Free Trade Agreements and the WTO Exceptions

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Summary

World Trade Organization (WTO) members must grant immediate and unconditional most-favored-nation (MFN) treatment to the products of other members with respect to tariffs and other trade matters. Free trade agreements (FTAs) are facially inconsistent with this obligation because they grant countries who are party to the agreement more favorable trade benefits than those extended to other trading partners. Due to the prevailing view that such arrangements are trade-enhancing, Article XXIV of the General Agreement on Tariffs and Trade (GATT) contains a specific exception for FTAs. The growing number of regional trade agreements, however, has made it difficult for the WTO to efficiently monitor the consistency of FTAs with the provided exemption. Negotiations on rules for regional trade agreements are part of the WTO Doha Round; separately, the WTO General Council in December 2006 established a new transparency mechanism for FTAs which provides for early notification by WTO Members of FTA negotiations. The United States is presently a party to nine bilateral or regional trade agreements. While Congress has approved FTAs with Oman and Peru FTAs, these have not yet entered into force. In addition, the Administration has entered into FTAs with Colombia, Panama, and South Korea FTAs, all of which are pending approval by Congress. Implementing legislation for the FTA with Colombia was introduced April 8, 2008 (H.R. 5724, S. 2830), but expedited legislative procedures that would have applied to the House bill were suspended by the House on April 10, 2008 (H.Res. 1092). The Administration has also been involved in FTA negotiations with several other countries, including Thailand, Malaysia, the United Arab Emirates, and the South African Customs Union. This report will be updated as events warrant.

Contents

Contacts

Free Trade Agreements: WTO Obligations

MFN Exception

As parties to the General Agreement on Tariffs and Trade (GATT) 1994, World Trade Organization (WTO) Members must grant immediate and unconditional most-favored-nation (MFN) treatment to the products of other Members with respect to customs duties and import charges, internal taxes and regulations, and other trade-related matters.[1] Thus, whenever a WTO Member accords a benefit to a product of one country, whether it is a WTO Member or not, the Member must accord the same treatment to the like product of all other WTO Members.[2] Free trade agreements (FTAs) are inconsistent with this obligation because of the favorable treatment granted by FTA parties to each other's goods. FTAs, however, have generally been viewed as vehicles of trade liberalization; therefore, the GATT contains an exception for such agreements.[3] Article XXIV of the GATT requires that parties must notify the WTO of these agreements, which are then subject to WTO review. The exception applies both to completed FTAs as well as to the interim agreements leading to their formation.

The increasing number of regional agreements and the substantial amount of trade covered by them led GATT parties to try to strengthen the existing multilateral discipline during the GATT Uruguay Round. GATT parties have never expressly disapproved an FTA, despite misgivings about the consistency of particular provisions with GATT requirements.[4] The Uruguay Round Understanding on the Interpretation of Article XXIV (the 1994 Understanding) attempts to increase multilateral surveillance over regional trade arrangements by "clarifying the criteria and procedures for the assessment of new or enlarged agreements, and improving the transparency of all XXIV agreements."[5] In 1996, WTO Members created the permanent Committee on Regional Trade Agreements (CRTA), which conducts reviews of new and existing FTAs and studies the overall impact of such agreements on the world trading system.[6] Further improvement in this area is also a part of the negotiating mandate for the WTO Doha Round. On December 14, 2006, the

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[1] General Agreement on Tariffs and Trade 1994, Text of the General Agreement, Art. I:1, *available at* http://www.wto.org/english/docs_e/legal_e/gatt47_e.pdf [hereinafter GATT 1994].

[2] While the WTO uses the term "most-favored-nation" to describe nondiscriminatory trade treatment, U.S. law since 1998 has referred to this treatment as "normal trade relations" status. *See* Internal Revenue Restructuring and Reform Act of 1998, P.L. 105-206 § 5003, 112 Stat. 685 (1998). This report uses the WTO terminology.

[3] See Appellate Body Report, Turkey—Restrictions on Imports of Textile and Clothing Products, ¶ 45, n.13, WT/DS34/AB/R (AB noted that "legal scholars have long considered Article XXIV to be an 'exception' or a possible 'defence' to claims of violation of GATT provisions" and referenced an unadopted 1993 GATT panel report noting that "Article XXIV:5 to 8 permitted the contracting parties to deviate from their obligations under other provisions of the General Agreement for the purpose of forming a customs union").

[4] J. JACKSON, W. DAVEY & A. SYKES, LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS 453 (4th ed. 2002)[hereinafter JACKSON, DAVEY & SYKES].

[5] Uruguay Round Understanding on the Interpretation of Art. XXIV of the GATT 1994, *available at* http://www.wto.org/english/docs_e/legal_e/10-24.pdf.

[6] For further information on the WTO and regional trade agreements, *see* the WTO website at http://www.wto.org/english/tratop_e/region_e/region_e.htm.

WTO General Council established a new transparency mechanism for FTAs which, among other things, provides for early notification of FTA negotiations.[7]

Article XXIV Requirements

To comply with Article XXIV, FTAs must meet four fundamental requirements: (1) duties and other restrictive commercial regulations must be eliminated; (2) substantially all trade must be covered; (3) external tariffs and commercial regulations—that is, measures applicable to nonparties—may not be higher or more restrictive than those in effect before the FTA or interim agreement was formed; and (4) interim agreements must contain a plan and schedule to achieve these goals within a reasonable period of time.[8] Even though the GATT requires that FTAs eliminate tariffs and restrictive regulations, it allows FTA parties to apply tariffs, restrictions, and GATT-inconsistent measures imposed under specified GATT articles, "where necessary."[9]

WTO Members entering into an FTA or an interim agreement must promptly notify the WTO and provide information that will enable reports and recommendations to be made to WTO Members.[10] FTA agreements have traditionally been examined by ad hoc working parties that prepare reports on their findings and present them to WTO Members for consideration. The 1994 Understanding provides that working parties will report to the WTO Council on Trade in Goods, which will make appropriate recommendations to WTO Members. Under Article XXIV, paragraph 10, WTO Members may, by a two-thirds vote, approve proposals that do not fully comply with Article XXIV, providing they lead to the formation of an FTA as contemplated by the Article.[11] Parties to a noncomplying agreement may also seek a waiver of obligations under Article IX of the WTO Agreement, which allows waivers in "exceptional circumstances" if agreed to by three-fourths of WTO Members.[12]

GATS Article V

The General Agreement on Trade in Services (GATS), which also contains a general MFN obligation, provides an exception for trade liberalizing regional service agreements, so long as barriers and other restrictions on trade in services be eliminated immediately or within a reasonable time frame and, the agreement provides substantial sectoral coverage.[13] In addition, nonparties must not be subject to higher or more restrictive trade in services barriers as a result of

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[7] WTO General Council, Transparency Mechanism for Regional Trade Agreements; Decision of December 14, 2006, WT/L/671 (December 18, 2006), *available at* http://docsonline.wto.org/DDFDocuments/WT/L/671.doc.

[8] GATT 1994, *supra* note 1, at Art. XXIV:5(b)-(c); see also *id.* at para. 8(b).

[9] *Id.* at XXIV:8(b).

[10] *Id.* at Art. XXIV:7(a).

[11] *Id.* at Art. XXIV:10.

[12] Agreement Establishing the World Trade Organization, Art. IX, *available at* http://www.wto.org/english/docs_e/legal_e/04-wto.pdf.

[13] General Agreement on Trade in Services, Art. V, *available at* http://www.wto.org/english/docs_e/legal_e/26-gats.pdf [hereinafter GATS] (stating that GATS "shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement.").

the agreement. Finally, parties to the agreement must notify the Council for Trade in Services of the existence of such an agreement and, if implementing on a time frame, report periodically to the Council.[14] The GATS also contains an exception for agreements establishing full integration of the parties' labor markets, provided that the agreements exempt citizens of parties from residency and work permit requirements.[15]

Free Trade Areas: Particular WTO Issues

"Substantially All Trade"

One of the most problematic aspects of Article XXIV, particularly as it applies to the exclusion of economic sectors from FTAs, is the meaning of the term "substantially all trade." The term has not been defined either by GATT Parties acting jointly or by GATT working parties, whose reports have tended to be inconclusive.[16] The 1994 Understanding does not expressly define the term; however, the preamble states that the trade expansion to which regional agreements contribute "is increased if the elimination between the constituent territories of duties and other restrictive regulations of commerce extends to all trade, and diminished if any major sector is excluded." In examining whether FTAs comply with this obligation, working parties have taken into account both quantitative and qualitative factors.[17] The working parties did express concerns regarding the exclusion of certain agricultural trade in the U.S. FTAs with Israel and Canada, but neither panel recommended the disapproval of the FTAs, and both reports were subsequently adopted.[18]

Status of Safeguard Measures

Article XIX of the GATT, as expanded upon in the WTO Agreement on Safeguards, allows parties to impose temporary restrictions on imports in the event of import surges. Article 2.1 of the Safeguards Agreement states the general rule that a WTO Member "may apply a safeguard measure to a product only if that Member has determined ... that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and

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[14] *Id.*

[15] *Id.*

[16] *See* W. Davey, *The WTO/GATT World Trading System, An Overview*, in P. PESCATORE ET AL., HANDBOOK OF WTO/GATT DISPUTE SETTLEMENT, Part One, at 27 (2002); WORLD TRADE ORGANIZATION, GUIDE TO GATT LAW AND PRACTICE; ANALYTICAL INDEX 824-26 (updated 6th ed. 1995)[hereinafter GATT ANALYTICAL INDEX].

[17] GATT ANALYTICAL INDEX, *supra* note 16, at 824-26. For further discussion of this and other legal issues regarding FTAs, *see* WTO, Synopsis of "Systemic" Issues Related to Regional Trade Agreements; Note by the Secretariat, WT/REG/W/37 (March 2, 2000), *available at* http://docsonline.wto.org/DDFDocuments/t/WT/REG/W37.doc[hereinafter WTO Issues Synopsis].

[18] Free-Trade Area Agreement Between Israel and the United States; Report of the Working Party adopted on 14 May 1987, GATT, 34th Supp. BISD 58, 64, ¶¶ 21-23 (1988); Working Party on the Free-Trade Agreement Between Canada and the United States; Report adopted on 12 November 1991, GATT, 38th Supp. BISD 47, 73, ¶ 83 (1992).

under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products."[19]

Article XIX is not listed as an FTA exception in Article XXIV, paragraph 8(b), and the Safeguards Agreement leaves open the question of the relationship of safeguards to FTAs.[20] WTO Members have expressed differing views on the subject, arguing that (1) safeguards may not be imposed against FTA partners because such measures are not exempted in paragraph 8(b); (2) safeguards must be applied on an MFN basis, in part because of the requirement in Article 2.2 of the Safeguards Agreement that a safeguard "be applied to a product being imported irrespective of source"; and (3) safeguards are allowed among FTA parties so long as third-party rights are not infringed.[21]

While not ruling on the relationship of Article XXIV to the imposition of safeguards, WTO panels and the Appellate Body have identified a requirement of "parallelism" in the Safeguards Agreement dictating that if serious injury were to be based on all imports, including those from the FTA, the safeguards should apply to the same imports. For example, in the WTO challenge to the now-removed safeguard on steel imports imposed by the United States in March 2002, the panel, as upheld by the Appellate Body, faulted the United States for including the imports of affected products from U.S. FTA partners in its investigation of whether increased imports were the cause of serious injury, while excluding these countries' imports from the remedial safeguard without providing a "reasoned and adequate" explanation for why the imports covered by the safeguard alone satisfied the requirements for imposing the measure.[22] The North American Free Trade Agreement (NAFTA), as well as U.S. FTAs with Israel, Canada, Jordan, Chile, Singapore, Australia, Morocco, Bahrain, Oman and Peru, and the Dominican Republic-Central American-United States Free Trade Agreement (DR-CAFTA), contain safeguards provisions for originating goods. Safeguards provisions are also included in recently signed FTAs with Colombia, Panama and the Republic of Korea, all of which are awaiting approval by Congress.

Dispute Settlement

The 1994 Understanding on Article XXIV, at paragraph 12, provides that WTO dispute settlement procedures may be invoked with respect to matters arising under Article XXIV provisions relating to free-trade areas and interim agreements. The provision clarifies that the review provisions of Article XXIV are not the only vehicle for examining the compatibility of FTAs with

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[19] *See* GATT 1994, *supra* note 1, at Art. XIX; *see also* WTO Agreement on Safeguards, Art. 2.1, *available at* http://www.wto.org/english/docs_e/legal_e/25-safeg.pdf [hereinafter WTO Agreement on Safeguards].

[20] The Safeguards Agreement states in a note that nothing in it "prejudges the interpretation of the relationship between Article XIX and paragraph 8 of Article XXIV of GATT 1994." *See* WTO Agreement on Safeguards, *supra* note 19, Art. 2.1, n.1.

[21] WTO Issues Synopsis, *supra* note 17, at 22-23.

[22] Panel Reports, United States—Definitive Safeguard Measures on Imports of Certain Steel Products 899-932, WT/DS248/R *et al.* (July 11, 2003); see also Appellate Body Report, United States—Definitive Safeguard Measures on Imports of Certain Steel Products 140-57 WT/DS248/AB/R *et al.* (November 10, 2003).

GATT rules.[23] WTO dispute settlement is also available with respect to all obligations under the GATS.[24]

Free Trade Agreements: United States GATT/WTO Practice

Both the U.S.-Israel FTA and the U.S.-Canada FTA were presented to the GATT Contracting Parties as interim agreements for the formation of a free-trade area.[25] The NAFTA, and FTAs with Jordan, Chile, Singapore, Australia, Morocco, Bahrain, and the DR-CAFTA were submitted both as free trade and services agreements.[26] A draft report on NAFTA was issued for consideration by the WTO Committee on Regional Trade Agreements in September 2000.[27]

The United States has also entered into FTAs with Oman, Peru, Colombia, Panama and South Korea. While implementing legislation for the FTAs with Oman and Peru has been enacted into public law,[28] neither FTA has yet entered into force. Implementing legislation for the FTA with Colombia was introduced April 8, 2008 (H.R. 5724; S. 2830), but expedited legislative procedures that would have applied to the bill were suspended by the House on April 10, 2008 (H.Res. 1092). Implementing bills for the FTAs with Panama and South Korea have not yet been introduced. The Administration has also begun negotiating FTAs with Thailand, Malaysia, the United Arab Emirates, and the Southern African Customs Union (SACU).[29]

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[23] JACKSON, DAVEY & SYKES, *supra* note 4, at 454-55.

[24] GATS, Art. XXIII. For further information on WTO jurisprudence involving Article XXIV, e.g., discussion of the conditions under which WTO-inconsistent measures may be justified under Article XXIV, see WTO Analytical Index; Guide to WTO Law and Practice, at http://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_e.htm#article24.

[25] GATT ANALYTICAL INDEX, *supra* note 16, at 804.

[26] WTO, Regional Trade Agreements Notified to the GATT/WTO and in Force, By status in the examination process, as of May 20, 2008, *available at* http://www.wto.org/english/tratop_e/region_e/status_e.xls. For further information on FTA issues generally, *see* CRS Report RL31356, *Free Trade Agreements: Impact on U.S. Trade and Implications for U.S. Trade Policy*, by (name redacted). The U.S. FTA with Canada was suspended upon the entry into force of the NAFTA. See DEP'T OF STATE, TREATIES IN FORCE, JANUARY 1, 2007, at 46.

[27] *See* Draft Report on the Examination of the North American Free Trade Agreement, WT/REG4/W/1 (September 28, 2000), *available at* http://docsonline.wto.org/DDFDocuments/t/wt/reg/4w1.doc.

[28] P.L. 109-283, 120 Stat. 1191 (September 26, 2006)(Oman); P.L. 110-138, 121 Stat. 1455 (December 14, 2007)(Peru).

[29] Countries involved in negotiations for the SACU agreement are include South Africa, Namibia, Lesotho, Botswana and Swaziland. For more information on the status of U.S. FTA negotiations, *see* CRS Report RL33463, *Trade Negotiations During the 110th Congress*, by (name redacted).

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