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## **The Economics and Politics of Non-Discrimination in the WTO**

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## **The Economics and Politics of Non-Discrimination in the WTO**

### ***I. Introduction***

- The most-favoured-nation (MFN) principle is typically characterised as the cornerstone of the multilateral trading system. The MFN principle states that:

“..... any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.”

- In short, MFN prohibits discrimination among fellow signatories of the WTO agreements in respect of “like products.” All countries must be treated the same.
- Similarly, the principle of national treatment (NT) also requires non-discrimination, but in this case between national and foreign products. Article III:4 of GATT 1947 states that:

“The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.”

- The principles of MFN and NT are complementary. MFN applies to both border and internal measures, but NT only applies with respect to internal measures. While MFN ensures equal treatment among foreign like products, NT is concerned with the treatment accorded to foreign products in relation to like domestic or national products.<sup>1</sup>
- With the introduction of the General Agreement on Trade in Services (GATS) at the time of entry into force of the WTO in 1995, the application of these principles was extended beyond products to cover producers as well. Thus, GATS provisions are concerned with services and service suppliers.
- Together, these principles define the notion of non-discrimination in the multilateral trading system. In virtually all discourse about the WTO, non-discrimination is trumpeted as a virtue and strength of the system. A key question, then, is whether non-discrimination, as expressed through MFN and NT, is always an optimal policy. In other words, is the principle of non-discrimination an unqualified virtue of the system that deserves to be defended under all circumstances, such that exceptions to the rule must be seen as a manifestation of policy failure – an inability of governments to follow best practice? Or do sanctioned departures from the non-discrimination rule in effect contribute to the overall coherence of the system, making up a rational part of the whole that does not necessarily carry economic or political costs, and may indeed be advantageous? Answers to these questions condition conclusions about the effectiveness of the multilateral trading system, its stability and durability. In analytical terms, economic theory provides valuable insights into the optimality question – is MFN always the best policy rules from

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<sup>1</sup> The standard for comparison between products is different between MFN and NT, since in the latter case “likeness” has been interpreted also to cover “directly competitive or substitutable products.”

a welfare perspective? But there is clearly a range of political economy questions to consider as well, not so easily answered in purely economic terms.

### *Plan of the Paper*

- The rest of the paper is divided into four sections. Section II reviews the main economic arguments based on welfare considerations for MFN versus non-MFN trade. Section III takes up a range of other considerations that might influence views taken as to the desirability of non-discrimination. Section IV examines the different grounds upon which exceptions are made to the non-discrimination rule in the GATT/WTO Agreements and assesses these different departures in terms of the discussion in Section II and Section III. Finally, Section V concludes.

## *II. Economic Arguments<sup>2</sup>*

- If free trade is permitted under assumptions of perfect competition the issues of MFN is moot. Neither tariffs nor any other barriers to trade are present, so the question of discrimination simply does not arise.
- If a non-free trade optimum were defined, such that tariffs were required in order to reduce trade flows below their free trade level, then it could be the case that a non-discriminatory tariff would be the most efficient intervention – most straightforwardly under conditions of perfect competition.
- But when other assumptions are introduced, such as returns to scale, the theoretical case for non-discriminatory tariffs may no longer hold. There can be no automatic presumption on standard economic welfare grounds in favour of non-discriminatory tariffs.
- Where countries can affect world prices and change the welfare calculus in their favour via terms of trade effects, differential export supply elasticities among sources of supply will also justify departures from MFN.
- Additionally, under liberalization scenarios, where countries are moving from one tariff structure to another, second-best considerations may yield outcomes where discriminatory tariff reductions can increase global welfare. The case depends entirely on the counter-factual, given the second-best nature of this scenario. In other words, if the alternative is between discriminatory liberalization and no liberalization, the former may trump the latter in welfare terms – the result depends on prior tariff levels and the degree of discrimination involved. These are essentially the welfare analytics underlying regionalism, preferences, etc.
- In sum, Harry Johnson<sup>3</sup> goes as far as to argue that “the principle of non-discrimination has no basis whatsoever in the theoretical argument for the benefits of a liberal international trade order in general, or in any rational economic theory of the bargaining process in particular.”

## *III. Political Economy and Other Considerations*

- If economic theory gives such limited justification for a strong MFN rule, why is so much made of the virtues of MFN in the context of the multilateral trading system? A mixture of economic and political economy considerations may offer some explanation. In purely political terms, there is an argument about perceptions of fairness. Non-discrimination may have value as a ground

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<sup>2</sup> The most developed discussions of the economics of MFN are to be found in Horn and Mavroidis (2001) and Schwartz and Sykes (1996).

<sup>3</sup> Johnson (1976).

rule for trade relations merely by virtue of the notion that alternative arrangements would generate suboptimal levels of international cooperation.

- An additional “political buy-in” argument may be that MFN serves the idea that large and small trading countries are contracting to cooperate on a level playing field on the basis of fair rules that “even up the odds.” Does a non-discrimination rule take the politics out of trade, helping to replace “the law of the jungle with the rule of law”?
- Public choice considerations suggest a case for a simple decision rule over a “made-to-measure” approach in tariff-setting. Welfare levels may be reduced if private interests diverge from social interests in decision-making, and the former take precedence over the latter in a world of discretionary authority.
- MFN may stabilize trade relations by guaranteeing that the results of a trade liberalization episode will not be affected through subsequent discriminatory liberalization agreements.
- An additional stabilizing factor is that MFN-based market access commitments are probably harder to reverse because of their multilateral character than they would be if they were more bilateral in character.
- Transaction costs are higher for a country in a world of multiple negotiating scenarios than in a situation where trade policy is uniquely defined in a multilateral setting.
- Countries with multiple trade regimes face higher costs in administering trade policy on account of the continuing need to identify trade flows on the basis of their origin.
- But some arguments go the other way. MFN may “under-generate” trade liberalization. One reason for this relates to strategic bargaining behaviour. Countries may seek to “free ride” on the liberalization efforts of others.
- A related argument is that small countries suffer in an environment where MFN and reciprocity go hand-in-hand. Small countries may find it difficult to engage large countries in reciprocal trade bargains because the latter are concerned that other large countries will be able to free ride on such bargains through the application of MFN. The same logic could apply in the case of small trading partners, but it is still the case that their main trading partners tend to be large countries and they have less to worry about when it comes to free riding on the part of their trade partners.

#### ***IV. Departures from MFN***

##### The challenge of “likeness”

- Before considering different types of departure from MFN, sanctioned or otherwise, something must be said about the problem of likeness (MFN) and of likeness and directly competitive or substitutable products (NT). The value of the non-discrimination rule depends on how the products (or producers) benefiting from it are defined. Narrow definitions of likeness open up greater opportunities for discrimination than broader ones. GATT/WTO jurisprudence does not provide clear guidance of how likeness should be defined – substitutability tests have turned on such questions as physical attributes and end use, although in some cases the economic concept of the elasticity of cross-substitution between two products has also been applied, giving play to the idea of “relevant market” in a more exact manner (notwithstanding significant measurement and information problems). The “aims and effects” test has also played a role, suggesting room for the attribution of intent in the determination of whether two products should be treated as alike or directly competitive or substitutable.

- Tariff or product nomenclature is very important too in determining the value of non-discrimination rules. In the area of goods the Harmonized System (HS) takes us some way. Classifications at a level of detail of up to six digits in the HS system appear to have legal force. After that products can be broken out into sub-categories, and finer distinctions come into play.
- The situation in services is far more complicated and unsatisfactory. The Central Product Classification (CPC) system remains a work-in-progress and is not even accepted as a basis for classification on the GATS Schedules of specific commitments of some WTO Members. Moreover, with multiple modes of supply, it is yet to be determined, for example, whether supplying a product through cross-border trade (mode 1) is the same as supplying that product through commercial presence (mode 3).

#### Departures from MFN involving non-compliance

- The main point here is that *de facto* discriminatory trade policy can become a feature of the multilateral trading system if there is a lack of consensus on the need to maintain MFN/NT intact. This reality impinges on the content of the rules. In the early '80s, for example, the ubiquity of illegal voluntary export restraint agreements was regarded as destabilizing and was a factor in building support for the Uruguay Round. This situation also led to a modification in the safeguard provisions, permitting the discriminatory application of safeguard actions in certain circumstances.

#### “Structural” departures from MFN – tariff variance as discrimination

- There is a sense in which the structure of protection can be seen in terms of discrimination. Developing countries often argue, for example, that the trading system discriminates against them because the average level of protection against products of particular interest to developing countries (e.g., agriculture and labour-intensive manufactures) is higher than in the case of products figuring prominently in trade among developed countries. Does this situation arise because of the MFN/reciprocity/free-rider features of multilateralism? Or is it because developing countries have yet to reciprocate in terms of their own liberalization?

#### Conditional MFN

- Conditional MFN is basically about reciprocity in the area of rules. This feature of the trading system became more prominent with the introduction of the Tokyo Round Agreements and Arrangements (the Codes), but was largely reversed via the single undertaking approach to the Uruguay Round results. Government procurement remains an important exception. The Uruguay Round Single Undertaking has generated significant concern among developing countries about the content of certain rules, as reflected in the “implementation debate” and the current work on special and differential treatment.
- The possibility has again been raised of some kind of conditional MFN, through discussion of “opt-in/opt-out” scenarios in the context of the Doha agenda. This time, however, there is significant opposition among developing countries to MFN departures, or a “multi-speed” system of rules, especially if the content of such rules is determined by those that opt in, and if the rules themselves involve discrimination against non-signatories. This whole issue goes to the heart of the MFN nature of the WTO. Is it possible to build a multilateral system based on non-discrimination that remains relevant and useful to a large number of countries with highly divergent economic interests and priorities and significantly different levels of development?

## Regionalism

- Article XXIV of GATT 1947 (plus Uruguay Round Decision) and Article V of GATS. The rules have not been effective, but how much has this hurt the system? Strong expansion of regional agreements since the early 1980s. The discussion has to be built on second-best considerations, and views about regionalism vary in large part on the basis of assumptions in relation to counter-factual scenarios. The Vinerian concepts of trade creation and trade diversion continue to offer a useful insight. The GATT Article XXIV and GATS Article V rules can in part be understood in these terms. The Kemp-Wan conditions are also relevant to this discussion.
- Much analysis has been undertaken recently on regionalism and its relation to multilateralism.<sup>4</sup> Arguments are mixed. Some point to the second-best nature of regional integration arising from distortions (trade diversion and other costs that are not always apparent), additional administrative and transactions costs, and a negative effect on the multilateral trading system. Others emphasize the opportunities offered by regional integration initiatives and tend to argue that in its predominant form as a relatively open form of integration, it does not do significant damage to the multilateral trading system. On the contrary, it should be seen as a vital complement, with multilateralism retaining its primacy.
- Among possible causes for concern are the following: first, does the dynamic of regionalism favour “easy” liberalization, reducing the possibility of broader trade-offs that are necessary for such sectors as agriculture, which seemingly can only be tackled multilaterally? Second, to the extent that regionalism diverts attention from multilateral liberalization and rule-making efforts, does it carry a particular bias against small developing countries that do not seem to offer attractive partnerships in regional arrangements? Third, are we aware of the full implications of the discriminatory elements intrinsic to regional initiatives, especially in the areas of regulation and rules of origin?

## Preferences and special and differential treatment

- Preferences are a bit like regionalism without the “substantially all” requirement of the rules covering customs unions and free trade areas. If the “substantially all” rule lessens the scope for distortions arising from preferential trade liberalization, then preferences may carry greater potential for distortions. In global markets, however, preferential trade for developing countries is unlikely to be quantitatively significant enough to introduce large distortions into the system. But from the perspective of beneficiary countries, preferences can be significant, and so too, therefore, might the risk be of additional costs linked to resource misallocation. But this only arises if the “infant” industries benefiting from preferences do not enjoy potential comparative advantage.
- Special and differential treatment (S&D) can be classified in terms of four categories, applying to two different groups – the developing countries and the least-developed countries. First, there are trade preferences, which have already been discussed. Second, developing countries may secure exemptions from particular rules, or be entitled to particular interpretations of rules. Special and differential treatment falling into this category does not really carry any MFN implications, although national treatment considerations may certainly apply. Third, S&D may take the form of extended time periods within which developing countries must comply with particular rules. These phase-in provisions do not carry MFN implications and any NT consequences will be of temporary duration. Finally, there are a range of measures that developed countries are entitled or perhaps required to take in favour of developing countries, and these measures might call MFN as well as NT into question.

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<sup>4</sup> Writings such as de Melo and Panagariya (1993), Lawrence (1995), Winters (1996), and Bhagwati (1998) cover many of the issues underlying the regionalism debate.

- Whatever view is taken of the adequacy or appropriateness of S&D measures, from a MFN/NT perspective, these measures are unlikely to be of great significance. Perhaps the one qualification to this would be preferences, which might have noticeable resource allocation and trade flow effects in certain circumstances. As suggested earlier, however, these effects will be felt most by smaller developing country beneficiaries, and not the larger trading entities.

### Regulation

- Where regulatory interventions affect trade flows, there may be significant MFN implications. Even in the case of quotas, which for these purposes we can think of as a non-price, regulatory intervention, rules about allocation will not be straightforward from a MFN standpoint, even where the intent is clearly non-discriminatory. Perhaps the one method of rationing quotas that approximates a price-regulated market is auction. Otherwise, allocation rules – such as first-come first-served or historical shares – are unlikely to replicate a non-discriminatory price-based outcome.
- Much the same applies to regulatory interventions such as restrictive licensing and technical regulations. There are many ways in which regulations can infringe MFN and NT, whether or not the underlying intention is to discriminate. As argued earlier, the economic impact of *de facto* and *de jure* discrimination through regulatory interventions is something that remains under-researched in the context of regional trading arrangements. We do not know enough about the full impact of discrimination arising from this source.
- The problem is not only one of the acceptability or otherwise of particular standards in an importing country, but also administrative costs associated with such matters as conformity assessment procedures. A final observation concerns the provisions in Article VII of the GATS dealing with mutual recognition. Here there is an explicit exemption from MFN when it comes to the treatment of foreign standards and qualifications, although the Article does try to control “unjustified” discrimination. There is an inevitable and largely intractable tension here, arising from similarities in standards in some countries and large differences in others. There is nevertheless a legitimate question as to how rules might be designed to avoid the more adverse consequences of discrimination arising from these factors.

## **V. Conclusions**