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# RESEARCH Paper

## The Most Favoured-Nation provision in the EC/EAC Economic Partnership Agreement and its implications:

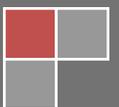
Agriculture and Development

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## 1.0 Introduction:

- 1.1 The Cotonou Agreement between the African Caribbean and Pacific (ACP) countries and the European Community member states (EC) signed in June 2000 (“the Cotonou Agreement”) provided the framework for new economic and trade cooperation between the parties. It was intended to establish a relationship that was *inter alia* compatible with the World Trade Organisation (WTO) provisions, where the parties are members. The Economic Partnership agreement (EPA) between the EC and the East African Community (EAC) (this agreement will henceforth be referred as “the EC/EAC EPA”) that is currently being negotiated and of which an interim agreement has been initialled is a result of this process.
- 1.2 Parties to a Free Trade Agreement (FTA) may decide to include a most favoured nation (MFN) clause in their agreement; this ensures that either party is able to benefit from better terms entered into by the other party with third parties. In the EPAs context the MFN Clause has its roots in the Cotonou Agreement, which provides for an MFN extension in favour of EC in the event that the ACP countries grant more favourable treatment to other developed States.
- 1.3 The MFN principle evolved from the early days of international trade where it was usually applied on a bilateral basis. An early example is the 1794 Jay Treaty, in which the United States granted MFN trading status to Britain and vice versa. The General Agreement on Tariffs and Trade (GATT), which eventually evolved into the WTO, requires members to extend MFN status across the board to all other members.
- 1.4 Generally, the MFN principle obliges a country to grant to the MFN beneficiary all trade advantages such as low tariffs that any other nation receives from it. In other words, the MFN principle obliges country A to grant to country B all trade advantages that country A currently extends and will extend in the future to any other country. The party with MFN status (in our example, country B) will not be treated worse than any other nation. Use of the unconditional MFN clause in a number of the European bilateral treaties, during the latter half of the eighteenth century, is credited for promoting a multilateral trading system. Among the advantages of the MFN principle is that it protects the value of concessions received from future erosion, since any subsequent preferences entered into with third parties are automatically extended to the original parties as well.

- 1.5 The MFN Clause in the EC/EAC EPA requires the EAC countries to extend to the EC any more favourable treatment that EAC countries may grant to developed and major developing economies other than the EC. Specifically, under Article 16(2) of the EC/EAC EPA, EAC countries are obliged to accord to the EC any more favourable treatment resulting from an economic integration agreement with any major trading “economy”. Conversely, under Article 16(1), the EC is obliged to accord to the EAC countries any more favourable treatment contained in an economic integration agreement between the EC and third Parties, with respect to the trade regime for goods.
- 1.6 The term “major trading economy” covers all developed countries, and any country accounting for a share of the world trade merchandise exports above 1 percent, or any group of countries acting individually, collectively or through an economic integration system accounting for a share of merchandise exports above 1.5 percent. To determine whether these numerical thresholds have been reached, the EC/EAC EPA stipulates that official WTO data on leading exporters in world merchandise be used. However, trade agreements between the EAC with ACP countries or other African countries and regions are excluded from this definition. With respect to these countries, there is therefore no obligation for the EAC countries to extend to the EC any more favourable treatment that may be agreed, even if the relevant numerical threshold has been reached.
- 1.7 Article I of the GATT 1994, provides for the most favoured nation principle (MFN) for goods trade. It provides that any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded to the like products originating in or destined for the territories of all other parties.<sup>1</sup> The object and purpose of this provision, as was explained by the Appellate Body in the *Canada - Autos*, is to prohibit discrimination among like products originating in or destined for different countries. Article I further serves as a mechanism that automatically extends concessions negotiated reciprocally to all other members on an MFN basis.
- 1.8 There are exceptions to the MFN principle in the area of goods trade. These include among others: the imposition of anti-dumping and countervailing duties under Article VI of the GATT, the Anti-Dumping Agreement, and the Agreement on Subsidies and Countervailing Measures (“the SCM Agreement”); the formation free trade agreements and customs unions-Article XXIV of the GATT 1994 (including interim versions of such agreements); The Decision on differential and more favourable treatment reciprocity and fuller participation of developing countries (also referred to as the “Enabling Clause”); and the waiver on preferential treatment for least-developed countries (LDCs). The EC/EAC EPA is yet to be notified to the

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<sup>1</sup> GATT 1994 Article I.

WTO. Given the preferences enshrined therein, it is envisaged that it will be notified under Article XXIV as a free trade area (FTA) or, alternatively, as an interim agreement leading to the formation of an FTA, depending at what stage the negotiations will be when the agreement is notified.

## 2.0 Overview of the MFN Provision in other Free Trade Agreements:

- 2.1 An overview of other free trade agreements (FTA) indicates that the MFN clause is typically applied with regard to the investment provisions. However, an MFN clause may also be stipulated for other matters. Below are some of the provisions on MFN status in selected FTAs.
- 2.2 Under the **Canada-Chile FTA**, the parties undertake to accord investors and investments treatment no less favourable than that they accord, in like circumstances, to investors of any non-party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments. This implies that the treatment accorded to non-parties both at the time of conclusion of the FTA and at any point in future shall be no less favourable than that applied to investors and investments of the parties to the FTA.
- 2.3 The **North American Free Trade Agreement** (NAFTA) between Canada, Mexico, and the United States includes a similar provision in Article 1103. NAFTA further provides for MFN treatment of service providers, as well as of financial institutions. Article 1103 provides that each party shall accord to investors of another party, financial institutions of another party, investments of investors in financial institutions and cross-border financial service providers of another party, treatment no less favourable than that it accords to the investors, financial institutions, investments in financial institutions and cross-border financial service providers of any other NAFTA party or of any non-NAFTA country in like circumstances.
- 2.4 The **US-Australia FTA** applies the MFN principle in the context of applied customs duties. It provides that, in the event that safeguard measures are introduced, the applied rate shall not exceed the MFN applied rate.

2.5 FTAs involving the EC typically do not include an MFN clause. An example is the **EC – Mexico** agreement. However, some EC agreements do include an MFN clause, for instance, the **EC – Chile** agreement. Here, the MFN clause is specific to the price band system<sup>2</sup> applied by Chile to control the importation of certain products into its territory. Article 61.2 obliges Chile to ensure that its price band system for certain imports does not afford more favourable treatment than it grants to the EC to imports of any third country, including countries with which Chile has concluded or will conclude in the future an agreement notified under Article XXIV of the GATT 1994. This implies that any benefit Chile would give under its price band system must automatically be extended to the EC. The inclusion of the specific MFN clause seems to have been due to the broad reach of Chile’s price band system, applied to manage the importation of an important number of products

### **3.0 The MFN provision in other Economic Partnership Agreements:**

3.1 All EPAs currently being negotiated, as well as the already finalized CARIFORAM, contain a similar MFN clause. All these MFN clauses contain the following elements:

3.1.1 The EC will accord to the ACP parties any more favourable treatment that the EC grants to third parties with which it concludes an economic integration agreement

3.1.2 Conversely, ACP parties are also to accord the EC any more favourable treatment resulting from an economic integration agreement concluded by the ACP countries with any “major trading economy”.

3.1.3 The requirement does not extend to economic integration agreements existing on the date of signature of the agreement.

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<sup>2</sup> Chile's Price Band System is governed by Rules on the Importation of Goods through which the

tariff rate for products at issue could be adjusted to international price developments if the price fell below a lower price band or rose beyond an upper price band.

3.1.4 Furthermore, ACP countries are not required to extend MFN status to the EC with respect to agreements between themselves, or other African countries and regions.

3.1.5 “Major trading economies” are defined as developed countries, or any other country accounting for a share of world merchandise exports above 1 percent, or any group of countries acting individually, collectively or through an economic integration agreement accounting collectively for a share of world merchandise exports above 1.5 percent. The two numerical thresholds of 1 and 1.5 percent relate to the calendar year before the entry into force of the EPA at issue.

3.2 Official data on leading exporters in world merchandise, published by the WTO, shall be used in the calculation of the major trading economies. Pursuant to 2007 statistics, the major trading economies that exceed the 1 percent threshold are as indicated below;

<b>Exporter</b>	<b>Share of world merchandise</b>
Korea	2.7
Russia	2.5
China	2.5
Singapore	2.1
Mexico	2.0
Saudi Arabia	1.7
Malaysia	1.3
United Arab Emirates	1.2
Brazil	1.2
Thailand	1.1

3.3 In case of the EAC member states statistics indicate that imports from “major trading economies” are on the increase. Therefore, any greater trade preferences that may in the future be agreed upon with these countries will trigger the EPA MFN provision. This means that these greater preferences will have to be automatically extended to the EC. Below are the imports from some of the major trading economies over a three year period;

<b>EAC Imports from Major Trading Economies (Amounts are in US \$)</b>			
<b>Country/Period</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
China	791,486	1,044,245	1,621,065
ASEAN	557,829	1,112,495	1,350,517
Brazil	57,944	64,869	93,030
India	658,929	1,005,185	1,731,895

#### **4.0 The EPA MFN Provision VS the Enabling Clause:**

4.1 The Enabling Clause permits derogation from the MFN principle allowing developing countries to enter into regional trade agreements among themselves; under paragraph 2(c) it relevantly provides that regional or global arrangements may be entered into amongst less-developed contracting parties for the reduction or elimination of tariffs and, for the mutual reduction or elimination of non-tariff measures, on products imported from one another, without according such treatment to other contracting parties.

4.2 The question is whether the above provision is in indeed an alternative legal basis for the formation of an FTA among developing countries and, hence whether the MFN clause as included in the EPAs effectively takes away this right from the developing countries that are categorised as “major economies” since any better preferences extended to them would have to be extended to the EC as well. This issue was raised by Brazil at the WTO General Council meeting of February 2008 and discussed in some detail by WTO Members.

- 4.3 Brazil, a country falling within the “major economies” category raised concerns with the inclusion of the MFN clause in the EPAs; it argued that the migration of trade preferences from schemes authorized under waivers to FTAs such as the EPA posed some questions and challenges, both to the ACP countries and to the broader WTO membership. Of particular concern to Brazil is the provision that obliges the ACP countries to extend to EC, any treatment they may negotiate with third parties. That if that clause remained in the EPAs, it would be turning the Enabling Clause upside down, since its main objective was to enhance trade among developing countries on a preferential basis as spelt out in paragraph 2(c).<sup>3</sup>
- 4.4 Brazil further argued that the process that had led to the adoption of the Enabling Clause had been very long and difficult and that such a painstakingly negotiated avenue to developing countries, that had since then been the basis for a number of agreements and schemes, constituting one of the pillars of the multilateral trading system should not be undermined. That in effect, the conditions the EC enjoyed in the market of the ACP countries would be the ceiling for access in those markets, as those countries would have to take into account the competitiveness of the EC’s industry when negotiating with other developing countries; thus, south-south trade would be seriously impacted by this measure.<sup>4</sup>
- 4.5 Brazil also noted that this position in the EPAs came at a time when there is a major expansion of south-south trade and therefore prospects for promoting further growth through initiatives like the negotiation of FTAs; the extension by some developing countries of duty-free quota-free market access to LDCs and the current round of negotiations in UNCTAD of the Global System of Trade Preferences (GSTP) among developing countries. The inclusion of the MFN clauses in the EPAs had the potential to undermine these initiatives and to create constraints to the development of south-south trade and this would not help the integration of developing countries into the world trading system, one of the central objectives of the Doha Round and the EPAs themselves. As a developing country that had seen its trade with other developing countries grow significantly to the point that south-south trade represented 55 percent of Brazil’s total trade- Brazil had not only systemic and legal concerns with the MFN clauses in the EPAs but also very concrete objections to those clauses.<sup>5</sup>

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<sup>3</sup> See the Communication from Brazil to the WTO General Council meeting of February 2008 WT/GC/W/585; included in the minutes WT/GC/M/113 available at [www.wto.org](http://www.wto.org)

<sup>4</sup> Ibid

<sup>5</sup> Ibid

- 4.6 Argentina also supported Brazil's arguments pointing out that the inclusion of such clauses as the MFN provision in the EPAs were inconsistent with the Enabling Clause, whose objective was precisely to enable the granting of differential and more favourable treatment to developing countries. It was designed "to facilitate and promote the trade of developing countries", as stated in its paragraph 3(a), and stipulated that developed countries would refrain from demanding reciprocity regarding concessions accorded, and from prescribing conditions incompatible with the pursuits of these objectives. The MFN clauses made it difficult to reconcile them with the development objectives of the Enabling Clause, which were ultimately the same as those being pursued in the Doha Round negotiations.<sup>6</sup>
- 4.7 In the same forum, India and China shared the concerns raised by Brazil. It was noted that the implications of an MFN provision in the EPAs, on the meaning and intent of the Enabling Clause would need to be carefully assessed, since it was an important pillar of the multilateral trading system and the WTO acquis and which Members could not allow to be undermined in any way. They emphasised that no clause in the new agreements should undermine the objective and principles laid down in the Enabling Clause.<sup>7</sup>
- 4.8 The observations made by South Africa, a party to the EPAs are worth noting; first that the MFN clause attempted to lock in ACP Members to the EC market by creating a disincentive for any other bilateral relationship that sought to build deeper trading relationships, in particular with countries that enjoyed more than one per cent of world trade. For South Africa, this would prejudice its bilateral relationships with the major emerging economies in the south, including India, China and Brazil. For many developing countries too, the new opportunities in the world economy to diversify their trading relationships and enhance their development with other developed countries and new emerging developing-countries markets could be affected negatively. Secondly, for many ACP countries, building south-south relationships, especially in regional context, were crucial to their development process-even more so than the EC regional integration process.<sup>8</sup>
- 4.9 EC responded to the issues raised above by stating that the EPAs were FTAs with asymmetrical liberalization that had utilized the flexibility in WTO rules to allow all ACP economies to adjust to

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<sup>6</sup> Submission by Argentina at the WTO General Council Meeting of 5-6 February 2008, as summarized in WT/GC/M/113 paragraph 101. Available at [www.wto.org](http://www.wto.org).

<sup>7</sup> Ibid para 103 and 107

<sup>8</sup> Ibid para 109

liberalization. It had opened its market to full duty-free quota-free imports- the most generous offer in the history of trade agreements. Inclusion of the MFN clauses in the EPAs was in line with Article XXIV of GATT and the reasoning behind them was not new since others had signed trade agreements which included similar provisions. The MFN clauses in the EPAs are limited in scope and concerned only future FTAs that might be concluded by EPA parties with third countries considered “major trading economies”- i.e. countries directly competing with the EC and would have no negative impact on overall south-south trade. Further the EC would grant ACP partners more favourable treatment arising from subsequent agreements it concluded with any third parties, while the ACP partners would only have to extend to the EC any more favourable treatment granted to “major trading economies” with whom they entered into an FTA. That well as the Enabling Clause permitted for preferential arrangements among developing countries, it did not prohibit the extension of the preferences to other Members, in conformity with other WTO rules.<sup>9</sup>

## 5.0 Specific Implications of the MFN Provision in the EPAs:

5.1 The MFN provision as included in the EC/EAC EPA implies that, any better preferences extended by EAC to a “major trading economy” would have to be extended to EC, well as the EC would extend any better preferences that it negotiates with third parties, to EAC; however since the EC market access offer under the goods regime is duty-free quota free, better preferences are not envisaged. On the EAC part this means that for example any better preferences it extends to a country like Brazil to export certain goods such as cars to its market free of tariffs, would equally apply to car imports from the EC, in its market. This means that a “major trading economy” Brazil would not have preferential treatment of its goods in the EAC market over the EC.

5.2 The above scenario is the bone of contention over the MFN clause, with the “major trading economies” arguing that it contravenes the Enabling Clause, well as the EC argues that this is not the case - see discussion above. Whether or not the provision contravenes the Enabling Clause is debatable<sup>10</sup>, what is

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<sup>9</sup> Ibid

<sup>10</sup> A counter-argument would be that paragraph 2 (c) of the Enabling Clause applies to ‘regional’ – like an FTA, or ‘global’ - like GSTP, arrangements amongst developing countries and not bilateral preferences amongst them.

clear is that EC seeks to prevent a competitive advantage over its products in the ACP market, from the “major developing economies”<sup>11</sup>.

5.3 From the foregoing, the issue with the MFN clause in the EPAs, is that it may slow down south-south trade since the “major trading economies” may not find any incentive to negotiate bilateral concessions with the EAC/ACP countries knowing that these would be taken advantage of by the EC rather than their own exporters; thus leading to slowdown in expansion/diversification of the export basket for EAC/ACP countries.

## 6.0 Conclusion/Recommendations:

6.1 The MFN provision does not affect the trading relations between the ACP countries or between the EAC and other African countries or African regional trading blocs, whereby even if these regions were to graduate to the “major trading economy” category, the EC would not be entitled to trigger the clause.

6.2 All in all, the potential of the MFN clause as drafted, to slow down south-south trade and affect initiatives such as the ongoing GSTP negotiations, needs to be taken into consideration in reaching a final EC/EAC EPA, which would suite the trading interests of EAC.

6.3 The inclusion of the MFN clause as drafted in the EPAs is definitely a contentious matter. There is hence a need for further research to determine potential adverse impact of the clause by undertaking a line-by-line analysis particularly on tariff lines where the EAC has not given deep concessions to EC in the EPA market access negotiations. This would be useful in determining whether a better comparative advantage of EC (whether due to subsidies or terms of trade or other reason) compared to the “major trading economies” would deter the latter from entering into bilateral/regional trade concessions with the EAC/ACP countries. Such an analysis would then be the basis upon which the MFN clause should or should not be included in the final EPA.

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<sup>11</sup> This may lead to a slowdown in the GSTP UNCTAD negotiations, since the “major trading economies” may be fearful of extending concessions to the EC through EPAs

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