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When and How Is a Regional Trade Agreement Compatible with the WTO?

By Gabrielle Marceau and Cornelis Reiman*

Abstract

As a consequence of regional trade agreements (RTAs) expansion, the WTO is confronted – more than ever – with Members being offered preferential treatment when joining RTAs, whilst those outside the RTA allege that such arrangements cause a negative impact. In a landmark report in the dispute on *Turkey – Textiles*, the WTO Appellate Body made a strong call for law and order among WTO Members. The decision states clearly that the formation of an RTA may justify measures that are inconsistent with GATT rules, but only after having demonstrated (1) the full compatibility of the RTA with Article XXIV:(5) and (8) of GATT and only (2) if the formation of the RTA would have been prevented otherwise. While reinforcing the threat of dispute settlement, the Appellate Body decision almost introduces a reverse consensus rule suggesting that, unless otherwise proven, any RTAs and RTA preferences are contrary to the WTO multilateral rules.

In its Report on *Turkey – Textiles*, the Appellate Body urged WTO Members to assume their responsibility towards the multilateral system and to exercise – with maturity – the monitoring of RTAs. So far, WTO Members have behaved like ostriches, hoping that this difficult issue would go away. The number of RTAs – and their coverage – are, increasingly, making the assessment of RTAs even more difficult. As a consequence of the rules on the burden of proof, this means that RTA states have even less chance of being able to demonstrate that their RTAs are WTO compatible. Obviously, the proliferation of RTAs does not increase their WTO compatibility.

This paper offers modest solutions to facilitate the monitoring of RTAs based on past GATT/WTO experiences – namely the tariffication exercise performed during the Uruguay Round for the Agreement on Agriculture. It adds suggestions involving more serious time-limit constraints, presumption rules, the possibility of negative inferences and the increased involvement of

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third-party support, such as that of the WTO Secretariat, to facilitate this exercise.

WTO Members' actions in this field are urgent. Short of proper tools, and caught in the meandering of consensus decision-making, the important matter of the WTO compatibility of RTAs may well end up before WTO adjudicating bodies. Will WTO Members, once again, abdicate their responsibilities in favour of the WTO adjudicating bodies?

1. Introduction

Certainly, the 'groupings of states by a common bond of policy'¹ have existed for many years: the former, wide-reaching British Empire is an obvious example.² Article 21 of the Covenant of the League of Nations recognized, in 1921, the co-existence of regional groupings and the, then, new global organization.³ Similarly, Article 52 of the Charter of the United Nations encouraged regional arrangements.⁴ The economist Viner wrote that the rationale for a customs union – being a type of RTA – had to be political.⁵ In 1950, he analyzed most of the numerous customs unions or integration agreements that had existed for centuries and concluded that racial, language and cultural reasons seemed to have been the main determinants of the

1. D. Bowet, *The Law of International Institutions*, 1982, p. 161.
2. For a list of existing arrangements before and after World War I, see J. Viner, *The Custom Union Issue*, 1950.
3. Article 21 of the Covenant of the League of Nations: 'Nothing in this Covenant shall be deemed to affect the validity of international engagements such as treaties of arbitration or regional understandings like the Monroe doctrine for securing the maintenance of peace'.
4. Article 52(1): 'Nothing in the present Charter precludes the existence of regional arrangements or agencies dealing with such matters relating to the maintenance of international peace and security as are appropriate for regional action provided that such arrangements or agencies and their activities are consistent with the Purposes and Principles of the United Nations.'
5. Viner argued that 'strong countries will not voluntarily enter into the union except as part of a political union and for predominantly political reasons'; see J. Viner, *The Customs Union Issue*, 1950, p. 69. Later he writes that small countries mainly want to form regional arrangements for economic reasons while more powerful states tend to do it for political reasons. See J. Viner, *Idem*, pp. 91–92. See also a similar discussion in the context of the EEA and the reasons for EFTA states to join the EEA as opposed to the reasons for the EEC to do so: J. Stragier, 'The Competition Rules of the EEA Agreement and their Implementation', *E.C.L.Rev.*, vol. 14, issue 1 (1993), p. 30.

formation of regional arrangements.⁶ El-Agraa agrees with him: 'In reality almost all existing schemes of economic integration were either proposed or formed for political reasons even though the arguments popularly, therefore, put forward in their favour were expressed in terms of possible economic gains'.⁷ For them, there seems to be no doubt that political considerations are an admitted rationale for the creation of free-trade areas and other regional arrangements.

Regionalism can, thus, be viewed from the perspective of the fundamental need of states for security and related trade relations. Regionalism, thus, allows states with similar concerns to align themselves. The difficulties of attaining universalism or multilateral relations – due to obvious, comparative differences in power, culture and needs – are the reasons for regionalism. Within a smaller regional forum, a consensus may more easily be reached. Certainly, regional arrangements were an essential element of post-World War II reconstruction⁸ and it is reasonable to expect that the GATT 1947 recognized this.

The issue of the duality between regional trade agreements (or even regional trade blocks) and the need to guarantee an open and fair multilateral trade system – such as that of the GATT 1947, and now the World Trade Organisation (WTO Agreement) – has been the subject of long and heated debates confronting economists, lawyers and political experts. As a matter of fact, trade liberalization under the GATT 1947 paralleled a process of increasing economic integration among contracting parties: for instance, from 1948 to the end of 1994, 107 RTAs were notified to the GATT under Article XXIV, out of which 36 remain in force.⁹ Yet, because the GATT provides that the compatibility review process takes place at the initiative of the Contracting Parties, after the RTA has been notified to the GATT Secretariat – and because the Contracting Parties only take decisions on the basis of consensus – there have been no clear-cut assessments of full

6. J. Viner, *Idem*, p. 95. He also adds at p. 103: 'customs union preceded by close association of language, race, culture or need of unity for external danger. ... To accept as obviously true the notion that the bonds of allegiance must necessarily be largely economic in character to be strong, or to accept unhesitatingly the notion that where the economic entanglements are artificially or naturally strong the political affections will also necessarily become strong, is to reject whatever lessons past experience has for us in this field. The power of nationalist sentiment can override all other consideration; it can dominate the minds of the people, and dictate the policies of government, even when in every possible way and to every conceivable degree it is in sharp conflict with what seems to be and are in fact the basic economic interests of the people in question'.

7. A. El-Agraa, *International Economic Integration*, 1982, p. 7 and at p. 126 in the 1988 edition.

8. A desire for security pushed the USA to encourage the integration of Europe when the EEC was being tested in GATT for its compatibility with Article XXIV. On this issue, see F. Haight, 'The Customs Union and Free-Trade Area exceptions in GATT', *J.W.T.L.* vol. 6 (1972), p. 392.

9. 19 RTAs have been notified under the Enabling Clause.

consistency with the rules.¹⁰ Similarly, there appears to be no agreed process by which to assess the economic impact of an RTA – whether existing or proposed.

As alluded to above, RTAs have greatly increased in number and importance since the establishment of the GATT in 1948.¹¹ The economic and political realities that prevailed when Article XXIV (authorizing some RTAs) was drafted have evolved and the scope of RTAs is now much broader than it was in 1948, thereby embracing – all and more – issues than those dealt with by the WTO Agreement. The perception that RTAs could contribute to the expansion of world trade was reiterated during the Uruguay Round when negotiators re-visited certain aspects of Article XXIV in an endeavour to clarify some of its provisions in the GATT 1994 Understanding on Article XXIV. The widening appeal of regional integration continued after the conclusion of the Uruguay Round, and the establishment of the WTO. In the 1996 Ministerial Declaration of Singapore, for example, Members reaffirmed the primacy of the multilateral trading system after having noted the importance of existing regional arrangements involving developing and least-developed countries, as well as the need to further analyse and clarify the relationship between the system of WTO rights and obligations, in addition to the expansion and extent of RTAs.

An important change was brought forth by the new GATT 1994 Understanding on Article XXIV (and the provisions of Articles IV and XXIII of GATS) wherein it is now provided that any matter relating to the application of Article XXIV can be the object of the new binding and mandatory dispute settlement procedures. It is in this context that, for the first time, a WTO panel and the Appellate Body issued their rulings in the *Turkey – Textiles* dispute on the relationship between the GATT/WTO rules guaranteeing non-discriminatory multilateral trade and the parallel permission for WTO Members to enter into RTAs. The Appellate Body surprised many in stating that one of the conditions for WTO Members to be able to invoke Article XXIV as a defence against a claim that discriminatory preferences have been given to some WTO Members, but not to others, was the demonstration – before WTO adjudicating bodies – that the duties and other regulations of commerce with Members not parties to the customs union were not, on the whole, more restrictive after the formation of the customs union than before. For the Appellate Body, this condition was an economic test.

10. Only for the customs union between the Czech and Slovak Republics were contracting parties able to conclude that the customs union was GATT compatible.

11. For a historic and graphical representation, see Figure II.1 in WTO (1999), Report of the Panel on *Turkey – Restrictions on Imports of Textile and Clothing Products*, WT/DS34/R, (*Turkey – Textiles*) adopted as amended by the Appellate Body Report on 19 November 1999. Since 1 January 1995, more than 70 new RTAs were notified under Article XXIV of GATT (and some pursuant to Article V of the GATS), most of which are presently in force. As of 2001, there are 121 RTAs notified to the WTO that are still in force.

In this paper, we review – briefly – the economics of regional trade integration agreements and the classical tests suggested to assess their impacts, namely in referring to traditional trade diversion and trade creation criteria. As many have done before, we conclude that these tests could not be used in the WTO context for various reasons, including the fact that – pursuant to Article XXIV of GATT 1994 and Article V of the GATS – the overall impact of an RTA may need to be demonstrated before its entry into force or very early on. We suggest a simplified economic assessment that could be based on the overall comparison of the situation before and after the formation of the customs union (CU), using a tariffication exercise similar to that performed during the Uruguay Round for agricultural products. With tighter deadlines and presumptive rules, together with a more active role of the Secretariat, such suggestions may encourage the Committee on Regional Trade Agreement (CRTA) actions, and avoid Panels and the Appellate Body from entering a veritable minefield of problems.

2. Economics of Regional Trade Agreements¹²

As stands to reason, RTAs are an economic, political, social and legal reality. Certainly, economic integration has a long history and encapsulates the inter-country policies of reducing or removing trade barriers on a discriminatory basis – with particular focus upon countries that agree to join together.¹³ Basically, RTAs arise for an assortment of reasons, such as the need for political or economic integration, foreign policy or national security, as well as for members to gain access to larger markets.¹⁴ The role of industry lobbying is, of course, an influential factor, although the political will is usually an overriding consideration.¹⁵ Additionally, RTAs might secure trade liberalization that could not otherwise become available, especially if multilateral processes of WTO rounds take longer than is acceptable to countries keen

12. For a thorough treatment of the economic theory dealing with RTAs, see A. Panagariya (2000), 'Preferential Trade Liberalization: The Traditional Theory and New Developments', *Journal of Economic Literature*, Vol. 38, pp. 287–331. Also, refer to R. Snape (1993), 'History and economics of GATT's Article XXIV', as well as J. McMillan (1993), 'Does regional integration foster open trade? Economic theory and GATT's Article XXIV', with both papers in K. Anderson and R. Blackhurst (eds.), *Regional Integration and the Global Trading System*, New York, St. Martin's Press, pp. 273–291 and pp. 292–310, respectively. For general commentary, see WTO, (1995), *Regionalism and the World Trading System*, Geneva, April.
13. Refer to J. De Melo, A. Panagariya and D. Rodrik (1992), 'The New Regionalism: A Country Perspective', in J. De Melo and A. Panagariya (eds.), *New Dimensions in Regional Integration*, Cambridge, Centre for Economic Policy Research/Cambridge University Press, pp. 159–193.
14. See B. Hoekman and M. Kostecki (1995), *The Political Economy of the World Trading System – From GATT to WTO*, Oxford University Press, Oxford – especially Chapter 9.
15. See G. Marceau (1994), *Anti-Dumping and Anti-Trust Issues in Free-trade Areas*, Oxford, Clarendon Press.

on trade reform.¹⁶ This latter point could well have contributed to the surge in RTAs registered by the WTO during and after the extended Uruguay Round. After all, it is likely to be easier to have two, or a few, countries agree on mutually beneficial trade reforms than is possible through the consensus of all WTO Members. The United States, for example, decided to negotiate RTAs with trading partners in the 1980s, partly because of its dissatisfaction with the refusal of GATT partners to initiate multilateral trade negotiations in 1982.¹⁷

Parties to an RTA offer to each other more favourable treatment in trade matters than to the rest of the world (including WTO Members). As is shown below, the actual depth of such preferential treatment varies from one RTA to another. It might involve only trade in goods, or might apply also to trade in services.

2.1. *Types of regional trade preferences*

Economic groupings of states can be presented in five main categories, based on their respective level of integration:¹⁸ Preferential trading arrangements where intra-group trade barriers, such as tariffs, are reduced on specific items but does not alter such for non-members;¹⁹ a free-trade area (FTA) is where intra-group trade barriers on nearly all trade between Members are abolished, yet each Member Country still maintains its external barriers to trade with non-members;²⁰ a customs union is where group members abolish barriers to nearly all the trade between themselves and also implement similar trade policies *vis-à-vis* non-members; further, customs revenue is apportioned;²¹

16. This is suggested by commentators, such as B. Hoekman and M. Kostecki (1995), *The Political Economy of the World Trading System – From GATT to WTO*, Oxford University Press, Oxford.

17. *Ibid.*, p. 216.

18. On the definition of customs union, free-trade areas, common market, economic union and political union see among many authors: P. Robson (1990), *The Economics of International Integration*; M. Jovanovic (1992), *International Economic Integration*; A. El-Agraa (1988), *International Economic Integration*; A. El-Agraa and J. Jones (1981), *The Theory of Customs Union*; J. Viner (1950), *The Customs Union Theory*.

19. An example of this is the British Commonwealth Preference Scheme of 1932, embracing the United Kingdom, as well as current and former members of the British Empire at that time.

20. Before the GATT, a 'free-trade area' was traditionally defined as an imperfect customs union. Since there are differences in external tariffs, the country with the lowest tariffs could 'let in' products that are usually restricted or non-existent in the Member State with higher tariffs. 'Rules of origin' must, therefore, be designed to confine intra-area free trade to products originating in, or mainly produced in, that free-trade area. The purpose of rules of origin is, thus, to limit the benefits of the agreement to producers of the Member States only.

21. 'Customs union' is the oldest concept where a group of States offer trade privileges exclusively to each other. Most studies of regional arrangements start with an analysis of customs union and then distinguish other types of integration.

a common market²² extends the CU arrangements by allowing intra-group mobility of labour and capital, as was done by the European Communities via the 1986 plan of action by the end of 1992; an economic union is where the integration is deepened beyond a common market by promoting common economic policies and a common monetary unit (this entails unifying monetary and fiscal policies of Member Countries); and, political unions assume a union with a single economic policy and a supranational government; resulting in a confederation that also enjoys great economic unity.

This list of RTAs is not exhaustive and there are various mid-term levels and forms of economic integration. The European Economic Agreement (EEA) is, for instance, more than a usual free-trade area (since competition policies and legislation have been completely harmonized) but less than a customs union since member states do not share the same external economic policies.

Article XXIV:8 of GATT 1994 only deals with two types of RTA, arguably because the last three types referred to above are different versions of a customs union with increased depths of integration, but where trade rules with third countries are similar to that of a customs union.

2.2. Assessing the impact of RTAs

The prevailing view until the seminal work of Viner in 1950, was that RTAs are beneficial to colluding countries and their governments.²³ Certainly, RTAs can lead to trade creation if the member countries are considered in isolation. However, RTAs can also cause trade diversion when non-member countries are also considered. Trade creation and trade diversion are, therefore, criteria frequently used in trade theory to assess the impact of RTAs. In practice, one must acknowledge that there are many confounding factors that can mask the extent of either effect. Such influences include shifts in factors of production – labour, capital, as well as technology – in addition to other issues, such as comparative changes in inflation, exchange rates and tariff levels. It should not, therefore, come as a surprise to learn that economic assessments of RTAs are not considered to be conclusive and, thus, are not convincing. A simple approach is, thus, necessary. Even so, it is worth considering the components of extant analysis before suggesting any improvement. Given that the primary considerations are trade creation and trade diversion, these are considered in turn.

22. The concept of 'common market' is said to have been introduced by the Spaak Report in 1956.

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

2.2.1. Trade creation in RTAs

Trade creation arises from the increased trade between members of a trade agreement when trade barriers between them are lowered or removed completely. For example, zero-tariff products from the new RTA partner replace tariff-laden imports that previously entered into a country. Trade often rises when internal tariff walls fall. The effect of trade liberalisation of the integrated entity is that member countries can produce and trade in relation to their comparative advantages, rather than have resource allocation affected by market intervention, such as tariffs. It is also likely that domestic production of a Member State is replaced by imports from a member of the RTA that is a more efficient producer.

Given increased access to a larger market due to trade liberalization, industries in an RTA are able to pursue larger production runs and the associated economies of scale. This will reduce average costs of production and enhance price competitiveness. Thus, large-scale competitive producers gain strength in the regional-trade area, as well as in the international market.

2.2.2. Trade diversion in RTAs

When new RTA members seek products from other RTA Members, trade with non-members falls. Trade diversion, therefore, results from a redirection of previous trade flows due to the inherent trade bias against non-members of an RTA. Note that prior imports may have come from an efficient world producer. The RTA partnership then diverts, or deflects, trade away from the efficient external producer to a less efficient producer within the RTA, doing so in accordance with RTA conditions of membership. Basically, this negative impact is the effect of preferential policy of the integrated regional entity.

Simply, if the resultant trade creation is larger than the trade diversion, then there is a net benefit as economic welfare rises; however, if trade diversion exceeds trade creation then economic welfare falls. This static analysis has, generally, been the mainstay of RTA assessments by economists for the past 50 years. There are, however, two approaches for empirically assessing the economic welfare impact of RTAs.

- (i) The *ex post* approach assesses the effects of an RTA membership after it has taken place, such as in measuring the trade diversion and trade creation effects, as suggested earlier in this paper.²⁴ Obviously, an 'after

24. For examples, see S. Nicholls (1998), 'Measuring Trade Creation and Trade Diversion in the Central American Common Market: A Hicksian Alternative', *World Development*, 26(2), pp. 323–335; also, E. Fukase and W. Martin (1999), 'Economic Effects of Joining the ASEAN Free-trade Area (AFTA) the Case of the Lao People's Democratic Republic', World Bank paper, April 3; as well as M. Kreinin (1972), 'Effects of the EEC on Imports of Manufactures', *The Economic Journal*, September, pp. 897–920.

the fact' analysis is of no direct consequence to any country seeking justification for RTA formation or expansion.

- (ii) The *ex ante*/simulation approach, however, assesses the impact by way of a partial or general equilibrium economic model that contains functions expected to change because of RTA formation or expansion. At a basic level, these economic models include the responsiveness of supply and demand to changes in price for products within the region and for those involving trading partners. Further considerations include income, investment and consumption effects experienced by people in the economies under review, as well as the possible extent of product substitutability. This approach seeks to replicate the economies of RTA Members and new or proposed members. These artificial economies are then exposed to the known changes of RTA expansion or membership. The 'before' and 'after' results can be compared to assess any changes, such as in economic welfare.

Although it is difficult to conduct such work, considerable analysis exists in this area.²⁵ Essentially, economics can approximate the magnitude of the static effects mentioned above. However, analysis that is static in nature does not account for dynamic growth effects. That international transactions are governed by many factors results in very expansive simplifying assumptions.

2.2.3. Other factors affecting trade estimations

Certainly, the estimation of trade creation and diversion is a complex process. Numerous analysts and commentators²⁶ suggest that changes in trade volumes attributed to RTAs are influenced by assorted confounding factors, such as:

- trade creation and diversion existing within the union;
- changes in the flows of capital and labour;
- changes in the general level of prices;
- changes in exchange rates.

Some have argued that the success of economic integration could be seen as something that comes more easily to developed countries than to developing

25. For further research results in this area, and associated discussion, see T. Srinivasan, J. Whalley and I. Wooten (1993), 'Measuring the Effects of Regionalism on Trade and Welfare', in K. Anderson and R. Blackhurst (eds.), *Regional Integration and the Global Trading System*, New York, St. Martin's Press, pp. 52–79; also, J. Serra, G. Aguilar, J. Córdoba, G. Grossman, C. Hills, J. Jackson, J. Katz, P. Noyola and M. Wilson (1997), *Reflections on Regionalism – Report of the Study Group on International Trade*, Carnegie Endowment for International Peace, Washington.

26. For example, M. Kreinin (1995), *International Economics – A Policy Approach*, Dryden, Fort Worth, p. 119; also, Yarborough and Yarborough (1997), *The World Economy – Trade and Finance*, Fourth edition, Dryden, Fort Worth.

countries. This is, in part, due to the developing countries in the same region, such as Africa, having very similar factor endowments, associated comparative advantages and trade patterns, particularly in relation to the need for goods and services from non-member countries. Consequently, this would not offer the scope for any significant trade creation advantages.²⁷ Analysis relating to Mercosur, for example, shows that the maintenance of RTA-level preferential practices against non-members increased trade diversion because intra-RTA trade is generally comprised of goods in which members do not have a comparative advantage.²⁸ As a result, resources are allocated on the basis of unnatural market signals, such as higher prices due to the continuance of tariff protection. Further, an associated lack of competition in outside markets suggests that the Mercosur RTA has a detrimental effect upon members and non-members.²⁹

As was introduced above, there is, of course, a need to acknowledge the political considerations that can also affect the success of any RTA.³⁰ Such factors might, however, prove to be elusive when seeking robust measurements. Even so, some factors have an *a priori* bearing on the relative size of the trade creation and trade diversion effects. These include:

- the larger the group, the greater is the chance of embracing lowest-cost producers, thereby minimizing trade diversion;
- similar production patterns in integrating countries will lead to greater scope for trade creation if there are differences in production costs;
- the fall of high initial tariffs encourages trade creation and the growth of economic welfare;
- low trade barriers lead to lower trade diversion.

The evidence of dynamic effects, therefore, suggests a greater complexity than can be captured by the static measures commonly used. Consider that the increased economic base – resulting from an integration of countries – can expand the size of the market. Larger production runs and economies of scale are, thus, possible. This can increase competition. Further, increased intra-region competition could lead to industry specialization that leads to the following of comparative advantage. Of course, non-members see their exports fall and, thus, also their market access and economic growth rates. Certainly,

27. Note that Cameroon is judged to have gained from RTA membership, if only because of its regional power. See F. Bakoupa and D. Tarr (1998), *How Integration into the Central African Economic and Monetary Community Affects Cameroon's Economy: General Equilibrium Estimates*, Working Paper No. 1872, World Bank Group, January.

28. A. Yeats (1998), 'Does Mercosur's Trade Performance Raise Concerns about the Effects of Regional Trade Arrangements?', *The World Bank Economic Review*, 12 (1), January, pp. 1–28.

29. *Ibid.*

30. G. Marceau (1994), *Anti-Dumping and Anti-Trust Issues in Free-trade Areas*, Oxford, Clarendon Press.

economies may evolve differently over time as a consequence of economic integration.

There is also an investment impact. As stands to reason, market expansion stimulates domestic and foreign investment and, thus, also growth rate potential. Investment creation and investment diversion, therefore, is also a possible result of RTAs, such as via multinational corporation reorganisation, or the establishment of production facilities to, say, take advantage of new trade opportunities. As a consequence, when any two or more countries agree to liberalize mutual trade arrangements – and expand their economies through increased industrial growth – there will be an investment inflow to take advantage of perceived gains. The rise in investment, particularly when it is direct, will add to economic growth and welfare of the member countries.³¹

In contrast, foreign direct investment in a region maintaining tariff barriers against the rest of the world is attracting the investment unnaturally by way of market and price intervention. This would, of course, lead to a less than effective allocation of resources and, thus, a fall in global economic welfare. Although we may expect that an RTA would see a shift in industries, the creation of the EEC did not lead to large-scale contraction of entire industries in any one country and their replacement by imports from another member. Perhaps this was because affected industries reinvented themselves to adapt to the new regime of increased competition. Consequently, they found their industry niche, thereby specializing in production, trading according to comparative advantage, exploiting potential economies of scale and remaining in business.

Increases in real income that arise from positive economic welfare benefits of an RTA – such as through specialisation in production and trade creation – can lead to increased imports from non-member countries. In fact, it is suggested that the correct way to judge the overall economic effect of a regional arrangement is to compare real income under the arrangement with that occurring if there were not an RTA, but this is a difficult approach to take due to the complexity and magnitude of the task.³²

For the sake of simplicity, one criterion for assessing RTAs should, thus,

31. See R. Fernandez (1997), *Returns to Regionalism: An Evaluation of Nontraditional Gains from Regional Trade Agreements*, Working Paper No. 1847, World Bank Group, November. In addition to bargaining power, this paper examines several possible benefits that regional trade agreements may confer on their partners, including credibility, signalling, insurance, and a mechanism for coordination. Consequently, uncertainties are reduced, thereby making it easier for the private sector to plan and invest.

32. P. Wonnacott and M. Lutz (1989), 'Is There a Case for Free Trade Areas?', in J. Schott (ed.), *Free Trade Areas and US Trade Policy*, Washington, Institute for International Economics, pp. 59–84.

be the economic welfare of non-RTA members.³³ Accordingly, we see that the process of RTA assessment – on economic grounds – can be simplified to the point where the economic welfare of non-RTA members will be protected if their exports to the RTA and/or new RTA member remain unchanged. However, this scenario would also need to maintain the existing terms of trade to ensure that non-RTA welfare is maintained. Consideration is, therefore, needed as to the value of the net trade balance before and after any RTA formation, or the addition of a new member.³⁴ Again, this is problematic in the *ex-ante* case when several other influential factors are at work in the global arena.

Even so, one can see that the assessment of the impact of an RTA can still be constructed as one that determines whether trade volumes and product prices are likely to alter considerably as a consequence of RTA formation or expansion.³⁵ However, this assumes that global forces elsewhere would, of course, not affect world product prices, as well as world trade levels of products under consideration.

Given this view of the economic issues associated with RTAs, we suggest that an economic assessment would need to consider the recent and/or expected shifts in the two particular measures of interest, specifically, trade flows and terms of trade per industry sector. Further, the trade flows would need to be viewed in relation to world trade in order to account for global forces that can reduce a country's trade flows without the influence of any particular RTA formation or expansion. On that basis, we suggest that a customs union's impact assessment could be based – at least partly – on the overall comparison between the potential trade flow situation before and after the formation of the CU. As a proxy, this could be done by trying to isolate the level of import protection – before and after the formation or expansion of the customs union – using a tariffication exercise similar to that performed for agricultural products during the Uruguay Round.

3. Regional Trade Agreements and the GATT/WTO multilateral rules

RTAs existed before the GATT 1947 and the GATT rules recognize their existence, as well as their potentially beneficial and detrimental effects for

33. A suggestion attributed to J. McMillan (1993), 'Does Regional Integration Foster Open Trade? Economic Theory and GATT's Article XXIV', in K. Anderson and R. Blackhurst (eds.), *Regional Integration and the Global Trading System*, New York, St. Martin's Press, pp. 292–310

34. As suggested by A. Panagariya (2000), 'Preferential Trade Liberalization: The Traditional Theory and New Developments', *Journal of Economic Literature*, 38, pp. 287–331 (at p. 327), also see J. McMillan (1993), pp. 292–310,

35. For example, see A. Winter and W. Chang (2000), 'Regional Integration and Import Prices: An Empirical Investigation', *Journal of International Economics*, 51, pp. 363–377.

multilateral trade. But what is the test suggested by the GATT/WTO to identify and distinguish the beneficial RTAs from the detrimental ones?

3.1. The desirability of preferential Regional Trade Agreements

The basic GATT principle of non-discrimination, expanded with adaptation to trade in services in the WTO Agreement, is the very essence of the WTO multilateral trade system. These non-discrimination obligations apply *vis-à-vis* to all forms of imports from all WTO Members (most-favoured nation principles) and *vis-à-vis* domestic products, or domestic services or services suppliers in sectors for which a Member has made specific commitments under the General Agreement on Trade in Services (GATS) (the national treatment obligations).

Parallel to this general non-discrimination principle, and as a means of increasing freedom of trade, Article XXIV of GATT recognizes that customs unions and free-trade areas between WTO Members may be desirable. To this end, Article XXIV of the GATT and Article V of the GATS provide for the possibility that Members forming an RTA may depart from WTO obligations.³⁶

There are a number of indications as to the broad desirability of Article XXIV agreements as a means of increasing freedom of trade. For example, paragraph 4 of Article XXIV provides that: 'The (Members) recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between economies of the countries parties to such agreements'. Similarly, the preamble of the WTO/GATT 1994 Understanding on Article XXIV – which was added to GATT 1994 as a result of the Uruguay Round – recognizes: 'the contribution to the expansion of world trade that may be made by closer integration between the economies of the parties to such agreements'; the same idea is reflected in paragraph 7 of the Singapore Ministerial Decision:³⁷ '... regional trade agreements (...) can promote further liberalization and may assist least-developed, developing and transition economies in integrating into the international trading system'.

3.2. The conditional right of WTO Members to form a Regional Trade Agreement

This aforementioned recognition of the desirability of regional trade agreements is, however, not without qualification. Article XXIV:4 appears to

36. Note, in this context, the statement of the Appellate Body in *EC – Bananas III* (WT/DS27/AB/R), para. 191: 'Non-discrimination obligations apply to all imports of like products, except when these obligations are specifically waived or are otherwise not applicable as a result of the operation of specific provisions of the GATT 1994, such as Article XXIV'.

37. See WT/MIN(96)/DEC.

recognize that some of these agreements may have detrimental effects and, therefore, the latter half of paragraph 4 of Article XXIV provides:

‘They also recognize that the purpose of a customs union and a free-trade area should be to facilitate trade between constituent territories *and not to raise barriers to the trade of other Members with such territories*’ (emphasis added).

This sentiment is reiterated in the preamble of the GATT 1994 Understanding on Article XXIV, which provides that: ‘*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*’ (emphasis added).

The terms of Article XXIV:5, thus, confirm that WTO Members have a *right* – albeit conditional – to conclude regional trade agreements.

Accordingly, the provisions of this Agreement [GATT 1994] shall not prevent, as between the territories of (Members), 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 ... :’

The GATS Agreement provides for rules on RTAs, the logic of which is roughly similar to those of the GATT. The first paragraph of Article V³⁸ recognizes the right of Members to enter into an RTA that would include trade in services under certain conditions. The conditions for a WTO compatible RTA, mentioned in paragraphs 4, 5 and 8 of the GATT and in paragraphs 2 and 4 of the GATS, are discussed in Sections V to VII below.

3.3. *The notification of RTAs and their examination by the WTO membership*

RTAs must be notified to other WTO Members who, in turn, can then request the establishment of a working group to examine the compatibility of such an agreement with the GATT.³⁹ GATT Contracting Parties have always been required to monitor the formation of such regional trade agreements. Article XXIV:7(b) provides that Members shall make available any information regarding the *proposed* CU or FTA that will enable the membership to make such reports and recommendations to [Members] as they may deem

38. See the text of Article V of GATS, annexed herewith.

39. Article XXIV(7) of GATT 1994.

appropriate. Such an examination, by the entire membership, was done by working parties established to review specific RTAs. It is important to note that the GATT Contracting Parties – and, today, the WTO Members – do not need to authorize such RTAs. The WTO membership does not give the ‘green light’ to RTAs; at best, WTO Members may show a ‘red light’ to an RTA. But, since WTO Members take decisions by consensus (including the RTA States and countries likely to be affected by a proposed RTA), only one RTA has ever been the object of a formal recommendation to accept an RTA, or to amend its components.⁴⁰

As with RTAs on merchandise, RTAs involving trade in services must be notified to Members [to the Council for Trade in Services, Article V:7(a)]. Such RTA Members shall make available to the Council such relevant information as may be requested by it. It is also envisaged that the Council may establish a working party to examine such an agreement, enlargement, or modification of that agreement and to report to the Council on its consistency with this Article.

In 1996, the WTO General Council established the Committee on Regional Trade Agreements (CRTA),⁴¹ with the mandate of, *inter alia*, examining all RTAs notified to the Council for Trade in Goods (CTG) under GATT Article XXIV. The CRTA is, likewise, entrusted with the examination of those RTAs notified under the Enabling Clause⁴² and under GATS Article V, and those referred to it by the Committee on Trade and Development (CTD) and the Council for Trade in Services (CTS), respectively. The mandate of the CRTA also includes consideration of ‘the systemic implications of [RTAs] and regional initiatives for the multilateral trading system and the relationship between them’.⁴³ The same WTO body is, thus, entrusted with the function of examining all WTO RTAs. It should, however, be noted that in the case of RTAs notified pursuant to the Enabling Clause, any formal review process by the entire membership is not provided for.

Until the Panel and Appellate Body Reports on the dispute between Turkey and India, as discussed hereafter, no adopted Panel reports had shed any light on the meaning of the provisions of Article XXIV and the conditions that they must fulfill in order to be compatible with the GATT/WTO. There were only a series of working group reports where individual contracting parties, or WTO Members, expressed their views of the GATT and WTO compatibility of certain RTAs, or aspects of such RTAs.

40. The 1994 customs union between the Czech Republic and the Slovak Republic, *Working Party Report*, GATT document L/7501, dated 4 October 1994.

41. WT/L/127.

42. The possibility of RTA by developing countries Members pursuant to the Enabling Clause is discussed in Section VII:A below.

43. WT/L/127, para. 1(d).

4. The Panel and Appellate Body Reports in the *Turkey – Textiles* dispute⁴⁴

4.1. *The facts of the dispute between India and Turkey: The EC-Turkey customs union*

In the context of the Turkey-EEC Association Agreement (the origin of which dates back to 1963), Turkey imposed quantitative restrictions against textile imports pursuant to a March 1995 Decision setting out certain modalities for the final phase of the association between Turkey and the European Communities (EC) for the completion of the customs union. Turkish quantitative restrictions were applied on imports from India of 19 categories of textile and clothing products.

As a consequence of the aforementioned quantitative restrictions imposed by Turkey, India challenged the WTO compatibility of the new import restrictions by alleging violations of Article XI of GATT and Article 2 of the Agreement on Textiles and Clothing (both Articles prohibiting quantitative restrictions). Turkey's defense was that, pursuant to Article XXIV:8(a),⁴⁵ it was obliged to harmonize its external trade policy⁴⁶ with that of the EC and, thus, was required to impose quotas on textile imports (since the EC had in place a series of WTO compatible textiles quotas).

The issue was, therefore, whether Turkey was entitled to violate Article XI of GATT and Article 2 of the Agreement on Textiles and Clothing (ATC), invoking its rights to form an RTA pursuant to Article XXIV of GATT.

4.2. *Panels and the Appellate Body can decide on the WTO compatibility of any Regional Trade Agreements*

The first issue (which was, however, incidental in that dispute) was whether the WTO adjudicating bodies have the jurisdictional capacity to assess the overall compatibility of RTAs. Paragraph 12 of the WTO/GATT 1994 Understanding on Article XXIV provides that panels and the Appellate Body have jurisdiction to examine 'any matters *arising from* the application of those provisions of Article XXIV' (emphasis added).

For the Panel, this meant that WTO adjudicating bodies could examine the WTO compatibility of one or several measures 'arising from' Article XXIV types of agreement. The Panel was, however, of the view that the CRTA appeared to be, generally, in a better position to assess the overall GATT/WTO

44. For a general discussion on the panel and Appellate Body Report on *Turkey – Textiles*, see James Mathis, 'WTO, Turkey – Restrictions on Imports of Textiles and Clothing Products', *Legal Issues of European Integration* (1999), Vol. 27, 200-1, at p.103

45. See Article XXIV:8(a) annexed to this article.

46. Article XXIV:8(a)(ii) refers to the obligation for members of a customs union to have 'substantially the same duties and other regulations of commerce'.

compatibility of a customs union, since it involves a broad multilateral assessment of any such custom union, i.e. a matter that concerns the WTO membership as a whole.⁴⁷ Such a review exercise subsumes a very complex undertaking that involves consideration by the CRTA – from the economic, legal and political perspectives of different Members – of the numerous facets of a regional trade agreement in relation to the provisions of the WTO. However, the Appellate Body indicated – albeit in an *obiter dictum* – that WTO Panels or the Appellate Body, have jurisdiction and, thus, the capacity to assess whether any specific customs union is in full compliance with all the requirements of Articles XXIV of GATT and V of the GATS.⁴⁸

4.3. Conditions under which Article XXIV can be invoked as a defense to violations of other GATT/WTO provisions: the test suggested by the Appellate Body

The Panel had concluded that, in the absence of legal conflict, and taking into account the obligation for an effective interpretation of Article XXIV, WTO Members were obliged to comply with the general obligations of Articles I and XI while pursuing their right to form RTAs pursuant to Article XXIV. This implied that only in situations of an impossibility to comply with both sets of provisions should basic obligations of GATT/WTO be set aside in the formation of any RTA in favour of the right expressed in Article XXIV, with this being a more specific provision.

The Appellate Body established an arguably more restrictive test. First, it emphasized the legal fact that Article XXIV is an exception and, as such, can be invoked as a defence, but under strict conditions. Thus, the Member invoking such an exception bears the burden of proof that the conditions of Article XXIV have been respected. Then, the Appellate Body stated that Article XXIV could be invoked to justify a WTO incompatible measure only if three conditions are respected by the Member invoking Article XXIV.

The conditions are as follows. First, the deviation from the WTO rules must take place upon the formation of the RTA; they cannot be adopted after the creation or completion of the RTA. Second, the Member invoking

47. See para. 9.52 of the Panel Report. The Panel also added (at para. 9.53) that 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.

48. See para. 60 of the Appellate Body Report where it is stated: ‘ (...) The Panel maintained that ‘it is arguable’ that panels do not have jurisdiction to assess the overall compatibility of a customs union with the requirements of Article XXIV. We are not called upon in this appeal to address this issue, but we note in this respect our ruling in *India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products* on the jurisdiction of panels to review the justification of balance-of-payments restrictions under Article XVIII:B of the GATT 1994 (original footnote 25, paras. 89–109 of the AB Report on *India – Agricultural Products*, WT/DS90/AB/R, adopted on 22 September 1999).’

rules on RTAs to justify its actions must prove that its RTA is in full compliance with both paragraphs 5 and 8 of Article XXIV. Third, the specific measure challenged (i.e. the measure was, otherwise, inconsistent with the GATT rules) must be necessary for the formation and completion of the RTA.

The Appellate Body stated:

52. Given this proviso, Article XXIV can, in our view, only be invoked as a defence to a finding that a measure is inconsistent with certain GATT provisions to the extent that the measure *is introduced upon the formation of a customs union which meets the requirement in subparagraph 5(a) of Article XXIV* relating to the ‘duties and other regulations of commerce’ applied by the constituent members of the customs union to trade with third countries. ... (emphasis added)

58. Accordingly, on the basis of this analysis of the text and the context of the chapeau of paragraph 5 of Article XXIV, we are of the view that *Article XXIV may justify a measure which is inconsistent* with certain other GATT provisions. However, in a case involving the formation of a customs union, this ‘defence’ is available *only when two conditions are fulfilled*. First, the party claiming the benefit of this defence 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*. Again, both these conditions must be met to have the benefit of the defence under Article XXIV. (emphasis added)

59. We would expect a panel, when examining such a measure, to require a party to establish that both of these conditions have been fulfilled. It may not always be possible to determine whether the second of the two conditions has been fulfilled without initially determining whether the first condition has been fulfilled. In other words, it may not always be possible to determine whether not applying a measure would prevent the formation of a customs union without first determining whether there is a customs union.

The Appellate Body did not, however, offer any indication as to how such compliance with these conditions can be demonstrated. We attempt to do so in the following sections.

5. Proving the compatibility of a customs union with paragraphs 5(a) and 8(a) of Article XXIV of GATT 1994 (and the parallel provisions of GATS)

A fundamental issue remains as to how WTO Members can demonstrate that they fully meet the requirements of paragraphs 5 and 8 of Article XXIV, as a required pre-condition for a Member to prove that a measure violating other WTO rules was ‘necessary to the formation’ of a customs union.⁴⁹

Paragraphs 5 and 8 contain requirements that such RTAs must meet, taking into account the parameters of paragraph 4 of Article XXIV. It is not unreasonable to assume that paragraphs 5 and 8 of Article XXIV were drafted with a view to suggesting criteria that would ensure the respect of the parameters of paragraph 4, i.e. some balancing between, on the one hand, the desirability of facilitating trade between the constituent territories and, on the other hand, the undesirability of raising barriers to the trade of other WTO Members. In this sense, the provisions of paragraph 4 can be seen as a form of an encapsulation of the overall assessment of associated trade diversion and trade creation.

This seems to have been accepted by the Appellate Body when it stated:

57. ... This objective demands that a balance be struck by the constituent members of a customs union. A customs union should facilitate trade within the customs union, but it should *not* do so in a way that raises barriers to trade with third countries. We note that the *Understanding on Article XXIV* explicitly reaffirms this purpose of a customs union, and states that in the formation or enlargement of a customs union, the constituent members should ‘to the greatest possible extent avoid creating adverse affects on the trade of other Members’ (emphasis added).

Article XXIV:5 provides the test of the impact of a customs union on the whole *vis-à-vis* third parties. But there is a direct link between paragraph 8 and paragraph 5 of Article XXIV. The type and the level of harmonization chosen by the CU states, pursuant to paragraph 8, must, in the light of paragraph 5 of Article XXIV, take into account the impact of such choices. Paragraph 8(a)(i) of Article XXIV governs the internal trade between constituent members of a customs union. Paragraph 8(a)(ii) governs the trade of the constituent members with third countries (and not the trade between the constituent members themselves). There is, thus, a direct link between the internal trade policy choices of a CU and its external trade. Let us now examine those requirements.

5.1. Article XXIV, subparagraph 8(a)(i) – the internal requirements

With regard to customs unions, paragraph 8(a)(i) of Article XXIV provides that duties and other restrictive regulations of commerce are eliminated on ‘substantially all the trade between the constituent territories’. There have been long debates regarding the meaning of the term ‘substantially all the trade’ and the consequential extent of the CU coverage. The classic reference is the statements made in the report of the working party on EFTA – Stockholm Convention (albeit an FTA) that substantially all the trade had qualitative, as well as a quantitative, aspects and that – since 90 per cent of trade was covered – such an FTA would be considered to cover substantially all the trade, even if agriculture was excluded.⁵⁰ There have always been two approaches among GATT contracting parties and, today, WTO Members. Some are of the view that the concept ‘substantially all the trade’ requires a *quantitative* assessment. Those states favour the definition of a statistical benchmark, such as a certain percentage of the trade between the parties, to indicate that the coverage of a given RTA fulfils the requirement. Others are of the view that a *qualitative* assessment is required. For them, no sector (or, at least, no major sector) can be excluded from the intra-liberalization of a CU where the amount of trade was small before the formation of the RTA due to the restrictive policies in place, as would be the case if a quantitative approach were used.

Three points can now be made. First, if it is true that subparagraph 8(a)(i) offers some flexibility, it is worth noting that, in the area of GATS, Members made clear that ‘agreements should not provide for the *a priori* exclusion of any mode of supply’. It is, therefore, most doubtful that the exclusion of an entire sector of trade in goods, such as agriculture, would be considered compatible with Article XXIV. Second, in *Turkey – Textiles*, the challenged regulations on textiles – which represented, at most, 4.5 per cent of Turkey’s external trade – ‘... could not be considered in this case to jeopardize the requirement of Article XXIV:8(a)(ii) that substantially the same regulations of commerce are to be applied by Turkey and the European Communities to third countries. The fact that this proportion of trade is regulated in a different way by Turkey cannot be seen to contradict the requirements of Article XXIV:8(a)(ii).’⁵¹ Third, the policy choices made by the CU States with regard to their internal integration framework, will have a direct impact on their external regulatory framework, whereby the level of internal integration will attract a higher level of external harmonization. Yet, as noted by the Panel in *Turkey – Textiles*, subparagraphs 8(a)(i) and 8(a)(ii) address distinct

49. Note that paras. 5 and 8 of Article XXIV have provisions for free-trade areas but the discussion hereafter focuses only on customs unions.

50. *Working Party Report on EFTA – Examination of the Stockholm Convention*, L/1235, adopted on 4 June 1960, BISD 9S/70.

but inter-linked policies. Therefore, the inclusion of a sector within the coverage of a CU, i.e. the removal of all trade barriers in respect of products of that sector between the constituent members of the CU, does not necessarily imply that those constituent members must apply identical barriers, or barriers having similar effects to imports of the same products from third countries.

Finally, an important issue that remains to be clarified is the scope of the exceptions listed between parentheses in paragraph 8(a)(i) and whether safeguard measures may still be used within an RTA and, if so, how this can be done. The recent ‘parallelism approach’ developed by the Panel and the Appellate Body in *Argentina – Footwear*⁵² and *US – Wheatgluten*⁵³ would appear to accept such internal safeguard measures, as long as substantially all the trade is covered and as long as the level of safeguard protection imposed on imports from third countries (not being members of the CU) corresponds to their increased level of exports causing the injury to the situation of the member of the CU imposing the safeguard measure.

5.2. Article XXIV, subparagraph 8(a)(ii) – the external requirements

Article XXIV:8(ii) provides that States forming the CU must have ‘substantially the same duties and other regulations of commerce’ with regard to the trade of territories not included in the CU. It is, generally, said that such CU States must ‘harmonize’ their trade policies. The Appellate Body in *Turkey – Textiles* stated, in this context, that the constituent members of a CU are, thus, required to apply a common external trade regime, one relating to both duties and other regulations of commerce. The Appellate Body stated that it agreed with the Panel that:

[t]he ordinary meaning of the term ‘substantially’ in the context of sub-paragraph 8(a) appears to provide for both qualitative and quantitative components. The expression ‘substantially the same duties and other regulations of commerce are applied by each of the Members of the [customs] union’ would appear to encompass both quantitative

51. Panel Report on *Turkey – Textiles*, para. 9.153.

52. Appellate Body Report on *Argentina – Footwear* (WT/DS121/AB/R) adopted on 12 January 2000, para. 112.

53. Appellate Body Report on *US – Wheat Gluten from the EC* (WT/DS166/AB/R) adopted on 19 January 2001, at para. 96: ‘In Article 2.1, the phrase would embrace imports from *all* sources whereas, in Article 2.2, it would exclude imports from certain sources. This would be incongruous and unwarranted. In the usual course, therefore, the imports included in the determinations made under Articles 2.1 and 4.2 should correspond to the imports included in the application of the measure, under Article 2.2.’

and qualitative elements, the quantitative aspect more emphasized in relation to duties.⁵⁴

The Appellate Body agreed with the Panel that, in the terms of subparagraph 8(a)(ii), and – in particular – the phrase ‘substantially the same’:

... offer[s] a certain degree of ‘flexibility’ to the constituent members of a customs union in ‘the creation of a common commercial policy.’ Here too we would caution that this ‘flexibility’ is limited. It must not be forgotten that the word ‘substantially’ qualifies the words ‘the same’. *Therefore, in our view, something closely approximating ‘sameness’ is required by Article XXIV:8(a)(ii) (emphasis added).*⁵⁵

In *Turkey – Textiles* dispute, Turkey’s trade in textiles with third countries represented less than 4.5 per cent of Turkey’s external trade. It was, thus, considered that, for the Turkey-EC CU to be GATT compatible, Turkey’s duties and regulations concerning textiles with third countries did not need to be harmonized with those of the EC.

Yet, if the implied ultimate and ideal situation is that the constituent members of the CU adopt a complete single common foreign trade regime, a series of different arrangements are possible. But, in all cases, the formation of a CU will necessitate important harmonization of duties and other regulations of commerce. In the light of paragraph 4, the requirements of paragraph 5 must be taken into account by RTA States in the determination of how harmonization should proceed, particularly since such harmonization should not lead to increased barriers to trade with third countries.

5.3. Article XXIV, paragraph 5 – the overall impact of the RTA

As discussed above, even the most orthodox economist will admit that any trade diversion/trade creation assessment of the incidence of a CU is extremely difficult to perform in a prospective manner and even more so when many products (and services) are traded. It may be for this reason that Members tried to improve and clarify this assessment prescribed in paragraph 5(a) in the GATT 1994 Understanding on Article XXIV⁵⁶ by dividing it into two types of evaluations: the impact of tariffs and that of other regulations of commerce.

It is not clear whether the requirement – that the incidence of the CU

54. See para. 49 of the Appellate Body Report on *Turkey – Textiles*, which contains this quote from para. 9.148 of the Panel Report.

55. At para. 50 of the Appellate Body Report in *Turkey – Textiles*.

56. The relevant provisions of the Understanding in annex.

should not be more restrictive after formation than before – is to be assessed separately for duties and other regulations of commerce, or whether paragraph 5 mandates an overall assessment based on two components: the impact of duties and the impact of new regulations of commerce. It is accepted that the test under paragraph 5 is an economic one.⁵⁷ The test refers to ‘applied’ tariffs, not bound tariffs: so, the assessment is to be based on the effective trade between states, not upon the assessment of their rights to collect duties up to their bound levels. This does not, however, mean that it must be mathematical and that the results ought to be quantifiable. Such an economic assessment can be qualitative, and may very well be so when assessing the incidence of other regulations of commerce.

Arguably, the incidence of duties may be more easily quantifiable. The incidence of other regulations of commerce, most often, will not be so. This leads us to believe that, because of their very different nature, the impact of duties – on the one hand – and the impact of other regulations of commerce – on the other hand – may not be easily compared with, and balanced against, each other. However, import restrictions in the form of quotas or regulations can, at least conceptually, be translated into tariff levels. In support of the reasoning that it is the overall incidence of the effects of duties, together with that of other regulations of commerce that is mandated by paragraph 5, one may refer to paragraph 4 of Article XXIV, which proscribes RTAs from ‘rais[ing] barriers to trade with third countries’; then, any form of barrier is referred to. This also seems to be the more recent intentions of Members when they adopted the Understanding (WT/REG/3) to expand the examination mandate of the CRTA⁵⁸ to include, in the examination of the compatibility of an RTA with Article XXIV, all measures covered by any of the agreements of Annex 1A:

the mandate to examine the incidence and restrictiveness of all duties and regulations of commerce, in particular those governed by the provisions of the Agreements contained in Annex 1A of the WTO Agreement ... it would be to ascertain whether on the whole the general incidence of the duties and other regulations of commerce has increased or become more restrictive

57. See the Appellate Body Report in *Turkey – Textiles*, para. 55: ‘... we also agree [with the Panel] that this is: “an economic test for assessing whether a specific custom union is compatible with Article XXIV”.’

58. The mandate for examination of RTAs normally reads as follows: ‘to examine, in light of the relevant provisions of the GATT 1994 ...’. Since this terminology refers only to the GATT 1994 and does not specify whether the examination may also be carried out against the background of all WTO Agreements relating to trade in goods, it was agreed to expand the terms of reference through an understanding.

This was also the conclusion reached by the Panel in *Turkey – Textiles*.⁵⁹ Paragraph 5 would imply an overall assessment based on two distinct components that could not be balanced with each other.

The fact that the test is an ‘economic’ one may also imply that the legality of the measures assessed is not, as such, relevant for the purpose of the paragraph 5 assessment. For instance, it is legal to raise tariff duties above their ‘applied’ level (but below their bound level): yet, they could become ‘higher or more restrictive’ within the meaning of paragraph 5 of the Understanding on Article XXIV and would be included in the calculation mandated by the Understanding. The same reasoning might be used with respect to other regulations of commerce. It can be argued that regulations introduced upon the formation of an RTA could be legal or ‘WTO compatible’, but lead to a situation more restrictive after the CU than before and, thus, be seen as inconsistent with the requirements of paragraph 5 of Article XXIV of GATT. This does not mean that the assessment of the impact of any new regulation of commerce must be based on effective trade between countries and not on the potential impact of the new regulation of commerce.

This distinction between legal and economic assessment reinforces the need to distinguish between the role of the CRTA and that of WTO adjudicating bodies. Economists, and other relevant experts outside the rigid framework of obligations and rights, better perform economic analysis and evaluations. In that context, the CRTA – arguably with the support of economists and statisticians – would be better able to offer parameters for this assessment. WTO adjudicating bodies, because of their adjudicatory nature, will perform this assessment with greater difficulties. In this sense, as the Panel had suggested, the overall economic WTO compatibility of an RTA could be performed by the CRTA, while the legal WTO compatibility of specific measures (or, for that matter, all of them) could be challenged before Panels and the Appellate Body. This approach would also be respectful of the fundamental right of WTO Members to form RTAs, while ensuring that it is not the occasion to introduce WTO incompatible measures, except when necessary to ensure the effectiveness of Article XXIV of GATT.

The Appellate Body has, however, clearly rejected this division of functions between the CRTA and Panels (and the Appellate Body) in stating that any matter can be taken to dispute. It is true that such a possibility may activate the ‘deadlocks’ in the CRTA due to the WTO general principle of decision-making by consensus. It is also hoped that the threat of disputes will, thereby, change the attitude of Members resisting discussions for more organized,

59. See the Panel Report at para. 9.10: ‘(...) In the context of the overall assessment of the potential trade impact of any such customs union, (a task envisaged to be performed by the WTO membership through the CRTA), duties and all regulations which existed in one or more of the constituent members and/or form part of the customs union treaty must be taken into account.’

objective and – when possible – scientific assessment of RTAs by the WTO membership.

To assist the CRTA in performing its assessment under Article XXIV:5(a), the Secretariat is mandated to 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. This methodology consists of a comparison between pre-CU and post-CU average MFN tariffs applied by the parties; both averages are, usually, weighted by the parties' MFN imports in the most recent three-year period before the formation of the CU. Such a calculation takes into account the results of the renegotiations provided for in paragraph 6 of Article XXIV.

The Secretariat works on the basis of data collected from the parties; collaboration of the parties is, therefore, necessary. But, what does or could happen when the CU States do not provide such data? It could be suggested that a time limit be imposed for the parties to submit such data. After the expiry of the imposed time-period, third countries could be entitled to submit further information, doing so with the risk that this may cause to the CU states' obligation to demonstrate that their customs union complies with paragraph 5 of Article XXIV. To some extent, adverse inferences will be drawn from an absence of collaboration since it is for the CU States to prove the WTO compatibility of their RTA. Adverse inference is a concept more appropriately handled in litigation. But, a similar attitude will also exist in any corresponding exercise performed by Members in the CRTA. If a time limit is agreed upon for the CU States to perform their demonstration of compatibility in the CRTA, the CU States will be the first ones to suffer from their lack of collaboration.

So far, nothing is envisaged as to how to evaluate the impact of 'other regulations of commerce'. There is no consensus among WTO Members as to the coverage of such an expression. For us, it seems that the use of the term 'other' implies a rather wide coverage of measures, including any measure, or any regulation, that is not a duty. The Panel in *Turkey – Textiles* reached that conclusion:

9.120. (...)While there is no agreed definition between Members as to the scope of this concept of 'other regulations of commerce', for our purposes, it is clear that this concept includes quantitative restrictions. More broadly, the ordinary meaning of the terms 'other regulations of commerce' could be understood to include any regulation having an impact on trade (such as measures in the fields covered by WTO rules, e.g. sanitary and phytosanitary, customs valuation, anti-dumping, technical barriers to trade; as well as any other trade-related domestic regulation, e.g. environmental standards, export credit schemes). Given the dynamic nature of regional trade agreements, we consider that this is an evolving concept.

How can one perform such an assessment of the incidence of other regulations of commerce? The GATT 1994 Understanding on Article XXIV recognizes this difficulty, but only provides that ‘the examination of individual measures, regulations, products covered and trade flows affected may be required’. With a view to facilitating this difficult quantification and aggregation, it is suggested that, as with tariff duties, the Secretariat should be mandated to perform a compilation of the regulatory situation of RTA States before, and after, the formation of the RTA. The Secretariat would perform such a parallel exercise on the basis of information initially collected from the RTA States. The identification of all such changes in the regulatory regime of RTA States would, at least, facilitate the discussions in the CRTA, as well as the assessment – even if on a qualitative basis – of the incidence of other regulations of commerce. As for tariff duties, RTA States should be given a period of time to provide appropriate information and, in the absence of their collaboration, information could be provided by third states.

In addition, Members may begin considering methodologies to try to facilitate the comparison – with regard to other regulations of commerce – of ‘before-after’ scenarios relating to the formation of an RTA. Comparisons of tariff duty levels are possible because of the use of commonly available numbers and mathematics. Economists, for example, have been able to calculate the impact of quantitative restrictions and transform them into duty levels that provide the same level of protection. A practical formula was also found for translating non-tariff protection on agricultural products into duty rates, pursuant to the Agriculture Agreement.⁶⁰ The Uruguay Round ‘tariffication’ exercise was based on a price-gap method. This was done by using the difference between domestic and world prices for each specific product. The specific protection was then replaced by a tariff level. For instance, if the world price was \$150.00 per tonne and the domestic price was \$200.00, then a tariff of \$50.00 per tonne was needed. This \$50.00 was then translated into a specific, or *ad valorem*, duty. But, the tariffication exercise under the Agriculture agreement was, limited in terms of time, as well as products, and was done once and for all. In the context of RTAs, the assessment would have to be done in a prospective manner, before the full and normal levels of trade resulting from the RTA could be calculated. In addition, the evaluation must cover many products.

Yet, it is conceptually possible to envisage that Members could agree that such a methodology be used for some products, or in some sectors of trade, especially those (alleged to be) affected by the formation of an RTA. Even if the results were not final, they may – once again – facilitate a more articulated discussion in the CRTA. Although even more unrealistic, Members could also agree on minimum thresholds of regulatory changes that would

60. The formula was based on the difference between the world price and internal price of products.

trigger the application of any such formula for the regulatory changes. For instance, if the RTA leads to changes in more than a specified number of Chapters or lines of the Harmonized Commodity Description and Coding System (Harmonized System or HS), or to more than a specified number of regulatory changes, such a tariffication exercise would have to be performed.

The main point of these theoretical suggestions is not only to emphasize that there are solutions, or partial solutions, to the difficult issue of evaluating the impact of RTA on third countries, but also that if such assessment is not, somehow, regulated in the CRTA, a definite decision on the WTO compatibility of an RTA will, ultimately, be taken by a panel in strict application of legal rules: specifically, RTAs are exceptions and RTA Member-States bear the burden of proving the WTO compatibility of RTAs. To some extent, the Appellate Body's conclusion that RTAs are a 'defence' available to RTA States – only when they prove the WTO compatibility of their RTA – has set aside the consequences of the consensus decision-making rule that has hampered the effectiveness of paragraph 7 of Article XXIV – which provides that RTAs will be amended if so recommended by WTO Members. Traditionally, RTAs have never been the object of any amendments following any examination by the GATT Contracting Parties, or WTO membership, because of the difficulty in reaching a consensus decision. In a way, the Appellate Body's decision – that, in case of a challenge, the RTA States bear the burden of proving the WTO compatibility of the RTA – has introduced some form of 'reverse consensus'. In this context, it will only benefit RTA States if their efforts to demonstrate the WTO compatibility of their RTA is supported by that of the Secretariat and some associated mathematical assessment.

There is an additional reason why actions and further research must be undertaken in this field and, again, it relates to the consequence of burden of proof in dispute settlement. With the Appellate Body ruling, Panels may now be asked to adjudicate on the compatibility of a specific RTA within the parameters of paragraph 5 of Article XXIV. Under the DSU, panels are obliged to proceed within a very short time frame. It is difficult to conceive that the defending party(ies) will be able to perform such a demonstration in so short a time. Moreover, even if Panels are entitled – pursuant to Article 13 of the DSU – to collect any information from any source (including the parties to the dispute that are obliged to collaborate⁶¹) it may be preferable – to ensure effectiveness, neutrality and transparency – to rely on the expertise of the WTO Secretariat. Moreover, without further CRTA action, individual panelists may end up deciding by themselves whether they consider that an RTA has led – on the whole – to a more restrictive situation than that existing before the formation of the RTA.

61. Appellate Body Report on *Canada – Aircraft* (WT/DS70/AB/R), adopted on 20 August 1999, para. 187.

Such modest proposals do not reduce the immense difficulty of assessing the overall impact of the incidence of duties and other regulations of commerce. But they might, nevertheless, facilitate the CRTA assessment exercise. Given that RTAs are exceptions to multilateral rules, and that the burden of proof of WTO compatibility rests on the RTA States, RTA States can only benefit from more thorough, well equipped and properly documented discussions of such incidences in the CRTA, well in advance of any Panel process. This would facilitate not only the CRTA examination process (and the Panel process), but will also assist RTA States in discharging a burden of proof in any future dispute.

5.4. *Parallel provisions in the GATS*

Article V of GATS also authorizes RTAs, but it does not distinguish between FTAs and CUs. As to the internal aspects of GATS RTAs, the subparagraphs (a) and (b) of Article V:1 of GATS contain language resembling that of paragraph 8 of Article XXIV of GATT. Subparagraph (a) refers to the requisite coverage of such a GATS RTA and provides that a GATS RTA shall have 'substantial sectoral coverage'. An associated footnote adds that '... agreements should not provide for the a priori exclusion of any mode of supply'. Like Article XXIV:8 of GATT, paragraph (b) of Article V:1 of GATS obliges Members 'to eliminate 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.

There are still many unresolved issues as to how to comply fully with the prescriptions of Article V of GATS regarding the internal functioning of a GATS RTA. The difficulty is increased due to the fact that reliable data on trade in services is unavailable. Members hold differing views on the scope of the 'substantial sectoral coverage' criterion, in particular as to whether one or more sectors can be excluded, or whether the evaluation should take place on a sector-by-sector, subsector-by-subsector or on a completely disaggregated basis. The meaning of 'substantially all discrimination' – in terms of the extent to which discriminatory measures should be allowed to exist in an RTA without breaching its consistency with Article V:I(b) – is also a matter for continued debate. This would be directly influenced by the scope of the lists of any exceptions.

Paragraph 4 of Article V of GATS includes principles contained in paragraphs 4 and 5 of Article XXIV of GATT 1994 in prohibiting that an RTA 'raises 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'. Identifying the appropriate method for determining the

change in the 'overall barriers to trade' in services against third parties is, probably, more difficult since trade in services is the object of restrictions coming exclusively from regulations of commerce (as no tariffs can be imposed on trade in services). Differences in regulatory mechanisms across countries, and the absence of detailed data on services, significantly impede any evaluation of the level of barriers in effect before, and after, the establishment of a GATS RTA.

Paragraph 2 of Article V of the GATS refers to the need to take into account the existence of 'a wider process of economic integration'. What does this imply for the 'overall level of barriers' against third parties? Would the extension of an MFN exemption for the members of the RTA constitute a new restriction to be evaluated, or should it be ignored since it will lead to greater economic integration in such sectors? Would the creation of an RTA in merchandise authorize the re-opening of the MFN list of exemption?⁶²

Some have suggested that the actual impact of an RTA on trade in services needs to be assessed. For them, Members forming a GATS RTA should be required not to reduce either the level, or growth, of trade in any sector, or sub-sector, below a historical trend. Changes in the volume of trade could be judged by data on domestic economic activities if data on trade in services is unavailable, or data from balance of payments, stocks of foreign direct investment and domestic industries in individual Members for purposes of evaluating the level of barriers. As for RTAs in merchandise, it could be suggested that all import restrictions be compiled and grouped by the Secretariat, possibly converted into tariff equivalents in order to arrive at an average tariff for each RTA State, compared with an average tariff after the formation of the RTA. By so doing, the potential impact of the RTA could be evaluated. But further reflection is needed when assessing the impact on trade in services of any RTA because of the high complexity of dealing only with regulations of commerce in an area where data are unreliable.

6. Proving that the measure inconsistent with GATT/WTO was 'necessary' to the formation of the RTA

The third condition imposed by the Appellate Body – that the measure was necessary for the formation of the customs union – is, thus, more or less some form of a 'necessity test'.⁶³ It is for non-compliance with this latter condition that the Appellate Body concluded that Turkey could not, validly, invoke Article XXIV to justify its violation of Article 2.2 of the ATC and

62. See for instance the discussion in the CRTA regarding the enlargement of the EC and whether new MFN exemptions (and these new exemptions) can be added to the EC's List pursuant to an Article V RTA after the closing of the Uruguay Round, WT/REG3/M7 and M8.

63. Some may argue that this is in parallel to the 'conflict' test that the Panel had suggested.

Articles XI and XIII of the GATT. We recall that, in a customs union, the CU Member States must adopt ‘substantially the same duties and regulations of commerce with the non CU states’. Particularly, the Appellate Body reported that:

62. We agree with the Panel that had Turkey not adopted the same quantitative restrictions that are applied by the European Communities, this would not have prevented Turkey and the European Communities from meeting the requirements of sub-paragraph 8(a)(i) of Article XXIV, and consequently from forming a customs union. We recall our conclusion that the terms of sub-paragraph 8(a)(i) offer some – though limited – flexibility to the constituent members of a customs union when liberalizing their internal trade. As the Panel observed, *there are other alternatives available to Turkey and the European Communities to prevent any possible diversion of trade, while at the same time meeting the requirements of sub-paragraph 8(a)(i)*. For example, Turkey could adopt rules of origin for textile and clothing products that would allow the European Communities to distinguish between those textile and clothing products originating in Turkey, which would enjoy free access to the European Communities under the terms of the customs union, and those textile and clothing products originating in third countries, including India. ...

63. For this reason, we conclude that Turkey was not, in fact, required to apply the quantitative restrictions at issue in this appeal in order to form a customs union with the European Communities. Therefore, Turkey has not fulfilled the second of the two necessary conditions that must be fulfilled to be entitled to the benefit of the defence under Article XXIV. *Turkey has not demonstrated that the formation of a customs union between Turkey and the European Communities would be prevented if it were not allowed to adopt these quantitative restrictions*. Thus, the defence afforded by Article XXIV under certain conditions is not available to Turkey in this case, and Article XXIV does not justify the adoption by Turkey of these quantitative restrictions. (Emphasis added.)

It is worth noting that the Appellate Body did not list which WTO provisions could be violated in the context of an RTA; but, in practice, it analysed whether Article XXIV would allow a violation to the ATC; it concluded that, in this particular case, it was not necessary to do so in order to complete the RTA.

64. (...) upholds the Panel’s conclusion that Article XXIV does not allow Turkey to adopt, upon the formation of a customs union with the European Communities, quantitative restrictions on imports of 19

categories of textile and clothing products which were found to be inconsistent with Articles XI and XIII of the GATT 1994 and Article 2.4 of the ATC.

65. We wish to point out that we make no finding on the issue of whether quantitative restrictions found to be inconsistent with Article XI and Article XIII of the GATT 1994 will *ever* be justified by Article XXIV. We find only that the quantitative restrictions at issue in the appeal in this case were not so justified. Likewise, we make no finding either on many other issues that may arise under Article XXIV. The resolution of those other issues must await another day. We do not believe it necessary to find more than we have found here to fulfill our responsibilities under the DSU in deciding this case.

It is, therefore, only on a case-by-case basis that the jurisprudence will evolve to identify situations where WTO rules can be set aside in the context of the formation of a specific RTA. The analysis of the relationship between Article XXIV and other WTO provisions dealing with trade in goods should be undertaken as a result of the Members' decision to expand the mandate of the CRTA 'to examine the incidence and restrictiveness of all duties and regulations of commerce, in particular those governed by the provisions of the Agreements contained in Annex 1A of the WTO Agreement. (...) Accordingly, although the Working Party would conduct its examination in light of the relevant provisions of the Agreements contained in Annex 1A of the WTO Agreement ...'.⁶⁴ It seems that the Members were of the view that an RTA may affect the provisions of many WTO agreements.

7. Special Regional Trade Agreements for developing countries

7.1. Provisions of the Enabling Clause

At the end of the Tokyo Round, Contracting Parties adopted a decision entitled 'The Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries', also called the Enabling Clause.⁶⁵ This decision allows for deviation from the MFN rule in favour of imports from developing countries. In this context, paragraph 2(c) provides that developing countries may form regional or global arrangements entered into themselves for the *mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed* by the Contracting

64. See the mandate of the CRTA, WT/L/127.

65. Decision of 28 November 1979 (L/4903).

Parties, for the *mutual reduction or elimination of non-tariff measures*, on products imported from one another.

The scope of paragraph 2(c) of the Enabling Clause is not clear. It seems to allow for the reduction of tariffs in less drastic terms than does paragraph 8 of Article XXIV, which prescribes that all (tariff) duties on trade shall be eliminated on substantially all the trade between members of an RTA. Tariffs on internal trade would, therefore, not need to be completely eliminated.

It is not clear whether the same is true with non-tariff barriers since there is reference to 'criteria and conditions which may be prescribed'. To date, no such criteria or conditions have ever been prescribed. Is the reference to 'in accordance' imposing a condition to such partial elimination of non-tariff barriers? Or, should we conclude that, in the absence of such criteria and conditions, a simple reduction of non-tariff barriers would comply with the Enabling Clause?

7.2. Paragraph 3 of Article V of GATS

The GATS deals differently with RTAs involving developing countries. Rather, it encourages 'flexibility' with regard to 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). 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.

Again, many issues remain unresolved. Would flexibility be granted in complying with the requirement of eliminating 'substantially all discrimination' as well as in that of implementing such elimination within a 'reasonable time frame'? Would it be possible to define the degree of favourable treatment by establishing some limits or conditions for granting such treatment, such as, for example, by reserving more favourable treatment to enterprises that are not globally competitive?

8. Other matters relevant to the issue of RTAs in WTO dispute settlement

8.1. Can a Regional Trade Agreement act in a WTO dispute procedure as a defendant?

The *Turkey – Textiles* dispute also underlines an important gap in the WTO dispute procedures regarding disputes involving an RTA. In the case at issue, India had only directed its complaint against Turkey. In Turkey's view, it was not individually responsible for acts that were, collectively, taken by the

members of the Turkey-EC customs union through the institutions created by the agreement. For Turkey, when two Members enter into a customs union, there is a fundamental change in the relationship between them and in their relationship with other WTO Members. This should be taken into account by the dispute settlement mechanism.

In the *Turkey – Textiles* dispute, it was factually clear that the measures at issue had been taken by Turkey itself, that they were enforceable on Turkish territory only, that Turkey itself was ensuring the surveillance of such quotas at its borders, and that the EC – and Turkey – have their respective systems of border control. The issue remained, however, as to whether the Turkey-EC customs union, itself, should have been the defending party to this dispute.

In answering this question with a negative, the Panel noted that the WTO dispute settlement system is based on Members' rights, is only accessible to Members and is only enforced and monitored by Members.⁶⁶ The Turkey-EC customs union was not a WTO Member and, in that respect, did not have any autonomous legal standing for the purpose of WTO law and, therefore, its dispute settlement procedures. It was, thus, impossible for the Turkey-EC customs union to have any standing in this procedure.

Moreover, in the absence of any formal right to 'intervene' and participate fully in that dispute, the EC – which had refused to act as a third party by arguing that it was, rather, a full party to the Turkey-EC customs union and, as such, should be entitled to defend such an RTA – simply did not participate in the Panel process. Certainly, the Panel would have been in a rather awkward position to assess the overall WTO compatibility of the Turkey-EC customs union. But, with the new Appellate Body ruling that Panels and the Appellate Body have the capacity and jurisdiction to assess the WTO compatibility of any specific customs union, one does wonder whether such adjudicating bodies could be assessing the overall WTO compatibility of a customs union in a dispute when some of the signatories of such an agreement are not to be represented. Further, what of situations where a customs union would be considered by the CRTA to be in full compliance with all the requirements of Article XXIV? Such a blessing by the CRTA would not provide the customs union with any status, or standing as WTO Member, thus, excluding it from any formal participation in WTO dispute process.

Even if the Panel's solution was followed – which was that, in the absence of any contrary treaty provision, Turkey could reasonably be held respon-

66. The Panel cited para. 101 of the Appellate Body Report on *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, adopted on 6 November 1998, WT/DS58/AB/R ('*US – Shrimp*').

sible for the measures taken by the Turkey-EC customs union⁶⁷ – there appears to be a need for some form of right of ‘intervention’ in favour of WTO Members as parties to an RTA when such an RTA is challenged or invoked as a defence. Essentially, a fully compatible RTA should also be provided some form of status in the dispute settlement procedure. At the moment, the other members of an RTA (not sued as a defendant) can only participate in the dispute as third parties (Article 10 of the DSU). Such third parties can only receive the first submissions of the parties to the dispute and attend the first meeting. In addition to these limited rights, a member of an RTA may argue that it should be a full party (and not only a third party) as its WTO right to form an RTA is directly challenged.

8.2. *A special case: the accession to a customs union and other Regional Trade Agreements of the EC*

The European Communities is a signatory of the Final Act of the Uruguay Round and its constituent countries are also Members, in their own right, of the WTO. Consequently, there is no issue as to whether the regional trade agreement of the EC is compatible with Article XXIV since its WTO membership has provided the EC with a full WTO personality.

The issue of the ‘Enlarged Community’ in the WTO includes, therefore, questions relating to the legal personality, in WTO terms, of this community. The Panel in the *Turkey – Textiles* dispute had to examine whether the measures at issue, adopted by Turkey in the context of the Turkey-EC customs union, could be considered a ‘change’ to an existing measure (and, thus, benefit from the coverage of the ATC). The Panel stated ‘... Conceivably, a change of geographical coverage could constitute a ‘change’ to an ‘existing’ restriction (as could be the case on the occasion of an enlargement of a customs union – an issue which in this case we do not need to address)’.⁶⁸ Thus, it could be argued, to the extent that a WTO Member only enlarges its geographical coverage, that all components of its new territory should be included under the coverage of the pre-existing WTO legal entity.

This does not, however, imply that where the WTO Agreement provides for a right or a specific obligation, compliance by the initial WTO

67. In the *Nauru* case one of the conclusions of Judge Shahabuddeen’s separate opinion was: ‘... the [International Law Commission] considered, that *where States act through a common organ, each State is separately answerable for the wrongful act of the common organ*. That view, it seems to me, runs in the direction of supporting Nauru’s contention that each of the three States in this case is jointly and severally responsible for the way Nauru was administered on their behalf by Australia, whether or not Australia may be regarded as technically as a common organ.’ *Nauru* case, Separate Opinion of Judge Shahabuddeen, at 284. R. Clark, Book review of Nauru: Environmental Damage Under International Trusteeship (C. Weeramantry), *The International Lawyer*, Vol. 28, No. 1, at 186.

68. See para. 9.78 of the Panel Report on *Turkey – Textiles*.

Membership will, necessarily, imply that the current enlarged WTO Membership can still benefit from the same legal situation. On the contrary, the specific requirements of any provision will, most often, require an assessment of the new situation following the creation of the enlarged WTO Membership.

9. Conclusion

If good governance needs to take place at the local, regional and multi-lateral levels to ensure sustainable development, one should not lose sight that the initial justification for multilateral rules was to ensure that the situation leading to the Second World War would not repeat itself, including the exclusion of Germany, the US beggar-my neighbour attitude, and the Commonwealth preferences. But, with the proliferation of RTAs for which the present WTO rules do not allow for an adequate monitoring, are we not heading back to where we were before?

In a landmark decision, the Appellate Body in *Turkey – Textiles* made a strong call for law and order among WTO Members. In stating clearly that RTAs can justify violations of WTO rules only if in place upon the formation of an RTA, and only if such violations are necessary to the formation of the RTA, and only after having demonstrated the full compatibility of the RTA with Article XXIV: (5) and (8), the Appellate Body almost introduced a reverse consensus rule that, unless otherwise proven, RTAs and RTAs' preferences are contrary to the WTO multilateral rules.

The Appellate Body urged WTO Members to assume their responsibility towards the multilateral system and to exercise, with maturity, the monitoring of RTAs. So far, WTO Members have behaved like ostriches, hoping that the issue would go away. The number of RTAs and their coverage are increasing and WTO Members have even fewer means to assess their WTO compatibility. As a consequence of the rules on the burden of proof, this means that RTA States have even less chances of being able to demonstrate that their RTAs are WTO compatible. The proliferation of RTA does not increase their WTO compatibility.

Further research and serious good faith negotiations are necessary in order to evaluate, objectively, before and after the formation of a customs union, the trade situation of the Members outside the RTA, as required by Article XXIV:5 of GATT. In this paper we have suggested modest elements of a response, relying for instance on the WTO experience in quantifying and evaluating the level and impact of protection in agricultural trade. Serious time-limit constraints, presumption rules, the possibility of negative inferences and the increased involvement of third-party support such as the Secretariat may facilitate this.

Short of proper tools, and caught in the meandering of consensus decision-

making, the important matter of the WTO compatibility of RTAs may well end up before WTO adjudicating bodies. It would be most unfortunate if WTO Members were to abdicate their responsibilities in favour of the WTO adjudicating bodies.

Annex

Selected GATT/WTO legal provisions on regional trade agreements (asterisks (**) indicate omitted provisions).

A. GATT Article XXIV

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;

(**)

(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;

2. Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994

(**)

B. Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994

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.

C. General Agreement on Trade in Services, Article V, 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 coverage,⁶⁹ 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.

69. 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.

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.

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

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

2(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.

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