Regional Trade Agreements in the GATT/WTO: Article XXIV and the Internal Trade Requirement
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6 Internal Trade and Economic Theory

6.1 Introduction
This second part of the book has reviewed some of the elements of GATT Article XXIV as to its provisions, to the practice established by Working Group review parties charged with examining regional agreements, and in the unadopted GATT dispute panel reports. The application of the Article in practice through the Overseas Association and other early reviews raised a number of the significant systemic issues that remain unresolved in the practice as it has developed through the early years of the WTO. Prior to GATT-1994, the Banana dispute panel decisions established, albeit without the effect of legal adoption, a core principle that parties invoking Article XXIV exceptions could not claim an immunity from review according to Articles XXII and XXIII of the GATT. The effect of these rulings, while tentative, appeared to limit the availability of the regional exceptions at least in those cases where a facial review of the agreements indicated that a free-trade area within the meaning of paragraph 8 of Article XXIV was not being established.

To conclude this Part, a different type of systemic issue is raised for consideration. This is the influence of economic theory regarding the trade creating or diversion effects of regional trade agreements. The issue addressed is whether economic welfare criteria should be applied to the question of legal compatibility of an assessment of Article XXIV agreements. This aspect deserves some extensive treatment in recognition of the role that economic theory has played in framing the debate on the question of compatibility. Viner's influence on the treatment of regional formations in the GATT is pervasive. Besides establishing the field of economic studies relating to regional economic integration since 1950, his work became seminal for a generation of legal analysis on the regional compatibility issue. Any argument made for instituting a definitional criteria of the Article leading from paragraph 8 effectively suggests that there is a rebuttal at hand of this impressive line of legal and economic scholarship. Accordingly, this section concludes with the proposition that trade creation/diversion analysis for compatibility purposes forces a reversal of the appropriate examination sequence as advanced by the author here.

The Part will conclude by drawing upon some general literature to outline in greater detail the possible justifications for a higher internal trade requirement for Article XXIV. These traditional justifications are then compared with a preservation of trade test, as raised in the first section. Since a modern economic test along the lines of a Kemp/Wan theorem can address the traditional justifications, an additional justification is submitted relating to actual territorial differences. This finally returns us to a brief examination of most-favoured nation. If MFN operates in practice to reduce certain disparities between large and small countries, then the stricter requirements of the regional exceptions may also be validated in this light.

This assists in establishing a more ambitious theme that is drawn through to the next Part. This thesis is premised on the notion that one's understanding of the scope of application for MFN, and other GATT rules, may be subject to evolution over time. It is possible to outline an interpretation of the GATT generally, which suggests that regional members remain legally bound by GATT rules in regard to their internal policies. The MFN principle as outlined within the GATT framework may well have been drafted from the outset to accommodate this more expansive application for non-discrimination. This view would suggest that Article XXIV does not establish an avenue for regional members to establish autonomous regimes, but rather, it is a limited exception permitting the exchange of certain positive preference according to particular conditions. As such, regional members may be under the continuing legal authority of the GATT Agreement and its rules as they may apply to the conduct of intra-regional trade, even while members exchange their positive preferences. Much
of the text through the next Part of the book will examine this thesis and attempt a determination as to whether GATT MFN, as now found in the WTO, has evolved or can evolve to such an application.

6.2 The Divergent views of law and economy

The question of how the requirements of the Article XXIV should be interpreted in light of economic theory considerations has been an ongoing concern since GATT's origin. As theory has evolved to outline the application of customs union theory to Article XXIV requirements, it is fairly evident that conflict also arose as to whether the Article's legal requirements respected these theoretical developments. If not, then considerations have been raised whether the Article should be formally amended to validate the economic considerations, or in the alternative, should be applied in practice to ameliorate the defects in the provisions. This conflict is simply demonstrated by suggesting that Article XXIV provisions require the imposition of a high internal trade-coverage requirement. Since any agreement so qualified may be more trade diverging than a more partially-preferential arrangement, a type of divergence between one interpretation of the legal text and the economic objectives is presented. To the extent that regional proponents have argued that trade creation is the final objective to be reached by the process of applying the requirements of the Article, they have also implicitly argued for a structured order for the provisions. This would weaken the definitional requirement of paragraph 8 in respect of more emphasis being placed upon the effects of trade barriers as according to paragraph 5, and perhaps paragraph 4 as this has also been argued upon occasion to constitute a distinct legal requirement. The economic considerations, raised regarding whether a regional trade agreement is trade creating or trade diverting, supports a view of the Article which de-emphasises the role of the qualifying definitional requirements of paragraph 8, as these coverage provisions are directly affected by any argument to loosen the Article's constraints. That this interplay between legal and economic considerations has become an aspect over the correct interpretation of the Article establishes the question as a systemic issue. The conclusion asserted here is that trade creation is not a component of the Article's requirements, and that the legal considerations arguing for more complete regional formations override the ancillary considerations of economic welfare.

6.2.1 Viner's Customs Union Theory

The economic approach to the question of regional preferential trade formations has been to adopt a balancing approach in order to favour regional formations which would finally create rather than diminish global economic welfare.1 In its most pure form, the result to be achieved by a wholly complementary arrangement is that each relatively efficient producer or source of supply, whether internal or external to the arrangement, shall be finally positioned to expand its production as a result of the formation. As such, preferences should only be permitted which reward regional producers who are more efficient than external producers. This presents a conflict with the legal requirements, as any such arrangement, while maximising welfare, is also likely to be incomplete in regard to its regional trade coverage. This result stands in conflict with an internal trade requirement imposed to cover substantially all of the trade between the regional parties.

As such, it has been the position of a number of economic theorists and legal commentators, as indicated below, that GATT Article XXIV is economically irrational. This follows from the central point that an agreement which covers all the trade can result in a higher degree of trade diversion, resulting in the shifting of production from efficient to lesser efficient producers, than one which cover only a portion of the trade. Likewise, regional trade agreements which are only partially preferential, and therefore unqualified according to a more severe Article XXIV test, may also result

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1 This is not to suggest that economic theory would favour a partial arrangement over either unilateral liberalisation or multilateral liberalisation. For a short but contemporary review of the evolution of economic theory regarding preferential trade agreements (customs union theory) see, J. Bhagwati and A. Panagariya, The Theory of Preferential Trade Agreements: Historical Evolution and Current Trends, The American Economic Review, V.86, No. 2, May 1996, pp. 82-88.
in lesser diversion of trade than a complete exchange of preferences. Simply stated, an incomplete formation may, in a given case, be economically superior to a complete formation.\(^2\)

It is generally agreed that the origin of this dichotomy rests with Viner and his 1950 treatise, The Customs Union Issue. Prior to his insight that customs unions were capable of diverting more trade than they created, it was assumed for the most part that all customs union were economically beneficial, and further, that Article XXIV arrangements reflected this by requiring completed formations. Viner illustrated the reasoning behind his argument by pointing out the absurdity of retaining a legal distinction between the minimal difference of a 100 percent preference and lesser marginal preference. Thus,

"Free-traders sometimes in almost the same breath disapprove of preferential reduction of tariffs but approve of customs unions, which involve 100 per cent preference, and this is the position at present of the United States Government and the doctrine of the Havana Charter. If the distinction is made to rest, as often seems to be the case, on some supposed virtue in a 100 per cent preference, which suddenly turns to maximum evil at 99 per cent, the degree of evil tapering off as the degree of preference shrinks, it is a distinction as illogical, the writer believes, as this way of putting it makes it sound."\(^3\)

This follows from Viner's identification of the economic issue arising in determining the effects of the changes in "the national locus of production of goods purchased." As the shifting of purchases either to the higher or lower cost sources of supply is engaged by union formation, then such a shifting in its net effects is either positive or negative,

"(a) for each of the customs union countries taken separately; (b) for the two combined; (c) for the outside world; (d) for the world as a whole."

Thus, "If the customs union is movement in the direction of free trade, it must be predominantly a movement in the direction of goods being supplied from lower money-cost sources than before. If the customs union has the effect of diverting purchases to higher money-cost sources, it is then a device for making tariff protection more effective."\(^4\)

6.2.2 Dam's interpretation of Article XXIV requirements

The juxtaposition of the GATT legal requirements with the 1950 economic analysis is often attributed to poor historical timing as Viner's contribution to the theory post-dated the drafting of the GATT Article responsible for the qualification of regional agreements. The position was shortly taken thereafter that Article XXIV, together with its substantially-all trade requirement, was more or less hopelessly outdated shortly after arrival.

The major legal contribution which applied Viner's theory to the Article XXIV requirements came from Dam in 1963, as he made a most extensive examination of the GATT reviews taken to date, and in light of Viner's proposition. Dam concluded that the Article was wanting in a most important respect,

"Since the tariff reduction inherent in such a preferential arrangement might be considered to be a movement toward free trade, albeit not so dramatic as that produced by a customs union or free-trade area, and since such a preferential arrangement by definition involves less

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\(^2\) The primary purpose of a customs union, and its major consequences for good or bad, is to shift sources of supply, and the shift can be either to lower - or to higher - cost sources, depending on circumstances." Viner, Jacob, The Customs Union Issue, Carnegie Endowment, (1950), p. 44.

\(^3\) J. Viner, Ibid., at pp. 49-50, and his note 6.

\(^4\) J. Viner, Ibid., at 42. "None of these questions can be answered a priori, and the correct answers will depend on just how the customs union operates in practice. All that a priori analysis can do, is to demonstrate, within limits, how the customs union must operate if it is to have specific types of consequences." Ibid., at 43.
discrimination against nonmembers than a customs union or free-trade area, the justification for proscribing such arrangements absolutely is not clear."  

Dam's prescription was to conclude that the Article required revision. Barring the practical difficulties of accomplishing a negotiated amendment to the Article, he recommended instead, a "creative reinterpretation" of its provisions to emphasise that aspect of Article XXIV:4 which called upon the parties "...not to raise barriers to the trade of other Contracting Parties." This was in effect a call to raise paragraph 4 to the status of an independent legal requirement that would supersede the coverage requirements of paragraph 8. This would also suggest an implicit reversal of the examination sequence in order to impose paragraph 5 as the leading factor for qualification, since the emphasis would be placed by his construction upon the final structure of barriers to outsiders, rather than upon the quality of internal free trade to be obtained by the regional parties at the outset. Amended in this way, qualified regional groupings would then serve the movement toward freer world trade by being individually rendered as trade creating.

6.2.3 Implications for the review process and for MFN

Without regard to the merits, this view has also since then tended to dominate the framework by which regional agreements are argued to be compatible with the GATT requirements. Moreover, once it was understood that a strict internal trade requirement could do more damage to world trade than a less strict requirement, the requirement's objective of supporting a broader application of most-favoured nation treatment was also placed into consideration. As Johnson succinctly stated in 1976, the MFN principle, "has absolutely nothing to recommend it on the grounds of either economic theory or the realities of international commercial diplomacy...The speciousness of the principle of non-discrimination is only exceeded by the irrationality of permitting nothing less than 100 per cent discrimination in the case of customs unions and free trade areas"  

However, Johnson did recognise in the same instance that the justification for the MFN principle was not within the economic sphere at all:

"(T)he principle has an important point and function, which can be loosely and inaccurately stated as the principle that if you pay your membership dues to a club you are entitled to decent treatment as one of the paid-up members." (Therefore), "...it seems the wiser course not to devise further exceptions to the principle or rewrite it, but instead to improve the framework of international economic relations within which countries receive non-discriminatory most-favoured-nation treatment."  

This recognises that the rules of the club provide an agreed-upon notion of "fair play" as between its members, and that this consensus reached, defining what is "fair" between these members, is not

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5 Dam, Kenneth W. (1963), *Regional Economic Arrangements and the GATT, the Legacy of a Misconception*, University of Chicago Law Review, V. 30, No. 4, pp. 615-665, at p. 633, italics added.
6 K. Dam, ibid., at p. 635.
7 K. Dam, ibid., at p. 663.
8 Article XXIV:4, "The Contracting Parties recognize 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." Only in the WTO 1994 Understanding on the Interpretation of Article XXIV is the "stepping stone" theory raised in, "(R)ecognizing the contribution to the expansion of world trade that may be made by closer integration between the economies of the parties to such agreements..."
10 H. Johnson, in R. Snape, ibid., at p. 31.
equivalent to a consideration of welfare efficiency. To place Johnson's point in a more legal
construction, the coherence of the principle rule of the club is obtained by its consistent application.
Where efficiency considerations may argue for a more flexible set of exceptions in order to attain a
higher welfare objective for the world as a whole, such flexibility also carries a certain risk. If
members do not believe that the core rule of the club is going to be applied consistently, then the
value of membership is openly put into question.

Unfortunately, the trend in economic theory regarding compatible regional systems has failed to take
Johnson's prescription into account. A major addition to Viner's proposition was introduced by Kemp
and Wan, also in 1976. This demonstrated that any regional integration agreement could (in theory) be
made to be welfare enhancing. Under certain conditions the external tariff for a customs union could
be reduced overall to avoid the effects of trade diversion.\textsuperscript{11}

\textbf{6.2.4 The modern test}

Kemp-Wan provided the foundation for a prescription that "compatibility" can be provided by a
balancing test methodology to accomplish a "trade neutral" regional exception. McMillan offered a
detailed expression of this view that relates precisely to the Article XXIV requirements. His opinion
was that regional formations should be assessed in practice by an examination of the resulting position
of non-members in regard to the preservation of their trade flows. Thus,

"(I) have suggested that the best test for judging whether a RIA (Regional Integration
Agreement) is harmful is the simplest possible: does the agreement result in less trade
between member countries and outside countries? If the answer to this question is no, then the
RIA is consistent with open trade...."\textsuperscript{12}

While such a status quo approach presents obvious appeal for non-members, it is an extreme
divergence from the approach adopted by the provisions of Article XXIV. A complete removal of
internal barriers between regional members will always present a greater difficulty for the resulting
trade position of the non-members. This however was addressed directly by McMillan in his
consideration of the value of the internal trade requirement:

"(T)his, also, is not in general in the interests of either the member countries or the rest of the
world. A zero intra-union tariff usually causes unnecessarily large amounts of trade diversion,
as Meade (1955) showed."\textsuperscript{13}

It would follow that a proposed agreement providing for 100 percent tariff reductions upon all of the
members' trade, while clearly in compliance with Article XXIV's paragraph 8 coverage provisions,
should be substituted by a more partial agreement that is demonstrated not to harm the trade of non-
members. The question raised by such a test is whether the GATT could accommodate such a change
and still retain any basis of legitimacy for MFN?

\textsuperscript{11} M. Kemp and H. Wan, (1976) An Elementary Proposition Concerning the Formation of Customs Unions,
Journal of International Economics, V.6, No. 1, pp. 95-97, at p. 95. According to Bhagwati and Panagariya, the
Kemp-Wan contribution consisted of showing, as a "possibility theorem" that, "one could always construct a
welfare-improving CU (customs union) among any subset of countries while the non-members were left at their
initial welfare." Bhagwati and Panagariya, Supra note 1 at p. 83.

\textsuperscript{12} McMillan, John, (1993), Does Regional Integration Foster Open Trade, in K. Anderson and R. Blackhurst,
306.

\textsuperscript{13} J. Mcmillan, Ibid., at note 8. McMillan acknowledges that there are "broad systemic reasons" for the internal
trade requirement, but as indicated in his conclusion above, the final test to be applied should refer first to the
position of non-members regardless of whether or not internal trade is made free.

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6.2.5 Does GATT Article XXIV accommodate an economic test?

What becomes evident from this brief review of the economic considerations is that there is a disagreement as to what "compatibility" of a regional agreement should be intended to mean. This concept is clearly not the same for economists as it was for the drafters. For economists, the concept appears to be focused upon trade creation, or at least upon the avoidance of trade diversion. Whether this would be a good idea or not, it is clear, as Dam pointed out, that economic considerations were not elevated to a primary position in setting the original parameters of the regional exception. Thus, Article XXIV:4 only provides that while the Contracting Parties,

"recognize the desirability of increasing freedom of trade by the development...of closer integration between the economies of the countries parties to such agreements. They also recognize that the purpose of a customs union or of 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." (italics added.)

The drafters may well have suffered under a primitive illusion that completed regional trade formations might contribute in all cases to an expansion of world trade, the very point invalidated by Viner. However, the italicised provision above also establishes the purpose of the exception as stated by drafters. That is to prefer those agreements that actually facilitate trade between the constituent territories. Just as Article XXIV provides a type of exception to the operation of other GATT rules, so may it also be an exception to the GATT objectives that are sought to be served by those other rules, like the expansion of world trade. While the paragraph recognises the desirability of increasing the freedom of trade, it does not place this objective in any context decidedly global or regional. In point, the paragraph only accomplishes one small task, and this establishes no relation to global trade. That is to simply declare that the exceptions are intended to be available for agreements which are intended to facilitate trade between their members, as contrasted with those which are intended to raise barriers to non members. As such, it is only stating the reason for granting the regional exception. It is not posing as a legal requirement in itself. It is indicating what is desirable rather than what is mandated. It does not suggest that agreements undertaken should pass any additional test of contributing to global trade.14

If GATT-1947 missed the emerging economic theory in establishing a welfare test for the exception, the drafters to the Uruguay Round also passed upon an opportunity to realign the provisions to the economic theory. Instead, the original goal of permitting regional formations subject to an internal trade requirement was not only restated by the GATT-1994 Understanding on the Interpretation of Article XXIV, but arguably strengthened from the original text. Although the Understanding does now refer to the idea that regional agreements may contribute to the expansion of world trade, such a contribution is also said to be decidedly 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...(and) (R)eaffirming that the purpose of such agreements should be to facilitate trade between the constituent territories..."15

14 The General Agreement preamble can be raised for consideration as it would inform the objectives provided in Article XXIV:4. Here, the relevant text provides that relations should be conducted with a view to "expanding the production and exchange of goods" by entering into arrangements directed to the "substantial reduction of tariffs and other barriers to trade..."(GATT 1947 Preamble). However, the preamble does not establish a basis to accord or not accord MFN on the criteria of whether or not trade is expanded.
15 Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994, preamble, OJ No L 336/16, 23.12.94. The Understanding modifies aspects concerned with Article XXIV:5,6,7, and 12. Article XXIV:8, which states the definition internal trade requirement, was left entirely untouched from the original text of 1947. It is not suggested here that the preamble is raising a new legal standard. It does however enunciate a Members' consensus that more complete formations are compatible with the purpose of the exception.
Although Viner's insight has had years of development in the economic and policy literature, even to the point dominating the analytical framework by which we place regionalism in the multilateral context, a criterion for trade creation has yet to find its place in any provisions of the Article, as amended. One can only conclude, that given a choice between an MFN principle relegated in each case to a "preservation of trade" test, that the club members have rather decided to reinforce the bar to MFN deviations rather than lower it.

The confusion between the economic and legal objectives occasionally traps even the staunchest opponents of regional free-trade trade agreements. Thus, as Bhagwati comments by way of footnote, "(A)side from the fact that NAFTA has its own holes,...Ambassador Eisenstat has nothing but assertion on his side when he claims that full preferences are better than partial preferences. Indeed, some economic arguments suggest the opposite."

Perhaps most economic arguments would suggest otherwise, but this remains beside the point. What is more germane to the question is the manner in which the economic argument has come to frame the question of legal compatibility. Further, whether at this juncture there is any possibility of placing this view into its proper position, which is outside the considerations of paragraph 8 of the Article. That this development needs to occur is nicely indicated by the following characterisation by Jackson regarding the use of contingent trade measures between regional members:

(A) similar argument, or problem, arises with regard to unfair trade rules (anti-dumping and countervailing duty rules), but a practice has developed of tolerating preferential agreements as long as they do not eliminate such unfair trade rules between the preference parties.

One can understand how non-members would apply the customs union argument to make the case that regional members should never be accorded a right under Article XXIV law to suspend the use of trade measures between them, since certainly trade diversion will almost always result. However, from the legal view one would consider that the retention of such trade devices between members would have a direct bearing upon whether a regional formation could sustain sufficient trade coverage as required by paragraph 8 at the outset.

6.2.6 Paragraph 8 requires a legal construction

These examples are not raised to criticise the value of customs union theory for its concept of trade creation, but rather to indicate how the theory has become gradually aligned with a view that denotes the concept of compatibility from the position of non-members. What has evolved is a more "outsider directed" perspective regarding the value of regional formations and the direct equation of this perspective with the larger interests of the multilateral system itself. In this environment, it is entirely possible to conclude that the highest-level regional integration schemes, like a completed customs territory formation establishing internal free circulation and disposing of internal trade measures, should be viewed as the most potentially diverting and therefore the most incompatible of all possible arrangements.

In contrast, the more flexible form of a free-trade area where countries retain their individual commercial policies, as in Jackson's example above, can be tailored so that they better serve the goal of net trade creation. Where sectors can so easily be omitted from internal coverage, this enhanced flexibility should permit outsiders a greater opportunity to preserve (or re-establish) their trade flows. Flexible organisational structure provides a better instrument, which, if properly applied could better

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meet the "no harm done" test as enunciated by McMillan. Partially discriminatory groupings suggest at least the possibility of creating a final result that is trade creating and therefore more compatible with the multilateral system.

This line of reasoning approaches a nearly absurd result when pursued to its logical endpoint. Consider together these two provisions from paragraph 1 and 8 of Article XXIV:

1... (E)ach such customs territory shall, exclusively for the purposes of the territorial application of this Agreement, be treated as though it were a Contracting Party...

8(a) ... A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories...

Thus, we are reminded that a customs union complying with the coverage requirements of paragraph 8 is a customs territory. Further, GATT's legal provision for territorial application requires that such a union shall be treated as though it were a Contracting Party. In this light, it must be viewed as ironic that a qualified union could be relegated as the "least compatible of all" possible formations, as suggested by an economic viewpoint. As a completed customs union is to be considered a Contracting Party as a matter of law, then one can only conclude that a trade creation or diversion criteria cannot possibly be imposed in disregard of this accorded legal status, by the express provisions.

6.2.7 Paragraph 5 accommodation of economic criteria

Where economics does play a role for Article XXIV determinations is in regard to the performance requirements dictated by paragraph 5. Although only formations already qualified according to paragraph 8 should be passed along to consideration under paragraph 5, the preamble of that paragraph does state that the exception accorded by the Article is only granted provided that certain criteria subject to economic measurements shall be met. To the extent that the general incidence of duties and regulations of commerce shall not be higher or more restrictive on the whole, this suggests that economic evidence is relevant to this assessment. It does not however suggest that there is a determination to be made that the formation must be, on balance, trade-creating. Moreover, a finding that a customs union was trade diverting on balance would not raise a presumption that paragraph 5 requirements were not being met. It is not difficult to compose a hypothetical union composed of high-tariff constituent members. The resulting common tariff could be significantly lower than the previous individual tariffs to non-members. However, this could yet be trade-diverting overall due to the complete elimination of internal barriers to trade.

What one concludes is that whether a customs union or free-trade area is trade-diverting may well have a negative implication for economic welfare and for the expansion of world trade. But, this consideration should not force a conclusion that a similar negative implication will be drawn for the world trade system. The multilateral trading system is not merely a reflection of world trade flows. The latter is concerned with the expansion of trade and the enhancement of welfare, or at least with the desire to not see overall welfare degraded. The former as we explore below, is concerned intrinsically with issues of providing a basis for equitable treatment between the parties contracted in the GATT in regard to the origins of their goods.

6.2.8 The implications of a flexible approach

We have suggested that, by reducing the regional question only to its external welfare effects, any rationale for a higher internal free-trade requirement is necessarily disregarded. Again from McMillan,

"In practice it is possible that some member countries will not benefit from a RIA. But it seems reasonable to have a hierarchy of concerns: to put preventing harm to third countries ahead of preventing members from harming themselves."^{18}

^{18} John McMillan, Supra, note 12 at p. 295.
This hierarchy of concern equates the interests of non-members with that of the multilateral system itself as though the multilateral system does not say nor should say anything regarding the conduct of parties within preferential arrangements. In practice, the equation of non-member interests with that of the trading systems itself has influenced the discourse concerning regional trade agreements. For an example, the following European Commission statement responded to the charge that a rise in the number of regional agreements poses a threat to the WTO system.

"WTO Secretariat analysis confirms the EU's view that, on the whole, the effect of regional integration agreements concluded since 1947 has been to create rather than divert trade, and has therefore tended to reinforce the benefits of the multilateral system rather than undermine them."19

The EC has relied upon this argument before. In the 1970 Working Group Report of the EEC Association with Tunisia and Morocco, Working Group members attempted to draw a linkage between the proliferation of developed/developing country regional agreements and the larger framework of international trade and development. The EEC's response at that time was that previous similar agreements had not led to any finding of damage to non-members, that a majority of the Contracting Parties had entered into such agreements over the previous twelve years, and that (nevertheless) world trade had expanded.20

The gist of the argument is that as long as world trade expands, then non-members are not negatively affected by regional formations. Therefore, regional agreements, partial or otherwise, are inherently compatible with the trading system. There are several points with which to contest this reasoning, not the least of which is to ask what would have been the growth of world trade by MFN in the absence of any such regional agreements? One may also pose the reverse inference for consideration. If there would occur a period in which world trade failed to expand overall, would non-members then have a basis to conclude that preferential agreements were no longer compatible with the multilateral system?

Foremost however is the persistent assumption that trade creation is the context within which the question of compatibility should be determined. This is asserted without any reference to the particular quality of the agreements themselves, as though all regional agreements were formed according to similar criteria and intended to meet a uniform set of goals.21 If one accepted the EC declaration at face value then one should also entertain some of the more problematic implications that follow. For example, if only more regional preferential agreements had been concluded since 1947, the resulting effects for the multilateral system would have been even more positive, since, "on the whole, the effect of regional integration agreements concluded since 1947 has been to create rather than divert trade."

To follow this reasoning along, the GATT's failure to require a higher threshold of internal trade coverage between members has been a fortunate accident of history. If institutionalised by an amendment to paragraph 8 provisions, Article XXIV could be reformed in order to drop the definitional requirements free-trade areas and customs unions altogether. This would permit a sector by sector examination of all notifications and permit all preference agreements between members for

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20 1972 BISD, L/3379, p. 149, para 5-11.
21 For examples, how much of the expansion was caused by customs unions as compared to free-trade areas, and how much was caused by free-trade areas in their differing varieties? Was more or less expansion caused by free-trade areas that omitted agriculture and textile coverage? Was more or less expansion caused by free-trade area plans between developed territories or between developing territories, or between developed and developing territories?
those sectors that do not interfere with the existing flows of trade to non-members. This is essentially 
the preservation-of-trade flow test proposed by John McMillan. In point, it complements well 
Kenneth Dam's original prescription to address the Overseas Association problem on a sector by 
sector basis.22

6.3 Justifying internal trade

6.3.1 A first justification: avoiding trade-diverting preferences

It was suggested above that trade creation is not a part of the legal test required for compliance with 
Article XXIV. However, there is a long thread of commentary regarding the internal trade 
requirement of paragraph 8 that does express a type of internal trade creating intention as drawn from 
the provisions. This follows from a recognition that there is a tendency within more flexible 
preference agreements for regional partners to seek to exchange only those preferences which serve to 
divert external trade. The higher internal trade requirement restricts this flexibility. Haddock identified 
this justification in response to those who, "charge that the present all-or-nothing rules are 
economically unsound..."

"(I)n addition, once governments are allowed to select some products and not others, political 
forces will inevitably exert enormous pressure to choose trade-diverting preferences first. 
Trade-diverting preferences are the ones that result in the greatest net political gain for 
governments; the political gains arise from pleasing local producers who displace third-
country producers, while political losses are entirely avoided because third-country producers 
do not vote."23

Jacob Viner also recognised this problem, and even appeared to suggest that this was a meaningful 
exception to his own assertion that a 100% preference was economically irrational. Thus, 
"(T)here is one ground only on which it can consistently be held that preferences are 
economically bad and are increasingly bad as they approach 100 per cent...Customs union, if 
it is complete, involves across-the-board removal of the duties between the members of the 
union; since the removal is non-selective by its very nature, the beneficial preferences are 
established along with the injurious ones, the trade-creating ones along with the trade-
diverting ones. Preferential arrangements, on the other hand, can be, and usually are, 
selective, and it is possible, and in practice probable, that the preferences selected will be 
predominantly of the trade-diverting or injurious kind."24

Although requiring 100 per cent preferences may be economically inferior to partial exchanges that 
select only trade-creating preferences, in actual practice such a beneficial partial exchange is not at all 
likely. Therefore the all-or-nothing approach installs the good with the bad, as contrasted to only 
installing the bad. Roessler recounted this same justification for the stricter requirement in suggesting 
that formations dedicated to the purpose of diverting external trade can be avoided by such an 
application of GATT Article XXIV:

"(D)omestic protectionist pressures will tend to favor trade diversion over trade creation, and 
governments negotiating RIAs will therefore be under pressure to avoid preferences in those 
sectors in which they are likely to increase imports. If the GATT were to permit governments 
to accord preferences selectively for certain products only, trade-diverting preferences would 
tend to prevail."25

22 Sectoral examination was endorsed by Dam (1963) for the Overseas Association, in reference to the Haberler 
Report. Supra note 5 at p. 652.
24 J. Viner, Supra note 2 at p. 51.
25 Roessler, Frieder (1993), The Relationship Between Regional Integration Agreements and the Multilateral 
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Roessler’s comment also suggests that, but for such a requirement, regional parties would have no inclination to exchange any preferences that would truly create regional competitive conditions. This infers that there is inherent in the requirement also an accommodation for the possibility that regional trade creation should also occur as a result of the preferences. Paragraph 4 of the Article suggests as much in indicating the purpose of customs unions and free-trade areas should be to facilitate trade between the regional members and not to raise barriers to other contracting parties.

Although this limited view of trade creation may not be optimal from a global perspective, it may be preferable to the absence of any other liberalisation. Although the efficient external producer offers the best trade creation potential if it attains access to the market of the regional members, this point also begs the question if there is no market presence for such a producer prior to the regional formation. Viner also entertained this prospect as a condition, since,

"(T)here will be commodities, however, which one of the members of the customs union will now newly import from the other but which it formerly did not import at all because the price of the protected domestic product was lower than the price at an any foreign source plus the duty. This shift in the locus of production in between the two countries is a shift from a high-cost to a lower-cost point, a shift which the free-trader can properly approve, as at least a step in the right direction, even if universal free trade would divert production to a source with still lower costs."

This scenario should be more scarce over time due to the results of tariff cutting in the successive multilateral rounds, but it probably remains a trade policy feature in a number of sensitive sectors, and even in regard to the developed country markets. These are also those sectors where developing countries claim comparative advantage.

In these examples, it appears that the internal trade requirement of Article XXIV:8 applied stringently actually does appear to serve a trade creating goal, albeit one formulated from a view based upon the reality of conduct of regional members and their natural inclinations to only select diverting preferences, if given the chance.

6.3.2 A second justification: preventing proliferation

Roessler has also suggested that the purpose of the requirement is to reduce the number of regional agreements overall, as,

"...(t)he political forces behind RIA’s that cover substantially all trade are such that a quasi-universal organization such as the GATT must permit them lest it lose its members. RIA’s covering a small portion of trade are unlikely to have as strong a political support. The substantially-all-trade requirement can therefore be seen as a requirement that helps differentiate between politically unavoidable and containable deviations from the most-favoured-nation principle..."

Here it is suggested that GATT parties will be more inclined to accept the deviations from MFN when the regional parties are themselves serious enough to consider meeting the internal trade requirements. This suggests that GATT can limit proliferation by proscribing those regional endeavours that would not carry significant political support anyway. This suggests an additional systemic interest that inures to non-member’s interest. If permitting agreements to form with a lower threshold of coverage means that a greater number of agreements will be formed overall, then the net result for all parties is that

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26 J. Viner, Supra note 2 at p. 43.

27 F. Roessler, Supra note 25 at p. 314. "RIAs" refers to regional integration agreements.
lesser international trade is governed by the MFN principle. In this context, the internal trade requirement can be understood to prevent proliferation of regional systems.

6.3.3 Challenging the traditional justifications
The justifications described above appear to reflect well-established views supporting the substantially-all trade requirement. They are, however, also addressed by a Kemp/Wan or McMillan approach. As to the first justification, in the absence of internal trade requirements, it is suggested above that parties would only exchange preferences that do not provide for internally competitive openings. However, while such minimal exchanges would not lead to regional trade creation, they would also not diminish external welfare to any particular degree. If such exchanges are economically neutral, i.e., if they do not hurt anyone, then there is no particular reason why GATT should be in the business of preventing them from occurring. For the cases where meaningful preferences are exchanged and regional trade creation is occurring, then the older pre-GATT environment described by Viner where non-members did not have market access in the first place, is not really so applicable now. Non-members are more likely to have had established trade in the modern era. Where bilateral preferences are exchanged, real market access is diminished and the preferences are therefore trade diverting. Thus, as barriers have come down overall, completed preferential exchanges may be more likely to divert external trade. As for the point raised by Haddock regarding the regional selection of only externally trade-diverting preferences, McMillan's approach would seem to confront this problem directly by simply requiring the preservation of pre-existing levels of external trade for the benefit of non-members.

The proliferation argument is more secure but is also challenged by a contemporary economic approach. If within this proliferation environment, trade flows for non-members were preserved on an agreement by agreement basis, then external trade diversion would be in check. This result would permit regional parties to advance integration when actual trade creation resulted, and would prohibit them from advancing regional integration when world external trade was harmed. This seems to go to the point of the Kemp/Wan construction, that it is possible to acknowledge the benefits of regional integration without reducing world welfare. In order to respond, one returns to the question raised in the first chapter of the book regarding the character of national prerogative as expressed in regional commercial diplomacy.

6.3.4 A third justification: containing national prerogative
Beyond considerations of welfare gains or losses generated by regional trade arrangements, a persistent point remains that some countries and territories have a greater power to initiate regional exchanges than others. The largest of the trading countries, upon which most other territories rely for markets, are in a most advantageous position to derive the benefit from a less stringent regional exception. In a more flexible system they are given an enhanced capacity to select among a larger number of potential partners who may be competing with each other to be favoured by preference, or perhaps to regain the balance lost by the granting of preference to others. Among all of these potential candidates, it is also apparent that some countries are simply more desirable regional

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28 This consideration was nicely expressed by a member of the working group in the review of the EEC-Agreement with Egypt, who considered that the additional expansion of the EC network of regional agreements would render the few remaining outsiders "least favoured nations". 1975 BISD, L/4054, para 11.
29 However, attempting to accord MFN on the basis of quantity is historically problematic. See, Tasca, Henry J., World Trading Systems, International Institute of Intellectual Cooperation, League of Nations, 1939, Paris, p. 25.
30 Regional agreements may be subject to a domino effect. For examples, recipients of the US preferences in the Caribbean Basin Initiative have sought to redress superior preferences granted to Mexico in the NAFTA. The EC-Turkey customs union completion was sought in part by Turkey to redress the new preferences being granted by the EC to the countries of central and eastern Europe in the Europe Agreements.
partners than others. For both the largest players and the most favourable regional candidates, a consideration of a more flexible non-trade diverting regional exception could be favourable. More agreements could be formed with more partners and under less restraint from GATT's more rigid substantially-all trade requirement.31

However, once one considers the possibility that country and market differences actually exist, then it also becomes more clear that the GATT most-favoured nation clause also operates as a restraint as it has a tendency to level the playing field of action between these unequal actors.32 From this it is suggested that the core justification for non-discrimination treatment is not primarily economic. It may rather reflect the recognised political imbalances between countries in addressing an historical problem of economic diplomacy by the use of a legal rule.

The Article XXIV internal trade requirement is an element in this GATT MFN construction as it restrictively prescribes the conditions for its exception. As indicated above by Roessler, lesser desirable regional partners have some basis to curtail the regional plans of others by delineating those with strong political support and those without. Further however, if one examines the manner in which preference functions in the regional setting, there is also the possibility that the non-discrimination principle is not only capable of protecting the position of non-members. There is a distinct possibility that the principle can be extended to also level the playing field between regional members. In order to explore this possibility, we return to Hirschman and examine his thesis, as raised prior to the commencement of the GATT.

6.3.5 Positive and negative regional preferences
The instruments employed to affect the internal trade flows between regional partners are those which have the capacity to select preferences not only for opening trade but also for closing it. We can refer to preferences as either positive or negative as between the members. In the absence of a regional exception, and where the MFN obligation is effective, any strategy by a regional member to establish preferences positive or negative is impossible to effectuate. Any positive preference sought to be given must be extended to all non-members. Likewise, any threat of a negative preference against one member must also be threatened against all non-members. Where a regional exception permits preferential activities, positive or negative, within certain parameters, the capacity to tailor preferences between members is either enhanced or reduced depending upon the degree of flexibility accorded by these parameters. Where a strict internal trade requirement requires complete positive preferences and does not permit the use of any negative preferences, the power of any one large member to affect its regional trade with other members by opening and closing trade should be curtailed absolutely.

6.3.6 Preference and dependency
Hirschman's 1942 thesis demonstrated the need for such a requirement in isolating what he named the "influence effect" of trade. He offered the case of Germany and Bulgaria. In 1938 this bilateral trade represented 52 and 59 per cent of Bulgaria's total imports and exports respectively. However for Germany, Bulgarian trade represented less than 2 percent of its total trade for both imports and exports. Even while the trade was monetarily balanced, Hirschman raised the obvious proposition that,

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31 Some countries specialise in accumulating regional attachments. For one example, Chile is a member of the Asian Pacific Economic Cooperation (APEC), a free-trade area party with Canada, a subject for NAFTA extension, an often mentioned candidate for an EU bilateral agreement, and a declared associate member of the Mercosur.

32 GATT Article I applies to those like products, "originating in or destined for the territories of all other contracting parties."
"...it will be much more difficult for Bulgaria to shift her trade with Germany to other countries than it will be for Germany to replace Bulgaria as a selling market and a source of supplies.\textsuperscript{33}

To Hirschman the granting of a positive preference by one territory to another served a first purpose in inducing the conditions of trade dependency. This strategy required an initial deviation from MFN and was a prerequisite to exercising influence. However, once dependency was established by the inducement of trade generated by these positive preferences, a second application of discrimination then became possible whereby the dominant territory could dictate additional terms by exercising, or threatening to exercise, the termination of this dependent bilateral trade. This second act would require the application of a negative preference, but would also require a deviation from MFN since otherwise, a threat to terminate the trade of one party must also be threatened against all.\textsuperscript{34} As Hirschman summarised,

"The idea could come to its full fruition only after commercial policy had been provided with the weapons necessary to influence the geographical distribution of foreign trade. As long as the most-favoured-nation clause was prevalent in commercial treaties and trade was regulated mostly by tariffs, governments had relatively little influence upon the geographical course of trade, or, at any rate, were not fully conscious of possessing this influence.\textsuperscript{35}

Therefore, the restoration of an MFN clause for international trade would contribute to the solution.

"...An argument \textit{a fortiori} applies to the simple abolition of discriminating treatments such as quotas, preferential or discriminating duties...This program is much less ambitious than that of universal free trade...it admits general tariffs and outright prohibitions. The most-favoured nation clause is one of the typical expressions of this system which is generally implied in such phrases as "equality of trading opportunity."\textsuperscript{36}

Hirschman would say that MFN was intended to diminish the power of a nation's economic diplomacy apparatus from being exercised to capture economic and/or political control of smaller states. In the modern era, we do not tend to conceptualise MFN in these terms. This may be because we view regional economic integration only in terms of a group of members exchanging a series of positive preferences. We look at MFN accordingly for its task to protect the non-members from the more negative external effects of these positive preferences made between members. However, there does not appear to be anything inherent as to the principle of most-favoured nation itself that suggests that its application should be necessarily so limited. To the contrary, to the extent that non-discrimination is intended to fulfil the GATT's objective of eliminating discrimination in international commerce, it is possible that this objective extends to the relationship between regional members as well as to the relationship between GATT parties generally. Thus, one concludes by inquiring of MFN what precisely is the source of its legitimacy in the international trading system, and as it is found in the primary provisions of the WTO Agreements.

\textsuperscript{33} Hirschman, Albert O., \textit{National Power and the Structure of Foreign Trade}, University of California Press, Berkeley, (1945, expanded edition, 1980), p. 31. If all countries were created the same, this would not be an issue.

\textsuperscript{34} In Hirschman's words, "...the power to interrupt commercial or financial relations with any country, considered as an attribute of national sovereignty, is the root cause of the influence or power position which a country acquires in other countries..." This served as the definition of trade policy for him. A. O. Hirschman, \textit{ibid.}, at 16. He also distinguished this strategy from mercantilism or autarchy, as the influence effect of trade cannot be achieved without engaging in trade.

\textsuperscript{35} A. O. Hirschman, \textit{ibid.}, at p. 8.

\textsuperscript{36} A. O. Hirschman, \textit{ibid.}, at p. 76. His prescription went beyond MFN to call for the reorganisation of international trade to eliminate the power of national sovereignty as, "...the exclusive power to organize, regulate, and interfere with trade must be taken away from the hands of single nations. It must be transferred to an international authority able to exercise this power as a sanction against an aggressor nation." \textit{Ibid.}, at pp. 79-80.
6.4 Part Two Conclusion: the basis of MFN legitimacy

Franck suggested that the MFN rule finds a basis for legitimacy as a function of its own inherent coherency. As summarised, "(GATT's) most basic provision is the most-favoured-nation (MFN) clause which (contrary to its name) seeks to preclude favouritism. It prohibits members from giving benefits to some but not all trading partners. As long as this rule is applied consistently, it appears to be coherent and thus legitimate."\(^{37}\)

As Franck's statement raises the notion of favouritism, there is arguably an implicit assumption that differences between states in their capacity to exercise power (to grant favouritism or demand it) is affected by the MFN rule. In regard to selecting or de-selecting goods for entry on the basis of their country origins, MFN appears to have the capacity to level the playing field as between the different sources of supply. To the extent that the capacity to effect this discrimination may also be a reflection of a country's political or economic diplomacy, MFN appears to act to separate this power from the field of commercial policy application, at least in regard to MFN's scope of application. As MFN acts to eliminate discrimination by precluding favouritism, the advantages which confer certain economic and political power advantages, as held by some territories as a matter of course, can be understood to be contained by principle. Otherwise favouritism, which is implemented in the legal setting by the use of discrimination, positive and negative, would certainly tend to be employed by those territories most likely to employ it successfully.

It seems to follow that incumbent to any notion of fairness in international economic law, as Franck has sought to define the term in this context, is an underlying idea that the powerful should, by operation of the principle, be restricted from extracting more favourable treatment from the weak.\(^{38}\) If so, then it can also be suggested that the principle should apply across a range of preferential activities. These would include protecting a third state "C" from the preference extracting activities of State "A" as directed to "B". This is a traditional understanding of what the MFN rule is intended to remedy in the GATT. It also seems plausible that the principle would also apply between two territories "A" and "B" in reference to the quality of their own exchanged preferences and in light of the paragraph 8 requirements of Article XXIV. If paragraph 8 were to require only a low threshold of exchange between the parties, then "A" could pursue the extraction of preference from "B" without mutuality from "B" or legal recourse from "C". By requiring a high degree of exchange and mutuality, "A's" capacity to control the terms of the schedule of preferential concessions as to "B" is reduced. In the strictest interpretation, only an "all or nothing" exchange between the two parties can foreclose a challenge by "C". This suggests a purpose of paragraph 8 of Article XXIV that is directed to the relationship between the regional members, and not just to the effects of this relationship as to non-members. If so, then the substantially-all trade requirement, in light of the MFN rule, may also prohibit negative preferences between regional members.

Franck also considered another requirement as the principle retains coherency only, "as long as the rule is applied consistently."\(^{39}\) Arguably, the record on Article XXIV through the years of GATT-

\(^{37}\) According to Franck, "a rule is coherent when its application treats like cases alike and when it relates in a principled fashion to other rules of the same system." Franck, Thomas, M. (1995), Fairness in International law and Institutions, Clarendon Press, Oxford, pp. 38 and 39.

\(^{38}\) Franck goes beyond this position in arguing that fairness also requires a corrective equity in trading arrangements. For MFN, "(A)fter it became clear that such a regime would produce further erosion of the developing world's share of world trade, GATT parties agreed to the GSP." (General System of Preferences) T. Franck, ibid., at 58. However, unlike bilateral preferences, GSP may well respect the coherency of MFN since GSP is also intended to treat all cases of like-developing countries alike.

\(^{39}\) Thus raising the question of institutional power to enforce the rule.
1947 is poor on this account. That occasional periods have seen proliferation of regional preferences would seem to suggest that there have been times when the MFN rule has been honoured only in the breach. However, a consideration of coherency in regard to GATT MFN may also argue that the consistency of its application should also be viewed as to its application between members as well as that between members and non-members. As between regional members, one could suggest that the MFN rule is not characteristically found to be incorporated in treaty provisions as a base level of protection within regional systems. In addition, the subject matter has not actually been identified as one which falls within the legal scope of application of the principle as a matter of GATT law.

However, this also does a disservice to the role that GATT has played in bringing forth the rules and the means by which their application may evolve. Throughout the GATT years, the working group review forum permitted statements to be made on record as to what the elements of the GATT provisions appeared to require and whether or not any particular agreement was perceived to be meeting these requirements. As WTO dispute settlement practice has come to the fore, these statements have found a new venue to refute the notion that the old GATT practice constituted acquiescence and an established pattern of subsequent practice. Although it has taken years, one can now see the possibilities emerging whereby application becomes more consistent with the expression of the rule. Interestingly, the groundwork is also laid for a view of the rule not so inconsistent with that of Hirschman's. As we turn to the next Part, we will see that the issue continues to turn upon the meaning of the requirements of paragraph 8 of Article XXIV and as this internal trade requirement effectively dictates the scope of the MFN obligation as to regional preferences. It remains a possibility in regard to later legal developments that GATT/WTO MFN may find its final interpretation, and its legitimacy, in the original concept of the "open door". This would acknowledge that the competition between great powers for influence in third markets is governed by the rule of MFN as it seeks to eliminate discrimination in international commerce.