Negotiating free-trade agreements: a guide

Australian Government

Department of Foreign Affairs and Trade

3. The multilateral rules for free-trade agreements

Negotiating a free-trade agreement that satisfies all the rules

Free-trade agreements have to meet not only the WTO rules and disciplines and the APEC principles and goals. They may also have to satisfy many other international requirements contained in multilateral conventions.

A superficial examination of free-trade agreements, both concluded and proposed, might suggest that there is much uniformity among them. A closer inspection shows, however, that superficial resemblances can hide deep differences in approach and ambition. In this chapter we therefore explore the rules under which free-trade are concluded.

The internationally-agreed rules for the content of free-trade agreements fall mainly under the purview of the World Trade Organization (WTO). At first glance they seem to be surprisingly simple. On a closer inspection, however, it turns out that some of these provisions are quite difficult to interpret in precise legal terms. This can lead to quite unprofitable discussions. One thing worth remembering in such situations is that a free-trade agreement is an instrument designed to liberalise trade between the parties. It is not an instrument for managing their trade or isolating sensitive sectors.

The rules for trade in goods can be found in Article XXIV of the *General Agreement on Tariffs and Trade* (GATT) and the rules for services in Article V of the *General Agreement on Trade in Services* (GATS). The text of these articles is reproduced in appendixes 1 and 3, respectively. Appendix 2 contains the Uruguay Round *Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994* which gives greater precision to some of the provisions in Article XXIV.

Developing economies can also negotiate preferential trade arrangements among themselves under the more flexible provisions of the *Enabling Clause*. This option is not available when developing economies negotiate free-trade agreements with developed economies. The point of all of these provisions (GATT Article XXIV, GATS Article V and the Enabling Clause) is that they permit departures from the non-discriminatory rules of the WTO.

The parties to a free-trade agreement can in fact determine to a considerable extent themselves what the content of the agreement should be, as long as the outcome is in conformity with the WTO rules.

This is a good place for reminding oneself that all the rights and obligations making up a free-trade agreement apply equally to the parties and their traders, unless a specific exemption or derogation has been drafted. A rule denying exporters of the other party a right

denies the same right to the exporters of one's own party. Restrictions, as much as liberalisation, apply both ways.

Free-trade areas for goods

Article XXIV of the GATT 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 on substantially all the trade between the constituent territories in products originating in such territories.

The concepts used in this definition are of differing levels of clarity. The concept of a "customs territory" is, of course, not controversial. The GATT defines it as "any territory with respect to which separate tariffs or other regulations of commerce are maintained for a substantial part of the trade of such territory with other territories". Within APEC the extent of a customs territory coincides with the territory of a member economy. The meaning of "duties" also is quite clear. Duties are the charges levied by customs authorities at the border when the good is imported. In other words, this is the tariff.

Box 3.1: Creating a free-trade area for goods: the procedural steps under GATT Article XXIV

The steps required under the GATT for the conclusion of a free-trade agreement can be summarised as follows:

- creation of a free-trade area consisting of two or more customs territories
- creation of a mechanism in the form of rules of origin for deciding what goods will be considered by the participating customs territories as products originating in the other participating customs territories
- eliminate duties and other restrictive regulations of commerce on substantially all the trade in goods deemed to be originating products
- ensure that in performing the above steps barriers against third parties are not increased
- notify the WTO promptly of any decision to enter into a free-trade agreement.

The concepts of "other restrictive regulations of commerce" and "substantially all the trade" are more difficult. They remain largely undefined in formal terms. Numerous debates and proposals in the WTO have not brought the international community much closer to a common understanding of them. The following brief discussion indicates some of the difficulties.

What is meant by "substantially all the trade"?

We can take it that everyone agrees that "substantially all the trade" does not mean "all the trade". We can also say confidently

that over the five decades since the conclusion of the first free-trade agreements in the 1950s and the negotiation of agreements now the gap between "substantially all" and "all" has narrowed considerably. Economies are now much more aware of the benefits of trade liberalisation, and on the whole they have become more ambitious.

Coverage of about 70% of trade would have seemed reasonable to many in the 1960s. Today a widely accepted view is that an agreement covering less 90% of trade is flawed. There is less agreement, however, on how this should be calculated. To consider existing trade only would be flawed since high tariffs or stringent tariff rate quotas are certain to restrict trade. A better measure would therefore be the amount of potential trade, but this raises other methodological difficulties. Some have suggested that a calculation of "substantially all the trade" should consider not only trade flows but also the number of tariff lines involved. Certainly, a criterion consisting of actual trade and the tariff lines involved would take us a long way towards a more objective standard.

A solution to this question will not be easy to find. Negotiators of free-trade agreements should bear in mind, however, that the benefits of an agreement will be maximised through the greatest possible coverage of trade in goods.

The trend towards a more ambitious interpretation of comprehensiveness is also shown, for example, in the *Understanding of the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994* which is part of the Uruguay Round outcomes. In this instrument WTO members agreed that the contribution of free-trade agreements to the expansion of world trade through closer economic integration would be "diminished if any major sector of trade is excluded". Observance of this Understanding will assist a larger coverage of trade by an agreement. The APEC best-practice principles, listed in Chapter 2, also seek to promote comprehensiveness.

The question of the ambit of "other restrictive regulations of commerce" also remains unresolved. Analysing their ambit would take us well into considering the rationale for non-tariff measures and a discussion of the distinction between non-tariff measures and non-tariff barriers. Such a discussion would have to recognise, *inter alia*, that without a system of predictable rules, many of them expressed in the form of non-tariff measures, international trade would be much more difficult to conduct. The outlook for a convergence of views on the interpretation of "other restrictive regulations of commerce" is at this stage unclear. This, however, is not the place for entering into a debate about the meaning of these concepts. The proper forum for doing so is the WTO.

In any case, free-trade negotiators usually have to honour quite strict time limits to complete the text of an agreement, and there are indications that the multilateral debate on these issues has some way to go. For the time being, therefore negotiators have no choice but to be as ambitious in defining the boundaries of these disputed concepts as conditions in the partner economies permit.

The meaning of Article XXIV in relation to tariffs is clear. It speaks of their elimination. It does not mention "reduction" or other words that would imply end points somewhere between the current tariff and a zero tariff. Article XXIV also accepts that in some cases immediate elimination of tariffs is not possible, and that a phase-out timetable may be required.

Article XXIV:6 must also be borne in mind. It provides the basis for requests for compensation by third parties if the parties to a preferential trade agreement raise some of their tariffs towards non-parties as part of their negotiation. This is more likely to be the case when a customs union is formed or enlarged because the parties need to harmonise their tariffs towards non-members. (Chapter 1 contains a brief description of a customs union). If, for example, the members decide to use the highest tariff applied by any of them as the basis of the harmonisation, this will increase the tariff towards third parties. If the third parties decide to seek compensation, the result will be a further set of negotiations under the WTO rules.

The final concept in Article XXIV is that tariffs only have to be eliminated in respect of goods originating in the customs territories making up the free-trade areas. In other words, rules of origin have to be drafted to enable the easy identification of such goods. The issues relating to preferential rules of origin are now well understood. Negotiating them can of course be quite challenging. Also, disagreements may arise later they have to be interpreted.

Interim agreements

GATT Article XXIV mentions the possibility of concluding interim agreements leading to free-trade areas or customs unions. It does not specify what the contents of an interim agreement might be beyond noting that any such agreement must include a plan and schedule for the formation of a free-trade area or a customs union within a reasonable time and that it must be notified to the WTO.

In a strict sense every free-trade agreement under which tariffs are eliminated over several years is an interim agreement. Also, some economies prefer to start with concluding a framework agreement setting out in detail the objectives and disciplines of the prospective free-trade agreement. They then conduct tariff, services and investment negotiations once the framework agreement is in force. Such a framework agreement could also be considered an interim agreement.

Chapter 4 covers some negotiating issues related to trade in goods, and Chapter 5 deals with rules of origin in more detail.

The Enabling Clause

The *Enabling Clause*, formally the *Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries*, was adopted by the members of the GATT (General Agreement on Tariffs and Trade) on 28 November 1979 as part of the Tokyo Round outcomes.

The Enabling Clause enables developed countries to accord more favourable treatment to developing countries without according such treatment to other countries. It is therefore, as already noted, a departure from Article I of the GATT (General Most-Favoured-Nation Treatment). The Enabling Clause applies, among other areas, to preferential trade arrangements between developing countries. It enables them to be more flexible in terms of sectors covered and tariff elimination or reduction than would be possible for agreements between developed countries. For example, they can enter into partial-scope agreements which cover some sectors only.

Some argue that the Enabling Clause applies to free-trade agreements developing economies are negotiating with developed countries. This is not the case. The Enabling Clause only refers to preferential arrangements between developing countries. It is silent on the question of a mixed membership. The Enabling Clause, however, refers to trade negotiations more generally where developing countries are not expected to match the commitments made by developed countries, but the context makes it clear that this means to multilateral negotiations.

Box 3.2: The Enabling Clause: application to free-trade agreements

The relevant parts of the Enabling Clause read as follows:

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

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

. . .

(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.

The result of free-trade negotiations must always be the elimination of tariffs, either on entry into force of the agreement or in stages. How this is done depends on the views of the negotiating parties. It is usually possible to reach agreement on phasing where this is necessary. In any case, few developed countries would ever expect exact reciprocity in their negotiations with developing countries.

One more point to consider is that free-trade agreements with developing and developed economy members will be examined by the WTO Committee on Regional Trade Agreements (CRTA) under the rules of GATT Article XXIV. Developed economies are therefore required to show that their agreements meet these standards. Agreements between developing countries are examined in the Committee on Trade and Development under the more lenient

standards of the Enabling Clause.

Free-trade in services

The WTO rules for creating free-trade agreements for services are listed in Article V of the GATS where they are called *economic integration agreements*, (see Appendix 3 for the complete text of this Article). They follow the pattern developed for trade in goods, but with important differences. One of the most important is that there is no mention of eliminating regulatory measures altogether. In other words, this Article also recognises that governments have the right to regulate their economies. Instead, Article V requires the elimination of existing discriminatory measures and a prohibition of new or more discriminatory ones. Since measures governing trade in services are usually expressed in the form of laws, regulations, etc., Article V can be satisfied by the removal of discriminatory treatment of foreign suppliers. That is, national treatment is required. But the regulation itself could remain. This is often overlooked by those commenting on the impact of free-trade agreements on the ability of governments to regulate their economies.

Article V also requires that a free-trade agreement has substantial sectoral coverage, expressed in terms of numbers of sectors, volume of trade affected and modes of supply (i.e. the way services are delivered). As in the case of "substantially all the trade" in the goods sector, "substantial sectoral coverage" in the services sector is not defined exactly. A footnote to Article V specifies, however, that "substantial sectoral coverage" is to be understood in terms of number of sectors, volume of trade affected and modes of supply. It adds that agreements, if they are to meet this condition, should not provide for the exclusion *a priori* of any mode of supply. (Chapter 7 contains a description of the modes of supply as defined under the GATS.)

One WTO condition for free-trade agreements in services is that they may not result in a higher overall incidence of barriers towards non-members. This is more likely to occur in the case of an economic union because of the concurrent harmonisation of some regulations among members of the union and a similar harmonisation of some regulations aimed at governing the entry of foreign service suppliers and their services. If significant changes occur, WTO members affected by them may seek compensation or even withdraw some of their MFN commitments. This would then lead to another set of negotiations, but this time in the WTO.

Box 3.3: Free-trade agreements in services: the WTO requirements

WTO members may enter into an agreement to liberalise trade in services through a free-trade agreement if the agreement:

- has substantial sectoral coverage, expressed in terms of numbers of sectors, volume of trade affected and modes of supply;

- eliminates or eliminates substantially discrimination in national treatment in the sectors covered and/or
- prohibits new or more discriminatory measures in these sectors; and
- does not raise barriers against non-members.
- A timetable can be established for eliminating discrimination.
- Measures concerning payments and transfers, safeguarding the balance of payments, general exceptions and security exceptions may be maintained.

Members of a free-trade area in services conforming with the requirements of GATS Article V are entitled to discriminate against services and suppliers of services from non-member economies, but there is one important exception. A service supplier from a third country incorporated in one of the parties to the free-trade agreement will also enjoy preferential treatment within the free-trade area as long as it engages in substantive operations within the territory of the parties. If the agreement involves developing countries only, they may continue to give better treatment to firms owned or controlled by their own nationals.

Finally, WTO member countries concluding free-trade agreements in services must notify these agreements, enlargements of them or significant changes to them to the WTO Council for Trade in Services. The Council then examines these notifications for their conformity with the WTO rules. This is a rigorous process which requires extensive preparatory work.

Box 3.4: GATS Article V: developing-country provisions

The GATS provisions for developing countries participating in free-trade areas are more lenient than those for developed countries:

- when developing countries enter into agreements with developed countries, they have more flexibility in terms of substantial coverage and the extent to which they must eliminate discriminatory measures; and
- agreements consisting entirely of developing countries may grant more favourable treatment to firms owned or controlled by natural persons from the parties.

Chapter 7 deals in more detail with some of the negotiating issues that arise in the case of services.

Investment

It is becoming increasingly clear that, as tariff barriers are lowered or eliminated, the importance of foreign investment as a driver of economic integration is growing. Indeed, under some free-trade agreements the promotion of increased investment flows now outweighs the prospective gains from tariff elimination.

Many agreements contain chapters on investment. Most of

these cover both liberalisation of investment regimes and the promotion and protection of investments. There are not as yet any multilaterally-agreed rules on investment. This means that economies have considerable freedom in designing these chapters. Nevertheless, as in the case of services, agreements normally seek to eliminate discrimination between foreign and domestic investors.

In addition, many other common features have emerged. This is particularly the case with rules relating to investment promotion and protection. The text of such agreements in many respects is close to standardised. Accordingly, this part of an investment chapter should not be all that hard to negotiate.

The difficulties increase considerably, however, in the case of liberalisation of investment rules. Economies have not yet developed concepts of sufficiently general application for this purpose.

Chapter 8 deals in more detail with the contents of investment chapters.

Notifying the agreement to the WTO

We have mentioned that WTO members negotiating free-trade agreements or customs unions must notify these agreements to the WTO where they are examined by the Committee on Regional Trade Agreements (CRTA). The aim of this examination is to promote high-quality free-trade agreements that are fully consistent with the WTO rules and disciplines.

These examinations are quite rigorous. It is usual to lodge an explanation of the legal text together with the text. Members then examine the agreement and submit written questions. The partners to the free-trade agreements are expected to treat these questions seriously and to answer them to the best of their ability. At the meeting itself, the answers to the written questions frequently lead to oral follow-up questions. Members of negotiating teams are likely to become involved in the examination also.

Box 3.5: The WTO Committee on Regional Trade Agreements

The WTO Committee on Regional Trade Agreements (CRTA) was established to ensure that preferential trade agreements concluded by WTO members meet the criteria established by the WTO. Its terms of reference are:

- to carry out examinations of bilateral and regional preferential trade agreements and report on them;
- to consider how the required reporting on the operation of the regional agreements should be carried out;
- the develop procedures to facilitate and improve the examination process; and
- to consider the systemic implications of regional agreements for the multilateral trading system.