

# Costa Rica's Challenge to US Restrictions on the Import of Underwear

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## I. The problem

### *Setting the scene*

In March 1995 the United States claimed that its domestic underwear industry was being seriously damaged or threatened with actual damage by imported cotton and man-made-fibre underwear<sup>(1)</sup> from Costa Rica and six other countries.<sup>(2)</sup> The United States initiated consultations with the countries alleged to be damaging or threatening its industry with the intention of invoking the transitional safeguard provisions of the Agreement on Textiles and Clothing (ATC).<sup>(3)</sup> During the course of these consultations, three of the seven countries agreed to quantitative restrictions on the imported underwear that would be allowed into the United States. However, after failing to reach agreements with Costa Rica, Honduras, Thailand and Turkey, the United States in June 1995<sup>(4)</sup> introduced restrictions on the importation of cotton and man-made-fibre underwear backdated to take effect starting in March 1995.

With the unilateral introduction of restrictions, the case was referred to the Textile Monitoring Body (TMB) for review and recommendations regarding the matter as required by the ATC. The TMB found that the United States had not demonstrated that its industry had suffered serious damage. However, it could not reach consensus on whether the existence of an actual threat of serious damage had been demonstrated, and thus recommended further consultations among the parties.

The United States eventually reached agreements with Honduras, Thailand and Turkey after further consultations. However, the United States and Costa Rica were unable to reach a mutual understanding after consultations in August 1995 and November 1995. On 22 December 1995 Costa Rica began the dispute settlement process under Article XXIII of the General Agreement on Tariffs and Trade (GATT 1994) and the corresponding provisions of the ATC.

Why did Costa Rica decide to pursue the dispute settlement process? This key decision had significance beyond the immediate details of the specific dispute. The case was the first formal dispute settlement case to address issues arising from the intended liberalization of trade in textiles as embodied by the ATC and the first case in which a small developing country initiated a dispute against the United States.<sup>(5)</sup>

### *WTO context*

In 1995 the newly created WTO and the recently concluded Uruguay Round of negotiations that culminated in the 1994 GATT offered its members improved access to the world trading

system. All members had negotiated and agreed to these mechanisms, which, in the best judgment of the members, represented fundamental principles of free or liberalized trade that would serve the best interests of the members and the world trading system. However, in 1995 many of these mechanisms (chief among these being the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU)(6) and the ATC) remained largely untested. Given the immense discrepancies in relative political and economic influence among the members, would the system withstand the intense, but inevitable, political and economic forces that would be brought to bear on specific dispute cases?

At the time of this dispute, members could not predict how the new DSU process would function. Developing countries, in particular, were concerned about the new system's fairness.(7) In recent years, developing countries have initiated more than half of all new dispute cases.(8) However, at the time when Costa Rica initiated its case, no small developing country had brought a case against a large developed country. Many observers viewed confronting the United States as a risky strategy — not only for Costa Rica, but also for the DSU process in general. How would the United States respond to a ruling against it? Unwillingness by the United States to abide by such a ruling could undermine the credibility of the entire process.

### *Textiles in the world trading system*

The Short-Term Cotton Arrangement (STA) of 1961 for the first time formally acknowledged special treatment of the textile sector in the world trading system. This special arrangement for cotton, which began as a one-year agreement, led to a sequence of arrangements on textiles spanning more than forty years. The Long-Term Arrangement (LTA) lasting from 1962 to 1973 and the Arrangement Regarding International Trade in Textiles (better known as the Multifibre Arrangement or MFA) lasting from 1974 to 1994, for all practical purposes exempted the textiles sector from GATT rules and discipline.(9) The ATC, which succeeded the MFA in 1994, explicitly acknowledged the need to integrate the textile sector into GATT and set a definitive end date (31 December 2004) for the special treatment of the sector. However, at the time of the Costa Rica-US dispute the liberalizing impact of the ATC remained unclear. And the history of textile treatment in the world trading system justified a certain level of scepticism.

### *Costa Rica's perspective on the problem*

Costa Rica had just approved the Uruguay Round. The administration gained domestic political support for the agreement by promising that if the country was willing to undertake trade liberalizing reforms, Costa Rica would benefit from increased rights and opportunities within the world trading system. Now, almost before the ink on the new agreement had dried, the promise of new rights and opportunities seemed in jeopardy. From Costa Rica's perspective, the United States' efforts to impose restrictions were inconsistent both with the spirit of the ATC's goal of integrating textiles into the GATT and with the ATC provisions for transitional safeguard measures. Costa Rica believed that the United States, as part of a systematic strategy, was attempting to maintain control of a vertically integrated industry by requiring countries to use US fabric in garments intended for the US market. The restrictions

effectively only applied to underwear garments made with fabric not of US origin. In essence, the United States was attempting to protect its fabric industries rather than the domestic underwear industry. This strategy would allow the United States to control the entire production chain while utilizing cheaper labour from Costa Rica (and other developing countries) for assembly. Costa Rica argued that the transitional safeguard measures available under the ATC did not provide for restrictions to be applied to the products of one industry (underwear garments) in order to protect the interests of another industry (fabric).

Of course, focusing only on the legal issues and the facts of the case ignores the political complexities of Costa Rica's decision to pursue a dispute settlement case through the WTO. Many diverse political and economic stakeholders with potentially conflicting priorities and interests influence a decision to pursue a formal dispute settlement process. Several other countries were in a similar situation to that of Costa Rica, yet only Costa Rica chose to proceed with a dispute settlement case. What were the internal dynamics in Costa Rica that led to the decision to pursue the case?

## **II. The local and external players**

### *Government players*

Within Costa Rica, three governmental entities actively influenced the course of events. The Ministry of Trade handled technical trade-related matters and relations — particularly in the context of WTO issues. The Ministry of Foreign Affairs was responsible for matters of international relations. Costa Rica's embassy in Washington, typically headed by a politician with significant clout in the Costa Rican government, handled matters of specific interest to the United States–Costa Rica relationship. These groups did not always see eye to eye on policy matters. The Ministry of Trade had only gained the status of a formal agency in the late 1980s and was, therefore, a relatively new governmental entity. The gradual evolution of a group handling trade issues into a formal agency meant that the Trade Ministry's jurisdiction was not clearly established in law, which sometimes led to conflicts with the Ministry of Foreign Affairs. The Ministry of Foreign Affairs tended to believe that trade issues were a subset of foreign relations and should be managed within the context of its broad perspective on Costa Rica's international relations. The prospect of bringing a dispute settlement case against the United States strained the relationships between these agencies, since the Ministry of Foreign Affairs and the Washington embassy did not initially support the action.

When Costa Rica became aware of the US plan to impose quantitative restrictions on the underwear industry, the Minister of Trade, José Rossi, gave responsibility for the case to a team of young lawyers.<sup>(10)</sup> Irene Arguedas, Francisco Chacón, Roberto Echandi and Anabel González had all received law degrees from top US universities and had developed a reputation as serious and competent technocrats. They provided Costa Rica with the necessary technical and legal capacity to handle a dispute settlement case.

### *Private-sector players*

In the period leading up to the dispute, clothing manufacturing had been one of the fastest growing export sectors in the Costa Rican economy, largely because the country had begun to process imported textiles into garments for export. This activity had benefited greatly from the US value added tariff provisions(11) and preferential access to the US market under the Caribbean Basin Initiative. Industry growth also coincided with a Costa Rican economic reform programme designed to raise domestic value added to products of export interest. The textiles and clothing industry achieved significant gains in the value added/output ratio.(12)

Consequently, the textile and clothing industry was an important industry at the time of the dispute, and although the restrictions only affected a segment of the overall industry, the potential economic consequences to the textile and clothing sector as a whole were significant. Costa Rica was a relatively high-cost, although globally competitive, producer of textiles and clothing. However, committing to the use of relatively high-cost US fabric would almost certainly undermine Costa Rica's long-term competitiveness in the global textile and clothing market. In order to remain competitive Costa Rica would need the flexibility to source its fabric from the lowest-cost suppliers.

Generally, the Costa Rican textile sector was very supportive of pursuing the dispute. However, US multinational corporations had substantial investments in the textile sector and lobbied actively and publicly against pursuing the dispute case.

### **III. Challenges faced and the outcome**

Costa Rica needed to gain the domestic support of key Costa Rican stakeholders to pursue the case at all. The Ministry of Foreign Affairs and the Costa Rican embassy in Washington held similar views concerning the decision to pursue the DSU process — given the narrow economic stakes in this particular case, the potential pay-offs of the underwear dispute did not justify risking the broader relationship with the United States. However, it was not just inter-bureaucratic quarrelling, but fundamentally different points of view that led to the divergent attitudes among the agencies towards this trade dispute. From the perspective of the Ministry of Trade these differing points of view represented a generation gap. They perceived the prevailing view among their colleagues in the Ministry of Foreign Affairs, who tended to be much older, as derived from an earlier era when the economy had been geared toward the Central American market and focused on import substitution. The Trade team believed that the Ministry of Foreign Affairs underestimated the importance of the WTO rules-based trading system to Costa Rica's economic development strategy, and hence viewed the potential dispute as primarily a textile issue. The Trade team viewed trade, and Costa Rica's full participation in a rule-oriented international trading system, as essential to the country's economic future.

While the team from the Ministry of Trade did not believe that the case should be pursued at all costs, they were motivated by strategic considerations in addition to the economic stakes. Roberto Echandi, a member of the legal team, stated the strategic point as follows:

[In] the Uruguay Round, a balance had been reached regarding the incorporation of textiles to the normal rules of trade (away from the unilateralism and discrimination of the Multifibre Arrangement). After such a balance was reached, here came the United States and unilaterally

attempted to ignore the deal. That was extremely dangerous to an economy as dependent on trade and on the US market as was Costa Rica's.

The Ministry of Foreign Affairs and the Washington embassy characterized the Ministry of Trade's position as unduly influenced by the 'romantic' and 'theoretical' ideas of a group of naïve technocrats. In their opinions, *realpolitik* should prevail.

The domestic textile industry did not automatically support pursuing the case either. As Irene Arguedas, a member of the team from the Ministry of Trade, recalls, two different types of companies worked behind the scenes to influence the decision to pursue the dispute settlement process. The first were those who were vertically integrated with the US industry and sourced their cut fabric from US suppliers. These companies could export their product back to the United States under the Guaranteed Access Level (GAL) programme<sup>(13)</sup> and were in favour of an amicable or negotiated solution. The other group of companies consisted of those who sourced their fabric from places other than the United States. They were not eligible to export their product to the United States under the GAL programme. The access of these companies to the US market would be directly affected by the specific limit (SL) quota restrictions and they were correspondingly more interested in pursuing the dispute.<sup>(14)</sup>

In the face of the strong reservations of key political players within Costa Rica and the aggressive lobbying by the US trade officials and US multinationals with investments in the textile industry,<sup>(15)</sup> the Ministry of Trade had to make strong and persuasive arguments to go ahead with the case. However, even within the Ministry of Trade, team members were reluctant to pursue the case, especially alone.

Members of the Ministry of Trade team recall that 'in order to avoid bearing the burden of testing the system alone' they attempted to forge alliances with other countries. First, they sought the support of other Central American countries facing similar issues to Costa Rica. However, those countries feared the potential double consequences of losing a dispute settlement case and/or losing access to the US market. Next, Costa Rica attempted to gain support from Turkey, Pakistan and India. Costa Rican trade officials travelled to Geneva to meet with the ambassadors to the WTO. Although these countries acknowledged that they faced similar issues, they did not believe that they could forge the domestic coalitions necessary to bring a dispute case to the WTO. India said that it would support Costa Rica at the WTO with a third-party submission, but would not join as a complainant in the case.<sup>(16)</sup> Costa Rica would have to make the decision to pursue the case alone to test 'whether the concepts and principles of GATT would in fact apply to the textiles sector'.

Ultimately, José María Figueres, the president of Costa Rica, decided to initiate the dispute settlement process. He was a former Minister of Trade himself, and had recently studied strategy and competition while pursuing a degree at Harvard University. Consequently he appreciated the strategic argument that the case transcended the economic considerations of the underwear industry. Failing to take a stand on what Costa Rica perceived as a threat to its rights under the GATT could eventually lead to a larger, and economically substantive, risk — the erosion of Costa Rica's ability to participate in and benefit from the world trading system.

Once the decision was made to pursue the case, the administration still had to decide how to handle its prosecution. Although the Ministry of Trade legal team was well educated and had a reputation for good work, they were also perceived in some quarters as too young to lead

Costa Rica's challenge in such an important case. Therefore, several attempts were made to secure outside counsel to assist with the case. However, given the amount of research the in-house team had already conducted on the specific issues, they found that they already knew more than the 'experts' they interviewed. In addition, the costs of retaining outside legal counsel were very high. Eventually, concerns about the limited value to be added by an external counsel relative to the costs and the fact that the case seemed legally straightforward, led the key stakeholders to allow the existing trade team to handle the case.

Despite the concerns about pursuing the case and managing its prosecution, Costa Rica prevailed in both the dispute settlement process and the subsequent legal appeal. Not only did Costa Rica receive favourable rulings, but the United States also accepted and conformed to the decisions.

From Costa Rica's perspective there were several positive outcomes in addition to the legal outcome of the case. First, the case helped to build the perception domestically (and internationally) that small countries could benefit from membership of the WTO. Second, without substantively damaging the relationship, Costa Rica gained an increased level of respect from the United States and more generally among WTO members. Finally, the country gained significant experience and expanded its capacity with regard to international trade and legal issues, while the legal team within the Ministry of Trade further enhanced its reputation for credibility within the Costa Rican government.

#### **IV. Lessons for others (the players' views)**

Costa Rica, despite its concerns about 'testing the system' alone, used the mechanisms available to it as a WTO member to ensure that important principles of the multilateral trading system (as agreed upon by the members' economies) were appropriately applied. The 'system' worked as intended in this case. Almost ten years after the dispute, both developed and developing countries regularly use the DSU process. This case, as an early test of the system, clearly pointed to some lessons.

Anabel Gonzales of the Costa Rican legal team identified one general lesson related to managing trade disagreements: 'Never underestimate a trade conflict. Pay attention to it from the beginning and throughout the process.' The United States probably underestimated both Costa Rica's resolve and its capacity to prosecute the case. While the other countries identified by the United States as posing a threat to its underwear industry quickly agreed to settle with the United States, Costa Rica did not. When the case went before the dispute settlement panel, many discrepancies in the information provided by the United States substantively undermined the credibility of the claim that its industry was being damaged.<sup>(17)</sup> The Costa Rican trade team handling the case believed that if the United States had seriously thought that a dispute settlement panel would eventually scrutinize the case, they would have assembled the data supporting their case more carefully.

While there were not many things that the team from the Ministry of Trade would perhaps have done differently if given the chance, Costa Rica's experience in navigating the DSU process suggests several additional lessons. Despite Costa Rica's success in this case, Irene Arguedas emphasizes that countries should use the DSU as a genuinely last resort: 'First, it is

key to exhaust every possibility there may be to try to avoid the dispute and settle with your partner.’ Pursuing a dispute case is intellectually demanding, time-consuming, resource-intensive and politically stressful. Only when the alternatives have been exhausted and the potential risks of not pursuing the case are substantial should countries initiate a case.

It is important for complainants to be well prepared. They must have a detailed understanding of the case issues and believe that there are substantive legal grounds for bringing the case. As Anabel Gonzales puts it, ‘Before taking your case to the [dispute settlement process], make sure you know it and [are confident] it is a winner.’ Having the capacity to handle the case is part of being well prepared. Technical and legal expertise is essential to being prepared for what is often described as an intense process. Irene Arguedas makes the point this way.

Once the process is launched, it moves according to the time periods provided by the [DSU], which are short (though adequate). It means that there is no time to learn! Therefore, in order to be able to face adequately this kind of challenge, it is key to have good in-house technical and legal expertise. Capacity building is normally a challenge and resources are usually lacking, but, in the absence of that, chances of success are minimal.

The members of the Costa Rican legal team believe that it has become even more difficult to handle a dispute settlement case as the process has evolved and parties have become more sophisticated than they were in the early days of the system. While capacity building is often difficult, it can nevertheless not be overlooked.

Even if a country thinks that the DSU process is its last resort, and that it has a well-prepared case, it should make sure it has the solid support of key players in government, industry and other stakeholders before proceeding with the case. Irene Arguedas says, ‘It is absolutely crucial to have solid support from the government and from at least an important part of the industry. In our case, the support of the President... was key.’ In addition to government and industry stakeholders, Anabel Gonzales suggests developing strong relationships with the domestic and international press. The Costa Rican team held regular informational meetings for the press to educate them on the issues and keep them informed about developments. While building relations with the press will not win a case, having the public media supporting a case is generally an advantage in maintaining domestic support. Ultimately, forging a solid and reliable domestic coalition is at least as important as preparing a quality case.

Finally, even when a country has exhausted other options, fostered capacity, prepared a solid case, and forged domestic support, building relationships with allies can enhance the case. In this case, India’s third-party submission supporting Costa Rica’s case was symbolically important. In addition, discussions with India during the case and India’s contributions to the oral hearings were very helpful to the Costa Rican team.

In reflecting on the case nearly ten years later, members of the Costa Rican team all expressed enthusiasm for the opportunity to have played an active role in the dispute settlement process. Although the underwear case is nearly a decade old, liberalization of textiles within the world trading system continues to present challenges for member economies. As the ATC’s 31 December 2004 deadline for the full integration of textiles into the GATT approached, the battle over textile quotas continued. Textile trade groups from countries that benefited from quotas continued to lobby aggressively for delays in their scheduled elimination.

## NOTES:

- 1.- US textile category 352/652.
- 2.- The other countries were Colombia, Dominican Republic, El Salvador, Honduras, Thailand and Turkey.
- 3.- ATC, Art. 6.
- 4.- Thirty days after the 60-day consultation period as required by Art. 6.10 of the ATC.
- 5.- Costa Rica's case was only the fourth dispute brought against the United States. The countries bringing dispute cases prior to Costa Rica were Venezuela, Brazil and Japan.
- 6.- GATT 1994, Art. XXIII.
- 7.- Although this may have been the concern of developing countries and some observers at the time, there are those who now believe that the system favours developing countries. That is, it has become politically difficult for a large country like the United States to bring a dispute case against a small developing country because no one likes a bully, but it is easy for a small developing country to bring a case against a large developed country because everyone loves an underdog. However, developing countries point out that they need the protection of a formal dispute process. They say that the large developed countries do not need a formal process to put pressure on their trading partners.
- 8.- 'WTO Dispute Settlement 1995-2003: A Statistical Analysis', *Journal of International Economic Law*, 2004.
- 9.- M. Raffaelli and T. Jenkins, *The Drafting History of the Agreement on Textiles and Clothing*, Geneva: International Textiles and Clothing Bureau, 1995.
- 10.- Everyone on the team was under 35 years of age and two of the team were under 30. Even the minister was still in his thirties.
- 11.- This is sometimes referred to as '807 Trade' in reference to the chapter in the former US tariff schedules by which it was covered. At the time of the dispute this trade was covered by item 9802.00.80 of the Harmonized Tariff Schedule of the United States (HTSUS).
- 12.- Trade Policy Review of Costa Rica, 1995 (document WT/TPR/S/1).
- 13.- Guaranteed access levels, or GALs, are the specific negotiated quota levels for particular products being given more favourable treatment because the products are made from fabric formed and cut in the United States. Generally the GALs being proposed by the United States as part of its overall restraints considerably exceeded the levels of current trade and would, therefore, have no real impact on trade in such products.
- 14.- It should be noted that a similarly challenging political dynamic was mirrored in the structure of the US industry. Companies using a totally domestic process to manufacture underwear would likely be threatened by increased imports of underwear. However, companies using 807 programmes to assemble their product abroad could benefit from increased imports. Therefore consensus among industry on the trade dispute in the United States was likewise unlikely.
- 15.- Members of Costa Rica's trade team say that lobbying efforts on the part of the United States in this case were among the most aggressive they have witnessed.
- 16.- India clearly had an interest in the case, as it subsequently brought two textile-related cases against the United States (DS 32 and DS 33) just months after the Costa Rican case.
- 17.- See [WT/DS24/R](#).

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