

Competition, Not Regulation – or Regulated Competition?

No Regulatory Purpose Test Under the Less Favourable Treatment Standard of GATT Article III:4 Following *EC-Seal Products*

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*GATT Article III:4 aims at equal treatment in respect of competitive opportunities of imports and competing domestic products by preventing protectionism. A key question is whether regulations with heavier burdens on imported products than on domestic products and a valid regulatory purpose are consistent with Article III:4. Inquiry into regulatory purpose under Article III:4 would allow by-passing Article XX whose list of regulatory objectives is a closed one and which puts the burden of proof on the defending WTO member. In *EC-Seal Products*, the Appellate Body has rejected any role for the regulatory purpose inquiry under Article III:4. This article shows why a purely empirical definition of likeness and less favourable treatment as disparate impact cannot logically lead to a finding of a violation of Article III:4. It then argues that regulatory purpose continues to play a role under Article III:4 because of the centrality of the notion of competition. It proposes to frame that competition as perfect competition. It shows that the adoption of perfect competition as the evaluative benchmark for all of Article III:4 makes better legal sense than starting from imperfect competition for the likeness analysis and perfect competition for the less favourable treatment standard, as is proposed in the literature. It also shows that even in case where imperfect competition is used as the sole benchmark for both parts of Article III:4, an assessment of how regulation interacts with competition continues to play some role.*

I. Introduction

This contribution focuses on the national treatment obligation enshrined in Article III:4 of the GATT. Article III:4 is one of the key trade liberalizing provisions in the GATT. It prohibits WTO members from worsening the competitive opportunities of imports compared to competing domestic products through regulatory measures. The issue of disguised regulatory protectionism hence looms under Article III:4. At the same time, it also has a large impact of WTO member's regulatory freedom because a preliminary violation of Article III:4 shifts the burden onto the defending member to justify the regu-

lation as necessary to meet one of the exhaustively enumerated public policy objectives under Article XX.

Academics have long wondered whether valid policy purposes can 'save' regulations that affect imports detrimentally from a violation of Article III:4. It seems that the Appellate Body in *EC-Seal Products* has decided that a violation of Article III:4 is purely effects-based without account being taken of the policy purposes that may explain and justify these impacts.

I want to put forth a theory of interpretation of Article III and incidentally of XX that shows that regulatory issues still play a direct role under the primary legal text of Article III:4 and that this follows from the way the likeness and less favourable treatment analysis has been defined. In doing this, I do not purport to offer a reconstruction of all of the case law on

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Article III able to fit the divergent approaches taken there. Instead, I only claim that my theory fits with the text of Article III itself and the bottom line of the Appellate Body's decision in *EC-Seal Products* that Article III:4 is about relations of competition while Article XX is about regulation.

What I want to suggest in the following is that regulations that deal with correctible market imperfections and are narrowly-tailored are a ground for finding that the national treatment standard is not violated. In other words, these issues become relevant under the Article III:4 standard itself and not under Article XX. However, two types of regulatory measures continue to fall outside of Article III:4 and are instead subject to Article XX. First, regulatory measures that arise from the impossibility in the real world of reaching a situation of perfect competition. Second, measures whose justification lies precisely in the fact that even a perfect market is not the right allocative instrument.

When interpreted through the lens of my theory, the *EC-Seal Products* decision that Article III:4 is about competition and Article XX about regulation may then not be as bad as it first looks. Read in the way I suggest, it would still preserve significant room for considering regulatory issues under Article III:4 while also leaving a role for Article XX. My analysis should nevertheless not be seen as an endorsement of the Appellate Body's decision in *EC-Seal Products*. The fact that the Appellate Body dealt with the regulatory aspects of the Seals Regime under Article XX shows that it was not guided by my theory. I only claim that the indeterminacy of the term 'competition' that the case law has left creates the possibility of fitting my theory into the decision in *EC-Seal Products*. My analysis is hence a constructive critique of the *EC-Seal Products* decision.

Section II.1 briefly reviews the case law on Article III:4. Section II.2, demonstrates with a direct example from *EC-Seal Products* why using detrimental impact plus attribution à la *Dominican Republic–Cigarettes* as the sole test is non-sensible. In section III, I set out my theory for the interpretation of likeness and less favourable treatment in Article III:4, discussing whether or not perfect or actual, imperfect competition should be the relevant type of competition at issue in Article III. Section IV demonstrates why perfect competition as the benchmark for Article III:4 also makes better legal sense. Section V concludes.

II. The Case Law Thus Far: The Two Tests of Article III:4 Are All About Market Competition – or Are They?

1. The Case Law Thus Far

Article III:4 applies to domestic laws, regulations and requirements of a WTO member and requires that those measures give imported products no less favourable treatment (LFT) than like domestic products. There really are two main legal tests: Are domestic and imported products like? And does the regulatory measure treat imports less favourably? In Article III:1, members also recognize that those measures should not be applied so as to afford protection (SATAP). Article III:1 sets forth a stipulation that informs Article III:4 but creates no separate obligation in respect of laws, regulations and requirements that is additional to Article III:4.¹ In fact, the Appellate Body has stated that an inconsistency with Article III:4 implies that there is protectionism.² The operative legal terms of likeness and LFT are therefore a specification of the notion of protectionism.

To make a case of a violation of Article III:4, a complainant first has to establish that products are like. The Appellate Body has stated that the likeness inquiry is fundamentally an inquiry into whether or not there is a competitive relationship between the products in the market of the member judged as a whole.³ In addition to other possible factors, tariff classification, physical properties of the product, its capability of serving the same or similar end-uses and consumer tastes and habits are relevant.⁴ In *EC-Asbestos*, the Appellate Body conceded that clearly established health risks had a bearing on physical properties, end-uses and consumer tastes and hence af-

1 European Communities – Measures Affecting Asbestos and Asbestos-Containing Products, Report of the Appellate Body, WTO Doc., WT/DS135/AB/R, 12 March 2001, para. 98.

2 Ibid., para. 100.

3 Ibid., para. 99.

4 Ibid., paras. 101, 103. In taxation cases involving Article III:2, the Appellate Body has also considered cross-price elasticity of demand as useful and a TBT case used consumer survey data as evidence of consumer tastes and habits. See, *Japan-Taxes on Alcoholic Beverages*, Report of the Appellate Body, WTO Doc., WT/DS8/AB/R; WT/DS10/AB/R, WT/DS11/AB/R, 1 November 1996, p. 25 and Appellate Body Report, *United States – Measures Affecting the Production and Sale of Clove Cigarettes*, WTO Doc., WT/DS406/AB/R, 24 April 2012, paras. 150-151.

affected the extent to which products compete.⁵ The Appellate Body suggested that the decision of manufacturers would be influenced by the fact that ultimate consumers might reject the product, by civil liability for asbestos-related illness and death and by the additional cost of using the product safely.⁶

If products are like, the next step in establishing a violation of Article III:4 is to show that the laws, regulations or requirements afford LFT. Approving of an earlier GATT panel report, the Appellate Body stated that this standard was about whether or not there was a modification of conditions of competition between imports and domestic products to the detriment of imports.⁷ So, in short, likeness is about whether or not products compete, LFT about whether the measure modifies the conditions of competition.

The Appellate Body has considered that the group of like imported products has to be adversely affected compared to the group of like domestic products for there to be LFT.⁸ In other words, the majority of the complainant's exports has to be adversely affected while the majority of domestic products has to enjoy the more favourable treatment. It is not enough that only one imported product is negatively affected for there to be less favourable treatment.⁹

Just a showing of detrimental impacts is nevertheless not enough for a complainant to demonstrate less favourable treatment. The Appellate Body added further loops through which a claim of LFT must pass to be successful. In *Dominican – Cigarettes*, the Dominican Republic imposed a fix bond on ciga-

rettes that resulted in a higher per-unit cost of the bond to cigarettes from Honduras than to cigarettes from the Dominican Republic because Honduran cigarettes had a smaller market share. Even though an – admittedly very small – effect on prices was present, the Appellate Body did not consider this enough for there to be LFT if the impact is explained by factors or circumstances unrelated to the imported origin of the product.¹⁰ This statement has given rise to the question of whether a non-origin related, regulatory purpose could save a detrimental impact from inconsistency with Article III:4.¹¹ In *US – Clove*, the Appellate Body clarified that its statement was meant to say that the detrimental impact could not be attributed to the bond because its detrimental effect arose through the choices of consumers in the market.¹²

Why is it significant whether Article III:4 contains an inquiry into regulatory purpose? Article XX GATT contains a closed list of regulatory objectives and there has been a worry that WTO members would find themselves unable to justify public policies they deem important.¹³ Allowing an open-ended inquiry into regulatory purpose under the LFT standard could address this worry. Additionally, fewer regulatory measures might have to be justified under Article XX where the defending member bears the burden of proof for the most part.¹⁴ Lastly, under the non-discrimination obligation in Article 2.1 of the TBT Agreement, no violation exists in case the detrimental impact stems exclusively from a legitimate regulatory distinction.¹⁵ There is a worry that the TBT

5 *EC – Asbestos*, Report of the Appellate Body, *supra* note 1, paras. 113-114, 118.

6 *Ibid.*, para. 122.

7 *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, Report of the Appellate Body, WTO Doc., WT/DS161/AB/R, WT/DS169/1B/R, 10 January 2001, paras. 135-7.

8 *EC – Asbestos*, Report of the Appellate Body, *supra* note 1, para. 100, *European Communities – Measures Prohibiting the Importation and Marketing of Seal Products*, Report of the Appellate Body, WTO Doc., WT/DS400/R, WT/DS401/AB/R, 18 June 2014, para. 5.117.

9 Lothar Ehring calls a legal standard whereby less favourable treatment would depend on whether one imported product was negatively affected the diagonal test. Lothar Ehring, "De Facto Discrimination in World Trade Law National and Most-Favoured-Nation Treatment—or Equal Treatment", 36 (5) *Journal of World Trade*, (2002), 921 et seq., at pp. 924-925.

10 *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes*, Report of the Appellate Body, WTO Doc., WT/DS302/AB/R, 19 May 2005, para. 96.

11 In *EC-Seals*, the EU tried to rely on *Dominican Republic – Cigarettes* to suggest that more than just a detrimental impact had to

be presented. See *EC-Seals*, Report of the Appellate Body, *supra* note 8, para. 5.103.

12 *US – Clove*, Report of the Appellate Body, *supra* note 4, footnote 372.

13 Weihuan Zhou, "US – Clove Cigarettes and US – Tuna II (Mexico): Implications for the Role of Regulatory Purpose under Article III:4 of the GATT", 15 (4) *Journal of International Economic Law* (2012), 1075 et seq., at pp. 1111-2.

14 Gene M. Grossman, Henrik Horn and Petros C. Mavroidis, "Legal and Economic Principles of World Trade Law: National Treatment", American Law Institute Project Legal and Economic Principles of World Trade Law, *IFN Working Paper No. 917*, 28 April 2012, available on the Internet at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2094286 > (last accessed 3 May 2015) at pp. 125-6.

15 *US – Clove*, Report of the Appellate Body, *supra* note 4, paras. 175, 181-2; *United States – Certain Country of Origin Labelling (COOL) Requirements*, Report of the Appellate Body, WTO Doc., WT/DS384/AB/R, 23 July 2012, paras. 271, 373-379, *United States, Measures Concerning the Importation, Marketing and Sale of Tuna and Tuna Products*, Report of the Appellate Body, WT/DS381/AB/R, 13 June 2012, paras. 215, 315-322.

Agreement might be more permissive of regulations than the GATT.¹⁶

In *EC-Seal Products*, the Appellate Body has now clarified that there is no inquiry into whether the disparate impact stems exclusively from a legitimate regulatory distinction under the LFT test.¹⁷ It gave two reasons for this conclusion. One is that there is no direct reference to the SATAP language of Article III:1, with the result that the violation has to be judged on the LFT terms of Article III:4 alone, which have been interpreted to refer to detrimental impacts.¹⁸ The other reason is that, unlike the TBT Agreement, the GATT contains Article XX to justify regulatory policies and that the aim of creating coherence and consistency across agreements (rather than provisions) requires taking this difference into account and interpreting Article III more restrictively.¹⁹

Ming Du has argued that regulatory purpose will henceforth not be considered under the LFT test, which will be failed just on the basis of a detrimental impact.²⁰ He concedes that the strictness of that test has to be weighed against any greater room for regulatory autonomy under the likeness analysis.²¹ It is true that an attempt to show LFT will never get off the ground if the products are unlike due to their risk. Citing Howse, he also concedes that the requirement that there must be a genuine relationship between the measure and the detrimental competitive impact on imports entails that it must be excluded that the detrimental impact is due to climatic, geographical or demographic factors, changing consumer tastes or ethical values.²² Where a measure only has incidental and negligible impacts on imports as in *Dominican – Cigarettes*, Du considers that it should pass the LFT standard.²³ To me, the more interesting question is whether a measure with significant impacts might not also pass that test. I want to suggest that this is possible. Last, Du considers that the investigation of the design, architecture and revealing structure of a measure may open some scope for subsuming the SATAP language of Article III:1 into Article III:4.²⁴ The question here is what ‘so as to afford *protection*’ actually means. Ideally, it should mean the imposition of measures that cannot be fully justified by regulatory reasons. But this is really just like the TBT-language of stemming exclusively from a legitimate regulatory distinction that the Appellate Body rejected in *EC-Seal Products*. Instead, the Appellate Body’s equation ‘detrimental impacts = LFT = SATAP’ shows that it interprets the term ‘pro-

tection’ to include beggar-thy-neighbour trade protectionism²⁵ and regulatory protectionism. The result is that any indirect consideration of the SATAP language under the design, architecture and revealing structure would continue to catch valid regulatory policies. What this means is that regulations of products in a competitive relationship are *prima facie* suspect if they have differential impacts – even though the GATT (and other covered agreements) do not evidence *laissez-faire* economics as their primary concern.

2. Detrimental Impact As the Sole Criterion for Less Favourable Treatment Is Unworkable

This section shows why detrimental impacts understood as a mere numerical evaluation of relative shares of products affected by the regulation cannot be the sole criterion for finding less favourable treatment. It first discusses a direct example from the *EC-Seal Products* case before presenting more general considerations and a hypothetical that reveal why numbers only cannot be determinative of less favourable treatment.

In the panel’s detrimental impact analysis in *EC-Seals*, the weight it attached to the relative shares of allowed domestic products and disallowed products

16 Zhou, “Role of Regulatory Purpose”, *supra* note 13, at p. 1112. Others have argued that the TBT Agreement is more restrictive of regulation because the detrimental impacts have to stem *exclusively* from a legitimate regulatory objective. See Lukasz Gruszczynski, “The TBT Agreement and Tobacco Control Regulations”, 8(1) *Asian Journal of WTO & International Health and Policy* (2013), 115 *et seq.* at pp. 132-133. Which of the two agreements is more restrictive of regulation is not material to my argument. For this reason, I do not discuss these conflicting perspectives further here.

17 EC – Seals, Report of the Appellate Body, *supra* note 8, para. 5.117.

18 *Ibid.*, paras. 5.114-5.117.

19 *Ibid.*, paras. 5.121-5.125.

20 Ming Du, “Treatment No Less Favourable’ and the Future of National Treatment Obligation in Article III:4 of the GATT 1994 after *EC – Seal Products*”, forthcoming in *World Trade Review*, p. 15.

21 *Ibid.*, at pp. 30-33.

22 *Ibid.*, at pp. 25-26 [with further references].

23 *Ibid.*, at pp. 26-27.

24 *Ibid.*, at pp. 27-30.

25 Defined as a small or absent domestic efficiency in the presence of a larger cross-border inefficiency. See Grossman, Horn and Mavroidis, *supra* note 14, at pp. 102, 113-116.

of the complainant occasions the need for some further reflection. In 2001, the total number of Canadian seal products in the allowed category (some 35,000) exceeded the very small number (86) of European seal products actually eligible as seals hunted to protect local fish stocks in accordance with a marine resources management plan (MRM) by a large margin.²⁶ Those 86 seals represented the entire European seal production whereas the bulk of Canadian seal production was excluded as commercially hunted seal. If there is such a discrepancy in absolute numbers, relative shares of complainant's products and domestic products in the allowed/disallowed categories are not really an indication of detrimental impact and origin-specificity but may simply be an incidental effect of the regulation. From a public choice perspective, if there is no established domestic industry of the defendant, there is also no danger of protectionist interest group capture. As Pitschas and Schloemann point out, the non-profit requirement in the MRM exemption implies that there was no commercial competition in the first place which could be protected and for which a change in competitive equality of opportunity could occur.²⁷ I suggest the panel needs to take into account the absolutely speaking low level of domestic production in order to assess whether or not there is discrimination.

The reader may think that this one, extreme example of the MRM seals is not enough to show that the detrimental impact test as the sole test for finding less favourable treatment is unworkable. As I will show now, however, the problems stem from the test itself rather than exceptional 'freak' situations.

The numerical test of the disparate impact analysis seems simple enough. If 90% of imports and 10% of like domestic products are in the disfavoured category and 10% of imports and 90% of like domestic products are in the favoured category, it does look as if the measure reduces the possibility for imports to

sell disproportionately. Unfortunately, the numerical test is also simplistic. It is illogical, under-theorised and fails to take seriously the many empirical ways in which competition can manifest itself.

To show why it is simplistic, we just have to ask ourselves: What if the percentage of imports in the disfavoured category is 50.1% and 49.9% of like domestic products and in the favoured category, we find 49.9% of imports and 50.1% of domestic products? Is this enough to show a disparate impact? Is 0.2% *really* a disproportionate effect that Article III:4 should worry about as trade protectionism, given that its overarching purpose is to prevent protectionism? If it is not, what percentage then is the right cut-off that indicates potential protectionism? 60%, 75%, 80% or 90%?

Does the cut-off percentage hinge on the type of product we are confronted with and the way it competes with other products? Does it matter whether the like products are ultra-sophisticated, knowledge-intensive and relatively unique products such as medical testing equipment produced by only a handful of firms worldwide rather than low-key, relatively uniform products such as pencils produced everywhere?

Consider this hypothetical: There are four manufacturers of like but slightly different medical testing equipment world-wide, two domestic (B_D and D_D), two from another WTO member Expatia (A_E and C_E).²⁸ B_D most closely competes with C_E and D_D most closely competes with A_E . A_E outperforms D_D by a significant margin and has done so for a long time. Competition between B_D and C_E is cut-throat. In other words, the competitive relationship between the products of B_D and C_E is very close and direct, it is less direct between the products of A_E and D_D because consumers tolerate some more price increases of A_E before switching to products of D_D and eventually to B_D and C_E . Now, the home market WTO member of B_D and D_D , Domestica, passes a highly restrictive regulation whose effect is to put D_D into the disfavoured category and this makes up for 51% of Domestica's production and B_D into the favoured category and this makes up for 49% of Domestica's production. The effect on Expatia is that A_E is in the favoured category (equaling 51%) while C_E is in the disfavoured category (equaling 49% of its exports). Numerically, the most detrimentally affected category is domestic (D_D) so there should be no less favourable treatment. But could we not say that Domestica nev-

26 *European Communities - Measures Prohibiting the Importation and Marketing of Seal Products*, Report of the Panel, WT/DS400/R, WT/DS401/R., 18 June 2014, fn. 227.

27 Christian Pitschas and Hannes Schloemann, "WTO Compatibility of the EU Seal Regime: Why Public Morality is Enough (but May not Be Necessary)", *Beiträge zum transnationalen Wirtschaftsrecht*, Institute of Economic Law, May 2012, available on the Internet at <http://telc.jura.uni-halle.de/sites/default/files/BeitraegeTWR/Heft118.pdf> (last accessed on 3 May 2015) at p. 16.

28 D_D and E_E stand for 'domestic' and 'imported from Expatia' respectively.

ertheless acted in a protectionist manner because it sacrificed the nearly bygone D_D in order to keep out C_E for the sake of protecting B_D against its closest competitor? Now, in the case of pencils produced by some 500 firms in Domestica and Expatia, it would seem rather unrealistic that roughly half of Domestica's domestic pencil producers managed to capture the regulator who then became completely indifferent towards the other rough half of its pencil producers and that one type of pencil should suffer from significant adverse consumer selection that is the result of product quality or reputation. These examples go to show that the cut-off percentage based on which a disparate impact will be found needs to be sensitive to the product we are confronted with and the way it competes in the market in order to tell us something about protectionism.

Furthermore, is the cut-off percentage not perhaps additionally influenced by the nature of the regulation and the way it affects competition? Should it not make a difference whether the regulation in the hypothetical with the high-tech medical equipment is a ban that prohibits market access completely as compared to a regulation that requires adding a sticker to high-tech medical equipment to warn health workers about the laser the product contains and that adds a small amount of cost? If it is a ban, perhaps it is not necessary that a majority of imports be detrimentally affected if we are confronted with highly sophisticated products and if it is an insignificantly restrictive regulation such as adding a sticker, perhaps the cut-off percentages have to be much higher (say, 90%)?

The upshot of this section is that numbers by themselves tell us nothing about what we are interested in under Article III: competition and protectionism. To formalise the insight of this section in terms of logic: When something like competition between products is a matter of degree (and it often is), it cannot be converted into a one-size fits all absolute threshold (such as 51%), at least not without the help of some other element. Pressing on, the result of the Appellate Body's decision in *EC-Seal Products* is that empirical likeness of products and empirical disparate effects together suffice for a *normative* finding of a violation of Article III:4. This is a *non-sequitur*. We cannot get from facts directly to a normative judgment. Facts do not have their own normativity. As Don Regan puts it, "[p]rotective effect has no normative significance in itself..."²⁹ I submit that

all violations of law are never just the result of a certain set of facts but rather the result of a normative judgement of blameworthiness passed on a set of facts. A telling and representative example from criminal law illustrates this. Thus, the crime of murder does not consist merely in the intentional killing of another human being but also in a series of other normative judgments about blameworthiness of the act, such as whether the killing occurred for reasons of self-defense, in military combat, etc.

What we can deduce from this section is that what is required is a qualitative understanding of how regulation affects competition and a normative benchmark of what kind of market competition it is that Article III seeks to protect against governmental protectionism. The following section aims to demonstrate why this need for a theory of market competition follows directly from the term 'competition'.

III. Is Article III:4 Fundamentally About an Unregulated or a Regulated Market?

When we speak of competition we can mean several things: a sports competition, an entry-level exam or market competition between products. Obviously, the latter is what should interest us under the GATT. Market competition is not a legal term, unlike, for instance *estoppel* or *pacta sunt servanda*, which are conclusively defined through the discipline of law alone. Instead, market competition refers to empirically observable phenomena and this makes economics, which studies these, relevant to how we should understand the notion of competition under Article III:4. Now, a fundamental distinction in economics is between perfect and imperfect competition. Perfect competition is a situation in which consumers dispose of all the necessary information in order to take decision that are ideally utility-maximising for themselves, externalities on third persons (such as pollution) are absent and companies do not possess market power to fix prices. Under perfect competition, consumers are in a position to make efficient

29 Donald H. Regan, "Regulatory Purpose in GATT Article III, TBT Article 2.1, the Subsidies Agreement, and Elsewhere: *Hic et Ubique*", in Geert van Calster and Denise Prévost (eds.), *Research Handbook on Environment, Health and the WTO* (Cheltenham, Edward Elgar, 2013), 41 *et seq.*, at p. 48. For related arguments about the lack of guidance numbers offer, see also pp. 47-48, 54.

choices and to assess which product best matches up to their preferences and their purchase and consumption does not adversely affect the utility of another person. A perfect competition really is one in which consumers are able to give informed consent to a product purchase or, put differently, where they incur any risks associated with a product voluntarily. Crucially for our purposes, under imperfect competition, not all relevant information is available to the consumer or their consumption gives rise to an externality on third persons. Where information is lacking, consumers will be making imperfectly efficient purchasing decisions for instance because they ignore that the product will damage their own health. Where a third party externality is present, someone else's utility is harmed without the product purchaser (or the producer) having to internalise the cost of this damage. Both in the case of a third-party externality and in case of inefficient decisions, risks or damages are incurred involuntarily. There is hence a reason for governmental regulation to correct these externalities.

Recall that in *EC – Asbestos*, the Appellate Body had determined that likeness was fundamentally about a competitive relationship between products. Unfortunately, the Appellate Body never specified whether this referred to a situation of perfect or imperfect competition.

1. Hypothesis A: Likeness Is About a Relationship of Competition Under Perfect Competition Against Which Less Favourable Treatment Is Benchmarked

If the different likeness criteria were to be assessed in a situation of perfect competition, the likeness analysis would usually not be concerned with direct evidence on the revealed preferences of consumers in the actual domestic market of the WTO member and actual end-uses. The reason why the actual domestic market would usually not be used as the market of reference is because any real market is likely to present various imperfections. Instead, the market should be experimentally modelled so that con-

sumers are given full information for efficient purchases and externalities on third persons and price-fixing power are absent.

This means that the key question Article III:4 is trying to answer is: Is the risk presented by the product efficient or not? In the case where the risk only affects the purchaser of the product and no-one else (i.e. it is a self-regarding risk), the assumption of the risk is efficient if its disutility is outweighed by the utility from the product and its low enough price. In other words, the consumer is better off with the product although it carries a risk than without it, given what other alternatives are available to the consumer. Presumably, the consumer then has good reason to buy the product and accepts the risk voluntarily. Obviously, if a third person externality was present, that is, if the product caused a risk to a third person, the product's production or consumption would be inefficient vis-à-vis the third person because this person would be asked to bear a risk from which she derives no utility.³⁰

To understand how this analysis would work, assume that there are different user groups of the imported product and that the imported product is risky for the vulnerable user group but not for the predominant user group. There are also domestic products with which it can be substituted that are not risky or much less so. A stylised example would be a prohibition to sell alcopops (attractive beverage for teenagers who risk drinking too much) while allowing the sale of beer (assume beer is not attractive for teenagers) in establishments frequented by young persons while allowing the sale of alcopops in establishments frequented only by adults (who do not overconsume alcopops). Now, all the information about the risks would have to be conveyed to the consumers in a situation of perfect competition. Based on *EC-Asbestos*, we know that the risk of the imported and domestic product affecting the consumer matters for the competitive relationship between them. For the sake of simplicity, also assume that no third person externality exists in this example.

How should the perfectly competitive market be modelled to ensure that we are catching only competition (and efficiency) of the relevant type? Clearly, in extreme situations, many different products can compete with each other. If the price of motor vehicle shoots through the roof, people will switch to buying bicycles but this does not mean that Article III:4 should concern itself with the regulatory treatment

30 There can be production and consumption externalities. An example of a production externality is methane gas emissions and the cutting down of rainforest in the raising of cattle. An example of a consumption externality is passive smoking.

of motor vehicles compared to that of bicycles. We need a test to focus the analysis on the *relevantly close* competition only. It is proposed that the small but significant non-transitory increase in price (SSNIP) test from competition law can do this focusing work. The test measures substitution effects between two products if the price of one product rises noticeably but still to a small extent. It is a measure for the directness of competition and thus of the extent to which consumers substitute one product for the other because they are seen as similar and capable of performing the same end use.

To measure whether or not the self-regarding risk matters for the competitive relationship of the two types of product, it should be assessed whether a small but significant non-transitory increase in price in the safer domestic product would lead the vulnerable group to switch to the riskier imported product.³¹ If this were so, the assumption of the risk becomes presumptively efficient at the given price. If this were not the case, there is a strong indication that the two types of product are not substitutable for the vulnerable consumer, in other words that they are not 'like'. For the predominant user group, the SSNIP test would reveal immediate substitution and indicate that overall, the products are 'like'.

Assume further that the regulatory measure is narrowly-tailored to operate only in situations in which consumers in the vulnerable group are likely to be exposed to the risky imported product. Under a purely formal criterion of less favourable treatment that looks only at the percentages of the products affected, there would be a detrimental impact from the regulation because 100% of domestic products find themselves in the favoured, unregulated category while 100% of the imported product is in the disfavoured category. Yet it seems very difficult to argue that the regulation treats the imported product less favourably as long as the regulation is narrowly-tailored in the way described above. It is difficult because, based on *EC-Asbestos*, one would conclude that in that market segment of vulnerable consumers, the two products do not in fact compete and the regulation has no impact on the other market segment where they do compete (and are equally safe or risky). If less favourable treatment refers to an adverse change in the conditions for competition it could only ever arise if the measure affects a market segment within which the products *do* compete. Less favourable treatment therefore needs to be defined

more substantively than just detrimental impacts in order not to lead to absurd results if likeness includes consumer tastes and end-uses and the risk of a product is relevant to the assessment of whether or not it competes with another product. I also think that a more substantive account of what it means to disfavour products in the market place is the only one that makes sense of the notion of favouring/disfavouring textually.

What I am suggesting is that likeness should be assessed under perfect competition and that less favourable treatment should measure the regulation against whether or not it brings the imperfect competition in a real market for which it is developed closer to perfect competition.³² The notion of *less favourable* here is supplied by the failure of the regulation to regulate in the right direction, that is, towards achievement of perfect competition. Note also that it is not necessary that the policy is covered by Art. XX in order to be consistent with Article III:4.

Several objections may arise at this point and I will try and counter all of them. The first objection is that it should then also become possible for a complainant exporting the safe product to challenge the failure of the defending WTO member to regulate its own, domestic, unsafe product. WTO law would thus be turned into an instrument of mandatory, regulatory reform. This is – I agree – inconsistent with the objectives of the GATT and the WTO Agreement being about trade liberalization rather than regulation. However, this possible counterargument can be rebutted because it gives rise to an inconsistency with

31 For an explanation of how the SSNIP test should be used for Article III (or 2.1 TBT) when there are different user groups, see Marios C. Iacovides, "Marginal Consumers, Marginalized Economics: Whose Tastes and Habits Should the WTO Panels and the Appellate Body Consider When Assessing 'Likeness?'," 48 *Journal of World Trade* (2014), pp. 323 *et seq.*, 350.

32 This suggestion builds in significant measure upon the theory for the interpretation of the national treatment obligation developed by Grossman, Horn and Mavroidis and on a similar perspective developed by Don Regan, *supra* note 29, especially pp. 54 and 61 *et passim*. Grossman, Horn and Mavroidis argue that likeness should comprise actual market likeness and policy-likeness (the question of externalities) and that the analysis of discrimination should examine whether the regulatory distinction remains in proportion to the extent of policy-difference. See Grossman, Horn and Mavroidis, *supra* note 14, at 110-116, 132. According to them, market likeness is needed in order to make sense of the notion of protectionism because products could give rise to the same externality but in different degrees without different treatment, however, being protectionist since the products are not substitutable for each other. What remains unclear from their account, however, is why the actual, imperfect market of a WTO member should be the correct reference market for assessing substitution.

the text of Article III:4 because it amounts to challenging an omission. Article III:4 concerns treatment in respect of laws, regulations and requirements. It only comes into play once a WTO member has decided to enact a legislative measure, not before.

The second objection is that by benchmarking less favourable treatment against perfect competition, WTO law would oblige members to enact optimal regulation once they decide to regulate, which cannot be squared with the freedom to determine policies and levels of protection unilaterally that the GATT confers.³³ I do not think this follows from my suggested approach. I have not suggested that the member's regulation has to attain the same result as under perfect competition in order not to treat less favourably. Rather, what matters is that it moves into the right direction, that is, of bringing actual, imperfect competition closer to perfect competition *and* that it does not concern purchases by consumers who readily substitute the products under perfect competition. Whether or not the level of protection against the risky product is set at exactly the level where it would be set through individual purchases under perfect competition is then irrelevant. It also follows that where products present different levels of risk (low, medium, high) and where these differences are reflected in different degrees of substitution at different prices, the regulation should respect the different ratios by which they differ in order not to treat less favourably.³⁴

A possible third objection might be that my model would only ever allow information measures but not bans or requirements on product composition since it is predicated on enabling the consumer to make maximally efficient self-regarding choices through the provision of ample information.³⁵ Even for situations in which no third party consumption externality is present, I do not think this counter-argument stands up to scrutiny. It seems to be reading a least-trade restrictive means obligation into Article III that it does not contain. Moreover, where the as-

essment of consumer choices in a perfectly competitive market shows that consumers would not buy the risky product, the informational measure would have just the same consequences as a prohibition narrowly tailored towards these consumers. There is, however, no indication in the text of Article III:4 that the form of a measure alone is determinative of treatment being less favourable.

The fourth objection is that my approach would make justification under Article XX superfluous. Either the regulation is narrowly tailored so as to affect only products that do not compete under perfect competition and there cannot be less favourable treatment or it does affect products that compete and, presumably then, there cannot be any possible justification for this regulatory overreach under Article XX. If Article XX could indeed no longer serve as a justification for violations of Article III:4 my approach would be inconsistent with the Appellate Body's concern in *EC-Seal Products* not to disrupt the structure of the GATT.

I also think this objection is a *non sequitur*. In fact, justifications for regulations that also affect non-risky products (or consumer in the non-vulnerable group) may be genuinely regulatory rather than being about the creation of a perfect market. They can have to do with the impossibility for a regulation to regulate in exactly the same impact as product choices occurring under perfect competition would turn out to be. Reasons for this can be that it is impossible to tell with certainty at the point of manufacture, importation or sale which product is safe and which one is unsafe. Producing this kind of information in order to enable perfect competition would be prohibitively expensive and it might either make the product unavailable for reasons of price if the cost burden of production of information falls on the producer or it might make the government unable to regulate other externalities if the cost burden of production of information falls on the government.³⁶ In the real world, governments may well face a conflict between pursuing individually efficient purchasing decisions through the provision of information and dealing with other externalities. Consequently, Article XX can come into play to justify regulations with some additional margin of safety or those that are not narrowly tailored to one market segment because of exposure to the product always combines the two user groups.

The other types of regulatory policies that fall under Article XX are those whose justification lies in

33 Ibid., at p. 116.

34 Grossman, Horn and Mavroidis argue likewise. Ibid., at p. 115.

35 For a related critique of the Appellate Body's reasonable consumer test in *EC – Asbestos*, see Petros C. Mavroidis, *Trade in Goods*, Oxford: Oxford University Press, 2007, at p. 242.

36 This construction of Article XX may also help to explain why the Appellate Body has accepted current technical unfeasibility and excessive costs as possible reasons to demonstrate why a less trade-restrictive alternative is not reasonably available.

the rejection of market choices as the right allocative instrument. Let me explain with the help of an example. Assume that an imported product used by adults presents a risk to life at old age that falls only on the user and that users are aware of this risk. Assume that the domestic alternative is safer but more expensive. Assume further that we are concerned with poor users in a poor developing country where average life expectancy is 45 years. Now, it may be perfectly efficient for the poor to take the gamble that they will not live to old age and purchase the cheaper imported product. Yet the situation does not look like a fair deal. It does not look as if the poor consumers really incurred the risk voluntarily as perfect competition suggests they should. However, this has nothing to do with a lack of information, a third-person externality or price-fixing power of firms but has all to do with the dire lack of purchasing power of the consumers and the general underdevelopment of the country reflected in low life expectancy. In fact, the situation looks like a failure of *free* consent or like a form of exploitation and the government may wish to regulate it even though the market operates perfectly. Since the regulation is not concerned with making competition perfect, it should fall to be justified under Article XX.

To draw some preliminary conclusions from this sub-section, it has been argued that the less favourable treatment standard should examine whether or not the regulatory treatment of two types of product brings their competitive relationship closer in line with how the products would compete in a perfect market, which forms the reference market for the purpose of the likeness analysis. This inquiry will involve issues one may refer to as 'regulatory' in common parlance because the inquiry would assess whether or not the regulation is narrowly focused so as to affect only products that do not compete in a perfect market. Matters of regulatory design and even-handedness in application are therefore not completely outside the scope of Article III:4. At the same time, Article III:4 does not contain a full-fledged test of regulatory justification either. Rather, I have suggested that justifications derived from genuine impossibilities to approximate a perfect market with regulation or the undesirability of the market as an allocative instrument find their home in Article XX and give rise to additional questions of regulatory design and even-handedness of application there.

2. Alternative Hypothesis B: Likeness Points to the Actual Domestic Market of the Defending Member (even if Imperfect) Against Which Less Favourable Treatment Is Benchmarked

If the reference market for the assessment of likeness is the actual domestic market of the regulating member, the focus of the inquiry for the likeness analysis is on the empirical factors that cause consumers to buy products interchangeably for the satisfaction of the same need. Less favourable treatment would then assess whether or not the regulation modifies the way the two types of products compete by affecting one or all of the likeness criteria. Even with this hypothesis, an Article III:4 analysis may sometimes have to do more than just determine that a regulation draws a distinction between two types of products that compete in such a manner that more imported products are concerned. It has to be shown how that distinction affects competition by affecting the factors responsible for substitution. To see why this is so, let us consider an example.

Assume that the domestic and the imported product compete based on price and not on product differentiation. Where products compete on price, it is their price which causes consumers to buy one rather than the other product. Where products compete based on product differentiation, it is in the first place a product's reputation, quality or design and not its price that causes consumers to buy one rather than the other product. Product differentiation qua reputation can often be relevant to consumer tastes, of course, but we assume that it is not for this specific product. Assume, for instance, that consumers regard dolphin-safe (domestic) and dolphin-unsafe (imported) as perfect substitutes and switch readily in response to price changes. The two products are therefore like. If the regulation affects product reputation (e.g. a neutral, factually accurate dolphin-safety label that is not available to the imported product) it would not modify conditions of competition nor treat less favourably because the treatment does not pertain to a factor relevant for the competition of the two products in that market. In fact, this label is ineffective at present and with respect to the competitive treatment of imported versus domestic products it simply treats them in no particular manner at all. As a result, the label cannot treat less favourably. This example again shows why less favourable treatment

must be given more substance than simply the drawing of regulatory distinctions with differential impacts. Instead, a detailed assessment of how regulations interact with market choices will be required, in particular where there are different types of consumers some of whom substitute whereas others do not and the regulation affects only one segment of the market.

It might be objected that positive consumer appreciation of the dolphin-safe tuna may develop over time, adding an additional element to how the products compete and that the label therefore treats less favourably because it creates this consumer appreciation. Two difficulties arise with this argument. One is that under hypothesis B, the likeness analysis is not concerned with how consumers came to have the kinds of preferences they do have because it only looks at current preferences. These current preferences may well be the result of past protectionism and yet they do matter for whether or not products are like under the alternative hypothesis discussed here. But if Article III:4 accepts consumer choices as *they currently are* for the likeness analysis and only asks whether governmental measures immediately affect them, it becomes logically impossible to prohibit a label under Article III:4 on the basis of *possible effects* it might produce on consumer choices *in the future*. Possible future effects would not amount to LFT in today's case and any influence on consumer choice the label did turn out to have later would not be a reason to set aside the consumer choices as they have turned out to be when it comes to the likeness analysis of the future case. Furthermore, if the information about dolphin (un)safety is also otherwise available and the information on the label is neutral and factually accurate, it becomes conceptually difficult to attribute adverse consumer selection to the label rather than the free choice of the consumers.³⁷ It may be the case that the label exerted *some* influence on consumers in developing or changing their

preference but independent consumer preference change may also have played a role. Such a confluence of governmental influence and market choice really is just like the situation in *Dominican Republic – Cigarettes*, where the fixed bond and market choice *together* accounted for the effect on cigarette prices. Remember that there was no Article III:4 violation in that case. The reasons for this result is that Article III:4 should only be concerned with situations where governmental measures *decisively* affect competition, including through *decisive* effects on consumer choice. What we can conclude from the foregoing analysis that aspects of regulatory design and even-handedness therefore again enter the less favourable treatment analysis, which the Appellate Body in *EC-Seal Products* was concerned to keep out of Article III:4.

This issue raised above goes to latent ways in which products can (and cannot) compete. Similar issues may arise in respect of latent demand for a product or latent end-uses, that is, instances where products currently are not substituted by consumers or used in a way so as to overlap with use of another product but might be. The difficulty here, as Broude and Levy have pointed out, is that latent demand and latent end-uses are criteria that remain indeterminate.³⁸ Conceivably quite different products may have the same latent and actual end-uses. Wooden chairs may be used as furniture and firewood and bicycles and cars can both be used for long- and short-distance transportation. Yet it would be far-fetched to argue that legislation requiring cars to have safety belts discriminates against them relative to bicycles. It might be argued that the Border Tax criterion of physical properties serves to prevent a finding of likeness in these cases. The difficulty Broude and Levy have pointed out, is that it is just as indeterminate. Sometimes, very similar or nearly identical products may not be substituted by consumers (e.g. organic vs. conventional food) whereas other times, physically quite different products may be substituted (fixed phone and computer for telephony).

37 The same conclusion does not necessarily hold if products compete based on product differentiation and the regulation affects price substantially, not reputation because substantial price increases are likely to be a sensitive factor for most consumers in almost all cases since they have scarce financial resources relative to their wants and needs. Price increases on luxury goods may be a possible exception.

38 Tomer Broude and Philip I. Levy, "Do you Mind if I Don't Smoke? Products, Purpose and Indeterminacy in US-Measures Affecting the Sale of Clove Cigarettes", 13 *World Trade Review* (2014), pp. 357 *et seq.*, at pp. 369-381.

IV. Perfect Competition As the Benchmark for Article III:4 Makes Better Legal Sense

The key issue under Article III:4 is what kind of competition it seeks to protect from governmental inter-

ference. The term ‘competition’ is neither a simple ontological entity nor a semantic category whose content can be accessed directly from the term itself without much need for theorizing and attention to context. Instead, the term inevitably requires interpretation and sensitivity to the speech context in which it is used, including the purpose of the speech act, in order to make sense of the term. Indeed, Article 31.1 of the Vienna Convention on the Law of Treaties requires as much because it requires the treaty interpreter to look at the context and the purpose of the treaty to interpret a term in addition to its ordinary meaning. The speech context within which references to the ‘competitive relationship’ between products and to ‘modification of conditions of competition’ have arisen is Article III, which includes as the overarching gist the ‘so-as-to-afford-protection’ language in Article III:1.

‘So-as-to-afford-protection’ points firstly to a result because it does not refer to affording ‘protection to domestic products’. When used without indirect object, the term ‘so as to afford protection’ takes on the meaning of ‘creating’ or ‘resulting in’. Nor is it plausible to construe Article III:1 as referring to ‘regulatory protection’ since the rest of Article III and the GATT is more concerned with economic operators. These omissions must mean something for how we interpret the term ‘so as to afford protection’: more specifically, they mean that neither subjective protectionist governmental intent nor the protection of consumers is the kind of protectionism Article III refers to. Second, the context of Article III supplied by Article XX and relevant according to Article 31.3(c) of the Vienna Convention on the Law of Treaties, indicates that the GATT as a whole targets *unjustified* regulation that restricts trade opportunities for imports. If this is so, why give a construction to less favourable treatment that preliminarily outlaws all regulations whose impact is felt more by imports, only to take that judgment back immediately under Article XX? Why be so broad only to create an exception that is also very broad? Should not an exception be, well, *exceptional*? In fact, why have general exceptions in the first place if the principal legal rule could easily be amended to state that (I simplify): ‘only unjustified regulations that create a disparate impact on imports are outlawed’?

Note also that the search for less trade restrictive alternatives under Article XX assumes that the alternative achieves the regulatory level of protection and

that so far, no direct interest balancing of the interest in an unregulated market and regulation has taken place under the necessity analysis. So the idea of the trade to be protected from restrictions expressed there is one that accepts regulation as more important than the prevention of disparate trade impacts. In contrast, the broad ‘disparate impact’ construction of Article III:4 takes exactly the opposite view. This is either normatively schizophrenic or it means that the normative commitment to the primary obligation (Article III) is not serious.

Note as well that in the theory of comparative advantage, whose realization might be seen as the purpose of the GATT, welfare gains from freeing trade are considered to arise only as long as they are not outweighed by larger externalities. Nothing in the theory indicates that governmental regulation with a heavier impact on imports is *per se* suspect; quite the contrary, if the modelling assumptions linked to an absence of externalities do not hold, regulation may be necessary in order to prevent free trade from becoming welfare-reducing and *unregulated* trade becomes the problem.

If the protection of competitive equality of opportunity Article III:4 aims at is taken to refer to perfect competition and the gist of (i) Article III:4 and (ii) Article XX are seen as being about (i) reducing externalities through the best possible market and (ii) reducing externalities where the best possible market remains unattainable in the real world of governmental regulation or replacing the market where the market is not the suitable allocative instrument, an underlying normative unity of purpose between Article III:4 and XX can be achieved. The same kind of unity is not achieved by the interpretation set forth under the imperfect competition hypothesis B. Such a kind of harmonious interpretation in search of unity of states’ underlying normative commitments is ultimately what the rules of interpretation in the Vienna Convention on the Law of Treaties seem to envision. This is why Article 31(1) speaks of the object and purpose of a treaty in the singular and why not only the provision to be interpreted is being looked at in the process of interpretation but also context and *telos* without a precise *ex ante* textual direction for the treaty interpreter how to factor them in.

In closing, I want to shed light on a further issue. Broude and Levy have argued that the sequence of considering market-likeness under likeness and regulatory-likeness under less favourable treatment or

inversely does not matter for the analysis.³⁹ However, if one accepts that likeness is about competition between products and less favourable treatment about modification of conditions of competition, an analysis in which regulatory-likeness linked to externalities is part of likeness *and* less favourable treatment, a consistent meaning is given to the term ‘competition’. This is not the case if likeness refers to imperfect market competition and less favourable treatment to perfect market competition.

V. Conclusion

In this article, I have shown that a purely empirical conceptualization of the two tests of Article III:4 of a competitive relationship (likeness) and disparate impact (less favourable treatment) is unworkable. Such an empirical conceptualization fails to take the complexity of competition and of regulation seriously. It also suffers from the logical problem that facts alone cannot ground a normative obligation (*in casu* not to engage in protectionism). Turning to the central notion of competition in the two tests of Article

III:4, I show why aspects related to regulatory design and purpose remain relevant to the economic concept of competition, whether we understand it as referring to perfect or to imperfect competition. Therefore, the supposed division of labour that the Appellate Body in *EC-Seal Products* envisages between Article III:4 as being about competition and Article XX as being about regulation is a chimera. I also show that under my theory, there is a class of genuinely regulatory measures that only fall under Article XX and not III. In this manner, the Appellate Body’s concern with not undermining the relevance of Article XX in relation to Article III is taken care of. Both have a distinct realm of application and there is a substantive category of measures that only fall under Article XX. Section IV establishes why it makes better legal interpretative sense to work with a concept of perfect competition as the relevant benchmark for the two tests of Article III:4. In the final analysis then, ‘regulatory’ issues are part and parcel of both likeness and less favourable treatment even though perhaps the Appellate Body in *EC-Seal Products* did not actually think so. The fact that it has kept the central language of competition, protectionism and regulation so indeterminate fortunately allows us, however, to craft a sensible theory for the interpretation of Article III:4 onto its case law.

39 Broude and Levy, n. 38, at 381-390.