

*PART TWO*

*International rules governing trade  
in goods (GATT 1994 and  
its associate Agreements)*

## CHAPTER 2

# Four main rules of GATT

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### *Summary*

*The entire edifice of GATT's open and liberal multilateral trading system is built on four basic and simple rules.*

*The first rule, while recognizing that it is important for member countries to follow open and liberal trade policies, permits them to protect domestic production from foreign competition, provided that such protection is extended only through tariffs and is kept at low levels. To this end, it prohibits countries from using quantitative restrictions, except in specified cases. The rule against the use of quantitative restrictions has been strengthened in the Uruguay Round.*

*The second rule provides for the reduction and elimination of tariffs and other barriers to trade through multilateral negotiations. The tariffs so reduced are listed on a tariff-line basis in each country's schedule of concessions. The rates given in these schedules are known as bound rates. Countries are under an obligation not to increase tariffs above the bound rates shown in their schedules.*

*The third rule requires countries to conduct their trade without discriminating among countries from which goods are imported or to which goods are exported. This rule is embodied in the most-favoured-nation (MFN) principle. An important exception to this rule is permitted in the case of regional preferential arrangements.*

*The fourth rule is known as the national treatment rule. It requires countries not to impose on an imported product, after it has entered their domestic markets on paying customs duties at the border, internal taxes such as sales or value-added tax at rates higher than those levied on a similar domestic product.*

GATT 1994, Preamble

The objective of the multilateral system for trade in goods created by GATT is to provide industries and business enterprises from different countries a secure, stable and predictable environment in which they can trade with one another under conditions of fair and equitable competition. This open and liberal trading system is expected to promote through increased trade, greater investment, production and employment and thus facilitate the economic development of all countries.

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## First rule: protecting the domestic industry by tariffs only

The legal system which GATT has created to attain the above objective is complex, but it is based on a few basic and simple rules

While GATT stands for liberal trade, it recognizes that countries may wish to protect their industries from foreign competition. It urges them to keep such

GATT 1994, Article XI  
GATT 1994, Article XII

protection at reasonably low levels and to provide it through tariffs. The principle of protection by tariffs is reinforced by provisions prohibiting member countries from using quantitative restrictions on imports. The rule, however, is subject to specified exceptions. An important exception permits countries that are in balance-of-payments (BOP) difficulties to restrict imports in order to safeguard their external financial position. This exception provides greater flexibility to developing countries than is available to developed countries to use quantitative restrictions on imports if these restrictions are necessary to forestall a serious decline in their monetary reserves.

## **Non-observation of the rule against quantitative restrictions**

### *Agricultural sector*

In the past, a number of countries did not abide by the GATT rule on protection by tariffs alone. In the agricultural sector for instance, a number of developed countries maintained quantitative restrictions which went far beyond those warranted by the exceptions provided in GATT. In addition to these restrictions, some of these countries, particularly those belonging to the European Union, applied variable levies instead of fixed tariffs to imports of temperate zone agricultural products such as wheat and other grains, meat and dairy products. The primary purpose of those levies was to ensure a reasonable income to farmers and to maintain a certain parity between the income earned by them and that earned by industrial workers. The levies payable were determined periodically and were generally equal to the difference between the landed import price and the guaranteed reference domestic price.

The variable levies thus resulted in domestic production being fully insulated from foreign competition, as the levies completely offset the competitive price advantages of foreign suppliers.

### *Trade in textiles and clothing*

In the industrial sector, most developed countries did not apply the rule against the use of quantitative restrictions to trade in textiles, a sector of particular interest to developing countries. There was one significant difference between the restrictions applied in the agricultural sector and those applied to textiles. With some notable exceptions, the restrictions maintained in the agricultural sector were outside the scope of GATT rules. In the case of textiles, the restrictions were authorized under the provisions of the Multi-Fibre Arrangement (MFA), negotiated under GATT auspices. MFA permitted countries to derogate from their basic obligation and to impose restrictions on imports of textiles and textile products, provided the conditions it laid down were met.

### *Developing countries*

A number of developing countries applied, in addition to high tariffs, quantitative restrictions on imports in both the agricultural and industrial sectors. Such use of restrictions was, however, in most cases justifiable from the legal point of view, under the exceptions to the GATT rules which permit countries in balance-of-payments difficulties to impose quantitative restrictions on imports.<sup>6</sup>

GATT 1994, Articles XII  
and XVIII:B

<sup>6</sup> Countries are considered to be in balance-of-payments difficulties when their external earnings from trade in goods and services and the flow of investment and loans are far from adequate for their external payments liabilities, and when monetary reserves for meeting immediate liabilities are declining. GATT rules provide developing countries in balance-of-payments difficulties a greater flexibility to use quantitative restrictions on imports.

## Reinforcement of the discipline against the use of quantitative restrictions

### *Tariffication in the agricultural sector*

The WTO legal system has brought about a considerable change in the use of quantitative restrictions and other non-tariff measures affecting imports. In the agricultural sector for instance, in accordance with the provisions of the Agreement on Agriculture, WTO member countries have abolished quantitative restrictions and their systems of variable levies, replacing these with tariffs. The new tariff rates have been determined by tariffication, i.e. calculating the incidence of quantitative restrictions and other measures on the price of the imported products and adding it to the then-prevailing tariffs. After tariffication, countries may henceforth protect their domestic agricultural production only by means of tariffs. (See chapter 15.)

### *Phased removal of restrictions on textiles and clothing*

In the area of textiles and clothing, the Agreement on Textiles and Clothing (ATC) requires member countries maintaining restrictions to phase them out gradually in four stages, so as to abolish them completely by 1 January 2005. (See chapter 14.)

### *Developing countries in balance-of-payments difficulties are urged to use price-based measures*

Understanding on  
BOP Provisions of GATT  
1994: 2, 3

In addition, the Understanding on Balance-of-Payments Provisions of GATT 1994 strongly urges member countries not to use quantitative restrictions to safeguard their balance-of-payments (BOP) situations. It requires countries, whether developed or developing, to prefer in such situations price-based measures (such as import surcharges and import deposit requirements) to quantitative restrictions as their impact on the price of imported products is transparent and measurable. Quantitative restrictions can be resorted to only when, because of a critical BOP situation, it is perceived that price-based measures cannot arrest a further sharp deterioration in the external payments position.

The WTO legal system has thus, by strengthening the rules against the use of quantitative restrictions, further reinforced the basic GATT rule that protection to domestic production should be given primarily through tariffs.

## Second rule: tariffs should be reduced and bound against further increases

### Reductions in tariffs

GATT 1994, Preamble;  
Article XXVIII bis

The second important rule of GATT is that tariffs and other measures that countries maintain to protect their domestic production should be reduced and, where possible, eliminated through negotiations among member countries and that the tariffs so reduced should be bound against further increases.

### Binding against further increases

GATT 1994, Article II:1(b);  
Understanding on the  
Interpretation of Article  
II:1(b)

The concept of binding needs some explanation. The rates of tariffs agreed in the negotiations as well as the other commitments assumed by countries are listed in schedules of concessions. Each WTO member country has a separate schedule and is under an obligation not to impose tariffs or other duties or

charges which “are in excess of those set forth” in its schedule. It is also obliged not to take measures such as the imposition of quantitative restrictions which would reduce the value of the tariff concessions. The rates of tariffs listed in the schedule are known as bound rates of tariffs (*see* box 8).

### **Box 8**

#### ***Binding of tariffs***

*It is not open to a country to increase the rates of tariffs above the bound rate indicated in its schedule of concessions. The schedule, inter alia, lists on a product-by-product basis the pre-negotiation tariff rate on a product and the rate of tariff at which the country has agreed “in the negotiations to bind the tariff rate”. In trade negotiations, a country could agree:*

- To bind its existing positive rate (e.g. 10%) or zero rate; or*
- To reduce the rate, for example from 10% to 5%, and to bind the reduced rate.*

*It is also possible for a country to bind its tariffs at a ceiling rate which is higher than the rate resulting from the tariff reductions agreed in the negotiations. Thus a country which has agreed to reduce a tariff from 10% to 5% may indicate that, while it will apply the reduced rate to imports, the bound rate of the tariff will be 8%. In that case, the country is free to raise its tariffs to 8% at any time without infringing any of its GATT obligations.*

*The Uruguay Round has brought about substantial progress in the binding of tariffs of all countries. All countries – developed, developing and transitional economies – have bound their tariffs in the agricultural sector. In the industrial sector over 98% of imports into developed and transitional economies will be entering under bound rates of tariffs.*

*In the case of imports into developing countries, the proportion of imports entering under bound rates is around 73%. A number of developing countries have, however, given ceiling bindings in certain instances. Such ceiling bindings take the form of a commitment not to raise the tariff:*

- Over the ceiling rates shown for each product;*
- Over the ceiling rate applicable to a particular sector;*
- Over the ceiling rate applicable across the board to all products.*

*It is possible for a country which has bound its tariffs to secure release from the binding and to raise the tariff above the bound rate. It does this by entering into renegotiations with the countries with which it had initially negotiated the concession as well as with the principal supplying countries of the product concerned and which therefore benefit from the concession. In such negotiations, the country requesting release is expected to make compensatory tariff concessions on other products in which the countries with which it is negotiating have a trade interest.*

## **Principle governing the exchange of concessions in negotiations**

What is the principle by which countries agree in trade negotiations to reduce tariffs, to bind them against further increases and to remove other barriers to trade? The basic principle governing the exchange of such concessions is the principle of reciprocity and mutual advantage. A country requesting improved access to the market of other countries, through tariff reductions or the removal of other barriers such as quantitative restrictions, must be ready to make concessions in tariffs and other areas that those countries consider to be advantageous and of reciprocal or equivalent value to the concessions they are making.

GATT 1994, Part IV  
(Trade and Development),  
Article XXXVI:8; Tokyo  
Round Decision on  
Differential and More  
Favourable Treatment,  
Reciprocity and Fuller  
Participation of Developing  
Countries, § 5,6 and 7

The rule of full reciprocity does not, however, apply to negotiations between developed and developing countries. Developing countries are required to make concessions in the form of tariff reductions on the basis of relative reciprocity, which takes into account the fact that, because of their lower level of economic development and their trade and financial needs, they may not be able to make concessions on the same basis as developed countries. The rule, however, recognizes that developing countries are not all at the same level of development; some of them have reached higher stages of growth while others are at various stages of development. Forty-eight of them are least developed countries.

The developing countries that have reached higher stages of development are required to make larger contributions and concessions in the form of tariff reductions and bindings than those at lower rungs of economic growth. This concept is also known as 'graduation', since it visualizes that as a developing country develops, it will graduate to a higher status and ultimately may be able to make tariff concessions and accept disciplines in other areas on the same basis as developed countries.

### **Greater contributions from developing countries in the Uruguay Round**

Because of the rule of relative reciprocity only a few developing countries made tariff concessions in the Tokyo Round and earlier rounds of negotiations. Furthermore, those that made concessions did so on only a few products. This situation changed considerably in the Uruguay Round, and almost all developing countries have agreed to make concessions by reducing tariffs on a percentage basis. However, in accordance with the principle of relative reciprocity, these concessions have been made at a lower percentage than that applicable to developed countries.

During the Uruguay Round, two factors were responsible for the greater willingness of developing countries to make concessions and to accept through negotiations higher obligations. First, a significant number of these countries had made considerable progress in their economic development. The second factor, closely related to the first, was the dramatic shift which had taken place in the trade policies of almost all developing countries. Previously, when they had followed import substitution policies, built high tariff walls and insulated domestic production from foreign competition, it was difficult for them to offer concessions in the form of tariff reductions.

These countries are now following policies promoting export growth and are reducing tariffs and eliminating the plethora of licensing and other systems they had maintained to restrict imports. These open and liberal trade policies enabled them in the Uruguay Round not only to take credit for their unilateral tariff reductions by binding them but also to improve their bargaining position in negotiations with their developed country partners.

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## **Third rule: trade according to the most-favoured-nation clause**

GATT 1994, Article I

The third basic GATT rule, which provides that trade must not be discriminatory, is embodied in the famous most-favoured-nation clause. In simple terms, the principle means that if a member country grants to another country any tariff or other benefit to any product, it must immediately and unconditionally extend it to the like products of other countries. Thus if country A agrees, in trade negotiations with country B, to reduce custom duties on imports of tea from 10% to 5%, the reduced rate must be extended to all WTO member countries. The obligation to extend such MFN treatment applies

not only to imports but also to exports. Thus, if a country levies duties on exports of a product to one destination, it must apply it at the same rate to exports to all destinations.

GATT 1994, Article I:1

Moreover, the obligation to provide MFN treatment is not confined to tariffs. It also applies to:

- ❑ Charges of any kind imposed in connection with importation and exportation;
- ❑ The method of levying tariffs and such charges;
- ❑ Rules and formalities in connection with importation and exportation;
- ❑ Internal taxes and charges on imported goods, and laws, regulations and requirements affecting their sales;

GATT 1994, Article XIII

- ❑ The administration of quantitative restrictions (e.g. by allocating quotas among supplying countries on a non-discriminatory basis) where such restrictions are permitted under the exceptions provisions.

The principle thus implies that, by agreeing to give MFN treatment, member countries undertake not to discriminate among countries and not to treat a country less favourably than another in all matters connected with foreign trade in goods.

### Exceptions to the MFN rule

GATT 1994, Article XXIV

The GATT rules, however, recognize that tariffs and other barriers to trade can be reduced on a preferential basis by countries under regional arrangements. The lower or duty-free rates applicable to trade among members of regional arrangements need not be extended to other countries. Regional preferential arrangements thus constitute an important exception to the MFN rule. In order to protect the trade interests of non-member countries, GATT lays down strict conditions for forming such arrangements. These conditions, *inter alia*, provide that:

GATT 1994, Article XXIV:8

- ❑ Member countries of regional arrangements must remove tariffs and other barriers to trade affecting substantially all trade among themselves, and
- ❑ The arrangement should not result in the imposition of new barriers to trade with other countries.

GATT 1994, Article XXIV:8

Such arrangements may take the form of customs unions or free-trade areas. In both instances, trade among member States takes place on a duty-free basis while trade with other countries continues to be subject to MFN tariff rates. In the case of customs unions, tariffs of member countries are harmonized and are uniformly applied to imports from outside countries. In free-trade areas, member countries continue to use, without harmonization, the tariffs set out in their individual national schedules.

There are now over 100 regional preferential arrangements in force. As box 9 shows, the emphasis on promoting trade on a regional basis by strengthening and deepening tariff and other concessions exchanged under regional preferential arrangements has increased in recent years. As a result, regional trade is steadily on the rise and a growing proportion of world trade is taking place on a regional basis.

Such preferential arrangements provide advantages to industries marketing their products in other countries in the region. At the same time, they may put industries in countries outside the region, which have to pay customs duties on an MFN basis, in a position of competitive disadvantage. One of the major challenges which WTO member countries have to face in the coming years is

**Box 9****Regional trade groupings: recent developments**

*During the past few years, the steady march towards the further strengthening of regional trade agreements has continued on all continents.*

**Africa**

*In Africa, the southern cone is moving towards closer integration within a free trade area through the Southern African Development Community (SADC). Within the group, member States of the Southern African Customs Union (SACU) are renegotiating their customs union relationships.*

*In other parts of Africa, there is also a revival of regional integration. For example, in West Africa, the new Economic and Monetary Union (WAEMU; in French UEMOA) plans to bring into effect a common external tariff, a joint Commission and many of the elements of the European system (a common currency in the shape of the CFA franc already exists). Members of the East African Cooperation (Kenya, Uganda and the United Republic of Tanzania) have continued their renewed movement towards eventual economic and monetary union, with a common currency.*

*The Common Market for Eastern and Southern Africa (COMESA), with 20 member States, remains the largest regional entity in Africa; its objective is to establish a customs union and a common external tariff.*

*Its members are: Angola, Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Rwanda, Seychelles, Somalia, Sudan, Swaziland, United Republic of Tanzania, Uganda, Zaire, Zambia and Zimbabwe.*

**The Americas**

*In the Americas, the establishment of the North American Free Trade Agreement (NAFTA) by the United States, Canada and Mexico has provided a new stimulus for the establishment of a free trade area for all countries in North and South America. In April 1998, 34 countries in the region signed an agreement to establish the Free Trade Area of the Americas (FTAA) by the year 2005. A number of agreements setting up regional or subregional groupings are expected to be fully implemented by that date.*

*One regional grouping is MERCOSUR (the Southern Common Market), which aims to establish a common market for its members Argentina, Brazil, Paraguay and Uruguay (Bolivia and Chile are associate members). Now a customs union, MERCOSUR has signed agreements with the Andean Community (to initiate a full free trade agreement by 2000) and with the Central American Common Market (to begin a tariff reduction programme leading to a free trade agreement). It has free trade agreements with Bolivia and Chile.*

*The Andean Community (consisting of Bolivia, Colombia, Ecuador, Peru and Venezuela) has agreed to establish a common market by the year 2005, and has signed a framework agreement with Panama aiming at the latter's full integration into the Community.*

**Asia**

*In Asia, the Association of South-East Asian Nations (or ASEAN, comprising Brunei Darussalam, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Viet Nam) is vigorously pursuing its efforts to establish a free trade area by further reducing tariffs and other barriers to intraregional trade.*

*The countries belonging to the Bangkok Agreement (Bangladesh, Bhutan, India, Maldives Nepal, Pakistan and Sri Lanka) are also seeking to promote intraregional trade though political difficulties have so far prevented significant progress from being made.*

*In Central Asia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan have joined hands with the Islamic Republic of Iran, Pakistan and Turkey to develop closer trade links.*

*The abolition of tariffs and other barriers to trade are also being sought by countries belonging to the Asia-Pacific Economic Cooperation forum (APEC). Its members are: Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Peru, Papua New Guinea, the Philippines, Republic of Korea, the Russian Federation, Singapore, Taiwan Province (China), Thailand, the United States and Viet Nam.*

### **Europe**

*In Europe, close economic integration has been achieved among 15 countries following the establishment of the European Union. Negotiations are underway on the admission into the Union of Cyprus, the Czech Republic, Hungary, Poland and Slovenia. The European Union also maintains a customs union with Turkey and is negotiating a 'new generation' of agreements on free trade areas with its trading partners in the Mediterranean region. Its current members are: Austria, Belgium, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.*

*It is thus clear that both the economic and political impetus to conclude regional trade agreements, which already cover a high proportion of world trade, will intensify in the coming years.*

*Source: WTO, Annual Report 1998. vol. 1, Special Topic: Globalization and Trade.*

how to ensure complementarity between efforts to develop regional trade and attempts to further liberalize trade at the multilateral level.

In addition to these arrangements, developed countries have introduced one-way free-trade arrangements under which imports from either all or a limited number of developing countries enter their markets duty free. These arrangements are non-reciprocal as the developing countries benefiting from preferential access do not extend any preferential treatment to imports from developed countries. Examples of such one-way preferential arrangements are:

GATT 1994; Tokyo Round Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries, § 2(a)

- The Generalized System of Preferences (GSP) under which developed countries allow imports from all developing countries of all industrial products, and of selected agricultural products on a preferential and duty-free basis;
- The Lomé Convention under which Member States of the European Union allow imports from a number of developing and least developed countries in Africa, the Caribbean, and Asia and the Pacific (i.e. the ACP countries) to enter on a duty-free basis;
- The Caribbean Basin Initiative, under which the United States allows imports from Caribbean countries on a duty-free basis.

The legal basis for the extension of preferential treatment by developed countries to imports from all developing countries under GSP is provided by the Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries. The Decision was adopted under GATT in 1979 and is commonly known as the General Enabling Clause. There is no definitive legal basis available under the provisions of GATT 1994 for

preferential arrangements like the Lomé Convention and the Caribbean Basin Arrangement, which allow preferential or duty-free access only to the limited number of developing countries with which the developed countries extending preferential treatment have historical or other ties. These arrangements are currently allowed under 'waivers' granted to the preference-giving developed countries from their obligation to extend MFN treatment.

From the legal point of view, these limited preferential arrangements lead to discriminatory treatment of imports from developing countries which do not benefit from the preferences. There are therefore pressures on the preference-giving developed countries to modify them and bring them in conformity with GATT rules.

The current Lomé Convention (Lomé IV) will expire in February 2000. The indications are that the European Union may be able to get a waiver to continue the arrangement in more or less its existing form for an additional period of five years, i.e. up to 2005. Negotiations are now taking place between the European Union and the beneficiary ACP countries on how the Convention can be modified to make it consistent with the provisions of GATT 1994 and the General Enabling Clause.

The waiver granted to the United States to implement the Caribbean Basin Initiative expires at the end of 2005.

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## Fourth rule: national treatment

GATT 1994, Article III

The MFN principle, as has been noted, requires Members not to discriminate among countries. The national treatment principle, which complements the MFN principle, requires that an imported product which has crossed the border after payment of customs duties and other charges should not receive treatment that is less favourable than that extended to the like product produced domestically. In other words, the principle requires member countries to treat imported products on the same footing as similar domestically produced goods. Thus it is not open to a country to levy on an imported product, after it has entered the country on payment of customs duties at the border, internal taxes (such as a sales tax) at rates that are higher than those applied to comparable domestic products. Likewise, regulations affecting the sale and purchase of products in the domestic market cannot be applied more rigorously to imported products.

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## Business implications

The new framework of rules covering agricultural products and textiles which the Uruguay Round has developed will help ensure that GATT's basic rules – against the use of quantitative restrictions and requiring that protection to domestic production is given only through tariffs – are followed in practice by all countries. Exporting enterprises prefer tariffs to quantitative restrictions for many reasons. Tariffs are transparent and their incidence on price is predictable. The use of quantitative restrictions imposes a certain uncertainty on trade, as administering authorities have the power to adjust the sizes of quotas from time to time. Finally, as the operation of quota restrictions requires licensing, enterprises can export only if their foreign buyers are able to obtain a licence.

The Uruguay Round has also resulted in significant progress in tariff binding by all countries. The assurance that, because of the binding, the lower rates agreed in the negotiations will not be raised by countries to which exports are being

made encourages enterprises to invest in manufacturing plants, equipment and distribution networks and to take other measures to develop trade. Furthermore, the bindings give enterprises a guarantee that the tariffs that are payable on the raw materials and inputs which they have to import for use in export production will not be increased by their own governments.

Lastly, the national treatment rule assures exporting enterprises that once their products have entered the importing market after payment of customs duties and other charges payable at the border, they will not be required to pay internal taxes at rates that are higher than those payable on products of domestic origin. The national treatment rule applies not only to internal taxes, but also to the rules governing mandatory standards for products and those applicable to the sale and distribution of goods. As governments are increasingly imposing taxes and adopting product regulations for the protection of the environment and for the health and safety of consumers, the rule that such taxes and regulations should be applied to domestic and imported products on a non-discriminatory basis is of vital importance to exporting enterprises.