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by

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## Non discrimination in the WTO Agreement

Generally speaking, WTO Members accept by virtue of the “non-discrimination” obligation to avoid distinctions across products solely on the basis of their national origin. This notion is manifested in two basic provisions in the WTO: The “Most Favored Nation” clause (MFN) essentially requires that equal treatment be afforded to all imported goods, irrespective of their origin, as long as they are “like”; the basic incarnation of MFN is found in Art. I GATT. The other non-discrimination principle is the “National Treatment” obligation (NT), which appears as Art. III GATT in its original form in the GATT. It requests WTO Members to treat imported goods no less favorably than domestically produced “like” products. By virtue of the MFN obligation, a WTO Member cannot treat goods originating in a non-WTO Member better than the like good originating in the WTO Member (hence the name MFN). The MFN obligation applies not only to trade instruments (tariffs), but by virtue of Art. I.1 GATT also to all *domestic* measures that affect trade. NT, on the other hand, covers domestic instruments only. Both MFN and NT are relevant irrespective of whether tariff commitments have been entered on a particular good. Thus, with respect to tariffs for example, MFN is relevant for both bound and applied rates.

The MFN principle has a long history. For instance, Hudec (1988) reports that the medieval city of Mantua (Italy) obtained from the Holy Roman Emperor the promise that it would always benefit from any privilege granted by the Emperor to “whatsoever other town.” According to Jackson (1997, p. 158), the term “MFN” appears for the first time at the end of the 17<sup>th</sup> century. During the 19<sup>th</sup> century, the provision appeared in a number of treaties across European states. For instance, the *Cobden-Chevalier Treaty* of 1860, liberalizing trade between Great Britain and France, included an MFN clause guaranteeing that a signatory would not be treated worse than any other state with which the other signatory had, or would assume, trade relations. Such schemes, however, did not amount to a world-wide non-discriminatory trade; if at all, non-discriminatory trade existed between a sub-set of all states, those that had entered into a similar contractual arrangement espousing the MFN clause.

Non-discrimination provisions appear in the WTO Agreement in all three Annex 1 Agreements,<sup>1</sup> that is in the General Agreement on Tariffs and Trade (GATT), in the General Agreement on Trade in Services (GATS), and in the Agreement on

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<sup>1</sup> Case law has consistently construed the WTO Agreement as being one entity with four Annexes: the three multilateral agreements (GATT, GATS, TRIPS) are featured in Annex 1.

Trade-Related Aspects of Intellectual Property Rights (TRIPs). The GATS and the TRIPs contain MFN and NT provisions that are essentially identical to those in GATT, as described above. However, the GATS NT provision (Art. XVII) covers only domestic instruments with respect to sectors that a WTO Member has decided to liberalize, and to the extent that no liberalization commitment has been entered, it is of no relevance.<sup>2</sup> There are also NT-like provisions in some of the other agreements constituting the WTO Agreement. For instance, the “consistency” requirement embedded in Art. 5.5 of the Agreement on the Application of Sanitary and Phyto-sanitary Measures (SPS), has a strong flavor of NT by requiring that WTO Members treat comparable risks associated with imported and domestic products in similar fashion.

WTO adjudicating bodies have understood MFN and NT to ban both *de jure* and *de facto* discrimination. The former concept covers cases where a discriminatory treatment is afforded by virtue of the origin of the product; the latter, refers to cases where treatment on its face non-discriminatory effectively confers an advantage to the domestic good. While the *de jure* cases are easy to delineate, this is not the case with *de facto* violations, where case law has developed in a rather erratic manner.

### **Non-discrimination and negative integration**

The inclusion of the non-discrimination obligations is largely the direct result of the decision to construct the GATT as a negative integration contract: policies are defined unilaterally and, to the extent that there are international spillovers, they will be internalized by virtue of the non-discrimination obligation. This means that a WTO Member can in practice adopt any regulation (rational or irrational) to the extent that it does not discriminate. The agreements on Technical Barriers to Trade (TBT) and Sanitary and Phyto-Sanitary measures (SPS) do request a certain degree of rationality from regulatory interventions, but without negating the non-discrimination discipline. For example, a WTO Member has (at least in principle) to base its SPS regulations on scientific evidence. Regulation not based on scientific evidence (when such evidence is available) is SPS-inconsistent, even if non-discriminatory.

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<sup>2</sup> We will thus, in what follows, examine the MFN and NT obligations in the GATT context. Our presentation is valid for the review of the same obligations under the GATS (with the caveat that we noted), and the TRIPs.

There is wide-spread view among policy-makers, lawyers, and many economists, that there are a number of strong economic rationales for non-discrimination. For instance, it seems to be rather commonly held (in particular among non-economists) that non-uniform tariff structures give rise to inefficient production and consumption patterns in a static sense. Other arguments in favor of non-discrimination hold that it eases tariff negotiations, or may prevent the formation of preferential trading agreements that are formed to exploit market power in world markets. However, a general theoretical *prima facie* case for non-discrimination is not as easily advanced as might be thought. Indeed, Johnson (1976, p.18) goes as far as arguing that:

"...the principle of non-discrimination has no basis whatsoever in the theoretical argument for the benefits of a liberal international trade order in general, or in any rational economic theory of the bargaining process in particular."

In what follows we will discuss some salient features of MFN and NT, respectively.

### **Non-discrimination in the form of Most-Favored Nation treatment**

The MFN obligation, as interpreted in case-law, consists of the following elements:

- (a) with respect to, in principle, all measures which affect trade either *de jure* or *de facto*, any advantage granted to goods originating anywhere in the world;
- (b) must be extended to the like products;
- (c) originating in any WTO Member;
- (d) immediately and unconditionally.

It emerges from the case law that two products sharing the same tariff classification will be deemed *like*. There is no WTO agreement on rules of origin, and, consequently, every WTO Member can unilaterally define its own policy in this respect and apply it in a non-discriminatory manner. *Immediately* means that the importing WTO Member has to grant an advantage with no passage of time. *Unconditionally* means that it cannot impose conditions that it has not imposed to another beneficiary. The standard of review applied by WTO adjudicating bodies in MFN cases is quite favorable to the complainant: there is no need to

demonstrate intent to discriminate, and there is no need to demonstrate the resulting trade effects either.<sup>3</sup>

MFN knows of two important exceptions: preferential trade agreements (PTAs), and special and differential treatment for products originating in developing countries which, by virtue of their origin, are granted in donors' markets a better treatment than like products originating in developed countries.

A number of factors contribute to make an economic analysis of MFN complicated.<sup>4 5</sup> First, in a world where free trade maximizes global welfare, there is of course no scope for tariffs at all, discriminatory or not. Any meaningful analysis of the desirability of MFN must therefore include a reason why there are tariffs at all. Consequently, it will involve comparisons of distorted equilibria, with associated second-best problems. Also, a study of MFN must involve at least three countries, with the plethora of different possible trade patterns and analytical difficulties this typically incurs.

Yet another difficulty in analyzing MFN is the fact that there is no general well-defined uniform structure with which to compare the non-discriminatory tariff structure. This is problematic since it is *a priori* clear that the arbitrary choice concerning this level will have a profound effect on the outcome: if the uniform level is the same as the lowest discriminatory tariff, the uniform structure will most likely be preferred, while an equally non-discriminatory structure, but set at the level of the highest discriminatory tariff, will most likely be worse from a welfare point of view. In neither case can the outcome be said to be related to discrimination, however. More generally, we lack a meaningful measure of the *degree* to which a structure fulfils MFN, it is not possible to simply "turn up" the degree of non-MFN and observe the outcome.

Despite these inherent complexities, there are several strands of economic theory that can shed light on impact of a MFN clause. An immediate observation here is that both the literature on Optimal Taxation and the Industrial Organization (IO) literature on price discrimination suggest reasons why discrimination may be socially desirable. For instance, if the *raison d'être* for tariffs is to raise government

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<sup>3</sup> Horn and Mavroidis (2004) discuss the case law on NT as it applies to taxation.

<sup>4</sup> This section draws on Horn and Mavroidis (2001), which also provide more references for the findings discussed in this section. See also the surveys by Schwartz and Sykes (1996), and Staiger (1995). An early analysis of MFN is Caplin and Krishna (1988).

<sup>5</sup> There may also be other rationales for non-discrimination. For instance, non-discriminatory treatment of trading partners may prevent political tensions, as often emphasized in the international relations literature.

revenue, the tariffs should (as taxes in general) be levied so as to minimize the resulting distortions, and this will often call for non-uniform structures.

Economic analyses of MFN can be broadly divided into two categories. The first comprises models in which governments set tariffs unilaterally. In a typical setup, firms decide on investment, the level of which is influenced by firms' perceptions tariff treatment, and thus on whether MFN has to be respected or not. A basic mechanism here is that MFN hinders *ex post* opportunistic taxation of economic rents and may thereby increase the *ex ante* private incentives for the creation of such rents. This mechanism lies behind several observations. For instance, by affecting the strategic interaction between firms and governments, a MFN clause may have a positive welfare impact even if the government would choose to set non-discriminatory in its absence; and a government that absent an MFN clause would choose to discriminate, may gain from being prevented from discriminating.

A second and more recent strand of literature is concerned with the role of MFN for multilateral trade liberalization, and in particular tariff negotiations. One fundamental role of trade agreements is to prevent negative externalities from nationally pursued trade policies. These international externalities may work through a number of different routes. For instance, they may take the form of changes in terms-of-trade, or through domestic prices affecting import demand. Bagwell and Staiger (2002) suggest that a central role of MFN is to channel these externalities through the terms-of-trade.<sup>6</sup> This is important, since tariff negotiations can directly address terms-of-trade externalities, but are less effective to address other forms of externalities. Bagwell and Staiger also show how MFN may work in concert with other characteristic features of the GATT/WTO system, such as reciprocity, to make multilateral trade agreements immune to Art. XXVIII GATT renegotiations.

The complexity of multi-country tariff negotiations is reflected in the wide variety of intuitively plausible, but often contradictory arguments that have been advanced in the informal academic literature, and in policy discussions. For example, MFN is said to promote tariff liberalization, by making trade agreements more credible; the increased cost of giving concessions makes it less attractive for a party to undermine an agreement by subsequently offering better terms of market access to a third country ("concession diversion"). MFN also

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<sup>6</sup> Kyle Bagwell and Robert W. Staiger have examined MFN in a series of writings, and Bagwell and Staiger (2002) summarizes some of this work.

makes it attractive for outsiders to enter into an existing agreement, since they get access to a package of low tariffs. And since entrants have to grant MFN, insiders get access to many foreign markets through the incentives for entry. On the other hand, MFN is also claimed to reduce the incentives to liberalize. It increases the costs of giving concessions, since the latter have to be given to all countries with which a country has MFN agreements; MFN makes large countries unwilling to make concessions to small countries, since in return for "peanuts" large countries have to extend their concessions to a large volume of trade; MFN reduces the benefit from a given concession since it has to be shared with other countries; MFN promotes free riding, since countries may opt to wait for agreements between other countries to spill over via MFN, rather than contribute with concessions themselves, and MFN also prevents countries from punishing free-riding; or MFN prevents subsets of countries from going further in liberalization than what is desired by the rest of the world.<sup>7</sup> A number of studies examine the validity of these types of claims. We will here just mention two of these.

The role of MFN to prevent concession diversion is at focus in Ethier (2000), who takes a very long run perspective on its impact. Governments are assumed to initially form reciprocal bilateral agreements. These must include MFN to avoid concession diversion, to be meaningful. As more and more bilateral agreements are formed, the incentives to participate in further agreements gradually diminish, since each agreement has through the partner's MFN commitment to be shared by more and more other countries, and more and more market access have to be given away through a country's own MFN commitments. A process of liberalization through bilateral agreements will therefore eventually come to a halt. It will become necessary to internalize the external effects of any further agreements by making the agreements multilateral. Hence, MFN causes multilateralism, not the other way around. This study can also be seen as an illustration of the more general point that bilateral negotiations conducted under MFN generally are associated with externalities, since the outcome of such negotiations affect parties who are not present in the negotiations.

MFN may potentially cause free-riding in at least two ways. One is that a country rejects an offer in order to let other countries reach agreements that it can benefit from without having to make concessions itself. This would be inefficient either because there would be delays in achieving an agreement, or because the agreement would feature higher tariffs compared to some other (undefined)

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<sup>7</sup> Several of these arguments were made by Viner (1924, 1931).

situation. This possibility has as far as we know not found any support in the literature so far. For instance, Ludema (1991), which is one of the few studies that employ a non-cooperative sequential bargaining model to study the impact of MFN on multilateral bargaining, shows how negotiators may find it optimal to devise equilibrium offers such that free riding does not occur, despite there being incentives and possibilities to free-ride.

As mentioned above, in this entry we do not cover the literature on PTAs. While studying phenomena that require exemptions from MFN, the attention in this literature is typically not on MFN as such. But it nevertheless deserves mentioning that there are more recent strands in the literature on PTAs that are of more direct relevance for the issue at stake here. There are in particular studies of the interplay between the domestic political system and the formation of PTAs, exemplified by the studies by Grossman and Helpman (1995), Levy (1997), and Krishna (1998), all of which suggest that MFN may have desirable welfare consequences by constraining the domestic political process.

Finally, there are some intuitively important aspects of MFN that have not been formally scrutinized, as far as we know. For instance, as noted already by Viner (1931), the administration of discriminatory tariffs is costly because of the need to keep track of product origin, and MFN thus significantly simplifies customs procedures. Another aspect that we believe is of considerable importance is the fact that MFN reduces the cost and complexity of negotiations by reducing the number of possible bids and outcomes. Finally, under MFN countries may have incentives to use narrow product classifications in order to avoid having to extend concessions granted on an MFN basis. There should thus be reasons for countries to try to manipulate customs classification schemes.

To conclude, the implications of MFN for multi-party tariff negotiations are inherently complex. A large number of partial effects have suggested, but the economic theory literature has only examined a few of these. It does support some of the claims concerning beneficial effects of MFN, but provides a far too scattered picture to serve as a basis for any more general claim concerning the desirability of MFN.

Finally, it is sometimes argued that MFN is today of limited practical importance, given the low average tariffs of developed countries on imports of industrial products. However, current tariffs are the result of a system built on MFN, and there is no guarantee a priori that the same levels could be supported in its absence. Also, there are important sectors such as agriculture, textiles, and

services where barriers are still high and where MFN (or its absence) might clearly be important. Furthermore, as discussed above, the MFN principle does not only apply to tariff negotiations in the rounds, but also to many other facets of the WTO.

### **Non-discrimination in the form of National Treatment**

Art. III GATT divides domestic policy interventions into fiscal (Art. III.2) and non-fiscal (Art. III.4) measures. With respect to fiscal measures, any tax differential across two “like” products will violate the NT discipline, whereas the tax differential across two DCS “directly competitive or substitutable” (DCS) products must operate “so as to afford protection to domestic production”, in order to be in violation of NT. Case law so far has held that large tax differentials across DCS products suffice for this requisite to be fulfilled. Two products are in a DCS-relationship, if they are considered by consumers to be inter-changeable. A demonstration of inter-changeability can be based on either econometric or non-econometric indicators. Two products are like if they are DCS *and* also share the same tariff classification, to the extent that it is detailed enough. Turning to non-fiscal measures, a measure roughly speaking violates NT if it affords to an imported good less favourable treatment than that afforded to a domestic like product. The term like has here been interpreted in a manner that roughly corresponds to the DCS notion for fiscal measures.

Two domestic instruments are by virtue of Art. III.8 GATT, excluded from the coverage of NT: production subsidies and government procurement. But the GATT does not contain a list of domestic instruments that have to observe the NT discipline. WTO adjudicating bodies have adopted an all-encompassing attitude in this respect, and have never so far refused the application of Art. III GATT on the grounds that a particular measure does not come under its coverage. There is indirect legislative support for this approach: Art. III.2 GATT stipulates that imported products shall not be subject “directly or indirectly” to higher taxation or levies than those imposed “directly or indirectly” to like domestic products. Hence, fiscal measures that only indirectly hit products are covered by the NT-discipline as well. Likewise, the term “affecting” in Art. III.1, which includes non-fiscal as well as fiscal measures, is in the same broad vein; finally, the Interpretative Note ad Art. III states that measures enforced at the border should still be considered domestic, if they are designed to regulate both domestic and imported goods.

Case law has established that violations of the NT-discipline can be justified through recourse to one or more of the public order grounds reflected in Art. XX GATT. The intellectual merits of constructing Art. XX as an exception to Art. III are highly doubtful however, since both provisions contain a non-discrimination clause. There is no doubt though, that NT can lawfully be disrespected on national security grounds (Art. XXI GATT).

Turning to the rationale for NT, the most striking feature of the economic literature is the near complete non-existence of studies of NT. The question of what role NT plays in trade agreement is part of the larger question of why do trade agreements typically treat internal measures very differently from border measures? Border measures are largely explicitly regulated; tariff levels are bound, import and export quotas as well as export subsidies are prohibited, etc. Internal measures, on the other hand, are left to be unilaterally determined by the contracting parties. Intuitively, the reason for this asymmetry seems to stem from a combination of two facts. First, a trade agreement is typically in place for a long period of time because of the costs of negotiating it, even if only binding border measures. Second, during the life span of the agreement, various non-protectionist regulatory needs are likely to arise. The agreement must therefore leave sufficient flexibility for the contracting parties to use domestic instruments for non-protectionist reasons.<sup>8</sup> But it would be extremely costly to condition the agreement on all possible developments, however. On the other hand, it cannot leave internal instruments completely unregulated, since this would enable countries to use internal measures to undo whatever restrictions are agreed upon regarding border measures. NT is the first line defense against such behavior. That is, NT can be understood as an attempt to remedy problems caused by incompleteness of the agreement.

In order to save on contracting costs, an NT provision is likely to impose a less than perfectly flexible discipline on domestic measures. The question therefore arises as to whether the restriction increases welfare? Horn (2006) shows how an extreme version of an NT provision – a dictum to never tax foreign products higher than domestic products – may improve the contracting parties' welfare even if it would be desirable to tax foreign products higher from an efficiency point of view. Basically, the NT restriction makes internal instruments blunter tools for protectionism – domestic instruments can be used against foreign products, but have to also hit domestic like products to the same extent. As a

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<sup>8</sup> The perspective to be briefly presented here is laid out in more detail in Horn and Mavroidis (2004), and in the formal analyses in Horn (2006), and Horn *et al* (2006).

result, taxes will be used less to protect, and countries may go further in their tariff liberalization, creating overall gains from the imposition of the NT provision. Such a strict NT restriction will not completely eradicate the problem caused by incomplete contracting, however.<sup>9</sup>

A fundamental weakness of the whole incomplete contract, trade agreement literature is the fact that the structure of the incompleteness – what is contracted and what is not – is simply assumed. In practice, parties to an agreement can choose not only tariff levels, say, but also whether or not to include an NT provision. A natural question is therefore when, if at all, is an NT provision likely to be part of an optimal agreement? Horn, Maggi and Staiger (2006) employ a model with explicit contracting costs to endogenously determine the incomplete structure of a trade agreement. It is shown how a strict NT-like provision of the above-mentioned type may be an optimal component of a trade agreement, by combining limited contracting costs with a degree of discipline on countries' use of domestic taxes for beggar-thy-neighbor purposes.

Overall, it must be concluded that the analysis of the implication, and even more the optimal design, of NT has only just begun. This is an unfortunate state of affairs, considering the importance of NT and NT-like provisions in the WTO Agreement, and in high-profile WTO trade disputes.

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<sup>9</sup> There are several studies of the role of domestic instruments in trade agreements that adopt an incomplete contracting perspective. Most of these are not concerned with discriminatory measures, however, and do thus not directly address the ability of NT to fulfill its purpose of stimulating tariff liberalization.

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