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# **The Legal and Economic Principles of World Trade Law: National Treatment**

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*LEGAL AND ECONOMIC PRINCIPLES  
OF WORLD TRADE LAW:  
NATIONAL TREATMENT*

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## Introduction

The purpose of the study is to propose interpretations of the National Treatment (NT) provision included in Art. III GATT, unbound by case-law interpretations of this provision. To make such proposals, we need to understand the role of the provision in the agreement. To this end, we first examine in Chapter 2 the negotiating record relevant to the rationale for the enactment of this provision, as well as the manner in which case law has understood it. In the same Chapter, we also discuss the role of NT in the General Agreement on Tariffs and Trade (GATT) from the perspective of economic theory. Having established the purpose of NT, we discuss in Chapter 3 the manner in which this provision has been implemented in case law: that is, here we focus on the understanding of the key terms implementing the purpose of NT by GATT and World Trade Organization (WTO) adjudicating bodies. At the end of this Chapter we provide a critical assessment of the case law. In light of our dissatisfaction with the case-law interpretations of some key terms, we present in Chapter 4 our preferred interpretation of NT.

The main findings of this study could be summarized as follows: we believe that case law, economic theory, and the negotiating record point in the same direction concerning the purpose of the provision: NT is meant to outlaw protectionist use of domestic instruments. It is often unclear whether case-law interpretations of the key terms of this provision promote, if at all, the purpose of the provision. This seems to be largely explained by the absence of a coherent methodology, based both on legal and economic thinking. This is the gap that this study aims to fill.

The reason for relying on legal analysis for an evaluation of a provision of the GATT needs no motivation in this context. But why also base the study in economics? There are several reasons why the working and appropriate design of Art. III GATT cannot be adequately addressed without economic analysis.<sup>1</sup>

A first reason derives from the fact that in order to determine how Art. III GATT should be interpreted (and possibly redrafted), it is crucial to take into consideration the rationale for the provision, and hence also the rationale for the agreement as a whole. We will discuss below the possible purpose of the agreement in much more detail, let us here just quote the preamble to the GATT:<sup>2</sup>

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<sup>1</sup> Note the difference between necessary and sufficient conditions.

<sup>2</sup> The preamble to the *Agreement Establishing the World Trade Organization* goes a step further, adding objectives related to the environment and sustainable development:

...Recognizing that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods . . . .<sup>3</sup>

The stated *purposes* of the GATT are thus all of inherently economic nature.

A second reason why economic analysis is needed as part of the evaluation is the fact that the extent to which the agreement achieves these policy objectives depends on how the regulations it imposes affect the working of markets. This interaction is of course an intrinsically economic issue.

Hence, the objectives of the GATT and the mechanisms through which the regulation it imposes achieve these objectives, are of inherent economic nature. An analysis of Art. III GATT that relied solely on a traditional legal (i.e., legalistic) perspective would not adequately reflect the importance and the meaning of the objectives. Economic analysis is thus an essential component when examining the question of how Art. III GATT should be interpreted.

How this should be done is far from being obvious: economic theory rarely provides concrete guidance for the design of regulations. In the case of Art. III GATT, matters are worse, since there is hardly any economic research on the appropriate design of a NT-provision. Also, to the extent that theory does provide suggestions for the treatment of domestic instruments in a trade agreement, the suggested treatment has very little resemblance to the structure of Art. III GATT, and it is therefore difficult to draw any

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*Recognizing* that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development, . . .

<sup>3</sup> One should not neglect that according to Art. 31 of the *Vienna Convention on the Law of Treaties* (VCLT), recourse to the object and purpose of a treaty is compulsory, leaving the interpreter with no discretion as to its relevance.

concrete inferences. Consequently, we are forced to rely on our subjective judgment when drawing on economic theory for the interpretation of Art. III GATT.

In this Chapter, we concentrate on the study of Art. III.2 GATT dealing with fiscal instruments.

## 1.1 The Text of Art. III GATT

The full text of Art. III GATT and its Interpretative Notes are reproduced here:

### **Article III\***

#### *National Treatment on Internal Taxation and Regulation*

1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.\*
2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.\*
3. With respect to any existing internal tax which is inconsistent with the provisions of paragraph 2, but which is specifically authorized under a trade agreement, in force on April 10, 1947, in which the import duty on the taxed product is bound against increase, the contracting party imposing the tax shall be free to postpone the application of the provisions of paragraph 2 to such tax until such time as it can obtain release from the obligations of such trade agreement in order to permit the increase of such duty to the extent necessary to compensate for the elimination of the protective element of the tax.
4. 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 provisions of this paragraph shall not prevent the application

of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.

5. No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources. Moreover, no contracting party shall otherwise apply internal quantitative regulations in a manner contrary to the principles set forth in paragraph 1.\*

6. The provisions of paragraph 5 shall not apply to any internal quantitative regulation in force in the territory of any contracting party on July 1, 1939, April 10, 1947, or March 24, 1948, at the option of that contracting party; *Provided* that any such regulation which is contrary to the provisions of paragraph 5 shall not be modified to the detriment of imports and shall be treated as a customs duty for the purpose of negotiation.

7. No internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions shall be applied in such a manner as to allocate any such amount or proportion among external sources of supply.

8. (a) The provisions of this Article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale.

(b) The provisions of this Article shall not prevent the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic products.

9. The contracting parties recognize that internal maximum price control measures, even though conforming to the other provisions of this Article, can have effects prejudicial to the interests of contracting parties supplying imported products. Accordingly, contracting parties applying such measures shall take account of the interests of exporting contracting parties with a view to avoiding to the fullest practicable extent such prejudicial effects.

10. The provisions of this Article shall not prevent any contracting party from establishing or maintaining internal quantitative regulations relating to exposed cinematograph films and meeting the requirements of Article IV.

To this there are the following ad notes.

#### Ad Article III

Any internal tax or other internal charge, or any law, regulation or requirement of the kind referred to in paragraph 1 which applies to an imported product and to the like domestic product and is collected or enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal tax or other internal charge, or a law, regulation or requirement of the kind referred to in paragraph 1, and is accordingly subject to the provisions of Article III.

#### Ad Paragraph 1

The application of paragraph 1 to internal taxes imposed by local governments and authorities with the territory of a contracting party is subject to the provisions of the final paragraph of Article XXIV. The term "reasonable measures" in the last-mentioned paragraph would not require, for example, the repeal of existing national legislation authorizing local governments to impose internal taxes which, although technically inconsistent with the letter of Article III, are not in fact inconsistent with its spirit, if such repeal would result in a serious financial hardship for the local governments or authorities concerned. With regard to taxation by local governments or authorities which is inconsistent with both the letter and spirit of Article III, the term "reasonable measures" would permit a contracting party to eliminate the inconsistent taxation gradually over a transition period, if abrupt action would create serious administrative and financial difficulties.

#### Ad Paragraph 2

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

#### Ad Paragraph 5

Regulations consistent with the provisions of the first sentence of paragraph 5 shall not be considered to be contrary to the provisions of the second sentence in any case in

which all of the products subject to the regulations are produced domestically in substantial quantities. A regulation cannot be justified as being consistent with the provisions of the second sentence on the ground that the proportion or amount allocated to each of the products which are the subject of the regulation constitutes an equitable relationship between imported and domestic products.

## 1.2 Art. III GATT 1947, Art. III GATT 1994

The text reproduced above is from the GATT 1947, that is, the original GATT. The GATT 1994 is not the same agreement that was signed in 1947. The latter was substantially modified through the negotiations during the *Uruguay Round* during which it was agreed to add to the original text all decisions adopted by the GATT contracting parties since 1947. So, although the original text has not been modified, some GATT practice has been incorporated into the text of the GATT as a result of the successful conclusion of the *Uruguay Round*. WTO Members are nowadays bound by the GATT 1994 which comprises the following elements:

(a) the provisions in the General Agreement on Tariffs and Trade, dated 30 October 1947, annexed to the Final Act Adopted at the Conclusion of the Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment (excluding the Protocol of Provisional Application), as rectified, amended or modified by the terms of legal instruments which have entered into force before the date of entry into force of the WTO Agreement;

(b) the provisions of the legal instruments set forth below that have entered into force under the GATT 1947 before the date of entry into force of the WTO Agreement:

(i) protocols and certifications relating to tariff concessions;

(ii) protocols of accession (excluding the provisions (a) concerning provisional application and withdrawal of provisional application and (b) providing that Part II of GATT 1947 shall be applied provisionally to the fullest extent not inconsistent with legislation existing on the date of the Protocol);

(iii) decisions on waivers granted under Article XXV of GATT 1947 and still in force on the date of entry into force of the WTO Agreement<sup>4</sup>;

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<sup>4</sup> The waivers covered by this provision are listed in footnote 7 on pages 11 and 12 in Part II of document MTN/FA of 15 December 1993 and in MTN/FA/Corr.6 of 21 March 1994. The Ministerial Conference shall establish at its first session a revised list of waivers covered by this provision that adds any waivers granted under GATT 1947 after 15 December 1993 and before the date of entry into force of the WTO Agreement, and deletes the waivers which will have expired by that time.

(iv) other decisions of the CONTRACTING PARTIES to GATT 1947;

(c) the Understandings set forth below:

(i) Understanding on the Interpretation of Article II:1(b) of the General Agreement on Tariffs and Trade 1994;

(ii) Understanding on the Interpretation of Article XVII of the General Agreement on Tariffs and Trade 1994;

(iii) Understanding on Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994;

(iv) Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994;

(v) Understanding in Respect of Waivers of Obligations under the General Agreement on Tariffs and Trade 1994;

(vi) Understanding on the Interpretation of Article XXVIII of the General Agreement on Tariffs and Trade 1994; and

(d) the Marrakesh Protocol to GATT 1994.

The term “other decisions of the CONTRACTING PARTIES to GATT 1947” featured in Art. 1(b)(iv) GATT 1994 is relevant for the purpose of our exercise: depending on its purview, the substantive content of Art. III GATT 1947 might have been modified. The term has been the subject matter of adjudication. As will be explained *infra*, GATT/WTO dispute-settlement reports do not come under the term “other decisions of the CONTRACTING PARTIES to GATT 1947,” but the *Working Party report on Border Tax Adjustments*, which relates to the coverage of Art. III GATT, should be understood as an “other decision.”

## 2 The Rationale for NT

In this Chapter we will seek to highlight the purpose of NT from three different angles: the negotiating record, the case law, and economic theory.

### 2.1 The Rationale for NT in Negotiating History

This Section discusses the negotiating record of Art. III GATT in order to unveil the purpose of the provision as perceived by its drafters, and thus the spirit behind the terms it contains.<sup>5</sup> As will be made clear, the words chosen to express the NT discipline are often wanting even in the view of the negotiators; it is no wonder the Art. III GATT case law has had a difficult time to define a clear benchmark for acceptable behavior, and a methodology that would resolve disputes coming under its purview in a more or less predictable manner.

The study of the negotiating record of the NT provision points to two conclusions:

- (a) This provision was thought as an anti-circumvention device, that is, as a means to safeguard the value of tariff concessions that would be exchanged in the first multilateral negotiation in Geneva (1948);
- (b) With the exception of a few specific domestic instruments that have explicitly been exempted from coverage in the body of the provision, NT was meant to cover all domestic instruments, whether of fiscal or nonfiscal nature.

These two conclusions seem solid in the light of the negotiating record that will be cited in what follows. There are further good reasons to believe that negotiators aimed at outlawing practices that either had the effect of conferring an advantage on domestic production, and/or were intentionally designed to do so: besides the actual words that were incorporated in the final text, a number of hypothetical examples that were used as basis for illuminating the parameters of this obligation, as well as various statements by participating delegates, point in this direction. The negotiating record also reveals the dissatisfaction of the framers of the Agreement with some of the terms that found their way into Art. III GATT: for example, the term *like products* was chosen *faute de mieux*, and it had been agreed to re-discuss it under the auspices of the planned International Trade Organization; this organization will be briefly described below.

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<sup>5</sup> In this Section, we provide a broader account of issues than necessary to discuss the rationale for NT in the negotiating record. The history of the negotiation of Art. III GATT is comprehensively discussed in Charnovitz (1994), and Jackson (1969).

## 2.1.1 The Forum and Context of Negotiation

The original GATT entered into force on January 1, 1948, at the end of a speedy negotiation that lasted less than a year. We will briefly describe in what follows the evolution of the drafting during these negotiations. As a background, we start with a broad overview of the developments.

Following a proposal for an International Conference on Trade and Employment at its first session on February 18, 1946, the United Nations (UN) Economic and Social Council (ECOSOC) established the *Preparatory Committee* charged with the task of drafting a convention for international trade.<sup>6</sup> Its members were: Australia, Belgium, Brazil, Canada, Chile, China, Cuba, Czechoslovakia, France, India, Lebanon, Luxembourg, the Netherlands, New Zealand, Norway, South Africa, the Union of Soviet Socialist Republics (USSR),<sup>7</sup> the United States, and the United Kingdom. At its second session (May 31, 1946), the ECOSOC announced that the necessary arrangements were in place for the *Preparatory Committee* to

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<sup>6</sup> See E/PC/T/117 Rev. 1 of July 9, 1947 at p. 1. See on this score, Curzon (1965), Dam (1970), Irwin et al. (2008), Jackson (1969), Hudec (1975), and Wilcox (1949).

<sup>7</sup> The USSR declined to participate. This is how Irwin *et al.* (2008, p. 72) discuss this decision: “In Moscow, George Kennen of the U.S. State Department requested a meeting to discuss Soviet participation in the upcoming conference. Soviet officials never granted this request and never responded one way or another to the U.S. invitation, despite the fact that their delegates had participated in the UN Economic and Social Council discussion of the resolution-on-trade conference and voted for resolution. The State Department was skeptical that the Soviet Union, given the state monopoly control on foreign trade, could participate in a useful way in the tariff negotiations. Still, despite the lack of response from Soviet officials, the State Department decided to include the USSR on the list of countries with which it intended to negotiate, leaving the door open for their participation (FRUS 1946, I, 1354-1355). The U.S. Embassy in Moscow cabled back with this message: “We have noted with interest several recent reports from London of conversations with Soviet officials giving various explanations why Soviet Government does not participate in many international meetings, particularly ITO. Reasons given for nonparticipation range from lack of personnel to Soviet preoccupation with questions of security. While there may be some modicum of truth in these arguments, we believe that in regard to such institutions as the International [i.e., World] Bank, ITO and PICAIO [i.e., Provisional International Civil Aviation Organization], the principal, if not the only, reason the Russians do not join is that they do not wish to. Kremlin insistence on keeping its independence of action in world affairs has even on occasion been frankly expressed by certain responsible Soviet officials, and, in any event, is self-evident in every aspect of Soviet policy in action.” Furthermore, the cable added, for the Soviets “to join any organization which would require them to give statistics on national income, international trade, balance of payments and gold production, would imply a complete reversal of a basic and scrupulously maintained Soviet policy of state secrecy in such matters. On the other hand, whenever they stand to gain something concrete by participation in an international organ or run the risk of losing something important by failure so to do, they appear to find no difficulty in effecting such participation (UNRRA, telecommunications, whaling). It would appear unreal, therefore, in the absence of concrete evidence to the contrary, to base any policy on the belief that Russians actually desire to join such organs as ITO but are precluded because of personnel or other administrative considerations” (FRUS 1946, I, 1355-1356).”

convene its first meeting in London on October 15, 1946.<sup>8</sup> The London negotiations went on until November 20, 1946,<sup>9</sup> and were also attended by countries that were members of the UN but not of the *Preparatory Committee*,<sup>10</sup> by UN specialized agencies,<sup>11</sup> by other international organizations,<sup>12</sup> and by nongovernmental organizations.<sup>13</sup> The *Preparatory Committee* held two meetings (sessions):

- (a) from October 15, 1946, to November 20, 1946, in London (first session);
- (b) from April 10, 1947, to October 30, 1947, in Geneva (second session), where the GATT text that entered into force on January 1, 1948, was definitively agreed.

In between, from January 20, 1947, to February 25, 1947, the *Drafting Committee*, an organ appointed by the *Preparatory Committee*, met in New York and prepared the first comprehensive draft of the GATT. The *Preparatory Committee* established the following working committees:

- (a) Committee I: *Employment and Economic Activity*;
- (b) Committee II: *General Commercial Policy*;
- (c) Committee III: *Restrictive Business Practices*;
- (d) Committee IV: *Inter-governmental Commodity Arrangements*;
- (e) Committee V: *Administration and Organization*.

Committee II is our main interest because under its aegis the first draft GATT articles, including the NT provision, were prepared. Committee II established a series of Subcommittees which were requested to report to it their findings: chief among them, the *Technical Subcommittee*, which dealt with a number of provisions appearing in the GATT, ranging from customs valuation to NT. Participation to the *Technical Subcommittee* was open

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<sup>8</sup> See E/PC/T/33 on p. 3. See on this score, Robbins (1971).

<sup>9</sup> See E/PC/T/117 Rev. 1 of July 9, 1947 at p. 1.

<sup>10</sup> Colombia, Denmark, Mexico, Peru, Poland, and Syria sent observers to both the first and the second session of the *Preparatory Committee*; Colombia, and Mexico, to the *Drafting Committee* (which became operational during the *New York Conference*, see infra); Afghanistan, Argentina, Ecuador, Egypt, Greece, Iran, Saudi Arabia, Sweden, Syria, Turkey, Uruguay, Venezuela, and Yugoslavia sent representatives to the second session of the *Preparatory Committee*. Note that the Syrian delegates were representing the Syro-Lebanese customs union, see E/PC/T/117 Rev. 1 of July 9, 1947 at p. 2.

<sup>11</sup> The International Labor Office (ILO), and the Food and Agriculture Organization (FAO), see E/PC/T/117 Rev. 1 of July 9, 1947 at p. 2.

<sup>12</sup> The International Bank for Reconstruction and Development (World Bank, WB), and the International Monetary Fund (IMF), see E/PC/T/117 Rev. 1 of July 9, 1947 at p. 2.

<sup>13</sup> The American Federation of Labor (AFL), the International Chamber of Commerce (ICC), the International Co-operative Alliance (ICA), the World Federation of Trade Unions, and the International Federation of Agricultural Producers, see E/PC/T/117 Rev. 1 of July 9, 1947 at p. 2.

to delegates for all the countries represented on the *Preparatory Committee*. Delegates of six different nationalities acted as *rapporteurs*, Leddy (U.S.), who is credited with the drafting of the first GATT text, being one of them.

The *Preparatory Committee* did not start negotiating from a clean slate: the U.S. proposal to establish an International Trade Organization (ITO) served as the basis for the negotiations (the *Suggested Charter*). In anticipation of the *London Conference*, the U.S. government prepared a *Suggested Charter* for the ITO in September 1946. This was a U.S. initiative, but very much the product of extensive consultations between the U.S. and UK governments.<sup>14</sup> The *Suggested Charter* was divided into seven Chapters: I Purposes; II Membership; III Employment provisions; IV General Commercial Policy; V Restrictive business practices; VI Inter-governmental commodity arrangements; VII Organization. NT figured in Chapter IV. The NT provision included in the *Suggested Charter* was the first multilateral attempt to introduce NT-type of provisions in a treaty, but not the first NT provision in general: the U.S. Tariff Act of 1930, as well as bilateral agreements that the United States had signed with Canada (1938), Mexico (1942), and Uruguay (1942), contained similar clauses.<sup>15</sup> These provisions provided an inspiration to the drafting of the NT provision that was included in the *Suggested Charter*, and the drafting of the eventual GATT NT provision.

The text that entered into force on January 1, 1948, is not the current Art. III GATT: it underwent one final transformation during the *Havana Conference* in 1948, where negotiators aimed at streamlining the language used, but also to leave little room for doubt as to the function of this provision within the overall GATT architecture.

## 2.1.2 The Transformation of NT

During the negotiations, NT underwent a series of changes.

### 2.1.2.1 The GATT, an (Independent) Part of the ITO

The decision to dissociate the drafting of the GATT from the drafting of the wider ITO Charter was taken during the *London Conference*, but in the beginning the *raison d'être* of the *London Conference* was the negotiation of the ITO.<sup>16</sup> It became increasingly clear to the negotiators, however, that a less ambitious project would keep the ball rolling and probably also provide the impetus for subsequent negotiations on the more ambitious endeavor.<sup>17</sup> The idea was to start with a multilateral exchange of tariff concessions rather than with a

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<sup>14</sup> Compare the views of Meade (1990), and Miller (2000) on this score.

<sup>15</sup> See Jackson (1967) at p. 314.

<sup>16</sup> See on this score, Hart (1995), Wilgress (1967), and Zeiler (1999).

<sup>17</sup> See Hart (1998), Irwin (1996), and Irwin *et al.* (2008).

comprehensive Charter regulating each and every facet of international trade. At that point, the GATT (or, more generally, a tariff agreement) would become necessary in order to safeguard the value of tariff concessions made during the negotiations.<sup>18</sup> The actual *ambit* of the GATT was nevertheless not definitively agreed at the *London Conference*.<sup>19</sup> Quoting from negotiating documents, Jackson (1969, p. 43) states that it was agreed that the GATT would include “such other provisions as may be appropriate.” NT was considered to be a key element of this less ambitious project, which became the GATT.

## 2.1.2.2 NT in the Various Drafts

### 2.1.2.2.1 NT in the London Conference

The NT provision was Art. 15 of the *London Draft*. The text of the *Suggested Charter* underwent a few changes in London.<sup>20</sup> The negotiations, which took place within *Committee II*, initially focused on internal taxes, which were distinguished from customs tariffs in that they were decided unilaterally by every state and were applied to both domestic and foreign products.<sup>21</sup> Eventually, the negotiators moved to other areas of internal regulation of nonfiscal nature.

The negotiators early on recognized the impossibility to draft a perfect regulation of domestic instruments. This is how the Chairman of the Technical Sub-committee in charge of preparing the draft provision on National Treatment (NT) during the London meeting of the Preparatory Committee understood the function of the group he was heading:

Whatever we do here, we shall never be able to cover every contingency and possibility in a draft. Economic life is too varied for that, and there are all kinds of questions which are bound to arise later on. The important thing is that once we have this agreement laid down we have to act in the spirit of it. There is no doubt there will be certain difficulties, but if we are able to cover 75 or 80 or 85 per cent of them I think it will be sufficient.<sup>22</sup>

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<sup>18</sup> The term *tariff concession*, which has customarily been used in the GATT-context and continues to be used in the WTO-era, does not make much economic sense: states make a concession to themselves as well since, at least those that cannot affect terms of trade, gain from trade liberalization. It does, nevertheless, make good legal sense, since it signals the transfer of sovereignty associated with the tariff promise: absent such transfer, trading nations would be free to increase or decrease tariff protection to their liking; through tariff concessions, they concede their sovereignty in this respect to the international plane.

<sup>19</sup> See on this score, Jackson (1969, pp. 42ff.).

<sup>20</sup> See E/PC/T/C.6/65.

<sup>21</sup> See E/PC/T/C.II/2.

<sup>22</sup> See E/PC/T/C.II/PRO/PV/7.

At the suggestion of the U.S. delegation, the negotiations were entrusted to a group of experts, in light of the technical nature of the issues at stake: a subcommittee (*Technical Subcommittee*) was created to this effect where delegates of all participants were invited to participate.<sup>23</sup> The negotiations were inconclusive, however, and the *London Draft* postponed consideration of this item.<sup>24</sup> Nevertheless, considerable progress was made in London:

*First*, discussions were held regarding the overall *purpose* of this provision. The views of many delegations on this score were later synthesized at the *Technical Subcommittee*-level. In the words of the French delegate, the NT provision should outlaw disguised restriction of trade through internal taxes;<sup>25</sup> in similar vein, the delegate of Benelux argued that the provision was meant to protect the value of tariff concessions by eliminating indirect protection of domestic production;<sup>26</sup> the report of the *Technical Subcommittee* ultimately held that the purpose of NT should be to avoid undoing the tariff promise through either fiscal or nonfiscal domestic instruments.<sup>27</sup>

*Second*, negotiations focused on the *coverage* of the NT obligation. There was an implicit consensus that negotiations should not focus on a positive (which instruments should be included) list, but rather on a negative (which instruments should be excluded) list, since it was understood that the value of tariff promise *could* be undone by a very large number of domestic instruments. In an effort to underscore the wide coverage of NT, the UK delegation proposed the introduction of the term “*indirectly*” so as to ensure that *any* domestic measure, without mentioning them explicitly one by one, should be in principle covered by this discipline. The UK proposal was unopposed, suggesting a consensus across the participants to opt for the widest possible coverage for this provision. Some instruments were explicitly mentioned: the widespread use of local content measures (including mixing requirements) probably explains why negotiators felt necessary to *explicitly* outlaw their use (in current Art. III.5 GATT).<sup>28</sup>

National delegations also tabled various proposals for carve-outs, some of which were accepted and found their way into the final text, and some that did not: government procurement, subsidies, and films belong to the first category.

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<sup>23</sup> See E/PC/T/C.II/3 at pp. 13-15.

<sup>24</sup> See E/PC/T/33 at p. 28.

<sup>25</sup> See E/P/C.II/12 at p. 2.

<sup>26</sup> See E/P/C.II/32 at pp. 1 and 2.

<sup>27</sup> See E/P/C.II/54 and 54 Rev. 1.

<sup>28</sup> For example, New Zealand had in place a number of local content measures involving tobacco and wool that it sought to exempt from the coverage of NT (E/PC/T/C.II/28 at p. 2). The overwhelming majority of delegations was opposed to the continuation of similar measures, see E/P/C.II/54 and Rev. 1.

Government procurement is the one area where there was consensus that it should be left out of the coverage of NT. Political economy-type of reasons were advanced some time explicitly and some time in concealed manner to defend this policy choice.<sup>29</sup>

The U.S. delegation, in line with the beliefs of the New Dealers, was eager to make room for subsidies (which would become for all practical purposes obsolete if they were to be covered by NT). In the words of Harry Hawkins, a U.S. negotiator:<sup>30</sup>

. . . subsidies kept prices down and demand up. They were expansionist rather than contractionist measures.<sup>31</sup>

Hawkins defended the choice to seek to target the use of tariffs and quantitative restrictions (QRs) that were harmful to trade rather than to focus on disciplining subsidies;<sup>32</sup> in the U.S. delegation's view, direct subsidies to producers were not harmful to international trade for the reason explained above in the quoted passage. The U.S. delegation was prepared however, to distinguish between domestic and export subsidies, and it was not opposed to condemning the export subsidies that were in its view considered harmful to international trade.<sup>33</sup> Canada agreed with the U.S. delegation,<sup>34</sup> and so did the UK delegation, which explicitly accepted the bifurcation between domestic and export subsidies.<sup>35</sup> The U.S.

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<sup>29</sup> See the lengthy discussions reflected in E/PC/T/C.II/PRO/PV/7. The UK and French delegations made proposals to this effect (see E/P/C.II/11 at p. 1 and E/P/C.II/12 at p. 1 respectively); Cuba proposed for a more limited exception that would cover only military procurement, which was eventually rejected (E/P/C.II/15 at p. 1), while Czechoslovakia agreed with the carve out but wished all foreigners to be treated on an MFN basis in national procurement markets (E/P/C.II/24 at p. 1). The advent of the Government Procurement Agreement (GPA) in the *Tokyo Round*, and its modern reincarnation as a plurilateral agreement during the *Uruguay Round* have set aside any arguments that have persisted to the effect that the proposal by Czechoslovakia had survived and government procurement had to be MFNed. Government procurement is, of course, nowadays exempted from the coverage of NT by virtue of Art. III.8 GATT.

<sup>30</sup> Hawkins later taught at Tufts University. See Irwin *et al.* (2008) for information about the *vitae* of the key delegates.

<sup>31</sup> See E/PC/T/C.II/37 at p. 8.

<sup>32</sup> It is probably true that negotiations focused on border measures since there was ignorance regarding the ambit and bite of domestic measures that were anyway nonobservable because of the high tariffs (customs duties) and QRs in place. There was some discussion of nontariff barriers in the literature; as exemplified by Bidwell (1939). The prevailing feeling among the negotiators was, however, that the bite of nontariff barriers was blurred by the high tariffs applied during that time. Baldwin's (1970) parable of the tide reflected this point. See also Hawkins (1951).

<sup>33</sup> See E/PC/T/C.II/3 at pp. 2-3.

<sup>34</sup> *Idem* at p. 9. Compare Hart (1995), and (1998), and also Brown (1950) who gives a detailed account regarding the U.S. position with respect to farm subsidies.

<sup>35</sup> *Idem* at p. 10.

position was not totally unopposed though: both Brazil,<sup>36</sup> and Australia argued in favor of special treatment of subsidies, pointing to their adverse effects on foreign competitors.<sup>37</sup>

The UK delegation should be credited with the carve out regarding films.<sup>38</sup> In the words of Shackle (the UK delegate), it was axiomatic (sic) that film be exempted from the NT discipline, since it was not strictly an economic matter: it involved cultural and other aspects of national life.<sup>39</sup> The UK found support in the New Zealand delegation: New Zealand had in place the *film hire tax*, a domestic tax that discriminated between domestic and foreign films, and also between UK films and other foreign films which were treated worse than imported films of British origin.<sup>40</sup> To this effect, it was the UK delegation that initially proposed (what later became Art. IV GATT) the exclusion of films from the coverage of Art. 15 of the *London Draft*. In the words of the UK delegate (Mr. Rhydderch):

...he would prefer a note to the Article to say it did not apply to films. There were cultural, as well as commercial, considerations to be taken into account in the case of films.<sup>41</sup>

This is probably one of the first expressions in favor of a *cultural exception* in the post-war world trading system.

There were proposals regarding the treatment of other domestic instruments: for example, Brazil tabled a proposal aimed at explicitly addressing navigation port dues,<sup>42</sup> and New Zealand wished to exempt some of its measures regarding domestic tobacco and wool. All proposals other than those concerning the treatment of government procurement, subsidies, and films were defeated.

*Third*, we observe the beginning of a discussion regarding the *parameters of the legal test* for consistency with the NT discipline. India, for example, wanted to ensure that discriminatory

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<sup>36</sup> *Idem* at p. 9.

<sup>37</sup> *Idem* at p. 10. See Capling (2001). Subsidies are currently exempted from the coverage of NT by virtue of Art. III.8 GATT. They are being regulated in a separate agreement (*Agreement on Subsidies and Countervailing Measures*, SCM) that was negotiated during the *Uruguay Round*.

<sup>38</sup> In the current GATT text, films are treated in Art. IV and explicitly acknowledged as exception to Art. III GATT which now reflects the NT discipline.

<sup>39</sup> See E/PC/T/C.II/55 at p. 8. See also E/PC/T/C.II/11 at p. 1 where the UK delegation explicitly admitted that their film quota in place was inconsistent with NT.

<sup>40</sup> See E/PC/T/C.II/28 at p. 1.

<sup>41</sup> See E/PC/T/C.II/E.14 of November 4, 1946 at p. 5. Incidentally, the UK position was supported by Czechoslovakia, France (later, an ardent supporter of the “cultural exception”), New Zealand, and Portugal).

<sup>42</sup> See E/PC/T/C.II/37 at p. 14.

taxation for the *sole purpose* of raising revenue should be acceptable. It seems as if India was implicitly advancing the understanding that NT should be concerned only with measures that *intentionally* were aiming at protecting domestic production, and not with measures which unintentionally did so.<sup>43</sup> By the same token, Norway expressed its wish to be allowed to vary domestic taxes for the purpose of achieving a uniform price across products (domestic and foreign) sold in its market.<sup>44</sup> Although the objective of NT was clear in the negotiators' minds,<sup>45</sup> no provision equivalent to the current Art. III.1 GATT was included in the *London Draft*; recall that this provision condemns any domestic regulation (of fiscal or nonfiscal character) that operates so as to afford protection. It was left for later to explicitly state that such should be the objective of this provision.

There was nevertheless substantial discussion regarding the terms that would be used to express the (undefined) test for consistency. The text prepared by the *Technical Subcommittee* refers to similar or identical products when it discusses the treatment of non fiscal instruments, and simply contains a prohibition not to use taxes so as to afford protection, without any reference to either similar or identical products.<sup>46</sup> Eventually, the term "*similar*" gave way to "*like*" during the New York Conference, probably in order to underscore the parallelism in the obligations assumed under MFN and NT; there was already some discussion in London as to the appropriateness of this term to express the agreed purpose of NT, and we observe a general dissatisfaction with the choice which was due to two main factors:

- (a) on the one hand, it was felt that the term was obscure, and that it would be necessary for the ITO to try to clarify at a subsequent stage. The idea was that a *Definitions Section* should be subsequently negotiated that would, *inter alia*, include an agreed definition of this term;<sup>47</sup>
- (b) on the other, it was felt that, since the *Suggested Charter* contained references to *like products* only,<sup>48</sup> with no reference at all to competitive products, what is now known

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<sup>43</sup> See E/PC/T/C.II/54 Rev. 1.

<sup>44</sup> See E/PC/T/C.6/97 at p. 7.

<sup>45</sup> See, for example, the French proposal where, in application of the French doctrine of *abus de droit*, France requested the insertion of a paragraph to the effect that "The members undertake not to institute or maintain internal taxes on the products of other member-countries the object of which might be a disguised form of protection for national production." This is one of the first statements to the effect that the national-treatment obligation would operate as an anti-circumvention provision: ITO Members should not circumvent through internal taxes their obligations with respect to tariff treatment of foreign products. Producer welfare would thus be legally protected through tariffs only.

<sup>46</sup> See E/PC/T/C.II/54.

<sup>47</sup> See E/PC/T/C.II/54 at pp. 36-38.

<sup>48</sup> See the *Suggested Charter*, at p. 4.

as directly competitive or substitutable products (DCS), something should be done to address cases where a domestic tax on imported coffee was higher than that imposed on domestic chicory.<sup>49</sup> In the words of the Dutch delegate, Mr. Van den Berg, the additional paragraph that was being negotiated during the *London Conference*, and that dealt with competitive products aimed “to guard against the more concealed types of discriminatory taxation.”<sup>50</sup>

*Fourth*, there was acknowledgement of the fact that *federal structures* might have a hard time enforcing NT. Roux (France) acknowledged that there are many issues to discuss regarding how much federal governments can do to force the hand of states.<sup>51</sup> It was felt that this issue extended beyond the coverage of NT. As a result, it was removed from the NT agenda, and eventually became the current Art. XXIV.12 GATT.

#### **2.1.2.2.2 NT in the New York (Lake Success) Conference**

In Lake Success it was not the *Preparatory Committee*, but the *Drafting Committee* that was in session. The mandate of the *Drafting Committee* was supposed to be limited to streamlining agreed upon terms and concepts. With respect to NT, nonetheless, it was thought that more than mere streamlining was necessary in light of the number of issues that were left undecided during the *London Conference*. NT was further negotiated under the aegis of the Subcommittee dealing with Arts. 15-23, with the participation of delegates from the United States, France, United Kingdom, the Netherlands, Belgium, Australia, and Czechoslovakia.<sup>52</sup>

Two days into the negotiations, the U.S. delegation submitted its first proposal concerning a redrafting of Art. 15 of the *London Draft*.<sup>53</sup> Negotiations were smooth,<sup>54</sup> probably because it

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<sup>49</sup> See E/PC/T/C.II/W.2 at pp. 5ff. In the words of Leddy (U.S.) wheat was like to wheat only, and not to other cereals. Leddy made his comments in the context of discussions regarding the ambit of MFN and not NT. It was feared however, that had this attitude been exported to NT as well, the overall purpose of NT would be severely undermined, see E/PC/T/C.II/65 at p. 2.

<sup>50</sup> *Idem*. The level of sophistication of the arguments made is remarkable. See, for example, an exchange between Mr. Morton (Australia) and Mr. Johnson (U.S.) on the legality of some Australian mixing requirements and preferential tariff rates, see E/PC/T/C.II/W.2 at p. 7.

<sup>51</sup> See E/PC/T/C.II/55 at p. 2.

<sup>52</sup> See E/PC/T/C.6/4.

<sup>53</sup> See E/PC/T/C.6/6 of January 22, 1947.

<sup>54</sup> It is New Zealand only that objected to the redraft insisting for some sort of arrangement that would take care of its *film hire tax*, see E/PC/T/C.6/8 of January 23, 1947. The *film hire tax*, however, was a delayed customs duty levied at the point where the real value of the film had become apparent. The New Zealand delegate eventually conceded that this imposition could form the subject matter of tariff negotiations under Art. 24 of the *London Draft*. New Zealand was not, at the time, producing films, other than educational and newsreels, see E/PC/T/C.6/55/Rev. 1 at pp. 7-8.

became gradually clear that the GATT would not contain any *detailed* obligations concerning domestic instruments, other than the obligation not to discriminate.<sup>55</sup> There are various reasons that mandated this approach:

- (a) more detailed provisions regarding (some) domestic instruments would be included in the ITO Charter, the advent of which would supersede the GATT. The GATT was conceived as some sort of regulatory minimum necessary to ensure that tariff concessions would not be circumvented. To this effect, an obligation not to discriminate was considered as adequate insurance policy against the danger of circumvention;
- (b) it was at least the U.S. view, that nontariff barriers (NTBs) should not matter much;<sup>56</sup>
- (c) many NTBs were simply not known to negotiators since they were “hidden” behind high tariffs. It was thus quite rational to first address tariff barriers before moving to discuss in a more elaborate manner NTBs.

The corresponding provision in the *London Draft* underwent some changes without altering its rationale or basic design.<sup>57</sup> With respect to internal measures of non fiscal nature, South Africa proposed the insertion of the terms “*laws, regulations and requirements*” that denoted a wide coverage of this provision, since it reduced the potential for circumvention.<sup>58</sup> As already mentioned *supra*, the term *identical or similar products* gave way to the term *like products*.<sup>59</sup> India continued to insist on a carve-out for taxation “strictly for the purposes of raising revenue,” but this proposal was not accepted.<sup>60</sup>

The final redraft of NT was not unanimously accepted. It was decided, however, to leave it to dissidents to consider whether they would maintain their objections: Cuba wanted an exemption for protection of infant-industry purposes; India’s desired carve-out regarded, as mentioned above, the possibility to tax discriminate in order to raise government revenue; Norway requested a carve-out in order to be in position to tax discriminate, if necessary, to maintain uniform prices for a given product in its domestic market.<sup>61</sup> Two texts (albeit with a lot of bracketed language which denoted lack of agreement) were prepared during the New

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<sup>55</sup> See E/PC/T/C.6/67 at p. 1.

<sup>56</sup> See Proposals, pp. 2ff.

<sup>57</sup> See E/PC/T/C.6/55 at pp. 2ff.

<sup>58</sup> See E/PC/T/C.6/55 at p. 3. It was argued by South Africa that laws could refer only to *formal* laws in some domestic legal contexts and thus, were NT to be limited to such acts only, the possibility for circumventing it through *informal* laws (such as, for example, administrative acts) would be open.

<sup>59</sup> *Id.*

<sup>60</sup> See E/PC/T/C.6/W.19 of January 24, 1947.

<sup>61</sup> See E/PC/T/C.6/55/Rev. 1 at pp. 3ff.

York Conference: one for the GATT, and one for the ITO Charter. The NT provision figured in both, was identical and became Art. II of the *New York* GATT Draft, and Art. 15 of the *New York* Draft ITO Charter.

### 2.1.2.2.3 NT in the Geneva Conference

During the negotiations, it was once again made clear that there was no room for preferential internal taxes, such as those previously practiced in some parts of the world (New Zealand, United States).<sup>62</sup> As a result, a definitive end was put to these requests. China wanted to limit the NT obligation to taxes (fiscal measures) only, but this attempt was thwarted by others.<sup>63</sup>

On the other hand, key terms such as *like products* which had been provisionally accepted *faute de mieux* continued to provoke a lot of discussion: Brazil mentioned the existence of a Committee (*Comissão de Similares*) that they had established to deal with determinations of like products precisely because the term was hard to define. It was felt that some similar action should be undertaken at the multilateral level as well. It was decided however, not to overburden the GATT negotiations with similar tasks. Since the GATT would eventually come under the aegis of the ITO, and the ITO would possess sufficient institutional structure, it was decided it to leave it to the ITO

...later on to establish a jurisprudence on the meaning of this term.<sup>64</sup>

Following a U.S. proposal to this effect, the obligation of NT was extended to cover not only *like*, but also *directly competitive or substitutable* (DCS) products,<sup>65</sup> the intent being to ensure that, in the absence of domestic production of like products, taxes could not be used to favor domestic DCS products.<sup>66</sup> The original idea was quite different from the current text: the DCS-discipline would come into play only when the regulating state had *no substantial* production of the *like* product; in this case, the regulating state could neither introduce new, nor increase old taxes so as to afford protection to its domestic DCS products. In contrast, were the regulating state to have substantial domestic production, it could legitimately treat DCS products in different manner, as long as it did not treat its products any better than the imported like products. Moreover, it was possible to maintain existing internal taxes that

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<sup>62</sup> See E/PS/T/W/179 at p. 3.

<sup>63</sup> See E/PC/T/W/181 at p. 3. In China's view, hence, there should be no NT obligation with respect to regulatory (nonfiscal) domestic instruments.

<sup>64</sup> See E/PC/T/A/PV/40(1) at p. 14.

<sup>65</sup> See E/PC/T/W7150 at p. 5.

<sup>66</sup> See E/PC/T/174 at p. 6.

afforded protection to DCS products, in cases in which there was no substantial production of the like product, subject to negotiations for their elimination or reduction (Art. 17).<sup>67</sup>

The UK delegation continued to think of films not only as economic, but as cultural goods as well. The continued support of Chile, Czechoslovakia, New Zealand, and now India, Norway, and South Africa, left only the U.S. delegation opposing the UK view. The United States saw no reason to treat films differently from other goods; in the view of its delegates, the preference of the audience should determine the trade in films.<sup>68</sup> It was clear, nonetheless, that the U.S. delegation was fighting a losing battle on this issue.<sup>69</sup>

Finally, during the Geneva Conference, the provision expanded and the current Art. III.8 GATT was introduced in order to ensure that subsidies and government procurement were not coming under the coverage of NT.<sup>70</sup>

#### **2.1.2.2.4 NT in the Havana Conference**

The *Havana Conference* on Cuba during the first months of 1948 is the first multilateral conference after the entry into force of the GATT. The main mandate of the negotiators was to discuss the Draft ITO Charter.<sup>71</sup> At the same time, however, some important GATT provisions were also discussed and important clarifications/amendments were agreed upon. NT is one of the provisions that underwent substantial redrafting during this conference.<sup>72</sup> Although its basic structure was not put into question, negotiators added clarity to a text that had left, as we saw, many of them unsatisfied:

- (a) It is now made clearer than ever before, through the introduction of what is now Art. III.1 GATT, that the intention of the drafters was that domestic instruments should not be used as a means of protection;<sup>73</sup>
- (b) A series of *Interpretative Notes* were agreed which clarify a number of issues regarding the ambit of NT;<sup>74</sup>

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<sup>67</sup> See E/PC/T/186.

<sup>68</sup> See E/PC/T/W/181 pp. 7-8.

<sup>69</sup> As already discussed, eventually, a separate provision applicable only to films and justifying an exception to national treatment would be agreed to in subsequent negotiations (the current Art. IV GATT).

<sup>70</sup> See E/CONF.2/C.3/A/W/W.49.

<sup>71</sup> See Toye (2003).

<sup>72</sup> It figures as Art. 18 in the *Havana Conference Draft*.

<sup>73</sup> See E/CONF.2/C.3/A/W.47.

<sup>74</sup> See E/CONF.2/C.3/A/W.49. For example, it was agreed that domestic measures enforced at the border should be considered to be covered by the NT discipline, and not by the discipline regarding QRs (Art. XI GATT).

- (c) An outright elimination of all taxes that protect domestic DCS in the absence of substantial production of domestic like products was agreed;<sup>75</sup>
- (d) Some clarification regarding mixing regulations was also agreed: regulations consistent with the first sentence of (what is now) Art. III.5 GATT shall not be considered to be contrary to the second sentence in any case in which all of the products subject to the regulation are produced domestically in substantial quantities.<sup>76</sup>

The records of the *Havana Conference* further reveal some interesting discussions whereby negotiators advance specific examples to demonstrate their understanding of the various terms used. Although the legal relevance of such examples specifically mentioned in the negotiating documents is limited, some of them bear mention: for example, the final text provided for the outright elimination of taxes protecting DCS products irrespective whether there was substantial production of the domestic like product; it was stated, nevertheless, that, an internal law that might help a domestic product (say, butter), but which hits equally imported and domestic oleomargarine (a DCS product), does not violate NT, if domestic production of oleomargarine is substantial.<sup>77</sup> More generally, we read that a tax that is uniformly applicable to a considerable number of products which conformed to (what is now) Art. III.2, first sentence (like products) would also conform to Art. III.2, second sentence (DCS products).<sup>78</sup> Similar opinions expressed provide further support to the view that the underlying intent of the negotiators was to outlaw protectionist intent.

During the *Havana Conference*, it was also felt that the language chosen might be *too* encompassing and that delimitations of the coverage were thus, in order. For instance, according to the *Havana Report* (p. 61):

...neither income taxes nor import duties fall within the scope of Art 18 (of the Havana Charter—Art III of the GATT) which is concerned solely with internal taxes on goods.<sup>79</sup>

If at all, this language seems to suggest that at least *some* fiscal instruments (like income duties) were meant to be left outside the coverage of NT. As we will see in Chapter 5, this

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<sup>75</sup> See E/CONF.2/C.3/A/W/52 at p. 8.

<sup>76</sup> See E/CONF.2/C.3/A/W.47 at p. 5.

<sup>77</sup> See *Havana Reports* at pp. 61-67.

<sup>78</sup> See *Havana Reports* pp. 62ff.

<sup>79</sup> See § 12 of the Annex to the Working Party report on *Border Tax Adjustments, op cit.*, citing the *Havana Conference*.

issue was re-discussed in the context of the *Working Party on Border Tax Adjustments* where negotiators did not manage to write an exhaustive list regarding the coverage of this provision.

The *Havana Conference* signals the end of the negotiation on NT: Art. III GATT has remained unchanged since the last negotiations in the early months of 1948 in Havana.

### 2.1.3 Summarizing the Negotiating Record

The negotiating record can be summarized as follows.

*First*, the study of the negotiating record of Art. III GATT shows that there was a consensus view regarding the function of this provision: it was considered to be necessary to safeguard the value of exchanged concessions. Absent an insurance policy to this effect, it was thought that participants would lose the incentive to continue engaging in trade liberalization, since the value of tariff concessions that they had extracted (and for which they had paid a price in terms of themselves making tariff concessions in return) could be easily undone through subsequent (to the international negotiation) unilateral action conferring an advantage to the domestic product. NT was thought of as the insurance policy against this eventuality.

*Second*, the negotiators explicitly acknowledged that they had to be content with an incomplete NT provision, in light of the number of instruments that qualify as domestic instruments, and their ever changing form. They thus knowingly left the provision to be gradually “completed” through subsequent adjudication (and, eventually, renegotiation)

*Third*, there was a consensus view that in principle all domestic instruments but those explicitly excluded from the coverage of the provision should observe the NT discipline.

*Fourth*, it was commonly understood that certain key terms, such as *like products*, were not specific enough, but it was agreed that the ITO would at a later stage give these terms more precision. The failure to launch the ITO hence meant that today’s judge has less guidance when dealing with cases coming under the ambit of Art. III GATT than was originally intended.

*Finally*, there is some, admittedly inconclusive, evidence that negotiators wanted to outlaw practices that were either intentionally protectionist, had a protectionist effect, or both.<sup>80</sup>

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<sup>80</sup> See C.3/A White Paper of 26 January 1948 (suggested by the Subcommittee) at p. 3 (on file at the WTO Library).

## 2.2 The Rationale for NT in Case Law

Recall that the negotiating record<sup>81</sup> suggests that the obligation to accord NT serves one purpose: prevention of *concession erosion*, that is, that tariff concessions made to trading partners should not be eroded through (subsequent) favorable treatment of domestic goods by means of domestic instruments; what is, for example, the value of a 5% import duty on imported cars if they are burdened with a 100% consumption tax whereas domestic cars are exempted from consumption tax altogether?

There has been repeated institutional acknowledgment of this rationale in case law. By means of illustration, we observe a note by the GATT Secretariat summarizing the meetings of the *Working Party on Border Tax Adjustments* on 18 to 20 June 1968 captures this point in the following terms:

In the case of Article III, the rules were designed to safeguard tariff concessions<sup>82</sup>

The AB, in its report on *Japan—Alcoholic Beverages II*, confirmed this understanding of NT. as we will see in more detail *infra*, the AB dealt in this case with a Japanese scheme that was taxing alcoholic drinks that were predominantly produced in Japan less onerously (in *ad valorem* terms) than drinks produced abroad. It went on to find that the Japanese scheme was GATT-inconsistent. The starting point of its analysis was its understanding for the rationale for Art. III GATT, which it stated in the following terms (p. 16):[

. . . The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III 'is to ensure that internal measures not be applied to imported or domestic products so as to afford protection to domestic production.' Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products.

This statement has been reproduced almost verbatim in each and every dispute that subsequently dealt with Art. III GATT. More on this in Chapter 4 where we discuss the case law.

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<sup>81</sup> See the discussion in Chapter 1.

<sup>82</sup> See GATT Doc. L/3039 of 11 July 1968, GATT Doc L/3464, adopted on 2 December 1970, GATT Doc BISD 18S/97ff.

## 2.3 The Rationale for NT from the Perspective of Economics

The previous Section sought to shed light on the motive for the drafters of the GATT to include a NT provision in the agreement. This Section considers the role of NT from the perspective of economics, and in particular, the economic literature on trade agreements.

It is a deeply rooted notion among economists that there are significant potential gains from international trade. These gains stem from a variety of sources: for instance, they originate from exploitation of comparative advantages stemming from differences in access to technology, in endowments of factors of production, or in preferences; there are gains stemming from increased competition and from better exploitation of economies of scale; gains can be derived from more product variety in consumption and production, etc. It is also clear that when governments determine their policies unconstrained by international obligations, they are prone to restrict imports. A theory of trade agreements requires an explanation of why national decisionmakers do not unilaterally ensure that these potential gains from trade are reaped. Indeed, if governments did not have such “protectionist” preferences, there would not be any role for a NT provision to play.

Most theories of trade agreements build on the notion that when making unilateral decisions concerning trade (and other) policies, national decisionmakers disregard the adverse impact these policies have on trading partners – there are in this sense negative *international externalities* from unilaterally pursued policies. The general purpose of trade agreements is to make countries “internalize” these external effects. This “international externalities” perspective will be adopted also here, even though we will say a few words towards the end of this Section about the main alternative – and in most respects complementary – view.<sup>83</sup>

In order to specify the nature of these international externalities, we must specify the objectives – the “preferences” – of the decisionmakers that bring the agreement about. Broadly speaking, the preferences describe how decisionmakers rank different possible outcomes of their interaction. Significant efforts have been spent by economists and political scientists to understand the nature of the preferences that are expressed through political decisionmaking. But for much of what follows, we can skirt the thorny issues concerning the nature of these preferences, by adopting an agnostic position. We will assume that the policies of relevance from an NT point of view are determined by a single rational decisionmaker – the “government.” The preferences of this government are hence the economic/political trade-offs that the country would be willing to make in the interaction with the governments representing trading partners. For the most part we do not need to take a stand on the more precise nature of these preferences, or the political constraints under which it operates. We will see the purpose of our exercise in Chapter 4 as identifying

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<sup>83</sup> See, e.g., Bagwell and Staiger (2002), and Staiger (1995), for reviews of the literature.

interpretations of Art. III GATT that would enhance the efficiency of the agreement – that is, enhance the extent to which it achieves the objectives of Member country governments of reaping gains from trade.

The structure of the rest of this overview is as follows. Section 3.1 highlights some basic aspects of the main economic approach to understanding the purpose of trade agreements; the reader is referred to the accompanying study *Why the WTO? An Introduction to the Economics of Trade Agreements* for a more extensive discussion. Section 3.2 describes the role of NT in this framework, and discusses some of the likely pros and cons of such a clause. Section 3.3 offers a brief remark comment on NT building on an alternative view of the role of trade agreements. Section 3.4 summarizes.

### **2.3.1 The Purpose and Structure of Trade Agreements**

Section 3.1.1 provides a very discussion of the complex issues involved in formulating the preferences of national decisionmakers. The subsection can be omitted without interrupting the flow of the reading.

#### **2.3.1.1 A Digression on Policy Objectives**

Trade negotiations are conducted by officials appointed by their national governments. To predict the outcome of a negotiation, and to interpret the meaning of the language of the agreement, we need to understand the objectives of these negotiators. Whose preferences do they represent? How do they evaluate and rank alternative proposals? And what guides the voting behavior of legislators, who in most cases must ratify the product of any negotiation? These are difficult questions that have perplexed economists and political scientists for decades.

It is tempting to argue that negotiators in a democracy represent the aggregate preferences of society. But how do we aggregate individuals' preferences? How much weight do the views of a particular person receive? Should we weigh individuals equally in some sense? If so, how do we deal with the fact that the intensity of an individual's preferences is a personal matter and impossible to compare to that of another? Suppose citizen 1 in country A would very much like a trade agreement with some given terms, but is less enthusiastic about another agreement. Meanwhile, citizen 2 has the opposite ordering. What are the preferences of society?

Perhaps the simplest approach would be to assume that each government seeks to maximize its country's national income, i.e., the sum of the incomes of all of its citizens. However, it is difficult to justify national income as the appropriate government objective either descriptively or prescriptively. As a description of government objectives, simple income measures are suspect because they neglect citizens' concerns about the prices of the goods

they buy, the insecurity they feel about potential disruptions to their income flows, the conditions under which they work, the quality of their environment, and so on. As a prescription, the measures suffer from these same omissions and moreover imply a lack of societal concern about the distribution of income.

A more common approach begins with the notion of a social welfare function. Social welfare is intended to measure overall societal well-being, a worthy objective for governments if not always the one they pursue. A non-paternal social welfare function is one that reflects only the citizen's own evaluation of their happiness and well-being. A paternalistic social welfare function can assess an individual's plight in a given situation differently than she would herself. In either case, the social welfare function must impose some scheme for aggregating individuals' well-being. Should they simply be summed and, if so, in what units should they be measured? If summing seems inappropriate, what weights should be applied to different individuals and what is the implicit evaluation of inequality in outcomes?

The assumption that governments maximize a measure of social welfare has the advantage of flexibility. In principle, the social welfare function can accommodate any considerations that the analyst deems appropriate. The analyst need not take a stand a priori on what are valid concerns for members of society or how these concerns ought to be weighed or compared. Of course, in the application of this approach, the analyst adopts an objective function with particular arguments and so implicitly imposes restrictions on the validity and importance of alternative concerns. Unfortunately, there is little to guide the choice of the social welfare function; essentially, the governments' objectives under this approach must come from outside the analysis.

An alternative approach to specifying the governments' objective function begins with an appreciation of political interactions. In this approach, the governments' objectives are induced by the political regime. Government officials, like private agents, are assumed to pursue their own well-being (or "utility") subject to constraints. Their utilities might reflect a taste for power or a pure desire to "do good," in addition to private concerns about material goods and perhaps the perquisites of office. After specifying the objectives of the political agents, the analyst must model the political interactions: What is the assumed electoral system? What are the voting rules, the political institutions, the role of campaign contributions, and the behavior of voters? Given the analyst's model of the political system, and the assumed interactions between political players, the government's objectives in its trade negotiations can be derived as a political outcome. That is, the electoral system, political institutions and rules of the political game determine, among other things, the identities of the elected leaders and the policy positions they take.

This "political-economy" approach to government objectives recognizes, for example, that elected officials might pursue more strongly the interests of some constituents than others. The favored constituencies might be residents of swing districts, voters for whom trade policy is the most salient issue, or groups with ample resources to contribute to campaign financing. In any case, it is no longer clear, or even expected, that the government will pursue the aggregate and socially-just welfare of society.

The political-economy approach also has shortcomings. First, the approach relies on the modeling of political interactions. The more explicit are the government preferences used in the analysis, the more dependent are the predictions about trade negotiations on the plausibility and reliability of the assumed political model. Second, the induced government objective function need not be stable over time. Changes in the identities of the elected leaders may change the preferences of trade negotiators; changes in political institutions in the negotiating countries almost certainly will do so. This makes it difficult to render interpretations or predictions about trade agreements without detailed information about the state of politics in all the participating countries at the time of their discussions. Third, and perhaps most troubling, the governments' preferences may be jointly determined with the outcome of the trade negotiations. For example, if changes in trade policy strengthen some groups in society and weaken others, it will be impossible to know the governments' preferences without knowing what trade policies prevail, and of course, impossible to predict the trade policies without knowing the preferences of the negotiating agents. In such circumstances, governments' preferences must be treated as endogenous, and predictions about the results of trade negotiations must be made jointly with predictions about political outcomes.

Arguably, the political-economy approach is the more useful for answering positive questions, whereas the social-welfare approach may hold appeal for addressing normative issues. In the category of positive questions, we would include predictions about the outcomes of trade negotiations and matters of interpretation of existing agreements. For these, an understanding of the political circumstances seems unavoidable. In particular, matters of interpretation require us to consider what the negotiators were trying to achieve when drafting the agreement. Their intentions surely are conditioned on their actual politically-induced preferences, and not on some ethically-defensible preferences that they might have held in some best-of-all-possible worlds. In contrast, normative questions are fundamentally about what ought to be – how should the WTO contract be structured to achieve some specific goal. Here, the analyst may be justified, depending on the circumstances of the analysis, in ascribing "social" preferences that are his or her own, or that come from outside the analysis.

### 2.3.1.2 Externalities from Unilateral Decisionmaking

The international externalities approach to trade agreements rests on two main assumptions. The first is that countries are economically entwined such that decisions by one government have noticeable effects on the welfare of other governments. The second central assumption is that when governments make unilateral decisions, they are only concerned about their consequences for various national interests (for instance, domestic firms and consumers), while the consequences for trading partners are of no direct concern. The international externalities from unilateral decisionmaking stem from the combination of these circumstances. The externalities could be positive; for instance, when deciding in how much to invest in medical research, governments may put less weight on the value of resulting medical advances for people in other countries. But for many policies, the externalities from unilateral decisionmaking are negative. This is particularly true of policies that seek to enhance the competitive position of domestic products relative to foreign firms.

The existence of externalities implies that the outcome of the interaction between governments does not bring the parties as much benefit as it could – the outcome is in economic jargon “inefficient.” Broadly speaking, a situation is efficient if it is not possible to improve the well-being of any economic agent, without reducing the well-being of some other agent. Henceforth, we will use the notion of efficiency to capture the extent to which pursued policies allow governments to achieve their objectives. It should be emphasized this efficiency notion uses *government* preferences as the yardstick.<sup>84</sup> More exactly, we will say that a policy is (politically) efficient if the gain that any change would yield to some governments could not suffice to compensate the governments that lose from the change; that is, we adopt a Kaldor-Hicks type of efficiency concept.

The distinguishing feature of unilateral decisionmaking – that is, when governments make their decisions without coordinating with other governments – is thus that it gives rise to international externalities that cause the outcome to be inefficient. It would therefore in principle be possible to change these policies, and in each case let the exporting country compensate the importing country’s government for the loss resulting from the reduction of its trade barriers. However, trade agreements use a different means of achieving something similar, which is to let the compensation take the form of reciprocal market access. That is, trade agreements can be seen as means to *reciprocally reduce trade barriers that governments would not pursue if they were to bear the full global costs of their policies.*

#### 2.3.1.2.1 Externalities Can Be Internalized through Negotiations

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<sup>84</sup> The notion employed here should be distinguished from the more conventional economic concept of “economic (or market) efficiency” which refers to the extent to which a market allocation maximizes social welfare.

The basic role of a trade agreement is to determine tariff levels through negotiations rather than through unilateral decisionmaking.<sup>85</sup> The exchange of offers and counteroffers during the bargaining over the tariffs may effectively present governments with the externality costs of their border barriers. For instance, if countries A and B negotiate their respective measures X and Y, B might offer A to change policy Y against a certain change by A in policy X. Government A can choose to continue pursuing the same policy X, but it has now become sensitized to the internationally experienced cost of this policy, in terms of the forgone change by B in policy Y. As a matter of theory, provided a number of special conditions are fulfilled, the negotiated outcome will be (internationally) efficient, and this is also assumed in most of the trade agreement literature.

#### ***2.3.1.2.2 What is Efficient Depends on Government Preferences***

The defining feature of an efficient situation is that it is impossible to rearrange policies such that some government gains without causing losses to other governments. It follows that the preferences of governments determines what is an efficient policy outcome. For instance, if governments seek to maximize national income, and markets are characterized by perfect competition, no scale economies, etc., efficiency requires free trade. But more generally it is by no means necessary that free trade is efficient. For instance, tariffs redistribute income from consumers of the imported products to local producers of these (or similar) goods, and the government may find such redistribution desirable, and for various reasons hard to achieve through other means. It may, therefore, be part of a (politically) efficient international arrangement that Members maintain tariffs.

#### ***2.3.1.2.3 Desirable and Undesirable Border Protection***

Chapter 4 will distinguish between two notions of “protection.” First, the term can be used in the same sense as the term “shield,” that is, as referring to a change in the competitive conditions to the benefit of domestic producers. Tariffs always protect in this sense. As just mentioned, an efficient agreement can feature positive tariffs, and it can hence be efficient despite protecting in this sense. Second, “protection” is also often used to refer to a policy that causes negative international externalities. For instance, a tariff that exceeds the efficient negotiated level would have such a property. To capture the protective effect of tariffs without taking a stand on whether they are efficient or not, we will say below that they “shield from competition,” whereas we will reserve the terms “protectionist” and “protectionism” to denote the pursuit of inefficient policies. As will be highlighted further in Section 4.1 of Chapter 4, the GATT uses the term protection in both these senses.

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<sup>85</sup> We here for simplicity treat a trade agreement as a once-and-for-all negotiated agreement on tariff levels. But economic theory highlights a number of more complex aspects of actual trade agreements, such as the role of bindings on other border instruments, the role of repeated negotiations, and the reasons for negotiated tariff ceilings rather than levels.

### 2.3.1.3 The Incompleteness of Trade Agreements

Border instruments are likely to be the instruments *par preference* for countries seeking to restrict trade, since they are targeted at trade, and are relatively easy to handle administratively. But many domestic policy instruments can be used for similar purposes as border instruments, and some instruments with more or less identical effects. For instance, sales taxes imposed specifically on imports are largely import tariffs by another name. If a trade agreement restricted the use of border instruments only, governments might instead resort to domestic instruments for the same purposes, if possible. The agreement must therefore constrain also the use of domestic instruments.

The inclusion of domestic instruments severely complicates a problem that exists already with regard to border instruments. First, there are an extremely large number of different domestic policy instruments with trade impact. These instruments are typically used for purposes that the members would agree to be legitimate, but they could also be employed for the purpose of protectionism. The agreement hence has to be sensitive to the underlying policy rationale – to be able to “sort the wheat from the chaff” – for an extremely large number of domestic policies.

Second, there is a need to make the restrictions imposed on domestic policies responsive to changes in the underlying economic/political environment. One possibility would be that the agreement specified for each Member the policies to be pursued in each and every situation that the Member might find itself in, that is, that the agreement is “state-contingent” in economic jargon.<sup>86</sup> But of course, with the agreement intended to be in place for an extended period of time, there would be a huge number of such different economic/political situations that would call for different policy responses.

Needless to say, it would require an enormously complex agreement to separately bind all domestic instruments with trade effects in a state contingent fashion. To the extent it would be conceptually feasible at all, the costs of negotiating and drawing up such a grand contract would be huge, and would most likely dominate the gains it would bring. Indeed, it would amount to central planning at a global scale. Trade agreements are for these (and probably also other) reasons therefore much less complex – they are contractually “incomplete.”

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<sup>86</sup> An alternative means of achieving politically efficient state contingency would be to leave discretion to the importing country government over its domestic instruments, but to have in place a mechanism that ensured that the governments face appropriate incentives from an efficiency point of view when unilaterally determining its domestic policies. A dispute-settlement mechanism would be a natural part of such a mechanism.

As an illustration of the difficulty facing negotiators, let us here quote again the Chairman of the Technical Sub-committee in charge of preparing the draft provision on National Treatment (NT) during the London meeting of the Preparatory Committee:<sup>87</sup>

Whatever we do here, we shall never be able to cover every contingency and possibility in a draft. Economic life is too varied for that, and there are all kinds of questions which are bound to arise later on. The important thing is that once we have this agreement laid down we have to act in the spirit of it. There is no doubt there will be certain difficulties, but if we are able to cover 75 or 80 or 85 per cent of them I think it will be sufficient.

Contractual incompleteness can take many forms.<sup>88</sup> For instance, undertakings in the agreement may not be conditioned on changes in the economic/political environment – they are “rigid.” In other instances the agreement is silent on particular issues, leaving “discretion” to individual governments to determine the policies unilaterally. Provisions may also be vaguely formulated, postponing to future adjudication or negotiations the clarification of the exact nature of the undertakings. The GATT exhibits all these forms of incompleteness, albeit sometimes in less clean form than described here. For instance, border (trade) instruments are rigidly bound: import and export quotas are forbidden and thus set at their free trade levels; import tariffs are legal, but tariff levels are negotiated, and the agreed-upon levels are then bound; export subsidies are illegal. But while the bindings of tariffs are rigid in the sense of not being explicitly conditioned on say the level of imports, there are still a number of ways in which the tariffs can be adjusted ex post tariff negotiations. For instance, temporary safeguards can be unilaterally imposed, it is possible to temporarily increase tariffs in case of severe macroeconomic disturbances, and renegotiations are possible.

Another example of the incompleteness of the GATT is the fact that it leaves domestic instruments at the discretion of Members. As noted, there are strong reasons to believe that governments have incentives to use such discretion for protectionist purposes, as a substitute for the border instruments that have been bound. The first line of defense against such behavior in most trade agreements is some form of NT provision.

### **2.3.2 The Role of NT: to Filter Out Protectionist Policies**

The basic idea of the NT provision is deceptively simple: since inefficiencies from the use of domestic instruments stem from less favorable treatment of imported products, countries should not be allowed to treat domestic products better than foreign products solely by

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<sup>87</sup> Document E/PC/T/C.II/PRO/PV/7.

<sup>88</sup> The reasoning in the remainder of this Section draws partly on Horn, Maggi, and Staiger (2010).

virtue of their different origins. While persuasive at a general level, the practical implementation of this simple idea is far from trivial.

As emphasized above, the basic problem facing the treatment of domestic instruments in a trade agreement is the need for it to be responsive to the nature of the national regulations it affects. The fact that a regulation imposes costs on trading partners is not sufficient to show that the measure is inefficient. It is therefore highly desirable that the regulation of domestic instruments primarily filters out only those instances where differential treatment is (internationally) inefficient.

A fundamental practical problem for this filtering is the fact that it *depends on the preferences* of the Members whether a policy is efficient or not. For instance, it may be efficient to restrict imports of a product when its environmental impact in the importing country is of concern to the importing country government, while it would not be efficient if the government were oblivious to such consequences. However, it is often very difficult to observe directly the preferences of governments, and hence the true rationale for policies that are pursued. Indeed, if it were possible to observe these motives, a NT provision would not be needed in the first place: it could then be replaced by a simple yet powerful general dictum to not pursue any inefficient policy.<sup>89 90</sup>

### 2.3.2.1 The Efficacy of NT for Given Tariff Levels

Having discussed the rationale for NT, we briefly turn to the question of its likely efficacy at preventing inefficient use of domestic policies, drawing on the meager economic literature on the role of NT in trade agreements. This literature is still in its infancy, and can at most help identify some likely positive as well as negative features of the provision. The literature for the most part considers a simplistic form of NT, what we will refer to as a “rigid” NT rule, according to which members of the trade agreement must not treat a foreign product differently than competing domestic products, *regardless* of any policy motives possibly advanced as rationale for the differentiation. There exists thus hardly any economic analysis that highlights the role of NT as a “filtering device.”

The literature has identified several mechanism though which NT may affect the welfare of the parties, even if rigidly imposed so that no differential treatment is allowed of imported and domestic products even if efficient. We will in this section consider effects that appear also for given tariffs.

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<sup>89</sup> Such a policy would in principle just be an extreme case of negative integration, while its outcome would be an extreme case of positive integration.

<sup>90</sup> The problem would be exactly the same if the measure were to be evaluated under an exceptions clause such as Art. XX GATT.

Consider first some possible beneficial aspects of a rigid NT rule.

A *first* observation is that the direct impact of a rigid NT rule is indeed to constrain the incentive to use of domestic instruments for protectionism, since any disadvantage imposed on imported products must also be imposed on domestic products.

*Second*, this chilling effect on the incentives to use domestic instruments for protectionism comes at a relatively limited contractual cost, since negotiators do not have to agree on a huge number of specific domestic policies, but only need to agree on a principle that requires a few lines of legal text. Furthermore, once such a principle is established and accepted, it does not need to be renegotiated in subsequent rounds of tariff negotiations.

*Third*, as discussed above, for bindings of domestic policy instruments to be fully efficient they would need to be state-contingent, conditioning the prescribed policy levels on all relevant circumstances that would affect their optimal levels. But such a complete contract scenario would be enormously costly. A rigid NT rules allows for a similar adjustment to exogenous circumstances, but in a very different, and from a contracting cost point of view much cheaper, way: by leaving discretion over the common treatment of imported and domestic products to importing country governments, it escapes the need for the parties to determine the level for these instruments for long swathes of time, as would be the case if this had to be done in a negotiation round. Instead, the importing country government can unilaterally respond to changes in the economic environment whenever it likes. NT hence has the virtue of limiting the possibility to use domestic instruments for protectionist purposes, while at the same time preserving a certain degree of freedom to respond to unforeseen events.

Turn next to the negative side of NT, still for constant tariffs. There are several fundamental reasons to believe that NT (applied as a rigid rule or not) will not be panacea for achieving full efficiency. To illustrate why, consider an example of taxation. A *first* limitation is that NT only applies in situations where the tax on a domestic product is lower than the tax on a competing imported product. This restriction would be hard to understand in a full information context, but can be seen as a partial remedy to an informational problem, since it tends to focus attention to cases where the likelihood of protectionism is likely to be higher. Consequently, it does not have any bite in situations where the domestic product is taxed higher than the imported product, but where this difference in taxation should be even larger. Nor can it enforce higher taxation of the domestic product in situations where it is taxed lower at the outset, it can maximally enforce equal taxation.

To illustrate, suppose that a domestic and a foreign product are identical in all respects, except for that the domestic product gives rise to environmental damage in the importing country. Suppose further that the efficient tax on imports is  $t_I = 0\%$  and that the efficient tax on the domestic product is  $t_D = 40\%$ . If the importing country were to set, say,  $t_D = 20\%$  and  $t_I = 10\%$ , NT could have no impact, despite the fact that these taxes are not efficient.

A *second* limitation to the efficacy of the NT provision is the fact that the decision over the common tax  $t_D = t_I$  will be made unilaterally by the importing country, and will thus likely give rise to international externalities. To illustrate, modify the example above so that both products are equally damaging to the environment, with efficiency requiring taxes  $t_D = t_I = 5\%$ . The importing country may unilaterally prefer  $t_D = 0\%$  and  $t_I = 20\%$  absent NT. But forced to set uniform taxes, it might balance the benefits from taxing the imported product against the costs of the taxation of the domestic product, by setting an inefficient common tax  $t_D = t_I = 10\%$ .<sup>91</sup> This would be a higher level than would be called for from the point of view of combating the environmental problem. But the resulting distortion would be worthwhile from the importing country government's point of view, since the government puts a value on the restraining effect on imports. More generally, whenever the policy decision neglects foreign interests, there are almost always alternative policies that are more efficient internationally.

This example reflects a more general asymmetry between the treatment of border instruments and domestic instruments from an efficiency point of view. There is a presumption that the negotiations over the bindings of border instruments will (at least under certain circumstances) lead to efficient outcomes. In the case of domestic instruments however, there is no presumption that NT-compatible tax levels will be efficient.

### 2.3.2.2 The Interaction between Tariffs and Taxes

As argued earlier in this Chapter, the purpose of NT is to prevent tariff concessions from being undermined through subsequent opportunistic use of domestic instruments, in order to provide incentives for countries to make such concessions. It is therefore essential to take into consideration the interplay between tariff setting and subsequent unilateral determination of domestic instruments. The literature has so far concentrated on the interplay with tax setting, so we concentrate on this case.<sup>92</sup>

*First*, as repeatedly stressed in the above, it may be desirable from an (international) efficiency point of view to allow for higher taxation of imported products. It may therefore

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<sup>91</sup> We are here disregarding the possibility that trade agreements may serve as a commitment device; this possibility will be discussed briefly in Section 4.

<sup>92</sup> Tie arguments in this Section draws on Horn (2006, 2009).

seem inevitable that a NT rule that does not allow for such differential treatment must be inefficient when it is desirable to tax imported products higher than domestic products. While there is something to this argument, some caution is needed. The reason is that the argument implicitly rests on the assumption of constant tariffs. But what matters for the market access of imported products is not only domestic taxation, but the total taxation these products face. For instance, in the case where the domestic instrument perfectly substitutes for the tariff, as with a sales tax on the imported product, what matters for imports is the sum of the tariff and the sales tax.

To illustrate, consider a case where because of an environmental hazard from imports, efficiency requires that the total taxation of the imported product exceeds that on the domestic product. It is clear that if such an environmental hazard were to appear unexpectedly after import tariffs have been agreed upon, an inability to impose a higher tax on imported products would be costly. On the other hand, if the environmental hazard is known at the time of tariff negotiations, and is taken into account by trade negotiators, the tariff on this product can fully reflect the adverse environmental impact, even if taxes are set equally, and the rigid NT rule hence is respected.

This example illustrates two related points. First, in order to assess the cost of an inflexible imposition of NT it is necessary to take tariff setting into account. Second, the cost of this inflexibility can be mitigated (and may in theory at least be dominated by the gains), provided that trade negotiators take into consideration the noncommercial effects of their tariff agreement.

*Second*, it was emphasized above that at the core of the rationale for NT is an informational problem: the need for the provision stems from the fact that government preferences are not easily observable. But very little work has been done to date on informational aspects of NT. One of the few steps in this direction (Horn (2009)) suggests a reason why NT primarily restrains governments with, from an efficiency point of view, legitimate reasons for imposing higher taxes on imported products than on competing domestic products.

Consider the following illustrative example. An importing country government can have two different motives to impose a higher tax on imports than on domestic competing products: all governments have the standard protectionist motive, and some governments face local environmental problems stemming from the transportation or consumption of the imported product. Outsider observers cannot tell whether a higher tax on an imported product is motivated by one or both of these motives. In economic jargon, we can thus think of the governments as being of two “types” – those that have only protectionist motives for differential taxation, and those that have both protectionist and environmental motives – and governments’ types are unknown.

Now note two features: First, since an environmentally affected government faces the same protectionist motives as the other type of government, its unilaterally optimal tax differential will be larger than if only protectionism motivated the tax setting, since the environmental problem adds a reason for taxing the imported products higher. Second, if the negotiated tariff is sufficiently high, there is no need to use domestic taxes to achieve any of these objectives. The importing country can set the same tax rate (perhaps equal to zero), and can achieve both its protectionist and a possible environmental target in a NT-compatible fashion through the tariff.

As the tariff is gradually lowered from this level however, it becomes increasingly likely that there is not enough of a difference in total taxation between the imported and the domestic product. The government to first experience this problem is the government that faces the environmental problems from imports, since it has stringer incentives to maintain a large tax differential than the government that is solely motivated by the protectionism. The environmentally affected type of government type will hence be the first to switch to lower taxation of the domestic product, and thus come under NT. In this sense, as trade is liberalized, *NT first affects those governments that desire high total taxation of the imported product not only for protectionist reasons, but also for environmental reasons.* NT in this sense starts to bind from the wrong side of the spectrum of government types.

Of course, this feature of NT may be immaterial if the adjudication process flawlessly determines whether countries have been exposed to environmental hazards of sufficiently severe nature for it to be in the global interest to let these countries continue with their differential taxation. But if there are, e.g., litigation costs, or adjudicating bodies occasionally commit judicial mistakes, this aspect may take on significance.

### **2.3.2.3 The Nature of the Costs of Judicial Errors**

Because of the difficulties in assessing the true nature of domestic measures, adjudicating bodies are bound to make mistakes. These can broadly speaking take one of two forms. One possible mistake is to permit measures that should be declared illegal. The cost of such mistakes are borne by the affected trading partner, and will at least partly take the form of reduced profits of exporters, and consequent losses of income for other interests associated with the exporting firms.

The other type of mistake is to outlaw measures that should be allowed. Considering the nature of the values that domestic regulations may seek to protect, such as human health and the environment, it may appear as if the costs from judicial mistakes in the form of erroneous impositions of an inflexible dictum to not set lower taxes on domestic products

may be particularly severe. While there is something to this argument, it does not seem to be entirely correct.<sup>93</sup>

To see why, consider the case where imports are associated with a severe health hazard; for instance, it has just been discovered that asbestos constitutes a severe danger to human health. With the tariff on an asbestos-containing product bound, efficiency might require to let the importing country set a higher domestic tax on the imported product, since consumers who are oblivious to the dangers of asbestos would otherwise purchase the cheaper asbestos-containing product. But suppose the adjudicator erroneously declares the measure to violate NT. In such case, despite the constraint imposed by NT, the importing country is still not forced to accept health damage from the consumption of the imported product: *it can still set the common tax level high enough to completely choke off imports.*<sup>94</sup> This will be optimal for the government to do if the health hazard is severe enough.

The point illustrated through this example is hence that a rigid application of NT always leaves the importing country with the possibility to shut out imports completely. The cost of the judicial mistake is in such an instance not in the form of reduced human health (other than possibly indirectly through, e.g., reduced national income). The cost takes instead the form of lost domestic consumer and producer welfare, since domestic production must face the same prohibitive taxes as imports. Health effects might instead arise in situations where the hazard is less severe, and where consequently it is not worthwhile for the government to completely shut out imports.

### **2.3.3 An Alternative View of the Role of Trade Agreements**

The theory laid out above sees trade agreements as means to limit international externalities from unilateral policymaking. An alternative view of the purpose of trade agreements builds on the notion that absent an agreement, each government pursues policies that are *not* in its own long-run interest. In particular, because of previous actions by private interests, a government may find itself in a situation where it finds it optimal to behave in a more protectionist fashion than it would normally prefer to do; for instance, a government may find it necessary to bail out a domestic industry that has put itself in dire straits in expectation of a bail-out. A commitment to a trade agreement may make it more costly for a government to give in to such a request. This may in turn induce private interests not to behave so as to put the government in this position in the first place, knowing that the commitment to the trade agreement will prevent the government from pursuing the policies the private interests would like to see. The difference between this approach and the international externalities approach is thus that a trade agreement in this view solves a

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<sup>93</sup> The reasoning here builds on Horn (2009).

<sup>94</sup> We disregard the possibility of a nonviolation complaint.

domestic political problem, rather than an international problem. The international dimension of the interaction concerns only the enforcement – the trade agreement provides a commitment possibility.

In what follows, we will rely on an international externalities approach, partly since it is used by all economic studies of the role of NT that we are aware of, and partly since it seems to explain certain features of Art. III GATT better than the commitment approach. It seems that if the main purpose of trade agreements were to commit governments to liberal trade, agreements would have been drafted differently. Indeed, a main feature of the DSU is that it limits the possibility for enforcement of concessions.<sup>95</sup> This is by no means to deny the fact that agreements may also serve other purposes, for instance, to help governments to commit vis-à-vis against lobbies to liberal policies.

#### **2.3.4 Summary of the Rationale of NT from an Economic Perspective**

The main observations to stem from the discussion of the role of NT from the perspective of economics are the following:

- (a) The purpose of trade agreements is to limit the extent to which governments expose trading partners to negative externalities from their unilateral policy decisions.
- (b) The role of NT is to reduce the externalities that follow from the fact that it is infeasible for governments to bind domestic instruments.
- (c) NT is likely to constrain the use of domestic instruments for protectionist purposes, but there are a number of reasons why NT will not achieve full efficiency, including the fact that unilaterally set NT-compatible (i.e., common) tax levels will not be internationally efficient.
- (d) The evaluation of the efficiency of a contested measure, whether it amounts to “protectionism,” requires information concerning government preferences.

## **3 The Implementation of NT in Case Law**

### **3.1 The Case Law Regarding Art. III GATT**

In this Chapter, we discuss the completion of Art. III GATT through case law since 1948. The main conclusions that stem from this study are as follows:

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<sup>95</sup> For instance, it puts an upper bound on the magnitude of counter-measures that can be legally imposed, and it can retard the implementation of counter-measures by several years by requesting the case to be reviewed by both a panel and the AB, and this despite the fact compensation is not possible.

- (a) Case law is not consistent in its interpretation of several core concepts in the provision;
- (b) Case law is often highly uninformative concerning the reasoning behind determinations. The fears of the negotiators regarding the (in)appropriateness of some of the terms used in the body of this provision have been confirmed: case law has not managed to pin them down in one measurable dimension and, as a result, there is still considerable uncertainty regarding the understanding of terms such as “*like products*” and “*less favorable treatment*.” This is probably due to the fact that, in line with the overall attitude especially of the AB, case law has privileged a textualist, a-contextual understanding of the various terms appearing in the body of Art. III GATT and deprived them of their connecting thread, the objective of this provision which is embedded in the first paragraph of Art. III GATT. References to the objectives of this provision have been selective and self-contained, in the sense that they have not informed the interpretation of the key terms appearing in the body of Art. III GATT.
- (c) Overall, it is unclear to what extent case law interpretations have implemented the purpose of NT.

Recall that Art. III GATT requests from WTO Members not to afford protection to domestic production through their domestic instruments; in other words, once (imported) goods have paid their ticket to entry (e.g., tariff) into a market, they cannot be subjected to any burden that the domestic products with which they are competing are not subjected to; as a result, all protection through border instruments in the GATT is a matter of negotiation and can take one form only: tariff protection. Art. III GATT does not enumerate one by one the domestic instruments to which it applies, except for local content requirements that are explicitly mentioned in Art. III.5 GATT. Two instruments (government procurement, subsidies) are explicitly omitted, and all the remaining instruments (irrespective whether of fiscal or nonfiscal nature) are, in principle, covered.

Recall further that the GATT does not impose any common policies on WTO Members; they remain free to unilaterally define their fiscal, competition, public-health, environment, etc. policies in any manner they deem it appropriate. What matters is that, at the stage when they regulate, they do not discriminate against imported products. The GATT is thus a *negative integration* scheme. Put differently, Art. III GATT seeks to equate conditions of competition *within* and not *across* markets.

The remaining part of this Chapter is divided as follows: Section 3.2 discusses the rationale for NT as it has been explained in case law, and the case-law interpretation of the various

terms appearing in the provision; Section 3.3 discusses the exceptions to NT; in Section 3.4, we revert to the critique that has been voiced against the manner in which case law has interpreted NT: this Section, although not exhaustive, reproduces the quintessence of the critique voiced so far. Section 3.5 briefly concludes the analysis of the case-law implementation of Art. III GATT.

## 3.2 The Legal Discipline

In theory, the argument could be made that *all* instruments affecting trade come under the purview of Art. III GATT. This view finds ample support in the text of the provision, which explicitly excludes two instruments only from its coverage, and has been endorsed, as we will see in more detail *infra*, in case law. The fact, however, that all domestic instruments are, in principle, covered by the NT provision does not mean that all of them can be *legally* used by the importing state and imposed on imported products: for example, the text of Art. III.2 GATT leaves little doubt that a domestic (say consumption) tax is covered by its disciplines and a WTO Member has *obligation* not to impose on imported goods a tax higher than it imposes on domestic *like* goods. This obligation nonetheless is predicated on a *right* to apply consumption taxes to domestic and imported goods. This right does not originate in the GATT. In fact, the GATT framers did not spend any time discussing this issue. They took it for granted that the GATT contracting parties (now, WTO Members) are all well-defined jurisdictional entities and will behave in line with the (public international law) rules governing allocation of jurisdiction.<sup>96</sup> These rules, nonetheless, are far from clear: one distinguishes between the *nationality*-principle (whereby a state regulates behavior of its nationals wherever committed), and the *territoriality*-principle (whereby a state regulates behavior which either occurs in, or has an effect on home soil).<sup>97</sup> Whereas it is clear in public international law that, in case of conflict between the two, it is the *territoriality*-principle that prevails, it is unclear what happens if a transaction affects more than one jurisdiction. In principle, more than one jurisdiction could decide this issue; this is so, for a number of reasons: first, it is nowhere stated that a quantification of effects is an appropriate tool in this context, and consequently it cannot to be excluded that, in practice, even minimal effects might confer jurisdiction; second, it could be the case that the importance two states attach to a particular effects differs (state A is not very risk averse and hence does not mind if acid rain hits it one day, whereas state B is quite risk averse and wants to avoid even a couple of drops); third, it is unclear whether effects must be tangible, physical effects, or whether 'moral' effects (such as for example, distress in country A caused by the fact that country B

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<sup>96</sup> See Horn and Mavroidis (2008).

<sup>97</sup> There are other bases conferring jurisdiction: there is for example, universal jurisdiction; it covers however, specific transactions. The two bases mentioned here are the default bases applicable whenever another, more specific rule does not kick in, see various contributions in Meessen (1996) on this score.

practices child labor, even if such products are not being exported to A), also confer jurisdiction. As a result, it is not unheard of that, in practice, a transaction is often submitted to various jurisdictions with the resulting burden in terms of transaction costs, and that disputes arise regarding the question who is competent to regulate a particular transaction.

### 3.2.1 Which Measures Come Under the Scope of NT?

The precise boundary between border and domestic instruments is unclear, and has been a recurring theme in case law. With regard to domestic instruments, Art. III.1 GATT stipulates an extremely broad coverage by referring to

. . . internal taxes and other internal charges, and laws, regulations and requirements . . .

having the effect of

. . . affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions . . .

The same broad approach is continued in Art. III.2 GATT, which states that exports of a Member shall not be subject,

. . . *directly or indirectly*, to internal taxes or other internal charges *of any kind* in excess of those applied, *directly or indirectly*, to like domestic products . . . [emphasis added]

Similarly, Art. III.4 requests no less favorable treatment of imported products with respect to

. . . all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

There are two exceptions to this approach:

- (a) Art. III.5 GATT explicitly outlaws *local content* requirements: all measures whereby a government privileges goods containing a set amount of domestic added value are outlawed. This prohibition has been further underscored through the advent of the TRIMs Agreement which contains an illustrative list of such measures. No other domestic instruments (other than local content requirements), are explicitly prohibited by Art. III GATT;

- (b) two measures are explicitly *exempted* from the NT obligation by virtue of Art. III.8 GATT: producer subsidies, and government procurement. Hence, with respect to these measures, WTO Members can behave unconstrained by the NT obligation.

The wording that the framers privileged was quite wide: the term *directly or indirectly* in Art III.2 GATT were inserted at the initiative of the UK delegate, and replaced the terms *in connection with* previously used.<sup>98</sup> It was felt that limits to the discretion of the regulating state were in order. At Havana, for example, it was recorded that:

. . . neither income taxes nor import duties fall within the scope of Art 18 (of the Havana Charter—Art III of the GATT) which is concerned solely with internal taxes on goods.<sup>99</sup>

The preparatory work thus suggests that the intent of the negotiators was to exclude at least some taxes from the coverage of this provision, even though the wording they agreed upon gives the opposite impression. It should be recalled however, as pointed out above, that the intention was to renegotiate some of the key terms of Art. III GATT in the ITO. This renegotiation never took place however, nor did GATT Members renegotiate the provision in subsequent GATT rounds. The failure of the ITO did lead to one attempt to clarify the ambit of Art. III GATT – the creation of the *Working Party on Border Tax Adjustments*. Some clarification with respect to the coverage of NT was provided through the negotiations in this context, although no full agreement was achieved regarding the coverage, but as we will argue below, the outcome did not resolve the core issues concerning the interpretation of the provision. We discuss this further in Section 3.3.

There is probably less ambiguity with respect to internal measures of nonfiscal nature. Art. III.4 GATT covers all internal laws, regulations and requirements *affecting* imported products. The term *affecting* suggests a will to cast the net widely. This view is also supported by the fact that there is no negotiating record indicating that specific transactions were intended to be excluded.<sup>100</sup>

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<sup>98</sup> See § 13 of the annex to the Working Party report on *Border Tax Adjustments* (GATT Doc. BISD 18S/87ff).

<sup>99</sup> See § 12 of the annex to the working party report on *Border Tax Adjustments*, *op cit*.

<sup>100</sup> See on this score, Irwin *et al.* (2008). This is not to suggest that NT can *equally* meaningfully apply to *all* domestic policies/measures. Its application on substantive (as opposed to procedural) antitrust laws is, for example, problematic: a WTO Member which accepts a merger between two domestic companies and, subsequently, rejects a merger between a foreign and a domestic company operating all four in the same relevant product market has not necessarily violated NT; moving from say six to five or from five to four companies in a market involves different considerations (*inter alia*, because the degree of concentration as measured in Herfindhal-Hirschmann Index terms will be different).

We now leave the letter of the law and its negotiating history, to turn to the case law. Case law has further clarified that NT covers transactions relating to both bound (i.e., goods on which a tariff concession has been concluded) and unbound items as well. The AB left no doubt in this regard (*Japan – Alcoholic Beverages II*, p 17):

. . . The Article III national treatment obligation is a general prohibition on the use of internal taxes and other internal regulatory measures so as to afford protection to domestic production. This obligation clearly extends also to products not bound under Article II.

Note that domestic measures enforced at the border come, according to the *Interpretative Note ad Art III of the GATT*, under the purview of Art. III GATT. Thus, a sales ban which is enforced at the border (and could be viewed as a trade embargo) will still be considered to be a sales ban (and, consequently, come under the purview of Art. III GATT, and *not* that of Art. XI GATT).

Finally, GATT panels and WTO adjudicating bodies have consistently held that not only *de jure*, but also *de facto* discrimination is covered by Art. III GATT.<sup>101</sup>

### 3.2.2 The Right to Regulate

As mentioned above, the GATT contracting parties did not spend any time during the negotiation of the GATT discussing the right to regulate for example, the level of customs duties or domestic taxes. One can thus reasonably assume that they took it for granted that the default rules governing the permissible jurisdictional reach of national legislation would be applicable in the trading context as well.

The default rules do solve some problems, but not others.<sup>102</sup> One deficiency is that the *default rules* do not exclude the possibility of *concurrent* exercise of jurisdiction (that is, cases where more than one sovereignty is awarded jurisdiction over a transaction and exercises its right to regulate it). Disputes concerning cases where countries concurrently exercising jurisdiction impose different forms of regulation often find their way to courts and arbitral

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<sup>101</sup> In the former case, imported and domestic products are treated differently solely by virtue of their different origins. *De facto* discrimination is less well-defined. It arises in situations where domestic and foreign goods are subject to the same policy rule, and in this respect are treated identically. But due to differences in the characteristics of the two products the application of the policy rules results in differential treatment, even though there is no regulatory motive for this other than protectionism.

<sup>102</sup> For a concise description, see Horn and Mavroidis (2008).

tribunals, if one (some of them) dispute the right of others to regulate the particular transaction. The GATT contracting parties entertained a discussion on this issue subsequent to the entry into force of the GATT in the above-mentioned *Working Party on Border Tax Adjustments*. This Working Party was not intended to discuss all issues associated with jurisdictional reach. In fact, its origins were much humbler: some GATT contracting parties felt that the GATT was not neutral towards the basic properties of a domestic fiscal system and was not treating in even-handed manner direct and indirect taxation. By attempting to determine which fiscal instruments could (and could not) be adjusted at the border by either the importing or the exporting state, this Working Party provided nevertheless, a partial response to the question which fiscal instruments can a particular jurisdiction lawfully employ.<sup>103</sup>

The Working Party did not manage to reach a total solution, as we will see in more detail *infra*. Consequently, disagreements on the permissible jurisdictional reach would have to be submitted to adjudication. However, at the time of writing, there has not been one single case where a WTO adjudicating body was requested to directly address the core jurisdictional issue: how are the rights to regulate distributed among WTO Members. Indirectly, nonetheless, WTO adjudicating bodies did provide scarce evidence regarding their understanding of this issue. They have not managed though, to complete the contract in this regard. For example, in *US – Shrimp*, the AB did state that the US should have shown a “nexus” between its interest to regulate and the transaction at hand, but the AB did not specify the precise meaning of this concept, nor did the AB explain what the implications would be if parties on both sides of the dispute could demonstrate a nexus. We tend to believe that the AB is mindful of the jurisdictional issue as prerequisite for lawful exercise of jurisdiction but we still lack a test that explains in concrete terms how to discern lawful exercise jurisdiction.

### 3.2.3 Fiscal Measures

Art. III.2 GATT reads:

The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other

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<sup>103</sup> An origin principle is often taken to mean that the taxation of a traded product is determined by the exporting country, while the importing country is assumed to set the tax on the product under the destination principle. However, the issue of origin versus destination principle is in principle separate from the allocation of the jurisdiction.

internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

The *Interpretative Note ad Art. III.2 of the GATT* reads:

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

Art. III.1 GATT (to which Art. III.2 GATT refers) reads:

The Members recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.

Therefore, a complaining party can choose between two possible routes. One is to argue that:

- (a) the domestic and the foreign products are *like*; and
- (b) the latter is taxed *in excess* of the former.

The other is to claim that:

- (a) the two products are *directly competitive or substitutable* (DCS);
- (b) the two products are *not similarly taxed*; and that
- (c) the dissimilar taxation is *applied so as to afford protection* (ASATAP) to domestic production.

Central to the scope of NT is the adjudicating bodies' interpretation of the italicized terms.

### 3.2.3.1 The Working Party Report on Border Tax Adjustments

The adoption of the report by the *Working Party (WP) on Border tax Adjustments (BTAs)*<sup>104</sup> was preceded by intermediate reports that remain unpublished<sup>105</sup> and that reflect the earlier discussions among the members of the WP.

The WP was asked to discuss which border tax adjustments were permissible by exporting and importing GATT contracting parties: could for example, the importing state lawfully adjust (lower) payroll taxes imposed by the exporting state? Could it adjust sales taxes? Conversely, could the exporting state exempt from domestic sales taxation exported products without running the risk of being accused for violating Art. XVI GATT? In short, how much regulatory authority do the exporting and importing states have when taxing traded goods?

#### 3.2.3.1.1 *The Findings in the Working Party Final Report*

The negotiators agreed on the so-called *destination principle*, which was understood to circumscribe the taxes that can be lawfully adjusted. Section 4 of the final report of the WP explains this principle in the following terms:

. . . which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products.

Taxation could thus, in principle, be adjusted by both the importing and the exporting state: the key was that if the destination of the good was a market other than the market where the good had been produced either the exporter or the importer could adjust the level of taxation imposed when the same good were sold in the market where it had been produced. The GATT contracting parties had before them a rather detailed document that explained how adjustment took place across various countries practicing it (GATT Doc. L/3389), and that served as background information.

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<sup>104</sup> Art. II.2 GATT provides the legal basis for border tax adjustments since it explicitly provides that tax adjustments are lawful provided that they meet the requirements of Art. III GATT. It does not, however, explain whether adjustments can be lawfully made on all or only on some taxes.

<sup>105</sup> GATT Docs. L/3138 and L/3190.

The GATT contracting parties reached agreement on *some* measures, but failed to do so on many others. The extent of their agreement is reflected in the following paragraph:

. . . the Working Party concluded that there was convergence of views to the effect that taxes directly levied on products were eligible for tax adjustment. Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added. It was agreed that the TVA, regardless of its technical construction (fractioned collection), was equivalent in this respect to a tax levied directly—a retail or sales tax. Furthermore, the Working Party concluded that there was convergence of views to the effect that certain taxes that were not directly levied on products were not eligible for tax adjustment. Examples of such taxes comprised social security charges whether on employers or employees and payroll taxes.<sup>106</sup>

The GATT contracting parties also agreed to provide information if requested, regarding the reasons for, and the calculation of, any tax adjustment (§ 17 of the final report):

It was generally agreed that countries adjusting taxes should, at all times, be prepared, if requested, to account for the reasons for adjustment, for the methods used, for the amount of compensation and to furnish proof thereof.<sup>107</sup>

There was also agreement between negotiators that some taxes, such as *cascade taxes*,<sup>108</sup> were eligible for adjustment, the modalities for adjusting were not clear though (§ 16 of the final report):

The Working Party noted that there were some taxes which, while generally considered eligible for adjustment, presented a problem because of the difficulty in some cases of calculating exactly the amount of compensation. Examples of such difficulties were encountered in cascade taxes. For adjustment, countries operating cascade systems usually resorted to calculating average rates of rebate for categories of products rather than calculating the actual tax levied on a particular product. It was noted, however, that most cascade tax systems were to be replaced by TVA systems, and that therefore the area in which such problems occurred was diminishing. Other examples included composite goods which, on export, contained ingredients for which the Working Party agreed in principle it was administratively sensible and sufficiently accurate to rebate by average rates for a given class of goods.

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<sup>106</sup> See § 14 of the final report.

<sup>107</sup> On the allocation of burden of proof in GATT/WTO, see Horn and Mavroidis (2009).

<sup>108</sup> A *cascade tax* is a *turnover tax* which is applied in every stage of the production process.

There was a divergence of views regarding the eligibility for adjustment of *taxes occultes* and some other taxes such as *property taxes*. The scarcity of complaints with respect to either of these two taxes however, persuaded negotiators to stop negotiating on them (§ 15 of the final report):

The Working Party noted that there was a divergence of views with regard to the eligibility for adjustment of certain categories of tax and that these could be subdivided into

(a) "Taxes occultes" which the OECD defined as consumption taxes on capital equipment, auxiliary materials and services used in the transportation and production of other taxable goods. Taxes on advertising, energy, machinery and transport were among the more important taxes which might be involved. It appeared that adjustment was not normally made for taxes occultes except in countries having a cascade tax;

(b) Certain other taxes, such as property taxes, stamp duties and registration duties . . . which are not generally considered eligible for tax adjustment. Most countries do not make adjustments for such taxes, but a few do as a few do for the payroll taxes and employers' social security charges referred to in the last sentence of paragraph 14.

It was generally felt that while this area of taxation was unclear, its importance - as indicated by the scarcity of complaints reported in connexion with adjustment of taxes occultes - was not such as to justify further examination.

The Working Party did not manage to resolve all ambiguities and disagreements regarding tax adjustability: for instance, no agreement with respect to *tax occultes* was possible; moreover, besides the agreement on the two outer sides of the continuum (consumption taxes on the one hand, property taxes on the other) this Working Party did not manage to design a legal test that would guide future practice with respect to the adjustability (or not) of domestic instruments.

### 3.2.3.1.2 *The Legal Significance of the Working Party Final Report*<sup>109</sup>

The report of the Working Party on BTAs was adopted by the GATT CONTRACTING PARTIES, the GATT-organ that had the authority to do so.<sup>110</sup> The legal value of similar acts is addressed in GATT (as it has been amended following the successful conclusion of the *Uruguay Round*) albeit in unclear terms: there is doubt whether the Working Party report should qualify as a decision by the CONTRACTING PARTIES, and thus come under the purview of Art. 1(b)(iv) GATT 1994, or whether it should be considered as part of the GATT *acquis*, and then come under the purview of Art. XVI of the *Agreement Establishing the WTO*. But no matter how it is classified, the WP report will have legal significance: if however, it comes under the former it should be regarded as *binding* on all WTO Members, whereas if it comes under the latter it should be regarded as merely creating *legitimate expectations* across WTO Members to the effect that WTO practice will be guided by its content.

Recall that the GATT 1994 is not content-wise the same agreement as GATT 1947. The latter was substantially modified through the negotiations during the *Uruguay Round* during which it was agreed to add to the original text all decisions adopted by the GATT CONTRACTING PARTIES since 1947. The GATT 1994 (as the new GATT is known) comprises a series of decisions by the GATT CONTRACTING PARTIES aiming at clarifying the original text.

Among the instruments included, Art. 1(b)(iv) GATT 1994 mentions “other decisions” of the CONTRACTING PARTIES. The meaning of this term is unclear. The panel report on *Japan–Alcoholic Beverages II* addressed the issue of whether GATT panel reports that had been adopted by way of a decision of the GATT CONTRACTING PARTIES are in fact “decisions” of the CONTRACTING PARTIES to GATT 1947 within the meaning of Art. 1(b)(iv) GATT 1994. The panel was of the view that adopted panel reports had the status of any *other decision* of the CONTRACTING PARTIES. Consequently, the panel held that adopted panel reports form an integral part of GATT 1994 as they are “other decisions of the Contracting Parties to GATT 1947” within the meaning of Art. 1(b)(iv) of GATT 1994.” (§ 6.10). The Appellate Body (AB) disagreed with the panel, and held that the “decision” to adopt a panel report is not a “decision” within the meaning of Art. 1(b)(iv) GATT 1994, though it did acknowledge that adopted reports are “an important part of the GATT *acquis*.” (p. 15). The term “GATT *acquis*” is a creation of the AB, which only clarified the meaning of this concept subsequently in *US – Shrimp (Art. 21.5 – Malaysia)*. We quote from §§ 108 - 109:

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<sup>109</sup> This Section relies heavily on Mavroidis (2007).

<sup>110</sup> When using block letters we refer to the statutory organ that has legal authority to decide a particular issue.

In this respect, we note that in our Report in *Japan – Taxes on Alcoholic Beverages*, we stated that:

‘Adopted Panel Reports are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute.’

This reasoning applies to adopted Appellate Body Reports as well. Thus, in taking into account the reasoning in an adopted Appellate Body Report — a Report, moreover, that was directly relevant to the Panel's disposition of the issues before it — the Panel did not err. The Panel was correct in using our findings as a tool for its own reasoning. Further, we see no indication that, in doing so, the Panel limited itself merely to examining the new measure from the perspective of the recommendations and rulings of the DSB.

Hence, it turns out that what the AB meant by the term *acquis* was the legitimate expectations of WTO Members to see that the relevant prior case law will duly be taken into account in future disputes, even though there is no *legal* obligation to follow the findings and conclusions of GATT panels that had previously dealt with the same issue. This issue arose again in the context of the dispute that led to the panel report on *US – FSC*, where the panel was of the view that *decisions* to adopt reports should come under Art. XVI of the *Agreement Establishing the WTO* (WTO Agreement). Such decisions are not legally binding on subsequent panels. Nevertheless, they are not totally irrelevant from a pure legal perspective either. Art. XVI WTO Agreement reads:

. . . the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to GATT 1947.

Consequently, the legal effect of adopted GATT reports is to provide “guidance.” On appeal, the AB in its report on *US – FSC* followed a rather convoluted reasoning even though it ended up ultimately following the panel’s conclusion (§§ 108-115).

Previous decisions by GATT panels are usually referred to as support for findings already reached. This trend is observable in WTO practice. In light of this discussion, it seems that the better arguments lie with the view that the Working Party report should come under Art. 1(b)(iv) GATT 1994: the Working Party was not convened to adjudicate on a dispute between

two GATT contracting parties;<sup>111</sup> it was requested to discuss the treatment of tax adjustments at the GATT-wide level. In subsequent practice, a number of WTO panel and AB reports have referred to this report, without however, classifying it either as part and parcel of Art. 1(b)(iv) GATT 1994 or under Art. XVI WTO Agreement.<sup>112</sup> But, as already argued, even if one takes the view that it should be considered to be part of the GATT *acquis*, it would still retain legal value as explained above. The fact that it has been often cited in WTO case law leaves little room for doubt that recourse to it will be made again if, for example, the question whether payroll taxes can be adjusted comes up. Consequently, at the very least, we should understand Art. III GATT as excluding from adjustment by the importing state some taxes such as payroll taxes.<sup>113</sup>

### 3.2.3.2 DCS Products<sup>114</sup>

The AB in its report on *Korea – Alcoholic Beverages* held that *like* products are a sub-set of DCS products: if two products are like, they are, by definition, DCS as well (§ 118):

‘Like’ products are a subset of directly competitive or substitutable products: all like products are, by definition, directly competitive or substitutable products, whereas not all ‘directly competitive or substitutable’ products are ‘like’.

It follows that case law regarding the definition of DCS is *ipso facto* relevant for the interpretation of the term *like* products.

The AB in its report on *Japan – Alcoholic Beverages II* provided its understanding of DCS products. This dispute arose because of a Japanese taxation scheme which, while on its face neutral, subjected *predominantly* Western products to a heavier taxation than predominantly Japanese products: as a result, *sochu* (an alcoholic beverage predominantly produced in Japan) was subjected to less burdensome taxation than, *inter alia*, whisky (an alcoholic beverage predominantly produced in Europe and the United States). Europe and the United States protested arguing that the products at hand were at least DCS, if not *like*, products. The panel had already accepted that all of the products concerned (with the exception of

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<sup>111</sup> Although the term WP was often reserved to what is now always referred to as a GATT panel, that is, an adjudicating body.

<sup>112</sup> See for example, the panel and AB report on *Japan – Alcoholic Beverages II*.

<sup>113</sup> To some extent this report is consonant with the default rules regulating allocation of jurisdiction: whereas sales taxes should be prescribed by the country where a sale takes place, payroll taxes should be prescribed by countries where production takes place.

<sup>114</sup> We start with the interpretation of the term DCS products because, as we will see, case law has clarified that DCS is a necessary but not sufficient property of like products.

vodka that was deemed to be *like* product to *sochu*) were DCS products. The AB upheld the panel's findings in this regard. In its view:

- (a) physical characteristics;
- (b) common end-uses; and
- (c) tariff classification

are appropriate elements to take into account when defining whether two products are DCS. Importantly, upholding the panel's findings in this regard, the AB made it clear that the test to define whether two products are DCS is in the marketplace, in the sense that, it is *consumers* who will ultimately decide whether two products are indeed in competition with each other. To this effect, *econometric indicators* (for instance, the *cross-price elasticity*)<sup>115</sup> are relevant to define whether two products are indeed in competition with each other. The European Community had submitted some consumer surveys to this effect, suggesting that Japanese consumers in the absence of discriminatory taxation would be prepared to substitute a host of Western drinks for *sochu* (p 25):

In this case, the Panel emphasized the need to look not only at such matters as physical characteristics, common end-uses, and tariff classifications, but also at the 'market place.' This seems appropriate. The GATT 1994 is a commercial agreement, and the WTO is concerned, after all, with markets. It does not seem inappropriate to look at competition in the relevant markets as one among a number of means of identifying the broader category of products that might be described as 'directly competitive or substitutable'.

Nor does it seem inappropriate to examine elasticity of substitution as one means of examining those relevant markets. The Panel did not say that cross-price elasticity of demand is '*the* decisive criterion' (footnote omitted) for determining whether products are directly competitive or substitutable. The Panel stated the following:

In the Panel's view, the decisive criterion in order to determine whether two products are directly competitive or substitutable is whether they have common end-uses, *inter alia*, as shown by elasticity of substitution.

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<sup>115</sup> The cross-price elasticity of demand provides information about the demand relationship between two products, by capturing how a price increase for one product increases the demand for another product. (Formally, it is defined as the percentage change in quantity demanded of some good X divided by the percentage change in price for good Y). Adjudicating bodies have not so far provided any guidance on what values of the cross-price elasticity that would normally be necessary for two products to be considered DCS.

We agree. And, we find the Panel's legal analysis of whether the products are 'directly competitive or substitutable products' in paragraphs 6. 28–6.32 of the Panel Report to be correct. (*italics and emphasis in the original*).

In *Korea – Alcoholic Beverages*, the AB kept the same test for defining whether two products are DCS, reducing, however, econometric indicators to be but one of several possible avenues to show that a DCS-relationship between two products exists. In this case, the facts were similar to those in *Japan – Alcoholic Beverages II*: beverages predominantly produced in Korea (*soju*) were hit by a substantially lower tax burden than their counterparts which were predominantly produced in the European Community, Canada, and the United States (vodka, whisky, etc). The European Community, Canada, and the United States complained, arguing that the Korean regime was GATT-inconsistent. Korea argued that its system could not be held to be GATT-inconsistent since, the products concerned were not DCS in the first place: the price of (diluted) *soju*<sup>116</sup> was a small fraction of the price of the Western drinks at hand, claiming thus that changes in the price of *soju* would not lead its consumers to consumption of Western drinks. Consequently, following the analysis in *Japan – Alcoholic Beverages*, and the relevance of econometric indicators in deciding whether two products are DCS, Korea argued that with respect to (diluted) *soju* at least no claim under Art. III.2 GATT could be sustained.

Complaining parties claimed that the fact that the western drinks hit by higher taxation were in DCS-relationship with a similar drink (*sochu*) in a similar market (Japan) provided enough evidence that *soju* as well was DCS product to the same drinks. The panel essentially upheld the complaining parties' view, holding that the products were indeed in a DCS relationship: only a reading of the AB report on *Japan – Alcoholic Beverages II* whereby cross-price elasticity would be elevated to *the* decisive criterion conferring DCS status, would lead the panel to rule otherwise; such a reading of Art. III.2 GATT, however, was in the panel's eyes unwarranted. The absence of systematic information concerning consumer purchasing behavior thus did not prevent the panel from finding that the two products were like in the eyes of Korean consumers. The AB upheld the panel's findings without any modification in this regard. It thereby explicitly reduced the importance of econometric indicators, claiming that it is but one of the various ways to show that two products are in DCS-relationship. The AB did not explain itself as to which other ways are available. It did however mention several factors that it took into account in order to confirm that *soju* and the western drinks were indeed in a DCS relationship. Price was not one of them (§§ 114 ff. and especially 133–134, 135–138):

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<sup>116</sup> The price of non-diluted *soju* was substantially higher.

### 1. Potential Competition

. . . In our view, the word ‘substitutable’ indicates that the requisite relationship *may* exist between products that are not, at a given moment, considered by consumers to be substitutes but which are, nonetheless, *capable* of being substituted for one another . . . .

### 2. Expectations

As we have said, the object and purpose of Article III is the maintenance of equality of competitive conditions for imported and domestic products.

### 3. ‘Trade Effects’ Test

. . . the Panel stated that if a particular degree of competition had to be shown in quantitative terms, that would be similar to requiring proof that a tax measure has a particular impact on trade. It considered such an approach akin to a ‘type of trade effects test’.

We do not consider the Panel’s reasoning on this point to be flawed.

### 4. Nature of Competition

The Panel considered that in analyzing whether products are ‘directly competitive or substitutable,’ the focus should be on the *nature* of competition and not on its *quantity* . . . . For the reasons set above, we share the Panel’s reluctance to rely unduly on quantitative analyses of the competitive relationship. In our view, an approach that focused solely on the quantitative overlap of competition would, in essence, make cross-price elasticity *the* decisive criterion in determining whether products are ‘directly competitive or substitutable’. We do not, therefore, consider that the Panel’s use of the term ‘nature of competition’ is questionable.

### 5. Evidence from the Japanese Market

. . . It seems to us that evidence from other markets may be pertinent to the examination of the market at issue, particularly when demand on that market has been influenced by regulatory barriers to trade or to competition. Clearly, not every other market will be relevant to the market at issue. But if another market displays characteristics similar to the market at issue, then evidence of consumer demand in that other market may have some relevance to the market at issue. This, however, can only be determined on a case-by-case basis, taking account of all relevant facts. (emphasis in the original).<sup>117</sup>

The AB report on *Korea—Taxes on Alcoholic Beverages* represents the state of the art as far as the definition of DCS products is concerned in WTO case law. It is, hence, now accepted that:

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<sup>117</sup> In the case at hand, the argument was made that demand in Korea was *latent* because of the regulatory barriers that impeded access for Western drinks. It did not however, beyond the generic references in the passage included above, refer specifically to these barriers. Hence, evidence from third-country markets was necessary to establish whether *soju* and a series of Western beverages were indeed DCS products. Korea pointed out that the price of *shochu* was higher than that of *soju*, and closer to that of the Western drinks. Note also that there have not been any *serious* challenges regarding likeness in subsequent case law.

- (a) two products will be *DCS* if they are viewed as such by consumers (that is, the test is in the marketplace);
- (b) recourse to econometric indicators is not *passage obligé*: a *DCS*-relationship can also be established through recourse to criteria such as physical characteristics, end uses, consumer preferences.

These criteria have been consistently referred to in subsequent case law.<sup>118</sup>

### 3.2.3.3 Applied So as to Afford Protection (ASATAP)

Art. III.2 GATT makes it clear that taxation of two *DCS* products is GATT-inconsistent, if it operates in a manner that is not consistent with Art. III.1 GATT; recall that Art. III.1 GATT outlaws domestic instruments that operate so as to afford protection (ASATAP) to domestic production. The *Interpretative Note ad Art III of the GATT* (to which Art. III.2 GATT refers) further explains that taxation operates ASATAP if a pair of products is not similarly taxed: it does, in other terms offer (at least) one instance where taxation across *DCS* products operates ASATAP, that is, the case of dissimilar taxation.

Two interrelated interpretative questions arise in this context:

- (a) how should we understand the terms “*not similarly taxed*” appearing in the *Interpretative Note ad Art III of the GATT*?
- (b) does *any* dissimilar taxation suffice for a tax scheme to operate ASATAP?

The AB addressed these issues in various reports. In its report on *Japan—Alcoholic Beverages II*, it held that, with respect to *like* products, taxation in excess should be understood as an instance of a measure operating ASATAP precisely because the imported product was taxed higher than the domestic like good (in other words, taxation in excess equals ASATAP as far as like goods are concerned); consequently, a complainant who has established that taxation on imported products is in excess of that on domestic *like* products, does not have to *also* establish that the measure at hand operates ASATAP (pp. 18–19):

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<sup>118</sup> Sharing the same tariff classification is not a necessary criterion to decide whether two products are *DCS*. It has been used, however, in order to decide whether two products are *like* (as we will see *infra*). Since *like* products in case law are a sub-set of *DCS* products, it is reasonable to assume that this criterion is *relevant* (albeit *not necessary*) to decide whether two products are *DCS*.

Article III:1 informs Article III:2, first sentence, by establishing that if imported products are taxed in excess of like domestic products, then that tax measure is inconsistent with Article III. Article III:2, first sentence does not refer specifically to Article III:1. There is no specific invocation in this first sentence of the general principle in Article III:1 that admonishes Members of the WTO not to apply measures so as to afford protection. This omission must have some meaning. We believe the meaning is simply that the presence of a protective application need not be established separately from the specific requirements that are included in the first sentence in order to show that a tax measure is inconsistent with the general principle set out in the first sentence. However, this does not mean that the general principle of Article III:1 does not apply to this sentence. To the contrary, we believe the first sentence of Article III:2 is, in effect, an application of this general principle. The ordinary meaning of the words of Article III:2, first sentence leads inevitably to this conclusion. Read in their context and in the light of the overall object and purpose of the *WTO Agreement*, the words of the first sentence require an examination of the conformity of an internal tax measure with Article III by determining, first, whether the taxed imported and domestic products are 'like' and, second, whether the taxes applied to the imported products are 'in excess of' those applied to the like domestic products. If the imported and domestic products are 'like products,' and if the taxes applied to the imported products are 'in excess of' those applied to the like domestic products, then the measure is inconsistent with Article III:2, first sentence. (italics in the original).<sup>119</sup>

With regard to DCS products, nevertheless, a similar reading was rejected (p. 27):

Unlike that of Article III:2, first sentence, the language of Article III:2, second sentence, specifically invokes Article III:1. The significance of this distinction lies in the fact that whereas Article III:1 acts implicitly in addressing the two issues that must be considered in applying the first sentence, it acts explicitly as an entirely separate issue that must be addressed along with two other issues that are raised in applying the second sentence. Giving full meaning to the text and to its context, three separate issues must be addressed to determine whether an internal tax measure is inconsistent with Article III:2, second sentence. These three issues are whether:

- (1) the imported products and the domestic products are '*directly competitive or substitutable products*' which are in competition with each other;
- (2) the directly competitive or substitutable imported and domestic products are '*not similarly taxed*'; and
- (3) the dissimilar taxation of the directly competitive or substitutable imported domestic products is '*applied . . . so as to afford protection to domestic production.*' (emphasis in the original).

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<sup>119</sup> As we will see *infra*, any tax differential, even if infinitesimal, satisfies the *in excess* criterion.

Hence, in the AB's view, Art III.1 GATT is relevant for the *whole* of Art. III.2 GATT, but its impact on the interpretation of the first sentence (dealing with like products) is not symmetric to its impact on the second sentence (dealing with DCS products):

- (a) with respect to like products, taxation in excess of the imported like product *ipso facto* amounts to a violation of the ASATAP requirement;
- (b) whereas with respect to DCS products, establishment of taxation in excess of the imported product is a *necessary*, but not *sufficient* condition for finding that a measure operates so as to afford protection.

Case law responded to the question what else, beyond differential taxation, the complainant needs to demonstrate in order to satisfy that a tax scheme operates ASATAP to the domestic DCS product in a series of reports.

In its report on *Japan—Alcoholic Beverages II* considered the distinction between *in excess*, on the one hand, and ASATAP, on the other, in the following terms (pp. 29–32):

In the 1987 *Japan—Alcohol* case, the panel subsumed its discussion of the issue of 'not similarly taxed' within its examination of the separate issue of 'so as to afford protection':

. . . whereas under the first sentence of Article III:2 the tax on the imported product and the tax on the like domestic product had to be equal in effect, Article III:1 and 2, second sentence, prohibited only the application of internal taxes to imported or domestic products in a manner 'so as to afford protection to domestic production.' The Panel was of the view that also small tax differences could influence the competitive relationship between directly competing distilled liquors, but the existence of protective taxation could be established only in the light of the particular circumstances of each case and there could be a *de minimis* level below which a tax difference ceased to have the protective effect prohibited by Article III:2, second sentence.

To detect whether the taxation was protective, the panel in the 1987 case examined a number of factors that it concluded were 'sufficient evidence of fiscal distortions of the competitive relationship between imported distilled liquors and domestic shochu affording protection to the domestic production of shochu.' These factors included the considerably lower specific tax rates on shochu than on imported directly competitive or substitutable products; the imposition of high *ad valorem* taxes on imported alcoholic beverages and the absence of *ad valorem* taxes on shochu; the fact that shochu was almost exclusively produced in Japan and that the lower taxation of shochu did 'afford protection to domestic production'; and the mutual substitutability of these distilled liquors. The panel in the 1987 case concluded that the application of

considerably lower internal taxes by Japan on shochu than on other directly competitive or substitutable distilled liquors had trade-distorting effects affording protection to domestic production of shochu contrary to Article III:1 and 2, second sentence.

As in that case, we believe that an examination in any case of whether dissimilar taxation has been applied so as to afford protection requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported products. We believe it is possible to examine objectively the underlying criteria used in a particular tax measure, its structure, and its overall application to ascertain whether it is applied in a way that affords protection to domestic products.

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such a protective application, as the Panel rightly concluded in this case. Most often, there will be other factors to be considered as well. In conducting this inquiry, panels should give full consideration to all the relevant facts and all the relevant circumstances in any given case.

In this respect, we note and agree with the panel's acknowledgment in the *1987 Japan—Alcohol Report*:

. . . that Article III:2 does not prescribe the use of any specific method or system of taxation . . . there could be objective reasons proper to the tax in question which could justify or necessitate differences in the system of taxation for imported and for domestic products. The Panel found that it could also be compatible with Article III:2 to allow two different methods of calculation of price for tax purposes. Since Article III:2 prohibited only discriminatory or protective tax burdens on imported products, what mattered was, in the view of the Panel, whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products.

We have reviewed the Panel's reasoning in this case as well as its conclusions on the issue of 'so as to afford protection' in paragraphs 6.33–6.35 of the Panel Report. We find cause for thorough examination. The Panel began in paragraph 6.33 by describing its approach as follows:

. . . if directly competitive or substitutable products are not 'similarly taxed,' and if it were found that the tax favors domestic products, then protection would be afforded to such products, and Article III:2, second sentence, is violated.

This statement of the reasoning required under Article III:2, second sentence is correct.

However, the Panel went on to note:

. . . for it to conclude that dissimilar taxation afforded protection, it would be sufficient for it to find that the dissimilarity in taxation is not *de minimis* . . . the Panel took the view that 'similarly taxed' is the appropriate benchmark in order to determine whether a violation of Article III:2, second sentence, has occurred as opposed to 'in excess of' that constitutes the appropriate benchmark to determine whether a violation of Article III:2, first sentence, has occurred.

In paragraph 6.34, the Panel added:

- (i) The benchmark in Article III:2, second sentence, is whether internal taxes operate as to afford protection to domestic production, a term which has been further interpreted in the Interpretative Note ad Article III:2, paragraph 2, to mean dissimilar taxation of domestic and foreign directly competitive or substitutable products.

And, furthermore, in its conclusions, in paragraph 7.1(ii), the Panel concluded that:

- (ii) Shochu, whisky, brandy, rum, gin, genever, and liqueurs are directly competitive or substitutable products and Japan, by not taxing them similarly, is in violation of its obligation under Article III:2, second sentence, of the General Agreement on Tariffs and Trade 1994.

Thus, having stated the correct legal approach to apply with respect to Article III:2, second sentence, the Panel then equated dissimilar taxation above a *de minimis* level with the separate and distinct requirement of demonstrating that the tax measure 'affords protection to domestic production.' As previously stated, a finding that 'directly competitive or substitutable products' are 'not similarly taxed' is necessary to find a violation of Article III:2, second sentence. Yet this is not enough. The dissimilar taxation must be more than *de minimis*. It may be so much more that it will be clear from that very differential that the dissimilar taxation was applied 'so as to afford protection.' In some cases, that may be enough to show a violation. In this case, the Panel concluded that it was enough. Yet in other cases, there may be other factors that will be just as relevant or more relevant to demonstrating that the dissimilar taxation at issue was applied 'so as to afford protection.' In any case, the three issues that must be addressed in determining whether there is such a violation must be addressed clearly and separately in each case and on a case-by-case basis. And, in every case, a careful, objective analysis, must be done of each and all relevant facts and all the relevant circumstances in order to determine 'the existence of protective taxation.' Although the Panel blurred its legal reasoning in this respect, nevertheless we conclude that it reasoned correctly that in this case, the Liquor Tax Law is not in compliance with Article III:2. As the Panel did, we note that:

. . . the combination of customs duties and internal taxation in Japan has the following impact: on the one hand, it makes it difficult for foreign-produced shochu to penetrate the Japanese market and, on the other, it does not guarantee equality of competitive conditions between shochu and the rest of <white = and <brown= spirits. Thus, through a combination of high import duties and differentiated internal taxes, Japan manages to ‘isolate’ domestically produced shochu from foreign competition, be it foreign produced shochu or any other of the mentioned white and brown spirits. (*italics in the original*).

In *Korea—Taxes on Alcoholic Beverages*, the AB almost *verbatim* reproduced this view (§ 150):

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such protective application . . . Most often, there will be other factors to be considered as well.

In *Chile—Alcoholic Beverages*, the AB had the opportunity to apply this test in a particular case. In this case, the AB was asked to pronounce on the consistency of the Chilean tax system for alcoholic beverages with the GATT: the scheme distinguished between two categories of alcoholic beverages, using alcoholic content as the distinguishing criterion: below 35° and above 39°. <sup>120</sup> The complaining party (European Community) had argued that many western products of slightly more than 39° were DCS products to Chilean products of less than 35°, and, that the tax differential operated ASATAP. In the view of exporters of “western” alcoholic drinks, the Chilean tax regime favored predominantly locally produced alcoholic beverages (some categories of *pisco*). Chile responded that its scheme did not condition the payment of the higher tax on the origin of the product, and, moreover, that in the 39° and above tax category the majority of the products hit by high taxation were domestic. As a result, in Chile’s view, no protection could result from such a taxation scheme (§ 58).

The AB condemned the Chilean fiscal scheme. It first held that the tax differential (27% and 47%) across the two categories of lower and higher alcoholic content drinks was more than *de minimis* (§§ 44ff).

The AB then asked the question whether the dissimilar taxation supported the conclusion that it was ASATAP to the domestic product. In this context, it repeated and clarified the test it had developed to decide whether such was the case. Although the quoted passage is

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<sup>120</sup> All cases discussed so far are cases of alleged *de facto* discrimination.

quite lengthy, we believe it deserves to be cited since it sheds precious light on the manner in which the AB understands the ASATAP test in case of differential taxation across two DCS products (§§ 62 – 66):

. . . . The *subjective* intentions inhabiting the minds of individual legislators or regulators do not bear upon the inquiry, if only because they are not accessible to treaty interpreters. It does not follow, however, that the statutory purposes or objectives – that is, the purpose or objectives of a Member's legislature and government as a whole – to the extent that they are given *objective* expression in the statute itself, are not pertinent. To the contrary, as we also stated in *Japan – Alcoholic Beverages*:

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the *design*, the *architecture*, and the revealing *structure* of a measure. (emphasis added)

We turn, therefore, to the design, the architecture and the structure of the New Chilean System itself. That system taxes *all* alcoholic beverages with an alcohol content of 35° or below on a linear basis, at a fixed rate of 27 per cent *ad valorem*. Thereafter, the rate of taxation increases steeply, by 4 percentage points for every additional degree of alcohol content, until a maximum rate of 47 per cent *ad valorem* is reached. This fixed tax rate of 47 per cent applies, once more on a linear basis, to *all* beverages with an alcohol content in excess of 39°, irrespective of how much in excess of 39° the alcohol content of the beverage is.

We note, furthermore, that, according to the Panel, approximately 75 per cent of all domestic production has an alcohol content of 35° or less and is, therefore, taxed at the lowest rate of 27 per cent *ad valorem*. [footnote omitted] Moreover, according to figures supplied to the Panel by Chile, approximately *half* of all domestic production has an alcohol content of 35° and is, therefore, located on the line of the progression of the tax at the point *immediately before* the steep increase in tax rates from 27 per cent *ad valorem*. The start of the highest tax bracket, with a rate of 47 per cent *ad valorem*, coincides with the point at which most imported beverages are found. Indeed, according to the Panel, that tax bracket contains approximately 95 per cent of all directly competitive or substitutable imports. [footnote omitted]

Although the tax rates increase steeply for beverages with an alcohol content of more than 35° and up to 39°, there are, in fact, very few beverages on the Chilean market, either domestic or imported, with an alcohol content of between 35° and 39°. [footnote: Chile's response to Question 1 of the Panel, 26 November 1998. These figures indicate that approximately 5 per cent of all distilled alcoholic beverages have an alcohol content in this range. At the oral hearing, Chile confirmed that very few beverages have an alcohol content of between 35° and 39°.] The graduation of the rates for beverages with an alcohol content of between 35° and 39° does not, therefore, serve to tax distilled alcoholic beverages on a progressive basis. Indeed, the steeply graduated progression of the tax rates between 35° and 39° alcohol content seems

anomalous and at odds with the otherwise linear nature of the tax system. With the exception of the progression of rates between 35° and 39° alcohol content, this system simply applies one of two fixed rates of taxation, either 27 per cent *ad valorem* or 47 per cent *ad valorem*, each of which applies to distilled alcoholic beverages with a broad range of alcohol content, that is, 27 per cent for beverages with an alcoholic content of *up to 35°* and 47 per cent for beverages with an alcohol content of *more than 39°*.

In practice, therefore, the New Chilean System will operate largely as if there were only two tax brackets: the first applying a rate of 27 per cent *ad valorem* which ends at the point at which most domestic beverages, by volume, are found, and the second applying a rate of 47 per cent *ad valorem* which begins at the point at which most imports, by volume, are found. The magnitude of the difference between these two rates is also considerable. The absolute difference of 20 percentage points between the two rates represents a 74 per cent increase in the lowest rate of 27 per cent *ad valorem*. Accordingly, examination of the design, architecture and structure of the New Chilean System tends to reveal that the application of dissimilar taxation of directly competitive or substitutable products will "afford protection to domestic production." (italics and emphasis in the original).

Note that the AB agreed that, as a matter of fact, most of the alcoholic drinks hit by the higher taxation were of Chilean origin. However, it dismissed the relevance of this observation for the interpretation of the ASATAP requirement in the following terms (§ 67):

This fact does not, however, by itself outweigh the other relevant factors, which tend to reveal the protective application of the New Chilean System. The relative proportion of domestic versus imported products within a particular fiscal category is not, in and of itself, decisive of the appropriate characterization of the total impact of the New Chilean system under Article III:2, second sentence, of the GATT 1994. This provision, as noted earlier, provides for equality of competitive conditions of *all* directly competitive or substitutable imported products, in relation to domestic products, and not simply, as Chile argues, those imported products within a particular fiscal category. The cumulative consequence of the New Chilean System is, as the Panel found, that approximately 75 percent of all domestic production of the distilled alcoholic beverages at issue will be located in the fiscal category with the lowest tax rate, whereas approximately 95 percent of the directly competitive or substitutable imported products will be found in the fiscal category subject to the highest tax rate. (emphasis in the original).

It should also be noted that the AB does not compare in absolute terms the size of the domestic production that is being hit by the higher tax to the absolute volume of imports being hit by the tax – it only compares proportions. But what if the domestic industry, despite representing a relatively small share of the total domestic industry, were much larger than imports, and therefore carried most of the burden of the tax? Could this not be

interpreted to mean that the tax distinction serves some other purpose than protectionism, a purpose that deserves to be taken into consideration in the evaluation of the measure? Chile argued that domestic producers were carrying most of the tax burden in the high tax category. In the view of the AB, however, this was not enough to establish that the legislation at hand did not operate ASATAP; in the view of the AB, the purpose of Art. III GATT is to establish equality of competitive conditions with respect to all DCS products. Since, in the AB's view, drinks slightly above and slightly below 39° are DCS products, and since some western drinks above 39° were hit harder than some domestic drinks containing alcohol below 39°, the Chilean tax scheme operated ASATAP.

Chile offered a more 'regulatory' defense as well in an effort to justify the tax differential (§ 69):

Before the Panel, Chile stated that the New Chilean System pursued four different objectives: "(1) maintaining revenue collection; (2) eliminating type distinctions [such] as [those which] were found in Japan and Korea; (3) discouraging alcohol consumption; and (4) minimizing the potentially regressive aspects of the reform of the tax system

The AB was not persuaded (§ 71):

The conclusion of protective application reached by the Panel becomes very difficult to resist, in the absence of countervailing explanations by Chile. The mere statement of the four objectives pursued by Chile does not constitute effective rebuttal on the part of Chile.

It follows that in this case the AB confirmed and clarified the basic approach that a 20 percent tax differential may satisfy the 'not similarly taxed' requirement; in this case it is the sharp tax differential across the two categories of alcoholic drinks (the lower category being predominantly of national origin, the higher of foreign origin) that reveal the protective character of the legislation. The fact that *de facto* it is domestic goods that bear the bulk of the tax burden in the higher-taxation category was judged immaterial since neither effects nor intent is relevant in the context of Art. III GATT.

#### 3.2.3.4 Like Products

Recall that, for a complainant to demonstrate a violation of Art. III.2 GATT, first sentence, it will have to demonstrate that:

- (a) the domestic and the foreign products are *like*; and
- (b) the latter is taxed *in excess* of the former.

The term *like products* has been interpreted in many GATT/WTO panels, and not always in consistent manner. GATT case law evidences two trends:

- (a) there are a number of cases that follow a marketplace test: *likeness* is defined by reference to consumers' reactions;<sup>121</sup>
- (b) there are two cases which reveal a willingness to take into account regulatory intent when establishing likeness among domestic and foreign products.

Let us start with the former. The *Working Party on Border Tax Adjustments*<sup>122</sup> established four criteria to define *likeness* (§ 18):

- (a) the properties, nature and quality of the products;
- (b) the end-uses of the products;
- (c) consumers' tastes and habits—more comprehensively termed consumers' perceptions and behavior—in respect of the products; and
- (d) the tariff classification of the products.

It did not assign a particular weight on each of them. Relying on these four criteria, the panel report on *Japan—Alcoholic Beverages I* held that, alcoholic beverages (§ 5.6):

. . . should be considered as 'like products' in terms of Article III:2 in view of their similar properties, end-uses and usually uniform classification in tariff nomenclatures.

The two reported cases that dismissed marketplace as the relevant criterion to decide on likeness are the panel reports on *US—Malt Beverages* and on *US—Taxes on Automobiles* ('*Gas Guzzler*', as it is widely known).<sup>123</sup>

In *US—Malt Beverages*, the panel defines *likeness* in § 5.25:

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<sup>121</sup> So far, there is not one single case where supply-substitutability has been accounted for when defining likeness or DCS relationship.

<sup>122</sup> See GATT Doc L/3464, adopted on 2 December 1970, GATT Doc. BISD 18S/97.

<sup>123</sup> This report remains unadopted and is, hence, of limited legal value. In fact, as we will see *infra*, it was totally rejected by a subsequent WTO panel dealing with the same issue.

Consequently, in determining whether two products subject to different treatment are like products, it is necessary to consider whether such product differentiation is being made ‘so as to afford protection to domestic production’. While the analysis of ‘like products’ in terms of Article III:2 must take into consideration this objective of Article III, the Panel wished to emphasize that such an analysis would be without prejudice to the ‘like product’ concepts in other provisions of the General Agreement, which might have different objectives and which might therefore also require different interpretations.

In *US—Taxes on Automobiles*,<sup>124</sup> the panel had the opportunity to elaborate further on this proposition by introducing the so-called *aims and effects* test (§§ 5.7 and 5.10):

In order to determine this issue, the Panel examined the object and purpose of paragraphs 2 and 4 of Article III in the context of the article as a whole and the General Agreement.

...

The Panel then proceeded to examine more closely the meaning of the phrase ‘so as to afford protection.’ The Panel noted that the term ‘so as to’ suggested both aim and effect. Thus the phrase ‘so as to afford protection’ called for an analysis of elements including the aim of the measure and the resulting effects. A measure could be said to have the *aim* of affording protection if an analysis of the circumstances in which it was adopted, in particular an analysis of the instruments available to the contracting party to achieve the declared domestic policy goal, demonstrated that a change in competitive opportunities in favour of domestic products was a desired outcome and not merely an incidental consequence of the pursuit of a legitimate policy goal. A measure could be said to have the *effect* of affording protection to domestic production if it accorded greater competitive opportunities to domestic products than to imported products. The effect of a measure in terms of trade flows was not relevant for the purposes of Article III, since a change in the volume or proportion of imports could be due to many factors other than government measures. (emphasis in the original).

According to this view, consequently, likeness will not be defined by reference to prevailing perceptions in the marketplace about the products concerned but, instead, by reference to the regulatory aims pursued by the intervening government.

In *Japan—Alcoholic Beverages II*, the panel explicitly rejected for various reasons (ranging from the insurmountable burden that such a test would impose on the complainant to the fact that

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<sup>124</sup> In this case, the European Community challenged the consistency of the U.S. tax scheme applicable to cars, according to which, the total fleet of a producer would be taken into account in order to decide on the tax that would be imposed. Producers with a fleet that consisted of large cubism cars (gas guzzlers) would suffer most, as a result. Many European producers belonged to this category. The U.S. regime was apparently enacted at a time when those suffering most were U.S. producers, in an effort to dissuade consumers eager to buy such cars from buying them.

adoption of the test would lead Art. XX GATT to redundancy) the relevance of the *aims and effects* test (§§ 6.15 – 6.19). The AB endorsed the panel’s approach (pp. 16ff.).

In the same report, the AB (pp. 19ff.) ruled that the term *like products* should be defined by reference to the marketplace. The AB did not *explicitly* hold in this report that for two products to be like they have to be DCS. It did so, however, in a subsequent report that we mentioned above, in its report on *Korea—Alcoholic Beverages* (§ 118). In *Japan – Alcoholic Beverages II*, the AB did state explicitly that the term *like products* invites a narrow reading, that is, a reading narrower than DCS, and that customs classification is relevant to establish likeness, beyond the criteria traditionally used to establish DCS relationship. In this often-quoted passage, the AB held that:

The concept of ‘likeness’ is a relative one that evokes the image of an accordion. The accordion of ‘likeness’ stretches and squeezes in different places as different provisions of the WTO Agreement are applied. The width of the accordion in any one of those places must be determined by the particular provision in which the term ‘like’ is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply. We believe that, in Article III:2, first sentence of the GATT 1994, the accordion of ‘likeness’ is meant to be narrowly squeezed.

However, not just any customs classification can assist in the definition of likeness. A necessary condition is that the classification be precise (pp. 23–24):

If sufficiently detailed, tariff classification can be a helpful sign of product similarity.

...

It is true that there are numerous tariff bindings which are in fact extremely precise with regard to product description and which, therefore, can provide significant guidance as to the identification of ‘like products.’

This would *usually* be the case with respect to six-digit classifications. Four-digit classifications are usually uninformative, and eight-digit classifications are a matter of national definition, and not of worldwide acceptance.

We can conclude that case law in its totality suggests that two products will be like if they are DCS *and* if they share a detailed (six digit for the overwhelming majority of cases) tariff classification.

### 3.2.3.5 Taxation in Excess

The AB has stated that even a *minimal* tax differential suffices to satisfy the in-excess criterion. In *Japan—Alcoholic Beverages II*, the AB relevantly held (p. 23):

Even the smallest amount of ‘excess’ is too much. ‘The prohibition of discriminatory taxes in Article III:2, first sentence, is not conditional on a ‘trade effects test’ nor is it qualified by a *de minimis* standard. (italics in the original).

This approach is very much in line with the GATT panel report on *US—Superfund*: a mere arithmetic difference suffices for a demonstration of violation of the *in excess* requirement.

### 3.2.4 Nonfiscal Instruments

Art. III.4 GATT deals with domestic nonfiscal instruments. The list of such instruments is endless as per our discussion *supra* on incomplete contracting, covering areas such as public health, environmental protection, human rights, antitrust, consumer protection. Irrespective of the precise subject matter, a complainant aiming to establish that this provision has been violated, will according to Art. III.4 GATT have to demonstrate that:

- (a) with respect to a law, regulation, or requirement;
- (b) affecting internal sale, offer for sale, purchase, transportation, distribution, or use;
- (c) a foreign good is afforded in comparison to a domestic like good;
- (d) less favorable treatment.

#### 3.2.4.1 Laws, Regulations, or Requirements

GATT/WTO case law has understood the term ‘laws, regulations and requirements’ featured in Art. III.4 GATT as equivalent to the term ‘measure’ featured in Art. XXIII.1b GATT, and Art. XI GATT. Case law under these provisions has consistently the term ‘measure’ in a broad manner.<sup>125</sup> The same should consequently hold true in the context of Art. III.4 GATT as well; indeed, so far we have witnessed no case where a WTO adjudicating body has rejected a claim because the complainant failed to show that a ‘law, regulation or requirement’ was being challenged. The inclusion of the term ‘requirements’ definitely

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<sup>125</sup> See, for example, the Panel report on *Japan – Trade in Semiconductors*, discussed in Chapter 2, which has been cited in every single case dealing with Art. XI GATT ever since. See also the Panel report on *Japan – Film (Kodak/Fuji)* on this score.

supports this construction: it was meant to ensure that the provision is not restricted to formal laws only.

The next question is to what extent a measure is attributed to a government, since the GATT does not regulate private behavior. WTO case law has addressed attribution in the context of Art. III.4 GATT in parallel with the approach followed in the context of Art. XI GATT: not only acts of governments, but also acts of private parties can be challenged under Art. III.4 GATT, provided that they can be attributed to a government.<sup>126</sup> We read in the Panel report on *US—FSC* (§ 10.376):

A literal reading of the words *all laws, regulations and requirements* in Article III:4 could suggest that they may have a narrower scope than the word *measure* in Article XXIII:1(b). However, whether or not these words should be given as broad a construction as the word *measure*, in view of the broad interpretation assigned to them in the cases cited above, we shall assume for the purposes of our present analysis that they should be interpreted as encompassing a similarly broad range of government action and action by private parties that may be assimilated to government action. In this connection, we consider that our previous discussion of GATT cases on administrative guidance in relation to what may constitute a ‘measure’ under Article XXIII:1(b), specifically the panel reports on *Japan—Semi-conductors and Japan—Agricultural Products*, is equally applicable to the definitional scope of ‘all laws, regulations and requirements’ in Article III:4. (italics and emphasis in the original).

It follows that government behavior that is channeled through private actors can be challenged under Art. III.4 GATT. This observation might have practical import in the field of antitrust where, following government authorization, private practices that might restrain trade could come under the purview of Art. III.4 GATT.

#### 3.2.4.2 Affecting Sale, Offering for Sale

This term has been interpreted to cover measures that not only actually, but also *potentially* and/or *indirectly* affect trade. The AB report on *US—FSC* confirmed the wide interpretation of the term ‘affecting’ (§§ 208–210):

. . . the word ‘affecting’ assists in defining the types of measure that must conform to the obligation not to accord ‘less favourable treatment’ to like imported products, which is set out in Article III:4.

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<sup>126</sup> Note that attribution is a nonissue in the context of Art. III.2 GATT: fiscal measures can only be imposed by governments, or by nongovernmental organs, following delegation of authority by governments.

The word ‘affecting’ serves a similar function in Article I:1 of the *General Agreement on Trade in Services* (the ‘GATS’), where it also defines the types of measure that are subject to the disciplines set forth elsewhere in the GATS but does not, in itself, impose any obligation . . . .

In view of the similar function of the identical word, ‘affecting’, in Article III:4 of the GATT 1994, we also interpret this word, in this provision, as having a ‘broad scope of application.’ (italics in the original).

There is not one single case where a challenged measure failed to meet the ‘affecting’ requirement.

### 3.2.4.3 Like Products in Art. III.4 GATT

Art. III.4 GATT does not distinguish between like and DCS products, in contrast to Art. III.2 GATT. The question hence arises whether the term like should have the same meaning across the two paragraphs. The AB decided that this should not be the case, as we detail in what follows. In its report on *EC—Asbestos*, the WTO adjudicating bodies were called to pronounce on the GATT-consistency of a French ban on the sales of asbestos-containing construction material. The sales ban was nondiscriminatory, that is, it applied irrespective of the origin of the asbestos-containing construction material. France’s prohibition (administrative decree) of sales of asbestos-containing construction material was based on scientific evidence: the *chrysotile fibers* in the asbestos in the imported product was a known carcinogen. But Canada argued that construction material containing chrysotile fibers was a like product to construction material containing *PCG fibers*, the corresponding asbestos-free substance in the domestically produced construction material. Construction material containing PCG fibers was being legally sold in France. Canada argued that by allowing sales of the material containing PGG fibers but not chrysotile fibers, the French ban accorded the Canadian good less favorable treatment than that accorded to the French like good.<sup>127</sup>

The Panel had decided that the two products were indeed like since the end uses of the two products were the same. The differential treatment of the two products meant that France was according imported products less favorable treatment than that accorded to domestic like products. Consequently, Art. III.4 GATT was violated. The Panel therefore moved to examine the French (or rather EU) defense under Art. XX GATT.

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<sup>127</sup> See the discussion of the AB report in Horn and Weiler (2007), which forms the basis for the analysis here.

The AB first addressed the issue whether asbestos-containing and asbestos-free materials were like products. In order to respond to this question, the AB as a first step held that the term like products in Art. III.4 GATT should be interpreted in light of the over-arching purpose of Art. III GATT: absent parallelism in the coverage across paragraphs III.2 and III.4 GATT, WTO Members would be incurring obligations of different scope with respect to fiscal and nonfiscal instruments; this view was not in the eyes of the AB supported by the negotiating record. The AB consequently held that the term like products in Art. III.4 of the GATT should be understood as covering products that are in competitive relationship with one another. It explicitly accepted a wide coverage of the term like products (wider than that of the corresponding term featured in Art. III.2 GATT), but not wider than the combined coverage of the terms like and DCS coming under the purview of Art. III.2 GATT (§§ 98–100).

Then, the AB reversed the Panel's findings with respect to likeness. In its view, the Panel should have examined all four criteria mentioned in the WP on BTAs (border tax adjustments) to confer likeness and not just end uses. Had it done so, the Panel would in the AB's view have observed the differences in physical characteristics between the two products. In the AB's view, the composition of a product is very much part of the physical-characteristics analysis. Chrysotile fibers and PCG fibers are not the same: the first are carcinogenic, whereas the latter are not. The health hazard would in the AB's view most likely have led ultimate consumers of construction material to avoid purchase material containing chrysotile fibers, had it been marketed. Professional buyers of construction material, who would often not be exposed themselves to the health risk, but would take such reactions into account, would therefore purchase less of such material. Based on such reasoning, the AB found the two products to be unlike (§§ 101–154). The finding of non-likeness was hence based on the AB's assessment of the construction companies' assessment of how the latter would be affected, through the market mechanism, of the assessment of their customers of differences in risk.

The AB effectively held that the presence of health risk in asbestos containing-construction material only raised a presumption that the two products were unlike, increasing the burden of proof for Canada. *In casu*, Canada did not rebut this presumption and consequently lost the case.<sup>128</sup>

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<sup>128</sup> In a separate but concurring opinion, an unnamed member of the AB held the view, that the scientific proof cited in this case was sufficient to conclude that the two products were unlike. One way to understand the need for a separate opinion is probably that, in this member's eyes, the difference in physical characteristics, and the ensuing consumers' reaction, does not merely raise a presumption, but amounts to a home run: Canada could never rebut such evidence.

The *EC-Asbestos* dispute hence contains a novelty from a burden-of-proof point of view. When making its likeness determination, the AB did not rely on studies or information concerning actual buyer behavior, the AB uses instead its own interpretation of what buyers would reasonably do, if facing a choice between the two products (§ 122):

In this case especially, we are also persuaded that evidence relating to consumers' tastes and habits would establish that the health risks associated with chrysotile asbestos fibres influence consumers' behaviour with respect to the different fibres at issue. We observe that, as regards *chrysotile asbestos and PCG fibres*, the consumer of the fibres is a *manufacturer* who incorporates the fibres into another product, such as cement-based products or brake linings. We do not wish to speculate on what the evidence regarding these consumers would have indicated; rather, we wish to highlight that consumers' tastes and habits regarding *fibres*, even in the case of commercial parties, such as manufacturers, are very likely to be shaped by the health risks associated with a product which is known to be highly carcinogenic. A manufacturer cannot, for instance, ignore the preferences of the ultimate consumer of its products. If the risks posed by a particular product are sufficiently great, the ultimate consumer may simply cease to buy that product. This would, undoubtedly, affect a manufacturer's decisions in the marketplace. Moreover, in the case of products posing risks to human health, we think it likely that manufacturers' decisions will be influenced by other factors, such as the potential civil liability that might flow from marketing products posing a health risk to the ultimate consumer, or the additional costs associated with safety procedures required to use such products in the manufacturing process. (§ 122, italics in the original, underlining added).

In the preceding recital to the above-quoted passage, the AB had however, noted:

Furthermore, in a case such as this, where the fibres are physically very different, a panel *cannot* conclude that they are "like products" if it *does not examine* evidence relating to consumers' tastes and habits . . . (italics in original).

Still, the AB did not think it was necessary to look for market evidence when deciding on the likeness of the products concerned. So the test for likeness is a market test in name only, since it is the hypothetical reactions of a reasonable consumer that will define, according to this test, whether two products are like.<sup>129</sup> In other words, the AB here effectively reduced the probative value of quantitative evidence.

This finding in the report raises a number of issues:

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<sup>129</sup> The AB found additional support for its overall finding in the fact that chrysotile fibers and PCG fibers do not share the same tariff classification, and, also, in the fact that scientific evidence was cited in support of the carcinogenic nature of chrysotile fibers.

- (a) if as the AB asserts, consumers would treat the two products as like, what was then the need for France to impose the sales ban in the first place? Arguably, France imposed the measure precisely because consumers would treat the two goods as substitutes. The axiomatic distinction that the AB drew is probably not supported by facts;<sup>130</sup>
- (b) this is not to say that France should have lost this case. On the contrary, France produced highly credible scientific evidence of the health hazard from exposure to asbestos. In our view, the question before the AB should have been whether France's measures afforded less favorable treatment to the imported goods, an issue that we discuss in what immediately follows.<sup>131</sup>

#### 3.2.4.4 Less Favorable Treatment

The function of this requirement has occupied a number of reports, and in particular the question regarding the relationship between less favorable treatment (LFT) and the ASATAP-requirement which appears in Art. III.1, and III.2 GATT. In *EC—Bananas III*, the AB held that:

Article III:4 does not specifically refer to Article III:1. Therefore, a determination of whether there has been a violation of Article III:4 does *not* require a separate consideration of whether a measure afford[s] protection to domestic production. (emphasis in the original).

In its report on *EC—Asbestos*, the AB explicitly held that LFT echoes the principle set forth in Art. III.1 GATT: WTO Members should not use domestic measures so as to afford protection to domestic production (§ 100):

The term 'less favourable treatment' expresses the general principle, in Article III:1, that internal regulations 'should not be applied . . . so as to afford protection to domestic

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<sup>130</sup> Lydgate (2011) reaches similar conclusions.

<sup>131</sup> The report received mixed reactions in doctrine. On one end of the spectrum, Yavitz (2002) criticizes this case law for not interpreting the key terms in this provision in a manner that would honor its agreed function, that is, to avoid that WTO Members use nonfiscal instruments so as to afford advantages to their domestic production. In contrast, Howse and Tuerk (2001) agree with the basis of the reasoning of the AB report, and disagree vehemently with the Panel approach. The authors defend a comprehensive discrimination test that should take place within the four corners of Art. III GATT (instead of moving the discussion to Art. XX GATT). They thus see the AB report as a positive step in this direction. These and other views are not necessarily mutually inconsistent, since their focus is on different parts of the report.

production.’ If there is ‘less favourable treatment’ of the group of ‘like’ imported products, there is, conversely, ‘protection’ of the group of ‘like’ domestic products. However, a Member may draw distinctions between products which have been found to be ‘like,’ without, for this reason alone, according to the group of ‘like’ *imported* products ‘less favourable treatment’ than that accorded to the group of ‘like’ *domestic* products. (emphasis in the original).

Two consequences stem from the quoted passages:

- (a) the complainant who is asked to show LFT, does not have to also show that a law is ASATAP;
- (b) distinctions can be drawn between like goods without necessarily violating Art. III.4 GATT.

The natural questions to follow are: What needs to be shown besides differential treatment? And who should carry the burden of proof? This is an area where case law has not progressed smoothly and coherently.

The AB report on *Korea—Various Measures on Beef* was the first report that discussed in detail the nuts and bolts of the LFT test. This dispute, between Korea on the one hand, and a host of beef exporters on the other, concerned the distribution of beef in the Korean market. Korea had enacted a law whereby traders at the retail level could sell either domestic or imported beef but not both; this was denoted the “dual retail system.” The complainants argued that as a result of this system, there were only 5000 points of sale for imported beef, compared to over 45,000 points of sale for domestic beef. Since this made it more difficult to sell imported than domestic beef, the dual retail system therefore violated Art. III.4 GATT. Korea pointed to the fact that it had in place an import quota for beef, the legality of which was not put into question during the proceedings: indeed, Korea had invoked the balance-of-payments provisions of the GATT to impose a quota on the import of beef, and complainants had not questioned the legitimacy of this action. Korea added that the quota had been absorbed all years when the system was in place, with one exception only: following the financial crisis in 1997, when overall consumption (of both domestic and foreign beef) fell dramatically. Hence, in Korea’s view complainants suffered trade damage only one year.

Korea also argued before the Panel that the dual retail system was not discriminatory, in light of the fact that traders were free to choose whether they would sell domestic or foreign beef, and that there was no legal compulsion obliging them to choose one category of beef over the other; they could further subsequently switch at no cost from selling beef of one

origin to selling the other.<sup>132</sup> Korea claimed that a legislation that provides equality of competitive conditions passes the test of consistency with Art. III GATT, even if some trade effects might look harmful to exporters; it was effectively arguing that the complainants cannot on the one hand claim that trade effects are immaterial, and on the other, base their complaint on trade effects.<sup>133</sup> The Panel rejected all of Korea's claims, and found in favor of the complainants.

On appeal, the AB held that this system, although formally nondiscriminatory, still modified the conditions of competition to the detriment of the imported product, and found Korea's practices to be inconsistent with Art. III.4 GATT since it afforded LFT to imported like products. The modification of conditions of competition was evident, in the AB's view, by the fact that fewer retailers decided to sell imported beef (§§ 143–151). The AB accepted that the choice to distribute domestic or imported beef was in the hands of private retailers. In a rather cryptic passage it held that LFT resulted from Korea's decision not to stick to the prior regime (§ 146):

We are aware that the dramatic reduction in number of retail outlets for imported beef followed from the decisions of individual retailers who could choose freely to sell the domestic product or the imported product. The legal necessity of making a choice was, however, imposed by the measure itself. The restricted nature of that choice should be noted. The choice given to the meat retailers was *not* an option between remaining with the pre-existing unified distribution set-up or going to a dual retail system. The choice was limited to selling domestic beef only or imported beef only. Thus, the reduction of access to normal retail channels is, in legal contemplation, the effect of that measure. In these circumstances, the intervention of some element of private choice does not relieve Korea of responsibility under the GATT 1994 for the resulting establishment of competitive conditions less favourable for the imported product than for the domestic product. (emphasis in the original).

The AB was quick to highlight what it had not been prejudging through its decision (§ 149):

It may finally be useful to indicate, however broadly, what we are *not* saying in reaching our above conclusion. We are *not* holding that a dual or parallel distribution system that is *not* imposed directly or indirectly by law or governmental regulation, but is rather solely the

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<sup>132</sup> Korea did not contest before the Panel the assertion of complainants that domestic and imported beef were like goods.

<sup>133</sup> Korea also made claims under Art. XX GATT, and argued that the system was in place in order to combat tax fraud: traders had the incentive to sell imported beef for domestic, in light of the very substantial price-differential between imported and domestic beef (the latter being substantially more expensive than the former).

result of private entrepreneurs acting on their own calculations of comparative costs and benefits of differentiated distribution systems, is unlawful under Article III:4 of the GATT 1994. What is addressed by Article III:4 is merely the *governmental* intervention that affects the conditions under which like goods, domestic and imported, compete in the market within a Member's territory. (emphasis in the original).

So, the AB did not go so far as to outlaw exclusivity contracts signed between suppliers and retailers. Arguably, exclusivity contracts, assuming market power in the upstream (or even, in some legal orders, in the downstream) market, will be judged illegal under many national antitrust statutes, unless they have benefited from antitrust exemption. Is a government anti-trust exemption sufficient for the AB to outlaw similar practices? The AB did not provide a comprehensive response to this question, although it did note that purely private contracts that provide for exclusivity have not been outlawed as a result of this report.

This case raises many questions casting serious doubt on the intellectual legitimacy of the AB's reasoning:

- (a) What exactly is the LFT here? Is it the fact that imported beef was previously being sold through the same channel as domestic beef, or is it the fact that only 5000 outlets sell imported beef whereas 45,000 outlets sell domestic beef? It cannot be the former, since the same requirement was imposed on domestic beef (it cannot be sold through the same channels as imported beef), hence no LFT results from this modification of conditions of competition. It cannot be the latter either since trade effects, so says consistent case law, are immaterial. Or are they?
- (b) If trade effects do matter, how can we judge whether availability of imported beef in 5000 as opposed to 45,000 outlets operates to the detriment of imported beef unless if we have information about the sales volumes in these outlets as well as the sales volumes in the policy-unconstrained case?
- (c) What exactly is the detriment to imported beef when the quota was absorbed all the years that it was in place except for one when indeed extraordinary circumstances (by any reasonable account) occurred? We should add here that it cannot be that the modification of conditions of competition *per se* constitutes a GATT violation: the GATT is a negative integration contract and trading partners retain the right to design and modify their laws as they find appropriate, as long as they observe the basic nondiscrimination obligation. Hence, it is the notion that the modification of conditions of competition is to the detriment of imported goods that must form the basis of the AB judgment; and

- (d) Since LFT equals ASATAP, should not the AB inquire into the design, structure, and architecture of the law? Well, it did so in the context of Art. XX GATT and did not cast doubt on the Korean justification that it was done for consumer-protection purposes: Korean beef sold at a much higher price than imported beef, and Korea argued that the dual retail system (along with other measures) were meant to guarantee that traders would not fraudulently sell imported beef as Korean. The acceptance by the AB of this reasoning leads to the question of how does the design, structure, and architecture of the measure support a finding of LFT?<sup>134</sup>

Without explicitly deviating from this case law, the AB in fact reversed it in a subsequent case: In its report on *Dominican Republic – Import and Sale of Cigarettes*, the AB upheld the Panel's rejection of Honduras's claim under Art. III.4 GATT. It agreed with the Panel that a detrimental effect of a measure (the measure here was a bond requirement, under which cigarette importers had to post a bond to ensure payment of taxes) on a given imported product does not necessarily imply that the measure accords less favorable treatment to imports, if the effect is explained by factors unrelated to the foreign origin of the product; in this case, the factor explaining the treatment was the market share of the importer, in the sense that the level of the bond requirement depended on the market share that the importer (or the domestic producer) attained in the Dominican Republic market (§ 96):

The Appellate Body indicated in *Korea – Various Measures on Beef* that imported products are treated less favorably than like products if a measure modifies the conditions of competition in the relevant *market to the detriment of imported products*. However, the existence of a detrimental effect on a given imported product resulting from a measure does not necessarily imply that this measure accords less favorable treatment to imports if the detrimental effect is explained by factors or circumstances unrelated to the foreign origin of the product, such as the market share of the importer in this case. In this specific case, the mere demonstration that the per-unit cost of the bond requirement for imported cigarettes was higher than for some domestic cigarettes during a particular period is not, in our view, *sufficient* to establish "less favourable treatment" under Article III:4 of the GATT 1994. Indeed, the difference between the per-unit costs of the bond requirement alleged by Honduras is explained by the fact that the importer of Honduran cigarettes has a smaller market share than two domestic producers

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<sup>134</sup> In §§ 172ff. of its report, the AB held that Korea had violated its obligations under Art. XX(d) GATT not because the measure was not authentically pursuing consumer protection, but because it was unnecessary, in the sense more trade-restrictive than necessary. We discuss this aspect of the report in Chapter 4. Suffice, nonetheless, to mention here that there is no necessity requirement in Art. III GATT: if the measure did indeed modify conditions of competition to the detriment of imported goods (a highly doubtful proposition for the reasons mentioned above), and was not origin-based (as the Panel and the AB accepted), then it should have passed the test of consistency under Art. III GATT as the AB report on *Dominican Republic-Import and Sale of Cigarettes* that we discuss *infra* has held.

(the per-unit cost of the bond requirement being the result of dividing the cost of the bond by the number of cigarettes sold on the Dominican Republic market). In this case, the difference between the per-unit costs of the bond requirement alleged by Honduras does not depend on the foreign origin of the imported cigarettes. Therefore, in our view, the Panel was correct in dismissing the argument that the bond requirement accords less favorable treatment to imported cigarettes because the per-unit cost of the bond was higher for the importer of Honduran cigarettes than for two domestic producers. (italics and emphasis in the original).

The argument here differed from the approach in *Korea-Various Measures of Beef*, where the principle laid down was that a measure afforded LFT if the detrimental effect for imported goods was a function of their origin. The AB did not explain the exact nature of the test that determines whether the detriment is due to the origin of goods (or not). In this case, it found in favor of the defendant because on its face the law did not link the level of bond requirements to anything other than market share. There is thus a marked difference between the two reports: a measure that operates to the detriment of imported goods is in violation of Art. III.4 GATT in the world of *Korea-Various Measures of Beef*; this is not necessarily the case in the world of *Dominican Republic-Import and Sale of Cigarettes*: if the measure is justified on reasons other than the origin of the goods then, even in presence of detrimental effects to imported goods, it will pass muster under Art. III.4 GATT.

In a similar vein, the AB held in its report on *US – FSC* (Article 21.5 – EC) in § 215:

The examination of whether a measure involves "less favourable treatment" of imported products within the meaning of Article III:4 of the GATT 1994 must be grounded in close scrutiny of the "fundamental thrust and effect of the measure itself". This examination cannot rest on simple assertion, but must be founded on a careful analysis of the contested measure and of its implications in the marketplace. At the same time, however, the examination need not be based on the *actual effects* of the contested measure in the marketplace. (emphasis in the original).

Yet, in a more recent case, we see no mention to the AB report on *Dominican Republic-Import and Sale of Cigarettes*. In *Thailand-Cigarettes*, the AB was asked to pronounce on the consistency of a Thai tax measure with Art. III.4 GATT. Thailand had argued before the Panel and the AB that its measures were not origin-related and hence not in violation of Art. III.4 GATT. In § 126 of its report, the AB discusses LFT referring time and again to *Korea-Various Measures on Beef* and avoiding any reference to *Dominican Republic-Import and Sale of Cigarettes*. To make things even more confusing on this front, in *US-Clove Cigarettes*, a Panel report released in September 2011, the Panel discusses the LFT requirement exclusively in light of the findings of the AB report on *Dominican Republic-Import and Sale of Cigarettes* (pp.

79ff.). This Panel report was issued months after the AB report on *Thailand-Cigarettes*, and it is quite legitimate to suspect that its authors were fully aware of its content. The only fitting conclusion here is that WTO adjudicating bodies are still struggling with the test that should be applied in order to decide whether the LFT requirement has been established or not.

#### 3.2.4.5 No Effects and No Intent Either? The Standard of Review

Note that in all cases discussed so far, the complainants were not asked to produce evidence regarding harmful effects resulting from the violation of Art. III GATT. A violation of Art. III GATT can in other words be established irrespective whether it has produced harmful trade effects to imported goods. Case law, at least in its original form went one step further: it did not request from the complaining party to demonstrate protectionist intent either. A complainant arguing a case under Art. III GATT would thus be requested to show that:

- (a) either an imported product was taxed in excess of a domestic like product;
- (b) or an imported product was taxed differently than a domestic DCS product, in the sense that the taxation operates ASATAP to the domestic DCS product;
- (c) or a domestic nonfiscal scheme affords, to an imported product, treatment less favorable than that afforded to a domestic like product.

In none of these three scenarios would the complaining party be *required* to demonstrate harmful trade effects or protectionist intent. This point was made clear in a GATT case, the panel report on *US—Superfund*. The United States had been taxing imported petroleum products slightly higher than its domestic counterpart. When the measure was challenged before the GATT dispute-settlement process, the U.S. response was that the difference was so minimal that it could not reasonably have an impact on the prices in the U.S. market. The products concerned by the U.S. taxation scheme were *like* products, a point conceded by the United States, which did not, however, advance any defense other than the absence of impact on the prices.

The GATT panel dismissed the U.S. argument. In its view, the fact that the effects on the market were negligible was a nonissue: Art. III GATT should be constructed and understood as a mechanism protecting legitimate expectations as to the quality of competitive conditions (§ 5.1.9):

. . . Article III:2, first sentence, cannot be interpreted to protect expectations on export volumes; it protects expectations on the competitive relationship between imported and domestic products. A change in the competitive relationship contrary to that provision must

consequently be regarded ipso facto as a nullification or impairment of benefits accruing under the General Agreement. A demonstration that a measure inconsistent with Article III:2, first sentence, has no or insignificant effects would therefore in the view of the Panel not be a sufficient demonstration that the benefits accruing under that provision had not been nullified or impaired even if such a rebuttal were in principle permitted. (underlining in the original; emphasis added).

So this report concluded that there is no need to show trade effects in order to establish a violation of Art. III.2 GATT when two like products have been treated differently.<sup>135</sup>

The holding in this report did not change at all over the years as far as the absence of need to demonstrate trade effects is concerned: if at all, subsequent panel and AB reports expanded its coverage and held that there is no need to show trade effects when DCS products are concerned, or when nonfiscal measures are at stake.

The AB in its report on *Japan—Alcoholic Beverages II* reproduced this idea in the following terms (p. 16):

. . . it is irrelevant that ‘the trade effects’ of the tax differential between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent; Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.

Consequently, in this report the AB extended the irrelevance of a trade-effects test to cases where DCS products are involved. Recall that, with the exception of the pair vodka, *shochu*, all other products were, in the AB’s view, DCS products.

We detect a similar attitude in the context of Art. III.4 GATT. The AB clarified, in its report on *US—FSC*, that, in parallel with its case law under Art. III.2 GATT, for a complainant successfully to absolve its burden of proof and demonstrate that the group of imported products have been afforded LFT than the group of domestic like products, there is no obligation to show trade effects (§ 215):

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<sup>135</sup> The panel did not explain its position any further. Probably what it had in mind is that prices fluctuate and a small tax differential can become quite big in the future. What it did, however, explicitly state is that trading partners expect a certain kind of behavior by the other GATT contracting parties, and that there should be no need to check the outcome of a particular behavior that is not accepted in the treaty language negotiated. A violation establishes a *prima facie* case that is clearly rebuttable as *per* the DSU (and before, in the GATT years, as *per* Art. XXIII.2 GATT), although as yet no respondent has made the rebuttal successfully.

The examination of whether a measure involves ‘less favourable treatment’ of imported products within the meaning of Article III:4 of the GATT 1994 must be grounded in close scrutiny of the ‘fundamental thrust and effect of the measure itself.’ This examination cannot rest on simple assertion, but must be founded on a careful analysis of the contested measure and of its implications in the marketplace. At the same time, however, the examination need not be based on the *actual effects* of the contested measure in the marketplace. (emphasis in the original).

Following this line of thinking, the AB condemned an EC scheme that provided traders with an incentive to trade EC goods at the expense of imported like products, even in the absence of any tangible evidence suggesting that there was a quantified trade impact stemming from this measure (§§ 213–214 of the AB report on *EC – Bananas III*). By the same token, the panel, in its report on *Canada – Wheat Exports and Grain Imports*, found that a routine authorization scheme was GATT-inconsistent simply because it was not being imposed on domestic products (§ 6.193). The fact that the scheme was not onerous at all (§ 6.193), that economic operators were familiar with it (§ 6.197), that in the past authorization had always been granted (§ 6.200), that the agency at hand had enough discretion to always grant authorization (§ 6.203), that there was an institutional possibility to obtain advance authorization (§ 6.207), that a more attractive, than the authorization scheme, alternative was available to foreign products (§ 6.213) were not reason enough for the panel to change its mind on this issue.<sup>136</sup>

The relevance of an intent test is a slightly different story. A couple of GATT panel reports (*US – Malt Beverages*, and *US – Taxes on Automobiles*) held, as we saw *supra*, that intent matters in the context of analysis under Art. III GATT. WTO panels explicitly overruled this approach. WTO panels did not, nevertheless, totally exclude the relevance of an intent test: case law has time and again stated that the *subjective* intent of the legislator does not matter, leaving thus room for the relevance of *objective* intent. As we will see, in what immediately follows, the substantive content of the two terms has not, alas, been clarified in case law.

In *Japan – Alcoholic Beverages II*, the AB distinguishes between *subjective* intent and the purpose of a regulatory intervention, as disclosed by *objective* features of the design of the

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<sup>136</sup> WTO Members might have to quantify the effects of a trade measure they have successfully challenged, at a later stage of the proceedings: assuming no compliance has occurred and the complainant requests authorization to impose counter-measures, it will have to quantify the trade damage it suffered, in light of the obligation enshrined in Art 22.4 of the DSU, that the overall level of counter-measures should not exceed that of the trade damage incurred.

measure. The former is irrelevant when it comes to establishing an Art. III.2 of the GATT violation; the latter could be relevant (p. 27):

This third inquiry under Article III:2, second sentence, must determine whether ‘directly competitive or substitutable products’ are ‘not similarly taxed’ in a way that affords protection. This is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent. If the measure is applied to imported or domestic products so as to afford protection to domestic production, then it does not matter that there may not have been any desire to engage in protectionism in the minds of the legislators or the regulators who imposed the measure. It is irrelevant that protectionism was not an intended objective if the particular tax measure in question is nevertheless, to echo Article III:1, ‘*applied* to imported or domestic products so as to afford protection to domestic production.’ This is an issue of how the measure in question is *applied*.

...

As in that case, we believe that an examination in any case of whether dissimilar taxation has been applied so as to afford protection requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported products. We believe it is possible to examine objectively the underlying criteria used in a particular tax measure, its structure, and its overall application to ascertain whether it is applied in a way that affords protection to domestic products. (emphasis in the original).

In the same report as well as in *Chile—Alcoholic Beverages*, the AB went one step further: it brought *objective regulatory purpose*, that is, the purpose as revealed through the design and architecture of the measure, within the analysis of the ASATAP criterion. At the same time, however, it continued to explicitly reject a *subjective* intent test. Moreover, it did not establish any criteria as to how it will evaluate the objective regulatory purpose, other than referring to the design and the architecture of the measure at hand. It discussed summarily the four regulatory objectives advanced as justification of the measure by Chile, and it explicitly rejected the relevance of the necessity criterion when evaluating a claim under Art III of the GATT (§§ 71–72):

We recall once more that, in *Japan—Alcoholic Beverages*, we declined to adopt an approach to the issue of “so as to afford protection” that attempts to examine “the many reasons legislators and regulators often have for what they do.” We called for examination of the design, architecture and structure of a tax measure precisely to permit identification of a measure’s objectives or purposes as revealed or objectified in the measure itself. Thus, we consider that a measure’s purposes, objectively manifested in the design, architecture and structure of the measure, *are* intensely pertinent to the task of evaluating whether or not that measure is applied so as to afford protection to domestic production. In the present appeal,

Chile's explanations concerning the structure of the New Chilean System—including, in particular, the truncated nature of the line of progression of tax rates, which effectively consists of two levels (27 per cent *ad valorem* and 47 per cent *ad valorem*) separated by only 4 degrees of alcohol content—might have been helpful in understanding what *prima facie* appear to be anomalies in the progression of tax rates. The conclusion of protective application reached by the Panel becomes very difficult to resist, in the absence of countervailing explanations by Chile. The mere statement of the four objectives pursued by Chile does not constitute effective rebuttal on the part of Chile.

At the same time, we agree with Chile that it would be inappropriate, under Article III:2, second sentence, of the GATT 1994, to examine whether the tax measure is *necessary* for achieving its stated objectives or purposes. The Panel did use the word “necessary” in this part of its reasoning. Nevertheless, we do not read the Panel Report as showing that the Panel did, in fact, conduct an examination of whether the measure is necessary to achieve its stated objectives. It appears to us that the Panel did no more than try to relate the observable structural features of the measure with its declared purposes, a task that is unavoidable in appraising the application of the measure as protective or not of domestic production. (emphasis in the original).

Regulatory intent can, consequently, be an issue in the limited case where two products are DCS, and the tax differential is not large enough, keeping in mind that case law has not provided a quantitative benchmark to decide what large actually means.

Case law regarding the relevance of *objective* intent when the consistency of a fiscal measure with the GATT is being challenged, can usefully be summed up as follows:

- (a) there is a threshold issue: not *any* tax differential is ASATAP; the tax differential must be more than *de minimis*. We do not know, however, what exactly constitutes *de minimis*, since case law did not provide a quantitative estimate in this regard. We do know, nonetheless, that mere arithmetic difference satisfies the *in excess* requirement, but not the *de minimis* requirement. Consequently, when dealing with claims regarding DCS products, if a WTO adjudicating body reaches the conclusion that a tax differential is less than *de minimis*, it will reject the complaint,<sup>137</sup>
- (b) assuming that the *de minimis* criterion has been satisfied, if the tax differential is *substantial*, then it will suffice, in and of itself, to establish a violation of Art. III.2 GATT. Once again, WTO adjudicating bodies have not provided an arithmetic benchmark. In *Chile—Alcoholic Beverages*, nevertheless, a 20 percent tax differential

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<sup>137</sup> Hence, infinitesimal tax differentials will satisfy the *in excess*—but not the ASATAP—criterion.

between two DCS products was judged *substantial*. There has been no case so far where a tax differential was judged more than *de minimis* but less than *substantial*; and (c) if a tax differential is more than *de minimis* but less than *substantial*, then an inconsistency with Art. III.2 GATT can be established only through recourse to other factors as well.<sup>138</sup>

Now, of course, one might legitimately wonder whether in practice inquiries into the *objective* intent will be necessary: indeed, a government that wishes to confer an advantage to its domestic production will, in all likelihood opt for substantial tax differentials assuming that this term covers cases where the tax differential affects prices. One will be hard pressed to find cases where, given protectionist intent, governments will opt for small tax differentials that might not affect prices at all.

Finally note that case law has clarified that the *objective* intent will be revealed through the design and the architecture of the measure challenged, but it has not explained in what way it differs from *subjective* intent. Indeed, in the absence of explanation, one might legitimately ask the question whether the distinction between *objective* and *subjective* intent is meaningful at all.

### 3.2.5 Allocation of the Burden of Proof

As conventional, we divide the *burden of proof* into the *burden of production* (who must bring forward evidence?), and the *burden of persuasion* (how much evidence is necessary for the burden to shift to the other party?). The GATT does not explicitly address this central issue, but it has been dealt with in case law.

Consider first the burden of production. The allocation of burden of proof is not explicitly addressed in the DSU. Panels however, have consistently made references to general maxims of law regulating this issue; even when they did not refer to them explicitly, they addressed the issue in a manner consistent with those maxims. By virtue of the maxim *actori incumbit probatio*, it is for the party making a claim to provide the necessary evidence that the claim holds. This maxim is the direct consequence of another maxim, *in dubio mitius*, which essentially means that there should be a presumption of legality of the challenged measure. If the law distinguishes between a rule and an exception, then legal orders follow the maxim *quicumque exceptio invokat ejudem probare debet*: the party invoking the exception carries the burden of proof to demonstrate compliance with the conditions reflected in the exception. In

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<sup>138</sup> This is a theoretical possibility that has been flagged by the AB. So far, as noted above, no such case has been submitted to WTO adjudication.

this case, there is a presumption of illegality since the party invoking an exception has by definition broken the rule; that is the legal canon for which the presumption of legality has been agreed.

The situation in case law is somewhat confusing, but essentially follows these two maxims.<sup>139</sup> There is no doubt that Art. III GATT is a rule and not an exception to a rule. As a result, the burden of production of proof stays with the complainant. The next question is, how much proof must the complainant contribute for the burden to shift to the other party? This takes us straight into the discussion regarding the burden of persuasion.

Let us next turn to the burden of persuasion. It is by now clear, that the complainant, in general (that is, not only in Art. III GATT cases) need not provide full proof that its claim holds; a *prima facie* case suffices. What exactly constitutes a *prima facie* case is difficult to specify: there is discrepancy across panel reports but, in general, some sort of reasonableness standard seems to emerge. Assuming a *prima facie* case has been made, the burden will shift to the other party which will aim at refuting the evidence against it. Absent effective *refutation* of *prima facie*, the complainant will prevail. Note that the defendant will prevail even in the case of *equipoise* between its own evidence and that provided by the complainant.

WTO adjudicating bodies will not shift the burden of proof from one party to the other depending on whether a *prima facie* case has been made; dispute adjudication in the WTO is nothing like a game of tennis where the ball has to fly above the net for the other party to respond: they will typically request from both parties to provide all evidence they wish to submit, and they will make their judgment whether a *prima facie* case has been made against this background, that is, by reviewing all of the evidence submitted before them. In this vein, we note that the panel, in its report on *Turkey – Rice*, summing up prior case law, held that it would not request from the defendant to respond only after the complainant had successfully made a *prima facie* case; rather, it would decide whether a *prima facie* case had been made on the basis of the totality of evidence brought by the parties to the dispute. There is not one single case so far that does not evidence this approach.

### 3.2.5.1 Making a *Prima Facie* Case

This requirement was first introduced by the AB in its report on *US - Wool Shirts and Blouses*. It has been cited in practically all disputes ever since when a burden of proof issue arose (§ 14):

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<sup>139</sup> In three cases (*EC – Sardines*, *EC – Hormones*, *EC – Tariff Preferences*) where the text of the agreement clearly indicates that we are dealing with an exception, case law still assigned the burden of production of proof with the complaining party. None of these cases is a GATT case though.

It is a generally accepted canon of evidence in civil law, common law, and, in fact, most jurisdictions, that the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defense. If that party adduces sufficient evidence to raise a presumption that what is claimed is true, the burden then shifts to the other party, who will fail unless it adduces sufficient evidence to rebut the presumption.

This passage provides only an indication as to the burden of *persuasion*; making a *prima facie* case is shorthand for observing the burden of persuasion. In subsequent cases, panels have used the term “to make a *prima facie* case” as equivalent to the obligation to “raise a presumption” that what is claimed is true (*US – Stainless Steel* at § 6.2). *Raising a presumption* is not a self-interpreting term either and, as a result, the question of the quantum of proof needed to discharge the obligation of burden of persuasion can only be evaluated on a case-by-case basis in WTO jurisprudence. Nevertheless, *raising a presumption* cannot amount to providing full proof by any reasonable understanding of this term. So it seems that what matters is that panels are satisfied that enough proof has been submitted regarding a particular claim and that the submitted proof, absent counter proof, could reasonably lead to the conclusion the complainant should prevail.<sup>140</sup>

The panel on *Mexico – Taxes on Soft Drinks* ruled that the duty of the complainant to make a *prima facie* case is not affected by the defendant’s decision not to challenge the claims and arguments made. In the case at hand, Mexico had chosen not to raise any defense in some of the claims advanced by the United States. The panel implicitly held that Mexico’s inaction did not amount to admission that the United States had made a *prima facie* case (§§ 8.16ff.). The panel went on and examined to what extent, in its view and in absence of a Mexican response, such was indeed the case.

### 3.2.5.2 Refuting a *Prima Facie* Case

In theory, assuming a presumption that a claim holds has been raised, the burden of proof will shift to the other party which will have to effectively refute the presumption: the panel report on *Thailand – H-Beams* for example, requests (§ 7.49) from Thailand to provide “effective refutation” against Poland’s *prima facie* case. In practice, nonetheless, as already noted, WTO adjudicating bodies do not raise a flag anytime a presumption has been created;

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<sup>140</sup> A claim is the identification of a factual situation and the ensuing breach of a legal rule: by imposing a quota on imports of widgets, country X acts inconsistently with its obligations under Art. XI GATT.

rather, WTO adjudicating bodies will make a global evaluation based on what has been pleaded before them by the parties to the dispute. As the AB noted in its report on *Korea – Dairy* there is:

. . . no provision in the DSU . . . that requires a panel to make an explicit ruling on whether the complainant has established a *prima facie* case of violation before a panel may proceed to examine the respondent's defence and evidence. (§ 145 italics in the original).

Consequently, the issue whether a party has indeed established a *prima facie* case, and/or the adjunct issue whether the *prima facie* case was effectively refuted will form an integral part of the general evaluation by the panel. This does not mean however, that panels cannot, at the end of the process decide that the complainant did not make a *prima facie* case (see, for example, *India – Autos* §§ 7.231 – 7.233). That is, the fact that the defendant has attempted to rebut a claim presented by the complainant does not *necessarily* mean that, in the panel's view, the complainant has established a presumption.

(c) *Equipose*

The panel, in its report on *US – 1916 Act (EC)* concluded that evidence submitted by the complainant and the defendant was in *equipose*. It then asked itself what the legal consequence of this finding should be. It held that, in such cases, the advantage rests with the party responding to the claim (§ 6.58):

If, after having applied the above methodology, we could not reach certainty as to the most appropriate court interpretation, i.e. if the evidence remains in equipose, we shall follow the interpretation that favours the party against which the claim has been made, considering that the claimant did not convincingly support its claim.

### 3.2.5.3 Art. III GATT Case Law<sup>141</sup>

In *Japan – Alcoholic Beverages II*, the complainant provided econometric evidence (based on consumer surveys) that the products in question were DCS. It also pointed to the fact that the defendant had not invoked any rationale for the tax differential across the various products. The defendant claimed that there was some policy rationale which was however, discarded by the panel (and the AB) since it was considered to be an *ex post facto* justification: the Japanese law providing for the tax differential across sochu and a series of western

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<sup>141</sup> In line with the approach in this paper, we will limit our observations to the leading, in our view of course, cases.

drinks did not contain any policy justification for the differential treatment of the various drinks coming under its purview.

In *Korea – Alcoholic Beverages*, the complainant provided evidence from the Japanese market regarding the relationship between the products in question arguing, inter alia, that the two markets (Japan, Korea) were highly comparable. However, as facts make it clear, western drinks did exist in the Korean market, the tax differential notwithstanding. The defendant claimed that the price differential between soju and the predominantly western drinks was such that Korean consumers would never treat interchangeably (at least diluted) soju and the western drinks involved. Nevertheless, neither the panel nor the AB explained why such evidence could not have been appropriately taken into consideration; they discussed evidence from the Japanese market without adequately explaining why evidence from the Korean market did not fit the bill. The panel and the AB further rejected the claims by Korea arguing that recourse to econometric indicators is not the only way in which likeness can be established. In the AB's view, two products would be considered like to the extent that they share physical characteristics, and end uses and consumers perceive them as such even if a price difference between the two exists.

In *Chile – Alcoholic Beverages*, the complainants provided evidence to the effect that some western drinks were being taxed substantially higher than some foreign drinks although the difference in alcoholic content was minimal. They submitted as evidence the Chilean law which contained sharp tax differentials across alcoholic drinks with various alcoholic contents. The defendant responded that it was Chilean producers of alcoholic drinks that were shouldering the majority of the tax burden in the higher category and provided evidence to this effect. Still the AB held that on balance the evidence submitted by Chile did not detract from the fact that imported goods were being taxed more onerously than domestic like/DCS products.

In *EC – Asbestos*, the complainant argued that the two products (construction material with and without asbestos) were like products and that the French measure was treating imported goods less favorably than their domestic counterparts. The defendant replied that the measure was based on scientific evidence pointing to the health hazards stemming from exposure to asbestos containing construction material. The panel and the AB reached divergent conclusions: in the panel's view the evidence submitted was not sufficient to show that the products were unlike. So it held that Canada won its claim under Art. III GATT, but it went on to find for the defendant under Art. XX GATT. In the AB's view, the evidence submitted supported a conclusion that the two products were unlike, because of consumers' perceptions regarding the health hazard associated with the imported goods.

In *Korea – Various Measures on Beef*, the complainants submitted evidence to the effect that, following the introduction of the dual retail system, most traders opted for selling domestic rather than imported beef. Korea responded arguing that this was only normal in light of the fact that a legitimate import quota was in place as a result of which total imports amounted to less than 10 percent of the total consumption. Korea also submitted evidence to the effect that the import quota had always been absorbed except for the years of the financial crisis when consumption was heavily reduced (with respect to consumption beef as well). The panel and the AB rejected Korea’s arguments finding that the measure had modified conditions of competition to the detriment of imported goods since fewer stores were now carrying imported beef; they did not deem the evidence on absorption of quota to be relevant since, in their view, the standard of review under Art. III GATT does not require analysis of trade effects. They further found against Korea under Art. XX GATT holding that while this measure was genuinely aiming at consumers’ protection, it was unnecessary since it was overly restrictive of trade.

In *Dominican Republic – Import and Sale of Cigarettes*, the complainant presented evidence regarding the bond requirement that imported cigarettes had to pay arguing that it was in excess of the similar burden on domestic like goods. The defendant did not dispute that occasionally this would be the case. It did, however, claim that the payable amount was a function of the size of the market of the producer involved in the transaction and, consequently, it was not linked to the foreign origin of the goods. The AB sided with the defendant stating that, to the extent that the regulator can point to a ground for adopting a measure other than the origin of goods, a measure will pass the test of consistency with Art. III GATT (even if occasionally it produces a negative trade outcome for imported goods).

There is little to disagree with the AB’s attitude on the *original* assignment concerning burden of production. For the rest, however, the AB’s attitude is hard to discern:

- (a) In name, the AB suggests that neither the regulatory intent nor trade effects will be taken into account: but in *Korea – Various Measures on Beef* the AB does in a way look at effects; how can it rule that conditions of competition have been modified to the *detriment* of importing goods without taking into account that there are fewer stores now (than before) selling imported beef?
- (b) By the same token, in *Dominican Republic – Import and Sale of Cigarettes*, the AB held that origin must not be the rationale for law, otherwise a measure will run afoul of Art. III GATT. How different is that from saying that the intent of the regulator cannot be to punish imported goods because of their origin? In the same context, in *Chile – Alcoholic Beverages* the AB attempts a difficult-to-understand distinction between objective (as opposed to subjective?) intent;

It is clear by now that panels and the AB will not turn the green light on every time the complainant has adduced enough proof to switch the burden to the other party. Unless, however, the standard of review, that is, all issues regarding burden of production and burden of persuasion, becomes clear, both parties might be disadvantaged when preparing themselves for adjudication at the WTO.

### **3.3 Exceptions to NT**

A WTO Member that has been found to be in violation of its obligations under Art. III GATT can still exonerate itself from liability by invoking one of the exceptions mentioned in the GATT. To this effect, however, the regulating WTO Member will carry the burden of proof to show that its measures, although in violation of Art. III GATT, are not GATT-inconsistent. We are not concerned here with temporary deviations, such as for example, a waiver, but rather with permanent exceptions that is, legal grounds that justify departures from NT without imposing any time constraints.

#### **3.3.1 Art. IV GATT: Film**

The letter and the negotiating history of Art. IV GATT make it clear that WTO Members can treat domestic cinematographic film better than foreign.<sup>142</sup> To this effect, they can, for example, establish screen quotas and thus, treat imported films less favorably than domestic films that might run quota free. From a pure legal perspective though, film quotas should not be treated as exceptions to NT, but rather as *lex specialis* to this provision. This is so since, otherwise, the burden of proof would have to shift to the country imposing the film quota. Art. XX GATT entitled 'General Exceptions' is prima facie an exception to Art. IV GATT as well, and it is in this context that the WTO Member imposing a film quota will be request it to defend it, that is, only assuming that the complainant had previously successfully challenged the consistency of a measure with Art. IV GATT.

So far, there have been no cases adjudicated under Art. IV GATT.

#### **3.3.2 Art. XX GATT: General Exceptions**

The title of this provision leaves no doubt that it was intended to be an exception to, in principle, all GATT provisions. Case law has confirmed that Art. XX GATT is an exception to

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<sup>142</sup> Deciding on the origin of films might be a quixotic test. This is not, however, an issue for the purposes of this work.

NT: an appropriate illustration is offered by the aforementioned report on *Korea – Various Measures on Beef*: it was a domestic instrument of nonfiscal nature (*dual retail system*) that was judged to be inconsistent with Art. III GATT; Korea attempted (unsuccessfully) to justify it through recourse to Art. XX GATT: both the panel and the AB examined the consistency of the challenged measure with Art. XX GATT, in accordance with Korea's claims.

### 3.3.3 Art. XXI GATT: Security Exception

The security exception is, like Art. XX GATT, an exception to, in principle, all GATT provisions. There has been no case law so far regarding domestic instruments in this context; indeed, there has been no case law at all under this provision since the inception of the WTO: the European Community attempted to challenge the consistency of the US *Helms Burton Act* with the WTO rules, but requested suspension of the panel established to this effect before it issued its report, and did not request that it reconvene within the statutory deadlines. As a result, the panel's authority lapsed (Art. 12.12 DSU). During the GATT years, one case was actually litigated: in *US – Nicaraguan Trade*, a rather idiosyncratic GATT panel, since it was clear that the final report was not going to be implemented anyway. In this case, the measures at stake were border measures (two-way embargo).<sup>143</sup> Still, there should be no doubt that a WTO Member can legitimately depart from NT if this is necessary to safeguard its national security: the wording of this provision leaves no room for doubt in this regard. It pertinently reads:

*Nothing* in this Agreement shall be construed

...

(b) to prevent any contracting party from taking *any* action which it considers necessary for the protection of its essential security interests. (emphasis added).

## 3.4 Critique of the Case Law

In what follows, we provide an overview of the debate and the critique expressed in the doctrine concerning the application of Art. III GATT in specific instances by the WTO adjudicating bodies, as well as the overall understanding of this provision by the WTO adjudicating bodies.<sup>144</sup>

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<sup>143</sup> See Mavroidis (2007) at pp. 322ff.

<sup>144</sup> Hundreds of papers have directly or indirectly discussed either specific applications of Art. III GATT or the WTO judges' overall understanding of this provision. We thus have to be selective in our description of the literature.

A significant part of the criticism regarding the case-law approach to Art. III GATT borrows from doctrinal work on the understanding of Art. III GATT, and on the role it is called to play within the world trading system. The question that many authors have asked concerns the limits that NT places on the regulatory authority of WTO Members. There are, of course, many variations regarding this basic question. Almost unanimously the doctrine condemns the tendency in (at least some) case law to base its findings in the perception that the terms of Art. III GATT should be understood in a contextual manner, without *adequate* regard to the *role* that NT has been committed to play by the GATT framers. Voices in the doctrine have not condemned the institutional architecture of the GATT or the drafting of Art. III GATT: critique has centered on the understanding of this provision by GATT/WTO adjudicating bodies.

There is still scarce analysis of NT in economics, and in particular of the NT case law. The same largely applies to the law-and-economics literature. It is illustrative that the two volumes coedited by Bhagwati and Hudec (1996), while containing many interesting contributions addressing the harmonization of domestic policies, did not contain any paper specifically addressing NT.<sup>145</sup>

We first present a summary of the general critique, that is, papers which do not discuss specific case law but rather the general approach of GATT/WTO panels when dealing with disputes coming under the purview of Art. III GATT (including a normative discussion, that is, the manner in which GATT/WTO panels *should* – rather than *do* – understand this provision). We then discuss critiques against specific reports by GATT/WTO panels.

We divide the doctrinal discussion into four parts: papers dealing with the *mandate and coverage* of NT, its *legal nature*, the *standard of review* that GATT/WTO panels do and/or should apply across cases, and finally the *understanding of specific terms* appearing in the body of Art. III GATT.

*The mandate and coverage of NT:* In a series of papers and books authored alone or with coauthors, Jackson (1989, 1998, 2003, 2006) explains the changing role of domestic regulation in a world where border instruments are becoming less and less meaningful.<sup>146</sup> Jackson recognizes the problems posed by the extension of NT to cover cases of *de facto* discrimination, but argues that, unless construed this way (that is, to encompass *de facto* discrimination as well), this provision would be easily circumvented. The extension of the ambit of NT to cover cases of *de facto* discrimination is thus a necessary evil; adjudicating

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<sup>145</sup> See Bhagwati and Hudec (1996).

<sup>146</sup> Jackson (1969) provided the first comprehensive assessment of the negotiation of this provision.

bodies then face the task of devising the appropriate test to ensure that in such cases they will be punishing only discriminatory (origin-wise) behavior and nothing else.

Staiger and Sykes (2009) deal with the limits of the current draft of Art. III GATT. They observe that WTO rules and disputes center on complaints about excessively stringent regulations. Employing the international externalities (terms-of-trade) framework for the modeling of trade agreements, they show how large nations may have an incentive to impose discriminatory product standards against imported goods once border instruments are constrained, and how inefficiently stringent standards may emerge under certain circumstances even if regulatory discrimination is prohibited. They then assess the WTO legal framework in light of their results, arguing that it does a reasonably thorough job of policing regulatory discrimination, but that it does relatively little to address excessive nondiscriminatory regulations.

*The legal nature of NT:* Surprisingly this area has not attracted a lot of interest. Petersmann (2002) is probably the only paper that squarely addresses this issue. He does not put into question the historic role for Art. III GATT. However, he does question its continued legitimacy in today's world. In Petersmann's view, the nondiscrimination principle in Art. III GATT should be understood as a 'constitutional' provision (using this term to denote hierarchy across the various GATT provisions) and should be anchored in human rights, that is, it should be interpreted in light of jurisprudence in the field of protection of human rights.

*The standard of review:* A number of papers have dealt with the *aims and effects* test and this should not come as surprise: in GATT/WTO, total reversals of case law are quite rare. Moreover, explicit over-turnings are even less frequent. Yet this is what happened, as we saw supra, in the context of disputes relating to Art. III GATT: the very first case that was adjudicated under the WTO (*Japan – Taxes on Alcoholic Beverages*) explicitly rejected the standard of review employed in the last GATT case that came under the purview of this provision (*US – Taxes on Automobiles*).

There are authors who have taken an unambiguous stance in favor of reinstating the *aims and effects* test (or a version of this test that would essentially ask the question what is the regulatory intent of the challenged measure and would subject the ultimate decision regarding violation on the response to this question). Hudec is one of many authors who devoted considerable efforts analyzing the standard of review that should be applied in cases dealing with Art. III GATT. Hudec (1988, 1998, 2000) explains the shortcomings of an Art. III test that disregards protective intent: in Hudec's view, this can cause GATT/WTO

judges to strike down domestic measures that should be considered legitimate. Hudec's criticism has been echoed by many other scholars.

Howse and Regan (2000) agree that intent should matter, and take a stance in favor of an *aims and effects* test à la US – *Taxes on Automobiles*. They mentioned the relevance of PPMs (process and production methods) when defining like products, arguing that, for example, environment-friendly and -unfriendly products should not be treated as like goods.

Building on his work with Howse, Regan (2000, 2002, 2003) has argued that the judge should inquire into the legislative intent in order to decide whether a measure is consistent with Art. III GATT: only measures pursued with the intent to protect should be judged GATT-inconsistent. Regan maintains, like others as well, that *de facto* the WTO judge does inquire into intent. At a principle level, he does not take distance from the *aims and effect* test as applied in GATT case law.

Roessler (1996) takes the view that panels have only paid lip service to the overarching purpose of Art. III GATT, that is, to combat protectionism. Consequently, in his view, domestic measures that serve a purpose other than protectionism should be exonerated from liability under Art. III GATT. To ensure that this indeed the case, Roessler calls for an understanding of the term *like products* that would be inspired by the regulatory objective pursued. Roessler also takes issue with the standard of review adopted by adjudicating bodies: in his view, recourse to Art. XX GATT is no panacea since this provision includes only an exhaustive list of justifying grounds whereas there are arguably many more potential policy goals that a society might legitimately wish to achieve. He thus argues in favor of a refocus of the nondiscrimination test as embedded in Art. III GATT.

Charnovitz (2002) expresses disagreement with the manner in which WTO adjudicating bodies have, by applying an erroneous standard of review that does not inquire into the intent of the challenged measure, *de facto* subjected the pursuit of social preferences (often pursued in nondiscriminatory terms) to trade concerns. This goes against the negotiating intent (that Charnovitz has explored in this and other work), and undoes the balance of rights and obligations as struck by the WTO Members during negotiations.

Porges and Trachtman (2003) use a legal-realist methodology and hypothesize that tribunals will, when examining domestic regulation under Art. III GATT, always look at *aim and effects* (no matter what they say). The authors then review the post-*Japan – Alcoholic Beverages* case law to prove that, indeed, tribunals have looked at aim and effects. This paper shows that the category of *de facto* discrimination cannot be determined except through a judicial evaluation of the *aim and effects* of domestic measures – discrimination is not otherwise a coherent concept.

There are also papers that do not espouse the *aims and effects* test. Davey and Pauwelyn (2000) express some dissatisfaction with the test applied by WTO adjudicating bodies in the context of Art. III GATT, and argue for the introduction of a discriminatory-effect test that should be introduced in order to decide for example, whether a tax has been imposed in excess. To them, the decisive question that panels and the AB should always ask when dealing with claims under the NT provision should be: is there discriminatory impact related to origin?

In similar vein, Di Mascio and Pauwelyn (2008) look at both the negotiating work and the case-law understanding of Art. III GATT and conclude that it serves a dual purpose: to protect tariff concessions and to prevent protectionism. They lament, nonetheless, the manner in which WTO adjudicating bodies have applied this principle in concrete cases. They argue that WTO panels and the AB have had recourse to ‘cyclical’ interpretations of this provision, moving from inquiries into the regulatory intent to marketplace tests and back, without always paying attention to its overarching objective. They conclude that, as a result, we still lack a compass against which we can judge the consistency of domestic instruments with the GATT.

Verhoosel (2002) and Bartels (2009) have advanced more or less the same argument: they call for the application of an ‘integrated necessity test’ (the term first coined by Verhoosel) whereby the WTO adjudicator will decide whether *de facto* discrimination has occurred by engaging in a two-prong test: first ask whether a measure specifically affects imported products, and if the response to this question is affirmative, then check whether the measure is necessary to achieve a legitimate policy goal.

A number of papers argue in favor of an economics-informed standard of review. There are differences, sometimes important, across these papers which typically reject the *aims and effects* test as applied in case law but do not necessarily reject an inquiry into the regulatory intent of the challenged measure. In fact, some of them explicitly call for this to happen.

Sykes (1999) observes that a wide array of policy instruments can protect domestic firms against foreign competition. Regulatory measures that raise the costs of foreign firms relative to domestic firms are exceptionally wasteful protectionist devices however, with deadweight costs that can greatly exceed those of traditional protectionist instruments such as tariffs and quotas. He examines the welfare economics of regulatory protectionism, and undertakes a related political-economy analysis of the national and international legal systems that must confront it, including the WTO, the NAFTA, the European Union, and the U.S. federal

system. Sykes explains why regulatory measures that serve no purpose other than to protect domestic firms against foreign competition will generally be prohibited in politically sophisticated trade agreements, even when other instruments of protection are to a degree permissible. He further suggests why regulatory measures that serve honest, nonprotectionist objectives will be permissible in sophisticated trade agreements even though their regulatory benefits may be small and their adverse effect on trade may be great – that is, he explains why trade agreements generally do not authorize "balancing analysis" akin to that undertaken in certain dormant Commerce Clause cases under U.S. law.

Horn and Mavroidis (2004) point to the relevance of regulatory intent but disagree with the *aims and effects* test. But since intent normally is difficult to determine directly, adjudicating bodies have to seek recourse to indirect evidence, as is frequently done in legal practice. Trade effects may be one such indicator.

Palmer (1993, 1999) argues that WTO Members do not, by signing the WTO agreement, usurp each other's sovereignty; they agree only to limit the exercise of their own sovereignty when they believe that such limitation is to their advantage. It is this understanding of trade agreements that should inform the role that the NT provision is called to play. He further makes the point that the earlier negative reaction of environmentalists to GATT rulings (such as *US – Tuna/Dolphin*), although probably grounded in solid arguments, was disproportionate: after all, it is not the text of the GATT that is a threat to environmental protection, but one application of it. Gains from trade liberalization on the other hand, can help finance environmental protection. The attention of adjudicating bodies should be shifted towards honoring the objective of the NT provision: in his view, when discussing the *Tuna/Dolphin* litigation, the GATT is quite explicit that WTO Members may impose nondiscriminatory environmental standards. It is when standards imposed on trading partners are more onerous than those imposed on the regulator that the NT provision is being violated.

Trebilcock and Fishbein (2007) take the view that if every attempt by governments to pursue domestic policy objectives is subjected to the imperative to facilitate imports, then regulatory autonomy would have been seriously impaired. In their view, this is not the appropriate standard of review to apply in cases dealing with NT. The authors believe that WTO adjudicating bodies have not managed to successfully distinguish cases of legitimate exercise of regulatory autonomy from cases of regulatory protectionism, precisely because of their incapacity to design the proper standard of review to be applied in similar cases.

Ortino (2003) does not espouse an economics-based approach but does point to similar observations. In his view, the lack of methodology by WTO adjudicating bodies has resulted

in lack of coherence across cases. This author finds it difficult to decipher the standard of review that WTO adjudicating bodies have employed, arguing that, while it is clear that they have rejected the *aims and effects* test, it still remains unclear what they have replaced it with. In his view, the quasi mechanistic application of the *Vienna Convention on the Law of Treaties* is probably an important contributing factor to the situation he describes: the insistence of adjudicating bodies on a contextual understanding of key terms has had an involuntary by-product, that is, the non advent of a methodology to deal with Art. III cases.

*The understanding of specific terms:* Recall our discussion supra, that some of the terms were chosen *faute de mieux*, and that there was even an in-principle understanding that some key terms (*like products*) would have to be renegotiated following the advent of the ITO.

The view has been expressed that it is never too late to address any deficiencies in this respect through legislative action: Bronckers and McNelis (2000) are of the view that, in light of the experience so far, it is probably too risky to leave it to adjudicating bodies to continue interpreting terms such as *like products*. They argue that it would be wiser to legislate further (in an effort to attempt to complete the contract to the extent possible) and preempt judicial action by clarifying this concept.

Others believe, without explicitly addressing the issue of legislative interference, that these terms could be clarified through adjudication. What these papers have in common is that they all argue for a contextual interpretation of the key terms, that is, an interpretation that would take into account the legislative objectives and the committed instruments to attain them. Horn and Mavroidis (2004) argue for a clear market-based interpretation of the term *like* and *DCS products*. They also argue however, for an understanding of terms such as ASATAP and LFT whereby the key question would be whether the contested measure is indeed protectionist or not, that is, whether the rationale for regulatory differentiation reflects the origin of the good.

Giri and Trebilcock (2005) agree with this understanding of the terms *like* and *DCS products*. With respect to the terms ASATAP and LFT, they argue that the question WTO adjudicating bodies should ask is whether the equality of competitive conditions across domestic and foreign products has been affected as a result of the challenged regulatory intervention.

In the same vein, Melloni (2005) agrees with the view espoused by adjudicating bodies that the NT provision is there to guarantee that no recourse will be made to regulatory protectionism. In his view, however, this test has been misapplied largely because the WTO adjudicating bodies (and more especially the AB) have refused to entertain any analysis

grounded on economics. In his view, recourse to simple econometric indicators such as cross-price elasticity for example, would greatly reduce the current uncertainty regarding the understanding of terms such as *DCS* and/or *like products*.

Dunoff (2009) discusses how WTO Members can through domestic instruments advance social goals, paying particular attention to cases where the regulating government acts as purchaser. He points to the difficulties that might arise in this context as a result of the manner in which WTO adjudicating bodies have understood the key terms that appear in the body of Art. III GATT.

Choi (2003) discusses exhaustively all of the case law until 2003. Her main conclusion is that the key term in the NT provision, *like products*, has been interpreted inconsistently. She pleads for an interpretation in light with the overall WTO aims, that is, trade liberalization that takes sufficient account of the negative integration model established by the GATT.

A number of authors have criticized specific applications of the NT provision in WTO disputes. Mattoo and Subramanian (1998) have argued that the panel ruling on *US – Taxes on Automobiles* has certain important implications. The manner in which Art. III GATT has been interpreted and applied tilted the balance heavily in favor of regulatory freedom, diluting the disciplines of Art. III GATT, which is one of the keystones in the construction of the GATT system. Two factors contributed to this dilution: first, very high standards are set for establishing that origin-neutral measures are protectionist; and second, the inconsistent or selective application of measures by a government is not given due consideration in determining whether the national-treatment obligation is violated. The combination of these two factors could make it difficult to establish that origin-neutral measures are inconsistent with Art. III GATT.

The report on *Chile – Alcoholic Beverages* has provoked substantial criticism. Ehring (2002) asks the pertinent question how many transactions should be affected for a scheme like the Chilean to be found inconsistent with NT? Would it suffice that one unit of account only (say one bottle of European whisky) be discriminated against for a violation of NT to occur, even if all other European exports to the Chilean market are treated in a nondiscriminatory manner? This author's criticism stems from his dissatisfaction with the AB's decision to totally neglect the fact that Chilean pisco was carrying the overwhelming majority of the tax burden in the higher-taxed category of alcoholic drinks, and not western drinks.

Horn and Mavroidis (2004) do not agree with the methodology the AB used in its report on *Korea – Alcoholic Beverages* to define whether the products concerned were like/DCS. In

particular, in their view, the AB does not seem to recognize that the characteristics it refers to assess the extent of consumer likeness – end-uses, physical characteristics, etc. – are reflected in a cross-price elasticity estimation. In the authors' view, statistical analysis should be the primary method of establishing consumer preferences for the products at stake. These other indicators are imperfect substitutes to employ in cases where there is not enough data, or its quality is too poor, to undertake statistical analysis. In contrast, the AB seemed to view neither of the two approaches as being conceptually superior.

Charnovitz (1996) takes issue with the *Japan – Alcoholic Beverages* panel's rejection of the aim-and-effect test. Noting first how two GATT panels had interpreted Art. III.2 GATT, the first sentence "narrowly in order to reduce interference with national tax sovereignty," Charnovitz warned that the decision "has important implications for the autonomy of national governments" and explained that with the door to Art. III GATT closed, environmental regulations will be reviewed under the restrictive rules of Art. XX GATT. After the Appellate Body upheld the panel, Charnovitz wrote again to criticize the abandonment of the aim-and-effect test. Charnovitz (1997) He noted that the new broader interpretation of like product "could spell trouble for policy-based taxes." He also suggested that Art. III GATT "may be even more important" than Art. XX GATT because no environmental defense under Art. XX GATT had succeeded (at the time of his writing, that is, before the AB report on *US – Shrimp*).

The AB report on *EC – Asbestos* has also provoked a number of reactions. In general, the environmental community took a favorable stance since it seemingly opened the door to PPM-based distinctions that the environmental community has been arguing in favor of for years. Horn and Weiler (2007), however, point to a number of weaknesses they see in the report. The authors are puzzled by the fact that the AB first expresses its intention to look for market evidence regarding consumers' reactions to asbestos-containing and asbestos-free construction material, only to reverse itself in the next paragraph and decide the issue of likeness in the absence of market evidence. They find the AB's reasoning to be based on a rather optimistic (or naïve) view of the working of the market, where for instance the threat of future liability would deter buyers from using dangerous construction materials. A number of arguments in their view instead suggest that the market should be expected to work very poorly in the case of a product with the presumed characteristics of asbestos-containing products. Indeed, the regulation might be needed exactly because buyers would not take the differences in hazards into account. But if so, the products are not like, contrary to the argument by the AB.

According to Mavroidis (2007), in *EC – Asbestos*, the AB *de facto* adopted a "reasonable consumer" test, speculating a fully informed consumer's likely purchasing behavior. This

approach is problematic for a number of reasons: first, if manufacturers, as the AB contends, were indeed anticipating consumers' reactions, then they would not be producing asbestos containing products either; as a result, there would be no need for regulation in the first place. Manufacturers stopped producing asbestos-containing construction material, not because of consumers' reactions, but because of the statutory prohibition to produce; second, if all that was needed was to inform buyers, in all likelihood, France would have financed an information campaign, and it would not have enacted a statutory prohibition on sales of asbestos-containing products. The government was probably worried that private parties would in any event impose health externalities on the society, and this is what prompted the prohibition; third, *some* manufacturers at least do produce such products and *some* consumers continue to buy them. They are located in Canada and not in France. Are they unreasonable, the author asks. Assuming that the risk associated with the consumption of such goods is, relatively speaking, low, and the price difference between asbestos-containing and asbestos-free products substantial, a country might think it makes good sense to allow for the production of both products, tax production/consumption of the former, and finance research to combat associated health hazards. This is not to suggest that France should have lost that case. In Mavroidis's (2007) opinion, France should have won anyway: its victory, however, should, in this author's view, have come under the *less favorable treatment* analysis.

Yavitz (2002) appreciates that the AB aimed at removing some of the strain that prior case law had caused on domestic regulators by interpreting key terms in Art. III.4 GATT in mechanical, acontextual manner. Yavitz criticizes prior (to *EC – Asbestos*) case law for avoiding to interpret the key terms in this provision in a manner that would honor the agreed function of this provision, that is, to avoid that WTO Members use nonfiscal instruments so as to afford advantages to their domestic production.

In similar vein, Howse and Tuerk (2001) agree with the basis of the reasoning of the AB report, and disagree vehemently with the panel approach. The authors defend a comprehensive discrimination test that should take place within the four corners of Art. III GATT (instead of moving the discussion to Art. XX GATT). They thus see the AB report as a positive step in this direction.

### **3.5 Concluding Remarks**

We will not attempt to summarize the critique of the case law in the literature. But our impression is that this critique points to the fact that adjudicating bodies have interpreted Art. III GATT lacking a conceptual framework (basically, an economic theory) for the role of Art. III GATT in the agreement. It also seems that WTO adjudicating bodies have been more

concerned not to allow measures that are protectionist, than to avoid accepting measures that are not protectionist. But as of *EC—Asbestos* the AB appears to have adopted a different attitude: reading between the lines, in this dispute the AB seemed more concerned to not make the error of striking down the legislation mistakenly. Also, in the subsequent case *Dominican Republic – Import of Cigarettes* the AB states that the term *less favourable treatment* must be understood as condoning differential treatment across like products if the rationale for differentiation is not protectionism. These are both steps toward a different approach to Art. III GATT. But the AB has still failed on a crucial point – to provide a conceptual framework for defining protectionism for the purpose of Art. III GATT. One of the purposes with the analysis to follow is to contribute toward this end.

## 4 How Should NT Be Interpreted?

We initiated the analysis above by examining the negotiating record of Art. III GATT. It was argued that the basic purpose of the GATT, as it appears from the negotiating record, was to liberalize trade, while at the same time preserving as much discretion for Members to pursue their domestic policy objectives as possible—hence the choice of negative integration as the *modus operandi* of the GATT. Indeed, a number of countries held the view that the ITO had gone too far in disciplining certain policies such as employment and the GATT formula (negative integration) was far more acceptable.

The following Section (Section 2) recapitulated some basic observations in the economic theory literature on the role of NT. It started from the observation that an inherent feature of domestic policy instruments is that they can be used both for protectionism, and for purposes that would be in the collective interest of GATT Members to allow. Ideally, the GATT should disallow the former but not the latter. The problem is, of course, that it is difficult to assess whether a particular measure is desirable or not from an international perspective, since this depends on the preferences of the regulating Member, as well as those of other Members, and these preferences are not directly observable. It was also noted that the fact that a measure harms trade partners is *not* sufficient to make it undesirable: oftentimes the benefit to the regulating country may dominate the harm to trade partners. The role of NT is then to sort the wheat from the chaff, that is, to prevent countries from pursuing internationally inefficient (beggar-thy-neighbor) policies, while allowing measures that countries generally view as legitimate. Members will of course be harmed when NT restricts them from pursuing the domestic policies they would prefer to pursue. But they will also benefit from the imposition of NT as exporters. Since NT prevents measures that are internationally inefficient, NT increases the total “size of the pie” to be shared among

members of the trade agreement, and unless countries are highly asymmetric, they all share the net gains.

Section 2 also presented the main features of the case law, as well as the scholarly critique, which led us to conclude that adjudicating bodies have failed to honor the agreed rationale for Art. III GATT, by not providing a contextual interpretation of the terms appearing in the text of the provision:

- While the basic purpose of Art. III GATT is to prevent domestic instruments from being “applied so as to afford protection,” “protection” has not been defined in satisfactory manner in case law.
- Case law has further failed to clearly define central concepts such as “like” and “DCS” products. Adjudicating bodies have, during the WTO era, interpreted these notions as reflecting the market relationship between imported and domestic products, but during the GATT era also devised different, and arguably internally inconsistent, understanding of these terms.<sup>147</sup>

There is undeniably a need for a more coherent approach to interpreting Art. III GATT since the understanding of this provision is central in the functioning of the GATT since it covers all domestic policies (instruments) hinging on the interpretation of the terms mentioned above. In particular, there is a need for a conceptual framework that can be applied across Art. III GATT disputes, making outcomes more consistent with the rationale of the provision, and for this reason, more predictable. In Section 4.1, we will suggest two alternative approaches to interpreting Art. III GATT that we believe would serve such a purpose. Both approaches rest on the idea that an examination of the legality of a domestic measure requires an evaluation of the extent to which the measure constitutes protectionism. The main difference between the approaches is the context in which this evaluation will be performed. According to one approach, the evaluation is done primarily in connection with the determination of whether the contested measure violates Art. III GATT. According to the other approach the evaluation is instead performed if and when an Art. XX GATT exception is sought.

The choice of approach would be immaterial if they were to yield the same adjudicated outcomes; “possibly” since there might be other aspects than the outcome that matters, such as legal fees. But as we will argue in Section 4.2, the two approaches would often yield

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<sup>147</sup>Indeed, even the very recent AB report on *Philippines-Distilled Spirits* is unclear in this respect: it advances first an interpretation of likeness to the effect that the competitive relationship among two products must be more intense than in case of DCS products, only to return to the relevance of HS classification (which does not necessarily reflect intense competitive relationship) a few paragraphs later.

different outcomes. This raises the question of which of the two approaches is to be preferred. Section 4.3 will discuss pros and cons of the two interpretations in light of the differences between them that were identified in Section 4.2. It will be argued that it is preferable to evaluate protectionism in the context of Art. III GATT. In Section 4.4, we will deal in more detail with the preferred approach. Section 4.5 revisits the leading cases from the perspective of the proposed interpretation. Our findings will be condensed into “Principles,” presented in the concluding Section 5. Finally, an appendix lists all Art. III GATT disputes since 1947.

## 4.1 Two Approaches to Evaluate Protection

The two interpretations to be proposed are both compatible with the economic view of NT and they are both consistent with the legal text as well. Hence, both approaches start from the notion that the general objective of the regulation of domestic instruments in the GATT is to limit the use of domestic instruments for protectionism, while at the same time allowing legitimate use of such instruments, even if this causes adverse consequences for trading partners by shielding import-competing products from foreign competition.

Broadly speaking, “Interpretation XX” largely continues the approach pursued in case law until recently: for a violation of Art. III GATT it suffices that there is potential for disparate effects in the sense that imported goods might be burdened more than domestic goods with which they compete. The alternative approach, “Interpretation III” requires that the measure is internationally inefficient, that is, that it can be said to constitute protectionism, in a sense to be made more precise below. Interpretation XX undertakes the evaluation of the protection as part of the determination of whether an Art. XX GATT exception can be granted (assuming that respondents request such exceptions if found to violate Art. III), and accepts as nonprotectionist only measures coming under the aegis of Art. XX GATT. According to Interpretation III, the evaluation is performed as part of the determination of whether Art. III GATT is violated and grounds beyond those reflected in Art. XX GATT could serve as basis to conclude that a measure is not protectionist. Put differently, Interpretation XX sees Art. III GATT as a net with fine meshes, and uses Art. XX GATT to evaluate what in the catch should be thrown back to sea. Interpretation III instead lets Art. III GATT take a more select catch, but one that for the most part is meant to be kept. The choice between the two interpretations would be (with the caveat mentioned) immaterial if the measures that are found to violate Art. III GATT according to Interpretation XX – measures that protect in the sense of shielding from competition – are also invariably protectionist, and thus internationally inefficient. However, as will be argued in Section 4.2, the outcomes of the two approaches are likely to differ.

One might legitimately ask how come Art. III GATT can be read in two so different ways? The term “protection” is nowhere defined in the GATT: as noted, there is no list of explicitly permitted and explicated prohibited policies, the GATT is “incomplete” in this way. Moreover, the term “protection,” which appears in both Arts. III.1 and XX GATT, is used in the GATT with two different meanings. It is occasionally used to mean “to shield from competition,” without any value judgment attached as to whether this is desirable or not. In other instances, it is used to denote illegitimate measures, i.e., in our terminology protectionist, or internationally inefficient, measures. This dual meaning of “protection” is reflected in text of the GATT. For instance, when using the phrase “so as to afford protection” concerning government mandated or operated monopolies, Art. II.4 states that

. . . such a monopoly should not . . . operate so as to afford protection on the average in excess of the amount of protection provided for in that Schedule.

Hence, a certain degree of “protection” is legitimate – the protection provided for in the Schedule – while any additional “protection” is illegal.<sup>148</sup>

It is clear that when Art. III.1 GATT sets the sight on domestic policy measures that are “applied so as to afford protection,” it refers to an undesirable form of “protection.” But it is also clear from negotiating history of the GATT, and from the general construction of the agreement, that the purpose of the GATT is not to prevent countries from persecuting all policies that protects in the sense of shielding import-competing firms from competition. This would effectively require positive discrimination of imported goods, since these could not face higher taxation in cases where they would be taxed higher, had they been domestic products (for instance, due to their environmental properties). A critical feature of the regulation of domestic instruments in the GATT is hence that, among all measures with protective effects, it manages to filter out only those that are harmful to the Membership, whereas measures that are detrimental to the parties’ common joint interest are allowed. Interpretation III is based on the idea that Art. III GATT should *only* capture measures that are undesirable in this sense, and that the protectionism test should hence be performed under this provision.

We now turn to a more detailed description of the two Interpretations, focusing in particular on the more novel Interpretation III, starting with the more conventional Interpretation XX.

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<sup>148</sup> Economic theory would suggest that the legitimacy of the protection provided by the measures that are bound in the Schedule stems from the fact that it has been *negotiated*.

### 4.1.1 Interpretation XX

To reach Art. XX GATT the complainant must have first established a violation of a GATT provision, in our discussion, Art. III GATT. WTO Members can justify violations of obligations assumed under the GATT through recourse to one of the grounds mentioned in Art. XX GATT. This list covers a variety of policy objectives, ranging from the protection of public health to conservation of natural resources. The provision was modeled after the corresponding provision included in the 1927 *International Convention for the Abolition of Import and Export Prohibitions and Restrictions* (World Economic Conference of 1927), the first multilateral attempt to liberalize international trade.<sup>149</sup>

Art. XX GATT opens with the sentence:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:

.....

The words "nothing in this agreement" leaves no doubt that the legislator's intent was that all grounds mentioned in this provision "trump" the trade liberalizing obligations in the rest of the GATT. Art. XX GATT thus provides a hierarchy between trade commitments and (national) social preferences: public morals, protection of human health, and all the other grounds mentioned in the body of this provision are more important than trade commitments. Trade thus is not elevated to the supreme common value that all WTO Members must observe at any cost. This understanding of GATT commitments is, of course, perfectly consistent with the negative-integration character of the GATT.<sup>150</sup>

At the same time, it does not suffice that a WTO Member simply invokes a ground mentioned in the body of this provision in order to lawfully violate its trade commitments. Two types of restrictions are imposed. First, the *actual purpose* of a contested measure must be to achieve one of the listed objectives. This is ensured by the qualifiers concerning the measure not being an "arbitrary or unjustifiable discrimination" or "disguised restriction on international trade," in order to qualify for an exception. Second, there are some restrictions imposed on the *means* by which the objectives are achieved. For instance, measures that protect public morals, or human, animal, or plant life or health must be "necessary."

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<sup>149</sup> On the content of the negotiations, and the reasons for the nonratification of the final text, see Charnovitz (1991), and Irwin *et al.* (2008).

<sup>150</sup> See the corresponding discussion in Chapter 3.

There may have been some disagreement as to the ambit of the provision during the negotiations. It seems that what the UK negotiator (one of the architects of this provision) had in mind was to include a provision which would operate as exception to import and export restrictions only, and not to internal measures:

The undertakings in Chapter IV of this Charter relating to import and export restrictions shall not be construed to prevent the adoption or enforcement by any member of measures for the following purposes, provided that they are not applied in such a manner as to constitute a means of arbitrary discrimination between countries where the same conditions prevail, or a disguised restriction of international trade.<sup>151</sup>

It is unclear how widespread this view was. But GATT/WTO case law has by now accepted that recourse to Art. XX GATT can be made in order to justify violations assumed with respect to both trade and domestic instruments. An example of the former is offered by the GATT Panel on *Thailand–Cigarettes*: in this case, the United States challenged the consistency of the *Thai Tobacco Act* of 1966 with Art. XI GATT. According to this law,

the importation . . . of tobacco is prohibited except by license of the Director-General (§63).

The *Thai Tobacco Act* of 1966 defined tobacco to include cigarettes. There was no dispute between the parties that the measure at hand constituted a quota in the sense of Art. XI GATT (§§ 21, 65); Thailand attempted to justify the quota in place by invoking, *inter alia*, Art. XX(b) GATT (§§ 72ff.). An example of how case law has accepted the applicability of Art. XX GATT to domestic instruments is offered in the report on *EC–Asbestos*, where the AB held that Art XX GATT could serve as legal basis to justify domestic measures that had been previously found to be inconsistent with Art. III GATT (§ 115).<sup>152</sup> The Panel on *China–Raw Materials* confirmed prior case law to the effect that Art. XX GATT could also serve as an exception to obligations assumed under a Protocol of Accession; nevertheless, this would be the case only if there is explicit or even implicit reference to this provision in the relevant protocol (§§ 7.158-7.160).

The AB has constructed Art. XX GATT akin to a two-tier test. For example, assuming a WTO Member invokes Art. XX(b) GATT in order to justify an import embargo on toxic waste (which is considered to be harmful to human health), the WTO adjudicating body will first examine whether such a measure is necessary to achieve the stated objective (protection of

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<sup>151</sup> E/PC/T/C.II/50, pp. 7ff.; E/PC/T/C.II/54, pp. 32ff.

<sup>152</sup> For confirmation, see the AB report on *Korea–Various Measures on Beef* §§ 152 ff.

human health), that is, whether the measure at hand conforms with the requirement included in Art. XX(b) GATT, before it examines whether the measure has also been applied in a manner consistent with the *chapeau* of the GATT. Both obligations must be met for a measure to be judged GATT-consistent, as the AB stated in its report on *US–Gasoline* (p. 22):

In order that the justifying protection of Article XX may be extended to it, the measure at issue must not only come under one or another of the particular exceptions—paragraphs (a) to (j)—listed under Article XX; it must also satisfy the requirements imposed by the opening clauses of Article XX. The analysis is, in other words, two-tiered: first, provisional justification by reason of characterization of the measure under XX(g); second, further appraisal of the same measure under the introductory clauses of Article XX.

The AB in its report on *US–Shrimp* expressed the view that it is the language of the *chapeau* that makes it clear that all exceptions appearing in Art. XX GATT are limited and conditional (§ 157). The AB, in its report on *Brazil–Retreaded Tyres*, eliminated any doubts on this score (§ 139).

Case law has consistently held, by virtue of the maxim that the party invoking an exception carries the associated burden of proof (*quicumque exceptio invokat ejusdem probare debet*), that the party invoking Art. XX GATT carries the burden of proof to demonstrate that it has met its requirements. The AB, citing prior case law to this effect (*US–Gasoline*, pp. 22-23; *US–Wool Shirts and Blouses*, pp. 15-16; *US–FSC (Article 21.5–EC)*, § 133) has confirmed this view in its report on *US–Gambling* (§ 309).

The AB, in its report on *Korea–Various Measures on Beef*, clarified that its judicial review has to be confined to the means used to achieve a particular objective, and cannot extend to an examination of the ends themselves (§ 176). Over the years, the AB made it clear that it would be more deferential when human health was at stake, and less so when WTO Members were pursuing other regulatory objectives mentioned in the body of Art. XX GATT. In its report on *EC–Asbestos*, the AB confirmed that this was indeed the case (§ 172).

Against this description of core features of the text and case law of Art. XX GATT, let us now turn to our first suggested interpretation of how Art. III GATT can be interpreted—denoted Interpretation XX—which largely continues the case-law approach. Interpretation XX hence stipulates that Art. III GATT is violated if an imported and a domestic product are “like” in the sense of being in a highly competitive relationship, and that the imported product is

directly or indirectly taxed “in excess” of the domestic product.<sup>153</sup> There would also be an Art. III GATT violation if the products are in a DCS-relationship, meaning that they are in competition albeit in less fierce competition than in the case of like products, provided that the products are “not similarly taxed.”

The focus in Interpretation XX is hence on the degree of competition between the imported and domestically produced goods, and the magnitude of the tax difference. If products are like, but not necessarily policy-like (a concept we explain in more detail *infra*) – perhaps approaching perfect substitutes – then any price differential due to differential taxation has the potential to have a significant impact on imports. As products become less substitutable, and cross the line into DCS, a small price differential due to differential taxation may have small effects on imports and be appropriately ignored. But a significant tax differential may be presumed to have a nontrivial impact on imports.

It should be stressed again that the extent to which products are like and/or DCS does not reflect possible differences between the products from a policy point of view. Similarly, the evaluation of whether the taxation of the imported product is “in excess” or that the products are “not similarly taxed,” does not take into consideration any policy rationale for a tax distinction. Both like and DCS products hence measure the same qualitative feature of the market situation – the extent of competition between the products – with like referring to situations with more intense competition.

An application of Interpretation XX would not mean that business should continue as usual in the case law, however. Until *Philippines–Distilled Spirits* (a report issued in January 2012) likeness was not necessarily confined to goods with high substitutability between them. And even there, as we stated *supra*, it is questionable whether the HS-classification is irrelevant to define likeness since the AB does mention it as a relevant criterion a few paragraphs later. Recall that for example, vodka and sochu share the same tariff classification at the six-digit HS level, and would yet by many consumers be viewed as far from perfectly substitutable.

#### **4.1.2 Interpretation III**

The regulation of fiscal instruments in Art. III GATT combines a general statement in Art. III.1 GATT with two specific restrictions in Art. III.2 GATT on the permissible difference in the level of taxation of imported and domestic products (and for fiscal instruments more generally). Interpretation III understands Arts. III.1 and III.2 GATT as jointly imposing a prohibition on protectionist measures, but on protectionist measures only. There are several ways in which the text could be read to harbor such an interpretation.

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<sup>153</sup> As stated, although not a very clear pronouncement to this effect, the AB report on *Philippines–Distilled Spirits* seems to side with this approach.

A first possibility would be to interpret Art. III.1 GATT as imposing a substantive restriction, requiring a demonstration that a measure is “applied so as to afford protection,” in order to establish a violation of Art. III GATT.

A second possibility would be to interpret the terms “in excess” concerning like products, and “not similarly taxed” concerning DCS products to reflect the rationale for any differences in absolute levels: for instance, an imported and a domestic product could then be viewed as being similarly taxed, even if they are burdened with different amounts of environmental taxation, provided that they differ in environmental impacts.

Interpretation III relies on yet another way of requiring a meaningful protectionism test under Art. III GATT, which is to interpret the notion of *like products* to reflect not only market likeness, but also *likeness from a policy point of view*. In what follows we will explain how such an interpretation is compatible with the text, and the associated interpretation of the requirement for DCS products.

#### 4.1.2.1 Like Products

Interpretation III, as well as Interpretation XX, follows the case law by interpreting “in excess” in Art. III.2 GATT, first sentence, as requesting that there should be no difference at all in tax burden in case of “like” products (a mere arithmetic difference suffices according to case law to satisfy this criterion, *US–Superfund*). But which product pairs are “like”? A distinguishing feature of Interpretation III is that it interprets products to be like if *there is no legitimate reason for imposing different tax burdens*, where legitimacy is evaluated from the point of view of the combined interests of the governments of the exporting and importing countries. Somewhat loosely put, two competing (we will return to this aspect below) products are “like” if an efficient agreement between the governments would stipulate identical taxes. Interpretation III hence requires that for products to be *like* for the purpose of Art. III.2 GATT:

- products would be competitive if they had equal opportunities of market access (they are “market-like”); and
- an internationally efficient agreement would entail no tax differential (they are “policy-like”).

Note two crucial features of this understanding of the ambit of Art. III.2 GATT:

*First*, Art. III.2 GATT, first sentence, plays the fundamental role for the whole regulation of fiscal instruments of *defining the level of ambition* for the combat of internationally inefficient

use of domestic fiscal instruments in the GATT.<sup>154</sup> It achieves this by specifying necessary and sufficient condition for a fiscal measure to not constitute illegal protection in a case of particular importance: where there is *no* efficiency rationale for treating highly competitive products differently. Put differently, Art. III.1 GATT sets the sight on (undesirable) protectionist use of domestic instruments, but does not specify what precisely defines protection. Art. III.2 GATT, first sentence, specifies exactly what constitutes the border between protectionism and nonprotectionism in one special case – where there is no (international) efficiency reason to allow differential taxation. For such a situation Art. III.2 GATT, first sentence, stipulates that it *suffices* for nonprotectionist behavior that each unit of the imported product does not carry a heavier fiscal burden than does each unit of the competing domestic product.

*Second*, the level of ambition that is laid down in Art. III.2 GATT, first sentence, is limited in that it does *not* explicitly or implicitly request from Members to pursue policies that are internationally efficient. As explained in Chapter 2, it should be expected that when Members unilaterally decide on a common tax level for domestic and imported products, they will disregard the interests of their trade partners, thus exposing them to international externalities. Consequently, *Art. III GATT-consistent taxation is likely to be internationally inefficient, even in the case of like products*. Put differently, Art. III.2 GATT, first sentence, does not require that the importing country refrain from measures that give rise to international externalities, only *not to use differential taxation* to this end and/or effect (we will discuss aims versus effects below).<sup>155</sup>

#### 4.1.2.2 DCS Products

We next turn to Art. III.2 GATT, second sentence, and the Ad Article III Interpretative Note.<sup>156</sup> The latter explicitly refers to product pairs that are defined in terms of the extent to

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<sup>154</sup> It does so also in another respect, following from our interpretation of “in excess” as any strictly positive tax difference, which is that it specifies the acceptable tax difference for like products to be 0%. This might seem as a natural number to choose, but the provision could in principle allow a 10% difference, say.

<sup>155</sup> The following statement by Harry Johnson was not made in the context of a discussion of NT, but seems relevant here nevertheless:

. . . 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. [Johnson (1976), p. 18]

<sup>156</sup> As a comment on the origin of the DCS notion, let us just recall from Chapter 2 that the negotiating history suggests that the DCS category was added because some negotiators felt that the value of tariff concessions would be too limited in case government behavior was not regulated for a wider set of circumstances than those involving like products, since the latter required that products fall under the same tariff heading in the predecessor to the Harmonized System, the tariff classification scheme being used at the time.

which they are in competition, i.e., in terms of the degree of market likeness, through the notion of “directly competitive or substitutable.” But it does not solely refer to this criterion. According to Interpretation III, the second sentence of Art. III.2 GATT requests that imported products for such product pairs should respect the principles of nonprotectionism embedded in Art. III.1 GATT, as given some precision through Art. III.2 GATT, first sentence. But while III.2 GATT, first sentence, pertains to situations where there is no efficiency basis to treat products differently, *the second sentence of Art. III.2 GATT addresses the situation where there is an efficiency rationale for yielding imported and domestic market-like products different policy treatment.*

As repeatedly mentioned above, there are situations in which it is desirable to allow an imported product to be burdened with a higher tax or fiscal duty than a competing domestic product. But the importing country obviously cannot be given a free reign to tax domestic and imported competing products differently. According to Interpretation III, Art. III.2 GATT, second sentence pertains to those instances where a higher tax on the imported product would be allowed, but where the particular tax difference is excessive. In contrast to the case of like products, it is not possible to specify exactly the property of the tax pairs that make them permissible. This is what explains the reference back to Art. III.1 GATT, which lays down a principle for how large the tax difference might be—it must not amount to undesirable protection.

The question then arises: what criterion should be used to evaluate whether a higher tax on an imported product than on a competing domestic product is acceptable?

From a theory point of view, the ideal would be to reject any tax pair other than the pair that maximizes the joint welfare of the two parties (or even better, the global membership). However, such an approach would request much more cooperation from the importing country than it agreed to when entering the GATT. The (negative integration) spirit of the regulation of domestic instruments in the GATT allows Members freedom to determine their domestic policies, subject “only” to the proviso that they are not “applied so as to afford protection.” The meaning of protection is generally speaking not clear, but as explained above, the first sentence of Art. III.2 defines exactly what is required in the special case of a policy- and market-like product to behave in a nonprotectionist fashion, which is to not tax the imported product higher than the domestic product. Since this provision refers to situations where there is no ground for tax differentials, the requirements for DCS products (where there are grounds for tax differentials) should be less strict.

To facilitate the discussion, we use the example of an importing country that levies a higher “environmental” tax on an imported product than on a competing domestic product, claiming that this is reasonable in order to achieve some emissions level that we denote E. It

is clear that each unit of the imported product is emitting more of the harmful substance (E) than does the corresponding domestic product, so there is a case from an environmental point of view to tax the imported product higher. The case hence clearly concerns a pair of DCS rather than a pair of like pair products. What is not clear however is whether the taxation scheme, which levies 40% on an imported good, and 0% on a competing domestically produced good, should be considered legal.

The fundamental problem is that, in principle, there are many tax pairs that could achieve the emissions level E. It might for instance be possible to achieve E by completely shutting out the imported product, by taxing it much higher than the domestic product. Alternatively, one could levy the same tax on both products, but set this common tax level high enough to achieve the target. There will also be tax pairs in between these extremes that will achieve the particular target. *Which* tax pair among all those that can achieve the emissions target should be considered legal? And could we for example envisage a situation where more than one tax pairs are considered legal? And if yes, what criteria should be fulfilled for this to be the case?

Let us here recall that the basic problem that the agreement seeks to address stems from the fact that when countries set their policies unilaterally, they have no direct concern for the interests of their trading partners. This is the source of the protectionism that the agreement seeks to limit. Hence, when looking for acceptable tax pairs, it would be desirable to consider the consequences for the *joint* welfare of the parties, rather than the welfare for the importing country only. There are different ways in which this could be done.

One possibility would be to argue as follows. The gist of Art. III.2 GATT is to request equal taxation of closely competing imported and domestically produced goods, while at the same time acknowledging that there will be occasions where equal taxation is not warranted. Differences in tax rates should then be permitted if, and only if, the gain to the importing country government from pursuing the differential taxation (rather than imposing a uniform tax), is large enough that the importing country could in principle compensate the exporting country for the adverse effects it is being exposed to as a result of the differential taxation and still benefit from pursuing its regulatory objective.<sup>157</sup> It should be emphasized that the idea is not that the importing country actually compensates the exporter in the industry at stake. Instead, with countries sometimes in the role of exporters and sometimes in the role of importers, there is a common interest in an NT-regime that allows differential taxation if and only if it increases aggregate welfare. What a Member might lose as an exporter, is then more than compensated for by what it might gain as a regulating importer in another industry. The logic is here exactly the same as in the case of reciprocal tariff liberalization: the

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<sup>157</sup> That is, the differentiation is desirable in the Kaldor-Hicks sense.

reduction in tariffs hurts the importing country government, but benefits the exporting country government more. The compensation for the import country government comes in the form of increased exports in other sectors, and due to the fact that overall there is too little trade at the outset, this gain will be larger than the loss on the import side.

For instance, suppose in the example above the importing country government taxes the imported product at 40% and the domestic product at 0% in order to achieve the environmental emissions target E. Assume also that if forced to set equal taxes, the importing country would set 8% on both products. The criterion for accepting the (40%, 0%) pair would then be that it yields higher welfare for the countries combined than does the pair (8%, 8%).

This approach would hence accept the pair (40%, 0%) provided that the importing country government could *in principle* compensate the exporting Member government for the cost the latter is exposed to as a result of facing the pair (40%, 0%) rather than the pair (8%, 8%). Compensation would be possible, and the measure would be legal, only if the gains to the importing Member from addressing the environmental problem were sufficiently significant.<sup>158</sup>

Note that this criterion pays no attention to the alleged rationale for the regulation nor to the desirability (or lack thereof) of the emissions target level (E). All it cares about is whether the joint welfare of the parties is higher with the pair (40%, 0%) than with the pair (8%, 8%). But the objective might still play a role in the evaluation of the gains from the differential taxation.

Another possibility could be to accept the alleged purpose for the differential taxation—the emissions target E—and still condition the acceptance of the measure on achieving the target in a reasonable manner from a joint welfare point of view. As with the previous alternative, this approach would take into consideration the possibility that it is desirable also from an international point of view to let the importing country tax the imported product higher than the domestic product, but in contrast to the previous alternative, the importing country would not do the protectionist calculation unilaterally, since it would have to take into account the costs for the exporting country. Suppose, for example, that the court concludes

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<sup>158</sup> To avoid misunderstandings, it is not suggested that this compensation should take a monetary form, but normally to come from the reciprocal nature of undertakings. If countries are highly asymmetric, so that some countries cannot be fully compensated for allowing its trading partners to differentiate their domestic taxation, the proposed solution is still desirable from the point of view of maximizing the size of the “pie,” but may give rise to distributional problems between countries.

that a 20% tax on the imported product and a 15% tax on the domestic product would be the most efficient manner of achieving the emissions target E.

It would then be possible for the court to reject any pair of taxes, where the tax on the imported product is higher than on the tax on the domestic product, other than the taxes 20% and 15%. The difference between this approach and the previous one is hence that whereas in the previous case the evaluation seeks to determine whether the challenged taxation is better than equal taxation (assumed to result in a common tax of 8%) regardless of its purpose, the evaluation here asks whether the stated objective of having emissions at the level E is achieved in an efficient manner.

Yet another possibility would be to follow the previous approach in accepting the emissions target E, and to determine that taxes 20% and 15% would be efficient means to reach the target E; but rather than rejecting any other differential taxes than those two, it would be determined that a 5 percentage point difference in taxation is what is maximally legitimate. The importing country could then set say 25% on the imported product and 20% on the domestic product, if it so wanted. In light of the possible uncertainty regarding calculations, providing for a leeway might be one way to reduce pressure on regulators and adjudicators alike.

All three approaches have their pros and cons. They all have a certain logic from an economic point of view, in that they build on some form of efficiency notion. But none of them implements the ideal criterion that we discussed above. The first approach goes the furthest in this direction, but the contested pair of taxes is in this approach only compared with the common tax level that the country would set if unable to differentiate in its taxation (which is not fully efficient since we are in the case of DCS products). The contested pair is not compared with all other possible pairs of taxes (which would be required to ensure full international efficiency). It hence imposes only a limited form of efficiency-restriction. In the second approach, the comparison is with an efficient tax pair, but only in the limited sense of being the tax pair that best achieves the emissions target E. This aspect pertains to the third approach as well. The third approach further suffers from the weakness that if the importing country were to choose any other tax pair with a 5 percentage point difference, the target E would be over- or undershot, which would cast doubt on the relevance of the calculation based on E in the first place. Suppose, for instance, that with the adjusted taxes, the resulting emissions level is  $E' < E$ . The question could then be raised whether a 5 percentage point tax difference is part of the optimal way for the parties to achieve  $E'$ .

On the other hand, while the second, and in particular the third, approach is less attractive from an economic point of view, they are more consonant with the text of Art. III GATT, because of their focus on whether tax *differentials* afford protection. The third approach in

particular seems more in line with a with negative integration mode than the previous two approaches – the unilaterally determined policy target E is accepted – and it operates by defining legality in terms of the degree of deviation from the equal taxation benchmark. We will therefore view it as the main candidate for how to more specifically understand Interpretation III.

## 4.2 The Difference in Outcome with the Two Approaches

The choice between the Interpretations III and XX would (or at least could) be immaterial if they accepted and rejected the same domestic policy measures. This section will argue that this will not be the case. Instead, *Interpretation XX is likely to impose a more restrictive regime on domestic measures compared to Interpretation III*. Following Interpretation XX, Art III GATT is insensitive to whether a measure is pursued for legitimate purposes, as long as it protects domestic production in the sense that it shields domestic goods from competition from imported products. Hence, a measure that provokes this outcome will only be justified through recourse to Art. XX GATT. This would not matter if the test is the same under both provisions. But the test for protectionism that is performed under Art. XX GATT is more demanding than the test performed under Art. III GATT, for at least two reasons.<sup>159</sup> First, as explained in more detail in Section 4.2.1, Art. XX GATT imposes some requirements in order for a measure to be eligible for an exception that are found in Art. III. Second, as discussed in Section 4.2.2, the two interpretations have different implications for the allocation of the burden of proof. Interpretation III requires the complainant to establish that a contested measure affords protection. With Interpretation XX, the burden will be much lighter for the complainant however, if the respondent requests an Art. XX exception. In the resulting protectionism test, it is instead the respondent who will have to show that a measure that shields a domestic product from import competition is not “disguised protection” (or undesirable protection, that is, protectionism in our terminology), in order to be allowed to continue pursuing a contested measure. This difference will contribute to make Interpretation XX a more stringent regime for the domestic instruments protectionism test is what makes it a more stringent regime.

The fact that Interpretation XX imposes a more stringent regime for the domestic measures would seem welcome if the measures that would be exposed to this additional restrictiveness would all be protectionist. But as Section 4.2.3 will explain, there is no

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<sup>159</sup> There could be a difference between the two Interpretations even if the tests were the same, if they could lead to judicial errors. With Interpretation III, if the respondent loses in the test performed under Art. III GATT, the respondent can seek an Art. XX GATT exception, in which case the same test would be performed twice, making it more likely that the contested measure would be allowed.

presumption that the measures caught under Art. III GATT following Interpretation XX will all be protectionist.

#### **4.2.1 Interpretation XX Imposes Additional Restrictions for Measures Not to Constitute Illegal Protection**

One difference between a protectionism test performed under Art. III GATT and under Art. XX GATT, is that Art. XX (and hence Interpretation XX) imposes some conditions for measures to be granted an exception that have no counterpart in Art. III GATT. These additional restrictions stem from two sources.

The first additional hurdle to pass in order to be granted an exception under Art. XX GATT, is that the measure at hand must seek to *achieve one of the policy objectives listed in the body of Art. XX GATT*. This list of justifications has in case law—reasonably in our view, in light of the wording—been interpreted as closed: in the absence of a legislative acknowledgment that the list is indicative, it is not possible to invoke grounds not explicitly appearing in this list. Considering the fact that Art. III GATT applies to an extremely broad range of government measures, and thus may have very significant impact on the possibility for governments to pursue unilateral policies, the exhaustive nature of the list of objectives embedded in Art. XX GATT might have important consequences on the overall ambit of obligations assumed upon accession to the WTO.

Second, Art. XX GATT does not simply specify a list of policy objectives that serve as a blanket basis for exceptions from undertakings in the rest of the GATT, provided they are not disguised protection. It also qualifies the grounds for several of those exceptions, by *imposing requirements on how the listed objectives should be achieved*. In particular, in order to be eligible for some of the grounds for exceptions, the measures employed must be “necessary.” For instance, Art. XX(b) GATT provides an exception possibility for measures “necessary” to protect human, animal, and plant life or health. The case law has interpreted this concept to require that no less trade restrictive alternative can achieve the same regulatory objective, more recently with the specification that the alternative measure should be “reasonably available.”<sup>160</sup>

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<sup>160</sup> See Sykes (2003).

#### **4.2.2 The Evidentiary Burden Falls Heavier on the Complainant with Interpretation XX**

The GATT does not explicitly regulate the burden of proof. The current practice has instead been developed in case law. Case law has endorsed the *in dubio mitius* principle, according to which WTO Members' actions should be presumed legitimate, unless challenged and proven inconsistent before a WTO panel (and/or the AB, as the case may be). This principle hence imposes the original burden of production of proof on the complainant. Assuming the complainant produces sufficient evidence to raise a presumption (an undefined notion in case law), the burden shifts to the other party. Conversely, the respondent has the burden of proof to establish eligibility for an Art. XX GATT exception.

As a consequence of these well-established evidentiary standards, Interpretations III and XX will differ in the extent to which it will fall on the complainant to provide evidence of illegal protection, as per Interpretation III, or on the regulating country to defend its practices, as advocated by Interpretation XX. In either case the demonstration will involve providing evidence of the objective of the contested measure – that is, information concerning the policy preferences of the regulating country. In a hypothetical situation of perfect information, it would be immaterial whether the burden is put on one party or the other, except that the distribution of the costs for judicial process might differ. But it may be important in situations where the true rationales for pursued policies are not known before the dispute-settlement proceedings, as is typically the case in this in this context. As argued in Chapter 2, at the heart of the rationale for Art. III GATT is an information problem; as explained, if there were easily available information concerning the true motives for regulations, it would be possible to contract these more directly, in which case there would not be any need for Art. III GATT in the first place, at least not as we know it.

#### **4.2.3 The Nature of Measures That Are Market-Like But Not Policy-Like**

As we have argued in the above, Interpretation XX will impose a more demanding protectionism test than Interpretation III. This would be desirable, if all these measures were known to be protectionist. After all, it may reflect outright protectionism if a higher fiscal burden is imposed on an imported product than on a competing domestic product. But there can be no *presumption* that the measures caught under Art. III GATT following Interpretation XX will be protectionist, however. On the contrary, such differences in fiscal burdens may reflect the *governments' pursuit of some of the fundamental roles that economic theory identifies as grounds for social-welfare-increasing government market interventions.*

To see why, recall that one of the main efficiency-enhancing motives for government intervention identified by economic theory is to *eliminate negative externalities* between

economic decisionmakers, such as consumers and producers. The distinguishing feature of such externalities is that their adverse impact for other consumers and producers is disregarded by those who cause them. A standard example is a negative environmental consumption externality, which arises when buyers disregard the adverse environmental impact of their consumption, treating polluting products as interchangeable with cleaner products. It is very easy to point to real-world examples of such behavior. For example, consumers may disregard the environmental impact that arises when products are scrapped, and will therefore not pay extra for more environmentally friendly product designs, unless forced to. Or, buyers of automobiles disregard the fact that their brakes emit asbestos into the air, since each buyer's emissions have negligible impact on the buyer's personal health (in contrast to the combined emissions from automobiles). Or construction companies may not take into consideration when buying construction material whether it will expose residents, or future demolition workers, to asbestos. A central, efficiency-enhancing role for governments is to combat such negative externalities, by for example, inducing buyers of polluting products to shift their purchases toward cleaner products.

Another rationale for government intervention might be informational problems. For instance, consumers may not be aware of differences in the safety of products, or may not take such information sufficiently into account in their consumption decisions, in the view of the government. Progressive taxation of beverages according to their alcohol content is occasionally motivated by such concerns (there are also other concerns, as the Art. III GATT case law has revealed).

Both of the above types of situations provide reasons for government intervention that are legitimate from an economic efficiency point of view. Indeed, they constitute two of the main rationales that economic theory identifies for government intervention.<sup>161</sup> The distinguishing feature of these situations is precisely that consumers do *not* necessarily (very often for good reasons) distinguish between the products, that is, that *the products are market-like but not policy-like*. Indeed, environmental regulations are to a large extent predicated on the fact that market likeness *differs* from policy likeness, and it is exactly *because of the market likeness* that there is a need for government intervention.

The need for governments to remedy the above type of problems is obviously not confined to situations where only domestic products are involved, but may also exist in case of imports. Hence, a necessary condition in order for a trade agreement to be efficient is that in situations where imported products are associated with more pronounced negative externalities than those stemming from competing domestic products, importing country

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<sup>161</sup> Other rationales are that markets are imperfectly competitive, that the laissez/faire income distribution is undesirable, and "non-economic" policy objectives (national security, for instance).

governments are allowed to levy higher taxes per unit of consumption or production on the imported products. Such taxation would violate Art. III GATT according to Interpretation XX, however. In contrast, the basic idea underlying Interpretation III is that such measures should not by automaticity be understood to run afoul of Art. III GATT. By including policy likeness in the definition of like and DCS, Interpretation III ensures that a test for protectionism is undertaken under Art. III GATT. Consequently, internationally desirable higher taxation of imports must seek exceptions through the more demanding Art. XX GATT test.<sup>162</sup>

To conclude, the main difference in terms of the measures that violate Art. III GATT under the two approaches, is that measures that put a heavier fiscal burden on imported products than on competing domestic products, will be exposed to a more demanding protectionism test following Interpretation XX compared to Interpretation III. This stricter test will be applied to purely protectionist measures. But it will also be applied to measures that are *legitimate* from an international perspective, despite imposing a higher fiscal burden on imports, measures that would be compatible with Art. III GATT according to Interpretation III.

### 4.3 Which Interpretation Is Preferable?

Section 4.2 showed that Interpretation XX will impose a stricter protectionism test than Interpretation III. Is this desirable, or does it unduly restrict the freedom for WTO Members to choose domestic policies? In this section, we explain why we believe that, on balance, Interpretation III is to be preferred, even if there are arguments pointing in the opposite direction.

In the discussion to follow, we will for analytical purposes distinguish between the consequences of the choice of interpretation for the expected adjudicated outcome of disputes, and for governments' policy decisions, such as the choice of domestic policy measures, and tariff concessions. Sections 4.3.1-4.3.3 will discuss the former type of effects. Section 4.3.1 and 4.3.2 will focus on the desirability of the additional restrictions that Art. XX GATT imposes compared to Art. III GATT (as per the discussion in Section 4.2.1), and Section 4.3.3 will focus on the difference in the allocation of the burden proof between the two interpretations (as per the discussion in Section 4.2.2). The benchmark for evaluating the two interpretations will here be the extent to which the NT provision manages to sort the

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<sup>162</sup> Recapitulating from above, following Interpretation III, measures that buyers treat interchangeably but that differ from a policy perspective, will be viewed as DCS, since there is a policy rationale for taxing them differently. The issue will instead be whether the magnitude of the tax differential is justified. If too large from an international perspective, the measure will be illegal, if not too large it will be acceptable.

wheat from the chaff: does it allow Members to achieve legitimate domestic policy objectives, while at the same time prevent them from using domestic measures for protectionist reasons?

The effects of choice of interpretation for expected adjudicated outcomes of disputes are relatively clear. But as emphasized in Sections 2 and 3, the overriding purpose of NT is to provide incentives for Members to increase trade, while still allowing them to use domestic instruments for legitimate policy purposes. The effects on tariff and trade liberalization are harder to determine, however. Section 4.3.4 will more briefly highlight such policy effects of the choice of interpretation, and discuss their desirability.

### 4.3.1 The List of Permissible Objectives in Art. XX GATT

As highlighted in Section 4.2.1, Art. XX GATT contains a closed list of policy objectives that may serve as a ground for an exception from other obligations in the GATT. A first question is whether this list was intended to describe not only the policy objectives that can serve as grounds for an exception from, e.g., Art. III GATT, but also as a *complete description of all permissible grounds for imposing heavier financial burdens on imported products than on competing domestic products*, as would be maintained according to Interpretation XX.

In our view, it does not seem plausible that Art. XX GATT was drafted with this role in mind. It rather appears as if it was meant to serve as a safety valve, as an assurance that despite efforts to ensure that core regulatory values would not be infringed upon, nothing in the agreement would do so.<sup>163</sup> This view of the original rationale for Art. XX GATT is consistent with the view of the GATT as a negative integration scheme, in which domestic policies will be defined unilaterally and only to the extent that they exhibit international externalities will tend to be regulated through Art. III GATT (as well as the Most-Favored-Nation Provision in Art. I GATT, which also applies to domestic instruments, by virtue of Art. I.1). This view of Art. XX GATT speaks against letting the list define the set of situations in which it would be permissible to treat imported products less favorably than competing domestic products, that is, against Interpretation XX.

A second and related issue is whether the closed list should, by any reasonable benchmark, be regarded as complete, in light of Members' policy preferences. It is fairly easy to come up with examples of common measures that might find it difficult to qualify as exceptions under Art. XX GATT, if their consistency with the GATT is challenged. For example, a WTO Member distinguishing between "ordinary" and "luxury" items in such a manner as to indirectly tax an imported product higher than a competing domestic product, will have a

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<sup>163</sup> See Irwin et al. (2008).

hard time finding justification under Art. XX GATT. Another example would be domestic taxation that treats products originating from small and medium enterprises more favorably than products of “bigger” players.<sup>164</sup> According to current case law for a violation of Art. III GATT, it suffices in both instances that just one imported product is taxed heavier than its domestic counterpart. The defendant would have then a hard time justifying its measures under Art. XX GATT since no exception enlisted in Art. XX GATT corresponds to the examples provided for here. Yet another policy would be the promotion of culture.<sup>165</sup> These examples of real-world policy objectives that would normally find it hard to find defense under Art. XX GATT suggests that the list in Art. XX GATT is not complete from the point of view of Member preferences, and thus that Interpretation III is preferable in this regard.

But there are counterarguments. A first argument is that the list in Art. XX(a) GATT includes the reference to measures that are “necessary to protect public morals.” This interpretation of this basis for exceptions is unclear, and negotiating history supports a narrow reading.<sup>166</sup> It can be noted, nevertheless, that in GATS, the negotiators opted for the most encompassing expression of the notion of “public order” (Art. XIV GATS), according to which *any* regulatory intervention is presumably done to serve public order. Were adjudicating bodies to interpret Art. XX GATT in a similar fashion, the closed nature of the list in Art. XX GATT would not be a severe constraint on the possibility to pursue nonprotectionist unilateral policies.

Secondly, it can be noted that the GATT membership has not seen the need to expand the list of exceptions in Art. XX GATT over its 60-year history. It is also noteworthy that there has been no dispute so far where a WTO Member found it impossible to fit a tax differential under one of the grounds mentioned in Art. XX GATT. Of course, it could be the case that WTO Members have preferred not to legislate fearing that their legislation would be struck down as a result of the current construction of Arts. III and XX GATT. We do not have sufficient information to conclusively decide on this point. However, at the very least it can be concluded that the track record does not suggest that the closed list feature of Art. XX GATT has so far unduly constrained Members (by providing an unacceptably short list of permissible policy objectives). Indeed, had this been the case, one would have expected much more movement toward change or amendment to loosen the grip of GATT on

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<sup>164</sup> The EU promotion of Small and Medium-sized Enterprises may exemplify such a policy,

<sup>165</sup> It can be argued that in several of these examples it would be easy to suggest alternative means of achieving the same policy objectives, but without running afoul of Art. III GATT. We will discuss the question of whether the GATT imposes restrictions on the means by which Members can achieve legitimate regulatory objectives in the next subsection.

<sup>166</sup> Based on the negotiating record, Feddersen (1998) argues that the term “public morals” was not perceived to be equivalent to “public order.” Charnovitz (1998) does not exclude a more wide understanding of the term without, however, disputing the evidence provided by Feddersen.

domestic regulation.<sup>167</sup> To the contrary, the clear trend in the history of GATT has been to expand the obligations imposed on national regulators through the technical barriers agreements.

Thirdly, it may possibly be argued that the closed-list feature is actually desirable, in that absent this limitation on the domain of possible exceptions to Art. III GATT, the door would be open to questionable policy rationales. This raises the more general issue of whether the GATT restricts the freedom of Members to pursue policy objectives beyond prohibiting protectionist policies. Interpretation III and XX are based on different views on this issue, as will be discussed later in this Chapter.

To conclude, Interpretations III and XX are supported by two rather different views on the closed-list feature of Art. XX GATT. Interpretation III is based on the notion that the provision was never intended to serve as definition of the set of policy objectives that could justify a less favorable treatment of imported products. Interpretation XX finds support mainly in the practical experiences with the legislation. In our view, the former arguments weigh significantly heavier, however, in particular when formulating principles for the design of the regulation of domestic instruments.

### **4.3.2 The Additional Requirements Imposed by Art. XX GATT**

The body of Art. XX GATT contains some qualifiers for the eligibility for exceptions that have no counterpart in Art. III GATT, as pointed out in Section 4.2.1. In particular, it requests, with respect to some of the grounds mentioned in the list at least, that the contested measure be “necessary” to achieve the stated objective. The presence of such qualifiers raises the central issue of whether the GATT should be generally construed as requesting Members to not use policy instruments that impose different burdens on domestic and imported competing products, when instruments with more symmetric effects are somehow available. And if so, what should be meant by “available”? For instance, if the purpose of a luxury tax is to redistribute income from the rich to the poor, there might be other instruments, such as income taxation, that can be used to this end, and that possibly treat imported and domestic products more equally. Similarly, if the goal of the different taxation of goods of small and large enterprises is to subsidize small business, a government could tax all goods uniformly and pay subsidies to small business without violating the NT provisions by virtue of Art. III.8(b) GATT, which exempts from NT the payment of subsidies to domestic producers (but possibly at the risk of facing, e.g., a countervailing duty). Is it a purpose of the GATT to discipline Members in this sense? Interpretations III and XX are supported by different views on this important issue.

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<sup>167</sup> On the other hand, amendments occur only seldom in the WTO, see Kennedy (2010).

Interpretation III is based on the view that the GATT framers did not conceive the GATT as an instrument for deregulation or for efficient domestic regulation, but rather for nondiscrimination, where the disciplining of domestic instruments served one purpose only: to ensure that the value of tariff concessions would not be impaired through their discriminatory use.

Interpretation XX takes a rather different view, seeing the additional disciplines imposed by Art. XX GATT as both valuable and intentional, fearing that the disciplines would be lost in an open-ended evaluation of protection under Art. III GATT, since regulations can often be designed in multiple ways to achieve the same objective. To take an example: a measure regulating acceptable levels of pollution created by automobiles might require that all automobiles use a catalytic converter to reduce emissions. But perhaps some automakers can achieve the same emissions target more cheaply by shifting to a different technology, like hybrid propulsion. If such manufacturers are foreign, regulators may nevertheless require that all manufacturers use catalytic converters simply because they have no regard for the burden imposed on foreigners, even if the regulators' objectives are legitimately related to environmental protection, or worse, as a means for protectionism. The necessity test together with the chapeau of Art. XX GATT make it impossible for the regulator to be indifferent to international externalities since the measure chosen must be the least burdensome on international trade.<sup>168</sup>

This raises the general question of how far WTO Members should be requested to go in order to minimize adverse trade effects from domestic policies, in order to be eligible for an Art. XX GATT exception? Case law has more recently added a "reasonably available" qualification to the "least trade restrictive" interpretation of *necessary* in Art. XX.b GATT. Even so though, Art. XX GATT imposes an extra discipline on regulators (when compared to Art. III GATT) by requesting that measures are not only nondiscriminatory but further the least restrictive means: a proxy (necessity) is thus elevated to a positive obligation. The upside is that an appropriate proxy to detect protectionism (or absence thereof) becomes part of the legal test for consistency with the GATT; the downside is it might lead to "regulatory chill," definitely not part of the objectives the GATT was meant to pursue.

Art. 3.2 DSU clearly states that it is not for the interpreter to undo the balance of rights and obligations as struck by the framers of the WTO. So, even if desirable to do so, the interpreter

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<sup>168</sup> In *US – Shrimp*, the AB requested from the U.S. to be flexible and accept in its market not only shrimps fished with TEDs (turtle excluding devices, a U.S. technology that guaranteed a low incidental take of life of sea turtles when fishing shrimps) but also shrimps fished with other technology as long as the rate of accidental take of life of sea turtles was comparable to that of TEDs.

should stop short of imposing its own rationality thus relegating negotiating intent to second-order consideration.

### 4.3.3 The Allocation of the Burden of Proof

As explained in Section 2, NT basically solves an informational problem—the lack of information for adjudicators concerning factual circumstances of the cases they are to adjudicate, and in particular with regard to government motives for contested regulation. Due to these informational problems, the design of the rules for the burden of proof will be important. In order to determine which interpretation is better in this regard, we will draw on the law-and-economics literature, focusing on two of the main themes in this literature. We thus start by analyzing how the possibility of judicial mistakes affects the desirable choice between Interpretations III and XX, and then turn to how this choice may contribute to the extraction of the parties' private information considering the circumstances that lead to the imposition of the contested measure.<sup>169</sup>

A first fundamental aspect that is highlighted in the literature is the impact of the allocation of the burden of proof for the occurrence of *judicial mistakes*. Generally speaking, the allocation of the burden of proof needs to balance the costs of false positive findings of violations (“Type I errors”) against the costs of erroneous acquittals (“Type II errors”). In the present context, it seems plausible that what is at stake for the complainant, is market access in its export market. For the respondent, what is at stake is instead the possibility to use domestic instruments for protectionism, or for legitimate purposes, as the case may be. The allocation of the burden of proof therefore needs to weigh the cost of erroneously denying an exporter the market access it should legitimately have, against the cost of denying a regulating country the possibility to pursue legitimate regulatory policies. The cost of the latter type of mistake, which would force the regulating country to levy a higher fiscal burden on the domestic product than it would otherwise do, will partly take the form of reduced sales for its import-competing industry. But, it may also suffer a cost if the prohibition of its measure induces a lower level of ambition with regard to the policy objective it was pursuing.

It is hard to say anything definitive about the relative costs of Type I and Type II errors. But a number of considerations would suggest that *in dubio* it is probably preferable to err on the side of commercial rather than public-order objectives. First, it is clear that WTO Members

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<sup>169</sup> A third consideration pointed to in the literature is the desire to minimize legal costs. This may not be a prime concern to developed WTO Members, but may be of considerable importance to poorer Members. It is not clear how the desirable choice between Interpretations III and XX would be affected by such a consideration, however.

have explicitly recognized that certain regulatory objectives are more important than commercial export interests, the chapeau of Art. XX GATT being an example. Second, Type I errors might comport negative implications for the institution itself: it is one thing for a panel to keep a dubious health policy in place and impose a trade cost on those trading with the country imposing it; it is yet another to strike down a health policy on dubious grounds and provoke a disease as a result.

A second theme in the law-and-economics literature on the burden of proof is the notion that it may be desirable to lay the burden on the party that is *better informed* concerning the contested issue; this may stem from the fact that the other party simply does not have access to information, or can only provide the information at a higher cost. By laying the burden of production on the better informed party, information that would otherwise not be available will be presented (or the information will be made available at lower cost). In the present context, the importing country is likely to be better informed concerning the reasons for the contested measure. The above reasoning would hence speak in favor of evaluating protection under Art. XX GATT, since the importing country would then bear most of the evidentiary burden. This would also be natural given the fact that a fundamental obstacle to the implementation of NT is lack of information concerning the government preferences that leads to the regulation.

To conclude, the choice between Interpretations III and XX should partly be influenced by the implications of the choice for the allocation of the burden of proof. The literature here points to a number of factors. One fundamental factor is the cost of judicial mistakes of different types; from this perspective, Interpretation III seems preferable. Another factor is the extent to which private information is extracted; Interpretation XX seems to perform better in this respect.

#### **4.3.4 Consequences for Trade Liberalization**

The discussion of the pros and cons of the Interpretations III and XX has thus far focused on how it would affect the outcome of adjudication, but has for analytical reasons disregarded implications for Members' policy choices. But the design of the adjudication mechanism will likely affect a whole range of government decisions, such as whether to invest resources in investigating domestic measures pursued by trading partners, whether to bring complaints, whether to request the establishment of panels, whether to appeal, etc. By affecting the likelihood of winning different types of claims, the choice of interpretation is likely to affect all these decisions.

What is of particular interest in this regard is whether Interpretation III or XX is more conducive to tariff liberalization, since a main purpose of NT is to support trade liberalization, while allowing governments to pursue legitimate domestic policies as they like (as emphasized in Sections 2 and 3).

What matters for trade liberalization is the combined effect of changes in tariffs and in the levels of domestic-trade-impeding instruments. We can here point to several mechanisms through which trade liberalization will be affected.

First, governments are typically unwilling to curb their discretion when it comes to regulation affecting their domestic market. They are therefore likely to respond to the imposition of stricter NT regimes for domestic instruments by maintaining higher tariffs, so as to ensure some policy space. The less restrictive Interpretation III may for this reason allow more tariff reductions than Interpretation XX.

Second, in order for countries to find it meaningful, and be willing, to make tariff concessions in the first place, it is necessary that they do not expect their trading partners to undercut the concessions they have given through opportunistic changes in the domestic policies. The stricter regime of Interpretation XX is likely to be better from this point of view. It is not possible to say, however, whether the combined effect will be to make Interpretation III or XX more conducive to reduced tariffs.

Third, trade liberalization requires not only tariff reductions, but also that domestic instruments are not used to fully offset the tariff concessions that countries have promised. Interpretation XX will be more efficient in preventing protectionist responses through domestic measures.<sup>170</sup>

There is also a broader aspect to take into consideration here, which is the *legitimacy* of the WTO more generally, since this affects the general willingness of countries to participate in the process of trade liberalization. We believe that Interpretation XX may be more problematic in this regard, since it puts on the regulating country the burden of proof to establish that contested measures are not disguised protection. According to Interpretation XX, a government would hence almost by automaticity violate one of the two fundamental nondiscrimination principles underlying the GATT/WTO if it were to intervene against regulatory problems that are particularly associated with imported goods. We believe that

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<sup>170</sup> Recall also, from the discussion in Section 3, that even if countries do not differentiate in domestic taxation, they can still respond to tariff reductions by increasing the common level of taxation, in order to at least partly dampen the effect of the tariff liberalization.

Interpretation XX may, for this reason, be seen as imposing a more intrusive legal regime than what is politically desirable.

To illustrate, consider the case of environmental policies. For instance, suppose an imported car pollutes the air more than does a competing domestically produced car, per unit of gasoline consumed. An environmental policy that imposes a tax in proportion to the fuel consumption of cars would thus impose a higher fiscal burden on the imported product. It would then be very simple for the exporting WTO Member to establish a violation of Art. III GATT. According to Interpretation XX, the regulating country would then face the burden to defend the environmental policy before a panel and possibly the AB, having to prove that the taxation is not disguised protection, and that it fulfills the requirements in the body of Art. XX GATT. The latter may or may not be simple, depending on the precise ground in Art. XX GATT that is called upon. But to establish that the measure is not disguised protection may be more onerous.

Even if it would often be straightforward to defend such measures, we believe that Members would still be unwilling to let there be a presumption that environmental measures of this kind violate one of the two core nondiscrimination principles in the WTO.<sup>171</sup> The same issue would arise for all public-health measures that do not come under the purview of the *Agreement on the Application of Sanitary and Phytosanitary Measures* (SPS): the regulating state would have to show why the measure is necessary, despite the fact (according to Interpretation III) that all it promised when acceding to the WTO was not to discriminate.

In sum, above we pointed to several counteracting mechanisms for how the choice between Interpretations III and XX will affect trade liberalization, but it does not seem possible to say anything conclusive about their net effect. We believe, however, that a major consideration for longer-run trade liberalization is the legitimacy of the WTO among Members. It would politically and legally violate the spirit of the GATT if governments would have to request exceptions for obviously legitimate policies, and in particular when they are denied such exceptions. This is, in our view, a major drawback of Interpretation XX.

### 4.3.5 Concluding Discussion

Section 4.1 sketched out two different approaches to interpret the regulation of fiscal instruments in Art. III GATT. In Sections 4.2 and 4.3, we discussed the merits of the two

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<sup>171</sup> See Horn and Weiler (2007) for a similar argument regarding the AB's determination in the *EC – Asbestos* dispute. They find it plausible that the AB simply could not accept the panel's approach of classifying the asbestos ban as violating one of the pillars of the WTO – NT – in light of the popular support of the measure, and perhaps also their own belief in its desirability.

approaches, paying particular attention to their implications for exercising the right to regulate at the national level and we linked this discussion to the overarching purpose that Art. III GATT was designed to serve. More specifically, Section 4.3.1 concluded that the list of legitimate grounds in Art. XX GATT should not be construed as a complete list of all permissible grounds for differential tax treatment of competing imported and domestic products, and pointed to example of policy objectives that would be difficult to find acceptance for under Art. XX GATT. Section 4.3.2 discussed the various requirements imposed by Art. XX GATT, such as the “necessity” requirements for certain policy objectives. The section concluded that the GATT should not be construed as requiring “good governance,” and that what is required from WTO Members is that they refrain from adopting some obviously beggar-thy-neighbor policies where they impose on imported goods a burden higher than that imposed on their domestic counterparts. On balance, these aspects point quite strongly in favor of Interpretation III.

Section 4.3.3 examined the desirable distribution of the burden of proof, highlighting two aspects. First, the fact that respondents are likely to have better access to information concerning the motives for regulations suggests that the evidentiary burden should be put on respondents, as it is under Interpretation XX. Second, there is a significant likelihood that judges will make mistakes, imperfectly informed as they are about the circumstances that have led to the disputes they adjudicate. To the extent that Members are more troubled when adjudicators erroneously strike down legitimate domestic regulation than when they erroneously allow protectionist measures—which we believe typically is the case—Interpretation III is preferable.

In our view, the analysis of Sections 4.3.1-4.3.3 of how the choice of interpretation is likely to affect the outcome of adjudication, speaks in favor of Interpretation III, although there are some arguments to the contrary. But as emphasized in Sections 2 and 3, a basic rationale for a NT provision is to induce countries to liberalize trade. We identified several differences between the interpretations in this regard. We finally took a broader perspective, highlighting the consequences of the choice of interpretation for the “legitimacy” of the WTO, an admittedly amorphous concept. We here concluded that a serious drawback of Interpretation of XX is that it is likely to be perceived as too severely restricting the “policy space” that WTO Members want to retain with regard to domestic policies. Based on the above, we conclude that Interpretation III is preferable. But we acknowledge that this decision is not only based on a strict legal and economic analysis, but also on our intuition.

A final consideration for the choice between evaluating protection under Art. III and XX GATT, is the consistency with existing practice. Changing practice comes at a cost, but so does, of course also, the continuation of a bad practice. It is actually difficult to determine where the case law currently stands with regard to the choice of whether to evaluate

protection under Art. III or XX GATT. One thing is for sure though: case law slowly moves towards an interpretation of Art. III GATT where the complainant will have to show that a measure that seemingly (e.g., because of potential trade effects) imposes a higher cost on imported goods is also linked to the origin of the good: first, in *EC–Asbestos*, the AB “widened” the understanding of likeness; then, in *Dominican Republic–Import and Sale of Cigarettes*, the AB confirmed that “mechanical,” acontextual understandings of the key terms appearing in Art. III GATT are a thing of the past. It thus appears as if the AB has embarked on a quest for a meaningful protectionism test. Interpretation III is very much in line with this attitude.

#### **4.4 Further Remarks on Interpretation III**

Above we proposed two modes of interpreting the nexus of Arts. III and XX GATT, one more in line with the earlier case law, and one more novel. We identified the differences between the two interpretations, and discussed their pros and cons. We concluded that Interpretation III is to be preferred. This Section will offer a number of further reflections, further comments on, in particular, the proposed Interpretation III.

##### **4.4.1 The Relevance of Art. III.1 GATT**

It is sometimes argued that Art. III.1 GATT is hortatory and that the legally binding language concerning fiscal instruments is contained in Art. III.2 GATT. However, absence of legally binding language does not lead to irrelevance: Art. III.1 GATT might be given less weight in the interpretative process than paragraphs 2 and 4, but should not be read to redundancy. To this effect, the basic idea underlying Interpretation III is that Art. III.1 and Art. III.2 GATT must be read in conjunction, since, because of their differentiated coverage (one dealing with fiscal instruments, the other with nonfiscal instruments) none of them could on its own serve as regulation of domestic instruments: both provisions aim at expressing in operational (binding) language the principle embedded in Art. III.1 GATT (*Japan–Alcoholic Beverages II*, AB). It is Art. III.1 GATT, for example, that gives the term “like products” the meaning of referring to situations where there is no justification for treating an imported product differently from a domestic product.

The constraint imposed on fiscal instruments by Art. III GATT is thus determined *jointly* by Arts. III.1 and III.2 GATT. Unfortunately, part of the case law has relegated to quasi-redundancy the importance of Art. III.1 GATT; panels have often made their determinations within the four corners of Art. III.2 GATT, and then simply confirmed their conclusion by referring to Art. III.1 GATT as context. They have been thus led to acontextual understandings of the key terms (like products, in excess, etc.), that is, they have improperly

or inadequately accounted for the context as embedded in Art. III.1 GATT which calls for a ban on protectionist-only behavior. The most common mistake that panels have made is to confuse disparate effects with discrimination, a term which is legalese for absence of protectionism. Contextual readings of the key terms help avoid (or at least reduce) the occurrence of this risk.<sup>172</sup>

#### 4.4.2 The Relative Facility to Find Grounds for Complaints

An issue that is rarely discussed, but that could be of significant importance, is the advantage complainants have in picking and choosing among trading partners' fiscal instruments. Tax systems are normally highly complex, consisting of a large number of specific tax regulations, such as corporate taxation, value-added taxation, environmental taxation, income taxation, capital-gains taxation, etc. Each of these tax schemes in turn consists of intricate sets of rules. Indeed, these schemes are so complex that they represent separate fields of specialization for, e.g., tax lawyers. As a result, when comparing the components of tax schemes, it is quite likely that there will be *some* component that falls heavier on the imported product than on a like domestic product.

To illustrate, assume that an imported product requires longer transportation routes in the importing country compared to some competing domestic product. An environmentally motivated tax on gasoline would then fall more heavily on the imported product than on the locally produced good. Following Interpretation XX, such a tax could violate Art. III GATT, since the tax falls more heavily on the imported product than on the competing domestic product. At the same time, there may be no protectionist intent, and the whole set of environmental taxes (or taxes even more broadly) may actually be favorable to the imported product, and/or be internationally efficient. It would be significantly more difficult for the complainant to win such a case following Interpretation III, since the complainant would then have to show that the gasoline tax is protectionist.

The issue arises due to an incompleteness in the GATT: the agreement does not restrict the way in which a Member can pick pairs of taxes out of a tax system to complain about.<sup>173</sup> Of course, the DS system has not witnessed a large number of frivolous complaints, so far. But there is no assurance that Members will show such restraint also in the future. In any event, it seems desirable to reduce the potential for this problem when laying down *principles* for

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<sup>172</sup> As mentioned before, it is the AB report on *Dominican Republic–Import and Sale of Cigarettes* that attempted to address this issue albeit without providing a methodology that would be appropriate to achieve this result.

<sup>173</sup> Ruling beyond the ambit of the claim would amount to a ruling *ultra petita*, which, standing case law suggests, is considered a cardinal sin for WTO adjudicating bodies.

the interpretation of Art. III GATT. This is achieved by requesting the complaining Member to bear a significant burden of persuasion to make a plausible case that the contested measures are indeed protectionist.

#### 4.4.3 Why Not Only Policy Likeness, Why Also Market Likeness?

Interpretation III requires that products are both market- and policy-like, in order for Art. III GATT to possibly be violated. Products are policy unlike when it would be desirable from an international efficiency point of view to treat them differently. Typically, the reason why there is a need to treat them differently is that buyers do *not* make the desirable distinction. That is, market likeness is often part of the reason why products are *not* policy-like.

But for products to be like, why not request *only* policy likeness, why include market likeness as a separate criterion? The main reason for including the market-likeness criterion is best illustrated through an example: it could by chance be the case that the joint welfare of the exporting and importing country governments would increase if the importing country government were requested to impose the same production tax on coffee cups as on diesel trucks—the products may thus be policy-like by chance. But it is obviously highly unlikely that the differential taxation would reflect protectionism. The requirement that products must also be market-like ensures that Art. III GATT will not be violated in instances where a WTO Member taxes trucks and cups differently which, as argued, are instances that protectionist behavior is highly unlikely.<sup>174</sup>

#### 4.4.4 The Relationship Between Like and DCS Products

Table 1 summarizes our aforementioned claims concerning the basic ambit of the regulation of fiscal instruments under Art. III GATT, as viewed from the perspective of Interpretation III. For the tax treatment of a pair of products to come under the ambit of Art. III GATT, the products concerned have to be in a sufficiently strong competitive relationship—they have to be market-like. There is no rationale from an international efficiency point of view to treat some of these pairs of products differently – assuming of course that they are not only

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<sup>174</sup> Another reason for including an explicit market-likeness criterion could perhaps be that this could be expected to enhance the quality of the adjudication process. As discussed *supra*, the case law has suffered from unclear evaluations of the market relationship between products, the *Korea – Beef* dispute being one example. The requirement of a separate demonstration of market likeness from that of policy likeness might enhance the transparency of the argumentation by the parties and the adjudication process. For instance, this would make it easier for outside evaluation of the methods employed in WTO disputes. One can here compare the interaction between research and policy in the development of principles and methods for the determination of relevant markets in antitrust.

market- but policy-like as well; in this case no tax differential should be allowed. For other product pairs, a differential tax treatment is warranted, and thus legal; the tax differential nevertheless should correspond to whatever level is necessary to achieve the regulatory objective sought. Consequently, both like and DCS products are market-like, but they differ in the extent of policy likeness. Hence, neither set of product pairs is a subset of the other set of product pairs. Note also that there is no difference in the extent of market likeness that is required for like and for DCS products.

**Table 1**

	<b>Market-like</b>	<b>Not market-like</b>
<b>Policy-like</b>	"Like"; no tax differential is allowed	Art. III not applicable; any tax differential is allowed
<b>Not policy-like</b>	"DCS"; some tax differential is allowed	Art. III not applicable; any tax differential is allowed

#### **4.4.5 GATT Does Not Request Full International Efficiency**

There are several reasons why a constraint on Members to tax imported and competing locally produced goods equally will not implement a fully efficient situation, and we highlighted them in Chapter 2:

- the provision has no bite in situations where the tax on the domestic product is higher than the tax on the imported product, but where the difference should be even larger;
- in cases where the tax on the imported product is higher, the provision may ensure equal treatment, but not better treatment of the imported product, even if this would be desirable from an international efficiency point of view; and
- the importing country is free to choose a common tax level it desires in case of like products, and any two tax rates that respect the permissible tax differential in the case of DCS products. Since decisions over these taxes are likely to disregard the interests of the exporting country, they are likely to be inefficient from an international perspective.

The reason why measures may deviate from what is internationally efficient in these respects is, of course, that governments will disregard the interests of trading partners when deciding on their domestic policies. This leads to the more general observation that *the GATT does not exhibit "zero tolerance" against protectionist behavior*, it only partially restricts the possibility for governments to behave in similar fashion.

#### 4.4.6 Can a Measure That Violates Art. III GATT Be Justified Through Recourse to Art. XX GATT?

Art. III and XX GATT are both tools to prevent protectionism. This raises the question of whether a measure that is found to be illegal protection, for the purpose of Art. III GATT, may still be granted an exception under Art. XX GATT, being found to not constitute disguised protection. According to Interpretation III, this is normally not possible, while it is fully possible according to Interpretation XX.

Interpretation III proposes that for a measure to violate Art. III GATT, it must be protectionist. Hence, as long as the meaning of protectionism in Art. III GATT is the same as, or more narrow than, the meaning of protectionism in Art. XX GATT, it would be illogical that a measure that violates the former could receive an exception under the latter, except as a result of a judicial mistake in the evaluation under Art. III GATT. In this vein, Art. XX GATT is unlikely to serve as an effective exception to Art. III GATT under Interpretation III.

Interpretation XX functions very differently in this regard, since it understands the restrictions imposed through Art. III GATT to be of a simpler form, not requesting any demonstration of protectionism. Instead, the evaluation of protection is performed under Art. XX GATT. Such a construction finds some support in the fact that Art. XX GATT is a list of “General Exceptions,” with no textual support that it was not intended to play a role in disputes involving Art. III GATT.<sup>175</sup>

Interpretation III does not render Art. XX GATT meaningless, and therefore does not conflict with the rules concerning treaty interpretation in the *Vienna Convention on the Law of Treaties* (VCLT). Art. XX GATT may still serve as an efficient exception clause for other provisions in the GATT, such as those addressing the use of border instruments (e.g., tariffs, QRs, etc.).<sup>176</sup> Also, it cannot be excluded that Art. XX GATT may actually, in special cases, serve as an exception to Art. III GATT. An example might be the following situation: Country A taxes an imported product X higher than a domestically produced product that is identical in all respects, in order to punish the exporting country B for producing another product Y that pollutes the environment of country A, but that it does not import from B, and hence cannot tax directly.

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<sup>175</sup> Recall, however, the views of the UK negotiators that we cited supra.

<sup>176</sup> Indeed, there is no basis in the VCLT to argue that the GATT should be interpreted such that Art. XX GATT becomes an effective exception to each other provision in the GATT.

#### 4.4.7 On Evaluating Market Likeness and Protection

Interpretations III and XX both require adjudicating bodies to determine the actual extent of market likeness and the international efficiency of protection. We will here make a few reflections on how such evaluations should be done.

First, in order to determine the nature and magnitude of the effects of contested measures, it is necessary to characterize the competition between the domestic and the imported product. The current case-law approach to undertaking similar evaluation leaves much to be desired for the reasons mentioned in Chapter 3.

The evaluation of the competitive relationship between the products should primarily be based on data collected from the actual market at hand. But lacking such data, as when the differential policy treatment is sufficiently pronounced to deny market access to the exported good, one must resort to more indirect sources of information. This could, for instance, be evidence on the relationship between the same products in other (comparable) geographical markets, or between similar products in the importing country. One could also use the indicators suggested in the *Working Party report on Border Tax Adjustments* (such as end uses, physical characteristics, etc.). Another source of information is tariff classification. For the most part, if two products are in the same six-digit Harmonized System category, they are likely to be in close competition, even though such tariff classifications are not always informative about the properties of the products. With finer HS-classification, it is of course even more likely that the products are highly competitive.

Next, the data should, as far as possible, be examined through econometric analysis, using standardized techniques. Indeed, such analysis is commonplace in the antitrust-context where the relevant product market within which market power will be estimated is routinely defined in this way. In light of the similarity in the function of trade and antitrust analysis, we see no reason why econometric analysis is routinely used in the latter and sparingly so in the former. Recourse to noneconometric indicators should only be taken to complement the econometric analysis, or when econometric analysis cannot be undertaken.

Another, and more complex, task facing adjudicators is to determine whether contested measures are internationally efficient or not. But it is hard to see how this can be avoided, as long as there is to be a test for protection that allows tax differentials under some but not all circumstances, and where the guiding principle is that differential taxation should only be allowed to the extent it is in the mutual interest (a concept which is at the heart of the notion that illegal protection is essentially a beggar-thy-neighbor type of behavior). It should be emphasized however, that the difficulty facing the adjudicator does *not* stem from the fact that the task is to evaluate challenged measures under Art. III GATT as per Interpretation III.

On the contrary, in the case of DCS products, the task facing the adjudicator actually may be *simpler* when evaluating a claim under Art. III GATT than under Art. XX GATT. What is requested in the former case is, according to Interpretation III, to compare two tax pairs, the contested pair, and an Art. III.2 GATT-compatible pair. The evaluation of protection under Art. XX GATT is likely to be more onerous, since it does not constrain the evaluation to a comparison of only two tax pairs, and it may additionally require a test for whether a measure is necessary.

We believe that adjudicators actually already perform tests of this sort, albeit implicitly. When evaluating whether a measure should be accepted, an adjudicating body will naturally seek to identify both the costs that the measure gives rise to for the complaining party, and the benefits it brings to the importing Member (even if no numbers are put on these costs and benefits). Hence, we would argue that when an adjudicating body approaches a case like *Japan – Alcoholic Beverages II*, it would be importantly influenced by observing that there seem to be no noncommercial benefits to Japan that could outweigh the cost to exporting Members. Had there been noncommercial reasons for Japan to pursue the measure, the adjudicating body would have been much more prone to accept the measure, provided that it did not impose too large costs on the trading partners. This is how we understand the AB when it points to the revealing “design and structure” of a contested measure. Conversely, although not a taxation case, it seems likely that in *EC – Asbestos*, adjudicating bodies felt that the costs of the measure for Canada were dominated by the gains for France, and that the measure for this reason preferably should pass the test; the main question was instead *how* this could be achieved. The point of these examples is hence to argue that adjudicating bodies already weigh the benefits of the contested regulation against the cost to the exporting country, albeit not openly. Of course, as is often the case for judicial decisions, within the parameters described above, the evaluation whether the contested measures constitute undesirable protection will still have to be a subjective judgment, regardless of whether done under Art. III or XX GATT. We therefore do not believe that the protectionism test that we envisage following both Interpretation III and XX, is significantly more onerous for adjudicating bodies than what is already being practiced. The suggested interpretation to a considerable extent simply codifies existing practice, providing a conceptual framework within which it can be understood.<sup>177</sup>

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<sup>177</sup> A complicating factor for any preference-based interpretation of protection in the GATT is the fact that governments change over time. Strictly speaking, this means that a measure that with one government is an expression of protectionism could with a change of government become legitimate, or vice versa. Allowing such changes over time is not so much a conceptual problem. But it is a practical problem, partly since it makes the actual meaning of tariff commitments more uncertain, and it complicates the formation of case law. The combination of a formal lack of *stare decisis* in the WTO, with a significant focus in dispute rulings on earlier case law, can perhaps be seen to reflect such a balancing between governments’ desire for the law to be responsive to political developments, while at the same time provide some stability to the undertakings.

#### 4.4.8 Intent Versus Effect

As highlighted in Chapter 3, case law has repeatedly discussed the intricate issue of whether the ASATAP notion should be seen as referring to the intent or effect of policy measures, but without bringing much clarity to the discussion.

In our view, it is useful to distinguish between the role of intent and effect in the *substantive obligation*, and the role of these notions from an *evidentiary* point of view. As for the substantive obligation, the agreed general purpose of Art. III GATT is to prevent WTO Members from circumventing their tariff concessions through opportunistic use of domestic instruments. The main purpose of these tariff reductions is in turn to prevent negative international externalities from unilateral policies. The ultimate aim is thus to prevent measures that have the *effect* of giving rise to internationally inefficient allocations, where the effects are evaluated based on the preferences of the Members involved.<sup>178</sup>

As for the roles of intent and effect from an evidentiary point of view, note that the evaluation of protectionism requires knowledge concerning government preferences, which is intimately associated with determining the intent behind measures. Since preferences are not directly observable, and since the regulating state has strong incentive to behave opportunistically, the judge must rely on indirect evidence concerning intent. Examples of such indicators are:

- The consistency by which the alleged objective is pursued across products: If the same objective is disregarded in other industries, the differential treatment of the product at hand might indicate that the protection is intentional; indeed, Art. 5.5 of the SPS Agreement reflects a very similar idea.
- The use of international standards: Assume for example that an international standard exists that can appropriately take care of the legislative objective sought. Deviations from the standard, while not necessarily unwarranted, should then be viewed with suspicion: it should be normal in similar cases to request from the deviating state to explain itself on its choice to deviate, rather than allocate the burden of production of proof *à la EC – Sardines* (AB report);

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<sup>178</sup> The question of whether a measure should be illegal if it is intended to protect but in actuality fails to do so, seems to be of limited practical relevance, except from an enforcement perspective. Since we are not concerned with enforcement issues here, we do not take a stand on the question. Of course, unintentional protective effects characterize situations where measures are internationally efficient, but still have adverse trade effects. Such effects clearly cannot be condemned *a priori*.

- Scientific evidence: Measures based on scientific evidence are in general more likely to respond to a genuine need to intervene, at least in light of the best current knowledge about a particular issue. Of course, this does not mean that measures based on the precautionary principle are necessarily protectionist: for such measures, recourse to some or all of the criteria mentioned above might be warranted.

Indications of the intent may also be obtained from the effects of contested measures, such as the magnitude of trade effects: The larger the trade effects, the more likely that they are intended. The choice of less trade restrictive should be understood as a proxy (albeit an imperfect one) that the measure has been enacted for motives other than protectionism. This list is by no means exhaustive, but only intended to illustrate the type of indicators that could be used to evaluate whether a measure is protectionist. Hence, the effects of measures may signal the reason why the measures themselves have been pursued in the first place.

In sum, both effect and intent are relevant to the definition of the substantive obligation. Effect matters since the purpose is to regulate measures that cause international externalities, and intent matters since it is closely related to the question whether international externalities are present.<sup>179</sup> Intent and effect are also relevant from an evidentiary perspective, since both perceived intent as well as observed effects in the market could serve as evidence concerning the preferences of the regulating country.

#### 4.4.9 The Aims and Effect Test

Interpretation III shares a certain similarity with an interpretation of Art. III GATT that has been denoted the *aims and effect* test, but also differs in important respects. This test goes back to the *US – Malt Beverages* panel report, where like is defined in the following manner (§ 5.25):

“Consequently, in determining whether two products subject to different treatment are like products, it is necessary to consider whether such product differentiation is being made ‘so as to afford protection to domestic production’. While the analysis of ‘like products’ in terms of Article III:2 must take into consideration this objective of Article III, the Panel wished to emphasize that such an analysis would be without prejudice to the ‘like product’ concepts in other provisions of the General Agreement, which might have different objectives and which might therefore also require different interpretations.”

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<sup>179</sup> Indeed, trade effects could signal intent.

In its *US – Taxes on Automobiles* Report,<sup>180</sup> the Panel had the opportunity to elaborate on this proposition by providing its own legal benchmark to establish likeness, the so-called *aims and effects* test (§§ 5.7, 5.10):

“In order to determine this issue, the Panel examined the object and purpose of paragraphs 2 and 4 of Article III in the context of the article as a whole and the General Agreement.

.....

The Panel then proceeded to examine more closely the meaning of the phrase ‘so as to afford protection.’ The Panel noted that the term ‘so as to’ suggested both aim and effect. Thus the phrase ‘so as to afford protection’ called for an analysis of elements including the aim of the measure and the resulting effects. A measure could be said to have the *aim* of affording protection if an analysis of the circumstances in which it was adopted, in particular an analysis of the instruments available to the contracting party to achieve the declared domestic policy goal, demonstrated that a change in competitive opportunities in favour of domestic products was a desired outcome and not merely an incidental consequence of the pursuit of a legitimate policy goal. A measure could be said to have the *effect* of affording protection to domestic production if it accorded greater competitive opportunities to domestic products than to imported products. The effect of a measure in terms of trade flows was not relevant for the purposes of Article III, since a change in the volume or proportion of imports could be due to many factors other than government measures.” (italics in the original).

According to the *aims and effect test*, likeness hence means policy likeness, in our terminology. However, contrary to what the name of the test suggests, the realized effects of contested measures are (to our understanding) explicitly irrelevant in the *aims and effect test*; in the name of the premise that Art. III GATT is about protecting competitive conditions, the *US – Taxes on Automobiles* panel held that trade effects are totally immaterial. In contrast, in our preferred approach (Interpretation III), like goods must be both market- and policy-like. We are in the dark as to the applicability of the *aims and effects* test on DCS goods, since the panel made no pronouncement in this vein.

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<sup>180</sup> In this case, the European Community challenged the consistency of a U.S. tax scheme applicable to cars, according to which the total fleet of a producer would be taken into account in order to decide on the tax that would be imposed. Producers with a fleet that consisted of large cubism cars (gas guzzlers) would suffer most, as a result. Many European producers belonged to this category. The U.S. regime was apparently enacted at a time when those suffering most were U.S. producers, in an effort to dissuade consumers eager to buy such cars from buying them.

#### 4.4.10 Taxation Based on Features of the Production Process (PPMs)

In light of the above, it seems safe to conclude that Art. III GATT applies, in principle, to all domestic instruments (irrespective whether of fiscal or nonfiscal nature) except for the two instruments that have been explicitly exempted from its coverage. The NT provision does not, however, as already discussed above, address the question of *prescriptive jurisdiction*: can an importing country effectively impose its own regulatory choices on imports, by making adjustments at the border for taxes paid by producers of domestic goods, but not by competing imported products? The text of Art. III GATT is silent on this score.

A contentious issue involving territoriality is the legality under Art. III GATT (as well as other GATT provisions) of domestic policies that condition market access for products on the manner in which they have been produced, rather than on the physical characteristics of the products; this is what the discussion concerning the role for production and process method (PPM)-based measures address. A core issue with regard to the compatibility of such measures with Art. III GATT is whether an imported product that physically is identical to a local product can nevertheless be viewed as not being like (or DCS), because of differences in the production process and/or method.<sup>181</sup> According to Interpretation III, the answer is “yes.”

Consider, for instance, the case where the production of an exportable causes environmental damage to the importing country, and the importing country levies a tax on the imported product to offset the damage. According to Interpretation III, the evaluation of this measure should take into consideration the environmental impact on the importing country. If the tax differential is not larger than what would be chosen if the environment objective were to be achieved in an internationally efficient manner, the measure should be allowed. Note, however, that a prerequisite for this is that the importing-country government is adversely affected by the measure other than through its impact on the competitive conditions in the domestic market—in the example there is transboundary environmental damage. If this is not the case, the only rationale for the PPM measure is protectionism.

This implication of Interpretation III is compatible with the “default rules” concerning allocation of jurisdiction in Public International Law. In short, and as briefly alluded to above, the default rules oblige states to not regulate transactions occurring outside their geographic borders except for in certain commonly agreed circumstances. However, states can exercise prescriptive jurisdiction on actions that occur outside their borders, by virtue of the so called “effects doctrine,” and a reasonableness criterion will help solve conflicts in cases in which more than one state have jurisdiction through these rules. It follows that

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<sup>181</sup> PPM-based measures may take the form of border tax adjustments (BTAs); see Chapter 2 above.

recourse to the default rules is quite helpful, but does not eliminate jurisdictional conflicts altogether; contractual solutions are hence encouraged.<sup>182</sup>

The default rules would thus suggest that an importing country has jurisdiction over production processes in other countries, provided that the production process has direct and foreseeable effect on the importing country, and provided that the countries in question do not have an agreement regulating the issue. Hence, the fact that the production and sales of the imported product will have effects on the competitive conditions in the importing-country market, is not a ground for the importing-country government to regulate the transaction, as long as there is an agreement concerning these effects—in this case the GATT/WTO. On the other hand, absent an international agreement between the two countries—such as might be the case in, e.g., the case of protection of the environment—the effects doctrine gives the importing country jurisdiction (assuming presence of effects in its market). When exercising jurisdiction, it will have to respect a reasonableness requirement when choosing its measures.

The default rules are not explicitly reflected in the GATT, nor have they been explicitly referenced in case law. However, the AB report in the *US – Shrimps* dispute can perhaps be seen as a step in this direction, in that it pointed to a “sufficient nexus” between an endangered species in the exporting country, and the importing country, absent which the regulating state would not be in position to lawfully exercise jurisdiction. The AB did not expand on this rather cryptic statement, so we still lack a legal test that will help us predict in future transactions when a nexus exists and when not.

This is not to say that recourse to the default rules is a panacea. Indeed, there is no convincing and consistent response in international adjudication regarding, for example, jurisdiction in the presence of “moral” externalities; for instance, assuming that the use of child labor causes public concern in a WTO Member, can it block the trade of a good that is produced with child labor? Or, can the importing country block trade if the exporting country uses child labor not in the imported goods, but in the production of other goods? The default rules do not provide clear answers to these questions. But they do constitute an appropriate first step to resolve a jurisdictional issue that may become of significant importance for adjudication in the WTO.

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<sup>182</sup> See Horn and Mavroidis (2008) for a discussion of jurisdictional aspects of the GATT, and the role of the default rules.

## 4.5 Revisiting the Leading Cases in Light of Our Proposals

The previous Sections of this Chapter presented two interpretations of Art. III GATT, based on our understanding of the case law, the negotiating history, and economic theory. We will, in this Section, briefly discuss whether applying our suggested interpretations would have affected the outcome in the GATT/WTO cases that have shaped the current understanding of Art. III GATT, and if so how.

As evidenced by the compilation presented in the Appendix, there are a large number of cases that have been adjudicated under Art. III GATT. Ideally, we would want to see how our suggested interpretations would fare in each of these cases, but this is not practical. Instead, we will briefly discuss how these interpretations would affect the determinations in some leading cases. To this end, we first identify the disputes that we believe represent the state-of-the-art of the existing case law. We then reexamine these disputes in light of the discussion in the study.

Although *de jure* there is no binding precedent (*stare decisis*) in WTO, it is commonplace that panels and AB have followed prior rulings. Indeed, in its report on *US – Stainless Steel (Mexico)*, the AB held that it expected panels to follow prior AB findings dealing with the same issue. It further deplored the attitude of the panel in question to disregard the AB approach on the practice of zeroing (§§ 158-162). With this in mind, it seems appropriate to try to identify the leading Art. III GATT cases where the AB has explained its overall understanding of the provision, and to which reference is customarily made in subsequent case law when issues relating to the interpretation of the provision arise.

Following this definition, the leading cases, and their main innovations, are as follows:

- *Japan – Alcoholic Beverages II* explicitly outlawed the *aims and effect* test (espoused by some GATT panels) as we saw in Chapter 3. It further incorporated the GATT leading cases (such as *Japan – Alcoholic Beverages I*, and the *Working Party report on Border Tax Adjustments*) that had opted for a test in the marketplace in order to define whether two products are like or DCS. As a result, in light of the similarity of the approach followed, we do not need to apply our approach to this class of GATT disputes as well.
- *Korea – Alcoholic Beverages* followed *Japan – Alcoholic Beverages II* in almost all aspects, but with two crucial additions: the AB established that, in order to define whether two products are *DCS/like*, the WTO adjudicator can *interchangeably* use econometric and/or noneconometric indicators; moreover, the AB also held that for two products

to be *like*, they must at the very least be DCS and share a detailed tariff classification as well: DCS emerges thus as a necessary but insufficient condition for likeness.

- *Chile – Alcoholic Beverages* introduced an inquiry into the objective intent of the regulator (in some, rather extreme, conditions) in order to detect whether a measure has been applied so as to afford protection to domestic production.
- *Philippines – Distilled Spirits* held that two goods are like when they are in intense competitive relationship (while DCS goods are in less intense relationship). It is unclear, nevertheless, whether this criterion in and of itself suffices to afford likeness or whether they must still share HS classification: a few pages later, in a separate finding, the AB mentions the relevance of HS classification. Because of the existing uncertainty (and the absence of a clear pronouncement overruling the relevance of HS classification as a criterion that can appropriately define likeness) we will not let this determination change our conclusions regarding the definition of likeness in case law.

In *Philippines–Distilled Spirits*, the AB faced the following facts (§ 98): distilled spirits produced from one of the following materials, sap of the nipa, coconut, cassava, camote, etc. (predominantly produced in the Philippines), were subjected to a flat rate, whereas distilled spirits produced from other materials (predominantly imported) were subjected to a higher excise tax. The AB suggested that DCS products are those with low substitutability between them, whereas like products are those with high, almost perfect substitutability (§§ 120-122, 148). [1] In sharp contrast to its prior case law (*Japan–Alcoholic Beverages II*), the AB did not condition a finding of likeness on common tariff classification across two products: it first held that a 4-digit tariff classification was uninformative, since not sufficiently detailed, and no conclusions on likeness could be drawn (§ 182). It then noted that two of the goods did not share the same 6-digit tariff classification; it still found that they were like, overlooking thus the significance of tariff classification, satisfying itself that the goods were like since they were in intense competitive relationship (§ 164).

We will now briefly discuss how these leading cases would have been adjudicated if Interpretations III and XX were adopted.

#### 4.5.1 Japan – Alcoholic Beverages II

Recall that in this case the AB found the Japanese measures to be in violation of Art. III.2 GATT, because Japan was taxing predominantly western drinks substantially higher than predominantly Japanese drinks. Recall further that Japan had no policy justification for this tax differential and only took recourse to *ex post facto* justifications to explain its policies; all its justifications were dismissed by the panel precisely because they were *ex post facto*. In this

case, the panel found (and the AB upheld) that a class of products were DCS based on consumer surveys that were conducted in Japan, which used econometric indicators to quantify the degree of substitutability across the various products. Two products were furthermore considered like since they shared the same tariff classification. Finally, the in excess/ASATAP-requirement was justified by the tax differential itself.

The outcome of this dispute seems desirable from both an Interpretation III and XX perspective. We are also in agreement with some of the reasoning in the report:

- DCS products should be defined by using econometric indicators, when appropriate (as was the case here);
- A substantial tax differential across two DCS products, and the absence of any policy rationale for it, suggest that the measure is protectionist.

We have two main misgivings concerning the report. First, following either of our suggested Interpretations, we would have preferred to see an explicit evaluation of whether the measure was to be considered protectionist. Second, Interpretation III is not compatible with the AB's understanding of the term like. In our view, sharing a tariff classification should not be a dispositive feature for a finding of likeness, since the products that come under the same tariff heading are not necessarily policy-like as well. In this case, however, this was immaterial since Japan was ostensibly not pursuing *any* policy goal through the differential taxation, other than providing its producers with a tax advantage.

#### **4.5.2 Korea – Alcoholic Beverages**

In this case, the AB found the Korean measures to be in violation of Art. III.2 GATT. Recall that the AB held that econometric and noneconometric indicators are equally useful methods to decide on the DCS-relationship across two products; without explaining under what circumstances recourse to either is warranted, it treated them as perfect substitutes irrespective of the facts.

As things stand, it is difficult to clearly determine whether we agree or not with the final outcome, since we lack information that is crucial for us to apply our test, irrespective whether we follow Interpretation III or XX: recall that DCS relationship is defined in the same way under both interpretations. The evidence supporting DCS-relationship across predominantly Korean and predominantly western drinks seems at least debatable to us. As mentioned above, recourse to econometric indicators is not panacea. We do not know if this was one of those situations where recourse to econometric indicators would solve the problem (although we suspect, in light of the evidence submitted by Korea, that this is not

the case). The panel in its report examined evidence from the Japanese market regarding the relationship between the products without explaining why evidence from the Korean market was inappropriate. However, as facts make it clear, western drinks did exist in the Korean market, the tax differential notwithstanding. Nevertheless, neither the panel nor the AB explained why such evidence could not have been appropriately taken into consideration. We consequently find unsatisfactory the manner in which the AB decided on the DCS relationship across the products.

Since we are unsure about the extent of DCS relationship, there is not much we can add with respect to *like products*, never mind the remaining parts of the test (ASATAP).

### **4.5.3 Chile – Alcoholic Beverages**

Recall that the case concerned a Chilean progressive taxation scheme, whereby the tax rate increased with alcohol strength. The AB found the scheme to be GATT-inconsistent because the tax differential across the various tax categories was too large, without explaining, however, what would be acceptable. We are opposed to the approach used, but cannot definitely pronounce on the outcome had our preferred approach been privileged. We have reasons to believe, nonetheless, that Chile should have prevailed under either approach.

In this case, there was no dispute regarding the fact that the goods at hand were DCS. The only disputed matter was whether the tax differential was discriminatory. The AB dismissed the relevance of the claim by Chile that the majority of the products hit by the higher tax were of Chilean origin. We find this hard to accept. Under Interpretation III, just as adverse trade effects indicate (but do not prove) intent to protect, adverse effects borne primarily by domestic product should be taken to indicate lack of such a motive; the AB dismissed the relevance of this factor, invoking the no-effects test that it customarily applies in Art. III GATT cases. To be precise, the AB accepted that it was Chileans that were burdened with paying the major proportion of the tax burden in the highest category, but explicitly dismissed its relevance arguing that this fact, in and of itself, was not enough to undo its belief that, in light of the sharp rise of the tax burden across categories and the fact that Chilean goods were predominant in the lowest tax category, the challenged tax regime was GATT-inconsistent.

As argued above, we do believe that regulatory intent is relevant for the evaluation of whether a measure is protectionist or not, and would therefore seek to understand the regulatory intent of the Chilean legislation at hand. To this effect, we would consider questions that the AB did not address, such as:

- Who is burdened by the higher tax? Chile raised this question, but it went unanswered by the plaintiffs and was considered, as mentioned, uninformative by the AB. From what we understand, however, the measure burdened Chilean producers more than it did EC producers;
- What is the alleged policy rationale for the tax differential? For instance, is it to combat alcoholism, or to raise revenue? Absent was an explanation by the respondent of what policy objectives the contested measure was meant to promote.)

#### **4.5.4 Concluding Remarks on the Revisit to the Leading Cases**

It stems from this brief discussion that in these leading disputes, from the perspective of Interpretation III, we disagree more with the reasoning by the AB than with actual outcomes.

## **5 Principles**

We summarize these findings in the following principles:

### **§ 1. The Provision Under Which a Protectionism Test Should Be Performed**

**The protectionism test should be performed primarily under Art. III GATT.**

### **§ 2. The Discipline on Fiscal Instruments in Case of Like Products**

**Two products are like for the purpose of Art. III.2 GATT if both (i) they are in close actual or potential competition; and (ii) international efficiency requires taxation by the same amount. Like products should be taxed equally, but the level of taxation is unilaterally determined by the importing country.**

### **§ 3. The Discipline on Fiscal Instruments in Case of DCS Products**

**Two products are DCS for the purpose of Art. III.2 GATT if both (i) they are in close actual or potential competition; and (ii) international efficiency requires higher taxation of the imported product. The taxation of DCS products may differ, but not by more than could be motivated from an**

**international efficiency point of view. The level of taxation is unilaterally determined by the importing country.**

## Appendix

**Table 1: NT Disputes Adjudicated Under the GATT<sup>183</sup>**

No.	Dispute	DS No	Subject Matter	Result	Report adopted
1)	Pakistan v. India: Tax Rebates on Exports (III.2)	2 – 24 Aug. 1948	Denial of rebates affected all of Pakistan's imports from India	India eliminated discrimination as part of broader settlement involving other trade problems.	YES
2)	France v. Brazil: Internal Taxes (III.2)	4 – 25 April 1949	Brazil's raise of taxes applied to many imports	In 1950, Brazil agreed to request corrective legislation. The tax discrimination was entirely terminated on 14 August 1957 as part of major tariffs revision.	YES
3)	Netherlands v. United Kingdom: Purchase Tax Exemptions (III.2)	12 – 26 Oct. 1950	Claim that purchase tax that provided exemptions for certain domestic products, but not for 'like' foreign products, violated III.2	Differential treatment of foreign products abolished in 1952.	YES
4)	Norway & Denmark v. Belgium: Family Allowances (III.2)	14 – 19 Sep. 1951	Claim that grants of exemptions from internal tax to products of some countries but not others were violations of Art. I and was not excused by PPA reservation for existing legislation	Entire tax abolished on 6 March 1954.	YES
5)	France v. Greece: Special Import Taxes (III.2)	19 – 27 Sep. 1952	Claim that new tax on imports was either internal tax contrary to III.2, or a border charge contrary to II	Tax eliminated on 9 April 1953.	YES

<sup>183</sup> Source: Hudec (1993).

6)	Italy v. Greece: Luxury Tax on Imports (III.2)	30 – 5 Oct. 1954	Claim that certain internal taxes applicable only to imports violated III	Discrimination in internal taxes was eliminated. Undertaking made to restore tariffs to bound rates.	YES
7)	Australia v. US: Hawaiian Regulations Affecting Imported Eggs (III.4)	36 – 28 Sep. 1955	Claim that regulation of Hawaiian territorial government requiring merchants to display 'We sell foreign eggs' sign violated III.4 and was not justified under rule-of-origin provisions of IX	Regulation invalidated, on ground that as a matter of US internal law, GATT obligations are binding upon territory of Hawaii, and that a measure violated art. III.4.	YES
8)	United Kingdom v. Italy: Turnover Tax on Pharmaceutical Products (III.2)	37 – 11 Oct. 1955	Claim that internal tax rate on imported pharmaceutical products violated III.2	Italy undertook to lower the rate on imported pharmaceuticals to 5 %.	YES
9)	US v. France: Auto Taxes (III.2)	40 – 12 Sep. 1956	Claim that auto tax structure based on horsepower/weight formula ('fiscal horsepower') resulted in significantly greater tax on certain foreign autos, which constituted violation of III.2	No change in French practice. (In 1986 the ECJ ruled that the fiscal horsepower formula violated 95 EC Treaty by affording indirect protection to French producers.)	NO
10)	Netherlands v. Germany (III.2)	41 – 23 Oct. 1956	Claim that formula for computing German turnover tax on printing work done in foreign country (Netherlands) resulted in higher tax charges that discriminated against foreign printing, in violation of III.2	Outcome not known	YES

11)	US v. Chile: Auto Taxes (III.2)	44 – 16 Nov. 1956	Claim that a new law imposing a sharply graduated tax on autos impaired value of tariffs concessions by placing significantly heavier burden on US autos	Problem rectified to US satisfaction by new legislation.	YES
12)	UK v. Italy: Discrimination Against Imported Agricultural Machinery (III.4)	46 – 29 July 1957	Claim that law granting buyers more favorable loan terms for purchase of domestic machinery violated III.4	Settled by undertaking to allow law to expire.	YES
13)	Germany v. Greece: Discrimination in 14) Credit Facilities for Imported Goods (III.4)	47 – 19- 23 Sep. 1957	Claim that Greece discriminated against imported goods in credit facilities made available to buyers, apparently claiming violation of III.4	Not reported.	CONSULTATIONS
15)	UK v. France: Discrimination Against Imported Agricultural Machinery (III.4)	48 – 3 Oct. 1957	Claim that subsidy to purchasers of domestic machinery violated III.4	Subsidy restored for foreign products.	YES
16)	Austria v. Italy: Measures in Favor of Domestic Productions of Ships Plates (III.4)	52 – 9 Oct. 1958	Claim that tax remission granted only to firms purchasing domestic product violated GATT	Tax remission extended in May 1961 to firms using any foreign products.	YES

17)	US v. Italy: Administrative and Statistical Fees (III.2)	60 – 1 Dec. 1969	Claim that service fee on import entries (...) violated III.2 by failing to provide National treatment to imports	A Presidential report to the US Congress for 1970 reported that the proposed law had been enacted by the Italian Senate and was expected to pass the House of Delegates and enter into force in January 1971.	YES
18)	US v. EC: Measures on Animal Feed Proteins (III.2 and III.4)	78 – 27 April 1976	Claim that regulation requiring sellers of certain animal feed proteins, of which 85% were imports, to purchase specified quantities of domestic milk powder was an internal QR in violation of (...) III.2 and III.4	According to the panel report, the EC measures had been expressly limited to a short duration and terminated for internal reasons on 25 October 1976, before the panel had even met. They had been in force for only six months.	YES
19)	US v. Spain: Measures Concerning Domestic Sale of Soybean Oil (III.4)	91 – 1 Nov. 1979	Claim that internal restrictions on the sale of soybean oil (...) were contrary to III.4 because they failed to impose similar burdens on other vegetable oils that were 'like products' ...	In seeking to overturn the panel report, the US announced that it was withdrawing its complaint against Spain – so that governments voting to reject the panel rulings would not be voting to find Spain in violation.	CONSUL- TATIONS
20)	US v. Japan: Restrictions on Imports of Manufactured Tobacco (III.2 and III.4)	92 – 8 Nov. 1979	Claim that practices of state trading monopoly violated Art. III	Japan agreed, inter alia, to repeal an internal tax on imported cigars, to make substantial reductions in the tariffs on cigarettes, cigars, and pipe tobacco, to expand the number of retailers allowed to sell foreign tobacco products, and to permit advertising of foreign tobacco products, in Japanese-language media.	YES

21)	US V. EC: 'Spin-Chill' Requirements on Imports of Poultry (III.4)	97 – 19 June 1980	Standards Code Complaint: Claim that standards for processing and production methods were subject to code's basic obligations via Code Section 14.25, and application of new processing standards to imports but not domestic products violated National treatment obligation of Code Section 2.1	According to US sources, the problem disappeared when US suppliers found it easy to comply with the new process, and so asked the US government to withdraw complaint.	CONSULTATIONS
22)	US v. Canada: Administration of the Foreign Investment Review Act (FIRA) (III.4)	108 – 26 March 1982	Claim that administrative practice of using foreign investment controls to promote undertakings by foreign investors to purchase domestic goods violates III.4 ...	On 5-6 November, Canada informed the Council that it had fully complied with the ruling.	YES
23)	EC v. Finland: Internal Regulations Having an Effect on Imports of Certain Parts of Footwear (III.4)	116 – 28 Sep. 1982	Claim that III.4 violated by Finnish regulation requiring that only shoes with soles of domestic origin could be exported to USSR; regulation constituted less favorable treatment for imported soles	In July 1984, EC informed GATT Secretariat that, while bilateral consultations were still continuing, dispute could be removed from GATT agenda. Not known whether Finland's export regulation ever changed.	CONSULTATIONS
24)	South Africa v. Canada: Discriminatory Application of Retail Sales Tax on Gold Coins (III.2)	132 – 3 July 1984	Claim that a provincial government tax on sales of gold coins, which exempted Canadian gold coins from tax, discriminated against imported gold coins in a manner inconsistent with the requirements of II and III	Within a month of the panel ruling, the Province of Ontario announced its intention to remove the tax discrimination, and the change became effective in January 1986.	YES

25)	EC v. Canada: Import, Distribution and Sale of Alcoholic Drinks by Provincial Marketing Authorities (III.2 and III.4)	139 – 12 Feb. 1985	Claim that trading practices of Canadian Provincial liquor boards were inconsistent with GATT provisions	Canada agreed to roughly the same liberalization granted to US.	YES
26)	Mexico, Canada and EC v. US: Taxes on Petroleum and Certain Imported Substances (Superfund) (III.2)	152 – 27 Oct. 1986	Claim that border tax adjustment on imported petroleum violated III.2 because it was higher than the internal tax on like domestic products. (also other claims under III.2)	In December 1989 the US Congress amended the Superfund legislation to equalize the tax on imported and domestic products.	YES
27)	EC v. Japan: Restrictions on Alcoholic Beverages (III.2)	154 – 5 Nov. 1986	Claim that tax system involving classification of alcoholic beverages into complex categories with substantially different rates for each category violated III.2	Japan abolished its ad valorem tax on the beverages affected by this ruling, its tax based on extract content, and its 'grading system' used for classification.	YES
28)	EC v. US: Tax Reform Legislation for Passenger Aircraft (III.4)	160 – 9 April 1987	Claim that tax advantage granted only to buyers of certain US – produced aircrafts violated III.4	None called for. Measure had expired.	NO
29)	EC v. US: Section 337 of the Tariff Act of 1930 ('Aramid Fibres Case') (III.4)	162 – 29 April 1987	Claim that special section '337' procedure for enforcing patent infringement claims against imported goods violated III.4 because special procedure was less favorable than procedure applicable to patent claims involving domestic goods	US indicated that compliance would be delayed until, and conditioned upon, the outcome of the Uruguay Round negotiations on intellectual property rights.	YES

30)	Canada v. US: Section 337 Action on Cellular Mobile Telephones (III.4)	167 – 15 Sep. 1987	Claim that special section 337 procedure for enforcing patent infringement claims against imported goods violated III.4 because special procedure was less favorable than court procedure applicable to domestic goods	Section 337 proceeding was terminated by consent of both parties.	YES
31)	US v. EC: Directive on Third-Country Meat Imports (III.4)	168 – 25 Sep. 1987	Claim that health requirements, which applied to imports but not to domestic products, violated III.4	In April 1988 the EC published a list of US firms found to qualify under the Directive. All or most US export firms qualified.	YES
32)	Chile v. US: Quality Standards for Grapes (III.4)	178 – 22 April 1988	Claim that law authorizing inspection of Chilean grapes at port of entry into US while Mexican suppliers were allowed inspection at point of origin in Mexico, violated I and III	No change was made in US marketing order regime.	NO
33)	US v. EC: Payments and Subsidies on Oilseeds and Animal-Feed Proteins (III.4)	179 – 22 April 1988	Claim that subsidy payments made to EC processors for processing EC oilseeds, but not foreign oilseeds, violated III.4	On 20 November 1992 the parties announced a settlement, involving both an agreement to limitations on EC soybean production and a broad agreement on the key elements of the Uruguay Round agricultural agreement then under negotiation.	CONSULTATIONS/ MAS

34)	Japan v. EC: Antidumping Regulation on Imports of Parts and Components (‘Screwdriver Assembly’ Case) (III.4)	188 – 8 Aug. 1988	AD duties not authorized by VI or XX(d) GATT, thus violated III	In agreeing to adoption of the report, the EC undertook to comply with the report, but stated it would defer compliance until implementation of yet- to-be-determined results of Uruguay Round negotiations on the Antidumping code.	YES
35)	EC v. Chile: Internal taxes on Spirits (III.2)	207 – 8 Nov. 1989	Claim that differential in sale taxes on substitutable products violated III.1 and III.2	Not yet known. According to EC sources, the complaint was frozen for the duration of the Uruguay Round, but not abandoned.	CONSUL- TATIONS

**Table 2: NT Disputes Adjudicated Under the WTO<sup>184</sup>**

No.	Dispute	DS No	Subject Matter	Report by <sup>185</sup>	Result
36)	EC v. Japan: Taxes on Alcoholic Beverages (Japan – Alcoholic Beverages II) (III.2)	8	Internal taxes on certain alcoholic beverages pursuant to the Liquor Tax Law	AB	Japanese Liquor Tax Law is inconsistent with GATT Article III.2.
37)	Canada v. Japan: Taxes on Alcoholic Beverages (Japan – Alcoholic Beverages II) (III.2)	10	Internal taxes on certain alcoholic beverages pursuant to the Liquor Tax Law	AB	Japanese Liquor Tax Law is inconsistent with GATT Article III.2.
38)	US v. Japan: Taxes on Alcoholic Beverages (Japan – Alcoholic Beverages II) (III.2)	11	Internal taxes on certain alcoholic beverages pursuant to the Liquor Tax Law	AB	Japanese Liquor Tax Law is inconsistent with GATT Article III.2.
39)	EC v. Japan: Measures affecting the purchase of telecommunications equipment (III.4)	15	The agreement between US and Japan regarding telecommunications	P	Although there has been no official notification, the case appears to have been settled bilaterally.
40)	Japan v. Brazil: Certain automotive investment measures (III.4)	51	Automotive investment measures incl. dom. content requirements, trade balancing requirements	P	No panel established.
41)	EC v. Indonesia: Certain measures affecting the automobile industry (Indonesia – Autos) (III.2, III.4)	54	National Car Program	P	The Panel found that Indonesia was in violation of Articles I and II.2 of GATT 1994, Article 2 of the TRIMs Agreement, Article 5(c) of the SCM Agreement, but was not in violation

<sup>184</sup> Source: Mavroidis & Horn, World Bank Database, 2011 (available at [www.worldbank.org/trade/wtodisputes](http://www.worldbank.org/trade/wtodisputes)).

<sup>185</sup> AB denotes Appellate Body Report, P denotes Panel Report.

					of Article 28.2 of the SCM Agreement.
42)	Japan v. Indonesia: Certain measures affecting the automobile industry (Indonesia – Autos) (III.2, III.4)	55	National Car Program	P	The Panel found that Indonesia was in violation of Articles I and II.2 of GATT 1994, Article 2 of the TRIMs Agreement, Article 5(c) of the SCM Agreement, but was not in violation of Article 28.2 of the SCM Agreement.
43)	US v. Indonesia: Certain measures affecting the automobile industry (Indonesia – Autos) (III.2, III.4)	59	National Car Program	P	The Panel found that Indonesia was in violation of Articles I and II.2 of GATT 1994, Article 2 of the TRIMs Agreement, Article 5(c) of the SCM Agreement, but was not in violation of Article 28.2 of the SCM Agreement.
44)	US v. Brazil: Certain measures affecting trade and investment in the automotive sector (III.4)	65	Discriminatory tariffs, domestic content requirements, trade balancing requirements, local content requirements	P	No panel established.
45)	EC v. Korea: taxes on Alcoholic Beverages (Korea – Alcoholic Beverages) (III.2)	75	Internal taxes imposed by Korea on certain alcoholic beverages	AB	Korea had violated Article III.2 of GATT 1994.
46)	EC v. Brazil: Certain measures affecting trade and investment in the automotive sector (III.4)	81	Discriminatory tariffs, domestic content requirements, trade balancing requirements, local content requirements		No panel established.

47)	US v. Korea: taxes on Alcoholic Beverages (Korea – Alcoholic Beverages) (III.2)	84	Internal taxes imposed by Korea on certain alcoholic beverages	AB	Korea had violated Article III.2 of GATT 1994.
48)	EC v. Chile: Taxes on Alcoholic Beverages (Chile – Alcoholic Beverages) (III.2)	87	Special Sales Tax on Spirits	AB	Chile's Transitional System and its New System for taxation of distilled alcoholic beverages was inconsistent with Article III.2 of GATT 1994.
49)	EC v. US: Tax Treatment for 'Foreign Sales Corporations' (US – FSC) (III.4)	108	Special Tax Treatment for FSCs	AB	The Appellate Body upheld the Panel's finding that the so-called "fair market value rule" under the ETI Act accorded less favourable treatment to imported products than to like US domestic products in violation of Art. III.4 by providing a "considerable impetus" to use domestic products over imported products for the tax benefit under the ETI Act.
50)	US v. Chile: Taxes on Alcoholic Beverages (III.2)	109	Internal taxes on certain alcoholic beverages	P	The US contended that this differential treatment of imported spirits violates Article III.2 of GATT 1994.
51)	EC v. Chile Taxes on Alcoholic Beverages (Chile – Alcoholic Beverages) (III.2)	110	Additional tax on alcoholic beverages	AB	Chile's Transitional System and its New System for taxation of distilled alcoholic beverages was inconsistent with Article III.2 of GATT 1994.
52)	EC v. US:	136	US Antidumping	AB	Claim under conditions.

	Antidumping Act 1916 (US – 1916 Act) (III.4)		Act 1916		Conditions not fulfilled.
53)	Japan v. Canada: Certain automotive industry measures (Canada – Autos) (III.4)	139	Automotive industry measures	AB	The Panel judged the application of the CVA requirements to be inconsistent with Article III.4 of GATT 1994.
54)	EC v. Canada: Certain measures affecting the automotive industry (Canada – Autos) (III.4)	142	Measures affecting the automotive sector	AB	The Panel judged the application of the CVA requirements to be inconsistent with Article III.4 of GATT 1994.
55)	EC v. Argentina: Measures affecting the export of bovine hides and the import of finished leather (Argentina – Hides and Leather) (III.2)	155	Export prohibition on raw and semi-tanned bovine hides, “additional VAT” on the import of products, “advance turnover tax”	P	Argentine tax inconsistent with III.2.
56)	US v. EC: Protection of trademarks and geographical indications for agricultural products and foodstuffs (EC – Trademarks and Geographical Indications) (III.4)	174	Protection of trademarks and geographical indications for agricultural products and foodstuffs	P	Regulation found to be inconsistent with III.4.
57)	US v. Philippines: Measures affecting trade and investment in the motor vehicle sector (Philippines – Motor Vehicles) (III.4)	195	Certain Measures in the Motor Vehicle Development Program		Panel established, not yet composed.
58)	Hungary v. Romania: Import	240	Decree prohibiting the import of wheat		Withdrew request for establishment of panel.

	Prohibition on Wheat and Wheat Flour (III.4)		and wheat flour which does not meet certain quality requirements		
59)	Brazil v. US: Equalizing excise tax imposed by Florida on processed orange and grapefruit Products (US – Florida Excise Tax) (III.2, III.4)	250	Equalizing Excise Tax		MAS. <sup>186</sup>
60)	Canada v. EC: Measures affecting the approval and marketing of biotech products (EC – Approval and Marketing of Biotech Products) (III.4)	292	Measures affecting the approval and marketing of products that contain, consist of, or are produced from, genetically modified organisms	P	Judicial Economy.
61)	Honduras v. Dominican Republic: Measures Affecting the Importation of Cigarettes (III.2, III.4)	300	Selective Consumption Tax, stamps to be affixed, bond as a prerequisite to importing		No panel established.
62)	Korea v. EC: Measures Affecting Trade in Commercial Vessels (EC – Commercial Vessels) (III.4)	301	Subsidies in favor of commercial vessels	P	Regarding the claim of Korea under Article III.4 of the GATT 1994, the Panel found that the subsidies authorized under the TDM Regulation were covered by the notion of “the payment of subsidies exclusively to domestic producers” in Article III.8(b) of the GATT 1994,

<sup>186</sup> MAS stands for mutually agreed solution.

					and thus were not “prevented” by Article III.
63)	Honduras v. Dominican Republic: Measures affecting the importation and internal sale of cigarettes (Dominican Republic – Import and Sale of Cigarettes) (III.2, III.4)	302	Rules, procedures, and administrative practices to determine the value of imported cigarettes for the purpose of applying the Selective Consumption Tax; stamps be affixed to cigarette packages; bond pursuant to imports	AB	Stamp requirement and bond requirement to be inconsistent with III.4; Selective consumption tax inconsistent with III.2, first sentence.
64)	US v. Mexico: Tax Measures on Soft Drinks and Other Beverages (Mexico – Taxes on Soft Drink) (III.2, III.4)	308	Soft drinks and other beverages that use any sweetener other than cane sugar	AB	Soft drink tax and distribution tax to be inconsistent with III.2 and III.4.
65)	EC v. US: Measures Affecting Trade in Large Civil Aircraft (US – Large Civil Aircraft) (III.4)	317	US subsidies to Boeing	P	Second Complaint.
66)	EC v. Brazil: Measures Affecting Imports of Retreaded Tires (Brazil – Retreaded Tires) (III.4)	332	Import ban on retreaded and used tires	AB	The measure maintained by the Brazilian State of Rio Grande do Sul in respect of retreaded tyres, Law 12.114, as amended by Law 12.381, was inconsistent with Art. III.4.
67)	US v. Turkey: Measures affecting the importation of rice (Turkey – Rice) (III.4)	334	Import licenses for rice	P	Turkey's requirement that importers must purchase domestic rice, in order to be allowed to import rice at reduced-tariff levels under the tariff quotas, accorded

less favorable treatment to imported rice than that according to like domestic rice, in a manner inconsistent with Article III.4 of the GATT 1994.

68)	EC v. China: Measures affecting import of automobile parts (China – Auto Parts) (III.2, III.4)	339	Measures affecting Imports	AB	Measures to be inconsistent with III.2 and III.4.
69)	US v. China: Measures affecting import of automobile parts (China – Auto Parts) (III.2, III.4)	340	Measures affecting Imports	AB	Measures to be inconsistent with III.2 and III.4.
70)	Canada v. China: Measures affecting import of automobile parts (China – Auto Parts) (III.2, III.4)	342	Measures affecting Imports	AB	Measures to be inconsistent with III.2 and III.4.
71)	US v. EC – Measures Affecting Trade in Large Civil Aircraft (III.4)	347	Measures affecting trade in Large Civil Aircrafts		A panel was composed, but its authority lapsed in 2006.
72)	EC v. India – Measures Affecting the Importation and Sale of Wines and Spirits from the EC (III.4)	352	Measures Affecting the Importation and Sale of Wines and Spirits		A panel was composed, but its authority lapsed in 2008.
73)	EC v. US – Measures Affecting Trade in Large Civil Aircraft (III.4)	353	Measures affecting trade in Large Civil Aircrafts	AB	Partially adopted.
74)	EC v. Canada – Tax Exemptions and Reductions for Wine and Beer	354	Tax Exemptions and Reductions for Wine and Beer		MAS.

(III.2, III.4)					
75)	US v. China – Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and other Payments (III.4)	358	Tax Exemptions, Refunds, and other Payments to Chinese Enterprises to purchase Domestic goods instead of Imported		MAS.
76)	Mexico v. China – Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and other Payments (III.4)	359	Tax Exemptions, Refunds, and other Payments to Chinese Enterprises to purchase Domestic goods instead of Imported		MAS.
77)	US v. India – Additional and Extra – Additional Duties on Imports from the US (III.2, III.4)	360	Two border charges, consisting of the "Additional Duty" and "Extra- Additional Duty" on imports	AB	Judicial Economy.
78)	US v. China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products (III.4)	363	Restricted Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products	AB	Measure to be inconsistent with XX(a) and III.4 of GATT and XVI and XVII of GATS.
79)	Canada v. EC – Certain Measures Prohibiting the Importation and Marketing of Seal Products (III.4)	369	Measures Prohibiting the Importation and Marketing of Seal Products		Panel not yet established.
80)	Philippines v. Thailand – Customs and Fiscal Measures on Cigarettes from the Philippines	371	Various Customs and Fiscal Measures on Cigarettes	AB	AB found Thailand violates its obligations by exempting only resellers of domestic cigarettes from obligation to pay VAT.
81)	EC v. India –	380	Discriminatory		Panel not yet established.

	Certain taxes and other Measures on Imported Wines and Spirits		Taxation on Imported Wines and Spirits		
82)	Canada v. US – Certain Country of Origin Labeling (COOL) Requirements	384	Certain Country of Origin Labeling (COOL) Requirements on Beef and Pork and COOL Implementation	P	Measure to be inconsistent with 2.1 and 2.2 of TBT and X.3(a) of GATT 1994 and Judicial Economy on Art. III.4 of GATT.
83)	US v. China – Grants, Loans and other incentives	387	Grants, Loans, and other incentives to Chinese Enterprises that are related to their Export Performance		Panel not yet established.
84)	Mexico v. China – Grants, Loans and other incentives	388	Grants, Loans, and other incentives to Chinese Enterprises that are related to their Export Performance		Panel not yet established.
85)	Guatemala v. China – Grants, Loans and other incentives	390	Grants, Loans, and other incentives to Chinese Enterprises that are related to their Export Performance		Panel not yet established.
86)	Philippines – Distilled Spirits	396	Discriminatory Taxation on Imported Distilled Spirits	AB	Philippines violates its obligations by taxing spirits made of cane sugar (predominantly produced in the home market) lower than spirits made of nondesignated goods (predominantly produced abroad).

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