Overview of Rules

Tariffs are the most common kind of barrier to trade; indeed, one purpose of the WTO is to enable Member countries to negotiate mutual tariff reductions. Before we consider the legal framework that establishes the discipline regarding tariffs, we must understand the definition of tariffs, their functions, and their component elements (rates, classification, and valuation).

Definition of “Tariff”

A tariff is a tax imposed on the import or export of goods. In general parlance, however, a tariff refers to “import duties” charged at the time goods are imported.  

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1. With regard to the scope of general most-favoured-nation (MFN) treatment, GATT Article I prescribes that MFN treatment includes “customs duties and charges of any kind imposed on or in connection with importation or exportation . . . .” It thus deals with not only tariffs on importation but also those on exportation.

2. Article 3 of Japan’s Customs Tariff Law defines a tariff as “a tax based on the standard of assessment of prices or volume of imported goods,” and explicitly limits tariffs to import cargo.
Functions of Tariffs

Tariffs have three primary functions: (1) to serve as a source of revenue; (2) to protect domestic industries; and (3) to remedy trade distortions (punitive function).

The revenue function comes from the fact that the income from tariffs provides governments with a source of tax revenue. In the past, the revenue function was indeed a major reason for applying tariffs, but economic development and the creation of systematic domestic tax codes have reduced its importance in developed countries. For example, Japan generates about 78 billion yen in tariff revenue per year, but this is only 1.5 percent of its total tax revenues (fiscal 2000). In some developing countries, however, revenue generation may still be an important tariff function of tariffs.

Tariffs are also a policy tool used to protect domestic industries by changing the conditions under which goods compete, in such a way that competitive imports are placed at a commercial disadvantage. In point of fact, a cursory examination of the tariff rates employed by different countries does seem to indicate that they reflect, to a considerable extent, the competitiveness of domestic industries. In some cases, “tariff quotas” are used to strike a balance between market access and the protection of domestic industry. Tariff quotas work by assigning low or no duties to imports up to a certain volume (primary duties) and then higher rates (secondary duties) to any imports that exceed the initial import volume level.

In principle the WTO bans the use of quantitative restrictions as a means of protecting domestic industries, but does allow tariffs to be used for this purpose. This is because tariffs are still considered to be more desirable than quantitative restrictions. (See “(c) Tariff Rates“ below.)

Punitive tariffs may be used to remedy trade distortions resulting from measures adopted by other countries. For example, the Antidumping Agreement allows countries to use “antidumping-duties” to remedy proven cases of injuri-
ous dumping; similarly, the Subsidies Agreement allows countries to impose countervailing duties when an exporting country provides its manufacturers with subsidies that, while not specifically banned, nonetheless damage the domestic industry of an importing country. (See Chapters 5 and 6 for further discussion.)

**Tariff Rates**

Obviously, one of the most important components of tariff measures is the rate at which the tariff is imposed. As noted in the tariff function discussion, any imposition of a tariff has the potential to reduce the welfare of the world economy as a whole. Since 1947, the GATT has been the standard bearer in an ongoing process of reducing tariff levels. During tariff negotiations (known as “rounds”, the most recent of which was the “Uruguay Round”), countries set ceilings on their tariff rates. This is known as the “bound rate” and refers to the highest allowable rate, in contrast to the rate that is actually applied, which is referred to as the “effective rate.” The GATT has been successful in encouraging mutual reduction of these rates. Since the conclusion of the Uruguay Round, there have been further efforts to reduce tariffs in specific sectors.

The Uruguay Round resulted in a final average bound rate for industrial goods (weighted average by trade volume) of 1.5 percent in Japan, 3.6 percent in the United States, 3.6 percent in the EU, and 4.8 percent in Canada. Japanese tariff rates are thus comparatively low.

**Figure 4-1**

Average Tariff Rates

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>US</th>
<th>EC</th>
<th>Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All products:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Simple average bound rate (2000)</td>
<td>5.2%</td>
<td>4.8%</td>
<td>4.8%</td>
<td>4.5%</td>
</tr>
<tr>
<td><strong>Industrial products:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Import-weighted average applied rate (1999)5</td>
<td>1.5%</td>
<td>3.6%</td>
<td>3.6%</td>
<td>4.8%</td>
</tr>
</tbody>
</table>

4 The industrial sector covers all goods except for the products covered under the Agreement on Agriculture. The industrial sector covers forestry and fishery products.

5 Japanese figures on industrial products (excluding petroleum and forestry and fishery products) are based
Tariff Classification

Like tariff rates, tariff classification represents a basic component of the tariff system. National tariff schedules are organized in the form of tables that consist of “tariff classification numbers” assigned to goods, and a corresponding tariff rate. The way in which an item is classified for tariff purposes will have an important and palpable effect on the duties charged. When imported goods are classified in an arbitrary fashion, they can effectively nullify previous rate reductions.

on the calculations of the Ministry of Economics, Trade and Industry. Japan’s figure for the industrial sector including forestry and fishery products is 1.7.
The GATT contains no rules regarding classification. In the past, countries had their own individual systems. As trade expanded, however, countries recognized the need for more uniform classification, which resulted in the drafting in 1988 of the “Harmonized Commodity Description and Coding System” or “HS” system at the Customs Co-operation Council (CCC; also known as the “World Customs Organization” or “WCO”).

Members of the HS Convention are obligated to bring the lists of items included in their tariff and statistical tables into conformance with the list of items found in the annex to the Convention (the HS item list). The tariff schedules attached to Japan’s Customs Tariff Law and Temporary Tariff Measures Law conform to the Harmonized System, as do its export/import statistical tables.

Some 102 countries and regions around the world, including Japan, the United States, and the EU, are Contracting Parties to the Convention, and many others do in fact employ it even if they are not officially Contracting Parties. In all, about 170 countries and regions employ HS tables in their tariffs, and 6-digit HS codes provide uniform tariff classification for the majority of countries around the world.

Although the HS nomenclature is created to reflect the current state of international trade, technological advances continue to bring out new products and change the nature of international trade. The Harmonized System has been revised three times since 1992 (in 1992, 1996 and 2002).

In November 2000, the HS Committee began meetings aimed at another revision to the HS nomenclature in 2007. Japan is following this initiative closely, with particular interest in the classification of IT-related equipment.

**Customs Valuation**

The final component of tariffs is the valuation of goods for tariff purposes. When countries assign arbitrary values for tariff purposes, they render tariff rates meaningless. GATT Article VII and the “Agreement on Implementation of Article VII” (Customs Valuation Agreement) define international rules for valuation.\(^6\)

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\(^6\) The Customs Valuation Agreement states that, “the primary basis for customs value under this Agreement is ‘transaction value’ as defined in Article 1...together with Article 8...adjustments.” This is an explicit affirmation that the price actually paid is to be used as the basis for customs valuation. Article 2 of the Agreement provides for the transaction prices of similar goods to be used in exceptional cases. In addition, Article 7 of the
Under Article 20 of the Custom Valuation Agreement, developing country Members may delay application of the agreement for the particular period if the other Members give their approval. As of January 2001, some 20 Members have delayed implementation.

**LEGAL FRAMEWORK**

The WTO bans, in principle, all quantitative restrictions, but allows for the imposition of tariffs. It then attempts to reduce the barrier posed by tariffs in “tariff negotiations” among Member countries, whereby they agree to “bind” themselves to maximum rates inscribed in their tariff schedules (“bound rates”) for individual items (in principle following the tariff classification nomenclature) and to negotiate for their progressive reduction.

**GATT Disciplines**

GATT Article II obligates Member countries to apply tariff rates that are no higher than their bound rates. GATT Article XXVIII specifies that when Members wish to raise their bound rates or to withdraw tariff concessions, they must negotiate and reach agreements with other Members with whom they had initially negotiated and enter into consultations with major supplying countries that have a substantial interest in any change in the bound rate.

**Disciplines on Tariff Classification**

Article 3.1 of the International Convention on the Harmonized Commodity Description and Coding System (“HS Convention”) stipulates that the signatories “shall not modify the scope of the sections, chapters, headings, or subheadings of the Harmonized System.” This is done to maintain uniform administration of the HS. The HS classifications are reviewed on a regular basis so as to keep pace with technological development. If, as a result of these reviews, the classification of a good changes in such a way as to raise its bound rate, countri-
es must enter into negotiations under the terms of GATT Article XXVIII.

The Importance of “Binding”

It should be obvious from the discussion so far that there are no problems in terms of WTO rules in setting high bound rates or in not agreeing to be bound at all. The WTO rules therefore allow countries to raise their effective tariff rates within the scope of their bound rates, and to raise tariff rates at will for non-bound items. Regardless of whether it is permitted by the rules, however, a sudden hike in tariff rates will obviously have a detrimental impact on trade.

Nevertheless, non-binding tariff rates is also contrary to the spirit of the WTO, which is based on the idea of using “binding” to reduce tariffs. From this perspective, the importance of binding must be emphasized. As a result of the Uruguay Round, the percentage of industrial products subject to bound rates in Japan, the United States, the EU, and Canada (total value of imports subject to bound tariffs divided by total value of imports) is now about 100 percent. The percentage of other countries and regions is somewhat lower, or in some cases substantially lower, for example: Republic of Korea (89 percent), Indonesia (92 percent), Thailand (70 percent), Malaysia (79 percent), Singapore (73 percent), and Hong Kong (23 percent).

ECONOMIC IMPLICATIONS

This section analyses some of the basic economic issues associated with tariffs. Specifically, it examines why tariffs are preferable to quantitative restrictions, and why it is desirable that they be reduced. This section then considers the importance of international tariff-reduction negotiations at the WTO.

The Effect of Tariffs

The most basic effect of an import tariff is to raise domestic prices in the country imposing the tariff. In “small countries” (defined for our purposes as countries that do not have an influence on world prices), the rise in domestic
price is equivalent to the amount of the tariff. In “large countries” (those that have an impact on world prices), the price rise is somewhat less than the amount of the tariff because the tariff will reduce demand, which reduces world prices.

The rise in domestic prices expands domestic production of the imported good while at the same time decreasing demand for it. Tariffs benefit competing domestic producers, but harm consumers. Obviously, the importing country also generates tax revenues from the tariff.

Tariffs have different benefits and costs to different groups within an economy; the relative sizes of these benefits and costs will create changes in the economic welfare of the importing country as a whole. For “small countries” with no influence on world prices, the imposition of a tariff necessarily reduces economic welfare, but for “large countries” a tariff may in some cases improve economic welfare because world prices are depressed thereby improving the terms of trade. If tariffs are sufficiently low, the improvement in terms of trade will always be greater than the costs of the tariff, and there is in theory an “optimal tariff” that will maximize economic welfare. However, an improvement in one country’s terms of trade corresponds to a deterioration in the terms of trade of other countries, and therefore a reduction in the economic welfare of trading partners. This may trigger retaliatory measures by trading partners.

When goods are produced using imported raw materials, the tariff rate on the finished good by itself does not generally constitute the level of protection that the finished good enjoys. Tariffs on the raw materials must also be taken into account. If the tariff on the raw materials is lower than the tariff on the finished product, the level of protection afforded the finished product is higher than the tariff rate on the finished product would suggest (protection rates that take account of tariffs on raw materials are called “effective protection rates”). It should be underscored, therefore, that even low tariff rates can provide full-fledged protection for domestic industries.

The Effect of Quantitative Restrictions

Quantitative restrictions take many forms, the most common of which is import quotas. Theoretically, the effect of quantitative restrictions is the same as that of import tariffs, a reduction of the amount of goods imported and higher domestic prices for those goods (the “equivalence theorem”).

Quotas differ from tariffs because the importing country’s government
Part II  Chapter 4  Tariffs

gains no revenue from quotas while the importers to whom the licenses are allocated obtain excessive profits ("rents"). (However, the importing country government would in theory obtain the same revenues as from tariffs if licenses were sold to importers by auction.)

Economists generally concede that the "equivalence theorem" does not stand up when the domestic market is not under perfect competition (e.g. in the case of monopoly), when the market is growing, or when there are changes in the price of the merchandise. In these cases, quantitative restrictions will usually have a more restrictive effect on the market than will tariffs.

Why Tariffs are Preferable to Quantitative Restrictions

As we have noted, the WTO Agreement bans in principle all quantitative restrictions, while permitting tariffs to be used to protect domestic industries. There are several reasons for this. Quantitative restrictions tend to lack transparency in their application (for example, decisions on license awards and quantities may be arbitrary) compared to tariffs. It is also easier to negotiate tariff reductions. Similarly, quantitative restrictions impose flat restrictions on imports regardless of changes in world prices and foreign-exchange rates. There is also no guarantee that import quotas will be fair. Finally, exporters can respond to tariffs by improving their efficiency.

Justifications for Tariff Reductions

The WTO Agreement permits tariffs as a means of industrial protection (unlike quantitative restrictions, which it bans outright), but it also seeks to gradually reduce those tariffs through negotiations among Member countries. Below is a summary of the economic rationale for tariff reductions.

Reducing tariffs mitigates the "loss of efficiency" generated by the distortions to the price system that the tariff causes (the "dead weight loss"). Reducing the degree of market protection also expands the market, allowing producers and exporting countries to enjoy economies of scale and bringing benefits to the economy as a whole.

There are also arguments against reducing tariffs. Large countries might argue that tariffs have certain benefits because they improve the terms of trade
Part II Chapter 4 Tariffs

(the “optimal tariffs” argument). Similarly, when there are domestic market failures, tariffs might be seen as a means of increasing welfare.

However, these arguments are not necessarily convincing. Any increase in welfare through an “optimal tariff” is achieved at the expense of trading partners and thereby reducing worldwide economic welfare relative to potential results in a free trade context. Even the economic welfare of the country imposing the tariff is uncertain, since retaliatory measures imposed by trading partners may ultimately result in reduced economic welfare in relation to a free trade situation. Meanwhile, domestic market failures would be better addressed directly than through tariffs.

Income Redistribution and the Importance of International Negotiations

From an economic standpoint, it would seem reasonable to conclude that tariff reductions are basically beneficial in that they increase economic efficiency, and that they are therefore indisputably desirable. It is rare, however, for countries to eliminate their tariffs completely. In practice, countries often impose tariffs not for the purpose of increasing overall welfare, but for the purpose of redistributing income. This is a reflection of political will, as influenced by the lobbying activities of interest groups and others.

When tariffs are imposed for such domestic reasons, it is difficult to achieve voluntary reductions merely because they will increase the economic welfare of the society as a whole. This domestic political reality is what makes international negotiations to reduce tariffs — the basic strategy of the WTO — so important. When international negotiations are conditional upon mutual benefits, governments are more likely to consent to tariff reductions and trade liberalization.

PREFERENTIAL TREATMENT FOR LDCs

History

During the Lyon Summit of June 1996, Renato Ruggiero, then Director-General of the WTO, advocated a tariff waiver program for least-developed
countries (LDCs). Subsequent summits have also advanced declarations calling for studies of ways to improve LDCs’ access to markets.

It was against this background that an initiative to provide special treatment to make duty-free and quota-free, essentially all products from LDCs was proposed during the third WTO Ministerial Conference in December 1999. Unfortunately, an agreement could not be reached at that time.

In February 2000, Director-General Mike Moore again proposed this initiative as a confidence-building measure for developing countries in preparation for the launch of the new round of negotiations. At a United Nations Conference on Trade and Development (UNCTAD) meeting in February 2000, then Japanese Prime Minister Keizo Obuchi declared his intention to promote the LDCs initiatives while encouraging the participation of other major countries. By the end of March of that year, Japan, the EU, the United States, and Canada reached an agreement that developed country Members would provide least-developed Members with enhanced market access by according and implementing tariff-free and quota-free treatment consistent with domestic requirements and international Agreements. Under the agreement Japan, the EU and the U.S. would develop preferential schemes for all products originating in LDCs.

After this agreement, the initiative was formally announced by Director-General Moore at the WTO General Council in May 2000. At that time, Chile, the Czech Republic, Hungary, Iceland, the Republic of Korea, New Zealand, Norway, Slovenia, and Switzerland expressed their desire to join.

The Chairman’s statement from the APEC Ministerial Meeting responsible for trade in June 2000 also urged the participation of more APEC member economies in the initiative. It has since been confirmed that Hong Kong, Australia, and Singapore will join.

In May 2001, the Brussels Declaration issued by the Third United Nations Conference on LCDs noted that UN members “aim at improving preferential market access for LDCs by working towards the objective of duty-free and quota-free market access for all LDCs’ products in the markets of developed countries.” A Programme of Action for LDCs was also adopted. The same course was reaffirmed in the G8 Communiqué issued by the Genoa Summit in July and in the WTO Ministerial Declaration (DOHA 2001).
TRENDS IN MAJOR COUNTRIES

UNITED STATES

Measures for LDCs in the AGOA/CBTPA

The United States passed its “Trade Development Act of 2000” on 18 May 2000. The Act had two basic components: 1) the African Growth and Opportunity Act (AGOA); and 2) the United States-Caribbean Basin Trade Act (CBTPA).

1) AGOA constructs a preferential system for 34 sub-Saharan African countries that have established or are making continued progress toward a market-based economy, rule of law, and economic policies to reduce poverty. AGOA provides for duty-free access to the United States for items other than textiles and apparel originating from these 34 countries that would otherwise be exceptions to the General System of Preference (GSP). Textiles and apparel are exceptions to GSP, but the law provides both duty-free and quota-free treatment for products using raw materials originating in, and processed by the 34 countries. However, to avail themselves of the benefits from AGOA, countries will need to comply with visa procedures designed to prevent circumvention and will need to make enhancements in their domestic laws. On December 19, 2000, the United States announced the designation of approximately 1,835 products for duty-free treatment under the GSP program for countries designated as beneficiaries under the AGOA.

2) CBTPA amends the Caribbean Basin Economic Recovery Act, which provides preferential treatment for 24 countries. It is commonly referred to as the “Caribbean Basin Initiative (CBI)”. The CBTPA does retain some exceptions, but provides preferential treatment to Caribbean countries for textile and apparel products processed in these countries from fabrics originating from the United States. These products were previously excluded from the CBI. It also eliminates tariffs for some beverages from Caribbean countries.
AGOA and CBTPA cover many LDCs, but the preferential treatment that they contain is limited to developing countries from specific regions and may contravene the most-favored-nation (MFN) principle because the measures exceed the scope of the 1979 enabling cause (permanent waiver of MFN treatment). In addition, these laws may infringe on the non-discrimination principle (GATT Article XIII) and the Subsidies Agreement because tariffs waivers and duty-free and quota-free treatment are offered in specific quantities if specific conditions are met. The United States plans to obtain a waiver for these laws.

EUROPEAN UNION

Proposal for Duty-free and Quota-free Treatment
For All LDC Products (Except Arms)

On 20 September 2000, the European Commission adopted the “Everything But Arms” initiative that provides duty-free and quota-free access for all LDC products. The initiative gives full duty and quota-free access to all goods produced by LDCs except arms. However, the initiative will be phased in for sensitive items like bananas, sugar, and rice, with full implementation not due until 2009.

The proposal is likely to be adopted by the Council of Ministers and the European Parliament.

CANADA

Expansion in Duty-free Treatment for LDC Products

On 1 September 2000, Canada added 570 items to the list of items for which LDCs enjoy preferential treatment, bringing the total to 6,412 items. The measure means about 90 percent of product categories from LDCs may enter
Canada duty-free. On August 23, LDC tariff rules of origin regulation were modified to require that a minimum of 20 percent of factory shipping values be from the LDCs or from Canada and another 20 percent from other LDCs, developing countries, or Canada. In the past, LDC origin was not recognized unless at least 40 percent of factory shipping values were from the LDC or Canada.

Nonetheless, Canada retains tariffs on textiles, apparel, shoes, refined sugar, and some agricultural products from LDCs, and quota management continues. Canada’s LDC measures apply to all LDCs recognized by the United Nations, with the exception of Myanmar.

**Figure 4-2**

Changes of Average Bound Tariff Rates (Non-agricultural Products)

<table>
<thead>
<tr>
<th>Japan</th>
<th>US</th>
<th>EU</th>
<th>Rep.of Korea</th>
<th>Australia</th>
<th>Indonesia</th>
<th>Thailand</th>
<th>Canada</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre UR</td>
<td>3.8</td>
<td>5.4</td>
<td>5.7</td>
<td>18.0</td>
<td>20.0</td>
<td>20.4</td>
<td>37.3</td>
<td>9.0</td>
<td>10.2</td>
<td>23.9</td>
</tr>
<tr>
<td>Post UR</td>
<td>1.5</td>
<td>3.5</td>
<td>3.6</td>
<td>8.3</td>
<td>13.2</td>
<td>36.9</td>
<td>28.0</td>
<td>4.8</td>
<td>9.1</td>
<td>24.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Japan</th>
<th>US</th>
<th>EU</th>
<th>Rep.of Korea</th>
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<th>Indonesia</th>
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</thead>
<tbody>
<tr>
<td>Pre UR</td>
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<td>100</td>
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<td>9</td>
</tr>
<tr>
<td>Post UR</td>
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<td>100</td>
<td>100</td>
<td>89</td>
<td>96</td>
<td>92</td>
<td>70</td>
<td>100</td>
<td>79</td>
<td>66</td>
</tr>
</tbody>
</table>

**Notes:**

1. Japanese figures are based on the Ministry of Economics, Trade and Industry calculations (excluding petroleum and forestry and fishery products). Average bound tariff rates are 1.7 percent in the industrial sectors including forestry and fishery products.

2. GATT Secretariat calculations are used for other countries (excluding petroleum).

3. Average bound tariff rates are trade-weighted average. Average bound tariff rate equals the sum over each tariff line of import value multiplied by the bound rate ÷ total import value of bound tariff lines × 100.
4. Scope of bindings rates is the trade-weighted average. Scope of bindings rates equals total import value of bound tariff line ÷ total import value.

5. “Pre UR” and “Post UR” refer to tariffs before and after implementation of Uruguay Round commitments.