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# Qualified Market Access: An Economic, Empirical and Legal Analysis

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## ABSTRACT

*In the aftermath of the debate on trade and “collective preferences” launched by Pascal Lamy in 2004, this paper considers a proposal for non-product related production process measures developed within the European Parliament, which involved surcharges on the imports of products produced in ways which do not satisfy the EU’s rules mainly but not exclusively for agricultural commodities and in particular on animal welfare. The proposal called “Qualified Market Access” would also have made the revenues from surcharges available to exporting countries to finance compliance. This paper discusses the philosophy behind this specific proposal to qualify market access and address consumer preferences and competitiveness concerns, as identified in a number of other actual and proposed measures, including the ban on seal fur imports into the EU and the ensuing challenge to this measure in the WTO Dispute Settlement Body. The paper contends that it cannot be ruled out that such a measure would be welfare improving if consumers have strong preferences regarding what other people consume, in which case labelling alone will not work and the case for such a proposal cannot be excluded a priori, even from a legal perspective. However, in reviewing the evidence, the paper concludes that there is no empirical evidence to support such a proposal.*

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# 1. Background

Qualified Market Access (“QMA”) schemes seek to “qualify” the market access of products on the basis of how they are produced or their production methods, rather than the properties associated with the final products. These production methods are known as non-product related production process methods (“NPR PPMs”). Such QMA NPR PPM schemes can be imposed either as a fiscal<sup>1</sup> or non-tariff measure.<sup>2</sup> Further, they can either be border measures operating ‘upon the importation’ of products, or alternatively, as so-called ‘behind the border’, domestic regulatory measures. While the dividing lines between these categories are not always clear, General Agreement on Tariffs and Trade (“GATT”) law nonetheless applies different rules based on these distinct characterisations.

This paper seeks to explore in particular the implications of a specific “QMA” proposal for agricultural products that would penalise, but not ban, products produced in ways not compliant with EU production process measures and did not affect the product as such.<sup>3</sup> The novelty of the proposal and the analysis is that it deals with a case where no outright ban is being sought on non-compliant imports. It puts forward an economic, empirical and legal examination of the proposal to qualify market access which ultimately submits that while there may be a legal avenue for defending such policies, there is no empirical case to be made for such a proposal.

QMA discussions emerged over a decade ago, most notably in 2004, when Pascal Lamy argued that where there could be clearly defined “collective preferences” which, if implemented, would cause it to restrict certain imports, in that context, WTO rules should allow such measures; albeit subject to certain conditions.<sup>4</sup> Commentators were respectful, but mostly unconvinced.<sup>5</sup> However, the notion has resurfaced in a number of concrete proposals, including the “Qualified Market Access” concept discussed here. In 2015, Lamy again sought to rethink collective preferences and international trade. He identified the old world of trade, as one where production systems were national and obstacles to trade were about protecting domestic producers from foreign competition. By contrast, the new world is where production is transnational along global supply chains of goods and services, and where obstacles to trade are about protecting the consumer from risks.<sup>6</sup> A recent indicator that the salience of NPR PPM in trade policy is the inclusion of labour and environmental standards in the Trans Pacific Partnership (“TPP”) agreement concluded in October 2015.

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1 Fiscal measures include import tariff duties or internal taxes such as excise or sales taxes.

2 Non-tariff measures (or so called quantitative measures) include quantitative restrictions in form of quotas or prohibitions that operate at the point of importation, and a wide variety of internal regulatory requirements including product and food safety standards that govern the marketability of products.

3 Wolfgang Sachs and Tilman Santarius, “Slow Trade– Sound Farming A Multilateral Framework for Sustainable Markets in Agriculture,” *Ecofair Trade Dialogue*, Heinrich Böll Foundation and MISEREOR, April 2007, [http://www.misereor.org/fileadmin/redaktion/slow\\_trade\\_sound\\_farming.pdf](http://www.misereor.org/fileadmin/redaktion/slow_trade_sound_farming.pdf) (accessed April 11, 2016).

4 Pascal Lamy, “The Emergence of Collective Preferences in International Trade: Implications for Regulating Globalisation” (speech, Brussels, September 15, 2004), [http://europa.eu.int/comm/archives/commission\\_1999\\_2004/lamy/speeches\\_articles/indexpldat\\_en.htm#2004](http://europa.eu.int/comm/archives/commission_1999_2004/lamy/speeches_articles/indexpldat_en.htm#2004) (accessed April 11, 2016).

5 Steve Charnovitz, “An Analysis of Pascal Lamy’s Proposal on Collective Preferences,” *Journal of International Economic Law*, 8 no. 2 (2005): 449.

6 Pascal Lamy, “The New World of Trade” (The Third Jan Tumlir Lecture, Brussels, March 9, 2015), European Centre for International Political Economy, <http://ecipe.org/app/uploads/2015/05/JAN-Tumlir-POLICE-Essays-%E2%80%9420151.pdf>.

What these plans have in common is that a majority is able to determine trade policy for consumers as a whole, and hence, is able to impose their preferences on a minority. This view is gaining currency, particularly since the WTO Appellate Body upheld the finding that the EU Seal Regime to prohibit the importation and marketing of seal was discriminatory, but the Appellate Body, nevertheless, found the discriminatory measure provisionally justified under the public morals exception of Art. XX (a).

The issue of utility-based externalities, for that is what Lamy was invoking, has a history going back to Adam Smith's notion of "sympathy" in his *Theory of Moral Sentiments*.<sup>7</sup> Sen has also observed that if one person's consumption does impose genuine utility externalities on another, there is an unavoidable tension between liberalism (free choice) and welfare maximisation.<sup>8</sup> In his comments on Lamy, Wyplosz suggests that this can be addressed by the use of the Coase theorem.<sup>9</sup> To elaborate, if in Sen's example, the right to wear whatever tie you wish is given to tie wearers, those offended by the colours of my tie must pay me to remove it, but if a dress code has been legislated I must respect the wishes of those who have views on what I wear.

It would once have been argued that GATT law assigned property rights to those who wish to consume without restraint, but since the WTO Dispute Settlement Understanding ("DSU") recommendations on the US -Shrimp dispute, it is clear that the Appellate Body recognises some rights akin to those sought by Lamy. Howse and Regan argued that this is appropriate, since citizens in one domain may well experience real disutility from the actions of others abroad.<sup>10</sup> In a Coaseian world, there would always be a market in which we could pay others to desist or they could purchase from us the right to carry on. But as Lamy observes, even the simple matter of when we have a right to act collectively by restricting imports is imprecise. He argues that these rules should be clarified on a systemic rather than case-by-case basis. In fact, as the legal analysis under Section 6 indicates, WTO has proceeded on a case-by-case basis and as such, there is no clear positive legislation or rule.

## 2. The Origins of the QMA Proposal

In 2007 the QMA proposal submitted that if the EU imposed environmental and social standards (mostly) on agricultural production methods within the EU and its trading partners did not, there would be a loss of competitiveness for EU farmers and a risk of pressures for a "race to the bottom." So there should be an incentive to foreign producers to comply with EU standards. This incentive would take the form of a tariff surcharge on non-compliant imports, which in turn would finance a subsidy to encourage adoption of these norms in exporters' markets. We define a QMA

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7 "How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it." Adam Smith, *The Theory of Moral Sentiments*, ed. D. D. Raphael and A. L. Macfie (Glasgow: Oxford University Press, 1976).

8 Amartya Kumar Sen, "The Impossibility of a Paretian Liberal," *Journal of Political Economy*, 78, no. 1 (1970): 152.

9 Charles Wyplosz, Pascal Lamy and Steve Charnovitz, *Mondialisation et préférences collectives: la réconciliation?*, (2005), 42, <http://entempsreel.com/mondialisation-et-preferences-collectives-la-reconciliation/> (accessed April 11, 2016).

10 Robert Howse and Donald Regan, "The Product/Process Distinction- an Illusory Basis for Disciplining 'Unilateralism' in Trade Policy," *European Journal of International Law*, 11, no. 2 (2000): 249.

policy more broadly and not just as one that makes the terms of access for goods to a specific market conditional on their production process being compliant with the importing country's process norms, but which relies on financial incentives rather than outright bans.

As noted, the QMA concept which forms the basis of this discussion falls into the category of so-called 'non-product-related process and production measures' (NPR PPMs). It addresses the compliance costs of environmental and social regulations on production processes not related to the product itself. The environmental or social harm is caused by the impact at the location of production. As we shall see, however, an argument can be made that where an activity physically occurs in one place but causes disutility to persons elsewhere, it could indeed be said to have cross-border externality effects.<sup>11</sup> In this paper we review the likely impact of such proposals based upon an analysis of the proposals and a welfare economics analysis based on a simple formal model, which is to be followed by a legal assessment of the permissibility of this proposal. The paper is based on a study commissioned from the authors by Director-General ("DG") of Trade.<sup>12</sup>

We consider whether it makes sense viewed from the point of economic welfare, above all in the EU, if we assume that the psychic externalities are indeed present. For although the original QMA plan was abandoned, the underlying idea has resurfaced in a variety of forms, both as proposals and in some actual policies. President Sarkozy and the chairman of the EP agriculture committee both suggested that compliance with EU norms should be a condition of market access into the EU for food products.<sup>13</sup> Border carbon adjustments are based ("BCAs") on a similar idea.<sup>14</sup>

The EU has long banned the imports of fur products caught using leg traps judged to be cruel.<sup>15</sup> The ban is designed to improve the well-being of animals and also that of EU citizens who feel psychic pain when animals are hurt even abroad. Proposals to restrict the import of oil products from the Athabasca Tar Sands due to the pollution caused by their exploitation also fall into this category.<sup>16</sup> Whereas an argument could be made that exploitation of the tar sands increases carbon

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11 United Kingdom, Cabinet Office, Performance and Innovation Unit (PIU), *Rights of Exchange: Social, Health, Environment and Trade Objectives on the Global Stage*, London, 2000; Howse and Regan, "The Product/Process Distinction-an Illusory Basis for Disciplining 'Unilateralism' in Trade Policy", 249; Sen, "The Impossibility of a Paretian Liberal", 152.

12 CARIS, "Qualified Market Access." European Commission, October, 2008, [http://trade.ec.europa.eu/doclib/docs/2009/february/tradoc\\_142341.pdf](http://trade.ec.europa.eu/doclib/docs/2009/february/tradoc_142341.pdf) (accessed April 12, 2016).

13 Alan Matthews, "Sarkozy Offers a Deal on CAP Reform", March 9, 2010, CAP Reform, <http://capreform.eu/sarkozy-cap-reform-deal/> (accessed April 11, 2016).

14 United States Government Publishing Office, *President Obama's Address Before a Joint Session of Congress on the State of the Union*, January 24, 2012, DCPD-201200048; Francois Hollande, "Le changement c'est maintenant: mas 60 engagements pour la France", Paris, Parti Socialiste, 2012; see also Benhamou Eric, "Derrière les mots de... Nicolas Sarkozy," *La Tribune*, March 27, 2010, <http://www.latribune.fr/journal/edition-du-2703/editos-et-opinions/392484/derriere-les-mots-de-nicolas-sarkozy-.html> (accessed April 11, 2016); "Sarkozy Vows to Fight Unwinding of EU Farm Policy," *EurActiv*, March 25, 2010, <http://www.euractiv.com/section/science-policy/news/sarkozy-vows-to-fight-unwinding-of-eu-farm-policy/>; "De Castro: EU Should Seek 'Reciprocity' in Green Farm Rules," *EurActiv*, March 31, 2010, <http://www.euractiv.com/section/agriculture-food/interview/de-castro-eu-should-look-for-reciprocity-in-green-farm-rules/> (accessed April 11, 2016); Lamy, "The New World of Trade", 2015.

15 Gillian Dale, "The European Union's Steel Leghold Trap Ban: Animal Cruelty Legislation in Conflict with International Trade," *Colorado Journal of International Environmental Law and Policy*, 7 (1996): 441.

16 European Parliament, *MEPs favour EU-Canada Trade Deal, But Worry About Seals, Tar sand Oil and Asbestos*, June 8, 2011, <http://www.europarl.europa.eu/news/en/news-room/20110608IPR20931/meps-favour-eu-canada-trade-deal-but-worry-about-seals-oil-and-asbestos> (accessed April 11, 2016).

emissions and this creates a cross border externality, it is hard to argue that a ban on imports into the EU would reduce this externality if the products would be sold elsewhere. An externality does still exist within the EU however if there is disutility caused by the knowledge that fuel being used is “dirty”.

Such legislation imposes a ban on the sale of the product in question, with some exceptions, and legal controversies arise very much from the nature of the exceptions. The QMA proposal that we discuss here is distinct in that it did not seek to ban imports that did not comply with EU norms but sought to impose a financial penalty on them. In the plan tariffs would be raised on products produced in a manner not approved within the EU. The revenues raised however would not be kept by the EU but would be recycled to the countries concerned to support the improvement of standards.<sup>17</sup> Although related to general social and environmental rules, they bear no relations to how specific products are made and involve no rebates. The supporters of QMA rejected this as a model since existing tariffs were held to be too low for their reduction to be a sufficient incentive. One other recent idea recalls this proposal, namely the one put forward by Thomas Cottier for industrial importers to raise Most Favoured Nation (“MFN”) tariffs across the board on carbon intensive products. Under that scheme there would be no distinctions by country or production process however.<sup>18</sup>

The sponsors of the QMA proposal discussed here were focussed very much on agriculture and our attention in this paper is also addressed to that. The argument that EU measures to ensure respect for environmental and social standards in farming would lead to increased imports from non compliant jurisdictions and as a result pressure within the EU for relaxation of standards is core to the justification of the proposed scheme. The proponents therefore put forward the QMA proposal for tariff surcharges for non-compliant imports and revenue recycling to developing countries to assist them upgrade.

There are, thus, two interrelated motives for advocating compulsion for non-EU farmers to comply. First to protect consumer sentiments, and second to seek protection for a level playing field for trade in agricultural products in the interests of EU food producers and to avoid regulatory competition presumed to be unfair, potentially leading to a race to the bottom, social dumping, etc. This topic is extensively covered in the literature<sup>19</sup> so we deal briefly with both the analytics and empirics below.

Since imports of non-compliant products create psychic externalities among EU consumers, QMA would increase EU consumer welfare by ensuring that consumers get the goods that meet their preferences, even if they have been produced abroad. There is a presumption that consumers would feel dissatisfaction from consuming goods produced through social exploitation or in environmentally unsound ways. In order to avoid surcharges exporters ought to implement EU regulations having measures that affect the local environment and animal welfare in the place of production. Proponents of the original QMA idea stated:

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17 This idea also bears some resemblance to the EU’s GSP+ scheme where compliance with certain NPR norms secures tariff reductions greater than GSP.

18 Thomas Cottier, Nartova Olga and Anirudh Shingal, “The Potential of Tariff Policy for Climate Change Mitigation: Legal and Economic Analysis,” *NCCR Trade Working Paper No. 2011/36* (2011).

19 Jagdish Bhagwati and Robert Hudec, eds., *Fair Trade and Harmonization* (Cambridge MA: MIT Press, 1996).

Countries which have achieved a higher level of social and environmental legislation and standards should effectively safeguard these standards in their territory. Based on these inclusive achievements, they may claim the right to apply levies on imports which could undermine these existing standards.<sup>20</sup>

Within the EU single market the NPR PPMs applying to EU agriculture –the Statutory Management Requirements (SMR)- aim to protect public, plant and animal health, the environment and the welfare of animals and apply to all farmers. Additionally the Good Agricultural and Environmental Conditions (GAEC) rules’ directive<sup>21</sup> includes standards where farmers are required to maintain soils, habitats and landscape features.<sup>22</sup> GAEC rules are standards that EU farmers must comply with in order to be eligible for direct payments under the Common Agricultural Policy (“CAP”). They are set by member states and impose higher standards than relevant EU minimum standards. As a result, farmers incur compliance costs that presumably affect their competitiveness against foreign suppliers who do not face such regulation. The parallel with QMA is clear: farmers are allowed to ignore GAEC rules but they lose subsidies if they do so.

The advocates of QMA are concerned about ‘unfair competition’ if the foreign producer is able to charge lower prices in the EU export market only because they do not pay the true social or environmental cost of their production. Fears have been expressed that regulatory competition in this context can lead to a competitive lowering of standards, a ‘race to the bottom’ or ‘social dumping’ or, in more neutral economic jargon, regulatory competition.<sup>23</sup> Advocates seek to deter such imports into the EU on the grounds they may create pressure on EU to lower standards. Advocates of trade liberalisation on the other hand claim that this is an opportunistic excuse invoked by protectionists. A case could in fact be made that the famous US –Shrimp case<sup>24</sup> was not solely driven by environmental concerns, as we observe that there has also been successful pressure for anti-dumping duties on Shrimps, which has in fact led to a further WTO Shrimp case brought by Vietnam against the United States (“US”).<sup>25</sup> Many free trade economists are firmly opposed to any willingness to concede the principle of allowing trade restrictions to be used for environmental purposes for fear that it will unleash a tide of thinly disguised “green protection”<sup>26</sup> and consequential retaliatory behaviour.

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20 Ecofair Trade Dialogue, “Slow Trade- Sound Farming”, 2007.

21 Council Regulation 73/2009/EC establishing Common Rules for Direct Support Schemes for Farmers under the Common Agricultural Policy and Establishing Certain Support Schemes for Farmers, O.J. L. 30, January 19, 2009.

22 Alliance Environment.. “Evaluation of the Application of Cross Compliance as Foreseen Under Regulation 1782/2003”, Executive Summary, Directorate-General for Agriculture and Rural Development, 2007. The Institute for European Environmental Policy published a report on the Executive Summary on September 30, 2007. The Executive Summary can be found at [http://www.ieep.eu/assets/373/cc\\_evaluation.pdf](http://www.ieep.eu/assets/373/cc_evaluation.pdf).

23 Deardorffs’ Glossary defines ‘social dumping’ as: “Export of a good from a country with weak or poorly enforced labour standards, reflecting the idea that the exporter has costs that are artificially lower than its competitors in higher-standards countries, constituting an unfair advantage in international trade.” *Deardorffs’ Glossary of International Economics*, comp. Alan Deardorff (2012), s.v. “social dumping”.

24 Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R (November 6, 1998).

25 Appellate Body Report, *United States – Anti-Dumping Measures on Certain Shrimp from Viet Nam*, WT/DS429/AB/R (April 22, 2015).

26 See Briefing Note by World Wildlife Fund for 5th WTO Ministerial Conference at Cancun, *Green Protectionism*, [https://www.wto.org/english/forums\\_e/ngo\\_e/wwf\\_greenprotec\\_e.pdf](https://www.wto.org/english/forums_e/ngo_e/wwf_greenprotec_e.pdf) (accessed April 12, 2016).

### 3. Instruments to enforce NPR PPMs and QMA

Given the mix of motives, a variety of measures or instruments could be used to address the issue of what are deemed unacceptably low standards abroad. They include:

- private voluntary labelling schemes;
- compulsory labelling of production process conditions;
- the imposition of taxes or higher tariffs on non-compliant imports;
- outright bans on the import of products that do not comply with internal rules

#### 3.1. Labelling

Labelling enables producers to demonstrate to consumers that they have met the standard and claim a premium on the price for doing the same. Profit maximisation will drive them to do so. There will emerge two versions of the product – the non-PPM one as before and a PPM one, - assuming constant costs and competition in both markets, the latter will command a price premium equal to the cost of meeting the standard. Producers are indifferent about which they produce considering both generate normal profits, but consumers potentially reap additional surplus. The non-PPM consumers are unaffected, whereas for those who care about the standard some of them may place such a high value on meeting the standard that they were previously not consuming at all, or at least begin to consume more once they know that production meets the standard. The absence of any labelling results in indistinguishable versions of a product. Consumers expect, and hence producers deliver, the non-PPM version of the product. Absence of labelling leads to a “lemons” problem -consumers’ inability to distinguish good and bad products will lead them to offer only the lower price for non-compliant products and this will drive compliant ones out of the market.<sup>27</sup>

The above analysis assumes that the price differential between compliant and non-compliant goods is a simple addition to variable costs. Other more complex outcomes are also possible. With upward sloping cost curves the relative price of non compliant goods might end up falling by more if reduced demand drives prices down. The fall may be less if individual consumers do not in fact value the compliance characteristics and actually switch demand to non-compliant products. Where there is a high fixed cost of compliance we might see the non-compliant product withdrawn from the market.

In order to pursue a labelling solution, the labelling has to be credible: there has to be a way in which firms are induced to label honestly. If they do not, the labels are devalued and the market risks a collapse back to the single non-PPM good. The threat of litigation and a free press may be able to achieve this. Alternatively the industry may be able to set up a certification process with sufficient independence to ensure firms’ honesty. The next step is to make the certification official: even if firms are not obliged to certify that they do or do not adhere to the standard, then if they claim to do so, this fact must be verified by the government or a government accredited agency. Provided that the costs of certification are covered by the industry (and indirectly their customers) this seems like an efficient use of the government’s reputational capital, provided of course

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<sup>27</sup> George Akerlof, “The Market for ‘Lemons’,” *Quarterly Journal of Economics*, 84, no. 3 (1970): 488.



that they are capable of certifying honestly. If some of the costs are publicly funded, it becomes a subsidy to the standard and would need to be justified by some sort of public interest argument. We turn to this case below.

A further extension of this line of thought is compulsory labelling, whereby the government insists that all varieties of the good be labelled as either satisfying or not satisfying the standard. This is not quite the same as food labelling, where calorific values and nutrient values have to be displayed. In the latter case labelling refers to a continuous variable, so that ‘no label’ could not be equated with either no calories or infinite calories. In the case of an on-off standard ‘no label’ might reasonably be thought of as indicating non-compliance. Governments might not be convinced that in the absence of a label consumers are clear what standard actually applies, this in turn might justify a compulsory label. Also the presence of an ‘off-standard’ label might be a way of encouraging consumption of ‘on-standard’ products, where the premium paid by willing consumers does not cover the cost of implementation of the standard or simply signalling government approval of a voluntary standard.

Finally, labelling can turn into a barrier to entry – an anti-competitive practice – if the certification process is not cheaply and rapidly available to firms that can achieve the standard, especially if it involves a high fixed cost. In many cases if the labelling is effective, it can achieve all that we desire. Those who value the standard can observe it, while those who do not, don’t. However, labelling has its limitations. Information asymmetries occur when high transaction costs make it difficult or impossible for consumers to obtain relevant information on product characteristics or production methods potentially offending their values and reducing their welfare from unrestricted consumption of the product. In these circumstances, neither voluntary nor compulsory labelling works, and thus the information asymmetry has to be overcome by a mandatory standard.

It needs to be established that there are, indeed, externalities in the regulatory domains associated with QMA. This is not self-evident. However, since mandatory PPM standards already exist and are implemented in the EU home market to reduce and/or remove perceived externalities, we will assume that such externalities can exist. This is a crucial assumption in this analysis.

### **3.2. Tariffs plus Subsidies**

The actual plan advocated in the QMA scheme was not simply for tariff surcharges on non-compliant imports. It included provision for returning the tariff revenue to the governments of non-compliant exports, ostensibly to provide revenue to upgrade their standards. Clearly this is a form of compensation, but the logic does not seem to be very coherent. The incentive effects would depend precisely on the terms of refunding. It seems somewhat perverse to offer revenue to the government conditional on the scale of non-compliant exports unless the pay-out is verifiably linked to increased expenditure on compliance. Different distortions would be created if the revenue were handed to producers, whether to compliant exporters as an additional reward or else to non-compliant exporters. This could be directed either as assistance to support compliance or as compensation for loss of market access. Simple economics suggests that if the EU wants to promote animal welfare or other social goals at home and abroad it should use its own resources and target them in an incentive compatible way.

## 4. The Economic Analysis

In this economic analysis, we examine first the case of an externality in production and the impact of various policy responses to that involving both domestic and foreign producers. We explore the issues under a number of assumptions about preferences of home consumers of the good to the removal of the externality at home and abroad. Individuals may differ in their valuation of an 'environmental bad' - say air pollution - or feel greater or less disgust about say the treatment of animals in food production. Some consumers may care about the presence of the externality abroad even if it has no physical implications for them, for instance, local water or air quality. We therefore explore the two key assumptions:

- where preferences in Europe about the externality and hence the resulting standards are universally held, i.e. where there are no dissenters; and
- where preferences apply to domestic and foreign production and specifically they apply to imports

We will look at two cases:

- A domestic standard that does not apply to imports; and
- QMA: a tariff along with a standard with specified exemptions from the tariff or a subsidy paid to foreigners to cover the cost of compliance funded from tariff revenue.

In each case we look at the impact on producers, taxpayers, where relevant, and consumers, as well as the net impact on the community as a whole. We also consider impacts on foreign producers and the impact of exporting the standard where preferences abroad are the same as or different from domestic preferences, or where absorption capability, for instance, for pollution is different abroad.

### 4.1. Trade Policy and Externalities

Figure 1 assumes that the rest of the world can supply as much of the good as the home country (Europe) can absorb at the prevailing world price  $P_w$ , thus the world supply curve is horizontal.<sup>28</sup> This may be because European consumption is small relative to world production or because the rest of the world is producing at constant costs. However, European producers have a rising supply curve  $S$ , which indicates rising costs of production as the quantity produced increases. The domestic demand curve is  $D$  when there are no barriers to imports. Price is  $P_w$ , at which price domestic production is  $Q_0$ , consumption is  $Q_w$  and imports are  $I_{pw}$ . This is the base case for all that follows.

Now assume that there is an externality in production and assume further that all consumers in Europe uniformly value (homogenous preferences) the externality at  $\text{€}C$  per unit of production, i.e. this is the amount they would be willing to pay to have the externality removed. We also make the simplifying assumption, that  $\text{€}C$  per unit also represents the cost to producers of correcting the externality. If they do so, this implies that removing the externality would shift the European supply curve from  $S$  to  $S+C$  in Figure 1 as cost of production increases by  $C$  per unit. In our graphic

<sup>28</sup> This draws on Drusilla K. Brown, Alan V. Deardorff and Robert M. Stern, "Computational Analysis of the Economic Effects of an East Asian Preferential Trading Bloc," *Journal of the Japanese and International Economies*, 10, no. 1 (1996): 37.

representation we show the externality as a shift in the supply curve even though it is partly a consumption externality, because the social cost arises from the sale of the offending item, not only its consumption by buyers.

An important distinction needs to be made here relative to the discussion of labelling, in section 3.1 above. There we assumed that people who cared for the standard were prepared to pay extra for goods that embodied it. But here we will analyse a situation where they are not willing. They do value the standard, but there is a co-ordination failure because of the public good nature of the problem. Because we treat the failure to achieve the standard as an externality, advocates feel disutility from *every* unit of consumption. Paying extra to achieve the standard on their own consumption makes only a very small insignificant contribution to their welfare if everyone else continues to violate it. Hence, they are now no longer willing to pay extra unless they are assured that everyone will have to do so, and the problem will be fixed. Indeed, in the latter case, they might still rather that everybody else paid to achieve the standard and that, in their own personal case; they could buy the good at the original, standard-violating price. This is the classic externalities analysis.

Now let us introduce a regulation that requires producers to remove the externality in this fashion. Their costs rise to  $S + C$  but price remains  $P_w$  as imports continue to enter freely. European production falls to  $Q_1$  and imports increase to  $h+i+b$ . Consumption remains at  $Q_w$  because the price is unchanged. The value of removing the externality to consumers is  $C$  times the initial level of production plus imports; this is decomposed in the figure into part due to the fall in domestic production (b) (replaced by imports) and part reflecting the fact that remaining domestic output is externality-free (a). At the same time producers face the cost ( $\text{€}C$ ) of the achieving the standard on their initial level of output, i.e. the area represented by rectangle  $c + d$ . But since their production falls to  $Q_1$  they save the excess cost over price on units  $Q_0 - Q_1$  represented by triangle  $d$ , so in net terms they are worse off by  $c$ . Overall, Europe is thus worse off  $a-c = -\frac{1}{2}b$ , since  $c = a + \frac{1}{2}b$ .

Intuitively, the standard increases domestic welfare to the extent it has eliminated the externality at home (in part by reducing domestic production and shifting resources to other more efficient uses), but European consumers import the rest of consumption from overseas which does not have/meet the standard and in doing so imposes an externality. This welfare calculus depends crucially on:

- all Europeans suffering from the externality (hence the ‘homogeneous’ label)
- there being an externality abroad, i.e. all Europeans experience an externality as imports rise;

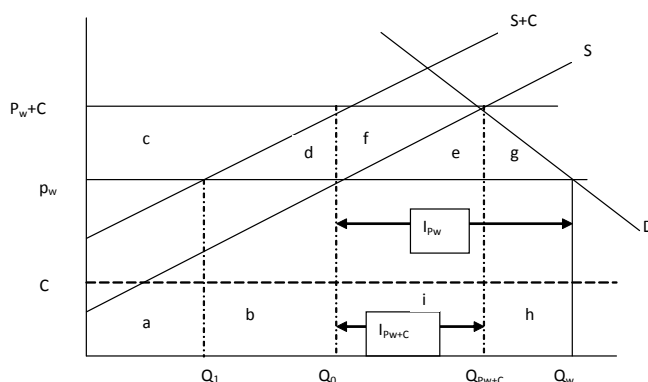
The assumption that consumers perceive the externality on imported goods as well as home produced, seems plausible – otherwise why conceive of an instrument such as QMA? The analysis is the same for ‘real’ – that is, with actual or potential physical or economic effects on individuals, and for ‘psychic’ externalities, for instance, disgust, provided the latter are genuinely and universally felt.

#### 4.1.1. A tariff to buttress the standard in Europe

When producers and consumers overall lose as a result of this policy compared with free trade and no standard, there is a room for lobbying by producers to get protection against “unfair” competi-

tion and lobbying from consumers to substitute domestic “good” production for foreign “bad” production (remember consumers are assumed to be willing to pay price  $P_w + C$  to get access to externality free goods). There is then a political economy driven case for a tariff.

**FIGURE 1: A EUROPEAN STANDARD PLUS A TARIFF, HOMOGENOUS PREFERENCES**



First, assume the tariff just equals  $\text{€}C$ , the cost of rectifying the externality. Import prices increase from  $P_w$  to  $P_w + C$  and domestic production remains where it was under free trade (the tariff increases import prices to the exact price necessary to allow domestic producers to meet the standard while maintaining output at  $Q_0$ ). Consumption falls from  $Q_w$  to  $Q_{P_w + C}$  and imports fall from  $I_{P_w}$  to  $I_{P_w + C}$ . Consider first the comparison relative to the situation where Europe has a domestic standard, but no tariff (See Figure 1). Given that  $(S+C)$  is, in fact, the ‘correct’ supply curve – it reflects the true social marginal cost of production allowing for the externality – we have the perfectly standard tariff story: consumers lose  $c+d+e+f+g$ ; of this,  $c$  accrues locally as producer surplus and  $e+f$  accrues locally as tariff revenue, so the efficiency losses are the triangles  $d$  and  $g$ . The former derives from the excess cost of producing units  $Q_1$  to  $Q_0$  at home and the latter from the consumption foregone. The tariff is as usual harmful to consumers.

What is different here from the free trade baseline is that consumers gain from the removal of the externality on domestic production ( $a+b$ ) and since imports do not meet the standard, the fact that they have fallen from  $Q_w$  to  $Q_{P_w + C}$  generates a removal of the externality valued at  $\text{€}C$  per unit represented by the rectangle  $h$ . Thus to set against the standard efficiency losses above of  $d+g$  we have gains from the removal of the externality of  $a+b+h$ . Since  $b=2d$  and  $h=2g$ , then the net effect is a gain of  $a+\frac{1}{2}b+\frac{1}{2}h$ .<sup>29</sup> This suggests that the combination of a tariff at the frontier and a compulsory standard at home under the very restrictive assumptions we deploy (100% of the population share the perceived externality, that the value of the externality to consumers, the cost of compliance to producers and the value of the Tariff is  $\text{€}C$  per unit and there is no tit-for-tat retaliation at local or systemic level) could exceed the resource loss imposed by the tariff. To the extent that less than 100% of the population share the psychic loss imposed by the externality, and/or the valuation of

29 If European preferences are not homogenous, the case for imposing the standard is weaker and the tariff losses remain, so the case for the combined intervention is weaker *pro rata*. The tariff does nothing to reduce the weakening effect that non-homogeneous preferences have on the case for intervention.

avoiding the externality was less than the compliance cost to producers or the tariff, this net benefit would fall and possibly disappear or indeed become a net cost.

## 4.2. The QMA Proposal

The point about the specific QMA plan under discussion here is that foreign suppliers who adhere to the standard are exempted from the tariff. If the cost of doing so is  $\text{€}C$ , exactly as in the EU and exactly the rate of tariff, Figure 1 applies with just a little re-interpretation. Foreign suppliers have a choice of paying  $\text{€}C$  either in the form of standards compliance costs or face an exactly equivalent tax (the incidence of which falls on European consumers in the case where the import supply curve is infinitely elastic). The former entails real resource costs as  $\text{€}C$  per unit is transferred to foreign suppliers whereas the tariff generates transfer from consumers to government and so *ceteris paribus* would be preferable. But if Europeans experience disutility from the violation of the standard abroad (again assumed to be  $\text{€}C$  per unit), the equivalence is restored, for Europe either gains revenue (paid by domestic consumers) in the tariff case or utility where the foreign supplier meets the standard,<sup>30</sup> in terms of Figure 1 Europe transfers  $e+f$  to foreigners to comply with the standard and Europeans get  $Q_{p+w+c} - Q_0$  imports that comply with the standard which is worth  $i$  to them and is just (under the strong assumptions that preferences are homogenous and that the consumers are willing to pay  $\text{€}C$  above the world price which is equal to the compliance costs for producers at home and abroad). In those circumstances the cost of paying  $e+f$  to foreigners to comply is just equal to the value  $i$  consumers put on compliant imports.

Thus, in this light, the QMA scheme is resource cost-neutral. Of course it runs into the paradox that if all imports are compliant there is no tariff revenue to cover foreign compliance costs. That suggests that there might be some sort of cycle through which once Europe runs out of hypothecated revenue to fund compliance the foreigners send non compliant products which raise tariff revenue to fund compliance and so on ad infinitum. In the phase where tariffs are being paid because foreigners are non-compliant, consumers are losing both  $-e+f$  in cash terms and psychic welfare worth  $i$ , since the externality has popped back into existence abroad! This suggests that when the foreigners are compliant the welfare effect is neutral since  $i=e+f$  and when foreigners are non-compliant consumers are worse off by  $e+f+i$ .

What we draw from this complex formal analysis is that there are certain circumstances in which the QMA proposal can raise welfare above simply doing nothing. This will not always be the case. We can rule out the extreme conclusions that either the QMA proposal is always welfare improving or that it is necessarily harmful. We would need more case specific information or else to make a decision on grounds other than welfare economics.

## 5. The Empirical Evidence

Although the main purpose of this paper is conceptual, it would be incomplete without a brief note on the evidence that would be needed to support a case for QMA. On the competitiveness issue, there is little evidence that EU or other developed country producers costs are significantly increased relative to external suppliers by agricultural regulations on food safety, animal wel-

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30 The 'triple equivalence' assumption (consumer benefits in EU = producer compliance costs in EU = producer compliance costs outside the EU) is a very strong assumption, not likely to be achieved in reality but making the analysis much simpler.

fare and environmental protection, on environmental protection more widely or even on labour standards.<sup>31</sup> Developing country producers may however incur significantly higher costs in the process of meeting developed country PPMs especially on costs of testing and certification.<sup>32</sup>

Studies have also been done on the benefits to consumers. These fall into three types:

1. Those which use actual data to assess quality premia obtained in the market-place, whether by simply direct observation or by econometric inference
2. Surveys of stated willingness to pay
3. Experimental results

The first type is the most reliable, but hardest to find. In addition there may also be gains in volume terms to producers if they are able to obtain price premia or guaranteed market access, which more than compensates for the cost of compliance. Estimates in the study by Van den Bossche, Schrijver and Faber do look at actual prices. They suggest that within the EU animal welfare costs can be recovered in the form of a higher price:

Free-range chicken breast fetches a much higher price premium, which may be as much as 50 per cent.

Complying with animal welfare standards may increase the cost of pig production in the UK by approximately 10 per cent (free range compared to minimum standards), which is covered by a price premium.<sup>33</sup>

A United Nations Environment Programme (“UNEP”) study observes that the apparent market share of fair trade labeled products is extremely small:

‘While the rate of growth in fair trade markets is significant, overall market penetration by fair trade products is relatively insignificant. For example, the relative proportion of total world trade for any single commodity listed is no greater than 0.2% (bananas, 2000). The volume of fair trade sugar increased by 38.8% between 2001 and 2002, but the total volume represented less than 0.0019% of global sales. The total value of certified sustainable coffee sold in 2000 is reported to have been US\$ 565 million, or roughly 1% of the global coffee market.’<sup>34</sup>

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31 Wiil Martin and Keith E. Maskus, “Core Labor Standards and Competiveness: Implications for Global Trade Policy”, *Review of International Economics*, 9, no. 2 (2001): 317 (accessed April 11, 2016); Dani Rodrik, “Labor Standards in International Trade: Do They matter and What Do We Do About Them,” in *Emerging Agenda For Global Trade: High Stakes for Developing Countries*, Robert Z. Lawrence, Dani Rodrik and John Whalley (Baltimore: Johns Hopkins University Press, 1996), 35; Robert M. Stern and Katherine Terrell, “Labor Standards and The World Trade Organization: A Position Paper, University of Michigan (2003).

32 Omar Aloui and Lahcen Kenny, “The Cost of Compliance with SPS Standards for Moroccan Exports”, *Agriculture and Rural Development Discussion Paper for World Bank*, 2005, <http://siteresources.worldbank.org/INTRANETTRADE/Resources/Topics/Standards/MoroccoCountrySurveyF.pdf> (accessed April 11, 2016); Peter Van den Bossche, Nico Schrijver and Gerrit Faber, *Unilateral Measures Addressing Non-Trade Concerns: A study on WTO Consistency, Relevance of other International Agreements, Economic Effectiveness and Impact on Developing Countries of Measures concerning Non-Product-Related Processes and Production Methods* ( Hague, The Ministry of Foreign Affairs of the Netherlands, 2007), 235, <https://openaccess.leidenuniv.nl/handle/1887/12563> (accessed April 11, 2016).

33 Peter Van den Bossche et. al., *Unilateral Measures Addressing Non-Trade Concerns* (2007), 236.

34 “The Trade and Environmental Effects of Ecolabels: Assessment and Response”, *United Nations Environment Programme*, 2005, <http://unep.ch/etb/publications/Ecolabelpap141005f.pdf> (accessed April 11, 2016).

It also quotes studies on the share of ‘organic’ products. For most European states the share of organics is 1.5-2.5% of total food sales, with a maximum of 3.7% in Switzerland. Narrower estimates for fruit and vegetables suggest a range of about 3-10% of sales. The evidence on the willingness of EU consumers to pay more for high standard compliant food is incomplete and ambiguous. High-grade food can sometimes command a premium but we do not know how high premia could be sustained if a large share of the market were to be involved. Moreover, there is inconclusive evidence on who is able to take advantage of this premium and who is excluded.

The result of the review of evidence is such that at present we do not have enough data to firmly conclude that there are either competitiveness needs or consumer benefits to justify QMA. However, we cannot demonstrate the contrary. Ultimately, the likely systemic impact of such a plan should cause us to refrain from such action in the absence of hard evidence of gain.

## 6. The Legal Analysis<sup>35</sup>

QMA schemes based on NPR PPMs can be imposed either as a fiscal or non-tariff measure. Further, they can either be border measures operating ‘upon the importation’ of products, or alternatively, as so-called ‘behind the border’ domestic regulatory measures. This section begins by examining the use of fiscal QMA measures under GATT Articles I and II. It then assesses regulatory or non-fiscal QMA measures as regards the internal treatment rules under GATT Article III. The analysis then focuses on the general exceptions that are available to WTO Members under GATT Article XX. The paper concludes with a summary discussion of the extent of the flexibilities offered under the GATT to WTO Members wishing to qualify market access according to social and environmental standards without the use of product labels.

### 6.1. Qualifying Market Access through Tariff Duties

A QMA proposal could call for raising tariff levels on ‘bad’ products in one of two ways: (i) a new tariff rate can be charged in excess of the existing scheduled tariff binding. This would likely be the case where the government imposing the new tariff rate is already charging the conventional and negotiated bound tariff duty rate; or (ii) a new tariff rate can be charged where the government imposing the QMA measure is charging an applied rate on qualified products at a rate below its negotiated binding. The first option is problematic under GATT law. Any charge that is higher than the negotiated scheduled rate will trigger a violation of GATT Article II.<sup>36</sup> Under Article II, WTO Members have agreed not to charge a tariff duty that is higher than set out their negotiated scheduled rate. Imposing a higher tariff is therefore an obvious violation of the GATT rules. The GATT Agreement does provide a legal possibility for adjusting bound tariff rates through the process of negotiation and agreement under Article XXVIII:2. This permits compensatory adjustment with respect to other products, and the attempt to maintain the ‘general level of reciprocal and mutually advantageous concessions not less favourable to trade than that provided for in the Agreement prior to such negotiations.’

35 This legal analysis is based on the assessments undertaken by J. Mathis and K. Dawar in the 2008 CARIS QMA Report and a subsequent paper based on those findings. See James H. Mathis and Kamala Dawar, “Qualified Market Access,” *SSRN*, October 15, 2008, <http://dx.doi.org/10.2139/ssrn.1970550>.

36 Article II:1. (a) states “Each contracting party *shall accord* to the commerce of the other contracting parties *treatment no less favourable than that provided for* in the appropriate Part of the appropriate Schedule annexed to this Agreement.”

An adjustment based on a QMA scheme could be effected through lowering tariffs on other products to adjust the compensation that is owed to the detrimentally affected Members. In practice this means that those Members with diversified trade can more easily rebalance the levels of compensation. Those Member countries that only trade in a few products, or do not trade in volumes adequate to offset the tariff increase, will find rebalancing compensation levels more difficult. This may result in the affected exporting country withdrawing ‘equivalent concessions’ on products of originating in the country imposing the QMA scheme. This type of suspension can operate as a ‘penalty’ both upon (unrelated) producers who lose market access, but also to the detriment of consumers and producers in the country retaliating.

The second tariff adjustment option deals with varying tariff rates ‘below the binding’. GATT law offers more possibilities if the Member imposing the QMA scheme is charging an applied rate below the binding level. That is, if a WTO Member charges an applied import duty rate below the binding level it is free to alter that rate up or down without violating Article II: 1(a) of the GATT. WTO Members are allowed to create fine differentials among very similar competitive products. Tariffs are a legitimate means of providing for economic protection for domestic producers, and countries are permitted a wide scope to differentiate products for applying different tariff rates. While almost any characteristic differences can be established and justified in a tariff negotiation, the violating line will be those more blatant characterizations.<sup>37</sup> Differentiations will be objected to when they are closer to an explicit distinction between countries than to a distinction between products according to their objective characteristics.<sup>38</sup> Further, it is the WTO Member who claims to be prejudiced by this practice of tariff differentiation that bears “the burden of establishing that such tariff arrangement has been diverted from its normal purpose so as to become a means of discrimination in international trade.”<sup>39</sup>

While a Member is free to create fine tariff differentials and raise tariff levels up to the bound level, a Member is not free to treat physically identical products more or less favourably without risking a violation of the most-favoured nation obligation under GATT Article I. This brings to the fore the central problem with the legality of all QMA schemes: the like-product analysis. The flexibility for Members to make fine distinctions among products is not unlimited when it comes to those distinctions associated with production process differences that are not based on physical characteristic or even end-use distinctions. In one WTO dispute, US –Poultry (China),<sup>40</sup> the Panel noted that like product analysis must always be conducted on a case-by-case basis. The traditional approach for determining ‘likeness’ has, in the main, consisted of employing four general criteria that a Panel must examine in turn to assess its significance in validating a distinction between products:

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37 The classic example of finely tuning product distinctions for the purpose of a tariff duty is drawn from the 1904 Swiss-German Treaty reducing tariffs on, “... large dapple mountain cattle reared at a spot 300 meters above sea level and having at least on month grazing each year at a spot at least 800 meters above sea level.”

38 Robert E. Hudec, “‘Like product’: The Differences in Meaning in GATT Articles I and III” in *Regulatory Barriers and the Principle of Non-discrimination in World Trade Law*, ed. Thomas Cottier and Petros Mavroidis (Ann Arbor: University of Michigan Press, 2000): 101. The cattle example can also be cited for the use of a process standard in a tariff description. Another example a PPM-based tariff might be different applied rates for ‘handcrafted’ products.

39 GATT Panel Report, *Canada/Japan – Tariff on Imports of Spruce, Pine, Fir (SPF) Dimension Lumber*, L/6470 - 36S/167 (July 19, 1989).

40 Panel Report, *United States – Certain Measures Affecting Imports of Poultry from China*, WT/DS392/R (25 October, 2010), paras 7.424–7.427, 7.429.



- the properties, nature and quality of the products
- the end-uses of the products
- consumers’ tastes and habits — more comprehensively termed consumers’ perceptions and behaviour — in respect of the products; and
- the tariff classification of the products

Consumer tastes and habits clearly offer the most potential to defend a QMA scheme based on NPR PPMs. Panels have seen legitimate expression of consumers’ perceptions and behaviour reflected in national legislative enactments. The criterion for assessing like products also includes consideration of ‘any other relevant factor’ that may be identified. This could include identifiable international obligations or declarations adopted by the Member imposing the QMA scheme, which might support the argument for production differentiation based primarily on ‘consumer tastes and habits.’ An additional obligation under Article I requires that ‘... any advantage ... granted to any product ... shall be accorded immediately and unconditionally to the like product originating in ... the territories of all other contracting parties.’ This means that irrespective of the like-product question for Article I MFN, this article imposes a separate requirement that tariff advantages may not be made subject to ‘conditions’. For a QMA arrangement granting better (or worse) tariff duty treatment on the basis of other country characteristics or legal regimes, this ‘unconditionality’ requirement also provides a basis for a WTO legal challenge.

## 6.2. QMA and the National Treatment Principle

This examination focuses on whether a taxation-based QMA scheme could be consistent with the GATT Article III national treatment requirement. This provision seeks to ensure that internal measures are not applied to imported or domestic products so as to afford protection to domestic production.<sup>41</sup> The intention was to treat the imported products in the same way as the like domestic products once they had been cleared through customs. Otherwise indirect protection could be given.<sup>42</sup> This analysis assumes that the QMA scheme is origin neutral, focusing on ‘bad’ production processes or firms, rather than ‘bad’ countries.<sup>43</sup>

The legal status of an origin neutral NPR PPM taxation requirement, such as the QMA scheme, within the GATT/WTO system is not uncontroversial. There are two broad schools of thought on their legality within the WTO. One of which argues that a contested NPR PPM should be assessed under Article III because this provision does not prohibit PPMs per se, only protectionist PPM-based measures.<sup>44</sup> The other school of thought contends otherwise: QMA Measures using NPR PPMs to distinguish between physically indistinguishable products violate Article III on the

41 GATT Panel Report, *United States — Section 337 of the Tariff Act of 1930*, L/6439 - 36S/345 (November 7, 1989), para 5.10.

42 GATT Panel Report, *Italian Discrimination Against Imported Agricultural Machinery*, L/833 - 7S/60 (October 23, 1958), para 11; Appellate Body Report, *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (November 1, 1996), para 16.

43 This assumption allows an assessment of the legality of QMA schemes beyond a narrow discussion of a *prima facie* violation of the non-discrimination requirement according to GATT Article III.9.

44 Howse and Regan, “The Product/Process Distinction- an Illusory Basis for Disciplining ‘Unilateralism’ in Trade Policy”, 249.

basis that these products are indistinguishable.<sup>45</sup> Their permissibility must be ascertained under the GATT Article XX which provides specified exceptions to the commitments of the entire Agreement, as is discussed below.

GATT Article III national treatment requirement seeks to ensure that internal measures are not applied to imported or domestic products so as to afford protection to domestic production.<sup>46</sup> Otherwise indirect protection could be given.<sup>47</sup> Article III obliges WTO Members to grant foreign products treatment that is ‘as least as favourable’ as the treatment granted to domestic or national ‘like products.’ Article III:2 covers domestic taxation policies, such as the measure set out in the proposed QMA scheme. The first sentence of this paragraph prohibits Members from taxing ‘like’ imported products in excess of ‘like’ domestic products. The second sentence states that Members will be in violation of their obligations if, under their tax regimes, ‘directly competitive or substitutable’ imported and domestic products are ‘not similarly taxed’ and then applied ‘so as to afford protection.’ The obvious legal challenge to be made in defending taxation based QMA measure is the ambiguity arising from the absence of definitional criteria within the provisions of Article III for distinguishing between traded products based on differences that are not physically embodied in a product – NPR PPMs. Such criterion is generally absent in the GATT/WTO with a few exceptions, such as the use of prison labour, set out in GATT Article XX(e). Consequently, Article III jurisprudence on ‘likeness’ has been conducted on a case-by-case basis, involving an ‘unavoidable element of individual, discretionary judgment.’<sup>48</sup>

Article III:2 has two categories of comparable products. Firstly it requires Members to ensure that ‘like’ imported products are not taxed at all ‘in excess’<sup>49</sup> of ‘like’ domestic products. Any level of taxation imposed on imported products that exceeds the level imposed on domestic ‘like’ products will be deemed inconsistent with the first sentence of Article III:2.<sup>50</sup> Secondly, but equally important,<sup>51</sup> under Article III:2 if Members do not subject ‘directly competitive or substitutable products’ to similar levels of taxation, there must be an assessment to determine whether the different rates of taxation are applied ‘so as to afford protection to domestic production’. While the scope of ‘directly competitive or substitutable products’ is broad, it is governed by the overall anti-protectionist thrust of Article III:I through an examination of whether or not the measure is applied ‘so as to afford protection.’

Complementing this, Article III:4 obliges Members to ensure that non-taxation based internal regulatory measures afford imported products treatment that is ‘no less favourable’ than that offered to ‘like’ domestic products. A QMA scheme that required firms producing socially ‘bad’

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45 Sanford E. Gaines, “Processes and Production Methods: How to Produce Sound Policy for Environmental PPM-based Trade Measures?,” *Columbia Journal of environmental Law*, 27 (2002): 383.

46 Panel Report, *Italy- Agricultural Machinery*; Appellate Body Report, *Japan- Alcoholic Beverages II*.

47 This assumption allows an assessment of the legality of QMA schemes beyond a narrow discussion of a *prima facie* violation of the non-discrimination requirement according to GATT Article III.9.

48 Appellate Body Report, *Japan –Alcoholic Beverages II*.

49 In *Japan – Alcoholic Beverages II*, Appellate Body found that any level of taxation imposed on imported products that exceeds the level imposed on domestic ‘like’ products will likely be deemed inconsistent with the first sentence of Article III:2. *Op cit.* (Section H.1.b).

50 *Ibid.*

51 *Ibid.* The Appellate Body clarified that the phrase ‘like products’ in Article III:2 must be interpreted narrowly so as to not overshadow Article III:2’s second, broader category of ‘directly competitive or substitutable products.’

products to inform consumers of their ‘unacceptable’ production methods would be considered under Article III:4.<sup>52</sup> Article III:4 solely refers to ‘like products.’ Nevertheless, the Appellate Body in EC – Asbestos stated that to give effect to the purpose of Article III, the combined product scope of Article III:2’s product categories should not differ significantly from the scope Article III:4’s ‘like products’ category.

If, under a non-taxation based QMA measure products were found to be ‘like’ under Article III:4 provisions, the WTO Panel would move to examine whether the imported products are afforded treatment ‘less favourable’ than their domestic counterparts. The examination would find that under such a scheme there is origin-based discrimination if the different requirements afforded to these ‘bad’ and ‘good’ products result in a bigger overall disadvantage to the group of like (‘good’ and ‘bad’) imports as compared to the group of like (‘good’ and ‘bad’) domestic products. A Member’s regulations may formally discriminate between imported and domestic products as long as those regulations do not modify the conditions of competition in the relevant market to the disadvantage of the imported product.<sup>53</sup> A QMA scheme operates to modify the competitive environment among products that are in a close competitive relationship. However, the question is whether this also results in a competitive disadvantage for (‘good’ and ‘bad’) imports compared to the group of like (‘good’ and ‘bad’) domestic products.

Clearly, if under Article III ‘likeness’ were to be interpreted so as to consider environmentally or socially harmful products as ‘unlike’ similar but environmentally or socially ‘good’ products, the WTO’s non-discrimination provisions offer considerable flexibility for Members wishing to enact a QMA scheme, whether taxation based or not. The difficulty with this interpretation is that precise boundaries of ‘likeness’ and the impact of a ‘likeness’ determination on domestic policy making are still unclear within both the text of Article III provisions and GATT/WTO jurisprudence. In the 1987 Japan-Alcoholic Beverages dispute,<sup>54</sup> the Panel examined the criterion of consumers’ tastes and habits, and concluded that such an analysis could be misleading because of the potential for differential taxes to crystallize consumer preferences for domestic products. The Panel also found that ‘directly competitive or substitutable products were those with common characteristics, and which consumers seemed to view or use as alternatives or substitutes for others. Some products that the Panel did not conclude were ‘like’ were nevertheless found to be ‘directly competitive or substitutable’.

Further guidance is offered by the criteria set out in the Border Tax Working Party Report for determining like products:<sup>55</sup>

- the product’s end-uses in a given market;
- consumers’ tastes and habits, which change from country to country;
- the product’s tariff classification;

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52 The Kimberly Process Certification Scheme (KPCS) for example, requires that a certificate accompanies all rough diamonds to ensure that they are not ‘conflict’ diamonds, used as a source of finance by rebel forces to undermine governments.

53 See Appellate Body Report, *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, WT/DS161/AB/R, WT/DS169/AB/R, (January 10, 2001).

54 GATT Panel Report, *Japan – Customs Duties, Taxes and labelling Practices on Imported Wines and Alcoholic Beverages*, L/6216 - 34S/83 (November 10, 1987).

55 Working Party Report, *The Border Tax Adjustments*, L/3464 (December 2, 1970).

- the product’s properties, nature and quality.

The Appellate Body has emphasised that panels must look at all evidence relevant to a ‘likeness’ determination, assessing each criterion separately, and then weighing all relevant evidence together when concluding whether or not the different products examined are ‘like products’.<sup>56</sup> In cases where the products are ‘...physically very different, a panel can still conclude that they are ‘like products’ if it examines the evidence relating to all four criteria in analysing ‘likeness’.

In defending a QMA measure that differentiates between desirably and non-desirably produced goods, once again, it is most obviously criterion (ii), that is consumers’ tastes and habits, that presents the most potential for justifying a differential policy on the basis of the products being “unlike”. This was the case in the EC - Asbestos dispute where the Appellate Body relied on the nature of the ‘competitive relationship’ between two products in determining product likeness, and on ‘consumer tastes and habits’ in determining product distinctiveness. Thus a QMA scheme may be considered consistent with Article III based upon evidence that the NPR PPMs in question have well-established markets and/or well established health or environmental risks which significantly shape consumer behaviour.<sup>57</sup> However, consumer tastes and habits is but one of the four criteria to be considered. A QMA scheme, taxation based or regulatory, would be found to differentiate between like products under the other three criteria since for each of those factors there are no differences between the products being compared.

### 6.3. GATT Article XX Exceptions

Even if a WTO Member’s domestic regulatory measure is found to violate the non-discrimination obligations of the GATT, a Member may still defend the measure under the Exceptions of Article XX. These are the main provisions in the GATT that aim to balance conflicts arising between the GATT’s free trade objectives and other listed legitimate domestic non-trade policy goals. The most relevant QMA measures exempted under Article XX are set out in these following paragraphs:

- (a) necessary to protect public morals;
- (b) necessary to protect human, animal, or plant life or health;
- (c) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.

Although the Article XX exceptions are seen to balance the obligations of Members with the right to implement legitimate domestic measures relating to the environment or social welfare, these provisions may not be sufficient to justify all NPR PPM QMA schemes. Moreover, under Article XX the burden of proof is shifted from the complainant onto the respondent – the implementer of the QMA scheme – who must prove the ‘necessity’ of the measure within the framework of the provisions governing the individual exceptions.

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<sup>56</sup> Appellate Body Report, *European Communities – Measures Affecting Asbestos and Products Containing Asbestos*, WT/DS135/AB/R (April 5, 2001), paras101–103.

<sup>57</sup> See Jason Potts, *The Legality of PPMs under the GATT: Challenges and Opportunities for Sustainable Trade Policy*, (Winnipeg: International Institute for Sustainable Development, 2008).

A QMA scheme could potentially satisfy the requirements of these Article XX exceptions under certain conditions. Firstly, the scheme must be origin neutral, focusing instead on ‘unacceptable’ products or firms. It is also likely that the scheme will be perceived to be more legitimate if the policy objectives are based on internationally determined standards rather than domestic preferences. A trade measure can be considered to be ‘extraterritorial’ when it either relates to practices that are beyond its own customs territory (regulation of practices on the high seas, for example), or when it seeks to compel another Member to comply with its own domestic requirements.

The Article XX exceptions do not address the territorial application of national measures. That is, while Articles XX (a) and (b), for example, allow Members to take measures necessary to protect public morals or life and health respectively, they do not say whether the application of this provision should be only within the jurisdiction of the WTO Member implementing the measure. And while Article XX(g) allows for the protection of exhaustible natural resources, it does not explicitly limit such protection to the territory enacting the measure. Article XX(e), in contrast, can only apply meaningfully to imports, i.e. to products made by prison labour abroad.

The issue of extraterritoriality has not been static in GATT/WTO jurisprudence.<sup>58</sup> Most recently, in the EC - Seals dispute, the Appellate Body left open the question whether purely extraterritorial public morals measures can be justified under Article XX(a), noting that the EU Seal Regime<sup>59</sup> clearly addresses the morality of persons on EU territory consuming seal products from inhumane commercial hunts.<sup>60</sup> NPR PPM QMA measure imposing ‘extra-territorial’ requirements is potentially capable of receiving validation under the GATT exceptions set out under Article XX. The exceptional categories that appear to relate most closely to a QMA regime’s environmental and social objectives include those necessary to protect public morals, health, life or the environment. For all of the exceptions under Article XX, a defence will be more convincing, and more successful, if the standards they aim to uphold are internationally recognised, such as fundamental International Labour Organization (“ILO”) labour rights. Unilateral trade measures seeking to implement domestically determined standards of behaviour may be more difficult to defend if contested.

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58 The *US-Shrimp* case reversed the earlier restrictive approach to ‘extra-territorial’ measures found in the unadopted GATT US – Tuna/Dolphin I Panel. The US- Shrimp panel explicitly stated that no measure of this type could ever be validated under the Chapeau of Article XX.(Panel Report, *US-Shrimp*, para 7.45) 45 On appeal, the Appellate Body found, however, that all measures seeking validation under Article XX had to first be considered according to the terms of the individual exceptions provided for in that Article (Appellate Body Report, *US- Shrimp*, para 121). The *US – Tuna/Dolphin I* case concerned the US law prohibiting the import of tuna caught by dolphin-unfriendly methods. The Panel, therein, declared this US NPR PPM measure incompatible with the GATT on the grounds that to rule otherwise would allow any Member to unilaterally determine the life, health and conservation policies of other parties, which would jeopardize the trading rights guaranteed by the GATT. GATT Panel Report, *United States- Restrictions on Imports of Tuna*, DS21/R- 39S/155 (September 3, 1991) paras 5.27. 5.32.

59 Council Regulation 1007/2009/EC on Trade in Seal Products, O.J. L286, September 16, 2009; Council Regulation 737/2010/EC on Detailed Rules for the Implementation of Regulation (EC) No 1007/2009 of the European Parliament and of the Council on Trade in Seal Products Text with EEA relevance, O.J. L 216, August 10, 2010.

60 Appellate Body Report, *European Communities – Measures prohibiting the Importation and marketing of Seal Products*, WT/DS400/AB/R / WT/DS401/AB/R (June 18, 2014).

## 6.4. Article XX(a): Necessary to Protect Public Morals

Article XX(a) states that nothing in the GATT 1994 shall prevent the adoption or enforcement of any measure ‘necessary for the protection of public morals.’ While the GATT does not define ‘public morals’, the US-Gambling Panel Report stated that what constitutes public morals can vary in time and space, depending upon a range of factors, including prevailing social, cultural, ethical and religious values.<sup>61</sup> It went on to define ‘public morals’ as ‘standards of right and wrong conduct maintained by or on behalf of a community or nation’. Therefore, the protection of public morals could be invoked as a ground for justifying a QMA scheme which discriminates against the sale and use of goods produced in a manner inconsistent with minimum labour standards, basic human rights, minimum animal welfare or accepted environmental standards.

The analysis developed within the WTO DSB requires the party invoking an Article XX exception to demonstrate a nexus between the measure and its chosen policy objective by proving a connection between the targeted product and the risk posed by that product.<sup>62</sup> Thus, in order to justify a QMA scheme under Article XX(a), it must be shown that the measure falls under the specified general policy objective. The limit to what constitutes a risk to public morals under Article XX(a) is not definitive. The analysis will necessarily be country specific. Article XX(a) was successfully invoked by Saudi Arabia in its Accession to the WTO to justify the ban on the importation of any alcoholic and all types of machines, equipment and tools for gambling or games of chance.<sup>63</sup> Article XX(a) was invoked by China to justify censorship of its imported publications and by the US to justify its ban of on-line gambling services.

This defence was also applied to the EU’s ban on seal imports. Here the Appellate Body accepted the EU’s position that moral concern regarding the protection of animals is a value of high importance in the European Union.<sup>64</sup> The European Union was able to show that the discriminatory aspects of the measure – which was the exception under the EU Seal Regime for indigenous communities and seal products obtained from seals hunted for purposes of marine resource management - were consistent with the public morals exception and therefore necessary under Article XX(a). Significance for this discussion, is that the discriminatory aspects of the EU Seals Regime would not have been consistent with a defence under either Article XX(b) or (g), even if the Regime also had aspects that fall under both of these two exceptions.

Moreover WTO Members may set different levels of protection even when responding to similar interests of moral concern. So even if the EU has the same moral concerns regarding seal welfare and the welfare of other animals, and recognizes the same level of animal welfare risk in seal hunts as it does in its slaughterhouses and terrestrial wildlife hunts, the EU is not required by Article XX(a) to address such public moral concerns in the same way.<sup>65</sup>

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61 Panel Report, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/R (April 20, 2005), para 6.462.

62 See Panel Report, *European Communities – Measures Affecting Asbestos and Products Containing Asbestos*, WT/DS135/R (September 18, 2000).

63 World Trade Organisation, *Report of the Working Party on the Accession of the Kingdom of Saudi Arabia to the World Trade Organization*, WT/ACC/SAU/61 (November 1, 2005), Annex F, List of Banned Products.

64 Panel Report, *EC-Asbestos*.

65 *Ibid.*, para5.200

## 6.5. The Necessity Test

Necessity tests are designed to establish the WTO consistency of a measure based on whether the measure is “necessary” to achieve certain policy objectives. They reflect the balance between preserving the freedom of Members to set and achieve regulatory objectives through measures of their own choosing, and discouraging Members from adopting or maintaining measures that unduly restrict trade. Despite textual similarities between different necessity tests in WTO provisions, each provision would have to be interpreted in the light of the object and purpose of the Agreement of which it is part.

In the 2001 EC – Asbestos Appellate Body Report, it was found that for a measure to be deemed ‘necessary’ it does not need to be ‘indispensable’ or ‘inevitable’.<sup>66</sup> Rather, situated somewhere between an ‘indispensable’ measure and a measure ‘making a contribution to’ a goal, albeit significantly closer to the pole of ‘indispensable’. The Appellate Body subsequently set out the following three factor balancing test for deciding whether or not a measure is necessary when it is not per se indispensable:<sup>67</sup>

- The contribution made by the measure to the legitimate objective
- The importance of the common interests or values protected
- The impact of the measure on trade

Under this balancing test, a QMA scheme could potentially be defended under (1) and (2) if it aimed to prevent child labour, for example, which is widely held to be socially unacceptable by the international community. However, the scheme most likely does significantly affect the competitive environment of those countries exporting goods produced using ‘bad’ slave labour, it therefore remains open to being challenged under balancing factor (3): the impact of the measure on trade. The balancing process undertaken by a Panel needs to take account of all three factors, but given that the objective of a QMA measure is to restrict the access to the domestic market of ‘bad’ products, the Panel will likely find factors (1) and (2) compelling enough to justify the trade restrictive QMA measure. The Appellate Body in the Brazil-Tyres dispute found that if the analysis yields a preliminary conclusion that the measure is necessary, the result must be confirmed by comparing the measure with possible alternatives, which may be less trade restrictive while providing an equivalent contribution to the achievement of the objective. This comparison should be carried out in the light of the importance of the interests or values at stake. It is through this process that a panel determines whether a measure is necessary.<sup>68</sup> The Appellate Body likewise found that the EU Seal Regime was necessary in making some contribution to its legitimate objective of protecting the public morals of EU citizens due to their evident concern for animal welfare.<sup>69</sup>

While the responding Member must defend a measure as necessary, it does not have to ‘show, in the first instance, that there are no reasonably available alternatives to achieve its objectives’.<sup>70</sup> A complainant Member may argue that there are alternative measures to a contested QMA scheme. For example, it could be argued that alternative GATT-consistent measures are available in the

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66 GATT Panel Report, *Japan- Alcoholic Beverages I*, para 161

67 Appellate Body Report, *US- Shrimp*, para 164.

68 Appellate Body Report, *Korea-Beef*, para 166; Appellate Body Report, *Brazil – Measures Affecting Imports of Retreaded Tyres*, WT/DS332/AB/R (December 17, 2007), para 187.

69 Panel Report, *EC- Asbestos*, para 5.203.

70 Appellate Body Report, *Brazil –Retreaded Tyres*, para 165.

form of advocacy, diplomatic persuasion and targeted development aid to increase the expertise and capacity of these countries to improve their production methods. However, the Appellate Body has also stated that the Chapeau authorizes ‘an importing Member to condition market access on exporting Members putting in place regulatory programmes comparable in effectiveness to that of the importing Member.’<sup>71</sup> Neither of these alternatives can be considered as ‘equally effective’.

Therefore, a QMA type scheme could be successfully defended under Article XX as necessary particularly if a) the standards referenced in the scheme are internationally recognised; b) the Panel determine the impact on trade to be not disproportionate to the contribution made by the measure to achieving the legitimate objective; and c) the importance of the common interests or values being protected by the scheme is demonstrated.

## 6.6. The Chapeau

To successfully defend a QMA scheme under Article XX, two elements must be considered sequentially. First, and as discussed above, it must be determined whether the QMA measure at issue falls within the scope of one of the subparagraphs. Secondly, it must in compliance with the introductory clause or “*chapeau*”.<sup>72</sup> The burden of showing that a measure complies with the requirements of the chapeau of Article XX falls on the defending party, even after that party has established that the measure qualifies under one of the subheadings of Article XX. The Appellate Body has stated that this is, of necessity, a heavier task than that involved in showing that an exception encompasses the measure at issue.<sup>73</sup>

The chapeau is designed to ensure that a contested measure is ‘not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination’ or a ‘disguised restriction on international trade’. Whether or not a QMA measure conforms to the chapeau would depend on whether or not the measure subjected the designated ‘bad’ product to the same penalty import tax regardless of its country origin. The Appellate Body regarded various factors of relevance to a QMA scheme as “unjustifiable discrimination” under the chapeau in the Shrimp/Turtle dispute.<sup>74</sup> For example, in practice the US government required other countries to adopt essentially the same comprehensive programme<sup>75</sup> without taking into consideration different conditions which may occur in the territories of those other members.<sup>76</sup> The US embargo also included ‘good’ shrimp but from non-certified countries. Furthermore, the application of the measure resulted in differential treatment among countries because the U.S. negotiated a convention with some countries but not others, providing those signatories with a longer compliance time and greater technology transfer efforts. The Appellate Body held that the US scheme was applied in a manner which amounted not only to “justifiable discrimination” but also to “arbitrary discrimination” between countries where “the same conditions prevail”. As a result, the Appellate Body concluded that the U.S. measure could not be justified under the GATT XX.

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71 Appellate Body Report, *US-Shrimp*, para 144.

72 Appellate Body Report, *United States –Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R (May 20, 1996), 22.

73 *Ibid.*, 22-23; see also WTO Analytical Index, Vol. 1, 340-342.

74 Appellate Body Report, *US-Shrimp*, para 176.

75 Turtle Excluder Devices (TEDs).

76 Appellate Body Report, *US-Shrimp*, para 164.



## 6.7. Summary of Legal Assessment

This legal analysis indicates that differential tariff treatment based on NPR PPMs is likely to be seen as a violation of Articles II and I because of the narrow like product analysis considered for tariffs. For non-tariff QMA measures, while controversial, it is also likely that tax or regulatory distinctions based on NPR PPMs will be considered a violation of Article III national treatment obligations. NPR PPMs are not likely to survive a like-product analysis. For while the factor of consumer tastes and habits provides some potential to differentiate products based on NPR PPMs, the case law has been more focused on assessing the competitive relationships among essentially identical products. While there is a legal possibility of differential treatment within the like product grouping, it is not clear how cases based on this 'group' identification standard would actually be treated in the practice.

Notwithstanding this pessimistic prognosis, the outcome is more hopeful for Article XX defences. There is considerable scope to justify particular QMA schemes under these exceptions, as long as the QMA measure being defended is based as far as possible, on non-origin criteria that recognises products and producers rather than countries or regions. This would be further aided by any international norm of soft law supporting such qualifying distinctions. The Appellate Body in the EC-Seals dispute accepted the discriminatory aspects of the EU Seals Regime because the exception for indigenous communities and seal products obtained from seals hunted for purposes of marine resource management -were consistent with the public morals exception under Article XX(a). This is of legal consequence for defending any NPR PPM QMA scheme that was implemented in order to protect public morals under the WTO Dispute Settlement Understanding.

## 7. Conclusions

This paper discusses a particular proposal for the use of trade penalties to punish partners whose labour or environmental standards do not meet those of an importer, NPR PPMs. The specific "Qualified Market Access" proposal was made a by European Parliamentarians to the European Commission, but it was not adopted. It has however resurfaced in a number of guises, including the proposal for Border Carbon Adjustments.<sup>77</sup> The TPP Agreement, signed as we were completing this text, also has explicit requirements on national labour and environment rules.

We conclude in our analysis that a proposal such as the QMA plan is not inconsistent with basic welfare economics, provided we recognise the existence of psychic externalities. This view has a long history going back to Adam Smith. Howse and Regan argued it should be applied in trade law.

We assume in this paper that European consumers suffer genuine disutility when they consume products within the EU knowing they have been produced in socially or environmentally undesirable ways, whether the consumption is their own or by other people. Making these assumptions we conclude that we cannot accept or reject the case for QMA on *a priori* grounds, when a welfare comparison is made between a status quo in which the externality exists and one in which the QMA proposal is applied. We find that the welfare effects depend on a number of unobserved

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<sup>77</sup> Peter Holmes, T. Reilly and Jim Rollo, "Border Carbon Adjustments and the Potential for Protectionism," *Climate Policy* 11, no. 2 (2011): 883.

parameters such as the degree of preference of the domestic consumers, as also the number of consumers who dissent from the majority view.

The economic analysis is followed by a legal analysis which in parallel comes to a conclusion that recent WTO jurisprudence, notably the Shrimp-Turtle and Seals cases, suggests that policies of this nature cannot be ruled out a priori as WTO-illegal. We are thus departing from the traditional view that argues that trade measures should never be used to enforce environmental aims. However, as was the case with BCAs<sup>78</sup>, the authors would argue for the same reasons that in the absence of a convincing welfare case in favour of these measures, we should err on the side of prudence and avoid such measures. It is also likely that greater scope for genuine environmentally motivated measures would stimulate spurious claims inspired by producers, as might possibly be happening in the US-Vietnam Shrimp anti dumping case. This opening of the Pandora's box would not only invite retaliation, but would also be a window of opportunity to countries which objected to EU or US social practices of using trade sanctions.

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78 Holmes et al., "Border Carbon Adjustments and the Potential for Protectionism", 883.