

*Chapter 1*

# MOST-FAVOURLED-NATION TREATMENT PRINCIPLE

## 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 bedrock 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 apply to all other WTO Members as well. In other words, if a country gives favourable treatment to one country regarding a particular issue, it must treat all Members equally with respect to the same issue.

The idea of MFN treatment has a long history. Prior to the GATT, an MFN clause was often included in bilateral trade agreements, and as such it contributed greatly to the liberalization of trade. However, in the 1930s, measures were taken that limited the functioning of the MFN principle. It is said that these measures led to the division of the world economy into

trade blocs. Lessons were learned from this mistake; in the wake of World War II, an unconditional MFN clause was included in the GATT, on a multilateral basis, and has contributed to the stability of trade around the world.

Against this background, the MFN principle in particular must be observed 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.

## LEGAL FRAMEWORK

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

#### *GATT Article I:1*

GATT Article I:1 provides for WTO Members to extend MFN treatment to like products of other WTO Members regarding tariffs, regulations on exports and imports, internal taxes and charges, and internal regulations. In other words, “like” products from all WTO Members must be given the same treatment as the most advantageous treatment accorded the products of any state.

Should an importing country flagrantly extend differential treatment to “like products” of the exporting country — by setting different tariff rates it would clearly be in violation of GATT Article I:1. However, Article I:1 violations can also occur even when there is no discrimination against the product of another Member, 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 instance, a country may apply a different tariff rate to a particular variety of unroasted coffee, but if that variety and other varieties of coffee beans were considered to be “like products” the differential tariff may have an effect on imports only from specific countries. This may be considered a violation of

the MFN rule.<sup>1</sup> 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 Member.<sup>2</sup>

### *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.

### *States Trading Enterprises*

“States Trading Enterprises” are defined as: 1) state enterprises established or maintained by a WTO Member; or 2) private 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 through discrimination on the part of importing country and quantitative restrictions. GATT Article XXVII obliges WTO Members to act in accordance with the rules of non-discrimination, including the MFN rule.

## EXCEPTIONS TO THE MFN RULE

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

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

*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. This may have a negative effect on countries outside the region, and is at odds with the liberalization of trade.

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. 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) is a system that grants products originating in developing countries lower tariff rates than those normally enjoyed under MFN status. GSP is a special measure granted to developing countries in order to increase their export earnings and to promote their development.

The GSP is defined in the GATT decision on “Generalized System of Preferences” of June 1971. Granting of 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”.<sup>3</sup>

The GSP has the following characteristics: First, preferential tariffs may be applied not only to countries with special historical and political relationships<sup>4</sup> (e.g. the British Commonwealth), but also to developing countries more generally (thus the system is described as “generalized”).

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<sup>3</sup> See Decision of the Members of 28 November 1979, BISD 26S/203.

<sup>4</sup> See (d) Other Exceptions.

Second, the beneficiaries are limited to developing countries. Finally, 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<sup>5</sup> 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.

These Article XIII provisions were created to deal with problems arising from accessions. 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 wanting to confer the 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 might, against its will, be forced to give

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<sup>5</sup> 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”.

MFN status to country B. WTO Article XIII is a way to respect country A's wishes by preventing a WTO relationship from taking effect between countries A and B. On the other hand, WTO Article XIII provides a way for the accession of country B, even if more than a third of the membership, like country A, has reasons for not wanting a WTO relationship with country B (in which case they will object to the accession itself) by allowing for 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. Yet in February 1997 the United States withdrew its invocation. In addition, the United States also notified that it would not apply the above-mentioned agreements to three other new Members: Mongolia; the Kyrgyz Republic; and Georgia, but withdrew it for Mongolia in July 1999; for the Kyrgyz Republic in September 2000; and for Georgia in January 2001.

### *Other Exceptions*

Other exceptions peculiar to the MFN principle include 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 Article XX regarding general exceptions for measures necessary to protect public morals, life and health, etc., and Article XXI regarding security exceptions.

It is also possible to obtain a waiver to 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 idea of MFN treatment has been extended to the areas of trade in services and intellectual property by the WTO Agreement, although with certain exemptions. Article II of the General Agreement on Trade in Services (GATS) provides for MFN treatment for services and service providers; Article 4 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) contains the same for the protection of intellectual property rights. The GATS affords 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; Chapter 12 for Intellectual Property Rights)

## ECONOMIC IMPLICATIONS

### *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. If, however, the MFN principle is applied between the three countries, then country A will levy its tariffs equally and therefore necessarily 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 also be applied equally to all. This increases the risk of the introduction of trade restrictions becoming a political issue, raises the costs 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 negotiation costs for disadvantageous treatment. In short, the most-favoured-nation 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, which reduces the cost of determining an import's origin and therefore improves economic efficiency.

The MFN rule is therefore of fundamental importance in improving economic efficiency. However, we must also note that the MFN rule is often misused. One argument runs that bilateral negotiations not 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 though they may be 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 treatment is may not be extended to countries not in the negotiation. Even if the results of the negotiations are extended through the MFN principle, it must be noted that the end "re-

sult” of improved treatment in trade does not necessarily justify the means. Continual vigilance is required to ensure that the most-favoured-nation rule is not abused in a results-oriented manner to undermine the basic importance of the dispute settlement process in the WTO.

## 2. MAJOR CASES

The MFN principle is used often in GATT disputes as a basic principle of the GATT together with national treatment. However, in those disputes, 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 take up the EU’s measures regarding bananas and Canada’s measures regarding automobiles where MFN is a major issue, and leave the detailed description of other specific cases to other chapters.

### 1. CANADA

#### *Measures Regarding Automobiles*

Under the “Auto Pact” (the Agreement Concerning Automotive Products with the United States, which took effect in 1966), 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 had been administered so as to give tariff exemption to automobiles imported by any company as long as the companies met the above conditions, but the signing of 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 in essence meant was that original Auto Pact member companies in Canada could import automobiles duty-free so long as they met

the above conditions, while non-members had to pay a 6.1 percent tariff (rate as February 2000), despite the fact that all of these companies involved like products and services through production, importation and sale of automobiles.

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 the Japanese argument, 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; 4) violated Article XVII of the GATS (national treatment); and 5) that the duty waiver violated Article II of the GATS (MFN treatment) and Article XVII (national treatment) of the GATS. However, this last finding was overturned by the Appellate Body.

Canada repealed the Auto Pact's measures on February 19, 2001.

## 2. THE EUROPEAN UNION

### *Measures Regarding Bananas*

The European Union maintains measures that provide preferential treatment to countries in Africa, the Caribbean, and the Pacific (ACP) regarding tariff quotas (that is both the quota amount and applicable tariff rates), under the Lomé Convention. These measures involving bananas have been before a panel twice under the GATT (See Chapter 15 on Regional Integration).

After the conclusion of the Uruguay Round, the European Union put in place a new tariff quota regime for bananas. However, the United States, whose companies mainly deal in Latin American bananas, was unsatisfied with the new regime, and argued that the licensing system still 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 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 the panel report issued in May 1997, the EU’s measures were found inconsistent with the WTO agreements on the following points. The report of the Appellate Body also basically upheld the main points of the panel report. The elements of the Appellate Body report are summarized 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.)