth, which, in two words is ‘huge’ and ‘unsustainable’. As even China’s Premier, Wen Jiabao, has admitted, it is ‘unstable, unbalanced, uncoordinated, and unsustainable’ for China to continue to rely on exports, rather than domestic consumption, as the dominant

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

component of its growth in Gross Domestic Product (GDP).\textsuperscript{17} In the United States, personal consumption was 67 percent of GDP for the last quarter of the 20\textsuperscript{th} century, and 72 percent between 2000 and 2008. In China, domestic consumption has fallen from 45 percent of GDP in the mid-1990s to 35 percent of GDP in 2009. China must increase its wage levels, so that its citizens have more disposal income to spend.\textsuperscript{18} But, how can China boost wage levels without damaging its international competitive advantage by driving up its own labor costs? Even if wage levels rise, why would average Chinese citizens spend on consumer items when they must save for their and their children’s education and health care, and for their pensions, as the state no longer provides a comprehensive safety net? Amidst these challenges, how can China continue to privatize state owned enterprises (SOEs), end export subsidies, allow its currency to float freely in foreign exchange markets, and open major sectors – like autos and auto parts – to free trade? Protectionism always is an option, however imprudent it may be.

Furthermore, although the circumstances have fundamentally changed following China’s accession to the WTO, China could not catch up with the changed circumstances under which industry policy decisions are instantly internationalized. Given the strong resistance by domestic automakers to liberalization in the aftermath of accession, and the lack of genuine competitiveness in the Chinese automotive sector, protectionism for its infant industry occasionally is the politically correct answer favored by the CCP to help maintain the traditional system based on CCP control over the industries. With the Auto Parts dispute, China faces a Herculean task of dealing with repercussions of such decisions.

In sum, the historic Auto Parts case is a multi-layered story in an environment of colossal challenges for China and the world. The case is about the development of legal capacity in the one developing country about which every other country cares. It is about a sector on which the fortunes of tens of millions of Chinese and foreigners ride. It is about the structure of the Chinese economic policies and the role the Chinese Communist Party (CCP) plays in directing domestic and foreign factors of production.

\textsuperscript{17} Quoted in David Pilling, \textit{China Should Raise Wages to Stimulate Demand}, \textsc{Financial Times}, 5 February 2009, at 9. The statistics in this paragraph are taken from this source. \textsuperscript{18} Wages in China account for 40 percent of GDP, whereas in the Group of Seven (G-7) industrialized nations the comparable figure is 52 percent.
2. China’s 2004 Automobile Policy

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


(2) Decree 125 – *Administrative Rules on Importation of Automobile Parts Characterized as Complete Vehicles*, Decree Number 125 of the People’s Republic of China, effective 1 April 2005.


Policy Order 8 establishes the legal basis for Decree 125 and Announcement 4. Under that Order, the Customs General Administration (CGA) works with other relevant Chinese governmental departments (such as the Ministries of Commerce and Finance, the National Development and Reform Commission (NDRC), and the Verification Centre) to

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20 Among the Chinese auto component makers are Weichai Power Co. Ltd. and Changchun FAW – Sihuan Automobile Co. Ltd. Some American component makers, like Delphi Corp. and Visteon Corp., also produce parts in China. Without doubt, exporters of autos and auto parts in the complainant countries are affected by the Appellate Body decision discussed herein, and insofar as car manufacturers in China import some components, rather than purchase from domestic suppliers, these firms are also among the ones potentially affected. See Jonathan Lynn, *UPDATE 2 – China Loses WTO Appeal in Car Parts Dispute*, REUTERS, 15 December 2008, posted at [www.reuters.com](http://www.reuters.com).

To be sure, several foreign car manufacturers (e.g., Honda, General Motors, Toyota, and Volkswagen AG) are wont to rely on components produced in China (and they account for 80 percent or more of the value of the models the foreign firms build in China), because the local parts are cheaper than imports (and the quality of local parts has improved), notwithstanding the added tariff cost associated with imports. In other words, these companies do not all complain about high Chinese tariffs, which leads to the inference that the Auto Parts dispute is perhaps more political than economic in nature. See *UPDATE 1 – China Commerce Ministry Regrets WTO Car Parts Ruling*, REUTERS, 16 December 2008, posted at [www.reuters.com](http://www.reuters.com); Richard McGregor & Geoff Dyer, *Trade Friction Puts Heat on China*, FINANCIAL TIMES, 1-2 April 2006, at 4.
promulgate specific rules about the imports of autos and auto parts. Decree 125
implemented those rules. Essentially, the rules deal with the supervision and
administration of parts that are imported and subsequently assembled into certain models
of cars. The rules also set the criteria to characterize whether imported auto parts should be
treated as a complete vehicle. Announcement 4 gives further details on the procedures
and criteria set out in Announcement 4.

Taken together, the measures may be referred to as ‘China’s 2004 Automobile
Policy’. Briefly stated, the Policy imposes a 25 percent charge on imported auto parts
used in the manufacture or assembly of certain models of motor vehicles in China, and
sold in the Chinese domestic market. But, the imposition occurs only if those imported
parts are characterized as – or, stated differently, if they have the essential character of –
a completed vehicle based on criteria prescribed in the Policy. Further, the charge is
levied only after the parts are imported and assembled in China into a finished vehicle.
The criteria are expressed in terms of particular combinations or configurations of
imported auto parts or the value of imported parts used in the production of a particular
vehicle model as follows:

(1) Volume threshold –
Employing certain key imported major parts (i.e., assemblies), or a
designated combination of imported major parts, to make a vehicle, which
effectively summed to 60 percent or more of the content of the vehicle.²²

(2) Value threshold –
Employing imported parts in a vehicle that account for 60 percent or more
of the total price of that vehicle.²³

If the imported parts used in a particular vehicle meet or exceed the relevant threshold,
then all of the imported parts used to assemble that model of vehicle are characterized as
complete vehicles. This requirement means that in effect, China rolls up all imported
parts together, and presumes irrefutably the imported parts impart the essential character
of a completed vehicle. In turn, all imported parts used for the vehicle model are subject
to the 25 percent charge.²⁴ China imposes the charge following the assembly of the
vehicles.

The 25 percent figure is no accident. It equals the average applied and bound
tariff rate China lists as in its Schedule of Concessions as applicable to complete motor
vehicles.²⁵ The 25 percent most-favoured nation (MFN) duty rate is higher than the
average rate of 10 percent at which China has bound its duty and applies to auto parts. As
for imported auto parts that China does not characterize as complete vehicles, they are

²² See Daniel Pruzin & Christopher S. Rugaber, U.S., EU Initiate WTO Dispute Complaints Against Chinese Restrictions on Auto Parts, 23 International Trade Reporter (BNA) 530-531 (6 April 2006).
²³ See China Auto Parts Appellate Body Report, ¶ 114.
²⁴ See China Auto Parts Appellate Body Report, ¶ 121.
²⁵ This document is Schedule CLII – People’s Republic of China (Part I – Schedule of Concessions and Commitments on Goods), attached as Annex 8 to China’s Accession Protocol, WT/ACC/CHN/49/Add.1.
subject to an average of 10 percent duty rate in China’s Schedule for parts. Manifestly, China’s 2004 Automobile Policy was an effort (inter alia) “to discourage foreign car makers from importing vehicles in large parts to circumvent the higher tariff.”

China also applies the 25 percent charge – i.e., the tariff for a complete vehicle – on a CKD and SKD kit. These kits are a sub-set of all the products covered by China’s 2004 Automobile Policy. Yet, its Policy does not provide any definition of a ‘CKD’ or ‘SKD’ kit. Filling this definitional void, the Panel stated it considered these kits to refer to all, or nearly all, of the auto parts necessary to assemble a complete vehicle, which must be packaged and shipped in a single shipment, and following importation, which must go through a process of assembly to become a completed vehicle. The distinction between the two kits concerns assembly. A CKD kit contains auto parts imported together in an unassembled state. Subsequently, the parts are assembled to make a complete vehicle. An SKD kit also has auto parts imported together. But, some of the components in an SKD kit have been assembled prior to importation.

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

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

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

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26 UPDATE 1 – China Commerce Ministry Regrets WTO Car Parts Ruling, REUTERS, 16 December 2008, posted at www.reuters.com. See also Daniel Pruzin, China Outlines Defense in WTO Dispute Over Auto Parts Tariffs, 24 International Trade Reporter (BNA) 621 (3 May 2007) (summarizing China’s argument about the prevention of circumvention by treating dissembled auto parts that have the essential character of a car as a complete vehicle, and thereby subjecting the shipment to the 25 percent vehicle tariff, not the 10 percent parts tariff).
29 This category is the one to which the average applied Chinese tariff is 25 percent. There are variations at the HS 8 digit level, but the 25 percent figure is the average.
30 This and the fourth categories are the ones for which China has an average applied tariff rate of 10 percent.
of the parts used in the production process. Accordingly, the Policy penalizes a manufacturer of vehicles in China for using imported auto parts in a vehicle destined for sale in China. Conversely, it gives producers an advantage if they use domestically-made parts.

In sum, under the 2004 Automobile Policy, China bound its tariff on auto parts at most-favoured nation (MFN) rates considerably lower than its tariff bindings for complete vehicles – 10 versus 25 percent. Yet, if an imported part is incorporated into a vehicle made and sold in China, and that vehicle contains imported parts in excess of a government-defined threshold, then the tariff imposed on the part is at the higher level, i.e., that of a finished vehicle. In effect, China bumped up the tariff on the imported part to the level of a finished good.

Note, then, China’s Schedule displays tariff escalation – the bound tariff rates are higher for complete motor vehicles than for components. The typical purpose of tariff escalation is to encourage the location of high value-added economic activity within the territory of the importing country. Further, the bump up is a way China discourages vehicle producers located in that country from using too many imported parts, and encourages them to source their inputs from suppliers in China. That is because China’s 2004 Automobile Policy specifies domestic content thresholds (using value or volume metrics).

The 2004 Automobile Policy also biases the pattern of foreign direct investment (FDI) into China, raising concerns among the complainants that they ran afoul of the WTO Agreement on Trade-Related Investment Measures (TRIMs). The Policy confers an advantage on enterprises that use in the production of vehicles domestic rather than imported parts. This advantage may induce firms to establish parts manufacturing operations in China. By locating their plants in China, rather than exporting auto parts from outside China, they avoid imposition on the parts of the full vehicle duty rate.
3. **China’s Defeat at the Panel Stage**\(^{31}\)

In the first decision by any WTO adjudicatory body against China,\(^{32}\) the *Auto Parts* Panel rendered a strong verdict against China’s Automobile Policy on the most potent arguments of the complainants. In particular:\(^{33}\)

- **National Treatment (Fiscal Measures) Violation** –

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

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

  The complainants argued that by maintaining China’s 2007 Automobile Policy, China violated GATT Article III:4, because it treated imported auto parts less favourably than like domestic auto parts. The less favourable treatment arose because the administrative procedures imposed on any auto manufacturer using imported auto parts in excess of the thresholds, as well as the criteria set out in the measures, combined with the assessment of the charge (which is based on the final assembly internally), create an incentive for auto manufacturers to use domestic auto parts instead of imported auto parts. China’s response again was that the 25 percent levy was an OCD under Article II:1(b) (first sentence), not an internal measure governed by Article III:4. The Panel agreed with the complainants.

- **Alternative Tariff Bindings Violation** –

  As an alternative contention, the complainants said China breached GATT Article II:1(a)-(b). The charge on imported auto parts imposed under

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\(^{31}\) This discussion is drawn from *China Auto Parts* Appellate Body Report ¶¶ 1-13, 108-126; World Trade Organization, *Update of WTO Dispute Settlement Cases*, WT/DS/OV/33 (3 June 2008), at 54-56.

\(^{32}\) The first WTO complaint brought against China was by the United States, which contended China taxed imported semi-conductors in a discriminatory fashion. (*China-Value-Added Tax on Integrated Circuits*, WT/DS309, request for consultations made on 18 March 2004). China settled that action by agreeing to end the discriminatory treatment. See Daniel Pruzin, *WTO Talks with China on Auto Parts Dispute Ends with No Sign of Resolution*, 23 International Trade Reporter (BNA) 762 (18 May 2006).

\(^{33}\) See *China Auto Parts* Appellate Body Report, ¶¶ 3-5, 7, 128-133, 183-184, 187.
China’s 2004 Automobile Policy – if considered an OCD – exceeded the bound tariff rates set out in China’s Schedule of Concessions. That Schedule is annexed to its Protocol of Accession; hence there was a violation of it. China countered that the Policy did not run afoul of Article II, but rather gave effect to the proper interpretation of the term ‘motor vehicles’ in its Schedule. In examining this alternative claim, the Panel found that under its policy, China imposed duties in excess of the relevant tariff bindings in China’s Schedule, which were incongruous with GATT Article II:1(a)-(b).

*Special Finding on Auto Kits –*

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

Certain members of the Working Party expressed particular concerns about tariff treatment in the auto sector. In response to questions about the tariff treatment for kits for motor vehicles, the representative of China confirmed that China had no tariff lines for completely knocked-down kits for motor vehicles or semi-knocked down kits for motor vehicles. *If China created such tariff lines, the tariff rates would be no more than 10 per cent.* The Working Party took note of this commitment.

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

*Failure of the Administrative Necessity Defense –*

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34 This specific conclusion was not appealed. The application of GRI 2(a), discussed *infra*, to the term ‘motor vehicles’ in China’s Schedule of Concessions, provided China with the legal basis for its classification of the kits.

35 *Quoted in China Auto Parts* Appellate Body Report, ¶ 212 (emphasis added).

36 See *China Auto Parts* Panel Report, paras 5.36-5.40.
The complainants urged that the violation of Article III:4, or in the alternative Article II:1(a)-(b), could not be excused under the administrative necessity exception of Article XX(d), which China had invoked. China invoked this exception because it said 2004 Automobile Policy ensures ‘substance over form’ in its administration of customs law. That is because the Policy allows Chinese customs officials to classify as a complete motor vehicle groups of auto parts that have the essential character of a complete vehicle, regardless of how an importer structures importation of the parts. In other words, the Policy prevents the circumvention of China’s tariff headings for complete motor vehicles. (This argument, of course, is about substantial completeness, a problem dealt with in United States customs law by the five-factor Daisy Heddon Test in United States customs law, and under World Customs Organization (WCO) standards by the General Rule of Interpretation (GRI) 2(a), known as the ‘Doctrine of the Entireties’. China’s point was that it properly applied GRI 2(a) by treating a dissembled set of parts that has the essential character of a car – i.e., is a substantially complete car – as a complete vehicle. Indeed, if it did not do so, said China, then importers would be able to circumvent its 25 percent MFN tariff on cars.) However, the Panel rejected China’s argument about tariff circumvention, partially because it disregards the economic reality of the automotive industry according to which many parts can be used interchangeably among different car models, allowing manufacturers to realize economies of scale by making families of vehicle models that share platforms and components, and for which 60-70 percent of parts are common to the models. In these circumstances, identifying a specific vehicle model into which certain auto parts will be incorporated would prove unnecessarily trade restrictive. The Panel agreed China failed to prove that its violations of its GATT obligations satisfied the two-step test under the Article XX(d) exception.

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

39 Ibid., paras 7.368, 7.276, 7.635.
4. The Unsuccessful Appeal

A. Issues and Holdings

Not surprisingly, but perhaps not wisely, China appealed the verdicts of the Panel. For the Appellate Body the key issues were as follows:

- **Internal Charge or OCD?**

  Is the 25 percent charge an internal charge under GATT Article III:2 (first sentence), rather than an OCD under Article II:1(b) (first sentence)? China argued the Panel erred in ruling this charge is properly characterized as an `internal charge` subject to the national treatment rule, rather than an OCD governed by the tariff binding rule. Briefly, the Appellate Body upheld the Panel finding, i.e., the Appellate Body agreed the charge is an `internal charge` under Article III:2 (first sentence), not an OCD under Article II:1(b) (first sentence).

- **National Treatment (Fiscal Measures) Violation?**

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

- **National Treatment (Non-Fiscal Measures) Violation?**

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

41 *China Auto Parts Appellate Body Report*, ¶ 108.

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


44 See *China Auto Parts Appellate Body Report*, ¶ 108(b)(i).
Is the 2004 Automobile Policy through which China imposes the 25 percent charge illegal under GATT Article III:4? China claimed the Panel was mistaken in finding its Policy treated imported auto parts less favourably than like domestic merchandise. The Appellate Body upheld the Panel’s ruling that the Policy accords less favourable treatment to imported parts than to like domestic parts in violation of Article III:4.

- **Tariff Bindings Violation?**

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

- **Accession Commitment Violation?**

Is the 2004 Automobile Policy inconsistent with the conditional commitment China made in Paragraph 93 of its Accession Working Party Report not to apply a tariff rate above 10 percent to imports of CKD and SKD kits? In specific, did the Panel err in construing the Policy as imposing a charge on CKD and SKD kits, and was it mistaken to rule that China did not meet its Paragraph 93 commitment? This holding rested on two other findings, namely, the Policy (1) was deemed to have created tariff lines for CKD and SKD kits, and (2) established separate tariff lines at the HS-10 digit level for these kits. Accordingly, these findings were at issue on appeal. Briefly, the Appellate Body sided with China, holding that the Policy did not impose a charge on CKD and SKD kits, and the

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47 See China Auto Parts Appellate Body Report, ¶ 108(c).
49 The complainants did not appeal the finding of the Panel that China acted consistently with GATT Article II:1(b) in classifying the kits as a complete motor vehicle and imposing a 25 percent charge on them. See China Auto Parts Appellate Body Report, ¶ 211.
measures at issue were not inconsistent with the Chinese accession commitment with respect to the kits.\textsuperscript{50}

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

China did not appeal the finding of the Panel that its 2004 Automobile Policy failed to qualify for administrative necessity under GATT Article XX(d).\textsuperscript{51} That decision is mildly puzzling. With the gamble China took on its argument-in-chief, it raised the stakes on itself when it remove its only viable fallback position, namely, the administrative necessity defense.

\textsuperscript{50} See China Auto Parts Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS340/AB/R (United States), ¶ 253(e); China Auto Parts Appellate Body Report, Findings and Conclusions in the Appellate Body Report WT/DS342/AB/R (Canada), ¶ 253(e).

\textsuperscript{51} See China Auto Parts Appellate Body Report, ¶ 198 fn. 282.
B. The Key Threshold Question\textsuperscript{52}

A trade measure cannot simultaneously qualify as an ‘internal charge’ under GATT Article III and an ‘OCD’ under Article II. The measure either is imposed after the border (i.e., post-entry), in which case it is in the first category and governed by the national treatment rules, or it is imposed at the border (i.e., pre-entry), in which case it is in the second category and governed by the tariff binding rules. Put simply, a measure is either an internal tax, or a tariff, but not both. Even China accepted this elementary distinction.\textsuperscript{53}

Thus, logically, the Appellate Body started with the question of what the 25 percent charge is, and thereby what rules of GATT govern it. Indeed, it spent considerable time and effort doing so. Why did the Appellate Body agree with the Panel, and hold that the 25 percent charge is best characterized as a ‘internal charge’ under GATT Article III:2 (first sentence)\textsuperscript{54}

The answer, in brief, is the Panel performed its task of defining and delineating carefully. Following the dictates on treaty interpretation in Articles 31-32 of the \textit{Vienna Convention on the Law of Treaties}, the Panel looked to the ordinary meaning of the terms ‘internal charge’ and ‘OCD’. It also looked to the context in which each term is situated. For ‘internal charge’, that context is the phrase ‘imported into the territory’ in Article III:2 (first sentence), and the Interpretative Note, \textit{Ad Article III, Paragraph 2} (also called the ‘Ad Note’). For ‘OCD’, the context was the phrase ‘on their importation’ in the first sentence of Article II:1(b), and the phrase ‘on or in connection with the importation’ in the second sentence of Article II:1(b).

On these bases, in respect of ‘OCD’, the Panel concluded logically as follows:

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

In contrast to ordinary customs duties, the obligation to pay internal charges does not accrue because of the importation of the product at the very moment it enters the territory of

\textsuperscript{52} This discussion is drawn from \textit{China Auto Parts} Appellate Body Report, ¶¶ 127-182.

\textsuperscript{53} See \textit{China Auto Parts} Appellate Body Report, ¶ 184.

\textsuperscript{54} See \textit{China Auto Parts} Appellate Body Report, ¶¶ 181-182.
another Member but because of the internal factors (e.g., because the product was re-sold internally or because the product was used internally), which occurs once the product has been imported into the territory of another member. The status of the imported good, which does not necessarily correspond to its status at the moment of importation, seems to be the relevant basis to assess this internal charge. (original emphasis)

Succinctly put, said 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.

According to the Panel’s view, 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’.

The work of the Panel serves as an excellent tutorial – for China and indeed all WTO Members – on the different scope of application between the tariff binding and national treatment obligations in GATT, and it is no surprise that the Appellate Body endorsed the analytical approach. The boundaries between these obligations must be respected, if their distinct objects and purposes are to be served. Binding tariffs under Article II preserve the value of negotiated reductions in duties. Non-discriminatory treatment, with respect to both internal taxes and regulatory measures, under Article III is essential to avoid the devilish protectionist temptation to favour like domestic products over imported merchandise. Together, the distinct disciplines promote the objective of the Agreement Establishing the World Trade Organization (WTO Agreement), namely, promote the security and predictability of reciprocal, mutually advantageous trade-liberalizing arrangements.

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57 China Auto Parts Appellate Body Report ¶¶ 161-163 (citations omitted, emphases original).
58 See China Auto Parts Appellate Body Report, ¶ 130 fn. 190.
59 Ibid.
C. China’s Three Unsuccessful Claims of Panel Error

In its appellant’s submission, China pointed out that the General Rules of Interpretation (GRI) of the Harmonized System allow national customs authorities to classify unassembled parts and components as the complete article, even though the assembly of the parts into the complete article necessarily occurs after the parts enter the customs territory of the importing country. To give a full effect to the right of WTO member under this GRI rule, the 25 percent levy by China needs to be characterized as customs duties.

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

Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished, provided that, as presented, the incomplete or unfinished article has the essential character of the complete or finished article. It shall also be taken to include a reference to that article complete or finished (or falling to be classified as complete or finished by virtue of this Rule), presented unassembled or disassembled.\textsuperscript{60}

China asserted this Rule enables customs authorities to classify unassembled auto parts as a complete motor vehicle, even in the situation in which the parts arrive in multiple shipments and the parts are assembled after importation.\textsuperscript{61} As for the text of Article II:1(b) (first sentence), China said it requires customs authorities to determine what the ‘product’ in question is, and then – following HS Rules – classify the product and apply the correct OCD to it.

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

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

\textsuperscript{60} Quoted in China Auto Parts Appellate Body Report, ¶ 134 fn. 197.

\textsuperscript{61} See China Auto Parts Appellate Body Report, ¶¶ 134-135.
Third, said China, the Panel erroneously dubbed the 25 percent charge an ‘internal charge’ under GATT Article III:2 (first sentence). China insisted that the fact that auto parts are assembled into a completed vehicle after importation does not mean the 25 percent charge is governed by that provision. In other words, China faulted the Panel for making too much of the time and place of assembly – after importation, post-border. All three claims of Panel error were related, and to some degree China’s style of argumentation – as recounted by the Appellate Body – lacks the clarity and precision expected of a sophisticated presentation (as discussed below).

1. Wrongful Separation of Issues

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

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

… ‘fundamental structure and logic’ of a covered agreement may require panels to determine whether a measure falls within the scope of a particular provision or covered agreement before proceeding to assess the consistency of the measure with the substantive obligations imposed under that provision or covered agreement. We consider this to be just such a case, particularly in the light of the Panel’s observation – with which China expressly agrees – that ‘a charge cannot be at the same time an ‘ordinary customs duty’ under Article II:1(b) of the GATT 1994 and an ‘internal tax or other internal charge’ under Article III:2 of the GATT’. If, as the Panel considered, the charge imposed on automobile manufacturers could fall within the scope of either the first sentence of Article II:1(b) or Article III:2, then the Panel had to begin its analysis by ascertaining which of these provisions applied in the circumstances of this dispute. (original emphasis; footnotes omitted).

In sum, the Appellate Body approved of the sequential methodology of the Panel to treat the threshold issue of ‘what GATT rule applies?’ before considering ‘did the 25 percent charge violate the rule?’

2. Using the GRI as Context to Interpret GATT

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63 China Auto Parts Appellate Body Report, ¶ 136.
64 China Auto Parts Appellate Body Report, ¶ 139 (emphasis original).
As to the second error that China contended the Panel made, here, too, the Appellate Body looked approvingly at the work of the Panel, and quoted generously from it. There is a strict, precise temporal element to Article II:1(b) (first sentence). That is clear from the terms surrounding ‘OCD’ that indicate an ‘OCD’ is imposed on ‘products, on their importation’. If a charge does not accrue at the moment of importation, it is not an OCD. China cited an Appellate Body precedent, *EC – Chicken Cuts*, in which the Appellate Body agreed it is permissible to examine the HS as context for interpretation of a GATT–WTO text, even though the HS is not technically part of the accords annexed to the *WTO Agreement* (i.e., it is not a covered agreement).

However, the Appellate Body observed China made too much of this precedent. It relates to the use of the HS only to interpret a term in a Schedule of Concessions, not a term in a GATT–WTO rule. As to the latter question of interpreting a term in a GATT-WTO rule, the Appellate Body looked to the direction of Article 31(2) of the *Vienna Convention*, which states that ‘context’ must be relevant to the interpretative question of treaty texts.

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

The essence of China’s appellate argument was that China correctly classified the ‘product’ – a completed vehicle – under *GRI* 2(a), thus its 25 percent charge must be an ‘OCD’ under Article II:1(b) (first sentence). But, ‘must be’ and ‘is’ are not the same. It is specious to conflate tariff classification under HS Rules, and the related matter of respect for tariff bindings under Article II:1(b) (first sentence), with the characterization of a charge as an ‘OCD’ under that Article. Just because classification is done properly (a completed vehicle despite dissembled parts), and a charge imposed (25 percent), does not make that charge an OCD. As for the HS Rules, they are context most relevant to product classification, but they are not context that supersedes the language of GATT.

To this finding and rationale the Appellate Body added a consequent justification, one suggested by the Panel. Suppose China’s argument were accepted: a 25 percent charge imposed on auto parts following, and as a result of, their assembly into a completed vehicle, constitutes an OCD. The consequence would be that whether any charge is an OCD would depend on circumstances that transpire after the border, rather than solely on the moment of (and by virtue of) importation. The distinction between border and post-border would collapse, because what happens after importation would affect characterization of a charge at the border. Stated differently, the scope of ‘OCD’

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65 See *China Auto Parts* Appellate Body Report, ¶ 153 (quoting GATT Article II:1(b)).
67 See *China Auto Parts* Appellate Body Report, ¶ 146.
68 See *China Auto Parts* Appellate Body Report, ¶ 150.
69 See *China Auto Parts* Appellate Body Report, ¶ 165.
and Article II:1(b) (first sentence) would expand, but the scope of ‘internal charges’ and Article III:2 (first sentence) would contract. The latter consequence would enervate the highly important national treatment discipline, and upset the balanced structure so carefully arranged by the GATT drafters and elaborated on through GATT and WTO adjudication.

3. Not Really an Internal Charge

Obviously, with the Appellate Body upholding the decision of the Panel that China’s 25 percent levy was not an ‘OCD’ under GATT Article II:1(b) (first sentence), the proper categorization was an ‘internal charge’ under Article III:2 (first sentence). That categorization – said China – was the third error made by the Panel. The Panel rightly scrutinized all relevant characteristics of the 25 percent charge, particularly its design and operation. That scrutiny enabled the Panel to identify the ‘center of gravity’ of the charge based on its ‘core’ or ‘leading’ features, an essential task because some aspects may point to a conclusion that this charge is an ‘OCD’, while others suggest it is an ‘internal charge’. The Panel also correctly examined the circumstances under which China imposed the 25 percent charge. With these observations, the Appellate Body did not agree with China, and found no fault with the work of the Panel:

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

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

174. That the declaration made at the time of importation does not control or necessarily affect whether the charge under the measures will ultimately be applied to specific imported parts is illustrated most prominently in the scenario where an automobile manufacturer does not import parts directly, but instead purchases them from an independent third party supplier within China. In such circumstances, the third party supplier imports and declares those auto parts at the border and pays a 10 per cent duty. Yet those same parts may subsequently be subject to the 25 per cent charge – imposed after assembly – if they are sold to an automobile manufacturer and assembled into a vehicle model that meets the thresholds set out in the measures at issue. 70

Even a quick read of these characteristics indicates the facts weighed heavily against China’s argument of Panel error. Were there any countervailing facts supporting the proposition the 25 percent charge was an ‘OCD’?

Indeed, there were four characteristics China stressed:

(i) the measures at issue use language typically reserved for references to ‘ordinary customs duties’; (ii) China’s explanation of the policy purpose of the measures, and that the charge imposed thereunder ‘objectively relate[s] to the administration and enforcement of China’s tariff provisions for motor vehicles’; (iii) China’s view that parts imported directly by an automobile manufacturer remain subject to customs control until after assembly/production of the relevant vehicle model; and (iv) the measures at issue and the charge imposed thereunder are administered primarily by China’s customs authorities. 71

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

The first feature is a matter of labeling by China. A WTO Member can manipulate rubrics to suit its ends, but the job of a panel or the Appellate Body is to see through formalistic labels and look to underlying substantive reality. That is clear from

70 China Auto Parts Appellate Body Report, ¶¶ 172-176.
71 China Auto Parts Appellate Body Report, ¶ 177.
Appellate Body precedent in *Softwood Lumber IV*. The second feature is China’s perspective. Legislative intent is difficult to discern, especially by external adjudicators, and is not conclusive. That is apparent from the Appellate Body decision in the *Byrd Amendment* case. The third feature actually cuts against China’s argument. Imported auto parts are not physically confined or otherwise restricted by customs authorities, and can be used freely in China’s internal market. That is, importation of these parts under the financial guarantee of a bond hardly amounts to ‘ongoing customs control’. The fourth feature is a matter of China’s internal administrative edifice. Decisive weight about interpreting a provision of GATT cannot be given to a point, like governmental structure, which is wholly under the control of a WTO Member. That is manifest in the 1990 *EEC – Parts and Components* GATT Panel Report. The fourth feature cited by China also is not the whole truth. Other organs of the CCP – the Ministries of Commerce and Finance, and the NDRC, and the Verification Centre – have official roles in the administration of the 25 percent charge.

5. **What China Got Wrong**

**A. National Treatment**

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

There is, of course, a second national treatment obligation. GATT Article III:4 covers all non-fiscal measures. The United States, Canada, and EC all successfully persuaded the Panel that the China’s 2004 Automobile Policy was an internal one within the ambit of this obligation, and was incongruous with it. That success carried through to the Appellate Body. The focus of this debate was on the regulatory requirements in the

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74 The key relevant parts of the decision are ¶¶ 5.6-5.7, and the case is cited supra.

75 See *China Auto Parts* Appellate Body Report, ¶¶ 183-186.

76 As explained below, the Article III:2 finding of the Appellate Body, like that of the Panel, excluded the imposition of the 25 percent charge on CKD and SKD kits. See *China Auto Parts* Appellate Body Report, ¶ 186 fn. 259.
Policy that require all vehicle manufacturers in China to register, and provide a listing and detailed records to Chinese customs authorities if they use imported auto parts.

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

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

Unfortunately for China, it again misunderstood or obfuscated what the Panel had ruled. The difference in bound rates for auto parts and completed vehicles in China’s Schedule was not the discrimination concerning internal use of imported parts on which the Panel relied to find a violation of GATT Article III:4. Rather, the Panel looked to the measures at issue, especially the incentives created for car manufacturers by the volume thresholds (i.e., the use of designated assemblies or combinations of assemblies) and value thresholds (i.e., the 60 percent test). Those thresholds determine whether China characterizes imported auto parts as complete vehicles. For an automobile manufacturer to avoid the 25 percent charge for a completed vehicle (and instead qualify for a 10 percent duty on parts), it must ensure the imported parts it uses to assemble a vehicle model are below the thresholds. Moreover, if a manufacturer exceeds the thresholds, then the 25 percent charge applies to all imported parts it uses in the vehicle model in question. Further, if a manufacturer exceeds the thresholds, then it is subject to tracking and reporting requirements, and attendant delays, concerning auto parts imported in multiple shipments.

Quite obviously, these realities are incentives for a manufacturer to limit its use of imported relative to domestic parts, and they ‘affect the conditions of competition for imported auto parts on the Chinese internal market’. The Panel was on solid ground,

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77 See China Auto Parts Appellate Body Report, ¶ 189.
78 See China Auto Parts Appellate Body Report, ¶¶ 190-197.
79 See China Auto Parts Appellate Body Report, ¶ 192.
80 See China Auto Parts Appellate Body Report, ¶ 195 (emphasis added).
citing the *U.S. – FSC*[^81] (*Article 21:5 – EC*) decision of the Appellate Body, which explained that an incentive for a manufacturer not to use imported inputs affects the internal use of imported products, and thus violates Article III:4. That decision, plus longstanding jurisprudence under this Article, emphasizes the importance of not tilting the competitive playing field against foreign vis-à-vis like domestic products.

**B. The Alternative**

The United States, Canada, and EC convinced the Panel to reach an alternative finding, namely, if the 25 percent charge were an ‘OCD’, then China violated GATT Article II:1(a)-(b) by exceeding the bound rates for auto parts in its Schedule of Concessions.[^82] Why did the Panel agreed to embark on the alternative analysis in the first place? It looked out to the demands of the parties, and up to the Appellate Body. The complainants and China disagreed on whether the charge violated this Article, so an issue was joined. There was the specter (perhaps remote) that the Appellate Body might overturn its finding under Article III:2 (first sentence), as the line between and ‘OCD’ and an ‘internal charge’ is not always bright.^[83]

The Panel sided with the complainants, stating:

... the tariff provisions for motor vehicles (87.02-87.05) of China’s Schedule of Concessions do not include in their scope auto parts imported in multiple shipments based on their assembly into a motor vehicle. Accordingly, to the extent the measures could be considered as falling within the scope of Article II of the GATT 1994, China’s measures have the effect of imposing ordinary customs duties on imported auto parts in excess of the concessions contained in the tariff headings for auto parts under its Schedule, inconsistently with its obligations under Article II:1(a) and (b) of the GATT 1994.^[84]

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

China’s appeal raised serious systemic concerns, and the United States and EC expressly stated as much.^[85] These two complainants sought a complete examination by the Appellate Body of the alternative finding of the Panel, so as to leave no doubt about the inconsistency of China’s 25 percent charge under GATT Article II. China posited two

[^81]: *United States-Tax Treatment for ‘Foreign Sales Corporations’*, WT/DS108.
[^82]: See *China Auto Parts Appellate Body Report*, ¶ 198.
[^83]: See *China Auto Parts Appellate Body Report*, ¶ 198 fn. 283.
[^84]: *Quoted in China Auto Parts Appellate Body Report*, ¶ 199.
[^85]: See *China Auto Parts Appellate Body Report*, ¶¶ 204-208.
different scenarios. First, trotting out its old argument, China urged the Appellate Body to reverse the Panel, and hold the 25 percent charge is an ‘OCD’ under GATT Article II:1(b) (first sentence). If the Appellate Body does so, then it will see the charge is based on a valid classification of imported auto parts under GRI 2(a) as a completed vehicle – hence, the charge is not a duty that is in excess of China’s tariff binding. This scenario, of course, did not materialize. Second, on the assumption the Appellate Body upheld the conclusion of the Panel that the 25 percent charge was an internal one governed by Article III:2 (first sentence), China called upon the Appellate Body to declare the alternative finding of the Panel to be moot and of no legal effect. Seeing no reason to do so, the Appellate Body rejected that call. In sum, leaving the Panel’s alternative finding alone, the Appellate Body did the bidding of neither the complainants nor China.

6. Legal Development and More

A. Keeping an Accession Promise

Promises made by a country to get into the WTO are not political campaign promises. Rather, they have legal consequences. They create an obligation enforceable under GATT–WTO law, specifically through the Understanding on Rules and Procedures Governing the Settlement of Disputes. That is true for a pledge set out in the Working Party Report on the accession of that Member that is incorporated into the Protocol of Accession to the WTO. In China’s case, Paragraph 342 of the Working Party Report incorporates into China’s Accession Protocol China’s promises in that Report, including Paragraph 93 concerning the 10 percent tariff on CKS and SKD kits, and Article 1.2, Part I of the protocol reaffirms this incorporation.

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

First, China said the Panel was wrong to characterize its 2004 Automobile Policy as imposing a ‘charge’ or ‘duty’ on importers of CKS or SKD kits who declare and pay duties at the border. In fact, the Policy excludes the kits from both administrative procedures (e.g., declarations, bonding requirements, tracking, reporting, and verifications) and the 25 percent charge. True, the kits attract a 25 percent duty – but that is the MFN rate in China’s Schedule of Concessions for completed vehicles, not the 25 percent charge under the Policy. In brief, the Policy entirely excludes the kits, and the basis for imposing the duty is Chinese customs law. So, it was illogical for the Panel to say China’s Policy as applied to the kits violated its accession commitments.

86 See China Auto Parts Appellate Body Report, ¶¶ 203, 209.
89 See China Auto Parts Appellate Body Report, ¶ 216-245.
The Panel ruled that China misread or misunderstood its own Policy. The Panel examined carefully the relevant language in it (especially Articles 2(1)-(2) and 21 of Decree 125). An auto manufacturer importing a CKD or SKD kit has the option to exclude them from the administrative procedures attendant with the Policy, declare the kit at the border, and pay a 25 percent charge on the kit as a completed vehicle. A manufacturer exercising this option is not relieved from the obligation to pay the charge, but it is subject to the red-tape associated with paying the charge later, after assembling the vehicle at a post-border location. This option is why the Panel excluded CKD and SKD kits from its ruling under GATT Article III:2 (first sentence). If an importer chooses to declare and pay duties on a kit at the border, then the 25 percent charge it pays is a result of the operation of the Policy, not an internal charge subject to the national treatment rule. Additionally, held the Panel, the Chinese Policy created new tariff lines, at the HS 10-digit level, for CKD and SKD kits. The 25 percent charge on the kits is associated with those new lines.

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

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

The ‘bottom line’ was that China did not violate its Paragraph 93 accession commitment about a 10 percent cap on tariffs applied to SKD and CKD kits. The finding of the Panel that China broke its promise rested on an erroneous reading by the Panel that the 25 percent charge on imported kits arises under China’s 2004 Automobile Policy. It does not. China’s Policy is a seamless web. A declaration of a kit as a complete vehicle at the border exempts the declarer from both the administrative procedures and 25 percent charge arising under the Policy. The declaration subjects the kits to payment of a 25 percent duty under China’s Schedule. In effect, Paragraph 93 is irrelevant to such kits.

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90 See China Auto Parts Appellate Body Report, ¶¶ 235-245.
The charge on the kits is nothing more than an OCD – the MFN duty – governed by Article II:1(b) (first sentence). Here, China kept its promise.\textsuperscript{92}

**B. Applying the Golden Rule**

The drafters of GATT showed considerable foresight in making as a pillar of their document the national treatment principle. The advocates for inclusion of China in the WTO urged that by becoming a Member, the international rule of law would circumscribe China’s trade behavior. The GATT Golden Rule would be an international legal obligation incumbent on China to eschew viewing its domestically-produced merchandise better than foreign competitors.

The *Auto Parts* case was China’s first lesson via adverse litigation as to what the Golden Rule of trade means in practice as well as theory. No doubt an elite cadre of CCP trade professionals in Beijing knew the logic and details of GATT Article III even before China acceded to the WTO on 11 December 2005. No doubt, too, this cadre is slowly increasing as China develops, spreading beyond the roughly 63 million CCP members and Beijing to non-Party members and other major cities. But, even in a small country, let alone the most populous nation, appreciation for why national treatment matters is not (and probably never will be) universal. Moreover, even advanced developed countries make mistakes on national treatment. The loss the United States suffered in the *Section 337* case\textsuperscript{93} is just one example.

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

> It’s a classic example of discrimination. China maintains regulatory policies that impose discriminatory tariffs and encourage its automakers to use Chinese parts, at the expense of auto parts from the United States and other countries. These regulations discourage U.S. exports and create and incentive for auto parts makers to relocate to China.\textsuperscript{94}

Hence, it was a case China was nearly destined to lose. The answer to this question is ‘yes’ only if China secretly hoped to lose, and then use the Appellate Body Report to bludgeon recalcitrant hard-liners to change their ways and begin treating foreign auto imports fairly. To the reformists in China, the traditional system based on CCP governmental control mass-produced inefficiency and frequent debates on protectionism. A fundamental reform of the system was indispensable. Thus, the issue was not whether

\textsuperscript{92} The Appellate Body exercised judicial economy as to whether China’s 2004 Automobile Policy created new tariff lines, at the HS 10-digit level, for those kits, or could be deemed as having done so. See *China Auto Parts* Appellate Body Report, ¶ 252.

\textsuperscript{93} *United States-Section 337 of the Tariff Act of 1930 and Amendments thereto*, WT/DS186.

\textsuperscript{94} *Quoted in* Daniel Pruzin & Christopher S. Rugaber, *U.S., EU Initiate WTO Dispute Complaints Against Chinese Restrictions on Auto Parts*, 23 International Trade Reporter (BNA) 530-531 (6 April 2006)
such reform was necessary, but how to do it. Yet, domestic protectionist pressures, coupled with a lack of international competitiveness, made it politically infeasible for the reformists to prevail. Pressures from outside China were necessary, as they provided a justification to the CCP to reform China’s system. Problems arose, however, because not all parts of the CCP government, some of which had overlapping jurisdiction, agreed, and coordination between central and local government often was poor. Indeed, which arm of the broad and deep government has the primary authority to negotiate with foreign countries in regard to trade matters and WTO disputes was not well-defined in law or practice, and a consensus among different governmental organs on this point did not exist. These factors surely hampered the ability of China to defend its first WTO case effectively. Further, doing so was a cultural shift for China. Traditionally, the Chinese prefer to settle disputes amicably, not through an adversary legal procedure.

Notwithstanding these observations, the bottom line may be that China ought to review carefully the cases it chooses to defend versus settle, if it hopes to avoid running up a string of losses. After all, there is no shortage of potential cases China may find itself defending in the years to come.\textsuperscript{95}

7. Conclusion

The \textit{China Auto Parts} case, in which China’s fiscal charge on imported auto parts was held to violate the national treatment rule, is an historic one set in the context of the political and economic development of China. A worrying sign of recession on China’s prized auto industry lies in the background of this discriminatory measure, which is reflecting hard-line development policies that have been pushed by the CCP for decades.

Through this case, trade-policy makers in Beijing learned the lesson of the Golden Rule of international trade law. Surely, or at least hopefully, they will duly take into account this lesson in making their future policies in the face of protectionist pressures. This case could also be a turning-point for many industries in China: the start of a new era in which they are attacked by international litigation. In this sense, China’s first WTO loss will play a certain role in reacting to the grip on industrial policy power held by the CCP.

Ironically, throughout this rather bitter experience, China lost the case, but possibly turned it into a long-term victory – or, at least, can endeavor to do so. In a situation where China was perhaps less than perfectly prepared for the WTO litigation, and being faced with a well-planned effort by the United States, EC and Canada, China may well manage to achieve its long-term goal, i.e., reformation of automotive sector, by using its international legal obligation as a justification for reform. China could learn through these experiences that WTO dispute settlement provides a good channel through which trade disputes among superpower countries – even among China, the U.S. and EC – could be solved with efficacy and alacrity. By invoking the binding effect of WTO adjudicatory decisions, the CCP could overcome domestic interest group pressure and get

\textsuperscript{95} See, e.g., \textsc{United States Trade Representative, 2008 Report to Congress on China’s WTO Compliance} (December 2008), posted at \url{www.ustr.gov} (chronicling many areas of apparent non-compliance, as summarized in Table II at pp. 11-14).
on with the job of reform. Arguably, precisely because of this possibility, WTO litigation has been gaining popularity in the international economic society to which China clearly belongs.

At any rate, a major contribution of the *China Auto parts* dispute to the government and people of China would be that it gives courage to confront fears about the new, post-WTO accession international political economy paradigm in which China now operates. A shift toward consistent non-discriminatory behavior might help one of the fastest-growing developing countries emerge from a Middle Kingdom mentality, a Maoist-era semi-isolationist sense, into a responsible stakeholder on the world economic stage. That kind of shift might even complement broader development objectives, including ones pertaining to human rights.

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96 The U.S. Deputy Secretary of State, Robert Zoellick coined this appellation in a speech he delivered in New York on 21 September 2005. His remark was that the U.S. should ‘step up efforts to make China a responsible stakeholder in the international system’.

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