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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 (FTA) are facially inconsistent with this obligation because they grant countries who are party to the agreement the ability to receive 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. With the recent Congressional approval of both the U.S.-Australia and U.S.-Morocco FTAs, the United States is presently a signatory to eight FTAs. In addition, the Administration has recently signed and released drafts of the Central American Free Trade Agreement (CAFTA), as well as the U.S.-Bahrain FTA. Finally, the Administration is involved in ongoing FTA negotiations with a number of other countries including the Free Trade Area of the Americas, Thailand, Panama, the Andean Nations and the South African Customs Union. This report will be updated.

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

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].

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. 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.³ The Uruguay Round Understanding on the Interpretation of Article XXIV 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."⁴ In 1996, WTO Members created a permanent committee on regional agreements, which conducts reviews of new and existing FTAs and studies the overall impact of such agreements on the world trading system.⁵ Further improvement in this area is also a part of the negotiating mandate for the Doha Round.

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 non-parties – 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.⁶ 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."⁷

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

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, Pub. L. No. 105-206 § 5003, 112 Stat. 685 (1998). This report uses the WTO terminology.

³ J. JACKSON, W. DAVEY & A. SYKES, *LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS* 453 (4th ed. 2002)[hereinafter Jackson, Davey & Sykes].

⁴ 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].

⁵ 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].

⁶ GATT 1994, *supra* note 1 at Art. XXIV:5(b)-(c); *see also id.*, at para. 8(b).

⁷ GATT 1994, *supra* note 1 at Art. XXIV:8(b).

made to WTO Members.⁸ 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 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.⁹ Parties to a non-complying 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.¹⁰

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.¹¹ In addition, non-parties must not be subject to higher or more restrictive trade in services barriers as a result of 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.¹² 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.¹³

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.¹⁴ 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

⁸ *Id.* at Art. XXIV:7(a).

⁹ *Id.* at Art. XXIV:10.

¹⁰ Agreement Establishing the World Trade Organization, Art. IX, *available at* [http://www.wto.org/english/docs_e/legal_e/04-wto.pdf].

¹¹ General Agreement on Trade in Services, Art. V, *available at* [http://www.wto.org/english/docs_e/legal_e/26-gats.pdf] (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.”).

¹² *Id.*

¹³ *Id.*

¹⁴ See 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].

restrictive regulations of commerce extends to all trade, and diminished if any major sector is excluded.”¹⁵ In examining whether FTAs comply with this obligation, working parties have taken into account both quantitative and qualitative factors.¹⁶ 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.¹⁷

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 under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products.”¹⁸

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.¹⁹ 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.²⁰

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 was 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

¹⁵ *See supra* note 4.

¹⁶ GATT Analytical Index, *supra* note 14, 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://www.wto.org>] [hereinafter cited as WTO Issues Synopsis].

¹⁷ 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) (U.S.–Israel FTA); 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) (U.S.–Canada FTA).

¹⁸ *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]

¹⁹ 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 18.

²⁰ WTO Issues Synopsis, *supra* note 16, at 22-23.

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.²¹ The North American Free Trade Agreement, as well as U.S. FTAs with Israel, Canada, Jordan, Chile and Singapore, Australia, and Morocco all contain safeguards provisions for originating goods.

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 GATT rules.²² WTO dispute settlement is also available with respect to all obligations under the GATS.²³

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.²⁴ The North American Free Trade Agreement (NAFTA) and the U.S.-Jordan FTA were submitted both as free trade and services agreements. According to the most recent report by the WTO Committee on Regional Trade Agreements, a draft report on the NAFTA is in its final stages of preparation, while factual examination of the U.S.-Jordan FTA has not yet begun.²⁵ The U.S.-Chile and U.S.-Singapore FTAs were presented to the WTO on December, 19, 2003, as both goods and services agreements.

Recently, the Administration signed and Congress approved FTAs with both Australia²⁶ and Morocco.²⁷ To date, however, these agreements have not been transmitted

²¹ United States – Definitive Safeguard Measures on Imports of Certain Steel Products; Final Reports of the Panel 899-932 (July 11, 2003) (WT/DS248/R *et al.*); *see also* United States – Definitive Safeguard Measures on Imports of Certain Steel Products; Report of the Appellate Body 140-57 (November 10, 2003) (WT/DS248/AB/R *et al.*).

²² Jackson, Davey & Sykes, *supra* note 3, at 454-55.

²³ GATS, Art. XXIII

²⁴ *GATT Analytical Index*, *supra* note 14, at 804.

²⁵ WTO, Regional Trade Agreements Notified to the GATT/WTO and in Force, By status in the examination process, as of Sept. 20, 2003, *available at* [http://www.wto.org/english/tratop_e/region_e/region_e.htm]. For further information on FTA issues, see CRS Report RL31356, *Free Trade Agreements: Impact on U.S. Trade and Implications for U.S. Trade Policy*; also "Free Trade Agreements" in the CRS Electronic Briefing Book, "Trade," *available at* [<http://www.congress.gov/brbk/html/ebtra1.shtml>].

²⁶ United States- Australia Free Trade Agreement Implementation Act, P.L. 108-286, 118 Stat. 919 (Aug. 3, 2004).

²⁷ United States- Morocco Free Trade Agreement Implementation Act, P.L. 108-302, 118 Stat. 1103 (Aug. 17, 2004).

to the WTO for approval.²⁸ The Administration has also signed an FTA with the Middle Eastern nation of Bahrain, as well as the Central American Free Trade Agreement (CAFTA), which includes Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.²⁹ In addition, the Administration has signed an Agreement with the Dominican Republic which, although separate, effectively includes them as a CAFTA member nation.³⁰ Negotiations also continue for multi-nation FTAs, such as the Free Trade Area of the Americas (FTAA) and with the countries of the Southern African Customs Union (SACU).³¹ Finally, the Administration has announced its intention to begin separate FTA negotiations with Thailand and Panama as well as with the Andean nations.³²

²⁸ See WTO, Regional Trade Agreements Notified to the GATT/WTO and in Force, By status in the examination process, as of Sept. 20, 2003, *available at* [http://www.wto.org/english/tratop_e/region_e/region_e.htm].

²⁹ The final text is available from the USTR website at [http://www.ustr.gov/Trade_Agreements/Bilateral/DR-CAFTA/DR-CAFTA_Final_Texts/Section_Index.html].

³⁰ See USTR Press Release, "Dominican Republic Joins Five Central American Countries in Historic FTA with U.S." Aug. 5, 2004, *available at* [http://www.ustr.gov/Document_Library/Press_Releases/2004/August/Dominican_Republic_Joins_Five_Central_American_Countries_in_Historic_FTA_with_U.S]

³¹ Countries involved in negotiations for this FTA include South Africa, Namibia, Lesotho, Botswana and Swaziland.

³² Countries involved in these negotiations include Bolivia, Columbia, Ecuador and Peru. For more information on the status of trade negotiations, see CRS Issue Brief IB10123, *Trade Negotiations in the 108th Congress*.