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Developments in Regional Trade Law

A View from Israel

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Abstract

This article analyzes the developments in Israel's regional trade agreements and their effects on the liberalization of its international trade. The article first addresses Israel's dependence upon its international trade and the case for liberalizing it (Section A); the RTAs concluded by Israel (Section B); the contribution of the first Free Trade Area Agreements (FTAs), concluded by Israel with the European Economic Community, on the one hand, and the United States, on the other, to the overall liberalization of its international trade (Section C); a discussion follows of the special problems encountered with the rules of origin, an essential characteristic of any FTA, and of the proof of origin under Israel's FTAs (Section D). The special features and problematic aspects of the customs union, concluded between Israel and the Palestine Liberation Organization (PLO), are analyzed (Section E). Finally, the article provides an outlook into the future of Israel's RTAs (Section F).

Keywords: foreign trade, free trade area agreements, regional trade agreements.

A. The Case for Liberalizing Israel's Foreign Trade

Three factors make the Israeli case for liberalized trade especially strong: (a) Israel has limited natural resources and is therefore dependent upon imports. Those should be funded from exports. Otherwise, capital has to be imported, through grants or loans, to make up for the foreign currency expenditure; (b) The small size of the domestic market dictates that, in the absence of competing imports, there would hardly be competition in many sectors. As long as domestic producers are protected from imports, they may sell their output on the local market only under conditions that they dictate. The profits are guaranteed even if they do not meet more stringent criteria and higher standards of similar goods in foreign countries; and (c) Mass production is often essential for an industry to be competitive. Israel is too small to provide a market for large-scale production. To reap the benefits of size, the industry must engage in export.

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B. Israel's Regional Trade Agreements

The importance of liberalized trade has been recognized early on. Israel became a party to GATT in 1962 and is now a member of the WTO/GATT 1994. Israel entered free trade area agreements (FTAs) with the EEC (1975) (after several amendments and updates, currently the Euro-Med Association Agreement (2000)), the United States (1985), and, at the time, was the only country that had a free trade area with both major trading partners.

The agreements with the United States and the EEC were followed by FTAs with the EFTA (European Free Trade Association) countries (1992), Canada (1997), Turkey (1997), Mexico (2000) and MERCOSUR (2007). The agreement with Argentine was the last to come into effect in Sept. 2011.

In 1996 a further agreement was concluded with the United States, the Agreement concerning Certain Aspects of Trade in Agricultural Products (ATAP). This agreement provided duty free, or other preferential treatment, for imports of certain agricultural products. Even though this agreement has not been formally extended, some existing trade barriers to agricultural products have been removed by each party.

Following the peace treaty with Jordan, a preferential agreement was concluded with Jordan in 1995 (upgraded in 2005), in addition to a QIZ [Qualified Industrial Zone] Agreement, concluded by the United States, Jordan and Israel. This agreement was followed by a QIZ Agreement concluded between the United States, Egypt and Israel in 2004. This agreement was extended in 2004, with effect until the end of 2010.

According to the Ministry of Industry, Trade & Labor, new FTAs with India and with Columbia are negotiated currently.

Israel is also a contracting party to one customs union, concluded between Israel and the Palestine Liberation Organization (PLO) in 1995, with respect to the territories of Israel and the territories administered by the Palestinian Authority.[1]

C. The FTAs' Contribution to the Liberalization of Israel's International Trade

The first two regional trade agreements (RTAs) concluded by Israel, namely, the Free Trade Area Agreement (FTA) with the EEC (1975) and the FTA with the United States (1985), served not only to liberalize trade between the contracting parties but also as a catalyst, forcing Israel to move from regional arrangements to a general program of trade liberalization.[2] The ability to import into Israel goods originating in her FTA-partners free of customs duties and quantitative restrictions, created a trade diversion in favour of importing goods from these coun-

1 Israel – Palestine Liberation Organization Interim Agreement on the West Bank and the Gaza Strip, 1995, Annex V – Protocol on Economic Relations.

2 Cf. T. Einhorn, *The Role of the Free Trade Agreement between Israel and the EEC – The Legal Framework for Trading with Israel between Theory and Practice*, Nomos, Baden-Baden, 1994, p. 61.

tries. Had the same goods been imported from countries in, for example, South East Asia, Israel would have spent far less foreign currency. However, customs duties and other non-tariff barriers (NTBs) made such imports unreasonably expensive and prevented such exchange from taking place. The Federation of Israeli Chambers of Commerce made a survey of the damage caused to Israeli economy as a result of this trade diversion.[3]

Another obstacle to free trade resulted from the very significant differences between the rules of origin annexed to each of the first two free trade agreements, with the EC and the United States. Consequently, Israeli manufacturers could not import inputs to their industry originating in the EC, process them in Israel, and then benefit from their free movement to the United States under the United States–Israel FTA, and vice versa. The FTAs did not enable Israel to become a bridgehead for the free movement of products between Europe and the United States, after processing them in Israel, as some Israeli manufacturers had originally hoped.[4]

In 1991, the Israeli government decided to expose Israel to more imports and replace NTBs that applied at that time with higher tariff rates with respect to imports from countries with which Israel had no FTAs and, where necessary, to impose duties under the newly enacted Trade Duties Law, 5751-1991 (covering safeguard, antidumping and countervailing duties). The higher tariffs were to be removed gradually over a period of five to seven years, depending upon the sensitivity of the domestic industry to such imports.[5] This unilateral liberalization would not have taken place if not for the substantial trade diversion created by the FTAs with the EC and with the United States, and its cost to the Israeli economy, which materialized only following the conclusion of these FTAs.

In 1996, the unilateral liberalization program was extended to additional sectors to accommodate Israel's WTO obligations. In 1997, after years of continuous increase in its annual trade deficit, Israel enjoyed a reduction of 24%. The reduction was due to a larger share of exports of the more efficient high-tech industries, at the expense of the traditional labour-intensive ones, such as textile, clothing and food. The liberalization policy was only partially responsible for this development, yet its long-term importance cannot be underestimated.

D. The Role of the Rules of Origin in Israel's FTAs

Because only the goods originating in one of the trading partners are allowed free movement into the territory of the other FTA partners, the annex which determines the rules of origin is of major importance. A couple of Israeli cases dealt with the rules of origin and with the proof of origin under the FTAs.

3 *Israel's International Trade Policy – Damage, Problems and Suggested Solutions*, Federation of Israeli Chambers of Commerce, Tel-Aviv, 1989 (in Hebrew).

4 A. Yoran, 'The possibility of the Triangle: Israel – the EC – the US', *The Accountant* 11-12 (272-273) (Aug.-Sept. 1976), p. 493 (in Hebrew).

5 E. Sharon, 'The Exposure of the Israeli Economy to Imports from Third Countries – Program and Performance Procedures', *The Israeli Tax Review* Vol. 20, No. 7, 1991/2, p. 66 (in Hebrew).

I. Cumulation of Origin

It is easier for goods to qualify as originating in a territory that is a large one, such as the United States or the European Union than for those which originate in a small territory like Israel. It is more likely that a source of raw materials and other inputs which are necessary to manufacture the goods will be found within the larger territory. Consequently, FTAs which allow cumulation of origin contribute to the enhancement of trade among the partners.

As of 1 January 2006, Israel joined the system of pan-Euro-Mediterranean cumulation of origin. This means that Israeli companies may enjoy cumulation of origin with materials and goods originating in other states that are have joined that system and with which Israel has a FTA, namely all Member States of the European Union, the EFTA States, Turkey and Jordan. Joining the system required all Member States to unify the pertinent rules of origin in their respective trade agreements. In a case that came before the Israeli Courts before the rules came into effect, an Israeli swimwear manufacturer, Gottex, purchased cloth in Italy, and had the swimwear sewn from the cloth in Turkey, Romania and Bulgaria. Whereas previously such goods could benefit neither from the EU-Israel FTA nor from the Turkey-Israel FTA,[6] now such diagonal cumulation is allowed, enabling a much larger range of clothes to benefit from free entry into the territory of all partners.

II. Proving the Origin of Goods

To benefit from the FTAs, the origin of the goods must be proved, exactly according to the provisions of the respective FTAs. The FTAs stipulate different proving methods, according to the requirements of the exporting state. It is important to present the correct certificate, be it EUR1 or Eur-Med. The Israeli customs authorities do not permit importers to produce the correct certificates at a later stage.

This statement notwithstanding, the subsequent production of the correct certificate was admitted in one Supreme Court precedent.[7] The case concerned cellular telephones that were imported from the United States under the United States–Israel FTA. The original cell phone kit contained a spare battery, produced in Finland, which did not affect the origin of the kit. However, the customs office discovered that in Israel the spare batteries were removed from the kit and sold separately. The customs opened proceedings against the importer, alleging that the batteries could not benefit from the United States-Israel FTA. The importer argued that, since the batteries were produced in Finland, they would have been eligible to benefit just the same from the EC-Israel FTA. The District Court considered that it was too late to produce the EUR1 certificate of origin, that should

6 Cf. *Customs and VAT Department v. Gottex Models Ltd.*, Criminal Case (Magistrate Court, Rishon Le-Zion) 2319/09, Nevo electronic database (12 July 2011).

7 Cf. *Eurocom cellular communications v. State of Israel, Department of Customs and VAT*, Civil Appeal 655/99, 55(5) PD 577 (19 July 2001). In this case, the declaration regarding the origin of the batteries was accepted seven years after the importation had taken place. At the same time, this is the only precedent of its kind. Cf., further, A. Dorot, *Customs and International Trade Laws*, International Chambers of Commerce, Ramat-Gan, 2006 (in Hebrew), pp. 636 *et seq.*

have been presented to the customs authorities upon importation of the goods. Whereas the Supreme Court, on the whole, upheld the District Court's conclusions, it none the less accepted the importer's declaration regarding the origin of the batteries in Finland, on the basis of the evidence presented in this case, making the batteries eligible under the EC-Israel FTA.

The discrepancies among the national procedures for proving origin may yield harsh results. Thus, in one case, the English supplier sought a pre-ruling from the Customs National Helpline for Classification regarding the qualification of the goods, to be exported to Israel, for a EUR1 certificate. The Israeli importer relied upon the declarations of the English exporter that the qualification of the goods for a EUR1 had been approved by a UK customs official, as well as upon the EUR1 certificate issued with the stamp of the English customs authorities. However, later on, the Israeli customs authorities requested the English authorities to carry out an on-site inspection regarding the origin of the goods. Having done that, the English authorities concluded that, indeed, the goods should not have qualified as originating in the EC, since the non-originating raw materials used in the final product exceeded the threshold allowed under the FTA for qualifying as goods originating in the EU. None the less, the English supplier was not fined or penalized, since the English customs authorities concluded that it sought and received a pre-ruling upon which it later acted. By contrast, the Israeli customs required the Israeli importer to pay the customs that would have been paid in the absence of a EUR1 certificate, even though it is possible to exempt an importer who did not make such payment in good faith, under certain conditions, according to the Indirect Tax (Tax Paid in Excess or Deficiently) Law, 5728-1968, if such payment was not made. The company's appeal to the Supreme Court was dismissed.[8] The Court held that the importer should have insisted upon receiving a written pre-ruling from the UK customs authority.

The FTAs may provide rules regarding the proof of the origin of goods, which are incompatible with the mode of proof required by the Israeli Evidence Ordinance (New Version), 5731-1971. In a case that concerned the proof of origin with respect to goods originating in the United States, the District Court held that, "When the State of Israel signed the FTA it agreed also to its provisions regarding the modes of proof included in the third annex to the Agreement [regarding certificates of origin]. Insofar as these rules deviate from the ordinary rules of evidence, the State is deemed to have agreed to this deviation, or, in the least, it is precluded from arguing against the admissibility of documents approved by that agreement"[9].

It is noteworthy that in two other cases, the District Courts of Jerusalem and Tel-Aviv respectively abolished safeguard duties imposed on the importation of

8 *Tempo Beer Industries Ltd. v. The Ministry of Finance*, Civil Appeal 4814/09, Nevo electronic database (22 December 2010).

9 Per Judge Dr. Dan Bein, *David Shtessel v. The Customs Director*, Originating Summons (District Court, Haifa) 727/93, tak-District 96(1), 423, Takdin electronic database (20 February 1996).

goods, after interpreting the Israeli Trade Duties Law in line with the provisions of the EC-Israel Free Trade Agreement.[10]

These decisions are compatible with the judicial doctrines prevailing in Israeli law, that reconcile domestic law with international law: (a) the rule of interpretation, according to which domestic law must be interpreted in compliance with international norms, provided that there is no Israeli legislation that contradicts expressly the international obligation. The silence of the legislature is not construed as an implied intention to disregard international law; (b) the rule of presumption, that is a corollary of the rule of interpretation, according to which the administrative and governmental authorities are presumed to be obliged to apply their discretion under the enabling legislation in a manner that conforms to international obligations, unless compelling public interests and considerations mandate disregard of those. Administrative regulations and orders, made in disregard of international obligations, may be set aside under this rule.[11]

E. The Customs Union Between Israel and the Palestinian Authority

I. *The Special Features of the Israeli-Palestinian Customs Union*

The agreements concluded between Israel and the Palestine Liberation Organization (PLO) in 1994 reflected "their determination to put an end to decades of confrontation and to live in peaceful co-existence, mutual dignity and security".[12] The Economic Protocol was a step in the right direction on the road to peace.[13] The establishment, by definition, of a customs union, was the best option available to the negotiating parties.[14] This conclusion is supported by the economic developments in Judea, Samaria & the Gaza Strip in previous decades.[15] A common customs tariff was established, essentially adopting the Israeli tariff. The provisions of the Protocol deal with institutional, substantive and procedural issues relating to import taxes and import policy; direct and indirect taxation; monetary and financial issues; rules regarding Palestinian workers in Israel; free

10 *Regent Ice-Cream v. The Minister of Trade and Industry*, Various Appeals (Jerusalem) 793/95, tak-District 97(1) 1785 (per Judge Yehudit Zur); *MDK* v. *The Minister of Trade and Industry*, Various Appeals 835/93 (April 1998, nyr) (per Judge Amnon Huminer).

11 Cf., T. Einhorn, 'Israel', *in* D. Shelton (Ed.), *International Law and Domestic Legal Systems*, Oxford University Press, Oxford, 2011, p. 288, at pp. 311 *et seq.*, with further references.

12 The Preamble to the Interim Agreement on the West Bank and the Gaza Strip, *kitvei amana* (Israel Treaty Series) 1071, p. 281.

13 Israel – PLO Interim Agreement on the West Bank and the Gaza Strip, 1995, Annex V – Protocol on Economic Relations. The text can be viewed on <www.knesset.gov.il/process/docs/heskemb6_eng.htm>.

14 E. Kleiman, 'The Economic Provisions of the Agreement between Israel and the PLO', 28 *Israel Law Review* 1994, p. 347; *World Bank Report – Developing the Occupied Territories: An Investment in Peace*, The World Bank, Washington, DC, September 1993, *Vol. 1: Overview*, p. 14; *Vol. 2: The Economy*, pp. 45-55.

15 T. Einhorn, 'The Need for a Rule-Oriented Israeli-Palestinian Customs Union: The Role of International Trade Law and Domestic Law', 44 *Netherlands International Law Review* 1997, p. 315, at pp. 322-336.

movement of industrial goods and agricultural produce; and regulation and coordination of tourism and insurance.

A new economic order should have been established, enabling each party, but especially the small Palestinian economy, to make the most of the comparative advantage. Unfortunately, the Protocol provisions are not conducive to economic cooperation. Two aspects were especially troublesome: the competition between the parties over import revenues and the absence of rules prohibiting unfair competition.

1. *The Import Revenues: A Palestinian-Israeli Zero-Sum Game*

The Protocol provides that the clearance of revenues from all import taxes and levies between Israel and the Palestinian Authority (PA) will be based on the place of final destination, stated in the import documentation. The problem is that in a customs union there are no customs borders. Consequently, there is no need for goods to be sold at the place of destination. This rule made Israel and the PA compete for the import revenues, regardless of where the goods were finally marketed and sold. They could be sold in Israel, but none the less the taxes were still collected by the PA, as soon as the final place of destination was within PA-controlled territories. Complaints that diversion of trade (or, more accurately, of import revenues) was in fact taking place were sounded by the Israeli Ministry of Trade, the Association of the Chambers of Commerce and the Association of Manufacturers. The Economic Department of the US Embassy in Israel reported that

> "both PA and GOI [Government of Israel] Ministry of Finance have revealed to us that statistics on customs and VAT clearances . . . confirm the counter-intuitive conclusions . . . imports [to the PA] are indeed on the rise in spite of the very real economic woes . . . imports rose across the board in all categories . . . except in building materials."[16]

This increase took place despite the repeated closures imposed for security reasons and despite the economic depression and a diminishing real GNP in PA-controlled territories.

2. *The Absence of Rules Regarding Competition and Its Impact*

The second fault, which was also responsible for the increase in imports into the PA-controlled territories, was due to the absence of competition rules. Immediately following the conclusion of the customs union, the PA set up its own agencies, or monopolies, to import goods from Israel as well as from third countries. Reportedly, more than 100 exclusive import monopolies were created, controlled by persons with close contacts to the PA Chairman, some of them serving simultaneously as PA officials.[17] The structure of the monopolies enabled the PA to share with its officials some of the import revenues collected from Israel upon

16 USDOC, 'Gaza Trade Statistics Show Drop in West-Bank – Gaza Turnover and Increased Reliance on Israeli Supplies and Markets', December 1996.

17 *See* R. Bergman, *Authority given* (Yediot Aharonot 2002) (in Hebrew), with further references.

clearance of the goods. Some of the taxes could even be passed on to the Israeli consumer, thus giving these imports a competitive edge. Independent Palestinian entrepreneurs lost a substantial share of their Palestinian market.[18] In particular, the agreement did not contribute to the establishment of industries in the PA-controlled territories.

II. *The Operation of the Customs Union at Present*

The Interim Agreement with the PLO was concluded for a period of five years, which had already lapsed. By and large, its provisions are still followed. None the less, in view of the serious diversion of import revenues to the PA, the Israeli Tax Authority issued new rules regarding imports to the PA since 2007.[19] The new, very detailed rules ensure that goods imported with final destination in PA-controlled territories will indeed be marketed and sold in those territories and not outside them. Whereas it is true that the rules were made necessary by the errors committed in drafting this customs union, these rules none the less make the PA-Israel RTA different from a customs union proper, in that it became necessary to establish customs frontiers and observe them as strictly as possible.

F. An Outlook into the Future of Israel's RTAs

Israel has concluded a substantial number of FTAs with most of its major trading partners (China being a very important exception). The FTAs are an exception to the WTO/GATT MFN principle. They have enhanced trade with the FTA partners; however, at present, as in the past (cf. Section A), they also divert trade in favour of importing more expensive goods from the FTA partners, rather than from the most cost-efficient source. The small size of the Israeli market makes the Israeli public especially vulnerable to the downsides of such diversion, since in many cases there are no more than one or two Israeli manufacturers, and consequently very little competition on the Israeli market.

To make the Israeli market more competitive, the Government decided to liberalize trade and lower customs barriers even further with respect to third countries, with which Israel does not have an FTA. In November 2011, recommendations were published with respect to the lowering of customs on industrial goods. On 30 November 2011, the Government appointed a professional committee to make recommendations regarding the lowering of customs duties on imports of foodstuffs and agricultural produce. The Committee submitted its recommendations on 29 January 2012.[20] It has since been agreed with the Association of

18 J. Dempsey, 'Poor pickings in Gaza for Palestinian Entrepreneurs: Monopolies are stifling small business', *Financial Times*, 3-4 May 1997.

19 The most recent version is State of Israel Tax Authority, *Customs Regulations (foreign trade)*, "Rules on Import to the PA (Chapter 12)" (30 June 2010). It can be viewed (in Hebrew) on <www.finance.gov.il/customs/nohalim/nohal12.doc>.

20 The recommendations regarding industrial goods can be viewed (in Hebrew) on <www.industry.org.il/?CategoryID=1174&ArticleID=7909>. The recommendations with respect to foodstuffs and agricultural produce can be viewed (in Hebrew) on <www.moital.gov.il/NR/exeres/5B82E8D9-32A6-41D4-88EA-2809E490B2FC.htm>.

Manufacturers that the lowering of the customs will be implemented gradually within five years.

To the extent that customs duties are lowered to the point that they are eliminated, or hardly count any more, the FTAs will lose much of their importance, but not all of it. They will still continue to provide a good legal framework, observed more closely by the trading partners, their diplomatic representatives, and the national manufacturers, exporters and importers. Furthermore, their rules are more easily enforceable, e.g., in the European Union,[21] than are the WTO/GATT rules that do not have direct effect in any major trading partner.[22]

21 *See* the decision of the ECJ in Case 104/81, *Hauptzollamt Mainz v. Kupferberg*, [1982] ECR 3641.

22 *See* C.-D. Ehlermann, 'On the Direct Effect of the WTO Agreements', *in* T. Einhorn (ed.), *Spontaneous Order, Organization and the Law – Roads to a European Civil Society – Liber Amicorum Ernst-Joachim Mestmäcker*, TMC Asser Press, The Hague, 2003, p. 413.