PART I
CHAPTER 1  MOST-FAVoured-NATION TREATMENT PRINCIPLE

1. OVERVIEW OF RULES

(1) The Background of Rules: Most-Favoured-Nation Treatment (MFN)

“Most-Favoured-Nation treatment” or “MFN,” which 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” of all other Members, is one of the bedrock principles of the WTO. Under the Most-Favoured-Nation rule, should WTO Member state A agree in negotiations with state B, which needs not be a WTO Member, to reduce the tariff on the same 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 handle all Members equally regarding the same issue.

The idea of Most-Favoured-Nation treatment in and of itself 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, several measures that limited the functioning of the Most-Favoured-Nation principle were taken. It is said that these measures led to the division of the world economy into trade blocs. Having learned from this mistake, after World War II, the unconditional Most-Favoured-Nation clause was then 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 free trade system. Regional integration and related exceptions need to be carefully administered so as not to undermine the MFN principle as a fundamental principle of the WTO.

(2) Legal Framework

(i) GATT Practice Regarding MFN Treatment

MFN treatment is stipulated in GATT Articles I, XIII, and XVII.

(a) GATT Article I:1

GATT Article I:1 provides for WTO Members to accord Most-Favoured-Nation 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 accord differential treatment to “like products” of the exporting country, i.e. by setting different tariff rates, it would be clearly a violation of GATT Article I:1. However, Article I:1 violations can also occur even when there is no ostensible discrimination against the product of a Most-Favoured-Nation, such as when an importing country accords differential treatment among products that are considered to be “like products,” which ultimately results in the de facto discrimination against products of specific contracting parties. For instance, a country may apply a different tariff rate to a particular variety of raw coffee bean, but if that variety and other varieties of coffee beans were considered to be “like products,” using criteria such as consumer tastes and end-use, the differential tariff may have an effect on imports from only specific countries. This may be considered in violation of the MFN rule.¹ In contrast, the concept of like products was strictly interpreted in Japan’s SPF (spruce, pine, and fir) case. 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.²

(b) Non-Discriminatory Administration of Quantitative Restrictions

GATT Article XIII stipulates that quantitative restrictions or tariff quotas on any product must be administered in a non-discriminatory fashion regarding like products, and that in administering import restrictions and tariff quotas, WTO Members shall aim to allocate shares close to that which might be expected in their absence. Article XIII provides for most-favoured-nation treatment in the administration of quantitative restrictions, and supplements the disciplines under Article I.

(c) States Trading Enterprises

“States Trading Enterprises” means state enterprises established or maintained by a WTO Member or private enterprises granted exclusive or special privileges by WTO Members, which make purchases or sales involving either imports or exports. By making use of their monopolistic status, such enterprises could operate against 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 rule of non-discrimination, including the MFN.

¹ Spain - Tariff Treatment of Unroasted Coffee, BISD 28S/102
² Canada/Japan: Tariff on Imports of Spruce, Pine, Fir (SPF) Dimension Lumber, BISD 36S/167
(ii) **Exceptions to the Most-Favoured-Nation Rule**

The GATT provides for certain exceptions to the Most-Favoured-Nation rule described above.

(a) **Regional Integration (GATT Article XXIV)**

Regional integration liberalizes trade among countries within the region, while allowing trade barriers with countries outside the region. Regional integration therefore may lead to results that are contrary to the Most-Favoured-Nation principle because countries inside and outside the region are treated differently. This may have a negative effect on countries outside the region, and thus lead to results contrary to the liberalization of trade. Therefore, GATT Article XXIV provides that regional integration may be allowed as an exception to the Most-Favoured-Nation 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 establishment of regional integration.

Regional integration has a vast impact on the world economy today and is the subject of frequent debate in a variety of forums, including the WTO Committee on Regional Trade Agreements. (For details, see Chapter 15 on Regional Integration.)

(b) **Generalized System of Preferences**

The Generalized System of Preferences or “GSP” is a system that grants products originating in developing countries lower tariff rates than those normally enjoyed under Most-Favoured-Nation status as a special measure granted to developing countries in order to increase their export earnings and promote their development.

The GSP is defined in the Decision on “Generalized System of Preferences” of June 1971, and is a measure taken based on the Decision on “Differential and More Favourable Treatment, Reciprocity, and Fuller Participation of Developing Countries” or the “Enabling Clause.” The GSP has the following characteristics:

First, preferential tariffs may be applied not only to countries with special historical and political relationships (e.g. the British Commonwealth), but to developing countries more generally (thus the system is described as “generalized”).

Second, the beneficiaries are limited to developing countries.

Third, it is a benefit unilaterally granted by developed countries to developing countries.

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3 Decision of the Contracting Parties of 28 November 1979, BISD 26S/203.
4 See (d) Other Exceptions.
(c) 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 either of the following conditions are met: (a) at the time the WTO went into force, Article XXV of GATT 1947 had been invoked earlier and was effective as between original Members of the WTO which were contracting parties to GATT 1947; 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 most-favoured-nation principle.

These Article XIII provisions were created to deal with problems arising from accessions. Ideally, the most-favoured-nation rule would be applied stringently so that when country B accedes to the Agreement, it is required to confer most-favoured-nation status on all other Members, and they, in turn, are required to confer most-favoured-nation 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. The WTO only requires the consent of two-thirds of the existing membership for accession, so it is conceivable that country A might, against its will, be forced to give most-favoured-nation 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 two other new Members: Mongolia and Kyrgyz Republic.

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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 is 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.”
(d) Other Exceptions

Other exceptions peculiar to the Most-Favoured-Nation principle include Article XXIV:3 regarding frontier traffic with adjacent countries, and Article I:2 regarding historical preferences which 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 Most-Favoured-Nation 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 constitute an exception to the Most-Favoured-Nation principle. Under WTO Article IX:3, countries may, with the agreement of other contracting parties, waive their obligations under the agreement. New waivers, however, can only be obtained for exceptional circumstances, and require the consent of three-quarters of the contracting parties. It is stipulated that the 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, and that waivers are subject to annual review (Article IX:4).

(iii) Most-Favoured-Nation Provisions Outside of GATT 1994

The idea of most-favoured-nation 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 most-favoured-nation treatment for services and service providers; Article 4 of the Agreement on Trade-Related Aspects of Intellectual Property Rights does the same for the protection of intellectual property rights. The GATS allows for exceptions where Members may waive their obligation to provide most-favoured-nation 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.)

(3) Economic Implications

The most-favoured-nation rule has several positive economic implications, which are discussed below.

Increased Efficiency in the World Economy

First, most-favoured-nation 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 A does not produce product X, and 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 Xs from country B than to product Xs from country C, country A may end up importing product Xs from country C, even though country C is not as efficient a supplier. This distorts trade and, as a result, reduces the welfare of country A and the economic efficiency of the entire world. If, however, the Most-Favoured-Nation principle is applied between the three countries, then country A will apply its tariffs equally to all exporting countries and will 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 Free Trading System**

Second, the most-favoured-nation rule requires that favourable treatment granted to one country be immediately and unconditionally granted to all other countries, while trade restrictions 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 Free Trade System**

Third, MFN reduces the cost of maintaining the free trade system. The equal treatment demanded by the Most-Favoured-Nation principle tends to act as a force for unifying treatment at the most advantageous level (which in trade means the most liberal level). The establishment and maintenance of the most-favoured-nation rule enables WTO Members to reduce their monitoring and negotiation costs - the cost of watching and comparing treatment received with that given to third countries - and of negotiating remedies to 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 most-favoured-nation 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.

Thus the most-favoured-nation rule is of fundamental importance in improving economic efficiency. However, we must also note that the most-favoured-nation rule is often misused. The arguments run that bilateral negotiations not under the auspices of the WTO can be justified by the most-favoured-nation principle, because 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 time-saving and effective means to remove “unfair” trade measures. However, this does not take into account the fact that because bilateral negotiations lack transparency, there is a possibility that MFN treatment is not extended to countries not in the negotiation, and the fact that bilateral negotiations tend to reflect the power relationship between the two countries. Even if the results of the negotiations are extended through the MFN principle, it must be noted that
the end “result” of improved treatment in trade does not necessarily justify the means, that is unfairness of procedure in bilateral negotiations. Continual vigilance is required to ensure that the most-favoured-nation rule is not abused in a result-oriented manner to undermine the basic importance of the dispute settlement process in the WTO.

2. PROBLEMS OF TRADE POLICIES AND MEASURES IN INDIVIDUAL COUNTRIES

The MFN principle is used often in GATT disputes as a basic principle of the GATT together with national treatment. However, in this case, it is rare for MFN to be invoked on its own, and articles regarding national treatment, quantitative restrictions, TRIMs, rules of origin, and standards and conformity assessment are often cited in conjunction (See Table 1-1). In this chapter, 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.

<Figure 1-1> Issues Regarding Most-Favoured-Nation Treatment

<table>
<thead>
<tr>
<th>Country</th>
<th>Issue</th>
<th>Description of problem</th>
<th>Refer to</th>
</tr>
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<tbody>
<tr>
<td>United States</td>
<td>Yellow-fin tuna</td>
<td>Discriminates between like products on the basis of whether the country of origin has specific policies for yellow-fin tuna.</td>
<td>Chapter 3 (Quantitative Restriction)</td>
</tr>
<tr>
<td>United States</td>
<td>Shrimp</td>
<td>Discriminates between like products on the basis of whether the country of origin has specific policies for sea turtles.</td>
<td>Chapter 3 (Quantitative Restriction)</td>
</tr>
<tr>
<td>Korea</td>
<td>Import Diversification Program</td>
<td>Erects quantitative restrictions against a specific country (Japan).</td>
<td>Chapter 3 (Quantitative Restriction)</td>
</tr>
<tr>
<td>Indonesia</td>
<td>National Car Programme</td>
<td>Provides special treatment to imports from a specified country (Korea) in the form of waivers of tariffs when finished cars are imported and luxury taxes when they are sold.</td>
<td>Chapter 2 (National Treatment Principle)</td>
</tr>
<tr>
<td>Canada</td>
<td>Automobiles</td>
<td>Provides tariff exemptions to only certain companies (Autopact members), only imported products from certain countries receive tax exemptions.</td>
<td>This Chapter</td>
</tr>
<tr>
<td>European Union</td>
<td>Bananas</td>
<td>Violates Most-Favoured-Nation treatment because bananas are treated differently depending on whether they come from former colonies in the ACP (Africa, Caribbean Pacific) or from Latin America, even though they constitute like products.</td>
<td>This Chapter</td>
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</tbody>
</table>

Canada

Measures Regarding Automobiles
Canada introduced measures that allow certain companies such as the “Big Three” US automobile manufacturers (Autopact members), to import automobiles at a zero tariff, under the condition that they satisfy certain conditions (such as a local content requirement of 60 percent) under the Autopact (The United States-Canada Automotive Products Trade Agreement: effective since 1966). It is stipulated that new members will not be added to the Autopact, but preferential treatment regarding these companies has been maintained in the NAFTA.

When automobile companies import automobiles from outside NAFTA countries, non-Autopact Members are levied 6.1 percent tariffs (as of January 1999), while Autopact members can import them duty-free.

By exempting only Autopact members from automobile tariffs, it is clear that there is discrimination between foreign companies, while it is not clear that there is any discrimination between imported products or suppliers of service in specific countries. However, taking into account the fact that these companies are service suppliers who import and sell these products, this measure, by providing preferential treatment to companies from specific countries, is inconsistent with Article II of the GATS (MFN). There is also a possibility that this measure is inconsistent with GATT Article I (MFN) in that it is possible for products from only certain countries to be imported duty-free, thus only imports from certain countries are provided preferential treatment de facto.

This measure also appears to be in violation of GATT Article III:4 (National Treatment), Article 2 of the TRIMs Agreement, and Article 3.1(b) of the Agreement on Subsidies and Countervailing Measures in that the tariff exemption may be an incentive for the Autopact Members to maintain the local content requirement.

In July 1998, Japan requested bilateral consultation under the WTO dispute settlement system and in September it held consultations with Canada. However, a mutually satisfactory solution was not reached. As a result, in November 1998, Japan requested the establishment of a panel. Since the European Union filed a separate complaint regarding the same matter, a single panel to hear complaints by both Members was established in February 1999.

<Reference> Measures Regarding Bananas of the European Union

The European Union maintains measures which provide preferential treatment to countries of Africa, the Caribbean, and the Pacific (ACP) regarding tariff quotas (i.e. quota and tariff rate), under the Lomé Convention, and 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 on the one hand and the United States and some Latin American countries (Ecuador, Guatemala, Honduras, and Mexico) on the other, 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.

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

(ii) 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.

(iii) 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 contracting parties that had a substantial interest in supplying the EU market, the EU’s allocation of tariff quota shares by agreement and by assignment to some Members not having a substantial interest in supplying bananas to the EU (including Nicaragua and Venezuela) but not to other Members (such as Guatemala) 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.

The European Union appealed from this panel report, but the report of the Appellate Body basically upheld the main points of the panel report. At the Dispute Settlement Body meeting in September 1997, both the panel report and Appellate Body report were adopted, and the EU’s measures were found inconsistent with the WTO Agreements. In accordance with this decision, in July 1998, the European Union announced its plan to reform these measures. However, the complaining Members argued that the plan - which may still accord unfair preferential treatment to ACP countries – was in violation of the WTO Agreement. The EU introduced the new banana import system in January 1999, which was the deadline for implementing the DSB’s recommendation. The United States announced that it intended to apply sanctions against the EU pursuant to Section 301 of the US Trade Act, insisting that this new system was still inconsistent with the DSB’s recommendation.6

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6 See Chapter 14 on Unilateral Measures.