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**The Function of the MFN clause**  
**in the Global Trading System**

**Akiko Yanai**

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**INSTITUTE OF DEVELOPING ECONOMIES**

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## I. Introduction

The General Agreement on Tariffs and Trade (GATT)<sup>1</sup> was established in order to substantially reduce tariffs and other trade barriers and to eliminate discriminatory treatment in international trade in general. In fact, the GATT and its successor, the World Trade Organization (WTO), have played key roles in managing the international free-trade system. Non-discrimination is the fundamental principle used to achieve these free trade objectives under the GATT/WTO framework, and this principle is embodied in the unconditional Most Favored Nation (MFN) clause under Article I of the GATT agreement. The WTO has continued to maintain this non-discrimination principle, and unconditional MFN clauses still play an important role in bringing about multilateral trade liberalization.

In recent years, however, there has been a global trend towards forming, or starting consultations on forming, bilateral and regional Free Trade Agreements or Free Trade Areas (FTAs). Article XXIV of the GATT agreement allows for FTAs as one of the exceptions within MFN treatment, because FTAs are expected to complement the WTO liberalization process. But it is a fact that FTAs are by nature reciprocal and preferential. Indeed, it is impossible to ignore that FTAs have the potential to dilute the function of unconditional MFN clauses. Policymakers who are paying attention to FTAs seem to regard FTAs not as exceptions to the unconditional MFN clause, but as an alternative way to promote trade liberalization other than the WTO process. Yet, this proliferation of FTAs or FTA thinking raises an important question: Is there a risk that “exceptions” may eventually outnumber examples of the so-called general rule?

In order to consider the complementary function of FTAs in widening and deepening multilateral liberalization, it will be necessary to examine the nature as well as the function of the principle, namely, unconditional MFN clauses. As such, this paper will look at the evolutionary development of MFN clauses (Chapter II), the incorporation of the reciprocity concept into MFN clauses (Chapter III), and the way in which MFN clauses are used in the multilateral trading system (Chapter IV).

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<sup>1</sup> Though the GATT was not an institution established under a treaty-based instrument like the United Nations but merely a general agreement, it has had an actual secretariat and has functioned as a de facto international institution. In this paper, therefore, the term “the GATT” will be used as an institution and “the GATT agreement” as an international agreement.

## II. The Inceptive Development Process of MFN Clauses

The embryo for MFN treatment can be found in the feudal age – from the eleventh to the thirteenth centuries – as lords granted equivalent concessions to merchants of different foreign cities.<sup>2</sup> The privileges were unilaterally granted by a lord to the citizens outside of his territory, and the favors to be granted were limited to those privileges already granted to others.

After the fifteenth century, the concept of MFN treatment developed together with sovereign states and ideals of equality advocated at the time. As the scope of commerce increased amongst European nations, the use of MFN clauses in bilateral commercial treaties also increased. Until the second half of the seventeenth century, MFN clauses generally obliged the contracting parties to grant each other existing and future concessions given by either party to any nation.

The concept of MFN treatment in modern history, however, differs from the feudal one in three respects (Murase 1974: 58–9). First, modern MFN treatment refers to exchanges between sovereigns, whereas MFN treatment during the Middle Ages was unilaterally conducted by lords. The new mutual feature appeared for the first time in a treaty England and Bourgogne concluded on 1 August 1417. Second, in modern MFN clauses, the definition of third parties was extended from specified to unlimited nations. For example, the provision between England and the cities of Flanders and Brabant (4 August 1446) stated: “Item: que les marchands d’Angleterre ... seront traités aussi doucement et gracieusement comme les autres nations fréquentant ces pays et villes (the merchants of England would be treated as gently and graciously as the other nations visiting to its country and cities)” (Hornbeck 1910: 11). Third, the concessions that would be granted in modern clauses went beyond privileges that existed at the time to include future privileges. A treaty between Great Britain and Sweden, dated 11 April 1654, stipulated that the citizens of each country shall enjoy the same privileges in each country just “as any other foreigner at present doth, or hereafter shall enjoy there” (Hornbeck 1910: 12).<sup>3</sup>

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<sup>2</sup> According to Hornbeck, the first appearance of an MFN clause in written treaties occurred on 8 November 1226, when the Emperor Frederick II conceded to the city of Marseilles the privileges previously granted to the citizens of Pisa and Genoa (Hornbeck 1910: 11).

<sup>3</sup> The terminology was varied in this period. Two examples include the terms “le people de n’importe quell

MFN clauses became widespread throughout Europe from the late seventeenth century to the early eighteenth century, partly because mercantilism – upon which most European nations based their trade policies – meant that trade was promoted in order to develop domestic industry.<sup>4</sup> Each sovereign would conclude preferential treaties with foreign nations to gain market access with more favorable conditions than others. It came to be standard practice to stipulate this preferential treatment as a conventional obligation. However, sovereigns became concerned about future discrimination. Thus, for instance, if Sovereign A (having already entered into a preferential agreement with Sovereign B) sought to obtain the trading benefits that Sovereign B had offered to a third party (subsequent to signing a treaty with Sovereign A), Sovereign A considered it preferable that the benefits that Sovereign A would offer in future to specified third party through another treaty would also apply to Sovereign B.

Even though mercantilist ideas exercised considerable influence on the development of MFN clauses, a more important factor that led to MFN clauses was the formation of the tariff system (Murase 1974: 61–2). During the Middle Ages, feudal domains used various kinds of duties and taxes. As Europe shifted from a social system based on the coexistence of many feudal lords into one of nation states, the new states began to integrate local duties into single tariff systems within their own territories. Because imposing tariffs and regulations on imports was a sovereign right, and because tariffs were necessary to protect industry and gain profits, the sovereigns could unilaterally establish and revise tariffs depending on the circumstances. However, as tariffs were raised by one nation, others retaliated, which led to tariff wars. Eventually, states came to control tariff rates through bilateral agreements, which made it impossible to change rates unilaterally. This led to the creation of a conventional tariff system. This system meant that when a nation revised the tariff rates of a certain agreement it had to modify all other agreements with tariff rates. States also feared overlooking concessions when making treaties. Consequently, alternative MFN clauses were devised that could avoid such repetitions and assure partner states that the benefits

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nation étrangère (the people of any foreign nation)” in the treaty between Great Britain and Denmark of 1660, and “all other strangers” in the treaty between Great Britain and Spain of 1667. The first usage of “la nation la plus favorisée (most-favored-nations)” appeared in the treaty between Denmark and the Hansa in 1692 (Murase 1974: 59).

<sup>4</sup> According to Murase (1974: 60–1), the balance-of-power system in the late seventeenth century supported the mechanism of a MFN clause in the sense of that the relations between nations operated on a system involving equal treatment.

of previous or subsequent concessions made to third states would be also provided to them (United States Tariff Commission 1919: 17).

At the time, MFN clauses functioned to generalize concessions. However, because MFN clauses were inserted in treaties with specific nations, it was not possible to secure non-discrimination in the same sense that operates in the present multilateral trade system. Instead, the clauses often worked as a means to discriminate against nations that had not concluded commercial treaties.

### **III. The Incorporation of Reciprocity into MFN Clauses**

In international relations, reciprocity originally functioned in the privileges and immunities of mission and consular staffs. It was after the mid-eighteenth century that reciprocity became the fundamental principle in international trade. Even though reciprocity can be considered merely as a basis for negotiation – as a guiding beacon for nations to begin the process of dismantling trade protectionism (Winham 1992: 49) – it can also have a more direct and substantial effect on international trade relations when it is inserted into MFN clauses.

#### **III-1. A Conceptual Definition of Reciprocity**

Reciprocity can be defined as a fundamental rule through which plural parties maintain a balance of treatment by means of granting the same or equivalent rights and benefits or undertaking obligations to each other (Yamamoto 1988: 245). A reciprocal relationship can be explained as a balanced condition in which one side gives the other certain treatment while the other returns equivalent treatment (Kuwahara 1975: 417). Keohane (1986: 5) considers reciprocity to have two essential dimensions – contingency and equivalence.

According to Blau (quoted in Keohane 1986: 5), reciprocity implies “actions that are contingent on rewarding reactions from others and that cease when these expected reactions are not forthcoming.” Reciprocal relations require antecedent actions

of one side that induce the other to act in consequent response.<sup>5</sup> The contingent actions, therefore, are inevitably taken in such a way that “good is returned for good, and bad for bad” (Keohane 1986: 8). This produces a “tit for tat” oriented policy, which could lead to a retaliatory relationship if the negative aspect of reciprocity is used excessively.

An equivalence of benefits is emphatically associated with the notion of reciprocity. However, measuring such equivalence is difficult in the context of international relationships. Moreover, equivalence might elicit substantial inequality and unfairness among states because reciprocity entails equal treatment among unequal partners on the basis of the sovereign equality principle.

Reciprocity is often regarded as synonymous with the term “mutual relationship.” However, the two terms are different. First, in reciprocal relationships, only the act of the giving side is voluntary because the act of the recipient is obligatory. In contrast, a “mutual” relationship occurs when both participants give to each other of their own free will. Second, reciprocity includes balance and symmetry between the partners in a bilateral relationship, where one gives and the other returns. On the other hand, a mutual relationship does not necessarily require a balance between the participants (Kuwahara 1975: 416).

According to Smith, reciprocity is roughly categorized into two types – open reciprocity and restrictive reciprocity (Ishikawa 1985: 10–11). Cline (1983) calls them passive and aggressive reciprocity, while Keohane (1986) uses the terms diffuse and specific reciprocity. The notion of the former implies broad coverage and a long-term relationship. The first type – open, passive or diffuse reciprocity – does not demand any direct response to an antecedent action; it merely imposes on the receiving side a certain obligation for repayment in the future.<sup>6</sup> On the other hand, the second type – restrictive, aggressive or specific reciprocity – places great emphasis on a simultaneous exchange of strictly equivalent benefits and/or obligations. The latter is apt to bilateral or limited-extent relationships.

These two notions on reciprocity divide MFN treatment into two types. Specific reciprocity elicits conditional MFN treatment. In contrast, diffuse reciprocity

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<sup>5</sup> These two different actions are clearly distinguished in the GATT vocabulary: an original tariff reduction is a “concession,” while a reciprocal reduction is “compensation” (Dam 1970: 65).

<sup>6</sup> Keohane (1986: 20) notes that “a pattern of diffuse reciprocity can be maintained only by a widespread sense of obligations.”



theoretically supports the GATT doctrine of multilateral and non-discriminatory liberalization, which is meant to be realized through the exchange of unconditional MFN treatment among member states. The distinction between unconditional MFN treatment and conditional MFN treatment can be explained as follows: Under an unconditional MFN clause, a country is prohibited from discriminating against any country with whom it has an agreement. Thus, if Nation A and Nation B agree upon an exchange of concessions based on unconditional MFN treatment, and Nation A then makes new concessions to Nation C, Nation A should also automatically apply these concessions in its dealings with Nation B. If Nation A and Nation B agree upon a conditional MFN clause, however, Nation B can receive those concessions only when Nation B provides Nation A with compensation equivalent to that offered to Nation A by Nation C.

The interpretation of reciprocity changes with the economic and social situation of the times, and has become diversified with varying approaches to trade liberalization.

### **III-2. Emergence of Conditional MFN Clauses**

It was the United States who brought reciprocity into trade policy. After gaining independence, the United States signed the first commercial treaty, in 1778 with France, which contained provisions for reciprocal trade concessions in order to secure a free flow of goods and ships. In the Preamble of the treaty, emphasis was placed on the significance of reciprocity with the phrase that a fair and permanent commercial relationship between the two countries could not be attained without the most perfect equality and reciprocity based on the agreement (Ishikawa 1985: 11).

This principle of reciprocity embodied in the MFN clause of Article II read as follows:

The Most Christian King and the United States engage mutually not to grant any particular favor to other nations in respect of commerce and navigation, which shall not immediately become common to the other party, who shall enjoy the same favor, *freely, if the concession was freely made, or on allowing the same compensation, if the concession was conditional* [Hornbeck's italics].

(Hornbeck 1910: 14)

Under this provision, if the United States made new concessions to any third party, France could receive these concessions only when it provided the United States compensation which would be equivalent to that offered to the United States by the third party.<sup>7</sup> Simply, it was explicitly stipulated that the favors granted to any third party could not be automatically extended between the two initial parties to the MFN clause.<sup>8</sup>

Until this time, the MFN clause customarily used would have had no limitations extending to the other original party concessions later granted to a third state. However, the insertion of a reciprocal principle into MFN treatment by the United States divided MFN clauses into two types: an unconditional MFN clause that extended favors freely and a conditional or “American” clause that required equivalent compensation.

The United States used reciprocity in its commercial policies in order to open up foreign markets and secure equality of opportunity in these markets. In the latter half of the eighteenth century, when the United States won independence, the European Great Powers had ordered international political and economic relations based on models of imperialism and mercantilism. Great Britain and the other European powers had set up preferential trade arrangements with their own colonies, and they discriminated against other countries by imposing high tariffs. Because the United States was a latecomer to world trade and had no colonies, it could only insist upon reciprocal treatment with a conditional MFN clause. Through the MFN clause, the United States was able to gain benefits under which the partner country reduced tariffs on US goods as a reward for US tariff reduction on goods from that country. The US approach of conditional MFN clauses was plainly described in a report of United States Tariff Commission:

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<sup>7</sup> However, the second party (in this case, France) may have the right to demand the favor on allowing the same concessions (Hornbeck 1910: 25).

<sup>8</sup> On the idea of a conditional MFN clause, MFN treatment at the time of concluding an agreement would be secured, while future discrimination would not necessarily be denied. The United States insisted that a conditional MFN clause would not discriminate because it did not exchange MFN treatment without a conditional MFN clause and did not conclude any exclusive arrangements with specified nations. In this sense, the United States treated every nation equally. Hornbeck, in describing this US attitude, suggests that “the opportunity was to be given for each country to purchase for itself such favors as might be granted to others for compensation” (Hornbeck 1910: 25).

By the means of reciprocity treaties, the United States has granted various concessions to certain countries, for compensation, and has accepted concessions from them. This has involved in each case particular reductions from the rates established in the general tariff. In most cases the determination to enter into such agreement has come as a result of unusual circumstances, such as a peculiar geographical factor or peculiar political relations. Having made concessions under special circumstances, or for special compensation, the US has not considered it obligatory or even just to extend the same favors to third states “freely.”

(United States Tariff Commission 1919: 19–20)

This view reflected the principle in the US’s commercial treaty-making policy that attached much importance to “bargaining between individual nations on the basis of reciprocal and progressive giving of favor for favor and concessions for concessions” (United States Tariff Commission 1919: 39).

In 1815, the United States enacted the Reciprocity Act, which included a clause eliminating US discriminatory tariffs in accordance with the principle of reciprocity. The Act was followed by an agreement with Great Britain in the same year to eliminate discriminatory tariffs reciprocally. By around 1830, the United States had also concluded bilateral commercial agreements that contained conditional MFN clauses with most of the Latin American countries. Furthermore, the conditional MFN clause was gradually accepted by the European states, where only the unconditional form had been used previously. Great Britain, for instance, enacted the Reciprocity of Duties Act in 1823, under which it entered into bilateral treaties to provide conditional MFN treatment for both signatories’ exports. Subsequently, the French government also followed the British trade policy of free trade based on reciprocity (Winham 1992: 18). In the period from 1825 to 1860, conditional MFN clauses were frequently adopted in the commercial treaties of the European states, thus superseding the unconditional MFN clause.<sup>9</sup>

The groundwork had been laid for conditional MFN treatment to flower in Europe. While Great Britain had established its position as “factory of the world,” the other European nations were struggling to develop their own domestic industries. Moreover, they did not desire to be integrated in the product system led by Great Britain, but to stand individually. For most European nations, a conditional MFN clause was a

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<sup>9</sup> Three-quarters of the important treaties made between 1826 and 1830 contained a conditional MFN clause. Conditional clauses accounted for more than 90 percent of all MFN clauses in treaties until 1860 (Hornbeck 1910: 49; Murase 1974: 71).

reasonable instrument to protect against the limitless liberalization of their market for foreign goods. Furthermore, as international trade was rapidly increasing, and as US commercial practices began to be influential, the European countries eagerly seized upon the principle of reciprocity, and a whole series of treaties based upon this principle were enacted.

Conditional MFN clauses were devised and spread because they protected the national interests. However, conditional MFN clauses were theoretically based on substantial equivalence; they were intended to treat all states equally. Therefore, conditional MFN clauses required the second party to a treaty to pay compensation in order to gain advantages equivalent to those paid by the third party to gain such advantages. Conditional MFN clauses would no longer act as an instrument to generalize concessions and their function consequently changed.

### **III-3. The Restoration of Unconditional MFN Clauses**

When the conditional MFN emerged, it became the main tool stipulating MFN treatment in commercial treaties. However, this did not mean that unconditional MFN clauses were out of date.

#### ***III-3-(1). Western Europe in the 1860s***

During the 1830s and 1840s, Great Britain unilaterally reduced tariffs on many kinds of goods. Moreover it repealed the Corn Act in 1846 and the Navigation Acts in 1849. This indicated a revolutionary change in Britain's policy from protectionism to liberalism. The French government then followed the British lead (Winham 1992: 18). These changes reflected the shift in the dominant trade theories of the time from mercantilism and protectionism to laissez-faire and free trade. Eventually, Great Britain and France concluded the Cobden-Chevalier Treaty of 1860, which substantially reduced tariffs on some goods and removed prohibitions on exports and imports between the two countries.<sup>10</sup>

In Article XIX of this treaty, Great Britain and France also secured MFN

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<sup>10</sup> According to Winham (1992: 18), this treaty demonstrated that trade agreements could be an effective means of trade liberalization.

treatment without conditions. Both nations viewed the adoption of an unconditional MFN clause to be of mutual benefit. For Great Britain, it was necessary to gain MFN treatment without conditions in order to avoid becoming a less-favored-nation. Because it had unilaterally reduced or eliminated its tariffs already on the basis of its free trade policy, it had nothing further to offer in return for a reduction of tariffs (Laughlin and Willis 1903: 13-4). Under these circumstances, if Great Britain had signed a commercial treaty with a conditional MFN clause, it might have been unable to receive concessions granted to other nations. It was thus inevitable that Britain fiercely insisted that an unconditional MFN clause be included in the treaty. For France, on the other hand, as the industrial revolution had progressed, it had reached a certain level of manufacturing capability whereby it began to export its products aggressively. France came to consider excessively high tariffs as an obstacle to trade and began to prefer liberalism instead of protectionism.

The Cobden-Chevalier Treaty had a great impact on the European nations. Most of the European nations who had commercial policies leaning toward free trade found it would be beneficial to participate in a free trade alliance between Great Britain and France and expressed a preference for concluding commercial treaties that included an unconditional MFN clause.<sup>11</sup> As a result, unconditional MFN clauses became a common practice in European commerce. Indeed, an elaborate system of agreements emerged between several European states,<sup>12</sup> and European trade flourished.<sup>13</sup>

Nevertheless, it was not long before a distinctly new tendency appeared (Laughlin and Willis 1903: 16). After the 1870s, protectionism overwhelmed Europe because of economic depression. In addition, strengthening taxation was considered necessary in order to finance the increasing expenditure on armaments. Consequently, tariff rates grew as a source of revenue.<sup>14</sup> As economic nationalism increased in power

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<sup>11</sup> It has been pointed out, however, that those countries which were most consistently protectionist, such as Russia, favored conditional clauses (Hornbeck 1910: 56).

<sup>12</sup> In the 1860s, the major European powers concluded commercial treaties with unconditional MFN clauses. For example, Italy concluded twenty-four treaties, the German Custom Union had eighteen, Austria-Hungary had fourteen, France had nineteen, and Belgium had twelve (Murase 1974: 84). Despite such circumstances, the United States did maintain a conditional MFN clause. The reason was the tariff system of the United States (United States Tariff Commission 1919: 19).

<sup>13</sup> According to David A. Wells, quoted in Laughlin and Willis (1903: 6, 16), the commerce of Austria, Belgium, France, Holland, Italy, and Great Britain grew by more than 100 percent between 1860 and 1873, while the trade of these countries with nations that had not entered into reciprocity treaties increased only by about 60 percent.

<sup>14</sup> In 1879, Chancellor Otto von Bismarck laid down new tariff legislation that significantly increased tariff rates, a move which was quickly followed by the other major powers.

after World War I (1914–17) and the Great Depression started in 1929, a head wind started to blow against free-trade. During this period, by imposing high tariffs and other trade barriers to protect their own industries, major countries such as Great Britain and France built economic blocs with their autonomous territories and colonies. With the establishment of this preferential treatment system, these countries were able to discriminate against non-allied states. This economic-bloc trade-system, and the associated currency devaluation, began a chain of events that resulted in a substantial reduction in world trade, and prolonged and deepened the Great Depression of the 1930s. Under these circumstances, however, the United States changed its attitude toward trade policy and started to conclude bilateral treaties that included unconditional MFN clauses.

### *III-3-(2). The US Bilateral Trade Agreements in the 1930s–1940s*

Until 1934, protectionism was also dominant in the United States. It had developed its protectionist policies by means of so-called “reciprocity provisions” in the Tariff Acts and conditional MFN clauses in bilateral trade agreements. Most of the Tariff Acts from 1890 to 1930 contained reciprocity provisions,<sup>15</sup> which gave the president the authority to impose duties on certain products when foreign governments were “reciprocally unjust or unreasonable,” or in other words when they discriminated against US products. These provisions emphasized a retaliatory aspect of reciprocity that “bad is returned for bad.” The Smoot-Hawley Tariff of 1930 was regarded as a typical Act based not on “reciprocity but retaliation” (Gilligan 1997: 68).

However, the enactment of the Reciprocity Trade Agreements Act (RTAA) in 1934 suggested that the United States was returning to a trade policy based on liberalism.<sup>16</sup> The RTAA was based on the recognition that flourishing international trade was vital to domestic prosperity (Tasca 1938: 39),<sup>17</sup> and the RTAA endorsed the adoption of unconditional MFN clauses. It was the administration of Franklin D. Roosevelt that was able to realize this revolutionary shift, but the path towards trade liberalization was by no means easy.<sup>18</sup> Not only the Congress, which mainly

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<sup>15</sup> For instance, the McKinley Act of 1890 and the Dingley Act of 1897: see Gilligan 1997: 62–70.

<sup>16</sup> The RTAA was legislated as the amendment to the Smoot-Hawley Tariff of 1930.

<sup>17</sup> It is generally accepted that the RTAA was the first piece of legislation in US tariff history to advance such a thesis (Tasca 1938: 39).

<sup>18</sup> For details, see Tasca 1938: 10-28.

represented domestic industry, but also the administration, including President Roosevelt himself, were far from great promoters of free trade (Cilligan 1997: 70). It was Secretary of State Cordell Hull who constantly emphasized that commercial policies of all nations should be liberalized. Making the world trade system more open and free was considered a necessary step to suppress economic nationalism and prevent military conflict, both of which were on the rise.<sup>19</sup> The Roosevelt administration assigned the task of reconsidering the trade policy of the United States to the Tariff Commission, and the commission stated in its report that a conditional MFN clause would bring discriminatory reciprocity. As such, the commission suggested that commercial policy should be changed to be nondiscriminatory and that reciprocity should be compatible with unconditional MFN clauses. This idea would be eventually developed in the RTAA.

In accordance with the RTAA, the United States concluded bilateral trade agreements with twenty-seven countries from 1934 to 1945.<sup>20</sup> Each agreement contained a reciprocal exchange of tariff reductions and an unconditional MFN clause. It is significant that the RTAA did not depend on specific reciprocity, even though it aimed at reducing tariffs and other trade barriers by bilateral negotiations. Instead, the RTAA relied on diffuse reciprocity. The United States made this change partly because the conditional MFN policy brought about a never-ending negotiation of bargains.

However, the adoption of unconditional MFN treatment was not based upon principles of nondiscrimination such as those of GATT; rather, it was based on the belief that it would maximize the benefits to the United States in return for the US opening its market to foreign nations. The unconditional MFN clause promoted by the US was a measure to reduce the tariff rates of trade partners. Unconditional MFN clauses in bilateral trade agreements under the RTAA were not aimed at securing non-discriminative treatment for all trade partners, but were aimed instead at expanding the export of US goods and services.

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<sup>19</sup> The United States turned the corner towards protectionism with Smoot-Hawley Tariff of 1930, which raised US tariff rates steeply. This triggered a series of discriminative bloc-making. In 1931, for instance, the German-Austrian Custom Union was established, and preferential tariff treatment was applied among members of the British Commonwealth after the Ottawa Conference held in 1932.

<sup>20</sup> The contracting partner of the bilateral agreements were: Argentina, Brazil, the Belgo-Luxemburg Economic Union, Canada, Colombia, Costa Rica, Cuba, Ecuador, El Salvador, Finland, France, Great Britain and Northern Ireland, Guatemala, Haiti, Honduras, Iceland, Mexico, Netherlands, Nicaragua, Peru, Sweden, Switzerland, Turkey, Uruguay, and Venezuela.

The progress of bilateral negotiations under the RTAA, however, was extremely slow and very limited. Four years after the RTAA legislation, Tasca (1938: 97) highlighted several factors that impeded the operation of US commercial policy based on reciprocal trade agreements:

- 1) the tremendous amount of research necessary and the caution and care exercised by the administration
- 2) the influence exerted by tariff pressure groups (although this was probably much less effective than previously)
- 3) the basic analysis which foreign countries found necessary to undertake before concluding trade agreements with the United States
- 4) the need to reconcile basic foreign commercial policies when they differed to any important degree from US policy

Despite these warnings, the use of bilateral negotiations for reciprocal trade agreements continued until the end of World War II. However, the view that “these defects could be remedied by negotiating within a multilateral framework” (Dam 1970: 61) gradually came to dominant within the US government, and after the war, the United States came to rely on multilateralism.

#### **IV. MFN Clauses in the Multilateral Trade System**

The GATT was established in order to proscribe the discriminatory trade treatment which had caused international trade to develop into economic blocs. The GATT, therefore, emphasized the principle of non-discrimination in trade. This principle was further divided into two parts: external non-discrimination prescribed in Article I and internal non-discrimination prescribed in Article III.<sup>21</sup> Article I stated that “any advantage, favor, privilege or immunity granted to one contracting party should be immediately and unconditionally applied to all other contracting parties.” This exactly matches the terms of unconditional MFN clauses and proscribes bilateral tariff preferences.<sup>22</sup>

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<sup>21</sup> Article III deals with the regulation of foreign products, indicating that, once they are imported and tariffs are paid, they should be treated on equal terms with domestic products in respect to taxes and other requirements. In other words, Article III enforces the National Treatment rule.

<sup>22</sup> This obligation is subject to a number of exceptions under the Agreement, such as the provision that certain



On the other hand, as the GATT superseded a series of reciprocal bilateral trade agreements,<sup>23</sup> it was inevitably based on the principle of reciprocity.<sup>24</sup> Even though most such trade agreements, especially those concluded between European states, contained a conditional MFN clause, these clauses were not incorporated into the GATT agreement. The reason for this is because the United States took the initiative in trade negotiations during World War II and its aftermath (Milner 1997: 138). As the United States advocated non-discrimination and diffuse reciprocity during this period, unconditional MFN treatment became a principal measure for trade liberalization under the GATT.

However, the first task of making unconditional MFN treatment operate in a multilateral trade system, as opposed to more straightforward bilateral relationships, led to various problems.

#### **IV-1. The Free-Rider Problem**

First, there was a problem with free riding. In the GATT agreements, the unconditional MFN clause prescribes that any bilateral agreement should be applied to other member states. This implies that states signing the GATT could take advantage of benefits without any binding agreement with others.

The free-rider issue originates from the contradiction between the two core principles of the GATT – non-discrimination and reciprocity.<sup>25</sup> Concessions such as reducing tariffs and eliminating non-tariff measures, which are provided unconditionally by a MFN clause, are not reciprocal but unilateral. That is, the side that makes these

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preferential trading arrangements in existence at the time GATT was implemented are allowed to continue. Another important exception to the MFN provision of Article I is the exception in Article XXIV for customs unions and free trade areas. Further exceptions are available to developing countries under GATT/WTO (Davidson 1997: 42-3).

<sup>23</sup> The 1942 agreement between the United States and Mexico is generally described as the model for the initial draft of the GATT agreement that was submitted by the United States in 1946 (Hudec 1987: 7).

<sup>24</sup> In the preamble to the GATT agreement and Article XXVIII- bis emphasis is on the need for negotiations to take place on a reciprocal and mutually advantageous basis directed toward the substantial reduction of tariffs. Though reciprocity was not defined in the GATT, the director-general of the GATT defined it as “the equivalence of concessions” (Keohane 1986: 8).

<sup>25</sup> Another possible reason for free riding was that the early GATT tariff negotiations were multilateral only in name. In reality, they were bilaterally negotiated between the principal supplier states and principal consumer states based on reciprocity. The results of such negotiations were given to all the contracting parties of the GATT on an unconditional MFN basis, and the strict application of an unconditional MFN clause inevitably induced free riding (Winham 1992: 53).

concessions cannot necessarily expect a return from the other side. Therefore, the principle of non-discrimination embodied in unconditional MFN clauses contradicts the principle of reciprocity, which is described as one side giving to the other and the other making an equivalent response.

However, this contradiction was resolved by the use of “diffuse reciprocity” because of its tolerance of equivalency. It is considered enough, based on diffuse reciprocity, if one side provides unconditional MFN treatment and the other side responds with a commitment to unconditional MFN treatment. The kinds of benefits exchanged in an unconditional MFN clause are unimportant. The United States, who played a leading role in the negotiations, tolerated free riding at first because the costs of coercion and policing against free riding outweighed the benefits that would come from more stringent enforcement (Krasner 1987: 1).

As member states increased, however, the negotiations became more complicated. Complaints about free riding were raised by some states who were required to reduce tariffs after negotiations. In addition, the United States itself could no longer permit free riding because it had to tackle economic stagnation at home and loss of hegemony abroad.

Two measures were thinkable to resolve this free riding problem: the first was to renounce unconditional MFN treatment; the second was to restrict the application of reciprocity by altering GATT procedures. The GATT could not modify its fundamental principle of non-discrimination, so it tried to minimize the cost of unconditional MFN treatment by changing operational procedures. After the Kennedy Round (1964–7), the GATT introduced a “package deal” into the decision-making process that effectively excluded free riders. The GATT not only obliged all the member states to participate in consensus building, but also decided to deal with the whole problem as an integrated package.

#### **IV-2. Departing from the Non-Discrimination Principle**

Free riding, as mentioned above, was the first dilemma which resulted from the decision to make unconditional MFN treatment function in multilateral relations; it was solved by the modification of the GATT’s operational procedures. Other problems regarding

unconditional MFN treatment, however, had an even greater impact upon the nondiscrimination principle, which became apparent with the departure from the principle of unconditional MFN treatment.

#### ***IV-2-(1). Introducing the GSP***

The Generalized System of Preferences (GSP), which was incorporated in the GATT system in 1971, enabled developing countries to enjoy tariff preferences from industrialized countries on a non-reciprocal basis. This scheme was devised in order for developing countries to strengthen their economies by exporting their goods to industrialized countries, which seemed to help increase their competitiveness in the world market.

In the late 1950s, owing to their failure to improve export performances, developing countries began to question whether the liberalism of the GATT system was an appropriate guiding principle for economic development. Most of these countries changed their industrial policies from import substituting industrialization to export orientation. In order to secure markets for exports, developing countries began to demand that developed countries open their markets unilaterally. At the same time, they criticized the strict application of reciprocity at the GATT because it was extremely difficult for states at different stages of economic development to obtain the same level of concessions. Therefore, they insisted on “special and differential treatment,” as well as exceptions to reciprocity.

Following protracted negotiations, the special and differential treatment embodied in the additional Part IV was approved at the Kennedy Round (1964–5) of negotiations. Article XXXVI-(8), which set up forth exceptions to reciprocity, stated that “the developed contracting parties *do not expect reciprocity for commitments* made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less-developed contracting parties [italics added].”

In 1971, the GSP started in the GATT system<sup>26</sup> as a temporary waiver of unconditional MFN obligations with a ten-year-limitation.<sup>27</sup> Despite the preference for

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<sup>26</sup> Establishment of GSP in the GATT system as well as addition of part IV into GATT agreement owed to aggressive activity by developing countries in the United Nations Conference on Trade and Development (UNCTAD), which preceded the GATT in adopting a framework of GSP in 1968. See Kasahara, 2001.

<sup>27</sup> In the Tokyo Round (1973–9), an “Enabling Clause” was adopted which made the 1971 waivers permanent on the one hand and provided a so-called “graduation mechanism” on the other.

the GSP to be granted voluntarily and unilaterally, many industrialized countries enacted the GSP program separately in the 1970s. For example, the European Community started to implement its GSP program in 1971, while the United States enacted its Trade Act in 1974.

The effect of the GSP was greater than the effect caused by the addition of Part IV, even though both were necessary from the standpoint of the developing countries. The “special and differential” treatment in the GATT agreement was subsumed under the changed concept of reciprocity, that is, the concept of “relative reciprocity,” which accepted divergence when measuring equivalence of benefits. In this sense, the addition of Part IV did not erode unconditional MFN treatment. On the other hand, the establishment of the GSP required an amendment to the fundamental principle of non-discrimination, and it resulted in the addition of a new exemption to MFN obligations. Yet, the departure from unconditional MFN treatment could be excused because the GSP could help the growth of developing countries.

#### ***IV-2-(2). Multilateral Codes***

At the Tokyo Round (1973–9) of GATT negotiations, the main agenda, in addition to tariff reduction, included non-tariff measures (NTBs) which covered sectors such as government procurement, customs valuation, and standards. Even though a series of multilateral agreements on NTBs, so-called “Codes,” were adopted as a result of the Tokyo Round, these Codes were separated from the GATT agreement. Participation in these Codes was optional and the Codes only applied to those countries who chose to sign. Most developing countries abstained from signing from the Codes, while each Code had a separate signatory that made the system complicated.

This approach was taken because of the attitude held by the United States. The US recognized that it could not obtain all the expected benefits by non-discriminatory liberalization based on diffuse reciprocity and, therefore, it began to put more emphasis on alternative approaches based on specific reciprocity. As such, within the framework of the GATT, the United States advocated the utilization of the multilateral agreement at the Tokyo Round; at the same time, it made use of bilateral negotiations outside the context of the GATT.

It became doubtful whether such an approach would be consistent with

unconditional MFN obligations. Directly after the Tokyo Round, the GATT members reaffirmed that the Codes did not affect unconditional MFN treatment under Article I, which implicitly showed a latent breach of the GATT agreement. Jackson (1983) discusses the issue of consistency between the NTB Codes and the non-discrimination principle, stating that the signatories of the Codes should extend the benefits under the Codes to non-signatories. However, in reality, only those signatories undertaking the disciplines of the Codes would enjoy the benefits. Though Cline (1982: 19) states that it was ambiguous whether even these Codes departed from unconditional MFN treatment, the NTB Codes of the Tokyo Round were a de facto exemption from MFN treatment. As Hafbauer, Erb and Starr (1980: 66) comment, it is not the unconditional but “the conditional MFN concept [which] plays an important role in the disciplinary framework established in the Tokyo Round.”

The GATT does indeed tolerate some kinds of deviations from the MFN principle; however, as Baldwin (2000: 23) mentions, “all such deviations are subject to disciplines designed to ensure that the primary intent of the preferential liberalization is liberalization rather than preference.” It is necessary to reconsider whether these deviations form preferential relations that erode unconditional MFN obligations.

Like the free rider problem, these deviations also stem from the controversial nature of the two GATT principles, that is, non-discrimination and reciprocity. The non-discrimination principle has been established as a substantial regulation of international law, while reciprocity is the guiding principle of negotiation. The former inevitably leads to unconditional MFN treatment that does not necessarily require the equivalence of benefits. In contrast, for the latter principle, equivalence is an essential characteristic, even though the extent of equivalency can be flexible, as illustrated in diffuse reciprocity or relative reciprocity.

Agreements on exchange concessions such as reducing tariffs and eliminating non-tariff measures are reached as a result of negotiation, and all such agreement-making processes are governed by reciprocity. However, once the agreements are concluded, the concessions are automatically multilateralized through an unconditional MFN clause on a non-reciprocal basis. It is inevitable, therefore, that an incongruity exists in the practice of unconditional MFN clauses.

## **V. Concluding Remarks**

An historical examination of MFN clauses suggests that their birth was the product of necessity – the need to avoid troublesome and repetitive procedures by applying the same conditions to all trade partners. Early MFN clauses functioned as instruments to generalize concessions, while present-day clauses work as means to actualize non-discrimination.

A new form of MFN treatment – the conditional MFN clause – developed when MFN practices were united with the concept of reciprocity. After they emerged, conditional and unconditional clauses alternated as the most widely used MFN clause.

Conditional MFN clauses were effective for obtaining foreign market access while protecting domestic industries. On the other hand, unconditional clauses were potentially useful for maintaining an open and free world trading system. Interestingly, the dominant nations in world trade have tended to prefer unconditional MFN clauses: the two most obvious examples being Great Britain during its Pax Britannica period and the United States during Pax Americana.

In the GATT-based multilateral trade system, non-discrimination was adopted as a fundamental principle. Unconditional MFN clauses were considered to be an effective measure for applying this principle to actual trade practices. In this sense, unconditional MFN clauses differ from the unconditional clause that was employed by the United States in its bilateral trade agreements in the prewar period. At that time, the United States utilized an unconditional MFN clause as a tool to open its trade partners' markets so that it could expand its exports. Thus, the United States used the clause as a countermeasure against the other major nations, who had tended to enclose their economies within the walls of preferential or imperial trading blocs.

In putting an unconditional MFN clause into operation under the GATT, several difficulties were encountered, difficulties that resulted, in part, from the controversial nature of the two GATT principles, non-discrimination and reciprocity. Because trade policy is essentially a tool used to pursue national interests, trade liberalization is often conducted through not unilateral action but reciprocal bargaining in order to gain maximum benefits. One nation lowers its trade impediments with the expectation that the other will make a consequent and equivalent response, because contingency and

equivalence are indispensable aspects of reciprocity. However, in the GATT system, such reciprocal concessions should be automatically multilateralized through unconditional MFN clauses.

When bilateral relations governed the world trade system, an MFN clause, even in an unconditional form, could be compatible with reciprocity. This was because the decision of whether to grant unconditional MFN treatment to some nation could be made case-by-case. However, in the multilateral trade system, it has become problematic to pursue MFN treatment and trade liberalization through reciprocal bargaining at the same time. Consequently, the road to reciprocity under the GATT/WTO system could take one of two directions: first, it could move in a multilateral direction with conditional MFN treatment, such as the NTB Codes used in the Tokyo Round; or second, it could take a bilateral direction that would allow for exceptions, such as FTAs, from unconditional MFN obligations. These deviations from the unconditional MFN principle might be explained as a return to outright “reciprocal” trade liberalization.

However, such departures should not necessarily be met with disapproval or condemnation. Some of these options could become stepping-stones for accelerating trade liberalization, and the others, for example the GSP, could promote the exports of developing countries. It will be necessary to examine whether such exceptions and departures from unconditional MFN treatment will lead to more trade liberalization or trade-creating possibilities in the future.

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