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– GATT Article XXIV”

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A. Introduction: Motivation and Research Question

‘Regional trade agreements, in tandem with multilateral liberalization, can also help countries (...) build on their comparative advantages, sharpen the efficiency of their industries, and act as a springboard to integration into the world economy. They can also help focus and strengthen their political commitment to an open economy. Regionalism can be a powerful compliment to the multilateral system, but it cannot be a substitute. The multilateral trading system was created after the Second World War precisely to prevent the dominance of rival trading blocks. The resurgence of regionalism today risks signalling a failure of global economic cooperation and a weakening of support for multilateralism. It threatens the primacy of the WTO, and foreshadows a world of greater fragmentation, conflict, and marginalization.’

Supachai Panichpakdi, November 26th, 2002.¹

In the speech delivered by one of the most internationally prominent compatiots of mine, one year after the Doha Ministerial Declaration (2001) and during the preparation of the Cancùn Ministerial by, the then Director General pointed the complicate relationship between preferential trade agreements, often termed and interchangeably used as regional trade agreements, regional trade arrangements or (economic) regionalism, and the WTO multilateral trade regime. Clearly, in the perception of its Director General and of many policy makers and academics, the WTO has or should have the primacy in shaping international commerce through its quasi-universally accepted legal rules and as rule-making forum for every member. However, the world trade feature in the recent year has been speaking a different language. Not only there exists a complex network of preferential trade agreements as subsystems coexistent to the WTO multilateral regime. Preferential trade agreements are increasingly dominating world trade in terms of trade volume, the preference and attention given by countries as promising international trade policy option and regarding the setting of new trade topics and norms innovation. Whereas the Doha Negotiations have experienced setbacks, preferential trade agreements proliferate dynamically and have become a potential threat to the welfare of WTO member countries and the the multilateral trade community as a whole. The Article XXIV of the

¹ Director General of the World Trade Organisation (2002-2005), speech titled ‘Why Cancùn Matters’, delivered at the Second International Conference on Globalisation, Leuven, Belgium, http://www.wto.org/english/news_e/sppl_e/sppl67_e.htm, retrieved on 1 September 2009.

General Agreement on Tariffs and Trade, the WTO regulation of preferential trade agreements, being drafted in 1947, probably did not foresee such a proliferation, all the more it is interesting to question whether nowadays the Article effectively fulfils the function of enhancing global welfare by shielding WTO members from possible welfare loss and ensuring positive welfare effects of preferential trade agreements on the whole WTO trade community. This questions has been answered by means of international trade theories and public international law studies. The Article being an (a public international legal) institution, it is definitely a law-and-economic question. However...

‘The economic analysis rarely has delved into the origin of (public international) legal rules, the interpretation of legal doctrine, or the consequences of particular legal regimes. Although there are exceptions to this pattern (...), those have not been a large portion of writings about international economic activity or relative paucity or about international law. The relative paucity of economic analysis of international law issues is especially striking when compared with the proliferation of law-and-economics writings in other legal fields.’

Ronald A. Cass.²

Indeed approaches in law and economics have been applied in many fields: contract law, tort law, other branches of civil law, criminal law, constitutional law, public administration, criminal and administrative procedure, etc. but not so in public international law. The question that arises is, if law and economics can deal in domestic context with individuals as rational actors, what are the perspective of and obstacles to law and economics application in analysing public international regime. Action patterns of rational states, constrained by limited resource, in anarchical structure on interantional politics is comparable with economic decisions of rational individuals subject to certain constraints, and, indeed, state conduct of international relations can be explained with intra-state cost-benefit analysis. Foreign policy decision-making necessarily takes into account possible consequences such as repisals, sanctions of international community or particular countries, effects on alliances or cooperation, legal consequences and, not least, effects on prestige. Particular characteristics of public international law may necessitate some changes in the application of law and economics

² Cass, Ronald A. (1996), Economics and International Law, in Bhandari, Jagdeep S., and Alan O. Sykes (ed.), *Economic Dimensions of International Law: Comparative and Empirical Perspectives*, London: Routledge (hereinafter Cass), p. 3.

in its analysis. It should, however, not render this efforts impossible, even less in the trade-related issues where quantifiable factors are predominant in state decision-making such as in the WTO regulation of preferential trade agreements.

Based on the motivations, the main research question of the thesis is whether the GATT Article XXIV fulfil its mission of enhancing efficiency to the global world trade in which the WTO multilateral trade regime with MFN and PTAs coexists. In order to answer this question, it is necessary to demonstrate the prospect of economic analysis of public international law.

B. Methodology and structure of the thesis

The task of the thesis is to discuss the global welfare in the world trade system with both the multilateral regime of the WTO and preferential trade agreements between the situation with the GATT Article XXIV in place and the situation where the WTO regulations do not contain the Article. It is therefore in some ways a comparison of welfare situation under different institutions. Although law and economics usually involves the task of institution comparison, the situation in which the WTO regulations omit the Article does in fact not exist. Consequently, the thesis will explore the channels through which preferential trade agreements can adversely affect the global welfare situation and subsequently discuss whether the Article has contributed to lifting these channels so as to improve the welfare. In other words, the thesis will look at state behaviour permitted by the institution: the rules, its interpretation and application, whether this lead to an improvement in global trade efficiency compared with when states are free to conduct trade policy relating to preferential trade agreements only subject to the rest of the WTO rule.

In doing so, the thesis does not intend to present quantitative welfare analysis of the institution. Nor will it be able to consider all relating aspects and factors in a comprehensive manner. Due to specific characteristics of public international law, multitude of actors and their motivation, and the complexity of the WTO rules, this is virtually impracticable in the analysis of such a regime. The thesis instead applies heuristic approach to move forward to the solution, whereby significant components and elements necessary for the analysis will be presented and discussed with the aim of being able to draw a plausible conclusion of the main question.

As regards the procedural method of the thesis, first, Section C will sensitize the readers to the extent of and the role preferential trade agreements play in international trade. In order to understand its efficiency, the Article needs to be understood. The next section D therefore presents the Article, its place within the WTO trade regime, its interpretation and application by the WTO Dispute Settlement Bodies, as well as its effectiveness from the point of view of public international law. The following section E presents briefly the fundamentals of law and economic and main characteristics of public international law, and concludes with the discussion about their

implications on the application of law and economics. Section F will fit the WTO and in particular the Article into the law and economic framework by discussing the components and elements that are necessary in law and economics application in the context of the GATT Article. These include transaction costs and elements of state's welfare function. The more detailed section G shows how, through which channels and under which circumstances preferential trade agreements affect states and global welfare. Section H analyses the findings in section D in connection with those from section G, thereby focusing on the law and economics rationale for the provisions in the article, state behaviour as consequence of the Article application, the welfare effects of the behaviour, as well as rule improving recommendation. The section will ultimately answer whether and how the Article indeed fulfils (or not) its efficiency-enhancing role. The final section I concludes the thesis by summarizing and linking the findings in all the sections.

C. WTO and preferential trade agreements in international economic relations

1. World trade feature

The international economic relation nowadays is characterised by the ever growing volume and value of economic transactions, wherein international trade has been playing the most important role in terms of economic production factors involved. World trade volume has been steadily growing in world history and reached its all-time high in 2008 before the financial and economic crisis in 2009. In 2008, the value of world trade in merchandise and services amounted to US\$ 34 trillion,³ compared with the 2007 world real GDP of US\$ 61 trillion.⁴ The growth rate of international trade volume has a strong positive correlation with the world real GDP growth and has comparatively been constantly more amplified: in the period between 1950-2007, the former increased by 6.2% annually, the latter 3.8%. Not only has the global trade volume increased in this period. The structure of world trade in terms of traded objects and trading nations has changed. Trade in services increases dramatically in the recent decades, unlike trade in agriculture and fuel. In 1953, the two main sources of international trade, the European and North American countries accounted for 60% of total global merchandise trade volume. By 2006, developing countries notably the so-called emerging countries not only have a significant shares in world trade: China 9%, newly industrialised Asian economies⁵ 9%, Russian Federation 3%, they also account for a larger share of industrial goods. Between 1990-2005 their trade volume rose by 9.3% annually, compare with the global growth rate of trade volume of 5.8%. Generally, international trade has become more diversified for each country in terms of traded goods and services and in term of trade destinations.⁶ This unprecedented rise of living standard expressed in national income and of global trade volume is accompanied by gradual liberalisation of international trade at global level through reciprocal

³ World Trade Organisation (2008), *World Trade Report 2008*, Geneva: World Trade Organisation (hereinafter WTR 08), p. 11.

⁴ International Monetary Fund (2007), *World Economic Outlook, October 2007: Globalization and Inequality*, Washington: International Monetary Fund, p. 169.

⁵ Chinese Taipei, Singapore, Hong Kong, Republic of Korea (South Korea), Singapore, Malaysia and Thailand.

⁶ WTR 08, pp. 12-19.

reduction of trade barriers and the establishment of fundamental principles to ensure more equitable and freer exchange: the establishment of GATT/WTO multilateral trade regime. This rise is arguable also spurred by the recent phenomenon of preferential trade agreements.

2. WTO multilateralism

Multilateralism is commonly understood as an expression referring to an action of groups of international actors, usually states acting in concert. Multilateral global governance establishes binding rules and procedures for the action and universally accepted global institution to govern the rules and procedures without evolving into a world government⁷ WTO multilateral trade regime involves two main features: the principle of non-discrimination between larger and smaller trading nations, which rules out the aggressive use of power by the strong to extract concessions from the weak and to force the latter to accept unfair rules, and the continuous exchange of reciprocal concessions in order to move towards free trade.⁸ The establishment of the WTO and its binding dispute settlement mechanisms are an important step towards global economic governance and the main contributor to the current world trade pattern, which is characterised by the mutually enforcing increased of trade volume, lower average tariff rates and quantitative barriers to trade, and economic development.

Being formally established in 1995, the WTO has its foundation in the GATT, and the latter remains the integrating part of the WTO. The GATT negotiations were organized in rounds, beginning with the Geneva Round in 1947 with 23 member countries. In the last GATT negotiations round prior to the advent of the WTO, the Uruguay round, more than 120 countries participated. More and more developing countries and countries in economic transition join the WTO.

The WTO is the main venue for tariffs reduction negotiations. Between the opening of the first round of multilateral liberalisation in Geneva in 1947 and the

⁷ Wilkinson, Rorden (2000), *Multilateralism and the World Trade Organisation*, New York: Routledge, (hereinafter Wilkinson), pp.32-4.

⁸ Bhagwati, Jagdish (1990), 'Departure from Multilateralism: Regionalism and Aggressive Unilateralism', *Economic Journal*, 100, p. 1304.

closure of the Tokyo round in 1979, the average world tariffs declined by nearly 70%.⁹ Since the end of the Uruguay round of negotiations (1983-1995), the average tariff rate of the largest trading nations accounting for more than 85% of the world trade have gradually decline. The average tariff rates for import of non-agricultural and non-fuel goods has decreased by more than 60% in the period. The US tariffs, for instance, dropped from 5.9% in 1992 to 3.5% in 2006, the EC from 6.8% to 3.9%, Japan from 3.7% to 2.4%, China from 42.2% to 9.1% and India from 59.1% to 15.3%.

Since Kennedy (1962-67) and Tokyo (1970-1983) round, negotiation have been extended to other trade sectors such as agriculture and trade in services, as well as non-tariff, non-quantitative barriers and other forms of protectionism that government continually invented.¹⁰ Therefore the GATT and later the WTO multilateral trade regime has evolved with the new development of trade issues in the parallel manner, such that other trade restrictions and other sectors have gradually been covered, for instance, subsidies, the protection of intellectual property, standards and regulations, rules of origin, technical barriers to trade, safeguards, trade in services, agriculture, and textile. The WTO has been strengthened institutionally compared with the GATT: policy review mechanism, consultation procedures, good offices, conciliation and mediation, arbitration and, most importantly, adjudication by dispute settlement bodies (the Panel and the Appellate Body). Further, since the Doha Negotiation round (2001-), trade and development issues, such as aid for trade, building trade capacity, trade and the least developed countries, have been given a priority. The Doha round also deals with new and complex issues such as market access for agriculture, intellectual property rights and textile, and have experiences several setbacks due to the controversial natures of the issues.

Disappointed by a lack of progress at the GATT/WTO negotiations, many countries, both developed and developing countries decided to pay more attention to conclude preferential trade agreements. With the gaining dynamic of 'Regionalism', preferential trade agreement are not just an option of economic diplomacy, but also a necessity. Especially with the gradual integration and expansion of the European Community, other developed countries, fearing that their access to world market and

⁹ De Melo, Jaime and Arvind Panagariya (ed.) (1993), *New Dimensions in Regional Integration*, Princeton, New York: Cambridge University Press (hereinafter De Melo), p. 3

¹⁰ Landau, Alice (2005), *The International Trading System*, New York: Routledge, pp.11-3.

their competitiveness could be threatened, began to turn to preferential trade agreements. Developing countries in turn out follow the suite of the same concern. This development makes preferential trade agreements one of the, if not ‘the’, determinant factor of the world trade.

3. Preferential trade agreements’ extent and role in international economy

The more ‘popular’ term ‘regional trade agreement’ is interchangeably used instead of ‘preferential trade agreement’, which can be defined as ‘an agreement under which partner economies impose lower tariffs and other trade restrictions on import from each other than on import from the outside world.’¹¹ As in the WTO context, the former may be agreements concluded between countries not necessarily belonging to the same geographical region, the latter term will be used in this thesis. A preferential trade agreement that foresees the elimination of tariffs and other trade restrictions among members can be called free-trade area. A free-trade area whose members impose common tariff rates and trade restrictive measures on import from third countries is called customs union. The feature of further economic integration (single market and economic union) are similar to customs union regarding their trade policy towards third countries and thus likewise customs union in the WTO context.

Since the creation of the WTO in 1995, the number of preferential trade agreements has dramatically increased, especially in the last few years. As of November 2009, there were 263 preferential trade agreements notified to the WTO and in force, most of them agreements on trades in goods.¹² Some regions are particularly actively in involving in negotiating new agreements. With the exception of Mongolia, all other WTO members are party to at least one preferential trade agreement.¹³ The spread of preferential trade agreements is a long progress parallel to multilateral negotiations. The first wave of preferential trade agreement proliferation came during the early 1960s in Europe with the European Common Market and also in Africa and Latin America. The

¹¹ De Melo, p. 160.

¹² WTO database, Internet: <http://rtais.wto.org/UI/publicsummarytable.aspx>, retrieved on 1 November 2009.

¹³ World Trade Organisation (2007), *World Trade Report 2007*, Geneva: World Trade Organisation (hereinafter WTR 07), p. 304.

first wave was interrupted during the economic crises in the 1970s and the early 1980s, and was followed by the second wave led by the United States (Northern American Free Trade Area - NAFTA), European Community (EC), ASEAN Free Trade Area (AFTA), South America (MERCOSUR) and several other cross-regional bilateral preferential trade agreement.¹⁴ The first south-south and north-south preferential trade agreements emerges in this period.¹⁵ Following the Asian financial crisis in 1998 and the increase of China's economic power, the third wave of preferential trade agreement proliferation can be observed in Asia-Pacific region¹⁶, where the countries until today remain the most active in concluding preferential trade agreement. Facing the slow progress made in the Doha round, many developing countries have opted to open up for bilateral trade agreement among themselves and with developed countries, increasingly cross-regional. The existing preferential trade agreements have experienced a consolidation in terms of deepening integration.¹⁷

Nowadays, the European Economic Area consisting of EC members and Iceland, Norway and Liechtenstein is globally the largest customs union in terms of trade volume. There are also many free-trade agreements between the EC and Eastern European and Mediterranean nations. In the western Hemisphere, the NAFTA (Canada, the US and Mexico), MERCOSUR (Brazil, Uruguay, Argentina, Paraguay and Venezuela) and the Andean Community (Peru, Bolivia, Colombia and Ecuador) dominates the trade volume, while some countries, such as Chile, Mexico, Peru, are particularly active in entering into free trade agreements with other extra-regional countries. In East Asia and Pacific region, all countries in the region engage in at least one negotiation, either as member of a regional trade agreement like AFTA or as individual country, the most active being South Korea, Japan, China, Singapore, Australia and Thailand. The East Asian Economic Community comprising of AFTA, Japan, South Korea and China, once realized, would become one of the largest customs union worldwide. South Asian countries are implementing the South Asian Free Trade Area (SAFTA), and its driving force, India and Pakistan, started bilateral and

¹⁴ De Melo, p.5.

¹⁵ Fiorentino, Robert V. et al. (2006), *Changing Landscape of Regional Trade Agreements: 2006 Updates*, Geneva: World Trade Organisation (hereinafter Fiorentino), p. 2.

¹⁶ Richard (2006), Is Regionalism an Increasing Feature of the World Economy?, IIIS Discussion paper 164, pp. 2-4. Internet: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=925802, retrieved in 13 August 2009.

¹⁷ Fiorentino, p. 6-10

plurilateral preferential trade negotiations with mainly Asian countries but also with MERCOSUR and the EC. In North Africa and the Middle East, the customs union of the Gulf Cooperation Council (GCC) is one of the most dynamic preferential trade areas worldwide, and the driving force of the pan-Arab Free Trade Area which includes all Arabic nations except Algeria. With the few exceptions of non-reciprocal preferential trade agreements with the EC, trade agreements of African countries are mostly based on geographical proximity. They are trade blocs forming the pillars of the African Economic Community with the goal of ever closer pan-African economic integration forms. Despite being the least active among the regions, the Central Asian countries are engaged in preferential liberalisation through other plurilateral initiatives, without forming region's own free-trade area.¹⁸

The share of trade among preferential trade agreement members in the world trade has become larger along with their proliferation. Whereas the figure was approximately 35-40% during the first wave of preferential trade agreements, it grew to 55-60% immediately before the Asian financial crisis.¹⁹ According to Crawford, the intra-preferential trade agreement trade accounted for almost 90% of the total world trade in 2005.²⁰ While the share of the Intra-regional trade in total foreign trade of two most industrialized preferential trade areas, NAFTA and the European Community, remain relatively stable in the last 10 years, it is not the case in emerging economies and developing countries which only recently have acceded to preferential trade agreements.²¹ That is probably due to the fact that the trade-stimulating effect of a preferential trade agreement tends to be higher between trading members having relatively high tariff rates and restrictions, which is the case for trade between or with developing countries.

Not only have preferential trade agreements increased in number, proliferated geographically at a more speedy pace and accounted for a larger proportion of world trade, they also include increasingly diverse areas of trade. While the first wave of

¹⁸ Ibid., p. 14-19.

¹⁹ Schiff, Maurice, and Alan L. Winters (1998), Dynamics and Politics in Regional Integration Arrangements: An Introduction, *World Bank Economic Review*, 12 (2), p. 178.

²⁰ Fiorentino, p. 2.

²¹ United Nations Conference on Trade and Development et al. (2007), *Trade and Development Report 2007: Regional Cooperation of Development*, Geneva: United Nations Conference on Trade and Development, p. 84.

preferential trade agreements dealt with tariff concessions and market access for goods, the later preferential trade agreements deal also with a large range of topics such as trade in services, harmonisation of domestic regulations, common standards (notably labour and environment standards), dispute settlement mechanisms, and building of common institutions that match deeper economic integration.²² The increase in the number of preferential trade agreements and in the institutional and thematic dimension have led to the phenomenon of overlapping memberships and confusion resulting from unregulated scope of application. Different trade rules applying to parties to different agreements has become frequent. The scope of preferential agreements may broaden to include those not regulated multilaterally, and the provision under preferential agreements could be inconsistent with multilateral rules or other preferential agreements.²³ This has led to confusion and implementation problems and to the question whether preferential trade agreements lead to fairer and freer world trade, and thus the adequacy of WTO regulations of preferential trade agreements: the questions that the thesis will also try to elaborate.

²² De Melo, p. 17.

²³ WTO Website, Internet: http://www.wto.org/english/tratop_e/region_e/scope_rta_e.htm, retrieved on 26 July 2009.

D. WTO and preferential trade agreements: the regulating regime and its effectiveness

This relatively descriptive part of the thesis presents some legal aspects of the WTO regime, in particular the GATT Article XXIV, that are significant to the economic analysis of the article. It serves three important purposes. First, it should raise the legal understanding of the Article by introducing its rules and interpretation, and thus serving as the basis of its own analysis. Second, it presents in the final part a brief answer to the question whether the Article contributes effectively to upholding WTO fundamental principles – a question similar to the main research question, answered from the international law point of view. And third, some findings in this part have a direct implication on the economic analysis of the article later in section H.

1. WTO multilateral trade regime and the GATT Article XXIV

Since its formal establishment in 1995, the World Trade Organisation has been the only international organisation that deals with international trade in the most extensive and intensive way. The WTO was developed from the General Agreements on Tariffs and Trade (GATT) during the Uruguay Round of GATT negotiations (1986-1994). Whereas the previous round had concentrated on negotiation on commercial concessions, the Uruguay Round witnessed negotiations on broader scope of trade including services, agriculture and intellectual property rights, and, put forward by Canada in 1990,²⁴ the more fundamental issue of trade rules: a formal organisation to effectively ‘govern’ the conduct of world trade by providing institution that would not only incorporate and build on the GATT²⁵ but also include other agreements not dealing with trade in goods which had been regulated by the GATT 1947 to be negotiated in the future. The Uruguay Round negotiations culminated in the Marrakech Declaration in which the GATT members expressed their intention to establish the WTO, and in the Agreement Establishing the WTO, the ‘constitution’ of the WTO. Beyond the development in institutional arrangements, central to the evolution was the

²⁴ Finger, J. Michael (1991), *That Old GATT Magic No More Casts Its Spell*, Journal of World Trade, p.22

²⁵ Wilkinson, p.29.

set of multilateral trade principles. These core principles originally enshrined in GATT have been embodied in the WTO agreements.

In order to understand the importance and the place of the GATT Article XXIV within the WTO trade regime, it is necessary to be acquainted with the structure of WTO agreements. The ‘umbrella’ or ‘core’ of the WTO multilateralism is the aforementioned Agreement Establishing the WTO (1994), henceforth the WTO Treaty. The WTO treaty contains in its annexes a set of specific agreements regulating trade in different areas as follows:

- Annex 1 consists of 3 agreements: Annex 1(a) General Agreements on Tariffs and Trade (henceforth GATT 1994); Annex 1(b) General Agreements on Trade in Services (GATS); and Annex 1(c) Agreements on Trade Related Aspects of Intellectual Property Rights (TRIPS)
- Annex 2 Dispute Settlement Understanding (DSU)
- Annex 3 Trade Review Policy Mechanisms
- Annex 4 plurilateral Trade Agreements consist of 4 agreements: Annex 4(a) Agreement in Trade in Civil Aircraft; Annex 4(b) Agreement on Government procurement; Annex 4(c) International Dairy Agreement; and Annex 4(d) International Bovine Meat Agreement.

While agreements in Annex 4 are of plurilateral nature, agreements in Annexes 1-3 are binding to all WTO members.²⁶ The GATT 1994, being legally distinct from the GATT 1947, which had served as the basic multilateral trade rule prior to the establishment of the WTO,²⁷ consists not only of all provisions of its predecessor, the GATT 1947, and all legal instruments that had entered into force under the GATT 1947 until the date of the establishment of the GATT 1994, but also of the Understandings on several issues related to GATT 1947 and the Marrakech Declaration on the GATT 1994.²⁸ GATT 1947 is the substantive rule of GATT 1994, and this is where the GATT Article XXIV can be found. Although the article has been formulated for GATT 1947, remains unchanged ever since and was incorporated into GATT 1994 as part of GATT

²⁶ Agreement Establishing the World Trade Organisation (hereinafter WTO Treaty), Article II:2 and 3. Internet: http://www.wto.org/english/docs_e/legal_e/04-wto.pdf, retrieved on 25 August 2009.

²⁷ Article II:4 of WTO Treaty.

²⁸ General Agreements on Tariffs and Trade (hereinafter GATT 1994), Paragraph 1

1947, the WTO documents legally correctly refer to the article as Article XXIV of the GATT 1994, as GATT 1994 is the document in force and legally distinct from GATT 1947. Considering the interpretation and application of the GATT Article XXIV, another important legal instrument plays the central role: the document called ‘the Understanding on the Interpretation of Article XXIV of the GATT 1994’. The Understanding bolsters the original interpretation and application of the Article beyond what it had been. The instrument will be therefore also taken into account in the analysis of the Article.

2. The the objectives of the WTO and Most Favoured Nation as the core principles of the GATT 1994

Understanding the objectives and the main principles of the WTO is very essential for the interpretation and application of Article XXIV, and thus to its appraisal, not only because the article provides for exception to the MFN principle, but also because answering the question as whether Article XXIV effectively regulates preferential trade agreements such that the latter comply with the WTO multilateral trade regime prerequisites the thorough appreciation of objectives, purposes and other main principles of the WTO.

As an international treaty, the ‘umbrella’ treaty of the WTO, the WTO treaty stipulates the objectives of the WTO in its preambular paragraphs. Like the principles and institutions of the WTO multilateral trade regime originated from the GATT 1947, the preambular paragraphs of the WTO treaty are developed from the preambular paragraphs of the GATT 1947. The objectives of the WTO are raising standard of living and ensuring sustainable economic development with steady income, employment, demand and production growth through ‘reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations’.²⁹ In pursuing these objectives, the core WTO principles were formulated and have been applied since the formation of the GATT 1994 and included in the GATT 1994 as follows:

²⁹ Preamble of the WTO Treaty

- Most Favoured Nation principle (MFN) aims at non-discrimination between trading partners;
- National Treatment principle (NT) aims at non-discriminate treatment between national and foreign like-products;
- Gradual elimination of tariffs and non-tariff trade barriers;
- Predictability and transparency of national trade policy through clear and binding commitment to eliminate trade barriers;
- Encouragement and enhancement of economic development in developing countries.³⁰

A special attention is paid on MFN, as a formation of a preferential trade agreement constitutes a clear violation of the principle. Article I:1 of the GATT 1994 reads

‘With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, (...) any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.’³¹

MFN is defined both as positive and negative commitment, in the sense that all advantages, favours and privileges, but also restrictive practices are to be accorded to all unconditionally and without restriction.³² Clearly, the benefits countries expect from the MFN stems not merely from ‘equality’, that is equally good or bad treatment,³³ but more importantly the gradual erosion of trade barriers. The virtue and backdrops of MFN shall be later elaborated in this thesis in connection with the economic analysis of Article XXIV.

³⁰ http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm, retrieved on September 28th, 2009.

³¹ Article I:1 of the GATT 1994

³² Wilkinson, p.46.

³³ Viner, Jacob (1951), *International Economics*, London: George, Allen and Unwin, p.100.

3. Article XXIV: rules, interpretation and application

The Article provisions reflect the desire to ensure coherent application of WTO and preferential trade agreements and progressively more open and fair world trading system through rule-based proliferation of preferential trade agreements. However at the same time, since customs unions and free trade areas have a long history before the constitution of WTO or even of the GATT 1947, many countries, mostly developed countries and former colonial powers at that time who had been since the sixteenth century familiar with their own pre-GATT commercial treaties providing for trade preferences³⁴, were less willing to deprive themselves of the freedom of forming preferential trade agreements. Little negotiation history of the Article been recorded.³⁵ The Article was in 1945 proposed by the United States³⁶ and gained wide support also from developing countries, who considered especially free trade areas as promising option of the future³⁷ and well-suited to countries with limited resources.³⁸ Without the intention to prevent the proliferation of preferential trade agreements, The GATT provides for regulations and criteria that allow its members to exercise their sovereign rights to accede to or create preferential trade agreements in accordance with principles and rules upheld by the WTO³⁹. The concept of the Article is therefore not to prohibit preferential trade agreements altogether, as it ‘recognize(s) the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements,’ but rather stipulate that the purpose of a preferential trade agreement, be it customs union or a free trade area, ‘should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories.’⁴⁰

³⁴ Herzstein, Robert E., and Joseph P. Whitlock (2005), *Regulating Regional Trade Agreements – a Legal Analysis*, in Macrory, Patrick F. J., *the WTO: Legal, Economic and Political Analysis*, New York. Springer, p. 220. (henceforth Herzstein)

³⁵ Ibid., p. 222.

³⁶ Mathis, James (2002), *Regional Trade Agreements in the GATT/WTO*, p. 33.

³⁷ Ibid, p. 34.

³⁸ World Trade Organisation (1995), *Regionalism and the World Trade System*, p. 29-35. (hereinafter *Regionalism and the World Trade System*)

³⁹ Koul, Autar, Krishen (2005), *Guide to the WTO and GATT*, The Hague: Kluwer Law International (hereinafter Koul), p. 328.

⁴⁰ Article XXIV:4 of the GATT 1994

3.1 WTO conformity of preferential trade agreements: Article XXIV: 5 and 8

The objective of Article XXIV is to guarantee that the design and implementation of preferential trade agreements are compatible with the objective and purpose of the WTO and its principles. It should also any possible minimize welfare loss to third parties as well as parties to preferential trade agreements, and avoid complication in the application of preferential trade agreements and WTO rules.⁴¹ For the WTO conformity, it is necessary though that a preferential trade agreement satisfies two most significant criteria in Article XXIV: the qualification as genuine preferential trade agreements according to Article XXIV: 8, the so-called ‘substantially all’ criterion, and the absence of an adverse effect on other WTO members according to Article XXIV: 5, the so-called ‘on the whole not higher’ criterion. In the case that an adverse effect on third parties pursuant to the establishment of a RTA, particularly a customs union, cannot be avoid, its members have an obligation to compensate under Article XXIV: 6 to restore the observance of Article XXIV: 5. For WTO rule conformity, a preferential trade agreement must also comply with Article XXIV:7.⁴² It is therefore of great important to look at the provision of these articles.

Internal trade requirement: Article XXIV:8

Article XXIV: 8 reads

‘For the purpose of this Agreement:

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

(a) (i) Duties and other restrictive regulations of commerce (except, where necessary, those permitted under Article XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and,

(ii) Subject to the provision of paragraph 9, substantially the same duties and other regulations of commerce are applied by each

⁴¹ Preambles of the Understandings on the Interpretation of Article XXIV of the GATT 1994 (hereinafter the Understanding).

⁴² Paragraph 1 of the Understanding reads ‘Customs unions, free-trade areas, and interim agreements leading to the formation of a customs union or free-trade area, to be consistent with Article XXIV, must satisfy, inter alia, the provisions of paragraphs 5, 6, 7 and 8 of that Article.’

of the members of the union to the trade of territories not included in the union;

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

To begin with, Article XXIV: 8(a)(i) requires that members of a customs union eliminate duties and other restrictive regulations. The main challenge here is that WTO members cannot agree on the meaning of the terms ‘substantially all the trade’ and ‘other restrictive regulations’. Although, article 3.2 of the DSU tries to facilitate the interpretation by stating that any interpretation has to be in conformity with the rule of interpretation contained in Article 31 of the Vienna Convention on the Law of Treaties⁴³, institutions of neither the GATT nor WTO could provide a clear legal definition for the terms.⁴⁴ Obviously, Article XXIV: 8(a)(i) tries to set the level of integration as qualification for a preferential trade agreement and as criterion for permission to depart from MFN obligations (with ‘substantially all’) and give the answer to the question as to what kind of restrictions is permitted among parties to preferential trade agreement (with ‘other restrictive regulations’).⁴⁵ With regards to the first term, the Appellate Body in *Turkey – Textile* case, agreeing with the Panel, rules that ‘substantially all’ offers some flexibility to constituent members of a customs union with regards to the degree of liberalisation, stating that ‘substantially all trade’ is not equal to all trade and considerably more than ‘some’ trade.⁴⁶ This flexibility is, however, limited by the requirement that ‘duties and other restrictive regulations’ be eliminated, with exceptions, if necessary, of measure under Article XI through XV and

⁴³ Article 31 of the VCTL obliges the interpreter to examine the ordinary meaning of the terms, the meaning in their context, in the light of purpose and objects, taking into account any subsequent decision and subsequent practice.

⁴⁴ Matsushita, Mitsuo, Thomas J. Schoenbaum and Petros C. Mavroidis (2003), *The World Trade Organization: Law, Practice and Policy*, New York: Oxford University Press (henceforth Matsushita et al), p.356

⁴⁵ Trachtman, Joel, P. (2007), ‘International Trade: Regionalism’, in Guzman, Andrew, T. and Alan O. Sykes (eds), *Research Handbook in International Economic Law*, Cheltenham: Edward Elgar (hereinafter Trachtman), p.162.

⁴⁶ Appellate Body Report, *Turkey – Restrictions on Imports of Textiles and Clothing Products*, WT/DS34/AB/R, adopted 19 November 1999 (henceforth Appellate Body, *Turkey – Textile*), paragraph 48.

Article XX of the GATT 1994.⁴⁷ Considering the term ‘other restrictive regulations of commerce’, it is not clear what kind of regulations Article XXIV: 8(a)(i) prohibits or allows. Nevertheless, the Appellate Body in *Argentina – Footwear* (European Community) case has established parallelism between the scope of investigation leading to restrictive measures and the application of such measures as additional requirement of ‘other restrictive regulations’ to be compatible with Article XXIV. In that case, the Appellate Body considered that Article XXIV: 8(a)(i) generally does not prohibit the imposition of safeguard measures on other customs union members, in that particular case the MERCOSUR, but Argentina must impose the measures on all MERCOSUR countries, as its investigation evaluated ‘serious injuries or the threat thereof’ from all MERCOSUR sources.⁴⁸

Article XXIV: 8(a)(ii) requires each constituent member of a customs union to apply not the identical but substantially the same duties and other regulations of commerce with respect to trade with third countries. The expression ‘substantially the same’ encompasses both quantitative and qualitative elements of trade restrictions. While the quantitative aspect of trade restrictions implies an identical external tariff rates, comparable trade regulations having similar effects with respect to trade with third countries, and not necessarily identical regulations, would generally meet the qualitative requirement of this subparagraph. However, the flexibility is limited as something closely approximating ‘sameness’ is definitely required.⁴⁹

Regarding free-trade areas (FTAs), the internal trade standard, the elimination of duties and other restrictive regulations of commerce on substantially all trade between constituent members set out in Article XXIV: 8(b) is almost the same as XXIV: 8(a)(i). Therefore, relevant case law and observations concerning the terms ‘substantially all’ and ‘other restrictive regulations’ are valid also for FTAs. Article XXIV: 8(b) does not contain the elimination of restriction with respect to trade between constituent members and non-member but trade in products originating from constituent members themselves.

⁴⁷ Bossche, Peter, van den (2005), *The Law of the World Trade Organization*, Cambridge: Cambridge University Press, p. 654.

⁴⁸ Appellate Body Report, *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R, adopted 12 January 2000, paragraph 113.

⁴⁹ Panel Report, *Turkey – Restrictions on Imports of Textiles and Clothing Products*, WT/DS34/R, adopted as modified on appeal, 19 November 1999, paragraph 9.148; *Turkey – Textile*, paragraph 50.

External trade requirement: Article XXIV:5

Beside the provisions in Article XXIV: 8, preferential trade agreements have to satisfied the external trade requirement contained in Article XXIV: 5, which reads

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

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

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

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

The main message of this Article is that a preferential trade agreement on the whole shall not create additional burden to trade with third parties compared with the general incidence prior to its application. For the coherence, this ‘external requirement’ should be discussed first in connection with FTAs. In addition to Article XXIV: 8(b), a member of a FTA must satisfy the requirement of Article XXIV: 5(b) that the duties and other regulations of trade with third parties must not be higher or more restrictive than before the formation of the FTA. As a FTA involves alterations of trade regulations

between parties of the FTA and there is no such creation of a common external tariffs that the trade regulations between each FTA member and third parties have to be harmonized, the duties and regulations as applied to third parties by each member should obviously remain unchanged. It is easy to prove the compliance with Article XXIV: 5(b).

For customs unions, the criterion ‘on the whole not higher’ encompasses two obligations: the obligation on the whole not to increase barrier to trade between members of customs union and third parties after the formation or expansion of the customs union (Article XXIV: 5(a)); in other words, duties must not be higher and other regulations must not be more restrictive⁵⁰, and the obligation to provide compensation in case that the additional burden to trade for third parties cannot be avoided, such that on the whole the trade barrier is not higher following the establishment of the customs union (Article XXIV: 6), the observance of Article XXIV: 5(a) is thus restored. The criterion ‘on the whole not higher’ is of a great importance, as a creation of a customs union necessitates a harmonization of external trade regulations, such that each member of the customs union applies ‘substantially the same’ external trade regulations (Article XXIV: 8(a)(ii)). A creation of a customs union makes additional trade measures inevitable. It is likely that the harmonization or the introduction of additional trade measures in some countries lead to higher duties or more restricted regulations with respect to trade between these countries and third parties. The qualifications of customs unions outlined in Articles XXIV: 5(a) and 6 prevent adverse effects of customs unions on third parties.

With respect to Article XXIV: 5(a), the term ‘general incidence’, a benchmark for the economic test of the extent of trade restrictions before and after the formation of the customs union, needs clarification. The Understandings on Article XXIV of GATT clarifies that the evaluation of the general incidence of the duties shall be based upon an overall assessment of weighted average tariff rates and of custom duties collected, and that the applied rate of duties, and not bound rate, must be used. The Understanding recognizes the difficulties in the evaluation of the general incidence of other regulations

⁵⁰ Turkey – Textile, paragraph 54.

of commerce, and that the examination of individual measures, regulations, products covered and trade flows may be required.⁵¹

Besides the quantification difficulties, the term ‘other regulations of commerce’ poses the question as to which ‘other regulations of commerce’ of custom unions are permissible under Article XXIV, i.e. whether Article XXIV allows only exceptions to MFN provisions or also other GATT provisions, and under which conditions. The jurisdiction of the Appellate Body in case *Turkey – Textile* offers some answers to this issue. Quantitative restrictions on textile and clothing products were imposed following the creation of the customs union between Turkey and the European Community in order to prevent trade diversion, since textile products could flow into the EC through Turkey. India brought the case to the WTO dispute settlement bodies arguing that such restrictions violated Article XXIV: 5. Firstly, the Appellate Body holds that Article XXIV: 4 and the preamble of the Understandings, which reaffirm that the purpose of a customs union is to facilitate trade between the constituent members and not to raise barriers to the trade with third parties, and that the former should to the greatest extent avoid creating adverse effect on the latter, set pervasive purpose for the whole Article XXIV.⁵² Taking into account the chapeau of Article XXIV: 5, the Appellate Body finds that the provisions of GATT 1994 shall not make impossible the formation of a customs union, and that Article XXIV may, under certain conditions, justify measures inconsistent with other GATT provisions, and may be invoked as a defence to a finding of inconsistency.⁵³ Therefore, under certain conditions, all ‘other regulations of commerce’ are allowed under Article XXIV. These conditions are that, first, the introduction of such GATT-inconsistent measures, including ‘other regulations of commerce’ thus included, takes place upon the formation of a custom union that satisfies Article XXIV: 8(a), and, second, the formation of such a custom union would be prevented if these measures are not introduced (necessity criterion).⁵⁴ The proof of the necessity of inconsistent measures involves the proof whether less trade-restrictive alternatives to these measures exist. Article XXIV does not serve as defence for measures to which less trade-restrictive alternatives are available. In case *Turkey – Textile*, the Appellate Body states that rules of origin to distinguish between Turkish

⁵¹ Paragraph 2 of the Understanding.

⁵² *Turkey – Textile*, paragraphs 55-6.

⁵³ *Ibid.*, paragraph 57.

⁵⁴ *Ibid.*, paragraphs 58-9.

and third country textile constitute a less trade-restrictive alternative to quantitative restrictions, and would have also addressed the concern of trade diversion. While the Appellate Body stresses that Turkey's quantitative restrictions cannot be justified by Article XXIV, it does not prohibit quantitative restrictions in general with regards to Article XXIV: 5(a).⁵⁵ As there is no qualification of rules of origin as 'other restrictive regulations' to be eliminated according to Article XXIV: 8(a)(i) in order for a preferential trade agreement to be qualified as customs union, the preferential trade agreement between EC and Turkey would also satisfy Article XXIV: 8(a) and become a custom union, though not the one that would not require border controls on good and consistent with the EC principle of 'free circulation'.⁵⁶ In sum, states forming a customs union are permitted upon the creation of such a customs union to introduce 'other regulations of commerce' with respect to trade with third parties otherwise prohibited by another GATT provision, provided that these measures are necessary for the creation of customs union and do not exceed the minimum standards set forth in Article XXIV, and there is no less trade-restrictive alternative.

Given that 'other regulations' with respect to Article XXIV: 5(a) introduced upon the creation of a customs union are justified by the aforementioned approach of the Appellate Body, these regulations along with the customs union duties rates will undergo the economic test provided for in paragraph 2 of the Understandings. This test finally answers whether the customs union satisfied the external trade requirement ('on the whole not higher' criterion) of Article XXIV: 5.

With regards to Article XXIV: 5(c), the GATT recognizes that customs union or free trade areas cannot come into being overnight and do need period of adjustment and transitions.⁵⁷ The vague requirement of 'within a reasonable length of time' is clarified by the Understandings that this should not exceed ten years except in exceptional circumstances. In that case, members of an interim agreements shall provide an explanation to the Council for Trade on Goods.⁵⁸

⁵⁵ Ibid., paragraph 65.

⁵⁶ Trachtman, p.165-6.

⁵⁷ Jackson, John H. (2000), *The Jurisprudence of GATT and the WTO*, Cambridge: Cambridge University Press, pp. 103-4.

⁵⁸ Paragraph 3 of the Understandings.

3.2 Compensatory adjustments: Article XXIV:6

Article XXIV:6 reads

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

If, for instance, in the formation of a customs union a constituent member must increase a bound duty, because the customs union duty is higher than the bound duty applicable before the formation, Article XXIV: 6, *lex specialis* to Article XXIV: 5(a), applies in order to fulfil the Article XXIV: 5 ‘on the whole not higher’ by providing for compensatory adjustments. Article XXIV: 6 establishes that the negotiation procedure according to the GATT Article XXVIII to be followed when upon the formation of a customs union a member of the customs union proposes to increase a bound rate of duty. The Understanding further elaborates that the negotiations should lead to mutually satisfactory compensatory adjustment, taking into account also the reductions of duties on the same tariff lines conceded by other constituents of the customs union. If the reductions are not enough to offer compensatory adjustment, reductions of duties on other tariff lines should be offered, and negotiations should be continued, if the adjustment are still unacceptable. In case that agreement in negotiations on compensatory adjustment cannot be reached, the customs union is free to modify or withdraw the concessions made, while members who are affected can also withdraw substantially equivalent concessions in accordance with Article XXVIII. Those third party members who benefit from the reduction of duties upon the formation of a customs union are not obliged to provide compensation to the members of the customs union.⁵⁹

3.3 Notification, examination procedure and review

Article XXIV: 7(a) requires WTO members to notify the establishment of a preferential trade agreement or an interim agreement leading to a preferential trade

⁵⁹ Paragraphs 4-6 of the Understandings.

agreement to WTO contracting parties. The Understandings state that all notification made under this subparagraph shall be examined by a working party in the light of the relevant provisions of GATT 1994. Following the notification, the Council for Trade in Goods (CTG) issues a mandate for examination for the Committee on Regional Trade Agreements (CRTA), where parties to the preferential trade agreement answer questions posed by other WTO members orally or in writing. Once the CRTA examination process is finished, the WTO Secretariat drafts a report based on issues covered the examination and submit it to members of the CTG, which will have to adopt the report by consensus in order to complete the examination process. With respect to interim agreements, the working party may make recommendations on proposed time-frame and measures required to complete the formation of preferential trade agreements.⁶⁰ If a interim agreement does not include a plan and schedule in accordance with Article XXIV: 5(c), the working party shall also recommend a plan and schedule. Unless the parties to an interim agreement modify or adopt the agreement in accordance with these recommendations, the interim agreement cannot be put into force.⁶¹

All preferential trade agreement are under an obligation to report periodically to the Council for Trade in Goods. Any significant change and/or development in preferential trade agreements as well as any substantial change in the plan or schedule of an interim agreement shall be notified also to the CTG.⁶²

Article XXIV: 7 obliges a notification but does not require WTO members to wait for an advance approval to form or join a preferential trade agreement. WTO members are free to form or join a preferential trade agreement if they satisfy the procedural and substantial requirements of Article XXIV. In reality, however, most of the agreements have been notified after their establishment, because they entered into force before the establishment of the WTO. The CTG, its working parties and the CRTA commonly have been presented with a *fait accompli*. Their notification and reviews in many cases become an *ex post* procedure.

⁶⁰ Paragraphs 7-8 of the Understandings.

⁶¹ Article XXIV: 7(b) and paragraph 10 of the Understandings.

⁶² Article XXIV: 7(c) and paragraphs 9 and 11 of the Understandings.

3.4 Observance of Article XXIV by WTO Dispute Settlement Body: another regulation of preferential trade agreements

The main bodies responsible for the control of the observance of Article XXIV are WTO dispute settlement bodies. The paragraph 12 of the Understandings specifically authorizes dispute settlement with respect to any matters arising from the application of Article XXIV.⁶³ Although the power of WTO adjudicating bodies extend only to matter arising from the application of Article XXIV and not the article as such, the application of Article XXIV can cover any matter that comes within the ambit of the Article. The broad wordings signals the willingness of WTO members to affirm their intention that WTO deals with issues related to preferential trade agreements.⁶⁴ The authority of the WTO dispute settlement bodies to evaluate compliance of preferential trade agreements with article has been asserted and emphasized in jurisdictions of the dispute settlement bodies. Concerning federal states, Article XXIV: 12 and paragraphs 13 and 14 of the Understandings obliges WTO members to ensure the observance of the provisions of the Article by their regional and local authorities. Article XXII and XXIII can likewise be invoked for the regional or local measures affecting the observance of Article XXIV.⁶⁵ Article XXIV does not question or invalidate an existing preferential trade agreement, nor is it likely that Article XXIV shapes the complete design of future preferential trade agreements a priori. Still, it should be stressed that there is no protection for pre-existing agreements from scrutiny in WTO dispute settlement mechanism. They can possibly be challenge under Article XXIV. The Case *Turkey – Textile* shows that preferential trade agreements are potentially subject to rather strict scrutiny.⁶⁶

To support and improve the observance of the Article, the General Council mandated The CRTA to define the scope of the existing obligations for preferential trade agreements and to report to the General Council on the agreements' implementation of the obligation under Article XXIV and the measures to reinforce

⁶³ paragraph 12 of the Understanding reads 'The provisions of Article XXII and XXIII of GATT 1994 as elaborated and applied by the DSU may be invoked with respect to any matters arising from the application of those provisions of Article XXIV relating to customs unions, free-trade areas or interim agreements leading to the formation of a customs union or a free-trade area'

⁶⁴ Matsushita et al, p. 365.

⁶⁵ Article XXIV: 12; paragraphs 13 and 14 of the Understandings

⁶⁶ Trachtman, p. 169.,

their complementarity with multilateralism.⁶⁷ As mentioned earlier, a preferential trade agreement review by CRTA becomes an ex post review. Consequently, some WTO-incompatible provisions of notified preferential trade agreements are unlikely to be sanctioned by the CRTA, as this decides by consensus.

4. Effectiveness of Article XXIV from public international law perspective

The evaluation of the Article with regards to its effectiveness as WTO legal disciplines in governing preferential trade agreements can be difficult from the perspective of public international law due to the fact that the legal interrelationship between WTO agreements and preferential trade agreements as international treaties is far from clear. Nevertheless, several international lawyers appraise the effectiveness of the Article by taking as evaluation benchmark the objectives and purposes of the WTO, the GATT 1994 and the Article itself.

Generally, the backdrops of the article originate from the legal provisions concerning the conditions imposed on preferential trade agreements and, more significantly, concerning the procedural matters including notification and examination of preferential trade agreements.

Regarding the first aspect some of the legal disciplines set in the Article are widely regarded as imprecise and vague inspite of the extensive clarification made by the Understanding and the relevant WTO jurisprudence,⁶⁸ and thus making the Article fail to regulate the current proliferation of preferential trade agreements in an effective manner.⁶⁹

To begin with, the key Article XXIV:8, which obliges preferential trade agreements to include substantially all trade, experiences a difference interpretation with regards to its significance. While some WTO members take quantitative approach, arguing that the obligation requires only that a certain percentage of trade volume be covered by a preferential trade agreement, other WTO members insist on a qualitative

⁶⁷ Koul, p. 333.

⁶⁸ Herzstein, p. 227.

⁶⁹ Cho, Sungjoon (2000), Breaking the Barrier between Regionalism and Multilateralism: A New Perspective on Trade Regionalism, *Harvard International Law Journal*, 42, p. 436.

approach, arguing that it requires that no major sector be excluded from coverage of preferential trade agreement, as the rules should be aimed at filtering preferential trade agreement that were formed with the intent to create sectorally discriminatory arrangements – the sectoral coverage should be the benchmark for screening a preferential trade agreement.⁷⁰ The former group of members usually object to preferential trade agreements that exclude agriculture from their coverage.⁷¹ Moreover, the Article XXIV:8 provision regarding ‘other restrictive measures’ can be detrimental to WTO objectives. An example of rules of origin provides an evidence: FTAs in absence of a common external tariffs necessarily apply rules of origin, as non-FTA exporters might have incentives to export goods through the member with lowest tariff rates and then transfer the goods to higher tariff members (trade deflection). The rules of origin may specify that non-FTA goods must undergo a substantial transformation process within the region in order to be qualified for regional preference. The rules may require that non-FTA input shall not account for more than a certain threshold of a production costs of a good in order for this good to be qualified as originated in the FTA. Alternatively, the rules may require some specific process be undertaken within the region. Although the rules of origin clearly can be more restrictive than necessary to counter trade deflection and thus constitute internal discrimination, there is no clarification as whether rules of origin can be disciplined by Article XXIV: 8 as other restrictive measures. WTO is working toward harmonizing and disciplining MFN rules of origin, however not preferential trade agreement rules of origin.⁷² Without clarification of the issue of ‘other restrictive measures, protectionist measures against other FTA members remain possible. Concerning Article XXIV:5, the requirement of a ‘reasonable’ transition period for interim agreements to free trade agreement or customs union in Article XXIV:5(c) needs clarification in the point of what constitutes ‘exceptional cases’ for an interim agreement to justify the extension of the ten-year period allowed by the Understanding.⁷³

With regards to the procedural matters, notification regime is less efficient and contains little incentives for compliance. Given a great number of existing but unnotified preferential trade agreements, having no clear provisions as to when, before

⁷⁰ WTR 07, p. 307.

⁷¹ Regionalism and the World Trade System, p. 38.; Ibid. p. 308.

⁷² Koul, pp. 338-9.

⁷³ WTR 07, p. 310.

or after a preferential trade agreement enters into force, notification should take place creates intransparency and enables protectionism, and leads to the fact that some countries regard the notification process as optional.⁷⁴ Without notification, parties to preferential trade agreement avoid controversial discussion, sustained and pointed inquiries and detailed scrutiny of all aspects of proposed agreement. Even if a preferential trade agreement is notified and undergoes the examination process, the consensus rule in the CTG results in not a single examination report on notified preferential trade agreements has been adopted, the same is valid of a complaint procedure, such as the one under Article XXIV:5(c), meaning that the WTO is incapable of judging or making recommendation about the WTO conformity of preferential trade agreements.⁷⁵ The consensus rule in the CRTA in case of the periodical review of preferential trade agreements has the same non-functional effects.

⁷⁴ CRTA, *Synopsis of Systemic Issues Related to Regional Trade Agreements*, WT/REG/W/37, paragraph 13

⁷⁵ Herzstein, pp.233-4.

E. Economic Analysis of Public International Law

1. Fundamentals and important components of law and economics

Law or legal system can be considered as institution. An institution is defined as systems of written or unwritten sets of rules that guide the behaviour of the involving parties that recognize and are expected to respect these rules and to sanction those violating them.⁷⁶ Law and economics deals with the application of the theories and empirical methods of economics to legal system. The subject as a branch of economics is relatively young, dating from the early 1960s, when the property rights and liability were analysed in economic terms.⁷⁷ Since then methods in law and economics have been increasingly applied in both in public and private law fields: tort, contract, and property law, public administration, constitutional law, criminal law, civil, criminal and administrative procedure, judicial administration, and law enforcement.

Law and economics involves a positive and normative analysis of law, reflecting the two fundamental inter-related sets of questions of the subject. The positive analysis of law explains the rules and their outcomes as they are, the effects on the involving parties and their behaviour, and the social desirability of such rules. Another set of questions is, if the rules are not sufficiently desirable, how to improve them, or which rules would yield the most desirable results. That is the normative analysis aimed at answering what legal norms should be in order to promote the efficiency or efficient allocation of resources. The boundary between both types of analysis cannot be drawn clearly.

Like other branches of economics, the assumption of ‘homo oeconomicus’ is applied in law and economics. This is sometimes termed ‘methodological individualism’ or ‘individual sovereignty’⁷⁸ assumes that each person is in charge of

⁷⁶ Weigel, Wolfgang (2003), *Rechtsökonomik*, Munich: Franz Vahlen (hereinafter Weigel), p. 13.

⁷⁷ Posner, Richard A. (1977), *Economic Analysis of Law*, Boston: Little, Brown and Company (hereinafter Posner), p. 16.

⁷⁸ Dunoff, Jeffrey L. and Trachtman, Joel P. (1998), *Economic Analysis of International Law: An Invitation and a Caveat* (hereinafter Dunoff), Internet: papers.ssrn.com/sol3/papers.cfm?abstract_id=73688, retrieved on 14 August 2009, p. 8.

his own utility function, thus selects according to his own personal preference among several alternatives the one that yields the highest net utility and is therefore a rational evaluative maximizer.

In other economic fields, utility maximisation can be realized for instance through possession and utilisation of material and immaterial objects. The parallel of objects in law and economics is property rights. Property rights in law and economics is different from the identical terms in legal sense, and can be defined as relations among individuals that arise from the existence of scarce good and pertain to their use.⁷⁹ Property rights are rights of utilisation, disposition of and ownership over material and immaterial objects.⁸⁰ Property rights constitute a subset of all possible actions, determined by action capability of a person at a given own costs of action, with regards to the treatment of resources. Property rights result from arrangement or institution (discussed later in detail) of inter-personal relations with regards to the mutual consequences from treatments of resources. Utility maximisation in law and economics involves besides utility from the possession and utilisation of objects or resources, such as physical objects, information, intellectual property, and also the rights hereto. Each individual maximizes his personal welfare by possession and exercise of property rights, whereby not only utility can be reaped, but doing so may cause positive and negative externalities and is often at a certain level of transaction costs.

‘Transaction costs’ is another important concept in law and economic and can be defined as ‘frictional loss’ or costs that incurs in the possession, exchange or exercise of property rights, for examples, costs of institution creation (‘time-and-trouble costs’, negotiation and bargaining costs), costs stemming from searching, gathering and evaluating of information necessary for transactions, legal uncertainty, complexity of applicable rules or risks of unpredictable events, but also costs of maintaining institution such as law enforcement (such as agreement surveillance or adjudication). The concept is important for efficiency analysis of law not only because efficient legal regime should help minimize transaction costs, but also because the existence of considerable transaction costs is a necessary rationale for institutional arrangements, i.e. legal regime, that prescribe an efficient allocation of property rights. For according to Coase’s

⁷⁹ Pejovich Svetozar (1995), *Economic Analysis of Institutions and Systems*, Dordrecht: Kluwer Academic Publishers (hereinafter Pejovich), p. 65.

⁸⁰ Weigel, p. 25.

theorem under the strict assumptions of a few numbers of actors, their cooperative behaviour (non-strategic behaviour) and their independent actions, if transaction costs are zero, the efficient allocation can be achieved through negotiations and is unaffected by institutional arrangement.⁸¹

While usually price mechanism regulates person's transactions of resources on a market in economic context, it is usually institution, as legal, administrative and customary arrangements for repeated human interaction are defined, that regulates interpersonal interactions in law and economic context, and necessarily limit what persons have capability and resources to do.⁸² The limitation is necessary, as individual being able to realize all possible actions can be socially inefficient due to their transaction costs. Therefore institution such as regulations and rules, legal system, legal institution and law that regulates and defines the allocation of property rights among involved persons is needed to cope with this phenomenon. Institutions thus prescribe individuals' pattern of behaviour. Given the 'homo oeconomicus' assumption, a legal system also determines the welfare of each individual person. Different legal systems, different institutions result in different levels of individual and social welfare. As institution has the objective of ensuring optimal welfare and increasing efficiency, the task of law and economics is to determine efficiency effect of different institution and to draw conclusions as to the efficiency improving effects of institutions, that is to find out whether an institution advances optimal welfare in the sense of two relevant efficiency concepts: *Pareto-improvement* (the concerned institution improves the welfare position of all parties) and *Kaldor-Hicks efficiency criterion* (the institution does improve aggregate welfare but not necessarily the welfare of all parties but the total welfare and allows for compensation scheme so as to prevent a welfare decrease for those whose welfare is negatively affected).⁸³

In the efficiency analysis, the individual welfare needs to be captured. It is imaginable that this is composed of individual utility and costs incurred from one's own and other individual behaviour. An efficient improving institution should therefore enable individual to increase utility and limit transaction costs from exercising property rights, by creating incentives for involved individual to behave in a cooperative and

⁸¹ Ibid., p. 51 and 53; Posner, p. 35-36;

⁸² Pejovich, p. 29-30.

⁸³ Weigel, p. 17-21.

adequate manner and to refrain from inefficient behavior that causes negative externalities and transaction costs. The incentives are for instance deterrent sanction regimes for non-compliance, the precision of the rights and obligations so that any positive or negative external effects that stems from exercising of his rights but incurs to other subjects are unambiguously attributable to the causer in order to minimize possible opportunistic behaviour which is a source of inefficiency.⁸⁴

Despite the fact that the efficiency criteria in law and economics is the more widely accepted tools for normative analysis, law and economics has some analysis frailties.⁸⁵ Similar to other fields of economics, law and economics is the study of rational choice that evaluates the effects of rational utility maximizing behaviour under conditions of scarcity. The philosophical basis of economics, the utilitarianism, is rejected by many lawyers as being unsuitable to render a practicable normative analysis of law.⁸⁶ Whereas economic theories stress allocative efficiency and welfare maximisation, legal scholars try to derive normative solutions in public international law from general principles which cannot be broken down to efficiency. Nevertheless, law and economists argue that the analysis of law using economic tools and the tangible efficiency criteria for social welfare (Pareto- and Kaldor-Hicks-Criterion) is also just and suitable, because the outcome suggests a more efficient use of resources without loss for any particular legal subject. Moreover, law and economics can effectively clarify the issue of expected outcomes of law and provide for alternative legal solutions. And because law and economic efficiency analysis usually involves cost-benefits analysis, it might have important limitations due to problems of identifiability, commensurability and inter-personal comparison of utility necessary for efficiency analysis, if it is applied on fields of law with unquantifiable parameters, such as in public international law. Tangible effects of law cannot be exactly apprehended. Last but not least, there is the objection concerning the equation of social welfare with the aggregation of individual preferences which can be by nature very different.⁸⁷ In accordance with the criticisms, it must be reiterated that the thesis does not present a comprehensive efficiency analysis of GATT Article XXIV, which by itself is already

⁸⁴ Ibid., p. 29-30.

⁸⁵ Cass, p. 19.

⁸⁶ Posner, p. 20.

⁸⁷ Cass, p. 18.

complex given the structure of WTO regime, the large number of member countries, their different utility function that include elements beyond economic ones. Rather, it applies approaches in law and economics, identify relevant factors that are necessary for the analysis and collects evidences for these factors in order to be able to draw a conclusion whether the Article contribute to a more efficient global trade system.

2. Significant characteristics of public international law

The term ‘international law’ or ‘public international law’ was developed from the older terminology ‘law of nations’ or ‘droit de gens’ which themselves can be traced back from the Roman concept of *ius gentium*.⁸⁸ The definition of public international law has been developed along with development of the law as regards its subjects. From the Westphalian peace treaties (1648) until the first half of the twentieth century, public international law was largely defined as the law that governs the relations only between states amongst each other, as only states could be subjects of public international law in the sense of enjoying full international legal personality and being capable of possessing international rights and duties, including the right to bring international claims. In general, public international law can be defined as the collection of the legal norms that govern the behaviour of the subjects of public international law and not belong to domestic norms of these subjects.⁸⁹ Public international law covers vast and complex areas of international concern from traditional topics like position of states, state succession, state responsibility, peace and security, war and humanitarian law, international treaties, conduct of diplomatic relations, to new areas of regulations, such as international economy and development, international organisations, disarmament, protection of human rights, environment and energy, etc.

Although public international law is primarily concerned with the legal regulation of international intercourse of states as primary subject of law, other actors with different degrees of international law subjectivity have emerged in times: international organisations, international non-governmental organisations (INGOs),

⁸⁸ Malanczuk, Peter (1997), *Akehurst's Modern Introduction to International Law*, London: Routledge (hereinafter Malanczuk), pp. 1-3, and p.9.

⁸⁹ Neuhold, Peter (2004), *Abgrenzungen, Strukturmerkmale und Besonderheiten der Völkerrechtsordnung*, in Neuhold, Peter et al (ed.), *Österreichisches Handbuch des Völkerrechts*, Vienna: Manz (hereinafter Neuhold), paragraph 6.

transnational corporations, and individual persons. International organisations are secondary subject of international law, as it has as much legal personality and competences as transferred to by states. INGOs, transnation corporations and individual persons, in contrast, are only partially subject to international law. Despite the fact that states are no more the sole actors of international relations and other actors have emerged in shaping the world order, states continue to play by far the greatest role in creating, enforcing and determining public international law, directly or indirectly.

States are organized as territorial entities and consider themselves as ‘sovereign’, ‘equal’ and ‘independent’. Whereas the political sovereignty defined as the ability to act independently is diluted given the political and economic interdependence of states, the legal sovereignty which is relevant for the analysis and defined as non-submission to the jurisdiction of any other legal subject⁹⁰ remains and has significant implication on public international law and its analysis. The (legal) sovereignty of legally ‘equal’ states implies that unlike domestic law, public international law lacks the supreme authority and central institution for law making, law implementation and law determination. Public international law is thus not a vertical but horizontal legal system and law of coordination between actors and not law of subordination.

The non-subordinating and horizontal character of public international law is observed in law making and law application process. The decentralised process of law making results in different sets of rights and obligations for states which they voluntarily submit to or bind themselves with. The binding force and thematical and geographical scope of public international law therefore depends on the willingness of states to start and participate in the law making process and submit themselves to the law. Many legal documents in international law has a character of declaration of political conviction, rely on voluntary implementation mechanisms and include various reservations. Unlike domestic law, the different, comparatively low degrees of binding force is another character of the law that immediately results from the concept of equal sovereignty. For this reason, public international law is sometimes called ‘soft law’.⁹¹ Further, in the law making process of public international law, the principle of reciprocity plays an important role, since states would be willing to give concessions to

⁹⁰ Ibid., paragraph 38.

⁹¹ Ibid., paragraph 7.

other states only if they can expect some benefits in return. This principle is also an important motif for an effective law application which are generally observed by the states themselves. The implementation of a legal obligation towards other states is decisively influenced by the prospect of benefits resulting from complying with the legal provision and by the prospect of sanctions by other states as consequences of non-compliance. If they perceived their rights being violated, they can take sanction measures by resorting not only to retorsion, an unfriendly yet lawful act, but also to reprisals, an unlawful act however justified by a preceding unlawful act such as treaty breach by other subjects. Whatever decision of compliance or non-compliance, retorsion or reprisal being taken, they are likely to take these actions according to their own 'costs and benefits analysis of foreign policy'⁹², without being unvoluntarily subordinated to any superior organs. Concerning law determining, there is no authority similar to national court to adopt universally binding verdict and no compulsory jurisdiction of international courts and tribunals without the consent of the legal subjects. The legal effectiveness of public international law is ensured only by its states decision and thus depends largely on the latter's resources.

Besides the horizontal character of law in terms of states, public international law has horizontal character as regards main sources. The Article 38(1) of the Statute of the International Court of Justice (ICJ) identifies three as primary sources international conventions, customary international law and general principles of law, and as subsidiary sources judicial decisions and renowned legal literature.⁹³ 'International convention' means international treaties, agreements, pacts, understandings, protocols, charters, statutes, accords, covenants, etc. and can be defined as international agreement concluded between states and governed by international law.⁹⁴ Customary international law is constituted by two elements: the objective element of general and actual practice, that is a factual, consistent and continuous behaviour over a sufficient period of time; and the subjective element '*opinio iuris*', that is the expression of the conviction that a

⁹² Ibid., paragraph 68.

⁹³ International Court of Justice (2009), Statute of the International Court of Justice, Internet: <http://www.icj-cij.org/documents/index.php?p1=4&p2=2&p3=0>, retrieved on 29 August 2009; The terms used for the three primary sources are respectively: a) international conventions, whether general or particular, establishing rules expressly recognized by the consenting states, b) international custom, as evidence of a general practice accepted as law and c), general principles of law recognized by civilized nations.

⁹⁴ Vienna Convention on the Law of Treaties 1969 (hereinafter VCLT), paragraph 1.

certain form of conduct is required or permitted by the law.⁹⁵ General principles of law means legal principles that stem from domestic legal systems of almost all states and have been transplanted to the international level by recognition, such as *pacta sunt servanda*. The ICJ Statute does not provide for hierarchical structure of these primary sources. The only exception in this connection is the overriding legal position of peremptory norms or *ius cogens*, the example thereof being the prohibition of the use of force or the threat thereto or the prohibition of torture.⁹⁶ Regarding the application of law, international treaties, customary international law and general principles of law are considered of the equal rank and there might be applicable law on the similar issue but of different sources at the same time. Beyond the identified sources, states of public international law sometimes also invoke in their action other less binding sources such as unilateral legal acts or resolutions of international organisations.

The characteristic differences of public international law give rise to some differentiations in economic analysis. Due to the horizontal structure of the law and its decentralized law finding, law application and law determination, the adjacent relevant legal instruments the analysis has to include become complex and numerous in order to correspond to the reality that international norms are developed and applied in observance of many other sets of norms. In international law, non-written rules such as customs and etiquettes as well as, due to the strong influence of some common law states, the verdict or legal opinion of international tribunals and courts are as important and valuable to legal institutions and their further development as are written laws like international treaties. Finally, recalling that legal institution should enhance efficiency, realize adequate behaviour of community member, reduce transaction costs and increase legal certainty and costs attributability through sets of universally recognized and clearly defined rules and appropriate incentives including sanctions, the lack of central enforcement and determining authority in international law, its weak legislative capacity and its less-binding 'soft law' character could prompt the feasibility and meaningfulness of the economic analysis.

⁹⁵ Malanczuk p. 44.

⁹⁶ Neuhold, para. 193-195., Malanczuk, p. 56.

3. Perspective of law and economics application on public international law: analogy between domestic and international 'market'.

In addition to the consideration that law and economics might be less useful in the international context, the rejection of fundamental economic philosophy of utilitarianism, and incommensurability, non-comparability and subordination of non-economic factors, another main reason for its non-application by legal scholars could be the allegedly inaccessible methodologies biased towards quantitative and mathematic tools.⁹⁷ On the economist side, despite the extensive fields of application in domestic law, law and economics has not widely been instrumental in analysis international law, even if its efficiency oriented approach can be useful in public international trade law, which is predicated and argumented on efficiency.⁹⁸ Although the less prominent role public international plays in law and economics can be reasoned by structural limitations and methodological constraints, it is possible to draw significant structural analogies between domestic and international legal institutions and to find that both contain mutually comparable factors. A great potential and possibility for the application of law and economics in public international law exists.

In the normative analysis of public international law, that is what the law should be, several international lawyers have recognized the limitation posed by state-centrist nature of the law and seek both new theories and methodologies in other adjacent academic disciplines, notably theories in international relations and international political economics⁹⁹ but less in economics and law and economics,¹⁰⁰ even though the ultimate objective of the analysis is the legal institutional choice for both law and economics and other discipline. Furthermore, law and economics has a comparative strength amongs various economic disciplines for legal analysis because it methods enable the analysis to extend to fields beyond traditional monetizable markets, that is to

⁹⁷ Dunoff, pp. 6-8.

⁹⁸ Cass, pp. 4-7, 23.

⁹⁹ For example, Burley, Anne-Marie S. (1993), *International Law and International Relations Theory: A Dual Agenda*, in *American Journal of International Law*, 87, 205-239.; Abbott, Kenneth W. (1989), *Modern International Relations Theory: A Prospectus for International Lawyers*, *Yale Journal of International Law*, 14, p.335-411.; Abbott, Kenneth W. (1989), *Modern International Relations Theory: A Prospectus for International Lawyers*, *Yale Journal of International Law*, 14, p.335-411.; Abbott, Kenneth W. (1999), *International Relations Theory, International Law, and the Regime Governing Atrocities in Internal Conflicts*, *The American Journal of International Law*, 93, pp.361-79.

¹⁰⁰ Dunoff, p. 2.

maximize multiple and more abstract values simultaneously,¹⁰¹ and thus also to draw elements from other non-economic disciplines.

Relevant similarities and structural analogies between domestic and international legal problems allows for the transfer of approaches and tool from domestic to international sphere. Like in a domestic society, international society is a place where individual actors or groups of actors carry out their transactions. In doing so, they seek to realize their self-defined interest through the most efficacious means under their own constraints. Acting for themselves, from their actions of like units emerges a structure, e.g. market or other institutions, that affects and constraints all of them.¹⁰² At the (still) state-dominant international level of transaction, it is comprehensible to assume as heuristic tool that states represent these self-interested and utility maximizing units given preferences and constraints.¹⁰³ With reference to the assumptions of the Coase's theorem and the obvious existence of transaction costs in international transactions, it can be assumed that these states interact to overcome the deficiencies or other negative externalities and to reach higher benefits through establishing (legal) institutions.

The traded assets in the international 'market' are not goods and services per se, but components of power. In legal sense, this power rests on rights (or jurisdiction) to prescribe, enforce and adjudicate, that is in other words to govern, deal with or treat goods, services, resources or subjects under jurisdiction such as citizens. This jurisdiction or power or rights is identical to property rights in law and economics. In this market, states trade in power or trade in rights in order to maximize their baskets of preference (utility function), which consequently include not only goods, services or subjects, but more importantly also the traded assets: power, rights and influence, and non-economic factors such as reputation, credibility, ideas and values. States' set of all possible actions is unlimited rights to act independently and constraintlessly, or state sovereignty, which naturally allows for also 'negative' behaviour such as war, genocide or grave violation of human rights. The exercise of sovereign rights may cause negative

¹⁰¹ Ibid., p. 3.

¹⁰² Keohane, Robert O. (1984), *After Hegemony: Cooperation and Discord in the World Political Economy*, Princeton: Princeton University Press, p. 84.

¹⁰³ The rationality of state as collective unit of rational individual can be challenged; also preferences might not be exogenously given, but depends on contexts including legal and institutional arrangement and are therefore endogenous. This could be theoretical difficulties for the analysis. However, these difficulties occur in domestic context too. 'They should not fatally undermine the effort to apply economic analysis to international legal phenomena.'; Dunoff, p. 16.

external effects that other states wish to limit. In the international systems, states can attempt bilateral persuasion through negotiations or reciprocal exchanges or they are willing to some extent to relinquish this autonomy by recognizing and declaring binding to a certain degree a legal institution overtime – public international law.

For example, in the field of peace and security, states can theoretically start wars at any opportune moment. Instead, states recognize public international law concerning the general prohibition of use of force and its few exception. The legal institution established here, the general prohibition of the use of force, helps states to avoid deficiencies, e.g. negative consequences of war, and to reach higher benefits, e.g. economic development and increase trade resulting from peace, states' reputation of being peaceful. The relevant sets of action is drastically reduced, and only a certain level of power and rights is (comparable with property rights in domestic context) allocated to state by the international law (comparable with domestic legal institution).

As the legal institution of interest in this thesis is immediately based on a set of international treaties, it might be interesting to draw some analogies and disanalogies that particularly exist between international treaties and contracts which are extensively studied in law and economics. Indeed, the WTO dispute settlement bodies regard the WTO agreements as the international equivalent of a contract.¹⁰⁴ Like contracts, treaties serve as a source of rights and obligations between parties in form of mutual exchange of promises about future behaviour. Both contain provisions concerning validity, breach, interpretation, observation, remedy, modification and termination. Both derive their validity from voluntary agreement of two a parties. However, relating to the concept of sovereignty, the use of reservation, not existant in contract law, allowing state parties to opt out from some treaty obligations and the lack of effective governing authority discussed above present the main disanalogies between treaties and contracts.¹⁰⁵

Dunoff and Trachtmann (1998) suggest three stages of development of international legal institutions. The first stage is that in which the nature established unwritten rule of how subsequent rules will be made by creating states and their

¹⁰⁴ Appellate Body Report, *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R, adopted on 4 October 1996, Section F, p. 16.

¹⁰⁵ Dunoff, pr. 23-4.

endowment and resources. In the second level, states, given constraints and preferences, start to trade their rights, establish market-organizing legal institutions of non-coercion in order to define their fundamental property rights, and for facilitating additional transactions among states. In the third stage, the second generation of institutions can be established to facilitate trade and reduce transaction costs.¹⁰⁶ The development of international legal institutions correspond to this scheme. First, market-organizing legal institutions have been developed; fundamental concept of modern public international law embodied in the Westphalian treaties (1648), rights of diplomats developed since the 18th century, laws of war (*ius ad bellum*) until early 20th century and laws in war (*ius in bello*) in 1948, Charta of the League of Nations and the United Nations, Vienna Conventions on the Law of Treaties (1967), Permanent Court of Justice under the League of Nations and International Court of Justice, international customs and etiquettes to name a few. Then, later in parallel manner, many other legal institutions arise, e.g. the GATT/WTO agreements, the so-called Kyoto Protocoll, Human Rights Declaration 1948 and subsequent specific conventions, bilateral and multilateral treaties, free trade agreements. This implies also that the second generation institutions must be analysed by taking into account also the first generation institutions. The implication corresponds to the remark in connection with the horizontal character of international law made earlier.

With reference to the question of meaningfulness of law and economics in public international law mentioned earlier, it is clear that the main weakness presented to the analysis lays in the application of the law. Consequently it would make sense in some cases for the analysis to distinguish between the rules governing substantive matters and the rules concerning law application. Clearly, an efficient legal institution must embody efficient both kind of rules. While rules concerning law application represent the readiness of states to be bound by the law, the substantive rules in many cases represent states' insightful understanding of problems and encompass efficiency-enhancing solution, which could be separately analysed as if the law were binding and there were an effective judicature. Furthermore, it is also the task of law and economic to identify the weakness of a legal institution, by differentiating the law, it could identify whether the incurred inefficiency is due to the decentralized and horizontal

¹⁰⁶ Ibid., pp. 10-1.

structure of public international law which directly affects the law application, or embodied in the rules, both substantive and those concerning the application.

F. WTO and GATT Article XXIV in Law and Economics Context

1. Transaction costs of international trade and the WTO as institution

The WTO legal regime does not only set rules for the international interaction in trade matters by member states but its member states also confer some authority and competency on it as agent in governing and administrating trading relations among signatory states. According to law and economics, the emergence and stability of legal institution presuppose the existence of substantial transaction costs. It is therefore at this stage essential to identify the sources of transaction costs identified in this context as costs that states must incur when then interact internationally in trade issues.¹⁰⁷ They will be mentioned the efficiency analysis of GATT Article XXIV later also.

When states engage in international trade, trade policy of trading partners is significant. States are exposed to changes and developments in trade policy of the others. The unpredictability of trade policy represent risks that can be regarded as source of transaction costs. These costs tend to arise overtime with the expansion of trade into diverse areas and with new trade policy instruments. The predictability can be enhance by negotiations and bargaining that are likely to result in reciprocal concession granting or by gathering and evaluating information from other states to determine their trade policy. The costs of bargaining and information processing, both transaction costs, can increase with the numbers of involving states and issues. Given an international agreement, the costs of policing its implementation and enforcement can be high in particular in the absence of supreme authority. In the event of trade disputes, states might resort to retorsion and reprisal measures that produce negative externalities. Transaction costs from these various sources are not insignificant and gives rise to the WTO as legal institution.

The WTO, and before 1994 the GATT, helps enhance predicibility of and reduce opportunistic behaviour in member states' trade policy through its legal instruments which set important principles and rules that help minimize protectionist trade policy

¹⁰⁷ WTR 07, p. 114.

measures in a relatively comprehensive manner. The progressive trade liberalization in form of gradual reduction of tariff and quantitative barriers to trade and non-tariff trade barriers that was achieved through negotiation rounds are declared binding and documented in the annexed the countries' schedule of commitments.¹⁰⁸ For non-agriculture goods in general, the schedule of commitments provides for binding commitments on tariffs. For agriculture, the schedule lists binding commitments on tariffs, quotas, export subsidies and some types of domestic supports. For services, the schedule determines how much market access foreign service providers are allowed in each sector and the sectors opt-out from the most favoured nation obligation.

The WTO agreements also limit arbitrary trade policy measures through its fundamental principles, notably the most favoured nation and national treatment for trade in goods and through the regulation of the exception from these principles. In the case of trade in goods, these exceptions are provisions concerning the safeguard of the balance of payment (GATT Article XII and its Understanding¹⁰⁹), the facilitation of economic development (Article XVIII and the mentioned Understanding), the emergency action on import of particular products (Article XIX, the so-called 'escape clause'), other general exceptions (Article XX), the security exception (Article XXI) and, of course, the formation of preferential trade agreements (Article XXIV and its Understanding). The agreements and additional Understandings on specific trade policy measure also regulate aspects of trade barriers, such as non-tariff barriers to trade, technical barriers to trade, rules of origin, safeguard and licensing measures, subsidies, government procurement, and anti-dumping. Other agreements deal with specific traded issues in order to keep pace with trade expansion and global economic development: agriculture, textile and clothing, intellectual property rights Trade-related Aspects of Intellectual Property Rights, trade and economic development, trade capacity building, the least developed countries, and environment protection.¹¹⁰

The mentioned WTO regulations are results of past negotiations and subjected to further development through future negotiations. The WTO is the central negotiation

¹⁰⁸ Notably, the GATT Article II for trade in goods and the GATS Article XX for trade in services.

¹⁰⁹ Understanding of the Balance of Payments Provisions of the GATT 1994, Internet: http://www.wto.org/english/docs_e/legal_e/09-bops.pdf.

¹¹⁰ Annex I of the WTO Treaty, and agreements, understandings, and decisions adopted by the WTO trade negotiations committee in http://www.wto.org/english/docs_e/legal_e/legal_e.htm, retrieved on 7 October 2009.

forum where member states can convene, exchange information, and bargain and exchange concessions with an universally accepted and clearly regulated procedure¹¹¹, which can thus reduce transaction costs and is therefore more efficient than participating in different for a with diverse procedures.¹¹² The current main negotiation forum is the Trade Negotiation Committee established by the Doha Ministerial Declaration functioning under the WTO General Council.¹¹³ The negotiations relating to trades of goods, the unique set of rules is provided for in the GATT Article XXVIII and XXVIII bis and its Understanding.¹¹⁴ For the purpose of negotiations, information has to be gathered and evaluated. The WTO reduces the incurred transaction costs by increase information access and transparency, storing, monitoring, processing, disseminating and providing accurate information necessary for decision making. This task is mainly observed and procedurally regulated by the Trade Policy Review Mechanism.¹¹⁵ Moreover, looking at the regime as incomplete contracts due to uncertainty about future events, in the events of external shocks in which some members might have rational incentives to secretly introduce unlawful hidden measures under the pretext of special circumstances¹¹⁶, an institution such as the WTO Trade Policy Review Mechanism can help extracting information about the taken measures and prevent inefficiency resulting from information imbalances.

The WTO facilitates the implementation, administration and operation of the WTO agreements.¹¹⁷ The WTO ensures that states policy be coherent and compliant with the WTO rules through minimizing interpretative ambiguity, since not all relevant situations and the resulting opportunistic behaviour can be foreseen, by effective determining of regulations, whereby it reduces transaction costs in many aspects.

¹¹¹ Article III:2 of the WTO Treaty.

¹¹² Ludema, R. D. (2001), *Optimal international trade agreements and dispute settlement procedures*, European Journal of Political Economy 17, 3, p. 374.

¹¹³ Paragraph 46 of the Doha Ministerial Declaration, World Trade Organisation Ministerial Conference, *Ministerial Declaration*, WT/MIN(01)/DEC/1, adopted on 14 November 2001, Internet: http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.pdf, retrieved on 8 November 2009.

¹¹⁴ GATT Article XXVIII, and The Understanding, Internet: http://www.wto.org/english/docs_e/legal_e/12-28.pdf, retrieved on 8 November 2009.

¹¹⁵ Article III:4 and the Annex 3 Trade Policy Review Mechanism of the WTO treaty.

¹¹⁶ WTR 07, p. 117., Dunoff, pp. 21-2.

¹¹⁷ Article III:1 of the WTO Treaty.

First, when a trade dispute occurs, its law determining process is likely to involve the calculation of damage which generally cannot be observed by all parties and are difficult to assess. Since the victim state(s) would probably overstate and the other(s) would play down the costs resulting on prolongation of dispute and costs, a neutral body is needed to arbitrate between the two and calculate the true damage.¹¹⁸

Second, the settlement of trade disputes through bilateral negotiations is likely to be more costly than deferring it to the WTO dispute settlement bodies and accepting their rulings. Such jurisprudence of the WTO dispute settlement bodies also considerably reduce transaction costs by precisising the rules interpretation and application and contribute to further regime development.

Third, in connection with inefficient opportunistic behaviour and the adjudicative role of the WTO, the dispute settlement bodies of the WTO can be regarded as regime-stabilising ‘honest broker’. The victim states whose rights under WTO regulations have been violated are expected not to resort to dramatic retaliations, nor to cease cooperation forever, but rather to return to the regime to profit from future cooperation. That’s because leaving cooperation forever would deprives the same punishing victim state of gains from international trade. Knowing that the retaliation is limited and punishment is credible only to a certain extent, states might have incentives to deviate from trade rules that they have previously agreed with each other in order to reach higher benefits in short-term, causing inefficiency and risks of institutional uncertainty. If the retaliation takes place, regardless of the degree, it can be responded by counter-retaliation, the dispute may set off a downward spiral of mutual reprisals that endangers the whole regime.¹¹⁹ It is therefore argued that the WTO dispute settlement as an independent and external legal institution empowered to judge trade disputes and impose costs in form of credible punishment for non-compliance is needed in order to effectively solve this problem and maintain cooperative regime.¹²⁰ The WTO dispute settlement bodies are provided for by the Article III:3 of the WTO Treaty. The

¹¹⁸ Sykes, Alan O. (2000), ‘The Remedy for Breach of Obligations under the WTO Dispute Settlement Understanding: Damages or Specific Performance?’, in Bronckers, M. and Quick, R. (ed.), *New Directions in International Economic Law*, The Hague: Kluwer Law International, pp. 347-9.

¹¹⁹ Schwartz, W. F. and Sykes, Alan O. (2002), ‘The Economic Structure of Renegotiation and Dispute Resolution in the WTO/GATT System’, *Journal of Legal Studies*, 31, 1 (hereinafter Schwartz and Sykes 2002), pp. S198-9.

¹²⁰ WTR 07, p. 115.

objectives and procedures are regulated in the Dispute Settlement Understanding (Annex 2 of the WTO Treaty), wherein different types of dispute settlement are offered and institutionalised: conciliation and mediation (Article 5), arbitration (Article 25) and adjudication through Panel and Appellate Body (Article 6-19).¹²¹

The adjudicative competences of the WTO should not be overvalued as being supreme adjudicative authority that effectively minimizes transaction costs. The WTO dispute settlement mechanisms remain a relatively weak sanction system, unless the agreement is able to impose excessive costs on violating member for non-compliance with the rulings.¹²² Despite the legally binding character of their jurisprudence, the dispute settlement bodies do not allow for central verdict enforcement mechanism but rather place the enforcement of the involved parties. The violating state is required to bring its policy into conformity with its obligations with a period of time. Unless so, the claiming party is permitted ask for compensation from or suspend concessions toward the violating state.¹²³ Ultimately, the mechanism could return to self-help system with the associated transaction costs effects.

2. Understanding the WTO and GATT Article XXIV as law and economics institution

The WTO can be seen as a complex, multiparty forum for barter between nations that allows each nation to represent the interests of its constituents to other nations, and facilitates agreements that reduce the harmful external effects of national policy.¹²⁴ In law and economics, legal institution like GATT Article XXIV is part of multiple possible bargaining outcomes that is chosen because it provides for higher benefits to all than without it. The elements for law and economics should be identified for the purpose of the analysis of institution in accordance with the analogy between domestic and public international law discussed earlier. Corresponding to the analogy drawn earlier in section E, the mentioned international transactions are primarily not the

¹²¹ Article III:3 of the WTO Treaty, and the Dispute Settlement Understanding, Internet: http://www.wto.org/english/docs_e/legal_e/28-dsu.pdf, retrieved on 8 November 2009.

¹²² Schwartz and Sykes 2002, p. 188, and Posner, Richard A. (2002), 'Some Economics of International Law: Comment on Conference Papers', *Journal of Legal Studies*, 31, 1, p. S327.

¹²³ Article 21(3) and 22(1)-(3) of the Dispute Settlement Understanding.

¹²⁴ Gerhart, P. (2003), 'The Two Constitutional Visions of the WTO', *Pennsylvania Journal of International Economic Law*, 24, 1 (hereinafter Gerhart), p. 30.

exchange of goods and service per se but states' choice of international trade policy.

The set of possible action remains generally the all possible state sovereign actions constrained by state-specific exogenously given factors such as resource endowment, and specifically in the context of the analysis of GATT Article XXIV all possible trade policy measures, particularly trade policy discrimination and preferential treatment of particular trade partners, introduction of trade barrier or protectionist measures, conclusion of or ascension to a bilateral or regional trade agreement, compliance or breach of a trade agreement or any trade retaliation. States cannot take all actions in the set due to legal institution generally in form of public international law, and specifically for the analysis the provision and in the WTO agreements. States' property rights encompass transactions or policy actions in trade matters permissible under WTO agreements. In case of the Article, the property rights are the rights to establish preferential trade agreements under specific conditions and subject to treatments provided for in the Article. States maximize their self-defined utility function with the set of policy measures in connection with preferential trade agreements, that is with property rights that are allocated by the Article. If all of them can reach a higher level of welfare under permissible actions under the Article than without it, the Article is welfare increasing and efficiency-enhancing and thus sustained.

To show whether and how the Article fulfil this role, which is the main task of the thesis, the concept of efficiency of the Article should be developed. The efficiency of the Article depends significantly on states' utility maximization given the property rights. Both issues should thus be discussed in detail.

3. Elements of states' utility function

As mentioned earlier, the diversity of utility functions of states party to an international institution presents a disadvantage to law and economics which analyses these functions. Nevertheless, it is plausible to assume that the elements of utility function reflecting the motivations of different states to conclude trade agreements is sufficiently coherent across states for the analysis purpose. The reasons are that, first, different states are likely to have overall similar objectives and motivations when they are engaging in trade matters, although it is likely that a state has a different set of prioritized objectives when it concludes trade agreements with different states. Second,

since the design of any institution is shaped fundamentally by the underlying goals pursued by the involved parties, being parties to the WTO agreements implies states parties share some sets of coherent goals that are consistent enough to be institutionalised, and are convinced that these goals be realized within the WTO institutional framework.

The WTO agreements and preferential trade agreements are trade agreements. States' motivations to conclude an agreement is what the institution should help realize and thus constituting its rationale by which its efficiency is to be measured.¹²⁵ At first sight, the main elements (state motivation) can be discovered in the agreement itself, as the goals of the states parties to an international agreement is enshrined in its preambular paragraphs: expansion of trade and production, economic development driven by efficiency created by optimal use of resources. The stated 'goals' such as elimination of trade discrimination or reciprocal reduction of trade barriers are not considered as elements of utility function. They are trade policy measures and thus property rights in law and economics sense.¹²⁶

States' objectives in trade matters are beyond national income maximization. Accordingly, the motivation is more complex than to be documented in a trade agreement and reflects besides economic consideration also political and legal deliberation, since the agreement will have political and legal effects on the conduct of international relations. Therefore, approaches in different disciplines of economics, international relations, and legal studies help going beyond monetizable factors capture not only the economic, but also political and legal elements constituting states' utility function.

3.1 Economic Approach

Generally, international economic theories believe that the main expected advantages from trade liberalisation are trade increase and efficient allocation of resources according to their comparative advantage. Every advancement towards global

¹²⁵ WTR 07, p.195.

¹²⁶ Preambular paragraphs of the WTO Treaty, the GATT 1947, Article XXIV: 4 and the preambular paragraphs of the Understanding of GATT Article XXIV.

free trade is likely to be efficiency-enhancing.¹²⁷ In new trade theories, the market access gained in trade liberalisation is equivalent to the increase market size that would allow firms to exploit economies of scale, produce at lower costs and thus becoming more competitive. A larger market size may increase country's attractiveness to foreign direct investment. The formation of a trade agreement in form of custom union and free trade area may be also motivated by the increase of their bargaining power in the context of multilateral negotiations.

If these motivations were the only motivations for trade agreements, international trade or at least preferential trade agreements would be characterized by completely free trade, and the trade liberalisation would be swift and comprehensive. However, trade liberalisation in reality in most items started from very high trade barriers and was negotiated step-by-step. And even 'free' trade areas or customs unions may entail trade barriers between the constituting members. The following discussion focuses on to particular branches of economic theories that not only are central to explaining state motivation for concluding trade agreements but also have the starting point of the analysis from a realistic situation where high trade barriers are in place: international trade theories and political economics.

International trade theories

(New) international trade theories claim terms of trade improvement as motivation to conclude trade agreements. The approach is based on two assumptions that governments use tariffs to manipulate the terms of trade, and that governments seek to maximize national welfare at the same time. Terms of trade is a measure of the relative price of a country's import and exports. If a country is able to lower the price of its imports relative to its export, or raise the price of its exports relative to its imports, then its terms of trade improves or in other words its national income and welfare increase. Although it has been assumed that large countries can influence the world price through optimal tariff setting and thus its terms of trade, even small countries with

¹²⁷ Bagwell, Kyle and Robert W. Staiger (2002), *the Economics of the World Trading System*, Boston: MIT (hereinafter Bagwell and Staiger 2002), pp. 2-4, Feenstra, Robert C. (2003), *Advance International Trade: Theory and Evidence*, Princeton: Princeton University Press, pp. 1-98.

differentiated products may have some market power and their optimal tariff, if tends to be positively correlated with their market power.¹²⁸

A government manipulates the terms of trade by setting its tariffs to change the world price, and in doing so to gain welfare. When the government is motivated by terms-of-trade consideration, a country may apply a tariff to lower the price of its imports, thereby, being large country, reduces world demand of the imported products, depress the price and thus generates a terms-of-trade benefits. But the terms-of-trade benefits must be subtracted by the costs of the tariff, which arises because the distortion of the resource allocation tariff introduces. Nonetheless, large countries can be better off, at least in short term, with such policy which incurs negative externalities that, as Bagwell and Staiger state, is shifted to other countries.¹²⁹ If every country increase the tariffs hoping for gains and shifting costs to other, the relative price might not change. The net terms-of-trade gain is less than the costs its imposes of trade partners. All end up in the inefficient Nash equilibrium of Prisoner's Dilemma game. The inefficiency is reflected in excess protection, that is the market access is too small. The role of cooperation is therefore to provide a mechanism through which the inefficiency is corrected and market access is set to the efficient level – that generally does not mean free trade but an efficient level of protection. As market access is exchanged in reciprocal manner in negotiations, gradually moving the players of the Prisoner's Dilemma Game from the the inefficient equilibrium field to the diagonal field. This argument gives rise to main feature of trade liberalisation applied in the WTO (for instance GATT Article XXVIII) and most preferential trade agreements – the reciprocity¹³⁰. Summing up, a trade agreement might eliminate the inefficiency by providing for freer trade, and the approach shows that terms-of-trade is a relevant motivation for countries engaging in any trade institution.

Political economics

¹²⁸ Gros, D. (1987), 'A Note on the Optimal Tariff, Retaliation and the Welfare Loss from Tariff War in a Framework with Intra-Industry Trade', *Journal of International Economics*, 23, p. 366.

¹²⁹ Bagwell and Staiger 2002, p. 28.

¹³⁰ In fact, governments with terms-of-trade considerations will always prefer reciprocal liberalisation and trade negotiation would make no sense without reciprocity, Ethier, W. J. (2004), 'Political Externalities, Non-discrimination, and a Multilateral World', *Review of International Economics*, 12, 3 (hereinafter Ethier 2004), p. 311 and 317.

The political economy approach also is based basically on the terms of trade as main motivation for trade policy. In this set up, governments are seen as the supplier of trade policies. The governments aims at maximize national welfare subject to political constraints.¹³¹ Terms-of-trade motives and political supports for government are the determining factors of trade policy. How high the protection level is, according to Baldwin (2006), determined by the intersection of the positively sloping protection demand curve, i.e. the readiness of firms to support the government, and the positively sloping protection supply curve, defined as how much the government will be willing to supply protection at a given firms support. The level of protection is in any case higher than the inefficiency-correcting, optimal level that has been found under traditional approach which is also the level that national-welfare maximizing the government desires.¹³² The reciprocal exchange of trade concession is in this approach very essential for any trade agreement, because it will convert exporters to opponents to protection-demanding importer within their own country. When trade concession is reciprocal, exporters can gain better market access only when tariff in their own country is lowered. This reduce the slope the protection demand curve, leading to lower level of protection provided for in the trade agreement. The level and sector of trade liberalisation reflect government's political choice of sector supported. Since a lower level of protection will reduce the number of protection-demanding import sectors and increase the number of exporters, the initial liberalisation will trigger pressure for further liberalisation by exporting sectors.¹³³

Furthermore, a trade argeement can pursuing efficiency-enhancing economic policy as signaling devise and instrument to solve the time-inconsistency problem of government's economic policy. In the pursuit of a particular policy, the announced policy will not be credible when the announced implementation period arrives, especially if such policy concerns the competitiveness enhancement, leading to the opening up, of an inefficient sector whose maintaining costs will be unsustainable. If the announcement is credible, the sector will decide for restructuring and investing in cost-saving technologies. Otherwise, especially when the industry regards the announcement as empty threat, the industry will not be liberalized and the government will continue to

¹³¹ WTR 07, p. 56.

¹³² Baldwin, Richard E. (2006), 'Multilateralising Regionalism: Spaghetti Bowls as Building Bloc on the Oath to Global Free Trade', *The World Economy*, 29, 11 (hereinafter Baldwin 2006), pp. 1458-9.

¹³³ Ibid., pp. 1459-65; WTR 07, p. 57.

live with inefficiency. A trade agreement can increase the policy credibility by providing for external threat and effective enforcement mechanism.¹³⁴ The government may also enter to a trade agreement to specifically prevent any foreseeable developments that might lead to inefficient resource allocation or sectors with strong lobbying power and to accelerate the structural reform.¹³⁵

3.2 International relation theories

Some motivations for trade cooperation from theoretical perspectives in international relations have similarities with those resulting from economic discussion. In the 'more traditional', statist international relation theories, states are unitary actors, play more prominent role and their preferences are taken as exogeneously given. They include the two most prominent theories of international relations explaining international cooperation: neoliberalism or neoliberal institutionalism developed from classical liberalism, and neo-realism developed from classical realism. Neoliberalism and neorealism are rationalist statist theories, because states as the central actor are self-interested, goal-seeking and utility maximizing actor.¹³⁶ The further development of international cooperation in the 20th century gives rise to another statist international relation theory: constructivism or strong cognitivism. In contrast to statist theories, the non-statist theories concentrate on the sub-state domestic agents and the question as to how international cooperation is shaped and affected by domestic politics. The non-statist theories of international cooperation are developed in a parallel manner to the statist ones: liberalism and weakly cognitivism.

Neoliberalism

The foundation of GATT and the WTO are based on the (neo-) liberal ideas in international economics and international relation theories, which stress the importance of welfare-enhancement through economic liberalisation and international cooperation. Neoliberalism therefore merits some attention. Nevertheless, neoliberalism or neoliberal

¹³⁴ WTR 07, p. 60-1.

¹³⁵ Maggi, G. and Rodriguez-Clare, A. (1998), 'The Value of Trade Agreements in the Presence of Political Pressures', *Journal of Political Economy*, 106, 3, pp. 595-6.

¹³⁶ Hasenclever, H., Mayer P. and Rittberger V. (1997), *Theories of International Regimes*, Cambridge: Cambridge University Press (hereinafter Hasenclever et al.), p.23.

institutionalism in general does not provide further motivations for state to conclude trade agreements than international economics. The motivation is the efficiency gain through correction of deficits, such as collective action dilemmas, transaction costs and information asymmetries that arise because of states' rational behaviour. In such situations, international regime allows states to cooperate by providing information, reducing uncertainty and lowering transaction costs. In the area of international trade, similar to the tradition approach in international economics, trade agreements firstly, help states overcome terms-of-trade inefficiency, termed in neoliberalism as negative world-price externalities.¹³⁷ Additionally, trade agreement can be viewed as instrument for cost reductions in terms of negotiating, drafting, launching and maintaining trade regime. For this second reason, cooperation in trade will take place irrespective of size and market power, as long as there is expected efficiency gains from the cooperation. The form of trade cooperation, multilateral, bilateral or plurilateral, depends on the market imperfections to be resolved, the negotiation environment, the negotiation costs and the expected gain for continued cooperation. The non-statist rationalist counterpart of neoliberalism is liberalism (in international relation sense). For liberalism, states's preferences are endogenously determined by domestic rational self-interested individual and social groups preferences translated by domestic institution and process and states pursue their preferences under constraints imposed by the preference of other states. Trade negotiators have to secure political support of domestic constituents or special interest group by taking into account their efficiency concerns while cooperating internationally.¹³⁸ While liberalism is instrumental in explaining policy determination process, it does not give rise to motivation for trade other than those mentioned earlier.

Neorealism

Whereas neoliberal institutionalism highlights the efficiency gain as the motif for cooperation, neorealism stresses instead on relative gains compared with other actors and compared with alternative non-cooperative policy, as the relative gain can eventually be transformed to higher relative military capability and political influence and create dependence. Therefore, power distribution and accumulation and dependence

¹³⁷ WTR 07, p. 69.

¹³⁸ Ibid., p.76.

are the main motif of cooperation according to the theory. Security-obsessed and self-help countries do not cooperate to reap primarily welfare-enhancing mutual efficiencies, but rather try to 'squeeze out' as many concessions from other countries to be on a higher power rank. Trade agreements are seen as strategic complement to political and military cooperation. The approach seems not to explain why countries conclude trade agreements, but helps in explain their extent and boundaries, especially between large and smaller countries. Generally, the extent and depth of a trade agreement involving large countries depend on their security ambition and credibility, as smaller countries are willing to join the agreement if large countries can credibly ensure that they will not opportunistically exploit the agreement and provide adequate concessions, economic, political or military nature.¹³⁹ But in extreme cases, large countries may use trade agreements to increase dependence of small countries which face only with two alternatives: entering sometimes disadvantageous agreements or becoming even worse off from non-entering. Smaller countries can usually either take side with large countries to survive politically and flourish economically, or form trade agreements with other smaller countries to counterbalance large countries.

Cognitivism

Constructivist or strongly cognitivist theories argue that realist statist theories fail to account for the role of ideas in shaping state policy and that international cooperation can be explained by normative structure that shapes states' identity.¹⁴⁰ Owing to the observation of historical development of multilateral institutions, it is according to constructivism largely values and ideas prevailing in international system that motivate and shape international cooperation, also in trade affairs. Countries that usually share common ideas and coherent goals tend to form institution, because ideas can influence states behaviours only when they are embodied in institutions which in turn legitimate and disseminate these ideas. For trade cooperation, one of the ideas is for example the peace promoting quality of trade. Multilateral and preferential trade agreements reduce risk of conflict by gradually increasing trust, making countries interdependence through increased trade and specialisation. Post-war European integration is an important example of a trade agreement for which peace was a primary

¹³⁹ Ibid., p. 93.

¹⁴⁰ Hasenclever et al., pp.167-8.

motivation.¹⁴¹ The non-statist counterpart of constructivism is the so-called ‘weakly cognitivist’ theories, which likewise focuses on ideas and values as motivation, but stresses the role of the network of experts with recognized competence in a particular domain, the so-called moral entrepreneur, in shaping states’ values needed for international cooperation.

3.3 Legal Approach

Legal approach to the rationale for trade agreement is based on two fundamental concepts. First, individual citizens are the only legitimate political principal and they are interested in possessing fundamental economic rights of free exchange and free entrepreneurship. Second, political agents, namely the legislative, executive and judicial branches for government, are sometimes not guided by national interests as defined by the legitimate political principal, and cause government failure through rent-seeking behaviour. In a domestic society, this is corrected through constitution, which protects equal rights of citizens against political misbehaviour by allocating lawmaking, decision making and control function among individuals and institutions. Every economic actor is born with inalienable economic rights derived from the fundamental rights, such as freedom from discriminatory competition, arbitrary taxation, expropriation, freedom to engage in free economic exchange. These rights can be protected domestically by constitution.¹⁴² Since these rights are exercised both in domestic and international context, that is economic actors must be able exercise them in international transactions, the same basic rationale likewise applies for trade agreements which in similar manner can be regarded as ‘constitution’.

Government’s international trade policy may be subject to special interest groups who dominate elected officials and tend to call for protectionism. Citizens wish to reduce inefficient rent-seeking by special interest groups and therefore wish to eliminate possibility to protectionism and discriminatory trade policy by pegging domestic decision to a trade agreement.¹⁴³ Trade agreements can thus function as the second defence line of citizens’ economic rights. This motivation can be realized,

¹⁴¹ Pomfret, R. (1997), *The Economics of Regional Trading Arrangements*, Oxford: Clarendon Press, p. 89.

¹⁴² WTR 07, pp. 79-81.

¹⁴³ Ibid., p. 83.

mainly because, first, trade agreements prevent arbitrary and competition-distorting trade policy by providing for concrete sanctions by trading partners, and, second, similar to argument by political economy approach, trade agreements gradually reduce the lobbying power of domestic pro-protectionist groups. However, rent-seeking and other protectionist measures can also come from foreign traders and governments. By raising protectionist barrier, foreign countries deprive domestic exporters of contracting rights and market freedom, for instance. This taxation by foreign government without representation in it can be solved by trade agreements, because they allow citizens to participate in and control the making of foreign countries' trade policy.¹⁴⁴ By all the virtues of the legal approach, the main criticism of this approach is that, even though inefficient rent-seeking is plausibly identified as motivation for trade agreements, it does not correspond to reality. Citizens' participation in trade negotiation is still limited, domestically and internationally, so that trade agreements between government still fail to minimize the risk of international government failure, precisely because self-interested, rent-seeking governments are the one who negotiate the deals.¹⁴⁵

4. Concluding remarks: Efficiency analysis of the GATT Article XXIV

The GATT Article XXIV is an efficient institution if it advances the aggregate welfare of the WTO trade community, composing of the welfare of individual members of the institution, in the sense of Pareto improvement or satisfying the Kaldor-Hicks criterion. The welfare of each individual member can be approximated by individual utility, defined by utility function, transaction costs and other externalities. The analysis should answer the question as to whether the Article enables the individual members to advance their welfare through incentives for adequate trade policy concerning the formation of preferential trade agreements. The preceding essay identifies sources of transaction costs: trade policy uncertainty, legal uncertainty and complexity, negotiation costs, information gathering and evaluation costs, trade policy monitoring costs, enforcement and adjudication costs, and elements of states' utility function: national income (exports and foreign investments), terms of trade improvement, efficiency (efficient resource allocation, rent-seeking reduction, pursuit of efficiency-enhancing

¹⁴⁴ Gerhart, pp. 22-5.

¹⁴⁵ WTR 07, p. 86-7.

policies), security (political and military power, peace, integration and good neighbourliness). This list is however non-exhaustive, and although some elements are arguably inter-dependent and inquantifiable, they are able to serve as components for the analysis to draw a plausible conclusion.

Due to the weakness of analysis given the special characteristics of public international law regarding law and economics, it is almost impossible to formalize and accurately quantify the utility function and transaction costs of each WTO member state in a comprehensive manner. Therefore the efficiency analysis of the Article will answer the main question by providing evidences about the effects of the Article on the elements of utility function and transaction costs only in qualitative manner, recalling that the main thesis question deals with the welfare comparison between the situation when the co-existence of the WTO multilateral trade regime and preferential trade agreement without the regulations by the Article and the situation without the Article. That is, having identified sources of transaction costs and elements of the states' utility function, the efficiency analysis of GATT Article XXIV can be made possible by looking at the rule effects on the identified elements which are embodied in the efficiency backdrops of the world without the Article and draw concluding comparisons.

G. Effects of Preferential Trade Agreements on the WTO Multilateral Trade Regime

1. The Rationale of Most Favoured Nation (MFN)

While the Most Favoured Nation (MFN) is one of integral principles of WTO trade regime and in most preferential trade agreements, the latter themselves constitute a stern contrast to the MFN itself. In the WTO context, GATT Article XXIV is an important exception to MFN. Unlike other exceptions, which enables members to engage in discriminatory practices, the Article empowers members to convey 'extra-preferential' treatment above the previous level of MFN to some members.¹⁴⁶ It is therefore necessary for a complete economic analysis of the Article to survey the rationale of the MFN as well as its virtues and backdrops regarding states' welfare. The elaboration serves at later stage as a base for the analysis which shows specifically in the WTO context that the coexistence of preferential trade agreements and the overall WTO regime may not be efficient.

The MFN commitment runs throughout the WTO legal regime, in trade in goods, service and trade-related aspects of intellectual property rights. In case of the GATT, the MFN specified in unconditional and positive manner, stipulates that:

'Any advantages, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.'¹⁴⁷

Discriminating treatment such as different regulations, standards, formalities, different tariff rates, amongst member countries is prohibited. The negotiation concessions documented in the annexed schedule of commitment must be accorded to every other member. By enshrining the MFN in the first article and as one of the two

¹⁴⁶ Wilkinson, p. 93.

¹⁴⁷ Article II of the GATT.

articles that requires a unanimous vote for amendment, the drafters made clear that discrimination among trading partners would be the exception rather than rule.¹⁴⁸

The MFN becomes relevant when there are more than two trading countries or in a multilateral setting. It is at first curious to see why government should be interested in committing themselves to extending concession made in negotiation between two or very few countries to all members of the WTO or particular trade agreement, especially since the MFN has been one of main principles of most trade agreements since the 17th century. The emergence of MFN stemmed from the declined of mercantilism. In the period until the formation of the GATT in 1947 concessions were granted on the condition of receiving adequate compensation, the conditional MFN. The unconditional MFN was characteristic to the US trade policy since the 1920s in order to motivate other countries to do the same. The modern day version of MFN is a direct descendent of the MFN clauses in bilateral and plurilateral agreements between the US and its trading partners.¹⁴⁹

Welfare-increasing role of the MFN

The efficiency-enhancing character of the MFN is most apparent because inefficiencies arise at its absence. Without the MFN, two countries granting each other trade concession has incentives to conduct bilateral trade negotiations with another non-participating country. This 'bilateral opportunism' can erode the benefits from their agreement.¹⁵⁰ One of the two countries, assumed country A, can enter into another agreement with a third country, country C, that harms the other country, country B, by reducing the value of the initial reciprocal commitment made by offering better terms of market access C. The value of concessions is eroded in the future through discrimination, the so-called 'concession-erosion' problem. B facing with this possibility would be willing to offer less in the initial negotiation and the scope of trade deals would be diminished.¹⁵¹ By stipulating non-discriminatory behaviour, B can be

¹⁴⁸ Schwartz, Warren F., and Alan O. Sykes (1996), the economics of the most favored nations clause, in Bhandari, Jagdeep S., and Alan O. Sykes (ed.), *Economic Dimensions of International Law: Comparative and Empirical Perspectives*, London: Routledge (hereinafter Schwartz and Sykes 1996), p. 66.

¹⁴⁹ WTR 07, pp. 132-3.

¹⁵⁰ Bagwell and Staiger 2002, p. 79.

¹⁵¹ Ethier 2004, pp. 315-8.

assured that the market access granted to A will not be diverted entirely to one of its competitor at a later stage (concession diversion), and if C is bound by the MFN, then any concession it offers to A will be extended to all of its competitors, and the further trade deal made between A and C will amount to further reciprocal liberalisation. This removes the incentives for A to deal sequentially and encourage all countries to make an optimal deal at the first place.

Another kind of inefficiency occurs in the case of different productivity. The incentives of discrimination will arise if one country (its firms) is more productive than the other. The most productive country will have higher rents and the importing country will want to impose higher tariffs on that country as this generates highest tariff revenues. This, however, punishes the most productive country and shifts the production to less efficient country that is granted the better market access, leading to inefficient allocation of resources. The MFN prevents the inefficiencies resulting from the discrimination, and enables all countries to reap benefits from trade agreement at the greatest possible extent through efficient production structure.

The MFN significantly also advances welfare by enlarging the regime's geographical scope. First, the MFN makes it attractive for non-members to enter into an existing agreement, since they get access to a package of low tariffs.¹⁵² Second, it provides reason for small countries to join a trade agreement. Country with less market power should have no incentives to raise trade barriers, and their pre-liberalisation optimal trade barriers are low. This can be a great disadvantage in the negotiation process toward reciprocal trade liberalisation with larger countries, as without MFN large countries may consider the reciprocal concessions from smaller countries not substantial enough reciprocal substantial concession. The MFN ensures that concessions granted to other larger countries are extended to small countries.

From a political economic perspective, Grossman and Maggi (1997) state that the non-discrimination commitment specifies trade policy such that subversion of government policy through strong lobbying groups at the expense of weaker groups is

¹⁵² Horn, H. and Mavroidis, P. (2001), 'Economic and Legal Aspects of the Most-Favoured Nation Clause', *European Journal of Political Economy*, 17, 2 (hereinafter Horn and Mavroidis 2001), p. 252.

reduced by reducing incentives to engage in wasteful political lobbying.¹⁵³ In the case of the WTO, Krishna (1998) finds that without the MFN, special-interest lobbying groups may effectively pressure the government to engage in preferential trade agreements which are detrimental to national welfare to prevent any possible future multilateral trade deal. The MFN allows the government to overcome this inefficiency and to pursue efficiency-enhancing policy.¹⁵⁴

It is argued that MFN has political benefits, as the prohibition of discrimination prevent states from applying trade policy as coercive political tools thus mitigating tensions that would otherwise arise. Trade on a non-discriminatory basis promotes cooperation on the basis of national conception of self-interest that prefers production to war, and has thus war-preventing and peace promoting nature.¹⁵⁵ Nevertheless, from the neo-realist point of view, the MFN imposes constraint on the conduct of foreign policy, while the potential gains from trade cannot be translated into significant military advance compared with other states, even if the effectiveness of economic measures as foreign policy instrument is limited and questionable.¹⁵⁶ The political benefits from the MFN seems ambiguous and less significant given that the MFN neither is the main foreign policy instruments with regard to peace and integration, nor has restrictive impact on power politics instrument.

Furthermore, Viner (1924) points out that even in situations where discriminatory trade policy is desirable, the administration costs to maintain the whole regime can be high for both government and firms because of the need to keep trace of goods origin, especially for those not produced in a single country, and the relevant administrative procedure.¹⁵⁷ The MFN helps reduces the complexity of trade regimes through creating transparency and uniformity in tariffs rules for the government, and the costs of information for other governments, thus facilitating further trade negotiations. A trading regime without an MFN obligation creates an opportunity to threaten to create

¹⁵³ Grossman, G. and Maggi, G. (1997), 'Free Trade vs. Strategic Trade: A Peek into Pandora's Box', *NBER Working Paper*, No. W621

¹⁵⁴ Krishna, P. (1998), 'Regionalism and Multilateralism: A Political Economy Approach', *Quarterly Journal of Economics*, 113, 1 (hereinafter Krishna), pp. 244-5.

¹⁵⁵ Keohane, Robert O. (2002), *Power and Governance in Partially Globalized World*, London: Routledge, p. 49

¹⁵⁶ Neuhold, paragraph 2407-8.

¹⁵⁷ Viner, Jacob (1924), 'Cost Curves and Supply Curves', *Zeitschrift für National Ökonomie (Journal of Economics)*, 3: pp. 23-46.

a discriminatory sub-regime. This possibility can be followed by counter-threats and retaliation that immensely increase transaction costs by making for uncertain and instable trade regime, threatening the gains from reciprocal trade liberalisation.¹⁵⁸ The MFN provision is therefore important for regime stability, legal certainty and necessary complement to the reciprocity principle. The MFN also contributes to the regime stability by reducing incentives for a renegotiation not leading to further liberalisation or a revision of concession. Any WTO member wishing to do so is confronted with the fact that the affected parties in this case are all other WTO members, who are now entitled to equivalent compensation in form of concession on other goods. Withdrawing concession in a tariff line would result in granting concession in many other lines, and that for all other members.¹⁵⁹ The MFN provisions means that the costs of renegotiation can be high and caused by concessions granted not only to the affected parties but practically all WTO members.

Welfare-reducing role of the MFN

MFN as rule of negotiation has influence on further liberalisation process. In this regard, it has both positive and negative role, that is liberalisation-advancing and impeding effect. The positive contribution, the elimination of ‘concession erosion’ was discussed in connection with ‘bilateral opportunism’. The decelerating contribution of the MFN to liberalisation process originates from its ‘foot-dragging’ and relating ‘free-rider’ effects, which represent a potential costs of bargaining under the MFN.

‘Foot-dragging’ is a negative effect of the MFN in the sense that it provides countries with incentives to hold back from making deals in order to maintain bargaining chips for future negotiations.¹⁶⁰ If country A expects in a later date to start the bargaining with country C on the same good as it is doing with country B, it will have to extend the concession negotiated with B to C due to the MFN, thereby losing bargaining chip. Therefore, country A may offer little concessions to B in order to retain stronger position for subsequent negotiations with C. The reservation of A tends to be

¹⁵⁸ Schwartz and Sykes 1996, p. 62.

¹⁵⁹ WTR 07, p. 134.

¹⁶⁰ Ibid., p. 135.

higher, the larger C, and thus the higher its pre-negotiation optimal tariffs is.¹⁶¹ The MFN thus prevents some countries from going further in liberalization, causing inefficiency by limiting potential welfare improvement from both individual and global perspective. In the WTO context, however, the ‘single undertaking principle’ introduced during the Uruguay Round and applied in the current Doha Round should effectively the incentives to foot-drag by providing that the negotiations form a single package of about 20 subjects and that the package will be accepted universally before being signed with a single signature without any option to pick and choose between different subjects.¹⁶² In the view of the future ascension to the WTO of new members not yet present at the Doha round, Bagwell and Staiger (2002) point that the WTO provides for ample opportunity for renegotiation. The current members should negotiate without foot-dragging to reap the highest benefit of liberalisation. Should the negotiations with the potential WTO member fails, the WTO provides for renegotiations involving all parties.¹⁶³

A country free-rides when it can capture the gains from unreciprocated concessions resulting from trade deals of other countries granted to them by the MFN. A country may reject an offer in order to let other countries reach agreements from which it can benefit without having to make concessions itself. It may be tempted to understate its concession, hoping that another country will offer the concession that induces the counter-concession it desires to benefit from. This is inefficient because the country accepting the offer or offering an optimal concession would lead to further concession exchange thus further liberalisation¹⁶⁴, and because further liberalisation with the free-riding country may become more difficult, having no bargaining chip (as was the case in the GATT/WTO before the Uruguay Round – ‘foot-dragging’ effect).¹⁶⁵

¹⁶¹ Bagwell, Kyle and Robert W. Staiger (2004), ‘Backward Stealing and Forward Manipulation in the WTO’, *NBER Working paper No.10420*, p. 18-27, 39-40.

¹⁶² http://www.wto.org/english/tratop_e/dda_e/texts_intro_e.htm, retrieved on 14 December 2009.

¹⁶³ Bagwell and Staiger 2002, p. 89.

¹⁶⁴ Horn and Mavroidis 2000, p. 269.

¹⁶⁵ Bagwell and Staiger 2002, p. 87.

2. Efficiency effects of preferential trade agreements on the WTO multilateral trade regime

Having discussed the MFN in general context, this part aims at first identifying rationale for preferential trade agreements as opposing to the MFN in the context of the WTO multilateral regime and more importantly the sources of inefficiency caused by discrimination in form of preferential trade agreements in the world in which preferential trade agreements coexist with the WTO regime. The information about the effects of preferential trade agreements on the efficiency of the WTO trade regime is crucial for the analysis of the GATT Article XXIV.

In the real world, preferential trade agreements coexist with the WTO multilateral trade regime. It is hardly obvious a priori that discrimination systematically harms countries interests in general. Rather, a preferential trade agreement usually helps their member extend their welfare while harms non-members, meaning that countries sometimes find it is more efficient for themselves to conclude preferential trade agreements, and if the welfare extension is less than the harms, it reduces the welfare of the WTO trade community. This part will first briefly discuss the rationale of concluding preferential trade agreements. Then it will look at their efficiency effects on the WTO trade community.

2.1 Rationale for preferential trade agreements

Preferential trade agreements can help single countries increase their market size and provide firms in member countries with a competitive edge relative to firms producing the same or a similar good outside the preferential market. Countries may become part of a preferential trade agreement also to insure themselves against the erosion of market access caused by other preferential trade agreement of which it is not member, especially for small countries seeking access to larger more developed markets.¹⁶⁶ Indeed, this seems to explain the current proliferation of preferential trade agreements between large and developed countries and (a group of) smaller less developed countries, whereby the latter are willing to give significant concessions to get

¹⁶⁶ This insurance policy against being placed at a competitive disadvantage through discriminatory policies of other countries is called 'domino regionalism' by Richard E. Baldwin; Baldwin 2006, p. 1462-4.

market access to the former.¹⁶⁷ This is particularly observed in those developing countries that are about to lose or have lost developing country preference schemes such as the generalized system of preference, GSP.¹⁶⁸ For preferential trade agreements among small countries, its rationale can be to increase bargaining power in international trade negotiation. The creation of such a preferential trade agreement will bring benefits through saving of international negotiation costs and giving small countries a larger voice international arena, provided that they have similar products as exports and thus being able to find a common negotiation position.¹⁶⁹ A preferential trade agreement can also serve a protectionist rationale, when it enhances the profits of well-organised, usually globally uncompetitive but competitive in the preferential area. In this case, preferential trade agreements enable the member countries to reap gains from trade in product areas where they cannot compete internationally.

Having observed the progress that can be made in difficult and time-consuming WTO negotiations, countries may wish to go deeper in integrating their economy that seems possible in the WTO multilateral framework. Preferential trade agreements enable government to negotiate on other issues untouched by the WTO, such as investment, competition, environment and labour standards, and harmonisation of economic policies and rules. Government can highlight preferential trade agreements' role in the new issues and set them as agenda of the multilateral negotiations, for example NAFTA provisions for liberalisation of investment measures was employed as stepping stone towards the Agreement on Trade Related Investment Measures (TRIMs) in the WTO.¹⁷⁰ Furthermore, transaction costs associated with trade negotiations in the WTO are likely to be higher than negotiations with fewer participants who in many cases share comparable culture, business practice and similar legal system.¹⁷¹ Preferential trade agreements as intra-state signalling device may help a government pursue particular economic policy more effectively and credibly than the WTO regime, if they provide for credible and effective enforcement mechanisms. Also the security

¹⁶⁷ WTR 07, p. 62-3.

¹⁶⁸ World Trade Organisation (2003), *World Trade Report 2003*, Geneva: World Trade Organisation (hereinafter WTR 03), p. 50.

¹⁶⁹ WTR 07, p. 64.

¹⁷⁰ Yeung, May T., Nicholas Perdakis, and William A. Kerr (1999), *Regional Trade Blocs in the Global Economy: the EU and ASEAN*, Cheltenham: Edward Elgar (Hereinafter Yeung), p. 23.

¹⁷¹ WTR 03, p. 49.

related benefits of trade agreements can be a significant rationale for preferential trade agreements, especially between neighbouring countries, as they can make conflicts more costly and favour cross-border collaboration, but also for larger countries to create economic dependence.

It should be recalled that the MFN creates free-rider problem which reduces the extent of trade liberalisation, because countries will be reluctant to offer concessions. Preferential trade agreements as relaxation of the MFN obligation permit countries to overcome this problem. A country cannot now hope for others to induce concession from a trading partner, and is now willing to offer its own concession. The trading partner having observed that the concession given to the country can be enjoyed only by this country, and is not worried in losing bargaining chip in negotiations with other countries and refrain from foot-dragging behaviour. Both may conclude a bilaterally optimal trade deal. In a situation in which free-rider effects of the MFN seriously impair WTO members from liberalisation, a preferential trade agreement may be second-best alternative, at least for its signatories.

From global perspective, the critical points of controversy between preferential trade agreements and the WTO multilateral regime are the net effect on global welfare and WTO members not party to preferential trade agreements, and whether preferential trade agreement contribute to the advancement towards the ultimate efficiency embodied in multilateral free trade or detract from it. The following discussion focuses on the situation in which preferential trade agreements and the WTO multilateral regime characterised by the MFN coexist. According to the previous discussion, the MFN reduces transaction costs in international trade, increases global welfare of trade deals by accelerating liberalisation process towards global free trade and by forging efficient resource allocation and increasing specialisation and exports. What are preferential trade agreements' effects on transaction costs in global international trade? What would happen to resource allocation, specialisation and trade volume of member and non-member countries of a preferential trade agreement at its formation? Whether and how preferential trade agreements stabilize the WTO multilateral trading system and eventually result in global free trade or fragment the world economy?

2.2 Preferential Trade Agreements increase transaction costs in trade among WTO members.

To begin with the transaction costs; preferential trade agreements as opposite to the MFN are expected to nullify and reverse MFN-induced transaction costs reduction and to incur considerable additional costs to economic transactions in the global WTO multilateral trading system. Bhagwati (1996) states that ‘spaghetti bowl’, the term used to describe the varying tariff structures and regulations as a result of preferential trade agreement proliferation that traders encounter and customs officials apply, immensely increase transaction costs.¹⁷²

First, the coexistence of preferential trade agreement and the WTO trade regime increase legal uncertainty in application, interpretation and adjudication. The legal uncertainty emerges by the nature of the law. Preferential trade agreements are considered international treaty according to the definition given by Vienna Convention on the Law of Treaties 1969 (VCLT).¹⁷³ It is possible to understand relationship between WTO agreements and preferential trade agreements however not only as between treaties, but also as between different sources of law. Giving other countries preferential treatment in form of preferential trade agreement is a right of or freedom for state, and have existed long before the advent of the GATT or the WTO, and hence can also be considered as customary international law.¹⁷⁴ Regardless of character of their relations, preferential trade agreements and WTO agreements are of equal rank. Although the Singapore Ministerial Conference ‘reaffirms the primacy of the multilateral trading system, which includes a framework for the development of regional trade agreements, and we renew our commitment to ensure that regional trade agreements are complementary to it and consistent with its rules.’,¹⁷⁵ the question as to which international treaties, WTO agreements and preferential trade agreements, should have primacy remains a source of conflict, remains and significantly causes legal

¹⁷² Bhagwati, Jagdish (1996a), ‘US Trade Policy: The Infatuation with Free Trade Areas’, in Bhagwati, Jagdish and Anne O. Krueger (eds), *The Dangerous Drift to Preferential Trade Agreements*, Washington: AEI Press, 1-20.

¹⁷³ VCLT Article 1(a) reads: ‘treaty’ is defined as an international agreement concluded between states in written form and governed by international law...

¹⁷⁴ Fabbriotti, Alberta (2008), *The Interplay between the WTO and RTAs: Is it a Question of Interrelation Between Different Sources of International Law*, p.1, papers.ssrn.com/sol3/papers.cfm?abstract_id=1151386, retrieved on 14 July 2009.

¹⁷⁵ Singapore Ministerial Declaration (1996) WT/MIN(96)/DEC adopted on 13 December 1996, para. 7.

uncertainty.¹⁷⁶ Legal uncertainty also arises due to the conflicting legal obligation. Preferential trade agreements are increasingly likely to include obligations that conflict with WTO provisions. While the issue of state responsibility for unlawful acts are regulated to a certain degree¹⁷⁷, the legal uncertainty due to conflicting legal obligation may arise with regards to choice of law and choice of legal forum: May WTO law be applied in dispute settlement set by a preferential trade agreement?; May preferential trade agreement be applied in the WTO dispute settlement mechanisms?; May a claimant bring identical or similar claims in more than one forum at a time, such as at the WTO and the forum provided for in preferential trade agreement?; How do these divergent sources of law influence one another in terms of interpretation. No clear answer is provided to these questions.¹⁷⁸

Second, the coexistence increases complexity of legal obligation, undermines transparency of world trading regime and create administrative and monitoring costs. The Proliferation of preferential trade agreements leads to large numbers of different tariff rates and other complex regulations. The parallel existence in a single country of differing trade rules applying to different trade partners represents a barrier to trade for firms and governments not only because of the costs involved in searching, gathering, meeting, administering, evaluating and monitoring a wide range of conditions of trade rules, but also because it reduces the clarity of the WTO regime.¹⁷⁹ This is particularly the case for free trade areas which unlike customs union does not adopt a common set of trade measures with respect to non-members and where tariff rates and regulations of each member country remain. The most prominent example of rule complexity is the Rules of Origin in free trade areas, as discussed in section D of this thesis.

2.3 Static effects of preferential trade agreements: trade diversion as sources of inefficiencies

¹⁷⁶ Trachtman, p.172.

¹⁷⁷ Mitchell, Andrew D. and Tania Voon (2008), Free Trade Agreements and Public International Law, p.3.; As some parts of the VCTL, including the interpretation of treaties, are accepted as codification of customary international law, respective provisions are binding for states regardless of their status of ratification of the Convention.

¹⁷⁸ Trachtman, p. 171.

¹⁷⁹ WTR 03, p. 65.

Preferential trade agreements have effects on trade volume and the efficiency of resource allocation. Two important terms are essential in order to answer whether preferential trade agreements contribute to trade growth and efficient resource allocation: trade creation and trade diversion.

Jacob Viner (1950) first introduces the concepts of trade creation and trade diversion in the economic analysis of preferential trade agreements. He defines trade creation as the **displacement of domestic production by imports from other members of a preferential trade agreement**. This is economically desirable, since production shifts from costly domestic producers to more competitive producers in another country. Trade diversion was **the shift in the source of imports from a cheaper non-member to a higher-cost producer in a member country**, which is economically undesirable because the production is substituted from low-cost to high-cost country.¹⁸⁰ Trade creation is a phenomenon between members and trade diversion between members and non-members of a preferential trade agreement. According to this definition, trade creation (between members) certainly occurs upon the formation of a preferential trade agreement, because trade barriers are eliminated among members. The crucial question is, however, about the source of the increased trade. If it is diverted from a competitive non-member producer, then trade diversion arises. The extent of trade creation and diversion determine welfare changes, and also their sources, for both member and non-member of a preferential trade agreement. The global welfare effects can be analysed in by summing up the welfare effects for member countries and those for non-members.

Trade creation, trade diversion and welfare effects in member countries of preferential trade agreements

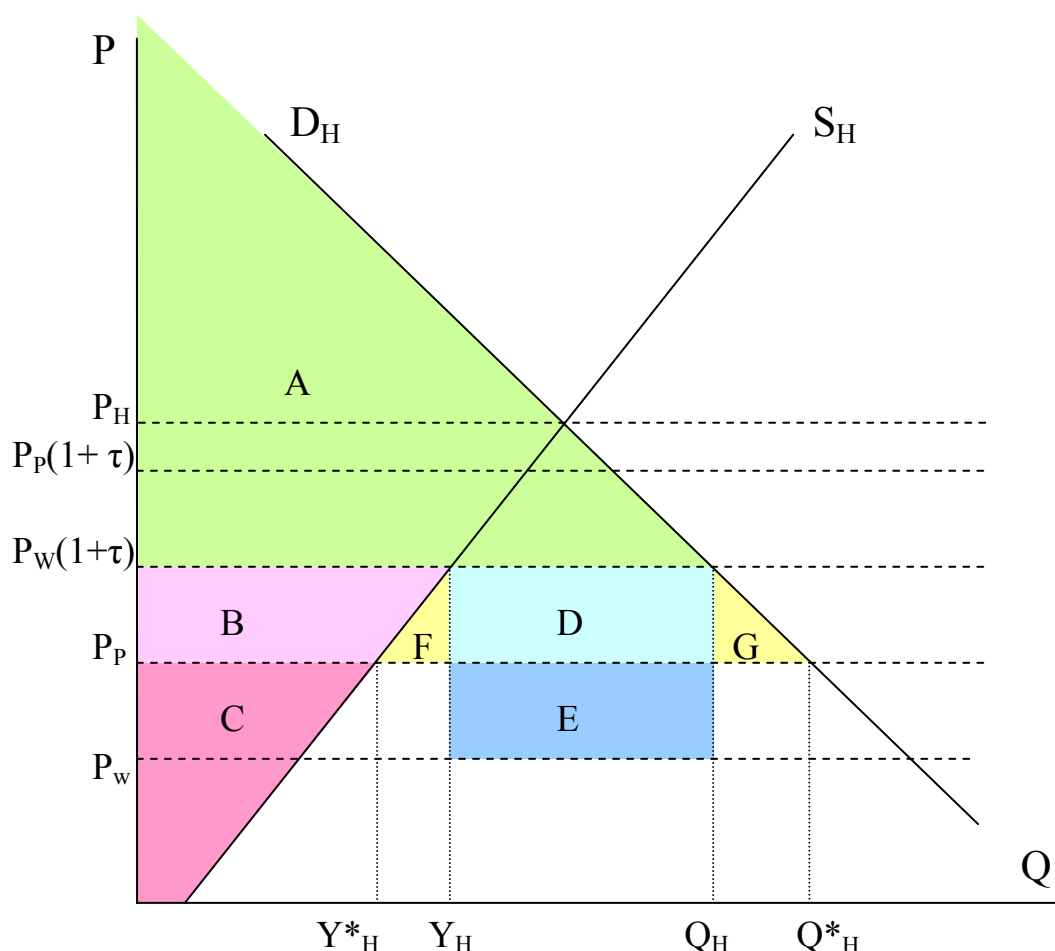
For member countries, the welfare effect is ambiguous if the preferential trade agreement diverts some trade from outside to inside the agreement area. In comparison with before its formation, the welfare may have gone down, up or remained the same. Even in the presence of trade diversion, the welfare of member countries might increase once the impact of trade creation on consumer surplus is taken into account. In the

¹⁸⁰ Viner, Jacob (1950), *the Customs Union Issue*, New York: Carnegie Endowment for International Peace.

partial equilibrium model of Johnson (1960) with three countries: home (H), partner (P) and rest of the world (W), where H does not have market power and forms a preferential trade agreement with P who is a globally inefficient producer of a good compare with W. The trade diversion effect takes place, as P has become supplier of this good for H instead of the more-competitive W. The trade creation effect takes place between H and P, as the increased imports to H are from more competitive P, corresponding to the expectation that the reduction of trade barriers within the preferential trade agreement area will stimulate trade in the area, so trade among the members is bound to increase. It can be shown that the welfare increase for the trade creation effect (area F and G in the graphic 1) can be larger than welfare loss from the trade diversion effect. (area E in the graphic 1), so that the overall welfare effect for member countries is positive.

In the graphic 1, the horizontal axis represents the quantity, the vertical axis the price of a traded good. Home's supply is represented by S_H , Home's demand by D_H . The autarky home price, P_H , is higher than the price in the country P under the MFN, P_P . Being an globally inefficient producer, P_P is higher than the price of the globally most competitive producer, which is the world price, P_W . Without the discrimination in favour of P, home country will have to import at $P_W(1+\tau)$, where τ is the MFN ad valorem applied tariff rate for the good. The imports is necessary because at $P_W(1+\tau)$, home country demands Q_H but produces only at Y_H . The total welfare under the MFN is computed as consumer surplus (area A) + producer surplus (area B and C) + tariff revenue (area D and E). As soon as home forms a preferential trade agreement with P abolishing all trade barriers between them, the good produced in P can be imported to H at the price P_P instead of $P_P(1+\tau)$. If P_P is lower than $P_W(1+\tau)$, then home will import from P at P_P instead of from the globally most competitive producer, thus causing trade diversion. In this situation, since the import price for home country decreases, the domestic demand increases to Q_H^* , while the domestic supply decreases to Y_H^* , thus making the imports under discrimination larger than the import under MFN. In other words, domestic production of H is replaced by imports from P, resulting in trade creation. Home country's welfare is computed as consumer surplus (area A, B, D, F and G) + producer surplus (area C). Its welfare level depends on the gain (area F and G) and the loss (area E). If area F and G together is smaller than area E, home country

experiences welfare loss, from a trade economic point of view, following the formation of a preferential trade agreement.¹⁸¹



Graphic 1: Welfare effect of Home country (H) at the formation of a trade-diverting preferential trade agreement.¹⁸²

However, if a preferential trade agreement purely increases trade among members without diverting trade from outside, thus leading to further substitution of domestic production by imports from other globally competitive members of the preferential trade agreement, the welfare effects is clearly positive. In this case, there is only trade creation and no trade diversion.

There is a general tendency to overestimate the trade creation effects. The suggested model deals only with tariff barriers, while in reality a preferential trade agreement might not eliminate all other trade restrictions within the agreement area, and these can still be used by a member country as disguise protectionist measures against

¹⁸¹ Johnson, H. (1960) 'The economic theory of customs union', Pakistan Economic Journal 10, 1, pp. 14-32.

¹⁸² Ibid., with some modifications.

other members, thus preventing the effective trade liberalisation and impairing and its potential benefits. An example is rules of origin which are necessary in a free trade area to prevent imports from non-member being routed through the member country with the lowest external tariffs. Even when tariff barriers among members of a preferential trade agreement are eliminated, the rules may encompass the content requirement could be so configured that an industry actually receives a greater protection than before the preferential trade agreement.¹⁸³ The rules of origin may prescribe the import of intermediaries used to produce a final good from an inefficient producer within the agreement area in order for the final good to be qualified for preferential treatments. This does not only lead to trade diversion from efficient outsiders to inefficient insiders. In many cases, the price of the intermediaries the producers of the final good pay is higher than imports from outside. This reduces welfare gains from the preferential trade agreement for its members.

Although it is clear that the trade diversion effect caused by preferential trade agreements is a source of inefficiencies for the member countries and trade creation effects can be reduced, it is reasonable to assume that the net welfare effects for the member countries should be positive, especially when non-economic elements of states' utility function are taken into account. Otherwise they would not form the preferential trade agreement at first place.

Trade creation, trade diversion and welfare effects in non-member countries

In contrast to the case of its members, the formation of a preferential trade agreement is highly likely to come at the expense of at least some non-members who lose out from trade diversion and for the resulting deterioration of their terms of trade, as the member countries have discriminate those goods that they can produced at a lower costs compared with non-members as well as those they cannot.

If the member countries decide to remove trade barriers of goods they can produce at lower costs than world market, member countries will gain from trade creation effect while leaving non-members at least unaffected in short-term, by not

¹⁸³ WTR 07, 139-40.

causing trade diversion. In this case, the preferential trade agreement leads to exploitation of economic of scale by the members in a longer term and further specialisation which will result in more efficient resource allocation also at global level, and improvement of the terms of trade of non-members who can now import the good at a lower price. This specialisation will subsequently also lead to expansion of trade at global level. A preferential trade agreement that largely entails trade-creating effects tends to increase welfare of both members and non-members.

If, however, member countries remove trade barriers of less-competitive goods, such that trade is diverted from more competitive non-member countries to the agreement area, the net welfare for members might still increase as discussed earlier, but non-members will definitely lose their export market. Moreover, the trade diverting effects of a preferential trade agreement induced expansion of trade within the agreement area may lead to such a decline in demand for exports of non-members that the price of these exports decline in world market.

To sum up, preferential trade agreements that create trade diversion have a negative welfare effects on non-members, and, given the probably positive welfare effects on its members, an ambiguous global welfare effects. The latter is, however, likely to be negative, since the trade creation is usually overestimated. In contrast, preferential trade agreements that does not create trade diversion is for members and non-members and thus globally welfare enhancing. The next step, different configurations of preferential trade agreement that give rise to trade diversion will be discussed.

Configurations of preferential trade agreement and trade diversion

First, how much a preferential trade agreement is trade-creating or trade-diverting depends on the choice as to which sectors are to be liberalised. It is possible for member countries to exchange market access concession only for globally less-competitive but regionally competitive products, thus causing trade diversion, with the consequence of non-members suffering from considerable decrease export volume and deteriorated terms of trade and the global welfare effect is negative. This is particularly

true for developing countries that wish to strategically build up key industries, and for both developing and developed countries that try to protect inefficient economic sectors.

Second, upon the formation a customs union, member countries, in addition to trade liberalisation among each other, adopt a common external tariff and other trade regulations. The original trade barriers between a non-member and the member countries could be higher or lower than the newly adopted common trade barriers. The common tariffs apply to all WTO non-members due to the MFN. If for the non-member exporting a good the custom union formation results overall in a higher trade barrier on that good, it may lose the export market to other more competitive non-members. The custom union's external tariff can be raised so high that the production is shifted to the most internally competitive, globally less-competitive member of the customs union, thus reducing trade with the rest of world in a trade diversion manner. The external tariff choice thus determines the incidence of trade diversion. Under some conditions it is possible to increase welfare of the members without changing the welfare of non-members; that is leaving the volume of trade between the non-members and the members unchanged, meaning that there is no trade diversion. The so-called Kemp-Wan Theorem starts from the fact that some members of the customs union were net exporters in some products and net importers in other products towards non-members. While the removal of trade barriers between the members similar to the formation of a free trade area will lead to trade diversions at the expense of non-members, the common external tariff can be adjusted such that for each product the customs union's trade with the rest of the world remains unchanged.¹⁸⁴

Empirical studies show ambiguous effects of preferential trade agreements concerning trade creation and trade diversion, not least because they are complicated by the fact that preferential trade agreements are nowadays overlapping. Most of the analyses suggest that preferential trade agreements do not offer strong evidence of trade creation.¹⁸⁵ Even if a preferential trade agreement has a net trade creation effects, there will still be non-member losers from the trade deal. For instance, whereas Chang and Winters (2001) suggest a term of trade deterioration of regional non-MERCOSUR

¹⁸⁴ Kemp, M. C. and Wan, H. Y. Jr. (1976), 'An Elementary Proposition Concerning the Formation of Customs Unions', *Journal of International Economics*, 6, 1, 95-98; Bhagwati, Jagdish (1991), *The World Trading System at Risk*, Princeton, New Jersey: Princeton University Press (hereinafter Bahgwati 1991), pp.60-1.

¹⁸⁵ WTR 03, pp. 54-5.

members,¹⁸⁶ Cernat (2001) and Gosh and Yamarik (2004) find that the MERCOSUR has a net trade creation effect.¹⁸⁷ Clarete et al.(2002) in their study of the effects of 11 trading blocs within the bloc and with the rest of the world in the 1980s and 1990s state that 6 studied blocs mainly of smaller trade agreements, such as the South Pacific Regional Trade and Economic Cooperation (SPARTECA), the European Free Trade Area (EFTA), the Andean Community of Nations, trade creation is at expense of the non-members. Among the larger blocs, while the EU did not feature trade diverting character, the ASEAN Free Trade Area (AFTA) and the North American Free Trade Agreement (NAFTA) are strongly trade diverting.¹⁸⁸ In contrast, Soloaga and Winters (1999) point out that the EU and EFTA is significantly trade diverting while all other studied preferential trade agreements are neither trade creating nor diverting.¹⁸⁹

Third, an important feature of free trade areas and customs unions is that they are typically completed in a gradual manner. Trade policy changes associated with a preferential trade agreement are phased in. The European Community customs union for example needed 12 years after the conclusion to be fully implemented.¹⁹⁰ The parties to the preferential trade agreement have the opportunity to determine the timeline of the implementation. Therefore it is possible that the earlier phasing-in measures are more trade-diverting to non-members than the others, and that the implementation period extends over too long a period of time. Without a regulation on implementation schedule, preferential trade agreements thus may potentially be detrimental to the global welfare.

At this stage, it has to be remarked that several factors determine the trade diversion effect of preferential trade agreements. Lipsey (1960) suggests that a

¹⁸⁶ Chang, W. and Winters, A. L. (2001) 'How regional blocs affect excluded countries: the price effects of MERCOSUR', *American Economic Review* 92, 4, pp. 889-904.

¹⁸⁷ Cernat, L. (2001), 'Assessing Regional Trade Arrangements: Are South-South RTAs More Trade Diverting?', *Global Economy Quarterly*, 2, 3, 235-59; Gosh, S., and Yamarik, S. (2004), 'Are Regional Trading Arrangements Trade Creating? An Application of Extreme Bounds Analysis', *Journal of International Economics*, 63, 2, pp. 369-95.

¹⁸⁸ Clarete, Ramon, Edmonds, Christopher, and Jessica Seddon Wallack (2002), *Asian Regionalism and Its Effects of Trade in the 1980s and 1990s*, ERD Working Paper Series, 30. Internet: http://www.adb.org/Documents/ERD/Working_Papers/wp030.pdf, retrieved on 1 October 2009.

¹⁸⁹ Soloaga, Isidro, and Alan L. Winters (1999), 'Regionalism in the Nineties: What Effect on Trade?', *CEPR Discussion Paper Series*, 2183, Internet: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=176728, retrieved on 1 October 2009.

¹⁹⁰ Bagwell and Staiger 2002, p. 116.

preferential trade agreement is more likely to be more welfare enhancing (less trade diverting) the higher the proportion of trade among the member and the lower the proportion with the outside world.¹⁹¹ A preferential trade agreement between ‘natural trading partners’, or countries which are expected to conduct disproportionately intensive trade due to geographical situation or low transport costs, tends to be less trade diverting. Neither the initial MFN tariff level nor the trade volume prior to the formation of a preferential trade agreement can be influenced by the GATT Article XXIV, which regulates rights and obligation of the WTO members.

2.4 Dynamic effects of preferential trade agreements: preferential trade agreements as ‘stumbling blocs’ for the WTO multilateral regime

While static approach looks at the short-to-medium-term welfare effects of preferential trade agreements on the WTO members, the ‘dynamic’ approach focuses on the influence the agreements have on the process of gradual WTO multilateral trade liberalisation.

Preferential trade agreements are efficiency-enhancing for the global trade if it accelerates the process towards global free trade. The preferential trade agreements will be discussed in the light of the question as whether they are ‘building blocs’ to the WTO multilateral trade regime in the sense that they help the regime move forward towards the global free trade, or whether they are ‘stumbling blocs’ which would eventually impede the process and cause the WTO regime to collapse.¹⁹² The circumstances that turn preferential trade agreements to become stumbling blocs, thus causing inefficiencies to the system, should be identified for the further discussion.

Generally, the formation of a preferential trade agreement can result both in further multilateral liberalisation (building bloc) and in proliferation of more preferential trade agreements, which can ultimately be building or stumbling blocs.

¹⁹¹ Lipsey, R. G. (1957), ‘The Theory of Customs Unions : Trade Diversion and Welfare’, *Economica*, 24, 1, pp. 40-46.

¹⁹² Building blocs and stumbling blocs are the terms invented by Jagdish to describe the dynamic time-path question as whether a preferential trade agreement or multilateral liberalisation or a combination of both is superior in achieving global non-discriminatory free trade, Bhagwati, Jagdish (1993), ‘Regionalism and Multilateralism: an Overview’, in Jaime de Melo and Arvind Panagariya (eds), *New Dimensions in Regional Integration*, Princeton, New York: Cambridge University Press (hereinafter Bhagwati 1993), pp. 22-51.

Preferential trade agreements may increase the pressure to act in the direction of further multilateral liberalisation for all. Since for the members, they de facto erode existing multilateral preference under the MFN, they increase support for further multilateral liberalisation. For the non-member countries, since they reduce the competitiveness margin relative to the members, these countries' incentive to move on the multilateral front to regain competitiveness margin will increase. Before the full implementation of a preferential trade agreement but after the announcement, non-members competitive countries who expect their export be diverted to the agreement area will also have the incentives to enter multilateral negotiations for further liberalisation in order to minimize the possible trade diversion.¹⁹³ For a customs union, the announcement of its formation increases, non-members' willingness to cooperate with the member-to-be at multilateral level may also increase, as upon the formation of a new trade bloc its members will have greater bargaining power in trade negotiations and ultimately in dispute settlement mechanisms. Further multilateral liberalisation will help non-members reduce risks and costs of future trade disputes as well as avoid difficult and costly future negotiations.¹⁹⁴ However, countries do not necessarily respond to preferential trade agreement formation only by advancing trade multilateralism. They can alternatively embark on negotiations for additional preferential trade agreements to reach these aims, leading to their further proliferation. The formation of a preferential trade agreement increases pressures for further liberalisation, which can be within or outside the WTO regime, or both at the same time. More important is the fact that the economic characteristics of preferential trade agreements determine their role regarding moving towards global free trade.

Whether preferential trade agreements work as building blocs or stumbling blocs depends significantly but not exclusively on whether they are more trade-creating or trade-diverting: trade-creating preferential trade agreements are likely to be building blocs, trade-diverting stumbling blocs. It is important to note there are many other channels through which a preferential trade agreement can be building or stumbling bloc.

¹⁹³ WTR 07, p. 312.

¹⁹⁴ Bagwell and Staiger 2002, pp. 118-9.

To begin with the argument that trade-creating preferential trade agreements tend to be building bloc, Baldwin (2006) has made this argument relying on the interaction between the ‘domino’ theory of preferential trade agreement and the ‘juggernaut’ theory.¹⁹⁵ The domino theory departs from a political economy equilibrium that balances pro-membership and anti-membership forces in the presence of a preferential trade agreement to which the country is not member. The former force is usually associated with industries exporting to the preferential trade agreement area, the latter with import-competing industries. Given an expansion of the preferential trade agreement area or the formation of a new preferential trade agreement, the pro-membership industries suffering from disadvantage as being producer outside the preferential area exporting into the area will become more active in lobbying for joining the preferential trade agreement, and the domestic political economy equilibrium will be shifted to the pro-membership group and the country will eventually join the preferential trade agreement. This will consequently heighten the pro-membership political economy forces in other non-member countries, leading to proliferation of preferential trade agreements. The ‘domino can start the juggernaut rolling’, if the preferential trade agreement is trade-creating, since such an agreement implies that in the preferential area the exporting sectors will expand and importing sectors will shrink compared with earlier. The trade-creating effects of preferential trade agreement ensures that when another round of multilateral reciprocal negotiations is launched, the pro-liberalisation industries will be stronger than the anti-liberalisation ones, since the former will favour also multilateral liberalisation.¹⁹⁶ In contrast, if a preferential trade agreement is trade-diverting, that is aiming at protecting import-sectors against more competitive non-members; the shift in political economic equilibrium after the formation will be in disfavour of multilateral negotiations, since there will be stronger lobbying against future multilateral liberalisation to protect the privilege gained at the formation of the preferential trade agreement, and since the expected loss from such liberalisation becomes higher compared with the situation before the formation of the preferential trade agreement. Trade-diverting preferential trade agreements thus critically impede multilateral trade liberalisation.¹⁹⁷

¹⁹⁵ WTR 07, p. 313.

¹⁹⁶ Baldwin 2006, pp. 1465-71.

¹⁹⁷ WTR 03, p. 58; Krishna, p. 245.

In contrast to the precedent argument, Ethier (1998) suggests that an originally trade-diverting preferential trade agreement does not necessarily work as stumbling bloc in a longer term, especially in the case when such an agreement is concluded between smaller developing and larger developed countries and does not aim at protecting inefficient importing industries, but rather at smaller countries exploiting lower costs of production through economies of scale in particular sectors. It is likely to attract foreign investment and shifts political balance towards necessary economic reforms in these sectors, so that they eventually become globally competitive and a force for multilateral liberalisation long-term.¹⁹⁸

As mentioned earlier, trade creation and trade diversion are not the sole determinants of preferential trade agreements being building or stumbling blocs. On the building bloc side, Trachtman (2007) stresses the role of preferential trade agreements as laboratories for international cooperation and the necessary instrument to mobilise public support for multilateral trade liberalisation. Preferential trade agreements further can work as pathfinder for multilateral disciplines and predetermine multilateral negotiation direction.¹⁹⁹

On the stumbling bloc side, although countries might response to the formation of preferential trade agreements by forging multilateralism, preferential trade agreements are preferred in order to regain competitiveness and secure further market access as compensation for diverted trade. In reality of tedious WTO multilateral negotiations, an additional preferential trade agreement tends to accelerate the proliferation of other preferential trade agreements and slow down multilateral trade negotiation for several reasons. First, every preferential trade agreement erodes the MFN multilateral concessions. With the possibility of concluding a preferential trade agreement in mind, all WTO member know that the WTO concessions can be eroded anytime, they have less incentives in concluding multilateral deals and turn to new preferential trade agreements to secure benefit they have lost as non-member of existing agreements. Second, preferential trade agreements are often preferred as best alternative

¹⁹⁸ Ethier, Wilfried J. (1998b), 'The New Regionalism', *Economic Journal*, 108, pp. 1149-61; Bagwell and Staiger 2002, pp. 122-3.

¹⁹⁹ Trachtman, p. 160.

to a negotiated multilateral agreement²⁰⁰ that cannot be reached within a desired period of time. Non-member countries try to enhance their leverage in multilateral negotiations by strategically cultivating preferential trade agreements.²⁰¹ Given the fact that the WTO multilateral negotiations since its formation in 1995 have been increasingly time-consuming, involving many parties and thematically complex and controversial, preferential trade agreements proliferate at such a high speed that the world trade now is dominated by a complex web of trade agreements and trade blocs which in turn mutually block progress at multilateral negotiation level. Third, the large number of preferential trade agreement negotiations a country engages in crowd-out the resource available and enthusiasm for multilateral negotiations.

Preferential trade agreements become stumbling bloc to WTO trade regime not only because they gravely slow down multilateral negotiations, but also because they can potentially cause the breakdown of the whole system. That is because, first, preferential trade agreements sometimes stipulate alternative regulatory structure and standards including dispute settlement mechanisms that are incompatible with the WTO rules, thus increasing non-transparency, unpredictability and weakening the enforcement of the WTO rules.²⁰² Second, they represent the ‘spaghetti bowl’ that increase transaction costs in trade. Third, trade organised in trade blocs with high bargaining power combined with weak WTO rule enforcement may result in tensions and retaliation and chain reactions in the event of a dispute.²⁰³

Direct systematic empirical evidence of building and stumbling bloc effects of preferential trade agreements is very limited, because theoretical literature focuses on whether the formation of preferential trade agreements reduces or not the incentives to sign a free trade multilateral agreement, although in reality negotiate for more or less

²⁰⁰ ‘Best alternative to a negotiated multilateral agreement’ is an adaptation of ‘best alternative to negotiated agreement’ – BATNA, which is a concept developed in the academic field of international negotiations. BATNA represents leverage in a negotiation. A negotiator shall not accept the negotiated outcome if it is worse than BATNA, which thus bears a similarity to reservation price in economics. Nevertheless, in the context of negotiations, BATNA is closely related to power structure and represent a safety net that must be heightened and demonstrated in order to signalize to other parties one’s own high leverage and low costs of failure; more information in Zartman, William I. (2002), *Structure of Negotiations*, in Kremenjuk, Viktor, *International Negotiation: Analysis, Approaches, Issues*, New York: Jossey-Bass, pp. 71-84.

²⁰¹ Trachtman, p. 161.

²⁰² WTR 07, p. 315.

²⁰³ Yeung, p. 28.

ambitious multilateral agreement rather than opting between yes and no.²⁰⁴ Nevertheless, some studies have highlighted robust positive correlation between the presence of preferential trade agreements and multilateral tariff level and support the view that preferential trade agreements may work as stumbling bloc, especially in case of large preferential trade agreements, such as the EC and NAFTA.²⁰⁵ Nevertheless there are studies that find evidence for concrete multilateralism-enhancing role of preferential trade agreements. For example, Winters (1996) points that the formation of the European Economic Community led directly to the Dillon and Kennedy Round, so did the prospect of APEC to the conclusion of the Uruguay Round.²⁰⁶

3. Concluding remarks

To conclude this part, preferential trade agreements are under some conditions detrimental to global welfare as well as to the welfare of non-members. The preceding paragraphs have discussed the possibility of the negative effects in such a manner that would facilitate the analysis of the article. They do not present an exhaustive and comprehensive list of circumstances under which preferential trade agreements are incompatible with the WTO trade community objectives. It also has to be noted that even if those detrimental effects are often associated with trade diversion and increased transaction costs of international trade, there exist other channels through which preferential trade agreements impede the realisation of optimal global welfare. Other negative effects of preferential trade agreements and backdrops of WTO trade regime are not covered in the scope of the Article: for instance, the WTO cannot prescribe member countries a road map of multilateral trade negotiations. Even the objective of global optimal welfare realized by global non-discriminatory free trade regime is purely hypothetical and serves as benchmark for analysis. Also some aspects of preferential trade agreement discussed earlier is dealt with by other provisions: for instance, the GATT Article XXIII (nullification and impairment) tackles the concession-erosion effects of preferential trade agreements.

²⁰⁴ WTR 07, pp. 316-8.

²⁰⁵ Karacaovali, B. and Limão, N. (2005), 'The Clash of Liberalization: Preferential versus Multilateral Trade Liberalization in the European Union', *The World Bank Policy Research Working Papers Series*, 3493; Limão, N. (2006), 'Preferential Trade Agreements as Stumbling Blocks for Multilateral Trade liberalization: Evidence for the United State', *American Economic Review*, 96, 3, pp. 896-914.

²⁰⁶ Winters, Alan (1996), Regionalism versus Multilateralism, *World Bank Policy Research Paper*, 1687.

To provide a basis of an agreement regulating discrimination, i.e. GATT Article XXIV, the WTO members, first, have to believe that the gains to countries who benefits from unregulated discrimination are systematically less than the loss to those who suffer from unregulated discrimination, that is the presence of preferential trade agreements inflicts upon the global trade community a net loss. Second, the WTO must provide for the regulations that either effectively ban the discrimination or effectively ensure that the regulated discrimination makes the gains become higher than the loss or and that no loss incurs to any signatory at the event of preferential trade agreement formation, or at least that the net loss is lower than without the regulations. The ‘task’ for an efficiency-enhancing WTO legal institution dealing with preferential trade agreements must therefore prescribe adequate configuration of preferential trade agreements in order to ensure that the global welfare effects is positive upon their formation by 1) limiting the possible welfare loss associated with trade diversion for non-members, including the ‘stumbling bloc’ effects. This loss originated in the undesirable changes of the elements of the state utility function: trade volume, efficiency of resource allocation and terms of trade. The legal institution should therefore shape states’ ‘property rights’ in order to minimize trade diversion; 2) by increasing gains for members and non-members through securing the trade creation effect. Furthermore, since non-members suffer some loss, the legal institution also has to ensure that 3) the non-members are entitle to compensation for the loss. Last but not least, it should also 4) reduce transaction costs that arise in presence of preferential trade agreements. In the next part, the discussion will focus on whether the GATT Article XXIV effectively fulfils these tasks.

H. Efficiency effects of Article XXIV

1. General remarks

One conclusion drawn from the precedent part of the thesis is that preferential trade agreements are not always detrimental to global welfare: with some characteristics they can be an advancement of the multilateral trade regime and enhance aggregate WTO members' welfare; but they can also pose damages to the world trade system and reduce welfare of some WTO members that are not parties to them, and thus potentially the total welfare. Therefore, they are not a pareto welfare improvement for the whole WTO trade community. Whether preferential trade agreements are desirable from the perspective of the WTO trade regime, they have existed long before the foundation of GATT in 1947 in various forms, unregulated, and they are there to remain coexisting with the later developed GATT/WTO regime and likely to spread.

At the time of negotiations, the Article XXIV was one of the main controversial issues. The discussion that would lead to the Article as it is was shaped by the United States and the United Kingdom. The US Secretary of State, Cordell Hull, had the vision of strong definition of non-discrimination and was willing to permit only preferential trade agreements with '100% preference', meaning completely free trade between its members, as only this – consistent with the later found effect of trade creation – 'can create wider trading area, removes obstacles to competition, makes possible a more economic allocation of resources and thus operates to increase production and raise planes of living'. The US position was strongly in favour of transparency and predictability of preferential trade agreements within a strong multilateral trade regime, having in mind the picture of the break-out of preferential trade agreement in the 1930s, which had led the world to the fragmented and discriminatory bilateralism. The US believed that the conditions set upon the formation by the Article should prevent this situation. The UK wanted to retain its Imperial Preferential System with less than 100% preference, meaning that there are still some internal barriers. The Article, especially Article XXIV: 8, was a compromise between both positions.²⁰⁷

²⁰⁷ Bhagwati 1991, pp. 63-6.

The history of the negotiation process combined with the fact that preferential trade agreements had long existed before GATT confirmed that the 23 signatories of the GATT in October 1947 conceived the GATT to be complimentary to the existing preferential trade agreements. The consequence is that the Article XXIV as it was formulated in 1947 was intended to make sure that the then newly created GATT posed no constraints to or necessitated any modification of the existing preferential trade agreements. That does not mean that the efficiency analysis of the Article is meaningless, since the world trade pattern and the nature of the multilateral trade regime have ever since continuously undergone fundamental changes.

In 1947, nobody expected the development of the WTO or the GATT to be universal and evolving into an international organ that globally governs international trade through legally binding liberalisation and regulations, regular implementation review mechanism and, most importantly, internationally recognized decisions. Although the WTO cannot be regarded as supra-national organisation, it comes to be an approximation of the concept of global governance by means of countries allocating their sovereignty and rights to it. The 125 WTO founding members in 1994 and more significantly the subsequent ascension of large trading nations such as China, Turkey and Switzerland as well as other economies in transitions, has advanced its status to an undisputed universal trade community, in which its members are entitled to demand for the insurance that any action of some members do not harm the interests of other community members. The primacy of the WTO regime is implicitly recognized. The concept of the Article XXIV regime has shifted from being an inactive bystander of the proliferation of preferential trade agreements to actively shaping the characteristics of preferential trade agreements by setting and applying rules for the latter to comply with the WTO regime, as demonstrated with the adaptation of an effective WTO dispute settlement mechanism but also the Understanding²⁰⁸ and reflected in the rulings of the WTO dispute settlement bodies in these regards. The WTO trade regime at least in its legal provisions has thus become a consensus upon which almost all trading nations agree to conduct commercial relations, without evolving as supra-national institution legally subordinating other international trade-related institutions. The efficiency analysis is therefore absolutely meaningful and desirable in the interests of the whole WTO trade community. As mentioned in section D, the Article does not aim at

²⁰⁸ The Understanding, paragraph 1

prohibiting preferential trade agreements but, in recognition of their economic benefits, but rather at shaping them so that to globally become maximally beneficial, minimally damaging and compatible with the objectives of WTO, since they cause externalities that can lead to net loss of the whole trade community.

This part examines the provisions of the Article, their interpretation and application by various WTO organs in relation to the identified negative externalities of preferential trade agreements to the WTO trade regime, and that to the extent to which these externalities are tackled by the Article, since not all of them are dealt with by the Article. The discussion is limited to Article XXIV: 5, 6, 7 and 8, corresponding to the fact that the Understanding has clearly emphasized the absolute necessity of compliance by stating that ‘Customs unions, free-trade areas, and interim agreements leading to the formation of a customs union or free-trade area, to be consistent with Article XXIV, must satisfy, inter alia, the provisions of paragraphs 5, 6, 7 and 8 of that Article.’²⁰⁹ Proceeding from each paragraph to another, it will discuss whether and how the Article regulates states’ behaviours in connection with the formation of preferential trade agreements, so that these behaviours yield desirable global welfare effects. It also discusses the backdrops of the Article due to which the Article’s welfare-maximizing effects are impaired, and presents improvement suggestions under discussion. The findings in the part will finally give the answer to one of the main questions as whether Article XXIV helps improve the global welfare of the WTO trade community with the presence of preferential trade agreements in comparison with the same situation but without it.

2. Article XXIV: 8

For the purpose of further elaborations, it should be recalled that the Article XXIV: 8 stipulates the definition of customs union (Article XXIV: 8(a)) and free-trade area (Article XXIV: 8(b)), whereby Article XXIV: 8(b) is in effect identical with Article XXIV: 8(a)(i) in requiring that duties and other restrictive regulations with some exceptions between members of a custom union and a free-trade area must be eliminated with respect to substantially all trade between them. Article XXIV: 8(a)(ii) additionally defines a customs union as having substantially the same duties and other

²⁰⁹ Ibid.

regulations towards non-members of the union.²¹⁰ Together with the paragraph 1 of the Understanding, the definitions set in Article XXIV: 8 become conditions for preferential trade agreements to be satisfied in order to be qualified as WTO-compatible preferential trade agreements.²¹¹ Article XXIV: 8 affects both members and non-members and has primarily the overall welfare objective. The focus of the analysis is given to the provision ‘substantially all’ and (elimination of) ‘other restrictive regulations’, since both concern the externalities of preferential trade agreement on the WTO trade regime.

2.1 ‘Substantially all’

Rationale

The ‘substantially all’ requirement plays a very significant role in increasing the trade-creating effects of a preferential trade agreement. Its rationale is based on the observation that in almost all cases, countries that conclude a preferential trade agreement usually import some goods and while export some goods to other parties to the agreement, but also to third countries. Accordingly the countries are globally competitive in producing some goods and are already exporter before the formation. Through the requirement that substantially all trade between the constituent members is to be liberalised upon the formation of a preferential trade agreement, it is highly probable that the trade in goods in the production of which the parties to the agreement are already globally competitive and exporting is liberalised, thus leading to trade creation effects without causing trade diversion. The requirement also prevents the member countries to exchange concession only in the trade in the goods in the production of which they are originally globally uncompetitive, thus potentially diverting imports from competitive third countries to uncompetitive countries within the agreement area, and thus causing trade diversion. It also helps avoid à la carte agreement that exclude broad range or sensitive sectors or include only few sectors.²¹²

²¹⁰ Article XXIV: 8

²¹¹ Note 2. The Understanding, which entered into force upon the formation of the WTO in 1994, strengthens the Article by explicitly stating that preferential trade agreements must satisfy the Article XXIV: 5-8.

²¹² World Trade Organisation (1995), *Regionalism and the World Trade System*, Geneva: World Trade Organisation, p. 66.

Additionally, Schwartz and Syke (1996) state that having to liberalise in an across-the-board manner, the formation of a preferential trade agreement tends to be preceded by an extended period of negotiations, profound debates and publicity which would allow economic actors to adjust to the change and increase transparency.²¹³ The requirement therefore helps ensure that the net global welfare effect is positive or at least the global net loss caused by preferential trade agreements are significantly reduced, by securing preferential trade liberalisations in at least some goods that do not lead to trade diversion but are predominantly trade creating.

Weakness and improvement under discussion

The weakness of the ‘substantially all’ requirement lies in its vague and ambiguous interpretation. The most precise interpretation given is ‘some trade but not all trade’ offered by the ruling in the *Turkey-Textile* case.²¹⁴ The key problem is the lack of a definition of the extent of the requirement and the methods used to measure it. There are three types of the approaches under discussion to define the requirement. The WTO member countries and WTO organs have yet to decide on these approaches.

First, the ‘substantially all’ provision might require a substantial percentage cut off point of tariff rates to a predefined extent for all traded items. A predefined reduction rate of 90% would mean that upon a formation of a preferential trade agreement, member countries are obliged to reduce the tariff rates by 90% in all tariff lines compared with before. This approach enables the Article XXIV: 8 to fulfil its rationale, since liberalisation takes place in the trade of all goods. A problem arises, however, when non-quantifiable non-tariff barriers of trade are concerned. Upon the founding of the WTO in 1994, Australia forwarded this approach and defined substantially all as 95% percentage cut. This proposal did not find sufficient support.

Second, the ‘substantially all’ provision might require that a preferential trade agreement liberalise tariffs and all other restrictions for goods accounting for a substantial part of the trade volume between members constituent to the agreement. This approach ensures that liberalisation of any good, once taken place, would be

²¹³ Schwartz and Sykes 1996, pp. 75-6.

²¹⁴ Turkey-Textile, paragraph 48; compare with section D

complete. The main weakness is the fact that an entire sector can be excluded from liberalisation. If the sector is competitive sector, the positive global welfare effects of trade creation might thus be forgone.²¹⁵

Third, the ‘substantially all’ provision might be interpreted in terms of sectoral coverage of a preferential trade agreement, and require that the elimination of all trade barriers cover substantial number of sectors. It does not make sense to define the percentage of the number of goods as being ‘substantial’, since an entire sector can still be exempted from liberalisation. For this reason, this ‘substantially all’ sectoral coverage is understood as no major sector being excluded from the agreement. This prompts the question as to which sectors can be considered major sector.

In reality, the evolvement of the third approach as WTO norm is less probable than the other approaches due to a large record of contravening state practice. Before 1994, the sectoral coverage of most preferential trade agreements was narrow. An extreme example was the European Coal and Steel Community which covered only 2 traded items. Even since the WTO establishment, most preferential trade agreements continue to omit sensitive sectors such as agriculture and textile. Even though some sectors are often excluded, by the tenth year of their implementation, almost all preferential trade agreements provide for at least 90%, and even 95% for agreements among developed countries, cut of tariff rates across-the-board in average, and cover at least 90% of their imports from other members. The state practice corresponds to the first and second rather than the third approach.²¹⁶

Since the choice of these approaches is still being discussed, and no agreement has been reached so far, countries continue to interpret and apply the requirement in a manner that would best suit their interests, thus often weakening the welfare-enhancing effects of Article XXIV: 8. Therefore, a clear provision concerning the extent of ‘substantially all’ and its measurement is urgently needed as improvement. Given the lack of a unified state practice in this regard, the norm improvement is unlikely to be derived from WTO dispute settlement bodies rulings, nor from review, complaint and notification processes at the conclusion of which the WTO members have the final say.

²¹⁵ Bhagwati 1991, p. 68.

²¹⁶ Dam, Kenneth (1970), *The GATT: Law and International Economic Organization*, Chicago: University of Chicago Press, p. 290; WTR 07, pp. 309-10.

In contrast, the substantive rule improvement is expected to come as a result of negotiations in the Doha round (probably in form of an understanding similar to the Understanding of 1994), which has included the negotiations on the WTO rules including the GATT Article XXIV. The issue of the clarity of ‘substantially all’ requirement has been given a priority among rules issues related to preferential trade agreements and a negotiation roadmap has been circulated to WTO member since June 2004.²¹⁷ In fact, the discussion is a continuation of the debate between the United States and the United Kingdom in the 1940s concerning the issue of ‘100% preference’. Due to the existing WTO global governance and the proliferation of preferential trade agreements, the stake for each position seems to be higher than 65 years ago. The Hong Kong Ministerial Declaration set the end of 2006 as the limit for the completing of the negotiation.²¹⁸ This aim was not reached and so far no progress has been made.

2.2 ‘Other restrictive regulations’

Rationale

The requirement of the elimination of ‘other restrictive regulations’ with respect to the trade between member countries of a preferential trade agreement should ensure that not only tariff barriers are eliminated but also other possible non-tariff barriers. The rationale of this provision is as follows. First, if a preferential trade agreement is not required to eliminate all other non-tariff trade restrictions, some member countries may still find some incentives to introduce these measures as protectionism against other members, thus preventing a genuine trade liberalisation and impairing its potential benefits from trade creation. Second, as discussed in section G, in absence of this ‘other

²¹⁷ Negotiating Group on Rules of the World Trade Organisation, *Statement by the Chairman in the Informal Open-Ended Meeting With Senior Officials on 25 November 2009*, TN/RL/W/246 (hereinafter TN/RL/W/246), dated 27 November 2009. The document is the latest record summing up the progress made in the rules negotiation until the period of thesis writing. The rules negotiations are conducted in the Negotiating Group on Rules established by the paragraph 28-9 of the Doha Ministerial Declaration, Ministerial Conference of the World Trade Organisation (2001), *Ministerial Declaration*, WT/MIN(01)/DEC/1, adopted on 14 November 2001, Internet: http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.pdf, retrieved on 8 August 2009.

²¹⁸ Ministerial Conference of the World Trade Organisation (2005), *Ministerial Declaration (Hong Kong Ministerial Declaration)*, WT/MIN(05)/DEC, adopted on 22 December 2005, Internet: http://www.wto.org/english/thewto_e/minist_e/min05_e/final_text_e.pdf, retrieved on 19 August 2009, Annex D, Section II, paragraph 3. The latest progress in the rules negotiations can be found in the Internet: http://www.wto.org/english/tratop_e/dda_e/status_e/rules_e.htm.

restrictive regulations’, some of the ‘other restrictive measures’ might be incorporated into the agreement so as to increase trade among members at the costs of non-members, thus giving rise to welfare loss for the latter due to trade diversion. The requirement was introduced in order to maximize trade creation effects and prevent possible trade diversion. Nevertheless, the Article allows for some exceptions. These exceptions are explicitly enumerated and include for instance quantitative restrictions, safeguards of balance of payment and other general exceptions. They are permitted only if necessary, under strict conditions and for a limited period of time. Further, they must be introduced in a non-discriminatory manner to all members of the preferential trade agreement.²¹⁹

Weakness and improvement under discussion

First, the weakness of the ‘other restrictive regulations’ lies in the fact that the aforementioned exceptions can systematically reduce welfare of non-members, especially in connection with quotas. As quotas or tariff rate quotas²²⁰ are permitted within the agreement area, members may provide in addition to the quotas existing before the agreement for each other. This leads to an expansion of the overall quota entitlements and a subsequent price reduction thus eroding quota rents for and the welfare of non-member.²²¹

Second, without clarification of ‘other restrictive measures’ protectionist measures against other members of the preferential trade agreement remain possible and unregulated. As long as it is not clear what kind of regulations Article prohibits or allows apart from the aforementioned exceptions, the exploitation of this unclear provision may prevent trade creations and cause trade diversion. The measures other than those listed in the Article are in fact implicitly allowed, as the case Argentina – Safeguard Measures on Imports of Footwear has demonstrated.²²² Beside safeguards, these measures include for instance antidumping (GATT Article VI), subsidies (Article XIV) and rules of origin.

²¹⁹ *Argentina – Safeguard Measures on Imports of Footwear*, paragraph 113.

²²⁰ A tariff rate quota specifies the quantity under which the imports cross the border at a low, in many cases zero, tariff rates. Imports beyond the quota are taxed at a higher tariff rate.

²²¹ WTR 07, p. 311.

²²² Note 12, *Safeguard Measures* was in this case discussed in connection with the GATT Article XIX which is not explicitly allowed for in the Article XXIV, and the Agreement on Safeguards which is an integral part of GATT 1994 that clarifies the application of the GATT Article XIX.

The Doha Negotiation Groups on Rule did not include the clarification of ‘other restrictive regulations’ requirement into the negotiations, despite the fact that the improvement of the Article should involve both aspects of the requirement. That is it should be made clear as to which and how far of the non-tariff barriers are allowed within a preferential trade agreement with the objective of increasing global welfare. Instead of regulating the non-tariff barriers within preferential trade agreements, the WTO members rather make progress in disciplining and clarifying non-tariff barriers among its members. Since the Uruguay Round, there have been Agreements on Safeguards, Antidumping and Subsidies as instruments complementary to their respective provisions in the GATT. The Doha Negotiations Groups have been making progress with regards to improving the rules concerning antidumping and subsidies.²²³ With regards to the rules of origin, in addition to the Agreement on Rules of Origin concluded in 1994 as an integral agreement to the GATT 1994, the WTO members is working toward harmonizing MFN rules of origin, however, not preferential trade agreement rules of origin.²²⁴

3. Article XXIV: 5

Article XXIV: 5 is another key provision in the Article, focus on the welfare of non-members, and aims to ensure that the formation of a preferential trade agreement result in trade barriers to third countries that are ‘not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce’ prior to the formation. Article XXIV: 5(a) deals with customs union, and Article XXIV: 5(b), with almost identical formulation, with free-trade areas. Regarding the term ‘general incidence of duties and regulations’, the Understanding further specifies that for duties, general incidence can be calculated as tariff average weighted on customs duty collected (weighted average tariff rates), and that case-by-case examination is needed for non-tariff regulations.²²⁵ Furthermore, Article XXIV: 5(c) and the Understanding provide for a reasonable length of time, that is 10 years, with possibility of extension in

²²³ TN/RL/W/246, pp. 1-8.

²²⁴ Srinivasan, T. N. (1998), *Regionalism and the WTO: Is Non-Discrimination Passé?*, in Krueger, Anne O. (ed.), *The WTO as an International Organization*, Chicago: University of Chicago Press (hereinafter Srinivasan), pp. 345-6.

²²⁵ Understanding, paragraph 2 and 3.

exceptional cases, for the completion of the implementation of preferential trade agreements. The following elaboration focuses on the two provisions: ‘reasonable length of time’ and ‘not on the whole higher or more restrictive than general incidence’.

3.1 ‘Reasonable length of time’

Rationale

The Rationale for this provision is that every preferential trade agreement needs a certain transition period for implementation. During this period economic actors need to adjust to new environment by, for instance, investing in new technologies, which are likely to cause some costs (adjustment costs). Too short a transition period, firms might not be able to finance these investments and the economy of the members could be prevented from reaping the highest benefit from the deal. From the perspective of non-members, transition period should offer sufficient time for economic actors to adjust to the new environment, for the government to formulate trade policy response and for the WTO to increase transparency by examining the agreement. Nevertheless, trade policy changes associated with a preferential trade agreement are phased in. It is possible a preferential trade agreement provides for the earlier phasing-in of measures that are more trade-diverting to non-members and less trade-creating for the members than the measures to be implemented later. Without a clear time limit as implementation schedule, such a situation might arise and preferential trade agreements thus may potentially be detrimental to the global welfare for an unnecessarily long period. A period of ten years was agreed as a reasonable length of transition time, with possibility of extension.

Weakness and possible improvement

Although the ten years of transition period was agreed upon without being justified by any economic reason, the practice shows that the implementation of more than 90% preferential trade agreements is completed by that period.²²⁶ That is

²²⁶ By 1994 when the Understanding, which specified the 10 year transition period, was agreed, most WTO members had already had some experience with preferential trade agreements. The timeframe therefore reflects the highly feasible scenario.

particularly due to the fact that most of them do not include agriculture and textile. Those agreements that include the sensitive sectors need usually longer time in average, sometimes as long as 20 years.²²⁷ The weakness of the provision is therefore not the seemingly arbitrarily chosen period of 10 years, but rather, first, what constitute ‘exceptional cases’ to justify the extension of the transition period and how this extension is permitted. The members of a preferential trade agreement usually refer to the Council for Trade in Goods (CTG) for its transition period extension. There is however no evaluation guideline for the CTG to examine the case, and the Council usually only takes note of most extensions as fait accompli. In fact, this provision does in practice make no significant difference on states’ behaviour. The second weak point concerns how the pace of liberalisation within the transition period is determined, and the constituent members of preferential trade agreements are free to set the speed and pace of implementation, such that, for example, for some strategic reasons, a effectively trade-diverting import-substituting liberalisation takes place in the early year and most of the trade-creating liberalisation concentrate on the very last year of the transition period.

Although it might appear to be necessary to regulate the liberalisation speed and pace of the transition in order to enable trade creation right at the beginning of the transition period, a rule improvement that involve such a regulation is unlikely to be politically optimal, since this would imply an ex-ante examination of a possible preferential trade agreement, thus requiring an involvement of countries or organs other than the constituent members and causing costs, and gravely limit states’ sovereign rights. In contrast, as a rule improvement, a guideline can be established for the CTG to examine the transition period extension request. Similarly to the ‘substantially all’ provision, the Doha Negotiation Group on Rules has been dealing with the clarification of the ‘reasonable length of time’ provision explicitly as a priority issue since 2004. A roadmap for negotiations has been agreed upon, without substantial progress being made so far.²²⁸

²²⁷ WTR 07, pp. 309-10.

²²⁸ TN/RL/W/246, p. 9.

3.2 'Not on the whole higher or more restrictive than general incidence'

Rationale

For free-trade areas which do not alter the trade barriers with respect to the third parties, the application, implementation and observance of the provision 'not on the whole higher or more restrictive' are a straight-forward matter. Only for customs unions which usually change the external barriers, the issue becomes interesting. The rationale behind the provision is that the formation of a preferential trade agreement must not negatively affect non-members by creating an additional burden, as both tariff and non-tariff barriers. Higher and more restrictive trade barriers compared with, to use the WTO terminology, the general incidence before the formation may result in a situation in which the production is shifted from outside to an internally uncompetitive, globally less-competitive member of the customs union, thus reducing trade with the rest of world in a trade diversion manner. It is also based in the belief that a new barrier not higher or more restrictive than the general incidence is sufficient to ensure that third countries are unaffected by the formation. With regards to the general incidence in tariff barriers, its calculation method (weighted tariff average on pre-agreement customs duties collected) reflects the focus on tariff revenue as an important determinant of third parties' welfare. Since, according to this method, their tariff revenue should be unaltered, they are not affected. The constant tariff revenue is believed to be an approximation for a constant trade volume, meaning no trade diversion occurs.

Weakness

With the requirement 'not on the whole higher or more restrictive than general incidence' in place, the potential negative welfare effects of preferential trade agreements on non-members can be reduced. Still, there are many backdrops that cause the regulation failure to serve the aim of keeping third parties unaffected. Three main weaknesses are found. The first concerns Article XXIV: 5(b) and the welfare effects of free-trade areas on third parties. The second concerns the method of calculation of the general incidence in tariff barriers in Article XXIV: 5(a). The third concerns the non-tariff barriers in the same paragraph.

As to free-trade areas, recalling that Article XXIV: 8 substantially contributes to a positive global welfare effects of a free-trade area, it does not rule out the possibility that some of the non-members may lose out from trade diversion. Whereas it is clearly measurable whether higher restrictions occur or not, no higher or more restrictive regulations do not avert this possible trade diversion. The regulation prevents only potential trade diversion that otherwise were caused by higher barriers. If a free-trade area is formed in accordance with the Article, and still some third parties suffer from free-trade-area-induced trade loss, they have to accept the loss, since there are no further regulations as to a compensation for it.²²⁹

As to the calculation of the general incidence in tariff barriers, clearly there is a direct link between the external tariff choice and trade diversion incidence. But economic literature suggests that the external tariff choice that keeps the tariff revenue of non-members constant after the formation of a preferential trade agreement, as the calculation method suggests, cannot prevent trade diversion and thus being unable to shield third parties from welfare loss, since this does not ensure a constant trade volume with the non-members, and since according to the Kemp-Wan theorem, a sufficient condition to prevent the welfare loss is, for each, product to preserve the pre-agreement trade volume. In order to be so, the new external tariffs must be lower than the general incidence. Nevertheless, the fact that the GATT members were able to agree on the calculation method for the general incidence represents a big step to make preferential trade agreements less WTO-damaging, because before 1994 as the only legal instrument that regulated preferential trade agreements was the Article itself, different customs unions used different method of calculation, even in a timely inconsistent manner. For example, the European Economic Community and later the European Community used arithmetic average for the calculation of new external tariffs upon the enlargement in 1957, 1973, 1981 and 1986, which effectively resulted in lower trade volume with third parties.²³⁰

²²⁹ Finger, J. Michael (1993), 'GATT's Influence on Regional Arrangements', in De Melo, Jaime and Arvind Panagariya (eds), *New Dimensions in Regional Integration*, Princeton, New York: Cambridge University Press, p. 134.

²³⁰ Srinivasan, pp. 344-5; WTR 07, pp. 312, 319-20.

As to the non-tariff barriers, since the quantification difficulties may arise, the regulations provided for case-by-case examination of other restrictive regulations. The ruling of the Appellate Body in the *Turkey - Textile* case allows for more restrictive, thus reversing the provision of the Article, provided they first are necessary for the formation, second does not conflict with other GATT provisions and third represent the least costly policy options.²³¹ The qualification of the violation of Article XXIV: 5(a) has been generally applicable and not only limited to this case. The WTO Appellate Body considers the potential welfare enhancing effects of preferential trade agreements to be desirable for the whole WTO trade community subjected to three important conditions it has set, even if a given preferential trade agreement may entail a clear violation of its provisions and welfare loss for non-members. It is believed that the three conditions set upon the violation would mean the increased welfare is significantly higher than welfare loss suffered by non-members. And since Article XXIV: 6 provides for compensatory adjustment, in the end nobody would end up worse off than before. Nevertheless, the rule application in fact weakened the rules, thus potentially diluting the welfare enhancing effect of the Article, which would be achieved if it were strictly implemented. That is because it opens the possibility of trade-diverting protectionist external tariffs being legally sanctioned, thereby hoping for equivalent compensation, but, as discussed later, the compensatory adjustment for non-members often do not lead to equivalent compensation for those affected. Knowing this, countries have more incentives to conclude preferential trade agreements that might not be conform to Article XXIV: 5 and, facing with the possibility of insufficient compensation, conclude further rule-violating preferential trade agreements to improve their welfare position or as trade retaliation. Therefore, while the ruling in the case focused on the static welfare effects, it may lead to negative welfare effects in short-term and profoundly ‘stumbling’ effects in long-term.

Possible improvement under discussion

With regards to how the rules could be improved, the suggested changes generally appear to be either economically desirable yet too radical to be politically optimal or technically difficult or unrealistic to be implemented. That might explain

²³¹ Turkey-Textile, paragraphs 58-9, 65; more in detail in Part D.

why the Doha Negotiation Group on Rule has not made any progress, even though the topic of economic neutrality of preferential trade agreements towards third parties has been one of the priorities.²³²

For both free-trade areas and customs unions to be economically neutral vis-à-vis non-members, they are likely to lower, both tariff and non-tariff, trade barriers after their formation. Most of the suggested rule improvements centre around the issue of how much this reduction should be. With regards to customs union, while Bhagwati (1993) believes that new tariff rates according to the Kemp-Wan that keep trade volume constant could be required from any newly formed customs union, he stated that the best way to fully eliminate trade diversion is to oblige a customs union not to set the new trade barriers that are higher than the pre-agreement lowest barriers among its members. If at least one of the members had a zero pre-customs-union tariff, this proposal would imply that such a union will result that a customs union would engage in free trade with all non-members. Thus, preferential trade agreements not only are exclusively trade creating and welfare enhancing but also automatically become ‘building blocs’ for multilateral negotiations. Bhagwati’s relatively radical proposal, though desirable reform, deters the formation of customs unions. Since countries usually form free-trade areas as stepping stone towards customs unions, and since free-trade areas under the current regulations (Article XXIV: 5(b)) may create some loss which is not required to be compensated, this proposal, if it stands alone, might result in lower global welfare through potentially keeping economic integration processes only to the level of free trade areas. Therefore, either it has to be complemented by substantial reduction of external barriers between free-trade area members and non-members (in order to make members at least indifferent between free-trade area and customs union), or the Article must rule out any free-trade area that to remain so and allow for only those that will be transformed within a reasonable length of time to a customs union according to the proposal.²³³

In line with the Kemp-Wan theorem, McMillan (1993) proposed as a less radical improvement that it should be further prescribe that customs union are not allowed to introduce policies that result in external trade volume being lowered. This implies that

²³² Note 229.

²³³ Bhagwati 1993, p. 36

trade volumes are to be monitored and analysed in long-term. If after some years a customs union reduces its imports from the rest of the world, it is required to adjust its trade restriction to reverse the reduction.²³⁴ The McMillan proposal simplifies the Kemp-Wan theorem which would otherwise require examining the trade with the rest of the world in every good.²³⁵ The backdrop of this proposal is, however, that the changes in aggregate trade volume need not necessarily indicate change in global welfare, although it is its better approximation compared with the current method.²³⁶

Regardless of whether and under which formula the new customs union's external barriers are lowered, the fact that the transformation of a free-trade area to a customs union most probably incurs negative effects for some member countries due to common external tariffs that are lower than individual tariffs or due to unilateral compensatory adjustments for non-members. Countries have thus less incentives for further integration beyond free-trade area. Given that Article XXIV: 6 (discussed later) in the case that free-trade areas do not provide for compensatory adjustment for possible welfare loss for third countries, customs unions are from this perspective economically less preferred than free-trade areas. Irrespective of the discussed proposals concerning customs unions, the rule improvement should require from countries forming a free-trade area the reduction of their individual external barriers to the rest of the world (as discussed earlier). Alternatively, the rules may oblige free-trade area members to compensations to affected countries.

The greatest obstacle to agreeing on an improvement proposal that goes beyond 'on the whole not higher or more restrictive' or that potentially or eventually results in the obligation to reduce external trade barriers is of political nature. First, the barrier reduction has a nature of compensation and therefore does not entail reciprocal concession from third parties, as it aims at restoring the pre-agreement welfare level or trade volume. Countries would have no motivation to offer unilateral concession. Especially as they have to do so to all other WTO members based on the MFN principle, including those with whom they expect difficult multilateral negotiations,

²³⁴ McMillan, J. (1993) 'Does Regional Integration Foster Open Trade? Economic Theory And GATT's Article XXIV', in Anderson, K. and Blackhurst, R. (eds), *Regional Integration and the Global Trading System*, London: Harvester Wheatsheaf, p. 300.

²³⁵ WTR 07, p. 320.

²³⁶ Srinivasan, p. 345.

there is no reason for countries to permit the loss their bargaining chips. Second, the obligatory reduction of post-agreement barriers lowers countries' incentives to conclude an agreement, and (because) it lowers welfare at least for some potential members and erodes potential gains from integration. For these reasons, it is unlikely that any proposal in this direction could become politically agreeable. Moreover, there are also serious implementation problems of such proposals. The McMillan proposal can hardly be realistically implemented due to the dynamic of preferential trade agreement proliferation as countries respond to a new preferential trade agreement by concluding another one, thus making an accurate long-term observation of trade volume difficult if not infeasible. The problem is more acute in case of free-trade areas where no common external barriers exist and any adjustment has to be done individually.

4. Article XXIV: 6 (compensatory adjustment)

Rationale

As *lex specialis* to Article XXIV: 5(a), Article XXIV: 6 and its respective provisions in the Understanding regulate compensation negotiations only in event of a customs union formation, and thereby relying on the negotiation procedure set forth in the GATT Article XXVIII. The formation of a customs union usually brings about the situation in which for some goods the pre-negotiation new customs union barriers between other WTO members and certain future members of the union are higher than before the formation due to the harmonization of external barriers. Other future members of the union shall offer a reduction of the new customs union barriers in the same goods, so as to comply with Article XXIV: 5(a). For example, in the case of an ascension to an existing customs union, economically and legally creating a new customs union, it is probable that for some commodities, the trade barrier between third countries and the ascending member(s), is higher than before the formation, as the external barriers of the ascending countries are increased to match those of the existing custom unions. That is a clear violation of Article XXIV: 5(a). The members of the former union shall reduce the existing trade barriers in the same goods as compensation. Should no satisfactory compensation be reached, the new customs can offer as compensation reduction of barriers with respect to trade in other goods. If this is not

achieved, affected non-members can withdraw equivalent concessions between them and the customs union members.²³⁷ To summarize, Article XXIV: 6 and its relevant part of the Understanding allow for three stages of negotiations. The first stage is the negotiations in order to comply with Article XXIV: 5(a). The second stage deals with the negotiations for compensation through barrier reduction in other goods. The third stage deals with the negotiations for compensation through concession withdrawal.

The rationale for the provision is based on the possibility of the efficient breach of Article XXIV: 5(a). A customs union that complies with all other provisions of the Article, including Article XXIV: 8, is believed to increase global aggregate welfare, even if it might violate Article XXIV: 5(a) by setting higher external trade barriers after its formation. Such a customs union thus satisfies the Kaldor-Hicks efficiency criteria. Since it is globally more beneficial to allow such a customs union than ruling it out for the violation, there must be a provision such as Article XXIV: 6 in place in order to provide compensations for those negatively affected by the violation. In other words, the expected global welfare gains from such a customs union are larger than the compensation adjustment and the costs of negotiations for the compensation. Article XXIV: 6 can be considered as an invitation to commit an efficient breach of Article XXIV: 5(a).²³⁸ Moreover, the sequence of negotiation stages reflects the Article intention to prioritize compensation adjustments that lead to further multilateral liberalisation (the first and second stage adjustments reduce trade barriers not only between negotiation partners, but thanks to the MFN also to other WTO members) over adjustments that in fact reverse multilateral liberalisation process (withdrawal of existing concessions).

Weakness and possible improvement

The weakness of the Article XXIV: 6 originates from the fact even if a customs union passes Kaldor-Hicks criterion, the Article fails arrange compensation so as to ultimately reach Pareto efficient outcome, thus leaving some non-members worse off than before. The Article is susceptible to reaching not only inefficient outcome but also weakening of the multilateral liberalisation process.

²³⁷ Paragraphs 4-6 of the Understandings.

²³⁸ Schwartz and Sykes 1996, p. 73.

First, since the compensation adjustment in the first and second negotiation stage take a form of MFN concession from which also non-affected non-member countries profit without any equivalent reciprocal concession (free-rider problem), the customs union members have less incentive to seriously engage in the process. If the loss from the third-stage-negotiation concession withdrawal by affected trade partners is smaller than benefit that would be forgone by customs union's concession withdrawal, they have incentives not to offer compensation but rather wait for the partner to withdraw concession, thus reversing the progress toward global free trade.

Second, even the third stage might not lead to an equivalent concession at all. This is especially the case between a large customs union and small countries. Since the expected concession withdrawal is relatively small, the third stage is easily reached and small countries might ultimately find an equivalent tariff concession withdrawal could increase the import price such that the whole economic is gravely affected, and therefore refrain from taking such a step, and choose to accept at least some loss. Knowing this, the customs union might have incentive to set high external trade barriers, possibly with trade diversion effects.

Third, as consequence, countries have incentives to organize themselves in customs union to increase bargaining power and the others' price for violation of Article XXIV: 5(a), leading to fragmentation of the world trade regime (stumbling bloc).

Possible rule improvement should include imposing additional costs on moving from the second to the third step in order to ensure that compensatory adjustments are constructive for multilateral trade regime and reduce customs union incentives to take liberty of introducing excessively trade-diverting without having to fear concession withdrawal. This is a far-ranging step that might dispel countries willingness to transform free-trade areas in customs unions which are economically superior to the former given the existing rules. The Doha Negotiation Group on Rules did not so far include the improvement of this rule in its work programme.²³⁹

²³⁹ Note 229

5. Article XXIV: 7 (notification, complaints and review procedure)

Rationale

Article XXIV: 7 and the corresponding paragraphs 7-11 of the Understanding arrange for procedures for notification, complaint and review of preferential trade agreements, thus representing the first step of the application of the GATT Article XXIV. During these processes, all WTO members are able to exercise control over preferential trade agreements by evaluating their rule compliance, solving their possible incompatibility with the WTO agreements and eventually adopting decisions for their corresponding modification. As discussed earlier, the provisions in these regards do not oblige to start the procedures before the formation of a preferential trade agreement. Ex post notification, complaint and review procedures are common. Under the existing rules, WTO members, organized in the Committee on Regional Trade Agreements (CRTA) have an extensive opportunity to engage in these processes and to obtain and exchange relevant information from states members to preferential trade agreements and from the WTO secretariat, which plays an important role in analysing the issues at hand. At the end of each process, the final decision as to whether or not to exercise control by adopting a binding decision, recommendation or report is incumbent upon the Council for Trade in Goods (CTG).

The rationale of the provisions is not only to ensure the WTO compatibility of preferential trade agreements by rendering other provisions of the Article operational and by setting a framework for their application. More importantly they also play a role in reducing transaction costs that arise from trade in the situation in which preferential trade agreements coexist with the WTO trade regime. The sources of these costs originate from, first, legal uncertainty, relating to the choice-of-law and choice-of-legal-forum problems or conflicting jurisprudence of preferential trade agreement dispute settlement bodies and those of the WTO, and, second, non-transparency and complexity of different legal regimes, which both increase costs of information gathering and evaluating, administration and monitoring.

Although the provision deals with the application and enforcement aspect of the rules, it must be noted that neither this Article XXIV: 7 and its corresponding

paragraphs in the Understanding nor other provisions in the whole Article XXIV counteract all aspects of rule application and enforcement. It does not deal with the first source of transaction costs. The Article does not prescribe or restrict a priori provisions in preferential trade agreements concerning their dispute settlement procedure, and concerning their choice of law and forum. Concerning the rule application and enforcement by the WTO, the WTO dispute settlement bodies takes only WTO law into consideration and any claim based on WTO law is the exclusive jurisdiction of DSB.²⁴⁰ Since there is no prohibition of the WTO rules being applied by preferential trade agreement dispute settlement bodies, these can take WTO law into consideration even if the claim is based the agreement as the case may be. Generally, they can also can verdict rulings conflicting with WTO provisions and rulings. The ‘spaghetti bowl’ problematic is not completely solved by the Article nor by the DSU.²⁴¹

In contrast, the provision has been designed to reduce the transaction costs from the second source, thus contributing to upholding transparency, which is one of the fundamental principles of the WTO. In the processes leading to the final adaptation of decisions, recommendations or reports by the CTG, the WTO non-members of a preferential trade agreement are provided with information about the agreement and are able to seek more information from and to engage in a profound discussion with the members of the agreement which is subject to detailed scrutiny. The WTO Secretariat with its expertise undertakes the task of disseminating, gathering and evaluating information. Based on the discussions between the WTO members in the CTRA, it also assume the task of making report for the final sanction by the CTG. The whole processes take place within the CTRA and the CTG with a well-established procedure.

Weakness and improvement under discussion

Although the provision is able to reduce transaction costs, it fails to fulfil its main tasks of rendering the whole Article operative and ensuring the WTO-compatibility of preferential trade agreements. Therefore, their effective control is hardly possible. Its main weakness lies in the fact that first, the Article contains little incentives for compliance, since there is no provision that expressly makes notification

²⁴⁰ Article 23 of the Dispute Settlement Understanding.

²⁴¹ Trachtman, pp. 21-2.

or review process obligatory or regular or allows for sanction for noncompliance with the rules. Second, even if a notification, review or complaint process has been launched and the WTO Secretariat has submitted an outcome report to the CTG, the adaptation by consensus prevents any decision from being made. Bearing no results, consequently, countries ignore these processes and regard them as optional, and, in case of trade disputes, often refer to the WTO dispute settlement bodies rather than to complaint procedure, even if the costs of law determination at the DSB are potentially higher.

Suggestions on the rule improvement are based on the belief that they will result in an effective rule application by the mechanisms provided for in the Article XXIV: 7 that is more efficient than its application and enforcement through the DSB. These suggestions include a proposal to strengthen review procedure by prescribing an obligatory periodical review of notified preferential trade agreements for every two years.²⁴² More radically, the consensus rule can be change so that with a sufficient of like minded countries, a report of the WTO Secretariat can be adopted by the CTG. This proposal is, however, less likely to be politically agreeable and welfare-enhancing in the eyes of states, who, facing a risk of politically-motivated and less economically or legally-based decision making compared with those of the DSB, are forced to engage in costly political lobbying and coalition building, which could generally undermine the upholding of WTO rules. More realistically, under the circumstances that the strength of the Article lies in the process (and less in the concrete outcome in form of adaptation of a binding document), Baldwin (2006) believed that the WTO Secretariat can enhance its role in the process by providing not only routine rule-compliance analysis of preferential trade agreements based on the inquiries in the CRTA but also analytical work to give member states a deeper understanding of measure possibly contained in the preferential trade agreement in question and of the risk it poses on global welfare and the WTO trade regime. By providing qualified information on these issues critical to the objectives of the WTO, it can alert members about the negative effects of preferential trade agreements beyond general assessment based on legal provisions.²⁴³ In accordance with the Baldwin and the first proposal, the Doha Negotiation Group on Rules has been able to agree on a draft concerning the improvement of the provision in June 2006. This draft agreement, though not yet in force, mandate the WTO Secretariat

²⁴² Srinivasan, p. 346-7.

²⁴³ WTR 07, p. 320; Baldwin 2006.

to prepare a regular report on notified preferential trade agreements and thereby focus on the measures that adversely affected non-members, in order to induce countries entering preferential trade agreements to increasingly adopt WTO-compatible rules. Moreover, the draft agreement specifies what must be contained in a notification, defines in a more precise manner the procedure within the CRTA and provides for technical assistance for developing countries.²⁴⁴ The draft agreement is the most concrete rule improvement proposal in connection with the GATT Article XXIV to date.

6. Concluding remarks

The preceding paragraphs show that Article XXIV contains legal provisions that regulate state behaviours regarding the formation of a free-trade area or a customs union. With the regulation in place, the design of preferential trade agreements should ensure that they increase global welfare and thereby not affecting any WTO member adversely, by limiting incidence that gives rise to trade diversion, encouraging the effect of trade creation, providing for compensations for members suffering from their formation, and reducing transaction costs. Therefore, the existence of the rule increase global welfare compared with the world without it. Nevertheless, the Article does not address all sources of inefficiencies created by preferential trade agreements. Its provisions contain some significant weaknesses especially concerning the rule application and enforcement as well as unclear language that have become a source of difficulties in rules application.

Similar to any other institution, the Article is subjected to enhancements, modifications and interpretations. At the time when it was agreed upon by the 23 GATT founding members in 1947, most of the economic effects of preferential trade agreements on the WTO regime had been unknown and their observed proliferation was then not expected, their effects were therefore underestimated or neglected. Since then the rule has been applied, and, notably, enhanced by the Understanding. Although the Doha Round includes the strengthening of the Article as one of its agendas, the improvement or further development through rule negotiations are not expected in the

²⁴⁴ Negotiating Group on Rules of the World Trade Organisation (2009), *Transparency Mechanisms for Regional Trade Agreements*, JOB(06)/59/Rev.5, adopted on 29 June 2009; WTR 07, p. 319.

very near future, since, apart from the remarkable progress made on Article XXIV:7, the discussion has been carried on without concrete text-based proposal from any member country since 2005.²⁴⁵

²⁴⁵ Negotiating Group on Rules of the World Trade Organisation, *Report by the Chairman of the Trade Negotiation Committee on 17 December 2008*, TN/RL/23, dated 9 January 2009.

I. Conclusion

The preceding sections have demonstrated a possibility of law and economics being applied in public international law by providing an economic analysis of the GATT Article XXIV which regulates and enhances WTO-comformity of preferential trade agreements. Despite some criticisms of law and economics regarding the problem of identifiability, commensurability and inter-personal comparison of utility and the rejection of its methodological philosophy of utilitarianism by law scholars, and despite the main characteristics of public international law which further pose constraints to its application, such as its horizontal and decentralized law-making, enforcement and determination, and the sovereign nature of states as its primary subjects, the international community show significant analogies to domestic market, where law and economics has been extensively applied. These structural analogies can be observed, since states are regarded as rationally acting, self-interested and welfare-maximizing actors in the 'international market' in which the traded assets are powers (jurisdictions or rights to act) and the 'international market' of power is governed by institution, public international law. In the context of the Article XXIV, the provisions in the Article regulate states' power to act in international trade matters regarding preferential trade agreements. Although the potential of law and economics in the field of public international law is present, specific characteristics of international law and the numerous actors in the international community with their diverse interests, in many cases unquantifiable and endowments mean a comprehensive and quantitative analysis becomes impracticable. It also means that approaches in different disciplines of economics, international relations, and legal studies may be useful in capturing going political and legal elements beyond monetizable economic elements.

Accordingly, the economic analysis of the Article aims at verifying its efficiency-enhancing role for the WTO trade community, focusing on the identification of sources of inefficiencies incurred to the multilateral system by preferential trade agreements, and on the question whether the rule interpretation and application correct the inefficiencies. In order to do so, the elements that constitute state welfare in the WTO context and the sources of transaction costs are that give rise to this trade institution have to be identified. Drawing on also non-economic disciplines, these elements are, for instance, national income expressed in exports and foreign investment,

terms-of-trade improvement, production efficiency, political security, whereas uncertainty about trade policy of trade partners, legal uncertainty, negotiation costs, trade rules enforcement costs are some examples of transaction costs in the WTO context. The presence of preferential trade agreements within the WTO trade regimes changes states' welfare by affecting these elements. They increase legal uncertainty in application, interpretation and adjudication of a complex web of legal obligations, undermines transparency of world trading regime and create administrative and monitoring costs. More significantly they lead to trade creation and trade diversion effects, which have profound welfare impact on the WTO system. A preferential trade agreement does not always increase global welfare. And in case it does, it may do so at the costs of some other non-members. The welfare-reducing effects are usually closely linked to trade diversion, defined as the substitution of import from globally efficient producer in non-member countries by globally inefficient but now preferentially treated producer in the agreement area. Trade diversion does not only lead to welfare reduction in short-term, it is also associated with the breaking up of the WTO regime. The 'stumbling bloc' character of trade-diverting preferential trade agreements leads to inefficiencies due to the fragmentation of world trade and high transaction costs, and prevent the trading community from attaining non-discriminatory global free trade. In contrast to trade diversion, trade creation is associated with welfare increase and being 'building bloc', thus complementary, to WTO multilateral trade liberalisation.

How much a preferential trade agreement is trade-creating or trade-diverting depends on its feature. For example, preferential trade agreements that liberalise all trade are more trade-creating than those maintaining some intra-agreement trade barriers. Liberalisation of competitive sectors tends to lead to trade creation, while liberalisation aimed at import substitution tends to be trade-diverting. The choice of external barriers of a preferential trade agreement determines the incidence of trade creation/diversion. Since the feature of a preferential trade agreement is a common trade policy choice of its members, the Article must sought to influence and regulatre the choice.

Article XXIV contains provisions that have the potential to effectively limit trade diversion, increase trade creation and reduce preferential-trade-agreement-induced transaction costs. Article XXIV: 8 increases trade creation by requiring that

substantially all trade, including non-tariff trade barriers, within the agreement area be liberalised. However, its unclear interpretation of the terms ‘substantially all’ and ‘other restrictive regulations, impairs potential trade creation effects. Article XXIV: 5 prohibits a preferential trade agreement from imposing higher trade barriers upon its formation in order to make sure that non-members are not adversely affected, and sets a timeframe for its realisation. Still, it has been criticised for the calculation method of the benchmark with which new external barriers are compared as being insufficient in preventing third parties from welfare loss. Article XXIV: 6 provides for compensatory adjustments for negatively affected non-members, in order to ensure that no WTO member would suffer from a possible preferential trade agreement. But this provision, too, in many cases fail to lead to adequate compensation. Article XXIV: 7 plays an important role in reducing the transaction costs by setting up notification, review and complaint procedure. It is aimed to allow for an effective monitoring, regulating and examining the WTO-compatibility of preferential trade agreements according to the Article. The fact that this effective control has never been and will probably no be exercised, the rule enforcement task is done by the WTO dispute settlement bodies. Although, its provisions contain some significant weaknesses especially concerning the rule application and enforcement as well as unclear language that have become a source of difficulties in rules application, and although the article cannot effectively make existence of preferential trade agreements in the WTO multilateral system beneficial for all, the existence of the rule increase global welfare compared with the world without it. At this stage, it also has to be noted that even if those detrimental effects are often associated with trade diversion and increased transaction costs of international trade, there exist other channels that cannot be captured and analysed in this thesis, through which preferential trade agreements impede the realisation of optimal global welfare.

Considering the ongoing discussion about rule improvement, the current Doha negotiations include the Article into its work programm. Until this day, only little progress has been made. Even if weakness of the Article might suggest a great improvement potential, the Article as it stands is perhaps a political optimum, so that there is no sufficient political interest in changing it. At the same time, there is apparently no interest to apply it seriously either, even though the positive and negative effects of preferential trade agreements on the WTO trade regime cannot be denied. This is probably due to countries’ lack of resource and interest to push forward

multilateral trade agenda given the relative ease of negotiating a preferential trade agreement, which is their right countries are reluctant to constrain. Given the proliferation of preferential trade agreements and their increasingly better known static and dynamic effects, it is not only possible for any future rule improvement to focus on these effects, it is necessary to take the economic consequences of different institutional frameworks into account and shift from a purely legal approach to a more comprehensive analysis, as Pascal Lamy stated that

‘We need to look at the manner in which RTAs operate, and what effects they have on trade opening and on the creation of new economic opportunities. (...) I think it would be useful to look systematically at the characteristics and design of RTAs not only in terms of legal compliance questions, but also in terms of whether their architecture is more or less likely to foster multilateralization in the future.’

Pascal Lamy, September 10th, 2007.²⁴⁶

And clearly and desirably, law and economics has a great potential to play a significant role in this process.

²⁴⁶ Opening speech delivered at the Conference on ‘Multilateralising Regionalism’, Geneva, Switzerland, http://www.wto.org/english/news_e/sppl_e/sppl67_e.htm, retrieved on 1 January, 2010.

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Appendix

1. Zusammenfassung in Deutscher Sprache

In heutigen internationalen Handelsbeziehungen, die zunehmend durch internationale Arbeitsteilung charakterisiert sind, nehmen die Handelsvolumen maßgeblich durch fortschreitende internationale Handelsliberalisierung überproportional zur Produktion zu. Dieser Prozess von Handelsliberalisierung bedeutet die Reduzierung oder gar Beseitigung von sowohl tariffären als auch nicht-tariffären Handelshemmnissen, die in Form von international rechtlich verbindlichen Verträgen (im rechtsökonomischen Sinne ‚Institution‘ sind) vereinbart ist. Die einzige universell anerkannte internationale Institution für Handelsregulierung und Handelsliberalisierung ist die Welthandelsorganisation (World Trade Organisation – WTO), deren Kern ihre Vorgängerinstitution, die General Agreements on Tariffs and Trade (GATT), bildet. Neben der WTO existieren zahlreichen plurilaterale oder bilaterale Handelsabkommen zwischen fast allen WTO-Mitgliedstaaten (die sogenannten Regionale Handelsabkommen), die, betrachtet man die Handelsvolumen innerhalb ihrer Geltungsgebiet, Welthandel zunehmend dominieren.

Die Koexistenz von der WTO als universelle Handelsregulierende Organisation und regionalen Handelsabkommen wirft eine Rechtsökonomische Frage bezüglich der Notwendigkeit und Sinnhaftigkeit von der Regulierung von regionalen Handelsabkommen durch die WTO. Denn die Mitglieder der regionalen Abkommen sind auch Mitglieder der WTO, und das Etablieren eines regionalen Handelsabkommens verletzt eines der zentralen Prinzipien der WTO, die Meisbegünstigungsklausel (Most Favoured Nation – MFN), da regionale Handelsabkommen bevorzugt einige Mitglieder der WTO Handelsgemeinschaft, nämlich diejenigen, die Mitglied der Abkommen sind, und schließen die anderen aus, deren Wohlfahrt laut internationaler Handelstheorien im Vergleich zur Situation vor der Etablierung abnehmen kann. Daraus resultiert, dass regionale Handelsabkommen die Gesamtwohlfahrt der WTO Handelsgemeinschaft reduziert. Als WTO Regulierungsmaßnahme von regionalen Handelsabkommen wurde das GATT Artikel XXIV etabliert mit dem Ziel, die regionalen Handelabkommen so zu gestalten, dass sie die Wohlfahrt ihrer Mitglieder steigern und zugleich sowohl die

Gesamtwohlfahrt der WTO Handelsgemeinschaft als auch die Wohlfahrt einzelner WTO Mitglieder, die nicht Mitglieder der Abkommen sind, nicht beeinträchtigt wird. In anderen Worten versucht das Artikel regionale Handelsabkommen zu konfigurieren, dass sie für die WTO Handelsgemeinschaft eine Wohlfahrtverbesserung im Sinne von Kaldor-Hicks oder wenn möglich eine Pareto-Verbesserung bedeutet.

Die Beantwortung der Frage, ob das Artikel dieses erwünschte Ziel erreicht, kann mithilfe Rechtsökonomischer Ansätze ermöglicht werden. Doch Rechtsökonomie wird nur im relativ begrenzten Ausmaß bei der Analyse von Rechtssystem bzw. Rechtsnormen im internationalen Kontext angewandt, vor allem im Bereich des Völkerrechts (public international law), bei dem Staaten nach wie vor die Hauptakteure sind. Dennoch gibt es Anwendungspotenzial für Rechtsökonomie im Bereich des Wirtschaftsvölkerrechts. Betrachtet man den Staaten als rationales Individuen, die sich auf internationalem Markt die Güter, die Macht beispielsweise in Form von rechtlicher Zuständigkeit, vom Kompetenzbereich oder Handlungsrechte, handeln, und sich die Institution, das Völkerrecht, untergeordnet sind. Obwohl das Souveränitätsprinzip und das Fehlen von zentralen Rechtsschaffungs-, Rechtdurchsetzungs- und Rechtssprechungsorganen die Möglichkeit der Anwendung von Rechtsökonomie in dem Gebiet erheblich einschränkt, kann man gerade im Falle des GATT Artikel XXIV zeigen, dass die Anwendung möglich und sinnvoll ist.

Weiters werden die unterschiedlichen Konfigurationen von regionalen Handelsabkommen identifiziert, die die Handelsabkommen für die gesamte WTO Handelsgemeinschaft Wohlfahrt reduzierend wirken lassen. Diese treffen zu, beispielsweise wenn regionale Abkommen zumeist die Liberalisierung jener Güter beinhaltet, die die Mitgliedstaaten vor dem Inkrafttreten des Abkommens von Drittstaaten importiert wurden, die nun aber durch Begünstigung durch Produktion innerhalb des Geltungsgebiets der Abkommens ersetzt wird (sogenannte Handelsablenkung - trade diversion), oder wenn die Handelsabkommen den Handel zwischen den Mitglieder nur unzureichend liberalisieren, oder weiterhin versteckte Handelshemmnisse erlauben. Folglich wird das Artikel überprüft in Hinblick auf die Vorgabe betreffend diese Konfigurationen und deren Umsetzung. Es wurde herausgefunden, dass sowohl die im Artikel vorgesehenen Regeln und Beschränkung der regionalen Handelsabkommen als auch deren Interpretation durch die WTO-

Gerichtsbarkeit die Gesamtwohlfahrt aller WTO Mitglieder erhöhen kann im Vergleich mit der Situation ohne sie. Allerdings behindern die im Artikel und in relevanten WTO Verträgen vorgesehenen Umsetzungsmechanismen eine wirksame Umsetzung des Artikel.

2. Curriculum Vitae

Theeraphat TRANGKATHUMKUL

Education

October 2003 – April 2010	Diplomstudium in Economics at University of Vienna, Austria
January 2007 – July 2007	Erasmus exchange semester at the Faculty of Economics at University of Louvain, Belgium
July – August 2006	Utrecht International Summer School on International Conflict Studies at University of Utrecht, the Netherlands
July – August 2005	European Summer University at University of Grenoble, France
July – August 2004	International Summer School on External Relations of the EU at The Free University of Brussels, Belgium
June 2003	A-Level examination (‘Ausgezeichneter Erfolg’), De La Salle Schule, Vienna, Austria
Since September 1999	Scholarship student of the Royal Thai Government, scholarship granted by the Ministry of Foreign Affairs of Kingdom of Thailand

Traineeship

August – October 2007	Department of International Organisations, Ministry of Foreign Affairs of Kingdom of Thailand, Bangkok
August – October 2006	Permanent Mission of Thailand to the UN in Geneva, Switzerland
February 2006	Royal Thai Embassy in Paris, France
September – October 2005	Royal Thai Embassy and Permanent Mission of Thailand to the UN and international organisations in Vienna, Austria
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