

# Regionalism and the WTO: New Rules for the Game?

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Nigel Nagarajan\*

## Abstract

The recent growth of regional integration agreements (customs unions and free-trade areas) has been accompanied by a mounting concern for the health of the multilateral trading system. Much of this concern stems from the generally accepted view that the current WTO rules do not provide an adequate set of disciplines on regional arrangements. The EU has been one of the main driving forces behind the recent growth of regionalism, but its interests are increasingly affected by regional arrangements formed between other countries. This paper argues that the lack of clear WTO disciplines on regional arrangements may have already had adverse consequences for the EU. Given that the EU has declared its support for a clarification of the rules, the paper tries to identify where its priorities should lie. It is argued that there should be two such priorities. The first should be to define more precisely what is meant by an “applicable” tariff. It has never been clear whether this refers to applied tariff rates or to bound ceilings. Because of this ambiguity, Mexico was able to raise applied tariffs (within bound ceilings) on imports from the EU and other third countries in response to the peso crisis, whilst lowering tariffs on her NAFTA partners. Secondly, the EU and other major WTO players need to address the problem of different rules of origin emerging from the proliferation of regional arrangements.

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## Regionalism and the WTO: New Rules for the Game?

### 1. Introduction

Regionalism is back. After a long hiatus, regional integration agreements have become much more popular in recent years. Of the 91 active agreements in the WTO, 52 have been notified since 1992. Furthermore, regionalism is no longer mainly confined to Europe. Customs unions and free-trade areas (FTAs) are now springing up outside Europe with much greater frequency than for many years.<sup>1</sup> At present, all WTO members apart from Japan, the Republic of Korea and Hong Kong China are parties to at least one regional arrangement.

Regionalism and multilateralism are often presented as complementary approaches. The resurgence of regionalism has nevertheless been accompanied by a concern that trading agreements between the few might undermine the benefits which the multilateral system is supposed to deliver to the many. Much of this concern stems from the long-held view that the rules governing regional arrangements are inadequate.<sup>2</sup> Article XXIV of the GATT, which is the legal basis for the most important regional arrangements in the WTO, is meant to ensure that such schemes facilitate trade between their members without raising barriers to trade with third countries.<sup>3</sup> However, there are a number of points on which Article XXIV is less than completely clear. For example, when a FTA is created, the member countries are required not to raise *applicable* tariffs on imports from third countries. It is not clear whether this term refers to bound tariffs (ceilings) or to actually applied rates. Article XXIV also requires the members countries of customs unions and FTAs to liberalize *substantially all the trade* between themselves, but again it is not clear exactly what this means.

The key ambiguities in Article XXIV, and the difficulties involved in reaching a consensus among GATT/WTO members, have meant that only one arrangement has ever been found to be GATT- or WTO-consistent, whereas no agreement has ever been ruled incompatible. It seems that the question is not so much whether the WTO needs clearer rules on regional arrangements, but whether WTO members are prepared to adopt them. In any game, the rules are more likely to be changed when the changes are in the perceived interests of the major players. As the world's major trading power, the EU has both a specific interest in securing

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<sup>1</sup> To be sure, regional arrangements outside Europe were also popular in the 1950s and 1960s, particularly in the developing world. See Bhagwati (1993) for a discussion of why this so-called First Regionalism failed to endure, and why the Second Regionalism is more likely to do so.

<sup>2</sup> See Jackson (1969) and Dam (1970) for early discussions of some of the problems posed by the GATT system. More recent contributions include those of Finger (1993), Snape (1993), and the various writings of Bhagwati cited at the end of this paper.

access to third country markets and a general interest in a strong, rules-based multilateral system. However, it also maintains a complex set of trading arrangements with third countries.<sup>4</sup> It is, in effect, the main “user” of Article XXIV. Clearer rules could improve the legal certainty of the EU’s own agreements within the WTO, but rules which are too strict could cause problems for the EU and its partners. Obviously, a balance needs to be struck between these different interests. Box 1 shows how this balance has shifted over the years, with the EU moving from a somewhat defensive stance on Article XXIV to its current position of supporting clarification of “areas of long-standing difficulty”.<sup>5</sup>

This paper is written from an EU perspective. It argues that there should be two priorities for the EU in any future negotiations on Article XXIV. Firstly, it should seek to harmonize the rules on FTAs and customs unions in relation to their obligations not to raise tariffs on third-country imports. Given the current ambiguity over the meaning of “applicable” tariffs, Mexico was able to raise some 500 applied tariffs on imports from third countries (including the EU) in response to the 1994/95 peso crisis, albeit within bound ceilings. At the same time, Mexico lowered tariffs on imports from the US and Canada under the NAFTA agreement. Such a strategy is hardly compatible with the “spirit” of Article XXIV – that barriers to trade with third countries must not be raised. However, the current rules are so ambiguous that it is unclear whether they have been broken. Secondly, the EU and other WTO members need to address the problem of different rules of origin emerging from different regional arrangements. With the proliferation of FTAs in recent years, a serious problem has arisen because of non-overlapping, and perhaps protection-accommodating, preferential rules of origin. Recent moves by the EU and its partners in European agreements to establish diagonal cumulation of origin offer a blueprint for other countries to follow, but the ultimate objective should be the adoption either of a single set of origin rules for all agreements or an international standard to which different rules should conform.

The rest of the paper is structured as follows. Section 2 contains a short history of Article XXIV, whilst Section 3 provides a brief summary of the economic issues which it raises. The three key ambiguities in Article XXIV are examined in Section 4. Section 5 discusses clarification of Article XXIV, and the paper’s conclusions are presented in Section 6.

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<sup>3</sup> Article XXIV applies to trade in goods. Article V of the GATS is the equivalent as far as trade in services is concerned. Some regional arrangements involving developing countries are notified under the so-called “Enabling Clause” (see below).

<sup>4</sup> This is described in Sapir (1998).

<sup>5</sup> “WTO Aspects of EU’s Preferential Trade Agreements with Third Countries”, Communication from the Commission to the Council and the European Parliament, SEC(96), 2168 final, 16 January 1997.

### **Box 1. The evolution of the EU's position on Article XXIV**

It should be recognized that many of the problems with Article XXIV were first brought to light when the customs union provisions of the Treaty of Rome were themselves examined within the GATT or when subsequent enlargements of the EU took place. (The Treaty of Paris, establishing the European Coal and Steel Community, was granted a waiver under Article XXIV.) Countries which were third parties to European integration complained when they perceived their interests to be adversely affected by these developments, but relatively weak enforcement under the GATT and the difficulty of reaching unanimous agreement between all GATT members, meant that the problems were never satisfactorily resolved.<sup>6</sup>

The EU has traditionally taken a somewhat defensive position on Article XXIV. Consider, for example, the issue of whether the external requirements on regional arrangements concerning their *applicable tariffs* should apply to bound rates or to applied rates. In 1961, the EU took the view that “the expression ‘applicable’ must be read, in contrast to the term ‘imposed’ used elsewhere in Article XXIV, as referring to a rule of law which is applied or *capable of being applied*, and that *it is for each contracting party constituting a customs union or a free-trade area to interpret its own legislation with regard to the duties which should be regarded as being applicable*” [emphasis added].<sup>7</sup>

Today, with regional integration schemes spreading outside Europe, the EU is increasingly in the position of being a third party to other countries' regionalism. When other countries exploit ambiguities in the rules governing such schemes, this can be detrimental to EU interests. For example, EU trade with Mexico was adversely affected by the latter's decision to raise more than 500 applied tariffs on imports from non-preferential partners in response to the 1994/95 peso crisis, whilst at the same time lowering tariffs on imports from the US and Canada under the NAFTA agreement. This situation could arise again several-fold in the FTAA process. Chile, for example, has a uniform *applied* tariff of 11 per cent, whilst its *bound* rate is generally 25 per cent.

In 1997, the European Commission adopted a Communication entitled, “WTO Aspects of EU's Preferential Trade Agreements with Third Countries”. The Communication identified a number of “areas of long-standing difficulty” in the rules on regional arrangements and stated that “the fact that a number of our trading partners are themselves likely to put preferential agreements in place is a cause for concern, given the uncertainties identified in respect of Article XXIV”.

A number of other WTO members apparently share the EU's concerns. At the first WTO Ministerial Conference held in Singapore, in December 1996, several WTO members expressed their support for a clarification of Article XXIV. The Ministerial declaration stated that “the expansion and extent of regional trade arrangements make it important to analyze whether the system of WTO rights and obligations as it relates to regional trade arrangements needs to be further clarified.”

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<sup>6</sup> Jackson (1969) has argued that the accommodation of the EEC within the GATT in disregard of the legal requirements of Article XXIV was itself the beginning of the breakdown of the GATT's legal discipline. This accommodation partly reflects the strategic interests of the EU's transatlantic partners in supporting economic integration in Western Europe as a way of containing the Soviet threat.

<sup>7</sup> Report of the Tariff Negotiations Committee in 1961, quoted in WTO (1995), p805.

## 2. A brief history of Article XXIV

GATT Article XXIV is an exception to the most-favoured nation (MFN) rule of Article I, which prescribes non-discrimination as a basic principle of trade policy. MFN clauses in trade agreements can apparently be traced back at least seven hundred years.<sup>8</sup> Article XXIV, on the other hand, is essentially a product of the wartime negotiations between the United States and the United Kingdom. The main point of dispute in these negotiations was the latter's imperial (later, commonwealth) preference scheme. There were two main aspects to this dispute. Firstly, whereas imperial preferences within a common sovereignty were generally accepted, preferences between autonomous countries of the British Commonwealth were not. However, as a compromise, specific and limited exceptions to Article I were allowed to be "grandfathered", with Article XXIV applying beyond them. Secondly, the US opposed the use of less-than-100 per cent preferences, but favoured customs unions in which the member countries removed completely the barriers to intra-union trade. The latter were regarded as "conducive to the expansion of trade on the basis of multilateralism and non-discrimination"<sup>9</sup>, whereas less-than-100 per cent preferences were not.

The US proposals of September 1946, which formed the basis of negotiations for a possible International Trade Organization (ITO), were therefore based on the general rule of MFN treatment, with exceptions allowed for 100 per cent preferences. However, these proposals differed in several important respects from the provisions which were finally settled in the Havana Charter, negotiated between November 1947 and March 1948. For example, whereas the US proposals allowed for customs unions, no mention was made of FTAs. In fact, FTAs were only added to the Havana Charter on a motion from Lebanon and Syria.<sup>10</sup> The ITO, of course, never saw the light of day and the eventual GATT agreement was only applied "provisionally" by its contracting parties (until the formation of the WTO).

It is worth noting that the GATT agreement also differs in several respects from the Havana Charter. For example, the latter contained a provision for preferential arrangements (limited to not more than fifteen years) in special circumstances between customs territories which were contiguous or in the same economic region, provided they received the approval of two-thirds of the members of the ITO. This provision did not appear in the GATT text.

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<sup>8</sup> Jackson (1989), p133.

<sup>9</sup> The words are those of a prominent US official of the time, quoted in Bhagwati (1991), p65.

<sup>10</sup> It is perhaps ironic that neither of these countries is a current WTO member. Those countries which are WTO members, on the other hand, have made much greater use of FTAs than customs unions.

The Tokyo Round of multilateral trade negotiations, which was concluded in 1979, created an additional exception to Article I. The so-called “Enabling Clause”, more properly referred to as the “GATT Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries of 28 November 1979”, established a separate legal basis for preferences for and between developing countries. In effect, the requirements on developing countries are substantially weaker than those for developed countries, and it has even been suggested that they “can more or less do whatever they want to do with respect to preferences for each other, unconstrained by Articles I and XXIV”.<sup>11</sup> This probably explains why the US tried in 1992 to have the MERCOSUR agreement notified under Article XXIV rather than the Enabling Clause. These efforts were ultimately unsuccessful, although the MERCOSUR countries have since agreed to an examination of their agreement under Article XXIV as well as to compensation negotiations (under paragraph 6 of Article XXIV) resulting from the formation of the MERCOSUR common external tariff.

The Uruguay Round, which was concluded in 1994, has had three important consequences for regional arrangements. Firstly, it led to the adoption of the “Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994”, which is part of the founding documents of the WTO. This understanding attempts to clarify some of the criteria and procedures for assessing agreements notified under Article XXIV as well as to improve the transparency of all such agreements. It does go a long way towards solving some of the previous problems. For example, it provides a framework for assessing the impact of customs unions on third countries. However, as we shall see, it does not by any means solve all of the problems. Secondly, the Uruguay Round also gave birth to the General Agreement on Trade in Services (GATS). Article V of the GATS is the equivalent of Article XXIV of the GATT as far as services are concerned. Finally, one should note the establishment, at the beginning of 1996, of the Committee on Regional Trade Agreements (CRTA). The main task of the CRTA is to assess the compatibility of FTAs and customs unions with the provisions of the GATT and the GATS. Since there is an important backlog of notified but unexamined agreements, the CRTA will have its work cut out. It also has a mandate to examine systemic issues, but as yet, it is too early to judge how successful it will be in this respect.<sup>12</sup>

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<sup>11</sup> Snape (1993), p285. The principle of “Differential and More Favourable Treatment” for developing countries is in contrast to the recent strategy of some developing countries to “lock-in” reforms through Article XXIV-sanctioned regional arrangements with developed countries. Examples include Mexico under NAFTA, and the Europe Agreements negotiated between the EU and the Central and Eastern European countries. Another problem with the Enabling Clause is that it is not clear which WTO members should be allowed to claim the status of a developing country. In the absence of explicit criteria, this is currently decided on the basis of self-selection.

<sup>12</sup> Future work on systemic issues in the CRTA will include the question of whether the WTO rules on regional arrangements need to be further clarified.

### 3. Economic issues in Article XXIV

It is often asserted that the free-rider problem can create difficulties in sustaining the impetus of multilateral trade liberalization when pursued on a purely MFN basis.<sup>13</sup> Regionalism can provide a way out of this impasse. If we allow for the possibility that a group of countries may find it more feasible to pursue mutual liberalization between themselves, perhaps as part of an ongoing process of political integration as in the EU case, then some sort of exception to the MFN clause is required. But the GATT is a pragmatic document, and Article XXIV is less a solution to the free-rider problem than a recognition of the fact that regional integration between groups of countries is a political reality. What, then, are the economic consequences of allowing countries to form regional arrangements?

When Article XXIV was written, the view among the majority of economists seems to have been that, since free trade maximizes welfare whilst tariffs and other distortions reduce it, an agreement which eliminates tariffs between a group of countries and does not raise barriers to trade with third countries must increase welfare even if it does not maximize it. The problem with this is that, whereas a regional arrangement removes distortions between the relative price of domestic goods and partner-country goods, it *introduces* another distortion between the relative price of goods which originate within the arrangement and those from outside. Applying Jacob Viner's concepts of trade creation and trade diversion (which are a particular instance of the general theory of second best), we know that the welfare consequences of pursuing such policies are ambiguous since it is unclear which effect will dominate.

What should be clear is that Article XXIV is not about distinguishing between trade-creating and trade-diverting arrangements. This is because GATT pre-dates Viner, whose book, *The Custom Union Issue*, was only published in 1950. As Finger (1993) points out, Article XXIV is not designed to isolate economically sensible departures from non-discrimination. It should instead be regarded as another example of the GATT-standard 'yes, but . . .' rule. In this case, discrimination is allowed, "but only when there is big-time discrimination: the countries who discriminate in favour of one another must *eliminate* (not just reduce) *all* restrictions on *substantially all* the trade among themselves."<sup>14</sup> In other words, Article XXIV imposes a cost to pursuing discrimination as an instrument of everyday commercial policy (for example, discrimination must be extended to "substantially all the trade", and cannot involve less-than-

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<sup>13</sup> For example, Caplin and Krishna (1988) have developed a formal model in which the (unconditional) MFN requirement that each country in a bilateral negotiation also lower its tariffs on countries which are not involved in the bargain creates an externality which is cannot be internalized in a bilateral bargain. As a result, a simultaneous round of bilateral negotiations under MFN rules may be less effective at lowering tariffs than would be the case if MFN treatment were not required.

<sup>14</sup> Finger (1993), p134.



100 per cent preferences). The underlying rationale seems to be that only those countries which are serious about discrimination, e.g. those with an ulterior political objective for integration, are likely to find that the benefits of integration meet this cost. Politics is important, and the GATT, as a pragmatic document, seems to recognize this.

Although “economic theory certainly does *not* come down wholly against preferential reductions of trade barriers” (Bhagwati, 1990, p1306), the fact remains that the first best policy is always to remove *all* distortions. So, the first-best Article XXIV is no Article XXIV, and the various options for reforming it are really just exercises in the theory of the second best. It is, therefore, perhaps salutary that the debate amongst economists has focused on the larger issues, rather than on what should be in a revised article in a legal text. One of these larger issues is the question of what would happen to world welfare if the world economy were to fragment into, say, three trading blocs. Box 2 summarizes the findings of the most well known economic model, due to Paul Krugman, and looks at some of the criticisms which have been directed against it. Another larger issue is whether regional arrangements help or hinder greater multilateral liberalization. In the words of Jagdish Bhagwati, are they likely to be “building blocs” or “stumbling blocs”? This issue is explored in Box 3.

Even if we accept pessimistic answers to both of these questions, it must be recognized that most countries are still unwilling to accept the first best solution of removing all distortions. This leaves us with the various second best options, at least for the moment. One rather pragmatic solution is for countries to follow what has been called “open regionalism”. This concept has not been precisely defined, but two ideas are usually associated with it. The first is that the privileges granted by countries to each other in a regional arrangement should be extended at a similar pace to other WTO members without full reciprocity. The second is that regional arrangements must be open to any country which wishes to join. Because of the political difficulties involved in accepting new members to existing blocs, Bhagwati (1997) suggests that “open regionalism is likely to prove a detour rather than a staging post on the path to liberal trade.”<sup>15</sup> Open regionalism could still prove useful where it is feasible, but a reform of Article XXIV seems to be a more direct way to solve some of the main outstanding problems. The next section explores some of them.

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<sup>15</sup> Bhagwati (1997), p24. He then goes on: “I recall a meeting in Tokyo some years ago, when a Brazilian diplomat announced proudly that Mercosur practised open regionalism. This prompted a mischievous official from Hong Kong to walk up to the stage and say: ‘Here is Hong Kong’s application. When can we start?’. No answer as yet.”

## **Box 2. Regional trading blocs: the world according to Paul Krugman**

A danger with the growth in importance of regional trading blocs is that the world economy could become fragmented. A particular fear seems to be that three trading blocs could emerge. The first would be in Europe, centred on the EU, the second in the Americas centred on the US, and the third in Pacific Asia, perhaps centred on Japan (see, for example, Thurow, 1992). What are the implications of such developments for world welfare? The most well known model of regional trading blocs is due to Paul Krugman (1991a), in which there are a large number of identical countries and one differentiated product. Each country specializes in the production of a single variety of this product, but households consume all varieties. If countries form into trading blocs and a tariff is levied on imports from all countries outside the bloc, this model suggests that world welfare is maximized when the number of blocs is either one or very large. If there is only one bloc in the world, then this is equivalent to multilateral free trade. If the number of blocs is large, then the *optimal tariff* (the tariff which will maximize bloc welfare given the tariff charged elsewhere in the world) is near zero. This is because each bloc accounts for only a small share in the other blocs' consumption, so it will have minimal market power. If the number of blocs is above zero but still small, on the other hand, each bloc will account for a larger share in the consumption of the others, thus granting it greater market power and raising the optimum tariff. Furthermore, the elimination of intra-bloc tariffs will introduce more distortions than it eliminates. Krugman suggests that the worst case scenario for world welfare arises when the number of blocs is indeed three.

There are, of course, a number of assumptions in the Krugman model. Firstly, trading blocs are assumed to set tariffs in order to improve their terms-of-trade (the ratio of export prices to import prices). More precisely, blocs are assumed to engage in optimal-tariff setting, i.e. they choose their tariffs so that the marginal gain from improved terms of trade just offsets the marginal loss from decreased specialization and exchange resulting from reduced trade. In theory, however, Article XXIV prevents blocs (or, at least, customs unions) from behaving in this manner. Krugman (1993) has extended his original model to relax the assumption of optimal-tariff setting. He shows that the original result still holds, i.e. world welfare is generally minimized when there are three blocs.

Secondly, the model ignores transport costs. Krugman (1991b) himself recognized, however, that if trade blocs form on a continental basis and inter-continental transport costs are prohibitively high, a series of regional blocs each covering one continent will produce the same outcome as would have occurred under global free trade. In other words, when inter-continental transport costs are prohibitive, regionalism can be benign if blocs are formed along continental lines. Krugman distinguishes such "natural" continental blocs from "unnatural" inter-continental blocs. With non-prohibitive inter-continental transport costs, the implications of regionalism for world welfare are less clear-cut. Frankel, Stein and Wei (1994) show that even "natural" blocs can be welfare-reducing for certain values of inter-continental transport costs. They call such welfare-reducing blocs, "super-natural".

Finally, the Krugman model relies on the assumption of symmetry, a point which has been heavily criticized. Srinivasan (1993), for example, has shown that if one allows for asymmetric blocs, there is no clear relationship between the number of blocs and world welfare. The problem is that the production structure in the Krugman model contains no element of comparative advantage, but is instead based exclusively on trade in differentiated products (i.e. products which are identical in all respects except for country of production are considered to be imperfect substitutes), with households consuming all varieties. Deardorff and Stern (1992) suggest that, since the Krugman model involves each country importing goods from every other country in the world, the likelihood of trade diversion is increased, which results in an overly pessimistic view of regionalism.

### Box 3. Building blocs or stumbling blocs?

A second question which economists have raised is whether the growth of regionalism is more or less likely to lead to eventual multilateral free trade: are regional arrangements “building blocs” or “stumbling blocs”? One way to answer this question is to ask how bloc formation and expansion can alter the incentives of different countries to pursue multilateral liberalization.

Baldwin (1995) argues that the formation of a bloc can have a “domino effect”. In his model, excluded countries will choose to remain outside the bloc if, at the margin, the gains from membership do not outweigh the costs. As regional integration increases (as the bloc expands in membership, or as integration between bloc members deepens), the incentives for excluded countries at the margin will be altered. Imperfectly competitive firms in the excluded countries will lose competitiveness compared to firms inside the bloc. The countries closest to the margin will then seek to join the bloc. If they do so, the costs of non-membership for countries at the next margin will also rise and they will, in turn, also seek to join the bloc. This is an analysis of the incentives of non-members, or what has been termed the *demand* for bloc membership. Of course, “insiders” will always need a set of “outsiders” to exploit, so they may have an incentive to veto bloc expansion. In other words, the *supply* of bloc membership also needs to be considered.

Krishna (1993) and Levy (1994) tackle exactly this issue by looking at the incentives of “insiders”. Krishna’s model has three countries, each with segmented, imperfectly competitive markets. Government policy is determined solely by its effect on profits, with producers playing a decisive role in shaping trade policy. Multilateral free trade is feasible from this starting point. However, two of the countries will have an incentive to create a bloc between themselves, with this incentive being greater the more likely the bloc is to be trade diverting. This is because when two countries form a bloc, firms in each country will gain increased access to the other’s market but will lose protection against partner country firms. So, the more the bloc involves trade being diverted away from firms in the rest of the world, the more likely it is that it will lead to gains for the two partner countries’ firms for a given loss of protection in their own domestic markets. Once such a bloc has been formed, however, its incentive to liberalize trade with the rest of the world will be reduced. Krishna shows that with sufficient trade diversion, this incentive could be so reduced as to make subsequent multilateral liberalization impossible. Regionalism, in this admittedly simple model, may therefore be a “stumbling bloc”, since the “insiders” have an incentive not to expand the bloc.

Levy reaches similar conclusions by considering the effects of different trade negotiations on the welfare of the median voter. Trade liberalization involves both “politically difficult” redistribution effects (typically when trade takes place between countries which are dissimilar) and “politically easy” variety and scale-economy effects (which typically arise when trade takes place between similar countries). If, in the absence of a bilateral agreement between two similarly endowed countries, the median voters in each would only marginally prefer multilateral liberalization to the status quo, then this must reflect the near balance of these two effects. Since scale-economy and variety effects typically benefit all voters, including the median voter, this implies that redistribution effects are detrimental to the median voter. Now assume that a bilateral bargain between these two similar countries can be concluded, so that the median voter in each can gain from “politically easy” effects without suffering any “politically difficult” ones. Such a deal must undermine support for further multilateral liberalization including vis-à-vis dissimilar countries, since now the gains for the median voter from scale economy and variety effects are that much smaller whilst losses from redistribution effects remain.

#### 4. Article XXIV's "areas of long-standing difficulty"

According to paragraph 4 of Article XXIV, "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 [countries] with such territories". There are two parts to this general requirement:

- regional arrangements must not raise barriers to trade with third countries – the provisions of paragraph 5 of Article XXIV are intended to protect the interests of third countries when a group of WTO members form a regional arrangement among themselves. The requirement is that the tariffs *applicable* on imports from third countries must not be raised or made more restrictive. A similar provision applies to *other regulations of commerce*.
- regional arrangements must facilitate trade between their members – paragraph 8 of Article XXIV requires that tariffs and other restrictive regulations of commerce on *substantially all the trade* between the members countries be abolished. The arrangement must meet this second test if it is to benefit from the general derogation from the rule of non-discrimination in GATT Article I.

We will now briefly examine some of the main ambiguities in these provisions.

##### 4.1. "applicable" tariffs

Article XXIV attempts to safeguard the interests of outsiders to a regional arrangement by requiring countries which form a customs union or FTA not to raise the tariffs which are *applicable* on imports from third countries. The interpretation of the word "applicable" is one of the most serious ambiguities in Article XXIV. The ambiguity arises because of the distinction between *bound* tariff rates and *applied* tariff rates. In the WTO, countries make commitments to bind their tariff rates at some level. They can break these commitments (i.e. raise a tariff above a bound rate), but only with difficulty. To do so, they must negotiate with the countries most concerned, which may result in compensation for loss of trade incurred by trading partners.

For developed countries, bound rates are now generally the same as the tariffs which are actually applied. For developing countries, although there was a considerable increase in the number of product lines subject to bound tariffs as a result of the Uruguay Round (from 21 per cent to 73 per cent), bound rates tend to be somewhat higher than the actual rates charged. The bound rates therefore serve as "ceilings". Now the question arises whether the restrictions

on countries in FTAs not to raise *applicable* tariffs on third-country imports refers to actually applied rates or to bound ceilings.

In 1995, as a reaction to the peso crisis, Mexico raised more than 500 applied tariffs on items such as textiles, clothing and footwear within bound ceilings. The tariff increases only applied to imports from non-preferential partners. Tariffs on imports from other NAFTA countries were not affected. Indeed, Mexico continued to eliminate progressively tariffs on imports from the US as required under NAFTA's tariff elimination provisions. It is perhaps useful to look at what happened to trade flows after these tariff changes. The clothing sector may be a useful case to consider.<sup>16</sup> The table below shows the evolution of exports of clothing from the US, the EU and the rest of the world to Mexico over the period 1994 to 1996. Over this period, Mexican tariffs on imports of clothing from non-NAFTA partners were raised from 20 per cent to 35 per cent, whilst tariffs on imports from the US continued to be progressively eliminated according to the relevant provisions of the NAFTA agreement.<sup>17</sup> If US exports of clothing to Mexico displaced exports of other countries over this period, this may be suggestive of trade diversion.

The table shows that over this period, US exports of clothing increased by 47 per cent, from \$1,160 million to \$1,700. On the other hand, EU exports fell by 55 per cent, whilst exports from the rest of the world fell by 71. The share of the US in the world's exports to Mexico increased from 76 per cent in 1994 to 93 per cent in 1996.

**Table. Exports of clothing to Mexico from the US, the EU-15 and the rest of the world  
1994 - 1996 (Millions of US \$)**

Exporting country	1994	1995	1996
US	1,159	1,370	1,698
EU-15	106	59	48
Rest of the world	254	106	73
US as % of total	76%	89%	93%

Source: UN COMTRADE and EU COMEXT statistics

Whilst this does not establish conclusively that trade diversion has occurred, the fact that US exports increased and exports from the rest of the world fell after Mexico raised tariffs on

<sup>16</sup> In fact, the analysis of the clothing sector is complicated by the fact that the NAFTA countries also adopted more restrictive rules of origin. This is discussed below.

<sup>17</sup> Some items from the US already entered free of Mexican tariffs at the beginning of 1994. Tariffs on remaining items are being progressively eliminated according to various schedules lasting up to 2003.

non-NAFTA imports does give rise to strong suspicions. It should be noted that this problem could occur several times over if a Free-Trade Area of the Americas (FTAA) is created. The developing countries of Central and Southern America tend to have tariff ceilings which are above their actually applied rates. Even Chile, which is often cited as an example of a developing country with a liberal and transparent trading regime, has an applied tariff of 11 per cent but tariff ceilings of 25 per cent for most goods and 31.5 per cent for some agricultural goods. Upon joining a future FTAA, Chile could lower tariffs from 11 per cent to zero on imports from other American countries and at the same time, raise them on other non-preferential countries to 25 or 31.5 per cent. Because of the ambiguous way in which Article XXIV is drafted, Chile could argue that this tariff escalation was WTO-consistent.

Historically, the ambiguity concerning the word “applicable” has affected both customs unions and FTAs. The external obligations on customs unions, in Article XXIV(5)(a), are worded in a similar manner to those on FTAs, in Article XXIV(5)(b). Indeed, the EU has in the past exploited this ambiguity itself. The calculation of the common external tariff of the original six members of the EEC customs union used the Italian bound tariff even though this rate had never been applied. In relation to customs unions, however, a key clarification has now been introduced by the Uruguay Round Understanding. This states that the overall assessment of customs unions shall be based on the *applied* rates of duty.<sup>18</sup> This clarification was introduced in order to ensure that calculations of compensation for third countries are based on the rates of duty actually applied by the customs union. However, whilst the clarification is to be welcomed, there is now a discrepancy between the rules on customs unions and those on free-trade areas. The legal situation of a country which joins a FTA and raises the tariffs it applies on imports from third countries (within bound ceilings) is ambiguous.

Once could argue that the term “applicable” must logically refer to *applied* tariffs, since bound tariffs are not meant to be raised in any event (regardless of whether or not a country decides to discriminate in its trade policy by forming an Article XXIV regional arrangement). On the other hand, this interpretation creates a difficulty over the legal status of tariff bindings. In effect, membership of a regional arrangement implies that a country’s applied tariff will become its bound tariff. There is therefore a danger that countries with large

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<sup>18</sup> The requirement in paragraph 5(a) of Article XXIV is that the trade barriers created by a customs union “shall not on the whole be higher or more restrictive” than was the case prior to the formation of the customs union. However, a key problem was that Article XXIV neither provided nor excluded any methodology for determining how the external effects of customs unions should be assessed. It was only with the adoption of the Uruguay Round Understanding that a specific methodological framework was introduced.

differences between applied and bound tariffs, i.e. developing countries, could anticipate a tightening of the rules on what constitutes an “applicable” tariff, and raise applied tariffs on imports from non-preferential partners within bound ceilings. This would be contrary to the spirit of ongoing multilateral liberalization.

#### **4.2. “substantially all the trade”**

Paragraph 8 of Article XXIV provides that customs unions and FTAs must liberalize “substantially all the trade” between their members. The implication is that an agreement which does not provide for the abolition of barriers to *substantially all the trade* between the member countries does not qualify as WTO-consistent and is therefore not a valid exemption from the general principle of non-discrimination which is contained in GATT Article I.<sup>19</sup>

As we have seen, the rationale for the requirement that countries in a regional arrangement liberalize substantially all the trade between themselves is probably to prevent discrimination from becoming a tool of day-to-day commercial policy. However, the ambiguous nature of the phrase “substantially all the trade” may have been the result of a deliberate decision to grant countries a certain degree of latitude with respect to the removal of trade barriers on individual products. The drafting history of Article XXIV shows that it “had been drafted against the background of the possibility of a free-trade area being established in Europe in which the United Kingdom, in particular, might wish to retain some barriers against certain imports from its partners mainly as a result of its [imperial] preferential arrangements”.<sup>20</sup> Furthermore, it appears that the latitude granted to countries by the phrase “substantially all the trade” was intended to be used with respect to *agricultural* products in particular. It was for this reason that the original EFTA countries argued that the exclusion of the agricultural sector from the free-trade provisions of the EFTA agreement should be regarded as consistent with paragraph 8 of Article XXIV.

Whilst a specific provision for the exclusion of the agricultural sector may have been considered desirable by some countries at the time the GATT was drafted, there is less reason for maintaining such a provision today. Considerable progress was made in the Uruguay Round in extending GATT discipline to agriculture, and further multilateral negotiations on this topic are due to begin after 1999. In addition, the Uruguay Round Understanding on Article XXIV seems to echo the sentiment that allowing specific sectoral exclusions from the

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<sup>19</sup> Article V of the GATS, which is the equivalent for trade in services of Article XXIV of the GATT, contains, if anything, a somewhat weaker requirement that a services FTA or customs union should have “*substantial sectoral coverage*”.

<sup>20</sup> Report of the GATT Working Party on the “European Free-Trade Area - Examination of the Stockholm Convention”, quoted in WTO (1995), p825.

liberalization provisions of regional arrangements is no longer appropriate. In the preamble to the Understanding, WTO members recognized the contribution to the expansion of world trade that may be made by closer integration between countries which form regional arrangements, but stated that “such contribution 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”. The key question, then, is whether WTO members are willing to extend free trade in agriculture to regional partner countries.

#### **4.3. “other [restrictive] regulations of commerce”**

The treatment of preferential rules of origin in Article XXIV is the third key ambiguity which needs to be considered. According to paragraph 5(b) of Article XXIV, which sets out the external obligations of free-trade areas, “the duties and other regulations of commerce” applied to trade with third parties “shall not be higher or more restrictive” than before the FTA was formed. Similarly, paragraph 8 (b), which sets out the internal requirements which FTAs must fulfil, requires “the duties and other restrictive regulations of commerce” to be eliminated on trade between member countries. A key problem, which has never been satisfactorily resolved, is whether the phrase “other [restrictive] regulations of commerce” includes preferential rules of origin. Preferential rules of origin are used to determine whether preferential, generally zero, rates of duty should be applied to a given product. FTAs require preferential rules of origin because with different national tariff rates on third-country imports there would otherwise be a problem of trade deflection (imports ultimately destined for high-tariff countries would enter via low-tariff countries to avoid these high tariffs).

If rules of origin are included in “other regulations of commerce” then preferential rules of origin cannot, in principle, be more restrictive than the ordinary rules of origin which are used to determine whether the MFN rate of duty should be applied. Preferential rules of origin under FTAs are, however, frequently more complicated than ordinary rules of origin. There is a legitimate reason for this: customs authorities must satisfy themselves that there is no fraudulent abuse of preferential duties and that only goods originating in preferential partner countries are allowed preferential tariff treatment. However, there is also a danger that *more complicated* can also mean *more restrictive*: rules of origin that are too restrictive can become a barrier to trade both between the parties to a regional arrangement and between those countries and the rest of the world. With the proliferation of FTAs in recent years has come a growing concern about non-overlapping, increasingly complex and, perhaps, protection-accommodating preferential rules of origin.



In some cases, preferential rules of origin seem designed to *frustrate* rather than *facilitate* trade between the parties to the agreement. For example, under the CUSFTA (the free-trade agreement between Canada and the US, which preceded the NAFTA), there was a rule that the production of aged cheese from used milk did not confer origin on the country where the cheese was made if it was different from the country where the milk was produced. It has been suggested that this rule reflected a covenant by the US and Canadian dairy industries not to compete in each other's market.<sup>21</sup>

There are also examples of preferential rules of origin which effectively raise new trade barriers against third countries. Perhaps the most infamous example is NAFTA's "yarn forward" rule, under which the US only grants duty-free treatment to Mexican garments if the yarn is made, the cloth woven and all cutting and sewing is done in North America. One critic of this rule of origin pointed out that "this makes as much sense as forcing Belgian companies to use American sugar for their chocolate exports".<sup>22</sup>

Preferential rules of origin which frustrate the possibilities for trade between countries in a regional arrangement, or which effectively raise new barriers to trade with third countries, clearly violate the spirit, if not the letter, of Article XXIV. As such, one can argue that they pose a threat to the cohesion of the multilateral system. However, since there is no agreement on whether preferential rules of origin are included in the definition of "other regulations of commerce", little has been done to address this issue. In the Uruguay Round, the WTO members did reach an agreement which aims at the long-term harmonization of rules of origin, supervised by a new Committee on Rules of Origin. This agreement aims to make rules of origin objective, understandable and predictable. Until the completion of the harmonization programme, contracting parties are expected to ensure that their rules of origin are transparent; and that they do not have restricting, distorting or disruptive effects. However, the agreement specifically excludes rules of origin relating to the granting of tariff preferences.<sup>23</sup> In other words, preferential rules of origin are not covered.

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<sup>21</sup> Palmeter (1993).

<sup>22</sup> J. Bovard, "NAFTA's Protectionist Bent", *Wall Street Journal*, 31 July 1992, p A12, col. 4, quoted in Palmeter (*op. cit.*) footnote 8.

<sup>23</sup> The agreement does include an annexe which provides a common understanding on preferential rules of origin. The common understanding is mainly concerned with ensuring that preferential rules of origin are transparent and not subject to arbitrary changes. The general question of compatibility of preferential rules of origin with Article XXIV is not addressed.

## 5. Clarification of Article XXIV

At the second WTO Ministerial Conference held in Geneva, in May 1998, the Ministerial declaration began with a “tribute to the [multilateral] system’s important contribution over the past half century to growth, employment and stability”. Multilateralism has survived thus far because countries have recognized the benefits of a rules-based system based on the general principle of non-discrimination. At the same time, the actual trade policies of many countries reveal a growing preference for regionalism. The degree of compatibility between regionalism and multilateralism continues to divide economists and political commentators, but there seems to be little disagreement over the fact that the current rules in the WTO are inadequate. As a recent article in the *Financial Times* noted there is a growing view that “the time has come to draft tougher WTO disciplines to stop regionalism proliferating endlessly into the future and threatening the cohesion of the multilateral system”.<sup>24</sup> Given that a rewording of Article XXIV, or the establishment of a new Understanding on Interpretation, could be one of the subjects discussed in the next round of multilateral trade negotiations, it is important to ask how the EU should proceed and where its priorities should lie.

It should be recognized from the outset that achieving an agreement in a WTO of more than 130 members is likely to be a difficult undertaking. Any proposal for change must therefore first meet the pragmatic requirement of being broadly acceptable to most WTO members.<sup>25</sup> Furthermore, if new rules are to be adopted, they should permit a simple ex ante judgement to be formed on whether a particular regional arrangement threatens the cohesion of the multilateral system.<sup>26</sup> This need for cohesion did not escape those who drafted the original GATT agreement. Indeed, paragraph 4 of Article XXIV contains an explicit criterion which could have been used to formulate such a judgement. This is the statement that the purpose of a customs union or a FTA should be to facilitate trade between member countries and not to raise barriers to trade with the rest of the world. However, as has been demonstrated, the language in the remainder of Article XXIV is less than clear in a number of key areas. As a result, this statement of purpose has not been used as a standard for evaluating regional arrangements.

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<sup>24</sup> Guy de Jonquières, “Blocking moves”, *Financial Times*, supplement ‘The World Trade System at 50’, page 6, 18 May 1998.

<sup>25</sup> Radical proposals, such as Bhagwati’s (1991) suggestion that FTAs should be abolished and only customs unions permitted, are unlikely to meet this test, whatever their other merits.

<sup>26</sup> This suggests that one should rule out proposals such as that of McMillan (1993), that regional arrangements should be allowed if the volume of trade with third countries is not adversely affected by their formation. It is difficult to see how this standard, even if it were to be acceptable, could be used to formulate an ex ante judgement. One can also rule out proposals to introduce *trade creation* and *trade diversion* as explicit judgement criteria. Even if cases of trade diversion and trade creation could be clearly identified, both seem to be compatible with Article XXIV’s criteria for an allowable regional arrangement.

As we have seen, there are three ambiguities which prevent any clear judgement being formed on whether a regional arrangement has met the tests which the original framers of Article XXIV seem to have had in mind. The first ambiguity relates to the external requirements on regional arrangements and concerns the meaning of an “applicable” tariff. A key priority for the EU should be to seek a harmonization of the rules on FTAs with those on customs unions. Countries in FTAs should not be allowed to raise *applied* tariffs on third-country imports, even if bound tariffs are not affected, without having to compensate trading partners. This issue needs to be handled with a great deal of care, however, since developing countries with large differences between applied and bound tariffs may have an incentive to raise the former within the limits set by the latter in anticipation of a tightening of the rules. This would be contrary to the spirit of ongoing multilateral liberalization and could result in increased trade diversion – which is precisely what any clarification of the rules is meant to avoid.

To prevent this sort of situation from arising, there needs to be some degree of *multilateral* leadership by developed countries which have negotiated regional arrangements with developing countries. In the framework of the Euro-Mediterranean association agreements (which encompass FTAs between the EU and individual Mediterranean basin countries), the EU is encouraging regional partners to lower tariffs on imports from third countries in order to minimize the losses from trade diversion. Such efforts should continue, and the US should do the same with hemispheric partner countries in any future negotiations on a FTAA (or, at the least, it should discourage them from raising tariffs on third-country imports).

The second ambiguity is over the meaning of “substantially all the trade” in the required degree of internal liberalization between countries in regional arrangements. An obvious solution here would be to remove the word “substantially”. The difficulty with such a proposal for the EU is, of course, that it would then be required to extend free trade in agriculture to all preferential partners. If this is the direction in which the common agricultural policy is to evolve, then the proposal makes sense, at least as a long term solution. If not, the prospects for the EU adopting such a stance seem less certain. Alternatively, the EU could favour a clarification which defined exactly what “substantially” should mean.<sup>27</sup> It could, for example, try to fix a proportion of trade which should be covered.<sup>28</sup> A danger with

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<sup>27</sup> At present, there seem to be a number of implicit percentage figures for what “substantially all the trade” could mean. Bhagwati (1990) suggests that the “percentage cutoff point” which some “skilful lawyers and representatives of governments” may have in mind could be 75%. There may have been some upgrading of the cutoff since then.

<sup>28</sup> In the absence of trade barriers, trade flows in protected sectors might be *substantially* higher. This suggests that any proportion of trade which should be covered by the word “substantially” should not be based on trade volumes. On the other

this approach for the EU, is that if it were to attempt to provide a definition or fix a percentage of trade, then other WTO members might be tempted to press for a tighter definition or a higher percentage. This could have adverse consequences for the legal situation of some of the EU's existing agreements, unless these were to be "grandfathered". More importantly, such an approach might provide an incentive for different sectoral interests within the EU to claim that particular products or areas should be exempted from the definition of substantially all trade. The effect of lobbying by such protectionist interests could be to undo in practice the benefits which tightening the rules is supposed to generate in theory.

The question of whether preferential rules of origin should be included in the definition of "other [restrictive] regulations of commerce" is also highly problematic. Designing rules which are simple to administer and relatively inexpensive for firms to comply with, and which at the same time are neither protectionist nor prone to fraud, is unlikely to be easy.<sup>29</sup> However, the recent adoption of pan-European cumulation suggests a way forward. Under these arrangements, preferential rules of origin contained in the various Europe Agreements, concluded between the EU and the Central and Eastern European countries (CEECs) have been aligned with those applied on preferential trade between the EU and the EFTA countries, and all these countries are now linked through a system of "diagonal" cumulation.<sup>30</sup> This system allows a manufacturer in the EU to source all material from a CEEC and export the finished product to, for example, another CEEC or an EFTA country whilst maintaining preferential origin for tariff purposes. If other countries were to follow this approach, this would facilitate the eventual adoption of an international standard for preferential rules of origin. Such a standard would mirror that already agreed in the Uruguay Round for non-preferential rules of origin, and would aim to make preferential rules of origin objective, understandable and predictable. Alternatively, WTO members could try to establish a single set of preferential origin rules which could then be applied to all regional arrangements.

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hand, any proportion based on product coverage will come up against the problem of how products should be defined (e.g. at what level of statistical disaggregation?).

<sup>29</sup> An innovative suggestion has nevertheless been put forward to create a hybrid form of regional arrangement between a customs union and a FTA. There would be a common external tariff for some items, whilst countries would maintain individual national tariffs on other items. This would eliminate the need for preferential rules of origin on items where there is a common tariff. It would also allow a *de minimis* rule to be used where trade deflection is unlikely to be an important problem. For example, there would be no rules of origin for products where all members adopted a low external tariff. See Wonnacott (1996).

<sup>30</sup> The countries concerned are Bulgaria, the Czech Republic, Estonia, Hungary, Iceland, Latvia, Lithuania, Norway, Poland, Romania, Slovakia, Slovenia and Switzerland.

## **6. Conclusions**

Regionalism and multilateralism have co-existed throughout the fifty year history of the GATT/WTO, and will no doubt continue to do so. Nevertheless, the resurgence of regionalism in recent years does pose problems for the cohesion of the multilateral system. These problems are exacerbated by the fact that the present rules on regional arrangements in Article XXIV are far from clear.

Article XXIV allows countries to form customs unions and FTAs as a pragmatic exception to the general principle of non-discrimination in trade policy. It states that the purpose of such schemes should be to facilitate trade between their members without raising barriers to the trade of third countries. However, the language in the remainder of Article XXIV is less than clear on a number of key points. The extent to which regional arrangements should facilitate trade between their members is not obvious, since Article XXIV requires that liberalization be extended to “substantially all the trade”. The requirement not to raise barriers to the trade of third countries is also ambiguously worded. As far as FTAs are concerned, it is unclear whether the rule that “applicable” tariffs must not be raised on third-country imports refers to bound duty rates or actually applied tariffs. Finally, the provisions relating to preferential rules of origin are also unclear. These provisions affect both the trade of countries within a regional arrangement and their trade with outside countries.

This paper has tried to identify some priorities for the EU in any future negotiations on strengthening WTO disciplines relating to regional schemes. It suggests that the EU should support a harmonization of the external disciplines on FTAs and customs unions. Countries in FTAs should be required not to raise the tariffs actually applied on imports from third countries. In addition, the EU needs to work with other WTO members to strengthen multilateral disciplines on preferential rules of origin.

Securing agreement among other WTO members for a change in the rules will be a major undertaking, but there are already indications that a consensus in favour of reform is emerging. At the first WTO Ministerial Conference held in Singapore in December 1996, a number of WTO countries expressed the view that a change in the rules on regional arrangements was desirable. A pragmatic approach to resolving some of the key ambiguities in Article XXIV seems most likely to win the support of other WTO members. To complement this, the EU should continue to advocate the need for further multilateral liberalization (through the proposed “Millennium Round”). This would help lower the discriminatory effects of tariff preferences and reduce the costs which regional arrangements can impose on the multilateral system.

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