CHAPTER 2 NATIONAL TREATMENT PRINCIPLE

1. OVERVIEW OF RULES

(1) The Background of Rules: National Treatment Principle

National treatment (GATT Article III) stands along side most-favoured-nation treatment as one of the central principles of the WTO Agreement. Under the national treatment rule, Members must not accord discriminatory treatment between imports and like domestic products - with the exception of the imposition of tariffs, which is a border measure. The GATS and the TRIPS Agreement have similar provisions. This is to prevent countries from taking discriminatory measures on imports on the one hand, and to prevent countries from offsetting the effects of tariffs through non-tariff measures. An example of the latter could be where Member A reduces the import tariff on product X from ten percent to five percent, only to impose a five percent domestic consumption tax only on imported product X, effectively offsetting the five percentage point tariff cut. The purpose of the national treatment rule is to eliminate “hidden” domestic barriers to trade by WTO Members through according imported products treatment no less favourable than that accorded to products of national origin. The adherence to this principle is important to maintain the balance of rights and obligations, and is essential for the maintenance of the multilateral trading system.

(2) Legal Framework

(i) GATT Article III

GATT Article III requires that WTO Members provide national treatment to all other Members. Article III:1 stipulates the general principle that Members must not apply internal taxes or other internal charges, laws, regulations and requirements affecting imported or domestic products so as to afford protection to domestic production.

In relation to internal taxes or other internal charges, Article III:2 stipulates that WTO Members shall not apply standards higher than those imposed on domestic products between imported goods and “like” domestic goods, or between imported goods and “a directly competitive or substitutable product.” With regard to internal regulations and laws, Article III:4 provides that Members shall accord imported products treatment no less favourable than that accorded to “like products” of national origin.

In determining the likeness of “like products,” panel conclusions in the past have relied on a number of criteria including tariff classifications, the product’s end uses in a given market, consumer tastes and habits, and the product’s properties, nature and quality. The same idea can be found in reports by WTO panels and the Appellate Body.
(ii) **Exceptions to GATT Article III (National Treatment Rule)**

Although national treatment is a basic principle under the GATT, the GATT provides for certain exceptions as follows.

(a) **Government Procurement**

GATT Article III:8(a) permits governments to purchase domestic products preferentially, making government procurement one of the exceptions to the national treatment rule. This exception is permitted because the WTO Members recognize the role of government procurement in national policy. For example, there may be a security need to develop and purchase products domestically, or government procurement may, as is often the case, be used as a policy tool to promote smaller business, local industry or advanced technologies.

While the GATT made government procurement an exception to the national treatment rule, the Agreement on Government Procurement resulting from the Uruguay Round mandates signatories to offer national treatment in their government procurement. However, the WTO Members are under no obligation to join the Agreement on Government Procurement. In fact, it has mostly been developed countries who have joined the Agreement. Therefore, in the context of government procurement, the national treatment rule applies only between those who have acceded to the Agreement, and for others, the traditional exception is still in force.¹

(b) **Domestic Subsidies**

GATT Article III:8(b) allows for the payment of subsidies exclusively to domestic producers as an exception to the national treatment rule, under the condition that it is not in violation of other provisions in Article III and the Agreement on Subsidies and Countervailing Measures. The reason for this exception is that subsidies are recognized to be an effective policy tool, and is recognized to be basically within the latitude of industrial policy authorities. However, because subsidies may have a negative effect on trade, the Agreement on Subsidies and Countervailing Measures imposes strict disciplines on the use of subsidies.²

(c) **GATT Article XVIII:C**

Members in the early stages of development can raise their standard of living by promoting the establishment of infant industries, but this may require government support and the goal may not be realistically attainable with measures that conform to the GATT. In such

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¹ See Chapter 8 on Government Procurement.
² See Chapter 6 on Subsidies and Countervailing Measures.
cases, countries can use the provisions of GATT Article XVIII:C to notify WTO Members and initiate consultations. After consultations are completed and under certain restrictions, these countries are then allowed to take measures that violate GATT provisions excluding Articles I, II and XIII. Unlike the trade restrictions for balance of payment reasons in GATT Article XVIII:B, the Article XVIII:C provisions allow both border measures and violations of the obligation to national treatment in order to promote domestic infant industries. In the case concerning Malaysia’s import permit system of petrochemical products, Malaysia resorted to GATT Article XVIII:C as a reason to enforce import restrictions on polyethylene. However, Singapore – which was a complaining country – withdrew its complaints and therefore a panel or the Appellant Body did not have an opportunity to rule on the case.\(^3\)

(d) Other Exceptions to National Treatment

Exceptions peculiar to national treatment include the exception on cinematograph films under Article III:10 and Article IV. The provisions of GATT Article XX on general exceptions, Article XXI on security exceptions, and WTO Article IX on waivers also apply to the national treatment rule. For further detail see the relevant sections of Chapter 1 (Most-Favoured-Nation Treatment Principle).

(iii) National Treatment Rules Outside of GATT Article III

With the entry into force of the WTO Agreement, the idea of national treatment has been extended, although in a limited fashion, to agreements on goods, services and intellectual property. Among the goods agreements, for instance, Article 5.1.1 of the TBT Agreement also addresses national treatment. GATS Article XVII provides national treatment for services and service providers and Article 3 of the TRIPS Agreement provides national treatment for the protection of intellectual property rights. The plurilateral Agreement on Government Procurement also contains a national treatment clause. (See the relevant chapters for more information on Trade in Services, Intellectual Property Rights, and Government Procurement.)

(3) Economic Implications

There is a tendency for importing countries to attempt to use discriminatory application of domestic taxes and regulations to protect national production, often as the result of protectionist pressures from domestic producers. This distorts the conditions of competition between domestic and imported goods and leads to a reduction in economic welfare.

The national treatment rule does not in principle permit these sorts of policies designed to protect domestic products. GATT Article II does permit the use of tariffs as a means of

\(^3\) Malaysia – Prohibition of Imports of Polyethylene and Polypropylene (WT/DS1)
protecting domestic industry, but this is because tariffs have high degrees of transparency and predictability since they are published and committed to in tariff schedules. On the other hand, domestic taxes and regulations are “hidden barriers to trade” that lack both transparency and predictability, which means that they have a large trade-distortive impact. The existence of GATT Article III generally impedes the adoption of policies and measures aimed at domestic protection, and promotes trade liberalization.

In addition, regarding tariff concessions, GATT Article II recognizes tariffs as tools for domestic industrial protection, and having done so, sets a course for the achievement of liberalization through gradual reductions. Even if tariff reductions were made as a result of trade negotiations, if domestic taxes and regulations were to be applied in a discriminatory fashion to protect domestic industry simultaneously, then effective internal trade barriers would remain. The national treatment rule prohibits countries from using domestic taxes and regulations to offset the value of tariff concessions and is, therefore, a significant tool in promoting trade liberalization.

2. PROBLEMS OF TRADE POLICIES AND MEASURES IN INDIVIDUAL COUNTRIES

National treatment provisions, as well as the MFN clause, are often invoked in WTO disputes. However, an argument on national treatment is rarely made on its own; instead, the national treatment principle is usually invoked in conjunction with other provisions regarding MFN, quantitative restrictions, TRIMs, and standards and conformity assessment (see Table 2-1). In this Chapter, we take up the United States’ Harbour Maintenance Tax, Korea’s Commercial Loans for Purchase of Domestic Machinery, Indonesia’s National Car Programme, and the Brazilian Automobile Policy, four cases in which national treatment is a major issue. In principle we have left detailed descriptions of other cases to other chapters.

(1) United States

Harbour Maintenance Tax

Since 1987, in accordance with the Water Resources Development Act (1986 Public Law 99-662) and related amendments, the United States has operated a system that is designed to impose ad valorem taxes of 0.125 percent (0.04 percent until 1990) as to freight (imports and exports and parts of national freight) on persons who own the freight and use harbours within the territory of the United States.

Under this system, imported products are almost inevitably subject to the tax since it is collected at the point of importation, where relevant duties are charged. On the other hand, the tax burden on exports and national freight is comparatively light because ship-owners or exporters voluntarily pay the tax in these circumstances on a quarterly basis. With regard to national freight, exceptions to this system are allowed in the following three cases: (a)
payment under ten thousand dollars per quarter, (b) traffic in Alaska, Hawaii and dependencies, and (c) landing of fish from ships, and some freights of Alaskan crude oil. Yet similar exceptions are not allowed for imported products. An annual limit of the above-mentioned ad valorem taxes that are to be granted to US military personnel is five hundred million dollars. It is reported that, as of October 1997, a surplus of 1.1 billion dollars has accumulated.

This new system instituted by the United States may be in violation of the WTO Agreement in the following three respects.

(a) GATT Article II (Schedules of Concessions): The system, which adopts the ad valorem taxes on import products, imposes a tax that is higher than that prescribed in the schedules of concessions;

(b) GATT Article III (National Treatment): Imported products are accorded less favourable treatment as explained above.

(c) GATT Article VIII (Fees and Formalities Connected with Importation and Exportation): The system is designed to levy charges that are heavier than fees for the maintenance of harbours.

In February 1998, the European Union requested consultations with the United States regarding this system pursuant to GATT Article XXII. Japan has participated in the consultations as a third party.

In October 1995, the US Court of International Trade ruled that the system violated the US Constitution prescribing the prohibition of direct taxation on export products. In June 1997, the Court of Appeals for the Federal Circuit, supporting this decision, ordered the prohibition of these taxes on the maintenance of harbours and the refund of collected taxes (about 1.1 billion dollars). In March 1998, the Supreme Court of the United States also delivered a similar judgement regarding the unconstitutionality of the tax. In accordance with this decision, the US Government decided not to collect the tax from exporters or exports from 25 April 1998. However, the problems above have not been solved yet.

Hence, we must closely observe what kind of measures the United States will take in the future and should make repeated requests to the United States to make the system compatible with the WTO Agreement.

2) Korea

Commercial Loans for Purchase of Domestic Machinery

Korea decided to take several measures in its so called “Campaign to Raise Industrial Competitiveness by ten percent,” which started in January 1997. One of these measures enables a company to receive low interest foreign financing for plant and equipment investment projects under the condition that 50 percent of the procured machinery is domestically produced (value based).

Measures which enable low interest financing for only domestic machinery may well
have been in violation of GATT Article III (national treatment). In December 1997, however, without regard to usage or requirements, Korea launched commercial loans to enterprises on a time-limited basis (for one year). Mid to long-term foreign funding by enterprises was already liberalized as a result of the amendment to the Foreign Exchange Control Regulation starting in July 1998. In addition, under the Foreign Exchange Trade Law, effective on 1 April 1999, full liberalization of foreign exchange trade is to be achieved. Under this trend of liberalization, the measure that we addressed in the 1998 Report was abolished in November 1998. We welcome this movement toward liberalized foreign exchange trade.

<Figure 2-1> National Treatment Problems

<table>
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<th>Country</th>
<th>Issue</th>
<th>Description of problem</th>
<th>Refer to</th>
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<tr>
<td>United States</td>
<td>Harbour Maintenance Tax</td>
<td>Designed to impose <em>ad valorem</em> taxes at to freight, however, certain exceptions are permitted to exporters and domestic products. Also only importers are imposed when they pay customs tariffs.</td>
<td>This Chapter</td>
</tr>
<tr>
<td>Korea</td>
<td>Commercial Loans for Purchase of Domestic Machinery</td>
<td>Enables low interest financing only to companies which purchase a certain percentage of domestic machinery. Abolished in November 1998.</td>
<td>This Chapter</td>
</tr>
<tr>
<td>Indonesia</td>
<td>National Car Programme</td>
<td>Provides preferential taxation in return for the achievement of set local content rates is a measure that is conditional upon priority use of domestic products over imports.</td>
<td>This Chapter, Chapter 6 (Subsidies and Countervailing Measures)</td>
</tr>
<tr>
<td>United States</td>
<td>Foreign Sales Corporations (FSC)</td>
<td>Tax exemptions regarding FSCs only cover products whose market value is over 50 percent domestic.</td>
<td>Chapter 6 (Subsidies and Countervailing Measures)</td>
</tr>
<tr>
<td>India</td>
<td>Local content requirements for automobiles</td>
<td>Local content requirements and import restrictions regarding parts dependant on the accomplishment of export performance are measures that are conditional upon priority use of domestic products over imports.</td>
<td>Chapter 8 (TRIMs)</td>
</tr>
<tr>
<td>United States</td>
<td>Corporate Average Fuel Economy (CAFE) regulations</td>
<td>Requires that the average fuel economy for all models handled by an auto company be above certain levels, but calculates domestic cars and imports as different groups. This is discrimination between like products according to whether they are domestic and foreign.</td>
<td>Chapter 10 (Standards and Conformity Assessment Systems)</td>
</tr>
<tr>
<td>United States</td>
<td>Gasoline regulations</td>
<td>Prevent imported gasoline from enjoying the advantageous sales conditions that domestic gasoline enjoys. This is discrimination between like products according to whether they are domestic.</td>
<td>Chapter 17 (Interpretation and Application of Existing WTO Rule)</td>
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<Column> Indonesian National Car Programme

The “National Car Policy” which the Indonesian Government announced in February 1996 raises various issues discussed in this Report. We will provide a general analysis in this chapter.
1. Past Automotive Industry Policy

Under a Minister of Industry Decree published in June 1993 and effective 1 January 1994, Indonesia applies differential tariff rates to parts used in the assembly of domestic automobiles and a reduction of the luxury tax from 35 percent to 20 percent depending on the achievement of certain levels of local content of a manufacturer's completed cars. The automobile deregulation package issued in May 1995 also applies differential tariff rates.

Under the Agreement on Trade-Related Investment Measures (the “TRIMs Agreement”), Indonesia would have been able to maintain this system as an “existing measure” through the transitional period to the end of 1999 if it had notified the WTO thereof by the end of March 1995. It failed to do so within this period, instead issuing a late notification in June 1995. (Later, during GATT Article XXII consultations with Japan, the EU and the United States, Indonesia withdrew this notification in an attempt to ensure consistency with the arguments it made in the consultations.)

2. New Establishment and Strengthening of Measures Related to the National Car Programme

(1) Enactment of the “National Car Programme” and Creation of New Advantageous Measures

Indonesia unfurled Presidential Decree No. 2 in February 1996 and immediately proceeded with the enactment of implementing legislation to flesh out a new “National Car Programme.” Under the programme, only “PT Timor Putra Nasional” was designated as a “pioneer” company and only “national cars” manufactured by this company were made eligible for special tax breaks under the conditions that it satisfy the local content requirement and other requirements. PT Timor Putra Nasional chose Kia Motors Corp., Korea, as its partner and Kia's “Sephia” became the base model for the “national car” to be produced by PT Timor Putra Nasional.

(2) Strengthening of Measures Related to the National Car Programme

Since this new National Car Programme may not be justified as a pre-existing measure eligible for the transitional period under the TRIMs Agreement, Japan urged Indonesia to correct its National Car Programme during bilateral consultations and many other WTO Members expressed their serious concerns with it in several WTO committees. In spite of this, in June 1996, the government of Indonesia published Presidential Decree No. 42 and concomitant ordinances that allow complete vehicles produced overseas to be imported tariff-free as “National Cars” (ordinary tariff and levy is 125 percent duty and 75 percent import
levy), and luxury tax free (ordinarily the luxury taxes of 35 percent is levied), as long as
Indonesian workers participate in overseas production of the vehicle and certain other
conditions are met (the foreign producer counter-purchases from Indonesian auto parts worth
25 percent of the value of the automobiles to be imported thereunder). This measure extended
discriminatory special advantages to automobile imports from Korea in substance and,
therefore, was a concern for many countries.

3. Japan’s Request for Consultations under Article XXII of the GATT

Although Japan urged Indonesia to correct the measure during bilateral discussions, in
light of the fact that sales of the “National Car” started October 1996, Japan, in parallel with
the EU and the United States, requested consultations with the government of Indonesia under
GATT Article XXII. The bilateral consultations did not result in a mutually satisfactory
agreement, and a panel was established in June 1997.

Below are the main legal arguments made by Japan.
(1) The exemption of luxury taxes for “National Cars” produced within Indonesia after the
second year is in violation of GATT III:2 (national treatment in terms of internal taxes).
(2) The provision of (a) tariff exemptions for parts imports, and (b) luxury tax exemptions for
finished “National Cars” as incentives to meet certain levels of local content rates violates
several provisions including, among others, GATT Article III:4 (non-discrimination between
domestic and foreign products in terms of domestic legislation and regulations) and Article II
of the Agreement on Trade-Related Investment Measures.
(3) The exemption from customs duties and from the luxury tax provided for in favour of the
“National Cars” assembled by Kia Motor Corp. in the Republic of Korea accord an advantage
to the imports from a specific country and thus violates Article I of the GATT (most-favoured-
nation treatment), and should the legal grounds for duty-free imports be unclear it may also
constitute a violation of GATT Article X (uniform, impartial and reasonable administration of
trade regulations).

Subsequently, a series of Asian monetary crises beginning around July 1997 threatened
Indonesia and its currency, the rupiah, collapsed dramatically. On 15 January 1998, the
“Economic and Financial Resilience Council” in Indonesia announced a structural reform
programme under an agreement with the IMF in relation to the financial crisis, which states
that preferential measures regarding the National Car Programme shall be abolished by
Presidential Decree No. 20. Japan should continue to monitor the progress of the abolishment.

On 2 July 1998, a panel published a final report in which complaining Members’
assertions (including Japan) were largely accepted. In a DSB meeting held in July 1998,
Indonesia declared that it would fully implement the Measure of 1993 – which still exists after
its abolition by Presidential Decree No. 20 and requires amendments of national legislation -
by 23 October 1999 (i.e. within the fifteen months, which is the longest period allowed under
the DSU.)
However, the EU argued that the fifteen months for implementation declared by Indonesia were too long and that the period had no rational ground. Since consultation between the complainants (Japan, the United States and EU) and the respondent (Indonesia) was arranged but no agreement was reached. As a result, it was decided that an arbitration procedure under DSU Article 21.3 should be instituted.

In 7 December 1998, the arbitrator, accepting EU’s assertion in principle, published the award that the period for implementation should be twelve months (i.e. 22 July 1999). Thus, a series of dispute settlement procedures on this case came to an end, and it is now hoped that Indonesia will comply with the recommendation.

The Indonesian government has notified PT Timor Putra Nasional that it should pay taxes, interests, fines, and tariffs. It also decided to impose import tariff and luxury tax on the national car “Timor,” whether sold or unsold. The amount of taxes would be over three trillion rupiah on fifty four thousand cars. With regard to governmental decision, PT Timor Putra Nasional decided not to pay taxes, opposing the decision. In light of these developments, Japan should continue to monitor the implementation of the recommendation by the DSB.

<Column> Brazilian Automobile Policy

The Government of Brazil introduced measures regarding automobiles in the period between June 1995 and December 1995. Investment measures thought to be in violation of the GATT, the TRIMs Agreement, and the Agreement on Subsidies and Countervailing Measures among others were included. Japan made the Brazilian Government a request for consultations under Article XXII of the GATT.

Brazil did not offer any specific improvements to its investment incentive measures in the informal and formal consultations that were held during 1996, but in August 1996 and in September 1998, it announced, as a unilateral measure, a Presidential Decree on tariff quotas that would give reduced tariff quotas to auto importers who did not enjoy the benefits of the investment incentive measures. Brazil implemented a similar measure in August 1997. While this move can be appreciated as an improvement in market access, the problems still remain since the investment incentive measures themselves are still in place. Japan should continue to monitor the administration of the investment measures and the tariff quotas.

In addition, Brazil is to abolish its existing investment-related measures by the end of 1999 and we need to closely observe gradual abolition of the measures by Brazil.