

# **Legal Review of FTA Tariff Negotiations**

**By**

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## **ABSTRACT**

Despite the proliferation of free trade agreements (FTAs) between nations today, academics and policy makers alike have yet to fully understand what aims do trading nations have when they pursue free trade agreements. This paper provides an explanation that an FTA is a contract through which FTA partners agree to a reciprocal exchange of preferential market access. Trading nations pursue FTAs to avoid exclusionary effects on non-members by securing preferential market access with FTA partners. Review of FTA tariff elimination provisions reveals that FTAs ensure that the expected benefits obtained from tariff elimination or reductions are protected from any future actions by an FTA partner or a third party. The paper concludes with a cautionary observation that the chance of a successful multilateral trade round is further reduced as the exclusionary effects of existing FTAs provide further incentives for non-parties to form new FTAs.

## I. Introduction

Since the beginning of the World Trade Organization (WTO), there has been a surge in the number of free trade agreements (FTAs)<sup>1</sup> WTO members enter into.<sup>2</sup> Despite this proliferation of FTAs, academics and policy makers still struggle to fully grasp the cause and effect behind the spread of FTAs. This paper is intended to enhance the understanding of this topic by reviewing the trade in goods section of concluded FTAs.<sup>3</sup> We examine the aims of a trading nation in entering into an FTA.<sup>4</sup> In particular, focus is placed on traditional market access provisions dealing with tariff elimination.<sup>5</sup>

The following section reviews the existing theoretical and empirical literature on the cause and effects of preferential trading agreements. The latest theoretical literature argues that FTAs impair the world trading system governed by the GATT.<sup>6</sup> In addition, growing empirical evidence concludes that the export interests of countries outside of FTAs are clearly harmed by an exclusion from FTAs.<sup>7</sup>

As a background to the study, section III provides an overview on the negotiating process of tariff elimination. The negotiating process of an FTA is primarily characterized as reciprocal exchanges of tariff elimination promises. Section IV reviews the legal provisions of the trade in goods section of FTAs and shows that they are drafted to ensure that import tariff reduction or elimination by a party is well compensated for by the reciprocal tariff reduction or elimination by the FTA partner country. In this section, the significance of the trade in goods section of an FTA is further explained, with more details given on how countries ensure that the negotiated benefits of improved access to an FTA partner's market are not undermined by later

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<sup>1</sup> The abbreviation "FTA" means any international agreement to form a free trade-area in pursuant to GATT Article XXIV, or the Enabling Clause. See n 40 below for the Enabling Clause. FTAs are distinguished from a customs union; participating countries in a custom union must adopt substantially the same duties and other regulations of commerce with respect to the trade of territories not included in the union in pursuant to GATT Article XXIV:8 (b).

<sup>2</sup> An average of eleven notifications were made since January of 1995 to the WTO as compared to only an annual average of less than three during the four and half decades of the GATT. See Jo-Ann Crawford and Robert V. Fiorentino, "The Changing Landscape of Regional Trade Agreements," Discussion paper No. 8, The World Trade Organization, 2005.

<sup>3</sup> Prof. Won-Mog Choi examined the jurisprudence of regional economic integration in the contexts of FTAs in East Asia. See Wong-Mog Choi, "Regional Economic Integration in East Asia: Prospect and Jurisprudence", 6(1) JIEL (2003), at 49-77.

<sup>4</sup> A trade in goods section of an FTA usually also includes a section on rules of origin and customs procedures. However, this paper will focus specifically on the parts that are directly related to tariff reduction or elimination.

<sup>5</sup> Although an FTA includes liberalization in other areas such as trade in services, for most FTAs, particularly those involving developing countries, it is the liberalization of the trade in goods that largely determines the overall balance in the exchange of benefits between the parties.

<sup>6</sup> See Kyle Bagwell and Robert W. Staiger, "Will Preferential Agreements Undermine Multilateral Trading Systems?", Jagdish Bhagwati, Pravin Krishna, and Arvind Panagariya, ed., *Trading Blocs, Alternative Approaches to Analyzing Preferential Trade Agreements*, MIT Press, 1999.

<sup>7</sup> See Nuno Limao, "Preferential Trade Agreements as Stumbling Blocks for Multilateral Trade Liberalization: Evidence for the United States", 96(3), *American Economic Review*, 2006, at 896-914.

actions or inactions by an FTA partner or third parties.

The paper concludes with a cautionary observation that the chance of a successful multilateral trade round is further reduced as the exclusionary effects of existing FTAs accelerates the proliferation of new FTAs.

## II. Economic Aims behind FTAs

Trade theorists have expressed the view that FTAs undermine the multilateral trading system which is designed to induce countries to enter into reciprocal tariff reduction agreements.<sup>8</sup> The theorists' view, however, is not currently in conformity with trade policy makers' decisions as major trading nations pursue FTAs at an unprecedented pace. The question some may ask is why trading nations are pursuing FTAs at rapid rates when there exists a perceived danger among policy makers as well as trade theorists that multilateral trading system under the GATT may be impaired by the proliferation of FTAs.

In their theoretical analysis of preferential trading agreements within the world trading system governed by the GATT, Kyle Bagwell and Robert W. Staiger have shown that preferential trading agreements undermine the GATT system since tariffs no longer satisfy non-discrimination principles. The multilateral system is logical from the world-wide economic efficiency perspective if the principle of reciprocal tariff elimination is combined with non-discrimination as codified in the Most Favored Nation (MFN) clause of Article I of GATT 1994.<sup>9</sup> Without multilateral trade agreements under the GATT, governments will manipulate terms of trade in their favor and set tariffs "higher than would be efficient from a worldwide perspective."<sup>10</sup> The inefficiently high tariff levels can only be lowered if countries enter into a multilateral trade agreement on the basis of the MFN principle where tariffs are promised to be reduced on a reciprocal basis.

However, the carefully designed world trading system under GATT is threatened as FTAs spread. As FTAs violate the GATT MFN clause, they undermine the efficient outcome aimed by the GATT system since governments would prefer to import more goods higher applicable tariff duties.<sup>11</sup> Imports of goods with higher tariffs are preferable since the goods

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<sup>8</sup> The view of trade theorists presented in this paper are mainly those of Bagwell and Staiger who have provided rationale for the GATT system grounded on an economic theory. Ibid.

<sup>9</sup> See above n 6 above. Although the reciprocity principle in multilateral trade negotiations under the GATT is often observed in practice, the GATT provisions do not provide for it unequivocally. Prof. John Jackson states that "the GATT does not require reciprocity". Prof. Jackson refers to GATT Article XXXVI: 8, which provides: "The developed contracting parties do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less-developed contracting parties." See John Jackson, *The World Trading System, Law and Policy of International Economic Relations*, Second Edition, The MIT Press, 1998, at 147. However, it should be noted that GATT Article XXVIII *bis* stipulates that multilateral tariff renegotiations under the GATT should be held on a reciprocal and mutually advantageous basis.

<sup>10</sup> Alvarez, José E. Alvarez, Kyle Bagwell, Petros C. Mavroidis and Robert W. Staiger, "It's a question of market access," 96 (56), *Am. J. Int'l L.*, 2002, at 1-19.

<sup>11</sup> Ibid, at 6.

raise greater tariff revenue and are priced at lower levels due to the tariffs. According to Bagwell and Staiger, the reciprocal tariff reduction principle under the GATT system would not be able to handle the inefficiency created by the discriminatory tariffs created by FTAs.<sup>12</sup>

Then, why are countries seeking FTAs when collectively there is increased inefficiency? There are various considerations that enter into a country's decision to seek free trade agreements<sup>13</sup>, but in explaining the market access part of free trade agreement negotiations, the proliferation of preferential trading agreements in itself is an important cause and motivation behind the pursuit of FTAs by many trading nations. In other words, trading nations do not want to be excluded from the spreading web of FTAs in the world trading system.

Empirical evidence from the study of Mersosur shows that non-members are directly hurt as the export price of goods exported by non-members to member countries are reduced.<sup>14</sup> Another study of U.S. FTAs has shown that multilateral MFN tariffs applicable to non-members of FTAs on goods traded under FTAs are maintained at higher levels relative to the multilateral MFN tariffs on similar products that are imported only from non-FTA partners.<sup>15</sup> Put differently, FTAs become a stumbling block in reducing multilateral MFN tariffs. For a non-member of an FTA, even a multilateral trade round cannot promise that the tariffs on its exports to countries in the FTA would be reduced in future multilateral negotiations. The permission of preferential trading agreements under the loose requirements set by GATT Article XXIV created a "prisoner's dilemma" in the world trading system where it would be in the best interest of a country to join the "bandwagon" of FTA creations even though the collective outcome would hurt the world trading system.

As observed by Jacob Viner in his seminal examination of preferential trading agreements, creation of FTAs creates trade as well as diverts trade from the existing trading relationship.<sup>16</sup> It is the trade diversion effect resulting from existing FTAs that provides non-parties to existing FTAs motivation to enter into FTA negotiations. Exporting countries whose products face discriminatory tariffs seek FTAs with an importing country in order to gain non-discriminatory treatment for its goods by the importing country. The prevalence of FTAs with

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<sup>12</sup> Ibid, at 519.

<sup>13</sup> John Whalley explains that in addition to traditional trade gains, countries seek FTAs to strengthen domestic policy reforms, increase bargaining power in multilateral forums, and cement strategic political alliances with FTA partners. See John Whalley in "Why Do Countries Seek Regional Trade Agreements", in J. Frankel ed., *The Regionalization of the World Economy*, University of Chicago Press, for NBER, 1998, at 63-89.

<sup>14</sup> In their empirical study, Won Chang and Alan L. Winters have shown that non-member countries exporting to Mercosur have seen their export prices to Mercosur decline while member countries to Mercosur have seen their export prices to Mercosur rise. They viewed that even if Article XXIV of the GATT prohibits FTA members to raise trade barriers to other WTO members, the formation of an FTA itself may hurt non-members in any case. Won Chang and Alan L. Winters 'How Regional Blocs Affect Excluded Countries: The Price Effects of Mercosur', 92(4), *American Economic Review*, 2002, 889-904.

<sup>15</sup> See Nuno Limao, 'Preferential Trade Agreements as Stumbling Blocks for Multilateral Trade Liberalization: Evidence for the United States', 96(3), *American Economic Review*, 2006, 896-914.

<sup>16</sup> Jacob Viner, 'The Customs Union Issue', in Jagdish Bhagwati, Pravin Krishna, and Arvind Panagariya, ed., *Trading Blocs, Alternative Approaches to Analyzing Preferential Trade Agreements*, MIT Press, 1999.

discriminatory tariff treatments further creates incentives for those excluded from existing FTAs to seek FTAs so that their exports will not be crowded out in the importing country's market.<sup>17</sup>

The following sections seek to glean from various concluded FTAs what intentions or purposes did the countries have in mind when they pursued FTA negotiations. For the purpose of this paper, we set aside the political consideration that may enter into a country's pursuit of an FTA and focus on the traditional trade gains resulting from tariff reduction or elimination.

### **III. Negotiating Tariff Elimination under FTAs**

FTA tariff elimination negotiations involve primarily two different tasks. The first involves negotiation over the legal text of the agreement on trade in goods.<sup>18</sup> This task is important because the main text of the agreement on trade in goods determines the modality of tariff elimination, including the scope and coverage of tariff elimination, acceleration clause, and trade remedy rules. In addition to the modality of tariff elimination, the text of the agreement in trade in goods addresses industry specific issues through separate sections on sensitive industries such as agriculture, textiles, automobiles, and pharmaceuticals.<sup>19</sup>

The second task involves the discussion of the schedule for tariff elimination, which is usually annexed to the agreement on trade in goods. A tariff elimination schedule provides for each tariff line whether the tariff for a product will be subject to immediate elimination or to a staging period, or altogether fall into an exclusion category.<sup>20</sup> This task of negotiating tariff elimination schedules is inherently a reciprocal trade-off process. Each party tends to measure the benefits of tariff elimination in terms of its exporters' access to its FTA partner's market, while measuring the costs in terms of the market access granted to products originating from its partner. The tariff elimination negotiation can be viewed as a process of reaching an agreement where the exchange of market access benefits between the parties leaves both parties better off as compared to the position without the exchange.

As FTA negotiating parties measure benefits in terms of the increased market access to an FTA partner's market, little account is taken of the overall benefits to the consumer welfare during a negotiation. In fact, a party's negotiating posture tends to reflect the narrow interests

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<sup>17</sup> WTO Director General, Pascal Lamy, in his speech addressed to Indian businessmen, expressed that, "Countries outside an agreement will try to conclude agreements with one of those that are inside to avoid exclusion. This has been called the "domino" or "bandwagon effect" and is the reason for much of the regional trade agreement activity seen in Asia recently."

<sup>18</sup> For a country with more negotiating power, it can rely on standard template provisions that were already incorporated in their previous FTAs with other partners. However, for a country with less negotiating power, it may have to depart from the standard provisions incorporated in its past FTAs.

<sup>19</sup> In most FTAs concluded by the U.S., sectors such as agriculture, textiles, and apparel products are addressed in individual sections. In the U.S.-Australian FTA, the pharmaceutical sector is addressed in a separate annex to the section on national treatment and market access for goods. In FTAs concluded by Canada, a separate annex deals with wine and distilled spirits.

<sup>20</sup> For agricultural products, a TRQ system is sometimes adopted. TRQ systems apply a preferential tariff level to imports below an agreed quota level of quantities and a non-preferential tariff is applied to import quantities above the quota level.

of sensitive domestic sectors rather than the overall interests of the domestic economy. The irony is that this negotiating posture is in contradiction to the rationale for launching FTA negotiations, which was largely based on the economic argument that tariff elimination would lead to increased consumer welfare.<sup>21</sup>

As a practical measure of the extent of market access exchanged between parties, negotiators often adopt the percentage of tariff lines given market access over the total tariff lines. Since this tariff line measure can include many tariff lines for which there exists little trade, a better measure would be the percentage of the current import value given market access over the total value of imports from an FTA partner. A drawback of this measure is that the potential trade liberalization is not captured by the “current” import value. For example, if a few tariff lines with a large amount of current import are included in tariff elimination while a large number of tariff lines with little import value are excluded, the trade weighted market access measure would report a high percentage of market liberalization. However, this measure would be a misleading measure of the increased market access because there may be tariff lines over which bilateral trade could be generated as a result of tariff reduction or elimination although at current levels of tariffs, only a minimum level of bilateral trade exists.

In addition to the economic evaluation of market access, a negotiating party always measures the extent of the market liberalization of its own market in terms of political sensitivities of the products subject to market liberalization. Negotiators may be able to achieve a balance of benefits in economic terms, but the deal may be untenable if the magnitude of the “political cost” is not sufficiently compensated for by any economic or political benefits offered by the partner country. For sensitive sectors, negotiators have little room to maneuver since a party’s position is already determined through protracted negotiations between domestic stakeholders.<sup>22</sup> As a result, in some sensitive products, reciprocal exchange of market access may not be achievable within the trade in goods section. Therefore, the parties may have to engage in overall negotiations crossing to market liberalization in services and other sectors to achieve a balance in the exchange of concessions through an FTA. However, the process of exchanging market access concessions across other sectors is inherently difficult since other areas such as service or intellectual property may involve liberalization of domestic regulations which cannot be easily be converted to a “tariff equivalent” level of liberalization.

For a country pursuing multiple FTAs, the outcome of FTA tariff elimination negotiations varies across FTAs as the “cost” of market liberalization measured by the

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<sup>21</sup> Before initiating an FTA negotiation, countries conduct studies estimating the economic benefits when an FTA with a partnering country comes into effect. The economic studies based on computable general equilibrium models provide rationale for launching FTA negotiations as the studies usually predict that consumer welfare will increase when tariffs on imported goods from an FTA partner are reduced.

<sup>22</sup> In the case of the United States, the Trade Promotion Act of 2002 mandates U.S. negotiators to achieve certain principal negotiating objectives. See the U.S. Trade Act of 2002, 19 USC 3801-3813. For example, U.S. negotiators cannot agree to trade remedy rules in its FTA that lessen the effectiveness of domestic and international disciplines on trade remedy laws. See the U.S. Trade Act of 2002 § 2102(b) (13).

sensitivities of domestic industries varies depending on its FTA partners. In some cases, it is conceivable that negotiating countries may conclude a negotiation at a point that is less ambitious than what it could have achieved if the negotiators were not constrained by time and resources. In less optimistic cases, negotiations can be stalled for long periods of time, as mutually acceptable solutions for negotiating parties are not easily accomplished.<sup>23</sup> Additionally, for a country with a record of concluding FTAs with a high level of liberalization, a trade liberalization package falling short of its past track record may not be acceptable for its negotiators even though the deal may improve market access for its firms and improve the overall welfare for the economy.

To understand the negotiating process of an FTA, it is also important to look at the number of parties to an FTA. In a bilateral FTA where there are only two parties to the agreement, a party prepares only one tariff elimination schedule. Thus, parties can negotiate tariff elimination at product specific levels instead of negotiating formulas for tariff reduction or elimination applicable to all parties.

However, when more than two countries pursue a formation of a regional trading agreement, the dynamics of the negotiation becomes inherently more complex. Negotiators may need to search for a more effective approach to overcome the complexity of negotiating multiple tariff elimination schedules. Unlike a bilateral FTA negotiation, a multilateral FTA negotiation may involve a track approach<sup>24</sup> by which parties' tariff lines are eliminated following a common schedule.

Under a track approach adopted in an FTA with multiple parties, parties agree to tariff reduction or elimination tracks, which specify the exact schedule of tariff reduction or elimination over a staging period for those products that fall under a specific track. This approach simplifies the negotiating process because it is not necessary for parties to negotiate tariff elimination schedules for each tariff line. Under this approach, ceilings may be imposed on the number of products that fall under a specific tariff reduction track. While constrained by the ceiling, a party is still free to place a specific product on a specific track.

A good example of the track approach to tariff reduction is the China-ASEAN FTA, where parties agreed to two tracks: a normal track and a sensitive track.<sup>25</sup> A product that is placed on a normal track will eventually have its tariffs eliminated in five years. In contrast, the tariffs on a product placed on a sensitive track will be reduced to a level but will not be

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<sup>23</sup> Negotiations for an FTA between Canada and EFTA countries have been launched in 1998 and agreements have been reached on most issues. However, negotiators reached an impasse on the treatment of ships and industrial marine products and the final conclusion of the negotiation has not been achieved. See the update on the negotiation at <http://www.dfait-maeci.gc.ca/tna-nac/efta-en.asp/>.

<sup>24</sup> In contrast to a mathematical formula adopted in the GATT tariff reduction negotiations, a track can be understood as a uniform schedule of tariff reductions for tariff lines belonging to a track.

<sup>25</sup> See Article 3 and Annex 1 and Annex 2 of the Agreement on Trade in Goods of the Framework Agreement on Comprehensive Economic Co-operation between the Association of Southeast Asian Nations and the People's Republic of China (China-ASEAN FTA). Tariff lines are placed on either the Normal Track or Sensitive Track. Tariff lines that fall under the Normal Track will be eliminated over a staging period. However, tariff lines placed on the Sensitive track will either be reduced or eliminated over a longer staging period.



eliminated. In addition, the sensitive track products will be subject to a much longer staging period.

In the China-ASEAN FTA, each party was permitted to choose “on its own accord” the track to which a particular product belongs.<sup>26</sup> In other words, it is expected that each party will independently determine whether a specific product will fall into a certain track of the tariff elimination schedule. Nevertheless, even under a track approach, a party’s decision to give access to its FTA partner is likely to be used as leverage to increase access to the FTA partner’s market. In the China-ASEAN FTA, the negotiating practice of reciprocal exchange of market access benefits is elevated as a binding requirement in the agreement; a reciprocal tariff reduction provision stipulates that a party can enjoy tariff concessions on a tariff line from an FTA party only if it has given concessions to its partner on that tariff line by placing the tariff line in the normal track.<sup>27</sup> In other words, on a product by product basis, a market access concession in the import market is exchanged for an improved market access in the export market.

Under a track approach to tariff concession, the ability of a party to negotiate a tariff elimination schedule for an individual product is constrained by tracks. Therefore, during the negotiation of the modality, it is in the best interest of a party to try to shape the tracks so that it will be able to accommodate the sensitivity of its products. For example, if a party wants to exclude some industrial products from tariff elimination, the threshold for the category of excluded products, both in tariff lines and trade value, should be large enough to accommodate the excluded products. A track approach such as the one adopted in the China-ASEAN FTA simplifies the negotiating process, but it increases the risk that an agreement may not be reached if countries are dissatisfied with the outcome of its FTA partner’s tariff elimination schedule, despite its consistency with the modality.

## **IV. Jurisprudence of Tariff Elimination**

### **A. Reciprocal Tariff Reduction**

Should a negotiation of tariff reduction or eliminations be in accordance with some form of reciprocity principle? The answer to this question is not unambiguous with regard to the tariff negotiations held at a multilateral level in pursuant to the GATT. Although the reciprocity principle in multilateral trade negotiations under the GATT is often observed in practice, the GATT provisions do not provide for the reciprocity principle unequivocally.

On the one hand, GATT Article XXVIII *bis* clearly stipulates that multilateral tariff

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<sup>26</sup> See para 2(a) and 2(b) of Article 3, the China-ASEAN FTA.

<sup>27</sup> Paragraph 1, Annex 1, the China-ASEAN FTA, Modality for Tariff Reduction and Elimination for Tariff Lines Placed in the Normal Track.

renegotiations under the GATT should be held on a reciprocal and mutually advantageous basis. On the other hand, GATT Article XXXVI:8 provides that “[t]he developed contracting parties do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less-developed contracting parties.” A developing country concluding an FTA with a developed country is not required to reciprocate the tariff concession it receives from a developed country. Professor John Jackson expressed the view that “the GATT does not require reciprocity...[n]evertheless, the practice in GATT among the major negotiating parties was always to seek reciprocity-whatever that means.”<sup>28</sup>

In multilateral tariff negotiations under the GATT, if a country wishes to grant unilateral tariff concessions to all members of the WTO, the concession would be unchallenged and probably desired if it is granted without discrimination on the basis of the MFN principle under GATT Article I (General Most-Favored Nation Treatment). However, “unilateral” tariff concessions given to a trading partner on a “preferential” basis are not permissible since it would be in violation of GATT Article I.

Take the case of the unilateral tariff reduction as a part of the tariff reduction and elimination to form an FTA. In this case, Article XXIV of the GATT would still not permit unilateral tariff reduction or elimination because GATT Article XXIV: 8(b) requires that duties and other restrictive regulation of commerce in substantially all trade must be eliminated between all parties to an FTA. Therefore, even if a WTO member makes a policy decision that tariff reduction on imported goods from a trading partner is expected to provide a great economic benefit to itself in improved consumer welfare and market efficiency, a WTO member country would not be able to grant ‘unilateral’ tariff reduction on goods imported from preferred trading partners under Article XXIV of GATT

In contrast to the multilateral tariff negotiations under the GATT, in tariff negotiations to form an FTA, GATT Article XXIV and GATT Article I in combination implicitly require reciprocal tariff reduction between FTA parties. Because GATT Article I prohibits unilateral tariff concessions to a preferred trading partner, countries must resort to a formation of a preferential trading agreement under GATT Article XXIV where “duties and other restrictive regulations of commerce are eliminated on substantially all trade between the parties”. In order for the agreement to be concluded, the tariff elimination on substantially all imports by a party should be met with equivalent tariff elimination on substantially all imports by the partner country. Thus, the notion of reciprocity becomes a negotiating principle that leads to the formation of an FTA.

In most FTAs, reciprocity is achieved through the exchange of concessions across different products. However, there are instances where reciprocal treatment is stipulated on a product-by-product basis. In the China-ASEAN FTA, when a party excludes a tariff line from concession to its FTA partner, a reciprocity condition provides that the party would not receive tariff concessions for its exports from its FTA partner on that same tariff line. Under this

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<sup>28</sup> See n 33, 147.

agreement, a party can enjoy a reciprocal treatment only if a party places a tariff line in the “Normal Track”, i.e., a track in which all the tariff lines will be eliminated in 10 years.<sup>29</sup> For example, if a party does not place tariffs on imports of refrigerators from an FTA partner in the Normal Track, an exporter of a refrigerator from that party will not be able to receive the concessionary tariff from its FTA partner. For those tariff lines that are only subject to tariff reduction, but not elimination, a reciprocal tariff treatment is provided only when the tariff rates are below 10 per cent.<sup>30</sup>

The above reciprocity principle is built into the agreement in order to achieve a greater level of liberalization by giving disincentive to a party who excludes a tariff line from the tariff elimination schedule. However, if a party has import sensitivity for a certain product but has little interest or comparative advantage in exporting the same product to the FTA partner country, the application of reciprocity principle would fail to induce market liberalization. Instead, it would result in exclusion from market liberalization for that tariff line by the party choosing reciprocal retaliation. The market liberalizing effect of the type of reciprocity principle in the China-ASEAN FTA would be nullified when adopted in other FTAs between developing and developed countries where developing countries has import sensitivities in manufacturing products while the developed countries have import sensitivities in agricultural products. The reciprocity principle only has meaningful effects when a country has both import and export sensitivities for the same product.

In most FTAs, a reciprocity principle on a product-by-product basis is not explicitly made part of the agreement. In the practice of usual FTA negotiations, negotiators may exchange concessions in different sectors to close the deal. Domestic producers who face increased import competition and have strong voices in the negotiation would strongly resist giving preferential tariff concessions to imports from an FTA partner if the FTA partner is not willing to provide an equivalent level of market access to its products in the FTA partner’s domestic market.<sup>31</sup> In general, as a negotiating principle, the reciprocity condition is a key element of a successful outcome of tariff negotiations to form an FTA, whether the reciprocal exchange of concessions are made on a product-by-product basis or across different products.

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<sup>29</sup> Ibid above n 27.

<sup>30</sup> Paragraph 6, Annex 2, Modality for Tariff Reduction/Elimination for Tariff Lines Placed in the Sensitive Track, the China-ASEAN FTA.

<sup>31</sup> During a recent FTA negotiation between Korea and the U.S., members of the U.S. Congress submitted a proposal to the administration that recommended a policy under which “the U.S. would reward Korea for each additional U.S. car that sells in Korea with reciprocal tariff cuts for Korean cars in the U.S. market.” See Inside U.S. Trade, March 9, 2007, at 16, [www.INSIDETRADE.COM](http://www.INSIDETRADE.COM).

## B. Scope and Extent of Tariff Elimination

### 1. Substantially All Trade Requirement

When negotiating an FTA, a key question negotiators must wrestle with is the extent and speed of tariff reduction or elimination. The Article XXIV of GATT 1994 of the WTO Agreement<sup>32</sup> permits its members to enter into an agreement to form a free trade area or a customs union and further provides some guidance as to the extent and the speed of tariff liberalization.

GATT Article XXIV:8(b), in particular, defines a free trade area as a group of two or more customs territories in which the duties and other restrictive regulations of commerce are eliminated in “substantially all” trade. GATT Article XXIV does not provide any details as to what it means by “substantially all” trade. A rationale behind Article XXIV is that if trade liberalization proceeds far enough between a group of countries within a trading area, then the formation of the trading area can provide a global advantage.<sup>33</sup> In other words, if restrictions of trade among several countries are substantially removed, trade creation would exceed trade diversion as a result of a formation of an FTA.

However, the above rationale is challenged by trade theorists who argue that preferential trade agreements that permit exceptions from the MFN clause would undermine the efficiency properties of a multilateral trading system founded on the principles of reciprocity and non-discrimination.<sup>34</sup> According to this theory, regardless of whether an FTA achieves liberalization in substantially all trade, global economic efficiency would be impaired.

In another line of research based on archival records, the legitimacy of GATT Article XXIV is challenged on the ground that it was crafted by U.S. policy makers to accommodate a trade treaty they had secretly reached with Canada.<sup>35</sup> According to this research, GATT Article XXIV was embedded in the GATT with little thought to the negative consequences it would bring to the world trading system.

Though there is no consensus on what is meant by “substantially all” trade, negotiators still need a measure to determine consistency with the substantially all trade requirement. A simple measure of the coverage of the market access concession is the percentage of tariff lines subject to tariff elimination out of total tariff lines. As a rule of thumb, the tariff line measure is the easiest to calculate. It also captures the extent of trade liberalization at both the current and prospective level.<sup>36</sup> However, this measure could be misleading if a few export items with

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<sup>32</sup> The Final Act of the Uruguay Round and the Marrakesh Agreement Establishing the World Trade Organization (the WTO Agreement).

<sup>33</sup> See John Jackson, *The World Trading System, Law and Policy of International Economic Relations*, Second Edition, The MIT Press, 1998, at 166.

<sup>34</sup> Above n 11, at 520.

<sup>35</sup> Kerry Chase, Multilateralism compromised: the mysterious origins of GATT Article XXIV, *World Trade Review* (2006) 5:1, at 1.

<sup>36</sup> A threshold level of 95 percent of all HS tariff lines at a six-digit level has been proposed by Australia, WTO Document WT/REG/W/22/Add.1, paras. 9-10.

large trade values are excluded from trade liberalization. A more appropriate measure is the percentage of actual trade value that falls under tariff elimination out of the total bilateral trade value. Although each measure has its own individual limitations, the percentage in tariff lines and the percentage in trade value criteria used in tandem provide a reasonable indication of the level of liberalization.

As an alternative approach, a qualitative measure to determine consistency with the substantially all trade requirement looks at whether all major sectors are included in the economic liberalization. In other words, if any major industrial sector is missing from trade liberalization, the FTA would fail the quantitative requirement. A drawback of this approach is that the definition of a major sector may not be clear. Therefore, an excluded sub-sector may be buried within the scope of a major sector which is defined widely. That is, even if all major sectors are included, it may not necessarily mean that substantially all trade requirements are met since a few products with large trade volumes may not be included in the trade liberalization.<sup>37</sup>

An FTA may successfully achieve immediate tariff elimination for all products upon entry into force of the agreement.<sup>38</sup> However, in most FTAs, some tariffs are eliminated over a number of years, and tariffs for certain items are all together excluded from tariff elimination.<sup>39</sup> In order to achieve a greater level of liberalization, during a negotiation for tariff elimination, parties may discuss the level of liberalization in different sectors before exchanging a party's offer of tariff elimination schedule. Once the offer of a tariff elimination schedule is exchanged, each party will review its FTA partner's submission and proceed to the negotiations of tariff lines. Detailed discussion usually follows on specific items where each party has strong export interests, all geared towards improving the offer of tariff elimination concessions. It should be noted that in the practice of FTA negotiations, countries are less concerned about infringing upon GATT Article XXIV than about achieving a meaningful trade liberalization that can win enough support for the concluded agreement from the public and exporters. This support is crucial to overcome the likely resistance from domestic industries facing increased foreign competition.

An FTA partner may try to exclude especially sensitive products that face significant challenges to market liberalization from the tariff elimination schedule altogether. In particular, agricultural products, textiles, and apparel products are excluded in some FTAs. The products excluded from tariff elimination are sometimes subject to tariff rate quotas (TRQ). Under the TRQ system, for import amounts below a threshold, an in-quota preferential tariff rate will be imposed. Amounts above the threshold are subject to an out-quota rate or non-preferential tariff rate is applied. For an exporting party, the TRQ is preferable to complete exclusion from

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<sup>37</sup> See WTO Document, WT/REG/W/37, 2 March 2000, at 21.

<sup>38</sup> In the agreement between New Zealand and Singapore (New Zealand-Singapore FTA), all tariffs on goods originating in the parties will be eliminated upon entry into force of the agreement. See Article 4, New Zealand Singapore FTA.

<sup>39</sup> See U.S. Harmonized Tariff Schedule, the United States-Australia Free Trade Agreement (US - Australia FTA).

tariff concessions since its exporters can at least benefit from preferential tariffs for the amount that fall under the TRQ ceiling.

## 2. Enabling Clause

FTAs between less developed countries may rely on the "Enabling Clause"<sup>40</sup> to satisfy GATT consistency. Paragraph 1 of the Enabling Clause provides that "[n]otwithstanding the provisions of Article I of the General Agreement, contracting parties may accord differential and more favorable treatment to developing countries, without according such treatment to other contracting parties." According to Paragraph 2(c) of the Enabling Clause, Paragraph 1 applies to "regional or global arrangements entered into amongst less-developed contracting parties" for the mutual reduction or elimination of tariffs and non-tariff measures on products imported from one another. Thus, the Enabling Clause provides an exception to the MFN clause of the GATT when the preferential tariff treatment is exchanged between less developed countries in an FTA.

The Enabling Clause is explicitly applicable to FTAs between "less developed countries". The Enabling Clause would also apply to tariff reduction or elimination accorded by developed countries to products originating from developing countries in accordance with the Generalized System of Preferences.<sup>41</sup> However, it should be noted that the Enabling Clause on its face does not apply to regional arrangements for mutual reduction or elimination of tariffs between developed and developing countries.

Since FTAs under the "Enabling Clause" do not have to satisfy the requirement that duties and other regulation of commerce in "substantially all trade" will be liberalized, negotiators do not face the pressure to pursue a high level of trade liberalization in terms of the coverage of the sectors. In addition, in contrast to the GATT Article XXIV:8, the Enabling Clause expressly permits "tariff reduction" as an alternative to "tariff elimination". Thus, the possibility of reducing tariffs to an agreed target level instead of eventually eliminating altogether is a convenient alternative available to negotiators and is adopted in some FTAs between developing countries.<sup>42</sup> In order to distinguish FTAs in pursuant to GATT Article XXIV and those in pursuant to the Enabling Clause, the latter agreements are often named "economic partnership agreement" or "economic cooperation agreement".<sup>43</sup>

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<sup>40</sup> GATT Contracting Parties, Decision of November 28, 1979 on Differential and More Favourable Treatment, Reciprocity and Fuller Participation on Developing Countries, GATT B.I.S.D. 926<sup>th</sup> Supp.) at 203 (1980) ("Enabling Clause").

<sup>41</sup> Ibid. n 40, at para 2(a) of the Enabling Clause.

<sup>42</sup> For example, in the China-ASEAN FTA, ASEAN 6 and China is permitted to reduce the tariff rates applied on tariffs lines placed in the respective "Sensitive Lists" to 0-5% no later than January 1, 2018. For those tariff lines placed on "Highly Sensitive Lists", parties can reduce the tariffs to not more than 50% by January 1, 2015. See Modality for Tariff Reductions/Elimination for Tariff Lines Placed in the Sensitive Track, Annex 2, the China-ASEAN FTA.

<sup>43</sup> For example, a preferential trading agreement between India and Singapore is called India-Singapore Comprehensive Economic Cooperation Agreement (CECA) and the one between Japan and Singapore is called Japan-Singapore Economic Agreement for a New Age Partnership (JSEPA). See the overview of the agreements at "[www.iesingapore.gov.sg](http://www.iesingapore.gov.sg)".

The requirement with regard to barriers to trade with third parties is also less stringent under the Enabling Clause than under GATT XXIV:5(b). Paragraph 3 of the Enabling Clause sets out a substantive requirement that preferential treatment “shall be designed to facilitate and promote the trade of developing countries and not to raise barriers to or create undue difficulties for the trade of any other contracting parties.” The loose standard required by the Enabling Clause is not a blessing for the world trading system since it makes it easier to form FTAs between developing countries. In addition, the lack of a threshold requirement that substantially all trade should be covered by an FTA may lead to an FTA with limited coverage of sectors, thus diverting rather than creating trade.

In contrast to GATT Article XXIV, the Enabling Clause provides explicitly a non-reciprocity principle applicable to FTAs between developed and developing countries. Paragraph 5 of the Enabling Clause provides that in tariff negotiations, developed countries shall not seek tariff concessions from less-developed countries that are inconsistent with the less-developed country’s development, financial, and trade needs. The non-reciprocity principle applies to the preferential tariff treatment accorded by developed countries to developing countries under the Generalized System of Preferences as provided in paragraph 2(a) of the Enabling Clause. The non-reciprocity principle, however, would not apply to FTAs because paragraph 2(c) of the Enabling Clause that permits FTAs only between less developed countries.

Those developing countries concluding a preferential trading agreement relying on the Enabling Clause for GATT consistency must notify to the WTO members and furnish all the information deemed appropriate relevant to the action to enter into the arrangement.<sup>44</sup> The Enabling Clause does not specify where the notification should be made; the only requirement is that WTO Members should be notified.<sup>45</sup> In practice, the notifications of the formation of FTAs pursuant to the Enabling Clause have been made to the Committee on Trade and Development.<sup>46</sup>

## **C. Ensuring the Orderly Reduction or Elimination of Tariffs**

### **1. Basis of Elimination**

To begin the process of tariff reduction or elimination, it is necessary to agree on the base rate from which tariff elimination will begin. Most FTAs use applied tariff rates in force on a certain date as the base rate. For those countries for which applied rates are different from WTO bound rates<sup>47</sup>, the reduction from the WTO bound rate would only result in the spurious

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<sup>44</sup> Paragraph 4, the Enabling Clause.

<sup>45</sup> See WTO document, WT/COMTD/W/114, at 6. Paragraph 4 of the Enabling Clause sets out procedural requirement of notification to and consultation with WTO Members

<sup>46</sup> Ibid. n 45 above.

<sup>47</sup> The term “WTO bound rate” refers to the tariff rate concessions as provided in the schedule annexed to the Marrakesh Protocol to the GATT 1994. The difference between the WTO bound rate and

reduction of tariffs if the then existing applied rate is much lower than the WTO bound rate. The use of the WTO bound rate as the base rate would give an incorrect impression that the tariff is being reduced in stages while the actual applied tariff rate is already below the WTO bound rate or already eliminated. Therefore, when the gap between WTO bound rates and the MFN applied rate is large, adopting the MFN applied rate as the base rate would serve the purpose of imposing a ceiling on the applied rate by preventing a party from raising the tariff level back to the bound rate.<sup>48</sup>

## **2. Acceleration Clause and Modification of Concession**

The acceleration clause enables parties to agree to “accelerate” tariff reduction so that tariff reduction or elimination is accomplished prior to the agreed dates set out in the tariff elimination schedule. An acceleration clause usually does not exist in FTAs which achieve tariff elimination in nearly all products immediately or within a short staging period after the entry into force of the agreement. However, when staging periods extending beyond one or two years exist, an acceleration clause allows parties to enter into agreements to expedite the process of tariff elimination.<sup>49</sup>

For FTAs where a sensitive sector is largely excluded from tariff elimination, a review clause may be provided with a view to improving tariff concessions in the future. For example, in the FTAs concluded by the EU, a review clause is provided whereby parties will examine on a product-by-product basis, the opportunities of enhancing market access for agricultural and processed agricultural products.<sup>50</sup>

Occasionally, FTAs also allow for modification of concessions. Instead of allowing any kind of modifications, parties may enter into agreements to modify tariff concessions provided that that modification will not result in a general level of reciprocal and mutually advantageous concessions less favorable to trade than that provided for prior to modification.<sup>51</sup> In order to meet this condition, parties may include compensatory adjustment in the modification agreement.<sup>52</sup>

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applied rate to a particular country occurs when, for example, Generalized System of Preference (GSP) preferential rates are granted by developed countries to less developed countries. Also, countries may lower applied MFN rate below the WTO bound rate on its own accord for the purpose of lowering the price of materials in consideration of the competitiveness of its industries.

<sup>48</sup> India’s final expected average bound tariff was 50.6% in 2005, while applied MFN tariff averaged 32.3% in 2001-2002. See WTO Trade Policy Review, India, Report by the WTO Secretariat, WT/TPR/S/100.

<sup>49</sup> See Article 10, the China-ASEAN FTA.

<sup>50</sup> See Article 74, the Agreement Establishing an Association between the European Community, its member states, and the Republic of Chile (EU-Chile FTA). See also Article 10 in EU-Mexico FTA.

<sup>51</sup> See Article 6, the China-ASEAN FTA.

<sup>52</sup> Ibid.



### 3. Standstill Clause

An FTA does not usually prevent a party from lowering a tariff level below the agreed level. However, if a party raises the tariff back to the agreed level, the consequence would be an effective withdrawal of benefit previously conferred to the other party. To prevent a disorderly movement in tariffs, a general “standstill clause” provides that parties may not raise tariffs or introduce new tariffs on a product covered by the agreement.

The purpose of a standstill clause is to cap tariffs on goods unless otherwise provided for in the agreement. For example, a standstill clause in EU-Mexico Free Trade Agreement provides: “No new customs duties on imports or exports shall be introduced, nor shall those already applied be increased in trade between the community and Mexico as from the date of entry into force of this Decision.”<sup>53</sup> In other words, tariffs can be lowered following the tariff elimination schedule, but they cannot be raised nor can a new tariff can be introduced other than those already agreed to in the tariff elimination schedule. For example, if the tariff elimination schedule includes only an *ad valorem* tariff rate, a new duty in the form of a specific duty may not be imposed.

One possible loophole in this provision arises when a party raises tariffs which were unilaterally reduced below the tariff level prescribed in the tariff elimination schedule. If the standstill clause specifically provides that “neither party may increase any existing customs duty”, the provision would be interpreted as prohibiting a party from raising the tariff back to the tariff level agreed upon in the tariff elimination schedule, even if the tariff was voluntarily lowered below the agreed tariff level to begin with. This robust version of a standstill clause would ensure that tariffs will take only a downward path.

In contrast to the above standstill clause, in the Canada-Costa Rica FTA, an exception is carved out in the standstill clause that amounted to nullifying its intended use. The standstill clause in the Canada-Costa Rica FTA specifically provided that it would not prevent either party from raising a tariff back to an agreed level in accordance with the phase-out schedule in the agreement following a unilateral reduction.<sup>54</sup>

### 4. Phasing Out

The period between the time of the entry into force of the agreement and the eventual tariff elimination is called a staging period. The staging period between the time of the entry into force of the agreement and the elimination of tariffs is usually set below ten years, but there are

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<sup>53</sup> See Article 3, para 4, the Free Trade Agreement between the European Union and Mexico (EU-Mexico FTA).

<sup>54</sup> See n 3 to Article III.3, para 1, the Free Trade Agreement Between the Government of Canada and the Government of the Republic of Costa Rica (Canada-Costa Rica FTA).

instances where the maximum staging period was set above ten years.<sup>55</sup>

With regard to the staging period, GATT Article XXIV: 5(c) provides that any interim agreement leading to the formation of a free trade area shall include a plan for the formation of a free trade area within “a reasonable length of time.” In interpreting this provision, an interim agreement is subject to clarification. A reasonable interpretation of an “interim agreement” is any free trade agreement in effect under which tariffs are in the process of being eliminated, but not yet eliminated on substantially all trade to fulfill the requirement of GATT Article XXIV: 8(b). Therefore, the time between the enactment of the free trade agreement and the formation of a free trade agreement should be “a reasonable length of time.”

As provided in the Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994 (Understanding), the reasonable length of time should exceed 10 years only in exceptional cases. The Understanding provides that if a party believes that 10 years would be insufficient they shall provide a full explanation to the Council for Trade in Goods of the need for a longer period.<sup>56</sup> Although for some products, the staging period may last more than 10 years, as long as a free trade area is formed before 10 years, i.e., tariffs and other regulations of commerce are eliminated in substantially all trade, it will not be necessary for FTA parties to explain to the Council for Trade in Goods the need for a longer period.<sup>57</sup> Although the GATT provides a requirement that completion of the formation of an FTA should be within 10 years, it does not appear to be firmly binding.

## 5. Other Duties and Charges

In most FTAs, tariff elimination applies to customs duties which are separate from other duties and charges. With regard to other duties and charges, parties may explicitly provide that adopting or maintaining other duties and charges, such as customs user fees on imported goods, is permitted as long as they are commensurate with the costs of services rendered.<sup>58</sup> The idea is that other duties and charges that may be used as hidden tariffs that circumvent the application of a tariff elimination schedule would be eliminated. However, fees imposed in exchange for services provided would be permitted.

In some FTAs, customs duties are not specifically delineated from other duties and charges. In those FTAs, a customs duty is defined as any charges or import duties imposed in connection with the importation of a good. However, this excludes anti-dumping and countervailing duties, as well as customs user fees.<sup>59</sup> Under this formulation, customs user fees would not be subject to tariff elimination. Fees imposed in relation to the importation of a

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<sup>55</sup> For example, in the US-Australia FTA, a staging period of 18 years is allowed for products such as pears and peaches.

<sup>56</sup> Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994, Article XXIV:5, para 3.

<sup>57</sup> Ibid.

<sup>58</sup> See Article 2.9, the US-Morocco FTA.

<sup>59</sup> Article 2.13, US –Singapore FTA.

good that exceeds the costs of services rendered would be included as part of customs duties. Therefore, this surcharge would be deemed customs duties, which would be subject to tariff elimination.

## **6. Merchandise Processing Fee**

Some countries maintain merchandise processing fees for the processing of imported merchandise through customs.<sup>60</sup> Since the merchandise processing fees constitute non-tariff barriers, an FTA sometimes provide that “a party shall not maintain merchandise processing fees for originating goods.”<sup>61</sup> The removal of merchandise processing fees for goods originating from an FTA partner would provide an additional benefit over and above tariff elimination. For example, the removal of merchandise processing fees for those tariff lines with zero MFN tariff rates would confer additional benefits in the absence of any benefit through tariff elimination.

### **D. Measures to Protect Expected Benefits**

FTA agreements provide measures that protect the expected benefits from reciprocal tariff eliminations. These measures are provided in the agreements so that the benefits of reciprocal tariff reductions would not be impaired by the policies and regulations of an FTA partner or countries that are not parties to the FTA. Some provisions are identical to those in the GATT; however, important differences can be found in the MFN and safeguard measures.

#### **1. National Treatment**

FTA parties usually accord national treatment to goods imported from its partner to the same extent it accords national treatment to goods imported from WTO members. The national treatment is given in accordance with Article III of the GATT, which is incorporated and made part of an FTA. As the MFN clause is usually absent, the national treatment provision is the single most important pillar of the trade in goods section of an FTA.

Some FTAs carve out an exception from the national treatment provision. Notably, FTAs involving the United States exclude the control on the export of logs of all species from the application of the national treatment provision.<sup>62</sup> The control over the export of logs potentially affords protection to domestic products manufactured from lower priced domestic logs over imported foreign products manufactured from more costly logs. As the export

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<sup>60</sup> The U.S. charges merchandise processing fees for the processing of merchandise that is formally entering or being released into the United States. A fee in an amount equal to 0.21 percent *ad valorem* is charged unless otherwise adjusted. See 19 U.S.C. 58c(a)(9)(A).

<sup>61</sup> See Article 2.8 of the U.S.-Singapore FTA and Article 2.12 of the U.S.-Australia FTA.

<sup>62</sup> See Annex 2A of the US- Singapore FTA; also see Annex 2A of the US-Morocco FTA.

control on the logs potentially infringes on the national treatment principle, the control by the United States on the export of logs is excluded from the national treatment provision. Another example of a U.S. exemption from the national treatment clause is the so called Jones Act.<sup>63</sup> The FTAs concluded by the United States expressly exempts from the national treatment imported vessels in commercial applications between points in national waters or the waters of an exclusive economic zone. Under GATT 1994, the U.S. provided the same exemption from GATT Article III by preserving the “grandfather” right in paragraph 3 of the preliminary notes to GATT 1994.

## 2. “MFN” Clause

The MFN clause of GATT Article I is seldom made part of an FTA. The MFN principle states in general that the imports from a party shall not be given less favorable treatment over any other imports from other countries. A bilateral FTA permits a WTO member to violate the GATT MFN clause because a country is giving a preferential tariff treatment to goods originating from an FTA partner. Therefore, the GATT MFN clause has no place in an FTA.

However, in FTAs where a significant portion of products are excluded from tariff elimination, an FTA non-discriminatory clause may be necessary to enable further tariff elimination in equivalent terms if the partner country later provides certain allowances to third parties in their future FTAs.<sup>64</sup> In other words, a party may want to receive the same benefit its counterpart affords to its future FTA partners. For example, the FTA between the EFTA States and Singapore provides: “If a Party concludes a preferential agreement with a non-Party under Article XXIV of the GATT 1994, it shall, upon request from another Party, afford adequate opportunity to negotiate any additional benefits granted therein.”<sup>65</sup> This provision enables a party to open tariff negotiations in order to receive the same benefits its counterpart grants to its future FTA partners.

The MFN clause in EFTA-Singapore FTA appears to reflect an asymmetric tariff concession in which EFTA states excluded some product lines from tariff elimination, while Singapore excluded no product lines from tariff elimination.<sup>66</sup> In conceding to an asymmetric tariff concession, Singapore reserved its right to renegotiate tariff concessions when EFTA states

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<sup>63</sup> The U.S. domestic law under the Merchant Marine Act of 1920 (46 App. U.S.C. 861, 889) permits only U.S. built and U.S. owned vessels with the U.S. flag to carry commercial cargo between points in national waters and Exclusive Economic Zones. As provided in paragraph 3 of GATT 1994, the U.S. Merchant Marine Act of 1920 would be exempted from the national treatment clause of GATT Article III. Similarly, the Merchant Marine Act of 1920 is exempted from the national treatment application in all FTAs the U.S. enters into.

<sup>64</sup> Article 2.11, para 3, Comprehensive Economic Cooperation Agreement between the Republic of India and the Republic of Singapore (CECA).

<sup>65</sup> Article 10, the EFTA-Singapore FTA at <http://secretariat.efta.int/Web/ExternalRelations/PartnerCountries/Singapore>

<sup>66</sup> See Annex 5, the EFTA-Singapore Free Trade Agreement.

grants more liberal tariff concessions to their future FTA partners.<sup>67</sup>

In the case of an FTA with more than two parties, a provision prohibiting discrimination between goods imported from FTA parties may serve a valid purpose of granting non-discriminatory tariff elimination concessions between the parties to the regional FTA. However, if parties wish to discriminate between the parties in a preferential trading agreement, a “regional MFN” provision will not be included in the FTA.<sup>68</sup>

Instead of providing an MFN clause applicable to all products, in the FTA between the United States and Morocco, a product specific MFN clause is provided. For beef and other agricultural products, in the event that Morocco grants any other trading partner in its future FTAs market access better than that granted to the United States under the FTA, Morocco is under obligation to grant the same treatment to the United States.<sup>69</sup>

### 3. Emergency Measures

#### Global Safeguards

Safeguard actions can be taken under most FTAs when import surges cause injury to a domestic industry producing a like product. If the injury results from imports from all countries including an FTA partner, an FTA usually permits employment of a “WTO safeguard measure” in pursuant to Article XIX of GATT 1994 and the Agreement on Safeguards that are incorporated into the FTA. This safeguard measure is usually called the “global safeguard” and is applied to imports from all countries regardless of the origin of the product. In some FTAs, such as the Australia-Singapore FTA, a global safeguard measure is explicitly disallowed between FTA partner countries.<sup>70</sup> The United States also did not apply global safeguard measures on imports from FTA partner countries.<sup>71</sup>

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<sup>67</sup> A similar MFN provision is provided in Article 2.11 of the CECA.

<sup>68</sup> Under NAFTA, Mexico’s tariff elimination schedule vis-à-vis imports from Canada is not the same as that from the United States for agricultural products such as dairy, poultry, egg, and sugar sectors. See Agriculture Fact Sheet, Tariff Elimination, [www.fas.usda.gov/itp/policy/nafta/tariff.html](http://www.fas.usda.gov/itp/policy/nafta/tariff.html).

<sup>69</sup> See para 3 (a), Annex 1, General Notes to the Tariff Schedule of Morocco, Annex IV, the U.S.-Morocco FTA.

<sup>70</sup> See Article 9, the Australia-Singapore Free Trade Agreement (Australia-Singapore FTA): “A Party shall not initiate or take any safeguard measures within the meaning of the WTO Agreement on Safeguards against the goods of the other Party from the date of entry into force of this Agreement.” The Australia-Singapore FTA, however, provides that a measure can be taken to safeguard a balance of payments and external financial difficulties. Ibid. Article 11.

<sup>71</sup> In a WTO panel dispute, Korea challenged a safeguard measure by the United States on imports of circular welded carbon quality line pipe on the grounds that it excluded NAFTA member countries from application of the safeguard measure in violation of GATT Article XIX and Article 2 of the Agreement on Safeguards. See WTO Panel Report, *United States-Definitive Safeguard Measures on imports of Circular Welded Carbon Quality Line Pipe from Korea*, adopted 8 March 2002, modified by Appellate Body Report, WT/DS202/AB/, DSR 2002:IV, 1473, paras 7.127-7.130. The panel found that GATT Article XXIV defense is available to the United States but the Appellate Body modified its finding by declaring that the panel’s finding is moot and has no legal effect. See WTO Appellate Body Report, *United States-Definitive Safeguard Measures on imports of Circular Welded Carbon Quality Line Pipe*

In determining the injury requirement under the “global safeguard” measure, the imports covered by preferential trading agreements should be excluded as a basis for a safeguard action because GATT Article XIX allows the imposition of a safeguard if the import surge is a result of GATT obligations.<sup>72</sup> An import surge as a result of tariff reduction from an FTA is not an import surge resulting from the GATT obligations. Therefore, the imports from FTA partners should be excluded from the injury determination of a global safeguard action.<sup>73</sup> Since the imports from FTA partner countries cannot be deemed to have caused injury to the domestic industry, they should be precluded from the application of global safeguard measures as well.

However, the exclusion of FTA partners from the application of global safeguard measures may appear to be inconsistent with Article 2.2 of the Agreement on Safeguards, which provides that “[s]afeguard measures shall be applied to a product being imported irrespective of its source.” Just as GATT Article XXIV justifies regional trading agreements that violate GATT provisions, inconsistency with the Agreement on Safeguards is arguably permitted. This argument is based on the view that a global safeguard measure is a restrictive regulation of commerce which needs to be eliminated in the formation of an FTA. Hence, excluding regional trading partners from a global safeguard measure is deemed as part of elimination of duties and other restrictive regulations of commerce with respect to substantially all trade between FTA partners, in accordance with the chapeau of Article XXIV:5 (a).<sup>74</sup>

### Bilateral Safeguards

In contrast to the global safeguard measure, bilateral safeguard mechanisms, provide for safeguard measures that can only be applied against goods imported from an FTA partner when, as a result of tariff reduction from the implementation of an FTA, the imports cause injury to a domestic industry. Since the cause of injury is the import surge from tariff reduction, a question is sometimes raised as to whether a safeguard measure can be applied once the tariff elimination is completed pursuant to the concession schedule of the agreement. To address this issue, some FTAs permit the application of a safeguard measure only during the transition period.<sup>75</sup> Having a transition period is logical since once the tariff elimination is completed, the import surge cannot be imputed to tariff elimination.

Unlike a global safeguard measure which could take the form of quantitative

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*from Korea*, adopted 8 March 2002, modified by Appellate Body Report, WT/DS202/AB/, DSR 2002:IV, 1403, para 263.

<sup>72</sup> See Joost Pauwelyn, “The Puzzle of WTO Safeguards and Regional Trade Agreements”, 7(1) JIEL, 2004, at 109-142.

<sup>73</sup> In practice, the injury determination of WTO safeguards investigations by a member of a regional trading agreement does not appear to clearly exclude imports from FTA partners.

<sup>74</sup> *Ibid.* 72 above.

<sup>75</sup> In the Canada-Costa Rica FTA, the transition period for staged tariff elimination is seven years for both Canada and Costa Rica.

restrictions including quotas for supplying countries<sup>76</sup>, a bilateral safeguard measure is usually in the form of the suspension of the tariff reduction or an increase in the tariff rate imposed on a good up to an applied MFN rate of duty in effect before the entry in force of the FTA.<sup>77</sup> In other words, the preferential tariff concession is suspended or the preference is retracted by applying an MFN tariff rate to an import instead of a preferential tariff rate.

Another important issue arises as to the whether an emergency safeguard measure can be applied to products originating from all FTA parties, or to products originating from a select number of parties under an FTA when there are multiple parties to an FTA. In FTAs with more than one party, whether safeguard measures can be applied selectively to countries within an FTA can be an issue. For this issue, no guidance can be provided by GATT Articles except that bilateral safeguard measures should not detract from the aim of eliminating tariffs in “substantially all” trade of products originating from FTA partners.

### Sectoral Safeguards

Some FTAs have separate safeguard measures for agricultural or textile products. These sector specific safeguard measures are generally similar to the bilateral safeguard measures but with some variations which can make it more or less difficult to invoke the safeguard measures. For example, in the U.S.-Bahrain FTA, bilateral safeguards applicable to textile and apparel goods require an investigating authority to examine relevant economic variables including output, productivity, and utilization of capacity, the same elements considered in the WTO safeguard measure, in determining serious damage or the possible threat of serious damage to the particular industry. However, it explicitly excludes from consideration changes in technology or consumer preference as factors supporting a determination of serious damage.<sup>78</sup>

For agricultural products, some FTAs adopt a priced-based safeguard measure. Under this safeguard measure, if the unit price of import is lower than a trigger level of price, a safeguard measure in the form of an additional duty can be imposed.<sup>79</sup> Similarly, under a quantity based safeguard measure, if the import volume of a good exceeds the trigger level volume, a safeguard measure can be imposed.<sup>80</sup> The quantity based safeguard measure is equivalent to a TRQ since a lower preferential tariff is applied to the quantity of imports below the threshold but a higher tariff is imposed on the imports above the threshold.

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<sup>76</sup> See Article 5, Agreement on Safeguards, Annex 1A, Multilateral Agreements on Trade in Goods, Marrakesh Agreement Establishing the World Trade Organization.

<sup>77</sup> See Article VI.2, Canada-Costa Rica FTA.

<sup>78</sup> See Article 3.1.2, Agreement between the Government of the United States of America and the Government of the Kingdom of Bahrain on the Establishment of a Free Trade Area (US-Bahrain FTA).

<sup>79</sup> In the United States-Morocco Free Trade Agreement (US-Morocco FTA), the difference in price between the import price and the trigger price must be greater than 10% to permit the imposition of a duty. See Article Annex 3-A, para 1, US-Morocco FTA.

<sup>80</sup> See the Schedule of Morocco, Annex 3A of the US-Morocco FTA.

## Antidumping

Most FTAs permit FTA partners to take anti-dumping actions in pursuant to Article VI of the GATT 1994 and the Agreement on Implementation of Article VI of GATT 1994. Unless there is variation in the administration of anti-dumping rules when applied to FTA partners, a separate provision for anti-dumping measures may not be provided for in FTAs.

However, some FTA parties seek variations in the administration of anti-dumping measures, in particular, in line with its efforts to amend anti-dumping rules in the WTO. In the Korea-Singapore FTA, parties prohibited “zeroing” by allowing both negative and positive dumping margins to be counted towards the weighted average.<sup>81</sup> In addition, parties required a “lesser duty” rule which mandates a dumping duty less than the dumping margin where such the lesser duty would be adequate to remove the injury to the domestic industry.<sup>82</sup>

In the EFTA-Singapore FTA, parties all together prohibited the application of anti-dumping measures between its FTA partners.<sup>83</sup> Instead of permitting anti-dumping measures, parties provided that measures to prevent dumping should be taken as provided under the section on competition policy, which required a consultation mechanism to eliminate anti-competitive practices of FTA partners.<sup>84</sup>

### 4. Counter Measures against Third Party Imports

Countries negotiating an FTA agreement take the risk that changing trading environments may undermine the improved market access gained from the preferential tariff treatment under an FTA. For example, low priced imports from a non-party may undermine the gains in the improved market access obtained through the FTA. In particular, subsidized agricultural exports from a non-party to the importing party’s market would impair the expected benefits of a preferential tariff treatment. To protect the expected benefit of the improved market access, in the recent FTAs concluded by the U.S., an agricultural export subsidies clause provides that:

[w]here an exporting Party considers that a non-party is exporting an agricultural good to the territory of the other Party with the benefit of export subsidies, the importing Party shall, on a written request of the exporting Party, consult with the exporting Party with a view to agreeing on specific measures that the importing Party may adopt to counter the effect of such subsidized imports.<sup>85</sup>

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<sup>81</sup> See Article 6.2, the Free Trade Agreement Between the Government of Republic of Korea and the Government of Republic of Singapore (Korea-Singapore FTA).

<sup>82</sup> Ibid, Article 6.2.3.

<sup>83</sup> See Article 16, the Free Trade Agreement between the EFTA States and Singapore (EFTA-Singapore FTA).

<sup>84</sup> Ibid.

<sup>85</sup> See Article 3.3 of U.S.-Australia FTA and Article 2.11 of the Agreement between the Government



The purpose of the provision is to enable FTA parties to cooperate in countering any impairment to the expected benefits from the FTA resulting from measures adopted by non-parties to the FTA.

Although ensuring against the risk posed by the subsidized import from a non-party makes an economic sense, the broad language of GATT Article XXIV does not permit an FTA where “duties and regulations” of commerce, in respect of trade with non-parties, is “higher or more restrictive” than those applicable prior to the formation of an FTA.<sup>86</sup> The available counter measure existing before the formation of an FTA is the countervailing duty measure investigated and applied in accordance with GATT Article VI: 6(b) and Article 11.6 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement). The SCM Agreement requires sufficient evidence of the existence of a subsidy, injury, and causal link to justify the initiation of an investigation. If the counter measure under an FTA is in any form other than a countervailing duty in accordance with the SCM Agreement, the provision would be inconsistent with GATT Article XXIV. Moreover, even if the countermeasure is a countervailing duty in accordance with GATT Article VI: 6(b) and Article 11.6 of the SCM Agreement, the measure should be applied by the party on its own accord without having a request and consultation from an FTA partner country.

Though the counter measure provision against subsidized imports from a third party is arguably a useful safeguard against the possible impairment of the expected benefits from improved export market access, the measure would be deemed in violation of GATT Article XXIV. A WTO panel may view the measure as a more restrictive regulation in respect of the trade of non-parties if a non-party brings a suit against FTA members for taking such a measure.

## **5. Other Measures to Further Trade Liberalization**

### **Prohibition of Export Taxes**

A party may use export taxes on raw materials to give an advantage to its domestic producers who process raw materials for exports.<sup>87</sup> The policy is intended to confer cost benefit to domestic producers who use the raw materials by suppressing the price of the raw materials in the domestic market. Because of the discriminatory effects on foreign producers using the raw materials, export taxes are usually prohibited in an FTA. In FTAs, in contrast to GATT, a separate provision is usually provided to prohibit export taxes.

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of the United States of America and the Government of the Sultanate of Oman on the Establishment of a Free Trade Area (US-Oman FTA).

<sup>86</sup> See Article XXIV: 5:(b) of the GATT 1994.

<sup>87</sup> For example, India maintains export taxes on hides, skins, and leathers, tanned and untanned. Export taxes constitute assistance to manufacturers of high value-added leather goods by depressing the domestic raw material prices of leather items. See WTO Trade Policy Review, India, Report by the Secretariat, WT/TPR/S/100.

Despite the trade restrictive effects of export taxes, export taxes are sometimes used to eliminate the differences in existing domestic tax levels on goods between geographically adjacent countries. Therefore, in some FTAs, an exception stipulates that export taxes will be allowed provided that the charge is adopted or maintained on any such good when destined for domestic consumption.<sup>88</sup> This exception would serve the purpose of allowing export taxes that do not result in the preferential treatment of domestic users of raw materials that are subject to export taxes.

### Prohibition of Duty Drawback

Some countries refund or reduce customs duties levied on imported materials when the materials are used in processing products that are subsequently exported. Duties are refunded on the ground that the materials are not used for domestic consumption. In some FTAs, however, the duty refund or “drawback” is prohibited when the materials are used for the production of goods that are subsequently exported to the territory of the other FTA party. In a notable exception, the duty drawback is permitted when the materials are originating materials from an FTA partner country.<sup>89</sup>

The prohibition of the duty drawback on materials imported from non-parties effectively provides an incentive to the producers of goods to use materials imported from an FTA partner country rather than non-parties. In other words, the prohibition on duty drawback promotes trade in materials between FTA partner countries.

Despite the positive effects of furthering trade between FTA partner countries, the provision on the prohibition of duty drawback is a suspect measure in view of GATT Article XXIV as it raises barriers to trade with non-parties. Higher effective duty is imposed on the imports of the materials from non-parties as the drawback of the duties is not permitted. Therefore, this measure would be deemed inconsistent with GATT Article XXIV because the prohibition of the duty drawback result in raising the duties maintained in respect of trade with non-parties after the formation of an FTA higher or more restrictive than corresponding duties prior to the formation of an FTA.<sup>90</sup>

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<sup>88</sup> Article III.10, the Canada-Costa Rica FTA

<sup>89</sup> Article 3.8, the U.S.-Chile FTA.

<sup>90</sup> See para 5 (b) of GATT Article XXIV.

## V. Conclusion

An FTA tariff elimination negotiation can be characterized as a process of reciprocal exchanges of market access benefits in which the benefit to a party is measured in terms of the foreign market liberalization, whereas the cost is measured in terms of the domestic market liberalization.<sup>91</sup> The outcome of FTA negotiations is often driven by the negotiators' and the public's perception based on this characterization. At the level of negotiators, for an FTA deal to succeed, the benefit of the improved access to its FTA partner's market should exceed the cost of conceding access to its own market to an FTA partner.<sup>92</sup>

The above observation is in conformity with the view that an FTA is a contract in which a preferential treatment for exports is promised in exchange for a preferential treatment of the imports from an FTA partner country.<sup>93</sup> Countries pursue FTAs in order to reduce tariff levels for their exports in the partner country's market in exchange for granting market access or other benefits to the imports from its FTA partner in their domestic markets.<sup>94</sup> This is perhaps why, in some FTAs, an unambiguous reciprocity principle is explicitly provided.<sup>95</sup> In addition to the provisions enabling reciprocal tariff exchanges, the review of the trade in goods section of FTAs reveals that FTAs are intended to ensure that the expectation of improved market access in the FTA partner country's market is not undermined by actions of the FTA partner or third parties.

The "mercantilist" nature of FTA negotiations and the resulting FTA do not bode well for the world trading system. For a trading nation which participates in the web of FTA negotiations, the multilateral GATT tariff negotiations would be seen as undermining the

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<sup>91</sup> This reciprocity notion should be distinguished from the reciprocity principle which is proposed by some trade theorist as the underpinning principle of the multilateral GATT system. See Kyle Bagwell & Rober W. Staiger, 'An Economic Theory of GATT', 89(1), *American Economic Review*, March, 1999, at 215-248.

<sup>92</sup> Though it is conceivable that reciprocal market access trade-offs could be made with benefits and costs in other sectors, including trade in services, the task would be hampered by how a party measures its benefits and costs in sectors other than a trade in goods and how it converts them into the benefits and costs in trade in goods.

<sup>93</sup> The classical trade theory in economics posits that the economic benefits are also obtained through unilateral tariff eliminations. However, a unilateral tariff reduction given preferentially to a WTO member country would be inconsistent with the MFN principle as expressed in GATT Article I unless a waiver from GATT MFN called "Generalized System of Preferences (GSP)" is permitted under the Enabling Clause in which developed countries grant unilaterally preferential tariff treatment to developing countries.

<sup>94</sup> A noted international trade theorist observed that "[a]nyone who has tried to make sense of international trade negotiations eventually realizes that they can only be understood by realizing that they are a game scored according to mercantilist rules, in which an increase in exports - no matter how expensive to produce in terms of other opportunities foregone - is a victory, and an increase in imports - no matter how many resources it releases for other uses - is a defeat." See P. Krugman, 'What Should Trade Negotiators Negotiate About?', *Journal of Economic Literature*, XXXV (March), 113-20.

<sup>95</sup> For the discussion of GATT reciprocity principle, see Anwarul Hoda, *Tariff Negotiations and Renegotiations under the GATT and the WTO, Procedures and Practices*, Cambridge University Press, 2001, at 8-9.

benefits of preferential and exclusionary access to FTA partners' markets. As FTAs become more "entrenched", countries fully benefiting from existing FTAs would see less merit in negotiating a multilateral tariff elimination agreement. An amendment of GATT Article XXIV should be seriously considered before the vested interests created by proliferating FTAs further diminishes the possibility of reviving a multilateral tariff reduction round.