CHAPTER IV

GATT, WTO AND RULES ON REGIONAL INTEGRATION

BACKGROUND

The unconditional most-favoured-nation (MFN) principle enshrined in Article I of the GATT is a **multilateral** obligation applicable to each Contracting Party in its treatment of products of all other Contracting Parties.[1] This is the fundamental principle of non-discrimination which is considered the pillar of multilateralism. At the same time, the GATT treaty contains a number of exceptions to this principle, allowing for discriminatory trade policies. The inclusion of a 'grandfather clause' permitting continued application of existing preferential trade arrangements is one such exception.[2]

However, the major exception, and the one which is of central concern to this study, is contained in Article XXIV permitting GATT signatories to set up regional free trade areas and customs unions.[3] In the original GATT signed in 1947, Article XXIV offered the only provisions for

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[1] Article I of the GATT is given in Appendix III. Chapter III of this study has dealt with the principal facets of the MFN clause.

[2] The existing arrangements involving partial preferences, principally those between former colonies and their colonial powers, were granted exemption from the MFN provision (Article I, para 2).

[3] The full text of Article XXIV of the GATT is given in Appendix V.

regional trading agreements. Subsequently, with the addition of Part IV (Trade and Development) of the GATT (Articles XXXVI, XXXVII, and XXXVIII) in 1965, and the Enabling Clause (the Decision on Differential and More Favourable Treatment, Reciprocity, and Fuller Participation of Developing Countries) in 1979, the GATT permitted the formation of partial RTAs. The latter two provisions are of relevance to regional arrangements involving developing countries. In addition, Article XXV (waivers) has provided the GATT basis for several past agreements.[4] Article V of the General Agreement on Trade in Services (GATS) is the counterpart of Article XXIV in the services sector, and together provide the legal and theoretical underpinnings of regional integration within the multilateral framework.

GATT PROVISIONS ON REGIONAL INTEGRATION AGREEMENTS

A brief overview of the provisions permitting the establishment of RTAs under the aegis of the GATT-47 (and subsequently the WTO) is given below.[5]

i) **Article XXIV** : This Article is the principal one dealing with customs unions and free trade areas. It provides a number of rules governing such

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[4] World Trade Organization, *Regionalism and the World Trading System* (Geneva, 1995), pp.6-7.

[5] World Trade Organization, "Regional Initiatives for the Multilateral Trading System", WT/REG/W8 (Geneva, 1996).

agreements, including notification and review by the Contracting Parties acting jointly. Agreements must meet the 'substantially-all-trade' requirement, and members of a regional integration agreement must have a trade policy with respect to third countries that is not on the whole higher or more restrictive than the individual policies prior to the agreement.

ii) **Grandfathering** : Certain then-existing preferential trade arrangements were exempted from the MFN requirement at the time of GATT's inception, including British Imperial Preferences, preferences granted by the Benelux Customs Union and the French Union. However, these preferences were capped and their significance reduced in the course of multilateral tariff-cutting exercises. If agreed by the Contracting Parties acting jointly, pre-existing regional integration agreements may be so exempted (grandfathered) at the request of new members at the time of their accession.

iii) **Part IV** : This clause on Trade and Development added to the GATT in 1965, provides for special measures intended to promote the trade and development of Contracting Parties. Prior to the 1979 Enabling Clause, Part IV was invoked by developing-country participants with respect to

preferential trade arrangements which did not meet the 'substantially-all-trade' requirement of Article XXIV.[6]

iv) **Enabling Clause** : The Enabling Clause, agreed in 1979 during the Tokyo Round of Negotiations, includes a legal cover for preferential trade agreements between developing countries, subject to certain conditions, including transparency. Among Contracting Parties, views differ as to whether the Enabling Clause covers regional integration agreements (customs unions and free trade areas) for which provision is also made in Article XXIV.[7]

v) **Article XXV** : The Contracting Parties acting jointly have occasionally granted waivers for sectoral free trade agreements (for example, the European Coal and Steel Community in 1952 and the 1965 Canada-United States Auto Pact). In one early instance, a waiver was obtained by France for its proposed customs union with Italy, then not a GATT member.

HISTORY OF ORIGIN OF ARTICLE XXIV

Under the bilateral trade agreements which proliferated in Europe in the nineteenth and early twentieth centuries, exceptions to the

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[6] In some instances, parties to agreements with developing countries have invoked Part IV in Article XXIV working parties to justify preferential, non-reciprocal access for developing-country members (for example, the European Community in the context of the First, Second and Third Lomé Conventions.

[7] The Enabling Clause is given in Appendix VI.

unconditional MFN rule and practice were allowed for customs unions, imperial preferences, and limited regional agreements.[8] While Britain maintained that an explicit exception was required to exempt customs unions from MFN legitimately, other countries, especially the United States, were hostile to British preferences in the negotiations which led to the GATT-47.[9]

Bilateral agreements frequently provided for exemptions from MFN for countries which had close affinity or which were contiguous, but these exemptions were minor in practice, at least until after World War I. Why did Article XXIV then come about, and what could have been its perceived rationale?

Economic theory suggests that preferential arrangements can be welfare enhancing for member countries and for others, and may therefore provide an acceptable route to GATT-wide free trade, but this is not the rationale that underlay the inclusion of Article XXIV into the GATT-47.[10] The theory was, in fact, developed after the formulation of Article XXIV.

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[8] Jacob Viner, *The Customs Union Issue* (New York, 1950), p.12.

[9] John H. Jackson, *World Trade and the Law of GATT* (Charlottesville, 1969), p.31.

[10] World Trade Organization, n.5.

THE ROLE OF THE UNITED STATES

The United States, which was firmly opposed to preferences, accepted from the beginning the case for customs unions in which the participating countries would adopt a common trade policy, including a common external tariff. A provision for customs unions was thus included, subject to conditions, in the United States' proposals of 1945 which launched the negotiations that eventually led, via the draft charter for the stillborn International Trade Organization (ITO), to the GATT-47.[11]

Politically, the United States' tolerance of 100 percent preferences is presumed to have been motivated by the idea that European stability would be aided by economic integration, and therefore must be supported. There was also a feeling (as evident from the following quote) that economic integration with 100 percent preferences was consonant with the objective of multilateralism. A leading U.S. negotiator, Clair Wilcox offered the following explanation.[12]

> "A customs union (with 100 percent preferences) creates a wider trading area, removes obstacles to competition, makes possible a more economic allocation of resources and thus operates to increase production and raise planes of living. A preferential system (less than 100 per cent) on the other hand, retains internal barriers, obstructs economy in production, and restrains the growth of

[11] Introducing this provision in the negotiations in 1945, the United States delegate argued that "customs unions were desirable, provided that they did not cause any disadvantage to outside countries in comparison with their trade before the customs unions were effected" adding that "this was also a standard clause in all commercial treaties". [United Nations document E/PC/T/C.11/38].

[12] Clair Wilcox, *A Charter for World Trade* (New York, 1949), pp.70-71.

income and demand.... A customs union is conducive to the expansion of trade on a basis of multilateralism and nondiscrimination; a preferential system is not."

RATIONALE BEHIND ARTICLE XXIX

The U.S. support aside, the rationale for inclusion of Article XXIV in the GATT-47 was threefold :[13]

i) Full integration on trade, that is, going all the way down to freedom of trade flows among any subset of GATT contracting parties, would have to be allowed since it created an important element of single-nation characteristics (such as virtual freedom of trade and factor movements) among these nations, and implied that the resulting quasi-national status following from such integration in trade legitimated the exception to MFN obligation towards other GATT contracting parties.

ii) The fact that the exception would be permitted only for the extremely difficult case where all trade barriers would need to come down (100 per cent preferences), seemed to preclude the possibility that all kinds of preferential arrangements would break out, returning the world to the fragmented, discriminatory bilateralism-infested situation of the 1930s.

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[13] Jagdish N. Bhagwati, "Departures from Multilateralism: Regionalism and Aggressive Unilateralism", *The Economic Journal,* vol.100, December 1990, pp.1308-09.

iii) Article XXIV could also be thought of as permitting a *supplemental,* practical route to the universal free trade that GATT-47 favoured as the ultimate goal, with the general negotiations during the many rounds leading to a dismantling of trade barriers on a GATT-wide basis, while deeper integration would be achieved simultaneously within those areas where politics permitted faster movement to free trade under a strategy of full and time-bound commitment.

The clear determination of 100 per cent preferences as compatible with multilateralism and non-discrimination, and the equally firm view that anything less was not, meant that when Article XXIV was drafted, its principal objective was to close all possible loopholes by which it could degenerate into a justification for preferential arrangements of less than 100 per cent.[14]

The first draft charter of the International Trade Organization (ITO) of the United Nations defined a customs union as "the substitution of a single customs territory for two or more customs territories, so that all tariffs and other restrictive regulations of commerce as between the territories of members of the union are substantially eliminated and the same tariffs and

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[14] Kenneth Dam, *The GATT: Law and International Economic Organization* (Chicago, 1970), pp.279-80.

other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union". (Article 38).[15]

This same language was maintained throughout the various versions leading to Article 42 of the Draft Charter, concluded in October 1947.

A substantial revision of Article 42 of the Draft Charter took place at the plenary United Nations Conference on Trade and Employment, held in Havana in 1947-48; wherein the definition of a customs union was significantly changed, and a new paragraph was added which contained a definition of a free trade area.[16]

> "A free-trade area shall be understood to mean a group of two or more customs territories in which the tariffs and other restrictive regulations of commerce between such territories are eliminated on substantially all the trade in products originating in constituent territories of the free-trade area."

Thus at the first session of the GATT-47 Contracting Parties in 1948, recognition was given to the concept of a free trade area in which members would remove their mutual trade barriers but maintain their individual national trade policies towards non-members.[17] On 24 March 1948, the Contracting Parties signed a Special Protocol amending Article

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[15] This first draft charter, based mainly on a proposal by the United States, was prepared at the Preparatory Committee meeting of the United Nations Conference on Trade and Employment in London in October-November 1946. [UN document E/PC/T/33].

[16] CRTA, "Drafting History of Legal Texts", WT/REG/W/21 (Geneva, 1997).

[17] Dam, n.14, p.281.

XXIV of the GATT in light of the final version of Article 42 of the Havana Charter. The relevant language in the present text mirrors that agreed in the Special Protocol.[18]

With the proposals being incorporated into the General Agreement in 1948, Article XXIV has remained essentially unchanged since, except for clarifications on certain provisions in the Uruguay Round.[19] However, the rules have remained the same.

ARTICLE XXIV: THE PROVISIONS

This Article states that a group of countries may form a free trade area or a customs union, dropping trade barriers among themselves, subject to certain criteria. This is the major deviation from the MFN principle. Paragraph 4 sets out the parameters of trade liberalization both internally and externally.

> "... the purpose of a customs union or of a free trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories."[20]

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[18] CRTA, n.16.

[19] The Understanding on the Interpretation of Article XXIV of the GATT 1994, provides the clarifications and improvements on Article XXIV provisions. See Appendix VII.

[20] Article XXIV of the GATT Articles of Agreement.

The three principal criteria for trading blocs to be sanctioned by the GATT are:[21]

1. Trade barriers against non-members should not be made more restrictive than before.

Article XXIV (para 5a) states that with respect to a customs union (essentially the same criteria are applied to a free trade area), **"duties and other regulations of commerce** imposed at the institution of any such union... shall not on the whole be higher or more restrictive than the general incidence of duties... prior to the formation of such union.."

2. Trade barriers must be eliminated on "substantially all trade" among members.

The Article specifies (para 8a) that 'duties and other restrictive regulations of commerce... are eliminated with respect to **substantially-all-the-trade** between the constituent territories of the union or at least with respect to **substantially-all-the-trade** in products originating in such territories.

3. Interim arrangements to permit forming of customs union or free trade area must be completed over a reasonable period of time.

Any interim agreement leading to a free trade area or a customs union shall include a plan and schedule for the formation of such a(n)...

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[21] GATT, *Guide to GATT Law and Practice* (Geneva, 1994), pp.39-43.

area within a **reasonable length of time**. (para 5c).

In 1994, at the conclusion of the Uruguay Round of Negotiations, this length of time was finally defined: it is normally not to exceed 10 years.[22]

INTERPRETATIVE ANALYSIS OF ARTICLE XXIV PROVISIONS

The GATT rules on regional integration remained on paper for most of the first decade after formulation. As envisaged by the drafters, they were a minor element in international political and economic relations. However, in 1957 with the notification to the GATT-47 of the Treaty of Rome establishing the European Economic Community (EEC), certain provisions of Article XXIV were open to interpretations by the GATT Contracting Parties.[23]

The Treaty of Rome was drafted within the GATT Article XXIV framework, but its examination raised serious questions regarding the compatibility with several Article XXIV provisions. It has been argued that in the attempt to reconcile GATT provisions with a political development of overriding importance (namely, the establishment of the EEC), compromises and interpretations were put forward that subsequently

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[22] The Understanding on the Interpretation of Article XXIV, n.19, clause 3.

[23] GATT, n.21, pp.39-56 provides a detailed account of the examination of regional agreements notified under Article XXIV.

undermined the authority and clarity of the GATT rules on regional integration agreements.[24]

On the whole, no agreement was reached on the compatibility of the Treaty of Rome with Article XXIV, and the Contracting Parties agreed that because "there were a number of important matters on which there was not at this time sufficient information... to complete the examination of the Rome Treaty... this examination and the discussion of the legal questions involved in it could not be usefully pursued at the present time."[25] The examination of the EEC agreement was never taken up again.

The inconclusive review of the Treaty of Rome set a trend which dominated virtually all examinations of agreements notified to the GATT under Article XXIV. An observation by the Chairman of the Working Party on the Canada-United States Free Trade Agreement (CUSFTA) in 1991 is quite significant.

> "Over fifty previous working parties on individual customs unions or free trade areas had been unable to reach unanimous conclusions as to the GATT consistency of those agreements. On the other hand, no such agreements had been disapproved explicitly... One might... question what point was there in establishing a working party if no one expected it to reach consensus findings..."[26]

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[24] J. Michael Finger, "GATT's Influence on Regional Arrangements" in Jaime de Melo and Arvind Panagariya, eds., *New Dimensions in Regional Integration* (Cambridge, 1993), p.46.

[25] GATT, *Basic Instruments and Selected Documents*, 7S/71.

[26] GATT document C/M/253, p.25.

Of the GATT working parties formed to review each of the 109 RTA agreements notified to the GATT between 1948 and 1995, only 64 completed their reviews; of those 64, only 6 were able to reach a conclusion on the given RTA's compatibility with the conditionality of Article XXIV.[27]

Clausewise, the principal provisions of Article XXIV which have been subject to interpretation are as follows.

a) The 'substantially-all-trade' requirement

According to GATT Article XXIV:8, a constitutive element for a customs union or a free trade area is the elimination of duties and other restrictive regulations of commerce with respect to 'substantially-all-the-trade' among parties.[28]

An important rationale for the substantially-all-trade requirement is that it helps governments resist the political pressures to avoid or minimize tariff reductions in inefficient import-competing sectors. The requirement also ensures that regional agreements are limited to those which have sufficient political support in member countries to overcome opposition to complete free trade among the participants, and that agreements are not

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[27] Jaime Serra and others, *Reflections on Regionalism: Report of the Study Group on International Trade* (Washington D.C., 1997), p.31.

[28] CRTA, "Systemic Issues Related to Substantially all the Trade", WT/REG/W/21. Add.1, December 1997.

misused as a cover for sectoral discriminatory arrangements.[29] However, there have been strong differences of opinion among participants in working parties regarding the interpretation of this clause. Discussions in the GATT indicated that this concept has both a qualitative and a quantitative dimension.[30]

In **quantitative terms**, a number of issues have been raised with respect to the *measurement* of the trade coverage of an RTA:[31]

i) Whether the percentage of the trade freed was to be expressed in relation to the trade of the parties with the world at large or only in relation to the trade among the parties themselves.

ii) How to assess the trade coverage in RTAs of a non-reciprocal nature which generally involved contracting parties at different levels of economic development.

iii) Whether only the trade of products for which duties and other restrictive regulations of commerce had been eliminated should be taken into account or whether trade of products for which barriers had only been reduced should also be included.

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[29] Jagdish N. Bhagwati, *The World Trading System at Risk* (Princeton, 1991), pp.56-8.

[30] CRTA, n.28.

[31] GATT, *Basic Instruments and Selected Documents*, 6S/99-100, paragraphs 50 and 51.

iv) RTAs involving a customs union on one side and a country (or a group of countries) on the other - whether the quantitative assessment of the trade conducted without restrictions should include or exclude trade within the customs union.

With regard to the **qualitative** perspective, third countries have questioned whether agreements that explicity excluded trade in unprocessed agricultural products - the case with most agreements - met the substantially-all-trade requirement.[32] Many Contracting Parties hold the opinion that the exclusion of a major sector of economic activity should not be allowed, no matter what percentage of trade it covered.[33]

A difficult aspect in determining whether an RTA fulfilled the substantially-all-the-trade requirement resulted from the fact that, in many instances, Contracting Parties could not agree on whether a trade-restrictive measure applied between the parties was permitted under the exception list in Article XXIV:8.[34]

b) The 'not on the whole higher or more restrictive' requirement

The requirement in Article XXIV:5 that the common external tariff and other restrictive regulations imposed at the time of the formation of

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[32] CRTA, n.28.

[33] BISD 9S/83-85, Paragraphs 48, 49 and 51.

[34] BISD 38S/73, Paragraph 83.

the union not be on the whole higher or more restrictive than those imposed by the constituent territories before the formation of the customs union placed a major constraint on the latter.[35]

Interpretive issues relating to the evaluation provided for in Article XXIV:5 include the following.[36]

i) Whether to approach the matter as a global exercise, by automatically applying a formula and judging a common external tariff in its entirety, or to examine individual commodities/sectors on a country-by-country basis.

ii) Whether a given calculation should be based on the bound rates or the actually applied rates, and whether a comparison of duties collected could be used.

iii) Whether arithmetic or trade-weighted averages of the duties of the constituent territories should form the basis for the calculation.

iv) Whether there should be some kind of tariff-equivalent measurement of quantitative import restrictions and variable levies.

The EEC calculated a simple arithmetic average of the tariffs that had been negotiated at the time of its notification, and refused to engage

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[35] WTO, n.4, p.14.

[36] WTO, WT/REG4/M/2, para 8, July 1995.

in any further discussion of calculation methods; in the EEC's view, Article XXIV's failure to specify a measure left that question up to RTA signatories.[37]

Both the concepts - the substantially-all-the-trade requirement, and the not-on-the-whole-higher or more restrictive requirement, have been open to diverse subjective legal and economic interpretation. Both principles remain vaguely defined even after the improvements contained in the Understanding of the Uruguay Round.[38]

c) Interim Agreements

Article XXIV:7 contains requirements to ensure transparency of proposed agreements. Agreements are to be promptly notified to GATT for examination by the Contracting Parties, which may make recommendations.[39] Since customs unions and free trade areas are normally established over a fairly long period to avoid the economic dislocation of a rapid move to free trade among the members, the Article explicitly provides for interim agreements. To avoid the danger that such interim agreements are used as a pretext for introducing discriminatory preferences, paragraph 5(c) requires that they include a "plan and schedule

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[37] BISD, 6S/99, paragraph 36.

[38] Jaime Serra, n.27, p.32.

[39] WTO, n.4, p.9.

for the formation of such a customs union or such a free trade area within a reasonable length of time."[40] With respect to interim agreements especially, Article XXIV provides for the Contracting Parties to make recommendations to the parties to the agreement, if after having studied the plan and schedule for its completion, they find that such agreement is not likely to result in the formation of a customs union or of a free trade area within the period contemplated or that the period is not a reasonable one.[41]

Most notified agreements have in practice been interim agreements, and the practice of participants in terms of the timing of notification has varied. In discussions among participants in working parties, the provisions of interim agreements have raised issues of interpretation. The terms 'interim agreement', 'plan and schedule', and 'a reasonable length of time' have led to controversy in certain cases in the absence of clear definitions. However, recent interim agreements notified to the GATT/WTO have included plans and schedules with fixed transition periods.[42]

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[40] Article XXIV:5(c).

[41] R.Z. Lawrence, *Regionalism, Multilateralism, and Deeper Integration* (Washington D.C., 1996), p.100.

[42] WTO document, WT/REG4/M/12, paragraphs 12, May 1996, pp.42-46.

d) Notification of RTAs

In 1972 it was decided that notification should be made following the signature of the agreements.[43] The Decision states the "Council decides to invite contracting parties that sign an agreement falling within the terms of Article XXIV, paragraphs 5 to 8 to inscribe the item on the agenda for the first meeting of the Council following such signature."[44]

The practice has been for parties to the agreement to provide trading partners with a text of the agreement, so that they may consider in detail its implications for their trade and economic interests. In practice, notification is followed by the establishment of a working party with the terms of reference "to examine in the light of the relevant GATT provision, [the particular agreement], and to report to the Council".[45] Participation in working parties is open, and the countries who are parties to the agreement are always members of the working party and have the same status as other delegations.

e) Rules of Origin

Article XXIV provides no guidance on one of the features that distinguishes a free trade area from a customs union, namely the rules of origin.

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[43] BISD 19S/13.

[44] ibid.

[45] BISD 26S/210, Paragraph 6 of the Decision on the "Understanding Regarding Notification, Consultation, Dispute Settlement and Surveillance".

There are some distinctions between the potential for trade diversion under the two main forms of RTAs. In a customs union, the parties to the RTA maintain common external tariffs (CETs); that is, they are required to apply a common tariff on imports of each product from all third countries. In such a case, the potential for trade diversion varies with the size of these tariffs.[46]

In a free trade area (FTA), the potential for trade diversion arises especially from the administration of rules of origin. In an FTA, each country maintains its own external tariffs vis-à-vis the outside world. To the extent that these barriers differ, there is always the incentive to import a good through the country with the lowest barriers. To avoid such trade deflection members adopt procedures to determine whether a good entering a member country has been produced within the region and is therefore eligible for duty-free entry.

These procedures are based on rules of origin. Three types of rules of origin are common in FTAs.[47]

i) A rule may specify that non-regional intermediate goods must undergo a 'substantial transformation process' within the region in order to qualify for regional preferences.

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[46] Richard Pomfret, *The Economics of Regional Trading Arrangements* (Oxford, 1997), pp.232-6.

[47] ibid.

ii) Rules of origin may require that non-regional inputs account for no more than some specified maximum percentage of the production cost or the transaction value of the good.

iii) A rule may also require that some specific process be undertaken within the region, or that some other product-specific technological requirement be met.

All the issues of interpretation of Article XXIV are collectively termed as the *systemic issues.*[48] Each issue is dealt with by including three classes of information: a summary of the treatment of the issues under GATT-47; a report of how the issue was dealt with during the Uruguay Round; and an account of interpretative points made in connection to the issue during CRTA discussions.

PART IV OF THE GATT

Part IV of the GATT on 'Trade and Development', dating back to 1965, establishes the principle of non-reciprocity in trade negotiations between developed and developing countries, and provides for developed countries to adopt special measures to promote the expansion of imports from developing countries. Part IV has been invoked in certain instances by

[48] WTO, "Checklist of the Systemic Issues Identified in the Context of the Examination of Regional Trade Agreements", WT/REG/W/12, February 1997.

developed- country parties to agreements with developing countries to justify preferential, non-reciprocal access for developing-country parties.[49]

It has been argued that it exempts developed countries that grant non-reciprocal preferential treatment to less developed Contracting Parties from the obligation of non-discrimination set out in Article I.[50] To the extent that unilateral concessions fail to meet the 'substantially-all-the-trade' requirement of Article XXIV, developed countries that are parties to trade agreements with less developed countries have resorted to Part IV in order to escape MFN obligation.[51] In other words, Part IV has been invoked in relation to agreements that fail to comply with MFN and should also be subject to compliance with the Article XXIV conditions. Thus, there appears to be a clear overlap and tension between Part IV and Article XXIV.

THE ENABLING CLAUSE

The Decision on Differential and More Favourable Treatment, Reciprocity, and Fuller Participation of Developing Countries, known as the

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[49] BISD 38S/65, paragraph 57.

[50] Serra, n.27, pp.29-30.

[51] Such is the case with the first three Lomé Conventions between the EEC and the ACP group of countries. In the light of sharp disagreement between GATT signatories on the compatibility of Lomé I, II and III with the MFN obligation and on the applicability of Part IV, it was stipulated that Lomé IV would be in conformity with the GATT only under an Article XXV waiver. [WTO, WT/REG/3/M/1].

Enabling Clause resulted from the Tokyo Round of GATT negotiations in 1979. The Clause allows Contracting Parties to grant preferential treatment to developing countries on a non-MFN basis. It thus provides legal cover for trade concessions granted to developing countries under the Generalised System of Preferences (GSP) of 1971, by waiving the provisions of Article I, in its application to developing countries initially for a period of ten years.[52]

Regional agreements entered into under the Enabling Clause are governed by several conditions. Paragraph 3 of the Clause requires that any such arrangement be designed to facilitate and promote the trade of developing countries, and not to raise barriers to or create undue difficulties for the trade of other Contracting Parties.[53] Another condition, which does not have a counterpart in Article XXIV, is that such agreements shall not impede the MFN reduction or elimination of tariff and non-tariff trade restrictions. As regards transparency, paragraph 4 requires that such arrangements be notified to GATT when they are introduced, modified or withdrawn, and that the participants be ready to consult with third parties upon request.

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[52] BISD 26S/203, paragraphs 8-9.

[53] See Appendix VI.

CRITICAL ANALYSIS OF GATT ARTICLE XXIV

Article XXIV has often been criticized, and there have been wide-ranging suggestions to make the provisions stricter and more precise. According to an eminent study group, many existing RTAs,[54]

> "fall for short of the requirements of Article XXIV... The exceptions and ambiguities, which have been permitted have seriously weakened the trade rules, and make it very difficult to resolve disputes to which Article XXIV is relevant. They have set a dangerous precedent for further special deals, fragmentation of the trading system, and damage to the trade interest of non-participants... GATT rules on customs unions and free trade areas should be examined, redefined so as to avoid ambiguity, and more strictly applied".

Some of the specific problems with regard to the systemic issues have been discussed earlier.

The Article represents the GATT-drafters' attempt to resolve the potential conflict between their ultimate goals of freer and non-discriminatory trade policies: as long as trade barriers exist, a preferential tariff reduction is a step towards the first goal and away from the second goal.[55] A scathing critique of the Article talks of a "fundamental misconception of the nature and consequences of the conflict between regional arrangements and non-discriminatory free trade".[56]

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[54] F. Leutwiler and others, *Trade Policies for a Better Future* (Geneva, 1985), p.41.

[55] Pomfret, n.46, pp.74-6.

[56] Dam, n.14, p.615.

The clear determination of 100 per cent preferences as compatible with multilateralism and non-discrimination, and the equally strong viewpoint that anything less than 100 per cent was not, meant that when Article XXIV was drafted, its principal objective was to close all possible loopholes by which it could degenerate into a justification of preferential arrangements of less than 100 percent. However, the inherent ambiguity of the provisions of the Article coupled with the political pressures for approval of substantial regional groupings of preferences of less than 100 per cent, have frustrated the original intention of the drafters to sanction only 100 per cent preferences.[57]

According to John Jackson, the accommodation of the European Common Market's imperfect union in disregard of the legal requirements of Article XXIV was the beginning of the breakdown of the GATT's legal discipline.[58]

Only a small proportion of the free trade areas that have evolved in the post-war years, and have been notified to the GATT, have been found to be compatible with Article XXIV by the working parties established at

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[57] Bhagwati, n.13.

[58] Jackson, n.9, p.78.

the time. The typical working party... reports are generally inconclusive with regard to GATT compatibility.[59]

According to one school of thought, Article XXIV's "design is inadequate to today's tasks. Its redesign must clearly get on to the ongoing agenda of revitalizing and refashioning the GATT".[60]

During the Uruguay Round, negotiators attempted to tighten Article XXIV by making certain wording more precise, but the focus has remained the same.

REGIONAL INTEGRATION AND THE WTO

Under the WTO, certain existing rules and provisions pertaining to regional integration agreements have been revised, and some new ones added. Among the principal plurilateral agreements included in the WTO, the Agreement on TRIPS does not contain provisions specific to regional agreements, while the multilateral agreements on goods and services do. In goods, the WTO takes over existing GATT provisions (Article XXIV, the Enabling Clause, and other relevant decisions of the GATT Contracting Parties), supplemented by the Uruguay Round Understanding on Article XXIV.[61] There is also an Agreement on Rules of Origin of relevance to free

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[59] John Whalley, "Comments", in J.J. Schott, *Free Trade Areas and U.S. Trade Policy* (Washington D.C., 1989), p.366.

[60] Bhagwati, n.29, p.76.

[61] WTO, n.4, p.19.

trade areas. In the services sector, Article V of the GATS has provisions for regional agreements which have certain similarities to those for goods.

THE UNDERSTANDING ON THE INTERPRETATION OF ARTICLE XXIV

During the Uruguay Round, Article XXIV was first considered within the Negotiating Group on GATT Articles. A review of the terms 'duties and other regulations of commerce' in Article XXIV:5, and 'duties and other restrictive regulations of commerce' in Article XXIV:8 was considered.[62]

The Understanding clarifies several aspects of the operation of paragraph 5 of the Article by providing guidelines to be followed in comparing the overall level of tariffs and charges on imports before and after the formation of a customs union. Also, a reasonable length of time for the formation of a customs union or a free trade area is deemed to be ten years, except for exceptional circumstances.[63]

The GATT-94 Understanding reaffirms that RTAs should facilitate trade between members and should not raise barriers to the trade of non-members. In their formation or enlargement, the parties to RTAs should "to the greatest possible extent avoid creating adverse effects on the trade of other members".[64]

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[62] GATT document MTN.GNG/NG7/W/13.

[63] GATT document, MTN.GNG/NG7/22.

[64] GATT, *The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* (Geneva, 1994), p.31.

Under paragraph 6 of the Article, it is clarified that the negotiations on compensation provided for, where needed, must begin *before* the common external tariff is implemented. This is important to third countries because the short-term trade diversionary effects of the establishment of a customs union are easier to mitigate when the new common external tariff already includes compensatory adjustments.[65] Where agreement on compensatory adjustment cannot be reached within a reasonable period from the initiation of negotiations, the customs union is free to modify or withdraw the concessions and affected members are free to withdraw substantially equivalent concessions.

The Understanding also clarifies the provisions regarding transparency, stipulating that *all* agreements notified under Article XXIV be examined by a working party. If an interim agreement is notified without a plan and schedule, the working party shall recommend a plan and schedule.[66] The Understanding also confirms the biennial reporting requirement for members of regional agreements. As mentioned earlier, the Understanding established a ten-year maximum for the transition period for implementation of an agreement, though allowance is made for 'exceptional circumstances'.[67]

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[65] ibid., p.35.

[66] Understanding, n.19, Clauses 7, 8, See Appendix VII.

[67] ibid., clause 3.

The purpose of the Understanding on Article XXIV is to clarify certain areas where the application of Article XXIV had given rise to controversy, particularly as regards the external policy of customs unions, it fell short of addressing some of the complex issues of interpretation. The 'substantially-all-trade' requirement, (Article XXIV:8) and clauses relating to 'other regulations of commerce', and 'other restrictive regulations of commerce' (Article XXIV:5, and XXIV:8), are such areas where participants in working parties are yet to arrive at consensus decisions.[68]

ECONOMIC INTEGRATION IN SERVICES

When the GATT-47 was established, the world's leading economies were *manufacturing* economics. Today, *services* are the predominant sector in these countries. But the rise in services is a world-wide phenomenon, not merely a feature of developed economies. As a result trade in service comprises an ever-increasing share of global trade flows. This fundamental change in the nature of global trade was not anticipated in the original GATT Agreement, but has since been addressed through the General Agreement on Trade in Services (GATS) that resulted from the Uruguay Round.

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[68] CRTA, "Communication from Australia", "Communication from Japan", WT/REG/W/25, WT/REG/W/28 (WTO, 1998).

Article V of the GATS[69] is equivalent, for services, of GATT Article XXIV and of the Enabling Clause, for developing countries. In addition, agreements that provide for the full integration of labour markets may also be exempt from the MFN obligation under Article V *bis*. The only such agreement notified so far is the one involving Denmark, Finland, Iceland, Norway and Sweden.

Compared with Article XXIV, Article V of the GATS provides for a *similar but not identical* set of conditions that have to be fulfilled by regional agreements.[70]

Similar to Article XXIV, the advantages of closer economic integration are recognized. Paragraph 4 sets out the parameters of services trade liberalization for integration agreements, both internally and externally.[71]

The Article V:4 establishes a requirement to not raise the overall level of barriers to trade in series -- within specific sectors and subsectors -- beyond the level existing prior to the relevant agreement. This condition is superior to the "not on the whole higher or more restrictive" condition of GATT Article XXIV. Moreover, unlike GATT Article XXIV, GATS Article V

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[69] Article V of GATS is given in Appendix VIII.

[70] Serra, n.27, p.36.

[71] Article V, GATS, See Appendix VIII.

expressly provides for arbitration between parties that fail to reach agreement on the modification of schedules following entry into an RTA by one of them (paragraph 5).

A common element of both the Articles is the substantially-all-trade requirement. Article V:1 requires that an agreement a) has substantial sectoral coverage, and b) provides for the absence or elimination of substantially all discrimination; in the sense of Article XXIV, between or among the parties in the covered sectors. Substantial sectoral coverage is defined both in terms of covered sectors and coverage of modes of supply.[72]

CRITICISM

GATS Article V has also been critically viewed as containing loopholes allowing for the formation of agreements that do not fully comply with multilateral disciplines. For instance,

- Article V:2 allows for consideration to be given to the relationship between a particular regional agreement and the wider process of economic integration among member countries.[73]

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[72] Footnote to Article V:1.

[73] W.F. Schartz and A.O. Sykes, "Toward a Positive Theory of the Most Favoured Nation Obligation and its Exceptions in the WTO/GATT Systems", *International Review of Law and Economics* vol.16, 1996, pp.27-51.

- Article V:3 gives developing countries involved in an RTA flexibility regarding the realization of the internal liberalization requirements and allows them to give more favourable treatment to firms that originate in parties to the agreement. In other words, it allows for discrimination against firms originating in non-members, even if the latter are established within the area.[74]

COMMITTEE ON REGIONAL TRADE AGREEMENTS (CRTA)

Nearly all of the WTO's 132 members have signed regional trade agreements with other countries. Some of these agreements are wide-ranging in scope; others have aimed to achieve trade liberalization across a number of sectors over time.

A fundamental debate concerning RTAs is their compatibility with the multilateral trading system. As mentioned earlier, the main requirement is that the purpose of an RTA is to facilitate trade between the constituent territories and not to raise barriers to the trade of other WTO Members which are not parties to the agreement.

- With an increase in the number of RTAs being notified to the WTO, more than 20 separate working parties had been set up to examine these agreements.[75] In February 1996, the WTO appointed a

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[74] Andre Sapir, *GATS 1994-2000* (Mimeographed).

[75] WTO, "Working Parties on Agreements Notified Under Article XXIV of GATT 1947", WT/REG 4/2, WT/REG6/2, WT/REG 11-18/1 (Geneva, 1995).

Committee on Regional Trade Agreements (CRTA). The Committee was primarily created to centralize the effort of working parties in one body and to examine in detail future RTAs notified to the WTO, including those relating to trade in services; and also to provide a common platform to discuss ways of dealing with the issue of regionalism in the WTO.[76] A key charge of the CRTA is to examine in detail whether regional integration arrangements are compatible with multilateralism. The terms of reference of the CRTA include,[77] *inter alia,*

- the examination of regional trade agreements in light of WTO rules;
- the development of procedures to facilitate and improve the examination process; and
- the consideration of the systemic implications of regional trade agreements and initiatives for the multilateral trading system and the relationship between them.

In 1996 itself, the CRTA took up 21 agreements for examination, including the NAFTA; the enlargement of the European Union to include Austria, Finland, and Sweden and the MERCOSUR agreement.[78]

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[76] CRTA, WT/REG 18/N/3, 1996.

[77] The Decision establishing the CRTA and containing the terms of reference is given in Appendix IX.

[78] CRTA, WT/REG/W/26, 1997.

By the end of 1997, the Committee had examined 44 regional trade agreements, which included a number of free trade agreements between both the European Communities and members of the European Free Trade Area (EFTA) with several countries in Central and Eastern Europe (namely, Hungary, Poland, the Czech Republic, the Slovak Republic, Romania, Bulgaria and the Baltic states of Estonia, Latvia, and Lithuania).[79]

The Committee also addressed how countries which are parties to RTAs should report biennially on the operation of such agreements. Efforts are now underway to finalize a standard reporting format, and two standard formats for the presentation of information by the parties are being used.[80]

Another area which the Committee will continue to discuss concerns the systemic implications of RTAs, and initiatives for the multilateral trading system and the relationship between them. Recent discussions have primarily focussed on what repercussions such agreements may have on the functioning of the WTO system of rights and obligations.

Apart from the improvement gained in the examination of RTAs the Committee has also made progress on the improvement of rules and

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[79] CRTA, "Examination of Free Trade Agreements", WT/REG 50/1-12, 1998.

[80] Impressions on the workings and functioning of the CRTA have been gathered from attending the Nineteenth Session of the CRTA, at the WTO Secretariat, Geneva, 9 September 1998 Document WTO/AIR/915.

procedures. Future analysis on systemic issues will permit the CRTA to decide whether WTO rules relating to RTAs need to be further clarified and what kind of recommendations are called for.

The rules on regional integration laid down by the GATT-47, which have been incorporated into the WTO framework, are vital inputs for discussions on the compatibility of regional trade agreements with the world trading system. The interpretation and application of the provisions on regional integration, and their possible improvements, provide the backdrop to the whole issue of the relationship between regionalism and multilateralism, which is analysed in the following chapter.