Chapter 1

MOST-FAVOURED-NATION TREATMENT PRINCIPLE

1. OVERVIEW OF RULES

"Most-Favoured-Nation" ("MFN") treatment requires Members to accord the most favourable tariff and regulatory treatment given to the product of any one Member at the time of import or export of "like products" to all other Members. This is a founding principle of the WTO. Under the MFN rule, if WTO Member A agrees in negotiations with country B, which need not be a WTO Member, to reduce the tariff on product X to five percent, this same "tariff rate" must also be extended to all other WTO Members. In other words, if a country provides favourable treatment to one country, it must provide the same favourable treatment to all Member countries.

The concept of MFN has a long history. Prior to the GATT, an MFN clause was often included in bilateral trade agreements and, as such, contributed greatly to trade liberalization. However, in the 1930s, measures were taken to limit the MFN principle. It is generally believed that these limits divided the world economy into trade blocs. Lessons were learned from this mistake and, in the wake of World War II, an unconditional MFN clause was included in the GATT on a multilateral basis contributing to global trade stability.

Considering this background, MFN in particular must be recognized as a fundamental principle for sustaining the multilateral trading system. Regional integration and related exceptions must be uniformly administered so as not to undermine the MFN principle.

2. LEGAL FRAMEWORK

GATT PRACTICE REGARDING MFN TREATMENT AS STIPULATED IN GATT ARTICLES I, XIII, AND XVII

GATT Article I:1

GATT Article I:1 requires WTO Members to extend MFN treatment to like products of other WTO Members with respect to tariffs, regulations on exports and imports, internal taxes and charges, and internal regulations. In other words, "like" products from all WTO Members must be accorded the same treatment as the most advantageous treatment accorded by a Member to the products of any one state or territory under the jurisdiction of that Member.

Should an importing country extend differential treatment to "like products" of one exporting country over another - by setting different tariff rates - it would clearly violate GATT Article I:1. However, Article I:1 violations can also occur when the discrimination against the product of another Member is less apparent, such as when an importing country accords differential treatment among products that are considered to be "like products." This is often defined as *de facto* discrimination. For example, a country may apply a different tariff rate to a particular variety of unroasted coffee beans, but if that variety and other varieties of coffee beans were defined as "like products", the differential tariff may affect imports only from specific countries. This may be considered a violation of the MFN rule.[1] The concept of like products was strictly interpreted in the *SPF* ("spruce, pine, and fir") case involving Japan. The panel in that case recognized that each WTO Member might exercise considerable discretion as to tariff classifications and that the legality of such classifications would be established to the extent that it did not discriminate against the same products from different WTO Members.[2]

Non-Discriminatory Administration of Quantitative Restrictions

GATT Article XIII stipulates that, with regard to like products, quantitative restrictions or tariff quotas on any product must be administered in a non-discriminatory fashion. It also stipulates that, in administering import restrictions and tariff quotas, WTO Members shall aim to allocate shares approaching as closely as possible to that which might be expected in their absence. Article XIII provides for MFN treatment in the administration of quantitative restrictions, and supplements the disciplines under Article I.

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1 *See* Spain - Tariff Treatment of Unroasted Coffee, BISD 28S/102.

2 *See* Canada/Japan: Tariff on Imports of Spruce, Pine, Fir (SPF) Dimension Lumber, BISD 36S/167.

State Trading Enterprises

GATT Article XVII defines "State Trading Enterprises" as those: 1) state enterprises established or maintained by a WTO Member; or 2) enterprises granted exclusive or special privileges by WTO Members that make purchases or sales involving either imports or exports. By making use of their monopolistic status, such enterprises could operate against the principles of international trade by discriminating against an importing country via quantitative restrictions. GATT Article XVII obliges WTO Members to act in accordance with the rules of non-discrimination, including the MFN rule.

EXCEPTIONS TO THE MFN RULE

Regional Integration (GATT Article XXIV)

Regional integration through customs unions or free trade areas liberalizes trade among countries within the regions, while maintaining trade barriers with countries outside the region or regions. Regional integration therefore may lead to results that are contrary to the MFN principle because countries inside and outside the region are treated differently. Thus, countries outside the region could be disadvantaged. Nevertheless, regional integration can complement WTO principles by encouraging free trade in areas where barriers are not created against trade between countries inside and outside the region and where trade is facilitated by the elimination of trade barriers on essentially all trade in the region.

Therefore, GATT Article XXIV provides that regional integration may be allowed as an exception to the MFN rule only if the following conditions are met: first, tariffs and other barriers to trade must be eliminated with respect to substantially all trade within the region; and second, the tariffs and other barriers to trade applied to outside countries must not be higher or more restrictive than they were prior to regional integration. (For a detailed discussion, *see* Chapter 15 on Regional Integration).

Generalized System of Preferences

The Generalized System of Preferences (GSP) program is a system that grants certain products originating in eligible developing countries preferential tariff treatment over those normally granted under MFN status. GSP is a special measure designed to help developing countries increase their export earnings and promote development.

GSP is defined in the GATT decision on "Generalized System of Preferences" of June 1971. Granting GSP preferences is justified by the 1979 GATT decision on "Differential and More Favourable Treatment, Reciprocity, and Fuller Participation of

Developing Countries" or the "Enabling Clause".[3]

To be permissible, GSP must have the following characteristics: first, preferential tariffs may be applied not only to countries with special historical and political relationships[4] (*e.g.*, the British Commonwealth), but also to developing countries more generally (thus the system is described as "generalized"); second, the beneficiaries are limited to developing countries; and third, it is a benefit unilaterally granted by developed countries to developing countries. (As a related issue concerning the expansion of market access for least developed-countries, *see* Chapter 4.)

Non-Application of Multilateral Trade Agreements Between Particular Member States (WTO Article XIII)

The Marrakesh Agreement Establishing the World Trade Organization (the "WTO Agreement") provides that "[t]his Agreement and the Multilateral Trade Agreement in Annexes 1 and 2 shall not apply as between any Member and any other Member", when any of the following two conditions are met: (a) at the time the WTO went into force, Article XXXV of GATT 1947 had been invoked earlier and was effective as between original Members of the WTO which were Members to GATT 1947[5] or; (b) "between a Member and another Member which has acceded under Article XII only if the Member not consenting to the application has so notified the Ministerial Conference before the approval of the agreement on the terms of accession by the Ministerial Conference."

In the case of non-application, benefits enjoyed by other Members are not provided to the country of non-application, which leads to results that are contrary to the MFN principle.

The WTO Agreement Article XIII provisions were created to deal with accession-related issues. Ideally, the MFN rule would be strictly applied so that when country B accedes to the Agreement, it is required to confer MFN status on all other Members, and they, in turn, are required to confer MFN status on country B. However, country A, which is already a Member of the WTO, may have reasons for not conferring all rights and obligations of the WTO on new Member B. Because the WTO only requires the consent of two-thirds of the existing membership for accession, it is conceivable that country A may, against its will, be forced to grant MFN status to country B. WTO Article XIII is a way to respect country A's concerns by preventing a WTO relationship from taking effect between countries A and B. Conversely, WTO Article XIII also provides a means for accession of country B, even when more than one-third of the membership, like country A, has reasons for not wanting a WTO relationship with

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[3] *See* Decision of the Members of 28 November 1979, BISD 26S/203.

[4] *See* (d) Other Exceptions.

[5] Although there is also a provision about non-application in GATT Article XXXV, it is recognized that WTO Article XIII prevails against GATT Article XXXV. This situation occurs because WTO Article XVI stipulates that "[I]n the event of a conflict between a provision of this Agreement and a provision of any of the Multilateral Trade Agreements, the provision of this Agreement shall prevail to the extent of the conflict".

country B (in which case they will object to the accession itself) by allowing for so-called non-application.

In January 1995, the United States notified the General Council that it would not apply the Agreement and the Multilateral Trade Agreements in Annexes 1 and 2 to Romania. In February 1997 the United States withdrew its notification. In addition, the United States notified that it would not apply the above-mentioned agreements to three other new Members: Mongolia, the Kyrgyz Republic, and Georgia. The United States withdrew its notification for Mongolia in July 1999, for the Kyrgyz Republic in September 2000, and for Georgia in January 2001.

Other Exceptions

Other exceptions particular to MFN include GATT Article XXIV:3 regarding frontier traffic with adjacent countries, and Article I:2 regarding historical preferences that were in force at the signing of the GATT, such as the British Commonwealth.

General exceptions to the GATT that may be applied to the MFN principle include GATT Article XX regarding general exceptions for measures necessary to protect public morals, life and health, etc., and GATT Article XXI regarding security exceptions.

It is also possible to obtain a waiver from the MFN principle. Under WTO Article IX:3, countries may, with the agreement of other Members, waive their obligations under the agreement. New waivers, however, can only be obtained under exceptional circumstances, and require the consent of three-quarters of the Members. Article IX:3 stipulates that exceptional circumstances, the terms and conditions governing the application of the waiver, and the date on which the waiver will be terminated shall be clearly stated. These waivers are also subject to annual review under Article IX:4.

MFN PROVISIONS OUTSIDE OF GATT 1994

The MFN principle has been extended, although with certain exemptions, to trade in services and intellectual property under the WTO Agreements. Article II of the General Agreement on Trade in Services (GATS) provides for MFN treatment of services and service providers; Article 4 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) contains the same requirements for the protection of intellectual property rights. The GATS provides exceptions where Members may waive their obligation to provide MFN treatment for specific measures in specific fields by listing the measure in the Annex on Article II Exemptions. The TRIPS Agreement also provides for exemptions regarding measures based on existing treaties in the area of intellectual property. (*See* Chapter 11 for Trade in Services and Chapter 12 for Intellectual Property Rights.)

3. ECONOMIC ASPECTS AND SIGNIFICANCE

Increased Efficiency in the World Economy

MFN treatment makes it possible for countries to import from the most efficient supplier, in accordance with the principle of comparative advantage. For example, if country B can supply product X at a lower price than country C, country A can increase its economic efficiency by importing it from country B. If, however, country A applies higher tariff rates to product X from country B than to product X from country C, country A may be forced to import product X from country C, even though country C is not as efficient a supplier. This distorts trade and reduces the welfare of country A and the economic efficiency of the entire world. However, under the MFN principle, country A must levy its tariffs equally with respect to countries B and C and therefore necessarily will import product X from country B because it is cheaper to do so. The most efficient result is thus attained.

Stabilization of the Multilateral Trading System

The MFN rule requires that favourable treatment granted to one country be immediately and unconditionally granted to all other countries. Trade restrictions, too, must be applied equally. This increases the risk of trade restrictions becoming a political issue, *i.e.*, it raises the costs and consequences of doing so, and therefore tends to support the liberalized *status quo*. By stabilizing the free trade system in this manner, MFN increases predictability and therefore increases trade and investment.

Reduction of the Cost of Maintaining the Multilateral Trading System

MFN reduces the cost of maintaining the multilateral trading system. The equal treatment demanded by the MFN principle tends to act as a force for unifying treatment at the most advantageous level (for trade that means the most liberal level). The establishment and maintenance of the MFN rule enables WTO Members to reduce their monitoring and negotiating costs *vis-à-vis* disadvantageous treatment. In short, the MFN rule has the effect of reducing the cost of maintaining the free trade system.

Finally, as long as the MFN rule is honoured, imports from all WTO Members are treated equally, reducing the cost of determining an import's origin and improving economic efficiency.

Thus, the MFN rule is fundamentally important in improving economic efficiency. However, we must note that the MFN rule is often misused. For example, some argue that bilateral trade negotiations not conducted under the auspices of the WTO can be justified by the MFN principle, since any trade benefits that result from these negotiations will be applied equally to all other WTO members, even if they are excluded from the negotiations. Bilateral negotiations are thus justified as a more efficient and effective means to remove "unfair" trade measures. However, this does

not take into account the fact that, because bilateral negotiations lack transparency and the negotiations tend to reflect the power relationship between the two countries, there is a possibility that MFN may not be extended to all countries not part of the negotiations. Even if the results of the negotiations are extended to all countries, even those outside the negotiations, through the MFN principle, it must be noted that the end "result" of improved treatment in trade does not necessarily justify the means. Continued vigilance is required to ensure that the MFN rule is not abused in a results-oriented manner to undermine the basic importance of the dispute settlement process in the WTO.

4. MAJOR CASES

The MFN principle is often invoked in GATT disputes as a basic principle of the GATT together with national treatment. However, it is rare for MFN to be invoked on its own and provisions regarding national treatment, quantitative restrictions, TRIMs, rules of origin, and technical barriers to trade are often cited in conjunction. In the following section, we discuss Canada's measures regarding automobiles, the EU's measures regarding bananas and the EC's generalized tariff preferences scheme, where MFN was a major issue.

Canada – Measures Regarding Automobiles

Under the Agreement Concerning Automotive Products with the United States, which took effect in 1966 (the "Auto Pact"), the government of Canada accorded duty-free treatment to vehicles, provided that importers (the Big Three and others, hereinafter referred as "Auto Pact members") met certain conditions (*e.g.*, Canadian value-added — the required rates varied, but in general they were 60 percent or more). The system was implemented to provide tariff exemption to automobiles imported by any company that met the above conditions. However, the Free Trade Agreement (FTA) between the United States and Canada resulted in barring extension of the Auto Pact status to any new companies. This treatment continued after the North American Free Trade Agreement (NAFTA) took effect.

What this essentially meant was that original Auto Pact member companies in Canada could import automobiles duty-free, provided they met the cited conditions, while non-members had to pay a 6.1 percent tariff (rate as of February 2000), despite the fact that all of these companies produced and offered like products and services.

The Ministry of Economy, Trade and Industry (METI) deemed this a priority trade policy and, in July 1998, requested bilateral consultations with Canada under WTO dispute settlement procedures. Japan requested the establishment of a panel in November of that year, and in February 1999 a panel was established to review the

Japanese complaint in conjunction with a similar EU complaint.

The panel issued its report in February 2000, and the Appellate Body issued its report in May. Both reports upheld virtually all of Japan's arguments, finding that the measure: (1) violated GATT Article I:1 (MFN treatment); (2) violated GATT Article III:4 (national treatment); (3) violated the SCM Agreement; and (4) violated Article XVII of the GATS (national treatment). However, the Appellate Body overturned the finding of the panel that the duty waiver violated Article II of the GATS (MFN treatment) and Article XVII (national treatment) of the GATS, stating that the panel based its ruling on a lack of sufficient evidence.

Canada repealed the Auto Pact measures on 19 February 2001.

EU – Measures Regarding Bananas

Under the Lomé Convention, the European Union maintains measures that provide preferential treatment to imports of bananas from countries in Africa, the Caribbean, and the Pacific (ACP) in the form of tariff quotas (*i.e.*, different tariffs are applied to set in-quota and out-of-quota amounts for the individual ACP countries). These measures have been before a panel twice under the GATT (s*ee* Chapter 15 on Regional Integration).

After the conclusion of the Uruguay Round, the European Union created a new tariff quota regime for bananas. However, the United States, whose companies mainly deal in Latin American bananas, was dissatisfied with the new regime and argued that the licensing system provided preferential treatment to ACP bananas. The United States further argued that the preferential allocation of the quota to Latin American countries, who are parties to the "Framework Agreement on Bananas (BFA)" (especially Colombia and Costa Rica), was inconsistent with the WTO Agreement. After bilateral negotiations under GATT Article XXII between the European Union and the United States, as well as with some Latin American countries (Ecuador, Guatemala, Honduras, and Mexico), a panel was established in May 1996. Japan participated in the panel process as a third party.

In May 1997, the panel found that the EU's measures were inconsistent with the WTO agreements on several points. The report of the Appellate Body generally upheld the main findings of the panel. The elements of the Appellate Body report are as follows:

(1) Allocating a portion of the quota regarding third-country and non-traditional ACP bananas to only operators who deal in the EU and traditional ACP bananas is inconsistent with Article I:1 (MFN) and Article III:4 (national treatment) of the GATT. The Lomé waiver does not waive the EU's obligations under Article I:1 with respect to licensing procedures applied to third-country and non-traditional ACP imports.

(2) The above preferential allocation of the quota to operators who deal in traditional ACP bananas creates less favourable conditions of competition for like service suppliers from third countries, and is therefore inconsistent with the requirements of Article XVII of GATS.

(3) Regarding the "BFA", although it was not unreasonable for the EU to conclude at the time the BFA was negotiated that Colombia and Costa Rica were the only Members that had a substantial interest in supplying the EU market, the EU's allocation of tariff quota shares is inconsistent with Article XIII:1 (non-discriminatory administration of quantitative restrictions). Regarding the relationship between the inclusion of the BFA tariff quota shares in the EU's tariff schedule and GATT Article XIII, the EU's tariff schedule does not permit the EU to act inconsistently with the requirements of Article XIII.

(For a broader discussion concerning the Lomé Conventions, *see* Chapter 15. For details on the implementation of the recommendation by DSB, *see* Chapter 14.)

EU– Differential provision of tariff preferences to developing countries

On December 10, 2001, the European Council announced Council Regulation No. 2501/2001 of generalized tariff preferences scheme covering the period from January 1, 2002 to December 31, 2004. The regulation consists of: (i) general arrangements; (ii) special incentive arrangements for the protection of labor rights; (iii) special incentive arrangements for the protection of the environment; (iv) special arrangements for least developed countries; and (v) special arrangements to combat drug production and trafficking (the "drug arrangement").

Among these arrangements, the general arrangements (i) are for developing countries in general, while the drug arrangement (v) is applicable only to the following twelve countries: Bolivia, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Pakistan, Panama, Peru, and Venezuela.

India argued that the Regulation is discriminatory since only twelve beneficiary countries are granted duty free access to the EC market, while all other developing countries are entitled only to the full applicable duties or duty reductions. In March 2002, India requested WTO dispute settlement consultations over the inconsistency of the Regulation with MFN and the Enabling Clause.

India requested the establishment of a panel in December 2002. The panel report was circulated to Member countries in December 2003. The panel found that the drug arrangement constituted a special treatment benefiting only some developing countries and, therefore, was inconsistent with GATT Article I. The panel further found that the measure's inconsistency with GATT could not be justified under the Enabling Clause, because not all developing countries equally received the special treatment, and such differential treatment was not based on special treatment for the least developed countries. Moreover, the panel found that the drug arrangement could not be justified

under GATT Article XX(b), since it allows exceptions only for "necessary measures to protect life and health" and the drug arrangement was not intended as such.

The EU appealed the panel's findings to the Appellate Body in January 2004. The Appellate Body report was issued in April 2004, and subsequently adopted. The Appellate Body found that, in light of the object and purpose of the WTO Agreement and the Enabling Clause, the Enabling Clause does not necessarily prohibit the granting of different special treatment to different GSP (Generalized System of Preferences) beneficiaries. However, the Appellate Body also found that identical treatment should be granted to all GSP beneficiaries who are at the same level of "development, financial and trade needs" that the treatment is expected to solve. The Appellate Body upheld for different reasons the panel's findings that the EU violated its WTO obligations because the drug arrangement did not establish any criteria of grounds to differentiate the beneficiaries under the drug arrangement from other GSP beneficiaries and that, therefore, all similarly-situated GSP beneficiaries did not benefit from the drug arrangement.