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Kenneth W. Dam

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REGIONAL ECONOMIC ARRANGEMENTS AND THE GATT: THE LEGACY OF A MISCONCEPTION*

KENNETH W. DAM†

THE last dozen years have seen a proliferation of customs unions and free-trade areas of unforeseen proportions. Such regional arrangements, far from being halfway houses on the road to nondiscriminatory and freer trade, may be in direct conflict with those goals. The General Agreement on Tariffs and Trade has been charged with the duty to regulate the formation of customs unions and free-trade areas in order to reconcile that conflict. The two principal conclusions of this discussion are that GATT has failed to discharge that responsibility and that its failure may be traced to a fundamental misconception of the nature and consequences of the conflict between regional arrangements and nondiscriminatory freer trade.

I.

The GATT counts among its Contracting Parties some forty-four nations accounting for more than eighty per cent of international trade.[1] The cornerstone of the General Agreement is the most-favored-nation clause of article I. That clause constitutes an undertaking by each contracting party to refrain from discriminating with respect to such matters as tariffs and quantitative restrictions; any concession accorded one contracting party must be accorded

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† Associate Professor of Law, the University of Chicago Law School.

[1] See GATT, BASIC INSTRUMENTS, 11th Supp. (1963). In addition, several countries have acceded provisionally to GATT and a number of countries, primarily former French African colonies, are subject to GATT "on a de facto basis." *Ibid.* On the early history of GATT and its stillborn predecessor, the International Trade Organization, see generally GARDNER, STERLING-DOLLAR DIPLOMACY (1956), and sources cited therein. On GATT generally, see SEYID MUHAMMAD, THE LEGAL FRAMEWORK OF WORLD TRADE (1958).

to every other contracting party.[2] Certain exceptions to this most-favored-nation undertaking are set forth in the General Agreement. Perhaps the most significant is that in article XXIV stating the conditions under which Contracting Parties may become members of customs unions and free-trade areas. From one point of view, there could be no clearer denial of most-favored-nation treatment than an agreement by two countries to eliminate all tariff barriers between them while maintaining existing barriers toward third countries. Yet such an agreement would create nothing other than a free-trade area which, assuming it conforms to certain standards set forth in article XXIV, is exempt from the most-favored-nation obligation of article I. A customs union is merely a more highly developed version of a free-trade area in which the member countries establish a single external tariff rather than, as in the case of a free-trade area, maintaining existing national tariffs against nonmembers.[3]

The most familiar of the new regional economic groupings is, of course, the European Economic Community (EEC), a customs union of six nations (Belgium, France, Germany, Italy, Luxembourg and the Netherlands).[4] The same six countries had earlier formed an economic grouping limited to the coal and steel industries known as the European Coal and Steel Community (ECSC) and simultaneously with the formation of the EEC, created a special organization for nuclear products known as EURATOM. Within the general EEC framework these six have also entered into a free-trade area with a large number of African and other nations and a special customs union, referred to as an association, with Greece. Seven other European countries (Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom) have formed the European Free Trade Association (EFTA) and it is in turn "associated" with Finland in a special free-trade area. In Latin America two major blocs have been formed: The Latin American Free Trade Association composed of seven South American countries (Argentina, Brazil, Chile, Paraguay, Peru, Uruguay and Mexico); and the Central American Common Market of five countries (Costa Rica, El Salvador, Guatemala,

[2] The most-favored-nation clause of article I reads: "With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation . . . any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."

[3] For a discussion of the related question whether a customs union or free-trade area agreement violates the most-favored-nation clause of a bilateral commercial treaty, see Hay, *The European Common Market and the Most-Favored-Nation Clause*, 23 U. PITT. L. REV. 661 (1962).

[4] Since Belgium, Luxembourg and the Netherlands had earlier formed the Benelux customs union, the EEC was made up of only four customs territories.

Honduras and Nicaragua) which, although it comprises a much smaller portion of world trade than the other regional groupings, nevertheless promises to be a decisive trading factor in the Central American area.

Each of the regional trading blocs just described is a going concern. In addition, plans with varying degrees of definiteness have been drawn up for a host of other regional groupings in Africa and Asia. Many are undoubtedly paper plans with little chance of success. Others will collapse in the hard bargaining which must precede the actual formation of any such grouping. But some will no doubt succeed, thereby raising the question of compatibility with article XXIV and straining still further the image of the most-favored-nation regime foreseen by article I.[5]

Article XXIV states the basic test in the case of a customs union, "or an interim agreement leading to the formation of a customs union." "Duties and other regulations of commerce . . . shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce [previously] applicable . . . ."[6] The rule for a free-trade area or an interim agreement leading to a free-trade area, parallels that for a customs union in most respects, but because the member nations of a free-trade area retain national tariffs, a somewhat different formulation is required. Here the "duties and other regulations of commerce" are not to be "higher or more restrictive than the corresponding duties and other regulations of commerce" previously in effect.[7]

The requirements for elimination of restrictions between members are set forth in the definition of customs unions and free-trade areas in article XXIV. Thus, where "duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX)[8] are eliminated with respect to substantially all the trade between the constituent territories . . . in products originating in such territories," the regional grouping may qualify as a customs union or free-trade area within

[5] A Working Party has already been established by the Contracting Parties to review the Cairo agreement of April 1, 1962, for an African Common Market composed of Algeria, Ghana, Guinea, Mali, Morocco and the United Arab Republic. 15 INT'L FINANCIAL NEWS SURVEY 1 (Jan. 11, 1963).

[6] GATT art. XXIV, para. 5(a). The full text of the relevant paragraphs of article XXIV is set forth in the appendix.

[7] GATT, art. XXIV, para. 5(a). While certain differences in wording not strictly required by the structural difference between a customs union and a free-trade area may be pointed out, the only ones of significance are the omissions of the "on the whole" and "general incidence" concepts in the latter rule.

[8] The excepted regulations of commerce permitted under articles XI, XII, XIII, XIV, XV and XX are restrictions adopted for such special purposes as classification, grading, or marketing standards and regulations, art. XI, quantitative restrictions to safeguard a country's external financial position and balance of payments, arts. XII, XIV, and XV, and restrictions imposed for the protection of health and morals, art. XX.

the meaning of those terms in article XXIV.[9] The principal purpose of this requirement is to assure that the article XXIV exemption is not used to justify preferential trading arrangements.

A special problem is presented by the creation of a customs union's common external tariff. The general principle of the tariff-negotiation provisions of the General Agreement is that once a given duty is agreed upon, that duty is "bound" against subsequent increase. In the creation of a common external tariff, tariffs of relatively low-tariff countries will usually be increased, while tariffs of relatively high-tariff countries will be decreased. Thus, some of the duties which will be increased will already have been bound in prior GATT tariff negotiations. Whatever the compatibility of the external tariff with the "higher or more restrictive" standard, it would not be a fully satisfactory solution to permit the customs union to offset reductions in duties against increases in "bound" duties. The nonmember countries which benefit by the reductions will not always be the same as those which lose by the increases and, in any event, the balance of benefits and losses will seldom be precisely the same for any given nonmember country. The general provisions providing for, in the case of increases in "bound" rates, compensatory adjustments in the rates for other products are therefore made applicable to increases resulting from creation of a common external tariff. In determining the appropriate compensatory adjustment, however, "due account shall be taken of the compensation already afforded by the reductions brought about in the corresponding duty of the other constituents of the union."[10]

Certain procedural requirements are included in article XXIV. Thus, members of a new customs union or free-trade area (or parties to an interim agreement) are required to notify GATT and to make available appropriate information to facilitate GATT review of the proposed arrangement.[11] Strict limitations are placed on the content and implementation of "interim agreements" leading to customs unions and free-trade areas. It was not the intention of the Contracting Parties to permit article XXIV to serve as a back-door route to preferential trading arrangements not constituting full-fledged customs unions or free-trade areas. On the other hand, it was impractical to require major regional groupings to spring over night into fully developed form. An interim agreement is required, therefore, to include a "plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time." The Contracting Parties are granted power to review such plans and schedules, in the light of the information to be provided by the

[9] Art. XXIV, paras. 8(a), 8(b). Reference is made to the full text of paragraph 8 in the appendix *infra*, for certain differences in definitions with respect to intermember trade. These differences do not appear to be of operative significance.

[10] Art. XXIV, para. 6.

[11] Art. XXIV, para. 7(a). The treaty language is somewhat ambiguous on the type and quantity of information required.

parties to the interim agreements, and to "make recommendations" if they shall find that "such agreement is not likely to result in the formation of a customs union or of a free-trade area within the period contemplated by the parties to the agreement" or if they shall find that "such period is not a reasonable one." The term "recommendations" is perhaps misleading because parties to an interim agreement are forbidden to implement it "if they are not prepared to modify it in accordance with these recommendations." Moreover, the plan or schedule may not be changed without consultation "if the change seems likely to jeopardize or delay unduly the formation of the customs union or of the free-trade area."[12]

If a single adjective were to be chosen to describe article XXIV, that adjective would be "deceptive." First, the standards established are deceptively concrete and precise; any attempt to apply the standards to a specific situation reveals ambiguities which, to use an irresistible metaphor, go to the heart of the matter. Second, while the rule appears to be carefully conceived, the principles enunciated make little economic sense. Third, the dismaying experience of the Contracting Parties has been that no customs union or free-trade area agreement presented for review has complied with article XXIV and yet every such agreement has been approved by a tacit or explicit waiver.

II.

Article XXIV appears, on first impression, to set forth a precise set of rules for determining the circumstances under which regional arrangements will be permitted. The apparent precision is quite illusory.

Perhaps the most troublesome ambiguity in article XXIV lies in the requirement that, in the case of a customs union, "duties and other regulations of commerce imposed [on external trade] shall not *on the whole be higher or more restrictive* than the *general incidence* of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union . . . ."[13] The general intent is clear and, while difficult to state in more specific terms than the treaty language itself, the intent simply is that, on balance, external trade barriers should not be raised in the process of creating the customs union.

The process of calculating a common external tariff to be applied both to high-tariff and low-tariff countries gives rise to troublesome problems of interpretation. A principal decision to be made is whether the words "on the whole" and "general incidence" refer to each item in the common external tariff schedule or to the common external tariff schedule as a whole. If the

[12] Art. XXIV, para. 7(c).

[13] Art. XXIV, para. 5(a). (Emphasis added.) A similar test is specified for a free-trade area but since establishment of a free-trade area does not presuppose the creation of common external tariff, fewer practical difficulties are presented. The ambiguities are nonetheless as far-reaching as in the case of customs unions. Art. XXIV, para. 5(b).

latter alternative is chosen, one must still determine if the initial step is to calculate the height and restrictiveness of each national tariff schedule and then to strike some kind of average between these national levels (as, for example, by calculating a "height" index for each country, taking an average of the indices in order to determine an index for the common external tariff and then working backward to calculate a schedule of external duties which will not in the aggregate exceed the "height" of that average). Or is one first to strike some union-wide average for each tariff classification and then to determine the aggregate height of a common external tariff composed of these union-wide averages, the customs union being free to assign any tariff to individual items in the common external tariff as long as the calculated union index is not exceeded?

Whichever alternative is chosen, the unfortunate fact is that one cannot determine from nominal percentage rates the restrictive impact that a duty may have. A relatively high duty may provide excess protection in the sense that it may be higher than necessary to eliminate all trade in the commodity in question. When one attempts to reach a judgment as to the overall restrictiveness of a schedule of duties, the assigning of weights to individual duties raises troublesome problems because the most convenient criterion for assigning weights, the respective volume of trade for each item, tends to be a function of, rather than independent of, the restrictiveness of the duty. To put these difficulties more concretely, some of the questions which must be answered in any calculation of a common external tariff are: (1) How does one average a tariff and no tariff? For example, if one were determining the "height" of a two-item schedule, one item having no duty and the other having a fifty per cent duty, would the average height be a simple twenty-five per cent? (2) How does one average a protective tariff and a revenue tariff? For example, if in a two-item schedule, each item were to bear a ten per cent duty and if for one item a ten per cent duty would be sufficient, in view of domestic production, to exclude all imports while for the other item a ten per cent duty had little or no effect on the volume of imports (because, for instance, the item could not feasibly be produced domestically), would it mean anything to say that the average "height" was ten per cent? And if the protective tariff were to be raised to fifty per cent in order to be multiply certain that no imports competed with domestic production, would the average be the arithmetic mean of thirty per cent or still only ten per cent on the theory that a ten per cent level on the protected item was sufficient to exclude all imports? (3) How does one average tariffs for items with greatly different volumes of imports? For example, should one use a simple average or a weighted average for two items where the volume of imports is much greater for one item than for the other? And if one decides to use a weighted average, how does one weight duties which, for example, are high enough to eliminate all trade? (4) How does one average tariffs between countries? Here the problem is not simply whether to

take a simple or a weighted average but, in the latter case, how to apply the weights—by level of actual imports, by level of potential imports assuming nil tariffs, or by some measure of the size of the national markets such as gross national product.[14]

These questions are not merely statistical puzzlers. As Loveday has made clear in his discussion of the calculation of the common external tariff of the European Economic Community, the method of calculation can have a dramatic effect on the composition of the common external tariff schedule.[15] Given a customs union composed of countries of sharply different economic sizes and propensities to import, each with tariffs on different combinations of items and each with a disparate mixture of protective and revenue tariffs, it would not be going too far to say that the language of article XXIV gives no guidance at all. Finally, even if these statistical problems can be solved satisfactorily, and assuming quantitative restrictions are included within the terms "duties and other regulations of commerce,"[16] one must weigh quantitative restrictions against tariffs, a task which if not impossible at least requires an unverifiable estimate of what tariff level would restrict imports to the levels permitted by particular quotas.[17]

No official interpretation exists. The text of an early draft of article XXIV using the terms "shall not on the whole be higher or more stringent than the average level," while perhaps slightly more certain of application, is of little assistance since we cannot be certain what substantive change was intended by the subsequent amendment. To be sure, the Havana Reports indicate that the intention was that the article "should not require a mathematical average of customs duties but should permit greater flexibility so that the volume of trade may be taken into account."[18] But to concede that no one method of calculation is required is not to state which methods are forbidden.

Further ambiguity lies in the meaning of the requirement that, in order for

[14] Further problems arise from differences in the tariff classification system of member states but these problems, though difficult, are in principle subject to rather precise solution. The problems set forth in the text, on the other hand, involve ambiguities in the standard to be used.

[15] Loveday, *Article XXIV of the GATT Rules*, 11 ECONOMIA INTERNAZIONALE 1 (1958).

[16] This is a further ambiguity in the treaty language. Although in normal parlance a quantitative restriction is surely a "regulation of commerce," it is arguable on the basis of a close textual analysis, that the term "regulation of commerce" has a more limited meaning.

[17] This task is doubly difficult with respect to certain types of products and commodities. For example, assume quotas are imposed on luxury goods for balance-of-payments purposes by a country with a substantial population of wealthy individuals. Is it really possible to determine what tariff level would keep the quantity of imports of, let us say, diamonds at a specified low level?

[18] GATT, ANALYTICAL INDEX OF THE GENERAL AGREEMENT ON TARIFFS AND TRADE 103 (Doc. No. MGT (59) 91) (rev. ed. 1959). Loveday is surely wrong where he construes the interpretative note to require a weighted average. Even the French text from which he apparently worked hardly warrants such a construction. See Loveday, *supra* note 15, at 2.

a regional grouping to qualify as a customs union or free-trade area under article XXIV, "duties and other restrictive regulations of commerce [must be] eliminated with respect to substantially all the trade between the constituent territories . . . ."[19] Quite aside from the obvious ambiguity as to what percentage constitutes "substantially all" trade, several more troublesome questions arise. Assume, for example, that it might be agreed (as has sometimes been suggested[20]) that eighty per cent is "substantially all" trade. Is the only proper reading of this language that internal tariffs must be eliminated on eighty per cent of all trade? Or might the test also be satisfied by reducing all internal tariffs to twenty per cent of their earlier levels? An affirmative answer would permit the establishment of a preferential trading arrangement in derogation of what appears to be the common understanding as to the purpose of the General Agreement.[21] Again, assume that tariffs and other restrictions were totally eliminated on eighty per cent of internal trade but that several major industries, comprising say the remaining twenty per cent of internal trade, were totally excluded from the scope of the customs union or free-trade area. Would the "substantially all" test be met? As we shall see, if the answer to that question is yes, as has frequently been argued, creation of the regional groupings may be greatly more favorable to some members, and much more injurious to many nonmembers, of the regional grouping than if no major sectors of the economy were totally excluded from the internal tariff cut.

III.

While article XXIV does not set forth its rationale, it is not too difficult to surmise the underlying theory. The General Agreement has two grand designs: That free trade be promoted through multilateral tariff negotiation and that discrimination be eliminated by means of the most-favored-nation principle. For the draftsmen of the General Agreement, customs unions and free-trade areas produced a conflict between those two goals. Such regional groupings seemed to be movements toward free trade to the extent that tariffs were lowered between member countries, but they also seemed to involve discrimination against nonmember countries. The solution adopted by the draftsmen was to permit customs unions provided the plans went all the way toward unfettered trade by full elimination of barriers on "substantially all" intermember trade, even though, in a sense, discrimination was thus increased, but to assure through the "higher or more restrictive" criterion that creation of the customs union or free-trade area was not seized upon as an opportunity to raise tariffs against nonmembers beyond the preexisting level.

What may not have been appreciated at the time of the drafting of the General Agreement was that customs unions and free-trade areas need not

[19] Art. XXIV, paras. 8(a), 8(b).

[20] GATT, BASIC INSTRUMENTS, 6th Supp., at 99 (1958).

[21] See, *e.g.*, WILCOX, A CHARTER FOR WORLD TRADE 46–47 (1949).

involve movements toward free trade. They may just as easily be, and perhaps in view of the widespread propensity toward protectionism are more likely to be, movements away from free trade. In order to determine the direction of any given customs union proposal, one must first isolate the fundamental justification for the free trade position. In general, that justification is that the most efficient allocation of resources for the world as a whole will be achieved by the elimination of tariffs and other arbitrary barriers to trade. In determining whether a customs union is a movement toward or away from free trade, it might seem elementary that an appropriate preliminary inquiry would be whether creation of the customs union would lead to a better, or poorer, allocation of world resources than previously existed. To be sure, it may be difficult to measure the amplitude of any changes in the efficiency of allocation but at least a rough estimate of the direction of change might be made.[22]

It has only been since 1950, under the stimulus of a few pages in a book by Professor Jacob Viner,[23] that serious thought has been given to the conditions under which allocation of world resources will be improved by creation of a customs union or free-trade area. Unfortunately, the work done thus far has been borne solely by economists and appears to have attracted little attention from lawyers or from men engaged in day-to-day work involving regional groupings.[24] Such parochialism has been unfortunate. In particular, as I shall attempt to show below, this thinking failed, with quite limited exceptions, to have any impact on the work of the Contracting Parties in their application of article XXIV. The misconceived premises of article XXIV have so dominated the Contracting Parties in reviewing proposed customs unions and free-trade areas under that article that their discussions have been dominated by issues irrelevant to the basic question of the impact of the regional grouping on allocation of world resources. Moreover, no attention has been given to the need for revamping article XXIV which would seem to be required as a result of the economists' work. Finally, economists have also suffered from this lack of demand for their work product; while considerable economic literature has been devoted to the economic effects of eliminating intermember tariffs, little has been devoted to the economic effects of creating a common external tariff.[25]

[22] Improvement in the efficiency of allocation of world resources is important because it involves an increase in the wealth of the world as a whole. It is important to bear in mind the elementary distinction between the wealth of the world as a whole and the wealth of the member countries of a customs union or free-trade area. It is possible, as we shall see, for a group of countries, through creation of a customs union or free-trade area, to improve their own lot at the expense of the rest of the world, and it is precisely the danger of such action which requires some rule on the subject in the General Agreement.

[23] VINER, THE CUSTOMS UNION ISSUE 41–56 (1950).

[24] One important exception is FRANK, THE EUROPEAN COMMON MARKET (1961), a book written by a United States Department of State official who is, it should be noted, an economist by training.

[25] The following books and articles in the economic literature have been particularly helpful in the analysis which follows and are not cited specially on each point: BALASSA,

Without plunging into a full-scale discussion of the conditions for optimum allocation of resources, it may be observed that in the most general terms a primary criterion is that there be no divergences between prices paid by consumers and costs incurred by producers. Such a goal may be achieved only if, among other conditions, (1) consumers make purchases on the basis of relative prices to be paid by them, both as between domestic and foreign sources and as among various foreign sources, rather than on the basis of other criteria—such as might be important, for example, in the case of quantitative controls—and (2) such relative prices paid by consumers do not diverge from prices received by producers. Assuming the former condition is met, the principal barrier to achievement of the latter condition will be the existence of tariffs and quantitative restrictions.[26] While many internal policies and practices both in importing and exporting countries may create other kinds of divergences between prices paid by consumers and costs incurred by producers—monopolies, cartels and local direct and indirect taxes, for example—the primary international barriers to optimization of allocation of world resources are tariffs and quantitative restrictions.[27]

Putting to one side for the moment the question of quantitative restrictions, it is important to observe at the outset that in a tariff-divided world the elimi-

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THE THEORY OF ECONOMIC INTEGRATION (1961); MEADE, THE THEORY OF CUSTOMS UNIONS (1955); 2 MEADE, THE THEORY OF INTERNATIONAL ECONOMIC POLICY (TRADE AND WELFARE) (1955); H.G. JOHNSON, *The Economic Theory of Customs Union*, MONEY, TRADE AND ECONOMIC GROWTH 46 (1962); Lipsey, *The Theory of Customs Unions: A General Survey*, 70 ECONOMIC J. 496 (1960); Lipsey & Lancaster, *The General Theory of Second Best*, 24 REV. OF ECONOMIC STUDIES 11 (1956).

[26] For example, a tariff produces a divergence between prices paid by consumers and prices received by producers by the amount of the tariff. If in country A producers receive $100 per unit from domestic consumers and country B has a $50 tariff, country B consumers will pay $150 per unit (assuming no price discrimination by country A producers), while country A producers will receive only $100. The divergence is $50 per unit, the amount of the tariff. Quantitative restrictions involve a more complicated situation because, by limiting imports to a specified quantity, country B artificially limits supply and hence induces a rise in price in country B above the price in country A by an amount which is difficult to determine in advance.

The foregoing analysis should not obscure the fundamental fact that the economic costs of protection, whether by way of tariff or quantitative restrictions, are incurred by domestic consumers in the form of prices paid on purchases from domestic producers. The tariff or quantitative restriction prevents domestic consumers from buying lower cost foreign goods. See H.G. Johnson, *The Cost of Protection and the Scientific Tariff*, 68 J. POL. ECON. 327 (1960).

[27] Export duties are fully as significant as a theoretical matter as tariffs, *i.e.*, import duties, in producing a divergence between prices paid by consumers and prices received by producers, but export duties are ignored in the following discussion for ease of exposition. This simplification is justified, it is believed, both because export duties are less frequent in practice than import duties and because the analysis involved would not be fundamentally different if export duties were considered.

It should also be recognized that, quite aside from the restrictions on trade in goods referred to in the text, restrictions on the free movement of capital and labor are important sources of inefficiency in the international economy. See discussion pp. 628–29 *infra*.

nation of any particular tariff or set of tariffs need not, contrary to what might appear the common-sense conclusion, lead to an improvement in the allocation of world resources.[28] This fundamental point may be illustrated by taking a hypothetical free-trade area in which we may observe the position of consumers in one member country with respect to purchases of goods from producers in nonmember countries (nonmember goods and producers), from producers in other member countries (member goods and producers) and from producers within the same country (local goods and producers). If the effect of eliminating intermember tariffs is to cause consumers to shift purchases of a particular commodity from relatively low-cost nonmember producers to relatively high-cost member producers, the impact of the creation of the free-trade area will be to that extent unfortunate for the efficiency of allocation of world resources. Before creation of the free-trade area, tariffs were presumably applied equally against all countries and, therefore, while the prices paid by consumers included the duty, nevertheless the relative levels of the prices paid by consumers reflected relative prices to producers for all foreign sources of supply. After elimination of interarea tariffs, it may be that even though prices to producers are identical, prices to consumers will be higher for purchases of nonmember goods, on which a duty must be paid, than for purchases of member goods, on which no duty need be paid.

On the other hand, the elimination of tariffs between members of the free-trade area may tend to shift purchases of a particular commodity from relatively high-cost local producers to relatively low-cost member producers. In that case the impact of creation of the free-trade area will be to that extent beneficial for the allocation of world resources. Such a shift would normally occur where prior to creation of the free-trade area the duty exceeded the difference between prices received by high-cost local producers and prices received by low-cost foreign producers.

These two shifts in source of production—from low-cost nonmember producers to high-cost member producers and from high-cost local producers to low-cost member producers—thus have diametrically opposed consequences for the allocation of world resources, the former unfavorable or "trade diverting" and the latter favorable or "trade creating."[29]

These effects may be classified as *production effects* since they refer to the impact of the creation of a free-trade area on sources of production, assuming no changes in consumption. They should be contrasted with consumption effects which refer to the impact on consumption of the creation of a free-

[28] See generally 2 MEADE, *op. cit. supra* note 25, especially at 8–9, 102, 565–66; Ozga, *An Essay in the Theory of Tariffs*, 63 J. POL. ECON. 489 (1955).

[29] VINER, *op. cit. supra* note 23, used the terms "trade diverting" and "trade creating" to describe these divergent production effects. The terms, while often used in the literature, are somewhat obsolescent since, in view of his assumption that consumption was unchangeable as between various countries, Viner failed to take account of the consumption effects hereafter described.

trade area. It is useful to think of production effects as involving local consumers' choices among local, member and nonmember sources of the *same* kind of goods and consumption effects as involving local consumers' choices among *different* kinds of goods, using the terms local goods, member goods and nonmember goods to differentiate the respective sources of such different kinds of goods.[30] We start with the proposition that the price paid by a consumer for foreign goods subject to a tariff necessarily equals the price received by the foreign seller plus the amount of the tariff.[31] The elimination of tariffs on imports from member countries coupled with retention of tariffs on imports from nonmember countries will tend to alter the relationships of prices to consumers between, respectively, (1) local goods and member goods, and (2) member goods and nonmember goods, but not between (3) local goods and nonmember goods. That is to say, the ratio of prices paid for local goods as against member goods (and member goods as against nonmember goods) will be altered by creation of the free-trade area, but the ratio of prices between local goods and nonmember goods will not be altered. To put the matter differently, consumers will tend to find prices of member goods cheaper, relative to the pre-free-trade area situation, than either local goods or nonmember goods. Consumers may be led to purchase more member goods than before creation of the free-trade area, and this increase may come partly at the expense of local producers and partly at the expense of nonmember producers.

The substitution of member goods for local goods will be favorable, and the substitution of member goods for nonmember goods unfavorable, for the allocation of world resources. The favorable shift from local goods to member goods may be examined first. Prior to creation of the free-trade area, consumers' choices between local and member goods were affected by the tariff, producing a disparity between prices paid by consumers and prices received by producers with respect to member goods and hence a demand for local goods which was uneconomic in terms of real costs of resources. After creation of the free-trade area, prices paid by consumers and prices received by producers will be equal for purchases of both local and member goods, a situation more favorable to an optimum allocation of resources than that which obtained prior to creation of the free-trade area.

The substitution of member goods for nonmember goods, on the other hand, may be unfavorable for the allocation of world resources. Here the application of the tariff to nonmember goods may tend to cause an uneconomic demand for member goods. To be sure, under pre-free-trade area conditions the basis for consumers' choices between member and nonmember goods was

[30] The distinction is something of an oversimplification. See note 32 *infra*.

[31] Transportation and similar costs are treated, for the purpose of this analysis, as incurred by foreign producers in order to make clear that buyers include such costs in choosing between various sources of goods.

not fully satisfactory because the tariff, which was equally applicable to each, caused a divergence between prices paid and prices received with respect to each. Nevertheless, in ordinary circumstances it may be that an equal divergence with respect to alternative foreign sources (the situation prior to the free-trade area) would tend to produce a more economic consumers' choice than would a divergence with respect to only one foreign source (the situation after creation of the free-trade area). It must be recognized, however, that each of these situations is inferior to one in which all foreign sources are free from divergences between prices paid by consumers and prices received by producers—the utopian conditions of world free trade.[32]

Every proposed free-trade area or customs union will involve, in all likelihood, each of the four types of effects just discussed: Favorable production, unfavorable production, favorable consumption and unfavorable consumption effects.[33] The problem is to determine whether these effects are on balance favorable or unfavorable for the world as a whole. From one perspective this weighing process presents a prodigious task, a task of perhaps impossible difficulty for any international organization. The effect of the free-trade area or customs union on every product, commodity and service would have to be taken into account in order fully to discharge this task. It does not follow, however, that because a rational standard is complicated, a less rational standard such as that contained within article XXIV should be adopted. In view of the irrelevance of the standards of article XXIV to the basic inquiry, certain simplifications and short-cuts might be justified in establishing new

[32] It will be noted that production and consumption effects have certain similarities. Both result from a change in price ratios among local, member and nonmember goods. But reference to production effects is intended to isolate the impact on the distribution of productive facilities throughout the world, while reference to consumption effects is intended to isolate the efficiency of consumers' purchases, measuring such efficiency in the only feasible manner—by the relative costs of various types and sources of goods. The two terms may be used to refer to the same phenomenon when the shift in source occurs with respect to identical goods. In order to avoid double counting, we have, as has been conventional in the economic literature, restricted references to consumption effects to situations in which shifts occur as between different kinds of goods. It should be noted, however, that consumption effects will tend to encourage production of the benefited goods in member countries, and hence will have an effect on production. This observation further emphasizes that production and consumption effects, in the sense in which those terms have been used, are not strictly speaking different in kind. See H.G. Johnson, *Discriminatory Tariff Reduction: A Marshallian Analysis*, 38 INDIAN J. OF ECONOMICS 39 (1957); H.G. JOHNSON, *op. cit. supra* note 25, at 53 n.11.

[33] The existence of many internal policies and conditions in one or more countries, such as monopolies and internal taxes, which cause a divergence between prices received by a producer and costs incurred by that producer, have an independent impact on the allocation of world resources and, if every factor were to be taken into account, such internal divergences might lead one to conclude that a particular production and consumption effect which appeared to be favorable was in fact unfavorable or vice versa. But these complicating circumstances have been ignored here on the grounds that the impact of such internal divergences is often marginal and problematical and, in any event, usually beyond any influence by the Contracting Parties. See MEADE, *op. cit. supra* note 25, at 565–66.

standards—such as excluding from the scope of GATT deliberations products playing minor roles in international trade. Moreover, a number of general principles can be deduced from the foregoing analysis of production and consumption effects which might serve as rules of thumb for the Contracting Parties in administering a revised article XXIV. For convenience of exposition, these principles are set forth on the assumption that the free-trade area involves two countries only, although the principles would appear to be equally valid for a multination grouping.

Production effects are favorable, as we have seen, where low-cost member goods replace high-cost local goods. Since creation of a free-trade area is most likely to constitute a movement toward free trade where, other things being equal, favorable production effects are maximized, our search for standards should be directed toward the conditions under which maximum favorable production effects may be expected. Any attempt to measure favorable production effects would have to take into account two principal dimensions—the quantity of trade which displaces local production and the difference in unit prices to producers between the displaced local production and the displacing member production. We may therefore conclude that, in general, favorable production effects of a proposed free-trade area will be greater, the larger the range of goods produced in both of the member countries and the greater the differential in prices to producers between the two member countries. The differential in prices may be roughly gauged by the height of the pre-union tariff; the higher that tariff, the greater will be the favorable production effects of a proposed free-trade area.

Unfavorable production effects, on the other hand, arise from substitution of high-cost member goods for low-cost nonmember goods. We may therefore conclude that, in general, unfavorable production effects of a proposed free-trade area will be smaller, the smaller the range of goods produced in both member and nonmember countries and the lower the differential in prices to producers between member and nonmember countries. Again, the latter criterion may be rephrased to state that the lower the tariffs against nonmember goods, the smaller will be the unfavorable production effects of a proposed free-trade area.

Consumption effects, it will be recalled, are favorable with respect to consumer choices between local and member goods but may be unfavorable with respect to consumer choices between member and nonmember goods. We may therefore conclude that the smaller the range of goods imported from nonmember countries relative to the range of goods imported from member countries, the smaller the unfavorable and the greater the favorable consumption effects.

The foregoing discussion has been concerned with tariffs rather than quantitative restrictions. The elimination of intermember quantitative restrictions is quite a different matter, so far as allocation of world resources is concerned,

from the elimination of intermember tariffs.[34] The elimination of quantitative restrictions among members will be favorable for the allocation of world resources in all cases, even though quantitative restrictions are maintained on imports from nonmember countries.[35] To explain this paradoxical conclusion, it is necessary to examine two types of situations. First, elimination of intermember quantitative restrictions, coupled with retention of quantitative restrictions against nonmember countries, may produce one of two consequences. First, it may permit additional imports of member goods at the expense of local goods. This result would involve favorable production effects. Second, it may permit additional imports of member goods at the expense of nonmember goods, but this result would occur only where prices to consumers are lower for both member and nonmember goods than for local goods (that is, only where in the absence of both quantitative restrictions and tariffs, there would be no local production). If member goods displace nonmember goods, it must be either because prices to producers are lower in member than in nonmember countries or because a tariff against nonmember goods is sufficiently high to offset lower prices to producers in nonmember countries. In the former case, the production and consumption effects are favorable. In the latter case, it is, strictly speaking, the tariff and not the elimination of quantitative restrictions which produces the unfavorable production effects.[36]

The difference between a free-trade area and a customs union is obvious but has been largely overlooked in the economic literature. If the tariffs of member countries were identical, formation of a free-trade area would have the same economic consequences as formation of a customs union. But where tariffs differ in the member countries, formation of a customs union may, because of the necessity of creating a common external tariff, lead to sharply different consequences from formation of a free-trade area. Economic theory

[34] Quantitative *export* restrictions are ignored in the text, but the analysis is not fundamentally different from that used for quantitative *import* restrictions.

[35] The text ignores situations where quantitative restrictions are superfluous, *i.e.*, where the quantity of imports permitted exceeds actual imports with respect to a given product or commodity. Such legal restrictions should not be considered restrictions in fact for the purpose of the analysis in the text.

[36] To put the latter point differently, if there were no tariffs against nonmember goods or equal tariffs against both member and nonmember goods, the elimination of quantitative restrictions against member goods would cause member goods to displace nonmember goods only in situations where prices to producers were lower in member than in nonmember countries. The displacement of nonmember goods which may be attributed to elimination of quantitative restrictions therefore involves favorable, rather than unfavorable, production effects.

It would seem that the consumption effects of elimination of quantitative restrictions between the two member countries, but not against nonmember countries, must also tend to be favorable in all cases. The analysis would parallel that for production effects, except that we are by hypothesis considering the impact on consumer choices between different kinds of goods.

is of very little assistance here because economists, in that new subdivision of economic theory known as the theory of customs unions, have been dealing with free-trade areas rather than customs unions. The economic impact of discriminatory tariff reduction has been studied to the exclusion of the economic impact of the alignment of external tariffs of two or more countries.[37]

The creation of the common external tariff may involve (1) increasing all duties, (2) increasing some and decreasing other duties or (3) decreasing all duties. Under article XXIV, assuming other requirements are met, only customs unions of the third category are clearly lawful. Where some external duties are raised and others lowered, the ambiguous "higher or more restrictive" test must be applied.[38] The common-sense notion underlying article XXIV is, of course, that so long as the common external tariff is no higher than were the members' tariffs collectively, one may conclude that the creation of the common external tariff has not been restrictive. But once we adopt as our principal measure of lawfulness whether creation of the customs union is a movement toward or away from free trade, we may no longer adhere to such a simplistic notion. A customs union involving the lowering of all external duties may be a movement away from free trade whereas a customs union involving the raising of all external duties may be a movement toward free trade. The direction of the movement depends on the combined effect of the elimination of internal barriers and the changes in the external barriers.

Our task would be simplified if we could be certain that aside from the effects of elimination of internal barriers, every decrease in an external duty involved a movement toward free trade and every increase a movement away from free trade. But just as we could not be certain that the elimination of trade barriers between member countries improved the allocation of world resources, so we cannot be certain of the effect of increasing or decreasing any individual duty on the efficiency of allocation of world resources. Given a world economy filled with divergences between prices to consumers and costs to producers such as tariffs, quantitative restrictions, taxes, subsidies and monopolies, it is not necessarily true that the reduction of any individual tariff (that is, the reduction pro tanto of those divergences) will actually improve

[37] For examples of such "customs union" literature, see, *e.g.*, Lipsey, *The Theory of Customs Unions: A General Survey*, 70 ECONOMIC J. 496 (1960), a paper purporting to be "a survey of the development of customs-union theory from Viner to date," and MEADE, THE THEORY OF CUSTOMS UNIONS (1955). As a lawyer, I do not pretend to have read the entire economic literature, but a considerable survey did not reveal any systematic analysis addressed to the consequences of creation of a common external tariff. To be sure, some economists have considered alternative methods of applying the "higher or more restrictive" test of article XXIV, *e.g.*, Loveday, *supra* note 15, but that is not necessarily the same question. Also different is the question of the method to be used in determining the "height" of a tariff. See BALASSA, *op. cit. supra* note 25, at 44–49; VINER, *The Measurement of the "Height" of Tariff Levels*, INT'L ECONOMICS 161–68 (1951). But see, some comments on the impact of European integration on Canada in Reuber, *Western Europe's Demand for Canadian Industrial Materials*, 28 CAN. J. OF ECONOMIC & POL. SCI. 16 (1962).

[38] See discussion at p. 619 *supra*.

the allocation of world resources.[39] Nevertheless, where we are dealing not with any individual duty but with the entire range of duties of a group of countries (as we inevitably are in assessing the common external tariff of a customs union), it may well be that a reduction in the external tariff as a whole will usually be accompanied by an improvement in the allocation of world resources.[40] In that sense article XXIV's "higher or more restrictive" test may contain a large element of wisdom. But even if we assume that a high correlation does exist, we are still left with the conclusion that the effect of creation of the common external tariff should be placed in the balance with the effect of the reduction of internal tariffs and quantitative restrictions in determining whether a customs union as a whole is a movement toward or away from free trade.[41] Where the one effect is favorable, and the other unfavorable, for the allocation of world resources, we have no developed techniques for striking that balance.

In weighing production and consumption effects, we have been considering only the elimination of restrictions on manufactured goods and commodities. Once improvement of the allocation of resources is adopted as the decisive

[39] See 2 MEADE, *op. cit. supra* note 25, at 513–20; Ozga, *supra* note 28, at 489; see generally Lipsey & Lancaster, *supra* note 25.

[40] The conclusions of Professor Meade seem particularly wise: "[T]here are strong theoretical reasons why in many cases one particular tariff or other trade control should not be removed so long as some other particular tariff or trade control or domestic duty or other divergence between marginal values and costs remains in operation. . . .

"There can be no question about the validity of this argument. Yet as a precept for practical policy, the present author at least does not find it very compelling. . . . [T]here remains a general presumption that a removal of a trade barrier will have good rather than bad effects. . . . The presumption should always be in favor of taking steps to reduce . . . other divergencies rather than of maintaining a particular barrier to offset the effect of . . . other divergencies. It must always be remembered that the lowering of any one particular barrier will generally increase the chances that good rather than evil will come out of lowering of any other barrier to trade." 2 MEADE, *op. cit. supra* note 25, at 565–66.

[41] One problem of some practical importance arises from the circumstance that the General Agreement is a multilateral instrument involving mutual rights and obligations. Thus, even where a customs union fully complies with the requirements of article XXIV, nonmember contracting parties are entitled under paragraph 6 to compensation for any duty which is increased in the process of creating the common external tariff, subject to the general principle that any duties reduced in that process are to be taken into account. The right to such compensation is personal to each contracting party. Normally compensation will take the form of reduction of duties on goods which are important exports of the injured contracting party (which reduction must be generalized to all contracting parties under the most-favored-nation principle). Since the decisive question in determining the right to compensation is the impact of increase in particular duties with respect to particular contracting parties, it may be that, even though a customs union in which every external duty was increased might theoretically be a movement toward free trade, concessions might nonetheless have to be given to other contracting parties. Such may indeed be the result of the scheme of rights and duties underlying the present General Agreement. One can only observe that the present compensation arrangements under article XXIV are illogical since they require the customs union to grant compensation for injuries arising to third parties from the creation of the common external tariff but not for similar injuries arising from the discriminatory elimination of internal tariffs.

test for the legality of a customs union under the General Agreement, a question arises whether the extent to which restrictions are eliminated on the free movement of labor and capital should be taken into account. Article XXIV, while requiring elimination of barriers on "substantially all" *trade*, does not require any reduction whatever of restrictions on mobility of labor or capital. But if elimination of such restrictions tends to promote more efficient allocation of world resources, then surely any steps taken in that direction by a customs union should be considered a favorable factor in weighing the compatability of the customs union with the most-favored-nation clause of the General Agreement.[42] However, if the effect of creation of a customs union is unfavorable, it is doubtful that freeing of labor and capital would often be sufficient to make creation of the union favorable, on balance, for the allocation of world resources. Perhaps a workable rule would be to exclude the effects of such liberalization from the scope of the Contracting Parties' deliberations except where it is impossible to make any judgment on the basis of the foregoing production and consumption effects.[43]

Quite aside from the criteria thus far discussed, it may be desirable to take into account certain other economic effects of creation of customs unions which may have some bearing on the degree of efficiency of world resources.[44] For example, national tariff walls may well preclude the achievement of the most efficient scale of output for firms. As the size of the market expands through elimination of barriers between member countries, expansion of firms and plants may occur to exploit those formerly unexploited economies of scale. While economies of scale to be enjoyed by creation of a customs union

[42] It must be recognized in determining the weight to be attached to elimination of restrictions on the free movement of labor and capital that the result sought to be accomplished—in economic terms, the equalization of the price of factors of production among countries—may under certain circumstances be accomplished solely by the elimination of restrictions on trade. See BALASSA, *op. cit. supra* note 25, at 80–98.

[43] The conclusions concerning elimination of restrictions on capital and labor would seem applicable to a free-trade area as well as a customs union. As a practical matter, however, such elimination is more likely to accompany a customs union than a free-trade area.

[44] There is one sense in which every customs union will tend to improve the allocation of world resources. By eliminating the necessity of customs administration on transactions between member countries, resources are freed for more productive undertakings. Even this principle must be qualified, however, because to the extent that the internal tariffs produced revenue and were not purely protective, some judgment must be made concerning the economic effects of alternative methods of raising the lost revenue.

Whether any similar improvement in the allocation of world resources can be claimed for the free-trade area is doubtful. Here the national customs administrations cannot easily be replaced by a single administration since the member countries retain their independent commercial policies. Moreover, the risks of transshipment inherent in a free-trade area require that some administrative systems for determining origin, or some system of countervailing duties, be established. See BALASSA, *op. cit. supra* note 25, at 69–79; OEEC, REPORT ON THE POSSIBILITY OF CREATING A FREE TRADE AREA IN EUROPE 11–12, 31–41 (1957). This additional complicating factor will most likely dissipate any administrative saving from the elimination of intermember tariffs.

will be of benefit primarily to member countries, they are nonetheless relevant to the efficiency of the resources of the world as a whole. On the other hand, the increase of efficiency to be expected from this source would seem to be rather minor for most customs union projects[45] and in any event extremely difficult to predict. Therefore economies of scale might well, except in unusual circumstances, be excluded from formal GATT consideration.[46] In any event the burden of coming forward and the burden of proof with respect to gains of this variety ought to be placed on the members of the customs union.

Preferential arrangements which involve partial rather than complete elimination of intermember tariffs are absolutely forbidden by the General Agreement, except insofar as the grandfather clauses of article I exempt preferential agreements previously in existence. Since the tariff reduction inherent in such a preferential arrangement might be considered 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 discrimination against nonmembers than a customs union or free-trade area, the justification for proscribing such arrangements absolutely is not clear.[47]

[45] See H.G. Johnson, *The Criteria of Economic Advantage*, in WORSWICK, THE FREE TRADE PROPOSALS 31 (1960); H.G. Johnson, *The Economic Gains from Freer Trade with Europe*, Three Banks Review No. 39, Sept. 1958, p. 3; SCITOVSKY, ECONOMIC THEORY AND WESTERN EUROPEAN INTEGRATION 22–32, 64–70, 112 (1958). *But see* Gehrels & Johnson, *The Economic Gains of European Integration*, 63 J. POL. ECON. 275 (1955); see generally BALASSA, *op. cit. supra* note 25, at 120–43.

[46] It is also possible that creation of a customs union may have certain favorable dynamic long-term consequences on the rate of growth within the customs union area which will tend to be favorable from the viewpoint of the world as a whole. Among these consequences are improvement in internal efficiency of local firms and the breaking up of local monopolies and private controls through the stimulus of new competition from firms in member countries, and the favorable impact of large markets on technological skills, communication and other so-called external economies. See BALASSA, *op. cit supra* note 25, at 144–88; see also ALFRED MARSHALL, PRINCIPLES OF ECONOMICS 138–322 (8th ed. 1925); Stigler, *The Division of Labor is Limited by the Extent of the Market*, 59 J. POL. ECON. 185 (1951). No doubt there are many favorable influences of these kinds but they are hard to measure in advance. See H.G. JOHNSON, *op. cit. supra* note 25, at 59–62. Where the proponents of a customs union are able to demonstrate with a fair degree of certainty that these consequences are to be expected, the Contracting Parties might take them into account.

[47] An explanation which reveals the characteristic confusion of thought evidenced toward preferential arrangements is that advanced by a United States Department of State official who played a major role in shaping United States commercial policy during the late 1940's, and in drafting the General Agreement itself: "A customs union creates a wider trading area, removes obstacles to competition, makes possible a more economic allocation of resources and thus operates to increase production and raise planes of living. A preferential system, on the other hand, retains internal barriers, obstructs economy in production, and restrains the growth of income and demand. It is set for the purpose of conferring a privilege on producers within the system and imposing a handicap on external competitors. A customs union is conducive to the expansion of trade on a basis of multilateralism and non-discrimination; a preferential system is not." WILCOX, *op. cit. supra* note 21, at 70–71. It is revealing to examine this instance of what may perhaps best be called a nonargument (*i.e.*, something which looks like an argument but is not in fact an argument) because it is typical of most discussions of preferential agreements. The first two sentences are simply a

Certainly it is strange to state, as article XXIV in effect declares, that discrimination is forbidden unless it is one hundred per cent effective.

At least we can say that it is likely that the favorable production effects (displacement of local goods by member goods) of any additional unit of trade created between members of a free-trade area are likely to be greater when tariffs are high, as during the first percentage reductions, than when tariffs are low, as during the last few percentage reductions. Any unit of new trade in the former case will be created where prices to local producers are much higher than prices to member producers; here again differences in prices may be measured by the tariff. After most of the scheduled tariff reductions have occurred, however, any subsequent unit of new trade will be created where prices to local producers and prices to member producers are less divergent. In the former case the displacement of the local producers by member producers involves a much more favorable impact on the efficiency of allocation of world resources. Unfavorable production effects (displacement of nonmember goods by member goods) of a given unit of production diverted from nonmember to member producers will be of equal magnitude in impact on allocation of world resources whenever, in the process of tariff reduction, it may occur because the tariff against nonmember countries remains at the same height at all times.[48] This analysis suggests that a good portion of the benefits to the world as a whole to be expected by a free-trade area could be achieved by a preferential arrangement between the same members.[49]

One basic distinction must be recognized in considering the appropriate treatment of preferential arrangements. There is one enormous practical difference between an arrangement in which, say, all intermember tariffs are reduced to eighty per cent of their former level and one in which intermember tariffs on eighty per cent of intermember trade are totally eliminated. Quite aside from the implications from the analysis just undertaken that favorable production effects will be greater in the former case since early reductions tend to be more beneficial than later reductions, members of a free-trade area are most likely to exclude from the scope of the arrangements those industries

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statement of the alleged differences between customs unions and preferential arrangements. The purpose attributed to preferential arrangements in the third sentence may be attributed with at least as much justice to customs unions. The fourth sentence is simply the author's conclusion.

[48] Where a customs union rather than a free-trade area is involved, the situation is much more complicated since the creation of the common external tariff will alter tariffs against nonmember countries. In making any final judgment concerning a customs union with preferential reduction rather than elimination of internal tariffs, one would have to consider the impact of the creation of the common external tariff.

[49] It may be, however, that in the case of any given free-trade area, fewer units of trade will be created, and more units diverted, by the first reductions than by the last reductions. We cannot, therefore, conclude that the first tariff reductions must necessarily be more valuable than the later reductions but can only observe that they are more likely to be more valuable.

where elimination of intermember tariffs could be expected to have the most favorable production effects. If an economically significant and politically sensitive industry is much less efficient in one of the member countries than in other members and has therefore received a large measure of tariff and quota protection, it can be expected that strong domestic pressure will be exerted on that member's government to exclude the industry in question from the scope of the free-trade area.

The foregoing analysis suggests that the General Agreement's treatment of preferential arrangements tends to have a perverse impact on allocation of world resources. Since it requires complete elimination of tariffs only on "substantially all" commodities (and eighty per cent has been suggested as the appropriate measure of "substantially all") but proscribes agreements to reduce all tariffs to, say, eighty per cent of their former level, article XXIV tends to encourage precisely those deviations from the perfect free-trade area model which would minimize favorable production effects. The conclusion would seem to be that preferential arrangements, rather than being absolutely proscribed, should be subjected to the same kinds of analysis as free-trade areas and customs unions.

IV.

Having examined the standards enunciated in article XXIV and assessed the validity of the rationale underlying those standards, it would be appropriate to review the history of the application of those standards by the Contracting Parties to customs unions and free-trade areas which have come into existence since the General Agreement became effective.

A. *Southern Rhodesia–South Africa*

The first customs union proposal to come before the Contracting Parties involved a 1948 interim agreement between Southern Rhodesia and the Union of South Africa.[50] While certain tariffs and other restrictions were immediately abolished and while the agreement contemplated that eventually all duties and other restrictions on internal trade would be abolished and a common external tariff adopted, the interim agreement did not establish a timetable or even a final date by which interunion tariffs were to be abolished or a common external tariff adopted. The procedure for further steps toward completion of the customs union was left entirely to future agreement.

The interim agreement thus quite clearly violated article XXIV by failing to "include a plan and schedule for the formation of such a customs union

[50] It might be said that the first customs union proposal to come before the Contracting Parties was the abortive French-Italian customs union agreement of 1948. The only issue dealt with by the Contracting Parties, however, was whether France would be violating the General Agreement by entering into any customs union agreement with Italy since the latter was not a Contracting Party. In granting France a waiver limited to this issue, the Contracting Parties were not required to review the customs union arrangement as a whole. See SEYID MUHAMMAD, *op. cit. supra* note 1, at 257–58.

. . . within a reasonable length of time."[51] The parties to the customs union were able to remedy this defect by undertaking to complete the customs union within ten years and to submit a "definite" plan and schedule at the end of the first five years. The two governments further undertook to submit a progress report to the Contracting Parties during the third year and, in addition, to submit annual reports. In effect, the two governments were granted the right to give each other preferential treatment immediately with respect to products in which they were not highly competitive but to wait for at least five years before deciding how to handle the products where abolition of tariffs would create severe competition. Opposition to the interim agreement arose among the members of the working party appointed to review the interim agreement on the grounds both that ten years was not a "reasonable time" under article XXIV and that the interim agreement did not, even in the light of the special undertaking, provide a more definite indication of the steps to be taken toward a common external tariff. Nonetheless, the Working Party voted to approve the interim agreement as modified by the representations of the two governments and the Contracting Parties subsequently issued a "declaration" that the two governments were "entitled to claim the benefits" of article XXIV.[52]

To evaluate the application of article XXIV to the interim agreement is not an easy task. Certainly Southern Rhodesia and South Africa were able to secure approval of an agreement which did not even approach the standards set forth in article XXIV. They were permitted, in effect, to defer for a five-year period the hard work of reaching even a general decision concerning completion of a full customs union.[53] Not only was the GATT review something of a capitulation on the legalistic level, but also there does not appear to have been any consideration of the fundamental underlying question whether the proposed arrangement was a movement toward or away from free trade.

On the other hand, the Contracting Parties were able to induce the members of the customs union to agree to make themselves accountable year by year

[51] Art. XXIV, para. 5(c).

[52] The Declaration, which might more properly have been denominated a waiver of the requirements of article XXIV, is interesting in its choice of qualifying words. Thus, the Declaration was made "taking note" of the two governments' undertakings and subject to a "request" that the annual report include a "definite plan and schedule" of the steps to be taken within each succeeding twelve-month period. The Contracting Parties reserved the right to review the Declaration if they should find that the interim agreement was not likely to result in the establishment of a customs union by the end of the ten-year period.

[53] Subsequent developments concerning the Southern Rhodesian–South African agreements were even more dismaying for the integrity of article XXIV. At the end of the first five years, the Federation of Rhodesia and Nyasaland (which had succeeded to the rights and obligations of Southern Rhodesia) and South Africa were unable to reach the definite agreement contemplated by the earlier Declaration. The Contracting Parties gave them another year's grace. GATT, BASIC INSTRUMENTS, 3d Supp., at 47 (1954), and when the Federation thereupon entered into a new trade agreement with South Africa, the Contracting Parties recognized a permanent preferential trading agreement between the two customs territories. See *id.*, 4th Supp., at 17, 72 (1955); 9th Supp., at 51, 231 (1960).

for progress in the implementation of their plans. This concession by Southern Rhodesia and South Africa constituted a recognition that the world-wide impact of customs unions makes their creation and implementation of common concern to all Contracting Parties. This principle, thus established quite early in the application of article XXIV, was to prove to be of no small importance to later customs unions.

B. *El Salvador–Nicaragua*

In 1951 El Salvador and Nicaragua agreed to enter into a free-trade area which did not conform in two respects, one technical and the other of considerable substance, with article XXIV. The former was that El Salvador was not a member of GATT, a circumstance raising difficulties under the language of paragraph 5 permitting free-trade areas "between the territories of contracting parties." The difficulty of greater substantive import was that the treaty permitted the imposition of quantitative restrictions on intermember trade under certain circumstances.[54] The Contracting Parties granted a waiver under the two-thirds majority provisions of paragraph 10 of article XXIV on the understanding that Nicaragua, the GATT member, would limit the exercise of its power to impose quantitative restrictions in a manner consistent with the general conception of a free-trade area under paragraph 8(a) and would submit annual reports on progress particularly concerning quantitative restrictions.[55] The Contracting Parties reserved the right to review their decision if they should find, either from the information submitted by Nicaragua or from other sources, that the treaty "is not resulting in the maintenance of a free-trade area in the sense of Article XXIV."[56] Thus, while the two governments were permitted to impose certain quantitative restrictions, the extent of those restrictions remained a question on which the members of GATT might require multilateral consultation. Thus, the precedent of the Southern Rhodesian–South African customs union was used to insure future consultation concerning the impact of the El Salvador–Nicaragua free-trade area on nonmember countries. It does not appear from the published report, however, that any attention was given to the question whether the free-trade area was a movement toward or away from free trade.

[54] See SEYID MUHAMMAD, THE LEGAL FRAMEWORK OF WORLD TRADE 250 (1958).

[55] The ambiguous phrasing of the *Decision of 25 October 1951*, 2 GATT, BASIC INSTRUMENTS 30 ("Taking further notice of the intention of the Government of Nicaragua that its action under the Treaty and specifically under Articles III and IV thereof will be limited to those consistent with the objective of maintaining a free-trade area as defined in Article XXIV, paragraph 8(*b*) of the General Agreement") was probably intended to suggest that quantitative restrictions might be approved on some but not most trade between the two countries.

[56] *Ibid.* It is not clear why the El Salvador–Nicaragua free-trade area was granted a waiver whereas the Southern Rhodesia–South Africa customs union was declared to be entitled to claim the benefits of article XXIV. The difference would appear only to be one of form.

C. *European Coal and Steel Community*

In two quite different ways the formation in 1952 of the European Coal and Steel Community was a decisive test of the role to be played by GATT in supervising the creation of regional economic organizations. First, the structure of this organization departed so sharply from the form envisaged in article XXIV that it was impossible to pretend that the requirements of that article were met. Second, the role of GATT as a forum for a continuing dialogue between regional economic organizations and interested foreign governments, rather than as a juridical body passing a once-for-all judgment on the conformity of the regional treaty with the General Agreement, became generally accepted not only as the preferable role, but also as perhaps the only effective role, which GATT as an international organization could play.

For several reasons ECSC was not a customs union or free-trade area within the meaning of article XXIV. It covered only coal and steel, clearly not "substantially all the trade between the constituent territories in products originating" within the ECSC member countries under article XXIV (8)(a)(i). The Community was, it will be recalled, a major experiment in "functional" integration, a type of regional organization largely unforeseen at the drafting of the General Agreement.[57] Second, aside from the limited number of products involved, the ECSC was a hybrid between a customs union and a free-trade area. It therefore did not provide for a common external tariff but neither did it leave its members free, within the limitations of their general commitments under GATT, to pursue independent external commercial policies.[58] Only a "harmonized" tariff was foreseen, a concept of uncertain content for some time after the entry into force of the ECSC treaty.[59] Even if these two differences could be overlooked on the ground that the ECSC was a novel organizational form serving the same objectives as traditional customs unions and free-trade areas, certain specific provisions of the ECSC treaty were difficult to square either with article XXIV in particular or the General Agreement as a whole. Italy, as a high-cost producer, was to retain its barriers against other ECSC members well beyond the time other internal barriers were to be abolished. The Benelux countries reserved the right to increase certain duties, in order to facilitate harmonization of ECSC external tariffs, without extending compensation to other Contracting Parties as required by the General Agree-

[57] See MORGENTHAU, POLITICS AMONG NATIONS 498 (2d ed. 1954).

[58] See MEADE, LIESNER, & WELLS, CASE STUDIES IN EUROPEAN ECONOMIC UNION 408–09 (1962).

[59] Under article 71 the member states were granted autonomy over commercial policy toward nonmember states, subject to certain limitations. With respect to tariffs, the Council was given the power under article 72 to establish, by unanimous vote on proposal by the High Authority, maximum and minimum rates of duty. The High Authority was given supervisory power over member-state import and export licensing programs and, to a limited extent, power to impose or require quantitative and other restrictions. See arts. 58, 73 and 74. See LISTER, EUROPE'S COAL AND STEEL COMMUNITY 339–43 (1960).

ment. Belgium reserved the right to maintain for seven years quantitative restrictions on coal in order to protect its inefficient collieries.[60]

Despite these grave departures from the terms of article XXIV, support for a waiver was almost unanimous among the Contracting Parties.[61] Whether this widespread support stemmed from political support for the Six, from faith in the economic promise of the ECSC experiment, or from a lack of confidence in the power of GATT to prevent establishment of the Community is unclear, although all three factors probably played a role.[62] This general support did not prevent those countries which feared the consequences of the new Community for their own economies from grasping the opportunity to exact concessions from the members of the ECSC. The proceedings of the Working Party provided a convenient negotiating forum. In the end the Six made certain major, if ambiguously stated, concessions. As set forth in the preamble of the Decision of the Contracting Parties granting the waiver, the Six agreed (1) "to take account of the interests of third countries both as consumers and as suppliers of coal and steel products, to further the development of international trade, and to ensure that equitable prices are charged by its producers in markets outside the Community," a commitment in substance to avoid serious disturbance to traditional markets and sources of supply; (2) "to harmonize their customs duties and other trade regulations . . . upon a basis which shall be lower and less restrictive than the general incidence of the duties and regulations of commerce now applicable," a somewhat more rigorous standard than the "not on the whole . . . higher or more restrictive" standard set forth in article XXIV; and (3) "to avoid placing unreasonable barriers upon exports to third countries, including, specifically, unreasonable duties and unreasonable quantitative restrictions,"[63] a commitment to take account of the interests of third countries which were dependent on Community sources for raw materials in the event that shortages within the Community led to export quotas.

[60] There were other conflicts between the ECSC treaty and the General Agreement. See GATT, BASIC INSTRUMENTS, 1st Supp., at 17–19 (1952).

[61] Only Czechoslovakia opposed a waiver.

[62] The Report of the Working Party may be found in GATT, BASIC INSTRUMENTS, 1st Supp., at 85 (1952), and the Decision of the Contracting Parties, *id.* at 17. It is perhaps revealing that the waiver finally granted by the Contracting Parties was not a waiver under paragraph 10 of article XXIV of the provisions of that article, such as had been granted the El Salvador–Nicaragua free-trade area, but rather a general waiver under article XXV from the provisions of the unconditional most-favored-nation provision of article I. Article XXV, paragraph 5, provides: "In exceptional circumstances not elsewhere provided for in this Agreement, the CONTRACTING PARTIES may waive an obligation imposed upon a contracting party by this Agreement . . . ." A two-thirds majority of votes cast, comprising not less than half of the Contracting Parties, is required.

The manner in which the Working Party proceeded is candidly revealed by the statement in its Report that "having agreed on the desirability" of the waiver, the Working Party "considered the principles on the basis of which a waiver should be granted." GATT, BASIC INSTRUMENTS, 1st Supp., at 87 (1952).

[63] *Id.* at 18.

The indefiniteness of these commitments required establishment of some reviewing mechanism to assure that they were not subsequently ignored by the Six. While the ECSC Convention was not in form an interim agreement, although a transitional period was contemplated, the policies previously adopted with respect to interim agreements provided a convenient precedent. The Working Party "agreed that, on the *analogy* of the procedure adopted with respect to interim agreements . . . it would be appropriate for the governments of the member States (of The Community) to submit an annual report . . . until the end of the transitional period . . . ."[64] Thus was established a framework for annual discussions between the Community and the Contracting Parties concerning not only compliance with specific undertakings but also the continuing economic impact of the Community on third countries generally.

The implications of this annual review were not at first fully understood by the High Authority. Upon submission of the first annual report of the Community, the Working Party demanded additional information with respect to such specific matters as export prices, cartel arrangements, export quotas and the High Authority's intentions concerning future commercial policy. During the discussions of the Working Party, the external policies of the Community were subjected to detailed and critical review.

Disagreement was the keynote of the six week series of meetings of the Working Party at the second annual review. The Report of the Working Party reviewed extensive criticisms of Community policy made by various countries as well as the High Authority's reply. At the conclusion of the Report, the Working Party reiterated its view that "the waiver states in a most unequivocal manner that the waiver was granted in consideration of the . . . definite assurances given by the High Authority and the Member States regarding their intentions to pursue constructive trade policies towards outside countries" and stated the views of various third countries that progress had not been sufficiently rapid. The Report further suggested that certain countries found the information supplied by the ECSC inadequate. The attitude of the High Authority toward these third-country criticisms and demands, as revealed in a subsequent public report, was highly skeptical.[65]

The third review went much better. The High Authority provided more

[64] *Id.* at 89. (Emphasis added.) For the decision by the Contracting Parties to require such an annual report, see *id.* at 21.

[65] "[C]ertain third countries clearly intimated that by granting the waiver, they considered they had a right to supervise all undertakings entered into by the member States or the High Authority under the Treaty. The delegates of the Community expressed themselves as alarmed by such an interpretation. . . . They added that various assurances had been given to the Contracting Parties, including the undertaking to provide it with information on the activities of the Community, but that it was definitely understood that such information was not always suitable for discussion before the Contracting Parties." HIGH AUTHORITY, THIRD GEN. REP. ON THE ACTIVITIES OF THE COMMUNITY 33–34 (1955).

definite information, thus diverting third-country grievances concerning prices from generalized unverifiable charges to more expert technical inquiries into the difficult economic problems faced by the Community. The additional information, according to the High Authority, "was much appreciated, and the atmosphere in which the discussions took place . . . was distinctly more encouraging than in previous years.[66] From this third review in 1955 through the review of the High Authority's final report at the conclusion of the transitional period in 1958, the tone of meetings became more technical and less political. The quality and extent of information supplied by the High Authority improved and the High Authority was no longer viewed, either by itself or by third countries, as "the defendant in the dock."[67]

The influence of the GATT reviews on the policies of the High Authority was undoubtedly beneficial to affected third countries. To take an example, Austria, a country whose steel production seemed likely to be displaced in Community markets by higher-cost Community producers, won important concessions.[68] As William Diebold concluded in his comprehensive study, *The Schuman Plan*, the GATT reviews proved to be the most effective outside pressure faced by the High Authority, preventing it from subordinating, out of expedience, external considerations to more urgent and direct internal pressures.[69]

D. *European Economic Community*

The six countries which formed The European Coal and Steel Community extended the scope of their integration to the rest of the economy through formation of the European Economic Community.[70] The Treaty of Rome, signed in March, 1957, provided not only for elimination of intermember trade barriers and establishment of a common external commercial policy but also for elimination of restrictions on movement of capital and labor and for coordination of certain internal economic policies. While the EEC thus went

[66] HIGH AUTHORITY, FOURTH GEN. REP. ON THE ACTIVITIES OF THE COMMUNITY, 34–35 (1956); see MEADE, *op. cit. supra* note 58, at 412.

[67] DIEBOLD, THE SCHUMAN PLAN, 525–32 (1959); MEADE, *op. cit. supra* note 58, at 411–12; *cf.* CAMPS, TRADE POLICY AND AMERICAN LEADERSHIP 15 (1957).

[68] In the course of certain multilateral negotiations within the framework of GATT, Austria received concessions on exports to the Community valued at approximately $15 million while making concessions on imports from the Community valued at approximately $2 million. See DIEBOLD, *op. cit. supra* note 67, at 476 n.6.

[69] DIEBOLD, *op. cit. supra* note 67, at 531–32; see Vernon, *Economic Aspects of the Atlantic Community*, in HAVILAND, THE UNITED STATES AND THE WESTERN COMMUNITY 53 (1957). Diebold also suggests that the High Authority itself profited; its international personality was enhanced by its negotiations with the Working Party and its commitment concerning export prices was useful in its conflict with the Community steel export cartel. DIEBOLD, *op. cit. supra* at 630–31.

[70] A separate organization, the European Atomic Energy Community was established, to create a common market for nuclear products. See *Report of the GATT Working Party*, BASIC INSTRUMENTS, 6th Supp., at 109 (1957).

far beyond traditional free-trade area and customs unions projects, it nonetheless had to pass muster under article XXIV.

The Treaty of Rome was submitted in the first instance to a committee of the whole which in turn established four "Sub-Groups" to examine each of the four most troubling problems raised by the treaty: The common external tariff, quantitative restrictions, agriculture and the association of overseas territories.[71]

1. *Sub-Group A: The Common External Tariff.* The primary concern of the first Sub-Group was the "height" of the common external tariff. For the first time in the GATT reviews under article XXIV, the ambiguities inherent in the provisions of article XXIV governing the permissible height of customs unions' common external tariffs had to be squarely faced. At the outset there was a disagreement between EEC members and other Contracting Parties concerning the relationship between paragraphs 4 and 5 of that article. Was the basic test to be the general test of paragraph 4, which declared that the "purpose" of a customs union "should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories"? Or was the governing standard to be the more technical criterion of paragraph 5, that the common "duties and other regulations of commerce" were not to be "on the whole higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union"? Or were the two paragraphs to be read together, and if so, how?

Most members of Sub-Group A argued that paragraph 4 enunciated the general principles, although any questions concerning the application of paragraph 5 were to be resolved in the light of paragraph 4.[72] Some members of the Sub-Group went further, asserting that paragraph 4 was controlling. The EEC members argued that paragraph 4 merely stated a general goal and paragraph 5 was intended—as the initial word "accordingly" indicated—to set forth the tests under which it could be determined whether the customs union did in fact have the general purpose set forth in praragraph 4. Under this view, if the tests of paragraph 5 were met, it could not be argued that a separate hurdle in paragraph 4 must also be cleared. No formal decision was reached, but the EEC members were successful in shifting the attention of the Sub-Group to the technical criteria of paragraph 5.

The implications of this shift were far-reaching. Legality became essentially a statistical question. The more general, and more relevant, question whether the EEC constituted a movement toward or away from world trade was not considered. The EEC members were thus able to avoid the product-by-

[71] Their reports are contained *id.* at 70–109.

[72] *Id.* at 71.

product and the country-by-country studies sought by some members of the Sub-Group.[73]

The materials submitted to the Sub-Group concerning the common external tariff were not adequate for any final judgment on the compatibility of the Treaty of Rome with article XXIV. In some cases the rates announced were only maximum "ceiling" rates and the final duties might be much lower. In other cases, particularly the products on "List G" with respect to which no agreement had yet been reached between the Six, no figures were available. Nevertheless, to the extent that final rates proposed had been calculated by taking an arithmetical average of the individual duties of the Six,[74] a substantial issue of compatibility with article XXIV was presented. The Six were not prepared to discuss the best method of calculation because, in their view, paragraph 5 did not require any special method.[75]

The intransigence of the Six against product-by-product or country-by-country studies and in favor of the arithmetic-average method, coupled with the absence of agreement among them on many duties in the common external tariff, led to postponement of resolution of the legal issues.[76] The Six were unwilling even to agree to a definite date by which they would be able to supply a completed schedule of the common external tariff, a not unreasonable attitude in view of the possible internal complications ahead for the Six in reaching agreement among themselves.[77]

[73] It does not appear to have been strenuously argued by any of the members of the Sub-Group that the items in the common external tariff schedule were to be examined individually in order to determine whether each duty was "on the whole higher or more restrictive" than the corresponding duties of the six members, although under such a view a product-by-product study would have been appropriate. See discussion at pp. 618–19 *supra*.

[74] Since Benelux was already a customs territory, it was counted as one of the four constituent units of the EEC in calculating the external tariff.

[75] Indeed, the Six argued that they had gone beyond the requirements of paragraph 5 by using in their calculations the actual rates in effect on January 1, 1957, rather than the maximum authorized or "legal" rates, despite the fact that some legal rates had then been under temporary suspension. Moreover, for a number of products arbitrary ceiling rates had been established which would be applied even though an arithmetic average would produce a higher rate. GATT, BASIC INSTRMUENTS, 6th Supp., at 72 (1957).

[76] Under Article 20 and List G of the Treaty of Rome, the rates of duty for products encompassing some 20% of total imports of the Community were left for future agreement. Since these products tended to be those on which there was the sharpest conflict of interest among Community members concerning the appropriate rate of duty, it was quite difficult to determine at the time of the GATT review the overall "height" of the future common external tariff. See Ouin, *The Establishment of the Customs Union*, in 1 STEIN & NICHOLSON, AMERICAN ENTERPRISE IN THE EUROPEAN COMMON MARKET 101, 137–39 (1960).

[77] The only question on which the Sub-Group could reach agreement was the necessity of negotiations within the general GATT framework with respect to compensation for the duties, notably those of Benelux, which would necessarily be increased in arriving at a common external tariff. But even here the Six were unwilling to make any commitments until consultations had been held concerning the significance of the provision of paragraph 6 to the effect that "due account shall be taken of the compensation already afforded by the reductions brought about in the corresponding duty of the other constituents of the union." GATT, BASIC INSTRUMENTS, 6th Supp., at 74 (1957).

2. *Sub-Group B: Quantitative Restrictions.* As part of the systematic elimination of internal trade barriers envisaged by the Treaty of Rome, each member was required to eliminate quantitative restrictions against other members.[78] Balance-of-payments difficulties were not to serve, with certain limited exceptions, as justification for such restrictions. While the provisions for elimination of internal quantitative restrictions thus tended to parallel the provisions for elimination of internal tariffs, the treatment of quantitative restrictions against nonmembers differed greatly from the treatment of external tariffs. Unlike the agreement to create a common external tariff, the Six merely agreed to aim, during the transition period, "at securing uniformity between themselves at as high a level as possible" and to follow, after the transition period, a "common commercial policy" based on "uniform principles" concerning "alignment of measures of liberalization."[79]

Two consequences followed from this differential pattern. The first was that under the Rome Treaty, an EEC member might eliminate quantitative restrictions against members while retaining restrictions against nonmembers. While a pattern of discrimination distasteful to nonmember countries was thus created, it was not essentially different from that to be created by the corresponding elimination of internal tariffs. In the view of the Six at least, the same rules applicable to tariffs would be applicable to quantitative restrictions imposed by the EEC—that is, EEC common quotas "must not on the whole be more restrictive than those . . . which they would have been able to apply if the union had not been established."[80] The second consequence was that the Community might require a member either to impose a quota, or to participate in a Community-wide quota, in order to protect the balance-of-payments position of another member. An exceedingly abstruse wrangle developed over whether such restrictions did not fall outside the balance-of-payments exception of article XII to the general prohibition against quantitative restrictions contained in article XI.[81]

[78] Treaty of Rome, arts. 30–37, 104–09 (1957).

[79] *Id.*, arts. 111, 113.

[80] GATT, BASIC INSTRUMENTS, 6th Supp., at 77 (1957).

[81] Article XII, since it did not refer specifically to customs unions, was quite understandably phrased in terms of the balance of payments of the contracting party imposing the quota, not the balance of payments of some other contracting party. Thus, it could be argued that the Treaty of Rome permitted an EEC member to impose quantitative restrictions under circumstances not permitted by articles XI and XII. Since the essence of a customs union—as opposed to a free-trade area—is a common external commercial policy, the Six were on strong ground when they insisted that the customs union could not be perfected if a common policy on quotas was not permitted. In any event, since article XXIV, paragraph 5 explicitly provided that the "provisions of this Agreement shall not prevent . . . the formation of a customs union" (assuming the requirements of article XXIV are met), surely the members of the customs union should be exempted from the quantitative restriction prohibition of article XI of the General Agreement in the same way in which they were exempted from the most-favored-nation obligation of article I. The opposing position was that until such time as the Six held their foreign exchange reserves in common, a situation

While the Six could not argue away the legal objections, they sought to quiet third-country fears by holding out the prospect that, balance-of-payments conditions permitting, the EEC would reduce quotas against nonmembers at the same time, though perhaps not so quickly, as the dismantling within the EEC.[82]

The deliberations of the Working Party were largely unsatisfactory. A good deal of energy was expended in parsing the various provisions of the Treaty of Rome and the General Agreement. No resolution of the legal issues proved possible.[83] Nor was any attention paid to the allocation-of-resources implications of discrimination between members and nonmembers in the quantitative restrictions. As we have seen, elimination of quantitative restric-

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not explicitly contemplated by the EEC treaty though no doubt held as a long-term goal by enthusiasts for European integration, Community-wide quotas and common quota policies could not be countenanced. The effect of imposing quotas against nonmembers without also imposing quotas against members would be that "imports would tend to flow to the country not in a position to finance them at the expense of the other Members [of the EEC] who had no difficulty in financing them." GATT, BASIC INSTRUMENTS, 6th Supp., at 79 (1957).

[82] The Six observed that a similar reduction of quantitative restrictions within the Organization for European Economic Cooperation had been required by the OEEC's Code of Liberalization. At the same time that the seventeen OEEC members reduced quantitative restrictions against one another, they also reduced such restrictions, albeit at a slower pace, against nonmembers. While the GATT had never explicitly reviewed the Code of Liberalization, most GATT members had not protested the resulting discrimination, both because it had some justification in balance-of-payments considerations (the OEEC members having facilities for clearing balances among themselves on a multilateral basis through the European Payments Union while being forced to clear balances with nonmembers on a bilateral basis) and because the Code was felt to be a move in the right general direction which should not be discouraged by legal considerations. See GATT, BASIC INSTRUMENTS, 6th Supp., at 80 (1957); *id.*, 3d Supp., at 178–79 (1954); FRANK, THE EUROPEAN COMMON MARKET 44–71, 245–46 (1961).

[83] The debates became extremely technical. On the one hand, it was argued by certain nonmembers that article XXIV did not contemplate a common external quota policy. Despite the reference by the Six to paragraph 8 (ii), which made it an element of the definition of a customs union that "substantially the same duties and other regulations of commerce [be] are applied by each of the members . . . to the trade of [nonmembers]," application of the term "other regulations of commerce" was properly to be limited, it was argued, to such routine matters as grading and marketing requirements. That the term should not be read so narrowly, argued the Six, was clear from the fact that the corresponding provision of paragraph 5(a) ("duties and other regulations of commerce . . . shall not on the whole be higher or more restrictive . . . .") clearly contemplated that "regulations of commerce" could be "restrictive."

The nonmembers argued, however, that paragraph 8(a)(i) indicated the proper construction of the term "regulation of commerce." It was there provided that one element of a customs union was that "duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated" with respect to internal trade. Not only did paragraph 8(a)(i) indicate that the draftsmen used the adjective "restrictive" to modify "regulations of commerce" when they wished to refer to quantitative restrictions but also that since paragraph 8(a)(i) specifically permitted the members of a customs union to impose quantitative restrictions against each other for balance-of-payments purposes, nothing in article XXIV required customs union members to discriminate against nonmembers in the imposition of quantitative restrictions.

tions among members is much more likely to have favorable effects than elimination of tariffs.[84]

3. *Sub-Group C: Agriculture.* The agricultural provisions of the Rome Treaty presented serious problems of a peculiar nature.[85] In the first place, although agricultural commodities were subject to GATT rules in precisely the same manner as other commodities, overproduction and protectionism were the rule throughout most of the temperate world. In some cases GATT rules were directly flouted and in other cases various types of internal taxes or other devices were used to interrupt the free flow of agricultural commodities.[86]

Furthermore, the Six, united in believing that even within the Community unrestricted free trade in agricultural commodities was impracticable, but unable to agree on definite policies for common administration of the agricultural sector, had included in the Treaty of Rome only very general provisions which contemplated more precise agreement at a later date. A "common agricultural policy" was to be adopted.[87] This common policy was to be implemented through a "common organization of agricultural markets"[88] which might utilize such techniques as price controls, subsidies, stockpiling and "common machinery for stabilizing importation or exportation."[89] During the transition period, each of the Member States was permitted to establish a system of minimum prices below which imports could be temporarily suspended or reduced.[90] In addition, until a common organization superseded the national agricultural organizations for a given commodity, EEC members might under certain circumstances carry on trade through long-term bilateral contracts.[91] The powers granted the Community with respect to the common organization and to the member states with respect to minimum prices and long term contracts were hedged about with a number of troublesome conditions. These conditions, while not specifically requiring new barriers to imports into the Community, nevertheless were phrased in a manner which suggested that new import restrictions might be imposed.

Agricultural exporting countries outside the EEC, concerned that their exports to the Community might be reduced, argued that the establishment of the common organization and of the transitional arrangements for minimum prices and long term contracts, were likely to be inconsistent with the admonition of paragraph 4 of article XXIV that the "purpose of a customs union . . . should be to facilitate trade between the constituent territories and not to raise barriers to trade of other contracting parties with such territories."

[84] See discussion at pp. 625–26 *supra.*

[85] Treaty of Rome, arts. 38–47 (1957).

[86] As the Executive Secretary of GATT has crisply summarized, "The legal situation . . . bears no relation to the facts." E.W. WHITE, THE FIRST TEN YEARS OF THE GATT 11 (1958).

[87] Treaty of Rome, art. 38, para. 4 (1957).

[88] *Id.*, art. 40, para. 2.

[89] *Id.*, art. 40, para. 3.

[90] *Id.*, art. 44.

[91] *Id.*, art. 45.

Whatever might occur in the course of the implementation of the agricultural provisions of the Treaty of Rome, it was difficult to show that the treaty itself violated article XXIV. The very generality of the EEC agricultural provisions and their permissive, rather than mandatory, character made clear that neither the EEC Commission nor the member states were required to take action which would violate GATT rules. In the view of the Six, if such action was taken in the future, there would then be an appropriate occasion to consider the legal questions. The upshot was that, although a majority of the members of the Sub-Group held the view that the agricultural provisions "carried a strong presumption of increased external barriers and a substitution of new internal barriers in place of existing tariffs and other measures," the majority decided that it was then impossible to determine the compatibility with the General Agreement of either the agricultural provisions or their future implementation. The majority sought to induce the Six to establish liaison machinery with the Contracting Parties concerning the implementation of the agricultural provisions but the Six refused, arguing that they should not be required to provide any information not required of other Contracting Parties. The discussions in Sub-Group C thus reached a total impasse.

4. *Sub-Group D: The Association Overseas Territories.* France, Belgium and the Netherlands came to the Rome Treaty negotiations with a series of preferential commercial arrangements with certain present and former colonies.[92] The General Agreement, while permitting continuation of these preferences, specifically prohibited any increase in the "margin of preference."[93]

It was generally conceded during the negotiations leading up to the Rome Treaty that special arrangements had to be made for these territories. As the result of hard bargaining by France, the member with by far the most extensive relations with these territories, the arrangements made were quite lavish. As "associated overseas territories" they were to receive the benefits of the progressive dismantling of intra-EEC barriers only to a limited extent. While the general rule was that the territories were to reduce import duties[94] at the same rate as the Six, they were permitted to maintain, and indeed to levy new, protective tariffs for economic development purposes and revenue tariffs for budgetary purposes, provided they proceeded systematically to eliminate any differentials in rates among members of the Community.[95]

[92] Italy also had a special relationship with the Territory of Somaliland. These arrangements were exempt from the most-favored-nation clause of the General Agreement either because they were specifically exempted in the General Agreement, or because they were between territories which were under common sovereignty on July 1, 1939. GATT, art. I, para. 2.

[93] The margin of preference is, in general, the difference as of April 10, 1947, between the preferential rate and the most-favored-nation rate. GATT, art. I, para. 4.

[94] The associated territories were not required to reduce export duties, a circumstance that produced some minor difficulties during the review by the Working Party.

[95] Treaty of Rome, art. 133, para. 3 (1957). For a detailed consideration of the overseas

Many contracting parties, particularly those exporting tropical products, were alarmed at the advantageous position granted the associated territories. These associated territories were to have tariff-free, quota-free access not only to France (or Belgium or the Netherlands, as the case may have been), but to the entire EEC market; at the same time, competing exporting nations, which formerly had sold to the remaining five EEC members on equal terms with the associated territories were to continue to face the old barriers and in some cases, as the common external tariff was adopted, even higher tariffs.[96] Since the nonmember contracting parties were more concerned with the impending injury to their own exports than with the allocation of world resources, they failed to make clearly the rather obvious point that since most of the associated territories' exports to the Six were tropical products not produced in the EEC itself, production effects were to that extent almost certainly negative. Local production in the EEC would not be hampered by competition from the associated territories, but substantial nonmember production was certain to be displaced.

When the EEC sought to justify the association arrangement as a free-trade area under paragraph 8(b) of article XXIV, many contracting parties were understandably hostile. The arrangement had neither been conceived as, nor denominated in the Rome Treaty as, a free-trade area and the EEC arguments seemed a legalistic afterthought. To many members of Sub-Group D, the arrangement was simply an extension of an existing preferential commercial arrangement and thereby a violation of the most-favored-nation clause of article I. Many of the arguments advanced against the arrangement were of dubious validity.[97] But the provisions granting the associated territories the right to retain tariffs (and indeed to impose new tariffs) against the Six appeared to conflict with the requirement of the General Agreement that tariffs be eliminated on "substantially all the trade between constituent territories." Since trade between the territories and the Six was minute compared to trade among the Six, the EEC representative was able to advance statistics showing that only 1.4 per cent of the total trade between the territories of the free-trade areas as a whole (the Six plus the overseas territories) was potentially subject

territories provisions, see Hay, *The Association of the Overseas Countries and Territories*, in 2 STEIN & NICHOLSON, *op. cit. supra* note 76, at 647.

[96] The associated territories arrangements had only a five year term and, since each member state was required to reduce tariffs and other barriers against the overseas territories only as fast as against other member states, the association arrangement would expire before all barriers had been eliminated against imports from overseas territories. But it was contemplated that the overseas territories arrangement would be renewed and thus at the end of the transition period, all barriers would be eliminated against imports from overseas territories.

[97] Examples of the less convincing arguments against the association arrangement were that article XXIV neither permitted a contracting party to be simultaneously a member of a customs union and of a free-trade area, nor permitted a free-trade area between industrialized and raw materials exporting countries.

to protective duties. Such a small percentage, it was argued, surely did not violate the "substantially all" criterion. A spirited debate followed with the nonmembers suggesting various comparisons which they considered more appropriate and the Six retorting that they could not be expected to furnish further statistics until agreement was reached on a definition of the "substantially all" criterion.

While the Six were as unbending on the legal issues as in the other Sub-Groups,[98] they did consent to a product-by-product study to determine the effects of association on other contracting parties. They stipulated, however, that such a study could not impose on them any obligations beyond the specific requirements of the General Agreement.

5. *Further Consideration of the Treaty of Rome.*

(a) *The Commodity Study.* The agreement by the Six to a commodity-by-commodity study of the impact of the overseas territories provisions upon third countries was a major break through in the direction of informed consultation. For the first time in the review of the Treaty of Rome, the discussion was brought down from lofty legalistic peaks to an expert, technical study of the concrete effects to be expected of the arrangements created by the treaty.[99]

The results of the study itself, however, were somewhat disappointing. First, of course, the study was necessarily limited by its terms of reference to a study of the effects of the overseas territories provisions and thus made no attempt to assess the effects of the Community as a whole. Second, only products imported from the overseas territories to the Six were studied; no attention was directed to exports from the Six to the overseas territories or trade among overseas territories. Third, only twelve commodities were studied,[100] and although these commodities constituted a very large percentage of total EEC imports from the overseas territories, it was not possible to say that even the total import situation had been reviewed. Fourth, the Six could not reach agreement with the majority of the Working Party[101] on the

[98] The debate became extraordinarily legalistic. For example, it was observed by certain nonmembers that article XXIV, paragraph 8(a)(i), did not include within the explicit exceptions to the "substantially all" requirement tariffs imposed for economic development purposes under article XVIII. The Six countered with the argument that paragraph 8(a)(i) also failed to mention article XXI but surely the General Agreement did not foreclose members of a free-trade area from imposing security restrictions (on fissionable materials, arms, ammunition, etc.) pursuant to that article. GATT, BASIC INSTRUMENTS, 6th Supp., at 97 (1957).

[99] For the text of the studies together with general conclusions of the Working Party, see GATT, REPORT OF THE WORKING PARTY ON THE ASSOCIATION OF OVERSEAS TERRITORIES WITH THE EUROPEAN ECONOMIC COMMUNITY INCLUDING COMMODITY TRADE STUDIES (Doc. No. 1805/Rev. 1, Adds. 1–12) (1958).

[100] Cocoa, coffee, tea, bananas, sugar, tobacco, oilseeds, cotton, hard fibers, wood, aluminum and lead.

[101] Only two members of the EEC were members of the Working Party: France and the Netherlands. Except for the United States and Greece, which apparently remained neutral throughout the discussions, the remaining members of the Working Party formed a solid

relevant principles to be applied in determining the impact of the association upon world trade in those commodities.

The last of the four limiting aspects of the report is worth more intensive consideration for the light it throws on the difficulty of assessing the future impact of a customs union or a free-trade area. The position of most members of the Working Party was simple and straightforward: The association would necessarily open to the associated territories a vast barrier-free, protected market adequate to absorb not only present production but all foreseeable production by the overseas territories as a whole in each of the twelve commodities. The effect would be, according to this analysis, to permit the associated territories to capture markets presently served by nonassociated areas; to encourage additional, and thus uneconomic, production in the associated territories with the necessary result of even further diversion of exports from nonassociated territories; and, given the necessity of third countries to find markets outside the Six in view of the increased production in the associated territories, to depress world market prices.[102]

To the Six, reasoning in this manner was reasoning in a vacuum. Harm to third countries could not be predicted without a forecast of future trends in world prices, at least through the transition period. The association would be only one factor among many determining the level of those prices. One could not overlook, the Six argued, the influence of rising world consumption which would accompany rising living standards, the stability of traditional trade patterns, or the physical, climatic and financial problems affecting production in the overseas territories. More particularly, it would be improper to ignore the rising level of consumption within the Community itself which, it was contemplated, would result from the creation of the customs union.

The majority of the Working Party defended on several grounds the procedure of attempting to isolate the influence of the association from all other influences on prices. Third countries would be entitled to participate in the fruits of rising consumption throughout the world if there were no Treaty of Rome.[103] They were, moreover, entitled to participate in the rising consump-

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front against the Six on most issues: Brazil, Ceylon, Chile, Dominican Republic, Ghana, India, Indonesia, Pakistan, Federation of the Rhodesias and Nyasaland, and the United Kingdom.

[102] Although the Six protested that no scientific study had been made of elasticity of demand in the twelve commodities under review, the majority of the Working Party clearly assumed that demand was inelastic and hence that a small increase in supply on the world market would seriously depress prices and thus have a drastic effect on national and foreign exchange earnings of primary producing countries. REPORT OF THE WORKING PARTY, *op. cit. supra* note 99, at 10.

[103] Much of such increased consumption, argued the third countries, was to be expected in state trading countries, such as the U.S.S.R. The lack of responsiveness of such countries' purchases to purely commercial factors made participation by third countries in the rising consumption of such countries uncertain. REPORT OF THE WORKING PARTY, *op. cit. supra* note 99, at 7.

tion of the Six stemming from economic integration since the expectation of such increased consumption was an essential part of the rationale underlying the customs union and free-trade area exceptions to the most-favored-nation principle in the General Agreement.

The twelve commodity studies represented the first serious attempt in the history of the application of article XXIV to reach a multilateral assessment of the economic impact of a regional grouping on nonmember contracting parties. A great deal of information was gathered, subjected to expert analysis and made available to interested countries. Those who have been dismayed at the failure of many international organizations, such as the United Nations, to be able even to address themselves to complicated economic problems without endless harangue and diatribe, should note that the Working Party's deliberations were carried on in a restrained atmosphere among experts who, while representing their respective nations' interests fully, were able to reach a surprising degree of agreement on difficult questions. The disagreements outlined above reflect primarily differences in standards. Such differences could be expected to diminish in importance if the discussions were conducted under standards set forth in a properly drafted article XXIV. The limitations in the utility of the commodity study were primarily the self-imposed limitations on its scope. Unless such a study were expanded to include all major commodities, exported to as well as imported from the overseas territories, no comprehensive judgment could be made on the impact of the overseas territories provisions of the Treaty of Rome, even assuming some delineation of standards was made in a revised article XXIV.

(b) *The Thirteenth Session.* At their Thirteenth Session in October and November of 1958, the Contracting Parties had before them not only the reports of the Sub-Groups which had met during the Twelfth Session but also the commodity-by-commodity report of the Working Party on Overseas Territories. In view of the absence of conclusions in those reports, no decision could be reached concerning the legality of the Treaty of Rome under article XXIV. Acting in the light of the recommendation of the Intersessional Committee that "it would be more fruitful if attention could be directed to specific and practical problems, leaving aside for the time being questions of law and debates about the compatibility of the Rome Treaty with article XXIV,"[104] the Contracting Parties decided that legal questions "could not usefully be pursued at the present time."[105] The legal issues were thus deferred indefinitely subject to the right of any Contracting Party to raise those issues where relevant within the context of other GATT procedures.

The legal issues, as such, were never raised again within the GATT framework. But this seeming debacle for treaty law was to prove to be progress

[104] GATT, BASIC INSTRUMENTS, 7th Supp., at 70 (1958).

[105] *Id.* at 71. For an independent study of the legal issues, see ALLEN, THE EUROPEAN COMMON MARKET AND THE GATT (1960).

both for GATT as an international organization and for the cause of freer trade in the world economy. Attention was "directed to specific and practical problems," as the Intersessional Committee had recommended, on several different levels.

(c) *The Haberler Report.* The formation of the association of overseas territories, with its inevitable far-reaching effects on world patterns of trade in primary products was an important influence in the decision of the Contracting Parties to embark upon a Trade Expansion Program. While the Program was not formally inaugurated until the Thirteenth Session in 1958, a significant first step was taken at the Twelfth Session in 1957 which appointed a group of economic experts to take stock of current trends in international trade. This report, known as the "Haberler Report" in recognition of the stature of its chairman, Gottfried Haberler, was a powerful document which profoundly influenced future activities of GATT.[106]

One of the topics considered in the Haberler Report was the effect of the EEC on world trade. In general, it was concluded that "provided that certain conditions are fulfilled the trade-creating effects in Europe should outweigh the trade-diverting effects; and in this case the higher level of industrial output and the increased level of real incomes in Europe should lead to a greater demand for raw materials and foodstuffs, part of which should increase imports from outside sources."[107] The Report urged that EEC external tariffs should be kept as low as possible through tariff negotiations with third countries in order to increase the likelihood that trade-creating efforts would outweigh trade-diverting effects (that is, that positive production effects would outweigh negative production effects).[108] The Report criticized the agricultural provisions of the Rome Treaty on the ground that they did not assure that intra-EEC trade in agricultural commodities would be freed. By permitting the EEC members to choose which commodities would be freed, the Treaty made possible "the sheltering of uneconomic forms of production."[109] The harshest criticisms were directed at the overseas territories arrangement. The freeing of trade between the Six and the overseas territories, coupled with retention of barriers against third countries, "will be predominantly trade diverting and not trade creating."[110] This conclusion:

> follows from the fact that larger imports of coffee, cocoa, tea, bananas from the French and Belgian overseas territories into the EEC cannot displace high-cost production of these commodities there, since these countries do

[106] GATT, TRENDS IN INTERNATIONAL TRADE (1958). Other members of the group were James Meade, Jan Tinbergen and Roberto de Oliveira Campos. It is interesting to note that Professor Meade, perhaps as much as any other economist, has contributed to that portion of international trade theory concerned with regional groupings. See, *e.g.*, MEADE, THE THEORY OF CUSTOMS UNIONS (1955).

[107] GATT, TRENDS IN INTERNATIONAL TRADE 116 (1958).

[108] See note 29 *supra.*

[109] GATT, TRENDS IN INTERNATIONAL TRADE 118 (1958).

[110] *Id.* at 120.

> not grow coffee, cocoa, tea and bananas. While larger importations of competitive food (and other competitive products) from the preferred areas, in addition to displacing imports from the outside world ("trade diversion"), leads to a more efficient pattern of production inside the economic union ("trade creation"), larger imports of non-competitive food following a preferential reduction in revenue duties can in the nature of the case not lead to a more efficient reshuffling of productive resources.[111]

(d) *Program for Expansion of International Trade.* The Haberler Report galvanized the Contracting Parties into unprecedented efforts to deal with some of the major problems of world trade. A Program for Expansion of International Trade was instituted and three committees were formed. In each case, although the terms of reference of the Committee were cast in general terms, the Committee considered at length the economic impact of the EEC. Committee I, dealing with the general level of trade barriers, supervised two major sets of multilateral negotiations: (1) The "compensation" negotiations required by paragraph 6 of article XXIV concerning concessions by EEC members in compensation for increases in duties resulting from the creation of the common external tariff and (2) the "Dillon round" negotiations leading to a reduction of duties on a wide range of products, the most important pair of negotiations being those between the United States and the EEC Commission.[112] Committee II, established to study the web of special protectionist devices which have increasingly removed agricultural commodities from the free-trade regime contemplated by the General Agreement, has been concerned in no small measure with the common agricultural policy of the EEC. Extensive consultations have been conducted with the EEC and may have been an important influence toward a more liberal, or at least a less illiberal, Community policy.[113] Committee III, concerned with barriers to exports of less developed countries, has been concerned with the impact of the association of overseas territories provisions of the Treaty of Rome.[114]

[111] *Ibid.* The Report recognized that, particularly if the common external tariff were kept low, the increase in consumption within the Six might eventually lead to an increase in total imports of tropical products from third countries. But even if that could be expected, as the Six had argued before the Working Party on the Overseas Territories, productive efficiency could not be said to be improved by the association arrangement. Thus, in the view of the Haberler Report, both the Six and the third countries had used improper criteria in the discussions before the Working Party on Overseas Territories.

[112] See 1 U.S. DEP'T. OF STATE, GENERAL AGREEMENT ON TARIFFS AND TRADE: ANALYSIS OF UNITED STATES NEGOTIATIONS, i–ix, 1–27 (Commercial Policy Ser. No. 186, 1962); GATT, THE ACTIVITIES OF GATT 1961–62, at 8–11; GATT, BASIC INSTRUMENTS, 8th Supp., at 101–21 (1960).

[113] GATT, BASIC INSTRUMENTS, 8th Supp., at 121–31 (1960); *id.*, 9th Supp., at 110–20 (1961); *id.*, 10th Supp., at 135–67 (1962); GATT, GATT PROGRAMME FOR EXPANSION OF INTERNATIONAL TRADE, TRADE IN AGRICULTURAL PRODUCTS (Second and Third Reports of Committee II) (1962); GATT, THE ACTIVITIES OF GATT 1961–62, at 11–13 (1962).

[114] GATT, BASIC INSTRUMENTS, 8th Supp., at 132–41 (1960); *id.*, 9th Supp., at 120–69 (1961); *id.*, 10th Supp., at 167–99 (1962); GATT, THE ACTIVITIES OF GATT 1961–62, at 14–19, 35–38 (1962).

(e) *Association of Greece with the European Economic Community.* Despite the various developments just canvassed suggesting a heightened awareness by the Contracting Parties of the factors governing the impact of customs unions and free-trade areas on the world as a whole, the formal review by GATT in 1962 of the Agreement of Association with Greece failed to reveal any fundamental departure from the earlier legalistic approach. The Association, in form a customs union to be perfected over a twenty-two-year transitional period, was subjected to much the same detailed provision-by-provision scrutiny as had been the Treaty of Rome and no consideration was given to the fundamental issue whether the Association was to be a movement toward or away from free trade. Again the Contracting Parties declined to pass on the legal issues.[115]

E. *The European Free Trade Association*

The Stockholm Convention creating the seven-nation European Free Trade Association was a British-led response to the formation of the EEC and to the breakdown of negotiations for a free-trade area composed of the seventeen members of the Organization for European Economic Cooperation.[116] That EFTA had much more limited goals than the EEC is revealed in the three principal ways in which the two regional groupings differed: (1) EFTA was a free-trade area, rather than a customs union; (2) no provisions were included in the Stockholm Convention for removing restrictions on free movement of capital and labor; and (3) agriculture, rather than being subjected to a special regulated regime, was totally excluded from the scope of the Stockholm Convention.[117]

The exclusion of agriculture (and also of fisheries) from the scope of the Stockholm Convention cast doubt on its compatibility with the requirement of article XXIV (8)(b) that duties and other restrictive regulations be eliminated on "substantially all" intermember trade. The Seven advanced a strong argument for compatibility. "Substantially all" was clearly less than "all," and if one examined the statistics, it appeared that ninety per cent of all trade would be freed from restrictions. The opposing arguments were twofold. First, whatever the statistics might reveal, the exclusion of an entire sector, particularly one as important as agriculture, indicated that the elimination of restrictions had not been extended to "substantially all" trade. Second, the ninety per cent figure was spurious because it included some five per cent of trade which would be conducted under bilateral agricultural agreements.[118] These

[115] For the Report of the Working Party, see GATT, BASIC INSTRUMENTS, 11th Supp., at 149 (1962); and for the Conclusions of the Contracting Parties, see *id.* at 56.

[116] On the abortive seventeen nation free-trade area negotiations, see *Negotiations for a European Free Trade Area,* CMD. No. 641 (1959); FRANK, *op. cit. supra* note 82, at 202–31.

[117] For the text of the Stockholm Convention, see *Convention Establishing the European Free Trade Association,* CMD. No. 1026 (1960).

[118] The bilateral agreements provided, it appears from the Working Party's Report, for removal of tariffs and other restrictions by the importing state with respect to designated commodities, and in that sense could be said to involve the elimination of trade restrictions.

bilateral agreements allegedly violated the antidiscrimination rules of the General Agreement[119] and, in any event, did not involve the kind of elimination of restrictions contemplated by paragraph 8(b) of article XXIV. In the end, no agreement could be reached within the Working Party on the "substantially all" issue.

Another dispute centered around a question which had produced an impasse in the GATT review of the Treaty of Rome—whether quantitative restrictions might be reduced among members of a regional grouping more rapidly than against nonmembers. The Seven, unlike the Six, recognized the force of the economic argument that quantitative restrictions imposed against nonmembers only would often fail to provide the desired protection for one member's weak balance-of-payments position. Where such differential treatment would be efficacious, however, the Seven insisted that they would have the requisite power under article XXIV. Criticism in the Working Party deliberations was somewhat muted, however, by the Seven's assurance—an assurance that the Six had been unwilling to give—that they "hoped" to reduce quantitative restrictions at the same rate against all countries, member and nonmember.

The Working Party could not reach agreement.[120] Indeed, those opposed to the Stockholm Convention could not even agree whether any waiver which might be granted could be justified under paragraph 10 of article XXIV or whether the Stockholm Convention so far departed from the General Agreement's concept of a free-trade area that the waiver would have to be given under the more general provisions of article XXV.[121] In view of the multiple disagreements within the Working Party, the recommendation given was that the Contracting Parties should postpone any action until their next session in the hope that the various issues could be resolved in the interim.

[119] Article XIII, paragraph 2 requires a Contracting Party, in applying import restrictions for any product, to "aim at a distribution of trade in such product approaching as closely as possible the shares which the various contracting parties might be expected to obtain in the absence of such restrictions . . . ." The Seven asserted that the agreements, despite their bilateral nature, were consistent with this and other requirements of article XIII.

[120] A good deal of the Working Party's attention was directed to two interrelated problems: (1) The criteria established in the Stockholm Convention for determining where goods imported into one member's territory from the territory of another member were not of "area origin" and hence not entitled to benefit from the elimination of interarea trade barriers; and (2) the impact on intermember trade of the Imperial Preference system maintained by the United Kingdom in its trade with the British Commonwealth. The EFTA members largely satisfied the Working Party concerning the appropriateness and workability of the provisions of the Stockholm Convention with respect to these two problems. Discussion of these subjects is omitted here because of space limitations, but there is no doubt that the means adopted to deal with the transshipment problem are of major significance in determining the potential impact of a free-trade area on third countries. See note 44 *supra;* FRANK, *op. cit. supra* note 82, at 210–20; see generally *Negotiations for a European Free Trade Area, supra* note 116, at 104–06.

[121] One consideration pointing to the latter alternative was that not all signatories to the Stockholm Convention were Contracting Parties of the General Agreement.

The Contracting Parties, unlike the Working Party, chose not to defer decision but rather refused to make any decision whatever. They stated that "there remain some legal and practical issues which would not be fruitfully discussed further at this stage" and therefore concluded that the recommendation called for by paragraph 7(b) of article XXIV could not be made. No specific recommendation was made for annual reviews of the implementation of the Stockholm Convention. In view of the great inertia which had to be overcome to induce the ECSC and the EEC to cooperate fully in ongoing consultations with the Contracting Parties concerning the implementation of their respective plans and the encouraging results of such consultations, the failure of the Contracting Parties to require annual reviews of EFTA's progress was surely a retrogressive step. The Contracting Parties did, however, "welcome" the Seven's readiness to supply further information under article XXIV(7)(b) and to engage in consultations with any Contracting Party under the general GATT consultation procedures of article XXII.

An opportunity for what amounted to a first annual review was provided, however, by Finland's limited accession in 1961 to the Stockholm Convention. Framed as an "association" between the EFTA members and Finland, its provisions were in general parallel to those of the Stockholm Convention. The Working Party appointed to review the Agreement of Association found that it raised the same issues which had produced disagreement in the Working Party reviewing the Stockholm Convention. The Contracting Parties adopted conclusions almost identical with those previously adopted with respect to the Stockholm Convention itself.[122]

F. *Latin American Free Trade Association*

The Treaty of Montevideo establishing the Latin American Free Trade Association (LAFTA) presented the Contracting Parties with an extreme instance of a problem which had run through all GATT reviews of customs union and free-trade agreements. The provisions of the Treaty of Montevideo concerning elimination of intermember tariffs were so general and the escape clauses so broad that it was impossible to determine with any certainty what action would eventually be taken by the member states. With respect to intermember barriers, the Treaty of Montevideo declared straightforwardly that the member states would "gradually eliminate, in respect of all their reciprocal trade, such duties, charges and restrictions as may be applied to imports of goods originating in the territory of any [member state]."[123] But, as we shall see, the more specific provisions of the treaty failed to indicate how that goal would be achieved and gave every reason for a suspicion that

[122] For the Report of the Working Party on the Association of Finland with the European Free Trade Association, see GATT, BASIC INSTRUMENTS, 10th Supp., at 101 (1962), and for the Conclusions of the Contracting Parties, see *id.* at 24. For the text of the Association Agreement, see CMD. No. 1547 (1961).

[123] Treaty of Montevideo, art. 3 (1960).

it might never be achieved. With respect to external barriers, the treaty provided that the members would "make every effort . . . to reconcile their import and export regimes, as well as the treatment they accord to capital, goods and services" but there was no indication that a common external tariff was contemplated and, in any event, the member states at all times represented LAFTA to be a free-trade area rather than a customs union.[124] Thus, while the Contracting Parties were expected to pass on the legal question of the compatibility of LAFTA with article XXIV on the basis of the treaty itself, the structure of LAFTA would depend entirely on the steps taken to implement the treaty.

The Working Party was thus stymied on the one hand by the impossibility of demonstrating that LAFTA would not comply with the article XXIV definition of a free-trade area by the end of the transition period and, on the other hand, by the solemn insistence by those LAFTA members which were contracting parties that they intended to live up to their obligations under the General Agreement. The Working Party, and subsequently the Contracting Parties, therefore decided that no final conclusion could be reached concerning compatibility with article XXIV. The Contracting Parties declared that "there remain some questions of a legal and practical nature which it would be difficult to settle solely on the basis of the text of the Treaty, and that these questions could be more fruitfully discussed in the light of the application of the Montevideo Treaty." LAFTA members were not required, however, to submit annual progress reports. Rather, the Contracting Parties contented themselves with noting the LAFTA members' expressions of willingness to consult with interested contracting parties of GATT under the conventional GATT consultation procedures and to provide further information in the future, albeit at unstated dates and under unstated circumstances.[125]

The LAFTA case presents most dramatically the consequences of the failure of the General Agreement to set forth appropriate standards for judging customs unions and free-trade area agreements and of the failure to provide for formal consultations on the basis of those criteria not only at the time such agreements are drawn up but also regularly throughout the period of implementation. There were substantial reasons for suspecting that LAFTA would tend to be a movement away from, rather than toward, free trade. Two dominant factors in Latin American trade prior to formation of LAFTA distinguished its character sharply from that of other regional groupings such as the EEC and EFTA. First, Latin American countries exported very few manufactured or semimanufactured products either outside Latin America or to other Latin American countries; rather exports tended to be almost entirely foodstuffs, fuels and raw materials. The second factor was that Latin Ameri-

[124] *Id.*, art. 15.

[125] For the Report of the Working Party, see GATT, BASIC INSTRUMENTS, 9th Supp., at 87 (1961), and for the Conclusion of the Contracting Parties, see *id.* at 21.

can countries traded very little with each other. The dominant trade patterns were between individual Latin American countries, on the one hand, and Europe and North America, on the other.

It is no secret that the dominant purpose of LAFTA, as conceived by those active in its formation, was to enable the member states to industrialize.[126] It seems appropriate to ask how LAFTA was expected to further industrialization. It is, of course, true that in some industries economies of scale are such that a single Latin American country could not provide a sufficiently large market to support local manufacturers. But that fact did not explain why individual Latin American countries have not developed export industries for manufacturers in the same manner as they have for certain primary commodities in which the local market might also be too small to support efficient production (petroleum and nitrates, for example). It is likely that for most manufactured products the real costs of production are much lower outside than inside Latin America. Under all of these circumstances the Contracting Parties might well have suspected that the purpose of a Latin American free-trade area, rather than to permit local industries to compete with each other so that the more efficient would capture markets from the less efficient, would be to permit local industries in one country to capture markets presently served by industries outside Latin America.

Two related incentives would lie behind the creation of such a free-trade area. First would be the protectionist purpose of extending the area of protection for local industries. Second would be the desire to change the terms of trade and thereby to accomplish a wealth transfer from nonmembers to members. These two types of advantages are quite unlike the gains to be achieved by a free-trade area which has the effect of permitting local industries within the area to compete with one another, thereby assuring that production of each product within the area is conducted by the lowest-cost producer. The primary purpose of the latter form of free-trade area is to release the forces of competition within the area, thus promoting the division of labor which is the *raison d'être* of competition and free trade. The production effects of the former regional grouping will primarily be negative while the production effects of the latter will primarily be positive.

That the Contracting Parties had reason to suspect that the Treaty of Montevideo would establish a free-trade area of the former kind becomes even clearer when one analyzes the treaty's provisions. Thus, the basic obligation undertaken by the member states was to grant each year "reductions in duties and charges equivalent to not less than eight . . . per cent of the weighted average applicable to third countries, until they are eliminated in respect of substantially all of its imports from the Area, in accordance with

[126] This is the overriding theme, for example, of an outstanding defense of LAFTA by a well-known Mexican economist. See URQUIDI, FREE TRADE ECONOMIC INTEGRATION IN LATIN AMERICA (1962).

the . . . Protocol."[127] The formula set forth in the Protocol, however, includes within the relevant duties and charges for the purpose of the annual eight per cent reduction only those on products actually imported from within the area during the preceding three-year period.[128] The effect of the formula was to exclude from a member's duty to reduce intermember tariffs any products in which local production had been sufficient in the past to supply local needs. A member state had no incentive to reduce a protective tariff which was so high as to exclude all imports, whereas there was a strong incentive to reduce revenue tariffs on products not produced locally where there were some imports from member states in the past. Thus, the duty to reduce intermember tariffs was so formulated as to assure that the effects of such reductions would rarely be to divert production from local sources to member sources.

Furthermore, a large number of exceptions and savings clauses were included which were intended to assure that protection afforded local industries would not be lessened by the creation of the free-trade area. Thus, in determining the relevant products for application of the formula, each member state was permitted "to exclude products of little value . . . provided that their aggregate value did not exceed five per cent . . . of the value of imports from within the Area."[129] This exemption of up to five per cent of imports from member states could prove to be very important in protecting local industries which have in the past faced some import competition from member states. With respect to agricultural commodities (which constituted the overwhelming bulk of intermember trade), a member state could apply nondiscriminatory tariffs where necessary to eliminate the differences between local and import prices and quantitative restrictions where necessary to limit imports to the quantity by which local production fell short of local consumption. In other words, with respect to the great bulk of commodities entering into intermember trade, there was no duty whatever to increase imports at the expense of local production.

The member states were permitted, moreover, to enter into agreements for increased trade in agricultural commodities provided "priority" was granted to commodities originating within the area. This provision permitted agreements between the member states to purchase agricultural commodities from one another on a basis which discriminated directly against nonmember countries. The production effects of such an agreement could only be negative. Finally, the member states could by agreement permit member states "at a relatively less advanced state of economic development" to impose nondiscriminatory barriers where necessary to protect local production of any kind,

[127] Treaty of Montevideo, art. 5 (1960).

[128] Protocol No. 1, to Treaty of Montevideo, tit. I. See Mikesell, *The Movement Toward Regional Trading Groups in Latin America*, in HIRSCHMAN, LATIN AMERICAN ISSUES 125 (1961).

[129] Protocol No. 1, to Treaty of Montevideo, tit. I, art. 7. It should be noted, of course, that this provision is only applicable during the interim period.

provided such barriers did not decrease local consumption. Thus, the reduction of barriers by the less developed member states might well be limited solely to products in which there is no local production whatever.

By emphasizing those portions of the Treaty of Montevideo which tended to increase the likelihood that the effect on allocation of world resources would be negative, it is not meant to suggest that the Contracting Parties were irrational in failing to attempt to block the formation of LAFTA. Support for LAFTA might rest, rightly or wrongly, either on political or on economic grounds. The economic grounds might be those which apparently motivated the LAFTA members—that the dynamic effects of industrialization would in the long-run outweigh any misallocation of world resources.[130] For either of these two classes of reasons the Contracting Parties might have been willing to incur the costs in misallocation of resources. This is not the place to attempt to measure either the extent of the misallocation or the validity of the industrialization theory of economic development which motivated the LAFTA members. What is significant in the context of the present analysis is that the approach adopted under article XXIV makes it impossible for the Contracting Parties to assess the magnitude of those costs. Certainly it is only after such an assessment is made that an intelligent decision can be reached concerning the compatibility of the Treaty of Montevideo with the principal objectives of the General Agreement.

V. Conclusion

We have reviewed article XXIV from three general points of reference. First, we have examined the meaning of the article as presently drafted and have found it ambiguous at best. Second, we have attempted to assess the soundness of the standards announced in the light of the underlying conflict between the most-favored-nation principle of article I and the discrimination inherent in customs unions and free-trade areas. Here the conclusion has been that article XXIV makes very little sense and that quite different standards should be adopted. Third, we have reviewed the experience of the Contracting Parties in applying article XXIV.[131] In attempting to reach general conclusions concerning article XXIV, it would be appropriate to determine what generalizations may be made concerning this historic record.

On first impression the historical record is a sorry one indeed. Not a single customs union or free-trade area agreement which has been submitted to the Contracting Parties has conformed fully to the requirements of article XXIV.

[130] See H.G. Johnson, *The Cost of Protection and the Scientific Tariff*, 68 J. Pol. Econ. 327, 339–40, 343 (1960).

[131] The review by the Contracting Parties of the Central American Common Market has not been analyzed here since, for a number of technical reasons, it has not to date been subjected to full scrutiny under article XXIV. See Report of the Working Party, GATT, Basic Instruments, 10th Supp., at 98 (1961); Decision of the Contracting Parties, *id.* at 48; GATT, Basic Instruments, 5th Supp., at 29 (1956) (earlier decision).

Yet the Contracting Parties have felt compelled to grant waivers of one kind or another for every one of the proposed agreements.

It cannot necessarily be concluded, however, that article XXIV has been of no consequence whatever. The desire to avoid unnecessary friction with other contracting parties may have been a marginal influence on the structure of new customs unions and free-trade areas. It is impossible, of course, to know what form those regional groupings would have taken in the absence of article XXIV. Only in the case of the Latin American Free Trade Association do we have concrete evidence available. Since most of the early planning was done under the auspices of the United Nations Economic Commission for Latin America, we have available a public record which suggests that a desire to comply with article XXIV, or at least to come respectably close to complying, was widely held among those who attended the planning sessions.[132] It may be that, but for article XXIV, a preferential trading arrangement with partial reduction of internal tariffs would have been chosen in preference to a free-trade area with complete elimination of internal tariffs.

Even assuming that article XXIV has had a significant influence on the structure of recent customs unions and free-trade areas, it does not necessarily follow that that influence has been uniformly beneficent. If, for example, as appears to this writer, the overseas territories provisions of the Treaty of Rome and the Latin American Free Trade Association as a whole will have, on balance, unfavorable production effects, it may well be that the requirement of article XXIV that internal restrictions on substantially all trade among member countries be eliminated has had an unfortunate influence. Partial reduction of internal barriers might well have been preferable to complete elimination from the viewpoint of the world as a whole for the reasons examined above.[133] The foregoing analysis suggests that, however feeble article XXIV may have been as a juridical rule in outlawing nonconforming regional economic agreements, the errors in policy underlying the article's formulation have had unfortunate consequences for the world as a whole.

Quite aside from any influence on structural planning, article XXIV, by proving in practice to be a barrier to summary GATT approval, has forced the members of some nascent regional groupings to discuss their plans at length within the GATT framework and to report yearly on the implementation of such plans. These consultations have not only been an important dispute settlement mechanism but also, by making available detailed information concerning the successes and difficulties of the various regional organizations, have dissipated ignorance and jealousy which might have led to serious disputes. But because article XXIV has been built on mistaken policy founda-

[132] ECONOMIC COMMISSION FOR LATIN AMERICA, LATIN AMERICAN COMMON MARKET 93–97, 100–02, 115–24 (U.N. Doc. No. E/CN. 12/531) (1959); URQUIDI, *op. cit. supra* note 126, at 62–73.

[133] See discussion at pp. 629–36 *supra*.

tions, the discussions have not always been addressed to issues which would have been the most fruitful from the viewpoint of the world as a whole. The issue in the discussions has all too often been whether particular nonmembers will be adversely affected, rather than whether the regional grouping will improve the allocation of world resources.

In reviewing the historical record, one is inclined to dismiss GATT as even a potentially effective force in regulating the formation of customs unions and free-trade areas. GATT, as an international organization, is indeed very weak. There are no judicial, arbitral or other formal dispute settlement mechanisms built into it. Nor does GATT have power to impose sanctions for violation of the General Agreement. History makes one dubious of the possibility of strengthening the organization. The General Agreement was not intended, of course, to be the charter of an international organization. It was in conception a multilateral trade agreement designed to preserve the fruits of a general tariff reduction pending the creation of the International Trade Organization. When ITO proved stillborn, the General Agreement was seized upon as the most convenient existing framework in which to pursue the objectives of the ITO.[134] Since the institutional structure planned for ITO did not exist in the GATT, it was only with some ingenuity that a modest Secretariat could be organized and intersessional procedures devised to provide some continuity between the periodic meetings of the Contracting Parties. Amendments to the General Agreement intended to provide more administrative centralization were decisively rejected by the United States Senate in 1955, even though no provision for sanctions or for arbitral or quasi-judicial sanctions was included. Given this history, any attempt to reform article XXIV must surely accept the severe institutional restraints under which GATT functions as the point of departure.

Even if one is so pessimistic as to hold that GATT is hopelessly ineffective and that any restraints on the structure of new customs unions and free-trade areas must operate within the context of traditional diplomacy, the revision of the standards of article XXIV and extension of GATT consultation procedures would be a useful step forward. If the only effect of such changes were to raise the level of public discourse concerning the impact of regional economic arrangements on the world as a whole, the changes would be worth the making. An improvement in both the objectives and the efficacy of traditional diplomacy in assessing and dealing with economic regionalism might follow. It must be recognized therefore that if disputes are to be settled within the GATT framework, it must be by consultation. In any revision of article XXIV it would be preferable to make the best of these unfortunate circumstances by requiring formal consultation among interested Contracting Parties prior to the entry into force of any customs union or free-trade area agree-

[134] On the demise of the ITO, see GARDNER, STERLING-DOLLAR DIPLOMACY 348–80 (1956).

ment. In the case of interim agreements, yearly consultations should also be required, such consultations to be based on annual reports concerning progress and future plans by the customs union or free-trade area. In order to assure that these consultations, unlike the consultations we have reviewed above, are directed to the questions which are most relevant from the point of view of all Contracting Parties, the revised article XXIV should set forth in some detail the criteria for judging whether a proposed customs union or free-trade area is a movement toward or away from free trade. We have tried to suggest some appropriate standards in Part III above.

All consultations would be held within the GATT framework with the Secretariat perhaps acting as a mediating body. Such an institutionalized consultative procedure, conducted in the light of previously agreed-upon standards, would be to consult in good faith on the basis of the specified standards, but there would, of course, be no obligation to reach any particular agreement.

Perhaps revision of article XXIV is impossible at this time, particularly in view of the large number of contracting parties which are members of existing customs unions or free-trade areas and which therefore have a vested interest in the legal status quo. In that event, some progress might be made within the context of the existing formulation of article XXIV by a reinterpretation of its provisions by the Working Parties assigned to review new regional arrangements. The very ambiguity of article XXIV provides an opportunity if primary emphasis can be placed on the statement in paragraph 4 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."[135] It has been the burden of the analysis undertaken here that a regional arrangement with negative production and consumption effects tends "to raise barriers to the trade of other contracting parties" whether or not it meets the tests laid down in the remaining paragraphs of article XXIV while a regional arrangement with positive production and consumption effects facilitates intermember trade without raising such barriers. Barring revision, the best approach may thus be a creative reinterpretation of article XXIV.

APPENDIX

PROVISIONS OF ARTICLE XXIV RELEVANT TO CUSTOMS UNIONS AND FREE-TRADE AREAS

4. The contracting parties recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of close integration between the economies of the countries parties to such agreements. They

[135] A construction of article XXIV which would place primary emphasis on paragraph 4 while treating paragraphs 5 to 9 as an illustration of possible approaches to the basic test of paragraph 4 was advanced by certain members of Sub-Group A considering the Treaty of Rome. See GATT, BASIC INSTRUMENTS, 6th Supp., at 71 (1957).

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.

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

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

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

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

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

7. (a) Any contracting party deciding to enter into a customs union or free-trade area, or an interim agreement leading to the formation of such a union or area, shall promptly notify the CONTRACTING PARTIES and shall make available to them such information regarding the proposed union or area as will enable them to make such reports and recommendations to contracting parties as they may deem appropriate.

(b) If, after having studied the plan and schedule included in an interim agreement referred to in paragraph 5 in consultation with the parties to that agreement and taking due account of the information made available in accordance with the provisions of sub-paragraph (a), the CONTRACTING PARTIES

find that such agreement is not likely to result in the formation of a customs union or of a free-trade area within the period contemplated by the parties to the agreement or that such period is not a reasonable one, the CONTRACTING PARTIES shall make recommendations to the parties to the agreement. The parties shall not maintain or put into force, as the case may be, such agreement if they are not prepared to modify it in accordance with these recommendations.

(c) Any substantial change in the plan or schedule referred to in paragraph 5(c) shall be communicated to the CONTRACTING PARTIES, which may request the contracting parties concerned to consult with them if the change seems likely to jeopardize or delay unduly the formation of the customs union or of the free-trade area.

8. For the purpose of this Agreement:

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

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

(ii) subject to the provisions of paragraph 9, substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union;

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

9. The preferences referred to in paragraph 2 of Article I shall not be affected by the formation of a customs union or of a free-trade area but may be eliminated or adjusted by means of negotiations with contracting parties affected. This procedure of negotiations with affected contracting parties shall, in particular, apply to the elimination of preferences required to conform with the provisions of paragraph 8(a)(i) and paragraph 8(b).

10. The CONTRACTING PARTIES may by a two-thirds majority approve proposals which do not fully comply with the requirements of paragraphs 5 to 9 inclusive provided that such proposals lead to the formation of a customs union or a free-trade area in the sense of this Article.