Working Paper No. 190

GATT, WTO and Rules on Regional Integration

by

Moana Bhagabati
Madras Institute of Development Studies

Madras Institute of Development Studies
79, Second Main Road, Gandhi Nagar, Adyar, Chennai 600 020
Ph: 044-24412589 • Fax: 044-24910872 • E-mail: pub@mids.ac.in

AUGUST 2004

GATT, WTO AND RULES ON REGIONAL INTEGRATION*

Moana Bhagabati

Abstract

Since the decade of the eighties, the global economy has been marked by fundamental changes, the most pervasive of which have been in the realm of trade. Most developing countries have opened up their economies, often dictated by compulsions of the macroeconomic adjustment process they had undertaken. Trade liberalization is being pursued as a primary objective. The policy regime supporting this strategy has been governed first by the General Agreement on Tariffs and Trade (GATT), and subsequent to the mid-nineties by the World Trade Organization (WTO). While such developments have underlined and strengthened the efficacy of the multilateral trading system, a parallel trend has sought to undermine the pillar of multilateralism. The second rise of regionalism, marked by the proliferation of regional trading arrangements (RTAs) is a clear indication that there is a renewed interest in establishing regional economic groupings by most countries of the world. The prolonged duration of the Uruguay Round of Multilateral Trade Negotiations was believed to have undermined the efficacy of the multilateral trading system, and led countries to seek regional partners (though not in the geographic sense) for achieving gains from trade. However, the number of such groupings and trade blocs has continued to increase even after the multilateral trade accord was concluded and its implementation placed under the aegis of the WTO.

Though these trends in the global economy are seemingly contradictory, the GATT and subsequently the WTO, has not been antithetical to the establishment of regional trade groupings. The GATT Contracting Parties and the WTO Members are allowed to enter into such arrangements provided they eliminate rather than just lower within-union trade barriers on 'substantially all trade'. Such arrangements must also not raise trade barriers on goods produced outside the union, other than those that existed prior to the formation of the arrangement. These exception to the most-favoured-nation clause, on which rests the thesis of multilateralism, are contained in Article XXIV of the GATT, which sanctions the establishment of regional trading groups.

As the global trading system seems poised between regionalism and multilateralism, the debate is keenly followed at the WTO. In 1996, the general council established the Committee on Regional Trade Agreement to examine the regional initiatives notified to the WTO, with a fundamental mandate to study how regional agreements might affect the multilateral trading system, and what the relationship between the two kinds of initiatives should ideally be.

This paper traces the origin and evolution of the provisions within the GATT that permit the establishment of RTAs, and primarily concentrates on Article XXIV of the GATT with a view to understanding the legal underpinnings and rationale of the regionalism phenomenon.

---

* This paper is part of my continuing effort to delve into and understand diverse facets of the history, laws, and economics of regional trading arrangements. Apart from my interpretation drawn from a maze of GATT/WTO documents, I have relied on the opinions/writings of a number of leading international trade theorists. However, I take sole responsibility for any shortcomings and errors.

PREAMBLE

In the conclusion of the Uruguay Round of Multilateral Trade Negotiations in 1994, and the establishment of the WTO (World Trade Organization) in January 1995, the international trading system saw a reinforcement of multilateralism. Parallel to this, there also emerged a perceived trend towards regionalization of the world economy. This is evident in the surge in RTAs (regional trading arrangements)[1] notified to the GATT (General Agreement on Tariffs and Trade) and subsequently to the WTO. Over the last decade or so, RTAs have proliferated, new pacts covering large geographic areas have been created, and established regional groups have been revitalized. A majority of the 147 members of the WTO are party to one or more regional trade agreements. Since the early 1990s there has been a surge in RTAs and this phenomenon has continued unabated. Some 250 RTAs have been notified to the GATT/WTO up to December 2002, of which 130 were notified after January 1995. Over 170 RTAs are currently in force; an additional 70 are estimated to be operational although not yet notified. If the RTAs planned or already under negotiation are concluded, it is expected that by end 2005, the total number in force might well approximate 300. This lends credence to the theory that regionalism is emerging as a parallel force to multilateralism in the world trading scenario.

The United States, historically an ardent supporter of multilateralism, is now considered a patron of regionalism being party to a number of major regional initiatives, most notably the NAFTA (North American Free Trade Agreement). In addition, the enlargement of the European Union to 25 members in place of the original 6, and a wave of economic integration in Asia-Pacific, in Latin America, and in Africa, covering virtually every part of the world have given the impetus to this trend.

Post World War II economic history is witness to two distinct waves of regionalism. The first was in the 1950s and 1960s when regional integration initiatives were undertaken primarily in Europe and In Latin America, with a sprinkling of a few other arrangements elsewhere in the world. This phase is dubbed as the ‘first regionalism’, and with the exception of Europe, mostly faded out from the rest of the world. The revival of regionalism came towards the end of the 1980s and boomed in the 1990s – with the creation of new pacts, revival and revitalization of earlier ones, and deepening of existing arrangements.

In the first round, regionalism was scarcely viewed as a threat to multilateralism. Developed countries dominated the GATT process heavily, with the US as the dominant economic power. Developed countries negotiated tariff reductions on products of interest to each other and extended them to other Contracting Parties[2] on the MFN (most favoured nation) basis. Therefore the integration schemes in the developing countries, primarily in Latin America, posed no threat to the GATT process. Moreover, the integration in Europe helped organize the GATT negotiations more effectively. The United States also found it more convenient to deal with the EEC (European Economic Community) as a single unit.

However, in the 1990s the impact of RTAs on the multilateral trading system is

considered one of the central issues of trade policy. The regional alignments have led to fears of fragmentation of the world economy into trading blocs. Does rising regionalism contribute to or detract from the multilateral trading process is the crucial question debated researchers and trade policy analysts. To put the question in Jagdish Bhagwati's oft-repeated phrase, are RTAs 'building blocks or stumbling blocks' in the multilateral trading system? As RTAs have spread, enlarged and deepened over the last decade, they have posed challenges at both the intellectual and policy levels. Do RTAs stimulate growth and investment, facilitate technology transfer, or induce political stability and economic cooperation? Or do they divert trade in inefficient directions? The answer probably is, *all of these, in different proportions according to the particular circumstances of each RTA.*

There is also the apprehension that in a multilateral negotiation countries may form alliances based on their trading blocks. This may have the effect of polarizing any multilateral debate, making it difficult for individual Members to take definitive positions. However, to date there has been no instance to suggest that RTAs (except the European Union, which explicitly negotiates as one entity while dealing with the rest of the world) are leading to the formation of negotiating blocks in the WTO.

In the light of such debates, it is significant to note that the GATT, and subsequently the WTO, sanctions the establishment and functioning of RTAs under its Articles of Agreement. Members are allowed to form such arrangements provided they eliminate, rather than just lower, within-union trade barriers on 'substantially all trade'. Such agreements must also not raise trade barriers on goods produced outside the union, other than those that existed previous to the formation of the arrangement.

The main plank of multilateralism, and on which rests the GATT/WTO is enshrined in the MFN clause (Article I of the GATT) [3]. This is the fundamental principle of non-discrimination, and is considered the pillar of multilateralism. Broadly speaking, unconditional MFN implies that in the trade of goods (and Services, included under the GATS), all imported products should receive the same tariff or non-tariff treatment irrespective of their country of origin. 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.[4]

However, the major exception, and the one that is the central focus of this paper, is contained in Article XXIV permitting GATT signatories to set up regional FTAs (free trade areas) and customs unions. [5]

GATT PROVISIONS ON REGIONAL INTEGRATION AGREEMENTS

In the original GATT signed in 1947 (hereafter referred to as GATT-47)[6], Article XXIV offered the only provisions for 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. 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.

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

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 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.[7]

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.[8]

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.

ORIGIN OF ARTICLE XXIV

Under the bilateral trade agreements which proliferated in Europe in the nineteenth and early twentieth centuries, exceptions to the unconditional MFN rule and practice were allowed for customs unions, imperial preferences, and limited regional agreements. 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 that led to the GATT-47.

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

One school of thought 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 underlies the inclusion of Article XXIV into the GATT-47. This theory was, in fact, developed after the formulation of Article XXIV.

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.[9]

Politically, the United States' tolerance of 100 per cent 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 per cent preferences was consonant with the objective of multilateralism. A leading U.S. negotiator, Clair Wilcox offered the following explanation.

"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 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." (Wilcox,1949)

ARTICLE XXIV: THE RATIONALE

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

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 among these nations. This would entail a virtual freedom of trade and factor movements and result in a quasi-national status. Following such integration in trade by a subset of countries 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.

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 first draft charter of the 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 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).[10]

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.

"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.". (WTO WT/REG/W/21, 1997).

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. On 24 March 1948, the Contracting Parties signed a Special Protocol amending Article 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.

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.[11]

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 of the Article 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."

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

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)... 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.[12]

INTERPRETATION OF ARTICLE XXIV PROVISIONS

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 the international political and economic scenario at the time. However, in 1957 with the notification to the GATT-47 of the Treaty of Rome establishing the EEC, certain provisions of Article XXIV were open to interpretations by the GATT Contracting Parties.

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

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." (GATT, *BISD*, 7S/71). The examination of the EEC agreement was never taken up again.

The inconclusive review of the Treaty of Rome set a trend that dominated virtually all examinations of agreements notified to the GATT under Article XXIV. An observation by the Chairman of the Working Party on the CUSFTA (Canada-United States Free Trade Agreement) 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..."(GATT, C/M/253)

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.

Clause wise, the principal provisions of Article XXIV that 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.

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 that have sufficient political support in member countries to overcome opposition to complete free trade among the participants, and that agreements are not misused as a cover for sectoral discriminatory arrangements. 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.

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

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.

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 explicitly excluded trade in unprocessed agricultural products - the case with most agreements - met the substantially-all-trade requirement. 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.

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.

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 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.

Interpretive issues relating to the evaluation provided for in Article XXIV:5 include the following:

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 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.

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.

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. 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 for the formation of such a customs union or such a free trade area within a reasonable length of time." 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.

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.

d) Notification of RTAs

In 1972 it was decided that notification should be made following the signature of the agreements. 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." (GATT,*BISD* 19S/13).

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" (GATT, *BISD* 26S/ 210, para 6). Participation in working parties is open, and the countries that 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.

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 CETs (common external tariffs); 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.

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.

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.

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* (WTO, 1997). 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 with the issue during CRTA discussions.

PART IV OF GATT

Part IV of 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 developed-country parties to agreements with developing countries to justify preferential, non-reciprocal access for developing-country parties.

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. 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.[13] The argument is that Part IV has been invoked in relation to agreements that fail to comply with MFN and thus should also be subject to compliance with the Article XXIV conditions. Hence, 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 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 Generalized 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.

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. 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 are ready to consult with third parties upon request.

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,

"fall far 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". (Leutwiler et al, 1985)

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 trade policies versus discriminatory practices: as long as trade barriers exist, a preferential tariff reduction is a step towards the first goal and away from the second goal. 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" (Dam, 1970).

According to Bhagwati (1990), 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.

According to Jackson (1969), 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.

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

A line of argument holds that 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" (Bhagwati, 1991).

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

REGIONAL INTEGRATION IN 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. There is also an Agreement on Rules of Origin of relevance to free 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.

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.

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" (GATT, 1994).

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. 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. 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'.

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 in subjects such as 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 considered the difficult areas.

ECONOMIC INTEGRATION IN SERVICES

When GATT was established in 1947, the world's leading economies were *manufacturing* economies. Today, *services* are the predominant sector in these countries. But the rise in services is a worldwide 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 GATS that resulted from the Uruguay Round.

Article V of the GATS is the equivalent, for services, of GATT Article XXIV and of the Enabling Clause. In addition, agreements that provide for the full integration of labour markets may also be exempt from the MFN obligation under Article V *bis*. An important agreement, which encompasses this is 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. 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.

The Article V:4 establishes a requirement to not raise the overall level of barriers to trade in services — within specific sectors and sub sectors — 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 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 (footnote to Article V:1).

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.
- 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.

COMMITTEE ON REGIONAL TRADE AGREEMENTS (CRTA)

Nearly all of the WTO's 147 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. 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. In February 1996, the WTO appointed the 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. 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, *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.

The Committee has examined numerous regional trade agreements, including 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).

However, no examination report has been finalized since 1995 because of lack of consensus. The possible links between CRTA-consistency judgment and the dispute settlement process is a major cause of disagreement. In addition, there are long-standing controversies about the interpretation of the WTO provisions against which RTAs are assessed, and institutional problems arising either from the absence of WTO rules (e.g. on preferential rules of origin), or from discrepancies between WTO rules and those contained in some RTAs.

Another area which the Committee continues 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 tightening of rules and 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. However, the task of the CRTA is made difficult by the proliferation of RTAs that have not been notified to the WTO. Their compliance with the provisions of Article XXIV or the Enabling Clause is difficult to monitor. Besides, there is no regulatory authority within the WTO whereby any Member entering into one or more RTAs need necessarily notify the agreement to the WTO.

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. It is a monumental task to decisively resolve the regionalism versus multilateralism issue. There are strong contradictory views on whether trade liberalization at the regional and the global level has proceeded together. While the ‘multilateralists’ brand the RTAs as nothing less than discriminatory arrangements, the ‘regionalists’ promote such agreements as stepping stones to worldwide free trade. On balance, I would submit

that the interactions could be viewed as positive as and when the RTAs are notified and consequently monitored by the WTO.

Notes

[1] Defined as ”all bilateral, regional, and plurilateral trade agreements of a preferential nature which are required to be notified…” by the WTO.

[2] The signatories to the GATT were known as the Contracting Parties since the GATT was essentially an Agreement. The WTO, being an international organization, has Members.

[3] Article I of the GATT is given in the Appendix.

[4] 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).

[5] The full text of Article XXIV of the GATT is given in the Appendix

[6] A distinction is made between GATT-47 and GATT-94. The former refers to the original Treaty established in 1947, while the latter incorporates all the provisions negotiated during the eight rounds of multilateral trade negotiations ending 1994.

[7] 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 EC in the context of the First, Second, and Third Lome¢ Conventions.

[8] The Enabling Clause is given in the Appendix

[9] Introducing this provision in 1945, the US delegate argued that “customs union 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 “this was also a standard clause in all commercial treaties [UN, E/PC/T/C.11/38]

[10] 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, E/PC/T/33].

[11] The Understanding on the Interpretation of Article XXIV of the GATT 1994, provides the clarifications and improvements on Article XXIV provisions. (Appendix).

[12] ibid, clause 3

[13] 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].

References

Anderson, K and Blackhurst, R (eds.), 1993. *Regional Integration and the Global Trading Sysytem*, Hampstead: Harvester Whetasheaf.

Bagwell K and Staiger, RW, 1997. "Regionalism and Multilateral Tariff Cooperation", Cambridge, MA: NBER Working Paper no. 5921

Balassa, Bela, 1961. The Theory of Economic Integration, London: Allen and Unwin.

Bhagwati, Jagdish,1990. "Departures from Multilateralism: Regionalism and Aggressive Unilateralism", *The Economic Journal*, vol. 100, no. 403, pp 1304-47.

_____, 1991. *The World Trading System at Risk*, Princeton: Princeton Univ Press.

Bhagwati, J, Krishna, P and Panagariya, A (eds.), 1999. *Trading Blocs: Alternative Approaches to Analyzing Preferential Trade Agreements*, Cambridge, MA: MIT Press.

Chishti, Sumitra,1995. "Regionalism, Multilateralism, and the Developing Countries since the end of the Cold War", *International Studies*, vol.32, no.4, pp. 461-74.

Dam, Kenneth,1970. *The GATT: Law and International Economic Organization*, Chicago: Chicago Univ Press.

de Melo, J and Panagariya, A, 1993. *New Dimensions in Regional Integration*, Cambridge: Cambridge Univ Press.

GATT, 1993. "The Final Act of the Uruguay Round of MTNs: a Summary", *Foreign Trade Review*, vol.xxviii, no. 263, pp. 236-63.

_____ ,1994a. *Guide to GATT Law and Practice*, Geneva: GATT Secretariat.

_____1994b. *Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations: the Legal Texts*, Geneva: GATT Secretariat.

_____, *Basic Instruments and Selected Documents*, various issues.

_____, Documents - C/M/253; MTN.GNG/NG7/W/13; MTN.GNG/NG7/22, Geneva:GATT Secretariat.

Haas, E B, 1964. *Beyond the Nation-State*, Stanford:Stanford Univ Press.

Jackson, John H, 1969. *World Trade and the Law of GATT*, Indianapolis: Bobbs Merrill Co.

____, 1996. "Perspectives on Regionalism in Trade Relations", *Law and Policy in International Business*, vol. 27, no. 4, pp. 873-78.

Lawrence, R Z, 1996. *Regionalism, Multilateralism, and Deeper Integration*, Washington DC: Brookings Institution.

Leutwiler,F, et al,1985. *Trade Policies for a Better Future*, Geneva: GATT Secretariat.

Machlup, Fritz, 1977. *A History of Thought on Economic Integration*, London: Macmillan.

Nye, Joseph, 1968. *International Regionalism*, Boston: Little Brown & Co.

Panagariya, Arvind,1998. *The Regionalism Debate: an Overview*, Geneva:Mimeo.

Pomfret, Richard,1997. *The Economics of Regional Trading Arrangements*, New York: OUP.

Sapir, Andre, 2000. *GATS 1994-2000*, Geneva: Mimeo.

Schartz, WF and Sykes AO, 1996. "Towards a Positive Theory of the Most Favourednation Obligation and its exceptions in the WTO/GATT System", *International Review of Law and Economics*, vol.16, pp.252-89.

Serra, J et al, 1997. *Reflections on Regionalism:Report of the Study Group on International Trade*, Washington DC: Carnegie Endowment.

Tinbergen, Jan, 1954. *International Economic Integration*, Amsterdam: North Holland.

UN Documents E/PC/T/C.11/38; E/PC/T/33

UNCTAD, 1995. "The Relationship between Regionalism and the Multilateral Trading System", UNCTAD/ITD/4, Geneva:UNCTAD.

Viner, Jacob, 1950. *The Customs Union Issue*, New York: Carnegie Endowment.

Wilcox, Claire,1949. *A Charter for World Trade*, New York: Macmillan.

Winters, L A, 1996. "Regionalism versus Multilateralism", World Bank: Working Paper no. 1687

WTO, 1995a. *Regionalism and the World Trading System*, Geneva: WTO Secretariat.

_____1995b. "Working Parties on Agreements Notified under Article XXIV of GATT 1947", WT/REG4/2, WT/REG6/2, WT/REG11-18/1.

____ 1996a. "Regional Initiatives for the Multilateral Trading System" WT/REG/W8.

____ 1996b. WT/REG/3M/1

____1997a. "Drafting History of Legal Texts", WT/REG/W/21

____ 1997b. "Checklist of the Systemic Issues Identified in the Context of the Examination of Regional Trade Agreements", WT/REG/W/12.

_____1998. "An Illustrative List of Elements in Article XXIV Requiring Clarification", Geneva: WTO Secretariat.

Appendix

I

General Agreement on Tariffs and Trade (1947)

Article I

General Most-Favoured-Nation Treatment

1. With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III, any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

2. The provisions of paragraph 1 of this Article shall not require the elimination of any preferences in respect of import duties or charges which do not exceed the levels provided for in paragraph 4 of this Article and which fall within the following descriptions:

A. Preferences in force exclusively between two or more of the territories listed in Annex A, subject to the conditions set forth therein;

B. Preferences in force exclusively between two or more territories which on July 1, 1939, were connected by common sovereignty or relations of protection or suzerainty and which are listed in Annexes B, C and D, Subject to the conditions set forth therein;

C. Preferences in force exclusively between the United States of America and the Republic of Cuba;

D. Preferences in force exclusively between neighbouring countries listed in Annexes E and F.

3. The provisions of paragraph 1 shall not apply to preferences between the countries formerly a part of the Ottoman Empire and detached from it on July 24, 1923, provided such preferences are approved under paragraph 5 of Article XXV, which shall be applied in this respect in the light of paragraph 1 of Article XXIX.

4. The margin of preference on any product in respect of which a preference is permitted under paragraph 2 of this Article but is not specifically set forth as a maximum margin of preference in the appropriate Schedule annexed to this Agreement shall not exceed:

a) in respect of duties or charges on any product described in such Schedule, the difference between the most-favoured-nation and preferential rates provided for

therein; if no preferential rate is provided for, the preferential rate shall for the purposes of this paragraph be taken to be that in force on April 10, 1947, and, if no most-favoured-nation rate is provided for, the margin shall not exceed the difference between the most-favoured-nation and preferential rates existing on April 10, 1947;

b) in respect of duties or charges on any product not described in the appropriate Schedule, the difference between the most-favoured-nation and preferential rates existing on April 10, 1947.

In the case of the contracting parties named in Annex G, the date of April, 10, 1947, referred to in sub-paragraphs (a) and (b) of this paragraph shall be replaced by the respective dates set forth in that Annex.

Source: General Agreement on Tariffs and Trade. *Basic Instruments and Selected Documents*, vol. IV, 1969.

II

General Agreement on Tariffs and Trade (1947)

Article XXIV

Territorial Application-Frontier Traffic-Customs Unions and Free-Trade Areas

1. The provisions of this Agreement shall apply to the metropolitan customs territories of the contracting parties and to any other customs territories in respect of which this Agreement has been accepted under Article XXVI or is being applied under Article XXXIII or pursuant to the Protocol of Provisional Application. Each such customs territory shall, exclusively for the purposes of the territorial application of this Agreement, be treated as though it were a contracting party; *Provided* that the provisions of this paragraph shall not be construed to create any rights or obligations as between two or more customs territories in respect of which this Agreement has been accepted under Article XXVI or is being applied under Article XXXIII or pursuant to the Protocol of Provisional Application by a single contracting party.

2. For the purposes of this Agreement a customs territory shall be understood to mean any territory with respect to which separate tariffs or other regulations of commerce are maintained for a substantial part of the trade of such territory with other territories.

3. The provisions of this Agreement shall not be construed to prevent:
(a) Advantages accorded by any contracting party to adjacent countries in order to facilitate frontier traffic;

(b) Advantages accorded to the trade with the Free Territory of Trieste by countries contiguous to that territory, provided that such advantages are not in conflict with the Treaties of Peace arising out of the Second World War.

4. The contracting parties recognize the desirability of increasing freedom of trade by the development, through voluntary, agreements, of closer integration between the economies of the countries parties to such agreements. *They also recognize that 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.*

5. Accordingly, the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or of a free-trade area or the adoption of an interim agreement necessary for the formation of a customs union or of a free-trade area; *Provided* that:

(a) with respect to a customs union, or an interim agreement leading to a formation of a customs union, *the duties and other regulations of commerce* imposed at the institution of any such union or interim agreement in respect of trade with contracting parties not parties to such union or agreement *shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union or the adoption of such interim agreement, as the case may be:*

(b) with respect to a free-trade area, or an interim agreement leading to the formation of a free-trade area, *the duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area, or interim agreement in the case may be; and*

(c) any interim agreement referred to in subparagraphs (a) and (b) shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a *reasonable length of time*.

6. If, in fulfilling the requirements of subparagraph 5(a), a contracting party proposes to increase any rate of duty inconsistently with the provisions of Article II, the procedure set forth in Article XXVIII shall apply. In providing for compensatory adjustment due account shall be taken of the compensation already afforded by the reduction brought about in the corresponding duty of the other constituents of the union.

7. (a) Any contracting party deciding to enter into a customs union or free-trade area, or an interim agreement leading the formation of such a union or area, shall promptly notify the Contracting Parties and shall make as will enable them to make such reports and recommendations to contracting parties as they may deem appropriate.

(b) If, after having studied the plan and schedule included in an interim agreement referred to in paragraph 5 in consultation with the parties to that agreement and

taking due account of the information made available in accordance with the provisions of subparagraph (a), the Contracting Parties 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 by the parties to the agreement or that such period is not a reasonable one, the Contracting Parties shall make recommendations to the parties to the agreement if they are not prepared to modify it in accordance with these recommendations.

(c) Any substantial change in the plan or schedule referred to in paragraph 5(c) shall be communicated to the Contracting Parties, which may request the Contracting Parties concerned to consult with them if the change seems likely to jeopardize or delay unduly the formation of the customs union or of the free trade area.

8. For the purposes of this Agreement:

(a) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that

(i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) 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 to such territories, and,

(ii) subject to the provisions of paragraph 9, substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union;

(b) A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on *substantially all the trade* between the constituent territories in products originating in such territories.

9. The preference referred to in paragraph 2 of Article I shall not be affected by the formation of a customs union or of a free-trade area but may be eliminated or adjusted by means of negotiations with Contracting Parties affected. This procedure of negotiations with affected Contracting Parties shall, in particular, apply to the elimination of preferences required to conform with the provisions of paragraph 8(a) (i) and paragraph 8 (b).

10. The Contracting Parties may be a two-thirds majority approve proposals which do not fully comply with the requirements of paragraphs 5 to 9 inclusive, provided that such proposals lead to the formation of a customs union or a free-trade area in the sense of this Article.

11. Taking into account the exceptional circumstances arising out of the establishment of India and Pakistan as independent States and recognizing the fact that they have long constituted an economic

unit, the Contracting Parties agree that the provisions of this Agreement shall not prevent the two countries from entering into special arrangements with respect to the trade between them, pending the establishment of their mutual trade relations on a definitive basis.

12. Each contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories.

Source : General Agreement on Tariffs and Trade, Articles of Agreement. *Basic Instruments and Selected Documents.*

III

THE ENABLING CLAUSE (1979)

GATT Contracting Parties, Decision of November 28, 1979, on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries

Following negotiations within the framework of the Multilateral Trade Negotiations, the Contracting Parties decide as follows:

1. Notwithstanding the provisions of Article I of the General Agreement, contracting parties may accord differential and more favourable treatment to developing countries, without according such treatment to other contracting parties.

2. The provisions of paragraph 1 apply to the following:

a) Preferential tariff treatment accorded by developed contracting parties to products originating in developing countries in accordance with the Generalized System of Preferences;

b) Differential and more favourable treatment with respect to the provisions of the General Agreement concerning non-tariff measures governed by the provisions of instruments multilaterally negotiated under the auspices of the GATT;

c) Regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed by the Contracting Parties, for the mutual reduction or elimination of non-tariff measures, on products imported from one another;

d) Special treatment of the least developed among the developing countries in the context of any general or specific measures in favour of developing countries...

Note : Excerpt only

Source : GATT, *Basic Instruments and Selected Documents*, 265/203.

IV

UNDERSTANDING ON THE INTERPRETATION OF ARTICLE XXIV OF THE GENERAL AGREEMENT ON TARIFFS AND TRADE 1994

Members,

Having regard to the provisions of Article XXIV of the GATT 1994;

Recognizing that customs unions and free trade areas have greatly increased in number and importance since the establishment of the GATT 1947 and today cover a significant proportion of world trade;

Recognizing the contribution to the expansion of world trade that may be made by closer integration between the economies of the parties to such agreements;

Reaffirming that the purpose of such agreements should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other Members with such territories; and that in their formation or enlargement the parties to them should to the greatest possible extent avoid creating adverse effects on the trade of other Members;

Convinced also of the need to reinforce the effectiveness of the role of the Council for Trade in Goods in reviewing agreements notified under Article XXIV, by clarifying the criteria and procedures for the assessment of new or enlarged agreements, and improving the transparency of all Article XXIV agreements;

Recognizing the need for a common understanding of the obligations of Members under Article XXIV: 12;

Hereby agree as follows:

1. Customs unions, free trade areas, and interim agreements leading to the information of a customs union or free trade area, to be consistent with Article XXIV, must satisfy the provisions of its paragraphs 5, 6, 7, and 8 inter alia.

Article XXIV : 5

2. The evaluation under Article XXIV: 5(a) of the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union shall in respect of duties and charges be based upon an overall assessment of weighted average tariff rates and of customs duties collected. The assessment shall be based on import statistics for a previous representative period to be supplied by the customs union, on a tariff line basis and in values and quantities, broken down by WTO country of origin. The WTO Secretariat shall compute the weighted average tariff rates and customs duties collected in accordance with the methodology used in the assessment of tariff offers in the Uruguay Round. For this purpose, the duties and charges to be taken into consideration shall be the applied rates of duty. It is recognized that for the purpose of the overall assessment of the

incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required.

3. The "reasonable length of time" referred to in Article XXIV: 5(c) should exceed ten years only in exceptional cases. In cases where Members believe ten years would be insufficient they shall provide a full explanation to the Council for Trade in Goods of the need for a longer period.

Article XXIV : 6

4. Paragraph 6 of Article XXIV establishes the procedure to be followed when a Member forming a customs union proposes to increase a bound rate of duty. In this regard it is reaffirmed that the procedure set forth in Article XXVIII, as elaborated in the guidelines adopted by the GATT 1947 CONTRACTING PARTIES on 10 November 1980 (27S/26) and in the Understanding on the Interpretation of Article XXVIII of the General Agreement on Tariffs and Trade 1994, must be commenced before tariff concessions are modified or withdrawn upon the formation of a customs union or an interim agreement leading to the formation of a customs union.

5. It is agreed that these negotiations will be entered into in good faith with a view to achieving mutually satisfactory compensatory adjustment. In such negotiations, as required by Article XXIV: 6, due account shall be taken of reductions of duties on the same tariff line made by other constituents of the customs union upon its formation. Should such reductions not be sufficient to provide the necessary compensatory adjustment, the customs union would offer compensation, which may take the form of reductions of duties on other tariff lines. Such an offer shall be taken into consideration by the Members having negotiating rights in the binding being modified or withdrawn. Should the compensatory adjustment remain unacceptable, negotiations should be continued. Where, despite such efforts, agreement in negotiations on compensatory adjustment under Article XXVIII as elaborated by the Understanding on the Interpretation of Article XXVIII of the General Agreement on Tariffs and Trade 1994 cannot be reached within a reasonable period from the initiation of negotiations, the customs union shall, nevertheless, be free to modify or withdraw the concessions; affected Members shall then be free to withdraw substantially equivalent concessions in accordance with Article XXVIII.

6. The GATT 1994 imposes no obligation on Members benefiting from a reduction of duties consequent upon the formation of a custom union, or an interim agreement leading to the formation of a customs union, to provide compensatory adjustment to its constituents.

Review of Customs Unions and Free Trade Areas

7. All notifications made under Article XXIV: 7(a) shall be examined by a working party in the light of the relevant provisions of the GATT 1994 and of paragraph 1 of this Understanding. The working party shall submit a report to the Council for Trade in Goods on its findings in this regard. The Council for Trade in Goods may make such recommendations to Members as it deems appropriate.

8. In regard to interim agreements, the working party may in its report make appropriate

recommendations on the proposed timeframe and on measures required to complete the formation of the customs union or free trade area. It may if necessary provide for further review of the agreement.

9. Substantial changes in the plan and schedule included in an interim agreement shall be notified, and shall be examined by the Council for Trade in Goods if so requested.

10. Should an interim agreement notified under Article XXIV:7(a) not include a plan and schedule, contrary to Article XXIV:5(c), the working party shall in its report recommend such a plan and schedule. The parties shall not maintain or put into force, as the case may be, such agreement if they are not prepared to modify it in accordance with these recommendations. Provision shall be made for subsequent review of the implementation of the recommendations.

11. Customs unions and constituents of free trade areas shall report periodically to the Council for Trade in Goods, as envisaged by the GATT 1947 CONTRACTING PARTIES in their instruction to the GATT 1947 Council concerning reports on regional agreements (BISD 18S/38), on the operation of the relevant agreement. Any significant changes and/or development in the agreements should be reported as they occur.

Dispute Settlement

12. The provisions of Articles XXII and XXIII of the GATT 1994 as elaborated and applied by the Understanding on Rules and Procedures Governing the Settlement of Disputes may be invoked with respect to any matters arising from the application of those provisions of Articles XXIV relating to customs unions, free trade areas or interim agreements leading to the formation of a customs union or free trade area.

Article XXIV : 12

13. Each Member is fully responsible under the GATT 1994 for the observance of all provisions of the GATT 1994, and shall take such reasonable measures as may be available to it to ensure such observance by regional and local governments and authorities within its territory.

14. The provisions of Articles XXII and XXIII of the GATT 1994 as elaborated and applied by the Understanding on Rules and Procedures Governing the Settlement of Disputes may be invoked in respect of measures affecting its observance taken by regional or local governments or authorities within the territory of a Member. When the Dispute Settlement Body has ruled that a provision of the GATT 1994 has not been observed, the responsible Member shall take such reasonable measures as may be available to it to ensure its observance. The provisions relating to compensation and suspension of concessions or other obligations apply in cases where it has not been possible to secure such observance.

15. Each Member undertakes to accord sympathetic consideration to and afford adequate opportunity for consultation regarding any representations made by another Member concerning measures affecting the operation of the GATT 1994 taken within the territory of the former.

Source : GATT, Interpretation Article XXIV, MTN/FA II-AIA-1(d), 1996.