International and Regional Trade Law: The Law of the World Trade Organization



J.H.H. Weiler

University Professor, NYU
Joseph Straus Professor of Law and European Union Jean Monnet Chair
NYU School of Law

AND

Sungjoon Cho

Associate Professor and Norman and Edna Freehling Scholar
Chicago-Kent College of Law
Illinois Institute of Technology

AND

Isabel Feichtner

Junior Professor of Law and Economics
Goethe University
Frankfurt

Unit III: Rules of Origin

© J.H.H. Weiler, S. Cho & I. Feichtner 2011

International and Regional Trade Law:
The Law of the World Trade Organization

Unit III: Rules of Origin

Table of Contents

1. Introduction 3

2. Methodology 9

3. United States - Rules of Origin for Textiles and Apparel Products 25

Optional Reading 65

Supplementary Reading

For a more complete overview over rules of origin and their relevance in international trade law we suggest the following reading:

Peter van den Bossche, The Law and Policy of the World Trade Organization, 2005, 432-436.

Raj Bhala, Modern GATT Law. A Treatise on the General Agreement on Tariffs and Trade, 2005, 483-490.

Michael J. Trebilcock & Robert Howse, The Regulation of International Trade, 3rd ed. 2005, 188-192.

John H. Jackson et al., Legal Problems of International Economic Relation, 4th ed. 2002, 376-385.

1. Introduction

Technical Information on Rules of Origin (WTO Website)

http://www.wto.org/english/tratop_e/roi_e/roi_info_e.htm

Definition

Rules of origin are the criteria needed to determine the national source of a product. Their importance is derived from the fact that duties and restrictions in several cases depend upon the source of imports.

There is wide variation in the practice of governments with regard to the rules of origin. While the requirement of substantial transformation is universally recognized, some governments apply the criterion of change of tariff classification, others the ad valorem percentage criterion and yet others the criterion of manufacturing or processing operation. In a globalizing world it has become even more important that a degree of harmonization is achieved in these practices of Members in implementing such a requirement.

Where are rules of origin used?

Rules of origin are used:

— to implement measures and instruments of commercial policy such as anti-dumping duties and safeguard measures;

— to determine whether imported products shall receive most-favoured-nation (MFN) treatment or preferential treatment;

— for the purpose of trade statistics;

— for the application of labelling and marking requirements; and

— for government procurement.

No specific provision in GATT

GATT has no specific rules governing the determination of the country of origin of goods in international commerce. Each contracting party was free to determine its own origin rules, and could even maintain several different rules of origin depending on the purpose of the particular regulation. The draftsmen of the General Agreement stated that the rules of origin should be left:

"...within the province of each importing country to determine, in accordance with the provisions of its law, for the purpose of applying the most-favoured-nation provisions (and for other GATT purposes), whether goods do in fact originate in a particular country".

Article VIII:1(c) of the General Agreement, dealing with fees and formalities connected with importation and exportation, states that "the contracting parties also recognize the need for

minimizing the incidence and complexity of import and export formalities and for decreasing and simplifying import and export documentation requirements" and the Interpretative Note 2 to this Article states that it would be consistent if, "on the importation of products from the territory of a contracting party into the territory of another contracting party, the production of certificates of origin should only be required to the extent that is strictly indispensable".

Interest in the harmonization of rules of origin

It is accepted by all countries that harmonization of rules of origin i.e., the definition of rules of origin that will be applied by all countries and that will be the same whatever the purpose for which they are applied - would facilitate the flow of international trade. In fact, misuse of rules of origin may transform them into a trade policy instrument *per se* instead of just acting as a device to support a trade policy instrument. Given the variety of rules of origin, however, such harmonization is a complex exercise.

In 1981, the GATT Secretariat prepared a note on rules of origin and, in November 1982, Ministers agreed to study the rules of origin used by GATT Contracting Parties. Not much more work was done on rules of origin until well into the Uruguay Round negotiations. In the late 1980s developments in three important areas served to focus more attention on the problems posed by rules of origin:

Increased number of preferential trading arrangements

First, an increased use of preferential trading arrangements, including regional arrangements, with their various rules of origin;

Increase in the number of origin disputes

Second, an increased number of origin disputes growing out of quota arrangements such as the Multifibre Arrangement and the "voluntary" steel export restraints; and

Increased use of anti-dumping laws

Lastly, an increased use of anti-dumping laws, and subsequent claims of circumvention of anti-dumping duties through the use of third country facilities.

The UR Agreement

Introduction

The increased number and importance of rules of origin led the Uruguay Round negotiators to tackle the issue during the negotiations.

Aims of the Agreement

Harmonization

The Agreement on Rules of Origin aims at harmonization of non-preferential rules of origin, and to ensure that such rules do not themselves create unnecessary obstacles to trade. The Agreement

sets out a work programme for the harmonization of rules of origin to be undertaken after the entry into force of the World Trade Organization (WTO), in conjunction with the World Customs Organization (WCO).

General principles

Until the completion of the three-year harmonization work programme, Members are expected to ensure that their rules or origin are transparent; that they are administered in a consistent, uniform, impartial and reasonable manner; and that they are based on a positive standard.

Coverage: all non-preferential rules of origin

Article 1 of the Agreement defines rules of origin as those laws, regulations and administrative determinations of general application applied to determine the country of origin of goods except those related to the granting of tariff preferences. Thus, the Agreement covers only rules of origin used in non-preferential commercial policy instruments, such as MFN treatment, anti-dumping and countervailing duties, safeguard measures, origin marking requirements and any discriminatory quantitative restrictions or tariff quotas, as well as those used for trade statistics and government procurement. It is, however, provided that the determinations made for purposes of defining domestic industry or "like products of domestic industry" shall not be affected by the Agreement.

Institutions

WTO Committee on Rules of Origin

The Agreement establishes a Committee on Rules of Origin within the framework of the WTO, open to all WTO Members. It is to meet at least once a year and is to review the implementation and operation of the Agreements (Article 4:1).

WCO Technical Committee

A Technical Committee on Rules of Origin is created under the auspices of the World Customs Organization (formerly the Customs Cooperation Council). Its main functions are (a) to carry out the harmonization work; and (b) to deal with any matter concerning technical problems related to rules of origin. It is to meet at least once a year. Membership is open to all WTO Members; other WCO members and the WTO Secretariat may attend as observers (Article 4:2 and Annex I).

The Harmonization Work Programme (HWP)

Article 9:2 provided that the HWP be completed within three years of initiation. Its agreed deadline was July 1998. While substantial progress was made in that time in the implementation of the HWP, it could not be completed due to the complexity of issues. In July 1998 the General Council approved a decision whereby Members have committed themselves to make their best endeavours to complete the Programme by a new target date, November 1999.

The work is being conducted both in the WTO Committee on Rules of Origin (CRO) in Geneva and in the WCO Technical Committee (TCRO) in Brussels. The TCRO is to work, on a product-sector basis of the HS nomenclature, on the following matters:

Definitions of goods being wholly obtained

To provide harmonized definitions of the goods that are to be considered as being wholly obtained in one country, and of minimal operations or processes that do not by themselves confer origin to a good;

Last substantial transformation

Change of tariff heading

To elaborate, on the bases of the criteria of substantial transformation, the use of the change of tariff classification when developing harmonized rules of origin for particular products or sectors, including the minimum change within the nomenclature that meets this criterion.

Supplementary criteria

To elaborate supplementary criteria, on the basis of the criterion of substantial transformation, in a manner supplementary or exclusive of other requirements, such as ad valorem percentages (with the indication of its method of calculation) or processing operations (with the precise specification of the operation).

The CRO considers the input of the TCRO with the aim of endorsing the TCRO's interpretations and opinions, and, if necessary, refining or elaborating on the work of the TCRO and/or developing new approaches. Upon completion of all the work in the TCRO, the CRO is to consider the results in terms of their overall coherence (Article 9:3).

Overall architectural design

The CRO and the TCRO have established an overall architectural design within which the harmonization work programme is to be finalized. This encompasses

— general rules, laid down in eight Articles provisionally entitled: Scope of Application; the Harmonized System; Definitions; Determination of Origin; Residual Rules of Origin; Minimal Operations or Processes; Special Provisions; and De Minimis;

— three Appendices:
Appendix 1: Wholly obtained goods;
Appendix 2: Product rules - substantial transformation; and
Appendix 3: Minimal operations or processes.

Results of the Harmonization Work Programme

The results of the harmonization programme are to be approved by the Ministerial Conference and will then become an annex to the Agreement. When doing this, the Ministerial Conference is also to give consideration to arrangements for the settlement of disputes relating to customs classification and to establish a time-frame for the entry into force of the new annex.

Disciplines during the transition period

During the transition period (i.e. until the entry into force of the new harmonized rules) Members are required to ensure that:

(a) rules of origin, including the specifications related to the substantial transformation test, are clearly defined;

(b) rules of origin are not used as a trade policy instrument;

(c) rules of origin do not themselves create restrictive, distorting or disruptive effects on international trade and do not require the fulfilment of conditions not related to manufacturing or processing of the product in question;

(d) rules of origin applied to trade are not more stringent than those applied to determine whether a good is domestic, and do not discriminate between Members (the GATT MFN principle). However, with respect to rules of origin applied for government procurement, Members are not be obliged to assume additional obligations other than those already assumed under the GATT 1994 (the national treatment exception for government procurement contained in GATT Article III:8).

(e) rules of origin are administered in a consistent, uniform, impartial and reasonable manner;

(f) rules of origin are based on a positive standard. Negative standards are permissible either as part of a clarification of a positive standard or in individual cases where a positive determination or origin is not necessary;

(g) rules of origin are published promptly;

(h) upon request, assessments of origin are issued as soon as possible but no later than 150 days after such request, they are to be made publicly available; confidential information is not to be disclosed except if required in the context of judicial proceedings. Assessments of origin remain valid for three years provided the facts and conditions remain comparable, unless a decision contrary to such assessment is made in a review referred to in (j). This advance information on origin is considered as a great innovation of the Agreement;

(i) new rules of origin or modifications thereof do not apply retroactively;

(j) any administrative action in relation to the determination of origin is reviewable promptly by judicial, arbitral or administrative tribunals or procedures independent of the authority issuing the determination; such findings can modify or even reverse the determination;

(k) confidential information is not disclosed without the specific permission of the person providing such information, except to the extent that this may be required in the context of judicial proceedings.

Disciplines after the transition period

As from the conclusion of the HWP, non-preferential rules of origin will be harmonized and Members will be bound to apply only one rule of origin for all purposes covered by Article 1. The principles contained in (d) through (k) above will continue to apply — i.e. transparency, non-discrimination (also including rules of origin applied for government procurement), and the possibility of reviewing any administrative actions concerning determination of origin (Article 3).

Consultation and dispute settlement

The WTO provisions on consultation and settlement of disputes apply to the Agreement.

Preferential rules of origin

Annex II of the Agreement on Rules of Origin provides that the Agreement's general principles and requirements for non-preferential rules of origin in regard to transparency, positive standards, administrative assessments, judicial review, non-retroactivity of changes and confidentiality shall apply also to preferential rules of origin.

Notifications Non-preferential rules of origin

Article 5:1 of the Agreement requires each Member to provide to the Secretariat, within 90 days after the date of entry into force of the WTO Agreement for it, its currently applicable rules of origin, judicial decisions and administrative rulings of general application relating to rules of origin. The Secretariat circulates to all Members lists of the information received and available to them.

At its meeting of 4 April 1995, the Committee agreed that any notifications made in a language other than a WTO working language should be accompanied by a summary in a WTO working language (G/RO/1).

Preferential rules of origin

Paragraph 4 of Annex II of the Agreement on Rules of Origin provides that Members shall provide to the Secretariat promptly their preferential rules of origin, including a listing of the preferential arrangements to which they apply, judicial decisions, and administrative rulings of general application relating to their preferential rules of origin as soon as possible to the Secretariat. The Secretariat circulates lists of the information received and available to Members.

At its meeting of 4 April 1995, the Committee agreed that any notification made in a language other than a WTO working language, should be accompanied by a summary in a WTO working language (G/RO/1).

***Note**: So far the Harmonized Work Programme has not been completed and approved by the Ministerial Conference.*

2. Methodology

Excerpts from:

Joseph A. LaNasa III ("Jody"), An Evaluation of the Uses and Importance of Rules of Origin, and the Effectiveness of the Uruguay Round's Agreement on Rules of Origin in Harmonizing and Regulating Them, Jean Monnet Working Paper, 1/96

http://www.jeanmonnetprogram.org/papers/96/9601ind.html

(…)

IV. Methods of Determining Origin

When a product is wholly obtained and produced in a single country, it is relatively easy to determine its origin. [13] Difficulties arise in determining the origin of a product that is manufactured in, assembled in, or uses materials originating in more than one country.

At least four different methods or criteria exist for determining the origin of goods that are manufactured in, assembled in, or use materials originating in more than one country:

1. Using the concept of substantial transformation as a rule;

2. Using an ad valorem percentage test;

3. Listing specific manufacturing or processing operations which confer or do not confer origin upon the goods; and

4. Requiring a specified change in tariff classification.

Whichever method is employed to determine origin, each seeks to prevent simple assembly and packaging operations from conferring origin. This section of the article will evaluate the different methods according to their effectiveness in determining the origin of a goal and in preventing circumvention, their clarity, their certainty, their transparency and the predictability or consistency of origin of determinations which use that method.

A. Substantial Transformation

The traditional substantial transformation rule states that a good originates in the last country where it emerged from a given process with a "distinctive name, character or use." [14] The substantial transformation of a good requires more than just a change in the article; it requires an article be transformed into a "new and different article" "having a distinctive name, character or use." [15]

The traditional substantial transformation rule captures the heart of the meaning of the rules of origin in a simple, concise way. For a product to be from a particular state, it must be substantially transformed there. To prevent a product from having multiple countries of origin, the good is a product of the country where it last underwent substantial transformation. The standard's flexibility allows it to evolve to meet technological change; however, this flexibility can result in inconsistent origin determinations that undermine the certainty required for strategic planning by businesses.

Moreover, the standard's flexibility provides an opportunity for it to be "captured" by lobbying groups, i.e., for the standard to be used in a results-oriented manner designed to accommodate political pressure for more trade restrictive effects. For example, the rule can easily be converted into a search for the most significant processing, instead of the last substantial transformation. This type of search requires the exporter, importer, or producer to furnish a great deal of factual information to prove substantial processing. This fact-intensive, time-consuming inquiry raises the cost of determining origin, makes the rule even more restrictive and complex than it otherwise would be, and contradicts the spirit and purpose of the last substantial transformation rule.

For example, in 1984, the United States Custom Service adopted a two-part test for determining the origin of textile goods that result from processes or materials from more than one country. [16] This "revised" substantial transformation test was more restrictive than the traditional substantial transformation test because it required the creation of a new and different article and substantial manufacturing or processing operations. [17] The revised test nominally was changed to prevent companies from circumventing textile quotas by passing goods through an intermediate country to confer that country's origin on the good.

The substantial transformation rule provides the custom authorities and the courts with a great deal of flexibility to adapt the rule to particular circumstances to avoid circumvention. As the amount of restrictions or duties on imports increases for unfavorable origin determinations, more companies will try to manipulate the rules of origin to avoid unfavorable determinations. This often forces the courts to stretch the common law developed around substantial transformation to prevent circumvention and ensure that the standard's basic purpose is met. In other words, as the rules on substantial transformation become more precise and defined, it becomes easier to circumvent the purpose of the law while formally complying with its language. The flexibility of the substantial transformation standard provides countries with the
ability to look beyond the form of the transaction to see if a substantial transformation actually occurred.

However, the ambiguity of the standard and its flexible decision-making can lead to unpredictable, seemingly arbitrary results, especially when substantial transformation rule is applied differently for different purposes. [18] The United States has attempted to deal with this lack of certainty by compiling lists of criteria. [19] However, instead of having the abstract concept of substantial transformation become more definite through concrete

application to factual situations, [20] the selective, inconsistent use of the criteria has led to more uncertainty and confusion. [21]

Some of the seemingly inconsistent and arbitrary determinations result from the fact that the rules are applied for different purposes. Courts and agencies may expend more effort on determining the true origin of a good for trade preferential or restrictive purposes than for marking purposes, and therefore the inconsistency may not be a sign of results-oriented policy-making. In other words, the seemingly fragmented and inconsistent application of the substantial transformation standard may be proof that the substantial transformation is working effectively, in that its abstractness gives it the flexibility to specifically address the facts of each situation and prevent circumvention. However, to some commentators, by varying the degree of transformation required according to how the origin determination will be used, the "only consistency [in defining substantial transformation in the United States] is a policy that results in either higher duties or in fewer imports." [22]

While the flexibility of the process leaves it open to political pressure and capture by lobbying groups who want overly restrictive applications of the standard for protectionist purposes, this problem exists with every method of determining origin, just at a different stage in the determination process. With more defined methods of determining origin, the capture and manipulation occurs when the definitions are being developed or by having the definitions rewritten or re-interpreted. Moreover, the rules are defined for these other methods in the
definitional stage where there is no adversarial relationship, no neutral decision-maker, no representation of the major viewpoints, and no factual situation to which the principle can be applied, unlike many of the applications of the substantial transformation standard. Therefore, a greater danger of capture and protectionism may exist with the more defined methods because of the lack of court oversight and the lack of the adversarial representation.

In summary, the substantial transformation standard has many advantages, including its flexibility, evolution over time, and development through application to specific facts in an adversarial situation where interested parties are represented. However, these advantages are also the root of its disadvantages: its inconsistent applications, its discretionary nature, and the costs of making an origin determination under it. The adoption or rejection of substantial transformation as a method of determining origin depends on which principle one values more: flexibility or certainty. While profit-maximizing firms need more objective, predictable and easier to use rules, the substantial transformation standard should be used as the motivating principle behind the development and continued refinement of more precise, defined rules of origin, because it captures the purpose of origin determinations in a simple, concise manner.

B. Value-Added Percentage Test

The value-added test defines the degree of transformation required to confer origin on the good in terms of a minimum percentage of value that must come from the originating country or of maximum amount of value that can come from the use of imported parts and materials. [23] If the floor percentage is not reached or the ceiling percentage exceeded, the last production process will not confer origin. If the determination is for non-preferential purposes, then origin will be conferred on a prior country; if it is for preferential purposes, then no further origin determination is necessary unless the prior county is also a beneficiary country under a preferential trading agreement with the importing county.

While the value-added method is often praised for its simplicity and precision, [24] in practice it is very far from that because it generates substantial compliance costs and uncertainty for companies. [25] The value-added test is a very unsatisfactory method of determining origin.

The value-added test generates substantial compliance costs for companies. It can be very costly and difficult to comply with its administrative requirements, especially if the rules require tracing the value of specific parts and materials. Firms often will find it cheaper not to comply with the value-added test, forgoing the trade preferences and paying the most-favored-nation tariff, when the product results from complex manufacturing operations or when the product does not otherwise face high tariff or non-tariff barriers. [26] To comply with a value-added rule requiring tracing, a manufacturer of a complex product would need a highly sophisticated inventory and accounting system to adequately ensure that particular goods contain specific local components at specific values.

The value-added test also generates substantial uncertainty for companies. Because the test ignores exchange rate risk and fluctuations in the price of raw materials, the status of goods can change daily as the currency values fluctuate or as the price of raw materials fluctuates, unless the firm is able to obtain a binding advance ruling from the country's customs authorities. [27] Additionally, the origin of identical goods may vary with each importing country, depending on the exchange rate relationship between the importing country's currency and that of the processing country. Furthermore, because the value-added test is a bright line test, it often results in seemingly arbitrary results for borderline cases. For example, if the rules require 50% local value-added to confer origin, then a good with 49% local value added will be denied origin while a good with 50% local value added will considered to originate there. When a firm seeks a certain origin, it may seek to manipulate the prices of the
good and its imports to ensure the desired origin determination. This threat of transfer pricing is especially prevalent with transactions among related parties. For example, related parties could underprice the imported materials so that the final good has enough local value-added to qualify for local origin. To limit or prevent this manipulation of "value-added", the rules of origin could force the related parties to show that the price is similar to prices reached in an arm's-length transaction, whether by showing that the price is similar to the price of identical materials or goods sold to third parties, as long as third parties have purchased a substantial number of those materials or goods, or by comparing it to the price of similar materials or goods sold in arm's-length transactions, or it could

force them to use a "net cost" method of determining value-added. [28] For example, in the NAFTA, the producer or exporter must use the "net cost" method when there is no transaction value (price) for the good or when the good is sold to a related party and related parties have purchased over 85% of the producers' identical or similar goods during the preceding six months. [29]

Moreover, the value added test leads to inconsistent results for similar products, because countries calculate the amount of value-added in different manners. [30] For example, the value-added test may result in inconsistent determinations of origin of identical goods in different countries because different countries include different amounts of the transportation costs in the "sales prices" for the good, thereby creating different sales prices for the same good. [31] The later the article is valued in the transport stage, the harder it becomes for the article to meet the local value-added content requirements, because the transport costs increase the value of the denominator, unless the delivery costs are also added to the numerator as originating costs. Further, even if countries valued all parts of the good at the same stage in the transport cycle, they would still have different origin determinations because
countries include different costs in its local value-added calculations. [32]

The value-added test penalizes low cost production operations, though they may be more efficient than high cost facilities. The value-added test penalizes labor-intensive facilities in countries with cheap labor costs, capital-intensive facilities in countries with cheap capital costs, and resource-intensive facilities in countries with cheap resource costs. Because there is a greater difference in the cost of labor than the cost of capital since capital is more mobile than labor or raw materials, the value-added test discriminates against lesser developed countries whose primary comparative advantage is cheap labor and cheap materials. [33]

As with any defined test, a value-added test is subject to industry capture during its formulation stage. For example, in the North American Free Trade Agreement, American automobile manufacturers pressured the negotiators into accepting overly restrictive special rules of origin for automobiles, [34] ones that had a higher regional value content requirement for automobiles than for other goods under the North American Free Trade Agreement. [35] Furthermore, to purportedly prevent roll-up, [36] NAFTA requires that the producer trace the value of imported automotive parts throughout the production chain [37] to improve the accuracy of the content calculation, thereby imposing substantial additional compliance costs and administrative burdens on the manufacturer. The combination of higher regional value content requirement with the tracing provisions forces automotive companies to manufacture the drive trains and engines of the vehicles within the free trade area if they want the good to qualify for preferential treatment, or, if they want to avoid the rules of origin, to source their assembly plant in the final market country, i.e., the United States. [38]

In summary, due to differences in calculation methods, the fluctuations in values, and the compliance costs, the value-added test is not a satisfactory method of determining origin.

C. Specified Processes

The specified process tests of origin, also referred to as technical tests, prescribe certain production or sourcing processes that may (positive test) or may not (negative test) confer originating status. [39]

The specified process test serves as a useful supplemental test because it is easily tailored to meet a specific situation in a clear, precise manner. However, it is not a satisfactory primary test of origin because it would be extremely difficult, if not impossible, to define a process test for the enormous array of products made, and to continually update these rules for new products and technological advances in production. Second, such a process of defining origin would be highly susceptible to capture by industry lobbying groups, because the drafters and administrators of the rule would have to rely upon industry for information, and, because the test would be in technical terms, its content would be hidden from public view. For example, Commission Regulation 288/89, on determining the origin of integrated circuits, stated that origin is conferred on a good whenever it undergoes diffusion. However, diffusion is always followed by assembly and testing, processes that are more labor-intensive and that may add more value than diffusion. [40] This product-specific technical rule was adopted because European Community producers of integrated circuits performed the diffusion process in the European Communities and then had the testing and assembly done in third countries while Japanese producers of integrated circuits had them tested and assembled in the European Communities. [41] Therefore, this regulation conferred EC origin on goods produced by EC manufacturers while denying EC origin on goods produced by Japanese manufacturers, thereby allowing the integrated circuits produced by the EC companies to trade on better terms than those produced by the Japanese. [42]

Third, it is a rigid test whose form could be met while subverting the underlying concept of requiring a substantial transformation to confer origin. Meeting this problem with anti-circumvention provisions would re-introduce the fact-intensive inquiries and their corresponding uncertainty that the technical and other defined tests seek to avoid.

Finally, negative technical tests leave large gray area, in that they only delineate which processes do not confer origin. For example, Commission Regulation 2071/89, on determining the origin of photocopiers, stated that the incorporation of an optical system into a photocopying apparatus will not confer origin, but did not explain which operations would confer origin. [43] This regulation was designed specifically to deny United States origin to copiers assembled in the United States by Ricoh, a Japanese corporation. [44] These copiers contained imported Japanese optical systems, and therefore were viewed as "Japanese" copiers by the origin test. Because anti-dumping duties had been imposed on Ricoh copiers from Japan, these copiers, which were assembled in the United States, were now subject to these duties.

D. Change in Tariff Classification

The change in tariff classification method determines the origin of a good by specifying the change in tariff classification of the Harmonized System of Tariff Nomenclature ("Harmonized System") [45] required to confer origin on a good. [46] Because the Harmonized System has been adopted by countries representing 90% of the world's trade, it provides a uniform, hierarchical nomenclature to be used in defining origin determinations for all products [47] in international trade.

The Harmonized System's systematic, hierarchical framework and its nearly universal acceptance among trading nations permit the drafters of rules of origin tremendous flexibility to define classification changes in a precise manner that sustains exceptions and special rules without sacrificing objectivity, certainty, or identity. [48]

The Harmonized System is divided into twenty-one Sections, each representing a broad industrial grouping; ninety-six Chapters, each representing a more narrow industrial sector; and one thousand two hundred and forty-one headings, each representing a narrow industrial section. [49]

The headings in a chapter generally are ordered by the degree of processing. The farther into the chapter the heading is, the more processing that good has undertaken. [50] Therefore, unless the rules of origin specify otherwise, any change in the level of classification of the product at the heading level should be sufficient to confer origin on that product in the country where that change last occurred; hence, this method of determining origin is often called the "change in tarrif heading method." [51] The Harmonized System's hierarchical framework, its division by industry, and its systematic arrangement of headings by increasing degrees of technical sophistication and economic effort provide an easy to use and easy to adapt underlying structure for origin determinations.

While the Harmonized System reflects the most sophisticated and refined tariff classification system, it is just that -- it's a system primarily designed for the dual purposes of commodity classification and compilation of statistics. [52] Because it was not designed to be used for origin determinations, changes in classification are not always an appropriate or effective test for determining origin. Therefore, an origin scheme based on change in tariff classification must be supplemented by a list of exceptions that describe when a sufficient transformation has occurred despite the lack of a change in tariff classification, [53] when a change in classification is not sufficient, [54] and which processes are not sufficient to confer origin even though they lead to a change in tariff classification. [55] These supplemental tests, which rely upon process and value-added tests as supplemental tests for origin, reintroduce the problems associated with those systems into the change in tariff classification system, albeit on a lesser scale than if these tests were the primary tests. As with any process system, both the required changes and the exceptions lists must be updated to reflect new products and technological advances.

The change in tariff classification method of determining origin is conceptually simple and easy to apply, once the product is classified. [56] Because the Harmonized System is

already used to classify 90% of the goods in international trade, custom authorities, exporters, importers, and manufacturers are comfortable and familiar with it. However, the classification of the product can give rise to problems, because products are not always classified in a uniform manner, despite the substantial efforts of the Harmonized System Committee to ensure that they are. [57] While it may appear that the change in tariff classification test which uses the Harmonized System as its underlying nomenclature will result in uniform determinations of origin because all of the countries are using an internationally harmonized nomenclature, this may not be the case because each country is free to classify the good as it sees fit, unless a system of binding dispute resolution open to both individual and member country complainants is developed.

(…)

Notes

[13] Origin complications may arise with wholly obtained products when dealing with products extracted from territorial waters and from the seabed. For example, fishery products are considered wholly obtained in a country as long as they are obtained on a vessel of that country. Because some origin definitions vary in terms of defining what constitutes that country's vessels, this rule may lead to the anomalous result of fish being caught in the waters of country A by a vessel from country B being considered fish of country B, even though they were "obtained" in country A's waters.

[14] Anheuser-Busch Ass'n v. United States, 207 U.S. 556, 562 (1908). See also Hartranft v. Wiegman, 121 U.S. 609, 615 (1887) (explaining that a good is substantial transformed when it is "manufactured into a new and different article, having a distinctive name, character or use from that" of the original article or good). The United States determines the origin of goods for non-preferential purposes by the rule of substantial transformation, a standard created by the courts and codified in administrative regulations.

The European Communities use a similar default rule. Council Regulation 802/68, which establishes the criteria to be used for determining the origin of imported goods when no other rule of origin is applicable, states, in part, that a product originates in the country in which the last substantial process or operation that is economically justified was performed, having been carried out in an undertaking equipped for the purpose, and resulting in the manufacture of a new product or representing an important stage of manufacture. Council Regulation 802/68, Art. 5.

[15] See Anheuser-Busch, 207 U.S. at 562. See also United States v. Gibson-Thomsen Co., 27 C.C.P.A. 267 (1940) (holding that under the marking statute, when imported wood toothbrush handles and imported wood hairbrush blocks are combined in the United States with bristles to form a brush, the brush originates in the United States because "each [part] lost its identity in a tariff sense, and [became] an integral part of a new article having a new name, character and use").

[16] Textiles and textile products country of origin, 19 C.F.R. §12.130. The Custom Service based these regulations on its interpretation of Uniroyal Inc. v. United States, 542 F. Supp. 1026 (1982). Country of Origin Rules Regarding Imported Textiles and Textile Products, T.D. 90-17, 24 Customs Service Bulletin 3, 6 (March 14, 1990). Uniroyal held

that a product originates in the country where it gained its identity or essence by means of processing operations performed in that country. Therefore, in Uniroyal under the marking statute, the attachment of imported leather uppers to domestic outer soles was not a substantial transformation of a shoe, because the upper maintained its identity, in that the upper was the essence a completed shoe.

For application of a similar test in a non-textile context, see Superior Wire v. United States, 669 F. Supp. 472 (Ct. Int'l Trade 1987), aff'd, 867 F.2d 1409 (Fed. Cir. 1989) (holding that wire produced in Canada from wire rod manufactured in Spain is of Spanish origin because the Canadian processing was not substantial in terms of complexity or cost).

[17] 19 C.F.R. §12.130(b) (stating that a "textile or textile product will be considered to have undergone a substantial transformation if it has been transformed by substantial manufacturing or processing operations into a new and different article of commerce"). The regulation then lists a series of manufacturing or processing operations that will "usually" result in "a new and different article", id. at §1230(d)(1), lists a series of factors to be considered to determine if the good underwent substantial processing, id. at §1230(d)(2), a list of processes that will "usually" result in conferring origin on that good, id. at §1230(e)(1), and a list of processes that will "usually" not result in conferring origin on that good, id. at §1230(e)(2).

[18] The United States applies the standard differently for different purposes. See Koru North American v. United States, 701 F. Supp. 229, 133 (Ct. Int'l Trade 1988) (stating that in ascertaining origin, the court must look to "the purpose of the particular statute involved"); National Juice Products Ass'n v. United States, 628 F. Supp. 978, 988-89, n.14 (noting that "although the language of the test applied under the statutes [tariff preferences, duty drawback, and country of origin marking] is similar, the results may differ where differences in statutory language and purposes are pertinent"). See also N. David Palmeter, Rules of Origin or Rules of Restriction? A Commentary on a New Form of Protectionism, 11 Fordham Int'l L. J. 1, 4 (1987) [hereinafter Palmeter, Protectionism] (arguing that the United States interprets its rules of origin differently for different purposes and providing the example that "threading is substantial transformation if it means GSP benefits will be denied but not if it means that a quota will be inapplicable").

When a court held that courts should not "depart from policy-neutral rules governing substantial transformation in order to achieve wider import restrictions [via a voluntary restraint agreement on steel imports from Japan] in particular cases," Ferrostaal Metals Corp. v. United States, 664 F. Supp. 535, 538 (Ct. Int'l Trade 1987), the United States Congress overturned it, rejecting the principle that the uniform application of a standard for all purposes, by giving the President the power to impose the VRA quota on steel that has been substantially transformed in a non-VRA country as long as the steel was originally melted and poured in a VRA country. Omnibus Trade and Competitiveness Act of 1988, Pub. L. 100418, §1322 (amending 198 U.S.C. §2253).

[19] The criteria include the distinction between producer and consumer goods, the amount of value-added, the complexity of the processing operation, and changes in tariff classification. See C. Edward Galfand, Comment, Heeding the Call for a Predictable Rule of Origin, 11 U. Pa. J. Int'l Bus. L. 469, 480 (1989).

[20] "The search for relevant meaning is often satisfied not by a futile attempt at abstract definition but by pricking a line through concrete applications. Meaning frequently is built up

by assured recognition of what does not come within a concept the content of which is in controversy." Bazley v. Commissioner, 331 U.S. 737 (1947) (J. Frankfurter) (explaining why the Supreme Court will not affirmatively define what a recapitalization under the Internal Revenue Code, but rather will just look at the facts of the transaction and compare them to the underlying purpose of a reorganization, of which a recapitalization is one type).

[21] For example, one criterion, the transformation of a good usable solely by producers into a consumer goods, has been held to be both determinative and indeterminative of origin. Compare Torrington Co. v. United States, 764 F.2d 1563 (Fed. Cir. 1985) (transformation determinative); Midwood Industries, Inc. v. United States, 313 F. Supp. 951 (Cust. Ct. 1970) (transformation determinative) with National Juice Products Ass'n v. United States, 628 F. Supp. 978 (Ct. Int'l. Trade 1986) (transformation not determinative); Uniroyal, Inc. v. United States, 542 F. Supp. 1026 (Ct. Int'l. Trade 1982) (no origin conferred despite transformation).

[22] Palmeter, Protectionism, supra note 20, at 4.

[23] See Vermulst, Revisited, supra note 3, at 63-64. The European Community uses the domestic content method as a test for non-preferential purposes and the United States uses it for preferential purposes. The import content method is used by the European Communities as a test for preferential purposes. The value-added test also can be articulated as requiring that a minimum percentage of the value of the parts come from the originating country. Id. The value of the parts test is used by the European Community in some product-specific origin regulations as a subsidiary test when the 45% value-added primary test is not met. See Commission Regulation 861/71 on determining the origin of tape recorders, art. 2 (1971); Commission Regulation 2632/70 on determining the origin of radio and television receivers, art. 2 (1970). It may be unduly restrictive of origin because it ignores local assembly and overhead costs.

[24] See Michael P. Maxwell, Formulating Rules of Origin for Imported Merchandise: Transforming the Substantial Transformation Test, 23 Geo. Wash. J. Int'l L. & Econ. 669, 671-72 (1990) (calling for a rule of origin based on value-added criteria).

[25] See Joseph LaNasa, Rules of Origin under the North American Free Trade Agreement: A Substantial Transformation into Objectively Transparent Protectionism, 34 Harv. Int'l. L.J. 381, 392 (Spring 1993) (arguing that most of the origin determination controversies under the Canadian-United States Free Trade Agreement involved the value-added test).

[26] See id. at 391-92, n.48-49; Jan Herin, Rules of Origin and Differences Between Tariff levels in EFTA and in the EC, Occasional Paper no. 13 (European Free Trade Association 1986) (25% of trade between EFTA and the EC is on a non-preferential basis because of the high costs of satisfying the change in tariff classification and the value-added rules of origin). See also Ralph H. Sheppard, NAFTA Rules of Origin from the Importers' Perspective: What the Agreement Should Contain, Mex. Trade and L. Rep., Rules of Origin Vol. 1 No. 2, Nov. 1, 1991 (stating that the need to certify content in specific shipment in order to comply with value-added requirements lead many businesses to forgo benefits due to the inordinate accounting or inventory costs).

[27] Of course, the fluctuation problem could be minimized through the use of weighted monthly, quarterly, or annual averages.

[28] The net cost method requires the firm to trace the cost of each item or material used in producing the good.

[29] NAFTA art. 402(5)(a,c). The exporter or producer also must use the net cost method when the transaction value is unacceptable under Article I of the GATT Customs Valuation Code, when it elects to accumulate the regional value content of a good or when it elects to designate a self-produced material containing no other intermediate materials as an intermediate material. Id. at art. 402(5)(b, e-f).

[30] See Vermulst, Revisited, supra note 3, at 65-71. The local value-added of a good can be calculated by either deducting the cost of non-originating parts from the sales price or by adding up all items of local value-added. This value is then placed over a denominator representing the price of the good, which yields the percentage of local value-added. If the import content rule is being used, subtract the resulting percentage from 100% to see if the import content ceiling is surpassed. While these two calculation methods in theory should lead to the same result, in practice they do not because of the lack of harmonization of calculation methods. Id.

[31] Id. at 65. Goods can be valued, in ascending order, at the ex-works price (the price as it leaves the factory), free on board (FOB) price (the price at the border of the exporting country), cost insurance and freight (CIF) price (the price at the border of the importing country) or the delivered into-factory price. For example, the European Communities uses the ex-works price. Any other costs must be deducted from the price. This greatly complicates the valuation process by requiring additional calculations and documentation of the costs of these other items. On the other hand, the United States often uses the appraised value of the good as it enters the United States. Because this value often will just be the transaction price in transactions between non-related parties, this method does not entail doing any additional calculations. Id.

[32] See Vermulst, Revisited, supra note 3, table 4 at 71 (showing that the same product will have a different domestic content ratios in the United States, the European Communities, Australia, Canada and Japan).

[33] While the problem of punishing low cost producers also arises with other methods of determining origin, because in practice, all origin rules impose value-added constraints since all origin rules require value-adding processing, the problem is most acute with an explicit value-added test. However, with substantial transformation as the test, the problem of discriminating against low-cost producers arises, if the agency or court compares processing costs to see if a substantial transformation occurred.

[34] See LaNasa, supra note 25, at 400-01 (arguing that the enormous clout of the American car manufacturers resulted in rules of origin for automobiles that discriminated against foreign car companies, an argument supported by the fact that General Motors received preferential treatment in its joint venture with Suzuki on the treatment of the origin of the CAMI).

[35] Compare NAFTA, art. 403(6) (requiring a regional value content equal to or greater than 62.5% for light trucks and passenger vehicles using the net cost method) with id. at art. 401(b) (requiring just a specified change in tariff classification for most goods) with id. at annex 401.1, §6401.10 - 6401.10 (requiring that footwear meet the specified tariff

classification change and that it have a regional value content equal to or greater than 55% under the net cost method).

[36] Roll-up occurs when imported parts are substantially transformed in a preference-receiving country into an intermediate part whose whole value then counts towards fulfilling the value-added requirement for the final good. For example, under the Canadian-United States Free Trade Agreement, an intermediate part was considered wholly a domestic part if it had regional value content equal to or greater than 50%. If it had a regional value content less than 50%, then the roll-down occurred, i.e., the part was considered wholly an imported part.

Under the Canada-United States Free Trade Agreement, the controversy over roll-up exploded into an international controversy. Honda assembled cars (Civics) in Canada with engines assembled in Ohio that used Japanese parts. Canada and Honda claimed that the engines had a direct cost of 66%, thereby entitling them to roll-up. With their value rolled-up, the assembled cars met the CFTA's regional value content requirement for cars and therefore were entitled to preferential treatment. The United States argued that the engines were not entitled to roll-up because Canada and Honda had included indirect costs in their computation of direct costs and that a proper calculation of direct costs revealed that the engines had less than 50% regional content and therefore their value must be roll-downed. Without being able to count the value of the engines, the Honda cars assembled in Canada no longer could not meet the CFTA's regional value content requirement for automobiles and therefore were not entitled to preferential treatment. The United States' interpretation of direct costs of assembly excluded costs that were reasonably allocated to the assembly costs, overhead costs and general expenses of doing business. The United States claimed that the dispute was purely a technical matter. The Canadians claimed that the decision was a political one motivated by American desires to bash Japan and to force Japanese companies to relocate their assembly operations to the United States. See Frederic Cantin and Andreas Lowenfeld: Rules of Origin, The Canada-U.S. FTA and the Honda Case, 87 Am. J. Int'l L. 375 (July 1993).

[37] NAFTA, at art. 403(1-2) (requiring tracing of the value of a specified list of automotive parts), annex 403.1-.2 (listing the automotive parts and materials whose value must be traced). The administrative burden is lessened somewhat by allowing the producer to use an annual averaging method. Id. at art. 403(4-5).

[38] See LaNasa, supra note 25, at 400-402.

[39] See Vermulst, Revisited, supra note 3, at 74. The United States uses them for preferential and non-preferential purposes, often in combination with a value-added test. The European Communities use them for many of their non-preferential product-specific origin regulations. Id.

[40] Edwin Vermulst and Paul Waer, European Community Rules of Origin as Commercial Policy Instruments, 24:3 J.W.T. 55, 66.

[41] Id. at 66.

[42] In the European Communities, certain product-specific regulations that purport to apply the "last substantial process" test can be viewed as nothing more than protectionist interpretations designed to benefit European Communities industry and restrict market access

of Japanese producers. Id. at 94 (citing the zipper, integrated circuits and photocopier regulations).

[43] Commission Regulation 2071/89 on determining the origin of photocopying apparatus incorporating an optical system or of the contact type, art. 1 (1989).

[44] See Vermulst and Waer, supra note 40, at 66-67.

[45] The Harmonized System was implemented by the International Convention on the Harmonized Commodity and Description Coding System on January 1, 1988. It was developed by and is administered by the Customs Co-operation Council. While one hundred twenty-one countries have adopted it for customs tariffs and trade statistical purposes, only seventy-one nations have contracted to the International Convention, as of June 1, 1993. See Hironori Asakura, The Harmonized System and Rules of Origin, 27 J.W.T. 4, 8 (Aug. 1993) [hereinafter Harmonized System]. Because the one hundred twenty-one countries account for 90% of world trade, the Harmonized System is one of the most basic and widely applied international trade laws.

[46] See, e.g., Origin Agreement, supra note 4, at art. 9(2)(c)(ii) (calling for global harmonization of non-preferential rules of origin defined primarily in terms of change in tariff classification using the Harmonized System as the underlying nomenclature); North American Free Trade Agreement, art. 401(b) (providing for determinations of origin by specified change in tariff heading), art. 413(a) ("the basis for tariff classification in Article 401 is the Harmonized System"), Annex 401.1 (using the Harmonized System as the tariff classification system used to define the required change in headings).

[47] If the product itself has not been classified, the products placed into a basket of unclassified goods. A question may arise as to in which basket it should be included.

[48] In contrast, when the substantial transformation standard was used to create exceptions or special rules, it produced "unguided formlessness" in which a diverse series of criteria were applied in an illogical or inconsistent manner. See Galfand, supra note 19, at 492 ("Whereas flexibility in the substantial transformation criteria equates to unguided formlessness, the objective and mechanically precise character of the Harmonized System renders it capable of sustaining exceptions and special rules without losing its identity.").

[49] Asakura, supra note 45, at 9. For example:

Section I
Live animals and animal products
Section II
Vegetable products
Chapter 6
Live Trees & Other Plants; Bulbs, Roots & the Like; Cut Flowers & Ornamental Foliage
Chapter 7
Edible Vegetables & Certain Roots & Tubers
Chapter 9
Coffee, Tea, Mate & Spices
Chapter 10
Cereals

***

Section IV
Prepared Foodstuffs; Beverages, Spirits & Vinegar; Tobacco & Manufactured Tobacco Substitutes
Section V
Mineral Products
Section VI
Chemical products
Chapter 28
Inorganic Chemicals
Chapter 29
Organic Chemicals
Chapter 30
Pharmaceutical Products
Chapter 31
Fertilizers

Id.

[50] For example:

Chapter 72 Iron & Steel

72.01
Pig Iron
72.04
Ingot
72.06
Semi-Finished Products
72.08 - 72.12
Flat-Rolled Products
72.13 - 72.15
Bars and Rods
72.16
Angles, Shapes & Sections
72.17
Wire

This example is taken from id. at 12.

[51] Many of the headings are further sub-divided into subheadings, which are further subdivided into two-dash subheadings. Id. at 9. Sometimes, the required change in tariff classification occurs at the subheading or the chapter level. For example, in the agricultural chapters, many of the headings specify different kinds of agricultural products which have undergone minimal processing. Id. at 17 (describing how in Chapter 7, which deals with edible vegetables and certain roots and tubers, the headings progress from fresh or chilled

vegetables (7.01 - 7.09) to frozen vegetables, whether uncooked, steamed or boiled vegetables (7.10), to provisionally preserved vegetables unsuited for immediate consumption (7.11) to dried vegetables (7.12, 7.19) to roots and tubers (7.19)). There, a product will be substantially transformed if the change occurs at the chapter level. For example, the North American Free Trade Agreement dealt with the vegetable problem by stating that items in headings 7.01 - 7.14 originate in the country where they were transformed from an item classified in a different chapter. See NAFTA, Annex 401.1. See also Asakura, supra note 45, at 17 (describing the eighteen times that NAFTA requires a change at the chapter level instead of at the heading level for at least some of the headings contained in that chapter).

[52] See, e.g., Vermulst, Revisited, supra note 3, at 73.

There is no need to develop a new classification system designed specifically for origin determinations, given that the Harmonized System has already developed a rather accurate, predicable, universally adopted, and well-managed classification system.

[53] See, e.g., NAFTA, art. 401(d)(i) (good originates in the preferential territory if it "is produced entirely in the territory of one or more of the Parties but one or more of the non-originating parts used in the production of the good does not undergo a change in tariff classification because the good was imported into the territory of a Party in an unassembled or a disassembled form but was classified as an assembled good pursuant to General Rule of Interpretation 2(a) of the Harmonized System").

[54] See, e.g., Origin Agreement, supra note 4, at art. 9(2)(c)(iii) (stating that the harmonized rules of origin may use supplementary criteria); NAFTA art. 402 (setting out the regional value content test which is used as a supplementary test to the change in tariff classification test).

[55] See Origin Agreement, supra note 4, at art. 9(2)(c)(i) (stating that the harmonized rules of origin will contain a list of minimal operations or processes that do not by themselves confer origin on a good); NAFTA, at art. 412 (listing non-qualifying operations).

These processes may include simple packing and preservation operations, simple mixing of products of the same or different kind, and simple assembly of parts into complete articles. These disqualifying provisions can be controversial because they may exclude processes, such as mixing and assembly, that may add a great deal of value. However, this problem can be resolved by adopting exceptions to the exceptions, i.e., by specifying the mixing and assembly processes that will confer origin, notwithstanding the general rule that mixing and assembly do not confer origin.

[56] However, disputes over tariff classification, such as whether a vehicle is a truck or a van, do occur, because this classification system, like any classification system, is sometimes imprecise and subject to political considerations. N. David Palmeter, The U.S. Rules of Origin Proposal to GATT: Monotheism or Polytheism?, 24:2 J.W.T. 25, 28 (April 1990).

[57] The Harmonized System Committee seeks to ensure uniform international application of the system by making classification decisions and settling international classification disputes between member countries. It also assists with the problem of fitting millions of goods into the 1241 four-digit headings by publishing the Harmonized System's General Rules for Interpretation, its detailed Legal Notes, and the extensive complementary publications such

as the Custom Co-operation Council's Explanatory Notes. These sources of information on interpretation and help with application help ensure more uniform, accurate and predictable classifications.

(…)

3. United States - Rules of Origin for Textiles and Apparel Products

Panel Report, WT/DS243/R, 20 June 2003
http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds243_e.htm

[The footnote numbering does not correspond to the footnote numbering in the original report]

Chairperson: Mr Lars Anell; Members: Ms Mary Elizabeth Chelliah, Mr Donals McRae

(…)

VI. FINDINGS

A. MEASURES AT ISSUE

6.1 The measures at issue in this dispute are:

(a) Section 334 of the US Uruguay Round Agreements Act[1] (hereafter "section 334"), which entered into force on 1 July 1996,

(b) the clarification of section 334 contained in section 405 of the United States Trade and Development Act[2] (hereafter "section 405"), which entered into force on 18 May 2000, and

(c) the customs regulations contained in 19 C.F.R. § 102.21[3], which implement the aforementioned statutory provisions.

6.2 Section 334, as amended, is codified at 19 U.S.C. § 3592. In this Report, we will use the term "section 334" to refer to those parts of section 334, as amended, which were not affected by the amendments made by section 405. Similarly, we will use the term "section 405" to refer to those parts of section 334, as amended, which incorporate the amendments made by section 405.

6.3 Section 334 and section 405 lay down rules of origin, *inter alia*, for fabrics and certain made-up non-apparel articles assembled in a single country from single country fabric. The latter category of goods, also referred to in this Report as "flat goods", include goods of export interest to India, notably bedding articles (bed linen, quilts, comforters, blankets, etc.) and home furnishing articles (wall hangings, table linens, etc.).

6.4 Section 334 provides, in relevant part, that fabrics and made-up non-apparel articles falling under 16 specified HTS 4-digit headings[4] – essentially flat goods – are considered to

[1] Pub. Law 103-465, 108 Stat 4809, enacted on 8 December 1994, and codified at 19 U.S.C. § 3592. For the text of section 334, see, *supra*, para. 2.2.
[2] Pub. Law 106-200, entitled "Clarification of Section 334 of the Uruguay Round Agreements Act", enacted on 18 May 2000, and codified at 19 U.S.C. § 3592. For the text of section 405, see, *supra*, para. 2.5.
[3] Reproduced, in relevant part, in Annex C.
[4] For a list of the goods concerned, see *supra*, para. 2.3. India notes that one of the 16 HTS headings refers to goods which are deemed to originate where the yarn was produced. India's first written submission, para. 36.

originate in the country where the fabric is woven, knitted or otherwise formed, regardless of any further finishing operations which may have been performed in respect of the fabrics or articles concerned.[5] The parties have in some instances referred to this rule of origin as the "fabric forward" rule. We prefer to use the term "fabric formation" rule.

6.5 Section 405 provides, in relevant part, for two exceptions from the fabric formation rule established by section 334. The *first* exception created by section 405 is that fabric classified under the relevant HTS headings as of silk, cotton, man-made or vegetable fibre are considered to originate in the country in which the fabric is both dyed and printed when accompanied by two or more of the following finishing operations: bleaching, shrinking, fulling, napping, decating, permanent stiffening, weighting, permanent embossing, or moireing. We will refer to this rule as the "DP2" rule, and to the relevant operations as "DP2 operations". The DP2 rule does not apply to wool fabric, which, therefore, remains subject to the fabric formation rule established by section 334.

6.6 The *second* exception created by section 405 is that made-up non-apparel articles classified under seven of the 16 HTS 4-digit headings specified in section 334[6] are subject to the DP2 rule, except where such articles are classified under the relevant headings as of cotton or of wool or consisting of fibre blends containing 16 percent or more by weight of cotton. The articles classified under the relevant headings as of cotton or of wool or consisting of fibre blends containing 16% or more by weight of cotton remain subject to the fabric formation rule established by section 334.[7]

6.7 The two tables reproduced below reflect in simplified form our understanding of the relevant provisions of section 334 and section 405.

Table 1 – Origin of Fabrics

ORIGIN OF *FABRICS*		
ORIGIN-CONFERRING PROCESS	**FABRIC-FORMATION** (KNITTING, WEAVING, ETC.)	**DYEING & PRINTING OF FABRIC & TWO OR MORE SPECIFIED FINISHING OPERATIONS ("DP2")**
Wool fabrics	YES (section 334(b)(1)(C))	NO
Other fabrics (silk, cotton, man-made fibres and vegetable fibres)	YES (section 334(b)(1)(C), unless subsequently subjected to DP2)	YES (section 405(a)(3)(B))

[5] United States' reply to Panel question No. 7.
[6] For a list of the goods concerned, see *supra*, para. 2.7.
[7] It is our understanding from the parties' submissions that, under the United States' regulations applicable before section 334 entered into force, DP2 operations were normally considered significant enough, for fabrics and certain flat goods, to confer origin. United States' replies to Panel questions Nos. 33 and 47(a); India's first written submission, paras. 14-15.

Table 2 – Origin of Made-Up Articles Assembled in a Single Country from Single Country Fabric(s)

ORIGIN OF *MADE-UP ARTICLES* ASSEMBLED IN SINGLE COUNTRY FROM SINGLE COUNTRY FABRIC(S)			
ORIGIN-CONFERRING PROCESS	**FABRIC-FORMATION** (KNITTING, WEAVING, ETC.)	**DYEING & PRINTING OF FABRIC & 2 OR MORE SPECIFIED FINISHING OPERATIONS ("DP2")**	**"WHOLLY ASSEMBLED"**
Articles (scarves, bed linen, etc.) **specified in section 334(b)(2)(A) and section 405(a)(3)(C) and made of**:			
- **Wool**	YES (section 334(b)(2)(A))	NO	NO
- **Cotton**	YES (section 334(b)(2)(A))	NO	NO
- **Cotton blends** (more than 16% cotton by weight)	YES (section 334(b)(2)(A))	NO	NO
- **Other** (silk, man-made fibres, vegetable fibres)	YES (section 334(b)(2)(A), unless subsequently subjected to DP2)	YES (section 405(a)(3)(C))	NO
Articles which are "knit to shape" (e.g., stockings)	YES (section 334(b)(2)(B), although "knitting-to-shape" is not considered fabric making, but component or article formation)	NO	NO
Other articles (including apparels)	NO	NO	YES (section 334(b)(1)(D))

6.8 It should be noted that the rules of origin contained in section 334, as amended, are used by the United States "for purposes of the customs laws and the administration of quantitative restrictions".[8] They are, accordingly, used not only for the administration of quantitative restrictions, but also for such purposes as the gathering of trade statistics, origin marking and administering MFN customs duties.[9] However, the present dispute primarily arises from the application of section 334, as amended, for the purpose of administering the textile quota regime maintained by the United States pursuant to the provisions of the *Agreement on Textiles and Clothing*.[10] Thus, this dispute concerns the use of rules of origin in support of a trade policy instrument – quotas – which, by definition, is trade-restrictive. The United States even acknowledges that the textile quota regime has been put in place "for the purpose of protecting its domestic industry during the […] transition period [provided for in the *Agreement on Textiles and Clothing*]".[11]

6.9 Regarding the customs regulations contained in 19 C.F.R. § 102.21, it is sufficient to note that they were promulgated pursuant to section 334(a) and amended, on an interim basis, to take

[8] Section 334(b)(1).
[9] United States' reply to Panel question No. 34.
[10] India's first oral statement, paras. 8 and 11.
[11] United States' second written submission, para. 10.

account of the amendments made to section 334 by section 405. The regulations contained in 19 C.F.R. § 102.21, including the interim amendments, are legally binding.[12]

B. OVERVIEW OF THE PARTIES' CLAIMS AND ARGUMENTS

6.10 **India** claims that the United States rules of origin set out in section 334 and modified in section 405 and the customs regulations implementing these statutory provisions, and the application of these statutory provisions and implementing regulations:[13]

(a) are being used by the United States as instruments to pursue trade objectives, thereby violating Article 2(b) of the *RO Agreement*. Section 334 is being used as an instrument to protect the United States' textile and apparel industry. Section 405 is being used as an instrument to favour imports of the products of concern to the European Communities;

(b) create restrictive, distorting and disruptive effects on international trade and are, therefore, inconsistent with the United States' obligations under Article 2(c), first sentence, of the *RO Agreement*;

(c) require the fulfilment of a certain condition not related to manufacturing or processing and pose unduly strict requirements and are, therefore, inconsistent with Article 2(c), second sentence, of the *RO Agreement*; and

(d) with respect to section 405, discriminate between Members, and in particular, discriminate in favour of the European Communities and are, therefore, inconsistent with the United States' obligations under Article 2(d) of the *RO Agreement*.[14]

6.11 Based on these claims, India requests that the Panel find that the measures at issue, and their application, are inconsistent with the United States' obligations under Article 2(b), (c) and (d) of the *RO Agreement*, and that the Panel recommend that the United States bring its measures into conformity with its obligations under the *RO Agreement.*[15]

6.12 The **United States** argues that the rules of origin at issue are not inconsistent with Article 2(b), (c) or (d). According to the United States, these rules were enacted to combat circumvention of established quotas, prevent transshipment, facilitate harmonization and best capture where a new product is formed. The United States further argues that these rules of origin were offered on an MFN basis, in accordance with WTO rules. In the view of the United States, the measures at issue are therefore not inconsistent with the *RO Agreement*. Rather, they facilitate the flow of international trade, consistent with the terms of the preamble to the *RO Agreement*.

6.13 Based on these arguments, the United States requests that the Panel find that India has failed to establish that the measures at issue are inconsistent with Article 2(b), (c) and (d) of the *RO Agreement.*

---

[12] United States' reply to Panel question No. 54(a); India's reply to Panel question No. 54(a); *supra*, para. 2.8.

[13] India's first written submission, para. 8; India's second written submission, para. 75.

[14] India's second oral statement, para. 18.

[15] India initially also claimed that the criteria used in section 334 and section 405 are so complex and arbitrary that it is nearly impossible to administer these statutory provisions in a consistent, uniform, impartial and reasonable manner and that these provisions are, therefore, inconsistent with Article 2(e) of the *RO Agreement*. India's first written submission, para. 101. India later abandoned this claim. India's second written submission, footnote 37.

6.14 The **Panel** notes that, in response to its questions, India has clarified that its claims concern the imposition and maintenance by the United States of the rules of origin set out in section 334 and section 405, and implemented through customs regulations, not the fact that the United States changed its rules of origin in 1996 and 2000.[16] As a result, we understand India's complaint to be in respect of the results of the United States' legislative changes made in 1996 and 2000, not the fact that changes were made.[17]

C. PRELIMINARY REMARKS

(…)

3. Disciplines prescribed by Article 2 of the *RO Agreement*

6.21 All of India's claims are based on the provisions of Article 2 of the *RO Agreement*. Article 2 lays down disciplines governing Members' application of non-preferential rules of origin "[u]ntil the work programme for the harmonization of rules of origin set out in Part IV [of the *RO Agreement*] is completed".[18] After this "transition period"[19], *i.e.*, "upon implementation of the results of the harmonization work programme"[20], Members will apply harmonized rules of origin and the application of those rules will be subject to the provisions of Article 3 of the *RO Agreement*.

6.22 As of the date of establishment of this Panel, the work programme for the harmonization of rules of origin set out in Part IV of the *RO Agreement* had not been completed. As a result, India is entitled to invoke the provisions of Article 2 of the *RO Agreement*.

6.23 With regard to the provisions of Article 2 at issue in this case – subparagraphs (b) through (d) – we note that they set out what rules of origin should not do: rules of origin should not pursue trade objectives directly or indirectly[21]; they should not themselves create restrictive, distorting or disruptive effects on international trade[22]; they should not pose unduly strict requirements or require the fulfilment of a condition unrelated to manufacturing or processing[23]; and they should not discriminate between other Members[24]. These provisions do not prescribe what a Member must do.

6.24 By setting out what Members cannot do, these provisions leave for Members themselves discretion to decide what, within those bounds, they can do. In this regard, it is common ground between the parties that Article 2 does not prevent Members from determining the criteria which confer origin[25], changing those criteria over time[26], or applying different criteria to different goods[27].

6.25 Accordingly, in assessing whether the relevant United States rules of origin are inconsistent with the provisions of Article 2, we will bear in mind that, while during the post-

[16] India's reply to Panel questions Nos. 15 and 18.
[17] *Ibid.*
[18] Chapeau of Article 2 of the *RO Agreement*.
[19] Title of Article 2 of the *RO Agreement*.
[20] Article 3 of the *RO Agreement*.
[21] Article 2(b) of the *RO Agreement*.
[22] Article 2(c), first sentence, of the *RO Agreement*.
[23] Article 2(c), second sentence, of the *RO Agreement*.
[24] Article 2(d) of the *RO Agreement*.
[25] India's first oral statement, para. 5; India's reply to Panel question No. 4; United States' first oral statement, para. 3.
[26] India's first oral statement, para. 6; United States' first oral statement, para. 3
[27] India's first oral statement, para. 6; United States' first written submission, para. 8.

harmonization period Members will be constrained by the result of the harmonization work programme, during the transition period, Members retain considerable discretion in designing and applying their rules of origin.

D. INDIA'S CLAIMS IN RESPECT OF SECTION 334 AND SECTION 405

6.26 In this Section, the Panel will assess India's claims in respect of the statutory provisions at issue in this dispute, *i.e.*, section 334 and section 405. In the next Section, the Panel will assess India's claims in respect of the customs regulations implementing these statutory provisions.

1. India's claims under Article 2(b) of the *RO Agreement*

6.27 India claims that both section 334 and section 405 are inconsistent with Article 2(b) of the *RO Agreement*. The Panel will examine these claims in turn. Before doing so, however, it is necessary to address the parties' interpretation of Article 2(b).

(a) Article 2(b) of the *RO Agreement*

6.28 Article 2(b) provides as follows:

> "Until the work programme for the harmonization of rules of origin set out in Part IV is completed, Members shall ensure that:
>
> […]
>
> (b) notwithstanding the measure or instrument of commercial policy to which they are linked, their rules of origin are not used as instruments to pursue trade objectives directly or indirectly[.]"

6.29 **India** considers that the operative clause of Article 2(b) is the obligation that rules of origin must not be used "as instruments to pursue trade objectives". India points out that the *New Shorter Oxford English Dictionary* defines "instrument" as "a thing used in or for performing an action; a means" and "objective" as the "thing aimed at or sought; a target, a goal, an aim". India considers, therefore, that the ordinary meaning of the term "trade objective" in the context of Article 2(b) is an aim, goal, or object related to trade. According to India, for the purposes of this dispute, it is not necessary to develop a general definition of the term "trade objectives". In India's view, it is sufficient for the Panel to find that trade objectives include the objective of protecting the domestic industry against import competition or of favouring imports from one country over imports from another. India maintains that any rule of origin that is used as an instrument to protect a domestic industry or to favour imports from one country over imports from another country is an instrument to pursue "trade objectives" as that term is used in Article 2(b).

6.30 India considers that its interpretation of Article 2(b) is supported by the context. The use of the term "notwithstanding" in the preceding clause – "notwithstanding the measure or instrument of commercial policy to which they are linked" – implies a contrast between this clause and the prohibition that rules of origin must not be used to pursue trade objectives. Thus, in India's view, measures or commercial policy instruments may pursue aims, goals or objects related to trade, or trade objectives, but rules of origin may not do so either directly or indirectly. In other words, WTO Members may use rules of origin to implement commercial policy instruments of the kind listed in Article 1.2 of the *RO Agreement*, but they may not use rules of origin to pursue policy objectives of the kind commonly pursued with these policy instruments.

6.31 India contends that the object and purpose of the *RO Agreement* also supports its interpretive approach. Specifically, India notes that the seventh recital of the preamble states that Members desire, through the *RO Agreement*, "[…] to ensure that rules of origin are prepared and applied in an impartial, transparent, predictable, consistent and neutral manner". India also notes that, according to its preamble, the *RO Agreement* is "to further the objectives of the GATT 1994". According to the preamble of the GATT 1994, the GATT 1994 is to expand the production and exchange of goods through the reduction of tariffs and other barriers to trade. In India's view, one of the fundamental purposes of the *RO Agreement* thus is to ensure that the barriers to trade Members agreed to reduce in the framework of the GATT 1994 are not indirectly re-established through the use of rules of origin protecting domestic industries.

6.32 Finally, with respect to how to assess whether a rule of origin is being used as an instrument to pursue a trade objective, India submits that one way is to assess whether the rule of origin in question achieves the same results as a measure or instrument of commercial policy. India also considers it useful to examine the design, architecture, and structure of the relevant rule of origin. India recalls that the Appellate Body has noted that "[a]lthough it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the *design*, the *architecture*, and the revealing *structure* of a measure".[28]

6.33 The **United States** agrees with India that the operative clause in Article 2(b) is the obligation that rules of origin are not to be used "as instruments to pursue trade objectives". The United States also agrees that "instrument" can be defined as "tool", "device", or "means" and that "objective" is a goal. Likewise, the United States agrees that the preamble to the *RO Agreement* provides the relevant "object and purpose" of the *RO Agreement*. However, the United States submits that India's interpretation of a "trade objective" is overly broad. The United States argues that if "trade objective" is understood to be any objective related to trade, rules of origin could not be used to pursue transparency or predictability, two trade-related goals. According to the United States, such an interpretation would be at odds with both the object and purpose of the *RO Agreement* and the context of Article 2(b).

6.34 As for India's contention that the protection of a domestic industry and the favouring of imports from one Member over imports from another would constitute "trade objectives" within the meaning of Article 2(b), the United States accepts India's contention that protection of a domestic industry is an "impermissible" trade objective for the purposes of Article 2(b). Concerning the other objective identified by India as a "trade objective" – the favouring of imports from one Member over imports from another – the United States cautions that rules of origin might have the practical effect of favouring one Member over another and that such rules could not, on that basis alone, be considered to pursue a "trade objective".[29] Apart from this, the United States does not raise concerns with respect to the second trade objective referred to by India. In fact, the United States suggests that "discrimination" in favour of one Member could be considered to be a "trade objective".[30]

6.35 Regarding the issue of how it can be assessed whether a rule of origin is being used as an instrument to pursue a trade objective, unlike India, the United States does not consider that it is necessary or relevant to analyse whether the design, structure and architecture of a contested rule of origin measure reveals an "impermissible" trade objective.

---

[28]Appellate Body Report, *Japan – Taxes on Alcoholic Beverages* ("*Japan – Alcoholic Beverages II* "), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, DSR 1996:I, 97, at 120 (emphasis added by India).

[29] United States' reply to Panel question No. 6; United States' second written submission, para. 31.

[30] United States' second written submission, para. 29.

6.36 The **Panel** agrees with the parties that the operative part of Article 2(b) is the phrase "rules of origin are not [to be] used as instruments to pursue trade objectives directly or indirectly". It is clear from this phrase that in order to establish a violation of Article 2(b), a Member needs to demonstrate that another Member is using rules of origin for a specified purpose, *viz.*, to pursue trade objectives. As noted by India, this interpretation of Article 2(b), which is not in dispute, confronts the Panel with the following two issues. *First*, how is the Panel to determine whether a Member's rules of origin are used for the purpose specified in Article 2(b)? And *second*, what are "trade objectives"?

6.37 Beginning with the *first* issue, we agree with India that the Appellate Body has already taken a position on how panels should conduct an inquiry into the objectives of a measure. The Appellate Body did so in the context of an analysis under Article III:2, second sentence, of the GATT 1994. In examining whether a tax measure was applied "so as to afford protection to domestic production", the Appellate Body stated that:

> "[…] it is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent." The *subjective* intentions inhabiting the minds of individual legislators or regulators do not bear upon the inquiry, if only because they are not accessible to treaty interpreters. It does not follow, however, that the statutory purposes or objectives – that is, the purpose or objectives of a Member's legislature and government as a whole – to the extent that they are given *objective* expression in the statute itself, are not pertinent. To the contrary, as we also stated in *Japan – Alcoholic Beverages*:
>
> > Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the *design*, the *architecture*, and the revealing *structure* of a measure. (emphasis added)"[31]

6.38 The reasons cited by the Appellate Body in support of its view do not appear to be specific to the provisions of Article III:2, second sentence, of the GATT 1994. Hence, these reasons apply with equal force in the context of Article 2(b) of the *RO Agreement*. Accordingly, in applying Article 2(b), we will follow the above-quoted statement by the Appellate Body.

6.39 In respect of the *second* issue, the meaning of the term "trade objectives" as it appears in Article 2(b), we recall the statement by India that, for the purposes of the present dispute, it is not necessary for the Panel to develop a general definition of the term "trade objectives". India considers that it would be sufficient for the Panel to find that the objectives of protecting the domestic industry against import competition and favouring imports from one Member over imports from another are "trade objectives" within the meaning of Article 2(b).[32] The United States has not objected to the Panel proceeding in this way.

6.40 In seeking to determine whether the objectives of "protecting the domestic industry against import competition" and "favouring imports from one Member over imports from another" are "trade objectives" within the meaning of Article 2(b), the Panel begins by noting that, as a textual matter, these objectives are clearly related to trade. In that sense, they could

---

[31] Appellate Body Report, *Chile – Taxes on Alcoholic Beverages* ("*Chile – Alcoholic Beverages*"), WT/DS87/AB/R, WT/DS110/AB/R, adopted 12 January 2000, DSR 2000:I, 281, para. 62 (footnotes omitted).

[32] India's second written submission, para. 24; India's first oral statement, para. 18.

certainly be covered by the ordinary meaning of the term "trade objectives", which, as India has identified, is "goals" or "aims" related to trade.[33]

6.41 The relevant context supports this reading of the term "trade objectives". Article 2(c), first sentence, of the *RO Agreement* provides that "rules of origin shall not themselves create restrictive, distorting, or disruptive effects on international trade". This provision reveals a concern about rules of origin inhibiting trade. Reading Article 2(b) in this context supports the interpretation that Article 2(b) prohibits the use of rules of origin for the purpose of protecting the domestic industry against import competition and of favouring imports of one Member over imports from another.

6.42 More importantly, we note that the operative clause of Article 2(b) – to the effect that rules of origin should not be used as instruments to pursue trade objectives – is preceded by the phrase "notwithstanding the measure or commercial policy instrument to which they are linked". This phrase implies that, whereas rules of origin may not pursue "trade objectives", commercial policy measures or instruments may do so. It follows that the "trade objectives" mentioned in the operative clause of Article 2(b) would include the kind of policy objectives which trade policy measures or instruments typically pursue. Plainly, the objectives of "protecting the domestic industry against import competition" and "favouring imports from one Member over imports from another" fit within this category.

6.43 Finally, we believe that interpreting the term "trade objectives" as suggested by India is consistent with the objective of Article 2(b). In our view, Article 2(b) is intended to ensure that rules of origin are used to implement and support trade policy instruments, rather than to substitute for, or to supplement, the intended effect of trade policy instruments. Allowing Members to use rules of origin to pursue the objectives of "protecting the domestic industry against import competition" or "favouring imports from one Member over imports from another" would be to substitute for, or supplement, the intended effect of a trade policy instrument and, hence, be contrary to the objective of Article 2(b).

6.44 Taken together, the foregoing considerations lead us to the conclusion that the objectives identified by India – *i.e.*, the objectives of "protecting the domestic industry against import competition" and of "favouring imports from one Member over imports from another" – may, in principle, be considered to constitute "trade objectives" in pursuit of which rules of origin may not be used.

6.45 Bearing in mind the above conclusions, we now turn to examine whether section 334 is inconsistent with Article 2(b), as claimed by India.

(b) Consistency of section 334 with Article 2(b) of the *RO Agreement*

6.46 **India** argues that an examination of the design, architecture, and structure of section 334 shows that it is used as an instrument to pursue the objective of protecting the domestic textiles and apparel industry. India submits that section 334 confers origin on the basis of criteria that are unrelated to the value added operations or the change in the nature of the product. Instead, the criteria are those that are commonly used in the application of commercial policy instruments.

6.47 India considers that the new rules of origin moved the United States away from those used by its major trading partners such as the European Communities and Canada. To India's knowledge, no other country determines origin on the basis of the place where the greige fabric was formed, if that fabric was further processed and made into a flat good, thereby reflecting the importance of cutting and sewing to produce a finished product. India notes that greige fabric, and even dyed and printed greige fabric, can be put to a variety of uses. India points out that, in

[33] *Supra*, para. 6.29.

contrast, once the fabric is cut and sewn into a pillowcase, no one can use that fabric for anything other than a pillow case.

6.48 India argues that the fact that the "fabric forward" rule set out in section 334 is used for a wide variety of non-apparel flat textile articles, such as bedding articles (quilts, comforters, mattresses, blankets), home furnishings (wall hangings, table linens) and fashion accessories such as scarves, shows that the section 334 rules are being used as instruments to pursue trade objectives. India notes in this respect that, for home textiles, bedding articles, furnishings, and miscellaneous made up articles, the section 334 rules work a significant change in the determination of the country of origin. India notes that under the "fabric forward" rule, these products are deemed to originate in the country where their constituent fabric is formed (woven or knitted) in the greige state and no account is taken of any subsequent value-added operations such as the dyeing, printing or finishing of the fabric, the cutting of the fabric into components, the assembly of those components into finished articles or any other operations. India offers the example of down-filled comforters, which are classified under HTS subheading 9404.90 and subject to the fabric forward rule. According to India, this means that if the down-filled comforter was cut, sewn and assembled in country A and had a value of US $200, it would be nevertheless determined as a product of country B if the greige fabric used in its manufacture, which cost only a few dollars, was woven in country B.

6.49 India submits that the clearly protectionist objective of section 334 can be demonstrated by its effect on the determination of origin for the products subject to section 334. India points out that the effect of section 334, especially its fabric forward provision, was that a range of textiles and clothing products imported into the United States were subjected to the strict quotas of the developing countries whereas previously they had been under no quota or a more generous quota. In India's view, the fabric forward rule increases the quantities of textile imports that are conferred the origin of the countries that are under quota.[34] India argues that this strengthens the impact of the United States' quota regime under the *Agreement on Textiles and Clothing* which – as the United States admits – was put in place to protect the domestic industry. According to India, the fabric forward rule is thus clearly being used to pursue a trade objective.

6.50 India further notes that, according to the Statement of Administrative Action (the "SAA") that accompanied the Uruguay Round Agreements Act[35], the purpose of section 334 was to:

- help combat transhipment and other circumvention of textile and apparel quotas;
- bring the United States' rules of origin in line with the rules employed by other major textile and apparel importing countries;
- advance the goal of harmonizing international rules of origin set out in the WTO *RO Agreement*;
- more accurately reflect where the most significant production activity occurs.[36]

6.51 With respect to the *first* objective listed in the SAA, India notes that there is a specific provision in Article 5 of the *Agreement on Textiles and Clothing* which enables countries to

[34] In its second oral statement, India went further and said that the fabric forward rule "by definition" increases the quantities of textile imports that are conferred the origin of the countries that are under quota. India's second oral statement, para. 8.

[35] The SAA may be found in "Message of the President of the United States Transmitting the Uruguay Round Agreement, Text of Agreements, Implementing Bill, Statement of Administrative Action and Required Supporting Documents", H.R. Doc. No. 316, 103d Cong. 2d Sess., Vol. 1 (1994) at 656 *et. seq.*; exhibit US-6.

[36] SAA, *supra*, pp. 118-119.

address the problem of "circumvention by transhipment, re-routing, false declaration concerning country or place of origin, and falsification of official documents". India points out that Article 5.2 specifically provides that "should any Member believe that [the *Agreement on Textiles and Clothing*] is being circumvented by transhipment, re-routing, false declaration concerning country or place of origin, and falsification of official documents, and that no, or inadequate, measures are being applied to address and/or take action against such circumvention, that Member should consult with the Member or Members concerned with a view to seeking a mutually satisfactory solution". In the view of India, the section 334 changes in determining the rules of origin do not assist the United States in combating transhipment and other circumvention of textile and apparel quotas.[37]

6.52 India further notes that Article 5.1 of the *Agreement on Textiles and Clothing* provides that circumvention "frustrates the implementation of this Agreement to integrate the textiles and clothing sector into GATT 1994. Accordingly, Members should establish the necessary legal provisions and/or administrative procedures to address and take action against such circumvention […]". India submits that *section 333* of the URAA[38], rather than section 334, was enacted to implement Article 5.1 since it tracks the language of Article 5.1 more directly, and addresses more specifically the type of circumvention noted in Article 5 of the *Agreement on Textiles and Clothing*.[39] According to India, this implies that section 334 was passed for reasons other than to prevent circumvention within the meaning of Article 5.1 of the *Agreement on Textiles and Clothing*.

6.53 India points out that, notwithstanding this, the United States insists that section 334 was passed, *inter alia*, "to prevent quota circumvention and address illegal transhipment […]".[40] India points out that the definition of "circumvention" was provided by the United States when it cited with approval a commentary that the United States *was* addressing circumvention through section 334 because "some new industrialized countries of Southeast Asia could otherwise try to circumvent the quantitative restrictions applied to their exports of textile products. They could do so by exporting semi-finished products (*in casu* dyed or printed cloths) to third countries, in the hope that the origin of those countries (for which no quantitative restrictions for exports of textile products are applied) would be attributed to the finished cloths". India submits that this is not circumvention. India recalls its view that circumvention is a term which implies a violation of the applicable origin rules through false declarations and other illegitimate means. India considers that the reaction of the market to the incentives and disincentives created by country-specific quotas cannot be described as circumvention. The newly industrialized countries of Southeast Asia were not, in the view of India, "circumventing" origin rules, but were adapting their production to their market access conditions. India considers that since the origin determinations of the products in these new trade patterns were conducted in conformity with the pre-section 334 rules of origin, as a matter of definition, they could not constitute "circumvention".

---

[37] According to India, the question arises here that if the United States believed the application of the principle of substantial transformation did not discourage transhipment or other circumvention of textile and apparel quotas and sought therefore to move away from this principle in section 334, why did it revert to the substantial transformation principle to determine origin for some of the products listed in the specified HTS heading in section 405, but not all products, when it settled the dispute with the European Communities?

[38] Exhibit INDIA-5.

[39] Referring to the negotiating history, India notes that in the Senate Report, under the heading "Textile transshipments" (section 333), there is a reference to Article 5.1 of the *Agreement on Textiles and Clothing*. Specifically, India notes that the Report states that section 333 of the URAA adds a new section to Title IV to address specifically the problem of textile transshipments.

[40] India refers to United States' first written submission, para. 29.

6.54 India further notes that the European Communities rightly points out that if the expression "circumvention of quotas" was used by the United States to describe the changing of trade patterns in response to quotas, the intent to pursue a trade objective could be established through the legislative history itself. India considers that the United States' intention to combat "circumvention" corresponds, in the words of the European Communities, to an intention to "re-apply quantitative restrictions where these have lost their bite through changes in trade patterns and regulations".[41] In India's view, this is precisely the type of trade objective that Members are not to achieve through the use of rules of origin.[42] India submits that the prevention of quota circumvention as defined by the United States is the pursuit of a trade objective.

6.55 Regarding the *second* objective of section 334 as described in the SAA, India asserts that the section 334 rules on fabric did not bring the United States' rules of origin in line with the rules employed by other major textile and apparel importing countries or United States trading partners. India considers that, to the contrary, section 334 was the subject of criticism in the WTO Committee on Rules of Origin. India notes, for example, that at the 1 February 1996 meeting, the representatives of Canada, the European Communities and Switzerland expressed concern with respect to the unilateral changes of origin rules for certain textiles and apparel by the United States.[43] India submits that if United States had in effect changed its rules of origin in order to harmonize them with those of its major trading partners such as the European Communities and Canada, those very trading partners would not have expressed concern over those changes. India argues that the fact that the European Communities challenged the United States rules of origin in the WTO indicated that it considered the United States' rules to be fundamentally different from those of the European Communities.

6.56 With regard to the *third* objective listed in the SAA, India contends that section 334 did not advance the goal of harmonizing the international rules of origin set out in the *RO Agreement*. India points out that Article 3 of the *RO Agreement* recognises the aim of Members to achieve the establishment of harmonized rules of origin, and, in this regard, sets forth in subparagraph (b) that "Members shall ensure, upon the implementation of the results of the harmonization work programme, that: […] (b) under their rules of origin, the country to be determined as the origin of a particular good is either the country where the good has been wholly obtained or, when more than one country is concerned in the production of the good, the country where the last substantial transformation has been carried out". In India's view, section 334 represents a step away from the basis of substantial transformation.

6.57 With regard to the *fourth* objective listed in the SAA, India considers that it is unclear how the principle of determining origin as set out in section 334(b)(2)(A), *i.e.*, that the origin for certain made-up articles is determined where the greige fabric is woven, would help the United States "more accurately reflect where the production activity takes place". In India's view, the production activity would more accurately be determined where the value is added or the last substantial transformation takes place, rather than where the greige fabric is woven.

6.58 The **United States** notes that India makes three arguments with respect to its claim that section 334 is inconsistent with Article 2(b): (1) the objective of the United States in formulating its rules of origin was to protect its domestic industry; (2) the Panel should look to the measures or instruments of commercial policy listed in Article 1.2 of the *RO Agreement* and assess whether the United States' rule of origin "achieves the same results"; and (3) "the design,

[41] India refers to European Communities' written third-party submission, para. 24.
[42] India refers to *ibid*.
[43] India refers to document G/RO/M/5, para. 1.6.

architecture and structure" of section 334 "demonstrate that it was adopted to protect the domestic textile industry".[44]

6.59 With respect to the *objectives* of the United States in formulating section 334, the United States argues that section 334 rules of origin do not have as their objective the protection of domestic industry. The United States notes that the SAA is clear on what the objectives of section 334 were: (i) to prevent quota circumvention and address illegal transshipment, to advance harmonization, and (ii) to more accurately reflect where the most significant production activity occurs.[45] According to the United States, the United States Congress concluded that greater clarity needed to be brought into determinations of origin in this area, which the United States says was of great interest to the United States" trading community – whether from the standpoint of seeking to import textiles and apparel or from the standpoint of deterring circumvention of commercial instruments. The United States points out that the type of finishing operations presented to the Customs Service for determination of origin and application of quotas had grown, and under the increasing number of case-by-case applications by the Customs Service of the substantial transformation criteria, the list of processes that were deemed to confer origin also expanded, sometimes including processes that in retrospect were understood not to be significant.[46]

6.60 The United States asserts that India has not shown that preventing circumvention, one of the four stated objectives of section 334, was a smokescreen for protectionism. The United States notes in this regard that the commentaries referenced by India acknowledge that the United States was trying to prevent circumvention: "Some new industrialized countries of Southeast Asia could otherwise try to circumvent the quantitative restrictions applied to their exports of textile products. They could do so by exporting semi-finished products (*in casu* dyed or printed cloths) to third countries, in the hope that the origin of those countries (for which no quantitative restrictions for exports of textile products are applied) would be attributed to the finished cloths."[47] The United States further argues that what India is asking the Panel to do is to disregard what the SAA says about section 334 and make a subjective judgment that preventing circumvention is somehow illegitimate and that this one "illegitimate goal" makes all of section 334 inconsistent with the *RO Agreement*. The United States recalls in this regard that WTO dispute settlement panels have acknowledged that the SAA contains an authoritative expression of the purpose of United States legislation.[48] The United States notes that the SAA stated that section 334 would combat circumvention[49] by: lessening confusion resulting from differences between United States' practices and the practices of other major trading partners (cutting would no longer confer origin); facilitating the use of more effective labelling requirements; and focusing on practices more easily subject to inspection by the United States Customs Service.

[44] The United States refers to paras. 46-49 of India's first written submission.
[45] The United States considers that these objectives are entirely consistent with and supportive of the objectives of the *RO Agreement* itself.
[46] As one example of these processes the United States cites cutting. According to the United States, some traders successfully argued that the location of cutting of a product that could receive further finishing conferred origin. The United States notes that Congress acted to harmonize United States rules in this respect with those of the United States' major trading partners
[47] The United States refers to exhibit INDIA-12.
[48] The United States refers, *inter alia*, to Panel Report, *United States – Section 129(c)(1) of the Uruguay Round Agreements Act* ("*United States – Section 129(c)(1) URAA*"), WT/DS221/R, adopted 30 August 2002, paras. 6.36-6.38.
[49] The United States notes that the reference in the SAA to "transshipment" has the same meaning as "circumvention" as that term is used in the *Agreement on Textiles and Clothing*.

6.61 The United States further argues that India's complaint is not so much whether or how the United States was going to deter circumvention but whether trying to address circumvention was acceptable. The United States notes that, in its answers to Panel questions Nos. 2 and 17, India sets a standard for judging whether preventing circumvention is legitimate – such circumvention must only be clearly fraudulent. The United States further notes that India also makes the claim that the United States was not seeking to prevent fraudulent circumvention, but rather "legal circumvention" and that this was therefore illegitimate. In the view of the United States, India's arguments fail for several reasons.

6.62 The United States points out, *first*, that, as India itself acknowledges and as also noted by the European Communities, there is no consensus as to what constitutes "circumvention". The United States believes that the *Agreement on Textiles and Clothing* provides examples of circumvention practices that frustrate the effective integration of textiles into the GATT 1994, but does not define circumvention and there is no consensus among Members on the concept of legitimate *versus* illegitimate circumvention. The United States considers, therefore, that India has not proven that there is an understanding among Members as to what "circumvention" means.

6.63 The United States argues, *secondly*, that if preventing quota circumvention were determined to be a "trade objective" for purposes of Article 2(b), then Members would be severely hampered in their ability to ensure compliance with textile and apparel quotas and to comply with Article 5 of the *Agreement on Textiles and Clothing*. The United States contends that what India so easily objects to as "protectionism" is a methodology for implementing measures sanctioned under the *Agreement on Textiles and Clothing*. In the view of the United States, rules of origin designed to simplify and provide certainty in origin determinations help prevent circumvention.

6.64 The United States notes, *thirdly*, that India's contention regarding section 333 of the Uruguay Round Agreements Act suggests that India has misread or is misrepresenting section 333. According to the United States, section 333 establishes new and more rigorous customs measures to counteract circumvention, once circumvention is uncovered (such as the publication of names of violators, additional "reasonable care" measures for importers to take when doing business with published violators, etc.). The United States argues that the purpose of section 333 is thus to establish "after the fact" remedies, which is different from section 334, the purpose of which is to prevent circumvention from happening in the first instance. The United States submits that both are valid measures to counteract and deter circumvention.

6.65 The United States argues, *finally*, that even assuming *arguendo* that the Panel would elect to disregard the statements in the SAA as "untrue", India would still have the burden of proving that the true purpose of section 334 was a trade objective, namely, the protection of the domestic industry. The United States submits that India has presented no evidence to support this allegation. The United States recalls that it already has a regime in place for the purpose of protecting its domestic industry during the *Agreement on Textiles and Clothing* transition period, *i.e.*, a quota regime, and it does not need to use additional measures or subterfuge for such purposes. According to the United States, it would, therefore, be a leap of legal logic to then find by "implication", as India urges, that the true purpose of section 334 was to protect the United States' domestic industry.[50]

6.66 With respect to the *results* which section 334 achieves, the United States notes that India points to no evidence to support its assertion that section 334 has been used to achieve protection of the domestic industry. The United States argues that, in section 334, it has achieved what it set out to do, *i.e.*, the rules reflect where the most important manufacturing process takes place, there

[50] The United States refers to India's reply to Panel question No. 17(a).

is closer harmonization with major trading partners, and the clear, concise rules have resulted in a greater ability to identify circumvention. The United States claims, in addition, that section 334 has "facilitated an enormous increase" in trade in textile and apparel products to the United States' market.[51] Accordingly, in the view of the United States, a conclusion that section 334 was enacted to protect the United States' textile industry and is therefore pursuing a trade objective in the context of Article 2(b) would not be based on any legal or factual foundation.

6.67 The United States also rejects India's claim that a protectionist objective can be inferred from "quota effect". In the view of the United States, India's contention is a gross oversimplification of a complex worldwide production and trade network. The United States contends that section 334 did not always shift origin to developing countries under tight quotas. In fact, according to the United States, at the time the rules of origin were implemented, and thereafter, six out of the top ten world exporters of cotton fabrics, accounting for 50 percent of world trade in cotton fabric, were countries that were not subject to quantitative restraints on fabric or bed linen in the United States. The United States maintains that, as a result, depending on particular and company-specific sourcing patterns, the application of section 334 rules was as likely to result in goods falling outside of quotas as it was to goods migrating into quotas. The United States further points out that, even before section 334, most cotton bed linen imported into the United States originated in the country where the greige fabric was formed because bed linen is normally either dyed *or* printed, but rarely dyed *and* printed.

6.68 With respect to the issue of the *design, structure and architecture* of section 334, the United States submits that India has not met its burden of showing that the design, structure and architecture of section 334 "reveals" that the United States' "true objective" in enacting section 334 was protection of its domestic industry.

6.69 The United States notes that section 334 established a body of rules that are based on the principle that the origin of fabric and certain textile products is derived where the fabric is woven, knitted or otherwise formed; and that the origin for any other textile or apparel product is where that product is wholly produced or assembled. The United States notes that if production or assembly occurs in more than one country, origin is conferred where the most important assembly, or manufacturing process, takes place. The United States contends that its system is based on the conclusion that origin is conferred where the most important assembly or manufacturing process takes place. According to the United States, this reflects the United States' judgment that assembly is generally the most important step in the manufacturing of assembled apparel and that fabric formation is the most important step in manufacturing fabric or flat goods.

6.70 The United States notes that India disagrees with the judgment of the United States that certain processes constitute sufficient "transformation" to merit changing the origin of a product (except in certain circumstances). The United States argues that there is nothing in the text of the *RO Agreement* that says that Members must confer certain origin determinations[52], and that there is nothing in Article 2(b) that indicates that if a Member does not include certain finishing operations in a determination of origin the Member is using its rules of origin to pursue trade objectives. The United States submits that it is the policy decision of the United States that origin-conferring production is based on assembly, not a finishing operation. The United States notes that its rules take into account which finishing operations merit changing origin, and that that may vary based on the type of product. In the view of the United States, Article 2 does not

[51] United States' second written submission, para. 12.

[52] The United States argues that, to require it to utilize a particular rule for a specific product, as it claims India advocates, would be to add an obligation not contained in the *RO Agreement* during the transition phase.

preclude Members from determining the origin of goods based on assembly, type of material, or type of product.

6.71 Moreover, the United States argues that Article 2(a) sets forth a range of criteria that can be used by a Member in formulating its rules of origin, and that United States' rules of origin for textile and apparel products are consistent with these criteria. According to the United States, India's arguments that the United States should not confer origin based on where the product is formed or assembled essentially renders Article 2(a) a nullity in view of India's sweeping view of the subsequent provisions of Article 2. The United States believes, furthermore, that rules of origin designed to simplify and provide certainty in origin determinations ensure transparency and predictability and allow importers, exporters and Members to work together to prevent circumvention, as directed by Articles 5.1 and 5.5 of the *Agreement on Textiles and Clothing*. Such a design, the United States argues, is clearly consistent with the purpose of Article 2 of the *RO Agreement.*

6.72 The **Panel** begins by recalling India's claim that the United States is using the fabric formation rule set forth in section 334 as an instrument to pursue the objective of protecting its domestic textile industry. This is clear, in India's view, from the features, or design, of the fabric formation rule as well as from its effect.

6.73 We first address the features, or design, of the fabric formation rule. India seeks to cast doubt on the validity of this rule. Specifically, India asserts that no other country uses a fabric formation rule for flat textile goods. Since we have not been provided with information on the rules of origin employed by Members other than the United States, we are not in a position to determine whether Indian's assertion is correct. However, we note *en passant* that, within the framework of the harmonization work programme, a significant number of those Members expressing a view on the issue have indicated support for a fabric formation rule for flat textile goods.[53] In any event, even if the United States was using an unusual rule of origin, that would be irrelevant. There is no requirement in Article 2 of the *RO Agreement* to use a particular type of rule. Instead, as pointed out earlier[54], Article 2 simply provides broad parameters for the use of rules of origin.

6.74 India also appears to question the rationality of a fabric formation rule. India argues, first of all, that a fabric formation rule does not reflect the importance of cutting and sewing to the making of a final article. India notes in this regard that, whereas greige fabric has a variety of uses, once the fabric is cut and sewn into a pillow case, the fabric can only be used as a pillow case. The United States, on the other hand, states that its rules of origin are based on where the most important assembly or manufacturing process takes place and that, in its judgment, fabric formation is the most important step in manufacturing flat goods. We are not aware of any basis in Article 2 of the *RO Agreement* on which to resolve the parties' disagreement regarding what is the most important manufacturing process. The silence of Article 2 on this issue suggests that Members are, subject to the disciplines contained in Article 2(b) and (c), free to make this determination as they deem fit.[55] At any rate, we do not find the United States' view that the flat goods in question (*e.g.*, bedsheets) are basically fabric to be on its face unreasonable.[56] Indeed, as we have noted, the fabric formation rule commands substantial support within the framework of the harmonization work programme. In these circumstances, we are not persuaded that the fabric formation rule is inherently unsound.

---

[53] Document G/RO/52, p. 69.
[54] *Supra*, para. 6.25.
[55] Of course, the disciplines in Articles 2(b) and (c) may bar a Member from using particular rules of origin in a given case. Indeed, this is precisely what we need to examine in this case.
[56] United States' reply to Panel question No. 14.

6.75 The other feature of the fabric formation rule which India finds revealing is that the fabric formation rule takes no account of any subsequent value-added operations, such as a DP2 operation, cutting, etc. India notes that, under a fabric formation rule, an article which has undergone value-added operations worth almost US$200 may be determined to originate in a country where the fabric was formed at a cost of only a few US dollars. However, India points to no legal provision which would require that, during the transition period, origin determinations must reflect the importance of the various value-added operations performed in the manufacture of a good. We see no requirement in Article 2 that Members need to confer origin on the country where a significant, or even the most significant, economic contribution to a final good has been made.[57] Nor do we consider that the fact that an origin-conferring operation may not be the one which adds the most value to the final good necessarily indicates an objective on the part of the United States to use its rules of origin to protect its domestic textile industry.

6.76 In sum, India has not persuaded us that the mere fact that the United States is using a fabric formation rule requires us to conclude that it is doing so in order to protect its domestic textile industry.

6.77 We now turn to examine whether the effect of the fabric formation rule demonstrates that the United States is using section 334 to protect its textile industry. India contends that the application of the fabric formation rule as of mid-1996 meant that a range of flat goods "were subjected to the strict quotas of the developing countries whereas previously they had been under no quota or a more generous quota".[58] Similarly, India asserts that the fabric formation rule, "by definition", increases the quantities of textile imports that would be conferred the origin of the countries that are under quota.[59] India argues that this "strengthens the impact"[60] of the United States' quota regime and renders it "more restrictive"[61].

6.78 It is clear that applying a fabric formation rule will result in flat articles subject to that rule being conferred the origin of the fabric-forming country. Also, *if* the relevant fabric-forming country is under quota in the United States for the article concerned, the article will be subjected to that country's quota. However, the Panel was not provided with any evidence and/or data regarding:

- which countries are under quota in the United States with respect to the articles in question;
- the quota levels of those countries;
- the quota utilization by those countries;
- which countries are important suppliers of relevant fabric (*e.g.*, cotton); and
- the price and quality of the fabric made by those countries and their production capacity.

6.79 In these circumstances, *i.e.*, without specific information on the design of the United States' quota system, the market in the relevant final and intermediate goods and the relationship

[57] Indeed, it is our understanding that, under the widely recognized substantial transformation criterion, a substantial transformation may, in some instances, be said to occur in situations where the transforming process adds little value, or even where it decreases the value of the transformed good.
[58] India's first oral statement, para. 22.
[59] India's second oral statement, para. 8.
[60] *Ibid.*
[61] India's reply to Panel question No. 72.

between the two, it is very difficult to assess the correctness, weight and implications of India's factual assertions.[62]

6.80 It may well be that articles subject to the fabric formation rule became subjected to quotas as of mid-1996, when previously they were not under quota because origin was conferred on a country which was not under quota or on a country which was under a more generous quota. However, in the absence of relevant factual information, it is equally possible that, as a result of the application of the fabric formation rule, certain articles:

- could be exported to the United States quota-free because their fabric was formed in a country that was not under quota, when previously such articles were under quota; and/or
- could be exported to the United States under a more generous quota because the quota levels of the fabric-forming country might be higher than those of the previous origin-conferring country.

6.81 Likewise, it is not apparent that, as a general matter, the fabric formation rule set out in section 334 "by definition" increases the quantities of textile imports that would be conferred the origin of the countries that are under quota. It would certainly not do so if:

- countries producing made-up articles (including fabric-forming countries which export such articles under quota) could source fabric from countries not subject to quota in the United States[63]; and/or if
- countries not under quota in the United States start a fabric-forming industry and export the fabric to countries producing made-up articles.

6.82 Moreover, if more articles would be conferred the origin of quota-countries, this would arguably matter only if the quota utilization of the fabric-forming countries is such that they have no, or insufficient, quota available for countries using fabric made by the quota-countries.[64] In the absence of relevant factual information, we are reluctant simply to conclude that all of these alternative "effects" of the fabric formation rule are hypothetical or irrelevant.

6.83 In conclusion, we consider that the evidence and argument adduced by India do not support the conclusion that the fabric formation rule necessarily, or in fact, brings more imports of made-up articles under quota in the United States.

6.84 In any event, if India had established to our satisfaction that, under the fabric formation rule, more imports would be under quota in the United States, this would only prove that there would be more restrained imports than under the pre-section 334 rules of origin. This circumstance would not prove, however, that the fabric formation rule is being used as an instrument to protect the United States' textile industry rather than as an instrument to implement United States' textile quotas and other commercial policy instruments. Article 2(b) is intended to

---

[62] The Panel does not believe that it would have been difficult for the parties to have provided this information. For instance, some of it is available from notifications to the WTO Textiles Monitoring Body ("TMB"). Without that information and arguments of the parties on its legal significance, the Panel is unable to draw any conclusion.

[63] India itself acknowledges this possibility. India's reply to Panel question No. 61. We also note the United States' assertion that, at the time the rules of origin were implemented, and thereafter, six out of the top ten world exporters of cotton fabrics, accounting for 50 percent of world trade in cotton fabric, were countries that were not subject to quota on fabric or bed linen in the United States. United States' second oral statement, para. 6. The United States has not, however, provided any evidence in support of its statement.

[64] India appears to acknowledges this. India's reply to Panel question No. 64.

preclude Members from using rules of origin to substitute for, or supplement, the intended effect of a trade policy instrument. Accordingly, where a rule of origin is linked, *inter alia*, to a quota, the rule of origin should not add to the protection already afforded by the quota.[65] India's argument is that if a rule of origin makes a quota regime more restrictive, the quota regime automatically becomes too restrictive in the sense that it would add to the protective effect of the quota regime, thus indicating the use of rules of origin in pursuit of the trade objective of protecting the domestic textile industry. But, India's argument focuses on the direction of a change in rules of origin, not the end point of the change. That is to say, India ignores the distinction between the use of rules of origin to implement and support a quota regime and the use of rules of origin to supplement the protective effect of the quota regime. Using rules of origin which render a quota regime more restrictive may be consistent with using rules of origin to implement and support such a regime.

6.85 Moreover, we note that the mere fact of making the quota system more restrictive could not, *ipso facto*, condemn the fabric formation rule. A restrictive fabric formation rule may have been adopted in pursuit of legitimate objectives.

6.86 One of the objectives claimed by the United States in using the fabric formation rule is "to more accurately reflect where the most significant production activity occurs".[66] Since we have already found that the fabric formation rule is not an unsound rule for the United States to apply to the made-up articles in question, we see no justification for determining that the stated United States objective of reflecting where the most important manufacturing process takes place is a pretext for protecting the United States' textile industry.[67]

6.87 Another objective claimed by the United States to underlie the fabric formation rule is to prevent quota circumvention. The United States has stated that the fabric formation rule helps prevent quota circumvention in two respects. *First*, the United States argues that a clear, simple and precise rule such as the fabric formation rule ensures transparency and predictability for traders and enhances the ability of customs officials to determine the origin of goods and, in that sense, identify circumvention.[68] *Second*, the United States maintains that the clearly stated fabric formation rule removed ambiguity and uncertainty which the United States says existed under the pre-section 334 rules of origin, inasmuch as for most fabrics and flat goods (specifically towels and linens) manufacturing processes were analysed on a case-by-case basis to determine whether they were significant enough to confer origin.[69] India has identified no provision in the *RO*

[65] We think a rule of origin which has the effect of discouraging the full utilization of a quota could be one example of a rule of origin which affords extra protection to the Member maintaining the quota in question.
[66] United States' first written submission, para. 29; United States' replies to Panel questions Nos. 14 and 19.
[67] Merely that the United States changed its substantive rules of origin in 1996 for some of the made-up articles in question does not, in our view, suggest that the fabric formation rule is not intended to "more accurately reflect where the most significant production activity occurs". It seems pertinent to note, in this regard, that the pre-section 334 rules, found at 12 C.F.R. 130, originated with the Administration, specifically the United States Customs Service, whereas section 334 was prescribed by Congress. India's first written submission, paras. 14 and 16. Nor do we think that the "clarification of section 334", enshrined in section 405, undermines the United States' assertion that the fabric formation rule is not intended to "more accurately reflect where the most significant production activity occurs". We note that, with respect to this clarification, the United States has stated that it was persuaded by the European Communities that, for the goods at issue, the most important manufacturing process would be better reflected by a DP2 rule. United States' reply to Panel question No. 76.
[68] United States' replies to Panel questions Nos. 2, 14 and 19.
[69] United States' replies to Panel questions Nos. 2, 19, 33 and 47(a).

Agreement, or the *Agreement on Textiles and Clothing*, which would preclude Members from taking appropriate preventative action against quota circumvention.[70]

6.88 In India's view, circumvention, properly understood, necessarily implies illegal behaviour. India contends, however, that the United States' notion of preventing quota circumvention is unduly broad, in that it encompasses not only action taken to prevent the illegal evasion of quotas by traders, but also action taken to prevent the legitimate avoidance of quotas.[71] India submits that, in contrast, evasive and adaptive action taken by producers in response to country-specific quotas (*e.g.*, through reallocation of production) is not circumvention. India argues that rules of origin used to counteract such action must be considered to pursue a trade objective. The United States counters India's contention by noting that there is no consensus among Members regarding the constituent elements of the concept of "circumvention". The United States also points out that India's view would undermine Members' ability to ensure compliance with textile quotas.

6.89 Even if we were to accept India's contention that the concept of "circumvention" does not include legal quota avoidance strategies, this would not detract from the fact that the United States has offered a plausible explanation of how the fabric formation rule promotes the objective of preventing illegal quota circumvention. In these circumstances, we see no reason to dismiss the United States' contention that one of the objectives of the fabric formation rule is the prevention of quota circumvention.

6.90 This does not dispose, however, of the issue, raised by India, whether the fabric formation rule is, in addition or even primarily, being used by the United States to prevent "legal" circumvention. India argues that, if the fabric formation rule is being used for that purpose, this would demonstrate that it is being used to afford protection to the United States' textile industry by making the quota regime "more restrictive".[72] We do not consider that there is an inherent link between the possible objective of preventing circumvention – defined here as the prevention of quota avoidance through legal means – and the objective of protecting the United States' textile industry, such that the two objectives could invariably be viewed as one and the same. The rationale for seeking to prevent quota avoidance may be to maintain the integrity and effectiveness of trade policy instruments, in this case textile quotas sanctioned by the *Agreement on Textiles and Clothing*.[73] Maintaining integrity and effectiveness is a valid concern for Members implementing *country-specific* quotas. For that reason, we cannot accept that using rules of origin in pursuit, *inter alia*, of the objective of maintaining the integrity and effectiveness of country-specific textile quotas would, *a priori* and without exception, constitute an illegitimate objective.[74]

6.91 The issue, then, is more appropriately framed as follows: Has India established that the fabric formation rule cannot be said to pursue the objective of maintaining the integrity and effectiveness of country-specific United States' textile quotas? In other words, has India

---

[70] India asserts that the fabric formation rule cannot be said to serve the purpose of preventing circumvention, given that another section of the URAA, section 333, was enacted for that purpose. The United States rebuts that assertion by pointing out that section 333 is designed to counteract circumvention by establishing certain measures to be taken once circumvention is found to have occurred, while section 334 is designed to prevent circumvention from occurring in the first place.

[71] United States' first written submission, para. 32.

[72] India's reply to Panel question No. 2.

[73] See also United States' reply to India's question No. 10.

[74] Indeed, India itself has stated that "[i]n the context of country-specific quotas, such as those permitted under the Agreement on Textiles and Clothing (ATC), the concept of origin is critical". India's first oral statement, para. 22.

established that this is an instance where the United States is using rules of origin to supplement the protective effect of its quota regime?

6.92 India argues that if the United States considered that its previous rules of origin did not protect the integrity and effectiveness of various trade policy instruments, it would have introduced changes for all products, and not just for textile and apparel products.[75] We are not persuaded by this argument. As we have noted above, trade in textile and apparel products is governed by a special WTO agreement, the *Agreement on Textiles and Clothing*, which, unlike most other WTO agreements, sanctions the use of country-specific quotas. Against this background, in this case, the use of sector-specific rules of origin would tend to confirm, rather than disprove, that the rules of origin in question are designed to implement and support sector-specific trade instruments. India further argues that the fine product distinctions drawn by the United States are "completely unrelated" to the objective of protecting the integrity and effectiveness of the United States' textile quotas. India does not, however, examine, and elaborate on, why the United States' product distinctions cannot be said to support the aforementioned objective.[76] In the light of the foregoing, we consider that India has failed to establish that the fabric formation rule cannot be said to pursue the objective of maintaining the integrity and effectiveness of country-specific United States' textile quotas.

6.93 We note in this regard that India has adduced other evidence which it considers demonstrates that the "real" objective of the fabric formation rule is to afford protection to the United States' textile industry by making the relevant quotas "more restrictive". These elements include the legislative history of section 334, notably the House and Senate reports[77]; post-enactment statements by two United States senators[78]; a statement by a United States textile importer association[79]; and publications by academics and a practising lawyer[80]. It should be noted that these elements are not part of section 334 itself, nor can they be said to "objectively manifest"[81] the objective of the fabric formation rule. Under the test established by the Appellate Body in *Chile - Alcoholic Beverages*[82], we are not to base our inquiry into the objective of the fabric formation rule on such elements.[83] In any event, we have carefully reviewed each of these elements. We do not consider that, individually or taken together, they are sufficient to support the conclusion that the United States is using the fabric formation rule to afford protection to its textile industry, over and above the protection it already enjoys as a result of the United States' quota regime. With respect to the legislative history, India has provided no support for its assertion that the House and Senate reports reveal that section 334 was intended by the United States Congress as an instrument to pursue trade objectives.[84] With respect to the post-enactment statements by two United States senators, India states that the senators in question referred to section 334 as a "very significant change in rules of origin".[85] However, such a characterization would not demonstrate that section 334 is "protectionist"[86]. Finally, with respect to the opinions expressed by a United States' textile importer association, academics and a practising lawyer, we

[75] India's reply to Panel question No. 72.
[76] *Ibid.*
[77] India's first written submission, para. 57.
[78] *Ibid.*, paras. 66-68.
[79] *Ibid.*, para. 64.
[80] *Ibid.*, para. 65.
[81] Appellate Body Report, *Chile - Alcoholic Beverages*, *supra*, para. 71.
[82] *Supra*, para. 6.37.
[83] We also note that, as a matter of United States law, the legislative history, for instance, is less authoritative than the SAA. United States' reply to Panel question No. 31.
[84] India's first written submission, para. 57.
[85] India's first written submission, para. 66; exhibit INDIA-3.
[86] India's first written submission, para. 66.

do not think they are particularly probative.[87] Indeed, the Panel was struck by the paucity of public and critical comment on the legislative changes.

6.94 In sum, India has not persuaded us that the fabric formation rule does not pursue any legitimate objectives, or that any such objectives are a sham. Therefore, even assuming that the fabric formation rule rendered relevant United States textile quotas more restrictive, India has failed to establish that any restrictive effects of the fabric formation rule are not incidental to the pursuit of legitimate objectives.

6.95 Up to this point, we have focused on the fabric formation rule as it applies to certain non-apparel made-up articles. Based on certain replies given to questions from the Panel, India could be understood to challenge the fabric formation rule also as it applies to fabrics subjected to further finishing operations.[88] However, neither in its written submissions nor in its oral statements has India offered specific legal arguments with respect to fabrics.[89] At any rate, *mutatis mutandis*, our reasoning with respect to made-up articles applies to fabrics as well. For these reasons, we find that India has not demonstrated that the fabric formation rule as it applies to fabrics is inconsistent with Article 2(b).

6.96 In the light of the above, we find that India has failed to establish that section 334 is being used as an instrument to pursue the objective of protecting the United States' textile industry.[90] Accordingly, we conclude that India has failed to establish that section 334 is inconsistent with Article 2(b).

(…)

2. India's claim under Article 2(c), first sentence, of the *RO Agreement*

6.119 India claims that section 334 and section 405 are also inconsistent with the first and second sentences of Article 2(c) of the *RO Agreement*. Consistent with the structure of Article 2(c), the Panel will commence its examination with India's claim under the first sentence of

[87] We note that the comments by the United States textile importer association were made at the time of the Congressional deliberations on what later became section 405 and sought to convince United States legislators to revisit the fabric formation rule in section 334. Exhibit INDIA-11, p. 14. The academic publication referred to by India is authored by members of an association which has prepared a report on obstacles to textile trade for the European Commission. Exhibit INDIA-12, opening footnote. The other publication referred to by India is by a private lawyer who, according to the United States, often represents importers. United States' second oral statement, para. 22.

[88] India's replies to Panel questions Nos. 19 and 61.

[89] We note, for instance, India's first oral statement, para. 22, and India's second written submission, para. 32, which only refer to made-up articles, not fabrics.

[90] In response to question 55(b) from the Panel, India briefly addressed some of the other purposes for which section 334 is used, that is to say, purposes other than the administration of quantitative restrictions. However, India's response does not establish that, when used for one of these purposes, section 334 is used to pursue a trade objective. With respect to origin marking, the mere fact that the fabric formation rule in section 334 may mean that some goods have to be marked as originating in a different country and that this may, in some cases, affect the marketability of these goods, would not, in and of itself, warrant the conclusion that the fabric formation rule is designed to protect the United States' textile industry. Also, the example mentioned by India, silk scarves, is not subject to the fabric formation rule, but to the DP2 rule provided for in section 405. With respect to the purpose of gathering trade statistics, we are not persuaded by India's argument that the fabric formation rule is intended to protect the United States' textile industry because it skews import statistics. India's argument is based on its disagreement with the United States as to where finished fabrics and flat goods should be deemed to originate, an argument which we have already dealt with.

Article 2(c). The Panel's first task in this respect is to consider the parties' interpretation of the first sentence of Article 2(c).

(a) Article 2(c), first sentence, of the *RO Agreement*

6.120 Article 2(c) provides as follows:

> "Until the work programme for the harmonization of rules of origin set out in Part IV is completed, Members shall ensure that:
>
> […]
>
> (c) rules of origin shall not themselves create restrictive, distorting, or disruptive effects on international trade. They shall not pose unduly strict requirements or require the fulfilment of a certain condition not related to manufacturing or processing, as a prerequisite for the determination of the country of origin. However, costs not directly related to manufacturing or processing may be included for the purposes of the application of an ad valorem percentage criterion consistent with subparagraph (a)[.]"

6.121 **India** considers that the language of Article 2(c), first sentence, that rules of origin shall not "themselves" create restrictive, distorting or disruptive effects should be read together with the language of Article 2(b) that "notwithstanding the measure or instrument of commercial policy to which they are linked, [Members shall ensure that] their rules of origin are not used as instruments to pursue trade objectives". India submits that, when the provisions in Article 2(b) and Article 2(c) are read together, it becomes clear that a measure or instrument of commercial policy may have restrictive, distorting or disruptive effects on international trade, but that the rules of origin as such (whatever the commercial policy instrument to which they are linked) should not have such adverse effects.

6.122 India also points out that the effects of the challenged rule of origin have to be "on international trade" and not only on imports. In this regard, India notes the difference between the wording used in Article 2(c) and that used in Article 3.2 of the *Agreement on Import Licensing Procedures*, which requires that "non-automatic licensing shall not have trade-restrictive or trade-distorting effects on imports additional to those caused by the imposition of the restriction". In addition, India considers that, under Article 2(c), first sentence, it is sufficient for a complaining party to show that the challenged rule of origin creates restrictive or distorting effects for *one* Member, which could be a Member other than the complaining Member.

6.123 With respect to the phrase "restrictive, distorting, or disruptive effects", India offers the following interpretation: Rules of origin create "restrictive" effects on international trade if they reduce the level of international trade. Rules of origin create "distorting" effects on international trade if they modify the pattern of international trade by changing either the type of product traded in international trade or the direction of international trade flows. Finally, rules of origin create "disruptive" effects on international trade if, for instance, they are very complex and arbitrary in nature.

6.124 In India's view, the central interpretative issue presented by Article 2(c), first sentence, however, is whether the words "create restrictive […] effects" refer to the effects that the rules of origin are capable of creating or whether they refer to the effects they actually create in the market place. According to the former, "*conduct-oriented*" interpretation, it would be sufficient for India to demonstrate that the incentives and disincentives faced by traders as a result of the rules of origin at issue are such that they create restrictive effects. According to the latter, "*result-*

oriented" interpretation, it would be necessary to demonstrate that the regulatory framework imposed by the United States has actually produced those effects on international trade.

6.125 India is of the view that the conduct-oriented interpretation is the correct one. What is relevant, according to India, under Article 2(c) is the nature of the rules of origin that the Member adopted, not the reaction of the market to those rules. India notes in this regard that Article 2(c), first sentence, uses the term "create" rather than "have". India points out that the *New Shorter English Oxford Dictionary* defines "create" as to "cause, occasion, produce, give rise to", and it defines "have" as to "possess as an attribute, function, position, etc.". India also recalls that Article 3.2 of the *Agreement on Import Licensing Procedures* states that "non-automatic licensing shall not have trade-restrictive or distorting effects on imports additional to those caused by the imposition of the restriction". In contrast, Article 2(c), first sentence, uses the term "create", which, in India's view, implies that Members must refrain from adopting rules of origin that create a framework capable of producing such adverse effects.

6.126 India notes that, under a conduct-oriented interpretation, Members could challenge another Member's rules of origin under Article 2(c), first sentence, as soon as they enter into force. India considers this important because, in its view, the adoption of new rules of origin can immediately stop production for a particular market or purchases from particular markets. India argues that, in contrast, under a result-oriented interpretation, a violation of Article 2(c), first sentence, has to be proven through a showing of an actual restrictive, distorting or disruptive impact on international trade reflected in trade statistics. According to India, the implication of such an interpretation is that Members wishing to challenge rules of origin under Article 2(c), first sentence, would have to wait until the rules of origin have actually produced an adverse impact and trade data are available to demonstrate this. A further implication, India maintains, is that the consistency of a rule of origin would depend on the market's reaction to it and consequently on factors that normally escape the control of Members. Moreover, India argues that, under a result-oriented interpretation, it would have to be demonstrated that the change in trade flows was caused by the rules of origin and not by other factors. India considers that, in those circumstances, Article 2(c), first sentence, would become for all practical purposes unenforceable because the effect of the rules of origin and the effect of the policy instrument to which they are linked could, in practice, not be segregated.

(…)

6.129 The **United States** points out, as a preliminary matter, that the Panel must examine whether the challenged United States rules of origin, as enacted, "create restrictive, distorting, or disruptive effects on international trade", not whether the change in United States rules altered conditions of competition. The United States notes that the text of Article 2(c) does not discipline changes in rules of origin *per se*; instead, it applies to rules of origin "themselves". That Article 2(c) was not meant to discipline changes *per se* is also borne out, in the view of the United States, by the fact that Article 2(i) of the *RO Agreement* contemplates changes in rules of origin.[91]

6.130 Concerning the interpretation of Article 2(c), first sentence, the United States rejects India's view. First of all, the United States rejects India's view that the Panel may assess whether

---

[91] Article 2(i) reads:

> "Until the work programme for the harmonization of rules of origin set out in Part IV is completed, Members shall ensure that:
> […]
> (i) when introducing changes to their rules of origin or new rules of origin, they shall not apply such changes retroactively as defined in, and without prejudice to, their laws or regulations[.]"

rules of origin create restrictive, distorting, or disruptive effects "on international trade" by looking at the effect on one single Member's trade. In the view of the United States, this reading simply cannot be found in the words of Article 2(c), first sentence. The United States argues that if Members had wanted to proscribe rules of origin that affected one or more Members it would have been easy: the provision could have read "Members shall ensure that their rules of origin shall not themselves create restrictive, distorting or disruptive effects on another Member's trade".

(…)

6.136 The **Panel** recalls that the text of Article 2(c), first sentence, states in relevant part: "[Rules of origin] shall not themselves create restrictive, distorting, or disruptive effects on international trade". The first element to be addressed is the term "themselves". We consider that, in the first sentence of Article 2(c), the pronoun "themselves" is used mainly to emphasise the preceding term "rules of origin". By emphasising the term "rules of origin", the pronoun "themselves" brings out very clearly that the first sentence of Article 2(c) is concerned with a Member's rules of origin, as distinct from something other than rules of origin, and that it is rules of origin, as opposed to something other than rules of origin, that must not "create restrictive, distorting, or disruptive effects on international trade".

6.137 This interpretation draws support from, and is further informed by, the provision immediately preceding Article 2(c). Article 2(b) provides that "notwithstanding the measure or instrument of commercial policy to which they are linked, [Members shall ensure that] their rules of origin are not used as instruments to pursue trade objectives". Thus, Article 2(b) contrasts rules of origin with the commercial policy instruments they are used to implement. As previously noted, Article 2(b) can be understood to mean that commercial policy instruments may pursue trade objectives, but that rules of origin may not. We consider that Article 2(b) lends force to our view that the focus in the first sentence of Article 2(c) is on rules of origin, not some other instrument or mechanism, and clarifies that the relevant other instruments or mechanisms include what Article 2(b) refers to as "the measure[s] or instrument[s] of commercial policy to which [rules of origin] are linked".

6.138 Consideration of relevant context thus leads us to the conclusion that the term "themselves" is meant to highlight that, although there may be commercial policy measures which create restrictive, distorting, or disruptive effects on international trade, the rules of origin used to implement and support these commercial policy measures must not create restrictive, distorting, or disruptive effects on international trade additional to those which may be caused by the underlying commercial policy measures.[92] Similarly, in cases where an underlying commercial policy measure does not cause any restrictive, distorting, or disruptive effects on international trade, the word "themselves" would serve to underscore that rules of origin must not create any new restrictive, distorting, or disruptive effects on international trade.

6.139 This interpretation is consistent also with the objective of Article 2(c), first sentence, which is to guarantee a certain trade-neutrality of rules of origin.

6.140 the next element of the text of the first sentence of Article 2(c) to be considered is the term "create". The ordinary meaning of the term "create" is to "cause, occasion, produce, give rise to".[93] Thus, it is implicit in the term "create" that a Member's rules of origin only contravene the first sentence of Article 2(c) if there is a causal link between those rules and the prohibited

[92] It is worth noting in this context that Article 3.2 of the *Agreement on Import Licensing Procedures* on non-automatic licensing contains provisions along these lines. Specifically, it states that "[n]on-automatic licensing shall not have trade-restrictive or -distortive effects on imports *additional* to those caused by the imposition of the restriction" (emphasis added).

[93] *The New Shorter Oxford English Dictionary,* L. Brown, ed., Clarendon Press, 1993, Vol. I, p. 198.

effects specified in the first sentence.[94] In our view, the term "create" does not imply, however, that the creation of the prohibited effects necessarily needs to be deliberate.[95]

6.141 Turning to the prohibited effects – *i.e.*, "restrictive, distorting, or disruptive effects" – the Panel notes that these effects constitute alternative bases for a claim under the first sentence of Article 2(c), as is confirmed by the use of the disjunctive "or". Accordingly, independent meaning and effect should be given to the concepts of "restriction", "distortion" and "disruption". In this regard, we note that the ordinary meaning of the term "restrict" is to "limit, bound, confine"; that of the term "distort" is to "alter to an unnatural shape by twisting"; and that of the term to "disrupt" is to "interrupt the normal continuity of".[96] Thus, the first sentence of Article 2(c) prohibits rules of origin which create the effect of limiting the level of international trade ("restrictive" effects); of interfering with the natural pattern of international trade ("distorting" effects); or of interrupting the normal continuity of international trade ("disruptive" effects).

6.142 The first sentence of Article 2(c) states that the prohibited effects must be on "international trade". India points out in this regard that the first sentence does not refer to effects on "imports". We agree with India that the phrase "effects on international trade" encompasses, but is not limited to effects on imports of the good to which the Member concerned applies the relevant rule of origin (*e.g.*, cotton bed linen). This gives rise to two issues. *First*, can the phrase "effects on international trade" also cover adverse effects on trade in goods in intermediate stages of production (*e.g.*, cotton fabric), rather than just trade in the final, or finished, goods to which the relevant rule of origin is applied (*e.g.*, cotton bed linen)?[97] *Second*, can the phrase "effects on international trade" cover adverse effects on trade in different (but closely similar) types of finished goods? For instance, would there be a distorting effect on international trade if a rule of origin modified international trade flows by changing the type of goods traded in international trade (*e.g.*, by increasing trade in silk scarves and decreasing trade in cotton scarves)?[98] We will address these two issues in turn.

6.143 Beginning with the issue of effects on trade in goods in earlier stages of processing – *i.e.*, "upstream" goods – it is not necessary, in this case, to resolve this issue. In our analysis of the measures at issue, we will assume, *arguendo*, that effects on relevant upstream goods can be viewed as "effects on international trade" within the meaning of the first sentence of Article 2(c).

6.144 With regard to the issue of effects on different types of finished goods, we think it is important, in considering this issue, to have regard, in particular, to the provisions of Article 2(d) of the *RO Agreement*. As we will explain below[99], Article 2(d) does not require Members to apply the same rule of origin to "closely related" (but different) goods. Consequently, we cannot adopt an interpretation of Article 2(c), first sentence, which would effectively bar Members from doing what is permissible under Article 2(d).

---

[94] It is relevant to point out here that the Appellate Body has given a similar interpretation to the previously mentioned Article 3.2 of the *Agreement on Import Licensing Procedures*. Appellate Body Report, *European Communities – Measures Affecting the Importation of Certain Poultry Products* ("*EC – Poultry*"), WT/DS69/AB/R, adopted 23 July 1998, DSR 1998:V, 2031, paras. 126-127.

[95] The parties share this view. India's reply to Panel question No. 11(a); United States' reply to Panel question No. 11(a).

[96] *The New Shorter Oxford English Dictionary*, L. Brown, ed., Clarendon Press, 1993, Vol. II, p. 2569; Vol. I, pp. 707 and 702, respectively.

[97] India argues that the phrase "effects on international trade" does cover adverse effects on trade in goods in intermediate stages of production (*e.g.*, cotton fabric). *E.g.*, India's second oral statement, para. 17; India's reply to Panel question No. 56.

[98] India considers this to be an example of distorting effects inconsistent with Article 2(c), first sentence. India's first written submission, para. 91.

[99] *Infra*, para. 6.249.

6.145 Indeed, if we were to accept that the first sentence of Article 2(c) prohibits adverse effects on trade in a good which is different from the good subject to the relevant rule of origin, we would effectively require Members to apply a uniform rule of origin to a wide range of different goods. It could then be argued, for instance, that a rule of origin which is not uniformly applied to all competitive goods creates "distorting" effects on international trade. Potentially, therefore, the scope of Article 2(c), first sentence, would be very broad.

6.146 In view of these far-reaching potential consequences, and having regard also to the circumstance that, prior to the entry into force of the *RO Agreement*, rules of origin were not subject to significant GATT disciplines, we cannot assume that Members intended to bring adverse effects on different types of goods within the ambit of the prohibition set out in the first sentence of Article 2(c). Indeed, as the Appellate Body has said in a different context, "[t]o sustain such an assumption and to warrant such a far-reaching interpretation, treaty language far more specific […] would be necessary".[100] We consider that the same could be said of Article 2(c), first sentence.[101]

6.147 Therefore, we consider that it would not be appropriate to interpret the phrase "effects on international trade" as covering adverse effects on trade in different (but closely similar) types of finished goods. We construe the phrase "effects on international trade" to cover trade in the goods to which the relevant rule of origin is applied (*e.g.*, cotton bed linen). Whether, in addition, this phrase covers trade in goods in intermediate stages of production (*e.g.*, cotton fabric) is an issue which we have said we do not need to decide in this case.

6.148 Relying on the phrase "on international trade", India argues that it is sufficient for a complaining party to show that the challenged rule of origin creates restrictive or distorting effects on one Member's trade.[102] Although it is possible to view trade between any two Members as "international trade", we are not convinced that demonstrating an adverse effect on one Member's trade would always and necessarily be sufficient. Indeed, while the use of a particular rule of origin may adversely affect the trade of one Member, it may favourably affect the trade of one or more other Members. For example, the mere fact that one Member would lose trade cannot, in our view, be regarded as conclusive, in and of itself, on the issue of whether the rule in question creates a "restrictive" effect on international trade.

6.149 Regarding the disagreement between the parties whether the phrase "create […] effects" refers to the effects that the rules of origin are *capable* of creating or whether it refers to the effects they *actually* create in the market-place, we note that, for the purposes of our analysis, we need not resolve the parties' disagreement. In our examination of India's claims under the first sentence of Article 2(c), we will assume, *arguendo*, that India is correct in asserting that the first sentence does not require a showing of actual prohibited effects on international trade and that it is sufficient to demonstrate that the rules of origin in question "create conditions of competition with restrictive, distorting or disruptive effects on international trade"[103], *i.e.*, that "the incentives

---

[100] Appellate Body Report, *EC Measures Concerning Meat and Meat Products (Hormones)* ("*EC – Hormones*"), WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, DSR 1998:I, 135, para. 165.

[101] In response to a question from the Panel, India argues that the plural in Article 2(c) means that that provision applies both to an individual rule of origin as well as to a Member's system of rules of origin. India's reply to Panel question No. 48. Since India, in developing its claim, does not rely on this interpretation of the text of Article 2(c), it is sufficient to note that we understand the plural in Article 2(c), first sentence, to refer to a Member's "rules of origin" taken individually, *i.e.*, to individual rules of origin as they apply to individual goods. Indeed, provisions like the second sentence of Article 2(c), the first clause of Article 2(d), Article 2(f) and Article 3(a) of the *RO Agreement* cannot reasonably be read to lay down disciplines for anything other than individual rules of origin.

[102] India's reply to Panel question No. 11(b).

[103] India's second written submission, paras. 48 and 60.

and disincentives faced by traders as a result of the rules of origin at issue are such as to create [the prohibited] effects".[104]

6.150 With the foregoing considerations in mind, we now proceed to assess the consistency of the measures at issue with the first sentence of Article 2(c).

(b) Consistency of the measures at issue with Article 2(c), first sentence, of the *RO Agreement*

6.151 India claims that section 334 and section 405 – hereafter the "measures at issue" – are inconsistent with the first sentence of Article 2(c) because they create (i) "restrictive", (ii) "distorting", and (iii) "disruptive" effects on international trade. In support of this claim, India has advanced two sets of arguments. The first set of arguments is developed mainly in India's first written submission and primarily focuses on the effects resulting from the application of the measures at issue in the implementation of the United States' textile quotas and from the changes made to United States rules of origin in 1996 and 2000.[105] The second set of arguments is developed in subsequent submissions and focuses on the features of the relevant United States rules of origin as such.[106] As the relationship between these two sets of arguments is not clear, the Panel will address them separately.[107] The Panel will begin its examination with the first set of India's arguments.

(i) India's arguments as developed in India's first written submission

"Restrictive" effects on international trade

6.152 **India** asserts that the measures at issue reduced the level of exports from countries such as India which exported greige fabric to third countries to be further processed into made-up articles before onward export to the United States because the fabric-exporting countries' quotas were debited for such further processed articles. According to India, the measures at issue thus entailed new quantitative restrictions on Indian goods exported to third countries, which goods had previously never been subject to any restrictions.

(…)

6.155 The **Panel** notes, as an initial matter, that India's claim with respect to the (alleged) "restrictive" effects of the fabric formation rule in section 334 concerns effects on upstream goods – greige fabric – exported by fabric-forming countries such as India which are under quota in the United States.[108] The Panel has indicated above that it is prepared to assume, *arguendo*, that such effects can be viewed as "effects on international trade" within the meaning of the first sentence of Article 2(c).

6.156 It should also be noted that India's assertion is that the fabric formation rule creates a *de facto* restriction on international trade, not a *de jure* restriction.[109] As has been observed by another panel, in circumstances where there is no *de jure*, or formal, restriction, "it is inevitable, as an evidentiary matter, that greater weight attaches to the actual trade impact of a measure", *i.e.*,

[104] India's first oral statement, para. 38.
[105] India's first written submission, paras. 91-96.
[106] India's first oral statement, para. 25; India's second written submission, para. 61; India's reply to Panel question No. 66.
[107] We note that India has not said that the second set of arguments was somehow intended to supersede the first set.
[108] *E.g.*, India's second oral statement, para. 17. We do not understand India to argue that the DP2 rule provided for in section 405 creates restrictive effects.
[109] India uses the term "chilling effect". India's second oral statement, para. 17.

to factual evidence supporting the existence of such a restriction, even if the WTO provision prohibiting such a restriction protects competitive opportunities rather than trade flows.[110]

(…)

6.159 In any event, even if India had demonstrated that the fabric formation rule creates a restrictive effect on its exports of greige fabric, we have stated above that a showing of a restrictive effect on the trade of a single Member is not sufficient, in all cases, to establish restrictive effects "on international trade". In this case, we have no basis for finding that a showing of restrictive effects on India's exports of greige fabric would, by itself, be sufficient to establish an inconsistency with Article 2(c), first sentence. As we have previously pointed out[111], we were not provided with any evidence and/or data regarding:

- which countries are under quota in the United States with respect to relevant downstream goods (*e.g*, cotton bed linen);
- which countries are important suppliers of the relevant upstream goods (*e.g.*, cotton fabric); and
- the price and quality of the upstream goods made by those countries and their production capacity.

6.160 Lacking information on the design of the United States' quota system, the market in the relevant downstream and upstream goods and the relationship between the two, we cannot simply assume that India is the only commercially viable sourcing option for Members importing the relevant greige fabric. There may be competitive suppliers other than India which are not under quota with respect to the relevant downstream goods.[112] A possible decrease in Indian exports of greige fabric might then be accompanied by a corresponding increase in competitive exports by other Members, such that there would not be a restrictive effect on international trade in the relevant greige fabric.

6.161 On the basis of the foregoing considerations, we conclude that India has not established that the measures at issue create restrictive effects on international trade within the meaning of Article 2(c), first sentence.

"Distorting" effects on international trade

6.162 **India** submits that the measures at issue allow more favourable access to certain products over other products. An example is the different treatment being accorded to products based on their fibre composition, such as silk, cotton and wool. In India's view, the measures at issue also favour the products of export interest to the European Communities over products of export interest to developing countries. According to India, the measures at issue consequently create distorting effects on international trade within the meaning of Article 2(c). India also argues that the measures at issue create distorting effects because they shift origin from a third country where the fabric was dyed and printed and subjected to two further finishing operations to the country

[110] Panel Report, *Argentina – Measures Affecting the Export of Bovine Hides and Import of Finished Leather* ("*Argentina – Hides and Leather*"), WT/DS155/R and Corr.1, adopted 16 February 2001, para. 11.20.
[111] *Supra*, para. 6.78.
[112] The United States asserts that, at the time section 334 was implemented, and thereafter, six out of the top ten world exporters of cotton fabrics, accounting for 50 percent of world trade in cotton fabric, were countries which were not subject to quotas on fabric or bed linen in the United States. United States' second oral statement, para. 6. We also recall our earlier finding regarding India's claim under Article 2(b) that India has failed to establish that the fabric formation rule necessarily, or in fact, brings more imports of downstream goods under quota in the United States. *Supra*, para. 6.83.

where the greige fabric was formed. Finally, India argues that, because of the new United States' rules of origin, importers have had to switch to new suppliers as traditional suppliers lost their access to the United States market, distorting historical trade patterns.

(…)

6.166 In considering India's claim of distortion, the **Panel** turns, *first*, to India's argument that the measures at issue create distorting effects on international trade because they shifted origin from a country where the fabric of a made-up article was subjected to a DP2 operation to the country where the greige fabric was formed.[113] In our view, the mere fact that a change in a Member's rules of origin results, for a given finished good exported to that Member (*e.g.*, bed linen), in a different country of origin is not sufficient, in and of itself, to demonstrate a distorting effect on international trade. Indeed, if the first sentence of Article 2(c) prevented a Member from changing a rule of origin merely because that would involve a change of country of origin, then, contrary to Article 2(i) of the *RO Agreement*, rules of origin could never be changed.

6.167 What matters, for the purposes of Article 2(c), first sentence, is whether the new rule of origin creates distorting effects, not whether the change from the previous rule of origin to the new one creates such effects. Indeed, as noted by the United States, the previous rule may itself have created distorting effects, such that any country of origin determination resulting from that rule could be inappropriate.[114]

6.168 The *second* Indian argument which we consider is that the measures at issue result in certain finished goods enjoying better access to the United States market than other finished goods and that this creates distorting effects on international trade. Specifically, India argues that the measures at issue create distorting effects on trade in different types of finished goods (*e.g.*, silk scarves *versus* cotton scarves).[115] We have stated above that we do not consider that the prohibition set out in Article 2(c), first sentence, covers distorting effects on trade in different types of goods. At any rate, for India's argument to succeed, India would need to demonstrate that the goods in question are in competition with each other and that the measures at issue distort trade in those goods. But India has not demonstrated that those goods which it alleges enjoy more favourable access to the United States market (*e.g.*, silk scarves) are in competition with those goods which it considers are given less favourable access (*e.g.*, cotton scarves).

6.169 Nor has India established that the measures at issue create distorting effects on trade. India's argument is that the measures at issue distort trade because, pursuant to these measures, some goods are subject to the DP2 rule, while others are subject to the fabric formation rule and because this determines whether particular exports fall within quotas in the United States. We do not consider that the fact that the United States uses a fabric formation rule for some finished goods and a DP2 rule for others is of itself sufficient to demonstrate distorting effects on trade in these goods. For example, if a country which performs a DP2 operation on a particular good is under quota in the United States for that good, a DP2 rule would not necessarily result in more favourable access to the United States market than a fabric formation rule.

6.170 For these reasons, we are unable to accept India's argument that the measures at issue create distorting effects because they result in certain finished goods enjoying better access to the United States market than other finished goods.

6.171 A related argument put forward by India is that the measures at issue create distorting effects because they create artificial incentives to modify the type of inputs used (*e.g.*, silk fabric

[113] India's first written submission, para. 96.
[114] United States' reply to Panel question No. 11(f).
[115] India's first written submission, para. 91.

versus cotton fabric).[116] India has not elaborated on this argument or provided supporting factual information. In our view, this argument is no more than a variation of India's previous argument, except that it is concerned with inputs, or "upstream" goods, rather than with the finished goods.[117] Notwithstanding this difference, our considerations relating to the previous argument apply, *mutatis mutandis*, to this argument as well.

6.172 The *third* Indian argument is that the measures at issue create distorting effects on international trade because they favour goods of export interest to the European Communities over goods of export interest to developing countries. To recall, such goods as silk scarves (a good of export interest to the European Communities) are subject to the DP2 rule, whereas such goods as cotton bed linen (a good of export interest to developing countries such as India) are subject to the fabric formation rule. Since India's argument concerns the trade implications of the application of different rules of origin to different goods, this argument, too, depends on the goods in question being in competition with each other and the measures at issue distorting trade. It is also premised on a reading of Article 2(c), first sentence, with which we do not agree, *viz.*, that the prohibition set out in Article 2(c), first sentence, covers distorting effects on trade in different types of goods. Even disregarding this, India has not specifically established the existence of a competitive relationship between individual goods of export interest to the European Communities, on the one hand, and developing countries, on the other.[118] Nor has India established that applying a DP2 rule to goods of export interest to the European Communities would necessarily favour those goods *vis-à-vis* goods of export interest to developing countries which are subject to the fabric formation rule.

6.173 *Finally*, we turn to India's argument that, because of the new United States rules of origin, importers had to switch to new suppliers, as traditional suppliers lost their access to the United States market, which, according to India, distorted historical trade patterns.[119] This argument concerns effects on "upstream" trade, specifically the sourcing of inputs of a particular type (*e.g.*, cotton fabric). We note that sourcing decisions by importers are not exclusively driven by rules of origin, such that a change in historical sourcing patterns is not necessarily attributable to a change in rules of origin. But even assuming that the measures at issue, rather than some other factor, led some importers to source particular inputs from new countries[120], we do not think that these measures could, for that reason alone, be considered to create distorting effects on international trade. India has not demonstrated, for particular inputs, that the measures at issue result in importers sourcing these inputs from countries whose inputs are not comparable in relevant respects (price, quality, etc.) to the inputs they used to obtain from other countries under the previous rules of origin. In the absence of any demonstration of this kind, we are unable to accept India's argument that the measures at issue create distorting effects on trade because some importers had to source their inputs from new supplier countries.

6.174 In the light of the above, we conclude that India has not established that the measures at issue create distorting effects on international trade within the meaning of Article 2(c), first sentence.

---

[116] India's reply to Panel question No. 66.
[117] As previously pointed out, we are assuming, *arguendo*, that effects on upstream goods can be viewed as "effects on international trade" within the meaning of the first sentence of Article 2(c).
[118] India's reply to Panel question No. 58(b).
[119] India's reply to United States' question No. 2.
[120] We note in this regard that the documentary evidence provided by India in support of the example of *Pac Fung*, the Hong Kong-based manufacturer of comforter shells, bed sheets and other home textile products, does not seem to support India's assertion that, because of the measures at issue, *Pac Fung* had to obtain its inputs from a country other than China in order to continue to export to the United States. Exhibit INDIA-16.

(…)

6.184 Before proceeding to examine what the Panel has referred to as the second set of India's arguments, it should be noted that the Panel takes no position on whether rules of origin which create restrictive, distorting or disruptive effects on international trade would necessarily constitute rules of origin which "themselves" create "restrictive, distorting, or disruptive effects on international trade", within the meaning of Article 2(c), first sentence.[121]

(…)

4. India's claim under Article 2(d) of the RO Agreement

6.232 The last of India's claims concerning the statutory provisions at issue is India's claim under Article 2(d) of the *RO Agreement*. That claim is limited to section 405. As with India's other claims, the Panel begins its analysis of the consistency of section 405 with Article 2(d) by considering the provisions of Article 2(d).

(a) Article 2(d) of the *RO Agreement*

6.233 Article 2(d) provides as follows:

> "Until the work programme for the harmonization of rules of origin set out in Part IV is completed, Members shall ensure that:
>
> […]
>
> (d) the rules of origin that they apply to imports and exports are not more stringent than the rules of origin they apply to determine whether or not a good is domestic and shall not discriminate between other Members, irrespective of the affiliation of the manufacturers of the good concerned[2][.]"

---

[2] With respect to rules of origin applied for the purposes of government procurement, this provision shall not create obligations additional to those already assumed by Members under GATT 1994.

6.234 **India's** claim under Article 2(d) is based on the second clause of Article 2(d), which provides that "[rules of origin] shall not discriminate between other Members, irrespective of the affiliation of the manufacturers of the good concerned".

6.235 India considers that Article 2(d) covers not only cases of *de jure* discrimination – that is rules of origin that explicitly distinguish between different WTO Members – but also cases of *de*

---

[121] We also note that India has not established that the fabric formation and DP2 rules, when used for purposes other than quota administration, create the effects on international trade prohibited by Article 2(c), first sentence. For instance, with respect to the use of United States' rules of origin in support of marking, India merely states that it is "arguable" that the change in rules of origin disrupted trade. In any event, this assertion is based on the effect of a change in rules of origin, rather than on the effect of the new rules of origin themselves. India's reply to Panel question No. 55(b). With respect to the use of the fabric formation rule for the purpose of gathering trade statistics, India has also not substantiated its assertion that this rule creates a distorting effect on trade by skewing import statistics. Nor, in our view, has it explained how the fabric formation rule "might make it appear as if imports from a given country, say, India, were increasing, when in fact, they might not be", such that anti-dumping duties might be imposed against such imports when there is no basis for doing so. India's reply to Panel question No. 55(b).

facto discrimination. India recalls that the concept of *de facto* discrimination was described by the Panel in *Canada-Patent Protection of Pharmaceutical Products* in the following terms:

> "de facto discrimination is a general term describing the legal conclusion that an ostensibly neutral measure transgresses a non-discrimination norm because its actual effect is to impose differentially disadvantageous consequences on certain parties, and because those differential effects are found to be wrong or unjustifiable."[122]

6.236 India argues that the Panel in this case should, therefore, examine whether section 405 imposes differentially disadvantageous consequences and if these different effects are justifiable. In support of this view, India notes that the Appellate Body, in the context of the non-discrimination provisions of the GATT[123] and the GATS[124], interpreted those provisions as prohibiting both *de jure* and *de facto* discrimination. In the view of India, there is no reason why this approach to the principle of non-discrimination should not also apply to the prohibition of discrimination in the *RO Agreement.* India believes that the danger of circumventing the purpose of Article 2(d) through product distinctions is just as great as the danger of circumventing the most-favoured-nation provisions of the GATT and the GATS through product- or service-specific distinctions. India is of the view that the case before the Panel is a clear demonstration that arbitrary distinctions between closely related products can be used to achieve the objective of favouring one WTO Member over others.

6.237 India further argues that Article 2(d), unlike Articles I and III of the GATT 1994, does not refer to measures distinguishing between products of other Members but to discrimination between other Members. According to India, the wording of Article 2(d) reflects the fact that the very purpose of the measures regulated by this provision is to determine whether a product is a product originating in another Member. India believes that Article 2(d) can, therefore, be violated by denying a product the status of originating in a Member.

6.238 India notes that, unlike Article III of the GATT 1994, Article 2(d) does not refer to discrimination between "like" products originating in different countries or to discrimination between imported and domestic products that are "directly competitive or substitutable". In India's view, this suggests that Article 2(d) can be violated even if the products distinguished in the rules of origin are neither like nor directly competitive or substitutable. India recalls that the Appellate Body decided that the question of whether two products are "like" or "directly competitive or substitutable" within the meaning of Articles III:2 and III:4 of the GATT 1994, must be answered by examining them from the perspective of the consumer in the market of the importing country. However, in India's view, two products that are "like" or "directly competitive or substitutable" from the perspective of the consumer should be accorded a different origin if they were produced in different countries. The criteria for determining whether two products are "like" or "directly competitive or substitutable" within the meaning of Article III of the GATT 1994 can therefore not be transposed to Article 2(d).

6.239 India submits that it would be equally inappropriate to transpose to Article 2(d) the concept of "like" products used in Article I of the GATT 1994. India notes that tariffs are a negotiable (and hence legitimate) instrument of protection, while rules of origin are not. India argues that, under the GATT 1994, Members are therefore permitted to make very fine product

---

[122] Panel Report, *Canada – Patent Protection of Pharmaceutical Products* ("*Canada – Pharmaceutical Patents* "), WT/DS114/R, adopted 7 April 2000, DSR 2000:V, 2295, para 7.101.

[123] Appellate Body Report, *Canada – Certain Measures Affecting the Automotive Industry* ("*Canada – Autos*"), WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, DSR 2000:VI, 2995, para 63.

[124] Appellate Body Report, *European Communities – Regime for the Importation, Sale and Distribution of Bananas* ("*EC – Bananas III* "), WT/DS27/AB/R, adopted 25 September 1997, DSR 1997:II, 591, paras. 233 to 234.

distinctions in their tariff classifications designed to protect specific domestic industries. However, under the *RO Agreement*, Members are not to use rules of origin to pursue trade objectives. According to India, it would, for this reason, not be logical to determine the scope of the prohibition of discrimination under the *RO Agreement* by using concepts that determine the scope of discrimination under Article I of the GATT 1994.

6.240 India considers that rules of origin violate Article 2(d) if they result in unjustifiably differential treatment of "closely related (Indian and European Communities) products". In India's view, textile products which are comprised of different types of fabrics or different types of fibre blends are "closely related" products. India argues that a Member cannot apply different rules of origin to textile products just because they are comprised of different types of fabrics or different types of fibre blends. India recalls that, in the case of the United States measures at issue, when a scarf is made of silk, it is conferred the origin of the country where it is subjected to a DP2 operation. On the other hand, when a scarf is made of cotton, it is conferred the origin of the country where the greige fabric is formed. India submits that, from the perspective of production techniques, these scarves are virtually identical, and that it is completely arbitrary to distinguish them for the purpose of determining their origin.

6.241 The **United States** notes that the second clause of Article 2(d) is directed at precluding the type of discrimination, in the form of non-preferential rules of origin, that would include a criterion based on the national affiliation of a company or nationality of is employees.

6.242 The United States considers that India's interpretation of Article 2(d) is based on the flawed understanding that the *RO Agreement* would preclude product-specific rules of origin and that the *RO Agreement* precludes different rules of origin from applying to different products. However, in the view of the United States, Article 2 of the *RO Agreement* does not require that the same rules be used for similar products. The United States submits that, contrary to India's desire, nothing in Article 2 or any other provision of the *RO Agreement* mandates that Members use a particular rule for a particular manufacturing process, or for particular products. The *RO Agreement* clearly allows for differentiation of rules between products, as can be seen in the harmonization work programme, where Members are addressing thousands of subheadings in the tariff schedule.

6.243 The United States then turns to the question of what disciplines the *RO Agreement* imposes on a Member in distinguishing products. The United States submits that the *RO Agreement* does not require the same rule of origin for all "like" or "directly competitive" products. In the view of the United States, such a requirement is not found in the *RO Agreement* and cannot be inferred from any provision of Article 2, nor has India made a case that it should be so inferred. Moreover, according to the United States, the *RO Agreement* does not require the same rules for all products that are similar in some other sense. Again, the United States considers that such a requirement is not spelled out in the *RO Agreement* and cannot be inferred from any provision of the *RO Agreement*. The United States argues that it would, therefore, be incorrect to interpret the *RO Agreement* as barring Members from distinguishing in their rules between products – regardless of whether these products are "like", "directly competitive" or similar in some other manner, and even if such product-specific rules are perceived to be based on distinctions deemed in some sense "narrow".

6.244 The **Panel** begins its analysis by recalling India's claim that section 405 violates the second clause of Article 2(d) because it results in unjustifiably differential treatment of "closely related (Indian and European Communities) products".[125] This claim is based on three cumulative assumptions. *First*, it assumes that the second clause of Article 2(d) imposes an

[125] India's reply to Panel question No. 60; India's second written submission, para. 68.

obligation on Members to apply the same rule of origin, or at least equally advantageous rules, to "closely related" products (*e.g.*, silk scarves and cotton scarves) imported from different Members.[126] *Second*, it assumes that the second clause of Article 2(d) should be interpreted to prohibit not only *de jure* discrimination between Members, but also *de facto* discrimination. *Third*, it assumes that an assessment of whether rules of origin discriminate, *de facto*, between Members calls for an examination of whether those rules impose differentially disadvantageous consequences on certain Members and of whether these different consequences are justifiable.

6.245 In respect of the first of India's three assumptions, we recall that the second clause of Article 2(d) states that rules of origin "shall not discriminate between other Members, irrespective of the affiliation of the manufacturers of the good concerned". It does not state that rules of origin "shall not discriminate between closely related goods of other Members […]". Thus, the plain terms of the second clause do not support India's reading.

6.246 Moreover, the expression "the good concerned" in the singular indicates that the second clause of Article 2(d) is not concerned with discrimination across different (but closely related) goods. Were it otherwise, the second clause would arguably have referred to "the goods concerned" in the plural. In our view, the use of the singular suggests that, for the purposes of assessing whether there is discrimination "between Members", a comparison should be made between the rule of origin applicable to a particular good when imported from one or more Members and the rule(s) of origin applicable to the same good – "the good concerned" – when imported from one or more other Members.

6.247 If the second clause of Article 2(c) were intended to preclude discrimination across different (but closely related) goods, we consider it likely that the drafters would have provided some textual guidance as to the product scope of the prohibition set forth in the second clause. Indeed, we note that other WTO non-discrimination provisions, such as Articles I, III and IX of the GATT 1994, do specify the product scope of the prohibitions they contain.[127]

6.248 Finally, our reading of the second clause of Article 2(d) is consistent with the objective of that clause. In our view, the principal objective of the second clause of Article 2(d) is to ensure that, for a given good, the strictness of the requirements that must be satisfied for that good to be accorded the origin of a particular Member is the same, regardless of the provenance of the good in question (*i.e.*, Member from which the good is imported, affiliation of the manufacturers of the good, etc.).[128]

6.249 In view of the above considerations, we are unable to accept India's assumption that the second clause of Article 2(d) imposes an obligation on Members to apply the same rule of origin, or at least equally advantageous rules, to "closely related" products imported from different Members.[129]

6.250 Since we have rejected the first of three cumulative assumptions underlying India's claim under Article 2(d), and since it is not necessary to our disposition of that claim, we do not decide whether the second and third of India's assumptions are correct. Accordingly, in examining

---

[126] We note that India does not offer a definition of the concept of "closely related products".

[127] For instance, Article I of the GATT 1994 prohibits discrimination as between "like" products only.

[128] The Panel notes that this is consistent with its view that Article 2 is intended to leave Members a considerable measure of discretion in designing and applying their rules of origin. *Supra*, para. 6.25.

[129] India could be understood as arguing as well that the second clause of Article 2(d) can be violated even if the products distinguished in the rules of origin are neither "like" nor "directly competitive or substitutable" products within the meaning of Article III of the GATT 1994. India's reply to Panel question No. 3. Our reasoning with respect to India's concept of "closely related products" would be equally applicable if India meant to argue that the second clause of Article 2(d) also prohibited discrimination as between products that are neither "like" nor "directly competitive or substitutable".

India's claim that section 405 is inconsistent with the second clause of Article 2(d), we will accept these assumptions on an *arguendo* basis.

(b) Consistency of section 405 with Article 2(d) of the *RO Agreement*

6.251 **India** recalls that section 405 provides exemptions to the general rules for determining origin for certain fabrics, certain goods and certain fibre blends. India acknowledges that these exemptions are, *de jure*, applied on an origin-neutral basis. However, in India's view, these exemptions *de facto* favour goods from the European Communities since the fabrics, products or fibre blends that benefit from the exemptions are mainly the type of textile and apparel products which undergo "value-added" or substantial transformation operations in the European Communities. Therefore, India argues, these products can enter the United States without being subject to any quota restraints. India notes that, in contrast, when these products are made of certain fibres such as cotton, those products will be conferred origin where the greige fabric is woven. India asserts that it is mainly developing countries under quota restraints that export cotton fabric. According to India, this demonstrates that the effect of section 405 is to impose differentially disadvantageous consequences for developing countries such as India which export cotton fabric and products thereof.

6.252 India argues, furthermore, that the differential effects created by section 405 are unjustifiable. India considers it indisputable that the United States enacted section 405 for the sole purpose of providing favourable market access for particular textile products that were of special concern to the European Communities. In India's view, the effects of section 405 are, therefore, unjustifiable.

6.253 According to India, the effects created by section 405 are also unjustifiable because, in its view, the exemptions in section 405 (which makes distinctions between certain products) bear no relation to the manufacturing or processing of those products. Specifically, India argues that the amendments in section 405 created arbitrary and inconsistent reversions to the pre-section 334 rules of origin for a group of selected textile products, without any particular regard for the degree of further processing, assembly or other operations and how the extent of those further operations would change the nature of the products. India submits that the exceptions created by section 405 were defined solely by the types of end products imported into the United States from the European Communities and for which the European Communities expressed concern. India asserts in this regard that the manufacturing and assembly of bed linen is the same whether it is made of silk or cotton. India is of the view that these products are the same. India considers in this respect that there are no technical reasons to discriminate in terms of rules of origin between products that are identical (and thus by definition are competitive or substitutable in the market) and that undergo the same manufacturing and processing.

6.254 In addition, India notes that the United States refers to its Harmonized Tariff Schedule (general note 22) which defines "wholly of" as meaning "that the goods are […] completely of the named material". India maintains that for section 405, however, the United States arbitrarily made more than 16% cotton as the criterion to determine the applicable rule of origin (*i.e.*, that origin would be conferred where the greige fabric is woven). India points out in this regard that the United States has noted that in response to a question from the Panel that "by establishing a rule of certain goods containing 16% or more of weight of cotton, we ensured that we would cover the products defined in our settlement agreement". India submits that by reducing the threshold of the definition of a cotton product from one that is composed *completely of* cotton to one that is merely *16% and above* of cotton, the United States effectively brought more items

under the definition of cotton, which according to section 405, would be conferred origin where the greige fabric was woven.[130]

6.255 The **United States** notes that India's primary claim with respect to section 405 is its charge that because the exceptions to section 334 took into account specific products of interest to the European Communities, this "favoured" the European Communities and is discriminatory. The United States notes that, of course, any settlement has to be satisfactory to the complaining party. But the United States submits that if the settlement is applicable to all Members on an MFN basis, it will in all likelihood benefit all exporting Members. In the view of the United States, India cannot rely on *Canada-Autos* to substantiate a claim of *de facto* advantage in favour of the European Communities. The United States notes that, in that dispute, the Appellate Body was addressing an advantage given to *some* products that was based on the country of affiliation of the producers. The United States emphasizes that, in that case, the *de facto* discrimination resulted because Canada was giving advantage to some of the *same* (*like*) products based on nationality. The United States considers that, in this dispute, India's charges in respect of the United States' rules of origin relate to *different* products. The United States further argues that, while it is true that in that report the Appellate Body made a reference to "*de facto* advantage", Article I:1 of the GATT 1994 is not at issue in this case. The United States notes that if India had wished to make such a claim, it could have brought a dispute under that provision.

(…)

6.258 The **Panel** understands India's claim to be based on three assertions: *first*, that section 405 results, *de facto*, in differential treatment of goods, by providing an advantage to goods of concern to the European Communities which it does not provide to goods of concern to developing countries like India; *second*, that the goods affected by the differential treatment are goods which are "closely related"; and, *third*, that the differential treatment of the goods in question is unjustifiable.[131]

6.259 We accept, *arguendo*, India's first assertion and, accordingly, begin by examining India's second assertion – that the (assumed) differential treatment resulting from section 405 affects "closely related" goods. We recall in this respect that we have rejected India's view that the second clause of Article 2(d) imposes an obligation on Members to apply the same rule of origin, or at least equally advantageous rules, to "closely related" products imported from different Members.[132] However, this does not, in itself, dispose of India's claim under Article 2(d). The reason is that the category of "closely related goods" logically comprises, as a subset, goods which are the same. It is necessary, therefore, to examine whether India has identified goods which are the same, but are differentially affected by section 405.

6.260 We note, *first*, that it is unclear whether India is suggesting that finished cotton fabric (*i.e.*, fabric which has been subjected to a DP2 operation), and cotton bed sheets are "closely related" goods.[133] These are goods in different stages of manufacturing, classified under different

---

[130] India considers that the "16% and more" definition is also not consistent with the definitions as set out in Chapters 50 to 55 of the Harmonized System which provides for a definition of "85% or more" as pointed out by the United States in its replies to the Panel's questions.

[131] India's second written submission, paras. 70-74; India's reply to Panel question No. 60.

[132] *Supra*, para. 6.249. We note that, at the same time, we have accepted, for the sake of argument, India's assumptions: (i) that the second clause of Article 2(d) should be interpreted to prohibit not only *de jure* discrimination between Members, but also *de facto* discrimination and (ii) that an assessment of whether rules of origin discriminate, *de facto*, between Members calls for an examination of whether those rules impose differentially disadvantageous consequences on certain Members and of whether these different consequences are justifiable. *Supra*, para. 6.250.

[133] India's first oral statement, paras. 28-29.

HS headings. It is not clear to us, therefore, how cotton fabric and cotton bed sheets could be viewed as the same products. In our view, merely that cotton fabric may be converted to cotton bed sheets does not make these goods the same. In any event, India has not made a prima facie case in this regard.[134]

6.261 *Second*, India could be understood as implying that wool fabric and other fabric, such as silk or cotton fabric, are "closely related" goods.[135] India's submissions with respect to its claim under Article 2(d) do not specifically address wool fabric. We note that in the context of a different claim, India argues that there is no difference in the process of weaving wool yarns into fabric and the process of weaving cotton or silk yarn into fabric.[136] Even ignoring the fact that this argument concerns a different claim, India has not provided any information on the processing of wool yarn and other yarn. Moreover, even if India were correct and there was no difference in the processing, it is not clear to us why this would detract from the fact that wool fabric, cotton fabric and silk fabric, which are classified under different HS headings, are quite different in their physical characteristics, quality and reputation. Thus, based on India's submissions, we are not convinced that wool fabric and other fabric, such as silk or cotton fabric, are the same for the purposes of the second clause of Article 2(d).

6.262 *Third*, India argues, explicitly, that silk scarves and cotton scarves are "closely related" goods. India submits that, from the perspective of production techniques, silk scarves and cotton scarves are virtually identical.[137] Here again, India provides no specific information regarding the manufacturing process of scarves made of different fabric. Nor does India address why the (alleged) fact that the manufacturing process is the same makes other differences, including differences in classification under the Harmonized System, physical characteristics, quality and reputation, inconsequential. In the light of this, we consider that India's submissions are insufficient to convince us that silk scarves and cotton scarves are the same for the purposes of the second clause of Article 2(d).

6.263 We note, furthermore, that, in India's view, bed linen made of silk and bed linen made of cotton are the "same" products. This argument, too, is based on the contention that both types of bed linen undergo the same manufacturing processes.[138] To that extent, *mutatis mutandis*, our observations in the preceding paragraph with respect to scarves apply equally here.[139] India could be understood to contend, in addition, that silk and cotton bed linen are "identical products" and, as such, competitive and substitutable in the market.[140] However, even were we to assume that silk bed linen and cotton bed linen could be determined to be the same on the basis of their competitive relationship, this would not assist India, since India has not submitted sufficient information for us to assess the nature and extent of a competitive relationship, if any. Consequently, we consider that India has not established that silk and cotton bed linen are the same for the purposes of the second clause of Article 2(d).

6.264 *Finally*, India could be understood as arguing that relevant goods made of a fibre blend with 16% or more cotton and goods made of a fibre blend with less than 16% cotton are the

[134] In fact, India itself seems to acknowledge that these are different "types" of product. India's first oral statement, para. 28.
[135] India says that, with respect to its claim under Article 2(d), it is challenging section 405(a)(3)(B), which deals with fabrics. India's reply to Panel question No. 19.
[136] India's second written submission, para. 40.
[137] India's reply to Panel question No. 60.
[138] India's second oral statement, para. 20.
[139] We note that India has not provided any information regarding the manufacturing processes for silk and cotton bed linen.
[140] India's second oral statement, para. 20.

"same" goods.[141] India's submissions with respect to its claim under Article 2(d) do not specifically address goods made of fibre blends. We note, however, that in the context of a different claim, India argues that there is no difference between the processing of a bed valance made of 83% polyester / 17% cotton blend as compared to a bed valance made of 86% polyester / 14% cotton blend.[142] In this particular instance, it is not necessary for us to decide whether India's submissions are sufficient to establish that goods made of fabric with 16% or more cotton and goods made of fabric with less than 16% cotton are the same. This is because India has, in any event, not persuaded us that it would be unjustifiable to apply different rules of origin to goods with 16% or more cotton and goods with less than 16% cotton.

6.265 Based on the foregoing, it is clear that, with the exception of one category of goods – goods containing fabrics made of a cotton blend – where we have made no finding, India has failed to establish that the (assumed) differential treatment resulting from section 405 affects goods which are the same. As a result, India has failed to establish its claim under Article 2(d), with the possible exception of goods made of a cotton blend.

6.266 Consistent with our conclusion in the preceding paragraph, with respect to goods made of a cotton blend, we need to proceed to examine India's third assertion that the (assumed) differential effect is unjustifiable. For the purposes of this examination, we will assume that goods made of fabric containing 16% or more cotton and goods made of fabric containing less than 16% are the same and that the different rules of origin applied to such goods as a result of section 405 provides a *de facto* advantage to goods of concern to the European Communities.

6.267 India argues that this (assumed) differential effect is unjustifiable because section 405 was enacted for the "sole purpose"[143] of favouring goods of export interest to the European Communities over goods of export interest to developing countries. However, we have already found, when examining India's claim under Article 2(b), that India has not established that the United States is using section 405 to favour goods of concern to the European Communities over goods of concern to other Members.

6.268 India appears to argue that the (assumed) differential effect is unjustifiable, in addition, because there is "no technical reason" to discriminate in terms of rules of origin between goods made of fabric containing 16% or more cotton and goods made of fabric containing less than 16%.[144] India considers that it is "arbitrary" to maintain such a product distinction for rules of origin purposes and to make more than 16% cotton the criterion to determine the applicable rule of origin.[145] The United States has explained that the 16% cotton threshold was established in order to implement the terms of the bilateral settlement agreement between the United States and the European Communities. The United States further points out that its definition of cotton blends is consistent with the structure of the Harmonized System. The United States points out that the Harmonized System, in Chapters 50 through 55, defines yarns and fabrics as "wholly of" a given fibre if they contain 85% or more of that fibre.[146]

6.269 We understand the United States to argue, in essence, that it needed to define which cotton blends, if any, should be entitled to the exception set forth in section 405(a)(3)(C), *i.e.*, the DP2 rule. Apparently, the United States determined that only those goods which are, effectively, "wholly of" a fibre *other than* cotton should qualify for the DP2 rule (provided such fibre is covered by the HTS headings specified in section 405(a)(3)(C)). Thus, a bed valance made of

[141] India's second written submission, footnote 33.
[142] *Ibid.*, para. 40.
[143] India's second written submission, para. 72.
[144] India's second oral statement, para. 20.
[145] India's reply to Panel question No. 60; India's second oral statement, para. 19.
[146] United States' reply to Panel question No. 9.

83% polyester / 17% cotton blend is not regarded as, in effect, a polyester bed valance. As such, it is not entitled to the DP2 rule. The (low) 16% cotton threshold would appear to be consistent with the complete exclusion from the DP2 rule of specified cotton goods which are not blends.

6.270 The 16% cotton threshold appears to be consistent with the structure of the Harmonized System, which recognizes the utility of specifying a certain percentage threshold for textile blends.[147] Thus, setting a relatively low percentage threshold is consistent with the fact that cotton goods which are not blends are completely excluded from the DP2 rule. We are, therefore, not persuaded by India's assertion that the 16% cotton threshold is arbitrary and, hence, unjustifiable.[148]

6.271 Accordingly, we find that, with respect to goods made of a cotton blend, India has not established that the (assumed) differential effects created by section 405 are unjustifiable. As a consequence, we reject India's claim under Article 2(d), insofar as it concerns relevant goods made of a cotton blend.

6.272 In the light of all of the above considerations, we conclude that India has failed to demonstrate that section 405 is inconsistent with the second clause of Article 2(d).

[147] See Chapter 50-55 of the Harmonized System.

[148] We also note that India has not shown that the 16% cotton threshold operates in such a way, for instance, that producers of certain Members cannot adjust their production so as not to exceed this threshold, or can only do so at an excessive cost.

Optional Reading

Moshe Hirsch, International Trade Law, Political Economy and Rules of Origin: A Plea for a Reform of the WTO Regime on Rules of Origin, 36 Journal of World Trade (2002) 171.