THE UNITED STATES-ISRAEL FREE TRADE AREA: IS IT VALID UNDER THE GATT?

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The General Agreement on Tariffs and Trade[1] (the GATT) permits its member states to enter into preferential trading agreements,[2] such as an agreement to form a free-trade area[3] (FTA) or a customs union.[4] Parties to preferential agreements

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[1] General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 187 [hereinafter GATT]. The GATT is a multilateral treaty that provides general rules for trade liberalization on a most-favored-nation basis, i.e., through the commitment by all member states to accord equal treatment to all other members with respect to trade and customs regulations. *See* GATT, art. I, 55 U.N.T.S. at 196. The GATT serves as the "charter" for global free trade. N.Y. Times, Sept. 15, 1986, at D10, col. 1. Twenty-three nations signed the GATT in 1947, 6 A. LOWENFELD, PUBLIC CONTROLS ON INTERNATIONAL TRADE at DS-5 - 6 (1983), and the number increased to over ninety by 1986, representing eighty percent of world trade. N.Y. Times, Sept. 15, 1986, at D10, col. 5. Throughout this Note, "GATT" is used to refer both to the General Agreement on Tariffs and Trade and to the organization of the GATT's "Contracting Parties."

[2] In a preferential trading system, trade advantages or privileges are given to member nations and denied to non-members. Preferential trading systems are considered discriminatory, since goods imported from outside are discriminated against. In contrast, in a non-discriminatory system, no advantage is accorded to *all* other states. Preferential trading systems are also often referred to as "bilateral trading systems," whereas non-discriminatory trading systems are often referred to as "multilateral trading systems."

The GATT is considered a non-discriminatory international trade agreement. However, it is only non-discriminatory with respect to the conduct it prescribes for GATT members in their relations with other GATT members: advantages accorded to one member must be accorded to *all* other GATT members. With respect to non-GATT nations, the GATT resembles a preferential trading system: an advantage accorded to a GATT member is generally *not* available to non-members.

What distinguishes the GATT from a purely preferential system is that GATT members are *not prohibited* from according non-members the same advantages which they accord to members, as long as GATT members are given these same advantages. This, in essence, is what the "Most-Favored-Nation" clause of the GATT mandates. *See* GATT, *supra* note 1 at art. I, 55 U.N.T.S. at 196, reproduced *infra* note 5.

[3] The GATT created the idea of a Free-Trade Area and defines an FTA as "a group of two or more customs territories in which the duties and other restrictive regulations of commerce . . . are eliminated on *substantially all the trade* between the constituent territories in products originating in such territories." GATT, *supra* note 1 at art. XXIV, 55 U.N.T.S. at 272 (emphasis added).

[4] A customs union is an arrangement between two or more nations whereby barriers are eliminated on "substantially all the trade" between the members *and* the members maintain the same *external* tariffs towards third-party countries. *See id.* at art. XXIV, para.

accord each other trading privileges which are not granted to other GATT members. The preferential nature of FTAs and customs unions is, however, contrary to the GATT's Most-Favored Nation (MFN) principle,[5] which requires equal treatment among all GATT members. Thus, in order to discourage a proliferation of such agreements and thereby preserve the MFN principle, FTAs and customs unions are required to meet certain criteria, the primary one being the elimination of barriers on "substantially all the trade"[6] between members of the FTA or customs

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8(a). The best-known and largest customs union is the European Economic Community (EEC). *See* A. LOWENFELD, *supra* note 1, at 52-59.

[5] Article I of the GATT, the "MFN clause," provides that:

> With respect to customs duties . . . imposed on or in connection with importation . . . any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country *shall be accorded* immediately and unconditionally to the like product originating in or destined for the territories *of all other contracting parties.*

GATT, *supra* note 1, at art. I(1), 55 U.N.T.S. at 196 (emphasis added). The MFN principle, both because it embodies the goal of economic non-discrimination among signatory states and because almost all other articles of the GATT relate to it, is considered the "cornerstone" of the GATT. Dam, *Regional Economic Arrangements and the GATT: The Legacy of a Misconception*, 30 U. CHI. L. REV. 615 (1963). For a discussion of the MFN concept and its relationship to international trade in the 1980s, *see* Bilizi, *Recent United States Trade Arrangements: Implications for the Most-Favored-Nation Principle and United States Trade Policy*, 17 LAW & POL'Y INT'L BUS. 209, 210-17 (1985) [hereinafter *Recent Development*] (arguing that the United States commitment to MFN may be changing).

[6] *See supra* notes 3-4. The other criteria for FTAs are: 1) the remaining barriers in the trade between FTA members and other GATT parties must not be greater than what they were prior to the formation of the FTA; 2) an FTA agreement must "include a plan and schedule for the formation of such a . . . free-trade area within a reasonable length of time"; and 3) the parties to an FTA must "promptly notify the contracting parties and shall make available to them such information regarding the proposed . . . area." GATT, *supra* note 1, at art. XXIV, 55 U.N.T.S. at 272 *as amended and restated by* the Special Protocol Relating to Article XXIV of GATT, March 24, 1948, 62 U.N.T.S. 58, 60, para. 5(b), 5(c) and 7(a).

The United States and Israel did notify the GATT of the FTA Agreement and two GATT members voiced opposition to it; Brazil and India objected to the Agreement's inclusion of trade services. [July-Dec.] Int'l Trade Rep., (BNA) Vol. 2, No. 41, at 1313-14, (Oct. 16, 1985). The GATT postponed any decision regarding this objection. *Id.* at 1314. For purposes of this Note's analysis, GATT approval or acquiesence to the FTA Agreement is irrelevant. It is submitted herein that the United States, generally, would be the GATT member most likely to object to an FTA agreement that fails to conform to Article XXIV of the GATT. *See infra* note 9. Since the United States is a party to the FTA Agreement in question, chances are slim that any GATT nation will assume the role traditionally held by the United States of requiring strict adherence to the Article XXIV requirements. Inquiry into the validity of this Agreement, however, may determine whether the United States is maintaining the high standard it has traditionally applied to other nations. If not, the likelihood that the United States will object to future FTA agreements to which it is not a party is diminished. This, in turn, could lead to a *de facto* abandonment of the GATT requirements for FTAs.

The United States has come under attack by some GATT members for the FTA be-

union. For many years, the United States criticized[7] several GATT members who entered into FTA or customs union agreements[8] on the ground that the specific provisions of these preferential agreements did not go far enough in eliminating barriers on "substantially all the trade" between constituent members.[9] Nevertheless, in 1985 the United States entered into an FTA agreement with Israel.[10]

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tween it and Israel. The chairman of a GATT panel that is examining the FTA Agreement to "verify its consistency with Article XXIV of Gatt," has indicated that there are concerns that the agreement "excludes considerable sectors of trade." Int'l Trade Rep. [Jan-June] (BNA) Vol. 4.

7 Nobody knew better than the United States that the Article XXIV exception for customs unions and FTAs was little more than a political compromise, because the Article was drafted by United States negotiators to accomodate conflicting political interests among the original GATT signatories. *See* A. LOWENFELD, *supra* note 1, at 43-46. Perhaps the compromise was a general feeling in 1948 that, as the GATT succeeded in lowering tariff rates across the globe, the preferential value of customs' unions and FTAs would decrease. To the extent that tariffs represented the major barriers to trade, this was a reasonable assumption; *but.see infra* note 25 (arguing that the emergence of "nontariff barriers", more potent restrictions than tariffs, requires this assumption to be reevaluated).

8 *See* J. JACKSON, WORLD TRADE AND THE LAW OF GATT 592-99 (1969) (listing all the FTAs and customs unions notified to the GATT as of January 1, 1969).

9 For example, the United States had long been critical of various preferential agreements between the EEC and certain Mediterranean nations, on the ground that such agreements merely benefit certain select sectors of the various countries' economies to the detriment of United States export. *See* N.Y. Times, Aug. 11, 1986, at D3, col. 4.

Another example of this policy of opposing preferential agreements was the American position on the agreement of the Association of South-East Asian Nations. In 1980, when the GATT discussed the proposed South-East Asian Agreement, the GATT members agreed to establish a "Working Party" to study the agreement. *See* J. LAMBRINIDIS, THE STRUCTURE, FUNCTION, AND LAW OF A FREE TRADE AREA 243 n.17 (1965) (explaining how Working Parties, which operate as committees comprised of representatives from various GATT nations, are regularly appointed to examine FTA or customs union agreements and to make appropriate recommendations). The Working Party drafted a decision recommending that the GATT adopt the Agreement; the American member of the Working Party, although voting in favor of GATT adoption of the Agreement, expressed American disapproval by saying that the United States viewed the Working Party's draft decision not as an approval of the agreement's compliance with Article XXIV, but as a *waiver* of the GATT's requirements for FTAs, pursuant to Article XXV of the GATT. *See* GATT, BASIC INSTRUMENTS AND SELECTED DOCUMENTS 321 (1980); GATT, *supra* note 1, at art. XXV, 55 U.N.T.S. at 272.

Had the United States taken the view of most of the Working Group's other members that the remaining barriers in the South-East Asian Agreement did not preclude its compliance with Article XXIV, then the United States would not have needed to clarify its vote. The decision to consider the Article XXIV requirements "waived," reflected the United States' narrow interpretation of Article XXIV.

10 Free-Trade Area Agreement, Apr. 22, 1985, Israel-United States, 24 I.L.M. 653 (1985) [hereinafter FTA Agreement]. With the sole exception of a 1965 automotive products agreement with Canada, the FTA Agreement was the first reciprocal preferential trade agreement which the United States signed after World War II. *See* Automotive

This FTA is susceptible to criticism on two grounds. First, as currently interpreted by the United States, the FTA permits American imposition of import quotas on certain Israeli-made goods.[11] This interpretation appears to conflict with both the provision of the FTA Agreement prohibiting the imposition of new quantitative restrictions and the GATT requirement of eliminating barriers on "substantially all the trade" among FTA members.[12] This violation is particularly problematic because it could serve as a precedent for new quantitative restrictions suggesting that the FTA in existence between the United States and Israel, distinct from the FTA Agreement,[13] does not satisfy the GATT requirements.

The second ground for criticism concerns the agreement's Rules of Origin. Rules of Origin require a substantial connection between goods and the country that claims the benefits of the trade agreement for those goods. The Rules of Origin of the FTA Agreement exclude certain goods from receiving the benefits of the agreement if they are only assembled in the party-country.[14] Consequently, the application of the Rules of Origin

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Products Agreement, Jan. 16, 1965, United States-Canada, 17 U.S.T. 1372, T.I.A.S. No. 6093.

The agreement with Canada was motivated by very different political and economic concerns from those that motivated the FTA Agreement. Since the 1920s, the major American automobile manufacturers had factories in Canada, a constant reminder to Canadians of their economy's foreign dominance. Because of the importance of the automobile industry to Canadian-United States relations, and in order to avoid a trade war, the United States agreed to sign a special pact eliminating all duties on automotive products. *See* A. LOWENFELD, *supra* note 1, at 393-95. Since this agreement eliminated duties on only one industry, it did not comply with Article XXIV of the GATT, and therefore, the United States secured a *waiver* from the GATT pursuant to Article XXV. *See id.* It is worth noting, as evidence of at least one prior example of American insistence on strict adherence to both the spirit and the letter of Article XXIV, that the United States, not Canada, appealed to the GATT for the waiver.

[11] Shortly after the Agreement went into effect, the United States announced its intention to impose a unilateral import quota on certain Israeli textile products. 50 Fed. Reg. 43,761 (1985). Quantitative restrictions were imposed through means other than a unilateral quota. *See id. See also infra* note 69 and accompanying text (regarding the imposition of a Voluntary Restraint Agreement).

[12] *See infra* text accompanying notes 70-81.

[13] The GATT criteria are imposed upon the free-trade *area*, not merely upon an agreement forming a free-trade area. Thus, this Note examines not only the text of the Agreement, but perhaps more important, its application.

[14] *See* FTA Agreement, *supra* note 10, at annex 3 paras. 1-3, 24 I.L.M. at 669-70. The purpose of the Rules of Origin, is to prevent products from third-party countries from being passed through a member country in order to take advantage of the duty-free arrangement between the two parties. This ineligibility of imported goods, whose only connection with a party-country is that they were assembled there appears, at least in part, to stem from the potential economic harm to domestic industries that their impor-

to some industries suggests that the Rules also fail to sufficiently liberalize trade because they are not flexible enough to allow some goods that do have a substantial connection with a party-country to receive FTA benefits.

This Note explores these two aspects of the FTA Agreement and the validity of the FTA under the GATT. Part I discusses the development of global trade rules and United States trade policy, and examines the GATT's requirements for FTAs, focusing on the requirement of eliminating "substantially all the trade". In particular, several provisions of the United States-Israel FTA Agreement are considered to determine whether they comply with the GATT. Part II examines how the presence of the Agreement's textile import quotas and Rules of Origin affect the "substantially all" determination. Part II analyzes the textile trade between the United States and Israel in detail; the one major controversy which has arisen since the FTA Agreement went into effect involved that industry.[15] Part III discusses the FTA's Rules of Origin, and why they are a barrier to trade. This Note concludes that the FTA, as currently implemented, fails to sufficiently liberalize trade because it permits quotas to be imposed and has excessively restrictive Rules of Origin. Therefore, despite the degree to which it eliminates most barriers to American-Israeli trade, this FTA does not meet the GATT criteria for FTAs.

I. UNITED STATES TRADE POLICY AND THE GATT

Despite the absence of a formal multinational trading system in the late nineteenth century, an international spirit of economic liberalism prevailed in the years preceding the First World War.[16] This liberal or "free-trade" spirit was severely shaken by the First World War and was virtually demolished by the depression of the 1930s.[17] As a result, by the outbreak of World War II,

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tation might cause. *See infra* note 67. The Rules of Origin are deemed an intregral part of the agreement. *See* FTA Agreement, *supra* note 10, at arts. 2(3) and (5), 24 I.L.M. at 658.

15 *See supra* note 11 and accompanying text. Rules of Origin usually have a great effect on the textile industry. *See* Ashoff, *The Textile Policy of the European Community Towards the Mediterranean Countries*, 22 J. COMM. MKT. STUD. 1, n.2 (1983) (stating that, with respect to textiles, preferential trade agreements generally have favorable rules of origin).

16 A. LOWENFELD, *supra* note 1, at 11-12.

17 "There was a sharp contraction of the world's trade. The attention of governments turned inward; the issue of unemployment dominated domestic politics . . . . Na-

the prevalent pattern in international trade was one of "preferences, bilateralism, [and] restrictionism."[18]

World War II was the turning point for the rules governing global trade, since, it was then that American policy makers rethought their failed restrictive trade policies of the twenties and thirties.[19] As one expert observed:

> [World War II led to] . . . the perception . . . that trade restraints had fostered retaliation, had failed to produce recovery, and had contributed to the outbreak of the war. In looking to the future, the planners of post-war international economic policies, *especially in the United States*, were determined not to repeat the errors of the 1920's and 1930's. . . . [This] meant a commitment to multilateral, as contrasted to bilateral arrangements, and a commitment to reduction of trade barriers on an MFN basis. . . . [And this meant the] construction of legal rules and an organization to administer them.[20] (Emphasis added).

The GATT was signed two years after the war ended, and since then, international trade among countries with market economies has been conducted largely on the basis of non-discrimination.[21] The GATT's committment to non-discrimination among signatory states is embodied in the MFN clause,[22] which requires every GATT member to accord all other GATT members the same privileges.[23] In addition to MFN, there are two other essential principles of the GATT: (1) "governmental restraints on the movement of goods should be kept to a minimum, and if changed, should be reduced, not increased;" and (2) "the conditions of trade, including the level of tariffs and other restrictions, should be discussed and agreed on within a multilateral framework."[24] Thus, through the GATT, liberalizing trade through

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tions no longer permitted production to adjust itself to the requirements of the world economy; where national and international interests came into conflict, internationalism gave way." *Id.* at 13 (quoting C. WILCOX, A CHARTER FOR WORLD TRADE 7 (1949, repr. 1972)).

18 *Id.* at 14. For the United States, this wave of protectionism was codified in the Smoot-Hawley Tariff Act of 1930, Pub. L. No. 71-361, 46 Stat. 590, which raised tariff levels to their highest point in American history. *See* A. LOWENFELD, *supra* note 1, at 13.

19 AMERICAN BAR ASSOCIATION, AN INTRODUCTION TO INTERNATIONAL TRADE LAW at 1-2 (1982) [hereinafter ABA].

20 A. LOWENFELD, *supra* note 1, at 14-15 (footnotes omitted).

21 *See supra* note 2. The GATT accounts for eighty percent of the trade of the non-communist world. *See* A. LOWENFELD, *supra* note 1, at 22.

22 *See supra* note 5 (for a discussion of MFN).

23 *Id.*

24 A. LOWENFELD, *supra* note 1, at 23. The United States in particular was an early supporter of the idea of a multilateral trading system and has always considered itself a

multilateralism[25] has been the rule.

A. *The GATT Exception for Free-Trade Areas*

Despite the MFN principle and its policy of multilateralism, the GATT does permit preferential arrangements in the form of

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leader in free trade in the post-World War II era. American trade policy traditionally was carried out by encouraging GATT nations to reduce trade barriers by multilateral trade agreements. One example of the success of this approach is the global reduction of tariffs: in 1947, the average tariff was forty percent, compared with today's five percent. Farnsworth, *GATT Talks Facing Tough Obstacles*, N.Y. Times, Sept. 22, 1986, at D7, col.3. *See also* July-Dec. Int'l Trade Rep. (BNA) No.1, at 625 (Nov. 21, 1984).

[25] Since the negotiation of the GATT in 1948, GATT members have held seven rounds of trade negotiations in which tariffs and other trade barriers have been removed or reduced. An eighth round began on September 15, 1986, and is expected to last four years. *See GATT at a Glance*, N.Y. Times, Sept. 15, 1986, at D10, cols. 5-6. In each GATT round, the United States has been instrumental both in setting the agenda and in the actual negotiating. A. LOWENFELD, *supra* note 1, at 131.

The most recently concluded round of trade negotiations, the seventh GATT round, known as the "Tokyo Round," was concluded in 1979. N.Y. Times, Sept. 15, 1986, at D10, col. 6. This round is generally regarded as "the most ambitious trade negotiation ever." ABA, *supra* note 19, at 4. In addition to reducing tariffs, the Tokyo Round also resulted in the development of a number of multilateral "codes of conduct" designed to limit trade distortions arising from "nontariff barriers" (NTBs). J. JACKSON, J. LOUIS, & M. MATSUSHITA, IMPLEMENTING THE TOKYO ROUND 13 (1984).

Prior to the Tokyo Round, tariffs were generally considered the most common trade barriers because they are usually easier to impose than, for example, import quotas. Quotas require a running total of the amount of the imported goods over a specific period of time, whereas tariffs are imposed on products regardless of how many are imported. However, as tariff rates have declined continuously since 1948, the major trading nations of the world, particularly the United States, now realize that NTBs have "replaced simple customs duties as the major impediment" to international trade. *See* ABA, *supra* note 19, at 2.

In the years immediately following the Tokyo Round, the level of global trade increased, with a parallel increase in the American trade deficit. In the early 1980s, the Reagan Administration felt political pressure to decrease the deficit but did not want to impose import quotas. The administration wanted to take steps to increase American exports in economic sectors in which the United States has a competitive advantage. Thus, in 1982, the United States became the first country to request a new round of trade negotiations. This request was turned down by EEC and most other GATT members. Int'l Trade Rep., [Jan-June], at 488 (Feb. 24, 1982). Only after the United States concluded its FTA Agreement with Israel, was America successful in persuading GATT members to agree on a new round. The possibility that the United States used the FTA Agreement to prod other nations to join in a new round was underscored by President Reagan's statement at the time the agreement was signed, that he hoped that the agreement would "serve to encourage greater liberalization of the *multilateral* trading system" and would "help us move ahead in our continued attempts to expand *world trade*." Int'l Trade Rep., Apr. 24, 1985 at 561, 564 (emphasis added). This was also the European perception. "The U.S. Government consider[s the FTA Agreement with Israel] as a form of *revenge* over the EEC, which refused the new round of trade negotiations requested by the United States." Just before Shamir's visit to Brussels, Israel prepared to sign a Free Trade Agreement with United States, Eur. Rep., No. 1113, at V-8 (Mar. 9, 1985).

FTAs or customs unions. These areas or unions, as distinct from the agreements signed by nations to form them, must comply with four GATT criteria.[26] The most important of these criteria is the elimination of "the duties and other restrictive regulations of commerce" on "substantially all the trade"[27] between the constituent members of the FTA. Interpretation of this phrase has been a major source of controversy in evaluating the validity of proposed FTAs.[28] It has been suggested that "susbstantially all" has both a quantitative and qualitative aspect.[29] The quantitative aspect, according to the official view of the European Economic Community (EEC), requires that barriers be eliminated on at least eighty percent of trade for an FTA or customs union to pass the "substantially all" test.[30] Although the GATT, as an organization, has never officially accepted this interpretation, it has been endorsed by other contracting parties.[31] With respect to the qualitative aspect, there is some agreement that in order to meet this criterion, "no important segment of trade" can be omitted from the scope of a proposed customs union or FTA.[32] Thus, in general, "substantially all the trade" requires that barriers be eliminated on at least eighty percent of the trade and that no important industry be omitted from the FTA or customs union. It is important to note that the GATT merely requires

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[26] *See supra* notes 3 & 6 and accompanying text.

[27] GATT, *supra* note 1, at art. XXIV, para. 8, 55 U.N.T.S. at 272. *See also supra* note 3.

[28] J. JACKSON, *supra* note 8, at 607-10.

[29] For example, when the European Free Trade Area (EFTA) was evaluated by the GATT, it was suggested that because the proposed FTA did not apply to agricultural products, it did not eliminate the duties and other restrictive regulations of commerce on "substantially all the trade":

> [Because] the phrase "substantially all the trade" [has] a *qualitative* as well as quantitative aspect[,] . . . it should not be taken as allowing the exclusion of a major sector of economic activity. For this reason, the percentage of trade covered, even if it were established to be 90 per cent, was not considered to be the only factor to be taken into account. The member states agreed that the quantitative aspect, in other words the percentage of trade freed, was not the only consideration to be taken into account.

GATT, 9th Supp., Basic Instruments and Selected Documents 83-84 (1961) (emphasis added). Despite this agreement, the differences between qualitative and quantitative value were not made clear. *See also* J. JACKSON, *supra* note 8, at 610 ("it has so far been impossible for GATT parties to agree on even the qualitative aspects").

[30] GATT, 6th Supp., Basic Instruments and Selected Documents 98-99 (1958). Although the EEC is a customs union and not a free trade area, both customs unions and FTAs are required to liberalize "substantially all the trade" among constituent states. Therefore, reference to the EEC is relevant, if not controlling, on the question of substantiality.

[31] J. JACKSON, *supra* note 8, at 609.

[32] *Id.*

preferential arrangements to eliminate barriers "within a reasonable length of time,"[33] as opposed to immediately upon entering into the arrangement.

Although traditionally, FTA agreements have emphasized the reduction or elimination of tariffs, since 1979 there has been a new recognition on the part of the major trading nations that tariffs are no longer the most *potent* form of trade restrictions.[34] One type of non-tariff barrier (NTB) that poses a greater threat to free trade is import quotas or "quantitative restrictions."[35] Even when tariff rates are high, purchasers in the importing nation can pay higher prices for the goods they want,[36] but when quantitative restrictions are imposed on specific imported goods, only a limited quantity of the goods may enter the domestic market.[37] Thus, even though on its face a tariff-free trading arrangement may appear to have removed barriers on "substantially all the trade" between the parties, the presence or absence of quotas is a more determinative test of whether this requirement has been met.[38]

B. *The United States-Israel FTA Agreement*

The United States-Israel FTA Agreement was, at least in part, a result of the overall United States trade policy of the first half of the 1980s. In the Trade and Tariff Act of 1984,[39] Con-

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[33] GATT, *supra* note 1, at art. XXIV, 55 U.N.T.S. at 272.

[34] *See supra* note 25.

[35] Recognizing the potential harm of quantitative restrictions, the GATT contains a general prohibition against quotas. *See* GATT *supra* note 1, at art. XI, para. 1, 55 U.N.T.S. at 224-226.

[36] *See generally Ending the Lunacy of Trade Protection,* N.Y. Times, Apr. 27, 1986 at F3, col.3 (arguing for an end to quotas and voluntary restraint agreements and their *temporary* replacement by tariffs).

[37] *See* A. LOWENFELD, *supra* note 1, at 34-35 (discussing United States opposition to import quotas).

[38] There is even a GATT precedent suggesting that an FTA agreement retaining substantial quotas fails to comply with Article XXIV of the GATT. The Nicaragua and El Salvador Free-Trade Area Agreement "envisaged the imposition of quantitative restrictions in certain cases," leading one scholar to argue that the quotas "*violated the requirement in the definition of a free trade area* . . . for the abolition of restrictive practices." V.A.S. MUHAMMAD, THE LEGAL FRAMEWORK OF WORLD TRADE 250 (1958) (footnote omitted) (emphasis added). Although the GATT's Contracting Parties did approve the Nicaragua-El Salvador agreement, they did so only by using GATT article XXIV, paragraph 10, which authorized them to approve proposals not in compliance with the legal requirements of article XXIV of the GATT. *Id.*

[39] Pub. L. No. 98-573, 98 Stat. 3024. The Trade and Tariff Act was the most important Congressional trade legislation since the Trade Agreements Act of 1979, 19 U.S.C. § 2501-82 (1982).

gress authorized the President to enter into direct negotiations with Israel[40] to formulate details for what eventually became the United States-Israel FTA Agreement. In 1984, the United States also reissued its call for a new round of multilateral GATT negotiations, which was previously rejected by many GATT members, including the EEC.[41] The United States, with its global trade

[40] Israel first raised the idea of an FTA Agreement with the United States in late 1983. H.R. Rep. No. 64, 99th Cong., 1st Sess. 2, *reprinted in* 1985 U.S. Code Cong. & Admin. News 61, 62. Preliminary negotiations began due to the close relationship between the two countries and American concern for Israel's economic improvement. *Id.*

Israel's goal in maintaining the FTA Agreement was primarily to gain duty-free entry into the American market. Like many developing nations, Israel had enjoyed duty-free access to the United States for many of its exports pursuant to American participation in the Generalized System of Preferences (GSP), a system of temporary tariff preferences for a wide variety of products from developing nations designed to promote their economic advancement. *See* P. FELLER, 1 U.S. CUSTOMS AND INTERNATIONAL TRADE GUIDE 11.07 (1987).

GSP benefits do not, however, compare with FTA benefits. The GSP is a temporary program, and therefore does not have the long-term promise of an FTA. *Id.* Additionally, GSP benefits do not apply to all exports from the developing nation, whereas FTAs are mandated by the GATT to apply to "substantially all the trade" between constituent states. Finally, through a concept called "graduation," GSP benefits are forfeited when a developing country's products become so competitive in the importing nation's market that they account for a significant share of it. *See* D. SERKO, IMPORT PRACTICE 144-46 (1985) (detailing the general rules for a product being "graduated" out of GSP eligibility). In an FTA, however, importing privileges are independent of the quantity of the imports. Thus, the FTA Agreement represented a significant step toward increasing Israel's exports to the United States.

[41] *U.S. Push to Bring Services in GATT Meets with Only Limited Success as Meeting Ends*, Int'l Trade Rep., at 670, Dec. 5, 1984, at 667-70. A new round of GATT negotiations was eventually agreed to and began on September 15, 1986. *See* Riding, *3d World Strike at Trade Talks*, N.Y. Times, Sept. 15, 1986, at D10, col. 1.

The United States did this largely because the Reagan Administration decided that it was time for the GATT members to resolve new issues. The two issues of most concern to the Administration were "trade in services," i.e., trade in insurance, banking, telecommunications, law and other service industries. *See* Farnsworth, *U.S. Plans to Defend Its Patents*, N.Y. Times, Apr. 7, 1986, at D1, col. 6. An example of the importance of this second issue to Congress and the administration is the provision in the Trade and Tariff Act of 1984, under which a country that fails to "provide adequate and effective means under its laws for foreign nationals" to exercise copyrights is not eligible for benefits under the GSP. *See* Trade and Tariff Act of 1984, Pub. L. No. 98-573, 98 Stat. 2948, 3000 (1984). *See also* Farnsworth, *supra* (stating that the United States is considering linking import privileges to certain countries' protection of American patents, copyrights, and trademarks).

Although the subject matter of the GATT is trade in goods, the United States considers the GATT's Contracting Parties to be the appropriate group for dealing with the issue of trade in services. It is likely that the United States would want the GATT nations to sign a comprehensive code of conduct, like those signed at the conclusion of the Tokyo Round, to deal with trade in services. So far, the GATT parties have not been receptive to this American initiative, and third-world GATT members in particular have voiced opposition. *See* Lewis, *Worldwide Canadian Initiative*, N.Y. Times, Apr. 10, 1986, at A31, col. 2. *See supra* note 6 (describing opposition from some GATT members to the

agenda rejected, and then signed, its first ever *bilateral* trade agreement,[42] the FTA Agreement with Israel.

The primary feature of this FTA Agreement is its schedule for the reciprocal elimination of all custom duties on trade between the United States and Israel by 1995.[43] The Agreement provides for several stages of tariff reductions,[44] according to three categories of tariff classifications.[45] Thus, all trade between the United States and Israel will be duty-free[46] by 1995.[47]

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idea of trade in services being considered within the jurisdiction of the GATT). The issue of trade in the services has also arisen during the preliminary negotiations of the proposed FTA between the United States and Canada. Lewis, *supra*, N.Y. Times, Apr. 10, 1986, at A31, col. 1.

The United States-Israel FTA Agreement contains articles dealing with trade in services and intellectual property. *See* FTA Agreement, *supra* note 10, arts. 14 & 16, 24 I.L.M. at 662 & 63. *See also* Declaration on Trade in Services, United States and Israel, 24 I.L.M. 679-81 (1985) (declaring that the United States and Israel "will endeavor to achieve open market access for trade in services with the other nation").

[42] H.R. Rep. No. 64, 99th Cong., 1st Sess. 2, *reprinted in* 1985 U.S. Code Cong. & Admin. News 61. *See also supra* note 10 (summarizing the Automotive Products Agreement between the United States and Canada, an agreement *not* entered into pursuant to Article XXIV of the GATT.)

[43] H.R. Rep. No. 64, 99th Cong., 1st Sess. 3, *reprinted in* 1985 U.S. Code Cong. & Admin. News 61, 63.

[44] *See* FTA Agreement, *supra* note 10, at art. 2, paras. 1 and 2, and annexes 1 and 2, 24 I.L.M. at 658, 667-69.

[45] *See* KEIM, FREE TRADE AREA AGREEMENT EASES BARRIERS TO U.S.-ISRAELI COMMERCE at 2 (1985) *reprinted from Business America* (June 24, 1985) (summarizing the complex scheduling of tariff reductions). All products are divided into three lists: A, B and C. The determination of what products went onto which list involved a variety of factors, including the product's volume of export, competitiveness, and previous duty rate. Products on list A will have their duties eliminated in three stages. "No duty reduction will be made until Jan. 1, 1990 on products specified on List C. At that time, a determination will be made on the duty elimination schedule. The duties will be eliminated by Jan. 1, 1995." *Id.*

[46] *Id.* The total elimination of duties is a major accomplishment since it is likely that none of the FTA Agreements entered into over the past four decades can claim to be truly duty-free. For example, the 1975 EEC-Israel Trade Agreement omitted agriculture and other sensitive commercial sectors. *See* Trade Agreement, Israel-EEC, 18 O.J. EUR. COMM. (No. L 136) 1 (1975). Because agriculture accounted for about thirty-five percent of Israel's total exports to the EEC, it is unlikely that, under any definition, "substantially all the trade" is liberalized by the EEC-Israel Agreement.

The EEC is also a party to other agreements that fail to comply with the GATT's "substantially all" criterion. In fact, one observer has noted that the EEC's policy of forming separate FTAs with several Mediterranean nations violates not only the letter of the GATT but also its spirit.

> The EEC, by entering into various bilateral free trade . . . arrangements, has been able to accord preferential treatment on a wide scale, contrary to the spirit of the principle of the MFN clause. It was not contemplated that the article XXIV exception to the [MFN] clause would be used on such a wide scale with each arrangement treated differently. Pursuant to article XXIV of the GATT, the "purpose of a . . . free trade area should be to facilitate trade between the

II. ANALYSIS OF THE FTA AGREEMENT'S PROVISION UNDER THE GATT

The FTA Agreement permits some barriers, including tariffs, to remain in the trade between the United States and Israel.[48] The effect which these barriers might have on the overall trade between the two parties must be examined in order to determine whether the Agreement, as a whole, eliminated barriers on "substantially all the trade" between the United States and Israel.

A. *Nonsubstantial Barriers to Trade*

Trade barriers that will be eliminated eventually or that can only be applied in very restricted circumstances are unlikely to affect negatively the determination of validity under the GATT. One such barrier is contained in article 10 of the Agreement, which permits Israel, within certain constraints,[49] to introduce customs duties for the purpose of developing "infant industries."[50] The term "infant industry", although not defined, is understood to mean an industry in existence for less than five years. Because there is a finite number of industries that can qualify as "infant" and article 10 limits the duration of this exception of

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constituent territories and not to raise barriers to the trade of other contracting parties with such territories." The EEC's differing treatment of each Mediterranean country has resulted in raising barriers rather than producing freer trade in the region.

Langer, *The Israel-EEC Free Trade Agreement An Analysis of the Agreement and its Effect on Investment*, 9 SYRACUSE J. INT'L L. & COM. 63, 95 (1982). *See also* N.Y. Times, Aug. 11, 1986, at D1, col. 4 (summarizing years of American opposition to EEC preferential relationships with Mediterranean nations).

Although the United States-Israel FTA Agreement does not have a general agricultural exception like that of the EEC-Israel Agreement, article 6 of the United States-Israel FTA Agreement does permit the two parties, based on agricultural policy considerations, to *maintain restrictions other than custom duties*. FTA Agreement, *supra* note 10, at art. 6, 24 I.L.M. at 659. *See also infra* note 63 (explaining the restrictive nature of article 6). This permission differs greatly, however, from the agricultural exclusion in the EEC-Israel Trade Agreement. Not only does the EEC agreement permit the imposition of *new* customs duties, but this exception applies to future restrictions in addition to ones already existing. Thus, although the United States-Israel FTA Agreement permits some agricultural barriers to remain, they are much less substantial than those permitted under the EEC-Israel Trade Agreement and cannot be considered a significant enough barrier to preclude the United States-Israel FTA Agreement from complying with the GATT.

47 *See* KEIM, *supra* note 45, at 2.

48 *See* FTA Agreement, *supra* note 10, at arts. 10 & 11, 24 I.L.M. at 660-61.

49 *See id.* at art. 10, paras. 1 and 2, 24 I.L.M. at 660.

50 *Id.* at art. 10, 24 I.L.M. at 660. The Agreement provides no examples of an infant industry.

1995,[51] it is unlikely that this exception, if used at all,[52] will affect the "substantially all" test of article XXIV of the GATT.

In addition, the Agreement allows temporary trade restriction for "balance of payment" problems.[53] Article ll provides, in relevant part:

> A Party may apply temporary trade measures when it is threatened by, or suffers from, a serious balance of payments situation. A Party may impose temporary trade measures only to provide time for macroeconomic adjustment measures . . . to take effect. Temporary trade measures . . . may not be used to protect individual industries or sectors.[54]

The Agreement limits the duration of any temporary restriction imposed for balance of payment problems to three hundred days.[55] Since such a restriction cannot have a lasting effect on the trade between the two nations, it is also unlikely that the article ll exception would be contrary to the "substantially all" criterion of the GATT.[56]

Finally, article 4 of the Agreement provides that new import quotas or other kinds of quantitative restrictions may be imposed only if they do not conflict with the FTA Agreement or the GATT:

> [N]ew quantitative restrictions on imports or exports or any measure having equivalent effect may be introduced in the trade between the Parties *only if permitted by this Agreement or by the GATT* as in effect on the date of entry into force of this Agreement and as interpreted by the CONTRACTING PARTIES to the GATT and insofar as not inconsistent with this Agreement.[57] (Emphasis

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[51] *Id.* at para. 3, 24 I.L.M. at 660.

[52] An Israeli official who played a major role in negotiating the FTA Agreement has said that it is unlikely that the article 10 exception will be used at all. Int'l Trade Rep., [July-Dec.] (BNA) No. 1 - 36 at 1122 (Sept. 11, 1985). Its presence in the Agreement is mostly a precaution, the official said, noting that while a similar provision appears in the Israel-EEC Trade Agreement, it has only been used once or twice in ten years. *Id.* To the extent that this provision can be considered merely a precaution, it is unlikely to amount to a substantial barrier to American-Israeli trade.

[53] Balance of payment problems pertain to difficulties that nations have in paying foreign debts.

[54] FTA Agreement, *supra* note 10, at art. 11, para. 1, 24 I.L.M. at 660.

[55] *Id.* at para. 4, 24 I.L.M. at 661.

[56] Furthermore, this exception is in accord with the GATT, which allows certain restrictions because of balance of payment problems. *See* GATT, *supra* note 1, at art. XII, para. 1, U.N.T.S. at 228. In fact, it is arguable that any stipulation in an FTA agreement regarding balance of payments is valid so long as it does not exceed the restriction permitted in article XII of the GATT.

[57] FTA Agreement, *supra* note 10, at art. 4, 24 I.L.M. at 658.

added).

Thus, the FTA Agreement incorporates the GATT's own explicit exceptions for the imposition of quantitative restrictions.

The only kinds of import quotas permitted by the GATT[58] are: quotas on the importation of foodstuffs during shortages,[59] restrictions necessary "to the application of standards 'for the classification, grading or marketing of commodities in international trade,' "[60] and "[i]mport restriction on any agricultural or fisheries product . . . necessary to the enforcement of governmental measures . . . ."[61] These GATT exceptions, which become FTA Agreement exceptions through article 4, are unlikely to affect a determination of whether the restrictions permitted by the FTA Agreement eliminate barriers on "substantially all the trade" between the two parties.[62] Currently, there is no reason to anticipate food shortages, and commodities are not a large part of the trade between the United States and Israel. Thus, these two exceptions are unlikely to be used. Additionally, the two parties have modified, through the FTA Agreement, the GATT exception for agricultural products so that only restrictions already existing are permitted.[63] This renders the GATT's agricultural exception irrelevant. Thus, these restrictions permitted by the FTA Agreement are unlikely to render it invalid under the GATT.

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[58] The GATT contains a general prohibition on the imposition of quotas on the importation of goods between contracting parties:

> GENERAL ELIMINATION OF QUANTITATIVE RESTRICTIONS
>
> No prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licenses or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party . . . .

GATT, *supra* note 1, at art. XI, para. 1, 55 U.N.T.S. at 224-26.

[59] *Id.* at para. 2(a), 55 U.N.T.S. at 226.

[60] *Id.* at para. 2(b), 55 U.N.T.S. at 226.

[61] *Id.* at para. 2(c), 55 U.N.T.S. at 226.

[62] There is nothing in the text or negotiative history of the GATT to suggest that the article XXIV determination of "substantially all the trade" is affected by article XI's permission of some quotas.

[63] Article 6 of the FTA Agreement, entitled "IMPORT RESTRICTIONS ON AGRICULTURE", says "[i]mport restrictions, other than customs duties, including but not limited to, quantitative restrictions and fees, based on agricultural policy considerations may be *maintained* by the Parties." FTA Agreement, *supra* note 10, at art. 6, 24 I.L.M. at 659 (emphasis added). The word "maintained" seems to modify the GATT exception, thereby applying only to restrictions already in existence at the time the Agreement entered into force.

B. *Significant Barriers to Trade: The Bedsheet Controversy*

Despite the FTA Agreement's very limited list of exceptions to its prohibition of quotas, the United States announced its intention to impose a new quota on imports of a certain type of Israeli-made bedsheet shortly after the Agreement took effect.[64] The quota was to be imposed if the two countries failed to reach an agreement on the quantity of Israeli exports of bedsheets to the United States.[65] Israel considered the quota to be in violation of the FTA Agreement. The United States claimed that the quota was valid because it was imposed pursuant to the Multifiber Arrangement (MFA),[66] an international agreement regulating trade in textiles.[67] However, Israel considered the provisions of the FTA Agreement to prevail over those of the MFA or any trade agreement to which the United States and Israel are signatories. This dispute reflects the inevitable conflict between the MFA and *any* FTA Agreement because, whereas the MFA restricts trade, FTAs are required by the GATT to liberalize trade.[68]

The bedsheet conflict was "resolved" when the two countries agreed to a Voluntary Restraint Agreement (VRA),[69] im-

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64 50 Fed. Reg. 43, 761 (1985); Jerusalem Post, Nov. 16, 1985 (Int'l ed.) at 21.

65 50 Fed. Reg. 43, 761 (1985).

66 *See id.* The Arrangement Regarding International Trade in Textiles, commonly known as the Multifiber Arrangement (MFA), was negotiated under the auspices of the GATT. *See* P. FELLER, *supra* note 40, at 1405. The MFA provides a general framework for the negotiation of bilateral textile agreements *or* for unilateral action by the government of the importing nation to restrict imports if a bilateral agreement is not reached. *Id.*

67 *See* 50 Fed. Reg. 14, 002 (1985). Under the MFA, a quota may be imposed when imports exceed only one percent of the American market. *See also* Int'l Trade Rep. (BNA) [Jan. - June], Apr. 2, 1986, No. 14 at 435 (summarizing the American argument that there is a direct link between the MFA and the GATT).

It is possible that the United States took the view that the quota was valid merely to appease a domestic industry. Shortly before the FTA Agreement was signed, the American textile/apparel lobby labeled the proposed Agreement one of the most "detrimental developments" for the textile industry and predicted that "terrible damage" would be inflicted upon the American textile industry by the Agreement's tariff cuts. Int'l Trade Rep. (BNA), Mar. 13, 1985, No. 11 at 392. Taking particular note of the Agreement's immediate grant of duty-free status to *cotton bedsheets*, one lobbyist called on Congress to insert a ten-year staging-in of the duty-reduction on textile and apparel goods under the FTA Agreement. *Id.* Another lobbyist called for a stiffening of the FTA Agreement's Rules of Origin with respect to textiles. *Id. See infra* note 83.

68 Perhaps there would be no inevitable conflict in the case of an FTA between nations that have agreements permitted by the GATT. Since the MFA negotiations took place under GATT auspices, it could be argued that the article 4 permission applies to MFA quotas also.

69 A VRA is a device used by governments to deal with excessive imports and is spe-

posed pursuant to the MFA. Under the VRA, the government of Israel agreed to limit Israeli exports of bedsheets to the United States. However, the issue of whether the MFA or the FTA Agreement governs bedsheets or any textile product was never resolved. If the VRA conflicts with the FTA Agreement, then there is a direct conflict between the requirements of the GATT and the actual implementation of the FTA. Thus, the legal issues raised by the bedsheet controversy remain, and affect whether the FTA Agreement, as applied, complies with the GATT.

Initially, it should be noted that various articles of the FTA Agreement suggest that the VRA violated the Agreement on its face. Article 3 of the FTA Agreement, entitled Relationship to other Agreements, provides:[70]

> The Parties affirm their respective rights and obligations with respect to each other under existing bilateral and multilateral agreements, including the Treaty of Friendship, Commerce and Navigation between the United States and Israel and the GATT. In the event of an inconsistency between provisions of this Agreement and such existing agreements, *the provisions of this Agreement shall prevail.*[71] (Emphasis added).

Article 3 renders the provisions of the FTA Agreement supreme[72] to existing agreements. Therefore, it is irrelevant that

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cifically authorized by the MFN. *See* P. FELLER, *supra* note 40, at § 14.05. A VRA differs from a quota in the means of enforcement: a quota is enforced by the importing country, while a VRA is enforced by the exporting country. Therefore, it is arguable that in form, a VRA does not violate the GATT's prohibition on quotas. *But see* N.Y. Times, Apr. 27, 1986 at F3, col. 1 (arguing that VRAs "are just quotas by another name").

[70] The article 4 prohibition on quotas is unqualified: "new quantitative restrictions . . . may be introduced . . . only if permitted by this Agreement or by the GATT. . . ." FTA Agreement, *supra* note 10, at art. 4, 24 I.L.M. at 658. Thus, it might at first seem unnecessary to examine article 3 which deals with conflicts between the FTA Agreement and other existing agreements. The reason to look at article 3 is that the article 4 permission of some quotas includes those permitted by GATT. Since the MFA negotiations took place under GATT auspices, it could be argued that the article 4 permission applies to MFA quotas also.

[71] FTA Agreement, *supra* note 10, at art. 3, 24 I.L.M. at 658.

[72] Because article 3 serves as a "supremacy clause," the United States could argue that the absence of any mention of the MFA in article 3 shows that the FTA Agreement was *not* intended to prevail over the MFA in the event of a conflict between the two. Yet such a construction of article 3 presumes that the FTA Agreement's drafters meant to exclude *all* other agreements between the two parties other than the GATT and the Treaty of Friendship, Commerce and Navigation.

This is unlikely for several reasons. First, article 3 says, "In the event of any inconsistency between provisions of this Agreement and *such existing agreements*, the provisions of this Agreement shall prevail." *Id.* (Emphasis added). Had the drafters intended only to include the GATT and the Treaty of Friendship, Commerce and Navigation, they could

the MFA is not specifically mentioned in article 3.[73] The MFA, pursuant to which the VRA was imposed, is superceded by the FTA Agreement because the MFA's quota conflicts with article 4 of the FTA Agreement which prohibits new quantitative restrictions.[74] Thus, the VRA, because it amounts to a quantitative restriction, violated the FTA Agreement.[75]

Because the text of any FTA Agreement reflects the parties' original estimation as to what kind of an arrangement would comply with the GATT, any violation of such an agreement casts

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have used the words "these two agreements," instead of "such existing agreements." Second, because the MFA was negotiated under GATT auspices, it would be absurd to conclude that article 3 was intended to render the FTA Agreement supreme to the GATT but not to agreements negotiated *under* the GATT. It is more likely that the words "and such existing agreements" show that article 3 was meant to include all *existing agreements* but not agreements to be created in the future.

[73] Israel could argue that, had the drafters of the FTA Agreement intended MFA quotas to be able to be imposed on the trade between the two parties once the FTA Agreement went into force, some mention of the MFA surely would have been made in article 4, which discusses the exception to the general prohibition on new quotas. *See supra* note 57 and accompanying text. The absence of the MFA from article 4 thus indicates that the FTA Agreement is meant to prevail in the event of a conflict.

[74] The United States could argue that the language of article 3 is very restricted: "... *including*, the Treaty of Friendship, Commerce and Navigation between the United States and Israel and the GATT." FTA Agreement, *supra* note 10, at art. 3, 24 I.L.M. at 658 (emphasis added). The phrase "including but not limited to" appears several times throughout the FTA Agreement. *E.g.*, FTA, at art. 6, 24 I.L.M. at 659. *See also* FTA annex 3, para. 7, 24 I.L.M. at 671. The phrase "including" appears only once. FTA Agreement, *supra* note 10, at art. 3, 24 I.L.M. at 658. Therefore, the United States could argue that by using only the word "including," rather than the phrase "including, but not limited to," the drafters intended *only* the GATT and the Treaty of Friendship, Commerce and Navigation to be superseded by the FTA Agreement.

However, this construction ignores the first sentence of article 3 which is an affirmation of rights under existing agreements. Since Israel and the United States have signed many such agreements, not only trade agreements, it would have been too cumbersome to list them all. Peace agreements to which both countries are signatories would be of questionable relevance to a trade agreement, and any omission of an agreement whose status is unclear, such as an executive agreement, might raise questions about its legality. These broad issues were not the concern of the drafters of the FTA Agreement, and any construction of article 3 that would raise them is mistaken.

[75] The United States has argued that there is a "direct link" between the MFA and the GATT, the latter of which is mentioned in article 4 of the FTA Agreement. *See* Int'l Trade Rep. (BNA), Apr. 2, 1986, No. 14 at 435. This view apparently rests on the fact that the MFA was negotiated under GATT auspices. However, this is of little consequence because the MFA was a temporary agreement, which expired in July, 1986. *See* Protocol Extending the Arrangement of Dec. 20, 1973, as extended, Geneva, Dec. 22, 1981, at 3. Although the MFA was renewed in August, 1986, *see* N.Y. Times, Aug. 2, 1986, at 33, col. 4, the United States' "direct link" argument means that the two parties agreed to have a potentially eternal agreement — the FTA Agreement — inferior to one that was due to expire less than sixteen months after the FTA Agreement was signed — the MFA.

serious doubt on whether the requirements of the GATT are being complied with. Thus, in order to determine how the bedsheet VRA affects the FTA Agreement's compliance with the GATT, it is necessary to examine both the quantitative and qualitative effects which textile quotas have on the total trade between the United States and Israel.[76]

Prior to the implementation of the FTA Agreement, ninety percent of imports from Israel already entered the United States duty-free, either on an MFN basis (i.e., through the same duty-free treatment which all other GATT members receive for any given classes of goods) or under the Generalized System of Preferences (GSP).[77] The textile/apparel manufacturing sector accounted for more than half of all the Israeli imports that did *not* enter the United States duty-free under the GSP.[78] Thus, the FTA Agreement's real value for Israel is, at least in the short run, in liberalizing the remaining ten percent of American imports, more than half of which are goods from the textile/apparel sector.[79]

Therefore, from both the quantitative consideration of liberalizing at least eighty percent of trade and the qualitative view of

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[76] It might seem necessary to know what percentage of the overall trade between the two parties the given textile product constitutes. However, since the United States is effectively retaining the right under the Agreement to impose MFA-sanctioned quantitative restriction on virtually all textile products through quotas or VRAs, the relative percentage for evaluating the effect of new quantitative restrictions is represented by the ratio of the *entire* textile industry to total trade. This percentage is not available. The United States International Trade Commission (ITC), in investigation 332-180 (May 1984), studied the effects of providing duty-free treatment for Israeli imports and reported its findings to the President, *see* H.R. Rep. No. 64, 99th Cong., 1st Sess. 14-15, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS 61, 74-75, and it is likely that the Commission's report contains the relevant statistics. However, the ITC has not published its report from Investigation 332-180, Telephone Interview with Sidney Weiss, Esq., Counsel to the American Israeli Chamber of Commerce (Feb. 5, 1986), and it is unlikely that the information will be made public because of its potential sensitivity to domestic American industries. *Id.* Nevertheless, educated inferences about the percentage can help in the determination. *See infra* notes 77-79 and accompanying text.

[77] H.R. Rep. No. 64, 99th Cong., 1st Sess. 3, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS 61, 63.

[78] Int'l Trade Rep. (BNA), [July-Dec.] Oct. 3, 1984, No. 13 at 362 (remarks of Senator Campbell during the congressional debate on the proposed FTA Agreement). For an explanation of the GSP, *see supra* note 40.

[79] In its report to the president, the ITC used the 1983 statistics. In that year, the United States had a *surplus* in textile trade with Israel. In other words, the United States exported more textile products to Israel than Israel exported to the United States. *Id.* This surplus makes the possibility of free textile trade even more important to Israel, who wishes to close the trade gap.

omitting no important industry,[80] the imposition of quotas on textile products is a significant limitation on the liberalization of trade between the two parties. Further, industries that rely heavily on the free-trade promises of the FTA Agreement may be discouraged from expansion because of highly unreliable markets, in particular, those subject to quotas.[81] Thus, it is difficult to reconcile any VRA or quota, imposed pursuant to the MFA, with the GATT's requirement of liberalizing "substantially all the trade" between the two parties. If the bedsheet controversy indicates that the United States will continue to impose quotas or insist on VRAs, then the FTA Agreement's validity is in serious doubt. Since the United States is the only party claiming that the FTA Agreement permits the imposition of MFA quotas on textiles, a unilateral declaration by the United States that the FTA Agreement is superior to the MFA and, therefore, that textile quotas are not permitted by the FTA Agreement, would resolve the problem.

III. RULES OF ORIGIN AS A BARRIER TO TRADE

Another barrier to trade is found in Annex 3 of the FTA Agreement, the Agreement's Rules of Origin. Unlike quantitative restrictions, Rules of Origin[82] serve a constructive, free-trade purpose: for example, in the case of an FTA, they preclude products from third-party countries from being accorded any of the advantages of the FTA if the products are merely "passed through" one of the member states. However, rules of origin can act as non-tariff barriers to trade by preventing the extension of FTA benefits to certain imports.

The FTA Agreement's Rules of Origin[83] provide that the

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[80] It is often difficult to distinguish between an industry's quantitative and qualitative value. *See supra* note 29. However, in the case of the bedsheet quota, it appears that the increase in American imports of the Israeli goods was not attributable merely to cheaper Israeli labor costs but rather to the higher quality of the goods in comparision with their American competitors. *See* Jerusalem Post, Nov. 16, 1985 (Int'l ed.) at 21, col. 3, 4.

[81] *Id.* With respect to the obstacles posed by the MFA quotas on textile products, a representative of International Business Consulting has said that the " 'game becomes to get around the quota system' . . . which 'is built to catch any successful item . . . .' " Int'l Trade Rep. (BNA), [July-Dec.] Nov. 26, 1986, No. 47 at 1431. He suggested that Israeli exporters "had better be able to diversify every time a product gets caught in a quota ceiling." *Id.* It is hard, if not impossible, to reconcile the need for an exporting country to diversify with the concept of a free-trade area.

[82] *See supra* note 14.

[83] During the negotiation of the FTA Agreement, certain Congressmen asked the Administration to exclude from the Agreement the entire textile industry, *see* Int'l Trade

Agreement shall apply to any article if:

> (a) that article is wholly the growth, product, or manufacture of a party *or* is a new or different article of commerce that has been grown, produced, or manufactured in a Party;
> (b) that article is imported directly from one Party into the other Party; and
> (c) the sum of (i) the cost or value of the materials produced in the exporting Party, plus (ii) the direct costs of processing operations performed in the exporting party is not less than 35 percent of the appraised value of the article at the time it is entered into with the other Party.[84] (Emphasis added).

Thus, any article not "wholly the growth, product, or manufacture of a party" may still obtain the benefits of the Agreement if it "is a new or different article of commerce that has been grown, produced, or manufactured in a Party"[85] and if it is imported directly and has the required domestic content or value.[86] Such an article or material is considered to be "*substantially transformed* into a new and different article of commerce, having a new name, character, or use, distinct from the article or material from which it was so transformed."[87] (Emphasis added). Thus, under the FTA Agreement, "substantial" requires an article to be "grown,

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Rep. (BNA), [July-Dec.] Sept. 26, 1984, No. 12 at 336 (remarks of Senator Mitchell), an industry in which assembly procedures are used extensively. The Administration responded by assuring these legislators that the FTA Agreement with Israel would have Rules of Origin *similar to those of the Caribbean Basin Initiative, Id.*, thereby effectively ruling out textile products whose only claim to the Agreement would be that they were *assembled* in Israel. *See infra* note 92.

In 1983, Congress passed the Caribbean Basin Economic Recovery Act, 19 U.S.C. §§ 2701-2706, (Supp. III 1985) more commonly known as the Caribbean Basin Initiative, or CBI. The CBI is a preferential program providing for duty-free entry into the United States for certain articles originating in developing nations of the Caribbean Basin. The CBI is similar to the GSP in that its purpose is to promote the economic development of beneficiary countries. *See supra* note 40. The CBI is a temporary program that will continue through 1995. The GSP and the CBI are *not* Free-Trade Areas. In fact, a GATT waiver had to be obtained before the United States could procede legally with the CBI. *See* Recent Developments, *supra* note 5, at 209.

Since the United States-Israel FTA Agreement was the first of its kind ever entered into by the United States, the American drafters of the Agreement's Rules of Origin looked for guidance to both the GSP and the CBI. *See* H.R. Rep. No. 64, 99th Cong., 1st Sess. 9, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS 61, 69. The Automotive Parts Agreement with Canada, although an international agreement granting certain trade preferences, is irrelevant for purposes of Rules of Origin because it is limited to one sector of trade. *See supra* note 10.

[84] FTA Agreement, *supra* note 10, at annex 3, para. 1, 24 I.L.M. at 669-70.

[85] *Id.* at para. 1(a), 24 I.L.M. at 669.

[86] *Id.*

[87] *Id.* at annex 3, para. 4.

produced, or manufactured in a party." Being "assembled" in a party-country, however, cannot qualify an article under the Agreement.[88]

As long as *no* assembly procedure is viewed as rendering a product substantially transformed, regardless of the cost or amount of time involved in the assembly,[89] the Rules of Origin eliminate an otherwise eligible class of goods from the benefits of the FTA Agreement, thereby constituting another restriction to the expansion of trade. This, in turn, prevents the FTA Agreement from satisfying the GATT's requirement of liberalizing "substantially all the trade" between the constituent members of the FTA Agreement.

Although it might be undesireable to include all assembly procedures as being capable of affecting a substantial transformation of an article,[90] the FTA Agreement has perhaps gone too far by disqualifying *all* assembly procedures.[91] A middle ground could be formulated where procedures would render an article

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[88] The question of whether an article of commerce has been "substantially transformed" so as to change its "country of origin" was answered differently by the Origin of the GSP and of the CBI. Specifically, the GSP allows *assembly* procedures to render a product substantially transformed, while the CBI does not. The GSP covers "[m]erchandise which is . . . the growth, product, manufacture, or *assembly* of [a GSP country or countries]." 19 C.F.R. § 10.176(a) (1986) (emphasis added). Unlike the text of the FTA Agreement, however, the GSP statute has no list of processes that substantially transform a product. 19 U.S.C. § 2463(a), (b) (1982 Supp. III 1986). However, a list of such processes may be found in the regulations which were written by the Customs Service of the United States, 19 C.F.R. § 10.176. The statute enacting the CBI permitted the Customs Service to prescribe regulations necessary to carry out the Rules of Origin of the CBI, expressly including regulations that limit duty-free treatment to those articles "wholly the growth, product, or manufacture of a beneficiary country . . . ." 19 U.S.C. § 2703(a)(2) (Supp. III 1986). This statute is silent about assembly procedures in the part dealing with "country or origin," *see id.*, as are Customs' CBI regulations. *See* 19 C.F.R. § 10.195(a)(1).

[89] *See supra* notes 88-91 and accompanying text.

[90] The following example illustrates the potential problem: if country *A* imports precut and pre-sized pieces of cloth from country *X* that are subsequently assembled into shirts in country *A*, and the shirts are then shipped as "new products" to country *B*, should the shirts then be eligible for benefits under an FTA Agreement between countries *A* and *B*, if little work is done in country *A* in making the final product? It is generally agreed that under such circumstances, the shirts should not be eligible. If the shirts were eligible, virtually all products from anywhere in the world could escape custom duties of other import restrictions by being "passed through" an FTA party.

[91] This is particularly evident when the FTA Agreement's Rules of Origin are compared with those of the GSP. The GSP does include assembly procedures. *See supra* note 92. Since a free-trade area is supposed to be even more liberal than the GSP, this difference suggests a serious problem with the FTA Agreement's Rules of Origin. *See also* Ashoff, *supra* note 15, at 1 n.2 (stating that FTAs generally have less restrictive Rules of Origin than does the GSP).

substantially transformed as long as they make a substantial quantitative or qualitative change in the product.

Such a middle ground was found in *Daisy-Heddon, Div. Victor Comptometer Corp. v. United States*,[92] a case arising from a classification dispute between an importer of Japanese goods, and the United States government. The importer sued the United States government for classifying the goods as completed fishing reels under the Tariff Schedule of the United States.[93] Each of the imported articles lacked certain parts necessary to make it functionally complete,[94] yet the government considered the "mere *assembly*" of the articles with various other parts insufficient to render the articles substantially transformed.[95] In determining whether a substantial transformation had taken place, the *Daisy-Heddon* court looked, *inter alia*, at costs, time and effort, and the usage of the article.[96] These factors clearly do not exclude assembly procedures from being capable of substantially transforming a component part, such as a textile product, into a completed article, with a different name, character, or use from the component part.

A set of similar criteria should be developed for the FTA Agreement to ensure that the Rules of Origin do not become a barrier preventing twenty percent or more of trade from qualifying for FTA benefits. If assembly procedures were permitted to effect a substantial transformation, they could have an impact on textiles and other industries, i.e., footwear items, electronic goods and non-textile luggage, which could all be substantially transformed through assembly procedures.

There are no statistics on how many imports have come or would come from Israel with assembly as the only Israeli work on the products. Nevertheless, it appears that the potential for such imports, at least in the textile industry is significant: the Ameri-

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92 600 F.2d 799 (C.C.P.A. 1979).

93 *Id.* at 800. The duty rate on complete fishing reels was higher than on component parts of fishing reels. *Id.* at 801. T.S.V.S. item 731.20, item 731.26.

94 *Id.* at 800.

95 *Id.* at 801.

96 *Id.* at 803. The court said that there are several factors which may be considered in determining whether an article is substantially complete:

> [W]here the article is incomplete due to the *ommission of one or more parts*, as opposed to where an article is incomplete because the material which comprises the article is in need of *further processing*, the following factors can be relevant: (1) comparison of the number of omitted parts with the number of included parts; (2) complete as well as completed states. When these factors are compared with the absolute prohibition of including assembly procedures

can textile industry demonstrated its concern over the possibility of such imports by raising this issue during Congressional hearings on the then-proposed FTA Agreement.[97] In particular, the industry was concerned about European textile materials being shipped to Israel, where assembly procedures might render the finished goods as products of Israel, and thereby entitled to duty-free entry into the United States.[98] Since Israeli wages are at most *one half* those of European wages,[99] the American textile industry's fear stems from the economic reality that it would be very profitable for Europeans to ship piece-goods to Israel for assembly and then export to the United States. Under the restrictive Rules of Origin of the FTA Agreement, however, such goods would be denied FTA benefits even though they would probably have the required thirty-five per cent domestic content and would be shipped directly to the United States.

Unlike the quantitative restriction problem,[100] the obstacle posed by the Rules of Origin is not a question of interpretation of the FTA Agreement, but involves an actual conflict between the text of the Agreement and the requirements of the GATT. Thus, this problem can be corrected only through an amendment whereby the FTA Agreement's Rules of Origin explicitly incorporate more flexible standards like those set forth in *Daisy-Heddon*. In fact, given the Agreement's broad exclusion of *all* articles that are only assembled in a party-country, in order for the Agreement to comply with the GATT's criterion of eliminating barriers on "substantially all the trade," an amendment is necessary.

CONCLUSION

This Note has examined how two non-tariff barriers to trade, quantitative restrictions and Rules of Origin, affect the determination of whether the United States-Israel FTA is valid under the GATT. Both areas indicate that at least one sector of trade textiles is still subject to severe restriction by those barriers.

Although the two problems with the FTA are quite different, both can be solved in ways that would render the FTA valid

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among those that substantially transform the Daisy-Heddon criteria appear much more flexible and more useful. *Id.* (Emphasis added).

97 Int'l Trade Rep. (BNA), Mar. 13, 1985, No. 11 at 392.

98 *Id.* at 392-93.

99 *See* Langer, *supra* note 46, at 99.

100 *See supra* notes 64-81 and accompanying text.

under the GATT. The quota problem could be resolved by a declaration by the United States, the only party claiming that the FTA Agreement permits textile quotas to be imposed, that the Agreement is superior to the MFA, and hence, that textile quotas imposed pursuant to the MFA are invalid. The Rules of Origin could be amended so that at least some products which are only assembled in a party-country could receive the benefits of the FTA.[101]

[101] The FTA Agreement contemplates the parties amending the rules. *See* FTA Agreement, *supra* note 10, annex 3, para. 11.