

London School of Economic and Political Science

**Multilateral Supervision of Regional Trade Agreements:
Developing Countries' Perspectives**

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Abstract

The number of regional trade agreements (RTAs) has risen sharply in the past decade. This has resulted in a new global trade landscape where a great proportion of trade is carried through preferential arrangements rather than on a most-favoured-nation basis. This prompts concerns over how such trade agreements should be managed. Importantly, developing countries are increasingly taking part in the current RTA proliferation. This thesis therefore sets out to identify the challenges facing developing countries when they negotiate and form such trade arrangements with their developed-country trade partners and among themselves, and seeks to deal with these challenges through the WTO rules and mechanisms pertaining RTA supervision.

To do so, the thesis first surveys the general trends and characteristics of the current RTA proliferation, and examines three bodies of literature, which are supplemented with the author's personal participation in RTA negotiations and interviews with trade negotiators, in order to identify the challenges facing developing countries. It then evaluates the WTO rules governing the formation of an RTA, namely, GATT Article XXIV, the Enabling Clause, and GATS Article V. It is argued that these rules are problematic and inadequate to deal with the challenges. In response, the thesis proposes a variety of interpretative solutions. Lastly, acknowledging the practicality of the proposed substantive reforms, the thesis explores whether there are other less contentious means that may complement and strengthen the existing WTO rules and mechanisms with regard to RTA supervision. These include promulgation of code of best practices, revision of the WTO surveillance mechanism, and technical assistance for developing countries in relation to RTAs.

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Dominican Republic–Cigarettes, WT/DS302/AB/R, adopted 19 May 2005

EC–Asbestos, WT/DS/135/AB/R, adopted 5 April 2001

EC–Hormones, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998

EC–Tariff Preferences, WT/DS246/AB/R, adopted 20 April 2004

Japan–Alcohol, WT/DS8,10,11/AB/R, adopted 4 October 1996

Korea–Beef, WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001

Turkey–Textiles, WT/DS34/AB/R, adopted 19 November 1999

US–Gambling, WT/DS285/AB/R, adopted 20 April 2005

US–Gasoline, WT/DS2/AB/R, adopted 20 May 1996

US–Line Pipe Safeguard, WT/DS202/AB/R, adopted 8 March 2002

US–Shrimp (Thailand), WT/DS343/AB/R, WT/DS345/AB/R, adopted 1 August 2008

WTO Panel Reports

Brazil–Tyres, WT/DS332/R, adopted 17 December 2007, as modified by the Appellate Body Report

Canada–Autos, WT/DS139/R, WT/DS 142/R, adopted 19 June 2000, as modified by the Appellate Body Report

EC–Chicken Classification, WT/DS269/R, WT/DS286/R, adopted 27 September 2005

Korea–Beef, WT/DS161/R, WT/DS169/R, adopted 10 January 2001, as modified by the Appellate Body Report

Turkey–Textiles, WT/DS34/R, adopted 19 November 1999, as modified by the Appellate Body Report

US–Gambling, WT/DS285/R, adopted 20 April 2005, as modified by the Appellate Body Report

US–Line Pipe Safeguard, WT/DS202/R, adopted 8 March 2002, as modified by the Appellate Body Report

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EEC–Bananas II, DS38/R, 11 February 1994 (Report not adopted)

EEC–Oilseeds, L/6627-37S/86, adopted 25 January 1990

North American Free Trade Agreement

NAFTA Chapter 20 Arbitral Panel Report, *Cross-Border Trucking Services*, 6
February 2001

NAFTA Panel Report (Chapter 20), *US Safeguard Action Taken on Broom Corn
Brooms from Mexico*, 30 January 1998

List of Abbreviations

ACORTA	Advisory Centre on Regional Trade Agreements
ACP	African, Caribbean and Pacific
ACWL	Advisory Centre on WTO Law
AFTA	ASEAN Free Trade Area
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BBC	British Broadcasting Corporation
BISD	Basic Instruments and Selected Documents
CACM	Central American Common Market
CARIBCAN	Caribbean-Canada Trade Agreement
CARICOM	Caribbean Community and Common Market
CBI	Cross-border Initiative
CEFTA	Central European Free Trade Agreement
CEMAC	Economic and Monetary Community of Central Africa
CEPA	China's Economic Partnership Arrangement
CERTA	Closer Economic Relations Trade Agreement
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
CRTA	Committee for Regional Trade Agreements
CTD	Committee on Trade and Development
CTG	Council for Trade in Goods
CTS	Council for Trade in Services
CU	Customs Union
DDA	Doha Development Agenda
DR-CAFTA	Dominican Republic-Central American Free Trade Agreement
DSM	Dispute Settlement Mechanism
DTN	Department of Trade Negotiations
EAC	East African Cooperation
EBA	Everything but Arms

EC	European Community
ECOWAS	Economic Community of West African States
EEC	European Economic Community
EFTA	European Free Trade Association
EPA	Economic Partnership Agreement
EU	European Union
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GNI	Gross National Income
GSP	Generalized System of Preferences
GSTP	Global System of Trade Preferences
HS	Harmonized System
HS-6	Six Digit Level of the Harmonized System
IMF	International Monetary Fund
IPR	Intellectual Property Right
ITC	International Trade Centre
ITO	International Trade Organization
ITTC	Institute for Training and Technical Cooperation
LAFTA	Latin America Free Trade Association
LAIA	Latin America Integration Association
LDC	Least-developed Country
LMIDC	Lower Middle Income Developing Country
Mercosur	Mercado Común del Sur
MFN	Most-Favoured-Nation
MITI	Ministry of International Trade and Industry
NAFTA	North American Free Trade Agreement
NTB	Non-Tariff Barrier
ORC	Other Regulation of Commerce
ORRC	Other Restrictive Regulation of Commerce
PTA	Preferential Trade Agreement
R&D	Research and Development

ROO	Rule of Origin
RTA	Regional Trade Agreement
SACU	Southern African Customs Union
SADC	Southern African Development Community
SADCC	Southern African Development Coordination Conference
SAT	Substantially All the Trade
SBO	Substantive Business Operations
SMP	Single European Programme
SPS	Sanitary and Phytosanitary
TBT	Technical Barriers to Trade
TFP	Total Factor Productivity
TPRM	Trade Policy Review Mechanism
TRTA	Trade-related Technical Assistance
UMIDC	Upper Middle Income Developing Country
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
US	United States
WTO	World Trade Organization

Introduction

On 14 of November 2010, the BBC news reported that “leaders of the 21-member Asia-Pacific Co-operation (APEC) forum have pledged to move towards creating a regional free-trade area. The agreement was announced at the end of a two-day summit in Yokohama, Japan. The move would link the world’s three biggest economies- the United States, Japan, and China.”¹ This is but one example of the many regional trade agreements (RTAs) that have been proliferating on the global trade landscape since the establishment of the World Trade Organization (WTO) in 1995, and the rate of proliferation is continuing unabated.²

To date, the number of RTAs notified to the WTO, which are in force, is at 288 agreements.³ More importantly and crucial for the purposes of this thesis, it emerges that more and more developing countries are taking part in the current RTA proliferation, by forming RTAs either with their developed-country trade partners or among themselves. This trend appears in all regions from Latin America to the Middle East and from Africa to Asia.⁴

Given the sheer numbers of RTAs in force, signed, and being negotiated, no developing countries are likely to be left untouched by the current wave of RTA proliferation.⁵ Furthermore, as major developed countries such as the United States, the European Union (EU), and Japan have adopted RTAs as one of their main trade policies, developing countries will find it hard to stay outside the playing field. This is particularly the case for those developing countries whose main competitors have concluded RTAs with their main developed-country trade partners. Under such circumstances, the non-member developing countries may have to respond by forming RTAs of their own with these developed countries or by applying for the membership of the existing ones.⁶

¹ See <http://www.bbc.co.uk/news/world-asia-pacific-11751933> (last accessed 15 November 2010).

² See J-A Crawford and RV Fiorentino, 'The Changing Landscape of Regional Trade Agreements' (Discussion Paper No8, WTO, Geneva 2005), p. 3.

³ See <http://rtais.wto.org/UI/PublicAllRTAList.aspx> (last accessed 15 November 2010). It should be noted that the agreements that encompass both goods and services trade are notified twice under the WTO framework and therefore counted twice.

⁴ See R Fiorentio, L Verdeja and C Toqueboeuf, 'The Changing Landscape of Regional Trade Agreements: 2006 Update' (Discussion Paper No12, WTO, Geneva 2006), pp. 13-25.

⁵ See Chapter 1.

⁶ This will be discussed in more detail in Chapter 3.

For some developing countries, RTAs are seen as an offensive trade strategy. For example, Singapore, a city state that does not have many natural resources, has been using RTAs as a way to widen its export markets and make it more attractive as a place for businesses.⁷ For others, RTAs are seen as a way to achieve economic development through economies of scale and increased competition.⁸ Such objectives are often associated with RTAs formed among neighbouring developing countries, for example the Mercado Común del Sur (Mercosur).

Regardless of the motivations which drive them to form RTAs, it appears that developing countries have fully embraced such trade arrangements. The proposed APEC free-trade area for example, if formed, will encompass more than ten developing countries in the region.⁹ However, one may wonder whether developing countries will in fact benefit from these agreements.

In Viner's 1950 seminal work, *The Customs Union Issue*, he argued, contrary to the accepted wisdom at the time which favoured RTAs in all cases, that the formation of an RTA is not *a priori* beneficial to the member countries.¹⁰ All depends on whether the RTA results in net trade creation or trade diversion.¹¹ Since then, a body of literature has been developed in order to understand more completely the economic effects that RTAs are likely to have.¹² Although one cannot predict in advance with certainty that an RTA will improve the welfare of the member countries, the literature has identified a number of factors that are influential to the success of such trade arrangements. These include the initial trading patterns between the member countries and the restrictiveness of the rules of origin adopted.¹³

Nevertheless, it is not an easy endeavour for developing countries, as a prospective RTA member, to make sure that they benefit from the formation of an

⁷ See SM Thangavelu and M-H Toh, 'Bilateral 'WTO-Plus' Free Trade Agreements: The WTO Trade Policy Review of Singapore 2004' (2005) 28 *World Economy* 1211. See also <http://www.bbc.co.uk/news/business-11671839> (last accessed 15 November 2010).

⁸ This will be discussed in more detail in Chapter 2.

⁹ See http://www.apec.org/apec/member_economies.html (last accessed 17 November 2010).

¹⁰ See J Viner, *The Customs Union Issue* (Carnegie Endowment for International Peace, New York 1950).

¹¹ This will be discussed in more detail in Chapter 2.

¹² For a collection of important works in this area, see C Freund, *The WTO and Reciprocal Preferential Trading Agreements* (Edward Elgar, Cheltenham 2007).

¹³ For example, see P Wonnacott and M Lutz, 'Is There a Case for Free Trade Areas?' in JJ Schott (ed) *Free Trade Areas and US Trade Policy* (Institute for International Economics, Washington, DC 1989), p. 6, and K Krishna and A Krueger, 'Implementing Free Trade Areas: Rules of Origin and Hidden Protection' in A Deardorff, J Levinsohn and R Stern (eds), *New Directions in Trade Theory* (University of Michigan Press, Ann Arbor 1995), World Trade Organization., *Rules of Origin Regimes in Regional Trade Agreements* (World Trade Organization, Geneva 2002), respectively.

RTA. Although the ability to analyse all the factors involved is very crucial for a successful outcome, developing countries often have constraints on such analytical capacity.¹⁴

Knowing how to maximize the potential benefits and minimize the potential costs of an RTA is only half of the story, however. Given that trade negotiations are mercantilist in nature and involve exchanges of trade concessions between the parties, developing countries will have to secure those that are favourable to their economies. A crucial factor here is the relative bargaining powers between the member countries. If they are on equal footing, one would expect the outcome to be satisfactory to all of the parties involved. On the other hand, if they are not, the outcome may be biased towards the more powerful partner.¹⁵ The latter scenario is more likely in the case of RTAs formed between developed and developing countries. Thus, negotiating capacity on the part of developing countries is also very important.

In an RTA, the member countries grant to one another trade preferences without extending them to the rest of WTO membership. Given this inherently discriminatory nature, the literature shows that non-members are likely to be adversely affected by the formation of an RTA.¹⁶ As mentioned earlier, their options are to form RTAs of their own with their main trade partners or apply for the membership of the existing ones.

The crucial point is that the successful use of RTAs by developing countries as a part of their growth and development strategies is not guaranteed and may depend on factors over which they have little control. Analytical and negotiating capacities, for example, are not something that they can improve very easily, especially in the short-run. In addition, given that non-members are excluded from the negotiating process, non-member developing countries will not be able to do much to protect their interests. Thus, there is a case for an international framework for RTA supervision that addresses challenges facing developing countries when forming these agreements.

¹⁴ For further discussion on the role of research in trade negotiations, see D Tussie, 'The Politics of Trade: The Role of Research in Trade Policy and Negotiation' in D Tussie (ed) *The Politics of Trade: The Role of Research in Trade Policy and Negotiation* (International Development Research Centre, Ottawa 2009).

¹⁵ See FR Pfetsch, 'Symmetry and Asymmetry in International Negotiations' (2000) 5 *International Negotiations* 21, pp. 37-40.

¹⁶ For example, see R Pomfret, *The Economics of Regional Trading Arrangements* (Clarendon Press, Oxford 1997), pp. 196-201.

The thesis therefore embarks upon two tasks. The first task is to find out *what specific challenges do developing countries face amid the current RTA proliferation when they negotiate and form such trade arrangements with their developed-country trade partners and among themselves?* The second task is to determine *to what extent do the existing WTO rules pertaining RTA supervision address these challenges and are there any ways to improve the rules and mechanisms so that the challenges can be better addressed?* The thesis sets out to answer these questions.

1. Challenges Facing Developing Countries

In order to accomplish the first task, the thesis will review three broad bodies of literature. First, and most importantly, there is a body of economic literature on RTAs which encompass a wide range of various economic frameworks including neo-classical liberalism, new growth theory as well as development economics.¹⁷ This body of literature seeks to identify and explain the potential benefits and potential costs of the formation of an RTA, in terms of its aggregate welfare effects. For example, an RTA may result in net trade creation and improved terms of trade, which in turn will increase the welfare of the member countries. Or, it may result in net trade diversion, which is harmful to both the member countries and non-members alike. The formation of an RTA may also result in economies of scale, knowledge and technology transfer, and an increase in competition and foreign direct investment (FDI), all of which can potentially benefit the members' economies. Second, the thesis will also review the findings of another body of literature, which considers the political economy dimension of RTAs. This body of literature seeks to understand the implications of the formation of an RTA on the member governments and their trade policies, and how domestic vested interests may respond to such agreements and/or

¹⁷ These frameworks make different assumptions. For example, a neo-classical economic framework assumes that competition is perfect while a framework based on new growth theory assumes that competition is not perfect and factors of production such as capital can accumulate over time and can have significant impact on economic growth. A framework based on development economics, by contrast, puts an emphasis on the difference in market conditions prevailing in merging economies, such as idle capacity, as compared to those in developed countries' economies generally assumed by the other economic frameworks.

attempt to influence their contents. It also seeks to predict how non-member governments may react to the formation of an RTA.¹⁸ Third, the thesis will also examine those works which look at negotiating dynamics of the formation of an RTA, particularly those concerning prospective developing-country members, as well as how the membership of an RTA or the prospect of forming one may affect developing countries at the multilateral level.¹⁹

It should be noted that the review of these bodies of literature is supplemented with the author's personal participation in RTA negotiations and the interviews conducted with trade negotiators during these trade negotiations.²⁰ The exposure to such negotiations and the interviews conducted provided the author with practical insights which are not available from purely document-based research.

One limitation of the thesis, therefore, is that it does not consider the effects of the formation of an RTA, which fall outside these three bodies of literature reviewed. As is well known, the creation of an RTA may have an effect on security and social dimensions and other domestic concerns that may include indirect effects on education and health care. For example, the formation of an RTA may help reinforce political support for a military conflict, e.g. the US-Republic of Korea free trade agreement (FTA) and its impact on the relationship between the latter and North Korea;²¹ an RTA may foster social and/or cultural integration between the member countries, e.g. the EU member states;²² and a regional integration agreement may provide a group of countries faced with a common health crisis with the necessary finances, infrastructure and expertise to address such crises, e.g. the outbreak of the *avian flu* and the Association of Southeast Asian Nations (ASEAN).²³ Such issues are

¹⁸ For example, the theory of domino effect was first introduced by Baldwin in the early 1990s. See R Baldwin, *A Domino Theory of Regionalism* (National Bureau of Economic Research, Cambridge, MA 1993).

¹⁹ For example, see M Diego-Fernandez, 'Trade Negotiations Make Strange Bedfellows' (2008) 7 *World Trade Review* 423 and JP Singh, 'Coalitions, Developing Countries, and International Trade: Research Findings and Prospects' (2006) 11 *International Negotiations* 499.

²⁰ This will be discussed in more detail below under the heading of Methodology and Sources

²¹ For example, see Y-S Lee, 'The Beginning of Economic Integration Between East Asia and North America? - Forming the Third Largest Free Trade Area Between the United States and the Republic of Korea' (2007) 41 *Journal of World Trade* 1091.

²² For further discussion, see S Zetterholm (ed), *National Cultures and European Integration: Exploratory Essays on Cultural Diversity and Common Policies* (Berg Publishers, Oxford 1994).

²³ For more detail, see R Coker and S Mounier, 'Pandemic Influenza Preparedness in the Asia-Pacific Region' (2006) 368 *The Lancet* 886.

not addressed in this thesis. In other words, the thesis does not attempt to deal with the *full analysis of all possible impacts of RTAs on members and non-members.*²⁴

Nevertheless, it is argued that the specific challenges facing developing countries that will be discussed and identified in Chapters 2 and 3 are serious and worthy of study in their own right. For example, it is clear from the literature that trade diversion can and does harm the economies of developing countries. This is true both for members of the RTA in question, and for developing countries which are not members of it since the RTA may result in competitor countries undercutting their access to lucrative export markets. For example, Thai farmers whose products were used to produce rubber and tyres were seriously affected by the formation of the Japan-Malaysia Economic Partnership Agreement (EPA) because their Malaysian counterparts could sell their products to Japanese firms at cheaper prices as a result of the agreement. Such consequences prompted Thailand to negotiate and form its own EPA with Japan, which was signed a year after the Japan-Malaysia EPA came into force. It is crucial, therefore, to understand the forces which lead to the creation of trade-diverting rather than trade-creating RTAs, and to assess whether international law can make a contribution to the challenge of addressing them.

Confronted with the challenge of constraints on analytical and negotiating capacities, developing countries are likely to find it difficult to make the most out of the formation of an RTA. Not only will they not benefit from such trade arrangements as much as they should, they may be in fact worse off as a result of having to make commitments that may have adverse effects on their economies, and hence their people. For example, many commentators criticize the proposed EPAs between the EU and the African, Caribbean and Pacific (ACP) countries on the basis that they do not offer adequate protection for food security in the latter, which could affect millions of people whose lives and livelihoods depend on affordable food prices and agricultural sector.²⁵

It is noteworthy that although the bodies of literature described above can help one better understand how developing countries, like Thailand, can make use of RTAs as a means to achieve economic development through economic growth and trade

²⁴ This is not to say that developing countries' trade negotiators do not need to take the full effects of the formation of an RTA into account. In fact, they should and it is very important that they do. However, as will be discussed in Chapter 2, developing countries may often lack the necessary analytical and negotiating capacities, and as a result, are disadvantaged in RTA negotiations.

²⁵ For example see <http://www.oxfam.org/en/node/251> (last accessed 8 November 2010).

liberalization more effectively, this is not to say that economic development can be pursued solely through RTAs. Other trade policies are also important, particularly those concerning distribution of wealth created through trade expansion.²⁶

So far, I have referred to the challenges which RTAs pose for *developing countries*. It may legitimately be objected that developing countries are not homogeneous, that their interests differ, and that they each may face a different set of challenges. The term *developing countries* does encompass a wide range of countries at different stages of development, economic or otherwise. This is reflected in the diverse interests among these countries. Not only do such diverse interests weaken their position in the WTO on certain issues, but they also make it extremely complex to design uniform solutions for their needs and difficulties when integrating into the global economy. Notably, there are no definitions of *developed* and *developing* countries within the WTO framework. In practice, Members determine for themselves whether they are one or the other although other Members can challenge the decision of a Member to make use of provisions available to developing countries.²⁷

The thesis nevertheless argues that there are some *common* challenges facing developing countries amid the current RTA proliferation. It argues that, in terms of these specific challenges, the differences between developing countries primarily affect their degree of severity rather than their existence *per se*. That said, wherever possible, the thesis also takes the heterogeneity of developing countries into account when it seeks to offer solutions to the shortcomings of the WTO rules and mechanisms pertaining RTA supervision.

Although the thesis does not categorically define the term *developing countries*, the working definition primarily corresponds to the three groups of countries classified by the World Bank as low income, lower middle income, and upper middle income.²⁸ Gross national income (GNI) per capita²⁹ will be used as the main criterion to deal with the issue of heterogeneity- by further dividing developing countries into three subgroups comparable to the World Bank's classification, each of

²⁶ For further discussion, see D Rodrik, 'Globalization, Social Conflict and Economic Growth' (1998) 21 *The World Economy* 143.

²⁷ See http://www.wto.org/english/tratop_e/devel_e/d1who_e.htm (last accessed 23 August 2009). For further discussion, see F Cui, 'Who Are the Developing Countries in the WTO?' (2008) 1 *The Law and Development Review* 123.

²⁸ See <http://data.worldbank.org/about/country-classifications> (last accessed 1 December 2010).

²⁹ GNI per capita is the dollar value of a country's final income in a year divided by its population. It reflects the average income of a country's citizens.

which would be subject to different treatments under the proposals. The three subgroups are: the least-developed countries (LDCs), comprising of the countries with per capita incomes below \$900; the lower middle income developing countries (LMIDCs) which includes countries with GNI per capita between \$901 and \$3,035; and the upper middle income developing countries (UMIDCs) which includes those countries with GNI per capita between \$3,035 and \$9,385.³⁰ Given that such a criterion has been adopted by the World Bank as its main criterion for classifying countries for operational and analytical purposes, it represents at present the closest thing to an internationally accepted benchmark in this area.³¹ It should be noted that in this thesis the Republic of Korea, Taiwan, and Singapore are considered as *advanced* developing countries despite the fact that they fall within the high income group classified by the World Bank.³²

It is, however, acknowledged that such a criterion is not perfect for dealing with the challenges facing developing countries amid the current RTA proliferation. For example, although GNI per capita is a good criterion since a country's analytical and negotiating capacities are generally related in an approximate fashion to its size and level of economic development, it may not have a direct correlation with how influential domestic vested interests are over the member governments and/or how high the implementation and adjustment costs will be for developing-country RTA partners. Nevertheless, it will be argued that a subdivision of developing countries *in advance* (as opposed to on an *ad hoc* basis) for the purposes of incorporating special and differential treatment principle into the WTO rules would strike the right balance between the individual needs of developing countries and predictability (and practicality) of RTA negotiations while a truly country-specific approach for special and differential treatment could be adopted with regard to the proposed technical assistance provided for developing countries.³³

³⁰ See Chapters 4, 5, and 6.

³¹ See <http://data.worldbank.org/about/country-classifications> (last accessed 16 November 2010).

³² One reason for this is to highlight the fact that although these countries were considered as developing countries at the end of the Second World War, they have achieved high level of economic development and raised the standards of living of their peoples. In addition, Singapore is a member of ASEAN, which in 2004 formed an RTA with China and notified it under the Enabling Clause. Given that only goods RTAs formed among developing countries are allowed to notify under the Enabling Clause, it seems that the countries involved consider Singapore as a developing countries. Similarly, the Republic of Korea is also a signatory of the Global System of Trade Preferences among Developing Countries (GSTP).

³³ This will be discussed in more detail in Chapters 4, 5, 6 and 7.

2. Proposals for the Improved WTO Oversight of RTAs

In order to accomplish the second task- namely, to evaluate the existing WTO regulatory framework- the thesis will primarily examine the WTO rules pertaining RTA supervision in light of the challenges identified in Chapters 2 and 3, so that they can be updated and revised in light of contemporary developments. As will be seen in Chapters 4, 5, and 6, the rules are a product of years of development in response to the evolving global trading system, with the result that represents a complicated and ambiguous framework, ill adapted to the present day needs of developing countries.³⁴

Within the WTO legal framework, RTAs are an exception to the most-favoured-nation (MFN) obligation, the non-discriminatory principle often described as a *core pillar* of WTO law. They are an exception because the member countries are allowed to grant to one another trade preferences without having to extend them to the rest of the WTO membership, provided only that they comply with the relevant WTO provisions. In the goods context, the provisions are primarily contained in Article XXIV of the General Agreement on Tariffs and Trade (GATT). For developing-country Members, they also have an additional route to form a goods RTA among themselves through the provisions under the Decision of 28 November 1979, entitled “Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries” (the Enabling Clause). Article V of the General Agreement on Trade in Services (GATS), on the other hand, sets out the requirements with which WTO Members have to comply in order to form a *services* RTA with one another.

Historically, the application and enforcement of these rules has been extremely weak. There are two ways through which they can be enforced. The first is the reviewing mechanism (as reformed by the Decision on the Transparency Mechanism for Regional Trade Agreements 2006 (the 2006 Mechanism)) conducted by the Committee on Regional Trade Agreements (CRTA) and the Committee on Trade and Development (CTD),³⁵ and the second is the WTO dispute settlement mechanism (DSM) carried out by panels and the Appellate Body. Over the years, these rules, particularly those contained in GATT Article XXIV, have been subject to

³⁴ GATT Article XXIV was enacted in 1947, the Enabling Clause in 1979, and GATS Article V in 1995.

³⁵ The CRTA is responsible for those RTAs which are notified to the WTO under GATT Article XXIV and GATS Article V; whereas, the CTD is responsible for those notified under the Enabling Clause.

debates among WTO Members (and GATT CONTRACTING PARTIES before them) and discussion in a limited number of case law. Despite (or perhaps because of) this lack of rigorous enforcement, the rules are full of ambiguity and in need of clarification.

While there is considerable literature on these provisions, it has so far mostly been confined to technical legal analysis of the relevant GATT/WTO jurisprudence, without explicit reference to the development dimension of RTAs and how they can be used by developing countries to achieve their economic development. In addition, discussion is mostly limited to GATT Article XXIV while the rules contained in the Enabling Clause and GATS Article V have received comparatively little attention.³⁶

Thus, the thesis seeks to supplement the existing literature with the insights obtained from the bodies of literature described above, as supplemented by the author's personal participation in RTA negotiations and interviews conducted during these trade negotiations, and to determine how the existing rules and mechanisms can be improved in ways that benefit developing countries. To put it differently, the thesis attempts to draw on the three bodies of literature in order to construct a framework for analysis that can be used to identify the challenges facing developing countries amid the current RTA proliferation (the first task); then use it to critically evaluate the three sets of WTO rules and existing mechanisms and guide the proposals made in response to the shortfalls of the WTO regulatory framework (the second task).

As a result of the way that I have framed this second task, one question which may arise is whether, and if so why, the WTO is the appropriate international body to oversee and guide the process of RTA formation by developing countries. The answer to this question is in two parts. First, and most briefly, it is important to reiterate that there is a need for *some* international framework for RTA supervision that addresses the challenges facing developing countries amid the current RTA proliferation. Experience has shown that developing countries cannot reasonably be expected to adequately address the challenges they face on their own, without the assistance of an

³⁶ The main works on GATT Article XXIV include KW Dam, *The GATT: Law and International Economic Organization* (University of Chicago Press, Chicago 1970), chapter 16 and JH Mathis, *Regional Trade Agreements in the GATT/WTO: Article XXIV and the Internal Trade Requirement* (T.M.C. Asser Press; Sold and distributed by Kluwer Law International, The Hague, Norwell, MA 2002). As far as GATS Article V is concerned, only few works discuss it in detail, for example, see S Stephenson, 'Regional Agreements on Services in Multilateral Disciplines: Interpreting and Applying GATS Article V' in S Stephenson (ed) *Services Trade in the Western Hemisphere: Liberalization, Integration, and Reform* (Brookings Institution Press, Washington, DC 2000).

appropriate international framework. This is particularly true in respect of capacity constraints, as well as in respect of the adverse effects which RTAs have on non-members, which by definition are not amenable to negotiated resolution among parties to an RTA.

Second, the question remains whether the WTO is the most appropriate international venue for international oversight of RTAs. This thesis chooses to focus primarily on the existing WTO rules and mechanisms for two practical reasons. The first concerns obligations of states under general public international law. States are essentially free to enter into any agreement of any kind and content. Equality of states entails the power to choose partners, and to discriminate against others. There are hardly any limitations in customary international law on engaging in preferential or discriminatory treatment, beyond the principles and rules enshrined in the Charter of the United Nations; neither is there a general obligation to treat all states alike.³⁷ Thus, it seems that the only way in which the current RTA proliferation can be supervised is through specific treaty provisions. The WTO rules pertaining RTA supervision, which bind its 153 Members- covering the vast majority of trading countries- are the primary relevant framework already in existence, and therefore of paramount importance in light of the increasing number and complexity of such agreements. Another reason is that the WTO's existing mechanisms mean any reforms proposed to the WTO rules can be enforced. For example, in Chapter 7 it will be proposed that a code of best practices with regard to the formation of an RTA should be established by the WTO since such a code would be used by the CRTA/CTD in the reviewing process and/or by panels and the Appellate Body through the DSM. A similar code of best practices established by other international organizations may not be as readily applicable or enforceable within the WTO framework.

Although it is open to debate whether the WTO at present has the institutional capacity to supervise RTAs effectively, with the membership of 153 countries coupled with the existing rules and mechanisms, it is arguably in a better position to

³⁷ See T Cottier and M Foltea, 'Constitutional Functions of the WTO and Regional Trade Agreements' in L Bartels and F Ortino (eds), *Regional Trade Agreements and the WTO Legal System* (Oxford University Press, Oxford; New York 2006), p. 43.

supervise the current RTA proliferation than any other international organization.³⁸ This is, however, not to say that the WTO has the *sole* responsibility to address the challenges faced by developing countries as a result of RTA proliferation. A full solution would require a multi-pronged approach, which may imply cooperation and coordination between the WTO and other existing international organizations such as the United Nations Conference on Trade and Development (UNCTAD) and the Advisory Centre of WTO Law (ACWL) or even new ones that could be established in order to deal with the current wave of RTA proliferation such as an Advisory Centre on Regional Trade Agreements (ACORTA).³⁹

Nevertheless, given that the WTO agreements, in fact, contain three sets of rules pertaining RTA supervision and establish mechanisms through which they can be enforced, it is arguably easier to amend and reform existing rules and mechanisms than to create new ones. The thesis does recognize the stalemate in the Doha Round of negotiations and how difficult it would be to carry out the proposed substantive reforms. That is why Chapter 7 will look at other less contentious means, which may complement and/or strengthen the existing WTO rules and mechanisms with regard to RTA supervision.

Structure of the Thesis

The structure of this thesis is as follows. Chapter 1 reviews the general trends and characteristics of the current RTA proliferation.⁴⁰ It is evident that the number of RTAs notified to the WTO has increased dramatically in the past decade, and the rate at which they are being notified is unprecedented. The RTAs in the current proliferation appear to be formed on a bilateral rather than plurilateral basis, many of which are formed between countries from different continents. Commitments made in

³⁸ For further discussion on institutional capacity of the WTO as an international organization, see M Footer, *An Institutional and Normative Analysis of the World Trade Organization* (Nijhoff, Leiden 2005).

³⁹ This will be discussed in more detail in Chapter 7.

⁴⁰ Note that although I only rely on primary sources to a limited extent, the secondary sources I use are produced by the WTO and the World Bank. These reports and working papers should provide reliable and accurate information on the current RTA proliferation.

these RTAs also tend to cover trade in services as well as trade in goods. More interestingly, there has been a significant increase in the number of RTAs between developed and developing countries, which stresses how important it is for the WTO regulatory framework to give due account to the challenges they face when forming such trade arrangements. This chapter aims to paint an overall picture of a global trade landscape criss-crossed by a complicated and expanding array of RTAs.

Chapter 2 investigates and identifies the challenges facing developing countries amid the current RTA proliferation from the perspective of a prospective member country. As a prospective RTA member, developing countries will arguably wish to make the most out of the agreement they have decided to sign. Therefore, they will try to promote the potential benefits and manage the potential costs which are induced by the agreement. In order to identify the challenges, Chapter 2 first examines how a developing-country partner may gain from an RTA and whether it may incur any costs in the process. It then identifies three main challenges which include domestic vested interests, high implementation and adjustment costs, and the lack of analytical and negotiating capacities on the part of developing countries.

Chapter 3, on the other hand, investigates whether there are any challenges that developing countries may face from two other perspectives, namely, as a non-member and as a WTO Member amid the current RTA proliferation. By its very nature, an RTA is designed and negotiated between the member countries. Non-members are however excluded from this process and will be discriminated against as a result of trade preferences granted between the member countries. Thus, it is important that one examines whether an RTA has any adverse effects on a non-member developing country and how they may respond to these effects. Concerns have also been raised that RTAs individually and as a collective group may have implications on the multilateral trading system and multilateral trade negotiations. If it is accepted that developing countries benefit from the multilateral framework offered by the WTO due to possible coalitions and a more rule-based dispute settlement process, anything that undermines the WTO should be considered harmful to developing countries. Thus, the effects of RTAs on the multilateral trading system and multilateral trade negotiations are also explored in this chapter.

Chapters 4, 5, and 6 embark upon the existing WTO rules pertaining RTA supervision, namely, GATT Article XXIV, the Enabling Clause, and GATS Article V, respectively. In these chapters, the existing framework of each set of rules are

explained and then evaluated in light of the challenges facing developing countries identified in Chapters 2 and 3. In response to the shortcomings revealed from the evaluation, the chapters propose a number of ways in which improvement can be made in accordance with the analytical framework as well as customary rules of interpretation of public international law and the available GATT/WTO jurisprudence on these rules.

Chapter 4 proposes that some form of special and differential treatment should be incorporated into GATT Article XXIV through the interpretation of the substantially all the trade requirement (*a.k.a.* the SAT requirement) in terms of the threshold levels and transitional periods so as to afford developing countries some flexibility. It also proposes that the emphasis should be placed on the duty half of the SAT requirement rather than the ORRC (other restrictive regulation of commerce) half in light of other WTO commitments.

By contrast, Chapter 5 argues that rules under the Enabling Clause are so lenient that they result in excess flexibility, which may not necessarily translate into trade/economic benefits for developing countries in practice. Furthermore, since the Enabling Clause only applies to South-South RTAs, and is not available to developing countries forming RTAs with their developed-country trade partners, the existence of the Enabling Clause creates undesirable complication and inconsistency in the treatment of goods RTAs which have developing-country Members as parties. In addition, the two sets of rules may create two types of South-South RTAs, namely, those notified under GATT Article XXIV and those under the Enabling Clause, the legal consequences of which are not clear and may result in discrepancy. Thus, Chapter 5 proposes that there should be a single set of rules for the formation of goods RTAs, *i.e.* GATT Article XXIV but only if the special and differential treatment proposed in Chapter 4 is incorporated into it.

Upon examining GATS Article V, Chapter 6 illustrates that the adoption of the criteria which are based on GATT Article XXIV may have resulted in undesirable complication due to services-specific problems, and have made the implementation of GATS Article V extremely difficult. Given the nature of barriers to trade in services and rules of origin, the magnitude of trade diversion induced by the formation of a services RTA may not be as major a concern as in the case of goods RTAs. This renders the criteria which in the latter case aim at minimizing trade diversion somewhat less significant. In addition and more importantly, services liberalization-

may it be at the bilateral/regional or multilateral level- raises unique challenges (besides those identified in Chapters 2 and 3) for developing countries, particularly those concerning regulation and movement of natural persons. GATS Article V arguably fails to deal with them explicitly. Nevertheless, Chapter 6 proposes that its existing architecture, namely, provisions on special and differential treatment and rules of origin, could be used to help developing countries tackle these unique challenges as well as those identified in Chapters 2 and 3, at least to a certain extent.

It should be noted at this juncture that the proposals made in Chapters 4, 5, and 6 intend to provide developing countries with *controlled*, rather than *unfettered*, flexibility so as to deal with the challenges they face. This is especially the case in Chapter 5 where it is argued that the rules under the Enabling Clause give excess flexibility to developing countries forming (goods) RTAs among themselves. In other words, any special and differential treatment available to developing countries should strike the right balance between the flexibility needed to address the challenges and the potential trade/economic costs which may result from excess flexibility.

The proposals made in Chapters 4, 5, and 6 aim at substantive reforms of the existing rules. However, they will not be easy to execute as almost all WTO Members are a party to one or more RTAs. While non-members are likely to benefit if these rules are clarified and enforced strictly and rigorously, their own current and future RTAs may be at risk of violating them. There is a conflict of interests here. Chapter 7, therefore, explores whether there are other less contentious means that may complement and/or strengthen the existing WTO rules and mechanisms pertaining RTA supervision. These include promulgation of code of best practices, revision of the WTO surveillance mechanism, and technical assistance for developing countries in relation to RTA negotiations. It is argued that together with the proposals made with regard to the enforceable rules, these other means can be complementarily used to supervise the current RTA proliferation in such a way that addresses the challenges facing developing countries.

Methodology and Sources

The methodology used for the first task of the thesis is primarily document-based. Secondary sources have been used as the basis for preliminary research and also as the basis of the analytical framework. The secondary sources include the works of publicists in the fields of international economics, international political economy, international trade negotiations, and those published by a number of non-governmental organizations such as the South Centre and Oxfam International.

This is supplemented by empirical research into the practices of ASEAN members, particularly Thailand's, with regard to their RTA negotiations. The material was gathered by means of interviews with delegates from the original six ASEAN members and the ASEAN Secretariat.⁴¹ These interviews were conducted during the RTA negotiations in which the author participated over the period between April 2007 and June 2010.⁴² These negotiations are for the Thailand-Japan EPA, the ASEAN-Republic of Korea FTA, the ASEAN-India FTA, and the ASEAN-EU FTA. A total of 20 separate interviews were conducted with 20 individuals. In some cases, if further clarifications from the interviews were necessary, they were obtained through electronic mail. The interviews took place prior to, during, or at the end of the RTA negotiations. For all cases, the author was introduced to the interviewees as part of the Thai delegation by a senior Thai trade negotiator. Such introduction, the author believes, helped gain trust and allowed the interviewees to answer the questions more freely. All of them were asked the same set of questions but were allowed to speak and elaborate their answers at their own pace. The interviewees gave their answers in confidence and most of them preferred to remain anonymous.

Additional research for the first task includes facilitated access as part of the Thai delegation at various rounds of RTA negotiations mentioned in the previous paragraph. It also includes facilitated access at meetings among the Thai government departments and ministries, which sometimes involved the private sectors as well.

It is acknowledged that the interviews and facilitated access were confined to negotiators from and RTA negotiations involving the ASEAN countries. As a result,

⁴¹ The original six are Brunei, Indonesia, the Philippines, Malaysia, Thailand, and Singapore.

⁴² The interviews can be considered as *elite interviews*. See JM Berry, 'Validity and Reliability Issues in Elite Interviewing' (2002) 35 *Political Science and Politics* 679.

the practical insights may be somewhat biased towards these countries. Nevertheless, secondary sources are used to compare and confirm these insights with what developing countries from other regions experience with their RTA negotiations.

The methodology used for the second task is based on a careful study of primary GATT/WTO documents in the public domain that have been published in the GATT and WTO Series of *Basic Instruments and Selected Documents (BISD)* as well as WTO documents which are available online through the WTO website. These include materials available on the electronic database on RTAs published by the Secretariat in 2009. GATT/WTO case law and jurisprudence are reviewed and cited to support certain facts or arguments. Secondary sources have also been used for the second task as the basis for preliminary research and as the basis of the analytical framework. The secondary sources include the works of publicists in the fields of international economic law and GATT/WTO law, and public international law.

Terminology

In this thesis, the term *RTA* is used to mean a trade arrangement between two or more countries by which they agree to trade with one another more freely than with the world in general and is or is required to be notified to the WTO under GATT Article XXIV, the Enabling Clause, and/or GATS Article V.⁴³ RTAs are traditionally formed between neighbouring countries within the same region, hence the word *regional*, but in recent years the world has witnessed a surge in trade agreements between countries from different continents, *i.e. cross-regional* RTAs. Thus, the term RTA can be misleading under certain circumstances. In addition, the term *PTA* (preferential trade agreement) is sometimes used to describe such trade arrangements. This is because by definition an RTA is discriminatory as the members give preferential treatments to one another and non-members are excluded. Nevertheless, the thesis adopts the term *RTA* since it is the terminology used by the GATT and subsequently the WTO.

⁴³ See J Black, *A dictionary of economics* (2nd edn Oxford University Press, Oxford 2002), p. 395.

When the term *RTA* is used in the context of goods RTAs, it encompasses both customs unions (CUs) and free trade agreements/areas (FTAs).⁴⁴ In a CU, tariffs and non-tariff barriers (NTBs) are eliminated among the members, and common external tariffs (CETs) and trade policy are agreed in relation to non-members. In an FTA, on the other hand, only the internal tariffs and NTBs are eliminated while the members retain their respective external trade barriers in relation to non-members. It should be noted that sometimes the terms such as *EPA* (economic partnership agreement) and *CERTA* (closer economic relations trade agreement) are used by the members. Nevertheless, a trade arrangement is an FTA (or a CU) if it meets the definition given above.

The thesis also uses the term *RTA* as including partial scope agreements. A partial scope agreement refers to an agreement between developing countries which only concerns trade in goods and provides for reduction and/or elimination of tariffs and non-tariff measures on a limited number of products. Such agreements are notified to the WTO under the Enabling Clause. It is *partial* because under the Enabling Clause developing countries are allowed to *partially* liberalize trade among themselves. This is contrary to the obligation under GATT Article XXIV, which requires RTA members to liberalize trade between themselves on a *substantially all the trade* basis.

When the term *RTA* is used in the context of an arrangement for services trade, *i.e.* a *services* RTA, no distinction is made between a CU, an FTA, and a partial scope agreement. This is due to the fact that GATS Article V does not distinguish between these different arrangements.

⁴⁴ In this thesis, the terms *free-trade area* and *free trade agreement* are interchangeable. It should be noted that generally the term *free-trade area* does not describe an area where goods can be truly traded. The member countries, in most cases, still maintain some barriers, particularly non-tariff measures.

Chapter 1

The Current Regional Trade Agreements Proliferation: General Trends and Characteristics

1.1 Introduction

Customs union and FTA are not new phenomena and have been around for hundreds of years. For instance, a CU of the provinces of France was proposed in 1664; Austria signed FTAs with five of its neighbours during the 18th and 19th centuries; and the colonial empires were based on preferential trade arrangements. Customs unions were also precursors to or were embodied in the creation of new states in, for instance, Germany (the Zollverein), Italy, and the United States.⁴⁵ However, as time changes, so do CUs and FTAs.

During the 1930s, there was a great fragmentation of the world trading system as governments struggled with the slump in demand without the benefit of global economic institutions, which exist today, to provide cooperative focal points. Trade preferences were adopted as one of the means to protect domestic economies.⁴⁶ Although the exact causal relationship between restricted trade and declining incomes during this period is still not clear, fragmentation into closed trading blocs may arguably have fostered inefficiency and frustrated recovery from the Great Depression.⁴⁷ At the end of the Second World War, countries came together and established the GATT where equal treatment of all partners (non-discrimination) was seen as a fundamental principle of the multilateral trading system. Exceptions were

⁴⁵ See MW Schiff and LA Winters, *Regional Integration and Development* (The World Bank, Washington DC 2003), p. 4.

⁴⁶ Ibid.

⁴⁷ For general background of the world economy then, see JN Bhagwati, *Termites in the Trading System: How Preferential Agreements Undermine Free Trade* (Oxford University Press, Oxford; New York 2008), chapter 1.

permitted, both on pragmatic grounds and for reasons of principle. Among these exceptions was the ability to create trade blocs- CUs as well as FTAs.⁴⁸

After the Second World War, there have arguably been three periods during which the world witnessed a surge in RTAs. The first period occurred towards the end of the 1950s and lasted until around the mid-1970s.⁴⁹ The formation of the European Community (EC) was initiated in 1958. Subsequently, RTAs also spread throughout Africa, Latin America and other parts of the developing world although it is noteworthy that Asia was somewhat immune to these series of RTA negotiations and aspirations.⁵⁰ The United States was then one of the few main supporters of the multilateral trading system. In addition, RTAs in this period were formed either between developed countries (North-North RTAs) or between developing countries (South-South RTAs).⁵¹ By the end of this period, however, the attempts at forming RTAs among developing countries had failed.⁵² Thus, while the world was indeed filled with proposals for RTAs, they were not successfully carried through and disappeared by the end of the period, except for the original EC, which later evolved into the EU, and the European Free Trade Association (EFTA).

The second period started around the mid-1980s. It was dominated by the EU's activities: it underwent a number of enlargements and approaching a true economic union. Such activities led to two concerns among the rest of the world: first, that the EU would be less interested in pursuing multilateral trade negotiations within the GATT; and secondly, a fear of *Fortress Europe*- the idea that the EU would become less open to trade with non-members.⁵³

Parallel to this, the United States was no longer an idle player in the field. It began its RTA policy by concluding an FTA with Israel in 1980 and Canada in 1989. This was followed by the negotiations and conclusion of the North American Free Trade Agreement (NAFTA) in 1994 with Canada and Mexico. There were other

⁴⁸ See Schiff and Winters, p. 5.

⁴⁹ See T Carpenter, 'A Historical Perspective on Regionalism' in R Baldwin and P Low (eds), *Multilateralizing Regionalism: Challenges for the Global Trading System* (Cambridge University Press, Cambridge 2009), p. 17.

⁵⁰ Asian countries remained either inward-oriented or fairly closed to the outside (e.g. India and China), or they adopted growth strategies based on exports and sought to expand their access to foreign markets (e.g. Japan, the Republic of Korea, and the Southeast Asian countries).

⁵¹ See R Faini, *Multilateralism and Regionalism after the Uruguay Round* (Macmillan, Basingstoke 1997), chapter 6.

⁵² See J Bhagwati, 'Regionalism and Multilateralism: an Overview' in J de Melo and A Panagariya (eds), *New Dimensions in Regional Integration* (Cambridge University Press, Cambridge 1993), p. 28.

⁵³ See Carpenter, p. 20.

regional integrations in the Americas, including the formation of Mercosur in 1991, and the resurrection of the Andean Pact and the Central American Common Market (CACM) in 1991 and 1993, respectively.⁵⁴

In this period, Asia appeared to embrace RTAs. It started in 1992 where the ASEAN countries, after 25 years of political cooperation with limited trade cooperation, formed the ASEAN Free Trade Area (AFTA).⁵⁵ Regional integration was also prevalent in Africa. In West Africa, the trade blocs, which were formed and failed at the end of the first period, re-formed in more liberal and more tightly organized blocs. The Common Market for Eastern and Southern Africa (COMESA) replaced the previous preferential arrangements,⁵⁶ and many of its members also took part in the Cross-border Initiative (CBI). The Southern African Development Coordination Conference (SADCC) transmogrified into the Southern African Development Community (SADC), which is a trade and economic cooperation association rather than a defence organization.⁵⁷ Similarly, East African Cooperation (EAC) sprang up where the East African Community had failed.⁵⁸ In North Africa, the Mahgreb and Mashraq groups renewed their integration efforts.⁵⁹

Unlike in the first period, RTAs formed during the second period did not disappear and most of them continue to be active in the third period, which has occurred since the conclusion of the Uruguay Round and lasted until today.⁶⁰ It is noteworthy that compared to the first and second periods, RTAs between developed and developing countries (North-South RTAs) are much more common in the third. Moreover, the pace at which RTAs are being initiated is more rapid. The main new feature in this period compared with the second is the sheer number of countries that pursue RTAs as their trade policy alternative to multilateral trade liberalization. For example, the EU is engaging in the negotiations for EPAs with the ACP countries;⁶¹ the United States has initiated and concluded 15 bilateral FTAs, particularly with

⁵⁴ Ibid., p. 21.

⁵⁵ See <http://www.aseansec.org/19585.htm> (last accessed 10 March 2010).

⁵⁶ See <http://about.comesa.int/lang-en/overview> (last accessed 10 March 2010).

⁵⁷ See <http://www.sadc.int/> (last accessed 10 March 2010).

⁵⁸ See <http://www.eac.int/about-eac.html> (last accessed 10 March 2010).

⁵⁹ See Schiff and Winters, p. 6.

⁶⁰ See Carpenter, p. 22.

⁶¹ See <http://ec.europa.eu/trade/wider-agenda/development/economic-partnerships/> (last accessed 10 March 2010).

developing countries;⁶² and many Asian countries are negotiating RTAs both with countries from other regions and among themselves.⁶³

There is no sign that the momentum towards RTAs will die out as in the first period. In other words, RTAs are here to stay. Thus, it is high time that RTA supervision were taken more seriously by the WTO and its Members. Before embarking directly upon an in-depth discussion on RTAs and how they can be supervised under the WTO regulatory framework, it is useful to begin by setting the scene in some detail. Although such a survey can be rather descriptive, it should illustrate the true nature of the current RTA proliferation and how this phenomenon raises concerns with regard to developing countries. This chapter therefore reviews the general trends and characteristics of the current RTA proliferation.

1.2 General Trends and Characteristics

When one looks at the statistics and what they may represent, one should bear in mind that although a lot of attention is drawn to the numbers of RTAs, in force, signed, or under negotiation, it is the proportion of international trade covered by such agreements that is more important.⁶⁴ Thus, given the size of their economies, RTAs which involve the United States and the EU are likely to have greater impact on non-members and the multilateral trading system than RTAs between small economies.

As will be shown in more detail below, there are a number of trends and characteristics which can be drawn from the statistics. First, it is apparent that the number of RTAs notified to the GATT/WTO has increased dramatically and the rate of proliferation is unprecedented. Secondly, FTA is by far the preferred form of RTAs notified to the WTO and they tend to be on a bilateral rather than regional basis. Thirdly, there is a pattern of expansion and consolidation of existing RTAs: on the one hand, there is a clear proliferation of cross-regional RTAs, which account for a

⁶² See http://www.ustr.gov/Trade_Agreements/Section_Index.html (last accessed 1 August 2009).

⁶³ See R Sen, "New Regionalism" in Asia: A Comparative Analysis of Emerging Regional and Bilateral Trading Agreements involving ASEAN, China and India' (2006) 40 *Journal of World Trade* 553.

⁶⁴ See Crawford and Fiorentino, p. 2.

large proportion of the total increase in RTAs; on the other hand, existing continent-wide RTAs are being replaced by more modern ones which involve deeper integration and expanded membership. Fourthly, the coverage of recent RTAs has gone beyond the traditional trade in goods: many cover trade in services and issues such as intellectual property rights (IPRs), investment, and competition policy. Finally, there is an increase in reciprocal RTAs between developed and developing countries, which is evidence of decreased reliance of some developing countries on non-reciprocal schemes such as the Generalized System of Preferences (GSP).

1.2.1 Numbers of RTAs

Compared to the period between the late 1950s and early 1960s, many more RTAs are being concluded today. Since 1990, the number of RTAs in force rose from 50 to 214 agreements in 2006 (see Figure 1). By December that year, 367 RTAs had been notified to the GATT/WTO. Of these, 243 were notified after the creation of the WTO in January 1995.⁶⁵ Interestingly, of the 124 RTAs notified during the GATT years, only 36 remained in force. This may reflect, in most cases, the evolution over time of the agreements themselves as they were superseded by more modern agreements between the same signatories or by their consolidation into wider groupings.⁶⁶

The proliferation of RTAs during the last ten years has also taken place at an unprecedented rate. Between 1 January 1995 and December 2006, 243 new RTAs were notified to the WTO, nearly double the number notified during the GATT years (see Figure 2). In part, the increase in notifications reflects the increase in WTO membership, which has doubled since its creation.⁶⁷ This coincides with the increase in RTA notification. However, what is more important is the rate at which RTAs are being notified. The annual average of notification is 20 notifications under the WTO whereas it was less than three under the GATT. Although the new notification

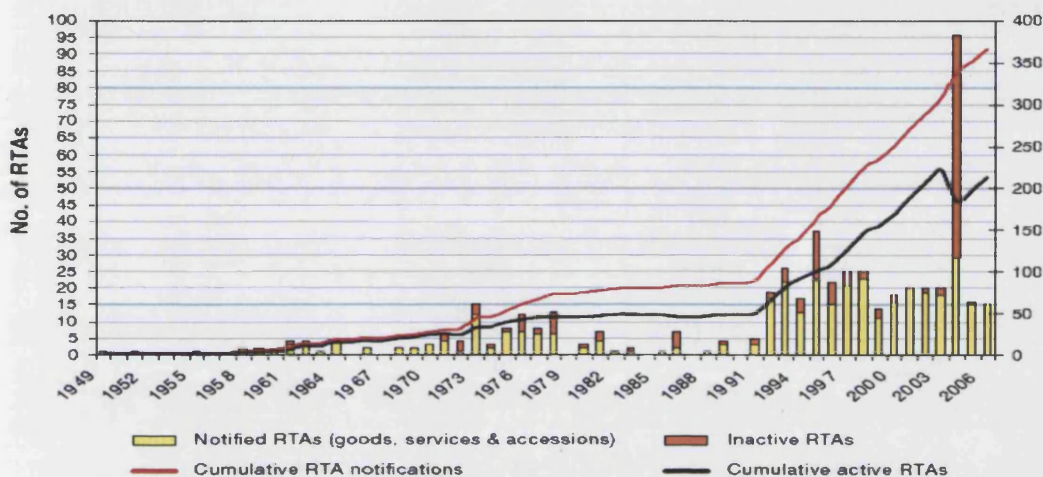
⁶⁵ For a list of RTAs notified to the WTO, see <http://rtais.wto.org/UI/PublicMaintainRTAHome.aspx> (last accessed 1 August 2009).

⁶⁶ See Crawford and Fiorentino, p. 3 and Fiorentino, Verdeja and Toqueboeuf, p. 4.

⁶⁷ As of 23 July 2008, there are 153 WTO Members. See http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (last accessed 1 August 2009).

obligations under the WTO agreements may also have contributed to the increase in notifications,⁶⁸ it is obvious that the rate of RTA proliferation is continuing unabated.⁶⁹ This supports the position that RTAs have become a significant part of the global trade landscape.

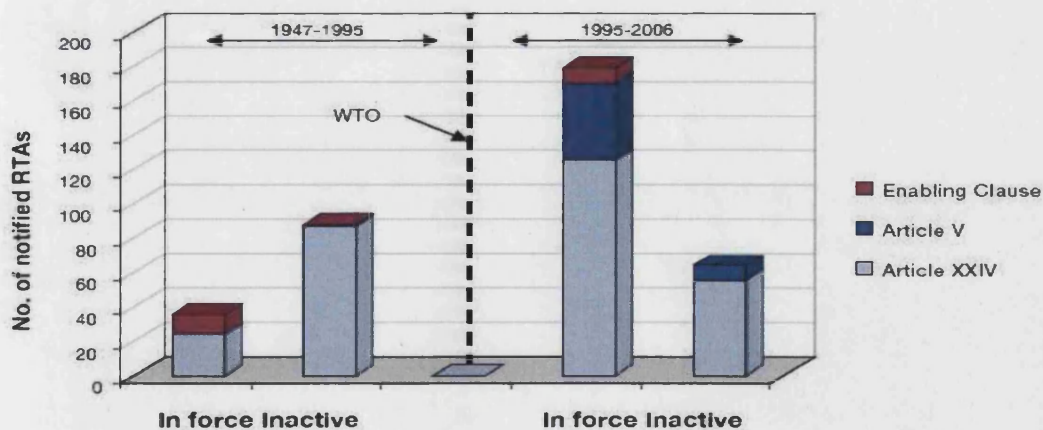
Figure 1: All Notified RTAs to the GATT/WTO (1948-2006), by Entry into Force



Source: Fiorentino, Verdeja and Toqueboeuf, p. 3

The black line, 'cumulative active RTAs', best supports the position that RTAs are here to stay as it illustrates the number of cumulative active RTAs between 1948 and 2006. Note that the dip in 2004 is a result of the EU enlargement which consolidated many bilateral agreements between the EU (15) and the ten new member states into one regional trade agreement.

Figure 2: Notified RTAs to the GATT (pre 1995) and WTO (post 1995)



Source: Fiorentino, Verdeja and Toqueboeuf, p. 5

It can be seen that after the WTO establishment in 1995, the number of RTAs notified has increased dramatically. This is especially the case for RTAs notified under GATT Article XXIV as can be seen from the size of light blue column.

⁶⁸ Since the establishment of the WTO, Members are required to notify services RTAs as well as those concerning trade in goods. For example, GATT Article XXIV:7 and GATS Article V:7.

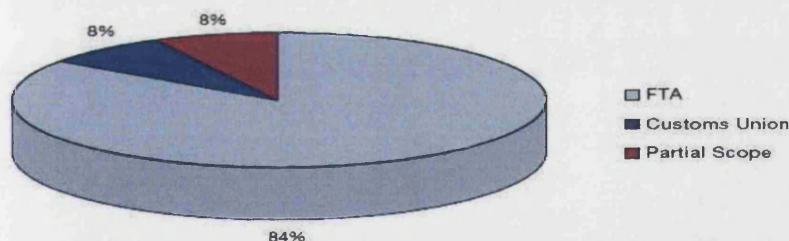
⁶⁹ See Fiorentino, Verdeja and Toqueboeuf, p. 5.

1.2.2 Typology of RTAs

As far as the typology of RTAs is concerned, the most common category is FTA, which accounted for 84 per cent of all RTAs in force as of December 2006 (see Figures 3 and 4). During the same period, partial scope agreements⁷⁰ and CUs accounted for 8 per cent, respectively. Of the RTAs not yet in force 92 per cent were FTAs; 7 per cent were partial scope agreements; and one per cent were CU agreements.⁷¹ Thus, in the near future, FTAs are likely to account for an even greater proportion of RTAs in force.

It should be noted that when the distinction between a CU and an FTA is material, *i.e.* for goods RTAs,⁷² the typology of RTAs is important since it determines the legal requirements RTA members must meet in order to make the RTA in question WTO-compatible. An FTA and a CU notified under GATT Article XXIV are subject to different sets of requirement.⁷³

Figure 3: Notified RTAs in Force, as of December 2006, by Type of Agreement



Source: Fiorentino, Verdeja and Toqueboeuf, p. 6

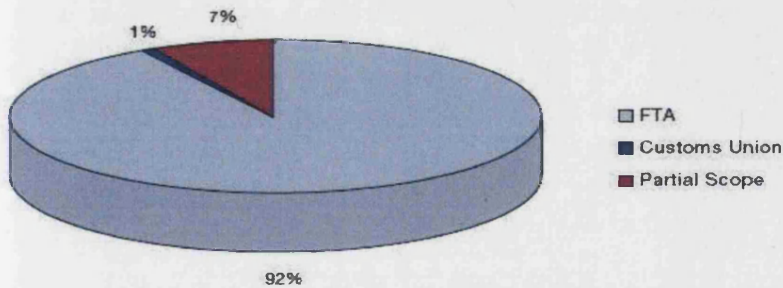
⁷⁰ For the definition of a partial scope agreement, see Introduction. Such agreements must be notified under the Enabling Clause. This will be discussed in Chapter 5.

⁷¹ See Crawford and Fiorentino, pp. 5-6.

⁷² As far as trade in services and GATS Article V are concerned, the distinction between CU and FTA is immaterial. This is due to the nature of barriers to services trade. This will be discussed in Chapter 6.

⁷³ For example, members of a CU will have to comply with paragraphs 5(a) and 8(a) of GATT Article XXIV; whereas, members of an FTA will have to comply with paragraphs 5(b) and 8(b).

Figure 4: RTAs Signed, under Negotiation and Proposed, as of December 2006, by Type of Agreement



Source: Fiorentino, Verdeja and Toqueboeuf, p. 6

1.2.3 RTA Configuration

RTA configuration refers to how RTA negotiations are arranged. For example, if there are two parties to the agreement, the RTA is said to be conducted on a bilateral basis. As of December 2006, bilateral agreements accounted for 75 per cent of all RTAs notified and in force and for almost 90 per cent of those under negotiation (see Figure 5). The fact that countries prefer to form RTAs on a bilateral rather than plurilateral basis may be associated with the trend that FTAs are preferred to CUs since plurilateral (and regional) configuration is more typical of the latter.

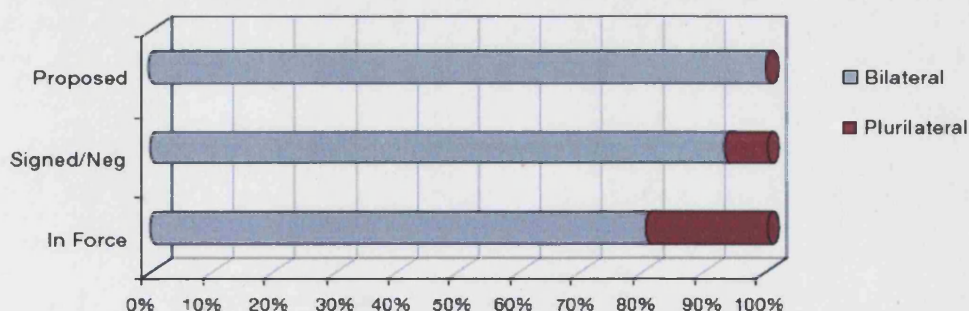
RTA configuration may also have some implications on how difficult negotiations will be in terms of the number of parties involved. Other things being equal, a bilateral trade negotiation should be less complex than a plurilateral one.⁷⁴ It should be noted that there are proposals of RTAs whose parties are distinct RTAs themselves.⁷⁵ This may simply reflect the growing consolidation of established trading relationships. However, the fact that several of such RTAs have been under negotiation for some time, but that very few, so far, have been concluded suggests that such RTAs are extremely complex to negotiate, especially where there is a lack of institutional capacity in the relevant RTAs.⁷⁶

⁷⁴ Note that other factors such as trade coverage also affect how complex an RTA negotiation will be.

⁷⁵ For example, the proposed ASEAN-EU FTA.

⁷⁶ In the proposed ASEAN-EU FTA in which I was a participant, the EU delegates often sarcastically complained that the EU had to negotiate the content of the FTA effectively with the 10 ASEAN

Figure 5: RTA's Configuration, as of December 2006



Source: Fiorentino, Verdeja and Toqueboeuf, p. 8

1.2.4 Geography of RTAs

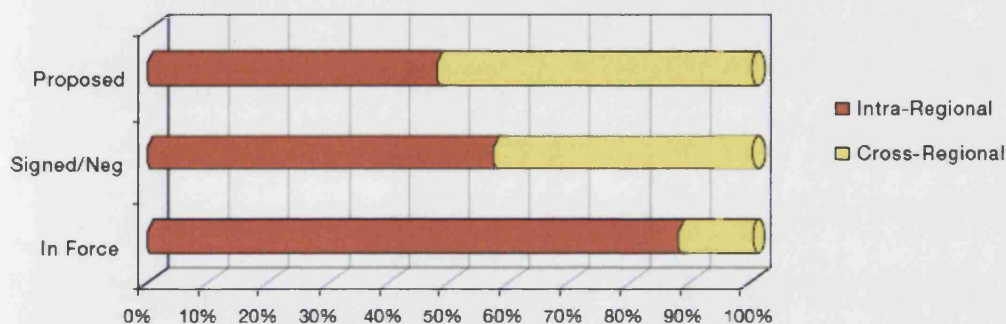
Traditionally, RTAs were formed between the so-called *natural* trading partners, geographically contiguous countries with already well-established trading patterns.⁷⁷ The CERTA between Australia and New Zealand, NAFTA, the EU, EFTA, and the Central European Free Trade Agreement (CEFTA) provide good examples. Indeed, most countries often sign their first RTA with one or several neighbouring or regional partners. This is supported by the Southeast Asian countries' participation in ASEAN, Sub-Saharan African groupings such as the Economic and Monetary Community of Central Africa (CEMAC) and the Southern African Customs Union (SACU), and the Americas groupings such as the Caribbean Community and Common Market (CARICOM), the CACM and Mercosur. However, once a country has exhausted its strictly regional prospects, it may begin to look further afield for non-contiguous preferential partners. Cross-regional RTAs, therefore, seem to be the next natural step, assuming that RTAs are considered as a preferred trade policy. Figure 6 shows that as of December 2006 more than 40 per cent of RTAs under

members rather than with one trade partner, *i.e.* ASEAN, as each member frequently inserted reservations for its own commitments and ASEAN as a group did not seem to have clear common positions.

⁷⁷ See P Krugman, 'Regionalism versus Multilateralism: Analytical Notes' in J de Melo and A Panagariya (eds), *New Dimensions in Regional Integration* (Cambridge University Press, Cambridge 1993), pp. 63-4; and L Summers, 'The Regionalism and the World Trading System' (1991) *Economic Review*, Federal Reserve Bank of Kansas City 295, pp. 297-9.

negotiation and more than half of RTAs proposed were cross-regional. This represents a sharp contrast with current RTAs in force, of which less than 20 per cent were cross-regional. The trend is most evident in countries of the Americas, Europe and increasingly Asia-Pacific.⁷⁸

Figure 6: Cross-Regional RTAs, as a Percentage of Total RTAs as of December 2006



Source: Fiorentino, Verdeja and Toqueboeuf, p. 9

1.2.5 Breadth and Depth of RTAs

The breadth and depth of each RTA differs considerably from one another, with some providing for the exchange of tariff preferences on a limited range of products and others being highly comprehensive in coverage and including wide-ranging trade regulatory regimes.⁷⁹

The breadth and depth of an RTA (along with other factors such as the developed/developing-country status of the RTA members) determine what set of WTO requirements the parties have to meet. For instance, partial scope agreements falling under the legal cover of the Enabling Clause concern exclusively agreements among developing countries and in many cases they tend to have limited product coverage. FTAs and CUs falling under the legal cover of GATT Article XXIV, on the other hand, are more comprehensive in scope and especially the most recent agreements often encompass NTBs on trade in goods, services liberalization, and new

⁷⁸ See Crawford and Fiorentino, pp. 8-15.

⁷⁹ See J Whalley, 'Recent Regional Agreements: Why so many, so fast, so different and where are they headed?' (Working Paper No9, The Centre for International Governance Innovation 2006).

issues such as IPRs, investment, and competition policy.⁸⁰ Commitments on these issues are often referred to as *WTO-plus* commitments. Thus, recent RTAs tend to cover issues, which have not been agreed on at the WTO, as well as commitments, which go further than the members' WTO commitments (both in terms of coverage and deeper commitments).⁸¹ As noted in a study by the World Bank, the inclusion of such commitments is especially marked in North-South RTAs, perhaps reflecting the importance that developed countries place on these issues (see Table 1).⁸²

Table 1: The Coverage of RTAs besides Merchandise Trade

	Standards	Transport	Customs Cooperation	Services	Intellectual Property	Investment	Dispute Settlement	Labor	Competition
U.S.									
U.S.-Jordan	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
U.S.-Chile	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
U.S.-Singapore	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
U.S.-Australia	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
U.S.-CAFTA	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	No
U.S.-Morocco	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	No
NAFTA	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
EU†									
EU-South Africa	No	No	No	No	Yes	No	Yes	No	Yes
EU-Mexico	Yes*	Yes	Yes*	Yes	Yes	Yes	Yes	No	Yes
EU-Chile	Yes*	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
Euro-Med. Agreements	No	No	No	No	Yes	No	Yes	No	Yes*
South-South									
MERCOSUR	Yes	Yes	Yes	Yes	No	Yes	Yes		Yes
Andean Community	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
CARICOM	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
AFTA	Yes	Yes	Yes	Yes	No	Yes	No	No	No
SADC		Yes	Yes	Yes	Yes	No	Yes		
COMESA	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
Other									
Japan-Singapore	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Canada-Chile	No	No	Yes	Yes	No	Yes	Yes	Yes	Yes
Chile-Mexico	Yes		Yes	Yes	Yes	Yes	Yes	Yes	Yes

Source: The Global Economic Prospects: Trade Regionalism, and Development, p. 35

† While EU agreements mention cooperation in most of the subject areas, only those in which specific commitments are undertaken receive a "Yes" rating.

* Implementation steps are to be agreed on at a later date (as of January 2005).

⁸⁰ See Crawford and Fiorentino, p. 5.

⁸¹ For example, see M Roy, J Marchetti and H Lim, 'Services Liberalisation in the New Generation of Preferential Trade Agreements (PTAs): How Much Further than the GATS?' (Staff Working Paper WTO, 2006).

⁸² See World Bank, 'The Global Economic Prospects: Trade, Regionalism, and Development' (World Bank, Washington, DC 2005), p. 35.

1.2.6 Types of RTA Partners

One interesting and more important feature of the RTAs in the third period for the purposes of this thesis is the dramatic increase in the participation of developing countries in both North-South and South-South RTAs.⁸³ Figure 7 shows that as of December 2006, 57 per cent of goods RTAs notified to the WTO involved developing countries;⁸⁴ whereas Figure 8 shows that 77 per cent of services RTAs notified to the WTO involved developing countries.⁸⁵ Given such a dramatic increase in the participation of developing countries, it is argued that not only should RTAs be supervised, but they should also be supervised in such a way that accommodates the challenges that developing countries face when forming an RTA.

It is noteworthy that, as far as a preferential trade relationship between developed and developing countries is concerned, there are two options namely reciprocal and non-reciprocal trade arrangements. RTAs notified under GATT Article XXIV and GATS Article V are underpinned by criteria such as reciprocity and comprehensive trade liberalization⁸⁶ as opposed to the non-reciprocal system of preferences under schemes like the GSP and other unilateral initiatives such as the Cotonou Agreement,⁸⁷ Everything but Arms (EBA),⁸⁸ and the Caribbean-Canada Trade Agreement (CARIBCAN), which are under the legal cover of waivers granted by WTO Members.

⁸³ See Fiorentio, Verdeja and Toqueboeuf, pp. 10-13.

⁸⁴ 57 is the sum of percentage of the light blue (25%), purple (27%), and green (5%) areas in Figure 7.

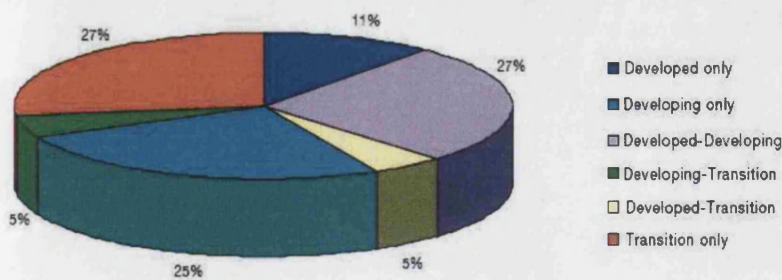
⁸⁵ 77 is the sum of percentage of the light blue (33%), purple (44%), and green (0%) areas in Figure 8.

⁸⁶ Given that the legal cover of the Enabling Clause only applies to goods RTAs concluded among developing countries, North-South goods RTAs can only fall under GATT Article XXIV and subject to the more demanding requirements therein.

⁸⁷ For further discussion, see FAST Matambalya and S Wolf, 'The Cotonou Agreement and the Challenges of Making the New EU-ACP Trade Regime WTO Compatible' (2001) 35 *Journal of World Trade* 123.

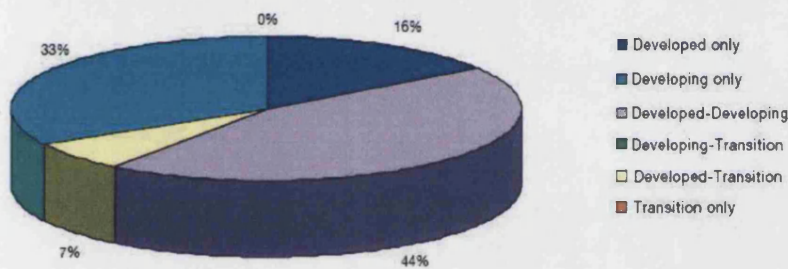
⁸⁸ For further discussion, see P Brenton, 'Integrating the Least Developed Countries into the World Trading System: The Current Impact of European Union Preferences Under "Everything But Arms"' (2003) 37 *Journal of World Trade* 623.

Figure 7: Notified RTAs in Goods by Type of Partner (as of December 2006)



Source: Fiorentino, Verdeja and Toqueboeuf, p. 11

Figure 8: Notified RTAs in Services by Type of Partner (as of December 2006)



Source: Fiorentino, Verdeja and Toqueboeuf, p. 11

1.3 Conclusion

The overview of the general trends and characteristics of the current RTA proliferation paints a picture of how RTAs have altered the global trade landscape. It is apparent that the alteration has been made, arguably permanently. According to the survey, countries tend to see bilateral FTA as a preferred form of RTA.⁸⁹

⁸⁹ The predominance of FTAs over CUs is probably due to the fact that they are faster to conclude and require a lower degree of policy coordination among the parties since in an FTA each party maintains its own trade policy in relation to non-members. A CU, on the other hand, requires the establishment of CETs and harmonization of external trade policy, implying a greater loss of trade autonomy of the members and longer and more complex negotiations and implementation periods. Moreover, while

Geographical proximity appears to be less crucial as more and more RTAs are cross-regional. In addition, contents of recent RTAs tend to encompass areas such as services trade, IPRs, investment, and competition policy as well as traditional trade in goods. This implies new and experimental rules which may have yet to be agreed at the multilateral level. Furthermore, the types of RTA partners seem to have changed. While in the first period of RTA proliferation, North-South RTAs were non-existent, they are much more common today.

Many countries from every continent have concluded RTAs and/or in the process of negotiating one or more. It is clear that RTA proliferation has become a global phenomenon and perhaps a global problem. As far as developing countries are concerned, many have concluded RTAs with their developed-country trade partners such as the United States, the EU, and Japan. In parallel, they also pursue RTAs with one another, both with those from the same region as can be seen in the Americas, Asia, and Africa, as well as those from different continents.⁹⁰

Having examined the general trends and characteristics of the current RTA proliferation, it can be seen that a great number of developing countries from around the globe are becoming embedded in the ever denser web of RTAs containing new and experimental rules. This raises concerns on how such trade arrangements should be supervised. The thesis argues that not only should RTAs be supervised, but they must also be supervised in such a way that gives due account to the challenges facing developing countries when forming an RTA. Given the increased participation of developing countries in the current RTA proliferation, it is imperative to do so. While this chapter sets out the scene of the current RTA proliferation in some detail, Chapters 2 and 3 will discuss and identify these challenges from three different perspectives.

many FTAs are cross-regional, CUs tend to be bounded by geographical proximity that plays a pivotal role in defining the objective of economic (and often political) integration among the members.

⁹⁰ For more detail, see <http://rtais.wto.org/UI/PublicMaintainRTAHome.aspx> (last accessed 9 November 2010).

Chapter 2

Challenges Facing Developing Countries amid the Current RTA Proliferation: as a Prospective RTA Member

2.1 Introduction

Chapter 1 illustrates that RTAs have changed over time and agreements in the current RTA proliferation have certain features which raise concerns over how such agreements should be supervised. If the increase in developing countries' participation is accepted as a fact and a starting point, the question that should be asked is whether the existing WTO rules and mechanisms address the challenges they face amid the current RTA proliferation. In order to answer this, one first has to investigate what these challenges may be. The thesis seeks to conduct the investigation from three different perspectives. The first is when a developing country is a prospective RTA member; the second is when it is excluded from an RTA, *i.e.* as a non-member; and the third is considered from a perspective of a developing country as a WTO Member amid the current RTA proliferation. This chapter deals with the first and the other two are explored in the next chapter.

As a prospective RTA member, developing countries will wish to promote potential benefits and manage potential costs which are induced by the agreement. In order to identify the challenges they face in the attempt to achieve this, it is necessary that one examines how a developing-country partner may gain from an RTA and whether it may incur any costs in the process.

The chapter is therefore divided into two sections. The first section reviews the potential benefits and potential costs induced by the formation of an RTA with an emphasis on implications for the developing-country partner, and the second section discusses possible challenges it may face in the attempt to promote the benefits and manage the costs.

2.2 Benefits & Costs

2.2.1 Potential Benefits

Theories on RTAs are frequently interpreted as beginning *de novo* with Viner's 1950 seminal work, *The Customs Union Issue*.⁹¹ Prior to Viner, an RTA was simply considered beneficial to the members as it stimulated trade between them.⁹² By introducing the concepts of *trade creation* and *trade diversion*, Viner illustrated that although an RTA generally increases trade between its members, this does not necessarily lead to an increase in the members' welfare.⁹³ The key question he asked is whether the formation of an RTA *creates* or *diverts* trade. Viner argued that:

[W]here the trade-creating force is predominant, one of the members at least must benefit, both may benefit, the two combined must have a net benefit, and the world at large benefits; but the outside world loses, in the short-run at least, and can gain in the long-run only as the result of the general diffusion of the increased prosperity of the customs union area. Where the trade-diverting effect is predominant, one at least of the member countries is bound to be injured, both may be injured, the two combined will suffer a net injury, and there will be injury to the outside world and the world at large.⁹⁴

To understand Viner's theoretical framework, imagine a hypothetical example, using Mexico, Chile, and Thailand. Thailand is a low-cost producer of rice (\$4 per ton), Chile a medium-cost producer (\$6 per ton), and Mexico a high-cost producer (\$8 per ton). Both Mexico and Chile maintain tariffs against all rice imports. If Mexico forms an RTA with Chile, the tariff against Chilean, but not Thai, rice will be removed. Is this good or bad for Mexico? To answer this, consider two cases.

First, suppose that Mexico's initial tariff was high enough to exclude rice imports from both Chile and Thailand. For example, with a tariff of \$5 per ton it would cost \$9 to import Thai rice and \$11 to import Chilean rice, so Mexican consumers would buy \$8 Mexican rice instead. When the tariff on Chilean rice is

⁹¹ See Viner.

⁹² See Pomfret, pp. 177-80.

⁹³ See Viner, pp. 43-4.

⁹⁴ *Ibid.*

eliminated, imports from Chile will replace Mexican production. From Mexico's point of view, this is a gain because it costs \$8 to produce a ton of rice domestically, while Mexico needs to produce only \$6 worth of export goods to pay for a ton of Chilean rice.

On the other hand, suppose the tariff was lower, for example, \$3 per ton, so that before forming the RTA Mexico bought its rice from Thailand (at a cost to consumers of \$7 per ton) rather than producing its own rice. When the RTA is established, consumers will buy Chilean rice at \$6 rather than Thai rice at \$7. So, imports of rice from Thailand will cease. However, since Thai rice is actually cheaper than Chilean rice, Mexico will have to devote more resources to exports to pay for its rice imports and will be worse off rather than better off.

From the hypothetical example, trade creation occurs when Chile's production of rice displaces the higher-cost production of Mexico as a result of the tariff removal between the two countries while trade diversion occurs if Chile's production displaces the lower-cost imports from Thailand as the tariff removal makes it cheaper to do so. Trade creation is considered welfare-improving because real resources are saved by shifting the production to the lower-cost producers within the preferential area, and consumers benefit from facing lower prices; whereas, when trade diversion occurs real resources are wasted since the production is shifted away from the lower-cost producers located outside the RTA to the higher-cost producers located within, hence resulting in a welfare reduction.

According to Viner, the extent of trade creation depends on the difference between the partner country's (Chile) and domestic production (Mexico) costs after the tariff has been removed. The bigger the difference, the greater trade creation will be. The extent of trade diversion, on the other hand, depends on two conditions.⁹⁵ First, trade diversion can occur only if Mexico has a tariff on imported rice from Thailand. The cost of trade diversion cannot exceed the height of this external tariff. Secondly, trade diversion arises only if production costs in Chile are out of line with costs and prices in Thailand. In other words, if there is no difference between the production costs of RTA partners and the rest of the world, the substitution of goods from outside the preferential area by those produced within will not have much impact on the partners' welfare, other things being equal. These factors can make the

⁹⁵ For further discussion, see M Schiff and L Winters, *Regional Integration and Development* (World Bank, Washington, DC 2003), pp. 33-6.

change in the sourcing of imports less sharp. As a result, they may mitigate the costs of trade diversion but may also reduce the gains of trade creation.

It should be noted that in the hypothetical example it is assumed that Mexican, Chilean, and Thai rice are perfectly substitutable and what matters to the consumers is the price (with or without tariff). This was indeed assumed by Viner.⁹⁶

To determine whether an RTA results in net trade creation or diversion is extremely difficult in practice since an RTA will create trade in some products and divert in others. The outcome depends on the relative magnitudes of all trade-creating and trade-diverting effects caused by the RTA in the member countries.⁹⁷ This can be calculated on a national basis or the RTA as a whole. One is nevertheless required to examine all of the products from which tariffs have been removed. This is a challenging task as an RTA may cover several thousands of tariff lines.⁹⁸ This raises the question of whether it is possible to identify certain features such that RTAs which have those features are necessarily welfare-improving. In response, Kemp and Wan show that if trade with non-members is fixed and external tariffs are allowed to adjust following the formation of an RTA, the preferential area will be welfare-improving.⁹⁹ The logic, Kemp and Wan argue, is that if tariffs are lowered to the extent that external trade is maintained at the same level as the pre-formation level, any additional internal trade that results from the formation of an RTA must be a product of trade creation. However, it should be noted that the practical implications of this

⁹⁶ See Viner, p. 43. Although Viner's concepts of trade creation and trade diversion caused a paradigm shift in the way in which RTAs are perceived, the theoretical framework itself is not infallible. For instance, Viner's model has been extended to three-country-two-product and three-country-three-product models. Despite new insights that such models give to how RTAs operate, the conclusions can differ depending on assumptions made. For example, see M Kemp, *A Contribution to the General Equilibrium Theory of Preferential Trading* (North-Holland, Amsterdam 1969) and PJ Lloyd, '3 x 3 Theory of Customs Unions' (1982) 12 *Journal of International Economics* 41, respectively.

⁹⁷ Meade points out that the relative magnitudes of trade creation and trade diversion alone are insufficient to determine the welfare effect of an RTA because benefits of preferential tariff liberalization depend not only on the extent of trade creation, but also on the magnitude by which costs are reduced on each unit of newly created trade. Similarly, losses are determined not just by the amount of trade diversion but also the magnitude of the increase in costs due to trade diversion. See J Meade, *The Theory of Customs Unions* (North-Holland Publishing Company, Amsterdam 1955), pp. 34-43. Some of Viner's assumptions have also been criticized. For instance, Gehrels views the assumption of zero demand elasticity in the domestic market as unrealistic and Michaely shows that Viner neglected demand changes and was inconsistent and ambiguous about whether production costs were constant or increasing. See F Gehrels, 'Customs Unions from a Single Country's Viewpoint' (1956-57) 24 *Review of Economic Studies* 61 and M Michaely, 'The Assumptions of Jacob Viner's Theory of Customs Unions' (1976) 6 *Journal of International Economics* 75.

⁹⁸ For example, see the Comprehensive Economic Cooperation Agreement between India and Singapore, Annex 2A, Schedule of India, available at <http://www.fta.gov.sg/ceca/annex%202a%20-%20tariff%20schedule%20of%20india.pdf> (last accessed 24 March 2010).

⁹⁹ See M Kemp and H Wan, 'An Elementary Proposition Concerning the Formation of Customs Unions' (1976) 6 *Journal of International Economics* 95.

result are not clear since external tariffs tend to be set by a combination of welfare concerns, domestic political constraints, and multilateral negotiations.¹⁰⁰

The welfare of each member is not necessarily improved although their combined welfare is if an RTA results in net trade creation (calculated on the basis of the RTA as a whole).¹⁰¹ Consequently, if a developing country is to benefit from trade creation, it has to ensure that its *national* welfare is improved regardless of the net outcome of the RTA.¹⁰² In addition, it has been argued that an RTA between two small developing countries tends to generate only trade diversion and no trade creation.¹⁰³ This can be seen most clearly in the case of homogeneous goods. Since small countries will typically not be able to supply all of their partners' needs for imports, each member will continue to import some quantity of most goods from the rest of the world. For these goods, domestic consumer prices will continue to be fixed at the world price plus the import tariff. Since neither of these changes with integration, consumption does not change. Production of these goods, however, increases because each country can now sell to the partner without paying tariffs. Thus, each member country replaces cheaper imports from the rest of the world with more expensive imports from the RTA partner. The outcome is trade diversion and a welfare loss for the member countries.¹⁰⁴

Another factor that is relevant to the magnitude of trade creation and trade diversion is whether the RTA members are *natural* trading partners. The logic is that countries that trade disproportionately more with each other are less likely to cause trade diversion since the RTA will be reinforcing natural trading patterns, not artificially diverting them.¹⁰⁵ Recall the hypothetical example. If prior to the formation of an RTA, Mexico only trades with Chile, and not Thailand (due to geographical proximity or Mexicans' preference of Chilean rice for example), the RTA will only create more trade between Mexico and Chile and will not divert trade

¹⁰⁰ See C Freund and E Ornelas, 'Regional Trade Agreements' (CEP Discussion Paper No961, Centre for Economic Performance, London School of Economics and Political Science, London 2009), p. 5.

¹⁰¹ For example, Mexico's welfare may increase 10 per cent due to the Mexico-Chile RTA while Chile's welfare may decrease 5 per cent. The combined welfare is still improved.

¹⁰² If the RTA results in net trade creation, the world at large benefits as world resources are being used more efficiently, and *vice versa*.

¹⁰³ For example, see A Panagariya, 'The Regionalism Debate: an Overview' (1999) 22 *The World Economy* 477, p. 483.

¹⁰⁴ For further discussion, see M Schiff, 'Small Is Beautiful: Preferential Trade Agreements and the Impact of Country Size, Market Share, Efficiency, and Trade Policy' (Policy Research Working Paper No1668, World Bank, Washington, DC 1996), pp. 8-13.

¹⁰⁵ See Wonnacott and Lutz, p. 69.

away from Thailand since it did not exist in the first place. Summers calculates the ratio of actual trade shares to those that geographically neutral trade would predict for major industrial countries.¹⁰⁶ He concludes that the most seriously contemplated efforts at regional integration involving industrialized countries, *e.g.* the EU, cement what are already large and disproportionately strong trading relationships. To this extent, they are likely to be trade-creating rather than trade-diverting.¹⁰⁷ Krugman takes Summers' argument further with an economic model that assumes prohibitively high transportation costs between continents.¹⁰⁸ He finds that if an RTA is formed between geographically contiguous countries, the magnitude of trade diversion is reduced. However, Frankel, Stein, and Wei, by assuming that transportation costs are neither so high as to be prohibitive nor zero, conclude that Krugman's finding would be less accurate and the magnitude of trade diversion would be greater.¹⁰⁹ It is noteworthy that Frankel, Stein, and Wei's assumption is arguably more realistic than Krugman's due to improved means of transportation, which lower transportation costs.

Besides the concept of natural trading partners, rules of origin are also relevant to the magnitude of trade creation and trade diversion.¹¹⁰ Rules of origin play a crucial function in the case of an FTA, as opposed to a CU. In an FTA, the members retain their national tariffs and external trade policy; whereas in a CU, the members agree on CETs and coordinate their external trade policy.¹¹¹ Consequently, imports from non-member countries destined to a high-tariff member may enter through a low-tariff member. Or more subtly, entrepreneurs in the low-tariff country may import a product in almost finished form, add a small value to it and export it to the high-tariff country free of duty.¹¹² To avoid this *trade deflection*, FTAs almost, if not, always include rules of origin according to which products receive the duty-free status only if they

¹⁰⁶ See Summers, p. 298.

¹⁰⁷ *Ibid.*

¹⁰⁸ See Krugman, pp. 63-4. Note that Viner assumed that transportation costs are zero.

¹⁰⁹ See JA Frankel, E Stein and S-J Wei, 'Trading Blocs and the Americas: The Natural, the Unnatural, and the Super-natural' (1995) 47 *Journal of Development Economics* 61.

¹¹⁰ For example, see Krishna and Krueger, *World Trade Organization*, and A Estevadeordal, 'Rules of Origin in FTAs in Europe and in the Americas: Issues and Implications for the EU-Mercosur Inter-Regional Association Agreement' in A Valladao and R Bouzas (eds), *Market Access for Goods & Services in the EU-Mercosur Negotiations* (Chaire Mercosur de Sciences Po, Paris 2003).

¹¹¹ The purpose of rules of origin in a CU is simply to determine the extent of preferential treatment for fellow members.

¹¹² See K Krishna, 'Understanding Rules of Origin' (Working Paper Series, National Bureau of Economic Research (NBER), 2005), p. 1.

meet the conditions set therein.¹¹³ The proliferation of criss-crossing FTAs alone can lead to a replacement of the non-discriminatory MFN tariffs by criss-crossing rules of origin whereby tariffs vary according to the ostensible origin of the product.¹¹⁴ It should be noted that in the case of trade in services, rules of origin tend to deal with the origin of services providers rather than the traded services and may not have the same effects as those that deal with trade in goods.¹¹⁵

Krueger offers a theoretical model of rules of origin as protectionist devices, showing that such rules effectively extend protection from high-tariff members of an FTA to low-tariff members.¹¹⁶ In order to be eligible for FTA treatment of their exports to the high-tariff partner, producers in the low-tariff partner may divert their imports (of intermediate inputs) from lower-cost non-member sources to the high-tariff partner. As a result, the production costs of these exports may increase. Thus, rules of origin can significantly reduce the extent of liberalization actually involved in FTAs. This, in turn, is likely to lessen trade-creating effects. Furthermore, rules of origin can also generate cumbersome paperwork for exporters that becomes increasingly costly as multiple agreements are signed, each with unique rules at the product level.¹¹⁷ As discussed in Chapter 1, in the current RTA proliferation countries tend to form bilateral FTAs, as opposed to a plurilateral FTA or a CU.¹¹⁸ This trend is likely to further aggravate the problems with criss-crossing rules of origin.

Apart from the welfare gains induced by trade creation, by its very nature the formation of an RTA implies that the member countries have preferential access to the other's market. For developing countries, preferential access to a lucrative market is often considered as one of the most important reasons why they form RTAs with

¹¹³ The criteria adopted in rules of origin for trade in goods can take a variety of forms. One simple and frequently-used rules of origin is that, in order to qualify as originating in the partner country, the item must change tariff classifications. Another is that a specified percentage of the commodity's sales price must consist of value added in the partner country and the third form of rules of origin specifies a percentage of purchased parts and components that must be purchased from RTA members. For more detail, see A Estevadeordal and K Suominen, 'Mapping and Measuring Rules of Origin Around the World' in O Cadot and others (eds), *The Origin of Goods: Rules of Origin in Regional Trade Agreements* (Oxford University Press and CEPR, Oxford 2006), pp. 72-6.

¹¹⁴ For further discussion, see R Baldwin, 'Multilateralizing Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade' (2006) 29 *World Economy* 1451.

¹¹⁵ This will be discussed in Chapter 6 in the context of GATS Article V.

¹¹⁶ See A Krueger, 'Free Trade Agreements as Protectionist Devices: Rules of Origin' in JR Melvin, JC Moore and R Riezman (eds), *Trade Theory and Econometrics: Essays in Honor of John S Chipman* (Routledge, London 1999).

¹¹⁷ For further discussion costs of rules of origin, see C Carrere and J de Melo, 'Are Different Rules of Origin Equally Costly? Estimates from NAFTA' (Discussion Paper No4437, Centre for Economic Policy Research (CEPR), 2004).

¹¹⁸ See Chapter 1.

their developed-country counterparts.¹¹⁹ Preferential access provides the developing-country partner with an advantage over non-members. Consequently, it can export more to its RTA partner. This, in turn, is likely to improve its terms of trade and is considered as beneficial. By using simulation in a three-country world in which two small developing countries can reduce protection either multilaterally or bilaterally (either with a large developed country or with a small developing-country neighbour), Puga and Venables suggest that a North-South RTA is likely to offer better prospects than a South-South RTA because of better overall net market access; for each developing-country partner, multilateral liberalization is less desirable because competition in the developed country is stiffer when the other developing country also has market access.¹²⁰ For example, a developing country would benefit from a preferential access to the US market where its products are cheaper compared to those imported from non-members. Given that a developed country is likely to provide developing countries with a more lucrative market than a fellow developing country, there is a case for a North-South, as opposed to South-South, RTA. This may explain why many developing countries have formed or in the process of forming an RTA with the United States, the EU, and Japan.¹²¹

So far, we have learnt that: a) based on Viner's model, whether an RTA will be welfare-improving depends on the extent of its trade-creating and trade-diverting effects; that b) this is extremely difficult to measure; but that c) trade creation is more likely to occur for developing countries when RTAs are formed between natural trading partners, and where rules of origin are not too complex and cumbersome; and that d) independent from the concepts of trade creation and trade diversion, preferential market access to a lucrative market is a very important consideration for developing countries. The discussion only focuses on the *static* effects of the formation of an RTA, according to this model. That is, how an RTA may affect the members' welfare and their terms of trade *at a point of time*, *i.e.* when tariffs are removed. However, there may be other benefits induced by the formation of an RTA, which are more dynamic in nature.¹²² In other words, over time an RTA may have an impact on the structure and environment of the members' economies. These *dynamic*

¹¹⁹ See Panagariya, p. 489.

¹²⁰ See D Puga and A Venables, 'Trading Arrangements and Industrial Development' (1998) 12 World Bank Economic Review 221.

¹²¹ See Chapter 1.

¹²² For technical definitions of static and dynamic efficiencies, see BA Balassa, *The Theory of Economic Integration* (RD Irwin Inc., Homewood, Illinois 1961), p. 13.

effects can contribute to net trade creation/diversion and/or the overall growth of the members' economies.

The formation of an RTA can facilitate economies of scale, which in turn result in lower costs of production. By discarding the assumption of perfect competition assumed by Viner,¹²³ Corden shows that the formation of an RTA can result in dynamic gains from economies of scale.¹²⁴ The extent of these economies of scale depends on the size of the markets prior to the formation of an RTA. That is if the individual markets were small, the combined market allows a larger scale of production, hence enabling scale economies; whereas if the initial size already allows scale economies, the subsequent formation of an RTA may not have much impact or even leads to diseconomies of scale.¹²⁵ It is noteworthy that competition and scale economies do not necessarily go hand in hand.¹²⁶ This is because in a small market there may be only one or two firms which can exploit scale economies and drive other smaller firms out of the market. Such scenario can lead to monopoly or oligopoly in the long-run, which are generally associated with inefficiency and abuse of market power. Since an RTA combines the members' markets, the number of firms which can achieve scale economies is likely to increase. Thus, the formation of an RTA can promote economies of scale as well as competition, which results in efficiency and competitive gains.¹²⁷ Moreover, the members' firms may benefit from external scale economies stemming from regional clusters of companies that can reap synergetic effects, *e.g.* because they can share infrastructure or they have access to a larger pool of skilled labour.¹²⁸

¹²³ For the relationship between economies of scale and imperfect competition, see Pomfret, pp. 208-11.

¹²⁴ See W Corden, 'Economies of Scale and Customs Union Theory' (1972) 80 *Journal of Political Economy* 465. Note that the concepts of trade creation and trade diversion remain relevant in Corden's model. See Corden, p. 469. The scale economies in Corden's model refer to 'internal' scale economies that arise as companies produce more identical or similar products. For more detail, see P Krugman and M Obstfeld, *International Economics: Theory and Policy* (5 edn Addison-Wesley Publishing Company, Reading, Massachusetts 2000), pp. 119-21.

¹²⁵ Diseconomies of scale occur when an increase in production results in higher costs of production. See Krugman and Obstfeld, *International Economics: Theory and Policy*

¹²⁶ See Corden, pp. 471-2.

¹²⁷ It should be noted that the actual gains from economies of scale and competition do not necessarily meet the predicted levels prior to the formation of an RTA. For instance, it was projected that the efficiency and competitive gains from the Single European Programme (SMP) would be up to a 5 per cent increase of GDP; the *ex post* evidence shows that an increase of 1 to 1.25 per cent of GDP was in fact achieved. See Schiff and Winters, *Regional Integration and Development*, pp. 50-61.

¹²⁸ See V Zahrnt, 'How Regionalization Can Be a Pillar of a More Effective World Trade Organization' (2005) 39 *Journal of World Trade* 671, p. 673.

As far as developing countries with small domestic markets are concerned, the formation of an RTA will be beneficial if it helps them to achieve economies of scale. This was, in fact, perceived as an important benefit of a South-South RTA during the first period of RTA proliferation.¹²⁹

Another dynamic effect is knowledge and technology transfer between RTA members. Knowledge and technology is said to play a crucial role in industrialization process.¹³⁰ If a country accumulates knowledge and technology over time, its productivity is likely to increase. This can, in turn, promote the country's long-term economic growth. Knowledge and technology can be effectively transferred from one country to another through international contacts and trade.¹³¹ Thus, since the formation of an RTA increases intra-bloc trade, knowledge and technology transfer should take place more frequently. Notably, this is independent from trade-creating and trade-diverting effects.

Given that most developing countries are not major producers of scientific or technical knowledge, it is important that they pursue trade policy which enhances the acquisition of knowledge and technology from abroad. Although RTAs can be used to promote this through trade, the choice of partner can play a crucial role. In an industry-level analysis, Schiff, Wang, and Olarreaga show that developing countries' total factor productivity (TFP)¹³² responds more strongly to North-South trade than to South-South trade.¹³³ In other words, North-South trade appears to increase the level of productivity of the developing-country partner more than South-South trade. Furthermore, they find that research-and-development (R&D)-intensive industries in the developing country learn mainly from trade with the developed-country partner and that industries with low R&D intensities learn mainly from trade within the developing-country partner.¹³⁴ Thus, the formation of a North-South RTA is arguably

¹²⁹ For more detail, see C Vaitsos, 'The Crisis in Economic Co-operation among Developing Countries' (1978) 6 *World Development* 719. Discussion on South-South RTAs will be carried out in more detail in Chapter 5.

¹³⁰ For further discussion, see J Mayer, 'Globalization, Technology Transfer and Skill Accumulation in Low-income Countries' in SM Murshed (ed) *Globalization, Marginalization and Development* (Routledge, London 2002).

¹³¹ See Schiff and Winters, *Regional Integration and Development*, p. 123.

¹³² Total factor productivity addresses any effects in total output not caused by inputs or productivity.

¹³³ See M Schiff, M Olarreaga and Y Wang, 'Trade-Related Technology Diffusion and the Dynamics of North-South and South-South Integration' (Policy Research Working Paper No2861, World Bank, Washington, DC 2002).

¹³⁴ *Ibid.*

better for the developing-country partner on the ground of knowledge and technology transfer.

The formation of an RTA can attract more FDI to the preferential area. FDI is likely to increase where expected returns from investment are greater or more probable.¹³⁵ While the enlarged market tends to be associated with increased demand, scale economies and competition tend to drive production costs down, hence larger profit margins. In addition, it has been argued that preferential access to the developed-country partner's market in a North-South RTA may increase FDI flowing into the developing-country partner.¹³⁶ Furthermore, firms can take the advantage of cheaper labour in the developing-country partner by concentrating labour-intensive activities there and at the same time benefit from the preferential access to the developed-country partner's market. The case in point is Mexico and NAFTA. Following the creation of NAFTA, there is evidence that Japan redirected part of its FDI from the United States and Canada towards Mexico.¹³⁷ This is supported by the fact that FDI to Mexico rose from \$4.3 billion in 1993 to \$11 billion in 1994, the year NAFTA came into force.¹³⁸ Thus, developing countries can benefit from the formation of an RTA if it attracts more FDI. On this basis, there may be a case for a North-South RTA.

It should be noted that FDI and investment in general can be diverted. Like trade, the formation of an RTA may create or divert investment¹³⁹ depending on whether it leads to an overall investment *creation* or investment *diversion*- investment creation is likely to contribute to trade creation and conversely investment diversion to trade diversion.¹⁴⁰ Investment can be divided into two broad categories, namely

¹³⁵ See R Pomfret, 'Trade Preferences and Foreign Investment in Malta' (1982) 16 *Journal of World Trade Law* 236.

¹³⁶ See W Ethier, 'Regionalism in a Multilateral World' (1998) 106 *Journal of Political Economy* 1214, pp. 1229-32. In a survey conducted by Japan's Ministry of International Trade and Industry (MITI) on the motives behind Japanese manufacturing FDI in Asia, North America, and Europe, 70 per cent of respondents cited local sales as a major factor. See M Kawai and S Urata, 'Trade Imbalances and Japanese Foreign Direct Investment: Bilateral and Triangular Issues' (Discussion Paper Series F-52, Institute of Social Science, University of Tokyo, Tokyo 1996).

¹³⁷ See U.S. International Trade Commission., *The Impact of the North American Free Trade Agreement on the U.S. Economy and Industries: A Three-Year Review* (USITC Publication, Washington, DC 1997).

¹³⁸ See The World Bank., *World Development Indicators* (World Bank, Washington, DC Various years).

¹³⁹ Hereinafter, the word *investment* when used in the context of investment creation and investment diversion shall encompass both FDI and investment in general.

¹⁴⁰ See R Fernandez, 'Returns to Regionalism: An Analysis of Nontraditional Gains from Regional Trade Agreements' (1998) 12 *The World Bank Economic Review* 197, p. 202.

market-seeking (or market-based) investment and efficiency-seeking (or factor-based) investment.¹⁴¹ Market-seeking investment is undertaken in order to supply the host and other markets in the preferential area. Efficiency-seeking investment, on the other hand, is driven by the desire to gain competitive advantages that provided by the home economy.¹⁴² Market-seeking investment can take two forms: tariff-jumping investment or investment triggered purely by tariff preferences, and investment driven by the market enlargement effect of the RTA. The former is likely to result in investment diversion and the latter investment creation.¹⁴³ Efficiency-seeking investment, on the other hand, is driven by the desire to gain competitive advantages that provided by the home economy. Thus, any form of efficiency-seeking investment is likely to result in investment creation.¹⁴⁴ The overall result of the formation of an RTA on FDI and investment in general depends on the forms of investment which the RTA induces. If the effect of tariff-jumping investment exceeds those of efficiency-seeking investment and investment driven by market enlargement, the formation of an RTA is likely to result in investment diversion, hence a contribution to trade diversion, and *vice versa*.

On the grounds of preferential market access, knowledge and technology transfer, and FDI, developing countries may benefit more from North-South than South-South RTAs. However, since the term *developing country* encompasses a range of countries at different stages of development and with different economic backgrounds, such a general observation may not always be accurate. A developing country can form a South-South RTA with fellow developing countries which have complementarities between their economies. For example, it has been argued that an RTA between ASEAN and China can be very beneficial where the former provide natural resources and intermediate goods, and the latter manufactured goods, capital and a preferential access to the Chinese market.¹⁴⁵ Similarly, an RTA with advanced developing countries such as the Republic of Korea, Taiwan, and Singapore should

¹⁴¹ For general discussion, see J Neary, 'Foreign Direct Investment and the Single Market' (Discussion Paper No3419, Centre for Economic Policy Research (CEPR), Oxford 2002).

¹⁴² See P-C Athukorala and J Menon, 'AFTA and the Investment-Trade Nexus in ASEAN' (1997) 20 *World Economy* 159, p. 160.

¹⁴³ *Ibid.*, pp. 161-2.

¹⁴⁴ *Ibid.*, p. 163.

¹⁴⁵ See JL Tongzon, 'ASEAN-China Free Trade Area: A Bane or Boon for ASEAN Countries?' (2005) 28 *World Economy* 191 and S Inama, 'The Association of South East Asian Nations - People's Republic of China Free Trade Area: Negotiating Beyond Eternity With Little Trade Liberalization?' (2005) 39 *Journal of World Trade* 559

facilitate knowledge and technology transfer in the less advanced developing-country partner. In addition, a study by UNCTAD shows that FDI outflows from developing countries increased from \$5.2 billion in 1990 to \$14.3 billion in 2006.¹⁴⁶ This means that more and more developing countries have now become new sources of FDI. The heterogeneity of developing countries means that each individual RTA can be vastly different from one another. The choice of RTA partner is therefore crucial to the extent developing countries can benefit from the formation of an RTA.

2.2.2 Potential Costs

Although developing countries can benefit from RTAs, this does not come without costs. The potential costs can arguably be divided into two types: the first is *implementation* costs; and the second is *adjustment* costs. An implementation cost refers to a cost that the developing-country partner directly incurs as a result of implementing an RTA commitment; whereas, an adjustment cost refers to a cost that it subsequently incurs as it attempts to respond to the effects of the implementation of the RTA commitment.

Apart from the welfare losses induced by trade diversion, a direct result of the tariff removal between RTA members is tariff revenue losses.¹⁴⁷ This is an implementation cost. The extent of the losses depends on the MFN tariff rates set prior to the formation of an RTA.¹⁴⁸ A developing-country partner is likely to incur greater revenue losses if its MFN rates are high; whereas a country with very low MFN rates is likely to incur negligible revenue losses. Given that tariff removal is carried out over a period of time as products are generally subject to different tracks of liberalization,¹⁴⁹ the losses borne by the developing country may not be so immediate.¹⁵⁰ It should be noted that by eliminating tariffs (and other NTBs), an RTA

¹⁴⁶ See http://www.unctad.org/en/docs/wir2006_en.pdf (last accessed 1 August 2009).

¹⁴⁷ See Viner, pp. 65-6.

¹⁴⁸ Recognizing the possible differences between bound and applied rates.

¹⁴⁹ For example, see the tariff commitments agreed in Thailand-Australia Free Trade Agreement, available at http://www.dfat.gov.au/trade/negotiations/aust-thai/tafta_annexes_sideletters_index.html (last accessed 18 March 2010).

¹⁵⁰ Note that the loss of tariff revenue is less significant in the case of services trade because barriers to such trade are mostly in the form of domestic regulation and other NTBs.

could reduce the flexibility on the part of developing countries to protect their domestic markets from foreign competition and to promote their infant industries.¹⁵¹ Arguably, the inability to do so may have an effect of *locking* the existing competitive structure in trade between developed and developing countries where the former are able to export more sophisticated, high value-added manufactured products and services, and the latter are limited to primary goods and relatively cheaper, labour-intensive products and services- creating large imbalances in trade gains between the two groups of countries.

Trade creation is considered welfare-improving because real resources are saved by shifting the production to the lower-cost producers within the preferential area and consumers benefit from the resulting lower prices. However, the shift of production also implies that the higher-cost producers will be forced out of the market and/or to move to new industries/sectors. These high-cost producers are the *losers* from the formation.¹⁵² Although this is considered a good thing from the welfare perspective, these uncompetitive producers are often unable to move to new industries/sectors. The government may have to step in and help, especially when this happens on a large scale. This is likely to be the case in developing countries as their workforce is arguably less flexible.¹⁵³ The adjustment costs involved in provisions of training programme and the likes can be very high for developing countries.¹⁵⁴ In addition, the welfare gains from trade creation may be illusionary where the cheaper imports are not produced by lower-cost producers but cheaper because of protectionist measures imposed by the RTA partner. This has been raised particularly in the context of agriculture where a North-South RTA may expose farmers in the developing-country partner to direct and unfair competition with highly subsidised producers in

¹⁵¹ While many economists criticize the validity of the infant industry argument, the development history of some of the most successful developing countries, such as the Republic of Korea, shows that the combination of infant industry promotion and aggressive foreign export policy can contribute to successful economic development. See Y-S Lee, *Reclaiming Development in the World Trading System* (Cambridge University Press, New York 2006).

¹⁵² Note that this also applies to trade liberalization in general.

¹⁵³ For estimates of adjustment costs potentially incurred by the ACP countries in the proposed EPAs with the EU, see C Milner, 'An Assessment of the Overall Implementation and Adjustment Costs for the ACP Countries of Economic Partnership Agreements with the EU' (School of Economics, University of Nottingham, Nottingham 2005), pp. 28-32.

¹⁵⁴ *Ibid.*, p. 33-9.

the developed-country partner.¹⁵⁵ Such exposure can threaten food security and the livelihoods of the rural population in the developing country.¹⁵⁶

It is important that governments in developing countries do not underestimate the potential consequences of the formation of an RTA, especially where those who are most adversely affected are poor and incapable of improving their own situations. Unlike in developed countries, the welfare state in developing countries is often limited and accounts for a smaller proportion of the country's annual budget.¹⁵⁷ Consequently, programmes such as unemployment benefits may not be readily available to the losers from the formation. Furthermore, once lost their jobs, these people are likely to find it difficult to afford basic health care, particularly where health services are provided mainly by the private sector. The same applies to housing and other basic needs. Under such circumstances, the costs of the formation of an RTA may go well beyond economic costs and involve extreme human costs, which can be extensive and morally unacceptable.¹⁵⁸

Given their stage of development, comprehensive services liberalization may not yet be suitable for many developing countries' economies. This is arguably why their enthusiasm at the WTO is rather moderate.¹⁵⁹ When an RTA covers trade in services, the developing-country partner may be faced with high implementation costs given the initial stage of its economy. For example, a robust regulatory framework is arguably a prerequisite for the development of any sector/subsector in services. Committing to services liberalization in an RTA would require the developing-country partner to put in place regulatory frameworks for the sectors/subsectors included in the liberalization.¹⁶⁰ This is particularly important in essential services such as provision of water, gas, and electricity. Otherwise, private companies could

¹⁵⁵ See Oxfam International, 'Unequal Partners: How EU-ACP Economic Partnership Agreements (EPAs) Could Harm the Development Prospects of Many of the World's Poorest Countries' (Oxfam Briefing Papers, Oxfam Great Britain, Oxford 2006), p. 2.

¹⁵⁶ See Oxfam International, 'Song of the Sirens: Why the US-Andean FTAs Undermine Sustainable Development and Regional Integration' (Oxfam Briefing Paper, Oxfam Great Britain, Oxford 2006), pp. 6-9.

¹⁵⁷ For further discussion, see N Rudra, 'Globalization and the Decline of the Welfare State in Less-Developed Countries' (2002) 56 International Organization 411.

¹⁵⁸ Human costs have been one of the major concerns with regard to the proposed EU-ACP EPAs. For example, see Act!onaid International, 'Trade Traps: Why EU-ACP Economic Partnership Agreements Pose a Threat to Africa's Development' (Act!onaid International, Johannesburg 2004), pp. 9-19, available at http://www.actionaid.org.uk/doc_lib/trade_traps.pdf (last accessed 9 June 2010).

¹⁵⁹ For example, see C Akamanzi, 'Development at Crossroads: The Economic Partnership Agreement Negotiations with Eastern and Southern African Countries on Trade in Services' (Research Papers, South Centre, Geneva 2007), pp. 12-3.

¹⁶⁰ See *Ibid.*, p. 21.

cherry-pick the most profitable market segments and leave out those with low profit margins.¹⁶¹ Although such a robust regulatory framework is beneficial to the developing-country partner in theory, it may involve high implementation and adjustment costs, which can affect the country's overall fiscal resources. This boils down to whether comprehensive services liberalization is appropriate for the developing country given its stage of development or whether its limited resources should be allocated to other priorities. In addition, like in the case of trade in goods, there are likely to be losers from services liberalization, with which the government may have to deal, and hence incurring further adjustment costs.

In Chapter 1, it is observed that many agreements in the current RTA proliferation, particularly those between developed and developing countries, tend to include WTO-plus commitments, which encompass those on IPRs, investment, and competition policy, for example. Whether their inclusion in an RTA is good or bad for the developing-country partner is a very complex question, one which goes beyond the ambit of this section.¹⁶² Nevertheless, for the purposes of this thesis, such commitments are likely to intensify the implementation and adjustment costs incurred by the developing-country partner.

So far, the discussion illustrates that developing countries can benefit from the formation of an RTA in various ways. However, it is also important to recognize that the potential gains are not guaranteed and there are many factors which can affect the extent of their success. In addition, forming an RTA is not without costs. Developing countries are likely to incur tariff revenue losses, which for some can severely limit their government spending.¹⁶³ Although a North-South RTA appears to be more beneficial to the developing-country partner on the grounds of preferential market access, knowledge and technology transfer, and FDI, the developed-country partner may be able to negotiate and include services liberalization in the agreement, which

¹⁶¹ See Oxfam International, 'Partnership or Power Play?: How Europe Should Bring Development into Its Trade Deals with African, Caribbean, and Pacific Countries' (Oxfam Briefing Paper, Oxfam Great Britain, Oxford 2008), p. 22.

¹⁶² For further discussion on IPRs, investment, and competition policy and developing countries, see CM Correa, *Intellectual Property Rights, the WTO, and Developing Countries: the TRIPS Agreement and Policy Options* (Zed Books, New York 1999), chapter 2, A Waldkirch, 'The New Regionalism and Foreign Direct Investment: the Case of Mexico' (2003) 12 *Journal of International Trade and Economic Development* 151, and O Solano and A Sennekamp, 'Competition Provisions in Regional Trade Agreements' (Trade Policy Working Papers No31, OECD, Paris 2006).

¹⁶³ See South Centre, 'Fact Sheet No3: Trade Liberalization and the Difficult Shift Towards Reciprocity in the EPAs' (Analytical Note, South Centre, Geneva 2007), pp. 15-19.

can impose high implementation and adjustment costs on the developing country.¹⁶⁴ For example, with the exception of its FTA with Israel all of the RTAs that the United States has formed with developing countries include provisions on services trade.¹⁶⁵

2.3 Challenges Facing Developing Countries as a Prospective RTA Member

In the previous section, the discussion is on potential benefits and potential costs of the formation of an RTA. In order to make the most out of an RTA, a prospective developing-country partner will have to promote the potential benefits and manage the potential costs induced by the agreement. This section investigates whether developing countries face any challenges when they try to do so.

From the discussion on trade creation and trade diversion, whether an RTA will result in net trade creation or diversion depends on how the RTA is designed and implemented: for example, whether it only liberalizes sectors that result in trade-creating effects; whether it is formed between natural trading partners; and whether it has liberal rules of origin (in the case of an FTA). Viner himself viewed this as an empirical rather than a theoretical question.¹⁶⁶ While in principle RTAs can generate either net trade creation or diversion, it is important to recognize that participation in any RTA is in the end a political decision made by the member governments. If they simply aimed to maximize national welfare, there would be no reason for concern. That is, only trade-creating (welfare-improving) RTAs would be formed. Unfortunately, governments also have other motivations, and can be influenced by various domestic vested interests.¹⁶⁷

¹⁶⁴ As noted in a study by the World Bank, the inclusion of these areas is especially marked in North-South RTAs, perhaps reflecting the importance that developed countries place on them. See World Bank, p. 35.

¹⁶⁵ See <http://rtais.wto.org/UI/PublicSearchByMemberResult.aspx?enc=BGNDAAo9i1u5NEK0fWo0Yn3kUaluo9yEpugxdmYSUOgU=> (last accessed 20 May 2010).

¹⁶⁶ See Viner, p. 52.

¹⁶⁷ In reality, trade policy including a decision to form an RTA takes place within a political-social milieu and is influenced by individuals and groups who feel that they will be better off with restricted trade even though the country as a whole may be worse off. As such, although reducing trade barriers may make the country better off, as the corresponding structural adjustments are made, some individuals will be made better off and some worse off. Politicians (hence the government) will find themselves confronted with a vast array of groups attempting to influence trade policy, and

Grossman and Helpman assume that when evaluating a possible RTA, each of the member government will consider the impact of the agreement on the average voters while being influenced by the domestic industries through campaign contributions.¹⁶⁸ When an RTA results in net trade creation, average voters will benefit as they face lower prices whereas import-competing sectors may be adversely affected due to the shift of production to lower-cost producers in the partner country. However, if the government values campaign contributions more than it does the average voters, domestic producers will have more influence in the RTA decision, and as such they are likely to oppose to situations where they would be made worse off. Thus, Grossman and Helpman argue that to the extent that it is free to do so, each member government would wish to exclude those products or sectors whose inclusion to the RTA would impose on it the greatest political costs.¹⁶⁹ In other words, member governments are unlikely to include those products and sectors that would result in trade-creating effects precisely because import-competing sectors will lose out. According to this view, the dynamics of interest group politics at the national level tend to push in the direction of trade-diverting rather than trade-creating RTAs.

Krishna develops his analysis in a different framework where member governments form an RTA based only on its impact on the profits of the domestic firms.¹⁷⁰ He finds that if the RTA does not generate trade diversion, firms from each member country will obtain only little or no net profit because although they obtain higher market shares (and hence profits) in the other member's market, they lose domestic profits as competition increases. However, if the RTA allows firms within the preferential area to displace those outside, the RTA will enhance profits for all members' firms, at the expense of firms located outside the preferential area. In other words, as far as domestic firms are concerned, a trade-diverting RTA is to be preferred.

The message from these analyses is that RTAs are likely to be politically viable exactly when they are trade-diverting, and hence welfare-reducing. Thus, although a trade-creating RTA is preferable from the welfare perspective, and hence

consequently, economic rationales are often compromised or even ignored. For further discussion, see D Appleyard and A Field, *International Economics* (4 edn McGraw-Hill, Boston 2001), pp. 323-9.

¹⁶⁸ For further discussion, see G Grossman and E Helpman, 'The Politics of Free Trade Agreements' (1995) 85 *American Economic Review* 667.

¹⁶⁹ *Ibid.*, p. 687.

¹⁷⁰ For further discussion, see P Krishna, 'Regionalism and Multilateralism: A Political Economy Approach' (1998) CXIII *Quarterly Journal of Economics* 227.

beneficial to the developing-country partner, this may not be easy to achieve in practice. Governments in developing countries will be faced with competing domestic vested interests, which may in the end influence them to form a trade-diverting (welfare-reducing) RTA.

As far as preferential access to a lucrative market is concerned, developing countries do not seem to have much control over it. Once a developing country concludes an RTA with its trade partner, its advantage depends on whether the partner will form new agreements with other countries. If it does so, the preferences will be eroded. The erosion is greatest where the new RTAs are formed with countries that export similar products and services to the partner. By the same token, the preferences can also be eroded if the partner decides to make similar commitments at the multilateral level, essentially extending the preferences to the rest of WTO Members.

Although developing countries may benefit from the dynamic gains, it is important to note that they are conditional in nature. For instance, the extent of the potential gains derived from increased economies of scale and competition is not certain. For the gains to be fully capitalized, the members' economies must have well-functioning markets as well as well-established legal systems to allow scale economies to take place and to enforce competition laws, for example. The formation of an RTA will adversely affect knowledge and technology transfer if it switches imports from richer to poorer sources, for example in a South-South RTA. This, in turn, may reduce the developing-country partner's long-term economic growth.¹⁷¹ The extent of gains from increased FDI is conditional on whether the RTA results in net investment creation or diversion. Furthermore, other macroeconomic policies may influence the extent of these dynamic gains. For example, even though tariffs are removed between the RTA members, other domestic regulations which are protectionist and inefficient can reduce the extent of these gains. Thus, they are likely to be subject to further qualifications and cannot be taken for granted.¹⁷²

The costs involved in the formation of an RTA appear to be an inevitable result of the RTA commitments agreed to by the member countries. In other words, the benefits and costs are two sides of the same coin. Tariff revenue losses are incurred because tariff removal is a prerequisite for trade creation (in the case of trade

¹⁷¹ See Schiff and Winters, *Regional Integration and Development*.

¹⁷² For further discussion, see P Dee, 'East Asian Economic Integration and its Impact on Future Growth' (2007) 30 *World Economy* 405.

in goods).¹⁷³ By the same token, the adjustment costs involved in helping domestic higher-cost producers move to new industries are also a result of trade liberalization between the RTA members. In fact, trade creation occurs precisely because they are displaced by lower-cost producers located in the partner country. Similarly, once a developing country decides to liberalize trade in services, it is likely to incur certain implementation and adjustment costs. The key here is whether the costs will outweigh the benefits offered by the RTA.

In order to answer this question, a developing country which is contemplating to form an RTA with its trade partner will have to conduct *ex ante* preparatory research.¹⁷⁴ In this preparatory work, all of the potential benefits will have to be balanced against the potential costs induced by the formation. However, it is far from easy to accurately estimate the potential benefits and costs of an RTA. Even for relatively simple trade barriers such as tariffs or those that can be expressed as tariff equivalents, measurement of their effects and the effects of their removal is not always straightforward and requires a relatively specialized set of economic analytical skills.¹⁷⁵ In addition, to determine whether an RTA results in net trade creation or diversion, one is required to examine all of the products from which tariffs have been removed. Furthermore, given that the extent of trade-creating and trade-diverting effects can also be influenced by other factors such as trading patterns prior to the formation of an RTA, transportation costs, and rules of origin, they have to be taken into account also. This can be a very challenging task. By the same token, the dynamic effects induced by economies of scale, competition, knowledge and technology transfer, and FDI, have to be aggregated from all products and industries affected by the formation of an RTA. This is equally, if not more, complex.

The problem with measurement is further complicated when RTAs go beyond the simple dismantling of border barriers to trade in goods and cover NTBs and trade in services. The balancing exercise for such agreements can be extremely difficult. While the effects of tariff removal (*e.g.* tariff revenue losses) are relatively visible, those of services liberalization (*e.g.* implementation and adjustment costs) are less

¹⁷³ Discussion on trade creation and trade diversion in relation to trade in services will be conducted in Chapter 6.

¹⁷⁴ This is what happened in the preparation towards the Japan-Thailand Economic Partnership Agreement, which I had an opportunity to participate.

¹⁷⁵ See J Rollo, 'The Challenge of Negotiating RTA's for Developing Countries: What Could the WTO Do to Help?' (Conference on Multilateralising Regionalism, WTO, Geneva 2007), p. 3.

clear and much more difficult to estimate.¹⁷⁶ The same logic applies to WTO-plus commitments.

Given that the developing country will have to rely on its preparatory work in the ensuing RTA negotiations, its accuracy is very important as it provides the scope within which the possible trade-offs can be made with the prospective RTA partner. Inaccurate and inadequate information can result in the developing country making commitments that will damage its economy and long-term economic development. Thus, developing countries have to conduct accurate research on the potential benefits and potential costs induced by the formation of an RTA so that they can comprehensively set out the objectives for their RTAs and what they can or cannot commit themselves to in the ensuing RTA negotiations.¹⁷⁷ The success of such endeavour depends on the *analytical* capacity of the developing country in question. It should be noted that domestic vested interests will seek to influence the contents of this preparatory work.¹⁷⁸

Once the developing country sets out its objectives for the formation of an RTA, the question is whether it will achieve them in the subsequent RTA negotiations. This depends on the *negotiating* capacity of the developing country. Given that trade negotiations are mercantilist in nature and involve exchanges of trade concessions between the parties, a crucial factor is their relative bargaining powers. If they are of equal bargaining powers, one would expect the outcome to be satisfactory to all of the parties involved. However, if they are not, the outcome may be biased towards the more powerful partner.¹⁷⁹

Bargaining power can be affected by a country's share of market power. In a bilateral RTA for instance, one party may be a major trade partner of the other, but the reverse may not be true. An example of this is NAFTA. While the United States is Mexico's largest trade partner and sources of FDI, the reverse is not true.¹⁸⁰

¹⁷⁶ For example, see P Bhatnagar and C Manning, 'Regional Arrangements for Mode 4 in the Services Trade: Lessons from the ASEAN Experience' (2005) 4 World Trade Review 171, Roy, Marchetti and Lim, and M Jansen, 'Services Trade Liberalization at the Regional Level: Does Southern and Eastern Africa Stand to Gain From Economic Partnership Agreement Negotiations?' (2007) 41 Journal of World Trade 411.

¹⁷⁷ For further discussion on the role of research in trade negotiations, see Tussie.

¹⁷⁸ Private sectors were consulted by the Thai government prior to its RTA negotiations with Japan. At this stage, private firms voiced their concerns and stated their positions in relation to the possible RTA commitments which were acceptable to them.

¹⁷⁹ See Pfetsch, pp. 37-40.

¹⁸⁰ See <http://www.ustr.gov/trade-agreements/free-trade-agreements/north-american-free-trade-agreement-nafta> (last accessed 13 April 2010).

Consequently, one would expect the United States to have more bargaining power than Mexico when it comes to RTA negotiations.¹⁸¹ In other words, a country with a large domestic market to which other countries want access or on which other countries are already dependent in terms of trade and investment, is in a better position to get its wishes in trade negotiations.¹⁸²

Both analytical and negotiating capacities are underpinned by well-functioning domestic institutions. They can enable a country to gather, distribute, and analyse information relating to its trade, economic and business performance as well as similar information about other countries.¹⁸³ These institutions include government's trade bureaucracy, business organizations (such as a national chamber of commerce), and individual corporations. The networks of these institutions can be facilitated and strengthened if there is a body which acts as a focal point of communication.¹⁸⁴

Human capital is also important to a country's analytical and negotiating capacities. Its importance can be seen throughout different stages of negotiation. Prior to the negotiating stage, competent experts- be they economists or otherwise- are necessary for the preparatory work on which the ensuing negotiations will be based. If the country in question does not have adequate experts to produce reliable preparatory work, *i.e.* lack of analytical capacity, its trade negotiators are unlikely to make informed decisions during the negotiating stage. Human capital also plays a crucial part in the negotiations since skilled and experienced trade negotiators are more likely to secure the set objectives than those that are not.

So, what are the implications for developing countries when it comes to RTA negotiations? The developing country in question cannot do much in terms of its market size and market power in relation to its prospective RTA partner. It can, nevertheless, try to improve its analytical and negotiating capacities. However, this is easier said than done.

¹⁸¹ See AO Mena, 'Getting to "No": Defending against Demands in NAFTA Energy Negotiations' in JS Odell (ed) *Negotiating Trade: Developing Countries in the WTO and NAFTA* (Cambridge University Press, Cambridge 2006).

¹⁸² See P Drahos, 'When the Weak Bargain with the Strong: Negotiations in the World Trade Organization' (2003) 8 *International Negotiations* 79, p. 82.

¹⁸³ *Ibid.*, p. 83.

¹⁸⁴ For example, in the case of Thailand, the Department of Trade Negotiations (DTN), the Ministry of Commerce, has become the main body which takes the lead in RTA negotiations and acts as a focal point of communication between relevant domestic institutions. Note that the DTN did not perform these functions exclusively when Thailand first embraced RTAs as its alternative trade policy. For example, the Ministry of Foreign Affairs was in charge in the negotiations of the Japan-Thailand EPA while the DTN was in charge in the negotiations of the Thailand-Australia and Thailand-New Zealand RTAs. See http://www.thaifta.com/english/index_eng.html (last accessed 21 May 2010).

A country's analytical and negotiating capacities are generally related in an approximate fashion to its size and level of economic development.¹⁸⁵ Given limited resources and stage of development, developing countries may not have well-functioning domestic institutions or simply cannot afford to finance them. By the same token, they may find it difficult to increase and improve their human capital. In any event, improvements are likely to take time and developing countries will have to utilize what they already have in the short-run. In addition, developing countries which take part in both WTO and RTA negotiations may find their human capital stretched since both are often carried out by the same staffs.¹⁸⁶ Similarly, where developing countries simultaneously engage in several RTA negotiations, their human capital can be spread even thinner. An example of this is Thailand prior to the 2006 political crisis where many rushed and concurrent FTA negotiations severely stretched its human capital and negotiating resources.¹⁸⁷

Compared to their developed-country counterparts, developing countries will generally have less analytical and negotiating capacities, and as a result find it harder to achieve their objectives in North-South RTA negotiations. Therefore, the final outcome of such agreements may, in fact, be rather one-sided as developing countries become an agenda-taker. For example, it is observed that Japan in its RTAs with the ASEAN countries tends to pursue a high level of market opening in manufacturing, services, and investment, while resisting the liberalization of agriculture or fisheries;¹⁸⁸ and the developing countries forming an FTA with the United States tend to commit themselves to TRIPS-plus commitments.¹⁸⁹ Consequently, developing countries may have to accept commitments which do not offer many benefits and

¹⁸⁵ See D Tussie and D Glover, *The Developing Countries in World Trade: Policies and Bargaining Strategies* (Lynne Rienner Publishers, Boulder, Colo 1993), p. 231.

¹⁸⁶ See S Laird, 'Regional Trade Agreements: Dangerous Liaisons?' (1999) 22 *World Economy* 1179, p. 1187.

¹⁸⁷ For more detail, see R Sally, 'Thai Trade Policy: From Non-discriminatory Liberalisation to FTAs' (2007) 30 *World Economy* 1594.

¹⁸⁸ For example, see Japan EPAs with Brunei, Chile, Indonesia, Malaysia, Mexico, and Thailand, available at <http://www.mofa.go.jp/policy/economy/fta/index.html> (last accessed 11 April 2010); see also G Hufbauer and J Schott, 'Fitting Asia-Pacific agreements into the WTO system' in R Baldwin and P Low (eds), *Multilateralizing Regionalism: Challenges for the Global Trading System* (Cambridge University Press, Cambridge 2009), p. 562.

¹⁸⁹ For example, patent drugs for disease such as HIV can be made less affordable due to the stringent IPRs regime. For further discussion, see FM Abbott, 'Intellectual Property Provisions of Bilateral and Regional Trade Agreements in Light of U.S. Federal Law' (ICTSD Project on IPRs and Sustainable Development, UNCTAD, Geneva 2006) and South Centre, 'Intellectual Property in Investment Agreements: The TRIPS-Plus Implications for Developing Countries' (Analytical Note, South Centre, Geneva 2005). See also <http://www.oxfam.org/en/node/144> (last accessed 12 April 2010).

incur high implementation and adjustment costs. The purpose of forming an RTA would be defeated if the costs actually exceed the benefits.

As noted above, it should again be recalled that since the term *developing country* encompasses a range of countries at different stages of development and with different economic backgrounds, a generalization of their position with regard to analytical and negotiating capacities has to be qualified. Advanced developing countries like the Republic of Korea, Singapore, and Taiwan are likely to have high analytical capacity while developing countries with big markets such as Brazil, China, and India are likely to have greater bargaining powers than those with medium or small markets.¹⁹⁰ In addition, the *relative* analytical and negotiating capacities between prospective RTA partners will vary on a case-by-case basis.¹⁹¹ Asymmetries between the parties may be greater in some RTAs than in others. For example, the proposed EPAs between the EU and the ACP countries involve trade negotiations between some of the most developed and some of the poorest countries in the world.¹⁹² By contrast, asymmetries between the parties in the Chile-Mexico FTA may be less as they are more similar economically.¹⁹³

2.4 Conclusion

As a prospective RTA member, developing countries arguably wish to make the most out of the RTA they have decided to form. Therefore, they will try to promote the potential benefits and manage the potential costs induced by the agreement. In order to identify the challenges they face, the chapter first examines

¹⁹⁰ For example, Brazil withstood the pressure from the United States in the Free Trade Area of the Americas. For more detail, see R Bouzas, 'The "New Regionalism" and the Negotiation of a Free Trade Area of the Americas' (2007) 12 *International Negotiations* 333.

¹⁹¹ Dent finds that less advanced developing countries which lack technocratic, industrial, and institutional capacities are likely to be exploited by their developed-country counterparts more than the more advanced developing countries. See CM Dent, *New Free Trade Agreements in the Asia-Pacific* (Palgrave Macmillan, Basingstoke, Hampshire; New York 2006), pp. 246-53.

¹⁹² For more detail on the 77 members of the ACP group of countries and their economies in relation to the EU, see L Fontagne, C Mitaritonna and D Laborde, 'An Impact Study of the EU-ACP Economic Partnership Agreement (EPAs) in the Six ACP Regions' (Directorate General for Trade, Commission of the European Union, 2008), pp. 26-31.

¹⁹³ See <http://rtais.wto.org/UI/PublicShowMemberRTAIDCard.aspx?enc=s6Od4vDej8KdMOYro/zINxODPw3reQX9YGM2L6m2dr8=> (last accessed 11 April 2010).

how a developing-country partner may gain from an RTA and whether it may incur any costs in the process. The discussion on potential benefits and potential costs also help inform and provide insights to how the WTO regulatory framework may work in practice and how it can be improved.

Developing countries can benefit from trade creation, preferential access to the partner's market, and the dynamic effects, namely increased economies of scale, competition, knowledge and technology transfer, and FDI. On the other hand, they are likely to incur implementation and adjustment costs as a result of complying with RTA commitments. The key for developing countries is how to ensure that the benefits outweigh the costs. This is far from simple in practice.

In order to do so, developing countries have to set out the objectives for their RTAs and what they can or cannot commit themselves to in the ensuing RTA negotiations. This requires analytical capacity on the part of developing countries. Their governments are also likely to be influenced by domestic vested interests, which may increase the likelihood of a trade-diverting agreement.

Given that the final content of an RTA is a product of trade negotiations, the success of developing countries depends also on their negotiating capacity. Thus, even if they know exactly what the most optimal agreement for their economies is, the final content (and hence the benefits and costs) will be subject to the ensuing negotiations. The constraints on both analytical and negotiating capacities may be a handicap that affects the extent that developing countries can optimize their participation in an RTA.

Not only do developing countries face challenges as a prospective RTA member, but they also do as a non-member and a WTO Member amid the current RTA proliferation. Thus, in order to have a complete picture, the next chapter will look at the possible challenges faced by developing countries from these two perspectives.

Chapter 3

Challenges Facing Developing Countries amid the Current RTA Proliferation: as a Non-member and a WTO Member

3.1 Introduction

Developing countries can gain from the formation of an RTA although the net outcome depends on various factors and the potential costs they may incur. Accordingly, the previous chapter looks at the challenges they face from the perspective of a prospective RTA member. However, RTAs do not only affect the member countries, but may also have effects on the outside world. This chapter, therefore, investigates whether there are any challenges that developing countries may face from two other perspectives, namely, as a non-member and as a WTO Member amid the current RTA proliferation.

By its very nature, an RTA is designed and negotiated between the member countries. As discussed in the previous chapter, they will seek to make the most out of the agreement. Non-members, on the other hand, are excluded from this process and will be discriminated against as a result of trade preferences granted between the member countries. In order to identify the challenges that developing countries face in such situation, it is necessary that one first examines whether an RTA has any adverse effects on a non-member developing country.

Concerns have been raised that RTAs individually and as a collective group may also have implications on the multilateral trading system and multilateral trade negotiations.¹⁹⁴ If it is accepted that the WTO provides advantages for developing countries through its multilateral trading framework and respectable DSM, anything that undermines the WTO may in principle undermine developing countries' interests as well. Thus, it is also necessary that the relationship between RTAs and the WTO is

¹⁹⁴ See Bhagwati, 'Regionalism and Multilateralism: an Overview'.

investigated in order to identify whether there are any challenges facing developing countries as a WTO Member whose interests may be affected as more and more trade negotiations and rule-making are being conducted through RTAs rather than the WTO.

The chapter is therefore divided into three sections. The first section looks at the challenges that developing countries may face as a non-member. The second section examines the relationship between RTAs and the WTO and discusses whether developing countries face any challenges as a WTO Member amid the current RTA proliferation. The final section concludes the discussion and determines whether the WTO has any role to play in addressing the challenges faced by developing countries in the context of the current RTA proliferation.

3.2 Challenges Facing Developing Countries as a Non-member

As discussed in the previous chapter, one benefit from the formation of an RTA is trade creation. However, it is also pointed out that an RTA can also result in trade diversion. This occurs when the lower-cost producers from outside are displaced by the higher-cost producers located within the preferential area as a result of trade preferences granted between the member countries. Trade diversion is therefore welfare-reducing and considered bad for the member countries.

Parallel to this, trade diversion can also affect countries which are discriminated against due to the preferences granted between the member countries. RTAs are, by definition, exclusive and discriminatory clubs. Every country in the world is excluded from nearly every RTA in the world, and every RTA excludes nearly every country. Thus, discrimination against non-members is inevitable and can adversely affect their economies. Although trade diversion is not necessarily harmful to non-members, it will be injurious under two situations: the first, when non-members tax their international trade (*e.g.* by imposing tariffs); and the second, when

non-members' export prices fall as a result of falling demand from the RTA members.¹⁹⁵

The first situation is caused by the fact that exporters located inside the preferential area may find it more profitable to export within the RTA due to freer intra-bloc trade. Other things being equal, imports from RTA members to non-members are likely to fall as a result. Consequently, as non-member governments impose tax on imports, they will incur revenue losses. In the second situation, due to the discrimination in favour of intra-bloc trade, consumers within the RTA may find it cheaper to buy goods and services produced within the RTA as compared to those imported from non-members. This is likely to result in falling demand for imports from non-members.

Thus, trade diversion can have an immediate and direct effect on the exports of excluded countries- they fall. This is frequently taken as sufficient evidence of harm since it worsens non-members' terms of trade in relation to the RTA members.¹⁹⁶ It is not, however, as simple when one turns to the welfare of non-members. Other things being held constant, a reduction in a country's exports would improve its economic welfare because the goods and services- or the resources used to produce them- could be reallocated to the domestic market.¹⁹⁷ In reality, however, things cannot be held constant. Non-members' loss of exports reduces their ability to buy imports. The losses their consumers incur as they cut back on imports must be balanced against their gains from consuming the resources that were to be exported. However, these components will not necessarily be perfectly offset since a unit of exports may generate more welfare than would alternative domestic uses of the resources taken to produce it. Consequently, losing exports can result in a reduction in real income and the welfare of non-members.¹⁹⁸

Falling exports are not the only concern for non-members. An RTA can have a significant effect on the prices at which non-member firms sell their products abroad. For example, Chang and Winters find that the creation of Mercosur was associated

¹⁹⁵ See Schiff and Winters, *Regional Integration and Development*, p. 210.

¹⁹⁶ See Pomfret, *The Economics of Regional Trading Arrangements*, pp. 196-201. Note that the exports will fall more sharply if the non-member in question exports similar products to the preferential area as the partner country.

¹⁹⁷ See Schiff and Winters, *Regional Integration and Development*, pp. 213-4.

¹⁹⁸ For further discussion, see J Haaland and V Norman, 'Global Production Effects of European Integration' in L Winters (ed) *Trade Flows and Trade Policy after 1992* (Cambridge University Press, Cambridge 1992).

with significant declines in the prices of non-members' exports to the group.¹⁹⁹ The extent of this depends on the size of the RTA in question. Schiff and Winters argue that small RTAs will rarely matter since they almost never affect the prices at which trade occurs, but some RTAs, such as those involving the United States and the EU, may be large enough to affect world prices.²⁰⁰ Thus, such an RTA can have significant implications for non-members regardless whether or not they deal directly with the RTA itself.²⁰¹ In addition, falling exports can affect the prices at which products are sold within non-members. Recall the hypothetical example of Mexico, Chile, and Thailand. In the scenario where there is trade diversion and Thai rice producers cannot compete with Chilean rice producers due to the formation of an RTA between Mexico and Chile, Thai rice producers will have to sell their rice elsewhere. If they cannot export the excess amount to other countries, they will have to sell it domestically. This, in turn, increases the supply of rice in the Thai market and is likely to drive the prices down. Consequently, Thai rice producers will earn less as a result of falling exports (and export prices) and falling domestic prices.

Like trade, FDI and investment in general can be diverted due to the formation of an RTA.²⁰² If an RTA results in net investment diversion, non-members are likely to receive less FDI. This, in turn, can have adverse effects on their long-term economic growth and development.²⁰³ Investment diversion can be worsened if a *hub-and-spoke* system is formed. This occurs when a country has formed RTAs with a number of countries that maintain barriers between each other. This *hub* country becomes the preferred location for investment as firms can reach more markets tariff-free than they can from any of the other locations, *i.e.* *spoke* countries. This will tend to bid up factor prices and raise real income in the hub.²⁰⁴ In other words, the hub country is likely to gain artificial competitive advantages due to the mere fact that it has concluded more RTAs than the spoke countries.²⁰⁵ The world's largest hub is the EU, which has separate RTAs with nearly all other European and many

¹⁹⁹ See W Chang and A Winters, 'How Regional Blocs Affect Excluded Countries: The Price Effects of MERCOSUR' (2002) 92 *American Economic Review* 889.

²⁰⁰ Schiff and Winters, *Regional Integration and Development*, p. 215.

²⁰¹ *Ibid.*

²⁰² See Chapter 2.

²⁰³ For further discussion, see H Hansen and J Rand, 'On the Causal Links between FDI and Growth in Developing Countries' (2006) 29 *The World Economy* 21.

²⁰⁴ For further discussion, see S Chong and J Hur, 'Small Hubs, Large Spokes and Overlapping Free Trade Agreements' (2008) 31 *The World Economy* 1625.

²⁰⁵ See Zahrnt, p. 673.

Mediterranean countries, most of which do not grant each other free trade.²⁰⁶ This will be worsened when the proposed EPAs between the EU and the ACP countries are concluded. Thus, hub-and-spoke systems can result in further investment diversion, and hence worsening trade diversion.

From the discussion, it is more likely that non-members will be adversely affected due to trade and investment diversion. These adverse effects represent costs of non-participation and arguably get higher as more and more countries form RTAs with one another, implying further trade and investment diversion. In response, non-members may apply for membership of existing RTAs and/or form new ones with their trade partners. The theory of *domino effect*, first introduced by Baldwin, can be used to explain this.²⁰⁷

The domino effect starts with a positive model of membership in an RTA and proceeds in two stages: the immediate impact of an idiosyncratic deepening of integration in the RTA; and the knock-on impact implied by bloc enlargement.²⁰⁸ The starting point is that a country's decision to join or form an RTA is determined by its domestic political equilibrium that balances pro-membership and anti-membership forces. Export sectors tend to associate with the former and import-competing sectors the latter. The reason is that an RTA membership is thought to be beneficial to exporting firms as it provides a preferential access to new markets; whereas it is thought to be detrimental to import-competing firms as it leads to new competition from the RTA partner. Given an initial political equilibrium membership in the RTA, an idiosyncratic shock that deepens the RTA's integration generates new political economy forces in non-members as non-member exporters now have a greater stake in membership- they face more discrimination if their country stays out and greater market access if it joins. Anti-membership forces are also strengthened in non-members as the liberalization implied by membership is heightened.²⁰⁹ It has been argued that exporting firms tend to be more organized and politically more influential than import-competing firms.²¹⁰ As a result, the idiosyncratic shock is likely to raise the pro-membership forces more than the anti-membership forces. Thus, for non-

²⁰⁶ See Chapter 1.

²⁰⁷ For more detail, see Baldwin, *A Domino Theory of Regionalism*.

²⁰⁸ See Baldwin, 'Multilateralizing Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade', pp. 1466-71.

²⁰⁹ *Ibid.*, p. 1467.

²¹⁰ *Ibid.*, p. 1468.

members that previously found it politically optimal to stay outside of the RTA, these changes shift the domestic political economy equilibrium towards pro-membership.

The second stage is triggered if a non-member country actually succeeds in joining the RTA. The RTA enlargement implies that discrimination facing the remaining non-members expands and this again heightens the pro-membership political economy forces in non-members, potentially producing a further membership application. Baldwin proposes that insofar as entry into the RTA is allowed, the cycle will repeat itself until a new political equilibrium membership in the RTA is reached.²¹¹ However, Yi criticizes Baldwin's assumption and shows that existing RTA members will ultimately have incentives to restrict entry.²¹² Andriamananjara confirms this and demonstrates that as an RTA expands, the potential benefits gained from the formation by the members first rise, reach a maximum, and then decline.²¹³ This is, in fact, what happens in practice. Countries in the current RTA proliferation tend to conclude new bilateral FTAs rather than to apply for membership of the existing ones.²¹⁴

An illustration of the domino effect is Japan and its RTAs with the ASEAN countries. Japan concluded its first RTA ever with Singapore in 2002,²¹⁵ and expressed interests in negotiating further RTAs with ASEAN as a whole and/or on a bilateral basis with the member countries.²¹⁶ Given that Japan is one of the region's main trade partners both in terms of export market and sources of FDI, its newly-found interests in RTAs within the region raised opportunities and concerns among the ASEAN countries.²¹⁷ Since non-members are likely to be adversely affected as a result of trade and investment diversion, the decision not to negotiate an RTA with Japan can be detrimental to the ASEAN countries, especially if the others choose to

²¹¹ Ibid., p. 1469.

²¹² See S Yi, 'Endogenous Formation of Customs Unions under Imperfect Competition: Open Regionalism Is Good' (1996) 22 *Journal of International Economics* 153. Note that Baldwin does recognize the possibility that RTA member countries may have an incentive to block entry in his later work, see Baldwin, 'Multilateralizing Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade', pp. 1468-9.

²¹³ See S Andriamananjara, 'On the Size and Number of Regional Integration Arrangements: A Political Economy Model' (Policy Research Working Paper No2117, World Bank, Washington, DC 1999).

²¹⁴ See Chapter 1.

²¹⁵ See <http://rtais.wto.org/ui/PublicShowMemberRTAIDCard.aspx?enc=GPbUmeAae9dRWFg5kN2yuaT1PNrPUN6jt8HkZ5qr998=> (last accessed 7 April 2010).

²¹⁶ See the speech by the Prime Minister of Japan Junichiro Koizumi, 14 January 2002, available at <http://www.mofa.go.jp/region/asia-paci/pmv0201/speech.html> (last accessed 7 April 2010).

²¹⁷ See <http://www.aseansec.org/5740.htm#1> (last accessed 7 April 2010).

do so, hence an increase in costs of non-participation.²¹⁸ For example, assume that Malaysia and Indonesia export similar products to Japan. Once the Japan-Malaysia RTA is established while Indonesia decides not to form an RTA with Japan, its products will be more expensive in the Japanese market and cannot compete with its Malaysian counterparts. The situation is likely to be worsened for Indonesia when the other ASEAN countries decide to form bilateral RTAs with Japan.

Thus, the theory of domino effect can be used to explain how the formation of the Japan-Singapore RTA and the prospects of other ASEAN countries forming RTAs with Japan may have generated new pro-membership political economy forces within the ASEAN countries.²¹⁹ In reality, Malaysia and Thailand formed an RTA with Japan in 2006 and 2007, respectively. To date, Japan has concluded seven bilateral RTAs with the ASEAN countries, and one with ASEAN as a whole.²²⁰

Costs of non-participation can also originate from the fact that a developing country may choose to form an RTA in order to secure or avoid losing trade preferences previously provided by a non-reciprocal trade arrangement with a developed country. The proposed EPAs between the EU and the ACP countries are the case in point.

The EPA negotiations have been triggered by the expiry of previous trade agreements between the EU and the ACP countries. Since 1976, political and economic relations between these two blocs have been governed by a series of five-year agreements, known as the Lomé Conventions.²²¹ These conventions provided the ACP countries with trade preferences and preferential access to the EU market without requiring them to reciprocate.²²² The last Lomé Convention (Lomé V) ended in 2000, and was replaced by the Cotonou Agreement.²²³ As part of the Cotonou Agreement, the EU and the ACP countries agreed to conclude new trade

²¹⁸ Such concerns were raised among Thai trade negotiators during the Japan-Thailand EPA negotiations and were used as a justification for compromises made with their Japanese counterparts.

²¹⁹ For further discussion, see L Low, 'Policy Dilemmas in Singapore's RTA Strategy' (2003) 16 *The Pacific Review* 99.

²²⁰ See <http://www.mofa.go.jp/policy/economy/fta/index.html> (last accessed 7 April 2010).

²²¹ For more detail, see http://ec.europa.eu/development/geographical/cotonou/lomegen/lomeitoiv_en.cfm (last accessed 7 April 2010).

²²² Note that the conventions violated WTO rules as they established unfair discrimination between developing countries. As such, the WTO Members agreed to grant a waiver to the EU to continue providing non-reciprocal preferences until the end of 2007. See http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_acp_ec_agre_e.htm (last accessed 10 April 2010).

²²³ For more detail, see http://ec.europa.eu/development/geographical/cotonouintro_en.cfm (last accessed 7 April 2010).

arrangements which are reciprocal in nature.²²⁴ In effect, the ACP countries have to negotiate an RTA with the EU if they are to retain their existing trade preferences and preferential access to the EU market. However, under the proposed EPAs, they will have to give the EU trade preferences and preferential access to their markets as well.²²⁵ Thus, for the ACP countries, the costs of non-participation in the EPAs will be the loss of trade preferences and preferential access to the EU market.²²⁶ Like the case of Japan and the ASEAN countries, the more ACP countries have concluded the proposed EPAs with the EU, the more pressure the remaining countries have to finalize their negotiations with the EU.²²⁷

Although developing countries may have a choice whether to form an RTA with their trade partners, the costs of non-participation can influence or even dictate their decision. Thus, it is arguable whether developing countries do have a real choice here. The fact that they increasingly form RTAs with their developed-country counterparts and among themselves suggests that they view the costs of non-participation as exceeding the potential costs that they may incur as an RTA member.²²⁸

Therefore, the main challenge that developing countries face as a non-member is how to reduce the adverse effects caused by trade and investment diversion. It is very unlikely that, if left to themselves, prospective RTA members will take into account such adverse effects. Notably, the members' firms benefit most precisely when the RTA results in trade diversion.²²⁹ More importantly, non-members are excluded from the negotiation process. Thus, there is little, if anything, non-member developing countries can do to curb trade and investment diversion. If they choose to respond by applying for membership of existing RTAs or forming new ones with their trade partners, they will nevertheless face with the challenges discussed in the previous chapter. Furthermore, as the theory of domino effect suggests, other non-member developing countries will be pressured to do the same, especially when their

²²⁴ See the Cotonou Agreement, Articles 34-38.

²²⁵ This is to satisfy the conditions set in GATT Article XXIV. See Fontagne, Mitaritonna and Laborde, pp. 41-44.

²²⁶ It should be noted that the ACP countries can still benefit from the existing GSP schemes offered by the EU but they will have to compete with other developing countries which are also eligible for such schemes.

²²⁷ For further discussion, see *'Oxfam Warns of Dire Consequences of EU's Rushed Trade Deals'*, available at <http://www.oxfam.org/en/node/240> (last accessed 12 April 2010).

²²⁸ See Chapter 2.

²²⁹ Ibid.

main trading partners have formed RTAs with their competitors. This is likely to result in an increase in the number of RTAs, and hence their impact on the outside world. In addition, as more and more RTAs are formed, it arguably becomes more and more imperative for developing countries to *jump on the bandwagon*.²³⁰ This, in turn, can result in non-member developing countries more willing to accept fewer gains and accept greater costs. To put it differently, the fact that other developing countries have embraced RTAs as an alternative trade policy may reduce the bargaining power of those which are yet or about to negotiate an RTA. This is likely to affect non-member developing countries' negotiating capacity.²³¹

Therefore, the thesis argues that something must be done to curb trade and investment diversion in order to reduce the costs of non-participation, which in turn should allow non-member developing countries to use RTAs as a positive means to achieve economic development rather than as a defence against trade and investment diversion.²³²

3.3 Challenges Facing Developing Countries as a WTO Member

The WTO arguably provides developing countries with a number of advantages.²³³ There are two advantages which are directly relevant in the context of RTAs and their proliferation: the first derives from the multilateral trading framework offered by multilateral trade negotiations; and the second from the WTO DSM. Coalitions among small and less powerful countries are common practice in international negotiations and the limited bargaining power of developing countries makes coalitions an especially crucial instrument for their success in the international

²³⁰ For more detail, see M Solis, B Stallings and SN Katada, *Competitive Regionalism: FTA Diffusion in the Pacific Rim* (Palgrave Macmillan, Basingstoke 2009).

²³¹ See Chapter 2.

²³² In the case of the proposed EPAs between the EU and the ACP countries, the costs of non-participation do not derive from trade and investment diversion as such, but from the possibility of losing trade preferences previously provided by a non-reciprocal trade arrangement with the EU. Consequently, their main challenges will be those discussed in the previous chapter.

²³³ On general discussion of how developing countries make use of the GATT and later the WTO, see C Michalopoulos, *Developing Countries in the WTO* (Palgrave, Basingstoke 2001).

arena.²³⁴ In multilateral trade negotiations, developing countries can cooperate in order to form a coalition against external pressures and protect their common interests, for example the G77.²³⁵ By contrast, in a bilateral or regional setting, a large and powerful country can arguably assert its economic and political leverage over a small and less powerful country more easily.²³⁶ This is often viewed as the reason why developing-country partners in North-South RTAs tend to make WTO-plus commitments.²³⁷

Developing countries also benefit from the WTO dispute settlement system as can be seen from their successes in using the DSM to protect their WTO rights.²³⁸ It has been argued that the WTO DSM is more advantageous for developing countries because it is less *power-based* and more *rule-based* than RTA dispute settlement mechanisms.²³⁹ While RTAs may be concluded between trade partners of roughly equal size and power, they often include parties that vary to a great degree in relative size and power. NAFTA and the proposed EPAs between the EU and ACP countries provide prime examples, as are almost any RTA entered into by the United States or the EU for that matter. Although many RTAs may appear to adopt dispute settlement provisions similar to those under the DSU, they often in fact exhibit aspects of power-

²³⁴ For a general discussion, see Diego-Fernandez.

²³⁵ See <http://www.g77.org/> (last accessed 1 August 2009). One caveat on such multilateral cooperation among developing countries is that they do not always unite on all issues. Given the heterogeneity among developing countries, they often have diverse interests depending on their individual circumstances and stage of development. Thus, the success of a coalition among developing-country Members is not a given and will depend on many factors. For further discussion, see A Narlikar, *International Trade and Developing Countries: Coalitions in GATT and WTO* (Routledge, London 2003).

²³⁶ This does not mean that asymmetries do not matter in WTO negotiations. It is simply argued that they matter less in the multilateral setting due to consensus and possible coalition among developing countries. See Singh. It should be noted that the new species of RTAs whose parties are distinct RTAs themselves, for example the proposed ASEAN-EU FTA, may allow the developing countries involved to form a coalition and better protect their interests. This was certainly the case in when I was taking part in the ASEAN-EU FTA negotiations.

²³⁷ For example, see J Whalley, 'Regional Trade Arrangements in North America: CUSTA and NAFTA' in J de Melo and A Panagariya (eds), *New dimensions in regional integration* (Cambridge University Press, Cambridge 1993). It should be noted that the new species of RTAs whose parties are distinct RTAs themselves, for example the proposed ASEAN-EU FTA, may allow the developing countries involved to form a coalition and better protect their interests. This was certainly the case in when I was taking part in the ASEAN-EU FTA negotiations.

²³⁸ For example, Thailand recently won its anti-dumping case against the United States. See WTO Appellate Body Report, *US-Shrimp (Thailand)*, WT/DS343/AB/R, WT/DS345/AB/R, adopted 1 August 2008. For further discussion, see W Davey, 'The WTO Dispute Settlement System: How Have Developing Countries Fared?' in Z Drabek (ed) *Is the World Trade Organization Attractive Enough for Emerging Economies?: Critical Essays on the Multilateral Trading System* (Palgrave Macmillan, Basingstoke 2010).

²³⁹ On the desirability of an adjudicative or rule-based approach to dispute settlement, as opposed to power-based or negotiation approach, see JH Jackson, 'Governmental Disputes in International Trade Relations: A Proposal in the Context of GATT' (1979) 13 *Journal of World Trade* 1.

based dispute settlement. For example, Mexico has had difficulty in obtaining compliance from the United States in the two NAFTA Chapter 20 cases it brought.²⁴⁰ While the same power asymmetries exist in the WTO, they are arguably more effectively offset in a multilateral setting than in a bilateral or regional one.²⁴¹

It is however recognized that the WTO DSM is not without criticism when it comes to developing-country Members' participation and success in the dispute settlement process. For example, it has been argued that the special and differential treatment provisions contained in the DSU are rather vague and ineffective.²⁴² The costs of litigation can also be prohibitively high particularly for small developing-country Members.²⁴³ In addition, developing-country Members may be constrained by their lack of human resources and administrative structures to detecting possible inconsistencies with the WTO agreements.²⁴⁴ It is noteworthy that these criticisms are not necessarily exclusive to the WTO DSM, and can arguably be exacerbated in a bilateral or regional setting.²⁴⁵ Given that the WTO DSM operates in a more rule-based fashion and developing countries are building the capacity to use it more

²⁴⁰ In the Broomcorn case, the safeguard at issue was imposed on 28 November 1996: 61 Federal Register 64431 (4 December 1996). The NAFTA panel found the safeguard to violate NAFTA rules in the case of Mexico on 28 January 1998. See NAFTA Chapter 20 Panel Report, *US Safeguard Action Taken on Broomcorn Brooms from Mexico*, 30 January 1998. The safeguard was terminated on 3 December 1998, officially because the US industry failed to take adjustment measures as required by US law: 63 Federal Register 67761 (8 December 1998). No mention was made of the NAFTA panel report in the termination decision. In the Trucking case, the decision was issued on 6 February 2001. See NAFTA Chapter 20 Arbitral Panel Report, *Cross-Border Trucking Services*. The report remains unimplemented.

²⁴¹ For further discussion, see W Davey, 'Dispute Settlement in the WTO and RTAs: A Comment' in L Bartels and F Ortino (eds), *Regional Trade Agreements and the WTO Legal System* (Oxford University Press, Oxford; New York 2006), pp. 354-7.

²⁴² See AH Qureshi, 'Participation of Developing Countries in the WTO Dispute Settlement System' (2003) 47 *Journal of African Law* 174, pp. 189-93.

²⁴³ See CP Bown and BM Hoekman, 'WTO Dispute Settlement and the Missing Developing Countries Cases: Engaging the Private Sector' (2005) 8 *Journal of International Economic Law* 861, pp. 863-4. Note that the establishment of the Advisory Centre on WTO Law may have improved the situation to some extent. For further discussion, see CP Bown and R McCulloch, 'Developing Countries, Dispute Settlement, and the Advisory Centre on WTO Law' (2010) 19 *The Journal of International Trade & Economic Development* 33.

²⁴⁴ See JLP Gabilondo, 'Developing Countries in the WTO Dispute Settlement Procedures: Improving Their Participation' (2001) 35 *Journal of World Trade* 483, pp. 484-5.

²⁴⁵ For further discussion on a comparison between the WTO and RTA DSMs, see J Pauwelyn, 'Going Global, Regional, or Both? Dispute Settlement in the Southern African Development Community (SADC) and Overlaps with the WTO and Other Jurisdictions' (2004) 13 *Minnesota Journal of Global Trade* 231.

effectively,²⁴⁶ it is therefore in principle a problem if it is undermined as an avenue for them in the future.

If it is accepted that the WTO provides advantages for developing countries through its multilateral trading framework and respectable DSM, anything that undermines these aspects of the WTO's operation may in principle undermine developing countries' interests to that extent as well. Thus, it is necessary that the relationship between RTAs and the WTO is examined in order to identify whether there are any challenges facing developing countries as a WTO Member whose interests may be affected as more and more trade negotiations and rule-making are being conducted through RTAs rather than the WTO. So, do RTAs complement or undermine the WTO and multilateral trade liberalization?

Since the early 1990s, the focus has shifted away from effects of an RTA on the member countries and focused more on the relationship between such agreements and the multilateral trading system- whether RTAs can reduce countries' support for the multilateral trading system and multilateral trade liberalization. In other words, even if RTAs are net trade-creating, they may still have long-term systemic effects on the extent of multilateral trade liberalization (*e.g.* reduction of MFN tariff rates), which can be achieved through the GATT/WTO. This shift appears to coincide with the second and third periods of RTA proliferation discussed in Chapter 1. Such a shift makes sense because as more and more RTAs are formed, their individual and collective impact on the multilateral trading system arguably grows.

The question is whether RTAs affect the viability and/or sustainability of the multilateral trading system. The key issue here is that RTAs may render infeasible an otherwise feasible multilateral trade agreement. The underlying logic is that the political support for multilateral trade liberalization may be reduced as a result of fear on the part of domestic vested interests that the gains already obtained through RTAs would be eroded. For example, Levy argues that a bilateral FTA is more likely to undermine political support for multilateral trade liberalization because it may provide disproportionate gains to the countries' average voters and they will not want the gains to be eroded by broader trade liberalization.²⁴⁷ Krishna, focusing on domestic

²⁴⁶ For more detail, see W Davey, 'The WTO Dispute Settlement System: How Have Developing Countries Fared?' (Illinois Public Law Research Paper No05-17, University of Illinois College of Law, 2005).

²⁴⁷ See P Levy, 'A Political-Economic Analysis of Free-Trade Agreements' (1997) 87 *American Economic Review* 509.

firms and their influence on the member governments, reaches a similar conclusion as he finds that RTAs will only be politically viable when they create artificial gains for the domestic firms as a result of trade diversion; and that as these domestic firms do not want to lose such gains, they will oppose to future multilateral trade liberalization.²⁴⁸ Other theoretical studies, however, point to the opposite conclusion. For example, Ornelas argues that if an FTA leads to a contraction of import-competing sectors within the member countries, their influence over the governments is likely to decline. Given that such sectors tend to have vested interests in retaining protectionist measures and resisting further trade liberalization, the decline in their influence over the governments should facilitate multilateral trade liberalization.²⁴⁹

To determine whether RTAs are good for the multilateral trading system, many studies focus on how RTAs affect countries' incentives to alter their MFN tariff rates. The logic is that if the formation of an RTA is accompanied by reductions in MFN rates (bound or applied), the arrangement is more likely to have positive effects on multilateral trade liberalization and improve aggregate world welfare without harming non-members. By contrast, if the RTA members raise MFN rates against non-members, diversion of external trade to RTA members is greater and more likely, which as already discussed can harm non-members as well as the members themselves. According to this approach, the welfare effects of RTAs on the outside world depend on the members' MFN rates after the formation of an RTA. In order to determine this, the literature looks at the optimal tariff response of members after the formation of an RTA.

A number of theoretical studies find that optimal tariffs are more likely to go up in a CU.²⁵⁰ For example, Bagwell and Staiger present a model of CUs which predicts that once a CU is fully implemented, the members will gain greater market power and the CU as a whole will face a greater incentive to defect to higher MFN

²⁴⁸ See Krishna, 'Regionalism and Multilateralism: A Political Economy Approach' and Chapter 2.

²⁴⁹ See E Ornelas, 'Endogenous Free Trade Agreements and the Multilateral Trade System' (2005) 67 *Journal of International Economics* 471.

²⁵⁰ See K Bagwell and R Staiger, 'Multilateral Tariff Cooperation During the Formation of Customs Unions' (1997a) 42 *Journal of International Economics* 91, C Syropoulos, 'Customs Unions and Comparative Advantage' (1999) 51 *Oxford Economic Papers* 239, C Freund, 'Multilateralism and the Endogenous Formation of Preferential Trade Agreements' (2000) 52 *Journal of International Economics* 359, and E Bond, C Syropoulos and A Winters, 'Deepening of Regional Integration and Multilateral Trade Agreements' (2001) 53 *Journal of International Economics* 335.

rates.²⁵¹ On the other hand, it is found that in the absence of enhanced market power, members are likely to reduce their MFN rates after forming an FTA.²⁵²

However, when political economy effects are taken into account, the results are less conclusive. For example, Richardson finds that, following the initiation of an FTA, lobbying will decline and MFN rates will fall as the import-competing sectors contract.²⁵³ The same result is found in a more recent work of Cadot, de Melo, and Olarreaga.²⁵⁴ By contrast, Panagariya and Findlay show that countries in an FTA will raise MFN rates because lobbying in favour of tariffs against the partner country will be diverted to lobbying for greater MFN rates.²⁵⁵ It should be noted that it is not only existing RTAs that matter. In their later work, Bagwell and Staiger illustrate that the mere potential for a future trade agreement may reduce the extent of current tariff reduction that can be negotiated at the multilateral level.²⁵⁶

Alternatively, RTAs may be viewed in a more benign light, merely as a result of the progress made at the multilateral level. The logic is that if WTO Members have gone as far as they can during multilateral trade negotiations, RTAs may be the next step for the minority of countries that want further and deeper integration. For example, Freund argues that countries have a greater incentive to form RTAs in order to promote deeper integration when MFN rates are low.²⁵⁷ Thus, the decline in MFN rates since the founding of the GATT has arguably increased the incentive for countries to form RTAs.²⁵⁸ Similarly, Ethier illustrates that the lower MFN rates have resulted in a rise in North-South RTAs as developing countries see them as a means to attract FDI.²⁵⁹

²⁵¹ See Bagwell and Staiger, p. 118.

²⁵² See K Bagwell and R Staiger, 'Multilateral Tariff Cooperation During the Formation of Free Trade Areas' (1997b) 38 *International Economic Review* 291 and E Bond, R Riezman and C Syropoulos, 'A Strategic and Welfare Theoretic Analysis of Free Trade Areas' (2004) 64 *Journal of International Economics* 1.

²⁵³ See M Richardson, 'Endogenous Protection and Trade Diversion' (1993) 34 *Journal of International Economics* 309.

²⁵⁴ See O Cadot, JD Melo and M Olarreaga, 'Can Bilateralism Ease the Pains of Multilateral Trade Liberalization' (2001) 45 *European Economic Review* 27.

²⁵⁵ See A Panagariya and R Findlay, 'A Political-Economy Analysis of Free-Trade Areas and Customs Unions' in R Feenstra, G Grossman and D Irwin (eds), *The Political Economy of Trade Policy: Papers in Honor of Jagdish Bhagwati* (MIT Press, Cambridge, MA 1996).

²⁵⁶ See K Bagwell and R Staiger, 'Multilateral Trade Negotiations, Bilateral Opportunism and the Rules of GATT/WTO' (2004) 63 *Journal of International Economics* 1.

²⁵⁷ See Freund, 'Multilateralism and the Endogenous Formation of Preferential Trade Agreements'.

²⁵⁸ *Ibid.*, p. 375.

²⁵⁹ See Ethier.

The empirical work on the effects of RTAs on the multilateral trading system and multilateral trade liberalization is, however, in its infancy with the focus on post-formation MFN rates.²⁶⁰ This is understandable since they are arguably more visible and less problematic empirically than political economy effects induced by the formation of an RTA. For example, Foroutan provides a general account of how countries forming RTAs have adjusted their MFN rates.²⁶¹ She uses data on trade and trade policy to compare two groups of countries: the first includes countries that have been a member of an effective RTA; and the second includes countries that are not a member of an RTA or have been in an ineffective one.²⁶² However, she does not find any clear differences in their MFN tariff reduction policy between the two groups, suggesting that RTAs are relatively benign.²⁶³

Other studies offer different conclusions. For example, by using trade and tariff data from Argentina, the second biggest member (to Brazil) in Mercosur, Bohara, Gawande, and Sanguinetti empirically prove the hypothesis that following the initiation of an FTA, lobbying will decline and MFN rates will fall as the import competing sector contracts.²⁶⁴ At the opposite end, Limão finds that the United States was more reluctant to lower its MFN rates in the Uruguay Round for products that offered high preferences.²⁶⁵ His result implies that RTAs may lead to less MFN tariff reduction at the multilateral level. Extending the criteria beyond MFN rates, Hindley and Masserlin find that in the EU the internal liberalization was accompanied by more vigorous anti-dumping against non-member countries.²⁶⁶

From the literature, while the theoretical work on the impact of RTAs on the multilateral trading system and multilateral trade liberalization has generated a number of interesting insights, it remains largely inconclusive. For economists, when faced with opposing theoretical results, the solution is typically to scrutinize the

²⁶⁰ See Freund, *The WTO and Reciprocal Preferential Trading Agreements*, p. xvi.

²⁶¹ See F Foroutan, 'Does Membership in a Regional Preferential Trade Arrangement Make a Country More or Less Protectionist?' (1998) 21 *World Economy* 305.

²⁶² Foroutan develops criteria to determine which RTA is effective and which is not. See *Ibid.*, pp. 306-11.

²⁶³ *Ibid.*, pp. 317-27.

²⁶⁴ See A Bohara, K Gawande and P Sanguinetti, 'Trade Diversion and Declining Tariffs: Evidence from Mercosur' (2004) 64 *Journal of International Economics* 65. Note that the study is conducted based on the data when Mercosur was still operating as an FTA, *i.e.* no CETs.

²⁶⁵ See N Limao, 'Preferential Trade Agreements as Stumbling Blocks for Multilateral Trade Liberalization: Evidence for the United States' (2006) 96 *American Economic Review* 896.

²⁶⁶ See B Hindley and P Masserlin, 'Guarantees of Market Access and Regionalism' in K Anderson and R Blackhurst (eds), *Regional Integration and the Global Trading System* (Harvester-Wheatsheaf, Hemel Hempstead 1993).

divergent predictions empirically. However, the question whether RTAs complement or undermine the WTO is such that it does not lend itself easily to testing. This is because at any point in time, only a single realization of WTO negotiations is observed. It is therefore very difficult to prove that multilateral trade negotiations would have been any faster (or easier), had there been fewer (or more) RTAs.²⁶⁷ This is arguably why the empirical work is rather limited. In addition, given that the surge in the number of RTAs has only begun towards the end of the 20th century and their impact on the multilateral trading system and multilateral trade liberalization is being realized, the empirical literature in this area is still being developed. Perhaps, an eventual conclusion of the Doha Round will offer more data to subsequent empirical studies.

It is also important to note that the focus of existing empirical studies usually revolves around tariffs and tariff reduction. This is arguably inadequate given the broader coverage of RTAs in the current proliferation, which encompasses NTBs on trade in goods, services liberalization, and new issues such as IPRs, investment, and competition policy.²⁶⁸ In addition, these agreements tend to contain provisions on trade remedies such as bilateral/regional safeguard measures, and have their own dispute settlement procedures.²⁶⁹ Consequently, such RTAs may in effect create separate trade regimes, albeit only applicable between the member countries, which are distinguished from that of the WTO. The existence of multiple trade regimes could result in fragmentations of the regulatory framework for international trade. Further research on the effects of these comprehensive agreements on the multilateral trading system is necessary in order to better understand the relationship between RTAs and the WTO.

Thus, the challenge facing developing countries as a WTO Member amid the current RTA proliferation is not clear. Given that both theoretical and empirical literature is not conclusive, it is difficult to take a decisive position on whether RTAs complement or undermine the WTO and multilateral trade liberalization. The fact that the possible effects of RTAs on the extent of multilateral trade liberalization are long-term and systemic also makes them less visible and more difficult to deal with.

²⁶⁷ For more detail, see Freund and Ornelas, 'Regional Trade Agreements', pp. 30-1.

²⁶⁸ See Chapter 1.

²⁶⁹ For example, see Article 2.12 of the Panama-Singapore RTA for a provision on bilateral safeguard measures, and Chapter 17 of the Thailand-New Zealand RTA for provisions on RTA dispute settlement procedures.

Although developing countries may have a stake in the smooth functioning of the WTO, their immediate concerns are likely to lie in the adverse effects caused by trade and investment diversion and/or how they can make the most out of the RTA that they have decided to form.²⁷⁰ It is unrealistic to expect prospective RTA members to design their RTA in such a way that would not undermine the WTO and multilateral trade liberalization. Nevertheless, if trade and investment diversion can be curbed to a significant extent, the costs of non-participation will be lower. Consequently, non-members may not feel the need to apply for membership of existing RTAs or form new ones with their trade partners. This would, in turn, slow the rate at which RTAs proliferate and perhaps bring the attention back to the WTO and multilateral trade liberalization.

Thus, as far as the challenges facing developing countries amid the current RTA proliferation are concerned, the attention should be given to those they face from the perspectives of a prospective member and a non-member. There are no doubt many other challenges that developing countries are confronted with as a result of the current RTA proliferation. The list does not purport to be exhaustive. However, the bodies of literature reviewed and recent practical experience and interviews with trade negotiators make clear that the challenges that are identified in the previous and present chapters are serious, and should be prioritized. For this reason, they are selected as the primary set of challenges to be addressed in the remainder of the thesis.

3.4 A Role for the WTO?

In Chapters 2 and 3, it can be seen that developing countries are confronted with a number of challenges, particularly from the perspectives of a prospective member and a non-member. As a prospective member, developing countries will wish to make the most out of the agreements they have decided to form. In order to do so,

²⁷⁰ Although the trade negotiators that I interviewed were aware of the debate on the relationship between RTAs and the WTO, their primary focus was on the RTAs they were assigned to and how they could further their national interests through these agreements.

they have to promote the potential benefits and manage the potential costs. Ultimately, they have to ensure that the benefits outweigh the costs. Although the logic is simple, it is not so easily achievable in practice. Their key challenges include domestic vested interests, high implementation and adjustment costs, and their lack of analytical and negotiating capacities.

As a non-member, developing countries tend to be adversely affected by trade and investment diversion. Given that RTA members, if left to themselves, are unlikely to take these adverse effects into consideration, non-member developing countries may attempt to mitigate these effects by applying for membership of existing RTAs or forming new ones with their trade partners. This can worsen trade and investment diversion even further and force other non-members to react.

From the perspective of a WTO Member amid the current RTA proliferation, although it is not clear whether RTAs undermine the WTO, to the extent that they do, developing countries are likely to be disadvantaged as more of their trade negotiations will take place in an environment where they are unable to form coalitions against large and more powerful trade partners. In addition, if more of their trade is being governed by RTA rules, any disputes arising from them will be settled through the relevant RTA DSMs, which may not be as advantageous for developing countries as the WTO DSM.

The increase in developing countries' participation in the current RTA proliferation suggests that they see these agreements as an alternative trade policy to multilateral trade liberalization achieved through the WTO- either as a means to positively achieve economic development or as a response to trade and investment diversion. It can be seen that the efforts on the part of developing countries to deal with these challenges, although necessary, may be limited and conditional to their resources and positions in the global economy. Their efforts arguably need to be complemented by some form of international framework for greater effectiveness. As a result, one may have to turn to someplace else. The WTO, an international organization which deals with global trade and trade liberalization, naturally comes to mind.²⁷¹

The WTO Agreements, in fact, contain rules which govern how RTAs are to be formed. These are GATT Article XXIV, the Enabling Clause, and GATS Article

²⁷¹ For further discussion on why the thesis chooses the WTO framework to address the challenges facing developing countries amid the current RTA proliferation, see Introduction.

V. GATT Article XXIV governs the formation of goods RTAs; the Enabling Clause relates to *inter alia* the formation of goods RTAs whose members are exclusively of developing-country status; and GATS Article V governs the formation of services RTAs. Furthermore, it also has in place the mechanisms to supervise RTAs, *i.e.* the reviewing process conducted by the CRTA/CTD, and a possible use of the WTO DSM to enforce the rules.²⁷² Although it is open to debate whether the WTO has the institutional capacity and feasibility to supervise RTAs effectively,²⁷³ with the membership of 153 countries coupled with the existing rules and mechanisms, it is arguably in a better position to supervise the current RTA proliferation than any other international organizations.²⁷⁴

However, it is not clear to what extent these rules and mechanisms address the challenges facing developing countries. Given the dramatic increase in North-South and South-South RTAs, I believe that not only does the WTO have a role to play in RTA supervision, but it must also supervise these agreements in such a way that addresses the challenges. This is supported by the Doha Ministerial Declaration²⁷⁵ which states that:

We [WTO Members] stress our commitment to the WTO as the unique forum for global trade rule-making and liberalization, *while also recognizing that regional trade agreements can play an important role in promoting the liberalization and expansion of trade and in fostering development* (emphasis added);²⁷⁶ and

We [WTO Members] also agree to negotiations aimed at clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements. *The negotiations shall take into account the developmental aspects of regional trade agreement* (emphasis added).²⁷⁷

In light of the challenges identified and the insights provided by the bodies of literature on RTAs as supplemented with the empirical research, Chapters 4-6 will

²⁷² This will be discussed in Chapter 7.

²⁷³ The capacity and feasibility of the WTO to supervise RTAs and their proliferation will be discussed in the context of the existing mechanisms, *i.e.* the reviewing mechanism through the CRTA and the WTO DSM. This will be discussed in Chapter 7.

²⁷⁴ Note that other international organizations could play a supporting role in RTA supervision. See Chapter 7.

²⁷⁵ See the Doha Ministerial Declaration, WT/MIN(01)/DEC/1, adopted 14 November 2001.

²⁷⁶ See *Ibid.*, para. 4.

²⁷⁷ See *Ibid.*, para. 29.

examine the extent to which the existing WTO rules address these challenges and whether there are any ways to improve them so that the challenges can be better addressed. Chapter 4 will look at GATT Article XXIV, Chapter 5 the Enabling Clause, and Chapter 6 GATS Article V. Given that any substantive reforms to the rules may not be easily executed, Chapter 7 will explore whether there are other less contentious means that may complement and strengthen the existing WTO rules and mechanisms. These include promulgation of code of best practices, revision of the WTO surveillance mechanisms, and technical assistance for developing countries in relation to RTAs.

Chapter 4

GATT Article XXIV

4.1 Introduction

GATT Article XXIV was in the original GATT 1947 and subsequently incorporated into GATT 1994. Its primary function is to provide a defence for the MFN principle formally inserted in GATT Article I. Under GATT Article XXIV, WTO Members can give trade preferences to one another without having to extend them to the rest of the WTO membership. This can be carried out through two types of arrangement, namely, *customs unions* and *free-trade areas*.²⁷⁸ Although RTAs are supposed to be exceptions to the non-discriminatory principle, the foundation on which the GATT/WTO were built, they are becoming the rule themselves due to the current RTA proliferation.²⁷⁹

The GATT's origin lies in the US State Department's *Suggested Charter for an International Trade Organization* (ITO), released in September 1946.²⁸⁰ At the start of the negotiations that led to GATT 1947, although the United States assertively supported multilateralism and repudiated bilateral/regional trade preferences, it recognized the legitimacy of an exception for CUs for economic and political reasons.²⁸¹ On economic ground, Clair Wilcox, the then Director of the Office of International Trade Policy, the US Department of State, stated that "a customs union 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."²⁸² On political ground, CUs were seen as a necessary means to achieve European integration. Given that the unification of Western Europe was one

²⁷⁸ For general definitions of customs unions and free-trade areas, see Introduction.

²⁷⁹ See Chapter 1.

²⁸⁰ See K Chase, 'Multilateralism Compromised: the Mysterious Origins of GATT Article XXIV' (2006) 5 *World Trade Review* 1, p. 3.

²⁸¹ See JH Jackson, *World Trade and the Law of GATT* (Bobbs-Merrill, Indianapolis 1969), pp. 576-7.

²⁸² See C Wilcox, *A Charter for World Trade* (Macmillan Co., New York 1949), pp. 70-1.

of the United States' central foreign policy goals, banning such trade arrangements became inconceivable.²⁸³ Thus, from the start CUs were to be added to GATT 1947, providing an exception to the MFN obligation.

Free-trade areas, on the other hand, were not initially included in the drafting of GATT Article XXIV.²⁸⁴ In subsequent negotiations, a number of developing countries from Latin America and the Middle East had however expressed dissatisfaction with the demanding requirements imposed on CU members, particularly the need to harmonize tariffs and external trade policies.²⁸⁵ While their request for permission to form partial scope agreements was rejected, FTAs were added to GATT Article XXIV, with the support from the United States, at Havana during the first session of GATT CONTRACTING PARTIES.²⁸⁶ Drawing from archival records, Chase however illustrates that the United States' support for the inclusion of FTAs was driven by its secret trade treaty with Canada rather than by a desire to make a compromise with the developing countries.²⁸⁷ Thus, the problematic text of GATT Article XXIV is a result of many factors, encompassing economic, political, and strategic ones.

Although GATT Article XXIV provides WTO Members with the right to form an RTA with one another, it is conditional and sets out a number of requirements. If the RTA members satisfy them, they can rely on the article as a defence against GATT violations.²⁸⁸ However, the wording of GATT Article XXIV has long been subject to criticism as it is anything but clear.²⁸⁹

The validity of an RTA under GATT Article XXIV arose before a GATT panel for the first time in *EC-Citrus Products*.²⁹⁰ Although the Panel considered that

²⁸³ See M Hogan, *The Marshall Plan: America, Britain, and the Reconstruction of Western Europe, 1947-1952* (Cambridge University Press, Cambridge 1987), pp. 57-60.

²⁸⁴ See Chase, pp. 3-6.

²⁸⁵ See Mathis, pp. 37-40.

²⁸⁶ See FA Haight, 'Customs Unions and Free-Trade Areas under GATT: A Reappraisal' (1972) 6 *Journal of World Trade Law* 391, pp. 394-7.

²⁸⁷ For further discussion, see Chase, pp. 12-6.

²⁸⁸ Reversing the Panel's decision that GATT Article XXIV could be used as a defence only against GATT Article I, the Appellate Body in *Turkey-Textiles* held that "Article XXIV may, under certain conditions, justify the adoption of a measure which is inconsistent with certain other GATT provisions, and may be invoked as a possible defence to a finding of inconsistency." See WTO Appellate Body Report, *Turkey-Textiles*, WT/DS34/AB/R, adopted 19 November 1999, paras. 42-5.

²⁸⁹ For more detail on the history of GATT Article XXIV and GATT practices, see S Cho, 'Breaking the Barrier between Regionalism and Multilateralism: A New Perspective on Trade Regionalism' (2001) 42 *Harvard International Law Journal* 419, pp. 435-43.

²⁹⁰ See GATT Panel Report, *EC-Citrus Products*, L/5776, 7 February 1985, (Report not adopted).

GATT Article XXIV was within its terms of reference,²⁹¹ it was of the view that the lack of consensus among the CONTRACTING PARTIES with regard to the conformity of the RTAs in question suggested that their legal status remained open and so refrained from ruling on it.²⁹²

Since then, there have been two major developments: a legislative development was made in the form of the Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994 (the 1994 Understanding); and a judicial development was made in 1999 with *Turkey–Textiles*. Nevertheless, GATT Article XXIV remains ambiguous and needs further clarification. Given the current RTA proliferation and the increased developing countries' participation, not only should GATT Article XXIV be clarified, but due account should also be given to the challenges facing them. This chapter attempts to do so within the premises of Chapters 1, 2, and 3.

The chapter is divided into two sections. The first section presents the existing framework of GATT Article XXIV, and the second section examines the article, specifically paragraphs 4, 5, and 8, in order to determine the extent to which GATT Article XXIV addresses the challenges facing developing countries amid the current RTA proliferation and whether there are any ways to improve the provisions so that the challenges can be better addressed.

4.2 Existing Framework

The underlying rationale behind GATT Article XXIV is that RTAs are only allowed as a reward for fully-fledged liberalization, in the form of either a CU or an FTA, among the member countries.²⁹³ Thus, it is important to note at the very outset that GATT Article XXIV does not make any exception for RTAs that fall short of a fully-fledged CU or FTA beyond a certain period of time. Partial scope agreements

²⁹¹ Ibid., para. 4.5.

²⁹² Ibid., para. 4.10.

²⁹³ See S-H Park, 'Regionalism, Open Regionalism and Article XXIV GATT: Conflicts and Harmony' in F Snyder (ed) *Regional and Global Regulation of International Trade* (Hart Publishing, Oxford 2002), p. 276.

will not suffice. The main substantive provisions of GATT Article XXIV are contained in paragraphs 4-8.

It is perhaps logical to start with paragraph 4 which sets out the objectives of the formation of an RTA. It states 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* (emphasis added).²⁹⁴

Prior to *Turkey–Textiles*, it was not clear whether paragraph 4 merely set out the objectives of GATT Article XXIV and was precatory in nature, or actually imposed a separate legal obligation on RTA members.²⁹⁵ The Appellate Body in *Turkey–Textiles*, however, clarified this and held that:

Paragraph 4 contains *purposive*, and not *operative*, language. It does not set forth a separate obligation itself but, rather, sets forth the overriding and pervasive purpose for Article XXIV which is manifested in operative language in the specific obligations that are found elsewhere in Article XXIV (emphasis added).²⁹⁶

In other words, the legal requirements as expressed in the other provisions control and give effect to the objectives expressed in paragraph 4. This arguably makes paragraph 4 an interpretative anchor for the provisions contained in GATT Article XXIV.

Paragraph 5 restricts members of a CU or an FTA from raising trade barriers in relation to non-members. In the case of a CU, subparagraph 5(a) specifies that:

with respect to a custom union, or an interim agreement leading to a formation of a custom union, the duties and other regulations of commerce imposed at the institution of

²⁹⁴ GATT Article XXIV:4.

²⁹⁵ This issue was first discussed in depth during the examination of the Treaty of Rome stabilizing the European Economic Community in 1957. The EEC's representatives held that the paragraph was merely laying down a general principle that was translated into legal requirements in subsequent paragraphs. See GATT, *Analytical Index of the GATT Guide to GATT Law and Practices* (GATT, Geneva 1994), pp. 796-7. However, most of members of the Sub-Group were not prepared to accept this interpretation and argued that consistency with paragraph 4 was something to be checked separately. See GATT, 'Report Submitted by the Committee on Treaty of Rome to the Contracting Parties', L/778, 29 November 1957, Annex I, para. 3. For further discussion, see Z Hafez, 'Weak Discipline: GATT Article XXIV and the Emerging WTO Jurisprudence on RTAs' (2003) 79 North Dakota Law Review 879, pp. 890-1.

²⁹⁶ See WTO Appellate Body Report, *Turkey–Textiles*, para. 57. This is also supported by the Preamble of the 1994 Understanding which reaffirms the text of paragraph 4.

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;

In the case of an FTA, subparagraph 5(b) specifies that:

with respect to free-trade area, or an interim agreement leading to the formation of a free-trade area, the duties and other regulations of commerce maintained in each of the constituent territories and applicable at the formation of such free-trade area or the adoption of such interim agreement to the trade of contracting parties not included in such area or not parties to such agreement shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area, or interim agreement as the case may be;

Subparagraph 5(c) states that “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.”

The difference in the rule for CUs and FTAs is necessary for practical reasons. A CU by definition involves elimination of each member’s individual schedule of duties and other regulations of commerce (ORCs) and substituting them with a regime of duties and ORCs common to all CU members. Unless the members have identical tariff schedules to begin with, the harmonization of their schedules will inevitably mean that the rates for each of the CU members will go up for some products and down for others. The same logic applies to individual ORCs and their harmonization. Subparagraph 5(a) requires that the common regime resulting from this harmonization does not *on the whole* impose higher duties or more restrictive ORCs on non-members. By contrast, because the formation of an FTA by definition does not involve creating a common external regime for the members to apply to non-members, there is no process of adjusting each member’s external regime upward and downward to reach a common target. Instead, each FTA member maintains its own regime for trade with non-members, and under subparagraph 5(b) the duties and ORCs in each of these individual regimes cannot be higher or more restrictive after the formation of the FTA.

Paragraph 5 has been clarified to some extent by the 1994 Understanding. It states that the calculation to assess whether the post-formation level of duties outweighs pre-formation ones shall be based on an overall assessment of weighted average tariff rates as well as applied (as opposed to bound) tariffs.²⁹⁷ In addition, it defines the term *reasonable length of time*, with regard to subparagraph 5(c) interim agreements, as ten years and allows additional time only in exceptional cases with an obligation to provide full explanation.²⁹⁸

In order to deal with the possibility that the substitution of a regime of duties common to all CU members may cause the rates of each of the member to go up for some products and down for other products, paragraph 6 establishes the procedure which aims to compensate for adverse effects on non-members induced by any increase in bound rates of duty on the part of CU members. It reads:

[I]f, in fulfilling the requirements of subparagraph 5(a), a contracting party proposes to increase any rate of duty inconsistently with the provisions of [GATT] 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.

A failure to properly carry out this procedure and/or compensate for the adverse effects can result in an affected non-member initiating the dispute settlement procedures under GATT Articles XXII and XXIII.²⁹⁹ It should be noted that the 1994 Understanding clarifies and elaborates how paragraph 6 procedure is to be carried out by CU members.³⁰⁰

²⁹⁷ The assessment of weighted average tariff rates and of customs duties will 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 Secretariat will 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. Note that for this purpose, the duties and charges to be taken into consideration are the applied, as opposed to bound, rates. See the 1994 Understanding, para. 2.

²⁹⁸ *Ibid.*, para. 3.

²⁹⁹ For example, see GATT Panel Report, *EEC–Oilseeds*, L/6627-37S/86, adopted 25 January 1990, paras. 142-54.

³⁰⁰ See the 1994 Understanding, paras. 4 and 5. Arguably, as a result of the clarification, the procedure under paragraph 6 following the EC's enlargements of 1995 and 2004 were carried out without subsequent complaints from non-members. For the agreement under GATT Article XXIV:6 between the EC and the United States following the EC's enlargement to include Austria, Finland, and Sweden in 1995, see U.S. Trade Compliance Center, *European Union Enlargement Compensation Agreement*, 22 July 1996. A similar agreement was reached following the EC's enlargement to include Estonia, Latvia, Lithuania, Poland, Slovakia, the Czech Republic, Slovenia, Hungary, Cyprus, and Malta in

Paragraph 7 imposes notification obligations on the part of RTA members (note the changes made by the 2006 Mechanism).³⁰¹ It states:

- (a) Any contracting party deciding to enter into a customs union or free-trade area, or an interim agreement leading to the formation of such a union or area, shall promptly notify the CONTRACTING PARTIES and shall make available to them such information regarding the proposed union or area 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. 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.
- (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.

Prior to *Turkey-Textiles*, paragraph 7 was relied on by RTA members in an attempt to prevent an affected non-member from bringing a case under GATT Article XXIII—arguing that the special procedure under paragraph 7 was more appropriate and its initiation barred Article XXIII procedure.³⁰² However, by referring to paragraph 12 of the 1994 Understanding, the Panel in *Turkey-Textiles* confirmed that the WTO dispute settlement procedures can be used to challenge any matters arising from the application of the provisions of GATT Article XXIV, notwithstanding the initiation of a paragraph 7 procedure.³⁰³

2004, see Press Release, U.S. Trade Representative, United States and European Communities Reach Agreement on Enlargement Compensation Package, 30 November 2005.

³⁰¹ This will be discussed in Chapter 7.

³⁰² For example, see GATT Panel Report, *EC-Citrus Products*, paras. 3.11 and 3.19.

³⁰³ See the 1994 Understanding, para. 12 and WTO Panel Report, *Turkey-Textiles*, WT/DS34/R, adopted 19 November 1999, paras. 9.49-51.

Paragraph 8 contains provisions which define the terms *customs union* and *free-trade area* under the WTO legal framework. It reads:

For the purpose 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 [GATT] 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 in 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 [GATT] 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.

Members of a CU or an FTA are required to eliminate duties and other restrictive regulations of commerce (ORRCs) on a substantially all the trade basis among themselves. An exceptions clause in the rule provides that where necessary, members of a CU or an FTA are not required to eliminate those duties and ORRCs, which are permitted under GATT Articles XI, XII, XIII, XIV, XV, and XX. In the case of a CU or an interim agreement leading to it, members are also required to have substantially the same duties and ORCs as each other applied to their trade with non-members.

An important development made by the Appellate Body in *Turkey-Textiles* is the creation of a *two-step test* which the WTO Member relying on GATT Article XXIV as a defence against GATT violations has to pass. Having analysed the text of GATT Article XXIV, particularly the chapeau of paragraph 5, the Appellate Body held that:

First, the party claiming the benefit of this defence [Article XXIV] must demonstrate that the measure at issue is introduced upon the formation of a customs union that fully meets the requirements of subparagraphs 8(a) and 5(a) of Article XXIV. And, second, that party must demonstrate that the formation of that customs union would be prevented if it were not allowed to introduce the measure at issue.³⁰⁴

The test would presumably apply to free-trade areas *mutatis mutandis*. The first part of the test requires the member to demonstrate that its RTA is compatible with the requirements set out in paragraphs 8 and 5. While the Panel was of the view that the CRTA was a more suitable WTO body for the task,³⁰⁵ the Appellate Body discarded the Panel's view and held that panels and itself were capable of making the assessment of GATT Article XXIV compatibility, and they must do so before applying the second part of the test.³⁰⁶ It is noteworthy that both the Panel and the Appellate Body agreed that the assessment was an economic test.³⁰⁷ The second part of the test requires the member to demonstrate that the individual measure at issue is necessary for the formation of its RTA.

The two-step test was followed in a subsequent case. The Panel in *US-Line Pipe Safeguard* considered the requirements in subparagraphs 8(b) and 5(b), and found that NAFTA was in conformity with GATT Article XXIV.³⁰⁸ However, this was not upheld on a subsequent appeal. Having explained why it was redundant to look at the Panel's findings with regard to GATT Article XXIV,³⁰⁹ the Appellate Body declared them "moot" and as having "no legal effects".³¹⁰ The sequence of examination can also be drawn from the parties' arguments in *Brazil-Tyres* although in the end the Panel did not make a ruling on the compatibility of GATT Article XXIV as it exercised judicial economy.³¹¹

³⁰⁴ Ibid., para. 58.

³⁰⁵ See WTO Panel Report, *Turkey-Textiles*, para. 9.52. Note that in the end the Panel held that in order to address the claims of India, and in light of the principle of judicial economy, it was not necessary to assess the compatibility of the Turkey-EC customs union agreement itself with Article XXIV, paras. 9.52-55.

³⁰⁶ See WTO Appellate Body Report, *Turkey-Textiles*, paras. 59-60.

³⁰⁷ See Ibid., para. 55.

³⁰⁸ See WTO Panel Report, *US-Line Pipe Safeguard*, WT/DS202/R, adopted 8 March 2002, para. 7.144.

³⁰⁹ See WTO Appellate Body Report, *US-Line Pipe Safeguard*, WT/DS202/AB/R, adopted 8 March 2002, para. 198.

³¹⁰ Ibid., para. 199.

³¹¹ See WTO Panel Report, *Brazil-Tyres*, WT/DS332/R, adopted 17 December 2007, paras. 4.387-4.424. Both Brazil and the EC followed the sequence of the two-step test in order to make their cases. Brazil argued that it had satisfied subparagraphs 8(a)(i) and (ii), and subparagraph 5(a) as it was using

It can be seen that the existing framework of GATT Article XXIV does provide some basis for RTA supervision. Paragraph 4 sets out the objectives of the formation of an RTA. Paragraph 5 imposes an obligation on the part of RTA members not to raise trade barriers in relation to non-members, which I will call *third-party* obligation. Paragraphs 6 and 7 establish procedures that promote transparency and allow RTA members and non-members to deal with effects of the formation of an RTA. Finally, paragraph 8 imposes an obligation on the part of RTA members to liberalize intra-RTA trade, which I will call *intra-RTA* obligation. Despite all this, GATT Article XXIV has long been criticized by many commentators as vague and ambiguous.³¹² Although the 1994 Understanding and the judgments in *Turkey-Textiles* help clarify the provisions to some extent, there are several ambiguities that still plague GATT Article XXIV. For example, the terms *substantially all the trade* and *other restrictive regulations of commerce* have not been defined. As a result, the applications of GATT Article XXIV are not clear. The fact that very few cases on GATT Article XXIV are brought to the WTO DSM makes it difficult for panels and the Appellate Body to clarify the existing ambiguities. Even when they are, panels and the Appellate Body have managed to find a way not to make any judgment on the article.³¹³

It is perhaps unlikely that WTO Members will bring GATT Article XXIV cases to the WTO DSM in the future. With the exception of Mongolia, all WTO Members are a party to one or more RTAs.³¹⁴ There is, therefore, a conflict of interests here. While non-members would benefit if GATT Article XXIV (and the other sets of rules) were clarified and enforced strictly and rigorously, their own current and future RTAs would be at risk of violating it. In other words, the *status quo* where the provisions are unclear and their enforcement is weak is preferred by those Members whose RTAs would potentially have been WTO-incompatible otherwise. The absence of affirmative recommendation on the part of the GATT working parties and the CRTA suggests that this could be the case for most RTAs notified to the

GATT Article XXIV as a defence; while the EC argued to the contrary. For Panel's decision to exercise judicial economy, see para. 7.456.

³¹² For example, see G Curzon, *Multilateral Commercial Diplomacy: the General Agreement on Tariffs and Trade and Its Impact on National Commercial Policies and Techniques* (Michael Joseph, London 1965), p. 64, Dam, p. 275, and Bhagwati, 'Regionalism and Multilateralism: an Overview', p. 44.

³¹³ For example, see WTO Panel Report, *Brazil-Tyres*, para. 7.274 and WTO Appellate Body Report, *Brazil-Tyres*, WT/DS332/AB/R, adopted 17 December 2007, para. 256.

³¹⁴ See Chapter 1.

GATT/WTO.³¹⁵ This conflict of interests, which results in the lack of political will on the part of WTO Members (and GATT CONTRACTING PARTIES before them), has arguably played a crucial role in the failure to make substantive reforms to GATT Article XXIV.

Besides the existing ambiguities, textually the article does not distinguish between developed and developing countries contemplating to form an RTA, unlike the Enabling Clause and GATS Article V.³¹⁶ Neither does it appear to give any due account to the challenges facing by developing countries amid the current RTA proliferation, identified in Chapters 2 and 3. Thus, the following sections will examine the article, specifically paragraphs 4, 5, and 8, in order to determine the extent to which GATT Article XXIV addresses these challenges and whether there are any ways to improve the provisions so that the challenges can be better addressed.

4.3 GATT Article XXIV and the Challenges Facing Developing Countries

Recall, developing countries are confronted with a number of challenges amid the current RTA proliferation, particularly from the perspectives of a prospective RTA member and a non-member. As a prospective member, developing countries will wish to make the most out of the agreements they have decided to form. In order to do so, they have to promote the potential benefits and manage the potential costs. However, this is easier said than done. The key challenges include domestic vested interests, high implementation and adjustment costs, and their lack of analytical and negotiating capacities.³¹⁷ On the other hand, the key challenge facing non-member developing countries is the adverse effects caused by trade and investment diversion.³¹⁸ The following sections will be discussed in light of these challenges and the need to address them.

³¹⁵ This will be discussed in Chapter 7.

³¹⁶ See Chapters 5 and 6.

³¹⁷ See Chapter 2.

³¹⁸ See Chapter 3.

4.3.1 Purpose of GATT Article XXIV as Contained in Paragraph 4 and the Challenges

According to paragraph 4, the purpose of an RTA should be to facilitate trade between the member countries, and not to raise trade barriers in relation to non-members. From the texts of paragraphs 5 and 8, one could argue that the requirements set out in paragraph 8 aim to facilitate trade between the member countries while those in paragraph 5 aim to prevent trade barriers in relation to non-members from being raised, although the texts do not state so explicitly.

To what extent does paragraph 4 deal with the challenges? The first sentence of paragraph 4 states:

[T]he 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 (emphasis added).

With the phrases such as *increasing freedom of trade* and *closer integration between the economies*, this sentence seems to support the position that RTA members can and should benefit from the formation of an RTA as a result of gains from trade creation and the dynamic effects, which derive from the elimination of trade barriers between the member countries.³¹⁹ Thus, to the extent that the objective to facilitate trade between the member countries can be read to promote these gains, it can be used to guide the interpretation of the requirements set out in paragraph 8.

The objective not to raise trade barriers in relation to non-members is, on the other hand, more problematic. As discussed in Chapter 3, non-members are likely to be adversely affected as a result of trade and investment diversion, which is caused by the formation of an RTA.³²⁰ The only way that trade diversion can be totally avoided is to allow external trade barriers to adjust following the formation so that trade with non-members is fixed at the pre-formation level.³²¹ The logic is that if external trade is maintained at the pre-formation level, any additional internal trade that results from

³¹⁹ See Chapter 2.

³²⁰ See Chapter 3.

³²¹ See Kemp and Wan, 'An Elementary Proposition Concerning the Formation of Customs Unions'.

the formation must be a product of trade creation.³²² Article XXIV seeks to protect non-members by ensuring that trade barriers are not raised with respect to them. However, this falls short of dealing with trade diversion in the entirety. The objective not to raise trade barriers in relation to non-members can only be read as a *stand-still* obligation since trade can be diverted as result of preferences granted between the member countries without trade barriers in relation to non-member being raised. In addition, paragraph 4 does not suggest any adjustment of external trade barriers to maintain external trade at the pre-formation level. Thus, certain amount of trade diversion is bound to exist.

As far as investment diversion is concerned, it occurs as a result of tariff-jumping investment.³²³ This can be worsened if a *hub-and-spoke* system is formed.³²⁴ Since this type of investment is triggered purely by tariff preferences, the greater the margin of preference between members and non-members is, the worse investment diversion will be. Although the objective not to raise trade barriers in relation to non-members may ensure that the margin of preference is not widened after the formation of an RTA, it does not reduce the margin of preference which is initially created by the formation. Thus, the second objective contained in paragraph 4 appears to deal with trade and investment diversion only to a limited extent. Nevertheless, given that preferential treatment is intrinsic in how RTAs operate, the stand-still nature of paragraph 4 second objective (and the third-party obligation under paragraph 5) is arguably inevitable. Further mitigation of trade and investment diversion may have to be pursued at the multilateral level or unilaterally.³²⁵

It is important to note that there is nothing in paragraph 4 that makes any reference to developing countries. The objectives appear to apply to North-North, North-South, and South-South RTAs on an equal basis. In other words, GATT Article XXIV does not distinguish between developed and developing countries. This is contrast with paragraph 3 of GATS Article V which explicitly incorporates the special and differential treatment principle into the article.³²⁶ The absence of an explicit incorporation of such principle into GATT Article XXIV makes it more difficult to

³²² However, the practical implications of this result are not clear since external tariffs tend to be set by a combination of welfare concerns, domestic political constrains, and multilateral negotiations. See Chapter 2.

³²³ See Chapter 2.

³²⁴ See Chapter 3.

³²⁵ This will be discussed below.

³²⁶ This will be discussed in Chapter 6.

deal with the challenges since it would have provided one with a legal basis for different interpretations of the provisions. Nevertheless, the remainder of the chapter will explore whether there are certain ways that the requirements contained in paragraphs 5 and 8 can be interpreted in order to address the challenges.

4.3.2 Intra-RTA Obligation and the Challenges Facing Developing Countries from the Perspective of a Prospective Member

The intra-RTA obligation contained in paragraph 8 aims to achieve paragraph 4 first objective. Essentially, RTA members have to make sure that they liberalize trade between themselves on a *substantially all the trade* basis. Thus, the main focus of this section is the SAT requirement.

The duty half of the SAT requirement

What does the term *substantially all the trade* mean? During the GATT years, some CONTRACTING PARTIES held that the SAT requirement only contained quantitative component while others advocated for a case-by-case approach. For example, during the examination of the Treaty of Rome, the European Economic Community (EEC) took a quantitative approach and argued that 80 per cent of the total trade should qualify as substantially all the trade.³²⁷ Other members of the Working Party disagreed as they were of the view that every CU or FTA needed to be considered on its merits, and it would be improper to fix a percentage of trade which must be liberalized internally.³²⁸ Until now, WTO Members are yet to agree on the matter.

The decision in *Turkey–Textiles* has however shed some light over the SAT requirement. Both the Panel and the Appellate Body were of the view that the word *substantially* in subparagraph 8(a) had both quantitative and qualitative

³²⁷ See *supra* note 295, Annex IV, para. 30.

³²⁸ *Ibid.*, Annex IV, para. 34.

components.³²⁹ In addition, with regard to subparagraph 8(a)(ii) where the word *substantially* qualifies the word *same*, the Appellate Body held that “something closely approximating sameness” was required by subparagraph 8(a)(ii) and the standard of “comparable trade regulations” suggested by the Panel would not suffice.³³⁰ This means that the word *substantially*, at least in the context of subparagraph 8(a)(ii), implies something very close to the word that it qualifies. By analogy, in the context of subparagraphs 8(a)(i) and (b), the word *substantially* would imply something very close to the word *all*. While these judgments help clarify the meaning of the word *substantially*, it does not say exactly when the SAT requirement is satisfied.

Besides the Panel and the Appellate Body’s judgments, it is useful to look at what has been tabled by WTO Members as well. One of the most active Members in this area is Australia. It has proposed to the WTO Negotiating Group on Rules that the term *substantially all the trade* be defined as eliminating all duties on a minimum of 95 per cent of tariff lines at the six digit level of the Harmonized System (HS-6) and that RTA members would have the flexibility of a ten-year transitional period as well as the ability to exclude from commitments five per cent of tariff lines provided that at least 70 per cent of tariffs at the six digit level are eliminated on entry into force of an RTA.³³¹ This tariff-line-based approach is a quantitative approach to the SAT requirement. It aims to ensure a comprehensive coverage of all major sectors and preempt the exclusion of some sectors in which little trade takes place. However, on its own the tariff-line-based approach does not reflect the actual goods which are traded between the RTA members. This, in turn, can result in a situation where few but heavily-traded tariff lines are left out of the coverage of liberalization, which would greatly reduce the impact of the agreements.³³²

Another quantitative approach to the SAT requirement is a method based on a share of the volume of trade. Instead of relying on tariff lines, this trade-volume-based approach relies on a quantitative benchmark of a percentage of trade volume being

³²⁹ See WTO Appellate Body Report, *Turkey–Textiles*, para. 49.

³³⁰ See WTO Appellate Body Report, *Turkey–Textiles*, para. 50.

³³¹ See WTO Negotiating Group on Rules, ‘Submission on Regional Trade Agreements by Australia’, TN/RL/W/180 (13 May 2005), paras. 4-6.

³³² See Background survey by the Secretariat, ‘Coverage, Liberalization Process and Transitional Provisions in Regional Trade Agreements’, WT/REG/W/46 (5 April 2002).

traded between the RTA members.³³³ For example, 90 per cent of trade between the members must be subject to tariff elimination commitment. While this approach would reflect the reality, it does not take into account the potential trade, which does not exist and might have existed but for the tariff peaks between the member countries.

Given that both quantitative approaches have their own advantages and disadvantages, a combination of the two methods has been proposed. In its latest submission, Australia introduces the concept of *highly traded products* which should complement its tariff-line-based approach.³³⁴ Highly traded products are defined as those that represent more than 0.2 per cent of the total imports from the RTA partner, at the HS-6 level;³³⁵ or alternatively they are defined as the top 50 imports of each RTA member at the HS-6 level that are traded between the RTA partners. Tariffs on these products would have to be eliminated upon entry into force of the agreement or within ten years. The tariff-line-based approach coupled with the concept of highly traded products would arguably mitigate the situation where few but heavily-traded tariff lines are left out of the coverage of liberalization. Furthermore, in order to deal with the products which would have been traded but for the tariff peaks, Australia introduces the concept of *significant exports*. These are defined as HS-6 level products that represent for each party at least two per cent of their exports to the world. Tariffs on such significant exports would have to be subject to elimination commitment whether or not they represent a significant share of the current trade between the members.³³⁶

It can be seen that Australia's proposal goes further than the Panel and the Appellate Body's judgments in *Turkey-Textiles* by specifying the numerical benchmark at which the *duty half* of the SAT requirement is to be satisfied. The proposal seems to combine the two quantitative methods, hence their strengths, in a

³³³ This trade-volume based approach has traditionally been adopted by the EU in most of its RTAs. For more detail, see R Lang, 'Renegotiating GATT Article XXIV- a priority for African countries engaged in North-South trade agreements' (Work in Progress No33, African Trade Policy Centre, Addis Ababa 2006), p. 27.

³³⁴ See *supra* note 331, paras. 12-5.

³³⁵ Given that there are approximately 5600 HS-6 lines, each line count as roughly 0.0002 per cent of the total. The Australian proposition therefore amounts to selecting the products for which the trade is approximately 100 times superior to the simple average repartition.

³³⁶ See *supra* note 331, paras. 16-7.

qualitative fashion. This is in line with the judgment that the word *substantially* in subparagraph 8(a) has both quantitative and qualitative components.³³⁷

With regard to the timeframe for the SAT requirement, Australia has called for 70 per cent liberalization of all tariff lines upon the entry into force of RTAs. This is rather *front-loaded*.³³⁸ The remaining 25 per cent must be liberalized within ten years. To put it differently, Australia proposes to limit what RTA members can do in *staging* their liberalization commitments. Moreover, Australia argues that the practice where WTO Members provide implementation periods for tariff phase-in commitments (often longer than ten years) for those RTAs which are not notified as interim agreements under subparagraph 5(c) of GATT Article XXIV has no legal basis.³³⁹ Thus, according to its proposal only those agreements which are notified as interim agreements would be entitled to the ten-year transitional period.³⁴⁰

Having examined Australia's definition of and timeframe for the duty half of the SAT requirement, one is faced with a dilemma. On the one hand, the proposal clarifies how the SAT requirement is to be complied with and arguably gives an alternative solution to the long-standing quantitative-qualitative debate. Such improvements would significantly help the CRTA with its reviewing process, and panels and the Appellate Body with the first part of the two-step test. On the other hand, the proposal does not distinguish between developed and developing countries. Consequently, it would impose on the latter rather demanding obligations. This has been criticized as going against the latter's interests.³⁴¹

A demanding definition of and a tight timeframe for the SAT requirement means that developing-country partners have less flexibility with regard to their trade policy space. This, in turn, may limit their ability to promote the potential benefits and manage the potential costs induced by the formation of an RTA. As discussed in

³³⁷ See WTO Appellate Body Report, *Turkey-Textiles*, para. 49.

³³⁸ Front-loaded tariff liberalization progress refers to a situation where the RTA member eliminates duties on the majority of its tariff lines early on during the transitional period; whereas, back-loaded progress, on the other hand, refers to a situation where the RTA member eliminates duties on the majority of its tariff lines later on during the transitional period. It is noteworthy that the tariff liberalization process on the part of the developing-country partners tends to be back-loaded as they may need more time to adjust to the consequences of tariff elimination, e.g. loss of tariff revenue. Given the relatively higher MFN rates, revenue losses incurred by the developing-country partners are likely to be greater than those incurred by their developed-country counterparts.

³³⁹ On the general practice with regard to interim agreements under subparagraph 5(c), see L Bartels, 'Interim Agreements' under Article XXIV GATT' (2009) 8 *World Trade Review* 339.

³⁴⁰ See *supra* note 331, paras. 18-21.

³⁴¹ For example, see CMO Ochieng, 'The EU-ACP Economic Partnership Agreements and the 'Development Question': Constraints and Opportunities Posed by Article XXIV and Special and Differential Treatment Provisions of the WTO' (2007) 10 *Journal of International Economic Law* 363.

Chapter 2, developing countries are likely to need greater flexibility, particularly in North-South RTAs because they need to *unlock* the existing competitive structure in trade between themselves and their developed-country counterparts where the latter tend to export more sophisticated, high value-added manufactured products and services, and the former are limited to primary goods and relatively cheaper, labour-intensive products and services- creating large imbalances in trade gains between the two groups of countries.³⁴² Furthermore, full liberalization may also involve high implementation and adjustment costs. If developing countries are allowed to eliminate tariffs over a longer period of time and/or stage their liberalization commitments more freely, they should be able to manage these costs better. Thus, with a high threshold of 95 per cent of tariff lines and a front-loaded elimination obligation coupled with a ten-year transitional period under Australia's proposal, developing countries would find it much more difficult to manage the potential costs induced by the formation of an RTA.

However, I propose that a demanding definition of and a tight timeframe for the SAT requirement can be beneficial to developing-country partners, specifically in North-South RTAs, provided that it is accompanied by special and differential treatment for them.³⁴³ As mentioned in Chapter 2, developing countries generally tend to have less bargaining power compared to their developed-country counterparts. Consequently, a large and powerful country like Japan can protect its agriculture by abusing the currently ill-defined SAT requirement. For example, it is doubtful that in a bilateral RTA with Japan a developing-country partner would be able to force it to comprehensively liberalize its agricultural sectors. This is, in fact, what happened in the RTAs formed between Japan and the ASEAN countries.³⁴⁴ Under such circumstances, developing countries may have to make a trade-off for the inclusion of agriculture in the RTA- for example, by committing to services liberalization. Such a trade-off might not be suitable for their stage of development and result in unnecessary implementation and adjustment costs.

³⁴² See Chapter 2.

³⁴³ In line with the Panel and the Appellate Body's judgments in *Turkey-Textiles*, the word *substantially* in subparagraphs 8(a)(i) and (b) should have both quantitative and qualitative components. In addition, a high threshold of the SAT requirement with regard to the duty half coupled with a tight timeframe similar to Australia's proposal should be adopted. Given that the word *substantially* qualifies the word *all*, such an approach is arguably supported by the text. The logic is similar to how the Appellate Body interpreted the word *substantially* in the context of subparagraph 8(a)(ii). See WTO Appellate Body Report, *Turkey-Textiles*, para. 50.

³⁴⁴ See Chapter 3.

If what proposed here is accepted, developed-country partners will not be able to exclude major sectors such as agriculture from goods RTAs. For example, faced with Australia's proposal for the SAT requirement, Japan would find it more difficult not to open at least some of its protected sectors on a timely basis since it would have to eliminate 95 per cent of its tariff lines within a period of ten years, with 70 per cent of all tariff lines eliminated upon the entry into force of its RTA. Thus, if developed-country partners were already required by GATT Article XXIV to eliminate a very high proportion of their tariffs on a timely basis, they would have fewer *bargaining chips* to lure developing-country partners to make inappropriate trade-offs. This, in turn, would allow developing countries to negotiate RTAs more effectively to their advantage. In other words, the lesser the SAT requirement allows flexibility, the lesser the large and powerful partner can exploit its bargaining power. This should level the playing field for developing countries to some extent and allow them to make better deals in RTA negotiations.

Besides promoting a level playing field, the proposed high threshold and strict timeframe for the SAT requirement may deter developed countries from forming RTAs with developing countries in the first place since they would be required to open more of their sensitive sectors and could gain less from the trade-offs. This is arguably desirable since if an RTA is to be formed between developed and developing countries, the latter should not be exploited due to its lack of analytical and negotiating capacities. Under the proposal, North-South RTAs which were concluded would be more mutually beneficial and allow developing-country partners to use RTAs as a positive means to achieve their policy objectives. Furthermore, the more stringent SAT requirement may also reduce enthusiasm on the part of prospective RTA members and slow down the rate at which RTAs proliferate- bringing attention back to multilateral trade negotiations.

Despite the proposed demanding definition of and timeframe for the SAT requirement, flexibility can nevertheless be provided for developing countries if the special and differential treatment principle is incorporated into GATT Article XXIV. The ACP countries have put forward a number of ways in which this can be achieved. It is proposed that for the duty half of the SAT requirement, favourable methodology and/or lower threshold levels in the measurement of trade and product coverage

should be applicable for developing-country partners.³⁴⁵ For example, under Australia's proposal, developing-country partners would be allowed to eliminate less than 95 per cent of their tariff lines; and/or they may be exempt from the applications of highly traded products and significant export. With regard to the timeframe for the SAT requirement, the ACP countries propose that the maximum length of the transitional period permissible should not be less than 18 years.³⁴⁶

The incorporation of the special and differential treatment principle may arguably have a basis under the Preamble of the Marrakesh Agreement where it is recognized that "there is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in growth in international trade commensurate with the needs of their economic development."³⁴⁷ Alternatively, the special and differential treatment principle could be incorporated into GATT Article XXIV on the basis of Part IV of GATT 1947.³⁴⁸ It is true that the Panel in *EEC–Bananas II* rejected the EEC's claim that GATT Article XXIV read in light of Part IV of GATT 1947 could be used as a defence against a violation of GATT Article I because the Lomé Convention did not constitute an FTA under GATT Article XXIV:8(b). However, it did not rule out the possibility that GATT Article XXIV could be *interpreted* in light of Part IV of GATT 1947.³⁴⁹ For example, an interpretation of the SAT requirement that allows some sort of *semi-reciprocity* between developed and developing-country partners should give the latter the flexibility to promote the potential benefits and manage the potential costs induced by the formation of an RTA.

Although the ACP submission is to be welcomed and it may be possible to use the special and differential treatment principle to afford some flexibility for developing countries, it is very important to have some limits. This is because too much flexibility on the part of developing-country partners may have unintended and undesirable consequences. For example, if a developing-country partner is subject to a

³⁴⁵ See WTO Negotiating Group on Rules, 'Submission on Regional Trade Agreements by the ACP Group of States', TN/RL/W/155 (28 April 2004), para. 11.

³⁴⁶ It is noteworthy that the incorporation of the special and differential treatment principle proposed by the ACP countries is to apply to all developing-country Members alike. In other words, the report does not propose a *country-specific* approach to the special and differential treatment principle. See *Ibid.*

³⁴⁷ See the Marrakesh Agreement, Preamble.

³⁴⁸ See GATT Article XXXVI:8, which states that "[T]he developed contracting parties do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less-developed contracting parties."

³⁴⁹ See GATT Panel Report, *EEC–Bananas II*, DS38/R, 11 February 1994 (Report not adopted), paras. 159-62.

very low threshold of the SAT requirement and a very long transitional period, it may lose sight of its initial goals (e.g. to liberalize trade in order to benefit from efficiency and competitive gains) as governments and circumstances change over time.

Another important undesirable consequence is that if a developing-country partner is allowed too much discretion to pick and choose which products or industries to protect, domestic vested interests may be able to lobby the government to exclude those that would result in trade-creating effects. As discussed in Chapter 2, RTAs are likely to be politically viable exactly when they are trade-diverting, and hence welfare-reducing.³⁵⁰ In addition, non-member developing countries can be adversely affected as a result of trade diversion induced by such agreements. Thus, too much flexibility can undermine the commitments made by developing-country partners, which can harm both themselves and non-member developing countries. Furthermore, excess flexibility may have implications on the predictability of how a developing-country partner liberalizes the intra-RTA trade. With a wide discretion, it would be very difficult for non-members to predict how much and when the developing-country partner would liberalize its intra-RTA trade. On the other hand, if the SAT requirement, as incorporated with special and differential treatment, is still kept sufficiently demanding, non-members would know what to expect and could respond accordingly. Therefore, I believe that the flexibility afforded for developing countries must be provided within certain limits.

Given the high stake and conflict of interests involved in the reform of GATT Article XXIV, it is hard to contemplate that any extreme proposals will be accepted by WTO Members. If any substantive changes were to be made, there must be a compromise. It is noteworthy that Australia and the EU are willing to discuss how the special and differential treatment principle can be incorporated into GATT Article XXIV.³⁵¹ I propose that the special and differential treatment should be in the form of a lower threshold level in the measurement of trade and product coverage, as opposed to different methodology. This way, it would be simpler and would not require WTO Members to agree on two separate methodologies. In addition, if future research and experience warrants, the threshold levels (both for developed and developing

³⁵⁰ See Grossman and Helpman, and Krishna, 'Regionalism and Multilateralism: A Political Economy Approach'.

³⁵¹ See *supra* note 331, para. 22, and WTO Negotiating Group on Rules, 'Submission on Regional Trade Agreements by the European Community', TN/RL/W/179 (12 May 2005), para. 16(a), respectively.

countries) can be adjusted so that trade creation is maximized and at the same time developing-country partners are granted sufficient flexibility. As trade diversion is discouraged, non-member developing countries should benefit as well.

The way in which the SAT requirement is calculated can be used as a means to incorporate the special and differential treatment principle into GATT Article XXIV. One can define the SAT requirement as an inclusion of certain percentage of the *combined* tariff lines of the RTA members. The tariff-line-based approach can be calculated in *aggregation* rather than in *separation* with the assumption that the developed-country partner will take on greater responsibility and liberalize more. For example, if the average threshold is set at 90 per cent of the combined tariff lines, in a bilateral North-South RTA the developed-country partner can eliminate 100 per cent of its tariff lines and the developing-country partner 80 per cent- together an average of 90 per cent of tariff lines between the members is eliminated. This way, GATT Article XXIV will still result in some sort of a *semi-reciprocal* relationship between developed and developing countries in North-South RTAs. Alternatively, the tariff-line-based approach can be calculated in separation with a lower threshold for the developing-country partner, *e.g.* 90 per cent of its tariff lines as compared to 95 per cent for the developed-country partner, for example.

It should be noted that the aggregation approach would allow the RTA members to negotiate mutually acceptable thresholds for the SAT requirement for themselves as long as the required average is met; whereas, the separation approach would specify (by the WTO) *a priori* the thresholds the members have to meet. In my view, the separation approach is more preferable than the aggregation approach since developing countries may be forced to accept a higher threshold in the latter approach, given their limited negotiating capacity. In other words, the aggregation approach *permits* special and differential treatment for developing countries, but it does not require it. One would have to rely on peer review (through the CRTA's reviewing mechanism) and *self-imposed* responsibility on the part of the developed-country partner. The separation approach, on the other hand, *guarantees* special and differential treatment for developing countries. However, it is acknowledged that for WTO Members to agree on one threshold level for the SAT requirement is likely to be very difficult already let alone two.

In line with the idea of staging liberalization, the transitional period for developing countries may be divided into stages. For example, upon entry into force

of a North-South RTA, the developing-country partner would have to eliminate 40 per cent of its tariff lines; another 30 per cent would have to be eliminated within ten years; and further 20 per cent would have to be eliminated within 15 years. Such staged and back-loaded liberalization commitments would allow the developing country to manage implementation and adjustment costs induced by the formation and at the same time force it to carry out the commitments on a timely basis rather than leave everything to the end of the transitional period. As for the developed-country partner, it can be subject to Australia's proposal, for example. Thus, from this illustration, the developing-country partner is committed to eliminate duties on 90 per cent of its tariff lines in three stages over a period of 15 years, and the developed-country partner 95 per cent in two stages over a period of ten years (the SAT requirement is calculated in separation in this example). In addition, since the percentages of tariff lines and the time in which they are subject to liberalization commitments are set out, non-members would be better informed and able to react or deal with possible adverse effects induced by the formation of an RTA.

It is also argued that something similar to the concepts of highly traded products and significant exports should be adopted in order to compliment the tariff-line-based approach so as to mitigate its defects. Such concepts should apply to all WTO Members on an equal basis to ensure that RTA members are encouraged to liberalize intra-RTA trade. The application of the concept of highly traded products would reinforce the existing trade between RTA members. This is in line with the theory of natural trading partners, discussed in Chapter 2.³⁵² The concept of significant exports, on the other hand, would ensure that major exports of each member country are included in the agreement. If a country is a major exporter of certain products to the rest of the world, it is likely that the country has comparative advantage in these products, *i.e.* producing them most cheaply. Thus, the inclusion of such products in the RTA would be more likely to promote trade creation in the preferential area.

From the proposal put forward, the transitional period for developing-country partners would be available only if they notify their RTAs as interim agreements (*i.e.* similar to Australia's submission). The length of the transitional period for developing-country partners by default falls within exceptional cases and could be set

³⁵² See Chapter 2.

at 15 years, for example. This would only be available to developing countries.³⁵³ Such a moderately strict timeframe and the obligation to provide plan and schedule would encourage developing countries to set out targets and take their commitments more seriously. In addition, availability of plan and schedule would increase transparency, which in turn would benefit non-members as well.

It is important to note that the figures in the previous paragraphs (in relation to the threshold levels, stages of liberalization, and transitional periods) are chosen for illustrative purposes only. Research should be conducted in order to set out the exact and optimal numerical benchmarks and transitional periods (including different stages of liberalization) for the duty half of the SAT requirement.

The proposed approach to the duty half of the SAT requirement is not far from reality. Scollay finds that if the transitional period is ten years and if the SAT requirement is defined as an inclusion of 95 per cent of the combined tariff lines of the partners, three out of 14 RTAs³⁵⁴ reviewed fail to meet this definition.³⁵⁵ If this definition is applied to each member on an individual basis, the three RTAs still fail to meet this definition. Given the same ten-year transitional period, if the SAT requirement is instead defined as an inclusion of 90 per cent of the combined tariff lines of the partners, only one RTA fails to meet this definition; whereas, if it is defined as 90 per cent of the tariff lines of each RTA member on an individual basis, only two RTAs do not comply with the definition.³⁵⁶ However, if the transitional period is allowed to exceed ten years, all agreements comply with the definition. In addition, if the SAT requirement takes the trade-volume-based approach and the transitional period exceeds ten years, Scollay finds that there are very few cases where excluded products account for more than ten per cent of the trade between the partners.³⁵⁷ Thus, the proposal is pragmatic in the sense that to a large extent it reflects what already occurs in practice. This reflection would ease the tension on the

³⁵³ This way, developed-country partners would have to commitment themselves to genuine liberalization process. Similar position is also proposed by China. See WTO Negotiating Group on Rules, 'Submission on Regional Trade Agreements by China', TN/RL/W/185 (22 July 2005), para. 11.

³⁵⁴ The RTAs are: US-Chile, US-Jordan, US-Australia, US-Singapore, Singapore-Japan, Singapore-Australia, Singapore-New Zealand, Thailand-Australia, Thailand-New Zealand, Korea-Chile, Canada-Costa Rica, Canada-Chile, Mexico-Chile, EU-Chile, EU-South Africa, EU-Morocco, EU-Czech Republic, and EU-Lithuania.

³⁵⁵ See R Scollay, "'Substantially All Trade": Which Definitions Are Fulfilled in Practice? An Empirical Investigation' (APEC Study Centre, Melbourne 2005), pp. 11-3.

³⁵⁶ Ibid.

³⁵⁷ Ibid., pp.14-6. The WTO meanwhile observed that FTA coverage rarely falls below 50 per cent, was higher than 75 per cent but with most notified under GATT Article XXIV having over an estimated 85 per cent coverage. See *supra* note 332.

debate whether the result from the Doha Round negotiations would apply retroactively to existing RTAs.

The proposals made so far are arguably in line with the first objective set out in paragraph 4, *i.e.* to facilitate trade between the member countries. The demanding definition of and tight timeframe for the SAT requirement would ensure that sufficient trade between the member countries are liberalized on a timely basis. The high threshold levels would leave less room for domestic vested interests to influence the governments and ensure that products and industries, which would result in trade-creating effects, are subject to liberalization commitments. Furthermore, the proposed differences in the threshold and timeframe for developed and developing countries would level the playing field between them as the former have less room to manoeuvre.

On the other hand, some flexibility can be given to developing countries through the incorporation of the special and differential treatment principle into GATT Article XXIV. The proposed different applications of the SAT requirement to developed and developing countries in terms of the percentage of liberalized tariff lines, staging of liberalization commitments, and transitional periods, would ensure that the former cannot exclude certain products or industries, *e.g.* agriculture, from liberalization commitments and have to carry them out on a timely basis. This, in turn, should allow the latter to negotiate the agreement more effectively and afford them the flexibility needed to promote the potential benefits and manage the potential costs induced by the formation of an RTA.

The proposed special and differential treatment would be generalized and available to all developing countries alike. However, given the heterogeneity of developing countries, a more *country-specific* approach to the proposals could be developed in order not to afford flexibility for those which do not need it. One way to do this is to further divide developing-country WTO Members into subgroups.³⁵⁸

For example, in a proposal for a new approach to special and differential treatment in the agricultural negotiations by the International Food and Agricultural

³⁵⁸ On general discussion of the special and differential treatment principle and a need to clarify it, see BM Hoekman, C Michalopoulos and A Winters, 'More Favourable and Differential Treatment of Developing Countries: Toward a New Approach in the World Trade Organization' (Policy Research Working Paper No3107, World Bank, Washington, DC 2003).

Trade Policy Council (the IPC proposal) for the Doha Round,³⁵⁹ developing-country Members were to be divided into three categories: the LDCs, comprising of the countries with per capita incomes below \$900, weak human resources and vulnerable economies;³⁶⁰ the lower middle income developing countries, including countries with gross national income per capita³⁶¹ between \$901 and \$3,035; and the upper middle income developing countries, including those countries with GNI per capita between \$3,035 and \$9,385. Such a criterion is also used by the World Bank as the criterion to classify countries for operational and analytical purposes.³⁶² Consequently, the threshold of and timeframe for the SAT requirement could be adjusted accordingly—that is a higher threshold and a tighter timeframe for the UMIDCs and more lenient requirements for the LMIDCs and LDCs. Under this method, any *self-proclaimed* developing countries that have higher GNI per capita than \$9,385 would not be eligible to the special and differential treatment.³⁶³ Not only would such differentiation offer a more nuanced approach to special and differential treatment for developing countries in the case of North-South RTAs, it would also make it fairer in the case of South-South RTAs notified under GATT Article XXIV where the member developing countries are different in terms of size, income and stage of development.

It should be noted that the thesis does not suggest that the IPC proposal is the best way to categorize developing countries. Better and more sophisticated methods or criteria might exist or could be further developed.³⁶⁴ Nevertheless, given that a country's analytical and negotiating capacities are generally related in an approximate fashion to its size and level of economic development, GNI per capita is arguably a good criterion. In addition, the IPC proposal also suggests that "countries should also be able to petition for classification into the next lower income category if their per

³⁵⁹ See International Food and Agricultural Trade Policy Council, 'An IPC Position Paper; A New Approach to Special and Differential Treatment' (International Food and Agricultural Trade Policy Council, Washington, DC 2004), available at <http://www.agritrade.org/Publications/Position%20Papers/13%20SND.pdf> (last accessed 16 July 2010).

³⁶⁰ Note that in the IPC proposal, the LDCs defined include more countries than those under the UN definition of LDCs. See *Ibid.* and <http://www.unctad.org/templates/Page.asp?intItemID=3641&lang=1> (last accessed 16 July 2010).

³⁶¹ GNI per capita is the dollar value of a country's final income in a year divided by its population. It reflects the average income of a country's citizens.

³⁶² See <http://data.worldbank.org/about/country-classifications> (last accessed 16 November 2010).

³⁶³ For example, Singapore whose GNI per capita in 2009 is \$35,294 would not be eligible. See <http://www.singstat.gov.sg/stats/themes/economy/hist/gnp.html> (last accessed 17 July 2010).

³⁶⁴ For further discussion, see Cui.

capita income does not reflect their unique vulnerabilities.”³⁶⁵ Something similar could be adopted here. For example, the empirical work conducted by the Trade Policy Review Mechanism (TPRM) could be used as a basis for such petition or even for the differentiation of the three subgroups in the first place.

Given that circumstances and conditions change over time, a review mechanism for graduation is also important to move developing countries up (or down) the subgroups. For example, an LMIDC must graduate to a UMIDC once its GNI per capita improves, and hence subject to more demanding requirements.

Despite its benefits, how realistic is this sharper differentiation of developing countries? On the one hand, a more nuanced approach to special and differential treatment is likely to be welcome by developed-country WTO Members as advanced developing countries like the Republic of Korea, Singapore, and Taiwan, or big developing countries like Brazil, China, and India can arguably compete with them on a more equal footing. On the other hand, these countries may oppose to such differentiation as they would be subject to more demanding requirements. Given the conflict of interests and the resulting lack of political will on the part of WTO Members, any attempt to incorporate the special and differential treatment principle into GATT Article XXIV is not going to be easy. It may well be the case that a generalized approach to special and differential treatment is a first and necessary step before a more comprehensive country-specific special and differential treatment regime can be further developed.

The ORRC half of the SAT requirement

In the previous section, the discussion is on the duty half of the SAT requirement. Paragraph 8, however, requires RTA members to eliminate *other restrictive regulations of commerce* on a *substantially all the trade* basis as well. To apply the SAT requirement, one has to know what the term *ORRCs* means.

³⁶⁵ According to the IPC proposal, “unique vulnerabilities” could be judged by the proportion of population undernourished according to the Food and Agriculture Organization (FAO), or if the country is a single commodity exporter. See International Food and Agricultural Trade Policy Council, p. 3.

Unfortunately, its meaning has yet to be agreed by WTO Members.³⁶⁶ Neither did the Panel and the Appellate Body in *Turkey-Textiles* take the opportunity to clarify it. Although the exact meaning of the term *ORRCs* is still unsolved, it must arguably refer to a sub-group of NTBs between RTA members. Or to put it in the terms of paragraph 4 first objective, RTA members are required to eliminate *certain* non-tariff barriers (*i.e.* ORRCs) between themselves on a *substantially all the trade* basis in order to *facilitate* intra-RTA trade.

As an integral part of the SAT requirement, the definition of the term *ORRCs* is crucial to how the requirement operates. If a wide definition were adopted, developing-country partners would be required to eliminate a large number of non-tariff barriers falling within the definition on a *substantially all the trade* basis. On the one hand, this would reduce their trade policy space, which in turn might restrict what they could do to promote the potential benefits and manage the potential costs induced by the formation of an RTA. For example, subsidies can be used by developing-country partners to mitigate the effects of increased competitions from their RTA partners. On the other hand, such elimination would ensure that trade between the members were liberalized as much as possible. This, in principle, would enhance the static and dynamic gains induced by the formation.³⁶⁷ Thus, a desirable situation is where the term is defined in such a way that maximizes the gains induced by the formation and at the same time does not impose so burdensome an obligation that developing countries cannot meet and/or do not have the flexibility they need. Is this possible?

As discussed in Chapter 2, effects of non-tariff barriers and their removals are much less visible compared to those of tariffs. The literature, in fact, primarily focuses on the latter.³⁶⁸ Furthermore, by definition NTBs can cover any trade measures other than tariffs. Thus, even though the term *ORRCs* may refer to a sub-group of NTBs, it is still extremely difficult to define it precisely. Given that the proposals made in the WTO Negotiating Group on Rules only deal with the duty half of the SAT

³⁶⁶ For the drafting history of GATT Article XXIV and the 1994 Understanding in connection with ORRCs and ORCs, see Background Note by the Secretariat, 'Systemic Issues Related to 'Other Regulations of Commerce'', WT/REG/W/17/Rev.1 (5 February 1998). For a useful review of the approach taken to these terms by working parties during the GATT years, see Background Note by the Secretariat, 'Systemic Issues Related to 'Other Regulations of Commerce'', WT/REG/W/17/Add.1 (5 November 1997).

³⁶⁷ See Chapter 2.

³⁶⁸ *Ibid.*

requirement, one is left with the impression that WTO Members find this to be the case as well.³⁶⁹ In addition, some non-tariff measures such as measures failing under GATT Article XX do have legitimate social objectives other than to restrict trade between the member countries. Consequently, it would be unreasonable to require RTA members to eliminate them. This is arguably why the exceptions list was inserted to subparagraphs 8(a)(i) and (b) in the first place.

There is also disagreement whether the list is exhaustive or not.³⁷⁰ This adds complication to the ORRC half of the SAT requirement. Thus, in order to make the SAT requirement workable, I argue that it would make more sense to separate the ORRC half from the duty half for the application of the SAT requirement. In other words, RTA members would be subject to the demanding definition of and tight timeframe for the duty half of the SAT requirement, albeit the proposed special and differential treatment available for developing countries, while the ORRC half would be enforced separately with less rigour. The concern with this proposal is whether intra-RTA trade would be sufficiently *facilitated* in accordance with paragraph 4 first objective.

As discussed earlier, paragraph 4 first objective encourages RTA members to eliminate trade barriers- be they tariff or non-tariff- between themselves so that they benefit from the static and dynamic gains induced by the formation of an RTA. However, the effects of their removals on these gains may not be the same in light of other WTO commitments.

The starting point is that tariffs are imposed on imported foreign products but not domestically produced ones. As a result, tariffs distort trade since they artificially increase the prices of imports, and hence reducing access to the domestic market. According to GATT Article I, WTO Members are however required not to discriminate between these foreign products, *i.e.* the MFN obligation. In other words, WTO Members are allowed to discriminate (through tariffs) between foreign and domestic products, but not between foreign products. The formation of an RTA, on

³⁶⁹ For example, see the proposals made by Australia, *supra* note 332, and the ACP group of States, *supra* note 345.

³⁷⁰ For detailed discussion on the exceptions list, see R Hudec and J Southwick, 'Regionalism and WTO Rules: Problems in the Fine Art of Discrimination Fairly' in M Rodríguez Mendoza and P Low (eds), *Trade Rules in the Making: Challenges in Regional and Multilateral Negotiations* (Brookings Institution Press, Washington, DC 1999), pp. 63-72. On whether GATT Article XIX and the Safeguards Agreement fall within the exceptions list, see J Pauwelyn, 'The Puzzle of WTO Safeguards and Regional Trade Agreements' (2004) 7 *Journal of International Economic Law* 109.

the other hand, requires the member countries not to discriminate between products imported from the partner country and domestic ones. Consequently, when RTA members eliminate tariffs between themselves (on a *substantially all the trade* basis or entirely), they remove the distortion from which the static and dynamic gains derive.³⁷¹

By contrast, as far as NTBs are concerned, WTO Members are also required not to discriminate between foreign and domestic *like* products. For examples, internal taxation and regulation are subject to the national treatment obligation contained in GATT Article III; and NTBs concerning sanitary and phytosanitary (SPS) and technical barriers to trade (TBT) measures are subject to similar non-discriminatory obligations as well.³⁷² In light of these commitments, the existing distortion (between foreign and domestic products) caused by NTBs is arguably mitigated. On this basis, the potential gains from the formation of an RTA would principally derive from tariff elimination. Thus, the strict enforcement of the duty half of the SAT requirement should be sufficient to achieve paragraph 4 first objective.

This is not to say that the elimination of ORRCs on a *substantially all the trade* basis would not result in the static and dynamic gains. It is simply argued that given the difficulties involved in defining the term *ORRCs* and the smaller margin of preference between foreign and domestic products created by them in light of other WTO commitments, WTO Members should make more efforts to agree on the duty half and make the SAT requirement workable by separating the two. In addition, without a clear definition of the term *ORRCs*, special and differential treatment for developing countries would only be in the form of a longer transitional period and not a lower threshold of the SAT requirement, unlike the duty half. Here, a numerical benchmark is much trickier to establish, if at all possible. One would be required to identify all the *ORRCs* existing prior to the formation of an RTA and then determine whether a *substantial* number of them have been eliminated by the end of the

³⁷¹ It should be noted that the extent of the gains also depends on other factors, for example the magnitudes of trade-creating and trade diverting effects. See Chapter 2.

³⁷² See the SPS Agreement, Article 2.3: "Members shall ensure that their sanitary and phytosanitary measures do not arbitrarily or unjustifiably discriminate between Members where identical or similar conditions prevail, including between their own territory and that of other Members. Sanitary and phytosanitary measures shall not be applied in a manner which would constitute a disguised restriction on international trade." See also the TBT Agreement, Article 2.1: "Members shall ensure that in respect of technical regulations, products imported from the territory of any Member shall be accorded treatment no less favourable than that accorded to like products of national origin and to like products originating in any other country."

transitional period. In order to do this, one would need to know what the term *ORRCs* actually encompasses. Furthermore, given that each ORRC may have different impact on trade between the member countries, it may make no sense to establish such a numerical benchmark in the first place. The fact that there are fewer prospects for special and differential treatment coupled with the difficulties involved in defining the term *ORRCs* means that a precise substantive requirement is more problematic here (than the duty half) and lax enforcement is arguably more pragmatic.

Nevertheless, further clarification to the definition of the term *ORRCs* and its application to the SAT requirement would be welcome. One could start with exploring whether there are any non-tariff measures which discriminate between foreign and domestic products and are not captured by the national treatment obligation and the likes, for example tariff quotas. If there are, they should be covered by the term *ORRCs* and RTA members should be required to eliminate them on a *substantially all the trade* basis. This would contribute to the achievement of paragraph 4 first objective. In any case, special and differential treatment in the form of longer transitional periods should be adopted for developing countries similar to what proposed for the duty half of the SAT requirement.

4.3.3 *Third-party Obligation and the Challenge of Trade and Investment Diversion*

The third-party obligation contained in paragraph 5 aims to achieve paragraph 4 second objective. Essentially, RTA members have to make sure that the post-formation *duties* and *other regulations of commerce* in relation to non-members are not higher or more restrictive than before the formation.³⁷³ This is in line with the stand-still nature of paragraph 4 second objective.

Given that the 1994 Understanding deals with the duty aspect of the obligation, the difficulty lies in the term *ORCs*.³⁷⁴ The term appears in both paragraphs 5 and 8. Under subparagraph 8(a)(ii), it is an integral part of the requirement that CU members have to harmonize their tariff and non-tariff measures

³⁷³ Note the difference between obligation for CU and FTA members discussed earlier.

³⁷⁴ See the 1994 Understanding, para. 2.

applied to their trade with non-members. The term *ORCs* under paragraph 5, on the other hand, is an integral part of the third-party obligation.

The Panel in *Turkey–Textiles* interpreted the term *ORCs* in the context of paragraph 5 quite broadly to include “any regulation having an impact on trade (such as measures in the fields covered by WTO rules, for example SPS, customs valuation, anti-dumping, TBT; as well as any other trade-related domestic regulation, for example environmental standards, export credit schemes).”³⁷⁵ However, CU members are required to have substantially the same *ORCs*. As mentioned earlier, the Appellate Body in *Turkey–Textiles* interpreted this requirement rather strictly.³⁷⁶ The broad interpretation of the term *ORCs* and the strict interpretation of the term *substantially the same*, would impose a heavy burden on developing-country CU members.

So, one is left with an overwhelming sense that the Panel’s definition of *ORCs* must either be limited to paragraph 5 considerations, or since the identical term is used in both paragraphs 5 and 8, that the definition is simply overstated as it would define *ORCs* generally.³⁷⁷ Given that the requirements contained in paragraph 5 aim to prevent trade barriers in relation to non-members from being raised while those in paragraph 8 aim to facilitate trade between RTA members (*i.e.* paragraph 4 objectives), I propose that the term *ORCs* should have different meanings under the two paragraphs.³⁷⁸

In order not to impose an impossible burden on developing-country CU members, the term *ORCs* under subparagraph 8(a)(ii) should be defined narrowly. As for paragraph 5, the broad definition of *ORCs* held by the Panel in *Turkey–Textiles* can be adopted. This would widen the scope of non-tariff barriers/measures that must not become more restrictive after the formation of an RTA. As a result, RTA members would have to be more careful during the negotiating and implementing

³⁷⁵ See Panel Report, *Turkey–Textiles*, para. 9.120.

³⁷⁶ See WTO Appellate Body Report, *Turkey–Textiles*, para. 50.

³⁷⁷ See Mathis, pp. 251-2.

³⁷⁸ This approach is in line with what the Appellate Body in *Japan–Alcohol* suggested for the term like products contained in subparagraphs 2 and 4 of GATT Article III. It held that “[T]he concept of “likeness” is a relative one that evokes the image of an accordion. The accordion of “likeness” stretches and squeeze in different places as different provisions of the *WTO Agreement* are applied. The width of the accordion in any of those places must be determined by the particular provision in which the term “like” is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply.” See WTO Appellate Body Report, *Japan–Alcohol*, WT/DS8,10,11/AB/R, adopted 4 October 1996, p. 21. See also R Hudec, “Like Product”: The Differences in Meaning in GATT Articles I and III’ in T Cottier, PC Mavroidis and P Blatter (eds), *Regulatory Barriers and the Principle of Non-discrimination in World Trade Law* (University of Michigan Press, Ann Arbor 2000), pp. 101-23.

stages in order not to violate this requirement. The broad definition would offer non-member developing countries greater protection.

Nevertheless, as discussed in the context of paragraph 4, it is important to note that the third-party obligation only deals with trade and investment diversion to a limited extent due to its stand-still nature. Any further mitigation of trade and investment diversion will have to be achieved at the multilateral level or unilaterally. For example, if WTO Members decide to cut their MFN tariff rates further, the margin of preference between RTA members and non-members will be less. This will automatically reduce trade and investment diversion. Alternatively, Srinivasan has proposed at the 1999 WTO high-level symposium on trade and development that a *sunset clause* be introduced to RTAs whereby preferences available to the member countries would be extended to all WTO Members after a certain period of time.³⁷⁹ Although such a clause would significantly protect non-members' interests, the proposal is likely to be strongly opposed by RTA members. In addition, it would make RTA negotiations much more complex as prospective members would have to contemplate the effects of multilateralizing RTA preferences at the end of the sunset period. Thus, multilateral/unilateral trade liberalization seems to be the most viable option to further mitigate the adverse effects of trade and investment diversion.

Given that non-tariff barriers/measures change over time, it is arguably very difficult to have a one-off examination conducted by the CRTA that would offer non-members perpetual protection from the adverse effects of ORCs being more restrictive after the formation of an RTA.³⁸⁰ It may well be the case that an affected non-member would have to resort to the DSM in order to protect its interests on a case-by-case basis. The broad definition of ORCs under paragraph 5 would widen the basis of a legal claim in the DSM. It is noteworthy that subparagraphs 5(a) and (b) do not specify a timeframe for the requirements therein. This supports the idea of perpetual protection for non-members through the DSM and stresses the problem with a one-off examination under the CRTA.

Another limitation of the third-party obligation is that it is not clear whether rules of origin fall within the definition of the term *ORCs*. As discussed in Chapter 2,

³⁷⁹ See World Trade Organization, *The Report of the WTO high-level symposium on trade and development* (1999), available at http://www.wto.org/english/tratop_e/devel_e/summhl_e.htm (last accessed 23 July 2010). Currently, the life of an RTA is permanent until the member countries decide to dissolve it, and Article XXIV does not impose any time limit on exclusive RTA preferences.

³⁸⁰ The mechanisms of the CRTA and DSM will be discussed in Chapter 7.

such rules are necessary in FTAs as they prevent trade deflection. Essentially, rules of origin imply constraints on firms as to from where they can source their intermediate inputs. By restricting firms' choices on sourcing of intermediates, rules of origin can be used as protectionist devices to extend protection from high-tariff members of an FTA to low-tariff members.³⁸¹ This would lessen trade-creating effects and worsen trade-diverting effects. Furthermore, extremely detailed rules of origin can also generate cumbersome paperwork for exporters that becomes increasingly costly as multiple agreements are signed, each with unique rules at the product level.³⁸² Thus, if the term *ORCs* covered rules of origin, RTA members would be required to ensure that they are not more restrictive after the formation of an RTA.

However, there is disagreement among WTO Members on whether rules of origin can be classified within the meaning of *ORCs*. For example, the United States has argued that rules of origin in an FTA merely deal with intra-RTA trade and determine the eligibility for the preferences granted by it, and in this sense they do not fall within the meaning of *ORCs* in terms of external trade of the FTA.³⁸³ By contrast, the Republic of Korea was of the view that in order to benefit from preferential treatment provided under an FTA, companies within it will naturally tend to increase local sourcing, which is bound to be injurious to the suppliers of non-members irrespective of their efficiency.³⁸⁴

Given the effects of rules of origin on trade and the broad definition of the term *ORCs* held by the Panel in *Turkey-Textiles*, *i.e.* "any regulation having an impact on trade", one could argue that they should be captured by the term *ORCs*. Doing so would offer non-members further protection from trade diversion.

Unfortunately, the term *corresponding* in subparagraph 5(b) seems to presuppose that *ORCs* must exist at the pre-formation stage. Prior to the formation of

³⁸¹ The rules of origin of the US-Canada FTA and NAFTA for ketchup demonstrate the effect that overly restrictive rules of origin can have. Under the applicable CUSFTA rule of origin, ketchup made in the United States or Canada from tomato paste imported from non-members (*e.g.* Chile) was considered of CUSFTA origin and therefore enjoyed the CUSFTA preferential tariff. After NAFTA rules of origin replaced those of CUSFTA, only ketchup made from tomato paste from a NAFTA country could receive the NAFTA preferential tariff. As a result, after the creation of NAFTA Chile ceased being the leading exporter of tomato paste to the United States and was overtaken by Mexico. See Annex 401, NAFTA, available at www.nafta-sec-alena.org (last accessed 27 July 2010). See also D Palmetier, *The WTO as a Legal System: Essays on International Trade Law and Policy* (Cameron May, London 2003), pp. 142-3.

³⁸² See Chapter 2.

³⁸³ See Committee on Regional Trade Agreements, 'Note on the Meetings of 27 November and 4-5 December 1997', WT/REG/M/15 (13 January 1998), para. 59.

³⁸⁴ See Committee on Regional Trade Agreements, 'Note on the Meetings of 6-7 and 10 July 1998', WT/REG/M/18 (22 July 1998), para. 23.

an FTA, a common regime of rules of origin between the member countries may or may not exist. For example, if an existing FTA is enlarged to another, more expansive FTA (such as the transformation of the Canada-US FTA (CUSFTA) into NAFTA), the comparison is between the common rules of origin at the time of CUSFTA and that of NAFTA. However, there is no common rule of origin in the case of the formation of a new FTA. As can be seen from Chapter 1, countries tend to form new (bilateral) FTAs rather than expand existing ones. Thus, there are more cases where a common regime of rules of origin between the member countries does not exist prior to the formation of an FTA. Thus, due to the wording of paragraph 5, an attempt to regulate rules of origin through the term *ORCs* does not seem to provide a good solution. This reinforces the limited extent that the third-party obligation can deal with trade and investment diversion.

A few innovative solutions have been put forward at the 2007 WTO Conference on Multilateralizing Regionalism.³⁸⁵ However, to date, no progress has been made at the multilateral level. Given that the potential misuse of these rules as protectionist devices is real, it is important that WTO Members make serious efforts to deal with them.

4.4 Conclusion

Although WTO Members may disagree on how to improve GATT Article XXIV, they can easily agree that the current situation is less than satisfactory as the provisions therein are plagued by many ambiguities. Although efforts made on the part of WTO Members have resulted in the 2006 Mechanism, it is procedural in nature.³⁸⁶ Substantive reforms have yet to emerge.

³⁸⁵ See M Gasiorek, P Augier and C Lai-Tong, 'Multilateralising Regionalism: Relaxing Rules of Origin or Can Those PECS be Flexed?' (Conference on Multilateralising Regionalism, WTO, Geneva 2007) and A Estevadeordal, J Harris and K Suominen, 'Multilateralizing Preferential Rules of Origin around the World' (Conference on Multilateralising Regionalism, WTO, Geneva 2007), both available at http://www.wto.org/english/tratop_e/region_e/conference_sept07_e.htm (last accessed 23 July 2010).

³⁸⁶ The 2006 Mechanism will be discussed in Chapter 7.

The chapter attempts to clarify some of these ambiguities in such a way that would address the challenges facing developing countries amid the current RTA proliferation. For example, the high threshold of and tight timeframe for the duty half of the SAT requirement is proposed for developed countries so that developing countries can negotiate their RTAs more effectively. On the other hand, special and differential treatment is proposed for the latter so that they have the flexibility to promote the potential benefits and manage the potential costs induced by the formation of an RTA.

Textually, there is, however, a limit to the extent that GATT Article XXIV can be used to protect non-member developing countries. The requirements contained in paragraph 5 as read in light of paragraph 4 second objective can only tackle trade and investment diversion in a limited fashion. This illustrates the inadequacy of GATT Article XXIV in protecting non-members' interests. To correct this inadequacy, efforts have to be made at the multilateral level or unilaterally, for example a commitment to further reduce MFN tariff rates.

Nevertheless, given that trade and investment diversion depends on how RTA members design and implement their agreements, the proposals made in relation to paragraph 8 which encourage trade creation and discourage trade diversion should, to some extent, help protect the interests of non-member developing countries.

Nothing in GATT Article XXIV appears to deal with the constraints on developing countries' analytical and negotiating capacities as identified in Chapter 2, however. Although some of the proposals could help neutralize asymmetries of the bargaining power between developed and developing countries, they do not directly foster the development of both capacities. Given their importance to the success of RTA negotiations (and those at the multilateral level), more efforts should be made to help developing countries build analytical and negotiating capacities. This will be discussed in more detail in Chapter 7.

As far as goods RTAs are concerned, GATT Article XXIV is not the only set of applicable rules. The Enabling Clause also contains provisions which govern how South-South RTAs are to be formed. Although a number of such agreements have been notified under GATT Article XXIV, the majority of them are notified under the Enabling Clause. Consequently, Chapter 5 will examine the Enabling Clause in light of the challenges facing developing countries amid the current RTA proliferation.

Chapter 5

The Enabling Clause: South-South RTAs

5.1 Introduction

As more and more developing countries joined the GATT, the issue of equal treatment of countries at different stages of economic development had become more and more controversial.³⁸⁷ Developing countries claimed that the GATT and its framework concerned only with the interests of developed countries and were geared towards the solution of their problems.³⁸⁸ As the issue started to attract the attention of the CONTRACTING PARTIES, the GATT ministerial decision on 29 November 1957 noted, *inter alia*, that the failure of the trade of less-developed countries to develop as rapidly as that of industrialized countries was a major problem for international trade.³⁸⁹

In response to the concerns among many developing countries that they were not benefiting from the GATT regime, the CONTRACTING PARTIES began to debate ways to assist with their efforts to integrate into the global economy and achieve economic development. These include trade preferences granted by developed to developing countries and preferences granted among developing countries. Such preferential arrangements are however contrary to the MFN obligation contained in GATT Article I. In 1979, the CONTRACTING PARTIES enacted the Enabling Clause, which waived the application of the MFN obligation to preferential tariff concessions granted by developed to developing countries in the

³⁸⁷ For further discussion on the changes in international economic order occurred during this period, see EP Reubens, 'An Overview of the NIEO' in EP Reubens (ed) *The Challenge of the New International Economic Order* (Westview Press, Boulder, Colorado 1981), pp. 1-18.

³⁸⁸ See A Yusuf, *Legal Aspects of Trade Preferences for Developing States: a Study in the Influence of Development Needs on the Evolution of International Law* (Nijhoff, The Hague 1982), p. 10.

³⁸⁹ See GATT, 'Trends in International Trade' (GATT, Geneva 1958), Terms of Reference. The document is also known as the Haberler Report.

form of the GSP and those granted among developing countries in the form of South-South RTAs. It is rules concerning the latter which are the main focus of this chapter.

The rules governing the formation of South-South RTAs under the Enabling Clause have never been tested in the GATT/WTO DSM. Nor has there been any in-depth examination carried out on the part of the CTD with regard to South-South RTAs notified to it.³⁹⁰ Thus, in order to understand the provisions therein and how they should operate in relation to the challenges facing developing countries amid the current RTA proliferation, it is important that one looks at the history of the Enabling Clause and rationale behind it.

As will be discussed in more detail below, the rules concerning South-South RTAs under the Enabling Clause are much more lenient than those under GATT Article XXIV. It will be my argument in this chapter that they are so lenient that they result in excess flexibility, which may not necessarily translate into trade/economic benefits in practice. Furthermore, since the Enabling Clause only applies to South-South RTAs, and is not available to developing countries forming RTAs with their developed-country trade partners, the existence of the Enabling Clause creates, in my view, undesirable complication and inconsistency in the treatment of RTAs which have developing-country Members as parties. The two sets of rules may create two types of South-South RTAs, namely, those notified under GATT Article XXIV and those under the Enabling Clause, the legal consequences of which are not clear and may result in discrepancy. I thus propose that there should be a single set of rules for the formation of goods RTAs, *i.e.* GATT Article XXIV, but only if the special and differential treatment proposed in Chapter 4 is incorporated into it.

The chapter is divided into three sections. The first section discusses the history of the Enabling Clause and the rationale why the rules concerning South-South RTAs were included. The second section presents the existing framework of the Enabling Clause with regard to these agreements. The third section examines the relevant provisions in order to determine the extent to which they address the challenges facing developing countries amid the current RTA proliferation and whether there are any ways to improve them so that the challenges can be better addressed.

³⁹⁰ The WTO surveillance mechanisms for RTAs will be discussed in Chapter 7.

5.2 History and Rationale

The origin of the Enabling Clause can be traced back to the demand made by developing countries that the fundamental principles of MFN and reciprocity underpinned the GATT should be challenged as they were heavily biased in favour of developed countries and hindered the former's efforts to achieve economic development through trade.³⁹¹ Essentially, developing countries argued that under the MFN and reciprocity principles, they were treated the same as their developed-country counterparts even though their economies and economic realities were much different from the latter's.³⁹² Such "equal treatment of unequal development" was deemed inequitable by developing countries.³⁹³ Throughout the 1950s, developing countries made several attempts to adapt the GATT to their specific development needs, many of which led to modifications and additions to the legal text.³⁹⁴

In the 1960s, they looked further afield and turned to the United Nations for renewed inspiration. The first United Nations Conference on Trade and Development was convened in Geneva in 1964 at the insistence of developing countries in order to discuss "all vital questions relating to international trade, primary commodity trade, and economic relations between developed and developing countries".³⁹⁵ One of the most important documents which were submitted to the Conference was the Report by the then Secretary-General, Mr. Raúl Prebisch, entitled "Towards a New Trade Policy for Development".³⁹⁶ This report clearly spelled out the demands and proposals of developing countries for restructuring international economic relations. The dissatisfaction of developing countries with the existing trade patterns and principles was expressed by the report in the following way:

The imposing code of rules and principles, drawn up at Havana and partially embodied in the General Agreement on Tariffs and Trade (GATT), does not reflect a positive

³⁹¹ See JH Jackson, *Economic Policies Towards Less-Developed Countries* (Allen and Unwin, London 1967), p. 237

³⁹² See Yusuf, pp. 8-10.

³⁹³ Ibid.

³⁹⁴ For example, GATT Article XVIII (Governmental Assistance to Economic Development).

³⁹⁵ See Declaration issued at the end of the Cairo Conference on Problems of Developing Countries, U.N., Doc/A/5162. See also D Cordovez, 'The Making of UNCTAD' (1967) 1 *Journal of World Trade Law* 259, p. 259.

³⁹⁶ See Report by the Secretary-General of UNCTAD, 1964, U.N., Doc/E/Conf.46/3.

conception of economic policy in the sense of a rational and deliberate design for influencing economic forces so as to change their spontaneous course of evolution and attain clear objectives. On the contrary, it seems to be inspired by a conception of policy which implies that the expansion of trade to the natural advantage of all merely requires the removal of the obstacles which impede the free play of these forces in the world economy. These rules and principles are also based on an abstract notion of economic homogeneity which conceals the great structural differences between industrial centres and peripheral countries with all their important implications. Hence, GATT has not served the developing countries as it has the developed ones. In short, GATT has not helped to create the new order which must meet the needs of development, nor has it been able to fulfil the impossible task of restoring the old order.³⁹⁷

The report then went on to draw up a manifesto of developing countries aimed at the establishment of a dynamic international trade policy which could favour the increase of the volume of their trade, the diversification of its components, and the assurance for their primary commodities of fair and remunerative export prices. It called for a three-pronged approach to the solution of development problems:

- a) International commodity agreements to give less-developed producers of primary products the same sort of price support and price-stabilization assistance as was enjoyed by the farmers of the developed countries;
- b) Preferential access for manufacturers and semi-manufacturers from developing countries to the markets of the developed countries, to enable them to compete on equal terms with the manufacturers of those countries, their preferential advantage over the other advanced countries manufacturers compensating them for the competitive disadvantage of underdevelopment; and
- c) *Preferential arrangements among developing countries, falling short of the GATT requirements for customs unions and free-trade areas, to permit them to gain the advantages of specialization in a larger market (emphasis added).*³⁹⁸

Meanwhile, some progress was made in the GATT. After the adoption of the non-reciprocity principle at the GATT ministerial meeting of 1963, it was decided that a legal and institutional framework should be elaborated within the GATT in such a way that would enable the CONTRACTING PARTIES to discharge their

³⁹⁷ Ibid., p. 6.

³⁹⁸ Ibid.

responsibilities towards the development objectives of developing countries. This decision led to the incorporation of a new Part IV into GATT 1947, entitled “Trade and Development”, which introduces for the first time in the GATT framework a clear differentiation between developed and developing countries, and the idea of non-reciprocity between them.³⁹⁹

More central to the purposes of this chapter, GATT CONTRACTING PARTIES were supportive to the idea of preferential arrangements among developing countries.⁴⁰⁰ Although it was not clear as to how such arrangements could be conducted, the GATT Working Party on preferences reported in 1964 that “there is no disagreement on the principle involved in the granting of preferences between less-developed countries”.⁴⁰¹ Subsequently, the CTD endorsed the conclusion that “the establishment of preferences among less-developed countries, appropriately administered and subject to the necessary safeguards, can make an important contribution to the expansion of trade among these countries and to the attainment of the objectives of the General Agreement.”⁴⁰²

In 1971, the Protocol Relating to Trade Negotiations among Developing Countries (the 1971 Protocol) was negotiated and agreed among GATT CONTRACTING PARTIES.⁴⁰³ Its origin can be traced back to the agreement between India, Yugoslavia, and the United Arab Republic, concluded in 1967, providing for an exchange of tariff preferences between the three signatories.⁴⁰⁴ The CONTRACTING PARTIES granted a waiver for the tripartite agreement,⁴⁰⁵ and then created a negotiating committee, under the Chairmanship of the Director General, to conduct negotiations among developing countries generally.⁴⁰⁶ After four years, the negotiations produced the 1971 Protocol covering an exchange of tariff preferences between sixteen developing countries.⁴⁰⁷

³⁹⁹ For further discussion on the legal effect of Part IV, see K Kock, *International Trade Policy and the GATT, 1947-1967* (Almqvist and Miksell, Stockholm 1969), p. 243 and Jackson, *World Trade and the Law of GATT*, p. 661.

⁴⁰⁰ See Dam, p. 251.

⁴⁰¹ See GATT BISD (1965) 13S/100-104.

⁴⁰² See GATT BISD (1966) 14S/129-136.

⁴⁰³ See GATT BISD (1972) 18S/11-18.

⁴⁰⁴ See GATT, L/2950/Add.1 (4 March 1968).

⁴⁰⁵ See GATT BISD (1969) 16S/17-19.

⁴⁰⁶ See MA-B Hamaz, 'Guidebook for the GSTP: the Global System of Trade Preferences Among Developing Countries- Origins, Dimensions, Negotiations and Prospects' (UNCTAD, Geneva 1987), pp. 2-8.

⁴⁰⁷ Thirteen were GATT CONTRACTING PARTIES: Brazil, Chile, Egypt (replacing the United Arab Republic), Greece, India, Israel, the Republic of Korea, Pakistan, Peru, Spain, Turkey, Uganda, and

However, it should be noted that the 1971 Protocol was not further developed nor joined by other developing countries despite the permanent legal status given to it by the Enabling Clause.⁴⁰⁸ Instead, UNCTAD captured the initiative and launched its own negotiations on preferential arrangements among developing countries, which later resulted in the Global System of Trade Preferences (GSTP).⁴⁰⁹ Within the GATT framework, the GSTP was notified under the Enabling Clause in 1989 and currently has 43 members.⁴¹⁰

Fundamentally, the concept of preferences among developing countries is incompatible with the MFN principle under the GATT as they are not extended to the rest of the GATT membership. This is why in 1971 the CONTRACTING PARTIES adopted a decision which waived the application of the MFN obligation to preferential tariff concession granted among developing countries under the 1971 Protocol.⁴¹¹ In 1979, the waiver was made permanent by the Enabling Clause, which was later incorporated into GATT 1994.⁴¹² Not only did the Enabling Clause make permanent the waiver, but it also effectively created a new route within the GATT/WTO framework for the formation of South-South RTAs in addition to GATT Article XXIV.⁴¹³

Yugoslavia, Mexico, the Philippines, and Tunisia were not GATT CONTRACTING PARTIES at the beginning, but became CONTRACTING PARTIES subsequently. Subsequent additions to the membership were Bangladesh, Paraguay, and Romania. Greece and, later Spain withdrew upon their accession to the EU.

⁴⁰⁸ See R Hudec, *Essays on the Nature of International Trade Law* (Cameron May, London 1999), pp. 333-4. See also <http://rtais.wto.org/UI/CRShowRTAIDCard.aspx?enc=qOoqsxtwKtAGhWmLC54zKFqWApNLPat07zIvM5KRdXE=> (last accessed 17 September 2010).

⁴⁰⁹ See R Hudec, *Developing Countries in the GATT Legal System* (Thames Essays, No50, Gower for the Trade Policy Research Centre, Aldershot 1987), pp. 109-12. The GSTP currently has 43 members and is open to accession by members of the G77. For more detail, see http://www.unctadxi.org/Secured/GSTP/LegalInstruments/gstp_en.pdf (last accessed 2 August 2010). It should be noted that members of the GSTP grant trade preferences to one another with no intention to create a fully-fledged CU or FTA.

⁴¹⁰ The GSTP currently has 43 members and is open to accession by members of the G77. See <http://rtais.wto.org/UI/PublicShowMemberRTAIDCard.aspx?enc=qOoqsxtwKtAGhWmLC54zKERazv356zD7+srNPP1/q8c=> (last accessed 29 August 2010). See also http://www.unctadxi.org/Secured/GSTP/LegalInstruments/gstp_en.pdf (last accessed 2 August 2010). It should be noted that members of the GSTP grant trade preferences to one another with no intention to create a fully-fledged CU or FTA.

⁴¹¹ See Trade Negotiations among Developing Countries, Decision of 26 November 1971, L/3636. For further discussion on the 1971 Protocol, see Hudec, *Essays on the Nature of International Trade Law*, p. 333 and GATT BISD (1972) S18/11-18.

⁴¹² See GATT 1994, Article 1(b)(iii). For more detail on the history of the Enabling Clause, see NB dos Santos, Rr Farias and R Cunha, 'Generalized System of Preferences in General Agreement on Tariffs and Trade/World Trade Organization: History and Current Issues' (2005) 39 *Journal of World Trade* 637.

⁴¹³ See Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries (Enabling Clause), Decision of 28 November 1979, L/4903.

It can be seen from the discussion so far that South-South RTAs are a part of the broader objective which is to create a more favourable international trade environment for developing countries so that they can pursue their economic development. How do South-South RTAs contribute to such objective? Traditionally during the first period of RTA proliferation, South-South RTAs were generally formed among *neighbouring* developing countries, *i.e. regional* South-South RTAs.⁴¹⁴ Even though Viner's theory suggests that the formation of an RTA does not necessarily improve the members' welfare, policy makers in developing countries as well as many scholars dealing with regional integration among developing countries dismissed Viner's conclusion as irrelevant for conditions prevailing in these countries, for example idle capacities.⁴¹⁵ They assessed intra-regional trade expansion as *per se* beneficial and even advocated trade diversion.⁴¹⁶ Gains from economies of scale were considered as the key benefit of a (regional) South-South RTA as most developing countries at the time had relatively small domestic and export markets, which might not allow economies of scale to take place.⁴¹⁷ According to this school of thought, economies of scale made possible by the formation of a (regional) South-South RTA would foster and facilitate infant industries in the member countries.⁴¹⁸ This, in turn, would promote intra-industrial specialization through product diversification and improve their international competitiveness.⁴¹⁹ In other words, the formation of a (regional) South-South RTA was seen as a means for developing countries to achieve industrialization as they transformed their economies.⁴²⁰ This was, in fact, referred to

⁴¹⁴ For example, the Latin American Integration Association (LAIA), the Economic Community of West African States (ECOWAS), and ASEAN. For the survey of South-South RTAs before the 1990s, see RJ Langhammer and U Hiemenz, *Regional Integration among Developing Countries: Opportunities, Obstacles and Options* (J.C.B. Mohr (P. Siebeck), Tübingen 1990).

⁴¹⁵ See *Ibid.*, p. 5.

⁴¹⁶ For example, see SB Linder, 'Customs Unions and Economic Development' in MS Wionczek (ed) *Latin American Economic Integration* (Praeger, New York 1966) and TA Jaber, 'The Relevance of Traditional Integration Theory to Less Developed Countries' (1970) 9 *Journal of Common Market Studies* 254.

⁴¹⁷ For more detail, see Vaitos, and the discussion on economies of scale in Chapter 2. For an empirical study, see J Haldi and D Whitcomb, 'Economies of Scale in Industrial Plants' (1967) 75 *Journal of Political Economy* 373.

⁴¹⁸ For further discussion on infant industry, see M Shafaeddin, 'Friedrich List and the Infant Industry Argument' in KS Jomo (ed) *The Pioneers of Development Economics: Great Economists on Development* (Tulika Books, New Delhi 2005), pp. 42-61.

⁴¹⁹ For further discussion, see D Morawetz, 'Extra-Union Exports of Industrial Goods from Customs Unions among Developing Countries' (1974) 1 *Journal of Development Economics*.

⁴²⁰ Industrialization was considered by almost, if not all, developing countries as desirable. See R Prebisch, 'Commercial Policy in the Underdeveloped Countries' (1959) 49 *The American Economic Review* 251, pp. 251-4. See also C Cooper and B Massell, 'Towards a General Theory of Customs Unions for Developing Countries' (1965) 73 *Journal of Political Economy* 461.

in the Report submitted by Mr. Raúl Prebisch in the first UNCTAD cited earlier, and was widely supported by GATT CONTRACTING PARTIES.⁴²¹

Past experiences (up until the early 1990s), however, show that many of these South-South RTAs were not as successful as they were expected to be.⁴²² They never became fully-fledged RTAs and ended up merely partial scope agreements as they were not followed by genuine liberalization commitments. Moreover, measures such as import-substitution were adopted and trade barriers remained very high even between the member countries.⁴²³ Consequently, potential gains from utilization of idle capacities and infant industries were not realized.⁴²⁴

It is also found that governments in these countries were either subject to the pressure of strong domestic vested interests which opposed trade liberalization that would expose inefficient import substitution activities to regional competition; or politicians and bureaucrats themselves may benefit from import substitution policies through their stake in inefficient public or private enterprises or their control over NTBs such as import quotas, licenses, and foreign exchange allocations.⁴²⁵ A number of studies find that the subordination of government decisions under individual welfare considerations had manifested itself in the dependence of politicians on influential businessmen in many Latin American and African countries.⁴²⁶ Thus, it seems that there is a strong link between domestic vested interests and the failure of integration efforts in these South-South RTAs.

Based on their structure and scale of production, small developing countries often produce similar products and are not able to supply all of their partners' needs for imports. If such countries form an RTA between themselves, each member will

⁴²¹ See *supra* note 396, and Dam, p. 252.

⁴²² See RC York, *Regional Integration and Developing Countries* (OECD, Paris 1993), pp. 66-7.

⁴²³ See Langhammer and Hiemenz, pp. 64-5.

⁴²⁴ For a review of South-South RTAs in this period, see RJ Langhammer and U Hiemenz, 'Regional Integration among Developing Countries: Survey of Past Performance and Agenda for Future Policy Action' (World Bank, Washington, DC 1991). The RTAs reviewed include the Latin American Free Trade Association, the Latin American Integration Association, the Adecan Pact, the Central American Common Market, the Caribbean Community, the West African Economic Community, the Central African Customs and Economic Union, the East African Community, and the ASEAN. The report concludes that the results of these agreements are unsatisfactory and may have harmed the members' economies.

⁴²⁵ See Langhammer and Hiemenz, *Regional Integration among Developing Countries: Opportunities, Obstacles and Options*, pp. 70-1.

⁴²⁶ For example, see D Morawetz, *Why the Emperor's New Clothes are not Made in Colombia: a Case Study in Latin American and East Asian Manufactured Exports* (Oxford University Press; Published for the World Bank, Washington, DC 1981), pp. 98-9 and R Jackson and C Rosberg, *Personal Rule in Black Africa* (University of California Press, Berkeley 1982), p. 84.

have to continue importing some quantity of most goods from the rest of the world which are still subject to high tariffs. As discussed in Chapter 2, this is likely to generate primarily trade diversion and little trade creation.⁴²⁷ This would arguably have contributed to the failure of a number of South-South RTAs in the past, particularly those in Sub-Saharan Africa.⁴²⁸

Regional South-South RTAs formed and/or revised since the early 1990s,⁴²⁹ notably in Latin America and Southeast Asia, have shown some success in terms of intra-RTA liberalization as well as extra-RTA trade.⁴³⁰ However, it is important to note that other factors such as adoption of export-oriented trade policies and unilateral liberalization may have contributed to their success as well as their efforts on regional integration.⁴³¹ In other words, South-South RTAs (any RTAs for that matter) are only one of many trade policies that developing countries can adopt as a means to achieve economic development. The key is for them to promote the potential gains and manage the potential costs if they choose to adopt such trade policy. More recent studies find that an RTA between developing countries is more likely to be welfare-improving if it promotes trade with non-members as well as between themselves, and minimizes discrimination against non-members.⁴³²

Besides trade/economic gains, developing countries can also benefit from regional South-South RTAs because members may become stronger as a group at the

⁴²⁷ See Chapter 2.

⁴²⁸ For more detail, see AJ Yeats, 'What Can Be Expected from African Regional Trade Arrangements? Some Empirical Evidence' (Policy Research Working Paper, World Bank, Washington, DC 1999). One way to avoid this is for developing countries to form a multilateral South-South RTA, like the GSTP notified under the Enabling Clause in 1989. The more members a South-South RTA has, the less its members have to rely on imports from non-members. However, it should be noted that this also depends on the breadth and depth of its coverage. As will be discussed in more detail below, the Enabling Clause does not require RTA members to liberalize much of the intra-RTA trade. Members only have to reduce or eliminate tariffs and non-tariff measures on a mutual basis.

⁴²⁹ See Chapter 1.

⁴³⁰ For South-South RTAs in Latin America, see R Echandi, 'Regional Trade Integration in the Americas during the 1990s: Reflections of Some Trends and Their Implication for the Multilateral Trade System' (2001) 4 *Journal of International Economic Law* 367, pp. 376-95. For an RTA among the ASEAN countries, see LH Tan, 'Will ASEAN Economic Integration Progress Beyond a Free Trade Area?' (2004) 53 *International and Comparative Law Quarterly* 935, pp. 939-43.

⁴³¹ For further discussion, see RD Fischer and P Meller, 'Latin American Trade Regime Reforms and Perceptions' (Documentos de Trabajo No65, Centro de Economía Aplicada, Universidad de Chile, 1999), available at http://www.webmanager.cl/prontus_cea/cea_1999/site/asocfile/ASOCFILE120030402113742.pdf (last accessed 19 July 2010) and A Krueger, 'Asian Trade and Growth Lessons' (1990) 80 *The American Economic Review* 108.

⁴³² For example, see M Kreinin and MG Plummer, *Economic Integration and Development* (Edward Elgar, Cheltenham 2002), pp. 4-5 and chapter 6.

multilateral level.⁴³³ Developing countries often face severe disadvantages in dealing with the rest of the world because of their low bargaining power and high negotiation costs.⁴³⁴ Multilateral trade negotiations often require substantial financial resources, time, and expert knowledge, which are limited in many developing countries. As the global economy has become more integrated and the number of issues to be dealt with in the international arena has grown, there are arguably more incentives for these countries to cooperate with their neighbours. Thus, small and low-resources countries can substantially reduce their negotiation costs and at the same time increase their market and negotiating power by pooling their resources and acting together to articulate shared interests.⁴³⁵ A good example of this is ASEAN in the WTO whereby the member countries pool their resources together to attend meetings and provide regular briefings for each other. If they agree on an issue, their representatives may speak for the group; if not, individual countries look after their own national interests.⁴³⁶ In addition, a South-South RTA among neighbouring developing countries can serve as a vehicle for consensus building on political and security issues as it offers a forum for mutual consultations and dialogues.⁴³⁷ This can be very beneficial for a region where conflicts between neighbouring countries are prevalent.⁴³⁸

It is noteworthy that such cooperation does not have to involve trade preferences and economic integration inherent in an RTA. In other words, developing countries can cooperate without having to form a preferential trade area. For example, they may form a coalition during multilateral trade negotiations and/or create a regional forum for political and security discussion. Nevertheless, when such cooperation involves trade preferences and economic integration, there is arguably more at stake if members want to reverse the cooperation. Thus, this may be why

⁴³³ See Langhammer and Hiemenz, *Regional Integration among Developing Countries: Opportunities, Obstacles and Options*, pp. 9-10.

⁴³⁴ See York, p. 26.

⁴³⁵ See S Andriamananjara and M Schiff, 'Regional Cooperation among Microstates' (2001) 9 *Review of International Economics* 42, pp. 42-4.

⁴³⁶ See Schiff and Winters, *Regional Integration and Development*, p. 204. In addition, from my personal experience in the ASEAN-EU and ASEAN-Republic of Korea RTA negotiations, the ASEAN countries also pool resources together and arrange pre-negotiation meetings among themselves to establish common positions.

⁴³⁷ ASEAN provides a good example as it was initially created for security and political stability in the region. For more detail, see M Leifer, *ASEAN and the Security of South-East Asia* (Routledge, London 1989).

⁴³⁸ See Langhammer and Hiemenz, *Regional Integration among Developing Countries: Opportunities, Obstacles and Options*, pp. 10-1.

regional cooperation often includes a creation of preferential trade area among the member countries.

While it is acknowledged that there are indirect trade/economic and political/security merits offered by a regional South-South RTA for its members, these benefits must be balanced against the costs imposed by the RTA on members and non-members, especially non-member developing countries.⁴³⁹ One of the central claims advanced in this thesis is that the WTO's rules governing the formation of RTAs should not allow the member countries to ignore the trade/economic consequences created by such agreements which can adversely affect themselves as well as non-members.⁴⁴⁰ This is also supported by the fact that the political and security benefits are often illusory and not realized in practice. The experiences with many South-South RTAs formed among Sub-Saharan African countries, for example, show that the formation of an RTA added little to political stability and poor economic consequences of the formation led to further conflicts.⁴⁴¹ An RTA, particularly a CU, entails a certain loss of sovereignty for each member country. It has been argued that this is an important factor why many RTAs between young independent developing countries were not successful as governments of these countries were extremely reluctant to forego even minor parts of their newly acquired political independence.⁴⁴² Consequently, the implementation of integration policies was often sacrificed for nationalist and protectionist ones, which in turn contributed to poor economic performances of these countries.⁴⁴³

So far, this section has looked at the drafting history of the Enabling Clause and the rationale behind the inclusion of the rules concerning the formation of an RTA among developing countries. The object and purpose of the Enabling Clause is arguably to, *inter alia*, provide developing countries with special and differential treatment deviating from GATT Article XXIV. The next section will explore the existing framework of these rules.

⁴³⁹ See Introduction.

⁴⁴⁰ If a cooperation, which violates WTO rules, is deemed so politically important that trade/economic consequences should be put aside, the WTO Members in question should attempt to obtain an Article XXV waiver rather than trying to justify it through the rules governing the formation of an RTA.

⁴⁴¹ See York, pp. 35-52.

⁴⁴² See Langhammer and Hiemenz, *Regional Integration among Developing Countries: Opportunities, Obstacles and Options*, pp. 60-1.

⁴⁴³ For further discussion, see *Ibid.*, pp. 64-8.

5.3 Existing Framework

Unlike GATT Article XXIV, the Enabling Clause does not deal exclusively with rules concerning the formation of goods RTAs. In fact, it also contains rules that govern how the GSP is to operate within the WTO framework. Thus, it is important to distinguish between the two and identify which provisions are relevant to the formation of South-South RTAs. At the outset, paragraph 1 allows the MFN obligation in GATT Article I to be violated under certain arrangements specified in paragraph 2:⁴⁴⁴

[N]otwithstanding the provisions of Article I of the General Agreement, contracting parties may accord differential and more favourable treatment to developing countries,⁴⁴⁵ without according such treatment to other contracting parties.

Subparagraph 2(c) states that the provision of paragraph 1 applies to:

[R]egional 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.

On the face of it, subparagraph 2(c) does not seem to contain operative or purposive language as it does not contain the word *shall* or *should*. It simply describes what type of arrangement paragraph 1 applies. However, given that paragraph 1 provides WTO Members with an exception to the MFN obligation, the arrangement described by subparagraph 2(c) effectively sets out the parameters for the WTO Members wishing to rely on paragraph 1. In other words, if they do not satisfy subparagraph 2(c), they will not be qualified to rely on the MFN exception

⁴⁴⁴ Both the Panel and the Appellate Body in *EC-Tariff Preferences* held that the Enabling Clause provided an exception to the MFN obligation under GATT Article I. See WTO Panel Report, *EC-Tariff Preferences*, WT/DS246/R, adopted 20 April 2004, paras. 7.31-9 and WTO Appellate Body Report, *EC-Tariff Preferences*, WT/DS246/AB/R, adopted 20 April 2004, paras. 91-9.

⁴⁴⁵ Footnote omitted.

under paragraph 1.⁴⁴⁶ Thus, the only RTAs permitted under the Enabling Clause are those “entered into amongst less developed contracting parties”, and only where they are entered into “for the mutual reduction or elimination of tariffs and ... non-tariff measures”.

It should be noted that the terms *less developed countries* and *developing countries* are not defined under the GATT/WTO framework. Countries announce for themselves whether they are *developed* or *developing* countries. However, other members can challenge the decision of a member to make use of provisions available only to developing countries.⁴⁴⁷

Paragraph 3 sets out a number of requirements which WTO Members wishing to rely on the MFN exception need to meet. It reads:

Any differential and more favourable treatment provided under this clause:

(a) shall 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 any other contracting parties;

(b) shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a most-favoured-nation basis;

(c) shall in the case of such treatment accorded by *developed* contracting parties to developing countries be designed and, if necessary, modified, to respond positively to the development, financial and trade needs of developing countries (emphasis added).

Although the Appellate Body in *EC-Tariff Preferences* held that “[P]aragraph 3 identifies three conditions that must also be satisfied by *any* measure under the Enabling Clause”,⁴⁴⁸ as far as South-South RTAs under subparagraph 2(c) are concerned, only subparagraphs 3(a) and (b) are relevant. This is because subparagraph

⁴⁴⁶ This is in line with the way in which the Panel in *EC-Tariff Preferences* determined whether the Drug Arrangements were justified under the Enabling Clause. It considered whether the Drug Arrangements were consistent with subparagraph 2(a), particularly the requirement of non-discriminatory in footnote 3 to the subparagraph. See WTO Panel Report, *EC-Tariff Preferences*, paras. 7.61-5.

⁴⁴⁷ See http://www.wto.org/english/tratop_e/devel_e/d1who_e.htm (last accessed 17 September 2010). See also Cui.

⁴⁴⁸ See WTO Appellate Body Report, *EC-Tariff Preferences*, para. 112.

3(c) obviously applies only to the GSP since it mentions *developed* contracting parties.

As to subparagraph 3(a), at first glance, one may see the similarities between this and the wording of GATT Article XXIV:4. Nevertheless, the word *shall* is used here instead of the word *should* which is used in the latter.⁴⁴⁹ Thus, it can reasonably be argued that subparagraph 3(a) sets out two requirements (as opposed to the two objectives under GATT Article XXIV:4): the first is that an RTA falling within subparagraph 2(c) must be “designed to facilitate and promote trade of developing countries”; and secondly, it must not be designed to “raise barriers to or create undue difficulties for the trade of any other [WTO Members]”. Subparagraph 3(b), on the other hand, requires that the RTA in question “shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a most-favoured-nation basis.”

Paragraph 4 sets forth procedural conditions for the introduction, modification, or withdrawal of a preferential measure for developing countries.⁴⁵⁰ The member countries shall:

(a) notify the CONTRACTING PARTIES and furnish them with all the information they may deem appropriate relating to such action;

(b) afford adequate opportunity for prompt consultations at the request of any interested contracting parties with respect to any difficulty or matter that may arise. The CONTRACTING PARTIES shall, if requested to do so by such contracting party, consult with all contracting parties concerned with respect to the matter with a view to reaching solutions satisfactory to all such contracting parties.

Similar to paragraph 7 of GATT Article XXIV, it imposes notification obligations on the part of RTA members (note the changes made by the 2006 Mechanism).⁴⁵¹

The existing framework for South-South RTAs under the Enabling Clause therefore does provide some basis on which the WTO is required to scrutinize and discipline RTAs formed between developing countries. Although subparagraph 2(c) describes the type of the arrangement paragraph 1 applies, it effectively sets out a number of requirements for RTA Members to meet in terms of the trade between

⁴⁴⁹ See Chapter 4.

⁴⁵⁰ See WTO Appellate Body Report, *EC-Tariff Preferences*, para. 112.

⁴⁵¹ This will be discussed in Chapter 7.

themselves. I will call this *intra-RTA* obligation. It is reinforced by subparagraph 3(a) first requirement, which obliges the member countries to design their agreements in such a way that facilitates and promotes the intra-RTA trade. Subparagraph 3(a) second requirement, on the other hand, can be considered as *third-party* obligation since it aims to protect non-members' interests.

It is noteworthy that unlike GATT Article XXIV:5(c), the Enabling Clause does not distinguish between an RTA and an interim agreement. Nor does it require developing-country members to carry out the requirements under subparagraphs 2(c) and 3(a) within a specific timeframe. Unlike anything under GATT Article XXIV, subparagraph 3(b) contains a requirement that aims at preserving multilateral trade liberalization through the reduction or elimination of MFN tariff rates and other restrictions to trade. In addition, the intra-RTA and third-party obligations under the Enabling Clause do not distinguish between CUs and FTAs although the member countries generally specify which form they want their RTAs to take. Furthermore, the wording of subparagraph 2(c) suggests that South-South RTAs notified under the Enabling Clause are not required to be fully-fledged CUs or FTAs and can be merely partial scope agreements, which are not allowed under GATT Article XXIV.⁴⁵²

Due to the absence of case law on these provisions, it is not clear how the rules pertaining South-South RTAs under the Enabling Clause are to operate in practice. Examinations of South-South RTAs by the CTD do not amount to any meaningful clarification of the rules either.⁴⁵³ For example, in the examination of the goods RTA between Chile and India notified under the Enabling Clause, the United States raised, *inter alia*, the issue whether the RTA met subparagraph 3(a) requirements since duties on those goods that were most highly traded between the parties were not *eliminated* under the agreement.⁴⁵⁴ In response, Chile and India argued that a significant amount of trade between them was included in the agreement: 94.8 per cent of Indian exports to Chile and 75.7 per cent of Chilean

⁴⁵² According to the RTA database created by the WTO Secretariat at the beginning of 2009, of 31 RTAs notified under the Enabling Clause: six are notified as CUs; ten are notified as FTAs; and 15 are notified as partial scope agreements. See <http://rtais.wto.org/UI/publicsummarytable.aspx> (last accessed 27 August 2010).

⁴⁵³ On the review process by the CTD, see http://www.wto.org/english/tratop_e/region_e/regcom_e.htm (last accessed 20 July 2010).

⁴⁵⁴ See Committee on Trade and Development, 'Dedicated Session on Regional Trade Agreements- Preferential Trade Agreement between Chile and India (Goods)', WT/COMT/RTA/4/2 (4 May 2010), para. 2.

exports to India were subject to either reduction or elimination commitments.⁴⁵⁵ Furthermore, they contended that since there was no requirement under the Enabling Clause for agreements negotiated by developing countries to cover “substantially all the trade” as it was the case of GATT Article XXIV, they were not obliged to do so.⁴⁵⁶ Other examinations by the CTD are similar to this where interested third-party WTO Members raise questions and the member countries answer them.⁴⁵⁷ Ultimately, the member countries can always defend their RTAs due to the leniency of the requirements under the Enabling Clause.

Although there is no case law on these provisions, the judgments in *EC-Tariff Preferences*, albeit made in the context of the GSP, may shed some light on their interpretation and application. The Appellate Body agreed with the EC that special and differential treatment was critical to achieving one of the fundamental objectives of the WTO Agreement, as identified in its Preamble- ensuring that developing countries “secure a share in the growth in international trade commensurate with the needs of their economic development”.⁴⁵⁸ It is noteworthy that both the Panel and the Appellate Body held that the Enabling Clause provided an exception to the MFN obligation under GATT Article I.⁴⁵⁹ To put this in the RTA context, the object and purpose of the rules under the Enabling Clause is to provide developing-country Members with an easier route, as compared to GATT Article XXIV, to form South-South RTAs so that they can use them as a means to pursue economic development. This is consistent with what discussed in the previous section.

Nevertheless, given the unsuccessful experiences with South-South RTAs in the first period of RTA proliferation and the non-guaranteed benefits of these agreements, it is important that one examines the rules in order to determine the extent to which they address the challenges facing developing countries amid the current RTA proliferation, identified in Chapters 2 and 3, and whether there are any ways to improve them so that the challenges can be better addressed.

⁴⁵⁵ Ibid., para. 3.

⁴⁵⁶ Ibid.

⁴⁵⁷ For example, see Committee on Trade and Development, ‘Dedicated Session on Regional Trade Agreements- Free Trade Agreement between Egypt and Turkey (Goods)’, WT/COMTD/RTA/1/2 (7 October 2008).

⁴⁵⁸ See WTO Appellate Body Report, *EC-Tariff Preferences*, paras. 15 and 111. See also the second recital of the Preamble to the Marakesh Agreement and GATT Article XXXVI, including in particular paragraph 3.

⁴⁵⁹ See *supra* note 444.

5.4 The Enabling Clause and the Challenges Facing Developing Countries

Recall from Chapters 2 and 3 that the key challenges facing developing countries from the perspective of a prospective RTA member include domestic vested interests, high implementation and adjustment costs, and their lack of analytical and negotiating capacities.⁴⁶⁰ On the other hand, the key challenge facing non-member developing countries is the adverse effects caused by trade and investment diversion.⁴⁶¹ Given that the Enabling Clause only applies to South-South RTAs, it is also important to consider whether the fact that all RTA members are developing countries would affect the nature and extent of these problems at all.

First, with regard to the challenge of domestic vested interests, the argument should still hold since the theories do not distinguish between developed and developing countries.⁴⁶² As discussed earlier, a number of empirical studies, in fact, support the position that domestic vested interests play an important role in the failure of South-South RTAs formed in the first period of RTA proliferation.⁴⁶³

Second, as far as implementation and adjustment costs are concerned, all depends on the actual commitments made in an RTA and the trade relationship between the member countries. For example, if competition from the RTA partner is fierce and domestic producers can only compete as a result of tariff and/or NTBs, a commitment to reduce or eliminate the barriers will imply high implementation and adjustment costs for the home country. However, since the Enabling Clause only requires developing-country members to mutually reduce or eliminate tariffs and non-tariff measures, the costs will also depend on the breadth and depth of commitments actually made.

Third, in absolute terms, developing countries will still face the constraints on their analytical and negotiating capacities in South-South RTAs. However, in relative terms, they may find that the gap of these capacities among themselves is generally smaller than in the case of North-South RTAs. As will be seen below, nothing in the Enabling Clause directly deals with the constraints on developing countries' analytical

⁴⁶⁰ See Chapter 2.

⁴⁶¹ See Chapter 3.

⁴⁶² For example, see Grossman and Helpman, and Krishna, 'Regionalism and Multilateralism: A Political Economy Approach'.

⁴⁶³ See Langhammer and Hiemenz, *Regional Integration among Developing Countries: Opportunities, Obstacles and Options*, pp. 64-5.

and negotiating capacities. Given the importance of analytical and negotiating capacities to the success of RTA negotiations (and those at the multilateral level), more efforts should be made to help developing countries build analytical and negotiating capacities. This will be discussed in more detail in Chapter 7.

Fourth, the challenge of trade and investment diversion should still hold although their magnitude may be less significant if the developing-country members in question are small and do not provide export markets for non-member developing countries.

5.4.1 The Intra-RTA Obligation and the Challenges Facing Developing Countries from the Perspective of a Prospective Member

Under the Enabling Clause, the intra-RTA obligation is comprised of the requirements contained in subparagraph 2(c) and the first requirement contained in subparagraph 3(a). Essentially, RTA members have to make sure that they liberalize trade between themselves on a mutual basis, and the agreement must be designed to facilitate and promote the trade of developing countries.

Subparagraph 2(c) requires developing-country members to reduce or eliminate tariffs and non-tariff measures on products from one another. On the one hand, these requirements are similar to the *substantially all the trade* requirement under GATT Article XXIV:8 in the sense that they oblige RTA members to liberalize their intra-RTA trade. On the other hand, they are different in the sense that they do not specify the amount of trade to be liberalized. It is true that the SAT requirement does not precisely specify the amount either but at least it implies a very high percentage or amount of intra-RTA trade.

The normal reading of subparagraph 2(c) in accordance with the ordinary meaning of the terms therein and in the context of South-South RTAs suggests that developing-country members simply have to reduce or eliminate tariffs and non-tariff measures on a mutual basis.⁴⁶⁴ They may satisfy this by mutually reducing or

⁴⁶⁴ According to Article 3.2 of the DSU, the covered agreements must be read in light of customary rules of interpretation of public international law, which is codified in the Vienna Convention on the Law of Treaty 1969 (the Vienna Convention). See the Vienna Convention, Article 31(1), which

eliminating tariffs and/or non-tariff measures on a limited number of tariff lines or five per cent of goods traded among themselves, for example. This is, in fact, the case of the 1971 Protocol, for which the 1971 waiver was passed to accommodate. The preferential tariff concessions agreed under the 1971 Protocol covered only about 740 tariff lines in total, with a 1972 trade value of about \$25 million.⁴⁶⁵ In addition, the preferential rates were often not a significant improvement on the members' existing MFN rates.⁴⁶⁶ Given that the Enabling Clause was agreed, *inter alia*, in order to make permanent the 1971 waiver and drawing from the commitments made in the 1971 Protocol, it is clear that subparagraph 2(c) is intended to be more lenient compared to the SAT requirement under GATT Article XXIV and does not specify how much intra-RTA trade that the member countries have to liberalize.

Such reading is consistent with the object and purpose of the Enabling Clause held by the Appellate Body in *EC-Tariff Preferences*.⁴⁶⁷ This object and purpose is supported by the recognition among GATT CONTRACTING PARTIES that developing countries should be permitted to form South-South RTAs falling short of the requirements under GATT Article XXIV so that they may gain the advantages of specialization in a larger market.⁴⁶⁸ Furthermore, it is also supported by Mr. Raúl Prebisch's Report,⁴⁶⁹ which could be considered as the circumstances of the conclusion of the 1971 waiver and/or the rules governing the formation of South-South RTAs under the Enabling Clause.⁴⁷⁰

requires that "[A] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

⁴⁶⁵ See MA-B Hamza, 'Guidebook for the GSTP: the Global System of Trade Preferences Among Developing Countries- Origins, Dimensions, Negotiations and Prospects' (UNCTAD, Geneva 1987), pp. 27-31.

⁴⁶⁶ For more detail, see RJ Langhammer, 'Multilateral Trade Liberalization among Developing Countries' (1980) 14 *Journal of World Trade* 508.

⁴⁶⁷ See WTO Appellate Body Report, *EC-Tariff Preferences*, para. 92.

⁴⁶⁸ See GATT BISD (1965) 13S/100-104.

⁴⁶⁹ See *supra* note 396.

⁴⁷⁰ Article 32 of the Vienna Convention states that recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable. Under the WTO jurisprudence, the Panel in *EC-Chicken Classification* held that a particular event, acts, or other instrument could qualify as part of the circumstances of conclusion as long as it was *relevant* to the treaty in question. See WTO Panel Report, *EC-Chicken Classification*, WT/DS269/R, WT/DS286/R, adopted 27 September 2005, para. 7.343. From the history of the Enabling Clause discussed earlier, it is arguable that Mr. Raúl Prebisch's Report is relevant to both the 1971 Waiver and the rules under the Enabling Clause as it explicitly considered South-South RTAs falling short of GATT Article XXIV requirements as part of the solution to development problems.

It is noteworthy that the term *non-tariff measures* is used here instead of the term *other restrictive regulations of commerce* under GATT Article XXIV:8. Although the use of the term *non-tariff measures* is conceptually simpler, it is rather immaterial due to the fact that it is not linked to the SAT requirement but only to a requirement to mutually reduce or eliminate.⁴⁷¹

On the whole, the requirements in subparagraph 2(c) are not difficult to meet, particularly when there is no time limit to comply as well. This is possibly why many South-South RTAs notified under the Enabling Clause tend to fall short of a fully-fledged CU or FTA and can only be considered as partial scope agreements. In addition, given that the Enabling Clause does not distinguish between CUs and FTAs, there is no requirement for the member countries to create a regime of CETs and to harmonize external trade policy.⁴⁷² Such lenient requirements allow developing-country Members to form RTAs among themselves more easily than if they are to do it under GATT Article XXIV. This is in line with the Appellate Body's judgment in *EC-Tariff Preferences*, which held albeit in the context of the GSP that WTO Members were *encouraged* to pursue special and differential treatment for developing countries under the Enabling Clause.⁴⁷³ However, it also cautioned in the same case that such deviation was "encouraged only to the extent that it complies with the series of requirements set out in the Enabling Clause".⁴⁷⁴ The EC, in fact, failed to meet the requirements with regard to the GSP under the Enabling Clause.⁴⁷⁵ If one were to take the same approach in the context of South-South RTAs, one would find that the requirements contained in subparagraph 2(c) are so lenient that the supervision of such agreements is almost rendered meaningless.

While, such leniency is consistent with the intention of the drafters of the Enabling Clause to permit developing countries considerable flexibility in the conclusion of South-South RTAs, in my view this leniency is excessive. As discussed

⁴⁷¹ It should be noted that with regard to non-tariff measures, subparagraph 2(c) states that they should be mutually reduced or eliminated "in accordance with criteria or conditions which may be prescribed by the CONTRACTING PARTIES". To date, no criteria or conditions have been prescribed by WTO Members (and the GATT CONTRACTING PARTIES before them). See Hafez, pp. 901-2.

⁴⁷² It should be noted that the absence of such a requirement does not mean that the member countries cannot choose to do so of their own accord. Mercosur provides a good example where the member countries notified the agreement under the Enabling Clause and after operating as an FTA for a few years successfully created CETs and became a CU. See <http://rtais.wto.org/UI/PublicShowMemberRTAIDCard.aspx?enc=cxIE/jp1Q6QlzkvvaDSyvyGjCyds4F92CgtQ6tuKRLk=> (last accessed 29 July 2010).

⁴⁷³ See WTO Appellate Body Report, *EC-Tariff Preferences*, para. 111.

⁴⁷⁴ *Ibid.*

⁴⁷⁵ *Ibid.*, paras. 187-9.

in Chapter 2 and in the context of GATT Article XXIV, if a developing-country partner is allowed too much discretion to pick and choose which products or industries to protect, domestic vested interests tend to be able to lobby the government to exclude those that would result in trade-creating effects. RTAs are likely to be politically viable exactly when they are trade-diverting, and hence welfare-reducing. Too much flexibility can therefore undermine the commitments made by developing-country members, which can harm both themselves and non-member developing countries.⁴⁷⁶ As discussed earlier, a number of studies have shown that domestic vested interests did contribute to the failure of many South-South RTAs formed during the first period of RTA proliferation, for example the Latin American Free Trade Association (LAFTA) and the Economic Community of West African States (ECOWAS).⁴⁷⁷ In addition, with a wide discretion on the part of developing-country members, non-members will find it much more difficult to anticipate or predict the outcome of RTA negotiations, hence handicapping their ability to react.

Thus, I argue that as in the case of the proposed special and differential treatment for developing countries under GATT Article XXIV, the flexibility afforded for developing countries should be provided within certain limits. But can this be achieved on the basis of the existing text? One could try to reinforce the requirements in subparagraph 2(c) with subparagraph 3(a) first requirement- that is the member countries also have to design their RTA to “facilitate and promote the trade of developing countries.” However, the application of this requirement is unclear.

One possible interpretation is that the use of the word *designed* implies that the requirement is about the intention and not the actual effects of an RTA. The Oxford English dictionary defines the word *to design* as to draw plans or to plan something.⁴⁷⁸ To put it in the context of subparagraphs 2(c) and 3(a) first requirement, RTA members must *draw plans* or *plan* to facilitate and promote the intra-RTA trade through mutual reduction or elimination of tariffs and/or non-tariff measures. If this is accepted, as long as the agreement intends to facilitate and promote the intra-RTA trade, subparagraph 3(a) first requirement would be met. This approach gains some support from the decision of the GATT Working Party which was established to

⁴⁷⁶ See Hudec, *Developing Countries in the GATT Legal System*, pp. 228-30.

⁴⁷⁷ See Langhammer and Hiemenz, *Regional Integration among Developing Countries: Opportunities, Obstacles and Options*, pp. 70-2.

⁴⁷⁸ See Oxford Advanced Learner's Dictionary, p. 358. For more detail on the use of dictionaries to obtain an ordinary meaning of a treaty term, see RK Gardiner, *Treaty Interpretation* (Oxford University Press, Oxford 2008), pp. 166-9.

examine the provisions of the Agreement on ASEAN Preferential Trading Arrangements. One may draw some insights from this since it could be considered as the circumstances of the conclusion of the rules under the Enabling Clause.⁴⁷⁹ The decision reads:

- (1) the parties to the agreement had *good intentions- intended to promote economic development through a continuous process of trade expansion among member countries of ASEAN without raising barriers to the trade of other contracting parties* (emphasis added),
- (2) the parties promised to be cooperative- are prepared ... to consider the possibility of participating in mutually beneficial trading arrangements with other developing countries, and
- (3) were not really doing anything anti-GATT- the Agreement should not constitute an impediment to the reduction or elimination of tariffs and other trade barriers on a most-favoured-nation basis,

the CONTRACTING PARTIES decide that:

Notwithstanding the provisions of Article I of the General Agreement the participating contracting parties may implement the agreement in accordance with the conditions and procedures set out hereunder.⁴⁸⁰

It is clear that the Working Party placed the emphasis on the intention of the member countries rather than the actual effects of the RTA in question. Although the agreement itself only covered a total of 826 tariff lines at the time of the examination, the Working Party was of the view that it "had good intentions".⁴⁸¹ Thus, the decision lends support to the interpretation that subparagraph 3(a) first requirement is about the

⁴⁷⁹ See *supra* note 470.

⁴⁸⁰ See GATT BISD (1978-79) 26S/321-326.

⁴⁸¹ The agreement provided the framework for a system of preferential trading arrangements involving i) long-term quantity contracts, ii) purchase finance supported at preferential interest rates, iii) preferences in government procurement, iv) preferential tariffs, and v) preferential non-tariff barriers. The agreement itself provided only a framework for exchanging preferences on any of these instruments: there was no plan or schedule, but by the time the Working Party was established, the member countries had agreed to two batches of tariff concessions, covering a total of 826 tariff lines. See also JM Finger, 'GATT's Influence on Regional Arrangements' in J de Melo and A Panagariya (eds), *New Dimensions in Regional Integration* (Cambridge University Press, Cambridge 1993), pp. 141-2.

intention and not the actual effects of an RTA.⁴⁸² This would also be in line with the object and purpose of the Enabling Clause which is to provide developing-country Members with an easier route to form South-South RTAs. On this approach, subparagraph 3(a) would impose a rather lax requirement on the part of RTA members and would not add much to the requirements contained in subparagraph 2(c).

On the other hand, if subparagraph 3(a) first requirement is about the actual effects of an RTA, it may be used to reinforce the requirements in subparagraph 2(c). However, such interpretation would require the measurement of the actual effects of an RTA, which can be very complex. More importantly, the formation of an RTA may take time to have an impact on trade. A review of actual effects would have to be conducted after years of implementation, by which time it would be very difficult to reverse the process of integration and adverse effects would have taken place. This seems to be contrary to the notification obligation contained in subparagraph 4(b) which requires the member countries to “afford adequate opportunity for prompt consultations at the request of any interested contracting party”.⁴⁸³ Thus, the inherent difficulties with this interpretation suggest that the interpretation of subparagraph 3(a) first requirement must be about the intention and not the actual effects of an RTA.

Nevertheless, although it is argued that subparagraph 3(a) first requirement is about the intention of an RTA, that intention might be inferred from the commitments made by the member countries and the *likely* effects these commitments may have on the intra-RTA trade. For example, in the examination of the RTA between Pakistan and Malaysia, the member countries- responding to the EC and the United States’ concerns over subparagraph 3(a) first requirement,⁴⁸⁴ contended that the Enabling Clause permitted developing-country RTA members simply to *reduce* MFN tariff rates between themselves and that this would promote bilateral trade, hence satisfying

⁴⁸² Other decisions of working parties established to review South-South RTAs prior to the passage of the Enabling Clause contain similar discussion where members of the working parties sympathized with developing-country RTA members and placed emphasis on their intentions rather than whether they met the requirements under GATT Article XXIV. For example, see the decision of the Working Party for CARICOM, GATT BISD (1976-77) 24S/68-72.

⁴⁸³ See the Enabling Clause, para. 4(b).

⁴⁸⁴ The EC and the United States pointed out that only 64.7 per cent of Malaysia’s top 25 dutiable exports to Pakistan and 34.6 per cent of Pakistan’s top 25 dutiable exports to Malaysia remained dutiable under the agreement. They were concerned whether subparagraph 3(a) first requirement was met. See Committee on Trade and Development, ‘Dedicated Session on Regional Trade Agreements- Closer Economic Partnership Agreement between Pakistan and Malaysia (Goods)’, WT/COMTD/RTA/3/2 (2 September 2009), paras. 11 and 20, respectively.

the requirement.⁴⁸⁵ Given that this answer was not further challenged by the members of the CTD, it is possible that such a response may be enough to meet subparagraph 3(a) first requirement.

It is important to note that any reduction and elimination of tariffs between the member countries is likely to have the effects of facilitating and promoting the intra-RTA trade in the sense that goods can be traded more cheaply, which in turn may lead to an increase in trade volume. However, this does not necessarily result in trade creation or improvement in the welfare of the member countries.⁴⁸⁶ Thus, given that subparagraph 3(a) first requirement is unlikely to be about the actual effects of an RTA, it would add little to the requirements in subparagraph 2(c).

A further difficulty is that although the Enabling Clause distinguishes between developing countries and least-developed countries, it does not distinguish between countries within the former group.⁴⁸⁷ As discussed in the previous chapters, the term *developing countries* encompasses a range of countries at various stages of development and with different economic backgrounds. Thus, in order to deal with this heterogeneity of developing countries, a more nuanced approach to special and differential treatment should be developed here.

For example, developing-country WTO Members could be further divided into three subgroups as suggested in Chapter 4, namely, LDCs, LMIDCs, and UMIDCs. These three subgroups would be subject to different thresholds and transitional periods with regard to how much of the intra-RTA trade the member countries are required to liberalize and over how long.⁴⁸⁸ The more country-specific special and differential treatment would level the playing field between developing countries whose analytical and negotiating capacities are vastly different. This is also in line with paragraph 7 which states:

“... [L]ess-developed contracting parties expect that their capacity to make contributions or negotiated concessions or take other mutually agreed action under the provisions and procedures of the General Agreement would improve with the progressive development of their economies and improvement in their trade situation and they would accordingly expect to participate more fully in the framework of rights and obligations under the General Agreement.”

⁴⁸⁵ Ibid.

⁴⁸⁶ See Chapter 2.

⁴⁸⁷ See the Enabling Clause, paragraphs 6 and 8.

⁴⁸⁸ See Chapter 4.

In other words, the more advanced a developing country is, the more it is expected to participate more fully and should not be entitled to the same special and differential treatment as countries that are less advanced than itself. However, the problem with this approach is that the intra-RTA obligation under the Enabling Clause specifies neither a threshold nor a timeframe for intra-RTA trade liberalization. Consequently, such a more nuanced approach to special and differential treatment does not seem to have a textual basis under the Enabling Clause.

To sum up, although the intra-RTA obligation under the Enabling Clause does provide an easier route for developing countries to form RTAs with one another compared to that of GATT Article XXIV, the requirements set out therein are so lenient that virtually no control can be placed over the member countries. As can be seen in the previous chapters, the formation of an RTA is not necessarily beneficial to the member countries. The functions of the rules should be to encourage the member countries to promote the potential benefits and at the same time allow them to manage the potential costs induced by the formation of an RTA. Given that they may be contradictory at times, one has to strike a balance between the two functions. In my view, the intra-RTA obligation under the Enabling Clause fails to do so. It is so lenient that it results in excess flexibility, which may not necessarily translate into trade/economic benefits in practice. Something similar to the SAT requirement under GATT Article XXIV would arguably strike a better balance as developing-country members would have to liberalize a reasonable percentage/amount of the intra-RTA trade. This would ensure that domestic vested interests and governments would find it more difficult to exclude trade-creating products and industries from the RTA coverage. In addition, since the member countries would have less discretion, it would be easier for non-members to predict the final content of the RTA.

5.4.2 The Third-party Obligation and the Challenge of Trade and Investment Diversion

The third-party obligation contained in subparagraph 3(a) second requirement demands that South-South RTAs under subparagraph 2(c) are designed “not to raise barriers to or create undue difficulties for the trade of any other contracting parties.”

As in the case of subparagraph 3(a) first requirement, the third-party obligation contained in subparagraph 3(a) second requirement is arguably to do with the intention and not the actual effects of an RTA. This interpretation can be supported by the decision of the Working Party established to examine the ASEAN Preferential Trading Arrangements cited earlier, and the same arguments apply.⁴⁸⁹

If this interpretation is accepted, RTA members would only be required to show that they do not intend to raise trade barriers or create undue difficulties in relation to non-members. Trade barriers are raised if the member countries increase their tariffs or impose quantitative restrictions in relation to their trade with non-members, for example. Consequently, as long as the member countries express in the agreement that they intend to keep trade barriers in relation to non-members unchanged, the first half of the third-party obligation should be met. This is supported by the examinations conducted by the CTD cited earlier where the member countries always explicitly stated that they had no plan to raise trade barriers in relation to non-members whenever subparagraph 3(a) second requirement was raised.⁴⁹⁰ Such a lenient requirement is unlikely to address the challenge of trade and investment diversion. As discussed in Chapter 4, even the more demanding and elaborative requirements contained in GATT Article XXIV:5 as read in light of paragraph 4 second objective only deal with the challenge in a limited fashion.⁴⁹¹ However, one might be able to use the second half of the third-party requirement, *i.e. not to create undue difficulties*, to protect non-members' interests in a more meaningful way.

For the ordinary meaning of the word *difficulty*, the Oxford English dictionary defines it as "a problem, a thing or situation that causes problems".⁴⁹² According to this, one can reasonably hold the adverse effects caused by trade and investment diversion on non-members as falling within the meaning of the word *difficulties* under subparagraph 3(a). The provision however does not aim at disallowing all difficulties. Only *undue* ones are not to be created. This is in line with the inherent discriminatory nature of (South-South) RTAs. Since these agreements are contrary to the MFN principle, difficulties (caused by trade and investment diversion) on the part of non-members are expected from these discriminatory regimes. The key question is what considers as *undue*.

⁴⁸⁹ See the previous section.

⁴⁹⁰ For example, see *supra* note 454, para. 3 and *supra* note 384, paras. 11 and 20.

⁴⁹¹ See Chapter 4.

⁴⁹² See Oxford Advanced Learner's Dictionary, p. 367. See also the Vienna Convention, Article 31(1).

According to the Oxford English dictionary, the word *undue* is an adjective which describes something that is “more than reasonable or necessary”.⁴⁹³ Are adverse effects caused by trade and investment diversion more than reasonable or necessary? This is an extremely difficult question. As discussed earlier in this chapter and previously, in an ideal world where governments considered national welfare as a top priority, there would be no need for any rules on the formation of an RTA- only trade-creating products and industries would be included. Anything more than minimal trade diversion would be deemed unreasonable and unnecessary. Investment diversion, on the other hand, might still exist since it is triggered purely by tariff preferences. Given that tariff preferences are inherent in RTAs, there will inevitably be some investment diversion.⁴⁹⁴ Thus, in an ideal world essentially all trade diversion would be considered as creating undue difficulties while some investment diversion could be tolerated.

Since the real world is less than ideal, there is likely to be trade diversion induced by the formation of an RTA.⁴⁹⁵ Is it possible for one to distinguish between *acceptable* and *undue* trade diversion? As discussed in Chapter 2, trade diversion occurs when the production is shifted away from the lower-cost producers located outside to the higher-cost producers located within the preferential area. There does not seem to be any criteria that would qualify certain trade diversion as acceptable and other undue. Any form of trade diversion is undesirable, but rather inherent in the formation of an RTA (in the real world where domestic vested interests can influence governments and the rules governing the formation of an RTA can only deal with it in a limited fashion). In the absence of such criteria, it would be difficult to apply the second half of the third-party obligation to the adverse effects caused by trade diversion. Given that the object and purpose of the Enabling Clause is to provide developing-country WTO Members with an easier route to form RTAs among themselves, adverse effects caused by trade diversion is bound to be acceptable under subparagraph 3(a). Otherwise, the requirement will never be met.

Despite this interpretation, it is important to note that trade diversion can be very damaging to non-member developing countries. To illustrate this point, consider a hypothetical example where Thailand and Vietnam export almost exclusively to

⁴⁹³ See Oxford Advanced Learner’s Dictionary, p. 1471.

⁴⁹⁴ See Chapters 2 and 4.

⁴⁹⁵ Indeed, one of the objectives of Chapter 4 and the current chapter is to examine how trade diversion can be minimized under the existing framework.

China although Thai goods are generally cheaper than Vietnamese counterparts. If China decides to form an RTA with Vietnam and reduce tariffs on Vietnamese goods, the RTA is likely to result in severe trade diversion away from Thailand. Since Thailand exports almost exclusively to the Chinese market, the formation of the RTA may create real difficulties for its economy. On what basis would one rely to argue that such difficulties are *undue*? After all, China and Vietnam are permitted, under the Enabling Clause, to form an RTA with each other. In addition, although the fact that Thailand exports almost exclusively to the Chinese market causes the severe trade diversion, China and Vietnam are not responsible for that. They could easily argue that Thailand should have diversified its export markets or even formed an RTA with China itself.

Thus, the challenge of adverse effects caused by trade and investment diversion on the part of non-members can be of great magnitude where non-members trade heavily with one of the partners and export similar goods to that country as the other RTA partner.⁴⁹⁶ However, at best, the third-party obligation under the Enabling Clause only deals with this challenge in a limited fashion. That is, as in the case of GATT Article XXIV, it only requires the member countries not to raise trade barriers in relation to non-members.⁴⁹⁷ At worst, due to the use of the word *designed*, its application could be merely about the intention of an RTA as inferred from the commitments made by the member countries. On this basis, as long as the member countries do not have plans to raise any trade barriers in relation to non-members, their RTA would meet the first half of the third-party obligation. As for the second half, it is difficult to see how the member countries could be held legally responsible for any difficulties on the part of non-members that may cause by trade and investment diversion. Although such difficulties are real and can worsen non-members' competitive conditions, they are arguably not *undue*. This reinforces the importance of using the intra-RTA obligation to curb trade and investment diversion to the greatest extent possible.

Nevertheless, the phrase *not to create undue difficulties* might be used to regulate rules of origin.⁴⁹⁸ With regard to such rules, the problem with GATT Article XXIV is that there is disagreement among WTO Members whether they can be

⁴⁹⁶ See Chapter 3.

⁴⁹⁷ See Chapter 4.

⁴⁹⁸ On the effects of rules of origin, see Chapter 2.

captured by the term *other regulations of commerce* under paragraph 5, which concerns external trade, since rules of origin deal with intra-RTA trade and determined the eligibility for the preferences granted by an FTA.⁴⁹⁹ Even it can be accepted that the term *ORCs* captures rules of origin, the word *corresponding* contained in subparagraph 5(b) appears to make this approach unworkable.⁵⁰⁰ Without the complication created by the term *ORCs* and the word *corresponding*, the phrase *not to create undue difficulties* should be flexible enough to be used to regulate how FTA members design their rules of origin. If they are overly restrictive, they can be regarded as creating undue difficulties for the trade of non-members.

For example, if rules of origin take the form of value-added content- that is it specifies a minimum percentage of domestic value added in one of the member countries before the product in question can be exported within the preferential area duty-free, the percentage should be set as low as possible,⁵⁰¹ and the verification process should be transparent and simple so as to allow domestic firms to source their inputs in the most efficient way.⁵⁰² This, in turn, would lessen the adverse effects on the part of non-members caused by trade diversion. One caveat to this interpretation is that it could make subparagraph 3(a) second requirement very difficult to meet, which may be contrary to the object and purpose of the Enabling Clause.

Besides the third-party obligation, subparagraph 3(b) contains a requirement that aims at preserving multilateral trade liberalization through the reduction or elimination of MFN tariff rates and other restrictions to trade. Unlike subparagraph 3(a), there is nothing to suggest that the requirement is about the intention and not the actual effects of an RTA. Otherwise, the provision would have read “shall not *be designed to* constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a most-favoured-nation basis”. However, the problem is how one determines whether the requirement is met or not.

As discussed in Chapter 3, the question whether RTAs complement or undermine the WTO is such that it does not lend itself easily to testing. This is because at any point in time, only a single realization of WTO negotiations is

⁴⁹⁹ See Chapter 4.

⁵⁰⁰ See *Ibid.*

⁵⁰¹ For example, in AFTA, the value-added content is set at 40 per cent. See M Manchin and AO Pelkmans-Balaoing, 'Rules of Origin and the Web of East Asian Free Trade Agreements' (Policy Research Working Paper No4273, World Bank, Washington, DC 2007), pp. 9-10.

⁵⁰² For further discussion on how to make rules of origin less restrictive, see Gasiorek, Augier and Lai-Tong, pp. 21-4.

observed. It is therefore very difficult to prove that multilateral trade negotiations would have been any faster (or easier), had there been fewer (or more) RTAs.⁵⁰³ After all, how can one empirically prove that an RTA constitutes an impediment to the reduction or elimination of tariffs and other restrictions to trade on a MFN basis? Other factors which may have undermined multilateral trade liberalization will have to be identified and distinguished from the effects of the RTA. Such endeavour will be extremely difficult, if at all possible. Furthermore, the literature on the relationship between RTAs and the multilateral trading system explored in Chapter 3 is not conclusive and being developed.

Thus, it will be very difficult to give effect to subparagraph 3(b) requirement in practice. Such difficulty may result in non-implementation of subparagraph 3(b) requirement, which seems to be the case given the absence of case law and in-depth examination by the CTD.⁵⁰⁴ Consequently, the requirement should not present much difficulty to RTA members in practice. On the one hand, this is in line with the object and purpose of the Enabling Clause. On the other hand, it highlights the fact that little control can be placed on the member countries. As argued throughout this chapter, such excess flexibility may not be beneficial to either developing-country members or non-members.

5.4.3 Two Sets of Rules Governing the Formation of Goods RTAs?

Does it make sense to have two separate sets of rules governing the formation of goods RTAs? While GATT Article XXIV applies to all goods RTAs, the Enabling Clause creates a separate and more lenient set of rules for those formed among developing countries. As discussed in the previous sections, the leniency of the rules

⁵⁰³ See Chapter 3.

⁵⁰⁴ In *EC-Tariff Preferences*, the Panel mentioned subparagraph 3(b) briefly in relation to GATT Article XX(b). It held that “tariff preferences should not be lightly assumed to be an appropriate means to achieve health objectives under Article XX(b) because any tariff preferences deviating from obligations assumed in the multilateral framework would necessarily have a direct and negative impact on the multilateral system. Even under the Enabling Clause, where tariff preferences are authorized within the multilateral framework as a deviation from Article I:1, paragraph 3(b) prohibits GSP schemes that “constitute an impediment to the reduction or elimination of tariffs... on a most-favoured-nation basis”.” See WTO Panel Report, *EC-Tariff Preferences*, para. 7.209 However, it did not elaborate as to under what circumstances a GSP scheme would violate the requirement under subparagraph 3(b).

may not translate into trade/economic benefits in practice and may even result in severe trade diversion which is harmful to both developing-country members and non-members alike.

Even if one holds the view that developing countries should be provided with *unfettered* flexibility when they form RTAs, under the existing framework, developing-country partners in North-South RTAs are however not eligible to the special and differential treatment available under the Enabling Clause since they are subject to the same requirements as their developed-country counterparts under GATT Article XXIV. As illustrated in Chapters 2 and 4, special and differential treatment is arguably even more necessary in the case of North-South RTAs so as to level the playing field and allow developing-country partners to deal with the potential costs more freely. Thus, if the object and purpose of the Enabling Clause is to provide developing countries with special and differential treatment that will allow them to use RTAs as a means to achieve industrialization and economic development, it is deficient because it is not available to developing-country partners in North-South RTAs.

This lacuna where developing-country partners in North-South RTAs are not eligible to the special and differential treatment offered by the Enabling Clause might have been created due to the fact that at the time of its drafting, RTAs between developed and developing countries were not envisaged. The focus was on either North-North RTAs, particularly those in Europe, or South-South RTAs in Africa and Latin America.⁵⁰⁵

The separate sets of rules also create two types of South-South RTAs, namely, those notified under GATT Article XXIV and those under the Enabling Clause.⁵⁰⁶ It is not clear whether they have the same legal consequences within the WTO framework. For example, reversing the Panel's decision that GATT Article XXIV could be used as a defence only against GATT Article I, the Appellate Body in *Turkey-Textiles* held that "Article XXIV may, under certain conditions, justify the adoption of a measure which is inconsistent with certain *other GATT provisions*, and may be invoked as a

⁵⁰⁵ See Carpenter, pp. 17-20.

⁵⁰⁶ From the practice of WTO Members (and GATT CONTRACTING PARTIES before them), it appears that the member countries of an RTA only notify their agreement to the WTO once, either under GATT Article XXIV or the Enabling Clause. See <http://rtais.wto.org/UI/PublicAllRTAList.aspx> (last accessed 31 August 2010).

possible defence to a finding of inconsistency (emphasis added).⁵⁰⁷ Even though the RTA in question was formed between the EU and Turkey, *i.e.* a North-South RTA, it should be safe to assume that the judgment will apply to South-South RTAs notified under GATT Article XXIV as well. However, it is not clear whether the Enabling Clause can be used as a defence against other GATT violations apart from the MFN obligation contained in GATT Article I. This issue was raised by the EU and the United States in *Brazil–Tyres* although it was not clarified either by the Panel or the Appellate Body.⁵⁰⁸

The Appellate Body in *Turkey–Textiles* came to its conclusion by considering the chapeau of GATT Article XXIV:5, which reads:

[A]ccordingly, 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... (emphasis added).

On the other hand, paragraph 1 of the Enabling Clause only and specifically refers to the provisions of GATT Article I. Thus, a discrepancy between the two types of South-South RTAs may have been created here- that is GATT Article XXIV may provide a better defence for members of South-South RTAs. If this is true, it may give an incentive for developing countries to notify their South-South RTAs under GATT Article XXIV rather than the Enabling Clause although they will have to comply with the more demanding set of rules.

It is noteworthy that more and more South-South RTAs are notified under GATT Article XXIV. For example, in the case of China, of its eight RTAs with other developing countries formed since its accession to the WTO in 2001, six were notified under GATT Article XXIV and two under the Enabling Clause. Of the two agreements, only the Asia Pacific Trade Agreement (APTA) (entry into force 17 June 1976, China's accession 1 January 2002) is a partial scope agreement. The ASEAN-China RTA (entry into force 1 January 2005) is, *inter alia*, intended to cover all tariff lines, which will be eliminated by 2012 between the six original ASEAN countries

⁵⁰⁷ See WTO Appellate Body Report, *Turkey–Textiles* paras. 42-5. In the case, the other GATT provisions in question were Articles XI and XIII.

⁵⁰⁸ See WTO Panel Report, *Brazil–Tyres*, paras. 4.449-52 and 5.155-7, respectively.

and China, and by 2018 by the remaining parties.⁵⁰⁹ Thus, it can be seen that apart from the APTA which was formed in 1976, all China's South-South RTAs- even the one with ASEAN that was notified under the Enabling Clause- are intended to be fully-fledged FTAs.⁵¹⁰ Such practice supports the proposal to have only one set of rules for the formation of goods RTAs.⁵¹¹

5.5 Conclusion

Having examined both GATT Article XXIV and the rules governing the formation of South-South RTAs under the Enabling Clause, and the latter's drafting history, it is clear that the rules contained in the latter were created in order to provide a more flexible alternative to the vague yet demanding GATT Article XXIV. However, the rules were drafted in such a way that renders it very difficult to impose any limits to the resulting flexibility. Although this is in line with the drafting history and objective of the Enabling Clause, the leniency of the rules may not translate into trade/economic benefits in practice and may even result in severe trade diversion which is harmful to both developing-country members and non-members alike. Furthermore, the existing two separate sets of rules for the formation of a goods RTA can result in the lacuna where developing-country partners in North-South RTAs are not eligible to any special and differential treatment and the discrepancy between two types of South-South RTAs.

Thus, given the excess flexibility, the lacuna, and the discrepancy, I propose that there should be a single set of rules for the formation of goods RTAs, *i.e.* GATT

⁵⁰⁹ See <http://rtais.wto.org/UI/PublicSearchByMemberResult.aspx?enc=BGND Ao9i1u5NEK0fWo0Yn7u86VXIYA8JFWG+eFcVR+o=> (last accessed 2 September 2010). In addition, from the interview conducted, the representatives from the ASEAN Secretariat said that their practice was to aim for the standard of GATT Article XXIV even where the agreement was notified under the Enabling Clause. However, it should be noted that the representatives assumed that the coverage of 90 per cent of tariff lines would satisfy the SAT requirement under GATT Article XXIV.

⁵¹⁰ For more detail of the ASEAN-China RTA, see <http://rtais.wto.org/UI/PublicShowMemberRTAIDCard.aspx?enc=xFQ67iMMzAdiCuzI+VZHgm8iKAnW/GSa6DUBsnbXXmE=> (last accessed 2 September 2010).

⁵¹¹ Similar trends can be seen elsewhere, for example, the Panama-Chile FTA, the Mexico-Guatemala FTA, and the Peru-Singapore FTA. See <http://rtais.wto.org/UI/PublicSearchByMember.aspx> (last accessed 2 September 2010).

Article XXIV, but only if special and differential treatment is incorporated into it. This could be achieved through what I propose in Chapter 4. Alternatively, WTO Members could amend GATT Article XXIV and include built-in special and differential treatment provisions which would be available for developing-country partners in both North-South and South-South RTAs. In addition, the more nuanced approach to special and differential treatment whereby developing countries are further divided into subgroups- each subject to different threshold levels and transitional periods for the SAT requirement, could also be adopted. Furthermore, the *new* GATT Article XXIV should contain provisions which are capable of dealing with rules of origin.

Something closer to this approach is adopted in respect of services RTAs where GATS Article V is the sole set of rules.⁵¹² As will be seen in the next chapter, it contains provisions that incorporate special and differential treatment for developing countries regardless of whether they are forming their RTAs with developed-country trade partners or among themselves. It also contains a provision that restricts what RTA members can do with regard to rules of origin. Chapter 6 will therefore examine GATS Article V in the context of the challenges facing developing countries amid the current RTA proliferation.

⁵¹² See Chapter 6.

Chapter 6

GATS Article V

6.1 Introduction

In Chapters 4 and 5, two sets of rules concerning *goods* RTAs were examined and discussed in light of the challenges facing developing countries amid the current RTA proliferation. However, as can be seen in Chapter 1, recent RTAs tend to include chapters or protocols on trade in services as well as those on trade in goods.⁵¹³ When this is the case, the member countries have to notify their agreements under GATS Article V as well as either under GATT Article XXIV or the Enabling Clause. These *services* RTAs (or to be more precise, their chapters or protocols on trade in services) are subject to the requirements contained in GATS Article V.

Like the other two sets of rules, GATS Article V provides a defence to the MFN principle formally inserted in GATS Article II, and possibly other GATS provisions.⁵¹⁴ Under it, WTO Members can give trade preferences to one another without having to extend them to the rest of the WTO membership. While GATT Article XXIV has been subject to years of debates and negotiations, albeit little agreement reached, GATS Article V is relatively novel given that services entered the multilateral trade agenda as late as the mid-1980s.⁵¹⁵ At first, most developing

⁵¹³ See Chapter 1.

⁵¹⁴ The Panel in *Canada–Autos* held that “Article V provides legal coverage for measures taken pursuant to economic integration agreements, which would otherwise be inconsistent with the MFN obligation in Article II.” See WTO Panel Report, *Canada–Autos*, WT/DS139/R, WT/DS 142/R, adopted 19 June 2000, para. 10.271. From this, it is not clear whether or not GATS Article V can be used as a defence against other violations of GATS.

⁵¹⁵ See M Krajewski, ‘Services Liberalization in Regional Trade Agreements: Lessons for GATS Unfinished Business?’ in L Bartels and F Ortino (eds), *Regional Trade Agreements and the WTO Legal System* (Oxford University Press, Oxford; New York 2006), p. 175. As noted in Chapters 2 and 3, the majority of theoretical and empirical studies concerning RTAs focus primarily on trade in goods. While new research is being conducted on services RTAs and their effects on members, non-members, and the multilateral trading system, it is not as comprehensive as studies on goods RTAs. In addition, data on trade in services are often incomplete, particularly in developing countries. This adds to the complexity involved in such research.

countries were very reluctant to discuss services liberalization because they were uncertain whether they would benefit from it and the comparative advantage would lie with developed countries. However, towards the end of the 1980s, there was a shift in attitude by many developing countries, in services as in other areas of the Uruguay Round, away from defensive positions and towards an active search for solutions that would allow them to participate fully in whatever gains the negotiations might bring.⁵¹⁶

GATS Article V, entitled “Economic Integration”, is part of the multilateral framework agreement on trade in services negotiated during the Uruguay Round. Initially, a draft provision on preferential trade for services was introduced by the EU and supported by Switzerland, Australia, and New Zealand. Economic integration agreements only became an issue in the negotiations at the end of 1988, when ministers agreed at the Montreal Mid-Term Review to include this discussion in the services negotiations.⁵¹⁷ In December 1989, a text was circulated by the chairman of the negotiating group on services that included a provision for a derogation to the non-discrimination principle, “under conditions to be negotiated [for example, regional integration arrangements, free-trade areas, preferential trading arrangements among developing countries]. Such arrangements shall, *inter alia*, not create any new, or raise existing, barriers to trade in services in relation to other signatories and shall in this respect be subject to multilateral discipline and surveillance.”⁵¹⁸

It was generally felt that certain criteria were needed to apply to services RTAs in order to allow the member countries to deviate from the non-discrimination principle. The debate on the derogation for services RTAs evolved around two distinct approaches. While some delegations argued that it should be related to the degree of liberalization of trade in services under the economic integration agreement itself, others were of the view that it should apply to services agreements concluded in the context of an RTA falling under GATT Article XXIV. In the end, a rather opaque compromise was reached. That is, a services RTA is to be examined under specific criteria with respect to services trade only but account is to be given to “wider process of economic integration” which refers to the liberalization of trade in goods in the

⁵¹⁶ See J Croome, *Reshaping the World Trading System: a History of the Uruguay Round* (2 edn Kluwer Law International, London 1999), p. 207.

⁵¹⁷ See TP Stewart, *The GATT Uruguay Round: a Negotiating History (1986-1992): Volume II* (Kluwer Law International, Boston 1993), p. 2368.

⁵¹⁸ See Background Note by the Secretariat, ‘Systemic Issues Related to ‘Substantially All Trade’’, WT/REG/W/21/Rev.1 (5 February 1998).

terms of GATT Article XXIV:5.⁵¹⁹ In addition, the criteria were drafted based on GATT Article XXIV, in an effort to keep the services framework agreement as parallel to GATT as possible.⁵²⁰

To date, GATS Article V has yet to be seriously tested under the WTO DSM. Neither has the CRTA satisfactorily clarified how the provisions should be implemented in practice.⁵²¹ Instead, the CRTA has merely cited the issues raised by Members during its meetings and pointed out how their views differed on these provisions.⁵²² Given the prevalence of services chapters and protocols in recent RTAs whose members include developing countries, this chapter attempts to examine the provisions therein within the premises of the discussion conducted in Chapters 1, 2, and 3 and in light of the challenges facing them.

As will be discussed in more detail below, it will be my argument in this chapter that the adoption of the criteria which were based on GATT Article XXIV may have resulted in undesirable complication due to services-specific problems, and have made the implementation of GATS Article V extremely difficult. Given the nature of barriers to trade in services and rules of origin, the magnitude of trade diversion induced by the formation of a services RTA may not be as major a concern as in the case of goods RTAs. This renders the criteria which in the case of goods RTAs aim at minimizing trade diversion somewhat less significant. In addition and more importantly, services liberalization- may it be at the bilateral/regional or multilateral level- raises unique challenges (besides those identified in Chapters 2 and 3) for developing countries, particularly those concerning regulation and movement of natural persons. In my view, GATS Article V fails to deal with them explicitly although its existing architecture, namely, provisions on special and differential treatment and rules of origin, could be used to help developing countries tackle these unique challenges as well as those identified in Chapters 2 and 3, at least to a certain extent. With regard to services RTAs, the constraints on developing countries' analytical and negotiating capacities may be even more severe than in the case of

⁵¹⁹ Ibid.

⁵²⁰ Ibid.

⁵²¹ See Note by the Secretariat, 'Synopsis of "Systemic" Issues Related to Regional Trade Agreements', WT/REG/W/37 (2 March 2000), paras. 70-103.

⁵²² For examples of the issues raised, see Communication from Hong Kong, China to the CRTA, 'Systemic Issues Arising from Article V of the GATS, WT/REG/W/34 (19 February 1999)' and Communication from the European Communities and their Member States to the CRTA, 'Article V of the GATS: Systemic Issues', WT/REG/W/35 (21 September 1999).

goods RTAs given the services-specific problems and unique challenges. As will be seen below, GATS Article V does not contain any provisions which directly deal with this challenge.

The chapter is divided into two sections. The first section presents the existing framework of GATS Article V, and the second section examines the article in order to determine the extent to which it addresses the challenges facing developing countries amid the current RTA proliferation and whether there are any ways to improve the provisions so that the challenges can be better addressed.

6.2 Existing Framework

The chapeau of paragraph 1 of GATS Article V states that “[T]his Agreement [GATS] shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement [...]” One may recall similar language in the chapeau of GATT Article XXIV:5. Deriving its decision from the chapeau of paragraph 5, the Appellate Body in *Turkey–Textiles* held that “[GATT] Article XXIV may, under certain conditions, justify the adoption of a measure which is inconsistent with certain other GATT provisions, and may be invoked as a possible defence to a finding of inconsistency.”⁵²³ On this basis, the wording of the chapeau of paragraph 1 suggests that GATS Article V can be construed as providing a defence against a violation of the MFN obligation under GATS Article II as well as other GATS provisions.⁵²⁴

The rest of paragraph 1 sets out the requirements in relation to trade between RTA members. Accordingly, a services RTA is WTO-compatible if it:

- (a) has substantial sectoral coverage (footnote omitted), and

⁵²³ See WTO Appellate Body Report, *Turkey–Textiles*, paras. 42-5.

⁵²⁴ It should be noted that the Panel in *Canada–Autos* only held that GATS Article V could be used as a defence against a violation of GATS Article II although it did not refer to other possible GATS violations. See WTO Panel Report, *Canada–Autos*, para. 10.271.

(b) provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under subparagraph (a), through:

- (i) elimination of existing discriminatory measures, and/or
 - (ii) prohibition of new or more discriminatory measure,
- either at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI, XII, XIV and XIV *bis*.

Subparagraph 1(a) requires the agreement to have “substantial sectoral coverage” while subparagraph 1(b) requires the agreement to provide for “the absence or elimination of substantially all discrimination, in the sense of Article XVII [national treatment], between or among the parties, in the sectors covered under subparagraph 1(a).” According to footnote 1 of GATS, the substantial sectoral coverage requirement is to be understood in terms of “number of sectors, volume of trade affected and modes of supply” and that in order to meet this requirement, agreements “should not provide for the *a priori* exclusion of any mode of supply.”⁵²⁵ According to the text, subparagraph 1(b) requirement can be achieved through “elimination of existing discriminatory measures,” and/or “prohibition of new or more discriminatory measures.” In addition, paragraph 1 requirements are to be met “either at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI, XII, XIV and XIV *bis*.”⁵²⁶

In evaluating whether the conditions under subparagraph 1(b) are met, paragraph 2 states that “consideration *may* be given to the relationship of the agreement to a wider process of economic integration or trade liberalization among the countries concerned (emphasis added).”⁵²⁷ It is understood that a *wider process of economic integration* refers to the liberalization of trade in goods in the terms of GATT Article XXIV:5.⁵²⁸ The provision does not, however, specify precisely how the relationship between integration in goods and services should be considered.

Paragraph 3 contains built-in special and differential treatment provisions for developing countries. Subparagraph 3(a) reads:

⁵²⁵ See footnote 1 of GATS.

⁵²⁶ It should be noted that there is no agreement as to what constitutes a *reasonable time-frame* under subparagraph 1 although in the context of the CRTA, WTO Members have suggested periods ranging from five to ten years. See *supra* note 521, para. 84.

⁵²⁷ See GATS Article V:2.

⁵²⁸ See *supra* note 521, para. 85. See *supra* note 522, para. 11.

[W]here developing countries are parties to an agreement of the type referred to in paragraph 1, flexibility *shall* be provided for regarding the conditions set out in paragraph 1, particularly with reference to subparagraph (b) thereof, in accordance with the level of development of the countries concerned, both overall and in individual sectors and subsectors (emphasis added).

Unlike subparagraph 2(c) of the Enabling Clause, subparagraph 3(a) is not limited to South-South RTAs.⁵²⁹ It also applies to North-South RTAs. It should be noted that the mandatory language featured by subparagraph 3(a), *i.e.* “flexibility *shall* be provided”, suggests a greater degree of deference to developing countries’ positions in services RTAs than the language used in paragraph 2, *i.e.* “consideration *may* be given” in the context of a wider process of economic integration. Subparagraph 3(b) grants further flexibility to members of South-South services RTAs. It reads:

[N]otwithstanding paragraph 6, in the case of an agreement of the type referred to in paragraph 1 involving only developing countries, more favourable treatment may be granted to juridical persons owned or controlled by natural persons of the parties to such an agreement.

Developing countries are allowed to have more restrictive rules of origin for juridical persons than those required by GATS Article V:6. Thus, they can restrict preferential treatment to services providers owned or controlled by their citizens.

Paragraph 4 states that:

“[A]ny services RTA referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not in respect of any Member outside the agreement raise the overall level of barriers to trade in services within the respective sectors or subsectors compared to the level applicable prior to such an agreement.”

At first glance, one may see the similarities between the wording here and that of subparagraph 3(a) of the Enabling Clause.⁵³⁰ It is important to note that the word *shall* is used twice here: the first one is followed by the phrase *be designed to*; but, the second one is not. This suggests that paragraph 4 of GATS Article V sets out two

⁵²⁹ See Chapter 5.

⁵³⁰ *Ibid.*

requirements which may be subject to two different interpretative standards- one is more restrictive than the other.

Similar to paragraph 6 of GATT Article XXIV, paragraph 5 stipulates that:

“[I]f in the conclusion, enlargement or any significant modification of any agreement under paragraph 1, a Member intends to withdraw or modify a specific commitment inconsistently with the terms and conditions set out in its Schedule, it shall provide at least 90 days advance notice of such modification or withdrawal and the procedure set forth in paragraphs 2, 3 and 4 of [GATS] Article XXI shall apply.”

In other words, paragraph 5 establishes a procedure that aims to promote transparency and allow RTA members and non-members to deal with effects of the formation of a services RTA.

Unlike anything in GATT Article XXIV or the Enabling Clause, paragraph 6 of GATS Article V restricts what RTA members can do with regard to rules of origin. The provision states that “[A] service supplier of any other Member that is a juridical person constituted under the laws of a party to an agreement referred to in paragraph 1 shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement.”

Similar to GATT Article XXIV:7 and paragraph 4 of the Enabling Clause, paragraph 7 imposes notification obligations on the part of RTA members (note the changes made by the 2006 Mechanism).⁵³¹ It states:

- (a) Members which are parties to any agreement referred to in paragraph 1 shall promptly notify any such agreement and any enlargement or any significant modification of that agreement to the Council for Trade in Services. They shall also make available to the Council such relevant information as may be requested by it. The Council *may* establish a working party to examine such an agreement or enlargement or modification of that agreement and to report to the Council on its consistency with this Article.

- (b) Members which are parties to any agreement referred to in paragraph 1 which is implemented on the basis of a time-frame shall report periodically to the Council for Trade in Services on its implementation. The Council may establish a working party to examine such reports if it deems such a working party necessary.

⁵³¹ This will be discussed in Chapter 7.

- (c) Based on the reports of the working parties referred to in subparagraphs (a) and (b), the Council *may* make recommendations to the parties as it deems appropriate (emphasis added).

The last provision under GATS Article V is paragraph 8 which clarifies that “[A] Member which is a party to any agreement referred to in paragraph 1 may not seek compensation for trade benefits that may accrue to any other Member from such agreement.” It should be noted that the provision does not find an equivalent in GATT Article XXIV although paragraph 6 of the 1994 Understanding contains similar wording.⁵³²

As mentioned earlier, to date, GATS Article V has yet to be seriously tested under the WTO DSM. One case that touched upon GATS Article V is *Canada–Autos*. The Panel in *Canada–Autos* considered GATS Article V in response to the United States’ third-party submission in which it claimed that the Canadian legislation⁵³³ at issue, to the extent that they provided more favourable treatment to service suppliers of the United States, were subject to the exception to GATS Article II conferred by GATS Article V:1. The United States argued that the more favourable treatment the complainants sought to condemn was accorded by a member of an economic integration agreement of the type specified by GATS Article V:1, *i.e.* NAFTA, to the service suppliers of another member of that agreement.

The Panel rejected this argument. In doing so, it found that the legislation at issue was implemented unilaterally by Canada even before the conclusion of NAFTA, and consequently could not be considered as part of the NAFTA provisions. It noted instead that “NAFTA members have agreed to allow their continued implementation through specific exceptions granted to Canada.”⁵³⁴ In addition, the Panel held that even assuming the legislation could be brought within the scope of services liberalization provisions of NAFTA, the exemption was accorded only to a small number of manufacturers and wholesalers of the United States, to the exclusion of all other manufacturers and wholesalers of the United States and Mexico.⁵³⁵ In other

⁵³² Paragraph 6 of the 1994 Understanding reads: “GATT 1994 imposes no obligation on *Members* benefiting from a reduction of duties consequent upon the formation of a customs union, or an interim agreement leading to the formation of a customs union, to provide compensatory adjustment to *its constituents*.” One can reasonably argue that the word *Members* refers to WTO Members not party to the CU in question and the phrase *its constituents* refers to members of the CU.

⁵³³ The Motor Vehicles Tariff Order 1998 and the Special Remission Orders.

⁵³⁴ See WTO Panel Report, *Canada–Autos*, para. 10.268.

⁵³⁵ *Ibid*, para. 10.269.

words, any favourable treatments accorded among the members of a services RTA must be granted on an MFN basis within the RTA in question. This is arguably the limited extent which *Canada–Autos* contributes to the interpretation of GATS Article V. It should be noted that on appeal, the issue concerning GATS Article V was not brought up by any of the parties and therefore was not dealt with by the Appellate Body.⁵³⁶

It can be seen that the existing framework of GATS Article V provides some basis for RTA supervision. Paragraph 1 sets out a number of requirements for RTA Members to meet in terms of the trade between themselves. I will call this *intra-RTA* obligation. It is arguably reinforced by paragraph 4 first requirement, which obliges the member countries to design their agreements in such a way that facilitates trade between the member countries. Paragraph 4 second requirement, on the other hand, can be considered as *third-party* obligation since it aims to protect non-members' interests. Distinct from GATT Article XXIV, paragraph 3 of GATS Article V contains built-in special and differential treatment provisions for developing countries. Paragraphs 5 and 7 establish procedures that promote transparency and allow RTA members and non-members to deal with effects of the formation of a services RTA. Unlike both GATT Article XXIV and the Enabling Clause, paragraph 6 explicitly restricts what members of services RTAs can do with regard to rules of origin. Finally, paragraph 8 explicitly prevents RTA members from seeking compensation from non-members if the latter benefit from the formation of their services RTA.

It is noteworthy that GATS Article V does not distinguish between CU and FTA. This is because a CU and an FTA only differ where the members of the former are required to establish CETs while the members of the latter are not. Since services are typically not subject to tariffs, a distinction based on tariffs would not make much sense for trade in services. Thus, GATS Article V adopts the term *economic integration* instead.

Given the absence of case law, debates among and proposals made by WTO Members, coupled with the relative novelty of services trade in general and services RTAs in particular, it is not clear how the rules contained in GATS Article V are to

⁵³⁶ Canada did challenge the Panel's finding that the measures at issue fell within the scope of GATS. See WTO Appellate Body Report, *Canada–Autos*, WT/DS139/AB/R, WT/DS 142/AB/R, adopted 19 June 2000, paras. 147-84.

operate in practice. Can one turn to the discourse on GATT Article XXIV for guidance? Although GATS Article V was drafted based on GATT Article XXIV, in an effort to keep the services framework agreement as parallel to GATT as possible,⁵³⁷ it is not clear to what extent the discourse on the latter can be extrapolated into the former. The differences between goods and services trade may imply different interpretations and applications of seemingly similar terms such as *substantial* and *substantially all* contained in GATS Article V and GATT Article XXIV.⁵³⁸ Furthermore, services-specific problems may even render these terms inoperable.

The next section will examine the article in order to determine the extent to which it addresses the challenges facing developing countries amid the current RTA proliferation as well as the unique challenges arising in the context of services RTAs, and whether there are any ways to improve the provisions so that the challenges can be better addressed.

6.3 GATS Article V and the Challenges Facing Developing Countries

Before one looks at GATS Article V in light of the challenges facing developing countries, it is important that one put them into the context of services trade. As noted in Chapters 2 and 3, the majority of theoretical and empirical studies concerning RTAs focus primarily on trade in goods and research on services RTAs and their impact on members, non-members, and the multilateral trading system is being developed. Although the existing literature on services RTAs may not be as comprehensive as studies on goods RTAs, it should shed some light on the extent to which GATS Article V addresses the challenges and whether there are ways to improve the provisions in order to deal with them.

⁵³⁷ See *supra* note 518.

⁵³⁸ For further discussion on the WTO jurisprudence on goods and services provisions, see F Smith and L Woods, 'Distinction without a Difference: Exploring the Boundary between Goods and Services in the World Trade Organization and the European Union' (2005) 12 *Columbia Journal of European Law* 1, pp. 8-26.

The starting point is the object and purpose of GATS itself. The Preamble reads:

Members,

Recognizing the growing importance of trade in services for the growth and development of the world economy;

Wishing to establish a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries;

Desiring the early achievement of progressively higher levels of liberalization of trade in services through successive rounds of multilateral negotiations aimed at promoting the interests of all participants on a mutually advantageous basis and at securing an overall balance of rights and obligations, while giving due respect to national policy objectives;

Recognizing the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right;

Desiring to facilitate the increasing participation of developing countries in trade in services and the expansion of their service exports including, *inter alia*, through the strengthening of their domestic services capacity and its efficiency and competitiveness;

...

As far as trade liberalization is concerned, the baselines of GATT and GATS are different. While WTO Members (and GATT CONTRACTING PARTIES before them) have made a lot of progress in the area of trade in goods since 1947, their commitments in the area of trade in services are much less ambitious. For example, although the MFN obligation under GATS Article II is drafted as a general obligation/discipline, Members were allowed to maintain inconsistent measures as

long as they listed them as exemptions.⁵³⁹ On the other hand, market access (Article XVI) and national treatment (Article XVII) obligations are drafted as specific commitments found in Part III of GATS. What this means is that WTO Members have to comply with these obligations only in services sectors/subsectors which they have inscribed in their respective GATS Schedules of specific commitments and the obligations are subject to the terms, limitations, and conditions set out therein. WTO Members may make more commitments in the present and future rounds of multilateral trade negotiations.⁵⁴⁰

Compared to GATT where the MFN and national treatment principles are drafted as general obligations, *i.e.* applying to all trade barriers, GATS affords considerable flexibility to WTO Members in the area of trade in services. This is understandable given the relative novelty of services trade. From the Preamble and as exemplified in its architecture, GATS aims to provide WTO Members with a framework agreement which they can use as a starting point for future negotiations and to further their services liberalization.⁵⁴¹ Drawing from the experience with trade in goods, one may expect that there will be many more years of ongoing negotiations on services concessions before GATS reaches the same level of comprehensiveness as that of current GATT.⁵⁴²

Unlike barriers to trade in goods where border measures like tariffs and tariff quotas are the major concerns, barriers to trade in services are primarily in the form of domestic regulations.⁵⁴³ According to Feketekuty,⁵⁴⁴ the closest analog with goods trade is the GATT rules which are designed to curb the trade-distorting effects of

⁵³⁹ See GATS Article II:2. It should be noted that as the word *maintains* indicates paragraph 2 only covers measures in existence before the entry into force of the WTO Agreement. However, the relevant lists subsequently submitted by individual Members contain not only existing measures, but also a few exemptions that might prove necessary in future, for example, in the context of advancing regional integration projects. For further discussion, see R Adlung, 'The GATS Turns Ten: A Preliminary Stocktaking' (Staff Working Paper ERSD-2004-05, WTO, Geneva 2004), pp. 3-4.

⁵⁴⁰ See http://www.wto.org/english/tratop_e/serv_e/s_negs_e.htm (last accessed 14 August 2010). This is in line with the Preamble of GATS. See also M Footer, 'The General Agreement on Trade in Services: Taking Stock and Moving Forward' (2002) 29 *Legal Issue of Economic Integration* 7, pp. 10-5.

⁵⁴¹ For the discussion on how GATS contains a built-in agenda that aim to address unfinished business left over from the Uruguay Round, see *Ibid.*, pp. 15-25.

⁵⁴² See JH Jackson, *The World Trading System: Law and Policy of International Economic Relations* (2nd edn MIT Press, Cambridge, MA 1997), pp. 306-7.

⁵⁴³ For further discussion on the distinction between goods and services and their trade barriers, see Smith and Woods.

⁵⁴⁴ See G Feketekuty, 'Assessing and Improving the Architecture of GATS' in P Sauve and R Stern (eds), *GATS 2000, New Directions in Services Trade Liberalization* (The Brookings Institutes, Washington, DC 2000), p. 92.

domestic standards that pursue other social objectives.⁵⁴⁵ To achieve services liberalization, WTO Members are encouraged to make commitments with regard to market access and national treatment. These require them to change their domestic regulations so that foreign services and services providers may enter the domestic market and are treated no less favourably than domestic services and services providers. This is seldom easy and often takes time to implement.⁵⁴⁶ Given that these are specific commitments, Members are free to pick and choose whichever sectors/subsectors they wish to open. Thus, one of the main objectives of GATS must be to persuade Members to bind as many services sectors/subsectors as much as possible under their GATS Schedules so that they are subject to market access and national treatment obligations.⁵⁴⁷

Studies conducted a few years after GATS was concluded, however, show that barring a few exceptions in basic telecommunications and financial services, the commitments inscribed in Members' Schedules were essentially confined, in the best of cases, to binding existing regimes in a limited number of sectors.⁵⁴⁸ In addition, despite the generally modest starting point for the negotiations under the Doha Development Agenda (DDA), after two rounds of GATS offers⁵⁴⁹ and several years of discussions, the DDA has so far showed little promise of further improvements in liberalization commitments.⁵⁵⁰

⁵⁴⁵ See the Agreement on Technical Barriers, Article 2.2, which requires that domestic standards should neither create unnecessary obstacles to international trade nor be more trade-restrictive than necessary to fulfill a legitimate objective (health, safety, environmental, etc.), taking account of the risks non-fulfillment would create.

⁵⁴⁶ From the interviews conducted, one of the Thai trade negotiators involved in the Japan-Thailand EPA said that he had much more trouble persuading representatives from professional unions and associations such as those of engineers and architects to grant market access to Japanese firms providing similar services than in the case of goods trade. This is because prior to the Japan-Thailand EPA, Japanese firms providing engineering services, for example, did not have access to the Thai market; whereas, Japanese goods had already entered the Thai market and became household names.

⁵⁴⁷ It should be noted that the extent of liberalization also depends on the terms, limitations, and conditions Members insert in their GATS Schedules.

⁵⁴⁸ For example see BM Hoekman, 'Assessing the General Agreement on Trade in Services' in W Martin and A Winters (eds), *The Uruguay Round and Developing Countries* (Cambridge University Press, Cambridge 1996), p. 101 and R Snape, 'Reaching Effective Agreements Covering Services' in A Krueger (ed) *The WTO as an Institutional Organization* (Chicago of University Press, Chicago 1998), pp. 287-9.

⁵⁴⁹ GATS offers are offers made by WTO Members with regard to their GATS Schedules of specific commitments. These can be found at http://www.wto.org/english/tratop_e/serv_e/s_negs_e.htm (last accessed 15 August 2010).

⁵⁵⁰ See JA Marchetti and M Roy, 'Services Liberalization in the WTO and in PTAs' in JA Marchetti and M Roy (eds), *Opening Markets for Trade in Services: Countries and Sectors in Bilateral and WTO Negotiations* (Cambridge University Press, Cambridge 2008), pp. 69-72.

Away from the WTO, services RTAs have been formed among WTO Members and commitments made therein have been found to go beyond their GATS commitments, *i.e.* *GATS-plus* commitments. For example, Roy, Marchetti, and Lim find that countries tend to bind more sectors/subsectors under services RTAs than under their GATS Schedules and GATS offers as well as to make deeper commitments with regard to market access and national treatment obligations.⁵⁵¹ More recent studies confirm this position.⁵⁵² It is also found that a number of the developing countries under review have made more spectacular *GATS-plus* commitments in their services RTAs, but only because their existing GATS commitments and GATS offers are much more moderate. This, at least in general terms, lends some support to the suggestion that some WTO Members may be holding off on their GATS offers so as to have something to offer in RTA negotiations.⁵⁵³ On the other hand, a number of countries are found to make limited *GATS-plus* commitments. Marchetti and Roy argue that these more limited commitments may be due to the fact that the RTA negotiations took place before the last DDA offer; what was conceded in the RTA later found its way into the GATS offers.⁵⁵⁴ These findings suggest that the sequence of trade negotiations at different levels, *i.e.* WTO prior to RTA and *vice versa*, may be relevant and can determine the extent to which countries make commitments in services trade.

So, if countries tend to make *GATS-plus* commitments in services RTAs, is this not desirable? After all, the Panel in *Canada–Autos* held that “[T]he purpose of Article V [GATS] is to allow for ambitious liberalization to take place at a regional level, while at the same time guarding against undermining the MFN obligation by engaging in minor preferential arrangements.”⁵⁵⁵ As discussed in Chapter 2, the formation of an RTA is not necessarily economically beneficial to the member countries. All depends on the aggregation of static and dynamic effects of the formation.⁵⁵⁶ Recall, traditionally, studies on RTAs are conducted on the basis of trade in goods. Can their insights be extended to trade in services as well?

⁵⁵¹ See Roy, Marchetti and Lim. It should be noted that this study only deals with modes 1 and 3 and does not look at modes 2 and 4 of services.

⁵⁵² For example, see Marchetti and Roy, pp. 75-91.

⁵⁵³ For further discussion, see M Roy, J Marchetti and H Lim, 'Services Liberalization in the New Generation of Preferential Trade Agreements: How Much Further than GATS?' (2007) 6 *World Trade Review* 155.

⁵⁵⁴ See Marchetti and Roy.

⁵⁵⁵ See WTO Panel Report, *Canada–Autos*, para. 10.271.

⁵⁵⁶ See Chapter 2.

As far as the static effects are concerned, the focus is on trade creation and trade diversion. The formation of an RTA will be beneficial to the member countries if it results in net trade creation, other things being equal. However, this is far from certain in the area of trade in goods since governments, as influenced by domestic vested interests, have the tendency to exclude trade-creating products and industries while include trade-diverting ones.⁵⁵⁷ With regard to services RTAs, Mattoo and Fink find that compared to the *status quo*, a country is likely to gain from preferential liberalization of services trade at a particular point of time since trade creation is more likely.⁵⁵⁸ This is because barriers to trade in services are often so high or restrictive that foreign services providers cannot enter the domestic market, in other words, no or little trade among the home country, the prospective RTA partner, and non-members. Once the member countries decide to reduce or eliminate the barriers between themselves, *i.e.* forming a services RTA, trade is created when supplies of services are switched to the most efficient services providers in the preferential area. However, there is no or little trade diversion since trade between the member countries and non-members does not exist in the first place. For example, Costa Rica agreed to dismantle its *public monopolies* in insurance and telecommunications under the FTA between the United States, the Central American countries, and the Dominican Republic.⁵⁵⁹ Consequently, more efficient firms from the RTA partners can enter the Costa Rica's market in these sectors/subsectors while nothing has changed as far as non-member firms are concerned. In addition, non-member firms may be able to enter the market if they satisfy the rules of origin set out under the agreement (see the next paragraph) and/or if Costa Rica subsequently decides to extend these preferences to the rest of the world.

Apart from the prohibitively high barriers, by their nature, rules of origin for trade in services differ from those for trade in goods. In the latter case, rules of origin restrict exporters' use of imported intermediate inputs. Taking advantage of RTA preferences requires ongoing proof that exported products meet origin rules. Different

⁵⁵⁷ See Chapter 2.

⁵⁵⁸ See A Mattoo and C Fink, *Regional Agreements and Trade in Services: Policy Issues* (Policy Research Working Paper 2852, World Bank, Washington, DC 2002), pp. 6-14.

⁵⁵⁹ See <http://www.ustr.gov/trade-agreements/free-trade-agreements/cafta-dr-dominican-republic-central-america-fta> (last accessed 15 August 2010). See also R Echandi, 'The DR-CAFTA-US FTA Negotiations in Financial Services: the Experience of Costa Rica' (Background paper commissioned by the Finance, Private Sector and Infrastructure Department of the Latin America and Caribbean Region, World Bank, Washington, DC 2006).

origin rules for different RTA partners may prevent countries from reaping economies of scale, as products with one set of imported intermediate inputs may qualify under the rules of one agreement but not others.⁵⁶⁰ In the case of services trade, rules of origin deal primarily with the origin of services *providers* rather than the origin of the traded services.⁵⁶¹ Services exporters are free to rely on the import of intermediate inputs of goods and services from anywhere in the world.⁵⁶² Generally, exporters face a one-time certification process that is unlikely to noticeably affect a supplier's production costs.⁵⁶³ Thus, rules of origin for trade in services are less likely to significantly contribute to trade diversion. Moreover, GATS Article V:6 restricts what RTA members can do with regard to rules of origin.

Another factor that may favour trade creation is that it is more difficult to discriminate against non-members. This is because barriers to trade in services are generally in the form of domestic regulations that affect services and services providers. Discrimination in the application of such measures is much more difficult compared to tariffs and may not always be feasible. Fink, in fact, finds that many governments opt for non-discriminatory implementation of their RTA commitments.⁵⁶⁴ Given these factors, it appears that services RTAs may not be prone to trade diversion to the same extent as goods RTAs. Not only does this make trade diversion less of a concern for RTA members, but it may also reduce the adverse effects caused by trade diversion on the part of non-members.

With regard to the dynamic effects, it is found that as in the case of goods trade, the formation of a services RTA can promote efficiency gains from increased competition and exploitation of scale economies, as well as knowledge and technology transfer.⁵⁶⁵ The formation of a services RTA is likely to attract more FDI

⁵⁶⁰ See Chapter 2.

⁵⁶¹ See C Fink and M Molinuevo, 'East Asian Free Trade Agreements in Services: Roaring Tigers or Timid Pandas?' (Policy Research Paper No40175, World Bank, Washington, DC 2007).

⁵⁶² One might argue that RTAs establish a rule of origin for services supplied through modes 1 and 2. For example, cross-border trade in services is typically defined as the supply of a service from the territory of one party into the territory of another party. At what point is a service supplied from outside the territory of a party if a service supplier relies on the import of intermediate service inputs from a non-party? While legal questions of this type may well arise at some point, they still appear to be academic at the moment. For further discussion, see *Ibid.*

⁵⁶³ For more detail, see C Fink, 'PTAs in Services: Friends or Foes of the Multilateral Trading System?' in J Marchetti and M Roy (eds), *Opening Markets for Trade in Services: Countries and Sectors in Bilateral and WTO Negotiations* (Cambridge University Press, Cambridge 2008), p. 141.

⁵⁶⁴ For further discussion, see *Ibid.*, pp. 116-24.

⁵⁶⁵ See Chapter 2 and Mattoo and Fink, pp. 16-8.

if, *inter alia*, it requires the member countries to reduce or eliminate barriers to mode-3 services (commercial presence).⁵⁶⁶

Thus, trade diversion may be less of a major concern for services RTAs than in the case of goods RTAs, and the potential benefits from the dynamic effects also apply. However, one caveat is that the sequence of liberalization matters more in services trade than in the case of goods trade. In particular, the benefits of eventual multilateral liberalization at the WTO may be different if it is *preceded* by preferential liberalization. This is because location-specific sunk costs of production are important in many services.⁵⁶⁷ So, even temporary privileged access for an inferior supplier can translate into a long-term advantage in the market. Thus, while the elimination of preferences may lead to a relatively painless switch to more efficient sources of goods supply, the entry of more efficient services providers may be durably deterred if their competitive advantage does not offset the advantages conferred by incumbency.⁵⁶⁸ These considerations are particularly relevant for developing countries that export mainly goods and import many services. Nevertheless, it is also important to note two qualifications to this caveat. First, entry by the more efficient firm could take place through acquisition- circumventing some of the problems of first-mover advantage, but this would require symmetry of information about the value of assets and no direct costs of transferring assets.⁵⁶⁹ Secondly, in certain services sectors/subsectors, firms could learn by doing.⁵⁷⁰ Thus, given time the relatively inefficient firms which were able to enter the market due to RTA preferences could become as efficient as the initially more efficient non-member firms.

Do any of these factors affect the challenges facing developing countries amid the current RTA proliferation? Recall, the key challenges from the perspective of a prospective RTA member include domestic vested interests, high implementation and

⁵⁶⁶ Mode-3 services directly concerns FDI. See G Karsenty, 'Assessing Trade in Services by Mode of Supply' in P Sauve and R Stern (eds), *GATS 2000: New Directions in Services Trade Liberalization* (Brookings Institution Press, Washington, DC 1999), pp. 43-8.

⁵⁶⁷ Sunk costs include costs of building headquarter, reputation/brand name, and so on. Sunk costs matter because they have commitment value and can be used strategically by those who are allowed to enter the market first. A firm that establishes a telecommunications or transport network today signals that it will be around tomorrow if it cannot easily resell the equipment. The commitment value is stronger the more slowly capital depreciates and the more specific it is to the firm. Then if some firms are allowed to enter the market early, these incumbents may accumulate a quantity of capital sufficient to limit the entry of other firms. For further discussion, see J Tirole, *The Theory of Industrial Organization* (MIT Press, Cambridge, MA 1988), pp. 314-22.

⁵⁶⁸ See Mattoo and Fink, pp. 14-6.

⁵⁶⁹ Ibid.

⁵⁷⁰ Ibid.

adjustment costs, and their lack of analytical and negotiating capacities.⁵⁷¹ On the other hand, the key challenge facing non-member developing countries is the adverse effects caused by trade and investment diversion.⁵⁷²

As far as the challenge of domestic vested interests is concerned, the existing studies, which are based primarily on goods trade, may not be readily applicable. Although the argument that domestic vested interests would prefer to exclude trade-creating sectors/subsectors from a services RTA should still hold, this position can be influenced by *cross-bargaining* between goods and services. Countries rarely aim to liberalize services trade with each other on a bilateral/regional basis without having already or simultaneously achieved a significant degree of integration in the area of trade in goods. In fact, many RTAs, particularly those formed between developed and developing countries, set out to liberalize both goods and services.⁵⁷³ Countries with a comparative advantage in services may be willing to open their highly protected agricultural sectors, for example, in the exchange of their RTA partners' commitment to liberalize their services trade. Such trade-offs are quite common where the developed-country partners have lucrative markets, which are attractive to the developing-country partners whose comparative advantage lies in agricultural and manufacturing goods.⁵⁷⁴ Consequently, domestic vested interests which are against services liberalization will be confronted with by not only those which will gain from services liberalization but also those which will gain from preferential access to such (goods) markets.⁵⁷⁵

Besides the cross-bargaining between goods and services, the challenge of domestic vested interests may also be influenced by the extent to which it is possible to discriminate against non-members. As discussed earlier, discrimination in the application of barriers to trade in services is much more difficult compared to tariffs and may not always be feasible. In addition, it would not be as effective as in the case of goods trade for domestic vested interests to use rules of origin as protectionist

⁵⁷¹ See Chapter 2.

⁵⁷² See Chapter 3.

⁵⁷³ For example, see the Thailand-Australia and Thailand-New Zealand FTAs, and the Thailand-Japan EPA.

⁵⁷⁴ This is certainly the case in the RTA negotiations in which I had an opportunity to take part. For example, the representatives from the Republic of Korea firmly demanded that the ASEAN countries offered a better protection to Korean investors under the ASEAN-Republic of Korea FTA and referred to the Republic of Korea's willingness to open its car and electronic industries in exchange.

⁵⁷⁵ There is evidence of such dynamics during the Japan-Thailand EPA negotiations, in which I was involved as a member of the Thai delegation.

devices, especially when such rules are subject to GATS Article V:6. Furthermore, in some sectors/subsectors, the nature of liberalization measures may be such that it is the first liberalization step- for example, the break-up of a monopoly or the admission of foreign branches- that faces the most political opposition. Once a government has taken that step, there may be little remaining opposition for extending the measure to third countries, especially if the RTA partner is a large economy with a large pool of competitive services providers.⁵⁷⁶ In other words, domestic firms already have to compete with a lot of competitors from the partner country and additional competition from non-members may no longer be perceived as a major threat.

With regard to implementation and adjustment costs, the one that becomes less relevant here is tariff revenue losses since barriers to trade in services are often not revenue-generating.⁵⁷⁷ However, as discussed at some length in Chapter 2, comprehensive services liberalization requires robust regulatory frameworks for the sectors/subsectors covered by the agreement. Establishing such frameworks often involve high implementation and adjustment costs.⁵⁷⁸ Other implementation and adjustment costs will depend on the actual commitments made in the services RTA in question and the trade relationship between the member countries.⁵⁷⁹

The constraints on analytical capacity on the part of developing countries are arguably more severe than in the case of goods trade. One reason for this is that data on services trade are not readily available and their collection requires specialized set of economic analytical skills and responsible institutions.⁵⁸⁰ The availability of data is often noted as a major limitation in the literature on trade in services. Consequently, the negotiating capacity on the part of developing countries is likely to be undermined due to this lack of analytical capacity as they may not know exactly what they can and cannot commit in the negotiations. Furthermore, given that successful services liberalization demands robust regulatory frameworks, analytical capacity with regard to necessary regulations and how to put them in place is crucial. For example, financial liberalization requires extremely complex and difficult regulatory

⁵⁷⁶ See Fink, 'PTAs in Services: Friends or Foes of the Multilateral Trading System?', p. 125.

⁵⁷⁷ See Mattoo and Fink, pp. 9-11.

⁵⁷⁸ See Chapter 2.

⁵⁷⁹ For example, if competitions from the RTA partner are fierce and domestic services providers can only compete as a result of trade barriers, a commitment to reduce or eliminate such barriers will imply high implementation and adjustment costs for the home country.

⁵⁸⁰ From the interviews conducted, a Thai trade negotiator revealed that Thailand has only started collecting data on services since the end of 2000.

frameworks to be established prior to or at the time of liberalization. It also involves close monitoring after the opening of the market, which entails well-functioning regulatory bodies. The vitality and complexity of such regulatory frameworks can be seen from the 2008 financial crisis which is originated in the United States' financial sector/subsectors.⁵⁸¹ If the world's most advanced economy fails to do it, there are significant impediments to developing countries having the capacity to succeed.⁵⁸²

The challenge of trade and investment diversion should still hold although their magnitude may be mitigated by the factors which lessen trade-diverting effects. Thus, non-members may not be adversely affected to the same extent as in the case of goods RTAs. It should be noted that paragraph 8 explicitly prevents RTA members from seeking compensation from non-members if the latter benefit from the formation of their services RTA. This suggests that non-members may actually gain from the formation of a services RTA.

In addition to the challenges identified in Chapters 2 and 3, there are two other unique challenges arising in the context of trade in services that are worth discussing. The first is whether developing countries, when making commitments in services RTAs, are capable of establishing appropriate and effective regulatory frameworks, which can vary from one sector/subsector to another. This is rather different from, although linked to, the implementation and adjustment costs discussed earlier. The starting point is that services liberalization is much more complicated than the case of goods trade. Even though the standard benefits from liberalization are similar to those of goods liberalization- *i.e.* the static and dynamic gains,⁵⁸³ the costs are much more sector-specific due to the diversity of services.⁵⁸⁴ Each sector/subsector tends to have its own characteristics and problems. These are generally and necessarily dealt with through various domestic regulations. Although putting in place appropriate and effective regulatory frameworks for all the sectors/subsectors covered by the agreement is very important, it is far from easy.

⁵⁸¹ For further discussion, see JB Taylor, 'The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong' (Working Paper No14631, National Bureau of Economic Research, 2009).

⁵⁸² An example of the failure to put in place financial regulatory framework and monitor business activities on the part of developing countries is the Southeast Asian financial crisis of 1997. See G Coretti, PA Pesenti and N Roubini, 'What Caused the Asian Currency and Financial Crisis? Part I: A Macroeconomic Overview' (Working Paper No6833, National Bureau of Economic Research, 1998).

⁵⁸³ See Chapter 2.

⁵⁸⁴ See O Cattaneo and others, 'Assessing the Potential of Services Trade in Developing Countries: An Overview' in O Cattaneo and others (eds), *International Trade in Services: New Trends and Opportunities for Developing Countries* (World Bank, Washington, DC 2010), p. 2.

In financial sector and subsectors, for example, while liberalization would promote competition and efficiency as well as FDI, regulations on excessive risk-taking behaviours and in/outflow of capital are necessary for financial stability and protection of small depositors.⁵⁸⁵ However, this is not easy to accomplish as can be seen from the fact that many developing countries suffered financial crises during the mid to late 1990s, *e.g.* Thailand in 1997, often several years after they had begun to carry out financial reforms and liberalize their banking sectors.⁵⁸⁶ This suggests that although financial liberalization may result in efficiency and competitive gains derived from a more open market, it can increase the vulnerability of financial systems to financial crisis as well. In addition, the sequence of internal (domestic) and external (international) liberalization is said to have significant effects on the success of financial liberalization. Edwards argues, in the context of Latin American countries, that any external liberalization of financial sector/subsectors should take place after internal liberalization because premature opening of capital markets can lead to volatile financial flows that can magnify domestic instability, particularly in terms of real exchange rate followed by capital flight.⁵⁸⁷ In other words, domestic financial sector/subsectors must not suffer from non-competitive structure and inadequate regulation prior to international liberalization. This is a crucial point as many developing are faced with underdeveloped regulatory frameworks for financial sector/subsectors, and may not yet be ready for external liberalization, including that achieved through services RTAs.⁵⁸⁸

Other services sectors/subsectors have different characteristics and are confronted with different problems. For example, in water services, although it is typically more efficient to have a single supplier of piped services to any particular area due to natural monopoly and significant network economies of scale, liberalization of water services can offer potential benefits in terms of investment,

⁵⁸⁵ See G Stiglitz, 'The Role of the State in Financial Markets' (Proceedings of the World Bank Conference on Development Economics, World Bank, Washington, DC 1994).

⁵⁸⁶ See M Brownbridge and C Kirkpatrick, 'Financial Regulation in Developing Countries' (2000) 37 *Journal of Development Studies* 1, pp. 7-8.

⁵⁸⁷ See S Edwards, 'The Sequencing of Economic Reform: Analytical Issues and Lessons from Latin American Experience' (1990) 13 *The World Economy* 1.

⁵⁸⁸ For example, see J Wahba and M Mohieldin, 'Liberalizing Trade in Financial Services: The Uruguay Round and the Arab Countries' (1998) 26 *World Development* 1331, pp. 1341-2.

technology and management expertise.⁵⁸⁹ However, successful liberalization would require a well-functioning regulatory framework. Not only are regulations important in dealing with market failures such as natural monopoly and asymmetric information,⁵⁹⁰ they are also crucial to ensure positive externalities as water is both essential for life/health of the population and the livelihoods of farmers in the rural areas.⁵⁹¹ These characteristics of water services provide additional arguments for regulation on social as well as economic grounds. Where a service is regarded as meeting a basic need or entitlement, regulation will be needed to ensure universal access, for example. This is vital for developing countries as it is estimated that 1.1 billion people in these countries do not have access to safe water supplies and 2.4 billion lack access to basic sanitation.⁵⁹² Thus, developing countries forming a services RTA that covers water services must put in place a regulatory framework which is able to secure access to safe, reliable, and reasonably priced water services, particularly for the poor and those who live in the rural areas.

Establishment of appropriate and effective regulatory frameworks for services sectors/subsectors requires significant resources, both in terms of human capital and domestic institutions. It is also likely to take time for regulatory bodies to build up their expertise in monitoring services and services providers and in obtaining economic and social objectives set by the government. In order to maximize the potential benefits and minimize the potential costs induced by the formation of a services RTA, developing countries cannot simply open their markets. They have to ensure that they are capable of establishing appropriate and effective regulatory frameworks in the sectors/subsectors covered by the agreement. The stage of development of a developing country is therefore relevant here as the more advanced ones are likely to already have relatively well-established regulatory frameworks in important services sectors/subsectors and better analytical capacity (due to better human capital and domestic institutions) to maintain or improve them.

⁵⁸⁹ See N Johnstone and L Wood, 'Introduction' in N Johnstone and L Wood (eds), *Private Firms and Public Water: Realising Social and Environmental Objectives in Developing Countries* (Edward Elgar, Cheltenham 2001), pp. 10-1.

⁵⁹⁰ Asymmetric information occurs where one party to a transaction has more information than the other about the quantity or quality of the outputs to be transacted and on that basis acts opportunistically to exploit its superior knowledge and gain at the expense of the other party.

⁵⁹¹ See C Kirkpatrick and D Parker, 'Domestic Regulation and the WTO: The Case of Water Services in Developing Countries' (2005) 28 *The World Economy* 1491, p. 1497.

⁵⁹² See Organisation for Economic Co-operation and Development, 'Water Partnerships: Striking a Balance' (OECD, Paris 2003).

Another unique challenge facing developing countries concerns *movement of natural persons* or mode-4 services. In general terms, developed countries are capital abundant and will benefit from free movement of capital while most developing countries are labour abundant and will benefit from free movement of labour. In other words, developing countries generally have comparative advantage in this factor of production. However, unlike free movement of capital, which is often promoted by bilateral investment treaties and/or investment chapters in RTAs, free movement of natural persons is usually met with less enthusiasm.⁵⁹³ For example, although the number of RTAs covering services is growing rapidly, the willingness to incorporate meaningful provisions on labour mobility as part of a service package is limited- most agreements contain only modest market access opportunities for foreign workers.⁵⁹⁴

Potential gains from free movement of natural persons are very important to developing countries. The most evident way in which mode-4 services benefit them is through the provision of a steady and continuous inflow of remittances. In 2008, such remittances amounted to about \$330 billion.⁵⁹⁵ Studies have shown that these remittances significantly reduce the level, depth, and severity of poverty in developing countries.⁵⁹⁶

In the context of services RTAs, a developing country is likely to gain if its partners, particularly developed-country ones in North-South agreements, make commitments that allow freer movement of natural persons in services sectors/subsectors in which the developing country has abundant supply of qualified workers. For example, the Philippines has been exporting nurses and other health care workers to English-speaking countries,⁵⁹⁷ whereas, India has benefited from its exports of financial and IT workers.⁵⁹⁸

⁵⁹³ See S Stephenson and G Hufbauer, 'Increasing Labor Mobility: Options for Developing Countries' in O Cattaneo and others (eds), *International Trade in Services: New Trends and Opportunities for Developing Countries* (World Bank, Washington, DC 2010), p. 29.

⁵⁹⁴ Ibid.

⁵⁹⁵ See IMF database, available at <http://www.imf.org/external/pubs/ft/fandd/2009/12/ratha.htm> (last accessed 4 October 2010). It should be noted that the total amount of resources remitted may be two or three times greater since a large number of transactions are affected through informal channels.

⁵⁹⁶ For example, see RH Adams and J Page, 'Do International Migration and Remittances Reduce Poverty in Developing Countries?' (2005) 33 *World Development* 1645, pp. 1652-5.

⁵⁹⁷ See M Mashayekhi, M Julsaint and E Tuerk, 'Strategic Considerations for Developing Countries: The Case of GATS and Health Services' in C Blouin, N Drager and R Smith (eds), *International Trade in Health Services and the GATS: Current Issues and Debates* (World Bank, Washington, DC 2006), p. 22.

⁵⁹⁸ See Cattaneo and others, p. 9. For further discussion on movement of natural persons and how mode-4 liberalization can affect developing countries, see Stephenson and Hufbauer, 'Increasing Labor Mobility: Options for Developing Countries', pp. 29-66.

The following sections will examine GATS Article V in light of these two unique challenges arising in the context of services trade in addition to the challenges facing developing countries amid the current RTA proliferation identified in Chapters 2 and 3.

6.3.1 Intra-RTA Obligation and the Challenges Facing Developing Countries from the Perspective of a Prospective Member

Under GATS Article V, it can be argued that the intra-RTA obligation is comprised of the requirements contained in paragraph 1 and the first requirement contained in paragraph 4. As far as subparagraph 1(a) is concerned, a services RTA notified under GATS Article V must have substantial sectoral coverage. The footnote to the provision explains that this requirement “is understood in terms of number of sectors, volume of trade affected, and modes of supply.” Subparagraph 1(a) is based on, and imports into GATS, the key concept of substantially all the trade in GATT Article XXIV:8.⁵⁹⁹ On the face of it, the wording of the provision and of the footnote clarifies that the requirement entails both qualitative and quantitative components.⁶⁰⁰ As can be seen in the context of GATT Article XXIV, the notion of what is *substantial* is controversial and has been subject to years of debates among WTO Members (and GATT CONTRACTING PARTIES before them). Things are arguably much more complicated under GATS Article V due to services-specific problems.

With regard to the qualitative component, it is not at all clear how the requirement of substantial sectoral coverage should be met. For example, can entire sectors be excluded from a services RTA or at what level of detail should the determination of included and excluded services be made, *i.e.* at the level of individual services, subsectors or whole sectors? The footnote uses the term *sectors*, which arguably suggests that the requirement is *inter alia* based on the concept of entire sectors, and that inclusion of substantially all of these sectors is necessary in

⁵⁹⁹ See *supra* note 518. See also R Wolfrum, P-T Stoll and C Feinaugle, *WTO-Trade in Services* (Max Planck Commentaries on World Trade Law: 6, Martinus Nijhoff Publishers, Leiden 2008), p. 130.

⁶⁰⁰ See Hudec and Southwick, 'Regionalism and WTO Rules: Problems in the Fine Art of Discrimination Fairly', pp. 75-6. For the discussion on this point in relation to GATT Article XXIV, see Chapter 4.

order to comply with subparagraph 1(a). The Appellate Body held in *Turkey–Textiles* that *substantially all the trade* is “not the same as all the trade”, and that it is “something considerably more than merely some of the trade”.⁶⁰¹ If the same reasoning were to be adopted here, subparagraph 1(a) would not require all sectors to be covered but that the agreement excludes no more than a very limited number of sectors. Although at first glance such interpretation is straightforward, it still does not specify when exactly the requirement is met. Does the inclusion of eight out of the 11 current services sectors identified by the Services Sectoral Classification List count as substantial sectoral coverage?⁶⁰² Furthermore, in assessing the relevance of exclusions, should the economic importance of the sector in terms of international exchange be taken into account? It has been suggested that the exclusion of major sectors, which represent great economic value, would in itself prevent a services RTA from passing the requirement of substantial sectoral coverage.⁶⁰³ It also remains unclear how those sectors that are only partially covered by a services RTA should be computed- that is those sectors in which one or more subsectors have been excluded.⁶⁰⁴

As for the quantitative component, the reference to volume of trade in the footnote to subparagraph 1(a) could imply that RTA members must liberalize those services which amount to substantial trade volumes between themselves in terms of both current and potential trade.⁶⁰⁵ According to this interpretation, the sectors/subsectors or even particular services where limitations are maintained, cannot be those where significant trade between the member countries occurs or would have occurred but for the limitations. However, it is extremely difficult, if at all possible, to accurately assess volumes of services trade, particularly potential trade which would

⁶⁰¹ See WTO Appellate Body Report, *Turkey–Textiles*, para. 48.

⁶⁰² See http://www.wto.org/english/tratop_e/serv_e/serv_sectors_e.htm (last accessed 18 August 2010). See also Note by the Secretariat, ‘Services Sectoral Classification List’, MTN.GNS/W/120.

⁶⁰³ See Committee on Regional Trade Agreements, ‘Note on the Meetings of 29-30 April and 3 May 1999’, WT/REG/M/22 (4 April 1999), para. 16.

⁶⁰⁴ Practice reveals that some services RTAs do fully exclude some service sectors from their coverage, as is the case of financial services in the Republic of Korea-Chile FTA. In addition, the exclusion of some subsectors is a common practice, in particular with the transport sectors for the air and maritime transport subsectors. See Wolfrum, Stoll and Feinaugle, p. 131.

⁶⁰⁵ See *Ibid.*, p. 132. It should be noted that the concept of “volume of trade” is of limited significance in the realm of international trade in services as covered by GATS. The mere idea of *volume* is at odds with the intangible nature of services. Moreover, international trade in services may occur without international transactions taking place, as is the case when services are provided through a locally established commercial presence, which also interferes with the assessment of the “volume of trade” in services between two countries in terms of international transactions.

have occurred but for the existing trade barriers.⁶⁰⁶ Not only do statistical data on trade in services currently fall short in amount and quality compared to those available for trade in goods, but there are also difficulties involved in different methodological approaches on how to collect them.⁶⁰⁷

Given that few services RTAs are likely to have 100 per cent sectoral coverage, the question- when exactly the substantial sectoral coverage requirement is satisfied?- is likely to come up repeatedly in the CRTA. For example, members of the NAFTA Working Party questioned whether the NAFTA's exclusion of aviation and maritime services and its grandfathering of state and local measures meant that it had less than substantial sectoral coverage.⁶⁰⁸ In the end, different views were noted by the Working Party on the extent to which activity reservations could result in a *de facto* sectoral exclusion but no firm conclusion was reached.⁶⁰⁹ It is noteworthy that in response to a Member's request for information on the economic value of the unbound sectors, the NAFTA members themselves noted the difficulty in deriving meaningful statistical information for trade in services.⁶¹⁰

Since the substantial sectoral coverage requirement determines the ambit of the requirement under subparagraph 1(b), its interpretation is very crucial. As discussed earlier, one unique challenge facing developing countries is the capacity to establish appropriate and effective regulatory frameworks for the sectors/subsectors covered in a services RTA. If the requirement is interpreted very strictly, developing countries will be obliged to include sectors/subsectors that they may not yet have well-functioning regulatory frameworks in place. This can arguably do them more harm than good. The function of the SAT requirement in the case of goods RTAs is to promote the inclusion of trade-creating products and industries. However, since trade diversion is less of a major concern in the case of services RTAs, the substantial sector coverage requirement may not be as important here.

⁶⁰⁶ See Stephenson, 'Regional Agreements on Services in Multilateral Disciplines: Interpreting and Applying GATS Article V', pp. 91-2.

⁶⁰⁷ On the problems related to the collection of precise data on services trade, see BM Hoekman, 'Tentative First Steps: An Assessment of the Uruguay Round Agreement on Services' (Policy Research Working Paper No1455, World Bank, Washington, DC 1995), S Stephenson, 'GATS and Regional Integration' in P Sauve and R Stern (eds), *GATS 2000-New Directions in Services Trade Liberalisation* (Brookings Institution Press, Washington, DC 2002), pp. 514-6.

⁶⁰⁸ See Committee on Regional Trade Agreements, 'Note on the Meeting 24 February 1997- Examination of the North American Free Trade Agreement', WT/REG4/M/4 (April 16, 1997), para. 26.

⁶⁰⁹ *Ibid.*

⁶¹⁰ *Ibid.*

One way to get around this is for developing countries to rely on subparagraph 3(a), which provides special and differential treatment for paragraph 1 requirements. Nevertheless, it is not clear how far they can do so. For example, would the substantial sector coverage requirement still be met if a developing country relies on subparagraph 3(a) to exclude six out of the 11 services sectors in its services RTA? Surely, in such situation, the number of sectors covered (less than half) would cease to be substantial. This interpretative problem suggests that it may have been a fundamental mistake to import into GATS the key concept of substantially all the trade in GATT Article XXIV:8 in this fashion.

In my view, developing countries should liberalize their services sectors/subsectors only to the extent that they are able to establish appropriate and effective regulatory frameworks.⁶¹¹ On the basis of the wording of subparagraph 1(a), I believe that a compromise can be made. Developing countries may be required to include substantial sectoral coverage (whatever that may be, e.g. eight out of 11 sectors) but they should be allowed to insert conditions and reservations with regard to the covered sectors/subsectors, which could be tied with their ability to establish appropriate and effective regulatory frameworks and/or other social objectives. For example, in the financial sector/subsectors, firms from RTA partners may operate only in subsectors which are adequately regulated (subjectively determined by the developing country) and/or as long as they also provide financial products which help the poor, e.g. microloans, for example.⁶¹² This way, there is no need to amend subparagraph 1(a), the substantial sectoral coverage requirement. It is noteworthy that although the CRTA and panels/the Appellate Body have yet to clarify this point, WTO Members seem to have adopted the practice where most sectors are covered but subject to *horizontal exceptions*.⁶¹³ Developing countries should be able to rely on

⁶¹¹ For example, Indonesia only made moderate GATS-plus commitments in its services RTA with Japan on the ground of the need to establish regulatory frameworks. However, it should be noted that Indonesia did not rely on GATS Article V:3(a) for this. See Committee on Regional Trade Agreements, 'Economic Partnership Agreement between Japan and Indonesia (Goods and Services)- Questions and Replies', WT/REG241/2 (7 September 2009), para. 15.

⁶¹² Microloans are extremely small loans, compared to the Western standard, which are given to those in poverty and designed to spur entrepreneurship among the very poor. For example, in Thailand, microloans valued between £50-200 are only offered by the state-owned bank to those below the poverty line without requiring evidence of steady employment or verifiable credit history. On general discussion on microloans and their role in development, see DR Snow, G Woller and TF Buss, *Microcredit and Development Policy* (Nova Science Publishers, Huntington, New York 2001).

⁶¹³ Horizontal exceptions are inserted at the beginning of covered sectors in order to set out exceptions which apply to all subsectors within the respective sectors. These exceptions allow RTA members to exempt themselves from subparagraph 1(b) requirement. For example, see the services chapter of the

subparagraph 3(a) to justify this. In addition, some form of technical assistance on how to put in place appropriate and effective regulatory frameworks for the sectors/subsectors covered should be available for them in order to deal with this challenge from all fronts.⁶¹⁴

Subparagraph 1(b) requires that a services RTA provides the absence or elimination of substantially all discrimination. This is understood in terms of GATS Article XVII, which requires that treatment granted to services providers from the partner country be no less favourable than that accorded to domestic services providers. Granting unqualified national treatment among the member countries would be the equivalent of providing free trade for services- that is no discriminatory barriers (except possibly those of a quantitative non-discriminatory nature) would exist to the establishment of member firms or to cross-border sales of services by member firms.⁶¹⁵ The key question is how to determine whether subparagraph 1(b) requirement is satisfied.

According to the text, subparagraph 1(b) requirement can be achieved through two channels, namely, “elimination of existing discriminatory measures,”⁶¹⁶ and/or “prohibition of new or more discriminatory measures.”⁶¹⁷ The former entails an obligation to liberalize as it requires the elimination of existing discriminatory measures; whereas, the latter features only a limited liberalization as it requires conditions of competition between domestic and partner services providers not to be worsened, *i.e.* a *stand-still* obligation. The adoption of one “and/or” the other means under subparagraph 1(b) raises the question whether or not these two channels can be considered to be two self-standing and independent ways of fulfilling the requirement therein. In other words, can RTA members freely choose between either of the two channels, so that the mere inclusion of a stand-still obligation would ensure compliance with the requirement under subparagraph 1(b)?

To answer this question one is required to construe subparagraph 1(b) as a whole. From the wording, one could argue that the main objective of subparagraph 1(b) is to ensure the absence or elimination of substantially all discrimination (in the

Thailand-Australia FTA, available at <http://www.dfat.gov.au/trade/negotiations/aust-thai/> (last accessed 5 October 2010).

⁶¹⁴ See Chapter 7.

⁶¹⁵ See Stephenson, 'Regional Agreements on Services in Multilateral Disciplines: Interpreting and Applying GATS Article V', p. 93.

⁶¹⁶ GATS Article V:1(b)(i).

⁶¹⁷ GATS Article V:1(b)(ii).

sense of national treatment obligation) between or among the member countries in the sectors covered in the agreement. The two channels are merely means to achieve this objective. For sectors in which discriminatory measures exist, the member countries must eliminate them to the extent that substantially all discrimination no longer exists. Instead, in sectors that are being liberalized or have previously been subject to unilateral liberalization, the stand-still obligation ensures that the absence of discrimination will be maintained. Thus, in my view, the two channels set out in subparagraph 1(b)(i) and (ii) are not independent alternatives. Rather, they are to be adopted in accordance with the situations that exist in the covered sectors.

As mentioned in the previous section, paragraph 1 requirements are to be met either at the entry into force of that agreement or on the basis of “a reasonable time-frame”. In the case of goods RTAs notified under GATT Article XXIV, the 1994 Understanding elaborates that “a reasonable length of time” contained in GATT Article XXIV:5(c) is taken to mean no longer than ten years.⁶¹⁸ Unfortunately, it is not clear what is to be considered reasonable in the case of services RTAs. WTO Members have suggested periods ranging from five to ten years for the phrase *reasonable time-frame*.⁶¹⁹ I think that a reasonable timeframe should be linked to the ability on the part of the developing-country partner to put in place appropriate and effective regulatory frameworks for the sectors/subsectors covered by the RTA. In addition, reasonable timeframes for developed and developing countries should be different, which can be justified under subparagraph 3(a). However, it is also important not to overdo this. As argued in Chapters 4 and 5, the flexibility granted to developing countries should be subject to certain limits and should not be excessive. Perhaps, the CRTA could review the existing and newly notified services RTAs in order to find out an appropriate length of time for developing countries to liberalize their services trade through RTAs. The difficulty with this is that developing countries are not homogeneous and each country may have different strengths and weaknesses in different services sectors/subsectors. The issue of heterogeneity of developing countries in relation to the built-in special and differential provisions are discussed further below.

So far, it can be seen that there are a number of unresolved interpretative ambiguities with subparagraph 1(b). In addition and more importantly, the question

⁶¹⁸ See the 1994 Understanding, para. 3.

⁶¹⁹ See *supra* note 21, para. 84.

remains- when is the requirement to eliminate substantially all discrimination satisfied? Can one apply a numerical benchmark to the requirement? For example, if there were 100 discriminatory measures in a covered sector, would the elimination of 90 measures account for substantially all discrimination being eliminated? Such an approach would have the benefit of simplicity, but it might not make much sense given that the remaining ten measures could restrict more intra-RTA services trade in the sector even more than the 90 measures eliminated collectively did. Or should the requirement be considered on the basis of trade volume being restricted by the existing measures. That is, the requirement would be met if, say, 90 per cent of trade volume within a covered sector was free of discriminatory measures. This approach would be more effective at ensuring services liberalization, but it would encounter the same problem as the quantitative component of subparagraph 1(a) with regard to data on services trade.

Noticeably, the difficulties with regard to subparagraph 1(b) are quite similar to those discussed in the context of *other restrictive regulations of commerce*. They may be even more problematic due to the lack of data on and the novelty of trade in services. In the case of ORRCs, I argue that it would make more sense to separate the ORRC half from the duty half for the application of the SAT requirement. That is, RTA members would be subject to the demanding definition of and tight timeframe for the duty half of the SAT requirement, albeit the proposed special and differential treatment available for developing countries, while the ORRC half would be enforced separately with less rigour.⁶²⁰ This proposal would still allow the intra-RTA (goods) trade to be sufficiently *facilitated* (GATT Article XXIV:4 first objective) because NTBs are subject to other WTO commitments, hence limiting trade distortion caused by discriminatory measures.⁶²¹

However, things are different under GATS. First, given that the primary type of barriers to trade in services is non-tariff measures, subparagraph 1(b) requirement is crucial for intra-RTA services liberalization. Secondly and more importantly, market access and national treatment obligations are specific commitments under GATS. WTO Members have to comply with these obligations only in services sectors/subsectors which they have inscribed in their respective GATS Schedules of specific commitments and the obligations are subject to the terms, limitations, and

⁶²⁰ See Chapter 4.

⁶²¹ Ibid.

conditions set out therein. This means that if a WTO Member has inscribed few services sectors/subsectors in its GATS Schedule, it can freely maintain or impose discriminatory measures in the unbound sectors/subsectors, which may cause severe trade distortion. On this basis, the implementation of both subparagraphs 1(a) and (b) is very important to promote trade creation and the gains from dynamic effects. However, given the lack of data on and the novelty of trade in services, it is extremely difficult to implement these provisions in practice. This raises the question whether GATS Article V is at all effective in achieving the object and purpose of GATS, and for the purposes of the thesis, the challenges facing developing countries amid the current RTA proliferation.

Due to the nature of these difficulties, it will take time for WTO Members and experts to agree on how the requirements under paragraph 1 should be interpreted; and it will also take time for them to come up with suitable methodological approaches for data collection with regard to services trade and actually carry it out so that the requirements can be implemented in practice. Until then, not much can be done as far as the interpretation of these requirements is concerned. However, it is also important not to exaggerate the consequences of the current situation.

As discussed in Chapter 2, the functions of the WTO rules should be to encourage the member countries to promote the potential benefits and at the same time allow them to manage the potential costs induced by the formation of an RTA. For example, the SAT requirement under GATT Article XXIV is there to indirectly force RTA members, which may be influenced by domestic vested interests, to include trade-creating products and industries as well as to enhance the dynamic effects resulted from the formation. Although the requirements under paragraph 1 of GATS Article V arguably aim to achieve these also, the magnitude of trade diversion, which is a major concern in the case of goods RTAs, may be mitigated by the nature of barriers to trade in services and rules of origin.⁶²² Consequently, the proposition that “some liberalization is better than none” is arguably more valid in the case of services RTAs.⁶²³ Since negotiations on GATS provisions and Members’ specific commitments are still ongoing and not yet comprehensive, services RTAs may provide a means to liberalize trade in services, albeit on a bilateral/regional basis.

⁶²² See earlier discussion.

⁶²³ A keen advocate of this proposition is Lawrence Summers, who was very influential under the Clinton Administration. See Summers.

Given the difficulties involved in the requirements set out in paragraph 1 and the rising number of services RTAs, perhaps it might be more fruitful to direct Members' resources and attention to elaborating GATS Article V:6 in order to ensure liberal rules of origin, which allow non-members to benefit from RTA commitments—effectively multilateralizing them.⁶²⁴ In addition, given the complexity of services liberalization and the need for appropriate and effective regulatory frameworks, greater efforts should be made to provide developing-country Members with necessary technical assistance when negotiating services RTAs.⁶²⁵ Technical assistance is arguably even more important here than in the case of goods RTAs.

As far as developing countries are concerned, GATS Article V:3 contains built-in special and differential treatment provisions. With regard to the requirements contained in paragraph 1, subparagraph 3(a) requires that flexibility must be provided in accordance with the level of development of developing-country partners, both overall and in individual sectors and subsectors. In principle, this should mean that developing countries are subject to the more lenient interpretation of the requirements under paragraph 1 in terms of the threshold levels of substantial sectoral coverage and substantially all discrimination, and the maximum period for reasonable timeframe. Assuming that WTO Members can agree on these issues and it is possible to collect quality and adequate data on services trade to implement paragraph 1 requirements, developing countries should be able to better manage the potential costs induced by the formation of a services RTA, given the flexibility afforded under subparagraph 3(a).

One desirable consequence of holding developed countries to the more demanding interpretation of paragraph 1 requirements is that they could be indirectly forced to make meaningful commitments on mode-4 services. In other words, if developed countries are required to include more sectoral coverage and they cannot *a priori* exclude any mode of supply (subparagraph 1(a)), and substantially all discrimination (in the sense of national treatment) in these covered sectors/subsectors must be eliminated (subparagraph 1(b)), they would have less room to manoeuvre. Thus, developing countries would be able to negotiate more effectively. Since they can legally liberalize less, developing countries may be able to use this as a leverage to demand their developed-country counterparts to liberalize mode-4 services. This is

⁶²⁴ This will be discussed in the next section.

⁶²⁵ See Chapter 7.

in line with what I propose in Chapter 4 where developed-country RTA members are subject to higher threshold level of and stricter transitional period for the SAT requirement.⁶²⁶ After all, the outcome of an RTA depends on the preceding negotiations where bargaining powers play a crucial role.⁶²⁷ Since bargaining power is linked with market power and/or other non-economic factors (such as security) and little can be done about it, to textually oblige developed countries to liberalize more should improve developing countries' negotiating capacity, and hence leveling the playing field in RTA negotiations.

It is noteworthy that the wording of subparagraph 3(a) implies a more country-specific approach to special and differential treatment, which should avoid cases where advanced developing countries like the Republic of Korea, Singapore, and Taiwan, or big developing countries like Brazil, China, and India are given the same flexibility as less advanced and smaller developing countries, both in North-South and South-South RTAs. However, there could be a disadvantage in having such a *tailored-fit* special and differential treatment for GATS Article V (as well as GATT Article XXIV and the Enabling Clause for that matter).

The disadvantage is that a tailored-fit special and differential treatment demands one to specify the threshold levels and transitional periods *after* having reviewed the circumstances of RTA members. This would arguably involve a review of an individual RTA member in absolute terms and in relation to its RTA partner: while the former could be carried out periodically similar to those produced under the TPRM, the latter would have to be conducted after an RTA is notified to the CRTA. The review of an individual RTA member in relation to its RTA partner is arguably as important as its review in absolute terms. For example, the flexibility afforded to Thailand in an RTA with Japan should not be the same as its RTA with Lao People's Democratic Republic. The differences lie in the partner countries and the level of integration envisaged in each individual RTA. Since a tailored-fit special and differential treatment would require such reviews, predictability is compromised. Prospective RTA members would have to guess what threshold levels and transitional periods they would be subject to during RTA negotiations. This would make it

⁶²⁶ See Chapter 4.

⁶²⁷ See Chapter 2.

extremely difficult, if at all possible, to negotiate an RTA.⁶²⁸ Thus, I believe that the more nuanced approach to special and differential treatment proposed in Chapters 4 and 5 (whereby developing countries are further divided into subgroups and different threshold levels and transitional periods are agreed *in advance*) would strike a better balance between the individual needs of developing countries and predictability (and indeed practicality) of RTA negotiations.⁶²⁹ Nevertheless, a tailored-fit special and differential treatment can be provided to developing countries in the form of technical assistance.⁶³⁰

The other part of the intra-RTA obligation is paragraph 4 first requirement. That is, services RTAs must be designed to facilitate intra-RTA trade. As discussed in the previous chapter in the context of subparagraph 3(a), the use of the word *designed* implies that the requirement is about the intention and not the actual effects of an RTA.⁶³¹ This should be reasonably easy for the member countries to satisfy. Given that the requirements contained in paragraph 1 are already onerous, albeit the difficulties involved in implementing them, I propose that a services RTA would intend to facilitate the intra-RTA trade if it satisfied paragraph 1 requirements. Such interpretation should simplify the intra-RTA obligation without watering down its objective.⁶³²

6.3.2 Third-party Obligation and the Challenge of Trade and Investment Diversion

The third-party obligation contained in paragraph 4 second requirement demands that a services RTA does not in relation to non-members raise the overall level of barriers to trade in services within the respective sectors or subsectors compared to the level applicable prior to its formation. How can such a requirement be tested in practice?

⁶²⁸ From the interviews I conducted, a representative from the ASEAN Secretariat told me that ASEAN adopts 90 per cent of the tariff lines as a numerical benchmark in its RTA negotiations to satisfy the SAT requirement under GATT Article XXIV.

⁶²⁹ See Chapters 4 and 5.

⁶³⁰ This will be discussed in Chapter 7.

⁶³¹ See Chapter 5.

⁶³² It is noteworthy that the conditions set out in paragraph 1 are already very onerous- unlike the requirements contained in subparagraph 2(c) of the Enabling Clause which are arguably very lenient, and as argued in the previous chapter, need to be read in light of subparagraph 3(a) first requirement.

In order to implement this requirement, one has to calculate the overall level of barriers to services trade in effect before the formation of a services RTA. This is an extremely difficult task. Given that barriers to trade in services are present in laws, decrees, and regulatory practices, their qualitative nature makes it very challenging to attach to them a quantitative value.⁶³³ Calculating tariff or price equivalents for the trade-restrictive effect of most domestic regulations has proved extremely complicated and most likely will continue to run into data and methodological difficulties, greater for some sectors than for others.⁶³⁴ This will be made worse where RTA members choose to avoid discrimination by harmonizing or creating a common regulatory regime (primarily in CUs) in a covered sector/subsector as non-members may find such a harmonized or common regulatory regime more restrictive than prior to the formation in one or more member countries.⁶³⁵ It should be noted that similar difficulties arise in the case of *other regulations of commerce* under GATT Article XXIV:5(a) where one is required to determine whether *on the whole* ORCs have become more restrictive than prior to the formation of a CU.⁶³⁶

Thus, the difficulties in quantifying restrictiveness that may be qualitative in nature coupled with the lack of precise statistical data on trade in services pose important obstacles in the practical application of paragraph 4 second requirement. Furthermore, the raising of the level of barriers must be attributable to the services RTA in a causal relationship between the agreement and the new level of barriers.⁶³⁷ Arguably, new restrictions introduced unilaterally by one of the member countries are to be evaluated on their own terms, unless they are directly or indirectly related to the change of circumstances induced by the services RTA in question. Otherwise, the member countries would violate paragraph 4 second requirement every time they

⁶³³ See Stephenson, 'Regional Agreements on Services in Multilateral Disciplines: Interpreting and Applying GATS Article V', pp. 95-6.

⁶³⁴ Ibid.

⁶³⁵ See Hudec and Southwick, 'Regionalism and WTO Rules: Problems in the Fine Art of Discrimination Fairly', p. 78. The GATS negotiators, in fact, considered a formulation that would have steered RTA members towards adopting the least restrictive regime in any of the members in the event that RTAs included harmonized or common measures. The 1990 draft text of what became GATS Article V stated: "[Regional arrangements] shall not in respect to other Parties raise overall levels of barriers to trade in services within the respective sectors/subsectors. Parties to an agreement should seek to implement any common measures with respect to other Parties at the least restrictive level existing prior to entering into such an agreement." However, this was rejected in the drafting of the final text of GATS Article V. For more detail, see S Terrence, *The GATT Uruguay Round: a Negotiating History (1986-1992): Volume II* (Kluwer Law International, Boston 1993), pp. 2383-4 and 2414.

⁶³⁶ See Chapter 4 and the 1994 Understanding, para. 2.

⁶³⁷ See Wolfrum, Stoll and Feinaugle, pp. 144-5.

unilaterally impose new domestic regulations that are more restrictive even though they have nothing to do with the services RTA and are necessary due to changes in technology or business practices.⁶³⁸

Despite the unresolved problems with the implementation of paragraph 4 second requirement, it is important to note that the extent of trade diversion induced by the formation of a services RTA may be mitigated as a result of the nature of barriers to trade in services and rules of origin. With regard to investment diversion, all depends whether tariff-jumping investment exceeds other types of investment.⁶³⁹ Given that FDI and investment in general will be influenced by liberalization of trade in services as well as trade in goods, it is almost impossible to prevent investment diversion only through paragraph 4 second requirement.⁶⁴⁰ In addition, if mode-3 services is liberalized as a result of a services RTA, more FDI is likely to be attracted to the preferential area, other things being equal.

As mentioned earlier, although it will take time for WTO Members and experts to solve the services-specific problems discussed both in the contexts of the intra-RTA and third-party obligations, I believe that the clarification of GATS Article V:6 would address the challenge of trade and investment diversion (benefiting members and non-members alike) and could be done within a relatively shorter timeframe.

Paragraph 6 sets out a conditional right of a juridical person constituted under the laws of a party to an RTA to favourable treatments accorded by the RTA: the condition being that the juridical person must engage in *substantive business operations* (SBO) in the territory of the parties to the RTA.⁶⁴¹ Essentially, it restricts what RTA members can do with regard to rules of origin.⁶⁴² However, paragraph 6 does not define the meaning of the term *substantive business operations*. Given that firms and companies are juridical persons, the SBO requirement is very important. One way to look at the requirement is to think of it as an integral part of the MFN principle in the sense that only legitimate service providers established in a services

⁶³⁸ It should be noted that such unilateral imposition of barrier to trade in services will also be subject to the country's commitments inscribed in its GATS Schedule.

⁶³⁹ See Chapter 2.

⁶⁴⁰ As noted in the Chapters 4 and 5, the rules contained in GATT Article XXIV and the Enabling Clause are likely to deal with investment diversion in a limited fashion. See Chapters 4 and 5.

⁶⁴¹ See GATS Article V:6.

⁶⁴² For further discussion on general (as opposed to preferential) rules on origin of services under GATS Article XXVIII(f), see H Wang, 'WTO Origin Rules for Services and the Defects: Substantial Input Test as One Way Out?' (2010) 44 *Journal of World Trade* 1083.

RTA are entitled to the benefits from its provisions.⁶⁴³ In other words, the SBO requirement is to ensure that the link between service providers and RTA members is genuine.

Given that paragraph 6 contains the SBO requirement and it is a necessary condition for juridical persons to enjoy RTA favourable treatments, one might expect RTAs to contain some provisions which elaborate on the requirement. However, the majority of services RTAs contain provisions which define the term *juridical person* rather than the term *substantive business operations*.⁶⁴⁴ Although some contain the term *substantive business operations*, only China's Economic Partnership Arrangements (CEPAs) with Hong Kong and Macao attempt to define the scope of the term *substantive business operations*.⁶⁴⁵ These two RTAs provide the criteria for the SBO requirement that include the nature and scope of business, years of operation, payment of taxes, business premises, and employment of staff.

The definition of the term *substantial business operations* is therefore crucial and determines how easy non-member firms can enter the preferential area. On the one hand, if it is restrictively defined, non-member firms will find it difficult to benefit from the services liberalization achieved through a services RTA.⁶⁴⁶ This, in turn, may result in greater trade diversion. On the other hand, if it is broadly defined, non-member firms may free-ride the preferences. This, in turn, may discourage the member countries from making liberalization commitments in the first place. In my view, the balance should be struck in favour of a broad definition given the services-specific problems which make it very difficult to apply the intra-RTA and third-party obligations contained in paragraphs 1 and 4.

Thus, I argue that WTO Members and experts in services trade should allocate their resources and attention to elaborate and clarify the SBO requirement under paragraph 6. If WTO Members could agree on an unrestrictive definition of the term

⁶⁴³ See A Emch, 'Services Regionalism in the WTO: China's Trade Agreements with Hong Kong and Macao in the light of Article V(6) GATS' (2006) 33 *Legal Issues of Economic Integration* 351, pp. 351-378.

⁶⁴⁴ For example, in the Panama-Singapore FTA, the term *enterprise* is used instead of *juridical person* and defined as an entity constituted or organized under applicable law, whether or not for profit, and whether privately or governmentally owned or controlled, including a corporation, trust, partnership, sole proprietorship, joint venture, association, or similar organization and a branch of an enterprise. See article 10.1(2).

⁶⁴⁵ For more detail of the CEPAs, see <http://www.imprensa.macao.gov.mo/edicoes/en/dse/cepa/>, and <http://www.tid.gov.hk/english/cepa/> (last accessed 1 August 2009). See also FG Snyder, 'China, Regional Trade Agreements and WTO Law' (2009) 43 *Journal of World Trade* 1.

⁶⁴⁶ For further discussion on how non-members' firms/companies may fail restrictive definitions of juridical person and/or substantive business operation, see Emch, pp. 364-377.

substantial business operations, hence promoting liberal rules of origin for services RTAs, trade diversion induced by the formation of a services RTA would be further mitigated, which would benefit both members and non-members alike.⁶⁴⁷ For example, RTA members should not be allowed to impose a temporal requirement, *i.e.* years of operation required before the SBO requirement can be met, which exceeds three years. In other words, any services provider which has been registered as a juridical person under the laws of a party to an RTA for three years or more would be considered as engaging in substantive business operation and entitled to the preferences.⁶⁴⁸ Under this criterion, the shorter the time period required is, the more liberal the rule of origin will be.

It should be noted that subparagraph 3(b) does afford some flexibility to developing countries forming South-South RTAs which allows them to grant preferential treatment to firms owned or controlled by natural persons of the member countries. Developing countries could rely on this provision to foster their local firms through exploitation of scale economies and shielding them against competition from non-member firms. Such special and differential treatment is in line with the idea of infant industry widely proposed in goods trade.⁶⁴⁹ Thus, a clarified SBO requirement that produces liberal rules of origin would circumvent the difficulties involved in the application of paragraphs 1 and 4, and at the same time address some of the challenges facing developing countries amid the current RTA proliferation.

6.4 Conclusion

Throughout this chapter, it can be seen that GATS Article V is anything but simple. Besides the interpretative ambiguities plagued the provisions, the main

⁶⁴⁷ For further discussion on the restrictiveness of services rules of origin, see C Fink and D Nikomborirak, 'Rules of Origin in Services: A Case Study of Five ASEAN Countries' (Policy Research Working Paper No4130, World Bank, Washington, DC 2007).

⁶⁴⁸ In the two China's RTAs, Article 3.1.2(2) requires that for construction and related engineering services, banking and other financial services, insurance and related services, and air transport services, a Hong Kong [or Macao] services provider must be registered in Hong Kong [or Macao] and have engaged in substantive business operation for five years or more. This is contrast to services providers in real estate services which are not subject to any temporal requirement at all.

⁶⁴⁹ See Chapter 5.

problem lies with how they can be applied in practice. The limited data on trade in services and the difficulties involved in the methodological approaches to data collection and evaluation make it extremely challenging to implement the intra-RTA and third-party obligations.

Does GATS Article V serve the object and purpose of GATS then? According to most studies, it is clear that WTO Members do make commitments in their services RTAs that go beyond those that they have made in their GATS Schedules or pledged in their GATS offers. Although this does not necessarily enhance the multilateral progress in the short-run, over time the nature of barriers to trade in services and rules of origin will arguably weaken domestic oppositions to services liberalization and may create opportunities to further multilateral services liberalization. By the same token, compared to the *status quo*, a country is likely to gain from preferential liberalization of services trade at a particular point of time since trade creation is more likely, which in turn, implies less adverse effects on non-members. Thus, services RTAs are more likely to enhance welfare of the member countries as compared to goods RTAs assuming that appropriate and effective regulatory frameworks are in place to deal with market failures and undesirable consequences of services liberalization.

As far as developing countries are concerned, they should be able to use subparagraph 3(a) to afford themselves some flexibility, with regard to the requirements contained in paragraph 1, either during RTA negotiations or the reviewing process conducted by the CRTA. The provision could be used to ensure that developing countries have sufficient flexibility to establish appropriate and effective regulatory frameworks in the covered sectors/subsectors. Furthermore, the implied different standards that are applied to developed and developing countries could be used to indirectly force the former to liberalize their mode-4 services, in which the latter have comparative advantage. Nevertheless, as long as the interpretative ambiguities plagued paragraph 1 and the problem with its implementation still exist, subparagraph 3(a) is likely to have limited application.

Having examined GATS Article V, one cannot help but notice that it is quite a distance away from being implementable in a meaningful way to regulate the formation of services RTAs. To circumvent this in the short-run, I argue that WTO Members and experts in services trade should allocate their resources and attention to elaborate and clarify the SBO requirement under paragraph 6. If they can agree on a

definition of *substantial business operation* which results in liberal rules of origin, more efficient services providers from outside the preferential area will be able to enter and compete in the members' markets. This, in turn, will mitigate trade diversion further which is beneficial to both members and non-members alike.

It should be noted that nothing in GATS Article V appears to directly deal with the constraints on developing countries' analytical and negotiating capacities, as identified in Chapter 2. Nevertheless, to the extent that the built-in special and differential treatment provisions contained in paragraph 3 afford flexibility to developing countries, GATS Article V should reasonably level the playing field between partners with different analytical and negotiating capacities. However, a possible tailored-fit special and differential treatment which may be implied by the wording of subparagraph 3(a) would not give due weight to the predictability and practicality of RTA negotiations. Thus, I argue for a similar approach to the more country-specific special and differential treatment proposed in Chapters 4 and 5 whereby developing countries are further divided into subgroups and different threshold levels and transitional periods are agreed in advance. A tailored-fit special and differential treatment can be given to developing countries in the form technical assistance, which is arguably even more important for developing countries in services than in goods RTAs. This will be discussed in the next chapter.

So far, the thesis has looked at the WTO rules governing the formation of RTAs, including GATT Article XXIV, the Enabling Clause, and GATS Article V. What they have in common is that they are vague and in need of clarification. Since almost all WTO Members are a party to one or more RTAs, there is a conflict of interests here. While non-members would benefit if these rules were clarified and enforced strictly and rigorously, their own current and future RTAs would be at risk of violating it. In other words, the *status quo* where the provisions are unclear and their enforcement is weak is preferred by those Members whose RTAs would potentially have been WTO-incompatible otherwise. As a result, it is unlikely that there will be enough political will on the part of WTO Members to clarify the existing rules in the near future. Thus, Chapter 7 will explore whether there are other less contentious means that may complement and strengthen the existing WTO rules and practices with regard to RTA supervision. These include promulgation of code of best practices, revision of the WTO surveillance mechanisms, and technical assistance for developing countries in relation to RTA negotiations.

Chapter 7

Proposals and Implementation

7.1 Introduction

In the previous chapters, a number of proposals are made in relation to the WTO rules, namely GATT Article XXIV, the Enabling Clause, and GATS Article V, in the attempt to address the challenges facing developing countries amid the current RTA proliferation, as identified in Chapters 2 and 3. It can be seen that the rules are plagued with ambiguities and often very difficult to apply in practice. The proposals are made with the primary aim to offer ways in which the rules can be used to better address the challenges. However, it is recognized that substantive reforms may be required if these proposals are to be implemented.

According to Article IX:2 of the Marrakesh Agreement, a decision to adopt an interpretation of the WTO agreements can only be decided by a three-fourths majority of the Members while Article X requires a two-thirds majority of the Members in order for an amendment to be approved of.⁶⁵⁰ Such requirements are very onerous and difficult to meet.⁶⁵¹ Given the conflicting interests and the resulting lack of political will on the part of WTO Members, it might not be easy and will take time to bring about the necessary changes to the texts and/or the ways in which they are interpreted. This chapter therefore explores whether there are other less contentious means that may complement and/or strengthen the existing WTO rules and mechanisms pertaining RTA supervision. These include promulgation of code of best practices, revision of the WTO surveillance mechanisms, and technical assistance for developing countries in relation to RTA negotiations.

⁶⁵⁰ Note that in practice it is understood that the decision will only be taken by a qualified majority vote where consensus cannot be reached. See Footer, *An Institutional and Normative Analysis of the World Trade Organization*, p. 264.

⁶⁵¹ See *Ibid.*, pp. 206-21.

The chapter is divided into three sections. The first section examines a possible utility of promulgation of code of best practices. The second section considers a revision of the WTO surveillance mechanisms. The third section looks at whether provision of technical assistance can be offered to developing countries with regard to their RTA negotiations.

7.2 Code of Best Practices

Alternative to substantive reforms to the existing rules, a code of best practices for the formation of an RTA can be published by the WTO.⁶⁵² An example of such a code is the *Best Practice for RTAs/FTAs of Asia-Pacific Economic Cooperation*.⁶⁵³ This document sets out certain RTA characteristics on which APEC members should base their RTA negotiations in order to achieve the APEC Bogor Goals.⁶⁵⁴ The document is however three-paged long, which only contains broad principles and does not set out any substantive trade commitments.⁶⁵⁵ What are the effects of such documents?

A code of best practices can arguably be defined as a document that contains practices which are considered to be most effective in achieving intended goals in a particular context. Such codes are prevalent in various areas of businesses, for example financial regulation.⁶⁵⁶ The key difference between the WTO rules and the APEC code of best practices is that the former are legally binding and the latter is not.

⁶⁵² Non-legally binding instruments already exist under the WTO framework. See M Footer, 'The Role of "Soft" Law Norms in Reconciling the Antinomies of WTO Law' (Working Paper No54/08, Society of International Economic Law, Geneva 2008), pp.4-8.

⁶⁵³ See the Appendix. Good practices for the formation of RTAs are discussed elsewhere in the context of their economic implications, but not as an alternative to substantive reforms to the existing WTO rules. Nor are the discussions on the relationship between code of best practices and the existing rules. For example, see M Plummer, 'Best Practices in Regional Trading Agreements: an Application to Asia' (2007) 30 *The World Economy* 1771.

⁶⁵⁴ See http://www.apec.org/apec/leaders_declarations/1994.html (last accessed 1 August 2009).

⁶⁵⁵ See http://www.apec.org/etc/medialib/apec_media_library/downloads/ministerial/annual/2004.Par.0004.File.tmp/04_amm_003.pdf (last accessed 1 August 2009). Besides this, APEC members have also published a number of codes of best practices with regard to RTA negotiations in other areas of trade liberalization such as rules of origin, SPS provisions, and competition policy. See http://www.apec.org/apec/apec_groups/other_apec_groups/FTA_RT.html (last accessed 1 August 2009).

⁶⁵⁶ For example the Basel Accords, see <http://www.bis.org/publ/bcbcsa.htm> (last accessed 1 August 2009).

APEC members, for example, do not have to comply with the code. The regime is voluntary and merely seeks cooperation from the members. In other words, the WTO rules are considered as *hard law* whereas the APEC code of best practices is considered as *soft law*. Given the focus of this thesis and the limited space herein, the discourse on *hard law-soft law* distinction is not fully investigated in this chapter.⁶⁵⁷ The discussion is conducted only to the extent necessary to determine whether a code of best practices may provide an alternative means of RTA supervision and/or complement the existing rules.

Snyder presents a short and comprehensive definition of soft law. He defines it as “rules of conduct which, in principle, have no legally binding force but which, nevertheless, may have practical effect.”⁶⁵⁸ Abbott and Snidal offer a conceptual framework for distinguishing hard and soft law that includes three elements, namely obligation, precision, and delegation.⁶⁵⁹ *Obligation* refers to whether the instrument in question is legally binding or not; *precision* refers to how specific the provisions in the instrument are; and *delegation* refers to the extent to which states delegate power and authority to an independent third party to clarify and manage disputes arising from violations of the instrument.⁶⁶⁰ It is argued here that *obligation* is the key element which determines whether an instrument is hard or soft law. Nevertheless, the other elements are useful for the understanding of the hard law-soft law distinction. It is also important to note that the interaction of these three elements can be very complex. For example, a hard law instrument may be very ambiguous while a soft law instrument very precise; and both of which may or may not be complemented with a strong and independent third-party judicial body. In any case, the common features of soft law instruments are their voluntary participation and their consensus-based mechanisms. Enforcement is usually not delegated to an independent judicial body,

⁶⁵⁷ For general discussion on soft law, see U Morth (ed), *Soft Law in Governance and Regulation: An Interdisciplinary Analysis* (Edward Elgar, Cheltenham 2004), BR Quillin, *The Effects of International Soft Law on State Behaviour: Understanding Degrees of Compliance with the Basel Accord, 1988-2000* (London School of Economics and Political Science, London 2004), and D Shelton, *Commitment and Compliance: the Role of Non-binding Norms in the International Legal System* (Oxford University Press, Oxford 2003).

⁶⁵⁸ See FG Snyder, 'The Effectiveness of EC Law' in T Daintith (ed) *Implementing EC Law in the United Kingdom: Structures for Indirect Rule* (Wiley/Chancery Law Publishing, Chichester 1995), p. 64.

⁶⁵⁹ See KW Abbott and D Snidal, 'Hard and Soft Law in International Governance' (2000) 54 *International Organization* 421.

⁶⁶⁰ *Ibid.*, pp. 441-3.

but instead tends to be left to a non-intrusive system based on cooperation.⁶⁶¹ Thus, it seems that codes of best practices correspond to these soft law features.

If the key difference between the WTO rules and a code of best practices is the legally binding force behind each instrument (or the lack thereof), one then has to examine what circumstances or conditions are unfavourable to the former while the latter may have a role to play. Without claiming to be exhaustive, it is argued here that there are two conditions under which hard law instruments such as GATT Article XXIV may not be suitable. The first condition is *diverse interests*.⁶⁶² Diverse interests on the part of the states involved are likely to result in a failure to agree on the content of hard law instrument in the first place. This, in turn, may lead to broad and ambiguous provisions in the instrument as states are not prepared to forego their vested, yet diverse, interests and be legally bound by it. The broad and ambiguous provisions then provide a compromise and room for flexibility. Consequently, despite its legally binding obligations, such an imprecise hard law instrument will be difficult to enforce.

The second condition is *uncertainty*- be it economic or political. Given that a hard law instrument has the legally binding force over the states involved, its content must supposedly be discussed and agreed on in light of a set of fixed conditions based on prior knowledge.⁶⁶³ However, there can be situations where conditions vary and prior knowledge is insufficient. Such situations of uncertainty may sometimes demand constant experimentation and adjustment. Thus, if states are not certain that what they are negotiating will subsequently be beneficial, or at least not disadvantageous, they are less likely to agree to be legally bound by a precise and restrictive hard law instrument. They will prefer room for flexibility, with which the ambiguous wording may provide. Consequently, like diverse interests, uncertainty is likely to result in a broad and ambiguous hard law instrument, which will be difficult to enforce. It should be noted that in some cases diverse interests and uncertainty may

⁶⁶¹ See JJ Kirton and MJ Trebilcock, *Hard Choices, Soft Law: Voluntary Standards in Global Trade, Environment, and Social Governance* (Global Environmental Governance, Ashgate, Aldershot 2004), pp. 22-3.

⁶⁶² See DM Trubek, P Cottrell and M Nance, 'Soft Law, Hard Law, and European Integration: Toward a Theory of Hybridity' (Research Paper No1002, University of Wisconsin Legal Studies, 2005), p. 13.

⁶⁶³ *Ibid.*, p. 4.

lead to the absence of hard law instrument in the entirety and an emergence of soft law instrument instead. Global forestry-related problems provide a good example.⁶⁶⁴

To put this in the RTA context, WTO Members have vastly diverse interests when it comes to RTAs since their positions differ as members and non-members.⁶⁶⁵ This may have resulted in the vague terms such as *substantially all the trade* and *substantial business operation* since the drafters traded precision for flexibility.⁶⁶⁶ So, there is no surprise that the existing rules are confusing and have hardly been tested in the WTO DSM.⁶⁶⁷ As far as uncertainty is concerned, RTA commitments can have unexpected consequences, both economic and political, which may require subsequent changes in trade policies. On this basis, WTO Members are less likely to be in favour of precise and restrictive rules on how they may form their RTAs. Like diverse interests, uncertainty can also explain the ambiguous wordings of the existing WTO rules.

Thus, due to the diverse interests and uncertainty revolving around the formation of an RTA, WTO Members may prefer a soft-law approach to RTA supervision. Despite their legally binding force, the rules are very ambiguous, and even though in principle they can be clarified and enforced by panels and the Appellate Body, in practice they are not. The absence of case law coupled with panels/the Appellate Body's exercise of judicial economy make any clarification almost impossible. While the WTO rules may satisfy the *obligation* element introduced by Abbott and Snidal, they seem to score lowly on the *precision* element. As for the *delegation* element, despite the availability of the WTO DSM, cases concerning the three sets of rules are hardly brought before panels and the Appellate Body.

In sum, soft law instruments such as codes of best practices may be useful in those cases where hard law is not feasible as states are not yet willing to commit themselves to binding international obligations either because they have diverse interests or because they are not certain as to the consequences of such obligations.

⁶⁶⁴ See S Bernstein and B Cashore, 'Non-state Global Governance: Is Forest Certification a Legitimate Alternative to a Global Forest Convention' in JJ Kirton and MJ Trebilcock (eds), *Hard Choices, Soft Law: Voluntary Standards in Global Trade, Environment, and Social Governance* (Ashgate, Aldershot 2004), pp. 33-63.

⁶⁶⁵ See Chapters 2 and 3.

⁶⁶⁶ See Chapters 4 and 6.

⁶⁶⁷ See Chapters 4-6.

So, if it is accepted that hard law instruments are not suitable when confronted with diverse interests and uncertainty, the question is can soft law instruments provide a better alternative. The main advantage of soft law instruments such as codes of best practices is its lack of legally binding force. When states see an instrument as non-binding, they may be more willing to agree on its content since subsequent violations will not result in legal action. This does not necessarily mean that negotiations on a code of best practices for the formation of an RTA will be an easy task as diverse interests and uncertainty are still present. Nevertheless, the fact that the resulting document will not be legally binding may considerably lessen the fear of subsequent legal action among WTO Members, and hence increasing the political will on their part. By the same token, the content can be more precise than those of the existing rules. Furthermore, future changes to a code of best practices can be made more easily as compared to substantive reforms of the rules, which have to meet the requirements contained in Articles IX and X of the Marrakesh Agreement. This is useful in the face of uncertainty and future development of RTAs.

Thus, to adopt Abbott and Snidal's conceptual framework, a code of best practices for the formation of an RTA will score zero on the first element, *obligation*, but it may score highly on the second element, *precision*. As far as the third element, *delegation*, is concerned, it is likely to be in the form of peer review or consensus-based mechanism rather than through an independent third-party judicial body with legal authority, *i.e.* through the CRTA/CTD reviewing process rather than the DSM.

As much as a code of best practices for the formation of an RTA may mitigate the lack of political will, it is important to recognize that it also has some limitations.⁶⁶⁸ The first is its impact. It is not clear how much impact such a code may have on WTO Members forming RTAs with one another. Having reviewed the APEC code of best practices, it is apparent that the code only contains guiding principles rather than substantive RTA commitments. Thus, one may wonder how effective the code is. Given that it is not legally binding, APEC members do not have to comply with the code. Its principles are more like guidelines rather than international obligations. Consequently, if the best practices are not adopted, the code will not have much impact on RTA supervision.

⁶⁶⁸ For general discussion on limitations of soft law, see Trubek, Cottrell and Nance, p. 3.

The second limitation is enforceability. This follows the first limitation. When a code of best practices is ignored, there is no way to enforce it. Again, the very same non-binding feature, which may have played a role in creating such a code in the first place, presupposes that there is no way the provisions therein can be legally enforced. Thus, soft law instruments can be a double-edged sword which cuts both ways.

Nevertheless, I believe that there may be some differences between a code of best practices published by APEC and one by the WTO. The latter may have significant dynamic effects on how RTAs are supervised and negotiated. First, the reach of such a code published by the WTO would be greater than the APEC's as WTO membership is much wider. Secondly, while the APEC code of best practices may only provide its members with the guiding principles, the proposed code published by the WTO could be used not only by the Members but also by the CRTA/CTD when reviewing an RTA as well as by panels and the Appellate Body when confronted with a case concerning the rules. Notably, APEC lacks both mechanisms. Finally, if the WTO code of best practices contained, besides guiding principles, some form of a model RTA and/or specific RTA commitments, which favour developing countries (*e.g.* lower thresholds of and longer transitional periods for the SAT requirement),⁶⁶⁹ it would have more impact than the APEC code. Developing countries could use the code as a starting point for their RTA negotiations and refer to the code when their developed-country counterparts appear to depart from its suggestions. This should have some political or practical effects on the negotiations.

For example, in the ASEAN-EU FTA negotiations, the EU initially tabled a draft which it argued ought to be used as a starting point of negotiation. The ASEAN countries were caught by surprise and had to agree to use the draft although they emphasized that it had no official/legal status whatsoever. Nevertheless, given that the negotiations were premised on this document, the ASEAN countries found it very difficult to depart from what contained in the draft. In the following round of negotiations, the ASEAN Secretariat produced a counter *non-paper* draft of its own. This was not well received by the EU delegation as the parties had to revisit provisions which were already agreed, at least in principle, basing on the EU's document. Thus, if there were a WTO code of best practices, the ASEAN countries

⁶⁶⁹ See Chapter 4.

could rely on the code as a starting point- assuming that the code would contain guiding principles as well as specific commitments which favour developing countries.

Assuming that the code would contain practices which maximize the potential benefits and minimize the potential costs induced by the formation of an RTA, if prospective RTA members use it as a starting point of negotiation, their RTA commitments are likely to be shaped in such a way that should lead to genuine trade liberalization, and hence benefiting the members' economies. Furthermore, if this results in lesser trade and investment diversion, non-members will also benefit.

Besides its own utilities, the proposed code of best practices may have effect on the existing WTO rules as well. It has been argued that soft law can have a positive relationship with its hard law counterpart.⁶⁷⁰ For example, the proposed code of best practices may have *elaborative* effect. In other words, it can provide guidance to the interpretation, elaboration, or application of the rules.⁶⁷¹

Another possible effect is that it can act as a catalyst for renegotiations of the existing rules. If WTO Members manage to agree on a code of best practices which contain a model RTA and/or specific RTA commitments, given time they may find the code useful and beneficial. As a result, renegotiations of the rules may subsequently be possible, hence a transformation of soft to hard law instrument. Due to the non-legally binding feature, states can experiment with a soft law instrument without having to worry about subsequent legal action for its violation. If states are content with their compliance with the soft law instrument, they can then move on to discuss the possibility of turning it into a hard law version.⁶⁷² Such practices are common in the EU where soft law instruments, such as regulatory standards, are turned into hard law instruments or given legal effect by the European courts.⁶⁷³ By the same token, panels and the Appellate Body could give some legal effect to the proposed code of best practices and the CRTA/CTD's recommendations.⁶⁷⁴ Thus, the

⁶⁷⁰ See Shelton, pp. 30-31.

⁶⁷¹ See Footer, 'The Role of "Soft" Law Norms in Reconciling the Antinomies of WTO Law', pp. 11-2.

⁶⁷² For advantages and disadvantages of soft law and hard law instruments, see K Raustiala, 'Form and Substance in International Agreements' (2005) 99 *American Journal of International Law* 581, pp. 591-614.

⁶⁷³ See I Osterdahl, 'The ECJ and Soft Law: Who's Afraid of the EU Fundamental Rights Charter?' in U Morth (ed) *Soft Law in Governance and Regulation: an Interdisciplinary Analysis* (Edward Elgar, Cheltenham 2004), p. 37.

⁶⁷⁴ This is further discussed below. It should be noted that the process of rule referencing does not necessarily turn soft law instruments into rules that are binding on WTO Members. See WTO

proposed code would provide guidance to the interpretation, elaboration, and application of the WTO rules as well as facilitate their reforms.

7.3 Revision of the WTO surveillance mechanisms for RTAs

The WTO surveillance mechanisms for RTAs are very important as they bring them into the WTO regulatory framework. In a nutshell, RTAs are to be notified to the WTO and then subject to a reviewing process. It is noteworthy that by the time an RTA is notified and subject to this process, it will have been signed and/or ratified by its members already. As a result, changes to the content are difficult to bring about. Historically, exposure of RTA texts and information to the rest of the GATT/WTO membership did not have much impact on the contents of these agreements partly because the meanings and applications of the relevant rules could not be agreed on. This is supported by the absence of recommendations on the part of the CRTA/CTD (and GATT working parties before them in relation to GATT Article XXIV).⁶⁷⁵ Alternatively, an RTA member may be taken before a panel by an affected third party, hence subjecting the RTA in question to WTO scrutiny.

The first real test to the WTO regulatory framework was the notification in 1957 of the Treaty of Rome establishing the EEC. An *ad hoc* working party set up to consider whether the agreement was compatible with GATT Article XXIV could not reach a clear-cut decision. In retrospect, the inconclusive nature of the deliberations on the establishment of the Treaty of Rome came to symbolize a continuing *de facto* recognition of the inoperability of the requirements contained in GATT Article XXIV.⁶⁷⁶ The subsequent examination of CUs and FTAs notified to the GATT did not yield any clearer assessments of full consistency with the rules, and friction arising between GATT CONTRACTING PARTIES in these areas was largely dealt with in a pragmatic fashion. That is, the CONTRACTING PARTIES simply formed RTAs

Appellate Body Report, *EC-Hormones*, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, para. 165.

⁶⁷⁵ See Finger, pp.134-5.

⁶⁷⁶ See R Fiorentino, J-A Crawford and C Toqueboeuf, 'The Landscape of Regional Trade Agreements and WTO Surveillance' in R Baldwin and P Low (eds), *Multilateralizing Regionalism: Challenges for the Global Trading System* (Cambridge University Press, Cambridge 2009), p. 55.

with one another despite the lack of affirmative recommendation from the working parties.⁶⁷⁷

The surge in the number of RTAs during the late 1980s and early 1990s started to create administrative blockages in the newly established WTO, since according to GATT practice, an *ad hoc* working party was set up for each notified RTA mandated for examination. To amend this situation, WTO Members agreed to establish the Committee on Regional Trade Agreements, in which all Members may participate,⁶⁷⁸ with the mandate to verify the WTO-compatibility of notified RTAs, and *inter alia* to consider the systemic implications of such agreements and regional initiatives for the multilateral trading system.⁶⁷⁹ However, at the time of the launch of the Doha Round in November 2001, the CRTA had made no progress on its mandate of consistency assessment, owing to the ambiguities in GATT Article XXIV.⁶⁸⁰ This raised concerns and resulted in negotiations on the WTO rules pertaining RTA supervision being included under the DDA.

The Doha Ministerial Declaration contains two references to RTAs.⁶⁸¹ Paragraph 4 of the Preamble reaffirms Members' commitment to the WTO as the unique forum for global trade rule-making and liberalization, while acknowledging the role that RTAs can play in promoting the liberalization and expansion of trade and in fostering development.⁶⁸² The negotiation mandate is contained in Paragraph 29 of the Declaration, which calls for the clarification and improvement of the disciplines and procedures under existing WTO provisions applying to RTAs, taking due account of the development aspects of these agreements.⁶⁸³

The objective of these negotiations is to clarify and improve the relevant RTA disciplines and procedures under the existing WTO provisions with a view to resolving the impasse in the CRTA, exercising better control of RTA dynamics, and minimizing the risks to the integrity of the multilateral trading system associated with

⁶⁷⁷ Only four arrangements had been formally declared to be compatible with GATT Article XXIV. These are the South Africa-Rhodesia CU, the Nicaragua-El Salvador FRTA, Nicaraguan participation in the CACM, and the CARICOM. See J Schott, *Free Trade Areas and U.S. Trade Policy* (Institute for International Economics, Washington, DC 1989), pp. 376-83.

⁶⁷⁸ See Footer, *An Institutional and Normative Analysis of the World Trade Organization*, pp. 62-3.

⁶⁷⁹ The working of the CRTA will be discussed in more detail below.

⁶⁸⁰ Neither have there been any affirmative recommendations with regard to GATS Article V.

⁶⁸¹ See *supra* note 275.

⁶⁸² See http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm (last accessed 1 August 2009).

⁶⁸³ *Ibid.*

the current RTA proliferation.⁶⁸⁴ Despite their efforts, WTO Members could not agree on the substantive clarification of the existing rules. Nevertheless, they could agree on those issues which were more procedural in nature. As a result, in December 2006 the Decision on the Transparency Mechanism for Regional Trade Agreements was adopted. It is noteworthy that the 2006 Mechanism, which applies to all RTAs—whether notified under GATT Article XXIV, the Enabling Clause, or GATS Article V, is being implemented on a provisional basis in accordance with Paragraph 47 of the Doha Ministerial Declaration, and will be replaced by a permanent mechanism to be adopted as part of the Doha Round of trade negotiations.

The 2006 Mechanism introduces a number of important procedural changes to the way in which RTAs are treated within the WTO regulatory framework.⁶⁸⁵ One is the concept of an *early announcement* for RTAs, either under negotiation or signed, but not yet in force. According to this, WTO Members participating in RTA negotiations are encouraged to provide basic information in the form of a press release or the likes which are made available on the WTO website.⁶⁸⁶ Once the RTA has been signed, members are to convey information, such as the scope and date of signature, relevant contact points, and/or website addresses to the WTO.⁶⁸⁷ The idea of a system of early announcements aims to increase the transparency of RTAs, allowing WTO Members and the public to make use of a centralized source of information on RTAs under negotiation or signed, but not yet in force. It should be noted that only about a third of the RTAs under negotiation or already signed have been announced early to the WTO.⁶⁸⁸ Thus, in order to make this information as comprehensive as possible, greater effort is expected from WTO Members engaging in RTA negotiations.

Besides the concept of early announcement, the 2006 Mechanism also strengthens existing provisions on *notification* by stipulating that notification is to take place “as early as possible... no later than directly following the parties’ ratification of the RTA or any party’s decision on application of the relevant parts of an agreement, and before the application of preferential treatment between the

⁶⁸⁴ See Fiorentino, Crawford and Toqueboeuf, p. 57.

⁶⁸⁵ See the Decision on Transparency Mechanism for Regional Trade Agreements 2006, WT/L/671, adopted 14 December 2006.

⁶⁸⁶ See the 2006 Mechanism, Articles 1 and 2.

⁶⁸⁷ Ibid, Article 1(b).

⁶⁸⁸ See Fiorentino, Crawford and Toqueboeuf, p. 60.

parties.”⁶⁸⁹ As in the case of early announcement, there is still room for improvement on the part of WTO Members to fully comply with the new obligations relating to notification.⁶⁹⁰

Another important change introduced by the 2006 Mechanism is *factual presentation*. A factual presentation, prepared by the WTO Secretariat, is a detailed summary of and contains data on the trade environment of the RTA parties, a description of the RTA’s regulatory features, and details of the tariff, trade, and regulatory liberalization envisaged over the transitional period of the RTA. The Secretariat is responsible for producing a factual presentation, in full consultation with the parties, and it cannot be used as a basis for dispute settlement procedures or to create new rights and obligations for the RTA members.⁶⁹¹ Notably, this differs from the practice prior to the 2006 Mechanism where information on the notified RTA was prepared by the members themselves.⁶⁹² The purpose of the factual presentation is to produce objective, homogeneous reports containing no value judgments which are used by WTO Members in their consideration of an RTA under review. In addition, the 2006 Mechanism imposes an obligation on the part of the Secretariat to establish and maintain an updated electronic database on individual RTAs which is easily accessible to the public.⁶⁹³

Although the 2006 Mechanism introduces important changes to the WTO regulatory framework for RTAs, the main body responsible for RTA supervision, particularly the reviewing process of RTAs notified under GATT Article XXIV and GATS Article V, is still the CRTA (while those notified under the Enabling Clause are reviewed by the CTD). Thus, it is important that the CRTA’s existing framework as reformed by the 2006 Mechanism and its criticisms are analysed in order to determine whether improvements are possible.

The CRTA was established in February 1996 by the WTO General Council.⁶⁹⁴ Its two principal responsibilities are to examine individual agreements; and to consider their systemic implications for the multilateral trading system and the

⁶⁸⁹ See the 2006 Mechanism, Article 3.

⁶⁹⁰ Of the 20 notifications of RTAs made during 2007, only five were received before the RTA entered into force. For more detail, see Fiorentino, Crawford and Toqueboeuf, p. 60.

⁶⁹¹ See the 2006 Mechanism, Articles 5-13.

⁶⁹² This resulted in many shortcomings such as inadequate information. This is discussed below in the context of the CRTA.

⁶⁹³ See the 2006 Mechanism, Article 21.

⁶⁹⁴ See Committee on Regional Trade Agreements, the Decision of 6 February 1996, WT/L/127.

relationship between them.⁶⁹⁵ Prior to the 2006 Mechanism, the examination process was different for RTAs falling under each of the three main sets of rules. RTAs falling under GATT Article XXIV were to be notified to the Council for Trade in Goods (CTG) which would then adopt the terms of reference and transferred the agreements to the CRTA for examination. RTAs falling under GATS Article V, on the other hand, were to be notified to the Council for Trade in Services (CTS) which had an option whether to pass the agreements on to the CRTA for examination since it was not mandatory to do so, unlike in the case of the CTG. The notifications of RTAs falling under the Enabling Clause were to be made to the Committee for Trade and Development. The agreements would be placed in the agenda of the CTD meeting where debates were to be held, but generally the CTD did not transfer the agreements to the CRTA for in-depth examination.⁶⁹⁶

The notification to and examination by the CRTA served two purposes: it ensured the transparency of RTAs and allowed Members to evaluate the WTO-compatibility of the RTA in question. It should be noted that the examination was conducted on the basis of information provided by RTA members themselves, through written replies to written questions posed by WTO Members or through oral replies to questions posed at CRTA meetings.⁶⁹⁷ Once the factual examination was concluded, the Secretariat drafted the examination report. Thereafter, consultations were conducted and once the report was agreed by the CRTA, it was submitted to the relevant superior body for adoption.

Since the passage of the 2006 Mechanism, the CRTA is now the WTO body responsible for RTAs notified under GATT Article XXIV or GATS Article V; whereas RTAs notified under the Enabling Clause are the responsibility of the CTD, convening in a dedicated session.⁶⁹⁸ Consequently, compared to the previous process, there are fewer administrative bodies involved. This streamlining of WTO bodies responsible for the implementation of reviewing process should reduce the procedural time lags and enhance the process of transparency. Furthermore, as discussed earlier, factual presentations are to be carried out by the WTO Secretariat rather than relying on RTA members to provide information. This should ensure that the information is more comprehensive and accessible by WTO Members and the general public.

⁶⁹⁵ See http://www.wto.org/english/tratop_e/region_e/regcom_e.htm (last accessed 1 August 2009).

⁶⁹⁶ Ibid.

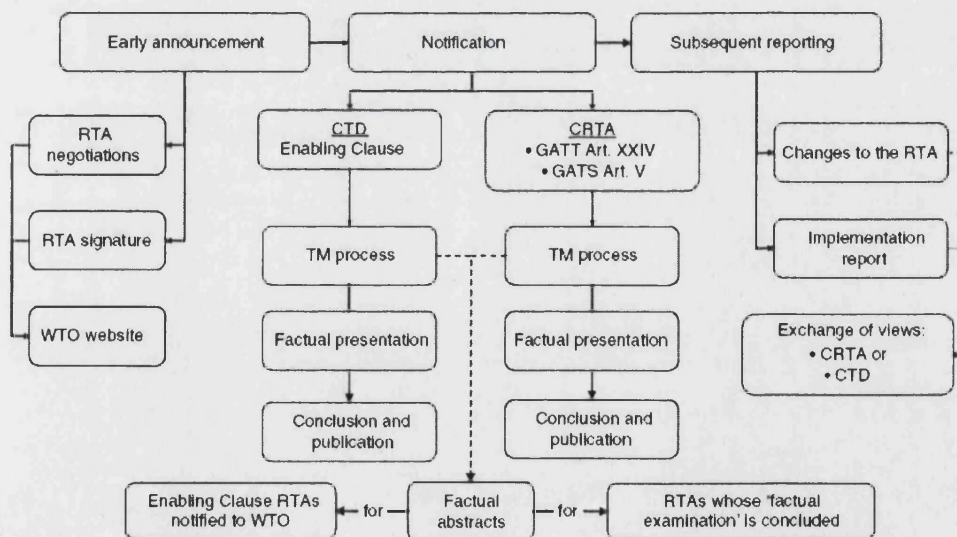
⁶⁹⁷ Ibid.

⁶⁹⁸ See the 2006 Mechanism, Article 18.

It is noteworthy that the 2006 Mechanism also emphasizes on *consideration* rather than *examination*.⁶⁹⁹ This stems from the fact that since its establishment the CRTA has not produced a single examination report which is to be approved by all members of the committee- although no RTAs have explicitly been disapproved by the CRTA either.⁷⁰⁰ It is, however, not clear how this new emphasis on consideration will reduce the tension between the committee's members when reviewing RTAs. According to the new procedure, consideration of a notified RTA is to be concluded within one year of the date of notification of the RTA in a single formal meeting. Any additional exchange of information is to take place in written form.

As far as systemic issues relating to RTAs are concerned, the CRTA still remains responsible. The committee deals with them under a three-pronged approach, encompassing i) legal analyses of relevant WTO provisions; ii) horizontal comparisons of RTAs; and iii) a debate on the context and economic aspects of RTAs. To date research has been carried out and a number of documents have been published by the CRTA.⁷⁰¹

Figure 9: WTO process for RTAs according to the 2006 Mechanism



Source: Fiorentino, Crawford and Toqueboeuf, p. 63

⁶⁹⁹ Compare Ibid., Articles 6, 7, 12, and 13 to the Decision of 6 February 1996, WT/L/127.

⁷⁰⁰ See http://www.wto.org/english/tratop_e/region_e/regcom_e.htm (last accessed 1 August 2009).

⁷⁰¹ For links to the documents, see http://www.wto.org/english/tratop_e/region_e/regcom_e.htm (last accessed 1 August 2009).

During the GATT years, the deficiencies which caused the absence of affirmative decisions are twofold: one is substantive; and the other is institutional. The substantive deficiency is to do with GATT Article XXIV itself. There are a number of ambiguities in the article which had resulted in disagreements among the CONTRACTING PARTIES on how to apply the provisions in the reviews.⁷⁰²

The institutional deficiency, on the other hand, is to do with the requirement of consensus. As the GATT operated on a consensual basis, any reports made by the working parties would be adopted by the CONTRACTING PARTIES only when consensus was reached. Consequently, it was inevitable that a recommendation disapproving an RTA would be rejected by the RTA members. The ambiguities of the wording of GATT Article XXIV would certainly provide a basis on which RTA members could rely to strike down such reports. The requirement of consensus might also have plagued the progress on substantive reforms on the article as well as the surveillance mechanisms themselves.

Have things been different since the establishment of the CRTA? Although, the ambiguities in GATT Article XXIV have been clarified to some extent by the 1994 Understanding and *Turkey-Textiles*,⁷⁰³ the requirement of consensus seems to continue to defect the CRTA much the same way it did the working parties during the GATT years. Over the first few years of its operation, there was solid progress made in outlining the systemic issues.⁷⁰⁴ Unfortunately, while the committee members could identify which aspects required clarification, they nevertheless continued to disagree on the substance of the answers that would free the process of evaluating particular agreements.⁷⁰⁵ Given this outcome, one is bound to ask oneself why the situation has not improved. Arguably, the main reason underlying both deficiencies is something to do with conflict of interests.

With the exception of Mongolia, all WTO Members are a party to one or more RTAs.⁷⁰⁶ There is therefore a conflict of interests here. While non-members would benefit if GATT Article XXIV (and the other sets of rules) were to be clarified and enforced strictly and rigorously, their own existing and future RTAs would be at risk of violating it. This in turn results in a lack of political will on the part of WTO

⁷⁰² See Chapter 4.

⁷⁰³ These are discussed in more detail in Chapter 4.

⁷⁰⁴ For example, see *supra* note 521.

⁷⁰⁵ See Mathis, p. 131.

⁷⁰⁶ See <http://rtais.wto.org/ui/PublicSearchByMember.aspx> (last accessed 8 September 2010).

Members as a whole to amend the deficiencies. In other words, the *status quo* where the provisions are unclear and their enforcement is weak is preferred by those Members whose RTAs would potentially have been WTO-incompatible otherwise. This has not been changed by the establishment of the CRTA, nor the 2006 Mechanism.

As long as the conflict of interests exists, so does the lack of political will on the part of WTO Members as a whole to make the system work. This means that only less contentious issues can be solved by the CRTA, whose operation is rather political in nature due to the consensus-based approach.⁷⁰⁷ The progress on less contentious issues has been made as can be seen from the adoption of the 2006 Mechanism.

With regard to more contentious ones such as substantive reforms to GATT Article XXIV, the lack of political will on the part of WTO Members is likely to make it difficult for any progress to be made. Nevertheless, the decision in *Turkey-Textile* may have increased the stake which RTA members have in obtaining the CRTA's approval, hence a possible increase in the political will. RTA members may try harder to comply with the requirements set out in GATT Article XXIV. For example, given the ambiguities plagued the article, the members may adopt the interpretations which are more acceptable to non-members. This can result in higher level of intra-RTA trade liberalization. In addition, panels and the Appellate Body may be forced to clarify the phrases in GATT Article XXIV in future cases. This can benefit the CRTA's reviewing process.

The relationship between the CRTA and the DSM is perhaps the key to improve the lack of political will on the part of CRTA's members. Arguably, the CRTA with its expertise and institutional structure is a more suitable WTO body to assess the overall WTO-compatibility of an RTA compared to panels and the Appellate Body. The lack of political will can be changed if the operation of the CRTA is reinforced and supported by the DSM. The relationship between the CRTA and the DSM was not relevant until *Turkey-Textiles* because before then, there was no reason why one should discuss the issue. *Turkey-Textiles* is the only WTO case which directly concerns GATT Article XXIV. Prior to the case, RTA matters had been dealt with mostly by the CRTA (and the working parties during the GATT years).

⁷⁰⁷ Under the current WTO framework is arguably inevitable. See Footer, *An Institutional and Normative Analysis of the World Trade Organization*, pp. 62-3.

The Panel in *Turkey–Textiles* noted that “the issue regarding the WTO compatibility of a customs union, as such, is generally a matter for the CRTA since it involves a broad multilateral assessment of any such customs union, *i.e.* a matter which concerns the WTO membership as a whole.”⁷⁰⁸ Consequently, the Panel assumed *arguendo* that the arrangement between Turkey and the EC was compatible with the requirements in paragraphs 8(a) and 5(a). It was of the view that:

[...] the terms of reference of panels must refer explicitly to the “measures” to be examined by panels. We consider that regional trade agreements may contain numerous measures, all of which could potentially be examined by panels, before, during or after the CRTA examination, if the requirements laid down in the DSU are met. However, it is arguable that a customs union (or a free-trade area) as a whole would logically not be a “measure” as such, subject to challenge under the DSU.⁷⁰⁹

The Appellate Body, however, disagreed. In its *obiter dictum*, the Appellate Body held that panels and itself may assess whether an RTA is compatible in accordance with GATT Article XXIV.⁷¹⁰ In other words, the overall WTO-compatibility of RTAs is within the jurisdiction of panels and the Appellate Body. This is very important as it is the first part of the *two-step* test introduced by the Appellate Body in the case:

[F]irst, the party claiming the benefit of this defence [Article XXIV] must demonstrate that the measure at issue is introduced upon the formation of a customs union that fully meets the requirements of subparagraphs 8(a) and 5(a) of Article XXIV. And, second, that party must demonstrate that the formation of that customs union would be prevented if it were not allowed to introduce the measure at issue.⁷¹¹

The test would presumably apply to free trade agreement/area *mutatis mutandis*.

Such an approach adopted by the Appellate Body has arguably changed the dynamic between the CRTA and the DSM. For one thing, the first part of the two-step test may have increased the stake on the part of RTA members in obtaining an affirmative recommendation from the CRTA. It is interesting to see how panels and

⁷⁰⁸ See WTO Panel Report, *Turkey–Textiles*, para. 9.52.

⁷⁰⁹ *Ibid.*, para. 9.53.

⁷¹⁰ See WTO Appellate Body Report, *Turkey–Textiles*, para. 60.

⁷¹¹ *Ibid.*, para. 58.

the Appellate Body will apply the two-step test if the RTA member at trial has obtained an approval from the CRTA. As highlighted earlier, the underlining problem with the CRTA is the lack of political will on the part of WTO Members, which in turn results in little progress made towards improvement of the current situation. Nevertheless, the Appellate Body's judgment may have paved the way in which a relationship between the CRTA and the DSM can be created. I believe that if the relationship between the two is constructed in a specific way, the operation of the CRTA, hence its effectiveness, can be improved.

The root of the problems arising out of GATT Article XXIV (and the other sets of rules) is that the formation of an RTA does not necessarily benefit its members while non-members are likely to be adversely affected by it. Consequently, the rules set out requirements which aim at maximizing the potential benefits and minimizing the potential costs induced by the formation. This can be seen in paragraphs 5 and 8 of GATT Article XXIV as read in light of the objectives set out in paragraph 4.⁷¹² As discussed in Chapter 4, the requirements under paragraphs 5 and 8 are not always consistent with one another. For example, members of a CU may choose to harmonize their domestic regulations in order to satisfy the requirement under subparagraph 8(a)(ii). However, such harmonization effort may result in the rise of the overall trade barriers in relation to non-members.⁷¹³ Consequently, the member countries will have to strike an appropriate balance between these provisions.

In *Turkey-Textiles*, the Appellate Body introduced the two-step test possibly in order to deal with this balancing exercise in a legalistic manner. According to the Appellate Body, first the party invoking GATT Article XXIV defence must demonstrate that its RTA complies with the requirements of paragraphs 8 (a commitment to liberalize intra-RTA trade) and 5 (a commitment not to raise trade barriers in relation to non-members), respectively; and secondly, it must demonstrate that the measure at issue is necessary for the formation of the RTA in question.⁷¹⁴

One could argue that the second part of the test is something that panels and the Appellate Body are familiar with. One might even hold that it is not so much different from *the necessity test* under GATT Article XX jurisprudence as one is asking whether the measure at issue is *necessary* for the achievement of the Member's

⁷¹² See Chapter 4.

⁷¹³ See *Ibid.*

⁷¹⁴ See WTO Appellate Body Report, *Turkey-Textiles*, para. 58.

particular policy objective.⁷¹⁵ Thus, panels/the Appellate Body are arguably the most suitable WTO body to deal with this part of the test. Can the same be held with regard to the first part?

According to the Panel and the Appellate Body in *Turkey–Textiles*, an assessment of whether an RTA is WTO-compatible is an economic test.⁷¹⁶ On this point, it has been argued that the CRTA- with the support of economists and statisticians- will be better able to offer parameters for the first part of the test; whereas, the DSM, due to its adjudicatory nature and composition, even given the use of experts by a panel, will perform this assessment with greater difficulties.⁷¹⁷ One may disagree with the first part of this statement since panels and the Appellate Body can always obtain information, including economic/statistical data and experts, if they deem necessary.⁷¹⁸ However, it is perhaps right that the adjudicatory nature of the DSM may not best accommodate debates on and the assessment of WTO-compatibility of an RTA.

Unlike the second part of the test, an assessment of whether an RTA is WTO-compatible is more political and controversial in nature, and may have a very wide implication since it can affect existing and future RTAs. Consequently, such an assessment may be better conducted in an environment where all stakeholders can offer inputs to the debates.⁷¹⁹ Not only will this enrich the debates, but it is also likely to result in a more acceptable and legitimate outcome, which in turn will have a long-term effect on its enforcement. For example, during the reviewing process, WTO Members can post questions and concerns to the RTA members, and as a result, useful dialogues can be made between them. This arguably provides the rules with a form of *soft-law* enforcement mechanism, *i.e.* open-forum and peer review. A similar forum has been used in the context of the SPS Agreement and WTO Members have used the forum provided by the SPS Committee to air grievances over measures when

⁷¹⁵ See WTO Appellate Body and Panel Reports, *Korea–Beef*, WT/DS/161/AB/R, WT/DS169/AB/R, WT/DS161/R, WT/DS169/R, adopted 10 January 2001; WTO Appellate Body Report, *EC–Asbestos*, WT/DS/135/AB/R, adopted 5 April 2001; WTO Appellate Body Report, *US–Gambling*, WT/DS285/AB/R, adopted 20 April 2005; and WTO Appellate Body Report, *Dominican Republic–Cigarettes*, WT/DS302/AB/R, adopted 19 May 2005.

⁷¹⁶ See WTO Panel Report, *Turkey–Textiles*, para. 9.120 and WTO Appellate Body Report, *Turkey–Textiles*, para. 55, respectively.

⁷¹⁷ See G Marceau and C Reiman, 'When and How Is a Regional Trade Agreement Compatible with the WTO?' (2001) 28 *Legal Issues of Economic Integration* 297, p. 320.

⁷¹⁸ The DSU, Article 13, "Right to Seek Information".

⁷¹⁹ For example, third parties have limited roles in the WTO DSM.

bilateral technical exchanges have reached an impasse.⁷²⁰ The opportunity to elucidate the details of an SPS regulation and its enforcement before other Members has sometimes led to the correction of erroneous accounts of trade barriers reported by industry sources.⁷²¹ In other cases, these discussions have served to pinpoint the source of disagreement between trade partners.⁷²² The CRTA can provide such a forum for RTA-related matters.

The WTO agreements also divide decision-making power between many different bodies for a reason. The assignment of decision-making authority to each of these bodies may reflect legitimate and negotiated policy objectives agreed by WTO Members when the organization was established. Each body must therefore determine its jurisdiction with due regard for the powers conferred on the other bodies and resolve conflicts of jurisdiction in a manner that reconciles those objectives to the maximum.⁷²³ Accordingly, in my view the CRTA with its *open-forum* and *peer-pressure* nature coupled with its RTA expertise is a more suitable WTO body to conduct the first part of the two-step test than panels and the Appellate Body.

If this position is accepted, the *concurrent-jurisdiction* judgment held by the Appellate Body is the key to improve the operation of the CRTA. As mentioned earlier, the concurrent jurisdiction of the CRTA and the DSM on the WTO-compatibility assessment raises the stake which RTA members have in obtaining an approval from the former. In other words, a possible litigation brought to the DSM acts as a threat or incentive on the part of RTA members to obtain CRTA's approval on which the respondent can rely as a defence. Without such a threat/incentive, the lack of political will on the part of WTO Members to improve RTA supervision will not change. However, the concurrent jurisdiction may not be sufficient to increase the political will to obtain an affirmative recommendation from the CRTA. I therefore propose that the CRTA should have a *primary* jurisdiction on the WTO-compatibility assessment; whereas, the DSM will have a *secondary* jurisdiction where the former fails or does not have an opportunity to exercise its jurisdiction.

⁷²⁰ For more detail, see D Roberts, 'Preliminary Assessment of the Effects of the WTO Agreement on Sanitary and Phytosanitary Trade Regulations' (1998) 1 *Journal of International Economic Law*.

⁷²¹ *Ibid.*, p. 397.

⁷²² *Ibid.* For discussion on SPS more generally, see J Scott, *The WTO Agreement on Sanitary and Phytosanitary Measures: a Commentary* (Oxford University Press, Oxford 2007).

⁷²³ See F Roessler, 'The Institutional Balance of WTO' in MCEJ Bronckers, R Quick and JH Jackson (eds), *New directions in International Economic Law: Essays in Honour of John H Jackson* (Kluwer Law International, Boston 2000).

In order to achieve the *primary-secondary* jurisdiction, panels and the Appellate Body must give more weight to an affirmative recommendation made by the CRTA. Not only that the CRTA is a more suitable organ to assess WTO-compatibility of an RTA, but the necessity test applied in the second part may also have a danger of shaping RTAs in such a way that RTA members just do enough to satisfy the requirements under GATT Article XXIV, *i.e.* resulting in *minimalist* RTAs. In other words, the necessity test does not necessarily strike the right balance between the measure at issue and the overall trade liberalization induced by the formation of an RTA. Panels and the Appellate Body only ask whether the measure at issue is necessary for the formation of the RTA in question. There can be a situation where even though the measure is deemed unnecessary due to the availability of a less restrictive alternative, the RTA may still strike an appropriate balance between the objectives, *i.e.* the extra trade restriction induced by the measure in question is compensated for with trade liberalization elsewhere as the RTA has resulted in lower barriers in relation to non-members overall.⁷²⁴ Thus, I argue that if the party invoking GATT Article XXIV defence has obtained an affirmative recommendation from the CRTA, panels and the Appellate Body should apply the necessity test very cautiously.

It is acknowledged, however, that giving due weight to a CRTA's approval in the two-step test is not straightforward. Essentially, panels and the Appellate Body have to make it more difficult for an affected non-member to challenge the legality of such measures where the RTA has been approved by the CRTA. Although the proposed primary-secondary jurisdiction may be more complicated to implement, it will ensure that the balancing of potential benefits and potential costs induced by the formation of an RTA is conducted by the CRTA, the more suitable WTO body. Thus, the question is how panels and the Appellate Body can achieve such a result, especially on the basis of the existing jurisprudence.

As mentioned earlier, the second part of the two-step test is arguably not so much different from the necessity test under GATT Article XX. Both tests require panels and the Appellate Body to determine whether the challenged measure is necessary for the achievement of an intended policy objective pursued by the Member invoking the defence: for GATT Article XX, protection of human, animal or plant life or health, for example; and for GATT Article XXIV, the formation of an RTA.

⁷²⁴ Indeed the measure at issue may necessarily be trade restrictive precisely because other measures already result in lower trade barriers in relation to non-members overall.

Under GATT Article XX jurisprudence, it has been held that WTO Members have the right to determine their own level of protection- be it the protection of human, animal or plant life or health, or the security of compliance with laws or regulations.⁷²⁵ Although WTO Members have the right to determine their own level of protection, the measures adopted must be the least trade restrictive.⁷²⁶ It is noteworthy that even there is a less restrictive measure available, the Member may not be required to adopt it where the administrative or enforcement costs involved are excessive.⁷²⁷ Thus, a measure is held *necessary* for the achievement of a GATT Article XX objective when there is no less trade restrictive alternative which will achieve the same level of protection.⁷²⁸

If it is accepted that the second part of the two-step test is similar to the necessity test under GATT Article XX, it follows that a measure will be necessary for the formation of an RTA when there is no less trade restrictive alternative which will achieve the same level of integration intended by the member countries. If one applies such a test to the facts of *Turkey-Textiles*, one might reach a different conclusion from those of the Panel and the Appellate Body. This is because the certification-of-origin alternative to the Turkey's quantitative restriction suggested by the Panel would simply fail to achieve the CU envisaged by the EC and Turkey, *i.e.* free movement of goods without border controls. In other words, there is no less trade restrictive alternative which would achieve the intended level of integration. This is where an affirmative recommendation by the CRTA can be given due weight to.

When applying the second part of the test, panels and the Appellate Body can refer to a CRTA's affirmative recommendation of the RTA at trial in order to determine the precise level of integration intended by the member countries. This way, the regulatory autonomy of the RTA members is preserved. Thus, on this basis, I propose that panels and the Appellate Body should consult a recommendation made by the CRTA in order to determine the intended level of integration.

Given that no affirmative or inconsistency recommendations have been made by the CRTA, the proposal can be rather academic. Nevertheless, thank to the 2006

⁷²⁵ See WTO Appellate Body Report, *Korea-Beef*, para. 176; and also GATT Article XX:(b) and (d), respectively.

⁷²⁶ See WTO Appellate Body Report, *Korea-Beef*, para. 165.

⁷²⁷ See WTO Appellate Body Report, *US-Gambling*, WT/DS2/AB/R, adopted 20 May 1996, para. 306.

⁷²⁸ For further discussion on GATT Article XX jurisprudence, see DH Regan, 'The Meaning of "Necessary" in GATT Article XX and GATS Article XIV: the Myth of Cost-benefit Balancing' (2007) 6 *World Trade Review* 347.

Mechanism, factual presentations are now available. In time, the WTO Secretariat should be able to produce such reports for all RTAs notified to the WTO. Thus, in lieu of CRTA's recommendations, panels and the Appellate Body can use factual presentations to determine the level of integration intended by the RTA members for the second part of the test.⁷²⁹

It is important to note that the changes introduced by the 2006 Mechanism (*i.e.* early announcement, notification, and factual presentation) only facilitate the operation of the CRTA in terms of procedural transparency. They do not alter the conflicting interests, hence the lack of political will on the part of WTO Members. Arguably, the proposed primary-secondary jurisdiction for the CRTA and the DSM can improve the current situation. The higher stake in obtaining an affirmative recommendation will encourage the RTA members and third-party WTO Members to carry out the CRTA examination/consideration. The secondary jurisdiction on the part of panels and the Appellate Body should act as a last-resort threat as they can decide whether an RTA is WTO-compatible or not. The open-forum and consensus-based nature of the CRTA should be preferred by both the RTA members and the other WTO Members to the adversarial and adjudicatory nature of the DSM. Consequently, while third-party WTO Members will scrutinize the RTA content ever more thoroughly during the reviewing process in fear of its subsequent use in the DSM, in anticipation the RTA members will also be more careful not to include RTA commitments which have clear detrimental effects on non-members in the first place.

In any case, if the CRTA still fails to produce a recommendation, panels and the Appellate Body can exercise their secondary jurisdiction and determine, to the extent necessary, whether the RTA in question is WTO-compatible or not. Factual presentations will also be useful to panels and the Appellate Body in applying the first part of the two-step test. It is hoped that in future cases, panels and the Appellate Body will take the opportunity to create a working relationship between them and the CRTA. If what proposed here is adopted in subsequent case law, I believe that the operation of the CRTA can be improved.

⁷²⁹ It is acknowledged that factual presentations are less likely to provide the rules with a soft law enforcement mechanism to the same extent as the CRTA would. Given that factual presentations are rather factual and neutral in nature, panels and the Appellate Body may find them less useful for the purpose of determining the intended level of integration than recommendations by the CRTA, which are supposed to contain a particular position taken by the CRTA.

An effective reviewing process for RTAs is crucial if the WTO is to supervise these agreements in such a way that addresses the challenges facing developing countries amid the current RTA proliferation as it is used to enforce the rules, albeit in a soft-law fashion. Without a reviewing process, RTA members can only be made accountable through the DSM, which may not be the best body to deal with RTA-related issues.

Given the diverse interests on the part of WTO Members with regard to RTA supervision, the current situation where the emphasis is placed on the procedural rather than substantive requirements is rather inevitable. Proceduralization is a normal response to situations like this. The primary-secondary jurisdiction coupled with the additional procedural requirements imposed by the 2006 Mechanism should help improve the current ineffective reviewing process. However, it must be recognized that as much as procedural requirements are useful and necessary, they can only do so much. Without the rules which address the challenges facing developing countries, it would be difficult to supervise RTAs in such a way that benefits them. Thus, it is vital that the proposed solutions regarding the rules are considered seriously. This includes the possible utility of code of best practices discussed earlier.

Together with the proposed code of best practices, the procedural requirements imposed by the 2006 Mechanism can have significant and dynamic effects on the contents of RTAs. For example, assuming that the proposed code of best practices exists, during the reviewing process third-party WTO Members may ask the RTA members why they did not follow the code. They may need to provide reasons for their departures. Such a peer review can arguably make prospective RTA members think twice before departing from the proposed code of best practices. Furthermore, the CRTA can guarantee an affirmative recommendation if the RTA members have adopted the proposed code of best practices. In other words, the proposed code will have the same function as *international standards* in the context of the SPS Agreement whereby an SPS measure is deemed to be WTO-consistent if it conforms to an international standard.⁷³⁰ Such presumption should encourage prospective RTA members to adopt the model RTA and/or specific RTA commitments contained in the proposed code of best practices. This way, not only can the code of best practices and the reviewing process provide a form of soft-law

⁷³⁰ See the SPS Agreement, Article 3.

enforcement mechanism for the existing rules, but they may also result in a convergence of RTAs towards the model RTA contained in the proposed code.

It is important to note that the proposed primary-secondary jurisdiction shared between the CRTA and panels/the Appellate Body is based on the judgments in *Turkey–Textiles*, particularly the Appellate Body’s two-step test. Consequently, it is not clear whether the proposal would have any legal basis in the case of RTAs notified under the Enabling Clause and GATS Article V. Nevertheless, I believe that such a relationship between these WTO bodies should be developed in all RTA cases so as to increase the political will on the part of WTO Members to seek affirmative recommendations from the CRTA (and the CTD in the case of RTAs notified under the Enabling Clause). In addition, the proposed primary-secondary jurisdiction would be more readily applicable if the proposal of having a single set of rules for the formation of goods RTAs is adopted as the CTD would have no role in the reviewing process and the CRTA would be the sole responsible body.⁷³¹

7.4 Technical Assistance

Given that the main problem with RTA supervision is the conflicting interests and the resulting lack of political will on the part of WTO Members as a whole, there is no surprise that any reforms to the existing rules and mechanisms will be complex and faced with opposition. One way to circumventing the lack of political will is to provide developing countries with some form of technical assistance. This is crucial to the lack of analytical and negotiating capacities on the part of developing countries since the WTO rules do not address this challenge at all.⁷³² As discussed in the previous chapter, the lack of analytical capacity is particularly important in services RTAs.

It is legitimate to ask whether the WTO should provide developing countries with technical assistance in relation to RTA negotiations. On the one hand, many critics argue that RTAs weaken the MFN principle and the multilateral trading

⁷³¹ See Chapter 5.

⁷³² See Chapters 2, 4, 5, and 6.

system.⁷³³ Thus, it would be self-destructive if the WTO were to encourage developing countries to form such agreements, either with their developed-country trade partners or among themselves, by providing them with technical assistance. On the other hand, given the dramatic rise in the number of RTAs notified to the WTO and the parallel surge in the number of developing countries participating in these agreements, the WTO cannot afford to act as an innocent bystander and arguably has a role to play in regulating their contents. After all, is it not why GATT Article XXIV, the Enabling Clause, and GATS Article V exist in the first place? Furthermore, despite of the concern that RTAs are undermining the multilateral trading system, WTO Members are engaging in RTA negotiations regardless. Would it not be more constructive if the WTO took the opportunity to ensure that these agreements complied with the rules and developing-country Members were not rendered disadvantaged?

The position that the WTO has a role to play in RTA supervision can be supported by paragraphs 4 and 29 of the Doha Declaration adopted on 14 November 2001, which read:

4. We [WTO Members] stress our commitment to the WTO as the unique forum for global trade rule-making and liberalization, while also *recognizing that regional trade agreements can play an important role in promoting the liberalization and expansion of trade and in fostering development* (emphasis added).

29. We also agree to negotiations aimed at clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements. The negotiations shall take into account *the developmental aspects of regional trade agreements* (emphasis added).⁷³⁴

From the declaration, it is apparent that WTO Members see RTAs as compatible with the multilateral trade liberalization and as a means to achieve economic development. Since developing countries face a number of challenges amid the current RTA proliferation, the WTO arguably has the responsibility to help them utilize these agreements. Besides the proposals made in the previous chapters and in the earlier sections, technical assistance should be provided in order to improve the analytical

⁷³³ For example, see Bhagwati, 'Regionalism and Multilateralism: an Overview', pp. 38-45.

⁷³⁴ See http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm (last accessed 9 September 2010).

and negotiating capacities on the part of developing-country Members with regard to their RTA negotiations, particularly those with low income or fall within the group of LDCs.

For example, Cambodia, Myanmar, and the Lao's People Democratic Republic (not yet a WTO Member) only sent a very small group of trade officials (three or less) to the RTA negotiations between: ASEAN and the EU, ASEAN and the Republic of Korea, and ASEAN and India.⁷³⁵ In addition, the trade officials hardly contributed to the discussion both among the ASEAN countries and between ASEAN and its trade partners.

The WTO does recognize that technical assistance and capacity building are core elements of the development dimension of the multilateral trading system.⁷³⁶ With the WTO Secretariat, trade-related technical assistance (TRTA) is coordinated by the Institute for Training and Technical Cooperation (ITTC). The CTD is the regular body overseeing all TRTA activities.⁷³⁷ These activities can be divided into five categories: i) general WTO-related technical assistance and training; ii) specialized and advanced technical assistance and training; iii) academic support for training and capacity building; iv) trainee programmes and internships; and v) E-learning.⁷³⁸ Thus, it can be seen that the WTO already has the basic infrastructure and bodies to provide technical assistance to developing-country Members. However, although these TRTA activities are no doubt useful and beneficial to developing-country Members, they do not necessarily nor directly help them with their RTA negotiations.

What I propose here is for these existing bodies and TRTA activities to shift some focus to technical assistance in the context of RTA negotiations. This should not require a huge amount of resources on the part of the WTO to do it. The TRTA activities can be designed to train trade officials from developing-country Members to

⁷³⁵ It should be noted that these countries sent the same trade officials to all three RTAs whose negotiations overlapped. The author recognized them on various occasions over the period between 2006 and 2010. This is a sharp contrast to the practice of Singapore where different teams of trade officials are assigned to different RTAs. The fewer number of trade officials suggests severe constraints on negotiating capacity on the part of Cambodia, Myanmar, and the Lao's People Democratic Republic.

⁷³⁶ See *supra* note 275, paras. 38-41.

⁷³⁷ See http://www.wto.org/english/tratop_e/devel_e/teccop_e/tct_e.htm (last accessed 9 September 2010).

⁷³⁸ See http://www.wto.org/english/tratop_e/devel_e/train_e/products_e.htm (last accessed 9 September 2010). For more detail, see G Shaffer, 'Can WTO Technical Assistance and Capacity-Building Serve Developing Countries?' in E-U Petersmann (ed) *Reforming the World Trading System: Legitimacy, Efficiency, and Democratic Governance* (Oxford University Press, Oxford 2005), pp. 261-8.

negotiate more effectively in a bilateral/regional context. In addition, specialized and advanced technical assistance and training should include sophisticated economic analytical skills that are required for *ex ante* preparatory research prior to RTA negotiations.⁷³⁹ Such programmes should help improve the human capital of developing-country Members specifically for RTA preparation and negotiations. Furthermore, advice should also be given with regard to how to create and/or organize domestic institutions, which will enable a country to gather, distribute, and analyse information relating to its trade, economic and business performance as well as similar information about other countries. Well-functioning domestic institutions will improve both analytical and negotiating capacities of developing countries, not only in the context of RTAs but also multilateral trade negotiations.

Given that human capital and institutional capacity may take time to develop, the WTO could go one step further and provide developing-country Members with economic and legal advice on their plans to form RTAs. Thus, while a developing-country Member's human capital and institutional capacity are being built, it could seek *consulting services* from the WTO. For example, if requested, the CRTA/CTD could provide economic advice to a developing-country Member whether to form an RTA with its developed-country trade partner and if it should, what commitments it should make. It could also advise the developing country on the legal implications of the RTA and how to make the agreement WTO-compatible. The provision of economic and legal advice would level the playing field between RTA partners whose analytical and negotiating capacities differ significantly.

The proposed economic and legal advice is also *ex ante* in nature. That is, RTA contents would be influenced before the member countries negotiate, sign, or ratify the agreements. Such *ex ante* approach to RTA supervision would complement the reviewing process conducted in the CRTA/CTD and the possible resort to the DSM, which are *ex post* in nature. In addition, as prospective developing-country Members sought advice, they would have to reveal their plans and supply the CRTA/CTD with necessary information at an early stage of their negotiations. This would indirectly help with the notification and reviewing process, which is in line with the concept of early announcement under the 2006 Mechanism. With such information, the CRTA/CTD could give economic advice which takes into account

⁷³⁹ See Chapter 2.

not only potential costs and benefits from the perspective of a prospective member but also from the perspectives of a non-member as well.

Another added benefit of this proposed economic and legal advice is that it would be provided on a country-specific basis as opposed to the more generic training (with the emphasis on RTA negotiations) of trade officials/negotiators from developing-country Members discussed earlier. In other words, the services could be tailored in accordance with the specific circumstances and needs of the developing country in question. This would be one way to offer a *tailored-fit* special and differential treatment for developing-country Members with regard to RTA negotiations and complement the more nuanced approach to special and differential treatment proposed in the context of the WTO rules (whereby developing countries are further divided into subgroups and different threshold levels and transitional periods are agreed in advance).⁷⁴⁰

In terms of specialization, over time the CRTA/CTD would be able to build up the expertise in RTA-related issues and develop a standardized *ex ante* analytical framework for the formation of an RTA. Furthermore, as far as efficiency is concerned, the CRTA/CTD could exploit economies of scale as the number of developing-country Members requesting for such services increases.

The problem with this proposal is whether the WTO has sufficient resources to provide such consulting services to its developing-country Members. For example, the economic advice would require well-trained economists and statisticians to work out the aggregation of potential benefits and potential costs induced by the formation of the RTA in question. The same applies to legal advice.⁷⁴¹ It is not clear whether the WTO can afford to hire these experts. One way to deal with this problem is to require the developing-country Member requesting the services to partially pay for them. Alternatively or in addition to partial payment, developed-country Members could make contributions to a trust fund which would be used to subsidize these services.⁷⁴² This is similar to the Aid for Trade funds agreed at the Hong Kong WTO Ministerial

⁷⁴⁰ See Chapters 4, 5, and 6.

⁷⁴¹ It should be noted that the WTO Secretariat does provide additional legal advice and assistance to developing countries in respect of dispute settlement at their request. According to DSU Article 27.2, it has to make available a qualified legal expert from the WTO technical cooperation services to any developing country which so requests. However, this is different from what suggested here, which primarily aims at the pre-DSM stage.

⁷⁴² Bilateral donors would be more difficult to orchestrate since there is more likely to be a conflict of interests if the donors are negotiating RTAs with the beneficiaries.

Conference in December 2005.⁷⁴³ If these means still do not provide sufficient funding for in-house services, one may need to look further afield.

As far as legal advice is concerned, the Advisory Centre of WTO Law could provide an answer.⁷⁴⁴ The ACWL is a Geneva-based intergovernmental organization which was established in 2001 by an international agreement signed by 29 WTO Members in Seattle on 1 December 1999. It is separate and independent from the WTO. The ACWL's main sources of financing are the revenues from its *Endowment Fund*, fees levied for support in dispute settlement proceedings and voluntary contributions.⁷⁴⁵ Not only does the ACWL provide legal assistance in WTO dispute settlement proceedings but it also provides legal advice on matters that are not yet the subject of the DSM.⁷⁴⁶ The latter service helps the country seeking the legal assistance to realize its trade policy objectives in a manner consistent with WTO law. Thus, it may be possible for developing countries to obtain *pre-DSM-stage* legal advice in relation to the formation of their RTAs from the ACWL. It is however not clear whether the centre does in fact possess the necessary expertise in RTA-related issues and/or is willing to develop it.

With regard to the proposed economic advice, UNCTAD might be able to offer such services. Established in 1964, it promotes the development-friendly integration of developing countries into the world economy. It has progressively evolved into "an authoritative knowledge-based institution whose work aims to help shape current policy debates and thinking on development, with a particular focus on ensuring that domestic policies and international action are mutually supportive in bringing about sustainable development."⁷⁴⁷

The organization works to fulfil this mandate by carrying out three key functions: first, it functions as a forum for intergovernmental deliberations, supported by discussions with experts and exchanges of experience, aimed at consensus

⁷⁴³ See http://www.wto.org/english/tratop_e/devel_e/a4t_e/aid4trade_e.htm (last accessed 11 September 2010). See also S Prowse, 'The Role of International and National Agencies in Trade-Related Capacity Building' (2002) 25 *World Economy* 1235, p. 1242.

⁷⁴⁴ See http://www.acwl.ch/e/index_e.aspx (last accessed 1 August 2009). For further discussion, see K Van der Borcht, 'The Advisory Centre on the WTO Law: Advancing Fairness and Equality' (1999) 2 *Journal of International Economic Law* 723.

⁷⁴⁵ See http://www.acwl.ch/pdf/QuickGuide_2008.pdf (last accessed 1 August 2009).

⁷⁴⁶ See *Ibid.*

⁷⁴⁷ See <http://www.unctad.org/Templates/Page.asp?intItemID=1530&lang=1> (last accessed 1 August 2009). For further discussion, see M Shah, *Developing Countries and UNCTAD (United Nations Conference on Trade and Development)* (1st edn Vora, Bombay, 1968) and WR Malinowski and M Zammit Cutajar, *UNCTAD and the South-North Dialogue: the First Twenty Years: Essays in Memory of W.R. Malinowski* (Pergamon, Oxford 1985).

building; secondly, it undertakes research, policy analysis and data collection for the debates of government representatives and experts; and finally, it provides technical assistance tailored to the specific requirements of developing countries, with special attention to the needs of the least developed countries and of economies in transition. When appropriate, it cooperates with other organizations and donor countries in the delivery of technical assistance.⁷⁴⁸

More importantly, UNCTAD has been taking on RTA-related issues more seriously and focusing on their development dimension in the recent years.⁷⁴⁹ Furthermore, it views itself as having “an important role to play in helping developing countries to deal with the interface between multilateralism and regionalism, and the interplay among RTAs, under a new trade, development and cooperation paradigm.”⁷⁵⁰ Thus, with developing countries at its heart and its available resources, UNCTAD is arguably capable of providing developing countries with advice on the economic impact of their RTAs.

Nevertheless, like the ACWL, UNCTAD is separate and independent from the WTO. This means that there may be a need for these international institutions to cooperate and coordinate their policy objectives and resources in order to assist developing countries participating in the current RTA proliferation. It should be noted that the existing WTO framework for technical assistance does accommodate cooperation and coordination between international organizations to some extent. For example, the Integrated Framework for Trade-Related Technical Assistance to Least-Developed Countries, coordinated out of the WTO, brings together six international organizations, namely, UNCTAD, the International Trade Centre (ITC), the United Nations Development Programme (UNDP), the WTO, the International Monetary Fund (IMF), and the World Bank.⁷⁵¹ Consequently, cooperation and coordination between the WTO and other international organizations should not be too difficult to achieve.

⁷⁴⁸ Ibid.

⁷⁴⁹ See for example, United Nations Conference on Trade and Development. Secretariat, *Trade and development report, 2007* (United Nations, New York; Geneva 2007), and United Nations Conference on Trade and Development, *Handbook of Economic Integration and Cooperation Groupings of Developing Countries* (United Nations, New York 1996).

⁷⁵⁰ See the Summary prepared by the UNCTAD Secretariat for Forum on Multilateralism and Regionalism: the New Interface, 8 June 2004, Rio de Janeiro, TD/L.369, para. 9.

⁷⁵¹ See http://www.wto.org/english/tratop_e/devel_e/teccop_e/if_e.htm (last accessed 10 September 2010). See also Shaffer, pp. 263-4.

It is noteworthy that the provision of consulting services could be made available by a new international institution. For example, Rollo proposes that there is a case for an Advisory Centre on Regional Trade Agreements, which are composed of economists and lawyers specialized in RTA-related issues.⁷⁵² It would be modelled after the ACWL with moderate consulting fees. Such a specialized institution would certainly benefit developing countries and help level the playing field between RTA partners with different analytical and negotiating capacities.

7.5 Conclusion

Given the conflicting interests and the resulting lack of political will on the part of WTO Members, it might not be easy and will take time to bring about the necessary changes to the rules and/or the ways in which they are interpreted. Thus, I propose to improve the *status quo* somewhat by adopting less contentious means which can be used to strengthen and complement the existing rules and mechanisms. These include promulgation of code of best practices, revision of the WTO surveillance mechanisms, and technical assistance for developing countries in relation to RTA negotiations.

Noticeably, the WTO rules (including code of best practices), the existing mechanisms, and the provision of technical assistance are dynamically intertwined and linked with one another. For example, the reviewing process is in a sense a mechanism to enforce the rules. Without it, the only way the rules can be enforced is through the DSM. On the other hand, if the rules are ambiguous and do not give due account to the challenges facing developing countries amid the current RTA proliferation, the reviewing process alone cannot do much to address them. In addition, without technical assistance, developing countries would be disadvantaged as they are constrained by their lack of analytical and negotiating capacities.

⁷⁵² See J Rollo, 'The Challenge of Negotiating RTAs for Developing Countries' in R Baldwin and P Low (eds), *Multilateralizing Regionalism: Challenges for the Global Trading System* (Cambridge University Press, Cambridge 2009), pp. 692-4.

RTA supervision requires a systemic approach as regulatory measures reinforce one another. In order to improve its RTA supervision, the WTO has to tackle the problems from different fronts. Some regulatory measures are less contentious than others and may take less time and resources- be they financial or political- to implement. Thus, perhaps in the short-run, the WTO should channel its resources and attention to less contentious regulatory means such as a code of best practices and provision of technical assistance. By strengthening such means, the WTO may be able to loosen the gridlock on the part of its Members to reform the existing rules and make RTA supervision more effective. Notably, the 2006 Mechanism is a good example of a shift in that direction. Nevertheless, substantive reforms to the rules still remain very important if one is to effectively address the challenges facing developing countries amid the current RTA proliferation.

Conclusions & Concluding Remarks

The thesis set out to accomplish two tasks: the first was to find out what specific challenges do developing countries face amid the current RTA proliferation when they negotiate and form such trade arrangements with their developed-country trade partners and among themselves?; and the second task was to determine to what extent do the existing WTO rules pertaining RTA supervision address these challenges and are there any ways to improve the rules and mechanisms so that the challenges can be better addressed?

The thesis started off with a survey of the current RTA proliferation. Two key features have emerged, namely, the rate of proliferation and the participation of developing countries. The current rate at which RTAs proliferate is very rapid compared to those during the GATT years, and markedly continues unabated. Consequently, more and more international trade is taking place through such arrangements. This raises the importance of the way in which these agreements are designed and negotiated. That is, they should be supervised so that benefits are maximized and costs minimized. More importantly, developing countries are increasingly taking part in the current RTA proliferation, both in North-South and South-South RTAs. Thus, not only should these agreements be supervised, but the existing WTO rules and mechanisms pertaining RTA supervision should also address the challenges facing developing countries when forming such trade arrangements.

Having examined the three bodies of literature and supplemented them with the interviews conducted during and personal exposure to a number of Thailand and ASEAN's RTA negotiations, Chapter 2 identified three major challenges facing developing countries amid the current RTA proliferation from the perspective of a prospective RTA member. These are domestic vested interests, high implementation and adjustment costs, and the lack of analytical and negotiating capacities on the part of developing countries.

Chapter 3, on the other hand, investigated whether there are any challenges that developing countries may face from two other perspectives, namely, as a non-member and as a WTO Member amid the current RTA proliferation. It was found that as a non-member, the main challenge facing developing countries is the adverse

effects caused by trade and investment diversion. However, if left to themselves, it is very unlikely that prospective RTA members will take into account such adverse effects. Furthermore, by its very nature, an RTA is designed and negotiated between the member countries while non-members are excluded from this process and will be discriminated against as a result of trade preferences granted between the member countries. Consequently, there is little, if anything, non-member developing countries can do to curb trade and investment diversion. They can only either attempt to form RTAs of their own with their main trade partners or apply for a membership of the existing ones. In doing so, they may be pressured by their trade partners, particularly those of developed-country status, to accept commitments that are not suitable for their stage of development. Thus, it was argued that the WTO has a role to play here.

From the bodies of literature reviewed in Chapter 3, the challenge facing developing countries from the perspective of a WTO Member is not clear, however. While the theoretical and empirical work on how RTAs affect the multilateral trading system and multilateral trade liberalization has generated a number of interesting insights, it remains largely inconclusive. It can be argued both ways. That is, RTAs may complement or undermine the multilateral trading system and multilateral trade liberalization depending on what factors one takes into consideration. Further research and time is needed on this front.

Although developing countries may have a stake in the smooth functioning of the WTO- to the extent that RTAs undermine the multilateral trading system and multilateral trade liberalization- their immediate concerns are likely to lie in the adverse effects caused by trade and investment diversion and/or how they can make the most out of the RTA that they have decided to form. Consequently, as far as the challenges facing developing countries amid the current RTA proliferation are concerned, attention should be given to those they face from the perspectives of a prospective member and a non-member.

Chapters 4, 5, and 6 embarked upon the second task as they examined the three sets of rules, namely, GATT Article XXIV, the Enabling Clause, and GATS Article V, respectively, in light of the challenges facing developing countries discussed and identified in Chapters 2 and 3. The main requirements contained in each set of rules can be divided into two categories: the *intra-RTA* and *third-party*

obligations.⁷⁵³ As discussed in these chapters, the intra-RTA obligation is relevant to the challenges facing developing countries from the perspective of a prospective RTA member while the third-party obligation, from the perspective of a non-member. A common finding with regard to the third-party obligation in all three sets is that the WTO regulatory framework does tolerate the adverse effects of trade and investment diversion on the part of non-members to a certain extent. This is because the rules, *i.e.* GATT Article XXIV:5, subparagraph 3(a) second requirement of the Enabling Clause, and the second requirement of GATS Article V:4, only demand that trade barriers in relation to non-members are not raised.⁷⁵⁴ Such a requirement can only deal with the adverse effects of trade and investment diversion on the part of non-members in a limited fashion. As far as the intra-RTA obligation is concerned, the three sets of rules differ from one another and as a result, different proposals were made in response to the shortcomings revealed from the evaluation.

The main proposal made in Chapter 4 with regard to the intra-RTA obligation was to incorporate some form of special and differential treatment into GATT Article XXIV:8. This could be achieved by setting different threshold levels of and timeframes for the SAT requirement: developed countries would be subject to higher threshold level and shorter timeframe than developing countries; in addition, developing countries could be further divided into subgroups, *i.e.* into LDCs, LMIDCs, and UMIDCs, and would be subject to different threshold levels and timeframes. This is a more nuanced approach to special and differential treatment and arguably would deal with the heterogeneity of developing countries more satisfactorily than at present. It was later discussed in Chapter 6 that a tailored-fit special and differential treatment for the intra-RTA obligation would not strike the right balance between the individual needs of developing countries and predictability (and practicality) of RTA negotiations. A tailored-fit approach could, nevertheless, be adopted with regard to technical assistance, which was discussed in Chapter 7.

It is important to note that the proposed special and differential treatment should not result in excess flexibility. Otherwise, domestic vested interests could lobby the government to exclude trade-creating products and industries from the RTA coverage.

⁷⁵³ It should be noted that each set of the rules also contains provisions which establish certain procedures and promote transparency pertaining the formation of RTAs.

⁷⁵⁴ It is noteworthy that subparagraph 3(a) second requirement is slightly different as it contains the phrase *undue difficulties*. See Chapter 5.

With the proposed incorporation of special and differential treatment into GATT Article XXIV, it was argued that developing countries should have the flexibility to promote the potential benefits and manage the potential costs induced by the formation of an RTA. In addition, such incorporation could help neutralize asymmetries of the bargaining power between developed and developing countries. Furthermore, it was also proposed that the duty and ORRC halves of the SAT requirement should be separated and subject to different standards of enforcement so as to make the SAT requirement operable and at the same time sufficiently promote the potential gains- be they static or dynamic- induced by the formation of an RTA.

In Chapter 5, it was found that the intra-RTA obligation under the Enabling Clause significantly differs from that of GATT Article XXIV as it grants (excess) flexibility to developing countries forming an RTA among themselves. Although this is understandable given the former's drafting history and the sentiments towards developing countries at the time of its enactment, it was argued that the leniency of the rules may not translate into trade/economic benefits in practice and may even result in severe trade diversion which is harmful to both developing-country members and non-members alike. In addition, the chapter discussed how the existing two separate sets of rules for the formation of goods RTAs may result in the lacuna where developing-country partners in North-South RTAs are not eligible to any special and differential treatment and the discrepancy between two types of South-South RTAs, one notified under GATT Article XXIV and the other the Enabling Clause. It was therefore argued that given the excess flexibility, the lacuna, and the discrepancy, there should be a single set of rules for the formation of goods RTAs, *i.e.* GATT Article XXIV, but only if the proposed special and differential treatment is incorporated into the provisions therein.⁷⁵⁵

Similar to the other two sets of rules, Chapter 6 found that GATS Article V is plagued with a number of ambiguities. The application of the provisions therein is also made more difficult due to the limited data on trade in services and the difficulties involved in the methodological approaches to data collection and evaluation. Furthermore, the attempt by GATT CONTRACTING PARTIES to import into GATS the key concept of substantially all the trade in GATT Article XXIV:8 is

⁷⁵⁵ Alternatively, WTO Members could negotiate altogether a new set of rules governing the formation of goods RTAs, which is not bound by the wording of GATT Article XXIV and better equipped to deal with rules of origin.

arguably a fundamental mistake and may have made GATS Article V even more complicated. Nevertheless, the nature of barriers to trade in services and rules of origin, which makes it more difficult to discriminate against non-members, may mitigate the potential adverse effects induced by services RTAs to some extent.

Given that GATS commitments are still far from comprehensive and countries do make GATS-plus commitments in services RTAs, it was argued that these agreements may complement the multilateral process rather than undermine it. Over time, the nature of barriers to trade in services and rules of origin is likely to weaken domestic oppositions to services liberalization and may create opportunities to further liberalization at the multilateral level. In order to maximize the potential benefits from services RTAs, it was also argued that WTO Members should allocate their resources and attention to elaborate and clarify the SBO requirement under paragraph 6. If they can agree on a definition of *substantial business operation* which results in liberal rules of origin, more efficient services providers from outside the preferential area will be able to enter and compete in the members' markets. This, in turn, will mitigate trade diversion further which is beneficial to both members and non-members alike.

As far as developing countries are concerned, services liberalization- may it be at the bilateral/regional or multilateral level- presents them with two additional challenges to the ones identified in Chapters 2 and 3, namely those concerning regulation and movement of natural persons. It was proposed that subparagraph 3(a) could be used to ensure that developing countries have sufficient flexibility to establish appropriate and effective regulatory frameworks in the covered sectors/subsectors. It was also proposed that the implied different standards that are applied to developed and developing countries could be used to indirectly force the former to liberalize their mode-4 services, in which the latter have comparative advantage.

Having examined GATT Article XXIV, the Enabling Clause, and GATS Article V, nothing in these rules appears to deal directly with the constraints on developing countries' analytical and negotiating capacities. Although some of the proposals could help neutralize asymmetries of the bargaining powers between developed and developing countries, they would not directly foster the development of both capacities. Given their importance to the success of RTA negotiations (and those at the multilateral level), more efforts should be made to help developing

countries build analytical and negotiating capacities. The way in which this might be achieved was proposed in Chapter 7.

As discussed in the previous chapter, the main obstacle to any substantive reforms of the existing rules is the underlying conflict of interests among WTO Members, which in turn results in the lack of political will to make reforms in this area. This is because almost all WTO Members are a party to at least one or more RTAs. As a result, they are likely to prefer the *status quo* where the rules are ambiguous and Members hardly bring disputes to the WTO DSM. On this basis, a number of proposals were made in order to improve the *status quo* somewhat by adopting less contentious means which can be used to strengthen and complement the existing rules. These include promulgation of code of best practices, revision of the WTO surveillance mechanisms, and technical assistance for developing countries in relation to RTA negotiations. It was argued that the rules (including code of best practices), the surveillance mechanisms, and the provision of technical assistance are dynamically intertwined and linked with one another. Thus, RTA supervision requires a systemic approach as regulatory measures reinforce one another.

Throughout this thesis, it can be seen that the WTO regulatory framework for RTAs is rather reactive in nature as prospective members are allowed to design and negotiate their agreements without having to consult with the rest of WTO Members. Although the 2006 Mechanism has introduced new procedural requirements which hopefully will improve the current situation, the early announcement concept, the notification obligation, and the factual presentations are still *after-the-fact* examinations. However, it is acknowledged that this reactive nature is perhaps necessary for RTA negotiations because they are based on reciprocal exchange of trade preferences, which will be undermined if they are to be disclosed to other WTO Members and the public prior to agreement.

Effects of WTO rules are often considered most visible when they are formally enforced through the DSM and/or the reviewing process conducted by relevant WTO bodies. However, they can also affect the process of national decision-making- the process that takes place prior to the actual adoption of a trade measure.⁷⁵⁶ Although the WTO does not formally interfere at this stage, its rules often do exert a

⁷⁵⁶ For further discussion, see J de Melo and A Panagariya (eds), *New Dimensions in Regional Integration* (Cambridge University Press, Cambridge 1993), pp. 151-3.

major influence on shaping the measure.⁷⁵⁷ This earlier stage in the process is particularly important when it comes to RTAs since the WTO's ability to regulate once governments have decided to make certain commitments in these bilateral/regional agreements is tenuous. This is because government decisions usually require extensive bargaining that is difficult to reopen- in the case of RTA negotiations, the bargaining is arguably even more complex since it involves more than one government. Consequently, reopening the process of decision on such agreements is anything but possible. This perhaps explains why GATT working parties and the CRTA/CTD have failed to make recommendations with regard to RTAs notified to the GATT/WTO.

The proposals made in this thesis aim to change this reactive nature as well as to address the challenges facing developing countries amid the current RTA proliferation. Subtly, the reformed rules should help shape subsequent RTAs towards a trade environment where developing countries are not so disadvantaged and at the same time not given excess flexibility. In addition, the proposed code of best practices will provide WTO Members with guiding principles and a model RTA and/or specific RTA commitments. Furthermore, while developing countries can rely on such specific RTA commitments as a starting point of negotiation, other WTO Members can also use them as a basis to scrutinize the RTA members during the reviewing process in the CRTA/CTD, which will be strengthened if the proposed primary-secondary jurisdiction is adopted. Over time, prospective RTA members will design and negotiate their RTAs in contemplation of such practices. In other words, the proposals on the substantive reforms of the rules should affect the way in which WTO Members design and negotiate RTAs. Moreover, the proposed provisions of technical assistance will help developing countries respond to the current RTA proliferation in a more proactive way as they will be better equipped with economic and legal expertise.

Last but not least, attention should be given to the idea of *multilateralizing* certain aspects of the current RTA proliferation.⁷⁵⁸ Such approach, although still reactive, is positively tackling it. Under this approach, benefits gained from the formation of RTAs with regard to regulatory measures for example, can be multilateralized. This will extend the benefits to the rest of the WTO membership and

⁷⁵⁷ Ibid.

⁷⁵⁸ See R Baldwin and P Low (eds), *Multilateralizing Regionalism: Challenges for the Global Trading System* (Cambridge University Press, Cambridge 2009).

at the same time curb the adverse effects of trade and investment diversion. However, it is important that any process of multilateralization gives due account to the development dimension of these agreements and how they can be used by developing countries to pursue their economic development.

It is hoped that this thesis has contributed to how to respond to the current RTA proliferation in such a way that addresses the challenges facing developing countries when forming RTAs both with their developed-country trade partners and among themselves. To deal with the current RTA proliferation is already an extremely challenging task. To do this with developing countries in mind is even more so. Nevertheless, as an international organization whose majority of its members are developing countries, it is vital that the WTO accommodates their needs and difficulties and does not allow countries with power and influence to use the organization as a vehicle to serve their self interests. Failing to do so would be the first step towards marginalization of the WTO in the global trading system.

Appendix

Article XXIV of GATT

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 maintained in each of the constituent territories and applicable at the formation of such free-trade area or the adoption of such interim agreement to the trade of contracting parties not included in such area or not parties to such agreement shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area, or interim agreement as the case may be; and

(c) any interim agreement referred to in sub-paragraphs (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 sub-paragraph 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 to the formation of such a union or area, shall promptly notify the Contracting Parties and shall make available to them such information regarding the proposed union or area 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 sub-paragraph (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. 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.

(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 in 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 preferences 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 by 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.

Ad Article XXIV

Paragraph 9

It is understood that the provisions of Article I would require that, when a product which has been imported into the territory of a member of a customs union or free-trade area at a preferential rate of duty is re-exported to the territory of another member of such union or area, the latter member should collect a duty equal to the difference between the duty already paid and any higher duty that would be payable if the product were being imported directly into its territory.

Paragraph 11

Measures adopted by India and Pakistan in order to carry out definitive trade arrangements between them, once they have been agreed upon, might depart from particular provisions of this Agreement, but these measures would in general be consistent with the objectives of the Agreement.

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 GATT 1994;

Recognizing that customs unions and free-trade areas have greatly increased in number and importance since the establishment of 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;

Recognizing also that such contribution is increased if the elimination between the constituent territories of duties and other restrictive regulations of commerce extends to all trade, and diminished if any major sector of trade is excluded;

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 paragraph 12 of Article XXIV;

Hereby *agree* as follows:

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

Article XXIV:5

2. The evaluation under paragraph 5(a) of Article XXIV 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. This 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 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 of Multilateral Trade Negotiations. 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 paragraph 5(c) of Article XXIV should exceed 10 years only in exceptional cases. In cases where Members parties to an interim agreement believe that 10 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 Members reaffirm that the procedure set forth in Article XXVIII, as elaborated in the guidelines adopted on 10 November 1980 (BISD 27S/26-28) and in the Understanding on the Interpretation of Article XXVIII of GATT 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. These negotiations will be entered into in good faith with a view to achieving mutually satisfactory compensatory adjustment. In such negotiations, as required by paragraph 6 of Article XXIV, 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 GATT 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. GATT 1994 imposes no obligation on Members benefiting from a reduction of duties consequent upon the formation of a customs 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 paragraph 7(a) of Article XXIV shall be examined by a working party in the light of the relevant provisions of 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 time-frame 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. Members parties to an interim agreement shall notify substantial changes in the plan and schedule included in that agreement to the Council for Trade in Goods and, if so requested, the Council shall examine the changes.

10. Should an interim agreement notified under paragraph 7(a) of Article XXIV not include a plan and schedule, contrary to paragraph 5(c) of Article XXIV, 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 CONTRACTING PARTIES to

GATT 1947 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 developments in the agreements should be reported as they occur.

Dispute Settlement

12. The provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked with respect to any matters arising from the application of those provisions of Article 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 GATT 1994 for the observance of all provisions of 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 GATT 1994 as elaborated and applied by the Dispute Settlement Understanding 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 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 GATT 1994 taken within the territory of the former.

Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries

*Decision of 28 November 1979
(L/4903)*

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 countries¹, without according such treatment to other contracting parties.
2. The provisions of paragraph 1 apply to the following:²
 - (a) Preferential tariff treatment accorded by developed contracting parties to products originating in developing countries in accordance with the Generalized System of Preferences,³
 - (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 on the least developed among the developing countries in the context of any general or specific measures in favour of developing countries.
3. Any differential and more favourable treatment provided under this clause:
 - (a) shall 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 any other contracting parties;
 - (b) shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a most-favoured-nation basis;

¹ The words "developing countries" as used in this text are to be understood to refer also to developing territories.

² It would remain open for the CONTRACTING PARTIES to consider on an *ad hoc* basis under the GATT provisions for joint action any proposals for differential and more favourable treatment not falling within the scope of this paragraph.

³ As described in the Decision of the CONTRACTING PARTIES of 25 June 1971, relating to the establishment of "generalized, non-reciprocal and non discriminatory preferences beneficial to the developing countries" (BISD 18S/24).

(c) shall in the case of such treatment accorded by developed contracting parties to developing countries be designed and, if necessary, modified, to respond positively to the development, financial and trade needs of developing countries.

4. Any contracting party taking action to introduce an arrangement pursuant to paragraphs 1, 2 and 3 above or subsequently taking action to introduce modification or withdrawal of the differential and more favourable treatment so provided shall:⁴

(a) notify the CONTRACTING PARTIES and furnish them with all the information they may deem appropriate relating to such action;

(b) afford adequate opportunity for prompt consultations at the request of any interested contracting party with respect to any difficulty or matter that may arise. The CONTRACTING PARTIES shall, if requested to do so by such contracting party, consult with all contracting parties concerned with respect to the matter with a view to reaching solutions satisfactory to all such contracting parties.

5. The developed countries do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of developing countries, i.e., the developed countries do not expect the developing countries, in the course of trade negotiations, to make contributions which are inconsistent with their individual development, financial and trade needs. Developed contracting parties shall therefore not seek, neither shall less-developed contracting parties be required to make, concessions that are inconsistent with the latter's development, financial and trade needs.

6. Having regard to the special economic difficulties and the particular development, financial and trade needs of the least-developed countries, the developed countries shall exercise the utmost restraint in seeking any concessions or contributions for commitments made by them to reduce or remove tariffs and other barriers to the trade of such countries, and the least-developed countries shall not be expected to make concessions or contributions that are inconsistent with the recognition of their particular situation and problems.

7. The concessions and contributions made and the obligations assumed by developed and less-developed contracting parties under the provisions of the General Agreement should promote the basic objectives of the Agreement, including those embodied in the Preamble and in Article XXXVI. Less-developed contracting parties expect that their capacity to make contributions or negotiated concessions or take other mutually agreed action under the provisions and procedures of the General Agreement would improve with the progressive development of their economies and improvement in their trade situation and they would accordingly expect to participate more fully in the framework of rights and obligations under the General Agreement.

8. Particular account shall be taken of the serious difficulty of the least-developed countries in making concessions and contributions in view of their special economic situation and their development, financial and trade needs.

⁴ Nothing in these provisions shall affect the rights of contracting parties under the General Agreement.

9. The contracting parties will collaborate in arrangements for review of the operation of these provisions, bearing in mind the need for individual and joint efforts by contracting parties to meet the development needs of developing countries and the objectives of the General Agreement.

Article V of GATS

Economic Integration

1. This Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement, provided that such an agreement:

- (a) has substantial sectoral coverage¹, and
- (b) provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under subparagraph (a), through:
 - (i) elimination of existing discriminatory measures, and/or
 - (ii) prohibition of new or more discriminatory measures,

either at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI, XII, XIV and XIV bis.

2. In evaluating whether the conditions under paragraph 1(b) are met, consideration may be given to the relationship of the agreement to a wider process of economic integration or trade liberalization among the countries concerned.

3. (a) Where developing countries are parties to an agreement of the type referred to in paragraph 1, flexibility shall be provided for regarding the conditions set out in paragraph 1, particularly with reference to subparagraph (b) thereof, in accordance with the level of development of the countries concerned, both overall and in individual sectors and subsectors.

(b) Notwithstanding paragraph 6, in the case of an agreement of the type referred to in paragraph 1 involving only developing countries, more favourable treatment may be granted to juridical persons owned or controlled by natural persons of the parties to such an agreement.

4. Any agreement referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not in respect of any Member outside the agreement raise the overall level of barriers to trade in services within the respective sectors or subsectors compared to the level applicable prior to such an agreement.

¹ This condition is understood in terms of number of sectors, volume of trade affected and modes of supply. In order to meet this condition, agreements should not provide for the *a priori* exclusion of any mode of supply.

5. If, in the conclusion, enlargement or any significant modification of any agreement under paragraph 1, a Member intends to withdraw or modify a specific commitment inconsistently with the terms and conditions set out in its Schedule, it shall provide at least 90 days advance notice of such modification or withdrawal and the procedure set forth in paragraphs 2, 3 and 4 of Article XXI shall apply.

6. A service supplier of any other Member that is a juridical person constituted under the laws of a party to an agreement referred to in paragraph 1 shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement.

7. (a) Members which are parties to any agreement referred to in paragraph 1 shall promptly notify any such agreement and any enlargement or any significant modification of that agreement to the Council for Trade in Services. They shall also make available to the Council such relevant information as may be requested by it. The Council may establish a working party to examine such an agreement or enlargement or modification of that agreement and to report to the Council on its consistency with this Article.

(b) Members which are parties to any agreement referred to in paragraph 1 which is implemented on the basis of a time-frame shall report periodically to the Council for Trade in Services on its implementation. The Council may establish a working party to examine such reports if it deems such a working party necessary.

(c) Based on the reports of the working parties referred to in subparagraphs (a) and (b), the Council may make recommendations to the parties as it deems appropriate.

8. A Member which is a party to any agreement referred to in paragraph 1 may not seek compensation for trade benefits that may accrue to any other Member from such agreement.

TRANSPARENCY MECHANISM FOR REGIONAL TRADE AGREEMENTS

*Decision of 14 December 2006
(WT/L/671)*

The General Council,

Having regard to paragraph 1 of Article IX of the Marrakesh Agreement Establishing the World Trade Organization ("WTO Agreement");

Conducting the functions of the Ministerial Conference in the interval between meetings pursuant to paragraph 2 of Article IV of the WTO Agreement;

Noting that trade agreements of a mutually preferential nature ("regional trade agreements" or "RTAs") have greatly increased in number and have become an important element in Members' trade policies and developmental strategies;

Convinced that enhancing transparency in, and understanding of, RTAs and their effects is of systemic interest and will be of benefit to all Members;

Having regard also to the transparency provisions of Article XXIV of GATT 1994, the Understanding on the Interpretation of Article XXIV of GATT 1994 ("GATT Understanding"), Article V of GATS and the 1979 Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries ("Enabling Clause");

Recognizing the resource and technical constraints of developing country Members;

Recalling that in the negotiations pursued under the terms of the Doha Ministerial Declaration¹, in accordance with paragraph 47 of that Declaration, agreements reached at an early stage may be implemented on a provisional basis;

Decides:

A. Early Announcement

1. Without prejudging the substance and the timing of the notification required under Article XXIV of the GATT 1994, Article V of the GATS or the Enabling Clause, nor affecting Members' rights and obligations under the WTO agreements in any way:

- (a) Members participating in new negotiations aimed at the conclusion of an RTA shall endeavour to so inform the WTO.

¹ WT/MIN(01)/DEC/1.

- (b) Members parties to a newly signed RTA shall convey to the WTO, in so far as and when it is publicly available, information on the RTA, including its official name, scope and date of signature, any foreseen timetable for its entry into force or provisional application, relevant contact points and/or website addresses, and any other relevant unrestricted information.

2. The information referred to in paragraph 1 above is to be forwarded to the WTO Secretariat, which will post it on the WTO website and will periodically provide Members with a synopsis of the communications received.

B. Notification

3. The required notification of an RTA by Members that are party to it shall take place as early as possible. As a rule, it will occur no later than directly following the parties' ratification of the RTA or any party's decision on application of the relevant parts of an agreement, and before the application of preferential treatment between the parties.

4. In notifying their RTA, the parties shall specify under which provision(s) of the WTO agreements it is notified. They will also provide the full text of the RTA (or those parts they have decided to apply) and any related schedules, annexes and protocols, in one of the WTO official languages; if available, these shall also be submitted in an electronically exploitable format. Reference to related official Internet links shall also be supplied.

C. Procedures to Enhance Transparency

5. Upon notification, and without affecting Members' rights and obligations under the WTO agreements under which it has been notified, the RTA shall be considered by Members under the procedures established in paragraphs 6 to 13 below.

6. The consideration by Members of a notified RTA shall be normally concluded in a period not exceeding one year after the date of notification. A precise timetable for the consideration of the RTA shall be drawn by the WTO Secretariat in consultation with the parties at the time of the notification.

7. To assist Members in their consideration of a notified RTA:

- (a) the parties shall make available to the WTO Secretariat data as specified in the Annex, if possible in an electronically exploitable format; and
- (b) the WTO Secretariat, on its own responsibility and in full consultation with the parties, shall prepare a factual presentation of the RTA.

8. The data referred to in paragraph 7(a) shall be made available as soon as possible. Normally, the timing of the data submission shall not exceed ten weeks – or

20 weeks in the case of RTAs involving only developing countries – after the date of notification of the agreement.

9. The factual presentation provided for in paragraph 7(b) shall be primarily based on the information provided by the parties; if necessary, the WTO Secretariat may also use data available from other sources, taking into account the views of the parties in furtherance of factual accuracy. In preparing the factual presentation, the WTO Secretariat shall refrain from any value judgement.

10. The WTO Secretariat's factual presentation shall not be used as a basis for dispute settlement procedures or to create new rights and obligations for Members.

11. As a rule, a single formal meeting will be devoted to consider each notified RTA; any additional exchange of information should take place in written form.

12. The WTO Secretariat's factual presentation, as well as any additional information submitted by the parties, shall be circulated in all WTO official languages not less than eight weeks in advance of the meeting devoted to the consideration of the RTA. Members' written questions or comments on the RTA under consideration shall be transmitted to the parties through the WTO Secretariat at least four weeks before the corresponding meeting; they shall be distributed, together with replies, to all Members at least three working days before the corresponding meeting.

13. All written material submitted, as well as the minutes of the meeting devoted to the consideration of a notified agreement will be promptly circulated in all WTO official languages and made available on the WTO website.

D. Subsequent Notification and Reporting

14. The required notification of changes affecting the implementation of an RTA, or the operation of an already implemented RTA, shall take place as soon as possible after the changes occur. Changes to be notified include, *inter alia*, modifications to the preferential treatment between the parties and to the RTA's disciplines. The parties shall provide a summary of the changes made, as well as any related texts, schedules, annexes and protocols, in one of the WTO official languages and, if available, in electronically exploitable format.²

15. At the end of the RTA's implementation period, the parties shall submit to the WTO a short written report on the realization of the liberalization commitments in the RTA as originally notified.

16. Upon request, the relevant WTO body shall provide an adequate opportunity for an exchange of views on the communications submitted under paragraphs 14 and 15.

² In their notification, Members may refer to official Internet links related to the agreement where the relevant information can be consulted in full, in one of the WTO official languages.

17. The communications submitted under paragraphs 14 and 15 will be promptly made available on the WTO website and a synopsis will be periodically circulated by the WTO Secretariat to Members.

E. Bodies Entrusted with the Implementation of the Mechanism

18. The Committee on Regional Trade Agreements ("CRTA") and the Committee on Trade and Development ("CTD") are instructed to implement this Transparency Mechanism.³ The CRTA shall do so for RTAs falling under Article XXIV of GATT 1994 and Article V of GATS, while the CTD shall do so for RTAs falling under paragraph 2(c) of the Enabling Clause. For purposes of performing the functions established under this Mechanism, the CTD shall convene in dedicated session.

F. Technical Support for Developing Countries

19. Upon request, the WTO Secretariat shall provide technical support to developing country Members, and especially least-developed countries, in the implementation of this Transparency Mechanism, in particular – but not limited to – with respect to the preparation of RTA-related data and other information to be submitted to the WTO Secretariat.

G. Other Provisions

20. Any Member may, at any time, bring to the attention of the relevant WTO body information on any RTA that it considers ought to have been submitted to Members in the framework of this Transparency Mechanism.

21. The WTO Secretariat shall establish and maintain an updated electronic database on individual RTAs. This database shall include relevant tariff and trade-related information, and give access to all written material related to announced or notified RTAs available at the WTO. The RTA database should be structured so as to be easily accessible to the public.

H. Provisional Application of the Transparency Mechanism

22. This Decision shall apply, on a provisional basis, to all RTAs. With respect to RTAs already notified under the relevant WTO transparency provisions and in force, this Decision shall apply as follows:

³ The Director-General is invited to ensure consistency in the preparation of the WTO Secretariat factual presentations for the different types of RTAs, taking into account the variations in data provided by different Members.

- (a) RTAs for which a working party report has been adopted by the GATT Council and those RTAs notified to the GATT under the Enabling Clause will be subject to the procedures under Sections D to G above.
- (b) RTAs for which the CRTA has concluded the "factual examination" prior to the adoption of this Decision and those for which the "factual examination" will have been concluded by 31 December 2006, and RTAs notified to the WTO under the Enabling Clause will be subject to the procedures under Sections D to G above. In addition, for each of these RTAs, the WTO Secretariat shall prepare a factual abstract presenting the features of the agreement.
- (c) Any RTA notified prior to the adoption of this Decision and not referred to in subparagraphs (a) or (b) will be subject to the procedures under Sections C to G above.

I. Reappraisal of the Mechanism

23. Members will review, and if necessary modify, this Decision, in light of the experience gained from its provisional operation, and replace it by a permanent mechanism adopted as part of the overall results of the Round, in accordance with paragraph 47 of the Doha Declaration. Members will also review the legal relationship between this Mechanism and relevant WTO provisions related to RTAs.

ANNEX

Submission of Data by RTA Parties

24. RTA parties shall not be expected to make available the information required below if the corresponding data has already been submitted to the Integrated Data Base (IDB),⁴ or has otherwise been provided to the Secretariat in an adequate format.⁵

25. For the goods aspects in RTAs, the parties shall submit the following data, at the tariff-line level:⁶

⁴ Trade and tariff data submissions in the context of an RTA notification can subsequently be included in the IDB, provided that their key features are appropriate. In this respect, see document G/MA/IDB/W/6 (dated 15 June 2000) for the Guidelines for Supplying PC IDB Submissions and documents G/MA/115 (dated 17 June 2002) and G/MA/115/Add.5 (dated 13 January 2005) for WTO Policy regarding the dissemination of IDB data.

⁵ Data submissions can be furnished in PC database formats, spreadsheet formats, or text-delimited formats; the use of word-processing formats should be avoided, if possible.

⁶ References to "tariff-line level" shall be understood to mean the detailed breakdown of the national customs nomenclature (HS codes with, for example, 8, 10 or more digits). It is crucial that all data elements supplied use the same national customs nomenclature or are associated with corresponding conversion tables.

- (a) Tariff concessions under the agreement:
 - (i) a full listing of each party's preferential duties applied in the year of entry into force of the agreement; and
 - (ii) when the agreement is to be implemented by stages, a full listing of each party's preferential duties to be applied over the transition period.
- (b) MFN duty rates:
 - (i) a full tariff listing of each RTA party's MFN duties applied on the year of entry into force of the agreement;⁷ and
 - (ii) a full tariff listing of each RTA party's MFN duties applied on the year preceding the entry into force of the agreement.
- (c) Where applicable, other data (e.g., preferential margins, tariff-rate quotas, seasonal restrictions, special safeguards and, if available, *ad valorem* equivalents for non-*ad valorem* duties).
- (d) Product-specific preferential rules of origin as defined in the agreement.
- (e) Import statistics, for the most recent three years preceding the notification for which they are available:
 - (i) each party's imports from each of the other parties, in value; and
 - (ii) each party's imports from the rest of the world, broken down by country of origin, in value.

26. For the services aspects in RTAs, the parties shall submit the following data, if available, for the three most recent years preceding the notification: trade or balance of payments statistics (by services sector/subsector and partner), gross domestic product data or production statistics (by services sector/subsector), and relevant statistics on foreign direct investment and on movement of natural persons (by country and, if possible, by services sector/subsector).

27. For RTAs involving only developing countries, in particular when these comprise least-developed countries, the data requirements specified above will take into account the technical constraints of the parties to the agreement.

⁷ In the case of a customs union, the MFN applied common external tariff.

Best Practice for RTAs/FTAs¹ in APEC

*16th APEC Ministerial Meeting
Santiago, Chile
17-18 November 2004*

RTAs/FTAs involving APEC economies can best support the achievement of the APEC Bogor Goals by having the following characteristics:

Consistency with APEC Principles and Goals

- They address the relevant areas in Part I (Liberalization and Facilitation) of the Osaka Action Agenda (OAA) and they are consistent with its General Principles. In this way they help to ensure that APEC accomplishes the free trade and investment goals set out in the 1994 Bogor Leaders Declaration.
- They build upon work being undertaken by APEC
- Consistent with APEC goals, they promote structural reform among the parties through the implementation of transparent open and non-discriminatory regulatory frameworks and decision-making processes.

Consistency with the WTO

- They are fully consistent with the disciplines of the WTO, especially those contained in Article XXIV of the GATT and Article V of the GATS.
- When they involve developing economies to whom the Enabling Clause applies, they are, wherever possible, consistent with Article XXIV of the GATT and Article V of the GATS.

Go beyond WTO commitments

- In areas that are covered by the WTO, they build upon existing WTO obligations. They also explore commitments related to trade and investment in areas not covered, or only partly covered, by the WTO. By so doing, APEC economies are in a better position to provide leadership in any future WTO negotiations on these issues.

¹ Regional Trade Arrangements (RTAs), Free Trade Agreements (FTAs), and other Preferential Arrangements.

Comprehensiveness

- They deliver the maximum economic benefits to the parties by being comprehensive in scope, and providing for liberalization in all sectors. They therefore eliminate barriers to trade and investment between the Parties, including tariffs and non-tariff measures, and barriers to trade in services.
- Phase-out periods for tariffs and quotas in sensitive sectors are kept to minimum, and take into account the different levels of development among the parties. Thus, they are seen as an opportunity to undertake liberalization in all sectors as a first step towards multilateral liberalization at a later stage.

Transparency

- By making the texts of RTAs/FTAs, including any annexes or schedules, readily available, the Parties ensure that business is in the best position to understand and take advantage of liberalized trade conditions. Once they have been signed, agreements are made public, in English wherever possible, through official websites as well as through the APEC Secretariat website.
- Member economies notify and report their new and existing agreements in line with WTO obligations and procedures.

Trade Facilitation

- Recognizing that regulatory and administrative requirements and processes can constitute significant barriers to trade, they include practical measures and cooperative efforts to facilitate trade and reduce transaction costs for business consistent with relevant WTO provisions and APEC principles.

Mechanisms for consultation and dispute settlement

- Recognizing that disputes over implementation of RTAs/FTAs can be costly and can raise uncertainty for business, they include proper mechanisms to prevent and resolve disagreements in an expeditious manner, such as through consultation, mediation or arbitration, avoiding duplication with the WTO dispute settlement mechanism where appropriate.

Simple Rules of Origin that facilitate trade

- To avoid the possibility of high compliance costs for business, Rules of Origin (ROOs) are easy to understand and to comply with. Wherever possible, an economy's ROOs are consistent across all of its FTAs and RTAs.

- They recognize the increasingly globalized nature of production and the achievements of APEC in promoting regional economic integration by adopting ROOs that maximize trade creation and minimize trade distortion.

Cooperation

- They include commitments on economic and technical cooperation in the relevant areas reflected in Part II of the OAA by providing scope for the parties to exchange views and develop common understandings in which future interaction will help ensure these agreements have maximum utility and benefit to all parties.

Sustainable Development

- Reflecting the inter-dependent and mutually supportive linkages between the three pillars of sustainable development- economic development, social development and environmental protection- of which trade is an integral component, they reinforce the objectives of sustainable development.

Accession of Third Parties

- Consistent with APEC's philosophy of open regionalism and as a way to contribute to the momentum for liberalization throughout the APEC region, they are open to the possibility for accession of third parties on negotiated terms and conditions.

Provisions for periodic review

- They allow for periodic review to ensure full implementation of the terms of the agreement and to ensure the terms continue to provide the maximum possible economic benefit to the parties in the face of changing economic circumstances and trade and investment flows. Periodic review helps to maintain the momentum for domestic reform and further liberalization by addressing areas that may not have been considered during the original negotiations, promoting deeper liberalization and introducing more sophisticated mechanisms for cooperation as the economies of the Parties become more integrated.

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