Negotiating free-trade agreements: a guide

Australian Government

Department of Foreign Affairs and Trade

Negotiating free-trade agreements: a guide

Walter Goode

ISBN 1 920959 55 6

Disclaimer

This publication has been prepared to support the conduct of workshops on negotiating free-trade agreements organised under the AusAID APEC Support Program. It does not represent the views of either the Australian Government, the Australian Department of Foreign Affairs and Trade or the Australian Agency for International Development.
While every care has been taken in ensuring the accuracy of the information provided, the Department of Foreign Affairs and Trade, its officers, employees and agents, accept no liability for any loss, damage or expense arising out of, or in connection with, any reliance on any omissions or inaccuracies in the material contained in this publication.

APEC Branch
Department of Foreign Affairs and Trade
R G Casey Building
John McEwen Crescent, Barton
Canberra ACT 0221

Telephone: (+61) 2 6261 1111
Facsimile: (+61) 2 6261 3009
E-mail: apec@dfat.gov.au
Internet: http://www.dfat.gov.au

Contents

Preface

This guide is a practical introduction to the negotiation of free-trade agreements. It is aimed particularly at those who may be involved in such negotiations for the first time, and it seeks to explain the main negotiating steps needed to arrive at an agreement and to make it enter into force.

The guide does not seek to be normative. Its purpose simply is to draw attention to issues that may arise in the course of free-trade negotiations and to suggest ways in which they may be handled. It does not describe matters from the perspective of a single economy, and it does not concern itself with negotiating techniques. All of the examples given in the text are taken from free-trade agreements in force between member economies of APEC.

This guide arose from workshops on free-trade negotiations in Beijing and Bandar Seri Begawan in December 2004. These workshops were organised by the Australian Department of Foreign Affairs and Trade as part of its capacity-building activities in APEC. The workshops were funded by AusAID (Australian Agency for International Development) under its APEC Support Program.

They were hosted by the Chinese Ministry of Commerce (MofCom) and the Brunei Ministry of Industry and Primary Resources (MIPR). Mr Zhang Shaogang of MofCom and Mr Philip Chong of MIPR supervised the preparations for the workshops and participated actively in them.

The workshops covered the entire history of a typical free-trade agreement. They began with the reasons why economies decide to conclude free-trade agreements. They then explored the nature of the preparations an economy needs to make, both in terms of policy development and formation of a negotiating team, to run a good negotiation.

The greater part of the workshops was concerned with the possible content of a comprehensive free-trade agreement (i.e. one covering goods, services and investment) and the rules applicable to these areas. The workshops also examined approaches to issues such as competition policy, government procurement and intellectual property. The last part of the workshops covered the formal and informal processes to bring the agreement into force, as well as selected aspects of implementation. The content of this guide pretty well follows the program for these workshops.

The main workshop presenters were Andrew Stoler of the Institute for International Business, Economics and Law at the University of Adelaide, Peter Gallagher of Inquit Communications in Melbourne, and Walter Goode of the Department of Foreign Affairs and Trade. Arrangements for the workshops were coordinated by Claire Elias, also of the Department of Foreign Affairs and Trade.

In February 2005 we organised a follow-up workshop under the auspices of the APEC Market Access Group (MAG) which gave us a further opportunity to discuss with representatives of all APEC members the question of the relationship between preferential rules of origin and market access. The speakers at that workshop were Antoni Estevadeordal of the Inter-American Development Bank, Michael Ferrantino of the United States International Trade Commission, Ken Miley of the Australian Department of Industry, Tourism and Resources, Jim O'Connor of the American Chemistry Council and Barbara Norton of the Office of the United States Trade Representative.

Acknowledgements

The following made many helpful comments and suggestions during the drafting of this guide: Andrew Stoler of the University of Adelaide; Rachel Fry, Mark Pearson and Penny Ridings of the New Zealand Ministry of Foreign Affairs and Trade; John Arndell of the Australian Customs Service; Roy Nixon of the Australian Department of the Treasury; Mike Loudon and Mike Rombouts of the Australian Department of Finance and Administration; and Chris DeCure, Stephen Deady, Bruce Gosper, David Livingstone, Hamish McCormick, Remo Moretta, Paul Myler and Elizabeth Young, all of the Department of Foreign Affairs and Trade (DFAT).

1. Before the negotiations begin

What to do before the negotiations begin?

Preparing well for the negotiations makes the actual negotiations a more manageable undertaking. This is the time to work out the negotiating objectives. It is also the time to identify, both at home and in the partner economy, businesses, industry associations and other non-government organisations, such as consumer bodies, that may have an interest in the agreement and to seek their views on what it should contain. Their support later in the negotiations will become very important. All involved need to understand that a free-trade agreement rarely can solve all bilateral market access issues. Some systemic issues may only be capable of a solution in a multilateral setting. Thought needs to be given to the formation of a negotiating team and the resources to be allocated to it. Finally, this also the time to consider what has to be done once the negotiations are over.

The rush globally towards concluding preferential trade agreements shows no sign of slowing down. All APEC economies have now either concluded preferential trade agreements, are currently negotiating one or more of them, or are at least examining the possibility of entering into negotiations, in many cases with other APEC economies.

Box 1.1: The main forms of preferential trade arrangements

Four main forms of preferential trade arrangements are in use. They are listed here in order of the depth of economic integration they promote.

- **Free-trade agreement:** two or more economies eliminate tariffs against goods originating within these economies. Each economy retains its own tariff and the right to conduct its own trade policy. The result is shallow integration. Preferential rules of origin have to be devised to allow identifying originating goods. It is increasingly common for such agreements to include provisions liberalising trade in services and investment flows also, but not the depth or extent met in the case of common markets (see below.
- **Customs union:** two or more economies eliminate all tariffs against goods originating within these economies. They negotiate a common external tariff and conduct a common commercial policy. Since all partner economies apply the same external tariff on goods, there is no need to develop preferential rules of origin. Integration is deeper than under free-trade agreements. A customs union agreement can of course also contain provisions for services and investment.
- **Common market:** two or economies apply common economic, monetary and commercial policies and create a single market for goods and services. Investment and people are allowed to move freely between the parties. Trade policy is conducted within a customs union. The result is deep integration. Other names for a common market are single economic space and economic union.
- **Economic and monetary union:** members adopt a common currency and pursue common macro-economic policies in addition

to unrestricted flows of goods, services and investment.

Most of these preferential agreements are free-trade agreements, but more ambitious proposals for economic integration, such as common markets, economic communities, economic unions and single economic spaces, are also being proposed. Fewer economies are pursuing the establishment of customs unions which lead to greater integration than is the case for free-trade areas, but not to the deep integration occurring in economic unions. We briefly examine the differences between free-trade areas and customs unions on pages 4 and 5.

This booklet is not concerned with economic complementarity agreements and partial scope agreements, concluded by some economies under the Enabling Clause (see Chapter 3). These agreements are sometimes called free-trade agreements, but typically they seek to solve only a limited range of specific issues. Sometimes they do not deal at all with difficult areas. They therefore fall outside the broad-based free-trade agreements meeting the requirements of Article XXIV of the GATT.

Some economies prefer to conclude Trade and Investment Framework Agreements (TIFAs) and other economic cooperation agreements as a first step towards free-trade agreements. Such agreements typically do not contain any market access provisions, though they often establish mechanisms for the promotion of trade liberalisation. None of these agreements fall, however, in the category of preferential trade arrangements.

Reasons for concluding free-trade agreements

There are many reasons why economies embark on free-trade negotiations. They include economic, political and strategic factors. Among the main reasons are:

- the search for improvements in market access;
- promotion of economic policy reforms;
- achievement of trade liberalisation more quickly than would be the case in multilateral negotiations;
- fostering strategic linkages; and
- the fear of being at a competitive disadvantage in a situation where competitors negotiate free-trade agreements; this is sometimes known as the *domino effect*.

APEC members also increasingly see free-trade agreements as one way to achieve the Bogor Goals of free and open trade and investment in the APEC region by 2010 for developed economies and 2020 for developing economies.

The widening ambit of free-trade agreements

One interesting thing is that the ambit of free-trade agreements has become very wide. All of them of course cover tariffs and non-tariff measures. In most cases they do this without raising their barriers against third countries.

Few agreements now confine themselves to goods only. Most include services, and coverage of investment is now quite common. In fact, most economies now strive to conclude what they call "comprehensive agreements".

Economies also aim to maximise the benefits of a free-trade agreement by having, for example, provisions on protecting intellectual property rights, promoting competition, opening government procurement to suppliers from partner economies, promoting the use of paperless trading, promoting more cost-efficient trade procedures and instituting other forms of cooperation.

This means is that free-trade agreements have become quite bulky documents involving a large number of ministries and agencies in their preparation and the eventual administration. Actually, the text of the main agreement is in most cases reasonably short. What makes many agreements so voluminous is the attached schedules of commitments for tariffs, services, investment, government procurement and the rules of origin. We explain later what all of these instruments are.

Box 1.2: What is a comprehensive free-trade agreement?

There is no common definition of a comprehensive free-trade agreement. However, many recent agreements have included provisions on all or many of the following topics:

- trade in goods, including trade remedies (safeguards, anti-dumping measures and countervailing duties)
- customs procedures
- rules of origin
- technical barriers to trade
- sanitary and phytosanitary measures
- electronic commerce
- trade in services
- trade in financial services
- trade in telecommunications services
- investment
- movement of natural persons
- intellectual property
- competition policy
- government procurement
- transparent administration of laws and regulations
- consultations and dispute settlement

Some comprehensive agreements also include chapters on labour and environment, but this not a standard approach.

Appendix 5 contains a stylised free-trade agreement which explains the provisions that might be included under each of these topics in more detail.

Widening the ambit of negotiations has consequences. Among these are more complex negotiating mandates and consultation processes. We address these and related topics later in this guide.

Why not consider a customs union?

One option open to economies is the formation of a customs union. Few, however, seem to be attracted to this option. Examples of customs unions are the European Union, Mercosur and the Southern African Customs Union (SACU).

Customs unions, like free-trade areas, are made up of two or more customs territories. In both cases, the parties must eliminate tariffs and other restrictive regulations of commerce on substantially all the trade between them. An important difference is that the members of a customs union have to negotiate a common external tariff which, overall, must not have a greater impact on third countries than the separate tariffs had. A consequence is that they must operate a common commercial policy since, obviously, unilateral tariff changes are no longer possible. In a free-trade area each party retains its own tariff towards third countries.

Another consequence of the creation of a customs union is that it does not need preferential rules of origin. The parties only use the non-preferential (or MFN) rules of origin applicable to all goods imported under the MFN tariff. Once a good has been admitted into the customs union by a party, it can move freely to another party without the need to pay additional customs duties. This may not be quite true when customs unions are established over time, i.e. when some tariffs between the parties are eliminated in stages. This, however, is a passing phase.

Box 1.3: Free-trade areas and customs unions: a comparison

Free-trade areas	***Customs unions***
• Two or more customs territories form a free-trade area	• Two or more customs territories for a customs union
• Elimination of tariffs and other restrictive regulations of commerce on substantially all the trade between the parties	• The same as for free-trade areas
• Each party maintains its own tariff towards third countries	• The parties adopt a common external tariff.
• Each party is free to pursue its own commercial policy, also known as trade policy.	• The parties adopt a common commercial policy
• Imposition of anti-dumping or safeguards measures against the other party is an option.	• Normally no anti-dumping or safeguards measures against the other party, but use in some cases of competition laws instead.
• Preferential rules of origin are needed for governing the trade	• No need for preferential rules of origin; the parties use non-

between the parties.	preferential (or MFN) rules of origin towards third countries; once foreign goods have been admitted by one party, they can be freely transferred to the other party.
• A free-trade agreement leads to shallow integration of the member economies.	• A customs union leads to deeper, but not deep, integration.

One reason for the limited popularity of customs unions may be the reduced flexibility they allow members in the conduct of their trade policy (i.e. their commercial policy). Considerable interaction between the parties will be required once the agreement is in force because, for example, there may be a need to consider, from to time, whether to impose anti-dumping or safeguards measures against third countries. If only one of the partners imposed such measures, they could easily circumvented. Any proposed adjustments to the tariff schedule also would need to be discussed together.

The negotiating effort required for free-trade areas and customs unions is probably about the same. The need to negotiate a common external tariff probably balances the absence of the need to develop preferential rules of origin.

What about the "spaghetti-bowl" effect?

Much has been made in recent comment on the impact of free-trade agreements on the global trading environment of the so-called "spaghetti-bowl" effect. The effect is said to be a result of the growing number of free-trade agreements, and their overlapping in some cases. This is thought by some to lead to added complications for traders and administrators and to increase the cost of trading. It is likely, however, that some of these claims are overstated.

It is true that no two free-trade agreements are exactly the same. Economies concluding them have considerable freedom in what they include and what they leave out. What all free-trade agreements do, however, is to make trading conditions between the partners less onerous to some extent than they would be under normal, i.e. most-favoured-nation (MFN), conditions.

It would probably be hard to find a recent free-trade agreement that has made trading conditions more onerous either for the parties or for outsiders. Of course, the formation of customs unions may lead in some cases to some higher tariffs towards non-members because of the need to negotiate a common external tariff, but there are well-established WTO procedures for obtaining redress in such cases. It is worth noting, too, that one of the aims of the APEC best-practice principles for RTAs/FTAs (see Chapter 2) is to minimise the incidence of adverse effects on traders and economies and to reduce the scope for agreements resulting in unnecessary or overly restrictive rules.

Free-trade trade agreements give the partner economies and the businesses operating within them an additional choice for conducting their trading relations. The MFN system remains available even after a free-trade agreement has entered into force.

The erosion of preferences

Another aspect to consider is that the trade-related value of free-trade agreements, i.e. the value of the preferences, gets eroded over time. The theoretical margin of preference available under some of these schemes is now larger for many products than the applied, or even the bound, tariff. In other words, the margin of preference can become increasingly meaningless in practical terms. The results of the Doha Development Round (DDA) negotiations will make this even more obvious.

Preference erosion is one major reason why free-trade agreements need to go beyond tariff elimination if they are to result in maximum benefits for the participating economies. Accordingly, many free-trade agreements attach great importance to liberalised investment provisions and to opening up reciprocally their government procurement markets.

Preference erosion occurs in two ways. One is that governments, as just mentioned, continue to lower their most-favoured-nation (MFN) tariffs, either unilaterally or through multilateral trade negotiations. Each time they do this, the margin of preference is getting smaller. The tariff-related value of a free-trade agreement will disappear altogether when a free-trade partner has eliminated all the MFN tariffs on goods of interest to one's own economy. When this is the case, the expected benefits of a free-trade agreement have to be sought elsewhere, such as in improved investment flows.

Box 1.8: The diminishing value of preferences: tariff rates

One way to look at the changing value of trade preferences over time is to proceed from the level of average tariffs.

For example, at the beginning of the Kennedy Round (1963) the average MFN tariff on non-agricultural goods levied by the United States was 13.5%. At the end of the Round it was 9.6%. The figures for Japan were 15.5% and 8.1%, respectively.

Source: Preeg, 1970

Average MFN tariffs by the United States at the beginning of the Uruguay Round (1986) were 4.4.%. This fell to 1.9% as a result of the negotiations. The figures for Japan were 6.2% and 3.6%, respectively.

Source: Martin and Winters, 1995

These figures show clearly how the margin of preference available through the zero tariff of a free-trade agreement has become much smaller as a result of successive rounds of multilateral trade negotiations. This is one of the reasons why economies increasingly seek benefits beyond tariff elimination when they negotiate agreements.

The other way the value of preferences diminishes over time stems from the increasing number of free-trade agreements entering into force. In the theoretical environment of a single bilateral free-trade agreement between two middle-ranking economies in a multilateral world, the value of the preferences to the partners would clearly be high. This value would of course still depend on the difference between the preferential tariff and the multilateral tariff and the ability of the partners to supply relevant goods.

However, in a world where many economies exchange preferences in an environment of falling tariffs, the value of each preference may be quite small and easily balanced by more efficient production, economic or trading and distribution systems. As we have noted earlier, this situation then forces business to make a choice between the preferential and the MFN frameworks.

Preferential trade is also conducted under the GSP (Generalised System of Tariff Preferences), the GSTP (Global System of Trade Preferences) and many asymmetrical (one-way) free-trade agreements. Among these are the ACP-EC Partnership Agreement, SPARTECA (South Pacific Regional Trade and Economic Cooperation Agreement), the Caribbean Basin Initiative (CBI), the Andean Trade Preference Act (ATPA) and the zero-tariff arrangements for least-developed countries established by developed economies. All of these give preferences to some economies and reduce the amount of trade conducted under MFN conditions.

Box 1.9: The diminishing value of preferences: trade flows

The share of global trade conducted under MFN (most-favoured-nation) conditions has grown smaller over the years. This is not only because of the spread of free-trade agreements and other reciprocal preferential arrangements. Much trade is now subject to preferential tariffs under one-way preferential trade arrangements.

In 1990 about 10% of global trade was conducted under regional trade agreements. By 2002 this had risen to about 30%.

Another way of looking at this is from the perspective of the number of regional trade agreements. In 1960 there were fewer than five of them. By 2004 the number had risen to about 250, but it depends on how they are counted.

Source: World Bank 2004

The value of the preferences under any given agreement may of course be considerable. Looking at it in a more generalised way, the reality can be different. For example, the World Bank noted in *Global Economic Prospects 2005* that the amount of global trade taking place under an economically meaningful tariff preference is now about 15%.

The effect of a free-trade agreement on business

One test of the usefulness of free-trade agreements is whether they promote regional economic integration. A mercantilist approach that seeks to balance tariff elimination or that seeks to protect inefficient sectors (the so-called sensitive sectors) will not yield the desired result even if the formal rules for free-trade agreements (see Chapter 3) are met. Nor will the aim of seeking strict balances (or reciprocity) within chapters of an agreement lead to useful results.

Negotiators must remain aware in all cases that the agreement they are drafting should result in an easier trading environment. If they do not succeed in this, the business community probably will not persist in struggling with its complexities. More likely, it will simply ignore the agreement, and an opportunity to enhance growth and integration will then have been lost.

Free-trade agreements affect business in another important way. Many businesses have established long-term relationships with suppliers and buyers in other economies. Often, a considerable investment has gone into developing these relationships. If it happens that a business relationship coincides with the free-trade agreement, the relationship will probably become more valuable. If, on the other hand, another economy now enjoys a considerable margin of preference, the business may be forced to form a new relationship with a company within the free-trade area. The transaction cost of achieving this should not be underestimated. It may well be possible for the business partners to absorb small cost differences and continue their relationship. If, however, the margins of preference have a considerable commercial impact, companies may have to decide what the best way to proceed in their case may be. Either way there will probably lead to additional costs for the company.

A free-trade agreement is certain to increase competitive pressures on some businesses. Some goods produced by foreign competitors will no longer have to face tariff barriers. This can force adjustments on producers in the importing economy. On the other hand, a free-trade agreement can also help domestic producers to become more efficient because some imported components will be less expensive than they were before the agreement entered into force. Both of these effects benefit the consumer.

However, the benefits of a free-trade agreement go wider than this. For example, export-oriented producers benefit from improved market access in the partner economy, and they will be more competitive in third countries because of a reduction in some of their input costs. These benefits will be strengthened if the agreement seeks at the same time to reduce the costs for business of trade procedures. Trade administrators gain from clearer trade rules and the greater transparency promoted by free-trade agreements.

Making sure that everyone is informed

Free-trade agreements can affect many areas of an economy, and it is not always possible at the start of negotiations to identify these areas, partly because the complete ambit of the negotiations may not become clearer until one or two negotiating rounds have been held. For this reason, many economies launch a program of consultations as early as possible before the negotiations get under way. They do this through placing newspaper advertisements, convening public hearings, putting information on departmental websites and writing directly to groups expected to be interested in the negotiations with the twin aims of informing them of objectives of the negotiations and possible timetables as well as seeking their preliminary views on the possible content of the proposed agreement.

The range of groups and organisations approached in this way will obviously depend on the economy concerned and the type of agreement envisaged. If, for example, the aim is an agreement limited to goods, the range of services providers that need to be consulted is more narrow than would be the case in an agreement covering goods and services. But in the case of a genuinely comprehensive agreement the range of possibly interested organisations and individuals will grow very large. Box 1.4 gives an indication of the range of organisations that may have to be consulted.

Equally important is the need to consult all government departments, ministries or agencies that may be affected by the operation of a free-trade agreement. Here also it is better to consult more widely than may be obvious at first glance. Often, several agencies have an interest in the handling of a policy item. Again, in the case of comprehensive agreement it may be wise to assume that all departments or ministries will have an interest in the negotiations. Additionally, this process often leads to the early discovery of domestic laws and policies that could complicate the negotiations.

Box 1.4: The need to consult widely

Many people and organisations outside the government will be affected by a new free-trade agreement. Some will have to be consulted or are known to have a wish to be consulted. Who is included in that depends on the conditions in a particular economy, but the following list, in alphabetical order, could be a start:

- agricultural producer and farming associations
- chambers of commerce and industry
- consumer bodies
- education and training providers
- importer and exporter associations
- industry associations
- intellectual property associations
- interest groups of various kinds
- professional associations
- standard-setting bodies

Another reason for wide consultations within a governmental apparatus is the need for the negotiating team to arrive at, and maintain, negotiating objectives reflecting the interests of all departments or ministries. In other words, it is necessary to develop a whole-of-government position. It is always worth bearing in mind that some government departments may be more inward-looking than others because of the range of their responsibilities.

A whole-of-government position does not mean that one agency seeks to impose its views on the negotiating process. Rather, it means that all those who are a given a negotiating role, be it as chief negotiator or as lead negotiator for a particular issue, understand clearly what the government's overall objective in the negotiations is. This greatly lessens the danger that members of a negotiating team inadvertently operate at cross-purposes.

Box 1.5: Consulting requires an effort

When the Australian Department of Foreign Affairs and Trade invited public submissions before the start of negotiations for a free-trade agreement with the United States, it received about 200 responses from industry, professional and non-government bodies, companies, unions and individuals.

Almost 60 of these came from peak industry and business organisations, representing the full range of agriculture, services and manufacturing industry sectors.

The Minister for Trade regularly discussed progress with ministerial advisory groups on trade issues.

The negotiating team had meetings with more than 200 industry groups, businesses, state government departments, consumer groups, unions and non-government organisations. It also briefed the eight state and territory governments before and after each of the five negotiating rounds.

The DFAT website was continually updated with media transcripts, background documents and answers to frequently asked questions. A newsletter was distributed to all federal and state members of parliament as well as over 1000 e-mail subscribers.

Source: Department of Foreign Affairs and Trade, 2004a

This aspect of preparing for the negotiations acquires additional importance in economies with a federal structure. The states or provinces probably will not be in the negotiating room, but they will always resist solutions that do not take account of their regulatory role.

Intra-governmental and inter-governmental consulting processes vary from economy to economy, and they depend of course also on the gravity of the issues to be considered. Approaches include inter-departmental or inter-ministry processes at various levels to which the agencies with an interest in the matter are invited. Lower-level meetings and exchanges tend to concerned with the more technical issues, and they usually are reasonably informal. At a high policy level these meetings can be quite formal. In either case, the meetings serve the important functions of promoting good policy-making and a high degree of transparency.

A different set of processes is needed to consult departments or ministries established by state and provincial governments. The exact consulting processes in these cases depend to some extent on the constitutional arrangements in an economy as well as its mechanism for treaty-making consultations. Sometimes consultations are obligatory, and at other times they are optional. No rule will be suitable for all cases, and this issue may have to be approached with a degree of flexibility and, desirably, good-will.

Scoping studies

To satisfy all of these consultative needs governments usually undertake a study of the likely impact of a free-trade agreement on producers, consumers and regulators before the negotiations get under way. This study is sometimes called a domestic sensitivity analysis. In other cases it is called a scoping study. There are different ways of doing this, and the method chosen will depend to a large extent on the make-up of an economy, its mechanisms for developing its trade policy and its composition of trade.

The study should give the government and the negotiators a reasonable assessment of the type and severity of difficulties that may be expected as well as areas where the greatest gains are likely to occur. The effort put into such studies often pays dividends once the negotiations are in progress because they ensure that few obstacles, once they arise, will be entirely unfamiliar to the negotiators. Box 1.6 contains the terms of reference adopted by Australia and China for their joint study into the feasibility of a bilateral free-trade agreement.

Sometimes governments also commission an econometric study of the prospective welfare effects of an agreement. Such studies can be helpful in drawing attention to trade-creating effects of a free-trade agreement and the increased investment an agreement may promote. Much depends, however, on the model selected, the credibility of the assumptions made by the modellers and, it follows, the credibility of the study itself. Wide divergences in predicted outcomes are common. This sometimes turns the interpretation of the results of econometric studies into a complex task.

Box 1.6: an example of the terms of reference for a scoping study

When Australia and China agreed on 24 October 2002 to undertake a joint feasibility study into the possibility of a bilateral free-trade agreement, they adopted the following terms of reference:

- to provide an overview of recent trends in bilateral trade and economic relations;
- to assess recent international trade policy developments and the possible implications for Australia-China trade and investment;
- to identify and describe existing barriers to trade and investment flows, covering goods, services and investment and other issues that might be addressed in a free trade agreement;
- to identify possible cooperation measures to promote trade and investment liberalisation and facilitation between Australia and China;

- to assess the impact of the removal and/or reduction of existing barriers to goods and services trade and investment; and
- make conclusions and recommendations as regards options for future action.

Source: http://www.dfat.gov.au/geo/china/framework/economic_framework.html

Free-trade agreements and the Uruguay Round

A major reason for the spate of free-trade agreements launched or concluded in the last decade can be found in the successful conclusion of the Uruguay Round. It is not that the Uruguay Round itself was especially preoccupied with preferential trade agreements. Rather, through its comprehensive approach to the negotiations and its success in opening new areas to multilateral rules it produced an environment in which it is much easier to conclude free-trade agreements.

The Uruguay Round outcome has resulted in very low tariffs in developed and developing economies on many goods. Tariff lines on which no duties are levied are now quite common. Agricultural products and textile, clothing and footwear goods automotive products remain among the more general exceptions, but the abolition of textile import quotas on 1 January 2005 has liberalised trade in this sector even in the absence of substantial tariff cuts.

Many economies, of course, still maintain relatively high, in some cases prohibitive, tariffs on many goods. But for most economies the step to eliminating tariffs on most goods for selected trading partners, as is the case under a free-trade agreement, is a much less drastic move than it would have been, for example at beginning of the Tokyo Round in 1979 or even the start of the Uruguay Round in 1986. We have already noted another effect of this in the section describing the erosion of preferences.

In other words, the shock of trade liberalisation caused by a free-trade agreement is now much smaller than it would have been twenty or thirty years ago. This is not to say, of course, that negotiating a free-trade agreement is a trivial exercise. On the contrary, free-trade agreement can have a profound effect on the trade and economic relations between the parties.

Box 1.7: What to name a free-trade agreement?

Free-trade agreements serve their purpose regardless of the name they have been given. What matters is the content of the agreement. Following are some examples of names for free-trade agreements:

- Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA)
- Agreement between New Zealand and Singapore on a Closer Economic Partnership (ANZSCEP)
- Agreement between Japan and the Republic of Singapore for a New-Age Economic Partnership (JSEPA); and
- North American Free Trade Agreement (NAFTA)

This new enabling environment is not limited to tariffs. The ten years of discussions and negotiations that led to the adoption of the *General Agreement on Trade in Services* (GATS) as part of the Uruguay Round outcomes have produced a much deeper understanding among WTO members of the role services, and the related investment and people flows, play in a well-functioning and competitive economy. The GATS itself produced a framework for the progressive liberalisation multilaterally of trade in services. It will be some time before trade in services will be, broadly speaking, as liberal as trade in goods, but governments now understand that liberalising trade in services is possible without undermining their ability to regulate the economy. Indeed, the GATS leaves regulatory powers in the hands of governments. One consequence of this is that many free-trade agreements now cover goods and services.

The Uruguay Round resulted in a third outcome that is now clearly assisting the expansion of international trade and investment that is facilitating greatly the negotiation of free-trade agreements. That is the conclusion of the *Agreement on Trade-Related Aspects of Intellectual Property Rights* (the TRIPS Agreement). Business can now be far more confident that mechanisms are available to protect its know-how and drive to produce new ideas and products.

The contribution made by the TRIPS Agreement to the expansion of international investment flows should not be underestimated, though differing views on aspects of intellectual property and the appropriate level of protection for them of course remain. Enforcement of intellectual property rights also remains a contentious issue. Some of these concerns are addressed by intellectual property conventions that have been concluded or that entered into force since the adoption of the TRIPS Agreement. Bilateral free-trade agreements sometimes are another convenient way to build on the solutions provided by multilateral conventions.

The enabling environment for preferential trade agreements created by the Uruguay Round should be improved further by results of the negotiations under the Doha Development Agenda which was launched in November 2001. WTO members expect significant achievements both in market access for goods and services and the rules of the multilateral trading system.

A major development of more recent origin is the decision by WTO members in July 2004 to begin negotiations on trade facilitation. This reflects a clear recognition by economies that the reduction and elimination of tariffs and non-tariff measures must be accompanied by measures to free up the flow of goods if the full benefit of trade liberalisation is to be passed on to the business sector. APEC, of course, has long had a major work program in trade facilitation, and this experience should benefit the WTO negotiations.

Free-trade agreements *versus* multilateral outcomes

Economies increasingly participate in multilateral trade negotiations at the same time as they conclude free-trade agreements. They clearly expect benefits in either case. The question therefore arises as to the situations under which governments should seriously consider entering into bilateral or regional free-trade negotiations.

There are no simple responses to this. An obvious answer is, however, that economies should consider the possibility of a free-trade agreement in cases where they could obtain a benefit earlier than they would under the multilateral system or where the multilateral system could not provide the benefit because it has no relevant rules. The latter is the case, for example, for investment.

Free-trade negotiations are quite demanding in terms of human, intellectual and financial resources, especially when several economies are involved. Economies therefore must assess carefully the range of benefits they can obtain from them. Solutions to some of the problems encountered in the multilateral trading system probably will only be obtainable through multilateral action. An example of such a problem is the agreement by WTO members to negotiate for the abolition of agricultural export subsidies as part of the negotiations under the Doha Development Agenda.

It would in any case be unwise to assume that free-trade agreements are always the right instrument to secure a benefit. For example, if a government is thinking of making its economy more competitive, a more effective way may be to liberalise the economy across the board through tariff reductions and deregulation. Sometimes, however, economic reform attracts greater support if it can be coupled with better access to one or more other economies. In other cases the possibility of benign experimenting with trade liberalisation in the form of a free-trade agreement is a strong attraction.

The negotiating process

The negotiating mandate

Usually the first step to be addressed by an economy in any negotiating process leading to a free-trade agreement is for the negotiators to secure a negotiating mandate. This mandate describes what must be covered, and in some cases, what may be covered, by the negotiations. In most cases, the initial mandate is defined fairly broadly since economies usually aim for comprehensive free-trade agreements. In any case, the mandate tells the negotiators whether they can negotiate on goods, services and investment, and what their broad objectives in each of these areas should be.

Economies tend to have established procedures for defining their negotiating objectives. In Australia's case, for example, government departments prepare a submission to Cabinet which sets out options and makes recommendations. This process can take several weeks. Cabinet then considers this submission and makes its decision. One effect of this process is that the negotiating objectives are tailored for each proposed negotiation.

Once the negotiations are under way and the ambit of possible outcomes becomes clearer, these negotiating objectives are then often refined through the repeat of the cabinet submission process. In the course of a complex negotiation, this process may be repeated several times. In this way, the negotiating mandate gets redefined from time to time. Sometimes it gets broader as the negotiations proceed. As noted elsewhere, what seems difficult at the start can turn out to be quite manageable later on. Most economies have processes of this kind, though the details will differ.

The United States has a quite different process. There, Congress gives the President a negotiating mandate in the form of the Trade Promotion Authority (TPA). This used to be known as fast-track authority. The current TPA gives the United States negotiators a mandate which ranges from quite broad provisions (e.g. to obtain more open, equitable, and reciprocal market access) to fairly precise ones (e.g. to promote universal ratification and full compliance with ILO Convention No. 182 Concerning the Prohibition and Immediate Action for the Elimination of the Worst Forms of Child Labour). United States negotiators must address each of the negotiating objectives listed in the TPA. The only flexibility they have is in the interpretation of some of the objectives. Intensive liaison takes place during the negotiations with congressional committees and representatives over the progress of the negotiations. Once the negotiations are over, Congress examines the draft agreement in the light of the negotiating mandate. It then either approves or votes down the text. It does not propose amendments.

Putting together a team

Another thing to do in the negotiating process is the assembly of a negotiating team. This can be done in more than one way. However, the overall approach taken by economies tends to show many similarities. For example, they usually appoint a chief negotiator, drawn from the department or ministry responsible for that economy's trade negotiations. This person then becomes responsible for progress on the entire agreement. He or she may also be the main conduit for contact with ministers, senior representatives of the private sector and heads of non-governmental organisations.

Whether the chief negotiator also takes charge of one or more subject areas, such as market access for goods, will depend on the magnitude and complexity of the negotiations and on the customary way of an economy's management of negotiations. It is usual to appoint a deputy chief negotiator, especially when it is clear that the negotiations will be substantial.

The chief negotiator is usually assisted by lead negotiators who will look after one or more of the chapters of the proposed agreement. Services and investment sometimes have separate lead negotiators, partly because of the complexity of the subjects, and partly because domestic responsibility for these areas often does not lie with trade ministries. Services negotiations especially may impinge on the responsibilities of many ministries, such as education, justice, finance, communications, transport, etc. An issue to be considered, however, is that a free-trade agreement is an instrument promoting international economic relations, and its contents have to be approached from that perspective.

These ministries in most cases have well-established channels of communication with the private sector which can be used to support the efficient conduct of the negotiations. No two negotiations are the same, and the number of lead negotiators and their responsibilities will depend largely on the substance of the negotiations.

Preparing for the negotiations and ensuring that positions are understood and the right arguments developed requires a major effort. This places considerable demands on the chief negotiator and his or her communications skills.

Negotiating teams will need to be arranged around the lead negotiators. These teams usually consist of experts in their areas as well as generalist officers. The number and composition of these teams will probably change during the negotiations. This is because negotiations on some chapters finish early. In other cases, the teams have to deal with quite specific issues which call for the use a different kind of expert.

Regardless of the necessity of such changes, a negotiating economy should aim to keep the core members of negotiating teams unchanged as much as possible. This applies especially to leaders. Their ability to recall the negotiating history of the agreement will always be welcome, and at times it will be essential. The chief negotiator's position should change only when this becomes absolutely unavoidable. Achieving this desirability is made easier by the fact that free-trade negotiations are typically concluded within two years.

Another important aspect of assembling a team is the need to ensure that it has funding for the conduct of the negotiations. Money will be required for intensive domestic and international travel by sometimes quite large teams. It may also be necessary to hire negotiating venues and, in some cases, to employ interpreters and translators. Negotiations for a free-trade agreement typically last for between one and two years. The budget cycle in some economies is, however, one year only. If this is the case, the negotiators must therefore ensure that their requirements are included in relevant funding bids.

The negotiating process

Most negotiating processes consist of plenary meetings and many informal meetings. The plenary should only be used to adopt decisions and to keep the various teams informed of progress in other parts of the negotiations.

Plenaries are quite unsuitable for resolving problems, but they can be used to explain to all participants in the negotiations where difficulties remain unsolved and what the possible solutions may be. That is, the plenaries perform the major role of promoting transparency of the negotiations. Plenaries should accordingly be kept short, and they should be relatively infrequent, at least compared to the number of informal meetings.

It is usually much more convenient to have the specifics of problems discussed in small groups of people with a real interest in resolving them. Many issues in the negotiations will be difficult. Some will arise in the first meeting, and they will accompany the negotiators right up to the last moment.

All negotiators hope that they will be given enough time to produce a quality agreement. Many of them are put in a position from the start where they cannot afford to waste any time at all. Of course, if the timetable is too short, the danger exists that some important issues will not be considered adequately. The other side of the coin is that the expectation of ample time tends to encourage a feeling that there is plenty of time to get the job done. Chances are that this assumption will be wrong. Whatever the time span for the completion of the negotiations is, practice has shown that they will always fill up the time available.

Deciding the content of the negotiations

The parties to the negotiations usually start with developing a timetable for the negotiating sessions and a set of principles which will broadly govern the conduct and content of the negotiations. These principles have to be detailed enough to offer genuine guidance. At the same time, they have to be flexible enough to be able to accommodate easily any changes to whatever plans may have been formed.

Where there is a disagreement over including an issue in the negotiations, it is almost invariably better to start with agreeing that everything is on the table. It may well be that in some cases agreement to complete negotiations on a given issue is in the end not possible, and that the parties then decide to leave things for resolution at another time. That decision should, however, be made only after the available options have been explored thoroughly.

The outlook towards the end of the negotiations for resolving things is often quite different to what it was at the start. What may have been viewed as a major problem can turn into a routine matter once it is seen in the context of progress elsewhere in the negotiations. Of course, the reverse is also true.

Early harvests

Sometimes the suggestion of an *early harvest* arises. The general idea of an early harvest is to agree quickly on areas where fast progress is possible, to reach agreement expeditiously and to implement the results there and then to the extent that this is possible. It all sounds attractive enough, but there are dangers in proceeding in this way.

Doing the easy things first does not necessarily help with solving the difficult ones. In some cases there will be little agreement on what constitutes an easier or more attainable target. Even where this has been worked out, it can leave the negotiators in a position where they have fewer options to bring about balanced results much later in the negotiations in the more difficult areas. Another problem is that the timetable for the negotiations may make an early harvest quite impractical. Also, agreement too early may make progress in related areas more difficult because it may turn out to be necessary to undo agreement made under the early harvest. For all of these reasons, many economies do not favour early harvests in free-trade negotiations.

Of course, it is sometimes possible to finish work on a chapter quite early in the negotiations. In such a case, the best way to proceed is to agree on the result, subject to changes that may become necessary because of progress in other areas. When this is clearly understood by both sides, there should not be any adverse effect on progress in the negotiations.

Annexes, schedules and side letters

We have already mentioned that schedules and annexes make up a large apart of most free-trade agreements. Preparing these also takes time, and work on them should start as early as possible. These schedules contain the detail of the obligations the parties have taken on, and they are important. The work on these schedules is not necessarily glamorous, and it usually takes up a lot of time. However, negotiators make things much easier for users of the agreement by ensuring that the schedules are accurate and allocating sufficient time to their drafting.

Side letters and other arrangements will inevitably be part of a comprehensive agreement. In Chapter 11 we explain their use and form in more detail. The point to remember at this stage again is that they need drafting and clearing, and this can take time.

The need for an indicative timetable

An indicative timetable for the negotiations is necessary for the good management of the process. The negotiating sessions must be spaced at sufficiently long intervals to allow negotiators to obtain ministerial guidance, to conduct consultations with interested organisations and to prepare for the next round. Intervals of about two months sound about right. Longer intervals may be necessary if several economies negotiate with each other. If the intervals are spaced too far apart, the possibility of a loss of momentum cannot be disregarded. If they are too short, it may not be possible to conduct the necessary consultations.

By the second half of the negotiating term some rapid adjustments to the timetable may be necessary. For example, the likelihood will grow that frequent small informal meetings will have to be held. Face-to-face meetings put an additional burden on the chief negotiator's coordinating functions, and it may also have implications for the financial aspects of the negotiations. Some of these financial burdens can be reduced through calling teleconferences and video-conferences.

Be prepared for that final mammoth negotiating session. It seems that few negotiations have been concluded without meetings going virtually non-stop for several days. As the days go on, however, the level for making decisions will creep up and the areas of disagreement will become quite narrow. Final decisions are mostly made by ministers and sometimes even by leaders.

Completing the agreement

You may think that it is rather early to think about the steps needed to complete agreement before the negotiations have even begun. On the contrary, this is the time to take a first look at the procedures needed to get there. Knowing what is required will almost certainly give you useful hints for the timing and management of the negotiations. In Chapter 12 we give a more detailed outline of them.

2. The APEC best-practice principles

Aiming to produce the best possible agreement

The APEC best-practice principles for RTAs/FTAs are not binding on economies. But they will assist any economy seeking to negotiate an ambitious, outward-looking agreement consistent with the WTO rules and disciplines and the APEC goals and principles.

APEC Economic Leaders adopted a set of best-practice principles for free-trade and regional trade agreements at their meeting in Santiago on 20 and 21 November 2004.

These principles are meant to help APEC economies negotiate high-quality free-trade agreements designed to promote regional economic integration. The principles are not binding. Neither are they guidelines for economies for the content of a prospective agreement.

The purpose of the best-practice principles is to remind economies that if they intend to include certain provisions in an agreement, APEC best practice suggests that this could be done in a preferred manner.

The full text of the set of principles is:

Best Practice for RTAs/FTAs in APEC[1]

RTAs/FTAs involving APEC economies can best support the achievement of the APEC Bogor Goals by having the following characteristics:

Consistency with APEC Principles and Goals

- They address the relevant areas in Part I (Liberalisation and Facilitation) of the Osaka Action Agenda (OAA), and they are consistent with its General Principles. In this way they help to ensure that APEC accomplishes the free trade and investment goals set out in the 1994 Bogor Leaders Declaration.
- They build upon work being undertaken by APEC.
- Consistent with APEC goals, they promote structural reform among the parties through the implementation of transparent, open and non-discriminatory regulatory frameworks and decision-making processes.

Consistency with the WTO

- They are fully consistent with the disciplines of the WTO, especially those contained in Article XXIV of the GATT and

[1] Regional Trade Arrangements (RTAs), Free Trade Agreements (FTAs, and other Preferential Arrangements

Article V of GATS.

- When they involve developing economies to whom the Enabling Clause applies, they are, whenever possible, consistent with Article XXIV of the GATT and Article V of the GATS.

Go beyond WTO commitments

- In areas that are covered by the WTO, they build upon existing WTO obligations. They also explore commitments related to trade and investment in areas not covered, or only partly covered, by the WTO. By doing so, APEC economies are in a better position to provide leadership in any future WTO negotiations on these issues.

Comprehensiveness

- They deliver the maximum economic benefits to the parties by being comprehensive in scope and providing for liberalisation in all sectors. They therefore eliminate barriers to trade and investment between the parties, including tariffs and non-tariff measures, and barriers to trade in services.
- Phase-out periods for tariffs and quotas in sensitive sectors are kept to a minimum, and take into account the different levels of development among the parties. Thus, they are seen as an opportunity to undertake liberalisation in all sectors as a first step towards multilateral liberalisation at a later stage.

Transparency

- By making the texts of RTAs/FTAs, including any annexes or schedules, readily available, the parties ensure that business is in the best position to understand and take advantage of liberalised trade conditions. Once they have been signed, agreements are made public, in English wherever possible, through official websites as well as through the APEC Secretariat website.
- Member economies notify and report their new and existing agreements in line with WTO obligations and procedures.

Trade facilitation

- Recognising that regulatory and administrative requirements and processes can constitute significant barriers to trade, they include practical measures and cooperative efforts to facilitate trade and reduce transaction costs for business consistent with relevant WTO provisions and APEC principles.

Mechanisms for consultation and dispute settlement

- Recognising that disputes over implementation of RTAs/FTAs can be costly and can raise uncertainty for business, they include proper mechanisms to prevent and resolve disagreements in an expeditious manner, such as through consultation, mediation or arbitration, avoiding duplication with the WTO dispute settlement mechanism where appropriate.

Simple rules of origin that facilitate trade

- To avoid the possibility of high compliance costs for business, rules of origin (ROOs) are easy to understand and to comply with. Wherever possible, an economy's ROOs are consistent across all of its FTAs and RTAs.
- They recognise the increasingly globalised nature of production and the achievements of APEC in promoting regional economic integration by adopting ROOs that maximise trade creation and minimise trade distortion.

Cooperation

- They include commitments on economic and technical cooperation in the relevant areas reflected in Part II of the OAA by providing scope for the parties to exchange views and develop common understandings in which future interaction will help ensure these agreements have maximum utility and benefit to all parties.

Sustainable development

- Reflecting the inter-dependent and mutually supportive linkages between the three pillars of sustainable development – economic development, social development and environmental protection – of which trade is an integral component, they reinforce the objectives of sustainable development.

Accession of third parties

- Consistent with APEC's philosophy of open regionalism and as a way to contribute to the momentum for liberalisation throughout the APEC region, they are open to the possibility for accession of third parties on negotiated terms and conditions.

Provision for periodic review

- They allow for periodic review to ensure full implementation of the terms of the agreement and to ensure the terms continue to provide the maximum possible economic benefit to the parties in the face of changing economic circumstances and trade and investment flows. Periodic reviews help to maintain the momentum for domestic reform and further liberalisation by addressing areas that may not have been considered during the original negotiations, promoting deeper liberalisation and introducing more sophisticated mechanisms for cooperation as the economies of the parties become more integrated.

3. The multilateral rules for free-trade agreements

Negotiating a free-trade agreement that satisfies all the rules

Free-trade agreements have to meet not only the WTO rules and disciplines and the APEC principles and goals. They may also have to satisfy many other international requirements contained in multilateral conventions.

A superficial examination of free-trade agreements, both concluded and proposed, might suggest that there is much uniformity among them. A closer inspection shows, however, that superficial resemblances can hide deep differences in approach and ambition. In this chapter we therefore explore the rules under which free-trade are concluded.

The internationally-agreed rules for the content of free-trade agreements fall mainly under the purview of the World Trade Organization (WTO). At first glance they seem to be surprisingly simple. On a closer inspection, however, it turns out that some of these provisions are quite difficult to interpret in precise legal terms. This can lead to quite unprofitable discussions. One thing worth remembering in such situations is that a free-trade agreement is an instrument designed to liberalise trade between the parties. It is not an instrument for managing their trade or isolating sensitive sectors.

The rules for trade in goods can be found in Article XXIV of the *General Agreement on Tariffs and Trade* (GATT) and the rules for services in Article V of the *General Agreement on Trade in Services* (GATS). The text of these articles is reproduced in appendixes 1 and 3, respectively. Appendix 2 contains the Uruguay Round *Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994* which gives greater precision to some of the provisions in Article XXIV.

Developing economies can also negotiate preferential trade arrangements among themselves under the more flexible provisions of the *Enabling Clause*. This option is not available when developing economies negotiate free-trade agreements with developed economies. The point of all of these provisions (GATT Article XXIV, GATS Article V and the Enabling Clause) is that they permit departures from the non-discriminatory rules of the WTO.

The parties to a free-trade agreement can in fact determine to a considerable extent themselves what the content of the agreement should be, as long as the outcome is in conformity with the WTO rules.

This is a good place for reminding oneself that all the rights and obligations making up a free-trade agreement apply equally to the parties and their traders, unless a specific exemption or derogation has been drafted. A rule denying exporters of the other party a right denies the same right to the exporters of one's own party. Restrictions, as much as liberalisation, apply both ways.

Free-trade areas for goods

Article XXIV of the GATT defines a free-trade area as

- a group of two or more customs territories in which the duties and other restrictive regulations of commerce . . . are eliminated on substantially all the trade between the constituent territories in products originating in such territories.

The concepts used in this definition are of differing levels of clarity. The concept of a "customs territory" is, of course, not controversial. The GATT defines it as "any territory with respect to which separate tariffs or other regulations of commerce are maintained for a substantial part of the trade of such territory with other territories". Within APEC the extent of a customs territory coincides with the territory of a member economy. The meaning of "duties" also is quite clear. Duties are the charges levied by customs authorities at the border when the good is imported. In other words, this is the tariff.

Box 3.1: Creating a free-trade area for goods: the procedural steps under GATT Article XXIV

The steps required under the GATT for the conclusion of a free-trade agreement can be summarised as follows:

- creation of a free-trade area consisting of two or more customs territories
- creation of a mechanism in the form of rules of origin for deciding what goods will be considered by the participating customs territories as products originating in the other participating customs territories
- eliminate duties and other restrictive regulations of commerce on substantially all the trade in goods deemed to be originating products
- ensure that in performing the above steps barriers against third parties are not increased
- notify the WTO promptly of any decision to enter into a free-trade agreement.

The concepts of "other restrictive regulations of commerce" and "substantially all the trade" are more difficult. They remain largely undefined in formal terms. Numerous debates and proposals in the WTO have not brought the international community much closer to a common understanding of them. The following brief discussion indicates some of the difficulties.

What is meant by "substantially all the trade"?

We can take it that everyone agrees that "substantially all the trade" does not mean "all the trade". We can also say confidently that over the five decades since the conclusion of the first free-trade agreements in the 1950s and the negotiation of agreements now the gap between "substantially all" and "all" has narrowed considerably. Economies are now much more aware of the benefits of trade liberalisation, and on the whole they have become more ambitious.

Coverage of about 70% of trade would have seemed reasonable to many in the 1960s. Today a widely accepted view is that an agreement covering less 90% of trade is flawed. There is less agreement, however, on how this should be calculated. To consider existing trade only would be flawed since high tariffs or stringent tariff rate quotas are certain to restrict trade. A better measure would therefore be the amount of potential trade, but this raises other methodological difficulties. Some have suggested that a calculation of "substantially all the trade" should consider not only trade flows but also the number of tariff lines involved. Certainly, a criterion consisting of actual trade and the tariff lines involved would take us a long way towards a more objective standard.

A solution to this question will not be easy to find. Negotiators of free-trade agreements should bear in mind, however, that the benefits of an agreement will be maximised through the greatest possible coverage of trade in goods.

The trend towards a more ambitious interpretation of comprehensiveness is also shown, for example, in the *Understanding of the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994* which is part of the Uruguay Round outcomes. In this instrument WTO members agreed that the contribution of free-trade agreements to the expansion of world trade through closer economic integration would be "diminished if any major sector of trade is excluded". Observance of this Understanding will assist a larger coverage of trade by an agreement. The APEC best-practice principles, listed in Chapter 2, also seek to promote comprehensiveness.

The question of the ambit of "other restrictive regulations of commerce" also remains unresolved. Analysing their ambit would take us well into considering the rationale for non-tariff measures and a discussion of the distinction between non-tariff measures and non-tariff barriers. Such a discussion would have to recognise, *inter alia*, that without a system of predictable rules, many of them expressed in the form of non-tariff measures, international trade would be much more difficult to conduct. The outlook for a convergence of views on the interpretation of "other restrictive regulations of commerce" is at this stage unclear. This, however, is not the place for entering into a debate about the meaning of these concepts. The proper forum for doing so is the WTO.

In any case, free-trade negotiators usually have to honour quite strict time limits to complete the text of an agreement, and there are indications that the multilateral debate on these issues has some way to go. For the time being, therefore negotiators have no choice but to be as ambitious in defining the boundaries of these disputed concepts as conditions in the partner economies permit.

The meaning of Article XXIV in relation to tariffs is clear. It speaks of their elimination. It does not mention “reduction” or other words that would imply end points somewhere between the current tariff and a zero tariff. Article XXIV also accepts that in some cases immediate elimination of tariffs is not possible, and that a phase-out timetable may be required.

Article XXIV:6 must also be borne in mind. It provides the basis for requests for compensation by third parties if the parties to a preferential trade agreement raise some of their tariffs towards non-parties as part of their negotiation. This is more likely to be the case when a customs union is formed or enlarged because the parties need to harmonise their tariffs towards non-members. (Chapter 1 contains a brief description of a customs union). If, for example, the members decide to use the highest tariff applied by any of them as the basis of the harmonisation, this will increase the tariff towards third parties. If the third parties decide to seek compensation, the result will be a further set of negotiations under the WTO rules.

The final concept in Article XXIV is that tariffs only have to be eliminated in respect of goods originating in the customs territories making up the free-trade areas. In other words, rules of origin have to be drafted to enable the easy identification of such goods. The issues relating to preferential rules of origin are now well understood. Negotiating them can of course be quite challenging. Also, disagreements may arise later they have to be interpreted.

Interim agreements

GATT Article XXIV mentions the possibility of concluding interim agreements leading to free-trade areas or customs unions. It does not specify what the contents of an interim agreement might be beyond noting that any such agreement must include a plan and schedule for the formation of a free-trade area or a customs union within a reasonable time and that it must be notified to the WTO.

In a strict sense every free-trade agreement under which tariffs are eliminated over several years is an interim agreement. Also, some economies prefer to start with concluding a framework agreement setting out in detail the objectives and disciplines of the prospective free-trade agreement. They then conduct tariff, services and investment negotiations once the framework agreement is in force. Such a framework agreement could also be considered an interim agreement.

Chapter 4 covers some negotiating issues related to trade in goods, and Chapter 5 deals with rules of origin in more detail.

The Enabling Clause

The *Enabling Clause*, formally the *Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries*, was adopted by the members of the GATT (General Agreement on Tariffs and Trade) on 28 November 1979 as part of the Tokyo Round outcomes.

The Enabling Clause enables developed countries to accord more favourable treatment to developing countries without according such treatment to other countries. It is therefore, as already noted, a departure from Article I of the GATT (General Most-Favoured-Nation Treatment). The Enabling Clause applies, among other areas, to preferential trade arrangements between developing countries. It enables them to be more flexible in terms of sectors covered and tariff elimination or reduction than would be possible for agreements between developed countries. For example, they can enter into partial-scope agreements which cover some sectors only.

Some argue that the Enabling Clause applies to free-trade agreements developing economies are negotiating with developed countries. This is not the case. The Enabling Clause only refers to preferential arrangements between developing countries. It is silent on the question of a mixed membership. The Enabling Clause, however, refers to trade negotiations more generally where developing countries are not expected to match the commitments made by developed countries, but the context makes it clear that this means to multilateral negotiations.

Box 3.2: The Enabling Clause: application to free-trade agreements

The relevant parts of the Enabling Clause read as follows:

1. Notwithstanding the provisions of Article I of the General Agreement, contracting parties may accord differential and more favourable treatment to developing countries, without according such treatment to other contracting parties.

2. The provisions of paragraph 1 apply to the following:

. . .

(c) Regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed by the CONTRACTING PARTIES, for the mutual reduction or elimination of non-tariff measures, on products imported from one another.

The result of free-trade negotiations must always be the elimination of tariffs, either on entry into force of the agreement or in stages. How this is done depends on the views of the negotiating parties. It is usually possible to reach agreement on phasing where this is necessary. In any case, few developed countries would ever expect exact reciprocity in their negotiations with developing countries.

One more point to consider is that free-trade agreements with developing and developed economy members will be examined by the WTO Committee on Regional Trade Agreements (CRTA) under the rules of GATT Article XXIV. Developed economies are therefore required to show that their agreements meet these standards. Agreements between developing countries are examined in the Committee on Trade and Development under the more lenient standards of the Enabling Clause.

Free-trade in services

The WTO rules for creating free-trade agreements for services are listed in Article V of the GATS where they are called *economic integration agreements*, (see Appendix 3 for the complete text of this Article). They follow the pattern developed for trade in goods, but with important differences. One of the most important is that there is no mention of eliminating regulatory measures altogether. In other words, this Article also recognises that governments have the right to regulate their economies. Instead, Article V requires the elimination of existing discriminatory measures and a prohibition of new or more discriminatory ones. Since measures governing trade in services are usually expressed in the form of laws, regulations, etc., Article V can be satisfied by the removal of discriminatory treatment of foreign suppliers. That is, national treatment is required. But the regulation itself could remain. This is often overlooked by those commenting on the impact of free-trade agreements on the ability of governments to regulate their economies.

Article V also requires that a free-trade agreement has substantial sectoral coverage, expressed in terms of numbers of sectors, volume of trade affected and modes of supply (i.e. the way services are delivered). As in the case of “substantially all the trade” in the goods sector, “substantial sectoral coverage” in the services sector is not defined exactly. A footnote to Article V specifies, however, that “substantial sectoral coverage” is to be understood in terms of number of sectors, volume of trade affected and modes of supply. It adds that agreements, if they are to meet this condition, should not provide for the exclusion *a priori* of any mode of supply. (Chapter 7 contains a description of the modes of supply as defined under the GATS.)

One WTO condition for free-trade agreements in services is that they may not result in a higher overall incidence of barriers towards non-members. This is more likely to occur in the case of an economic union because of the concurrent harmonisation of some regulations among members of the union and a similar harmonisation of some regulations aimed at governing the entry of foreign service suppliers and their services. If significant changes occur, WTO members affected by them may seek compensation or even withdraw some of their MFN commitments. This would then lead to another set of negotiations, but this time in the WTO.

Box 3.3: Free-trade agreements in services: the WTO requirements

WTO members may enter into an agreement to liberalise trade in services through a free-trade agreement if the agreement:

- has substantial sectoral coverage, expressed in terms of numbers of sectors, volume of trade affected and modes of supply;

- eliminates or eliminates substantially discrimination in national treatment in the sectors covered and/or
- prohibits new or more discriminatory measures in these sectors; and
- does not raise barriers against non-members.
- A timetable can be established for eliminating discrimination.
- Measures concerning payments and transfers, safeguarding the balance of payments, general exceptions and security exceptions may be maintained.

Members of a free-trade area in services conforming with the requirements of GATS Article V are entitled to discriminate against services and suppliers of services from non-member economies, but there is one important exception. A service supplier from a third country incorporated in one of the parties to the free-trade agreement will also enjoy preferential treatment within the free-trade area as long as it engages in substantive operations within the territory of the parties. If the agreement involves developing countries only, they may continue to give better treatment to firms owned or controlled by their own nationals.

Finally, WTO member countries concluding free-trade agreements in services must notify these agreements, enlargements of them or significant changes to them to the WTO Council for Trade in Services. The Council then examines these notifications for their conformity with the WTO rules. This is a rigorous process which requires extensive preparatory work.

Box 3.4: GATS Article V: developing-country provisions

The GATS provisions for developing countries participating in free-trade areas are more lenient than those for developed countries:

- when developing countries enter into agreements with developed countries, they have more flexibility in terms of substantial coverage and the extent to which they must eliminate discriminatory measures; and
- agreements consisting entirely of developing countries may grant more favourable treatment to firms owned or controlled by natural persons from the parties.

Chapter 7 deals in more detail with some of the negotiating issues that arise in the case of services.

Investment

It is becoming increasingly clear that, as tariff barriers are lowered or eliminated, the importance of foreign investment as a driver of economic integration is growing. Indeed, under some free-trade agreements the promotion of increased investment flows now outweighs the prospective gains from tariff elimination.

Many agreements contain chapters on investment. Most of these cover both liberalisation of investment regimes and the promotion and protection of investments. There are not as yet any multilaterally-agreed rules on investment. This means that economies have considerable freedom in designing these chapters. Nevertheless, as in the case of services, agreements normally seek to eliminate discrimination between foreign and domestic investors.

In addition, many other common features have emerged. This is particularly the case with rules relating to investment promotion and protection. The text of such agreements in many respects is close to standardised. Accordingly, this part of an investment chapter should not be all that hard to negotiate.

The difficulties increase considerably, however, in the case of liberalisation of investment rules. Economies have not yet developed concepts of sufficiently general application for this purpose.

Chapter 8 deals in more detail with the contents of investment chapters.

Notifying the agreement to the WTO

We have mentioned that WTO members negotiating free-trade agreements or customs unions must notify these agreements to the WTO where they are examined by the Committee on Regional Trade Agreements (CRTA). The aim of this examination is to promote high-quality free-trade agreements that are fully consistent with the WTO rules and disciplines.

These examinations are quite rigorous. It is usual to lodge an explanation of the legal text together with the text. Members then examine the agreement and submit written questions. The partners to the free-trade agreements are expected to treat these questions seriously and to answer them to the best of their ability. At the meeting itself, the answers to the written questions frequently lead to oral follow-up questions. Members of negotiating teams are likely to become involved in the examination also.

Box 3.5: The WTO Committee on Regional Trade Agreements

The WTO Committee on Regional Trade Agreements (CRTA) was established to ensure that preferential trade agreements concluded by WTO members meet the criteria established by the WTO. Its terms of reference are:

- to carry out examinations of bilateral and regional preferential trade agreements and report on them;
- to consider how the required reporting on the operation of the regional agreements should be carried out;
- the develop procedures to facilitate and improve the examination process; and
- to consider the systemic implications of regional agreements for the multilateral trading system.

4. Trade in goods

What is the purpose of the provisions on trade in goods?

At a minimum, the provisions on trade in goods

- define the geographical area benefiting from preferential market access;
- establish a system of rules of origin to determine whether a good receives preferential market access;
- define the tariff lines on which all duties have been eliminated on entry into force of the agreement;
- set out a phase-in schedule for tariffs to be eliminated in stages;
- prescribe the approach of the parties to the use of trade remedies; and
- outline the procedures to be followed by customs authorities when they deal with goods imported from within the free-trade area.

The tariff negotiations, together with the rules of origin, often are the most difficult part of the negotiations under the chapter on trade in goods. This is often the case even when tariffs are already very low. This chapter explains what the problems are, and how a solution to some of them might be found.

Some free-trade agreements, such as the Agreement between New Zealand on Singapore Closer Economic Partnership (ANZSCEP) and the Singapore–Australia Free Trade Agreement (SAFTA) have eliminated all tariffs on products originating from the parties from the date of entry into force. This is the most efficient and most beneficial way to achieve a result, but for many negotiations this is not an option in the face of demands by some industries for time to adjust to the zero tariff.

Elimination of tariffs

Article XXIV of the GATT requires, however, the elimination of tariffs on substantially all the trade on products originating in the partners to the agreement. Finding acceptable procedures for achieving this can pose a challenge to negotiators. It is therefore advisable to find the common ground on how to proceed through the exploration of a suitable negotiating framework.

The Harmonised System

The usual basis for the negotiation of tariff elimination is the *Harmonised Commodity Description and Coding System*, developed and maintained under the auspices of the World Customs Organization (WCO). This system is more commonly known as the *Harmonised System* or simply *HS*. The large number of economies using this system for their customs administration ensures that there is a common starting point in most cases for comparing tariff rates.

The Harmonised System consists of 97 chapters which are divided into headings and sub-headings. These are common to all users. Chapters are numbered with two digits (e.g. 01), headings with four digits (e.g. 0101) and sub-headings with six digits (e.g. 010110). The number of digits therefore always indicates clearly how a tariff item fits into the hierarchy of the Harmonised System.

Box 4.1: The hierarchy of the Harmonised System

The Harmonised System is organised into chapters (2-digit level), headings (4-digit level) and sub-headings (6-digit level). Here is an example:

18	Cocoa and cocoa preparations
1806	Chocolate and other food preparations containing cocoa
180610	Cocoa powder, containing added sugar or other sweetening matter.

Economies sometimes find it convenient to divide the sub-headings further into split sub-headings which sometimes go up to eleven digits. Split sub-headings are specific to the economy that creates them. Hence, even if two economies split a sub-heading further and gave the resulting item an identical number, chances would be that the goods bearing that number would not be the same. This is a complication, but it can be surmounted through the use of up-to-date tariff schedules and an understanding between the negotiators how the split sub-headings are to be dealt with.

The choices are that sub-headings are automatically assumed to cover split sub-headings, or that split sub-headings are considered to require specific attention. This is important because the rate of duty for split sub-headings is often higher than that for the sub-heading itself. The existence of split sub-headings often in facts point to possible negotiating difficulties because they may owe their origin to sectoral pressures.

Which tariff to use?

At the outset negotiators have to decide whether to use the bound tariffs (i.e. the tariff rates inscribed in the tariff schedule lodged with the WTO as being subject to a contractual ceiling) or the applied tariffs (i.e. the tariff rates actually levied by the customs authorities when the goods are imported). The difference between bound and applied rates can be considerable. Use of the bound rate would often suggest massive tariff reductions when in fact the applied rate may be at zero.

Most negotiators agree to use the applied rates in force on a certain date. They are often much lower than the bound rates. They reflect more accurately the needs of producers and consumers, and they also give a better indication of the adjustment to be made as a result of the negotiations. A third point is that the partners to a free-trade agreement expect to gain substantive market access benefits from the agreement, and this is done more effectively through starting with applied tariffs.

There are suggestions sometimes that developed economies should use their GSP (Generalised system of Preferences) rates as the basis of the negotiations. This raises practical difficulties in that GSP do not apply to all tariff rates and, in some cases, they may not be the same for individual economies. It is therefore customary to use the MFN rate.

How to identify tariffs for elimination?

The Harmonised System has more than 9,000 six-digit headings. Going through them one by one would be an inordinately time-consuming task. Negotiators therefore tend to look for formula methods to speed up the process. The easiest of these are:

- decide as first step whether the applied (preferably) or the bound tariffs of an economy at a certain date, often the date the negotiations are announced, are the starting point for all tariff negotiations;
- agree that all tariffs bound at zero will stay that way, and that they will not be considered further in the negotiations; raising them would in any case become troublesome because other WTO members could seek compensation, this initiating an unrelated negotiation;
- agree that all tariffs bound above zero, but with an applied rate of zero, will be eliminated from the entry into force of the agreement;
- agree that all tariff lines for goods entering at zero under temporary concession schemes, autonomous tariff quotas and the like, will also be eliminated from the entry into force of the agreement; and
- agree that all applied tariff rates of 5% or less will be eliminated on entry into force of the agreement.

Tariff structures and economies differ. The approach given above does not suit all of them. Such an approach, where it seems practical, will in many cases remove the greater part of tariff lines from further consideration. The negotiators can then direct their attention to the remaining tariffs, many of which usually turn out not be controversial at all.

No single approach to tariff elimination is correct. Much depends on the sectors in which the tariffs are to be eliminated. Sometimes the higher tariffs are concentrated in one or two sectors, such as textiles, clothing and footwear (TCF) and agriculture. Some economies prefer in their negotiations to group tariffs into roughly similar levels and then identify a suitable method for eliminating them. The result of such an approach may be a phase-out schedule. Remember that the WTO rules require that no sector is exempt from liberalisation.

The solution to a situation where tariff elimination would cause hardship in an industry or occupation in some cases lies in adopting a structural adjustment plan. Such a plan would need to take account of the investment cycle of an industry. In the chemical industry that is reportedly about five years. Also, a structural adjustment plan could be drawn up to be phased out at the same time as the tariffs are eliminated.

The focus of the negotiations at all times must, however, always be on the elimination of tariffs. This means that there is virtually no scope for mechanisms like the Swiss Formula which are designed to achieve tariff reductions depending on the initial tariff rate result in more or less harmonised tariff levels for those using the formula.

Phasing-out arrangements for tariffs

GATT Article XXIV implicitly recognises that in some cases tariffs can only be eliminated through a phased reduction of tariff rates within a "reasonable length of time". The parties agree that the tariff applied on a certain date is their starting point. This can be the date on which the governments agreed to launch negotiations. They also agree that the tariff will go to zero in a prescribed number of steps. These steps need not be equal, but the normal procedure is to make the first reduction on the day the agreement enters into force. The parties are usually free to eliminate tariffs faster than specified in the agreement either unilaterally or upon request.

Box 4.2: Phased tariff reductions: an example

NAFTA (North American Free Trade Agreement) entered into force on 1 January 1994. It established the following broad timetable for the elimination of duties on goods covered by the agreement:

- duties on goods included in staging category A were eliminated on entry into force;
- duties on goods included in staging category B were eliminated by 1 January 1998 in five equal stages;
- duties on goods included in staging category C were eliminated by 1 January 2003 in ten equal stages;
- duties on goods included in staging category C+ will be removed by 1 January 2008 in fifteen equal stages; and
- duties on goods in staging category D remained free of duty on 1 January 1994.

A look at the tariff schedules appended to the Agreement will show that the situation was rather more complex than shown here, but more elaborate examples of phase-in schedules are not hard to find.

NAFTA also contains a provisions allowing for the negotiation of accelerated tariff reductions, and this was used once the Agreement was in force.

The Understanding on the Interpretation of Article XXIV (see Appendix 2 for the full text) explains that the "reasonable length of time" is to be understood as exceeding ten years only in exceptional cases. Good practice would therefore suggest that phasing out of tariffs, to the extent that it is needed, is done within ten years. No matter what the timetable adopted by the parties, it should be specified clearly in the agreement or the schedules attached to it. Doing so can prevent many minor disagreements. Most agreements therefore specify the starting point and the starting rate for each item subject to a phase-out, the dates on which specified reductions will occur, and the dates on which the tariff will have been eliminated.

Free-trade agreements should include as a matter of good practice a provision enabling accelerated phase-outs, either as a unilateral action or because of a request from the other party. This may sound preposterous at the time of the negotiations, but in many cases acceleration has turned out to be surprisingly easy once the phase-outs were under way.

Rules of origin

Every free-trade agreement needs a mechanism to identify the goods eligible for preferential market access. This mechanism consists of the rules of origin. The chapter in a free-trade agreement on rules of origin has several main functions:

- it defines the class of goods that will always be considered as originating in the other party or parties and therefore eligible for preferential tariff treatment; these are goods that are *wholly obtained*, *wholly produced* or *substantially transformed;*
- it establishes the method to be used for assessing whether *substantial transformation* has occurred;
- it defines the conditions under which goods will not be considered for preferential tariff treatment, usually because they have undergone *insufficient processing* or *insufficient operations* in the exporting economy, or have merely been transshipped from another economy;
- it describes the method needed for claiming preferential status, i.e. through the presentation of a *certificate of origin*, through *self-certification* or through other agreed means;
- finally, it defines the options available to the importing economy if it suspects, or has established, that goods were falsely claimed to have originated within the free-trade area. Among these options is a suspension or denial of preferential tariff treatment.

Rules of origin tend to be highly complex because of attempts to make them precise and to eliminate, as much as possible, room for dispute between the parties. They can of course also be used for protectionist purposes. For example, although the tariff on a good may have been eliminated, onerous value-added or processing rules may render the zero tariff virtually without any commercial value.

One other point to mention is that the *Common Declaration with regard to Preferential Rules of Origin*, an annex to the WTO *Agreement on Rules of Origin*, lists certain requirements for the rules of origin used in free-trade agreements. The Common Declaration can be found in Appendix 4. More details on approaches to rules of origin may be found in Chapter 5.

Anti-dumping measures

GATT Article VI states that dumping occurs when "products of one country are introduced into the commerce of another country at less than the normal value of the products, i.e. "if the price of the product exported from one country to another . . . is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country". When dumping is thought to have occurred, GATT Article VI and the WTO *Anti-Dumping Agreement* specify the conditions under which an economy may impose anti-dumping measures, including a prescribed investigation process.

Most free-trade agreements retain the possibility that the parties may wish to resort to anti-dumping measures against each other. In these cases the parties usually simply reaffirm their rights and obligations under the GATT and the WTO Anti-Dumping Agreement. There is, however, no legal need to do so. If both parties are WTO members, their WTO obligations continue to apply against each other unless they have modified or abandoned their rights in respect of the other party through a bilateral agreement. The same applies to safeguards and countervailing duties, discussed below.

In a few cases, however, the parties have agreed that taking anti-dumping action against each other would not be consistent with the aim of achieving greater economic integration. Australia and New Zealand, for example, have renounced the right to take anti-dumping action against each other, and they have instead agreed that to the extent dumping constitutes anti-competitive conduct, it is actionable under either country's competition laws. Similarly, the member states of the European Community cannot take anti-dumping action against goods imported from other member states. Cases of such provisions in free-trade agreements are, however, rare.

Box 4.3: Anti-dumping in ANZCERTA

Australia and New Zealand adopted a *Protocol on Acceleration of Free Trade in Goods* on 18 August 1988. This protocol provides in Article 4 that

1. The Member States agree that anti-dumping measures in respect of goods originating in the territory of the other Member State are not appropriate from the time of achievement of both free trade in goods between the Member states on 1 July 1990 and the application of their competition laws to relevant anti-competitive conduct affecting trans-Tasman trade in goods.
2. From 1 July 1990 neither Member State shall take anti-dumping action against goods originating in the territory of the other Member State.

Abandoning the right to initiate anti-dumping action appears indeed only possible where other remedies in the form of enforceable competition laws are available, for instance, if possible sensitivities concerning predatory actions are to be allayed. Australia and New Zealand, for example, have accorded each other the right to collect evidence in the other jurisdiction and to hear cases there. They were able to do this because of strong similarities in their legal systems and especially their competition laws. This kind of close legal cooperation is often not possible between other economies.

Global safeguards

Safeguards are measures imposed by the importing country to deal with surges in imports of a good where the surge is causing, or threatening to cause, serious injury to domestic industry. Many free-trade agreements make provision for more than one system of safeguards, but practice in this regard is by no means uniform.

First, many agreements use the safeguards available under the multilateral system through Article XIX of the GATT and the WTO *Agreement on Safeguards*. These are often known as *global safeguards*. Such safeguards can be imposed if certain conditions have been satisfied (see Box 4.4). Importantly, if they are applied, this has to be done against an imported good irrespective of its source. Second, some agreements allow *transitional safeguards* which are generally limited to the phase-in periods for tariff elimination under the agreement (see Box 4.5 for an example). Third, *special safeguards* are available in some agreements for limited product categories, mainly agricultural or textile products (see Box 4.6 for an example). As the differences between these three types of safeguards can be considerable, it is necessary to be clear at all times about the proposed safeguard that may be under consideration. In this section we discuss global safeguards.

A safeguard imposed by an economy usually takes the form of a tariff increase, an import quota or a tariff quota (i.e. once imports of the good in question exceed a certain amount, the tariff applied to it is increased).

Differing views exist on whether the members of a free-trade area should have access to global safeguards to administer the trade between themselves. Some say that free-trade agreements are instruments for closer economic integration, and that safeguards should have no place in them. In their view, free-trade agreements are expected to lead to changes in competitive conditions. Others maintain that they have the right under the WTO rules to impose safeguards under prescribed conditions, and that they see no reason to abandon that right.

Box 4.4: When can WTO members impose safeguard measures?

GATT Article XIX:1 states that

(a) If, as a result of unforeseen developments and the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions, any product is being imported into the territory of that contracting party in such increased quantities and

> under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the contracting party shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession.
>
> (b) If any product, which is the subject of a concession with respect to a preference, is being imported into the territory of a contracting party in the circumstances set forth in subparagraph (a) of this paragraph, so as to cause or threaten serious injury to domestic producers of like or directly competitive products in the territory of a contracting party which receives or received such preferences, the importing contracting party shall be free, if that other contracting party so requests, to suspend the relevant obligation in whole or in part or to withdraw or modify the concession in respect of the product, to the extent and for such time as may be necessary to prevent or remedy such injury.
>
> Article 2 of the *Agreement on Safeguards* clarifies that
>
> 1. A Member may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products.
> 2. Safeguard measures shall be applied to a product being imported irrespective of its source.

Either way of looking at the problem has merit and is acceptable under the WTO rules. Footnote 1 to Article of the *Agreement on Safeguards* states that "[n]othing in this Agreement prejudges the interpretation of the relationship between Article XIX and paragraph 8 of Article XXIV of GATT 1994". This makes it pretty clear that the question of whether or not one is obliged to apply safeguards to a free-trade partner is really wide open from a legal standpoint.

Proponents of one approach say that they seek to maximise regional integration. Proponents of the other approach say that they are making use of a legal right available to the parties in any case. Neither economy may in fact have any intention of using the safeguard provision against the other party. There are cases, however, where third parties may be disadvantaged. This happens when a party imposes safeguards against non-parties only even though the other party to the free-trade agreement may have contributed to the surge in imports. However, support for the agreement from key industry organisations can sometimes only be assured through the inclusion of a safeguard provision.

Some free-trade agreements, such as the New Zealand–Singapore free-trade agreement and the Australia–Singapore free-trade agreement, do not permit safeguard measures. Many others allow the use of safeguards in accordance with GATT Article XIX, i.e. global safeguards. NAFTA and the Canada–Chile free-trade agreement are in this category, but safeguards can be imposed only if imports from another party account for a substantial share of total imports.

But there is a complication known in WTO law as “parallelism”. If a party decides to initiate global safeguards, it must decide how to deal with goods imported under preferential conditions. If these are excluded from the investigation, then any safeguard measure imposed cannot be applied to these preferential imports. On the other hand, if goods imported under preferential conditions are included in the safeguard investigation, then the subsequent safeguard measures must be imposed on these imports.

Transitional, special and provisional safeguards

Whether a free-trade agreement permits transitional or special safeguards depends entirely on the views of the parties to the agreement. A decision on whether they are required should be part of the negotiations. There should not be an automatic presumption that such safeguards are needed. Clearly, if the trade-liberalising shock of the agreement is likely to be strong, a better case can be made for these types of safeguards. Where liberalisation is minor, it probably would be better to resist the temptation of including them.

There will always be tension between the concept of providing a safety net for producers and the risk, if safeguards are available almost on demand, that the trade-liberalising thrust of a free-trade agreement is undermined. A serious effort must therefore go into the design of the safeguard mechanism to ensure that a valid case for safeguards is made.

Some agreements solve the problem of possible over-use of safeguards by requiring a compensatory adjustment within the sector in which a safeguard has been applied. So, for example, if importers of table linen were successful in obtaining a safeguard, an equivalent reduction in the import duty of another textile product would have to be found.

Transitional safeguards

The purpose of transitional safeguards is to give producers of the same good in the importing economy breathing space to adjust to expanded imports during the phase-out period for tariffs. Sometimes they allow a snap-back to the MFN tariff, but this clearly no longer has any effect when the MFN tariff itself is at zero. In cases of staged tariff elimination, the snap-back sometimes is only to the tariff level prevailing before the current.

The duration of safeguards so imposed depends on the provision in the agreement, but two years is quite common. Some agreements permit one or more extensions of the safeguards. Many agreements appear to have a limit of two extensions. They also permit the invocation of a transitional safeguard once only for a good. It is also logical for a transitional safeguard measure on a good to expire altogether once the tariff has gone to zero, or soon after. Nevertheless, there are cases of free-trade agreements where a snap-back to an earlier MFN tariff is available for a limited period.

Box 4.5: An example of a transitional safeguard

mechanism

Transitional safeguards are available under Article 503 of the Thailand–Australia Free Trade Agreement (TAFTA) if the following main conditions are satisfied:

- safeguard measure only available to prevent or remedy serious damage and to facilitate adjustment;
- initial period may not exceed two years, followed by a maximum two extensions if conditions are satisfied;
- total period of a safeguard measure may not exceed six years;
- safeguard measures lapse in all cases two years after the tariff has been eliminated, and no measure may be applied after that date;
- if the safeguard measure exceeds one year, liberalisation at regular intervals is required;
- a safeguard measure may not be imposed more than once on the same good unless the length of the interval without a safeguard matches the length of the earlier safeguard;
- a transitional safeguard may not be used if another safeguard available under the WTO agreements is already in force; and
- when a safeguard is terminated, the tariff on the good must revert to the level it would have been without a safeguard.

Good practice would be to ensure that petitions for invoking transitional safeguards have to undergo a credible investigation. They should not be available more or less at the routine request of a producer or a group of producers. A point that always needs to be remembered is that a safeguard measure protecting one segment of industry may in fact be a burden on another segment and make it less competitive.

Transitional safeguards need not be available for all goods sectors. For many goods, access to the normal emergency safeguards available under GATT Article XIX should be enough. This is especially true when the applied tariff was already low when the agreement entered into force. In any case, the transitional safeguards mechanism will always become redundant once all tariffs have been eliminated.

Special safeguards

Some free-trade agreements have provisions for the use of special safeguards. These are usually confined to trade in a limited range of agricultural products. Many agreements manage to do without such safeguards. Two basic forms of mechanisms are used.

The first uses "injury" as a criterion. In other words, the impositions of special safeguards may be requested when imports, usually of the some product, cause, or threaten to cause, injury to the domestic producers. This is of course also the basis for the imposition of global safeguards.

The second type of special safeguards is triggered when imports exceed a certain volume in a given period. Such safeguards therefore can put a ceiling on imports at the preferential tariff rate even when there is no perceived risk of injury to the domestic producers. The inclusion of such a mechanism may be inescapable, but it would be possible to mitigate its effect to some extent through not making it automatic. This could be achieved by a requirement that the safeguard mechanism will only be triggered through a petition.

Box 4.6: An example of a special safeguard mechanism

Special safeguards for certain sensitive agricultural goods are available under Article 509 of the Thailand–Australia Free Trade Agreement (TAFTA) if the following main conditions are satisfied:

- special safeguards may only be applied to a defined list of agricultural goods;
- they may only be imposed during the time specified for that good in the agreement;
- they may only be imposed if imports in a given calendar year exceed the trigger levels specified in the agreement;
- if these conditions are met, a party may increase the customs duty for that good for the remainder of the calendar year to the current MFN rate or the base rate, whichever is the lower;
- special safeguards must be applied in a transparent manner and notice given to the other party as far as possible in advance;
- special safeguards may not be used if another safeguard available under the WTO agreements is already in force;
- a review of the appropriateness of the list of goods and trigger levels must be conducted no later than three years after the entry into force of the agreement; and
- if a party enters into a free-trade agreement with a potential supplier of the goods on the sensitive list without arranging for special safeguards on these goods, the parties are required to consult about the possibility of removing that good from the list.

Designing a mechanism that avoids creating an expectation that special safeguards are available whenever imports have risen or are likely to rise is very difficult. Those calling for such a mechanism will want to ensure that it is available when needed. It should, however, be possible to provide that special safeguards can no longer be invoked on agricultural products with a zero tariff under the agreement.

Provisional safeguards

These are short-term safeguards, usually available for no more than 200 days. They can be imposed in critical circumstances where a party assesses that damage to domestic industry would be difficult to repair if no safeguard action were taken. The proviso usually is that a normal safeguards investigation then has to be started and that, if this investigation shows that the action was not warranted, the tariff increases have to be refunded.

Subsidies and countervailing measures

Export subsidies on industrial products are illegal under the WTO provisions. Few free-trade agreements therefore have extensive provisions in this area. Most appear to be satisfied with reaffirming their rights and obligations under the WTO *Agreement on Subsidies and Countervailing Measures*. The *Australia New Zealand Closer Economic Relations Trade Agreement* (ANZCERTA), which precedes the Uruguay Round, states that goods eligible for an export incentive have that eligibility removed if they are exported to the other party.

WTO members have agreed to negotiate for the elimination of agricultural export subsidies also. In the meantime, some agreements, such as the free-trade agreement between the United States and Chile, contain provisions exhorting or requiring the parties not to use agricultural export measures against each other. That agreement also gives the parties the right seek consultations when they become aware that a third country is exporting subsidised agricultural products into the free-trade area. Thirdly, the United States and Chile agree to cooperate toward agreement in the WTO to phase out agricultural export subsidies.

5. Rules of origin

What is the purpose of the rules of origin?

The rules of origin are used by the customs authorities to determine whether a good can be imported under the preferential tariff. They can be highly technical because they must allow a customs officer to arrive at a clear decision.

Concluding the chapter in a free-trade agreement on rules of origin (ROOs), together with the tariff negotiations, is often one of the most demanding aspects of free-trade negotiations. Getting this chapter right requires a good understanding of the economy, the principles of international trade and the prospective effect of the rules. This chapter is concerned mainly with preferential rules of origin, but it also explains briefly the purpose of non-preferential, or MFN, rules of origin.

Non-preferential rules of origin

All economies use *non-preferential rules of origin* to determine the origin of goods imported under conditions that do not entail preferential market access. They serve many purposes. Among these are the need to determine whether a good qualifies for most-favoured-nation (MFN) treatment, the need to maintain accurate trade statistics, to ascertain whether quota restrictions apply, to enable anti-dumping, countervailing duties and safeguards investigations, etc.

Box 5.1: Non-preferential rules of origin

Article 1 of the WTO *Agreement on Rules of Origin* defines rules of origin as

> "those laws, regulations and administrative arrangements and administrative determinations of general application applied by any Member to determine the country of origin of goods provided such rules of origin are not related to contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of paragraph 1 of Article I of GATT 1994 [the most-favoured-nation rule]".

One important characteristic of non-preferential rules is that they must be capable of ascribing a place of origin to every good that enters through the customs process, for example, to satisfy statistical recording of trade.

Preferential rules of origin

Rules of origin in free-trade agreements, i.e. preferential rules of origin, on the other hand, have only one purpose. They must enable the partner economies to decide whether a good imported from the other partner qualifies for preferential market access. In technical language, the purpose of preferential rules of origin is to enable customs authorities to determine whether a good is *originating* or *non-originating*. If a good is held to be non-originating, it will be processed by the customs authorities under the non-preferential rules of origin, and it will not benefit from the lower tariff.

Box 5.2: Preferential rules of origin

The WTO *Common Declaration with Regard to Preferential Rules of Origin*, part of the *Agreement on Rules of Origin*, states that

> "preferential rules of origin shall be defined as those laws, regulations and administrative determinations of general application applied by any Member to determine whether goods qualify for preferential treatment under contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of paragraph 1 of Article I of GATT 1994 [i.e. most-favoured-nation treatment".

Preferential rules of origin are divided further into reciprocal (or contractual) rules and non-reciprocal (or autonomous) rules. The former are used in free-trade agreements. The latter are employed in unilateral preference schemes, such as the Generalised System of Preferences (GSP). In this guide we are not concerned with non-reciprocal rules.

Rules of origin therefore determine to a considerable extent how liberal or restrictive a free-trade agreement is. The more conditions a good has to satisfy to qualify for preferential market access, the less likely it is that it will indeed qualify for preferential treatment. Similarly, if the complexity of the rules of origin is such that disputes over its origin become a normal occurrence, importers and exporters will also be less likely to seek to benefit from them. When this happens, the free-trade agreement as a whole loses some of its effectiveness.

Many commentators have expressed a concern that the spread of free-trade agreements leads to a spread of ROOs systems with limited compatibility. This is the so-called *spaghetti-bowl effect.* They note that especially where an economy is a party to several free-trade agreements, business may have to incur additional transaction costs because of these variations.

Whether all of these concerns are justified is not clear. Much depends on how well a firm understands its own production process and the extent to which it can adapt them to meet the rules. It is likely that smaller firms sometimes will have less flexibility in this regard. Nevertheless, negotiators must always be aware of the effect the agreement will have on business, and close liaison with the business community is necessary at all stages of the negotiations.

Key concepts

The key concepts in ROOs systems are *wholly obtained goods* (or *wholly produced goods*) and *substantial transformation*. Goods satisfying these criteria are *originating goods*. A wholly obtained good is made entirely in the exporting economy from materials produced there. Examples would be bauxite mined and processed into alumina within a single economy, animals bred in the exporting economy or rice produced by the exporter. Such goods always qualify for the preferential tariff.

An originating good may contain some third-country materials or components, but it can still satisfy the requirements for preferential market access because it has undergone substantial transformation. An example of this would be furniture produced from imported timber. The bulk of the rules of origin in most free-trade is in fact concerned with establishing the criteria for preferential access for goods containing materials obtained from outside the free-trade area.

Box 5.3: Wholly obtained goods

These are goods that originate entirely within the territory of a free-trade agreement partner. They always benefit from preferential market access. Here is one definition of such goods:

"Wholly obtained goods" means

i. mineral goods extracted in the territory of a Party;

ii. agricultural goods harvested, picked, or gathered in the territory of a Party;

iii. live animals born and raised in the territory of a Party;

iv. goods obtained from live animals in the territory of a Party;

v. goods obtained directly from hunting, trapping, fishing, gathering, or capturing in the territory of a Party;

vi. goods (fish, shellfish, plant and other marine life) taken within the territorial sea or the relevant maritime zone of a Party seaward of the territorial sea under that Party's applicable laws in accordance with the provisions of the *United Nations Convention on the Law of the Sea*, or taken from the high seas by a vessel entitled to fly the flag of that Party;

vii. goods obtained or produced on board factory ships entitled to fly the flag of a Party from the goods referred to in subparagraph (vi);

viii. goods taken by a Party, or a person of aParty, from the seabed or subsoil beneath the seabed of the territorial sea or the continental shelf of that Party, in accordance with the provisions of the *United Nations Convention on the Law of the Sea*;

ix. waste and scrap derived from production in the territory of a Party, or used goods collected in the territory of a Party, provided such goods are fit only for the recovery of raw materials; and

x. goods produced entirely in the territory of a Party exclusively from goods referred to in subparagraph (i) through (ix).

Source: Australia-Thailand Free-Trade Agreement

It follows that all goods that have not undergone a substantial transformation in the exporting economy are *non-originating goods*, i.e. they will not enjoy preferential market access, unless the rules in a given free-trade agreement allow otherwise.

The concept of the "last substantial transformation" is therefore of critical importance. Often, a complex good will in fact have undergone several substantial transformations before being traded under a free-trade agreement. What counts for the purpose of preferential market access is where the last substantial transformation occurred. For example, making clay into a flower pot would normally be considered a substantial transformation.

Glazing or painting the flower pot would not qualify as a substantial transformation under some rules of origin because the purpose and name of the resulting article would remain unchanged. Therefore, if the pot was made outside the free-trade area, but imported by one free-trade area partner for glazing and then re-exporting to the other free-trade area partner, the earlier substantial transformation would not be taken into account. The pot accordingly would not enjoy preferential market access.

Box 5.4: Substantial transformation

Annex D.1 to the *International Convention on the Simplification and Harmonization of Customs Procedures* (the Kyoto Convention) concerning rules of origin defines the "substantial transformation criterion" as

- the criterion according to which origin is determined by regarding as the country of origin the country in which the last substantial manufacturing or processing, deemed sufficient to give the commodity its essential character, has been carried out.

Things can get more complicated. Some systems of rules of origins may require double or even triple transformations for a good to qualify for preferential market access. An example of a double transformation is what is known in free-trade agreements concluded by the United States as the *fabric-forward rule*. To qualify for preferential market access the fabric used for a garment, as well as the garment itself, have to originate from within the free-trade area. A triple transformation occurs when the yarn used for producing the fabric also has to be a product of the free-trade area. This is known as the *yarn-forward rule*.

Methods for ascertaining substantial transformation

Three main methods are available to work out whether substantial transformation has occurred. They are listed in Annex D.1 concerning rules of origin to the *International Convention on the Simplification and Harmonization of Customs Procedures* (the Kyoto Convention). The three methods are:

- *change-in-tariff heading method* (also known as change-in-tariff classification method) which says that the product in question has undergone sufficient manufacturing or processing if it falls into a category of a tariff classification different to the ones applied to each of the materials or components used;
- *process-based method* which means that the good must have a

undergone a specified manufacturing or processing path to qualify for preferential treatment; and

- *value-added method* which measures how much of the value of a good is due to processing or working in the exporting economy and compares it with a prescribed threshold usually known as the *regional value content*, or *qualifying value content*, expressed as a percentage in each case.

The change-in-tariff classification method is more common than the others, though no two agreements have the same rules. In practice, two, and sometimes even all three of these methods, are combined to furnish the criterion for substantial transformation. This does not necessarily mean that the criterion is especially onerous since it may simply reflect the production process that is necessary in any case.

All free-trade agreements seek to ensure that its provisions are not abused, and that only goods originating in the partner economy gain preferential market access. One of the ways to do this is to prohibit *transshipment*. This means that it is not possible to buy a good cheaply in a third economy and export it to the free-trade partner under preferential conditions by way of one's own ports.

This prohibition is usually supported by a description of what constitutes *insufficient working or processing operations*. These are operations that do not change the nature of a good substantially. Examples of such operations are cleaning, dilution with water, re-packaging or cool-room storage. Simple assembly operations are also normally excluded.

Box 5.5: Rules on insufficient operations: an example

Article 26 of the Japan–Singapore Economic Partnership Agreement defines insufficient operations as:

(a) operations to ensure the preservation of products in good condition during transport and storage (such as drying, freezing, keeping in brine) and other similar operations;
(b) changes of packaging and breaking up and assembly of packages;
(c) affixing marks, labels and other like distinguishing signs on products or their packaging;
(d) disassembly;
(e) placing in bottles, cases, boxes and other simple packaging operations;
(f) simple cutting;
(g) simple mixing;
(h) simple assembly of parts to constitute a complete product;
(i) simple making up of sets of articles; and
(j) a combination of two or more operations referred to in sub-paragraphs (a) through (i) above.

We will now look at the three methods for ascertaining substantial transformation in more detail.

Change-in-tariff-heading method

The most commonly used method to ascertain whether substantial transformation of a good has occurred is to compare its tariff classification number (or the tariff numbers of its components) when it entered the exporting economy with the number under which the finished good is imported by the free-trade area partner under preferential conditions. The tariff classification used is normally the *Harmonised Commodity Description and Coding System* (usually known as the Harmonised System or HS). This is often called the *specific rule*.

The hierarchy of the Harmonised System is the chapter (expressed as two digits), the heading (four digits) and the sub-heading (six digits). The transformation requirement is expressed as, for example, a change to a specified sub-heading from any other sub-heading. A major advantage of the Harmonised System is that down to six-digit division it is the same for all economies using it, i.e. for all WTO members. A disadvantage is that, since it was developed to assist customs officers in making decisions in levying the appropriate rate of duty, it often does not reflect production processes.

There is broad agreement that changes requiring a change from one chapter to another usually require more in-country processing than changes from one heading to another. Least onerous are changes from one sub-heading to another. Sometimes, however, a change from one chapter to another is the only possible solution, as in the case of raw skins of sheep or lambs (HS4102) which can only come from live sheep (HS0104).

Box 5.6: Change in tariff classification: three examples

Tariff item	Description of products	Specific rule
4102	Raw skins of sheep or lambs	Change to heading 4102 from any other chapter
7411	Copper tubes and pipes	Change to heading 7411 from any other heading
843210	Ploughs	A change to subheading 843210 from any other subheading

Source: United States–Singapore free-trade agreement

It is easy to imagine a situation, however, where the required change can be made blatantly protectionist. A hypothetical example will illustrate this. Imagine the case of wire of iron or non-alloy steel (HS7217). If the change required is from any other heading, it could be made from bars and rods of iron or non-alloy steel (HS7215). Both of these are within chapter 72 (iron and steel). If, however, a change from any other chapter was required, one would have to go back to chapter 26 (ores, slag and ash). This could only be fulfilled if one had a domestic iron and steel industry. The protectionist intent of the rule would then immediately become clear.

Requirements for changes in tariff classification are usually expressed in quite clear terms. They are expressed as statements that describing what the good must have been before it became what it is. Negotiating them can be an onerous task because it has to be done line by line. On the other hand, a benefit of this method is that manufacturers get adequate guidance if they wish to take advantage of preferential market access.

One problem, however, is that this method can lead to disputes over the classification of a good when, during a tariff phase-out period, tariffs for goods are at different levels. A dispute occurs for example, when the importer insists that that the good should be admitted at the lower rate because, he claims, it is of a certain kind, and the customs authorities give it a higher rating because, as they interpret the rules, it is of another kind. The availability of a system for obtaining binding advance rulings from the customs authority in the importing country then can be of critical importance.

On the other hand, the change-in-tariff-heading method shares many of the characteristics of the harmonised non-preferential rules of origin now being jointly developed by the World Trade Organization and the World Customs Organization. If economies were to decide at some stage to harmonise preferential rules of origin, they could benefit from the groundwork already done under free-trade agreements using such rules.

Box 5.7: Assessing the change-in-tariff classification method

Advantages

- More predictable in terms of origin outcomes ("once qualify, always qualify") and therefore permits more effective planning.
- Permits precise formulation of conditions determining origin and therefore easier for government to administer.
- Economically efficient because it allows importing from the cheapest source.
- Advantageous for small and medium-sized enterprises because there is less need to maintain costly records systems.
- Should assist eventual work in the WTO on multilateral preferential rules of origin.

Disadvantages

- Possibility of disputes during the phase-out period over the classification of a good.
- Negotiating the specific rules can be an onerous task.
- Difficulties can arise when the free-trade partners use many split-subheadings.
- The Harmonised System was developed for the use of customs officials at entry and exit ports; it does not necessarily reflect production processes.
- The drafting of the rules may become captive to protectionist interests because they can be tailored to individual requirements.
- As the Harmonised System is normally revised about every five years, it may be necessary to revise the schedule of rules origin from time to time.

Process-based method

The process-based method shares many of the characteristics of the change-in-tariff-heading method. Its descriptions, for example, are usually based on the sub-headings in the Harmonised System.

Process-based rules specify that a good must undergo a specific process in the exporting country if it is to be eligible for the preferential tariff in the importing country. They are common, for example, for chemical products where the required process is usually a prescribed chemical reaction, but they are used for many other goods.

Box 5.8: Process-based rules: an example

Tariff item	Description of product	Specific rule
030341	Yellowfin tunas	Product of combination of 3 or more processes, including freezing, cleaning, gutting, removing of gills, scaling and de-heading

Source: United States–Singapore free-trade agreement

Process-based rules can be drafted to give a clear picture of what is required to qualify for preferential treatment. They are therefore very helpful to manufacturers and processors as long as it possible to comply with the prescribed process in a way that does not increase production costs. The disadvantages of such rules are that they may lead to an unreasonable number of product-specific items and that they may require quite onerous documentation. All such requirements add to the cost of trading.

Box 5.9: Assessing the process-based method

Advantages

- Permits precise and objective formulation of conditions determining origin.
- Gives complete scope to reflect the production process.

Disadvantages

- Negotiating the specific rules will be an onerous task.
- Major changes in production processes will require renegotiation of the rules.
- The drafting of the rules may become captive to protectionist interests because they can be tailored to individual requirements.

Value-added methods

Two main methods are used for calculating the value added to a good. The first is the *net-cost method* (also called *ex-factory cost method*). The second is the *transaction value method*. Both of them express the minimum amount or threshold of value to be added as a percentage of the value of the good. However, the differences between them and the methods for calculating them are considerable.

Box 5.10: The net-cost method: an example

$$RVC = \frac{NC - VNM}{NC} \times 100$$

where RVC is the regional value content of a good, expressed as a percentage;

VNM is the value of non-originating materials used by the producer in the production of a good; and

NC is the total cost incurred in respect of all goods produced by a producer, minus any costs related to sales promotion, marketing, after-sales service, packaging, shipping.

Source: Canada–Chile free-trade agreement

The basis of the net-cost method is a compilation of all the value added by a firm to a good. It therefore requires identification of all the costs incurred in the production of a good. This includes, for example, materials, labour, electricity, rent, insurance, etc. The total cost incurred by the firm in the production of the good (i.e. the value it has added to it), is then compared with the value of the good itself. An example would be a carpet worth \$100 of which the net production cost incurred by the firm was \$40 and the value of the non-originating materials amounted to \$60. In a free-trade agreement where the rules specify a regional value content of at least 40%, this carpet would normally qualify for preferential market access under this method.

One of the difficulties with the net-cost method is that most companies produce more than one product and the products are of different value, they then have to devise a method for allocating the costs to each product. This is not be too onerous for a modern car manufacturer where the cost of each component is known precisely, but small enterprises often do not have the capacity to perform these tasks.

The *build-up method* in free-trade agreements concluded by the United States is a variation of the net-cost method. Appendix 2 contains a description of this method.

The *transaction value method* is often called the *FOB method*. In either case, the valuation of non-originating materials is based on the FOB (free on board) import price of these materials. The calculation of the regional value content of a good starts with its free-on-board value. This can be ascertained through an inspection of the exporter's invoice. The value of all non-originating materials (i.e. those imported from third countries), is then deducted. Their value can also be ascertained through invoices. In the case of a carpet worth \$100 FOB, the value of the non-originating materials may have happened to be \$60 and the value added by the producer \$40. In this case, the regional value content therefore would also be 40%. Again, if the regional value content prescribed in the free-trade agreement is 40% or more, the carpet should qualify for preferential access.

Box 5.11: The transaction-value method: an example

$$RVC = \frac{TV - VNM}{TV} \times 100$$

where RVC is the regional value content of a good, expressed as a percentage;

TV is the transaction value of the good adjusted to a free-on-board basis; and

VNM is the value of the non-originating materials used by the producer of the good.

Source: Canada–Chile free-trade agreement

The main advantage of transaction-value method is that the producer can avoid many calculations by simply referring to invoices listing the FOB price of the materials. The *build-down* method used in free-trade agreements negotiated by the United States is a variation of this method. Appendix 2 contains a description of this method.

Value-added thresholds look deceptively simple to negotiate and to implement. Only one rule seems necessary for the entire range of goods traded under the agreement. The reality is different.

The calculation itself can be quite difficult and time-consuming for smaller exporters. Where the difference between the MFN tariff rate and the preferential rate is small, exporters may in fact decide that the easier option for them is export under the MFN rate.

Another problem is that no matter what the threshold level is, there will always be goods that miss out by just a few percentage points. This creates dissatisfaction in the trading community. There is probably less of a problem in the case of two large diversified economies because they can more easily find component sources within the free-trade area. Another solution is to permit cumulation of value-added components across several economies.

Tolerance rules also can minimise this problem to some extent, but the decision on their use often depends on the importing economy. In other cases, hundreds of specific exceptions have become necessary to ensure that preferential trade does not become more burdensome than MFN trade.

Few preferential arrangements in fact rely wholly on a value-added rule. The Australia–New Zealand and the Australia–Singapore free-trade agreements are among those that do. In March 2005 the European Commission announced that it was considering eliminating the current multiplicity of rules of origin in preferential agreements with certain third countries and replacing them with a single rule based on value added in the beneficiary country. Most agreements, however, use the value-added criterion to supplement a change-in-tariff classification system, or to bring additional clarity to it. The tolerance rule can then be applied quite liberally.

Box 5.12: Assessing the value-added method

Advantages

- The rule is simple and precise.
- Much of the evidence can be established from commercial records or documents.
- If there is only one value-added threshold covering all products, classification disputes cannot occur.
- Sectoral pressures are harder to accommodate.

Disadvantages

- Regardless of the value-added threshold, some goods will always miss out by a small amount, and this creates frustration.
- Such systems can only be made to work properly through the use of tolerance rules or *de minimis* rules.
- Changes in the exchange rate and commodity prices can have an influence on the value of inputs which places exporters in a vulnerable position.
- Goods with low overheads, labour and locally-obtained materials compared to the cost of imported materials may have greater difficulty in satisfying the regional value content.
- Small firms may have difficulty calculating and allocate the relevant costs without obtaining additional expertise.
- Differing accounting conventions will lead to disputes over allowable costs.

Cumulation

Some free-trade agreements seek to minimise the problem of shortfalls from thresholds through permitting cumulation. This means that value-added content from two or more economies can be combined to make up the regional value content. This can be done in agreements with three or more members. The more members there are, the better it will work.

The Thailand–Australia Free Trade Agreement (TAFTA) has a variation on this. TAFTA establishes a regional value content of 55% for goods falling within chapters 50 to 64 of the Harmonised System (i.e. textiles, clothing and footwear). However, non-originating materials produced in developing countries may contribute towards the regional value content for such goods up to a maximum allowable proportion of 25% of the FOB value of the goods. Using again the example of the carpet with an FOB value of $100, its regional value content would have to be at least $55. If this criterion cannot be met through materials originating within the free-trade area, it would be possible to count up to $25 of materials originating in developing countries towards the threshold. This approach will still prevent the transshipment of goods.

De minimis and tolerance rules

Disagreements can occur when a good incorporating some imported component seems to be in most respects a product of a free-trade partner, but with the complication that it evidently has not undergone a substantial transformation. These situations are usually dealt with through the adoption of *de minimis* rules. These rules effectively suspend the general rules for a small number of exceptions.

Box 5.13: The *de minimis* rule: an example

Many free-trade agreements contain a *de minimis* rule. Article 3.3 in the agreement between the United States and Singapore is an example:

1. Each Party shall provide that a good that does not undergo a change in tariff classification pursuant to Annex 3A [the rules of origin] is nonetheless an originating good if:

   (a) the value of all non-originating materials used in the production of the good that do not undergo the required change in tariff classification does not exceed 10 percent of the adjusted value of the good; and

   (b) the good meets all other applicable criteria set forth in this Chapter for qualifying as an originating good.

The value of such non-originating materials shall, however, be included in the value of non-originating materials for any applicable regional value content requirement for the good.

These rules are called "tolerance rules" in some free-trade agreements.

The WTO requirements for preferential rules of origin

The WTO *Agreement on Rules of Origin* has attached to it a *Common Declaration with Regard to Preferential Rules of Origin* (see Appendix 4 for the complete text). In this Declaration WTO members agree that all preferential rules of origin must conform to the following requirements:

- where a change in tariff classification is used, the rule must specify clearly the sub-headings and headings within the tariff nomenclature;
- where the value-added criterion is used, the method applied for calculating percentages must be indicated;
- where the criterion of manufacturing or processing is prescribed, the operation conferring preferential origin must be specified precisely;
- preferential rules of origin must be based on a positive standard, i.e. they must state what criterion confers origin;
- the GATT transparency rules apply to the administration of preferential rules of origin;
- any exporter, importer or any other person with a justifiable cause may apply for an advance assessment of the preferential origin that might be accorded to a good, and this assessment must be issued no later than 150 days after all the necessary information has been submitted;
- advance assessment are to remain valid for three years provided

that the facts and conditions on which they were based, including the preferential rules of origin, remain comparable;

- changes to preferential rules of origin or new systems must not be applied retroactively as defined in laws and regulations;
- all administrative action relating to the determination of preferential origin must be capable of review by a body independent of the authority making the original determination, and that body must be able to change or reverse the original decision;
- all information provided on a confidential basis must be treated as such unless permission has been given to make it public; and
- all changes to preferential rules of origin or new systems must be notified to the WTO.

6. Trade facilitation

Paying attention to the cost of trading

The aim of trade facilitation measures is to bring down the cost of doing business while at the same time ensuring the integrity of border controls. Measures to support secure trade can complicate efforts to simplify procedures, but they also bring benefits. Getting the trade facilitation provisions right can make a big difference to an economy's competitiveness.

Trade facilitation is an umbrella term for actions taken by governments to enable international trade to function smoothly. Many definitions of trade facilitation are available. A good one is that developed by the United Nations Economic Commission for Europe (UN-ECE). It considers "trade facilitation to encompass the systematic rationalisation of procedures and documentation for international trade, where trade procedures are the 'activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade'".

Box 6.1: What is covered by trade facilitation?

Trade facilitation applies to the entire trade transaction process. It includes at least the following:

- agreement of sale between the buyer and seller;
- processing of the agreed commercial documentation;
- compliance with health, safety and other regulations and standards;
- fulfilment of the required customs and other documents and procedures at the time of border crossing;
- the efficient movement of the goods from the seller's to the buyer's premises;
- compliance of the goods with the buyer's requirements;
- payment for the goods; and
- disposal of goods and end products.

Source: United Nations Economic Commission for Europe 2003

In APEC customs procedures, standards (often referred to as technical barriers to trade), e-commerce and business mobility are considered the core areas of trade facilitation. Chapter 9 deals with business mobility in more detail.

The WTO view of the coverage of trade facilitation measures, as expressed in the mandate for the negotiations on trade facilitation which were launched in August 2004, appears at first glance quite narrow. It seeks to clarify and improve relevant aspects of GATT Article V (Freedom of Transit), Article VIII (Fees and Formalities connected with Importation and Exportation) and Article X (Publication and Administration of Trade Regulations) with a view to expediting further the movement, release and clearance of goods, including goods in transit. However, much has happened in these areas since the GATT was drafted in 1947. Increasingly, business and governments are cooperating to reduce formalities to a minimum and to transmit forms electronically, wherever possible. The negotiators will have to take account of these changes, especially the fact that business without electronic means is now unimaginable.

A 2003 OECD study estimated that trade transaction costs related to border procedures varied according to the kind of goods, the size and type of the businesses involved and the efficiency and integrity of interacting businesses and administrations. It found, however, that trade transaction costs amounted to 1% to 15% of the value of the traded goods. The higher figure easily exceeds the level of the bulk of tariffs now levied on manufactures. It gives a good indication that savings should in many cases be possible.

The UN-ECE study quoted earlier notes that an average trade transaction goes through 27 to 30 parties, and that in a poor regulatory environment this can mean up to 40 documents. The importance of good trade facilitation chapters in free-trade agreements thus becomes readily apparent, as does their ability to contribute to significant savings in doing business.

The emphasis of trade facilitation in free-trade agreements should be on reducing the costs for business. In this way, these agreements can contribute to making the partner economies more competitive globally because they can obtain goods and components of goods at a better price and dispose of them more effectively. The trade facilitation sections of a free-trade agreement should therefore never be used to support protectionist leanings or simply to describe the situation prevailing when the agreement was negotiated.

Trade facilitation provisions tend to have their own chapters in free-trade agreements. This is often the case with customs procedures, electronic commerce, standards and sanitary and phytosanitary measures. Partly this reflects the institutional situation: customs procedures are negotiated and implemented by the customs authorities, sanitary and phytosanitary measures by the quarantine services, and so on. In some cases, however, trade facilitation measures are included in the chapter on trade in goods.

The location of these provisions in a free-trade agreement really is of no great significance. Much more important is that the provisions indeed facilitate trade. What has to be borne clearly in mind, however, is that all of these procedures can add significantly to the cost of importing and exporting.

Customs procedures

The chapter on customs procedures occupies a prominent place in every free-trade agreement. It usually is placed immediately after the chapter on trade in goods. The reasons for this are clear. Speedy clearance of the goods, predictable application of the rules and procedures, use of automation, the availability of advance rulings, implementation of risk management systems, etc., can result in considerable savings.

On the other hand, the benefits of improved market access can easily be limited or negated altogether through opaque or unpredictable handling of the goods at the border because they add to the cost of trading with the partner economy.

Box 6.2: What are customs matters?

The Australia–United States Free Trade Agreement describes customs matters as

- "matters pertaining to the classification and valuation of goods for customs duty purposes, rates of duty, country of origin, and eligibility for preferential treatment under this Agreement, and all other procedural and substantive requirements, restrictions, and prohibitions that a Party maintains on imports or exports, including those pertaining to goods imported or exported by or on behalf of travellers. Customs matters do not include matters pertaining to antidumping or countervailing duties."

Other definitions are of course possible.

Chapters on custom procedures therefore tend to have at a minimum the following provisions:

- an undertaking to use, wherever possible, the transaction value as the basis for the valuation of goods (see box on methods of customs valuation);
- a commitment to give binding advance rulings on the classification of goods and their eligibility for preferential market access;
- an undertaking to release the goods as soon as possible, sometimes within a fixed period and before the final determination of the applicable tariff rate;
- an undertaking to encourage paperless trading, the use of automated systems and to promote the modernisation of business procedures and the adoption of new technologies;
- an undertaking to apply a system of risk management to ensure that *bona fide* consignments are not held up;
- a commitment to transparency, including the publication on the Internet of any relevant customs procedures;
- an undertaking to establish enquiry points where the other parties to the agreement can easily obtain customs information; and
- agreement to cooperate in the development of improvements to customs procedures.

In Chapter 6 dealing with the rules of origin we described briefly the transaction-value method for calculating the regional value content of a good. Customs authorities are not always convinced, however, that this method would lead to an accurate assessment of the value of a good for the purpose of levying the correct rate of duty. This situation sometimes occurs when the importer and exporter are related parties, but the problem may arise in other circumstances also. The WTO Customs Valuation Agreement then gives them five other methods, each resulting in greater flexibility for the administrators than the previous one.

The requirement is, however, that the transaction value is the starting point, and that it is only possible to go to the next method if this method is unsatisfactory, and so on. As each successive method becomes more labour-intensive, it is clearly in the interest of the exporters and importers to ensure that their goods are always dealt with under the transaction-value method.

Box 6.3: Methods of customs valuation

The WTO Customs Valuation Agreement lists six methods for valuing goods at the border. The methods are listed in the order they are to be applied, i.e. if the first method doesn't yield useful results, then go to the second, and so on. The transaction value is, however, the method customs authorities are expected to use.

1. **Transaction value:** the price actually paid or payable for the goods when sold for export to the country of importation, adjusted according to the conditions outlined in the agreement.
2. **Transaction value of identical goods:** the price paid for identical goods sold for export to the same country of importation at or about the same time as the goods being valued.
3. **Transaction value of similar goods:** the price paid for similar goods in a sale at the same commercial level and in substantially the same quantity as the goods being valued.
4. **Unit price of the imported good:** if none of the methods above work, the customs value can be determined by the use of the unit price at which the imported goods or identical or similar imported goods are sold in the greatest aggregate quantity, at or about the time of the importation of the goods valued, to unrelated persons.
5. **Computed value:** a value based on the cost of materials and processing incurred in producing the imported good, an amount for profit and general expenses, and the cost or value of expenses outlined in the Agreement.
6. **Other reasonable means** consistent with GATT Article VII and the Customs Valuation Agreement, but not, for example, the selling price in the importing country, the price of the goods in on the domestic market of the exporting country, a system allowing acceptance of the higher of two values, the export price to another country, minimum customs values, and arbitrary or fictitious values.

Electronic commerce

A good infrastructure for the conduct of electronic commerce can greatly assist the development of international trade. Free-trade agreements often seek to ensure that all parties maximise the use of e-commerce. They do this by promoting a good technical environment and protection of users and consumers.

The chapters on electronic commerce therefore tend to be relatively simple. The Australia–United States free-trade agreement is typical of such chapters. Its main contents are:

- neither party may impose customs duties, fees or other charges on the import or export of digital products, regardless of whether they are fixed on a carrier medium (such as a CD or DVD) or transmitted electronically;
- the parties may not discriminate between similar digital products because it may have been created, produced, stored, etc., outside their territories;
- the parties must have domestic legislation governing electronic transactions which encourages competition, regulates industry only to the extent required, and gives parties to electronic transactions full standing before the courts;
- the parties recognise the importance of maintaining and adopting transparent and effective measures to protect consumers from deceptive or fraudulent commercial practices when they engage in electronic commerce; and
- the parties will try to make all trade administration documents available to the public in electronic from, and they will endeavour to accept electronic versions of documents as the legal equivalent of paper documents, they encourage paperless trading.

Standards

The chapters on standards, often known as technical barriers to trade, usually deal with the recognition of standards, either unilateral or mutual, harmonisation of standards and the recognition of conformity assessment procedures The latter are procedures to determine whether products or processes meet the applicable technical requirements in the importing economy. Sometimes the chapter on standards also deals with sanitary and phytosanitary standards (see next section), but many economies consider that although some of the issues raised by them are related, in substance the two sets of standards and the procedures for dealing with them are quite different.

Box 6.4: The definition of standards

The WTO *Agreement on Technical Barriers to Trade* defines a standard as a:

- Document approved by a recognized body, that provides, for common and repeated use, rules, guidelines or characteristics for products or related processes and production methods, with which compliance is not mandatory. It may also include or deal exclusively with terminology, symbols, packaging, marking or labelling requirements as they apply to a product, process or production method.

Many economies are satisfied that the WTO *Agreement on Technical Barriers to Trade* (often known as the TBT Agreement) allows them to deal effectively with standards-related issues. Where this is the case, they often simply reaffirm their rights and obligations under the TBT Agreement. In fact, some free-trade agreements do not even have provisions concerning standards.

Some free-trade agreements distinguish in their standards chapters between the multilateral core obligations established by the TBT Agreement and bilateral supplementary mechanisms. The latter aim to facilitate trade and reduce transaction costs between the parties through, for example, brining together the regulators to find practical solutions to problems where technical barriers to trade are affecting trade.

Some standards chapters in free-trade agreements have a requirement that the economy rejecting the other party's standards or conformity assessment results must explain its reasons for doing so. This is a useful transparency provision.

In some cases, parties to free-trade agreements agree on establishing frameworks for the negotiation of mutual recognition arrangements both for standards and for conformity assessment procedures. Because the agreement is designed to last for many years, and because procedures for amendments are usually time-consuming, it is best to draft such frameworks in sufficiently broad terms to allow the parties to respond to changing circumstances.

Box 6.5: Recognition, harmonisation and equivalence

These words occur frequently in the chapters on technical barriers to trade. Their meaning broadly is as follows:

- *Recognition:* agreement by a party that that a standard used by the other party is sufficiently high to meet its requirements. Recognition can be unilateral or mutual. Each party is free to retain its own standard.
- *Harmonisation:* agreement between two or more parties that on a common standard to apply to all of them. This can be done through the adoption of the standard of one of the parties, through negotiating a new standard or through the adoption of an existing international standard. It is of course possible also for one party to harmonise its standards regime with international standards.
- *Equivalence:* agreement by one party that the mandatory requirements of the other party meet its own objectives, though the requirements of the other party are different. This is often used in the context of testing procedures.

Free-trade agreements for this reason often establish a Committee on Technical Barriers to Trade which meets regularly. Many agreements also find it useful to establish contact points to exchange information on standards and conformity assessments.

Sanitary and phytosanitary measures

Most economies maintain strict sanitary and phytosanitary measures, often known as quarantine measures, to protect human, animal or plant life or health from diseases, disease-carrying or disease-causing organisms not found domestically. Sometimes the agency charged with enforcing sanitary and phytosanitary measures also has the task of looking after food standards, but practice in this regard varies considerably. Box 6.6 gives a definition of sanitary and phytosanitary measures.

The WTO *Agreement on Sanitary and Phytosanitary Measures* (the SPS agreement) gives members the right to impose sanitary and phytosanitary measures that are consistent with the Agreement. Article 2 requires that WTO members "shall ensure that any sanitary or phytosanitary measure is applied only to the extent necessary to protect human, animal or plant life or health, is based on scientific principles and is not maintained without sufficient scientific evidence . . .". In other words, the SPS agreement seeks to ensure that these measures are not used for protectionist purposes.

Negotiating a free-trade agreement does not alter the rights and obligations of economies unless the parties agree that in their trade relations under the free-trade agreement different rules should apply.

Box 6.6: What are sanitary and phytosanitary measures?

A sanitary or phytosanitary measure is any measure applied:

a. to protect animal or plant life or health within the territory of the Member from risks arising from the entry, establishment or spread of pests, diseases, disease-carrying organisms or disease-causing organisms;

b. to protect human or animal life or health within the territory of the Member from risks arising from additives, contaminants, toxins or disease-causing organisms in foods, beverages or foodstuffs;

c. to protect human life or health within the territory of the member from risks arising from diseases carried by animals, plants or products thereof, or from the entry, establishment or spread of pests; and

d. to prevent or limit other damage within the territory of the member from the entry, establishment or spread of pests.

Sanitary or phytosanitary measures include all relevant laws, decrees, regulations, requirements and procedures including, *inter alia*, end product criteria; processes and production methods; testing, inspection, certification and approval procedures; quarantine treatments including relevant requirements associated with the transport of animals or plants, or with the materials necessary for their survival during transport; provisions on relevant statistical methods, sampling procedures and methods of risk assessment; and packaging and labelling requirements directly related to food safety.

Source: Annex A to the WTO *Agreement on the Application of Sanitary and Phytosanitary Measures*

It is mainly for these reasons that few free-trade agreements appear to go beyond the provisions set out in the WTO *Agreement on the Application of Sanitary and Phytosanitary Measures*. Most reaffirm the rights of the parties under that agreement. Some agreements do not contain any provisions in this area at all. In some agreements technical standards and quarantine standards are covered by the same chapter, but many prefer to keep them separate.

The use of sanitary and phytosanitary measures can turn into an irritant in international trade, especially when their purpose or their administration is misunderstood by one party. Occasionally negotiating parties may be tempted to use free-trade negotiations to solve longstanding issues. This seldom works. Free-trade negotiations typically have to be concluded in a short time. Often negotiators are given no more than two years. Most SPS problems require a much longer time to deal with. Even relatively simple import risk assessments are difficult to complete in that time. Once time is added for consultations both at home and with relevant trading partners, several years may have elapsed between the launch of a risk assessment and the entry into force of whatever new regulation may have been developed.

A better way may therefore be for the parties to agree to establish a cooperative work program, sometimes through the formation of a working party or a Committee on Sanitary and Phytosanitary Measures.

Secure trade

"Secure trade" is not something that can be overlooked in a discussion of trade facilitation or dealt with through smart drafting in a free-trade agreement.

A report issued in 2004 by the Department of Foreign Affairs and Trade notes that security measures to combat terrorism are expensive, and that they have the potential to drive up costs and reduce exports, particularly from developing countries. The report adds that, if properly managed, these security measures also hold the promise of facilitating and securing trade and investment.

Studies examining the cost of measures to combat terrorism have found that such measures often bring benefits apart from reducing exposure to terrorism. Because they rely on technological advances, they are likely to increase the efficiency of cargo handling, cargo movement tracking and people movement. These benefits may in fact lower the cost of international trade because they reduce losses, pilfering and help anti-corruption activities. The gains for developing economies from ant-terrorist measures may be disproportionately high because they will need the introduction of more efficient systems common in developed economies.

7. Trade in services

What do the rules on trade in services do?

They determine whether a service provider, or a service offered by that provider, will receive preferential treatment under the free-trade agreement. Services can be delivered electronically or through people. Therefore the agreement will need to cover electronic commerce and the movement of people. These provisions are often dealt with in separate chapters.

Comprehensive free-trade agreements have a chapter liberalising trade in services between the parties. Often they also have chapters on telecommunications services and financial services. In Chapter 3 we outlined the WTO rules for a free-trade agreement in services, contained in Article V of the *General Agreement on Trade in Services* (GATS). The technical term used there is "economic integration agreement". However, since economies usually cover goods and services in the same agreement, we also use refer to free-trade agreements in this context. The full text of Article V can be found in Appendix 3.

Box 7.1: How services are traded: the GATS delivery modes

Most free-trade agreements follow the GATS terminology on services delivery. The GATS divides delivery into four modes. These modes do not necessarily reflect real-life transactions where a service is often delivered through more than mode. However, the four modes establish a useful analytical framework for market access:

Mode 1: *cross-border supply:* provision of a service across borders through electronic, postal or other means without requiring the buyer or seller to meet

Example: a buyer purchases an electronic book or investment advice through the Internet.

Mode 2: *consumption abroad:* the services consumer travels to the economy where the services supplier is located to purchase and consume the service.

Examples: a family takes a holiday in another country, or a student from China pursues a university degree in Australia.

Mode 3: *commercial presence:* the service supplier establishes an outlet through an investment in the economy where the buyer is located

Examples: a bank establishes a subsidiary in another economy, or a telecommunications company establishes a joint venture in another economy.

Mode 4: *movement of natural persons:* a representative of a services provider from country A travels temporarily to country B to market or deliver a service.

Examples: a senior manager of a foreign bank relocates temporarily to the economy where a new branch or subsidiary has been established; a hotel chain assigns a manager from its home base to manage a newly established hotel in an overseas resort.

International trade in services differs considerably from international trade in goods. Goods are tangible objects which in all cases have to packed and taken to a port, an airport, a truck terminal or a railway freight yard for despatch to another economy. At least at the border of the importing economy they will be inspected by customs personnel to ensure that they comply with the economy's import regulations and the correct rate of import duty is paid.

Services, on the other hand, are intangible. They can be traded internationally in different ways. For example, it is possible to order software, take delivery of it and pay for it entirely through the Internet. In other cases, such as the provision of training in dentistry, the service can only be provided satisfactorily if the teacher and the trainee meet. In yet other cases it is necessary for the purchaser of a service to travel to another economy to take delivery of it. This happens in the case of a holiday abroad. Box 7.1 sets out the classification of delivery modes for services adopted under the GATS.

One important respect in which a services chapter differs from a goods chapter is that the former usually will have provisions on short-term business mobility. These are needed because many services can only be sold and delivered through the presence of people in the transaction. However, as similar issues arise from longer-term entry provisions on investment, many agreements combine the provisions on short-term and long-term business entry.

Eliminating discrimination and liberalising trade: there is a difference

The approach to negotiations on trade in services leading to a free-trade agreement can be divided into two categories: (a) elimination of discrimination and (b) liberalisation of a services sector.

Article V of the GATS requires the parties to an economic integration agreement (free-trade agreement) to eliminate discrimination in terms of national treatment. In other words, foreign services and their suppliers have to be treated in the same way as domestic suppliers. Meeting this requirement leaves the regulatory framework for services unchanged, but it introduces an element of competition because services suppliers from the free-trade area partners now are able to look for new markets.

For example, firms practising domestic law may have limits imposed on them on the number of partners they can have. They may also be required have certain domestic legal qualifications. According national treatment in these conditions would mean that foreigners could now establish law practices under the same conditions, as long as they met the requirements for domestic qualifications. This would lead to some liberalisation, but it may be quite limited if the conditions remain restrictive.

The second category concerns the liberalisation of a services sector in addition to extending national treatment to foreign services and their suppliers. In the case of law firms this might mean, for example, that limits on the number of lawyers would be abolished, and that firms could offer domestic and foreign law. The effect on the profession in this case would naturally be more profound.

Elimination of discrimination in services trade is done through changing the relevant regulations. This introduces an additional complexity in federal states (e.g. Australia, Canada, Malaysia, Mexico, United States, etc.) because many services in such economies are regulated by provinces or states. In unitary states (e.g. Chile, Indonesia, New Zealand and Singapore), the central government regulates services. As the perspectives of provinces or states may differ from that of the central government or between themselves, extra effort is sometimes required to achieve a good result.

The contents of a service chapter

The chapter on trade in services in a free-trade agreement at minimum usually carries provisions governing the following aspects:

- a broad description of the services to which the agreement applies; many agreements follow the GATS and exempt bilateral air services and services bought by governments for their own use (government procurement) and services supplied by governments neither on a commercial basis nor in competition with other service suppliers;
- the market access options available to the services providers from the other party; these usually are all of the four modes of services delivery listed in the GATS (see Box 7.1);
- an undertaking of national treatment for services covered by the national schedules of commitments; some agreements also include an obligation to give the other party most-favoured-nation treatment for services not yet covered by the schedules, but this is not really necessary because the GATS already contains this obligation;

Box 7.2: GATS: prohibited limitations on the supply of services

Article XVI of the GATS (market access) prohibits the following market access limitations on services supplies in the sectors where a commitment has been made in a schedule of commitments, unless the schedule specifies otherwise:

(a) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test;

(b) limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;

(c) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test;*

(d) limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test;

(e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and

(f) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment.

*Subparagraph 2(c) does not cover measures of a Member which limit inputs for the supply of services.

- since in many economies some services are supplied by a monopoly provider, the agreement needs to specify what these services are, the extent to which competitors may supply ancillary services and a guarantee that foreign services firms have access under non-discriminatory conditions to the services provided by a monopoly; note that some free-trade agreements do this through the chapter on competition policy
- the extent to which, and under what conditions, the parties may impose quantitative restrictions or supply limitations on their services trade; here many agreements simply follow the list of prohibited limitations contained in Article XVI of the GATS (see the box below); where limitations are required to safeguard the balance of payments, the parties often use the provisions outlined in GATS Article XII;
- a description of the extent to which the services regulated by sub-national levels of government (states and provinces) are covered by the agreement;
- procedures for the recognition, either unilateral or mutual, of licences and qualifications of service suppliers of the other party;
- a description of the conditions under which a party may deny preferential treatment to a service supplier from the other party; and
- arrangements for the inscription of commitments in the services schedules, procedures for changes to these commitments and any mechanisms for their regular review.

Some have suggested that services chapters in free-trade agreements should allow for the imposition of safeguard measures similar to those permitted under GATT Article XIX for trade in goods (see page 27). This issue has been under discussion in the WTO for ten year. So far, there has not been agreement either on the necessity for or feasibility of such a provision, or, if it were feasible, how it might be formulated. In the expectation that agreement might be reached in the WTO, some free-trade agreements have a provision noting that the matter would be reconsidered in the light of any multilateral solution.

Services schedules

The provisions on trade in services need to be supplemented by schedules of commitments. These schedules have a function similar to that of tariff schedules. In preparing them, economies usually adopt one of two methods: positive listings or negative listings. It is of course possible to find schedules which use both of these methods.

Positive listings

The positive-listings method means that only the services included in the schedule will enjoy preferential treatment. A disadvantage of this method is that each time the parties want to liberalise a service, they must amend the schedules of commitments. The *General Agreement on Trade in Services* (GATS) uses this method, and some economies prefer this approach for free-trade agreements, mainly because they are more familiar with it.

It is customary in the use of positive listings to identify a service by the relevant product number from the United Nations [Provisional] Central Products Classification (UNCPCC). This practice was initiated by the drafters of the GATS. As this classification does not list all traded services, the GATT Secretariat issued during the Uruguay Round a supplement known as W/120 from its document number. Even so, many services do not have a number at all, or they are shown as being part of some other service activity. Negative listings rarely use these product numbers.

Box 7.3: Positive listings: an example

This example is taken from the schedule attached by Singapore to its free-trade agreement with Japan.

Modes of supply: 1) Cross-border supply 2) Consumption abroad 3) Commercial presence 4) Presence of natural persons

Sector or subsector	Limitations on market access	Limitations on national treatment	Additional commitments
SECTION II: SECTOR-SPECIFIC COMMITMENTS			
1. BUSINESS SERVICES			
A. Profession al Services			
Financial auditing services (86211)	1) Unbound 2) None 3) None 4) Unbound except as indicated in the horizontal section	1) and 3) None except that public accountants must be effectively residents in Singapore or at least one of the partners of the firm must be effectively	

		resident in Singapore 3) None 4) Unbound	

Some explanations may make this inscription clearer. *Unbound* means that this mode of supply is not feasible because it is effectively prevented by law. *Horizontal section* refers to the laws and regulations that apply to the entire economy. These are listed in a separate part of the services schedule. The classification number is taken from the United Nations [Provisional] Central Products Classification (UNCPCC).

A simplified positive listing

Some free-trade agreements, such as the example shown above, use the model pioneered for the commitments under the WTO *General Agreement on Trade in Services* (GATS) for their services schedules. They have an introductory section outlining horizontal commitments (conditions applying to all services sectors), followed by sectoral commitments which are divided further into the four modes of services delivery (see Box 7.1).

This not only makes the schedules more complex than need be. It also adds to negotiating time since many services have to be considered from the perspective of four possible ways of delivery. The approach taken by the Thailand – Australia Free Trade Agreement (TAFTA) offers an easier way. It has the traditional section on horizontal commitments, but it then simply lists sectoral commitments without specifying how they might be delivered as the following extract from the agreement shows. The agreement, by the way, uses positive listings.

Box 7.4: TAFTA: Australian commitments on services

I. HORIZONTAL COMMITMENTS

Market access and national treatment measures listed in the limitations column condition all sector-specific commitments.

ALL SECTORS INCLUDED IN THIS SCHEDULE	**FOREIGN DIRECT INVESTMENT, INCLUDING COMMERCIAL PRESENCE** . . . **Banking** Foreign investment in the banking sector needs to be consistent with the *Banking Act* 1959, the *Financial Sector (Shareholdings) Act* 1998 and banking policy, including prudential requirements. Any proposed foreign takeover or acquisition of an Australian bank will be considered on a case-by-case basis and judged on its merits. . . .

II. SECTORAL COMMITMENTS

Notes: Commitments in this schedule are subject to the general limitations contained in the "Horizontal Commitments" section of this schedule.

	* Denotes that a sector-specific commitment for cross-border supply is unbound due to lack of technical feasibility. ** Denotes that the service or services specified constitute(s) only a part of the total range of activities covered by the CPC Code.
Accounting, auditing and book-keeping services (862)	Only natural persons may be registered as auditors and liquidators. At least one equity partner in a firm must be a permanent resident. Otherwise unbound except as indicated in the horizontal section.
Taxation services (863)	No limitations.

Negative listings

The negative-listings method means that all services except those listed in the schedule are subject to preferential treatment as outlined in the free-trade agreement. A major advantage of this method is that all new services are automatically covered by the liberalising provisions of the agreement. It is also much easier to reduce over time the number of activities not yet liberalised.

Whether negative schedules are easier to negotiate depends on the extent of discrimination in a regulatory system. The less discrimination there is when negotiations start, the shorter the schedule will be.

Economies sometimes resist this method of listing on the basis that they cannot possibly know what services might be developed over time. It is worth bearing in mind, however, that in the end all services are subject to an economy's regulatory framework, and that economies retain the right to regulate.

The example of the negative listing from Australia–New Zealand protocol on trade in services, a supplement to the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) shown below was designed long before the Uruguay Round ended. Its simplicity has not been reproduced in the more modern listing methods. It illustrates well, however, what the intent of a negative list is.

Box 7.5: Negative listings: an example

The *Australia New Zealand Closer Economic Relations Trade Agreement* (ANZCERTA) uses negative listings for its commitments on services. Services providers from New Zealand and their services are treated in the same way as Australian providers in all services except the following:

Air Services

State governments hold powers to regulate intrastate aviation on economic and public interest grounds.

Scheduled passenger and freight services within and between Australia and New Zealand are governed by an air services agreement which has treaty status and by the Australia-New Zealand Single Aviation Market Arrangements of 1996.

Coastal Shipping

Cabotage policy

Broadcasting and Television

Limits on foreign ownership as set out in the Broadcasting Services Act 1992.

Broadcasting and Television (Short-Wave and Satellite Broadcasting)

Third Party Insurance

Compulsory third party motor vehicle insurance.

Postal Services

The Australian Postal Corporation (Australia Post) has, under section 29 of the Australian Postal Corporation Act 1989, the exclusive right to carry letters for reward within Australia, whether the letters originated within or outside Australia. Section 30 of the Act sets out a number of exceptions to the reserved service, including:

- the carriage of letters weighing more than 250 grams;
- the carriage of letters where the charge or fee is at least four times the standard letter rate;
- the movement of documents within document exchange services; and
- the carriage of letters between offices of the same organisation by a third party.

A different approach to negative listings can be found in many of the free-trade agreements concluded by the United States. This approach results in two schedules which list, respectively, services which will be brought under the agreement and those remaining exempt from its provisions.

The first schedule lists what are described as "inconsistent measures" or "non-conforming measures". Non-conforming measures are those that for the time being continue to result in discrimination against the foreign service supplier. These measures can be maintained by the parties in their current form, but they cannot be made more restrictive. Additionally, once a measure included in this schedule has been made less inconsistent with the agreement, it cannot be made more restrictive at a later date. This is, in other words, a form of standstill and rollback.

A schedule of non-conforming measures can be made much more effective if it contains a timetable for bringing the measures into conformity, i.e. a date by which discrimination against foreign supplier will be eliminated.

Box 7.6: an inscription of a non-conforming measure

The following example of a non-conforming measure is taken from Annex I to the chapter on trade in services in the Australia–United States Free Trade Agreement.

Sector:	Professional Services
Obligations Concerned:	National Treatment (Article 10.2) Most-Favoured-Nation Treatment (Article 10.3)

Level of Governmen t:	Central
Source of Measure:	*Migration Act 1958*
Description:	Cross-Border Trade in Services To practise a migration agent in Australia a person must be an Australian citizen or a citizen of New Zealand with a special category visa.

The second schedule lists what are described as "reserved sectors". The parties have the right to maintain existing measures in these sectors, and they can make them more restrictive. Importantly, they can add new restrictive measures sectors listed in this schedule.

Box 7.7: an inscription of a reserved sector

The following inscription of a reserved sector is taken from Annex 8B to the United States–Singapore Free Trade Agreement. Note that the reservations for trade in services and investment in this sector are combined.

Sector:	Social Services
Obligations Concerned:	National Treatment (Articles 8.3 and 15.4) Most-Favoured-Nation Treatment (Articles 8.3 and 15.4 Local Presence (Article 8.6) Performance Requirements (Article 15.8) Senior Management and Boards of Directors (Article 15.9)
Description:	Cross-Border Services and Investment The United States reserves the right to adopt or maintain any measure with respect to the provisions of law enforcement and correctional services, and the following services to the extent they are social services established or maintained for a public purpose: income security or insurance, social security or insurance, social welfare, public education, public training, health, and child care.

Any measures relating to services not listed in either of these two schedules are subject to the provisions of the free-trade agreement.

Financial services

Many free-trade agreements have a separate chapter covering trade in financial services. It often treads a fine balance between market liberalisation, market regulation and enforcing prudential requirements.

Box 7.6: What are financial services

The *Annex on Financial Services* to the GATS defines financial services as follows:

Insurance and insurance-related services

(i) Direct insurance (including co-insurance)
  (A) life
  (B) non-life

(ii) Reinsurance and retrocession;

(iii) Insurance intermediation, such as brokerage and agency;

(iv) Services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement services.

Banking and other financial services (excluding insurance)

(v) Acceptance of deposits and other repayable funds from the public;

(vi) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions;

(vii) Financial leasing;

(viii) All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts;

(ix) Guarantees and commitments;

(x) Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:
  (A) money market instruments (including cheques, bills, certificates of deposits);
  (B) foreign exchange;
  (C) derivative products including, but not limited to, futures and options;
  (D) exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;
  (E) transferable securities;
  (F) other negotiable instruments and financial assets, including bullion.

(xi) Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues;

(xii) Money broking;

(xiii) Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services;

(xiv) Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments;

(xv) Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services;

(xvi) Advisory, intermediation and other auxiliary financial services on all the activities listed in subparagraphs (v) through (xv), including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy.

Many of the standard provisions in the services and investment chapters could of course easily apply to financial services also. However, there has been a distinct preference for separate chapters, partly because of the following reasons:

- supervisory agencies consider that the financial services sector needs rather more detailed provisions than those applying to services generally, especially where negative listings are used;
- for prudential reasons many financial services, such as life insurance, can only be delivered through a branch or subsidiary of a foreign firm, and regulators or supervisors of financial services providers need to be able to be able to ensure that their guidelines are honoured;
- consumers may be reluctant to engage in dealings with a foreign provider who does not have a permanent office in the importing economy;
- a retail bank, for example, cannot operate properly without establishments in the target market, and customers are more likely to use the services of an investment adviser that has offices within the economy; and
- there may be a wish to adopt dispute settlement provisions that take account of the unique characteristics of the financial services sector.

Other reasons can of course be adduced for a separate chapter. In the end it is up to the parties to decide whether they wish to proceed along this track.

The chapters on financial services accordingly have several functions. They must describe what categories of financial services are permitted to operate under preferential conditions, what services they are able to sell, and under what conditions they may sell them.

The chapter on financial services must also ensure that there are no unnecessary obstacles to financial flows. These flows consist of capital proper and of fees earned and payable for the provision of financial services. For example, a fee may be payable to a stockbroker for recommending and purchasing certain shares, and a separate transfer may then be necessary to pay for the shares.

Telecommunications

Some free-trade agreements have a separate chapter covering telecommunications. This areas can be quite complex, and it often is not easily accommodated in a more general chapter on services.

There is obviously no single approach to a telecommunications chapter. Its content and form depend entirely on what the parties want to achieve. Many agreements, such as the Japan–Singapore and the New Zealand–Singapore free-trade agreements, do not have separate provisions for telecommunications services at all.

Others, such as Singapore–Australia and the Canada–Chile free-trade agreements, set out in some detail the rights and obligations of the parties in respect of these services. Both of them apply to basic services. The latter covers in addition value-added services.

Box 7.7: Telecommunications services

Telecommunications services can be divided into basic telecommunications (relay of voice or data from sender to receiver) and value-added services (supplier adds value to a customer's information).

Basic telecommunications services include voice telephone services, packet-switched data transmission services, circuit-switched data transmission services, telex services, telegraph services, facsimile services, private leased circuit services, mobile phone services, satellite-based services, etc.

Value-added telecommunication services include on-line processing, on-line data base storage and retrieval, electronic data interchange, e-mail, voice-mail, etc.

Source: www.wto.org

One difficulty arises from the expanding ambit of telecommunications services. The parties therefore have to take care to define what is covered by the agreement, and what is not. The chapter usually states that it applies to measures affecting trade in telecommunications services, and that it does not relate to broadcast or cable distribution of radio or television programming except to the extent that broadcasting stations and cable systems must have access to the telecommunications system. In other words, it does no cover measures relating to broadcast or television content.

An important reason for a separate chapter is that telecommunications services are often provided by a monopoly company or under conditions where a former monopoly, now privatised and operating under deregulated conditions, still dominates the market. The free-trade agreement seeks to ensure in such cases that service suppliers from the other party have access to the existing telecommunications infrastructure and that the existing dominant provider cannot resort to practices locking out newcomers. Indeed, many of the provisions found in a separate telecommunications chapter stem directly from this situation, and this chapter normally has both services and competition elements.

Another reason is that some suppliers simply want to sell some specialised services using the available communications network. These companies often do not have ambitions to become a provider of basic telecommunications services.

The chapter on trade in telecommunications services therefore tends to cover the aspects listed here in a greatly simplified manner:

- enterprises of the other party are guaranteed access to the use of any public telecommunications service offered by the other party in its territory or across its borders;
- access conditions may be imposed only to the extent that they safeguard the responsibilities of the providers of telecommunications services and protect the integrity of public networks;
- any universal service obligation must be administered in a transparent, non-discriminatory and competitively neutral

manner to ensure that it is no more burdensome than necessary for that type of service;
- interconnection with the suppliers of public telecommunications services of the other party must be guaranteed;
- number portability must be available where a user changes to another supplier within the same location;
- scarce telecommunications resources must be allocated in a timely, transparent and non-discriminatory manner;
- each party must ensure that the other party has reasonable and non-discriminatory access to submarine cable systems;
- major suppliers in either party must give public telecommunications suppliers of the other party the same treatment that their subsidiaries, affiliates and non-affiliates in similar circumstances;
- measures must be in place to prevent major suppliers from engaging in anti-competitive cross-subsidisation, using information they have obtained from competitors with anti-competitive results and not making available necessary technical information;
- suppliers of public telecommunications services and value-added services must be allowed to choose their preferred technologies, except where this would clash with legitimate public interests; and
- enterprises supplying value-added services cannot be compelled to supply such services to the public generally, forced to justify their rates, file a tariff for such services, be required to interconnect their networks with any particular customer or conform with any particular standard or technical regulation apart from that required to connect with a public telecommunications network.

Telecommunications chapters usually also cover the procedures to be followed by regulating bodies, especially those relating to impartial decision-making, transparency and technical standards. Closely related to these provisions are those covering the behaviour of monopolies and dominant suppliers.

Definitions are important. Some of them can be quite technical. Indeed, this chapter is usually negotiated between the telecommunications authorities of the parties, and these are also the bodies implementing the provisions.

8. Investment

What is the purpose of the investment rules?

The rules on investment determine under what conditions an investment, or an application to invest, from the other party to the free-trade agreement receives preferential treatment. They can influence investment decisions considerably and, accordingly, the benefits from the free-trade agreement.

The services and investment chapters in free-trade agreements share, at least superficially, many characteristics. Inevitably, their provisions will to some extent overlap. Good drafting can of course minimise this problem. However, there is a major difference between services and investment.

Services can be traded. Some can only be sold if the seller is permitted to invest in the importing country, and to this extent investment is a factor in obtaining market access.

The investment chapter is concerned with the movement of capital from one party to the agreement to another party and to create a favourable climate for investment. Motivations of investors vary, and the agreement has to make allowance for that. Some investors may make an investment with the intention of conducting international trade. But other investors may be more concerned with acquiring an asset or disposing of it.

Investment chapters therefore often have provisions concerning investment promotion and protection (the area traditionally occupied by bilateral investment agreements) and investment liberalisation. Some agreements even formally divide the two areas. This seems to be the case especially for economies where responsibility for investment liberalisation and investment promotion is handled by different agencies. In theory, this makes no difference. What matters is the way the various articles affect investment flows, but in practice it may confuse investors.

One interesting point is that some economies welcome greatly foreign investment in manufacturing industries, especially export industries. They often place minimal conditions only on such investments. Conditions in these economies on foreign investment in agriculture and service industries tend to be much more restrictive. Often, they prohibit foreign investment in some industries or occupations altogether. It is not the purpose of this booklet to argue the case for freer investment.

Negotiating economies should always bear in mind that economy's competitiveness is determined to a considerable extent by the efficiency of its services sector. By imposing a restrictive investment regimes on the services sector, economies are therefore likely to deny themselves access to foreign know-how and technology that could in fact help them a great deal in achieving their trade and economic aspirations. Another aspect is that manufacturing industries cannot put their goods on the market without the use of services of all kinds of services. Sheltered or inefficient services sector make them less competitive.

Agreements sometimes also distinguish between foreign direct investment (FDI) and portfolio investment. The former usually implies direct participation by the investor in the management of the investment. The latter refers to minority holdings, usually less than 10%, of shares, bonds or other securities. Whether a free-trade agreement covers portfolio investment depends on the wishes of the parties. Inclusion is now quite common. A look at the definitions in the investment chapter usually clarifies the situation quickly.

Box 8.1: A definition of investment

Free-trade agreements usually define "investment" with a high degree of precision. The definition used in the Australia–United States free-trade agreement is fairly typical:

Investment means every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include:

(a) an enterprise;

(b) shares, stock, and other forms of equity participation in an enterprise;

(c) bonds, debentures, other debt instruments, and loans;

Some forms of debt, such as bonds, debentures, and long-term notes, are more likely to have the characteristics of an investment, while other forms of debt, such as claims to payment that are immediately due and result from the sale of goods or services, are less likely to have such characteristics.

(d) futures, options, and other derivatives;

(e) turnkey, construction, management, production, concession, revenue-sharing, and other similar contracts;

(f) intellectual property rights;

(g) licences, authorisations, permits, and similar rights conferred pursuant to the applicable domestic law; and

Whether a particular type of license, authorisation, permit, or similar instrument (including a concession, to the extent that it has the nature of such an instrument) has the characteristics of an investment depends on such factors as the nature and extent of the rights that the holder has under the applicable domestic law. Among the licenses, authorisations, permits, and similar instruments that do not have the characteristics of an investment are those that do not create any rights protected under domestic law. For greater certainty, the foregoing is without prejudice to whether any asset associated with the license, authorisation, permit or similar instrument has the characteristics of an investment.

The term **investment** does not include an order or judgment entered in a judicial or administrative action.

(h) other tangible or intangible, movable or immovable property, and related property rights, such as leases, mortgages, liens and pledges.

In the case of trade in goods and services, negotiators need to work within the frameworks of the *General Agreement on Tariffs and Trade* (GATT) and the *General Agreement on Trade in Services* (GATS). The free-trade agreement in both cases builds on the well-understood multilateral trade disciplines.

The case is different for the investment provisions. There is as yet no multilateral agreement governing all aspects of international investment flows. However, the numerous investment promotion and protection agreements (IPPAs) and bilateral investment agreements (BITs) already in existence show much convergence in their contents. Many economies in fact use them as a starting point for their negotiations on the investment chapter in a free-trade agreement.

What is usually lacking in IPPAs and BITs is a framework for the liberalisation of investment flows. A good investment chapter will have to take account of this through supplementing these provisions by articles aimed at liberalising capital flows.

The content of the investment chapter

Investment chapters in free-trade agreements typically cover:

- a description of the type of investments to which the chapter applies;
- a description of the treatment extended to investors and their investments under the agreement, with national treatment being the basic rule;
- prohibition of performance requirements;
- provisions governing the treatment of intra-corporate transferees (this is often done in a separate chapter on business mobility);
- in federal systems of government a description of the extent to which an investment may be subject to the jurisdiction of a state or province;
- a description of the conditions under which a party may deny preferential treatment to an investor or an investment from the other party;
- a range of investment promotion and protection provisions, including an article on payments and transfers;
- a provision governing the settlement of disputes over matters arising from the agreement (both between governments and between investors and governments); and
- arrangements for the inscription of commitments in the investment schedules, procedures for changes to these commitments and any mechanism for their regular review.

Treatment of investors and their investments

Pre-establishment and post-establishment

Investment agreements or free-trade agreements with investment provisions usually distinguish between the pre-establishment phase (i.e. before the investment has been made) and the post-establishment phase (i.e. after the investment has been made). In some cases, the investor and his investment only receive national treatment after establishment. In other cases national treatment applies for both phases in cases where an inscription in a party's schedule of commitments has been made.

Non-discrimination

When an agreement covers all investment activities, the parties usually accord each other *national treatment* (i.e. foreign investor is treated no less favourably then the domestic investor in like circumstances) in respect of the establishment, acquisition, expansion, management, operation, sale, etc., of an investment. If only some investment activities are covered, the obligation to give national treatment is often limited to these activities.

The parties also undertake to give each other treatment no less favourable than they give to investors and their investments from third-countries in like circumstances. This is the *most-favoured-nation* (MFN) obligation. National treatment and most-favoured-nation treatment together constitute the non-discrimination provision.

Minimum standard of treatment

Some investment chapters also contain an obligation to accord investments from the other parties a *minimum standard of treatment*. This is described, for example, in Chile–United States free-trade agreement, as "treatment in accordance with customary international law, including fair and equitable treatment and full protection and security". "Fair and equitable treatment" is defined as including "the obligation not to deny justice in criminal, civil or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world". The obligation concerning "full protection and security" requires the parties to provide the level of police protection required under customary international law".

Performance requirements

Investment provisions as a rule prohibit mandatory performance requirements. These are obligations the investor must meet to obtain permission to invest. Among these are requirements to export a certain share of production, to use a prescribed level of local content, to transfer technology or to employ local staff in prescribed positions. Many of these performance requirements are not allowed under the WTO *Agreement on Trade-Related Investment Measures*.

Box 8.2: Performance requirements

Most investment chapters in free-trade agreements prohibit a range of performance requirements. The following list is taken from the Chile–United States free-trade agreement. The agreement requires the parties not to impose or enforce any of the following requirements:

(a) to export a given level or percentage of goods and services;

(b) to achieve a given level or percentage of domestic content;

(c) to purchase, use, or accord a preference to goods produced in its territory, or to purchase goods from persons in its territory;

(d) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment;

(e) to restrict sales of goods or services in its territory that such

> investment produces or supplies by relating such sales in any way to the volume or value of its exports or foreign exchange earnings;
>
> (f) to transfer a particular technology, a production process, or other proprietary knowledge to a person in its territory; or
>
> (g) to supply exclusively from the territory of the Party the goods that it produces or the services that it supplies to a specific regional market or to the world market.

Many such performance requirements are illegal under GATT Article III (National Treatment), the WTO *Agreement on Trade-Related Aspects of Investment Measures* (TRIMS) and the *General Agreement on Trade in Services* (GATS).

Similarly, the investment provisions usually prohibit the "receipt of an advantage" subject to meeting certain performance requirements. What constitutes an advantage is not usually defined, but it may include actions such as the payment of governmental subsidies or according more favourable treatment in government purchases, etc.

Transfers and payments

Every investment chapter requires the parties to permit all transfers relating to an investment covered by the agreement to be made freely and without delay. Transfers can include items such as capital, profits, dividends, royalties, proceeds from sales of investments, etc.

Some limitations on transfers may, however, be legally justified or necessary. Most importantly, such limitations relate to preserving the rights of the parties under their membership of the International Monetary Fund (IMF) to impose capital controls in times of balance-of-payments crises. Others relate, for example, to the need to protect creditors in bankruptcy or insolvency proceedings, pursuit of criminal offences or laws covering trade in securities, futures or derivatives. Some agreements also have a general exception permitting restrictions on foreign exchange transfers under specified conditions. Another common provision in this area deals with "convertibility". It usually requires the parties to permit transfers to be made in a freely usable currency at the applicable market rate when the transfer is made.

Expropriation and compensation

International law recognises that governments may resort to expropriation (i.e. the forcible acquisition of an investment belonging to a private investor), but only if certain conditions are satisfied. These conditions are that:

- the expropriation is for a public purpose related to the internal needs of the economy and under due process of law;
- the expropriation is non-discriminatory; and
- the expropriation is accompanied by the payment of prompt, adequate and effective compensation.

Expropriation is a rare event. Nevertheless, the chapter on investment in a free-trade agreement usually contains a provision to this effect, and certainly in every case of an investment protection and promotion agreement.

Apart from overt expropriation for a public purpose as described above, expropriation can also occur by stealth. This can happen when economy makes operating conditions for an investor so difficult that the investment loses its value and can effectively only be sold to the host government. Most investment chapters therefore also contain a provision covering the occurrence of this possibility.

Senior personnel

A company making a direct investment in another economy usually wants to place one or more of its senior executives in a position where they can manage the investment. The rules covering such placement are usually included in investment chapters or in separate chapters dealing with the short-term and long-term mobility of business personnel. Some agreements permit nationality limitations on boards of directors, but only on condition that this does not impair the ability of the investors to exercise control over their investments. A more detailed description of these provisions can be found in chapter 9.

Scheduling investment commitments

The purpose of the schedules of investment commitments is to give investors in the economies that are party to the agreement a clear description of the type of treatment they and their investments can expect in the partner economy. Note that the schedules do not give a full description of how an investment or an investor will be treated. They only explain how a foreign investor or investment will be treated differently from domestic investors or investments.

The schedules usually are divided into horizontal and sectoral commitments. Additionally, they are divided into schedules of non-conforming measures and schedules of reserved measures. We will explain shortly what that means. The approach taken for investment therefore differs significantly from that for services where one schedule, either positive or negative, serves the purpose.

The vast majority of investment commitments is done as negative listings. For this reason we concentrate in this guide on negative listings. It would of course be possible to adopt the positive-list approach, but the disadvantages of doing so would be the same as in the case of services.

A negative listing means that measures are listed only if they do not conform to the provisions of the agreement. All other measures are deemed to be in conformity with the agreement. What this means is that no measure is outside the ambit of the agreement. One consequence of negative listings is that they exclude new restrictions in sectors or activities already liberalised, especially if they are combined with a standstill commitment.

Negative scheduling promotes transparency of regulation. Every regulation is covered by the schedules and the agreement, either as a non-conforming measure, a reserved sector or, if it is not listed, because it already is in conformity with the agreement. Additionally, new sectors or activities are automatically covered by the agreement.

Horizontal commitments

The horizontal commitments apply in principle to investment activities across the board. These inscriptions show actual or potential measures that may be applied against foreign investors. These commitments are usually concerned with matters such as foreign investment approval procedures, land purchases, foreign exchange regulations, eligibility for government subsidies, etc.

Box 8.3: a horizontal commitment in investment

The following is a horizontal investment commitment made by Japan in its free-trade agreement with Singapore:

1. (a) Matter: Land Transaction
   (b) Legal source or Authority: Alien Land Law (Law No. 42, 1915)
   (c) Relevant Obligation: National Treatment (Article 73)
   (d) Description:

With respect to acquisition or lease of land properties in Japan, prohibitions or restrictions may be imposed by Cabinet Ordinances on Singapore nationals or entities, where Japanese nationals or entities are placed under identical or similar prohibitions or restrictions in Singapore.

Schedules of non-conforming measures

This schedule contains a list of all those measures that are not fully in conformity with the liberalising provisions of the agreement. It is customary to include a provision stating that a measure so listed can be brought into greater conformity with the agreement, but not the reverse. Sometimes an agreement also contains undertakings that certain measures will be brought into conformity with relevant provisions within a certain time.

Box 8.4: an example of a listing of a non-conforming investment measure

This inscription is taken from Annex I to the Australia–United States Free Trade Agreement. It combines the services and investment inscriptions.

Sector:	Broadcasting
Obligations Concerned	National Treatment (Article 11.3) Senior Management and Boards of Directors (Article 11.10)
Level of Government	Central
Source of Measure	*Broadcasting Services Act 1992* (BSA)
Description of Reservation	Investment A foreign person must not be in a position to exercise control of a commercial television station broadcasting licence.

	Two or more foreign persons must not have company interests in a commercial television broadcasting licensee that exceed 20 per cent. No more than 20 per cent of the directors of each commercial television broadcasting licensee may be foreign persons. A foreign person must not have company interests in a subscription television broadcasting licence: (a) of more than 20 per cent; or (b) that, when added to the company interests in that licence held by other foreign persons, exceed 35 per cent. The terms **foreign person**, **in a position to exercise control**, **commercial television broadcasting licence**, and **company interests** have the meanings they have in the BSA (sections 6, 7, and 8 and Schedule 1).

Schedules of reserved sectors

The second schedule lists the so-called reserved sectors. These are sectors in which the parties may make unilateral changes without contravening the provisions of the agreement. These schedules generally include policies dealing with education, health, according preferences to national minorities, cultural sectors, and so on. Classifying a sector as "reserved" does not necessarily mean that foreign investment is not permitted at all, though sometimes that may be the intention. If investment is permitted, it may be subject to quite stringent controls.

Box 8.5: an example of a listing of a reserved investment sector

This inscription is taken from Annex II to the Australia–United States Free Trade Agreement. It combines the services and investment inscriptions.

Sector:	All
Obligations Concerned	National Treatment (Articles 10.2 and 11.3) Market Access (Article 10.4) Performance Requirements (Article 11.9) Local Presence (Article 10.5) Senior Management and Boards of Directors (Article 11.10)
Description	<u>Cross-Border Trade in Services and Investment</u> Australia reserves the right to adopt or maintain any measure according preferences to any indigenous person or organisation or providing for the favourable treatment of any indigenous person or organisation in relation to the acquisition, establishment, or operation of any commercial or industrial undertaking in the service sector. Australia reserves the right to adopt or maintain

	any measure with respect to investment that accords preferences to any indigenous person or organisation or provides for the favourable treatment of any indigenous person or organisation. For the purpose of this entry, **indigenous person** means a person of the Aboriginal race of Australia or a descendant of an indigenous inhabitant of the Torres Strait Islands.
Existing Measures:	Legislation and Ministerial statements at all levels of government including Australia's foreign investment policy and the *Native Title Act 1993*.

Combining services and investment inscriptions

Because many of the regulations applying to the provision of services also apply to investment, it has become customary to list services and investment measures in the same schedule. This adds considerable clarity to the explanation. Box 8.6 shows an example that does not distinguish at all between services and investment.

Box 8.6: A combined services and investment inscription

This example of an Australian entry in the Singapore–Australia Free Trade agreement shows how combining services and investment inscriptions can add to the clarity of a schedule.

Sector	Financial services
Sub-sector	Non-life insurance services
Industry classification	8129
Type of Reservation	Market Access National Treatment
Source of Measure	*Insurance Act 1973*
Description of Reservation	An authorised insurance company operating in Australia as non-incorporated entity must appoint an Australian resident as an agent of the insurer.

Settlement of disputes between an investor and a party

Disputes between the parties concerning the interpretation of the investment provisions in a free-trade agreement are usually dealt with under the normal consultation and dispute settlement provisions of the agreement.

Some agreements also open the way for the launch of proceedings by an investor against a party. How to proceed depends entirely on the preference of the negotiating partners. NAFTA, for example, permits private investors to launch a claim against one of the parties in relation to the investment provisions generally and actions that may have been taken by a state enterprise or a monopoly, but only if the investor has incurred a loss or damage because of these actions. Actions must be taken within three years of the date when the investor first became aware, or should have become aware of the problem.

Box 8.7 describes briefly the mechanism adopted in the free-trade agreement between Japan and Singapore. More or less detailed procedures can easily be found in other agreements.

Box 8.7:
Settlement of investment disputes between an investor and a state

Article 82 of the free-trade agreement between Japan and Singapore is typical of provisions in free-trade to resolve disputes between a private investor and the government of the other party. The main steps to be followed are as follows:

- a dispute may be launched if an investor of one party believes that the other party (i.e. the government) has forced it to incur damage or loss because of the way it has administered the agreement;
- the parties to the dispute are exhorted to resolve their dispute amicably;
- if this cannot be done, the investor can either (i) seek an administrative or judicial settlement (i.e. use the court system), (ii) use dispute settlement procedures previously agreed between the parties if these exist, or (iii) request the establishment of an arbitrary tribunal under the provisions of the free-trade agreement;
- arbitration under the agreement is only available if the action is started within three years of the date when the investor first knew, or should have known, about the problem at issue;
- arbitrators must have the necessary expertise relevant to the specific financial matters under dispute;
- the award issued by the arbitrary tribunal must state whether has been a breach of any rights under the agreement, and if there has been a breach, a remedy which may be financial compensation, restitution in kind or both;
- if the parties to the dispute cannot agree within 60 days on the amount of compensation, either party may refer the matter to the arbitrary tribunal for a final and binding decision;
- the award of the arbitrary tribunal then can be enforced under the laws of the state in which its execution is sought.

9. Business mobility

Why have provisions on business mobility?

International business functions best when it is easy for people to travel from one economy to another. This is the case for both short-term and long-term stays. One of the purposes of a free-trade agreement is to promote economic integration. The provisions on business mobility are therefore of considerable importance.

International trade without easy mobility of business people would be much more difficult to sustain. It certainly would be hard to imagine even in the age of rapidly growing electronic commerce. International business requires meetings face to face to allow the establishment of trust between those involved.

Most business deals of any magnitude therefore require at least one, and probably more, meetings between the principal parties. Investment deals can seldom be concluded without the presence of lawyers. Firms making a direct investment in another economy often do so with the intention of providing some of the senior management of the enterprise.

It is clear, therefore, that economic integration through free-trade agreements works best when the agreement has provisions making entry and exit of business visitors and long-term personnel as simple as possible. Australia and New Zealand have abolished travel restrictions between them. Another example where this has occurred is between the member states of the European Union. In most cases, however, economies will require the meeting of certain conditions, especially where long-term stays are involved.

Box 9.1: What are business visitors?

The Thailand–Australia free-trade agreement defines short-term defines "business visitors" as

"a natural person of either Party who is:

i. a service seller;

ii. an investor of a Party, or a representative of an investor, seeking temporary entry to establish an investment; or

iii. seeking temporary entry for the purposes of negotiating the sale of goods where such negotiations do not involve direct sales to the general public."

Chapters on business mobility can be quite difficult to negotiate and to draft. This is because they have to deal with competing priorities that can be difficult to reconcile. The chapter on temporary entry for business persons in the free-trade agreement between Canada and Chile, has as its general principles:

- the desirability of facilitating temporary entry on a reciprocal basis;

- the desirability of establishing transparent criteria and procedures for temporary entry;
- the need to ensure border security; and
- the need to need to protect the domestic labour force and permanent employment in the territories of the two parties.

Box 9.2: What are intra-corporate transferees?

The Thailand–Australia free-trade agreement defines short-term defines "intra-corporate transferee" as

"an employee of a service supplier, investor or juridical person of a Party established in the territory of the other Party through a branch or affiliate, and who is a manager, executive or specialist".

Some free-trade agreements do not have provisions on business mobility at all. In these, the normal immigration procedures of the two parties will continue to apply. Where business mobility provisions are included, they usually distinguish between short-term temporary entry and long-term temporary entry. The former often is a period of up to ninety days, whereas the latter may run into several years, especially if extensions are permitted. They also distinguish between "business visitors" (i.e. short-term visitors) and intra-corporate transferees" (i.e. longer-term temporary visitors who will take up managerial positions).

The following explains briefly the possible content of a chapter on business mobility. Variations between existing chapters are considerable, and broad conclusions only can be drawn from them. The relevant provisions are usually negotiated by the immigration authorities of the parties concerned.

Main provisions

As there is usually considerable overlap between the business mobility provisions in the services and investment chapters, it would seem appropriate, where possible, to combine relevant provisions in one chapter. These chapters tend to have provisions governing the following matters:

- a statement that the agreement does not apply to measures regarding nationality or citizenship, permanent residence or permanent employment;
- a listing of the chapters in the agreement to which the provisions on entry apply;
- conditions under which temporary entry for short-term business visitors and intra-corporate transferees may be granted;
- conditions under which temporary entry may be denied;
- agreement that the parties retain the right to regulate the entry of natural persons and to ensure the orderly movement of natural persons across their borders;
- a provision enabling on-line lodgement of visa applications and their processing;
- exclusion of labour market testing in any of the parties;

- an undertaking to exchange information on domestic laws and policies governing temporary entry;
- an undertaking to handle appeals against decisions by immigration authorities expeditiously; and
- a description of the extent to which the agreement's dispute settlement provisions apply to the chapter;

Labour markets

Article V *bis* of the GATS allows the formation of labour markets integration agreements. The Article does not greatly elaborate the nature of such agreements. A footnote to the Article states, however, that "[t]ypically such integration provides the citizens of the parties concerned with the right of free entry to the employment markets of the parties and includes measures concerning conditions of pay, other conditions of employment and social benefits". Such an agreement must also exempt citizens of the parties from residency and work permit requirements.

The GATS appears to view such agreements as additional to free-trade agreements. They are, however, rare. The European Union and Australia–New Zealand would appear to be the only two examples available.

10. Government procurement

What is the purpose of the provisions on government procurement?

The provisions on government procurement

- define the extent to which government purchases are covered by the agreement;
- list the levels of government and the organisations covered by the agreement;
- define the minimum value of government purchases covered by the agreement; and
- set out the tender procedures, decision-making processes and the avenues available to unsuccessful bidders who want to challenge a bid.

Government procurement refers to acquisitions by governments or their agencies of goods (including every type of right, interest or thing which is legally capable of being owned) and services (including consultancy services). Government procurement does not generally cover the commercial activities of state-trading enterprises.

Procurement generally encompasses the whole process of acquiring goods or services. It begins when an agency has identified a need and decided on its procurement requirement. Procurement continues through the process of risk assessment, seeking and evaluating alternative solutions, award of contracts, delivery and payment for goods or services and, where relevant, the continuing management of a contract and consideration of any options related to the contract. Procurement extends to the ultimate disposal of goods at the end of their useful life. Procurement does not generally include grants (whether in the form of a contract or conditional gift), statutory appointments or the engagement of employees.

Why include a chapter on government procurement?

Governments at all levels are big buyers of goods and services. These purchases represent huge opportunities for international trade. Many economies therefore attach great importance to a good coverage of this area in their free-trade agreements. They consider that no free-trade agreement can truly claim to be an instrument of economic integration if it carves out such an important slice of economic activity.

Estimates of the value of government procurement present considerable statistical challenges. However, a thorough study prepared by the OECD in 2002 estimated that in 1998 OECD countries governments spent on average 20% of GDP on purchases for their own use. In non-OECD countries the average figure is about 15%. But not all of this can be competed for by foreign suppliers.

Defence-related purchases, for example, are usually excluded. The contestable share (i.e. purchases open potentially to international trade) was estimated to be about one-third of the total for both OECD and non-OECD countries. Box 10.1 contains a breakdown of these estimates.

Much of this purchasing within the potentially contestable share is conducted on an open and non-discriminatory basis. Preferential government procurement policies do exist, however, and they have an effect on potential trade opportunities. For example, some economies link their government procurement policies to an objective of industrial development. Other economies maintain "buy-local" policies which can limit the ability of government agencies to purchase from foreign suppliers.

Box 10.1: The importance of government procurement

Government procurement is important in all economies. Opening it up to free-trade area partners can make a big contribution to trade expansion.

An OECD study issued in 2002 estimated that for OECD countries as a whole the ratio of total government procurement (consumption and investment expenditure) for all levels of government was 19.96% of GDP (using 1998 GDP data) or USD4,733 billion. For non-OECD countries the ratio was estimated at 14.48% or USD816 billion.

But not all of this is contestable (i.e. potentially open to international trade). The study estimated that in 1998 potentially contestable government procurement in OECD countries was 7.57% of GDP (valued at USD1,795 billion). For non-OECD countries the ratio was 5.1% (valued at USD 287 billion).

Another comparison makes this even clearer. The same study estimated that in 1998 total government procurement worldwide was roughly 82.3% of world merchandise and commercial services exports. Potentially contestable government procurement worldwide was estimated at 30.1% of world merchandise and commercial services exports.

Source: OECD 2002

A chapter on government procurement within a free-trade agreement can therefore provide substantial opportunities to partner economies and enhance opportunities for bilateral cooperation. An agreement covering government procurement can also close a significant gap in trade liberalisation and market integration and establish a seamless procurement environment between the public and private sectors.

Neither the *General Agreement on Trade in Services* (GATS) nor the *General Agreement on Tariffs and Trade* (GATT) apply to government procurement. The WTO *Agreement on Government Procurement* contains detailed rules, procedures and requirements for government purchasing. But it is a plurilateral instrument (i.e. taking on its obligation is not a necessary condition of WTO membership) with only 28 members. Members of this agreement of course have strong practical reasons to ensure that their obligations under it and a free-trade agreement are consistent.

Chapters on government procurement in free-trade agreements generally cover, at a minimum, central government entities, but in many cases they also list some provincial or state government entities and government business enterprises. Sometimes even local government is covered. It is worth noting the finding of the OECD study quoted above that procurement by sub-central governments is generally two or three times larger than that of central governments.

If a sub-central governments of an economy have independent responsibility for the procurement of their agencies, as is the case in Australia and many other economies, free-trade negotiations sometimes include a person representing the these governments.

What goes into a chapter on government procurement?

Economies considering including a chapter on government procurement in their free-trade agreements are able to benefit from APEC Principles on Government Procurement. Many of these principles, such as transparency, value for money, accountability and due process, should prove very useful.

Some free-trade agreements do not cover government procurement at all. Some do no more than establishing a framework for cooperation enabling inclusion of disciplines on government procurement at a later stage. In yet other cases the parties simply agree that they will follow the provisions of the WTO *Agreement on Government Procurement* and, in the case of non-members, to seek membership of it.

In the case of a full chapter on government procurement, the parties usually agree on provisions covering at least the following:

- agencies and their officers must ensure that any procurement process is open and transparent, and that decisions are justified;
- agreement on processes which support appropriate scrutiny of the procurement activities of the parties;
- preparation of a list of governments, agencies and authorities to whom the procurement principles apply (this list may include central government entities, state, provincial or prefectural government entities and local government entities);
- a listing of procurements which are exempt from the agreement, such as purchases undertaken by defence departments for national security objectives;
- usually the parties are required to accord the goods, services and suppliers of the other parties national treatment, i.e. treatment no less favourable than they give their domestic goods, services and suppliers;
- the minimum value of goods and services purchases covered by the provisions on government procurement; this may vary according to the level of government;
- a general requirement for each party to publish its government procurement rules and principles, such as the tender process and tender conditions, publishing requirements, time limits for the tendering process, etc.
- protection of intellectual property rights tenderers and suppliers;

- protection of confidential information;
- the manner in which a decision concerning a successful tenderer is made public; usually through the publication at least of the name of the purchasing entity, a description of the goods or services that have been purchased, the name of the successful supplier and the value of the winning contract;
- the rights available to unsuccessful tenderers (i.e. the appeals provisions) if they wish to challenge a tender decision and the procedures they must follow ; these do not usually differ from those available to unsuccessful domestic tenderers; and
- agreements also tend to specify that a challenge by an unsuccessful bidder must be heard by an independent administrative or judicial authority, including an outline of the procedures to be followed to ensure fair treatment of the appellant.

The preparation of the schedules showing the commitments in government procurement is among the most onerous tasks in any free-trade negotiation, especially if more than one level of government is involved. Negotiators therefore must be especially careful to ensure that their consultative processes in this regard are working well.

11. The rest of the agreement

What else does an agreement cover?

So far we have talked mainly about goods, services and investment and the provisions usually drafted for them. But free-trade agreements in most cases include provisions intellectual property, competition policy, consultations and dispute settlement, etc. This chapter outlines some of these provisions.

A glance at any free-trade agreement concluded recently shows immediately that they have a tendency to be rather long even if one disregards the annexes containing the schedules of commitments and the rules of origin. One reason for this is that the content of free-trade agreements has for some time gone well beyond liberalisation of trade in goods and services. It is now clearly understood that the benefits of a free-trade agreement will increase if the right framework for trade facilitation is in place. Various provisions are needed to make that work. Another reason for longer agreements is the inclination of drafters, especially in cases of doubt, to include provisions from multilateral agreements that do not need repeating in a bilateral agreement. In this chapter we look at the remaining parts of a possible free-trade agreement and how they might be drafted.

The preamble

The preamble sets the scene for the agreement. It can be as short or as long as the parties would like it to be. A bilateral agreement probably needs nothing more than an expression of intent to agree on what follows in the operative articles and possibly some description of their motivation to conclude a free-trade agreement. Above all, the preamble must be consistent with the main text since it may have to be used for the interpretation of the agreement. The drafting of the preamble can easily be left until the end of the negotiations, and its content should rarely be controversial.

Definitions

Definitions, on the other hand, may have a real impact on the interpretation of an agreement. They have several functions. During the negotiations they can ensure that delegations understand a concept in the same way. This avoids some needless discussions. Sometimes the negotiators have no choice but to agree on a definition of a key issue before they decide what to with it. Another function is to assist readers of the agreement in gaining a full understanding of the text. Yet a third function of definitions is to assist in the settlement of disputes over the meaning of an obligation.

The list of definitions should be started when the negotiations get under way and added to as necessary. Simply compiling word lists at the end of the negotiations, as one would do in compiling a book index, ignores the benefit of adequate definitions.

Some definitions simply make clear what the intent of the drafters was when they used terms specific to the agreement which cannot be defined with reference to other texts or agreements, such as

- "base rate" means the applied tariff rate in force on [a certain date];
- "customs administration" means the competent authority that is responsible under the laws of a Party for the administration of customs laws, regulations and policies;
- "financial institution" means any financial intermediary or other enterprise that is authorised to do business and regulated or supervised as a financial institution under the law of the Party in whose territory it is located;
- "global safeguards" means the measures provided for in Article XIX of the GATT and the WTO *Agreement on Safeguards*.

Others consist of names and terms that often are used as abbreviations or in a short-hand way. Examples are:

- "APEC" means Asia-Pacific Economic Cooperation;
- "Anti-Dumping Agreement" means the *Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994*;
- "Customs Valuation Agreement" means the *Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994*;
- "Madrid Agreement" means the *Madrid Agreement Concerning the International Registration of Marks* [or perhaps, as the case may be, the *Madrid Agreement for the Repression of False or Deceptive Indications of Source on Goods*].

Good practice is to include definitions used in at least two chapters in an article containing definitions for the entire agreement. An example is again the WTO Customs Valuation Agreement which is likely to be mentioned at least in the chapter on customs procedures and the chapter on rules of origin. Definitions applying to one chapter only can be listed in that chapter. An example is "equivalence of sanitary and phytosanitary standards" which would probably only be encountered in the chapter on sanitary and phytosanitary standards.

Intellectual property

The WTO *Agreement on Trade-Related Aspects Intellectual Property Rights* (the TRIPS agreement) has introduced much greater certainty into the treatment of intellectual property in international trade. All free-trade agreements now take the rights and obligations of the parties under this agreement as their basis. At a minimum, this may mean a provision to cooperate in the implementation of the TRIPS agreement. They also usually agree to cooperate in the enforcement of their laws to protect intellectual property rights owned by the other party.

Additional intellectual property conventions have been concluded or have entered into force since the TRIPS Agreement was adopted. New copyright provisions have become necessary, for example, because of the fast pace of technological change in the information technology and telecommunications (ICT) industries. This is part of the reason why in some free-trade agreements the parties take on additional obligations. One example is the Singapore–Australia Free Trade Agreement (SAFTA) where the parties agree to accede to or ratify within four year years of the entry into force of the agreement the *WIPO Copyright Treaty* and the *WIPO Performances and Phonograms Treaty*. They also agree to comply with the provisions of the Geneva Act of the *Hague Agreement Concerning the International Registration of Industrial Designs*.

Box 11.1: Intellectual property rights: an example

Provisions on intellectual property rights in free-trade agreements can be quite extensive, as this example from the United–Singapore free-trade agreement shows:

Article 16.1: Each party to ratify, accede to or give effect to nine intellectual property conventions and protocols

Article 16.2: Rights and obligations concerning trademarks, including geographical indications

Article 16.3: Domain names on the Internet

Article 16.4: Obligations common to copyright and related rights

Article 16.5: Obligations pertaining to related rights

Article 16.6: Protection of encrypted program-carrying satellite signals

Article 16.7: Patents

Article 16.8: Certain regulated products (pharmaceutical or agricultural chemical products)

Article 16.9: Enforcement of intellectual property rights

Article 16.10: Transitional provisions (implementing provisions)

The United States–Singapore free-trade agreement is more onerous. It requires the parties to accede to *Convention Relating to the Distribution of Programme-Carrying Signals Transmitted by Satellite*, the *International Convention for the Protection of New Varieties of Plants*, the *WIPO Copyright Treaty*, the *WIPO Performances and Phonograms Treaty* and the *Patent Cooperation Treaty*. It also requires the parties to give effect to Articles 1 through 6 of the *Joint Recommendation Concerning Provisions on the Protection of Well-Known Marks* and to make best effort to ratify or to accede to the *Hague Agreement Concerning the International Registration of Industrial Designs* and the *Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks*.

These examples show clearly how it is possible to tailor an agreement to the needs of a bilateral partnership.

Competition

Many free-trade agreements have chapters on competition or antitrust matters, but the ambit of these chapters varies greatly. Where economies have a history of cooperation on competition issues, they clearly find it easier to enter into more substantive obligations. In most cases, however, the agreements confine themselves to cooperative activities.

To some extent, this reflects the fact that multilateral work on competition issues has not yet reached the stage where a multilateral framework of rules and disciplines could be envisaged. As a result, the harmonisation of many competition concepts lags behind other areas, such as intellectual property rights or services, even though the terms used in national competition laws often do not differ greatly and, indeed, the basic thrust of these laws tends to be quite similar.

Box 11.2: The content of a competition chapter: one example

The Thailand–Australia Free Trade Agreement requires the parties to

- promote competition by addressing anti-competitive practices in its territory, and by adopting and enforcing such means or measures as it deems appropriate and effective to counter such practices

  It defines "anti-competitive practices as

  a. business conduct or transactions that adversely affect competition, such as
  b. anti-competitive horizontal arrangements between competitors;
  c. misuse of market power, including predatory pricing;
  d. anti-competitive vertical arrangements; and
  e. anti-competitive mergers and acquisitions;
- ensure that all businesses are subject to generic or relevant competition laws that are in force.
- cooperate in exchanging information;
- consult with a view to eliminating particular anti-competitive practices that affect trade or investment between them;
- consult, within three years of the entry into force of the agreement, on amendments necessary to ensure comprehensive protection of legitimate business interests of the other party; and
- publish or otherwise make publicly available their laws promoting fair competition and their laws addressing anti-competitive practices.
- The dispute settlement provisions of the agreement do not apply to this chapter.

Competition chapters in free-trade agreements are increasingly important, and they are now quite common. This is because many of the guarantees of market access and national treatment provided by governments elsewhere in the agreement could easily be negated by anti-competitive activities. New market entrants might find that are locked out of new business opportunities.

This possibility is usually addressed specifically in, for example, the chapter on telecommunications services which tends to have quite detailed provisions covering the obligations of the parties in respect of monopoly suppliers or dominant suppliers.

At the very least, telecommunications chapters therefore generally urge the parties to maintain measures against anti-competitive activities. Sometimes such measures are made mandatory, especially to the extent that they apply to state-owned enterprises. Competition chapters typically also establish cooperative activities and processes to ensure transparency of regulation.

Free-trade agreements often exclude the competition provisions from the dispute settlement mechanism established under the agreement, mainly to ensure that judgments cannot be challenged internationally.

Box 11.3: The content of a competition chapter: another example

The article on competition in the free-trade agreement between New Zealand and Singapore has three parts. They require the parties to

- recognise the strategic importance of creating and maintaining open and competitive markets and to implement, as far as possible, the *APEC Principles to Enhance Competition and Regulatory Reform;*
- endeavour to reduce or remove impediments to trade and investment through:
  a. application of fair competition principles to economic activities, including private and public business activities;
  b. application of competition and regulatory principles in a manner that does not discriminate between or among economic entities in like circumstances;
  c. reduction of transaction and compliance costs for business; and
  d. promotion of effective regulatory coordination across borders.
- protect effectively the competitive process across their economies through:
  a. consulting and cooperating in the development of any new competition measures;
  b. give adequate resources to their competition authorities to let them carry out their functions; and
  c. endeavour to exchange information between regulatory authorities responsible for competition and to explore the scope for further cooperation between them.

Consultations and dispute settlement

Chances are that at some stage after the entry into force of the agreement the parties have differing views about the meaning of a provision. It is also possible that one party claims that the other party is honouring its commitments under the agreement fully. A third possibility is that a party is accused of denying an expected benefit to the other party through a law or policy that, ostensibly, is in accordance with the terms of the agreement (i.e. a non-violation action).

The parties then enter into consultations, and in most cases this will lead to satisfactory result. There may, however, be instances where consultations do not solve the problem. Other means will then have to be found to resolve the matter. Multilateral and plurilateral instruments sometimes have formal dispute settlement rules and mechanisms, but this is not normally the case for free-trade agreements. In any case, the closer relationship between economies under such agreements often precludes adversarial proceedings.

Most free-trade agreements therefore seek to solve disagreements first through consultation or the use of a mediator. If that doesn't work, they tend to go arbitration. The degree of detail about the handling of arbitration proceedings varies greatly. Some agreements set out all the steps required and how the cost of the proceedings is to be met. Others simply say that proceedings will be conducted under a standard framework, such as the *UNCITRAL Arbitration Rules* or the *New York Convention* (United Nations Convention on Recognition of Foreign Arbitral Awards).

Some agreements seek to prevent forum-shopping, i.e. the pursuit of proceedings on the matter in a different forum if there has been an adverse decision. The Thailand–Australia Free Trade Agreement, for example, states in Article 1601 that

> "Once a dispute settlement procedure has been initiated between the Parties with respect to a particular dispute under this Chapter or under any other international agreement to which the Parties are parties, that procedure shall be used to the exclusion of any other procedure for that particular dispute. This paragraph does not apply if substantially separate and distinct rights or obligations under different international agreements are in dispute."

This approach ensures that a dispute is ended expeditiously, and that costs remain manageable. At the same time, it does not deny the parties any of the legal rights available to them.

The usual practice is for consultations or formal dispute settlement actions to result in the removal either immediately or within a reasonable time of the measure or practice causing difficulties between the parties. In other words, rectification of a breach is required. Sometimes such a rectification is for various reasons difficult to achieve. Compensation may then become payable in the form of trade measures. One way to do this is to give the other party better access in an area not related to the dispute. A second way is for the aggrieved party to deny the other party trade benefits commensurate with the benefits that would be available to it in the disputed area. The level of compensation and the way it might be given to the other party usually requires careful negotiation.

An innovation in the Australia–United States free-trade agreement designed to deal with situations where a party considers that it cannot offer trade benefits is the option for it to pay a monetary assessment instead. The monetary assessment will be set at 50% of the value of the suspended benefits determined by the parties unless they agree otherwise. A further interesting point is that this monetary assessment can be used for initiatives to facilitate trade between Australia and the United States. Such a provision might be particularly useful for federal systems where the party to the agreement (i.e. the central government) may have limited ability to deal with the removal of an impediment in the short term.

General and security exceptions

Every free-trade agreement gives its members the right not to apply the provisions of the agreement in specified circumstances by invoking general or security exceptions.

Most agreements use the WTO provisions as the basis for these articles. These are GATT Articles XX (General Exceptions) and XXI (Security Exceptions) for trade in goods and GATS Articles XIV (General Exceptions) and XIV*bis* (Security Exceptions) for trade in services. This can be done in two ways:

- copying these provisions *verbatim* in their entirety, or with any changes they parties consider desirable, into the free-trade agreement; or
- incorporating them into the agreement through reference to them.

The second option is probably preferable. It ensures a uniformity of obligation, it also ensures that any changes made in the WTO to these provisions are automatically carried into the free-trade agreement, and it makes for a shorter text. One disadvantage of copying the provisions *verbatim* is that, because of their origin in a multilateral agreement, some of them may look somewhat strange in a bilateral agreement.

Review provisions

Most free-trade agreements contain a provision mandating general reviews of the operation of the agreement. These reviews often take place at ministerial level.

It is usual to have a first review about one year after the agreement has entered into force. By that time it should have become reasonably clear where the main implementation difficulties are occurring. This is then followed by a provision for general reviews about every five years.

This may not sound like a heavy burden, but one has to bear in mind that other chapters in the agreement also create review bodies and, perhaps, review timetables. All of these add up. They also need to be seen in the context of other free-trade agreements the parties may have. Very possibly they will also contain review provisions. It may therefore be advisable to build some flexibility into the review provisions so that the parties do not appear to be disregarding treaty provisions when a review cannot take place as prescribed.

The parties may also find it advisable to curb excessive enthusiasm in the establishment of committees, working parties, etc. Experience shows that a mechanism can be created easily to deal with an *ad hoc* problem.

Environmental and labour standards

Differing views can be found among economies on the place of environmental and labour issues in free-trade. Some agreements contain separate chapters on labour and environment. Others cover them in side letters or similar arrangements. Some do not refer to them at all.

However, any economy intending to negotiate a free-trade agreement with the United States will need to form a position on environmental and labour standards since the United States trade legislation makes their inclusion mandatory.

Side letters and exchanges of letters

Most free-trade agreements have attached to them an array of side letters and exchanges of letters. These letters have the same legal force as the agreement itself, unless the parties agree to give them a different status. As they are important for the interpretation of the agreement, they should always be included with its text.

Side letters and exchanges of letters are used for a wide range of purposes. Sometimes they are used when they apply to a temporary situation. For example, a party may have undertaken to enact a law in a given area. In another case a part may explain to the other party of the intent of a domestic law and assure it that it can see no reason why it would be applied to the other party. In such cases an exchange of letters then confirms the understanding of the parties that this is the case. This obviates the need for a separate provision in the agreement which would soon be superseded or be of exceedingly minor importance.

It may also be that some minor difficulty was discovered after the negotiations on a chapter were completed. In such cases parties sometimes agree that it may be preferable to fix the matter through an exchange of letters rather than reopening negotiations on the text of the agreement. Sometimes the parties simply confirm their respective understanding of a policy maintained by one of the parties.

It is unlikely that a comprehensive agreement will be able to do without any side letters. They are a useful way to solve all sorts of problems. On the other hand, if there is a looming proliferation of side letters, especially in areas that in treaty terms should be fairly unexceptional, negotiators would be well advised to ask what the reason for all these letters might be. If this problem is discovered early enough, remedial action is usually possible through addressing the issue in the body of the agreement.

The exchange of letters concerning the treatment of an aspect of financial services under the free-trade agreement between the United States and Singapore shown in Boxes 11.4 and 11.5 is typical of such exchanges. These letters can of course be much longer.

Box 11.4: The first part of an exchange of letters

May 6, 2003

The Honorable
Ralph F. Ives
Assistant U.S. Trade Representative
for Asia, the Pacific and APEC Affairs
Office of the U.S. Trade Representative

Dear Mr. Ives:

This letter confirms that that the United States and Singapore affirm their right to apply prudential measures regarding the supply of insurance services. In this regard, the Government of Singapore clarifies that, for prudential reasons, its commitments regarding the cross-border supply of MAT intermediation by brokerages in Singapore paragraph 1(e) in Annex 10A is limited by the requirement that the US brokerages can only place MAT insurance with US financial institutions. Singapore would remain open to consulting on this issue.

Sincerely

Tommy Koh
Ambassador-at-Large
Ministry of Foreign Affairs

Source: http://www.sice.oas.org/tradee.asp#Singapore

The reply in this case is brief (see next page). More often, the reply repeats word for word the points made by the initiator of the exchange.

Box 11.5: The second part of the exchange

May 6, 2003

The Honorable
Tommy Koh
Ambassador-at-Large
Ministry of Foreign Affairs

Dear Ambassador Koh:

The United States acknowledges Singapore's clarification on its commitments regarding the cross-border supply of MAT intermediation by brokerages contained in your letter of May 6, 2003.

Sincerely,

Ralph F. Ives
Assistant U.S. Trade Representative
for Asia, the Pacific and APEC Affairs

Source: http://www.sice.oas.org/tradee.asp#Singapore

The following example of a side letter is drawn from the Australia–United States free-trade agreement. In it, the United States confirms, following an examination, that a policy maintained by Australia does not contravene relevant provisions of the agreement. The length of such letters can varies considerably.

Box 11.6: An example of a side letter

EXECUTIVE OFFICE OF THE PRESIDENT
THE UNITED STATES TRADE REPRESENTATIVE
WASHINGTON, D.C. 20508

The Honorable Mark Vaile MP
Minister for Trade
Parliament House
Canberra ACT 2600

Dear Minister Vaile:

I refer to discussions between our respective delegations in the course of negotiations regarding Article 2.8 (Waiver of Customs Duties) of the United States–Australia Free Trade Agreement (the "Agreement").

The United States has examined the provisions of Australia's Automotive Competitiveness Investment Scheme (ACIS) and affirms that, as of the date of this letter, ACIS does not contain any performance requirements as defined in Chapter Two (National Treatment and Market Access for Goods) of the Agreement.

Sincerely,

Robert B. Zoellick

Source: http://www.dfat.gov.au/trade/negotiations/us_fta/final-text/index.html

12. Preparing the agreement for entry into force

Knowing the correct procedures

Getting the agreement ready for entry into force requires a good understanding of one's economy's treaty procedures. The timetable for this has an important bearing on choosing the date for this.

Free-trade agreements are normally drafted in the form of binding international treaties. This requires that they must meet certain standards both in relation to content and to style. Many of these standards vary from economy to economy, but others follow agreed international norms. The principal instrument codifying these norms is the *Vienna Convention on the Law of Treaties*.

A government agency will be given the responsibility to administer the agreement. The text of the agreement must be clear enough to enable good decision-making, and also flexible enough to permit dealing with unexpected situations in the spirit of the agreement.

The person selected by an economy to maintain the draft legal text of the agreement should therefore make an effort to become familiar with his or economy's treaty requirements and to seek advice from the economy's agency charged with treaty matters to ensure that the agreement meets national and international norms.

Box 12.1: What is a treaty?

The *Vienna Convention on the Law of Treaties* defines it thus:

> "treaty" means an international agreement concluded between States in a written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation.

Most negotiators are given one to two years to complete their agreement. Such time constraints mean that the negotiating team must attempt to anticipate task and problems as much as possible to ensure that procedural problems at least do not become an unnecessary obstacle at the end.

The day has now arrived when the text of the treaty has been carefully scrutinised by the various agencies responsible for its implementation, and they are satisfied that the text of the treaty both reflects the aims and understandings of the negotiators and that the text itself is free of mistakes. The process of bringing the agreement into force can then get under way.

Domestic processes for approving a treaty

All economies have an established formal process for bringing a treaty into force. This usually involves at least scrutiny by Cabinet and a parliamentary committee and, sometimes, passage of enabling legislation by Parliament. The precise components of this process, and the documentation required for it, of course vary according to the economy. What these processes have in common is that they require time.

Following is a brief description of the formal steps required in Australia to have treaty approved.

Box 12.2: Australia's treaty approvals process

The Australian treaty approvals process includes the following main steps for all treaty actions, i.e. creating a new treaty, amending an existing one or abrogating a treaty:

- preparation of a National Interest Analysis (NIA) which sets out the advantages and disadvantages to Australia of becoming, or not becoming, a party to the treaty, including significant quantifiable and foreseeable economic and/or environmental effects of the treaty. Among several other points, the NIA must detail what consultations have taken place with the States and Territories and with community and other interested partners;
- preparation of a Regulatory Impact Statement (RIS) which includes an assessment of the impact of the proposed regulation (i.e. the treaty), and alternatives, on different groups and the community as a whole;
- tabling the treaty before Parliament for twenty sitting days and consideration of the proposed treaty action by the Joint Standing Committee on Treaties (JSCOT). If Parliament is in recess, several weeks or even months may elapse before this criterion has been met;
- preparation and passage of the enabling legislation. The timing of this depends on the complexity of the proposed legislation, the timetable of parliamentary sittings and the demands of other business before Parliament.

In addition to the formal process, there is usually in every economy an informal process involving all parties to ensure that all parts of the proposed agreement reflect a common understanding and that all errors have been eliminated. This is often called "legal scrubbing".

Both the formal and informal processes require time, and negotiators must allow for them when they envisage that the agreement should enter into force on a certain date.

Bringing the agreement into force

In this section we briefly outline the formalities required by the parties to bring the agreement into force. The parties usually agree on a date when they expect to have completed all their domestic processes. In most cases these dates can be met without too many difficulties, but elections and other major events can easily upset the timetable. That kind of event is well out of the control of the negotiators, but they still have to inform themselves of possible obstacles to a timetable and be aware of possible alternatives.

Bringing the agreement into force is usually done through an exchange of diplomatic notes (also known as *notes verbales* or third-person notes) in which the parties notify each other that they have completed all domestic formalities to enable the agreement into force. Box 12.3 gives such an exchange between Australia and the United States in 2004.

Box 12.3: an example of an exchange of diplomatic notes

The Australian note

NOTE NO. 270/2004

The Embassy of Australia presents its compliments to the Department of State of the United States of America and has the honour to refer to the Australia–United States Free Trade Agreement, done in Washington on 18 May 2004 (the "Agreement").

The Embassy refers to Article 23.4.1 of the Agreement on its entry into force by way of written notifications exchanged by Australia and the United States certifying completion of their respective necessary internal requirements.

The Embassy has the honour to confirm that Australia has completed its necessary internal requirements for the entry into force of the Agreement and proposes that the Agreement enter into force on the First day of January 2005.

The Embassy of Australia avails itself of this opportunity to renew to the Department of State of the United States of America the assurances of its highest consideration.

WASHINGTON, DC

17 November 2004

The United States note

The Department of State acknowledges receipt of note No. 270/2004 from the Embassy of Australia, dated November 17, 2004, notifying the Government of the United States of America that the Government of Australia has completed its necessary internal requirements for entry into force of the Australia–United States Free Trade Agreement, done at Washington on 18 May 2004 (the "Agreement").

The Department of State is pleased to notify the Embassy, pursuant to Article 23.4.1 of the agreement, that the Government of the United States of America has completed its necessary internal requirements for the entry into force of the Agreement.

The Department of State accepts, on behalf of the Government of the United States of America, the Embassy's proposal, pursuant to Article 23.4.1 of the agreement, that the Agreement enter into force on January 1, 2005.

Department of State,

Washington, November 17, 2004.

DIPLOMATIC NOTE

Source: http://www.dfat.gov.au/trade/negotiations/us_fta/final-text/index.html

Once the exchange of the notes has occurred, the agreement enters into force on the agreed date.

13. Hints on drafting the agreement

The importance of a good agreement

A free-trade agreement is a legally binding treaty between the partner economies. It will be in use long after the negotiators have moved on to other responsibilities. The agreement has to stand the test of time. Clarity in the provisions will make this easier.

This section offers a few observation and hints aimed at easing some of the difficulties of the drafting process. In most cases, this process will be "messy" at times, but it is possible to approach the task in such a way that any confusion resulting from the inevitable changes in positions can be minimised.

The drafting of a free-trade agreement can of course be approached in more than one way. The method chosen in a particular negotiation will depend to a considerable extent on the approach to the negotiations taken by the chief negotiator.

The main challenge is, however, nearly always the same: how to produce a reliable text reflecting the outcome of the latest stage of negotiations.

Few major negotiations are done in plenary. Its main purpose is to keep everyone informed of the latest developments. Much more usual is to create negotiating groups for various aspects of the agreement, especially when the subject matter requires expert knowledge. These negotiating groups then create their own texts, most often in the form of chapters, but sometimes their task does not exceed one or two articles.

This is good negotiating practice, and it needs to be supported with good drafting practice. The following points show some of the steps a negotiating team can take to ensure that the draft text always meets the needs of the negotiators:

At the start of the negotiations

- appoint a single person to be in charge of the draft text
  - this person should be able to develop a "feel" for the eventual look of the agreement, though not, of course, what the rights and obligations will be
  - this person also needs patience and good humour to cope with all the changes that will be made to the text
- agree on broad editorial guidelines and structures of chapters
  - in this way it is possible to inject a sense of uniformity into the text and to eliminate much duplication quite early

- do not rush into legal drafting:
  - negotiators can become quite "territorial" and unwilling to give up any of the words they have come to like
  - often the better approach in the case of difficulties will be to have a good discussion first, followed by the drafting of a brief paper that outlines views of possible solutions
  - this also helps delegations to develop the same understanding of an issue even though their aims and positions are different
  - in any event, don't be afraid to use square brackets liberally
- do not assume that specialists in various issues are familiar with the requirements for drafting a treaty
  - they will get the substance right, but they may need advice on how the provision should be drafted
- exercise economy in the drafting, as shown in the following examples
  - put definitions applying to more than one chapter (e.g. the WTO Customs Valuation Agreement) into a single definitions article applying to the whole agreement, and include definitions applying to a single chapter only (e.g. equivalence of sanitary and phytosanitary measures) into that chapter
  - exceptions applying to the entire agreement can be collated in one single chapter; among these are general exceptions, confidentiality provisions and balance-of-payments provisions
- adopt a single numbering system that easily identifies the chapter and the article, and stick to it
  - if an article is added, simply give it the number of the previous article and add, for example, the letter A, as in "Article 1601A"
- above all, always bear in mind that the agreement will change the way business is being done between the parties

Once the negotiations are under way

- early in the negotiations establish clearly how the treaty approvals system in your economy works

- as the text may have to conform to certain conventions, these ought to be understood by the negotiators

- consult your legal advisers frequently since at this stage legal drafting problems and concepts are much easier to deal with than in the final stages

- ensure that the chief negotiator and the legal advisor at least receive the latest version of the text soon after each negotiating session, regardless of the amount of text in square brackets

- do not change the numbering of any article during the negotiations because other parts of the text will contain cross-references

- if an article is deleted, retain its number and simply mark it as "deleted"

When the negotiations are over

- verification or "legal scrubbing" of the text can now begin and should not be too difficult because you have kept the text in good order throughout the negotiations

- the first step is to ensure that the text conforms to the negotiating team's understanding of what has been agreed, and the other side will do the same

- once this has been done, notes can be compared with the other side

  - this can easily be done by e-mail, and many problems can then be sorted out with few problems

- Some discrepancies may be harder to solve, and it may be necessary to have a meeting to work things out

  - it would be unusual to introduce new negotiating proposals at this stage, but the two sides may sometimes agree that clarity would be served by the insertion of an additional article that would not, however, disturb the balance of the agreement.

- At this stage it may become apparent that quite a few mechanisms for consulting and implementation of the agreement have been established

  - these mechanisms are necessary, but it is worth bearing in mind that the greater the number of mechanisms, the more difficult it may become to look after all them.

- At the end of all of this, you are at the point where the agreement passes over to cabinet and parliamentary processes
    - you will still be kept busy with all sorts of briefing requirements, but soon you will be able to say with pride: “I was part of the negotiations for that agreement”.

Appendix 1: Excerpt from GATT Article XXIV

Article XXIV

Territorial Application – Frontier Traffic – Customs Unions and Free-trade Areas

[Paragraphs 1 to 3 covering territorial application and frontier traffic are omitted.]

4. The contracting parties recognize the desirability of increasing freedom of trade by the development through voluntary agreements, of closer integration between the economies of the countries parties to such agreements. They also recognize that the purpose of a customs union or 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 subparagraphs *(a)* and *(b)* shall include a plan and a 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 subparagraph 5 *(a)*, a contracting party proposes to increase any rate of duty inconsistently with the provisions of Article II [Schedules of Concessions], the procedure set forth in Article XXVIII [Modification of Schedules] shall apply. In providing for compensatory adjustment, due account shall be taken of the compensation already afforded by the reduction 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-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 subparagraph *(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 purposes 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 the 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 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 paragraphs 8 *(a)*(i) and 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.

[Paragraphs 11 and 12 covering a special case of bilateral trade relations and the observance of the agreement by regional and local governments are omitted].

**Ad Article XXIV*

Paragraph 9

It is understood that the provisions of Article I would require that, when a product which has been imported into the territory of a member of a customs union or free-trade area at a preferential rate of duty is re-exported to the territory of another member of such union or rea, the latter member should collect a duty equal to the difference between the duty already paid and any higher duty that would be payable if the product were being imported directly into its territory.

Appendix 2: Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994

Members,

Having regard to the provisions of Article XXIV of GATT 1994;

Recognizing that customs unions and free-trade areas have greatly increased in number and importance since the establishment of GATT 1947 and today cover a significant proportion of world trade;

Recognizing the contribution to the expansion of world trade that may be made by closer integration between the economies of the parties to such agreements;

Recognizing also that such contribution is increased if the elimination between the constituent territories of duties and other restrictive regulations of commerce extends to all trade, and diminished if any major sector of trade is excluded;

Reaffirming that the purpose of such agreements should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other Members with such territories; and that in their formation or enlargement the parties to them should to the greatest possible extent avoid creating adverse effects on the trade of other members;

Convinced also of the need to reinforce the effectiveness of the role of the Council for Trade in Goods in reviewing agreements notified under Article XXIV, by clarifying the criteria and procedures for the assessment of new or enlarged agreements, and improving the transparency of all Article XXIV agreements;

Recognizing the need for a common understanding of the obligations of Members under paragraph 12 of Article XXIV:

Hereby *agree* as follows:

1. Customs unions, free-trade areas, and interim agreements leading to the formation of a customs union or free-trade area, to be consistent with Article XXIV, must satisfy, *inter alia*, the provisions of paragraphs 5, 6, 7 and 8 of that Article.

Article XXIV:5

2. The evaluation under paragraph 5(a) of Article XXIV of the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union shall in respect of duties and charges be based upon an overall assessment of weighted average tariff rates and of customs duties collected. This assessment shall be based on import statistics for a previous representative period to be supplied by the customs union, on a tariff-line basis and in values and quantities, broken down by WTO country of origin. The Secretariat shall compute the weighted average tariff rates and customs duties collected in accordance with the methodology used in the assessment of tariff offers in the Uruguay Round of Multilateral Trade negotiations. For this purpose, the duties and charges to be taken into

consideration shall be applied rates of duty. It is recognized that for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows may be required.

. The “reasonable length of time” referred to in paragraph 5(c) of Article XXIV should exceed ten years only in exceptional cases. In cases where Members parties to an interim agreement believe that 10 years would be insufficient they shall provide a full explanation to the Council for Trade in Goods of the need for a longer period.

Article XXIV:6

4. Paragraph 6 of Article XXIV establishes the procedure to be followed when a Member forming a customs union proposes to increase a bound rate of duty. In this regard Members reaffirm that the procedure set forth in Article XXVIII, as elaborated in the guidelines adopted on 10 November 1980 (BISD 27S/26-28) and in the Understanding on the Interpretation of Article XXVIII of GATT 1994, must be commenced before tariff concessions are modified or withdrawn upon the formation of a customs union or an interim agreement leading to the formation of a customs union.

5. These negotiations shall be entered into in good faith with a view to achieving mutually satisfactory compensatory adjustment. In such negotiations, as required by paragraph 6 of Article XXIV, due account shall be taken of reductions of duties on the same tariff line made by other constituents of the customs union upon its formation. Should such reductions not be sufficient to provide the necessary compensatory adjustment, the customs union would offer compensation, which may take the form of reductions of duties on other tariff lines. Such an offer shall be taken into consideration by the Members having negotiating rights in the binding being modified or withdrawn. Should the compensatory adjustment remain unacceptable, negotiations should be continued. Where, despite such efforts, agreement in negotiations on compensatory adjustment under Article XXVIII as elaborated by the Understanding on the Interpretation of Article XXVIII of GATT 1994 cannot be reached within a reasonable period from the initiation of negotiations, the customs union shall, nevertheless, be free to modify or withdraw the concessions; affected Members shall then be free to withdraw substantially equivalent concessions in accordance with Article XXVIII.

6. GATT 1994 imposes no obligation on Members benefiting from a reduction of duties consequent upon the formation of a customs union, to provide compensatory adjustment to its constituents.

Review of Customs Unions and Free-Trade Areas

7. All notifications made under paragraph 7(a) of Article XXIV shall be examined by a working party in the light of the relevant provisions of GATT 1994 and of paragraph 1 of this Understanding. The working party shall submit a report to the Council for Trade in Goods on its findings in this regard. The Council for Trade in Goods may make recommendations to Members as it deems appropriate.

8. In regard to interim agreements, the working party may in its report make appropriate recommendations on the proposed time-frame and on measures required to complete the formation of the customs union or free-trade area. It may if necessary provide for further review of the agreement.

9. Members parties to an interim agreement shall notify substantial changes in the plans and schedule included in that agreement to the Council for Trade in Goods and, if so requested, the Council shall examine the changes.

10. Should an interim agreement notified under paragraph 7(a) of Article XXIV not include a plan and schedule, contrary to paragraph 5(c) of Article XXIV, the working party shall in its report recommend such a plan and schedule. 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. Provision shall be made for subsequent review of the implementation of the recommendations.

11. Customs unions and constituents of free-trade areas shall report periodically to the Council for Trade in Goods, as envisaged by the CONTRACTING PARTIES to GATT 1947 in their instruction to the GATT 1947 Council concerning reports on regional agreements (BISD 18S/38), on the operation of the relevant agreement. Any significant changes and/or developments in the agreement should be reported as they occur.

Dispute Settlement

12. The provisions of Article XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked with respect to any matters arising from the application of those provisions of Article XXIV relating to customs unions, free-trade areas or interim agreements leading to the formation of a customs union or free-trade area.

[Paragraphs 13 to 15 covering observance of the GATT by regional and local governments are omitted.]

Appendix 3: Article V of the General Agreement on Trade in Services

Article V

Economic Integration

1. This Agreement shall not prevent any of its members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement, provided that such agreement:

(a) has substantial sectoral coverage[2] and

(b) provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII [National Treatment], between or among the parties, in the sectors covered under subparagraph (a), through:

3. elimination of existing discriminatory measures, and/or

(ii) prohibition of new or more discriminatory measures,

either at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI [Payments and Transfers], XII [Restrictions to Safeguard the Balance of Payments], XIV [General Exceptions] and XIV *bis* [Security Exceptions].

2. In evaluating whether the conditions under paragraph 1(b) are met, consideration may be given to the relationship of the agreement to a wider process of economic integration or trade liberalization among the countries concerned.

3. (a) Where developing countries are parties to an agreement of the type referred to in paragraph 1, flexibility shall be provided for regarding the conditions set out in paragraph 1, particularly with reference to subparagraph (b) thereof, in accordance with the level of development of the countries concerned, both overall and in individual sectors and subsectors.

(b) Notwithstanding paragraph 6, in the case of an agreement of the type referred to in paragraph 1 involving only developing countries, more favourable treatment may be granted to juridical persons owned or controlled by natural persons of the parties to such an agreement.

4. Any agreement referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not in respect of any Member outside the agreement raise the overall level of barriers to trade in services within the respective sectors or subsectors compared to the level applicable prior to such an agreement.

5. If, in the conclusion, enlargement or any significant modification of any

---

[2] This condition is understood in terms of numbers of sectors, volume of trade affected and modes of supply. In order to meet this condition, agreements should not provide for the *a priori* exclusion of any mode of supply.

agreement under paragraph 1, a Member intends to withdraw or modify a specific commitment inconsistently with the terms and conditions set out in its Schedule, it shall provide at least 90 days advance notice of such modification or withdrawal and the procedure set forth in paragraphs 2, 3 and 4 of Article XXI [Modification of Schedules] shall apply.

6. A service supplier of any other Member that is a juridical person constituted under the laws of a party to an agreement referred to in paragraph 1 shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such an agreement.

7. (a) Members which are parties to any agreement referred to in paragraph 1 shall promptly notify any such agreement and any enlargement or any significant modification of that agreement to the Council for Trade in Services. They shall also make available to the Council such relevant information as may be requested by it. The Council may establish a working party to examine such an agreement or enlargement or modification of that agreement and to report to the Council on its consistency with this Article.

(b) Members which are parties to any agreement referred to in paragraph 1 which is implemented on the basis of a time-frame shall report periodically to the Council for Trade in Services on its implementation. The Council may establish a working party to examine such reports if it deems such a working party necessary.

(c) Based on the reports of the working parties referred to in subparagraphs (a) and (b), the Council may make recommendations to the parties as it deems appropriate.

8. A Member which is a party to any agreement referred to in paragraph 1 may not seek compensation for trade benefits that may accrue to any other Member from such an agreement.

Article V bis

Labour Markets Integration Agreements

This Agreement shall not prevent any of its Members from being a party to an agreement establishing full integration[3] of labour markets between or among the parties to such an agreement, provided that such an agreement:

(a) exempts citizens of parties to the agreement from requirements concerning residency and work permits;

4. is notified to the Council for Trade in Services.

[3] Typically, such integration provides citizens of the parties concerned with the right of free entry to the employment markets of the parties and includes measures concerning conditions of pay, other conditions of employment and social benefits.

Appendix 4: WTO : Common Declaration with Regard to Preferential Rules of Origin

1. Recognizing that some members apply preferential rules of origin, distinct from non-preferential rules of origin, the members hereby *agree* as follows.

2. For the purpose of this Common Declaration, preferential rules of origin shall be defined as those laws, regulations and administrative determinations of general application applied by any member to determine whether goods qualify for preferential treatment under contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of paragraph 1 of Article 1 of the GATT 1994[4].

3. The members *agree* to ensure that:

(a) when they issue administrative determinations of general application, the requirements to be fulfilled are clearly defined. In particular:

5. in cases where the criterion of change in tariff classification is applied, such a preferential rule of origin, and any exceptions to the rule, must clearly specify the subheadings or headings within the tariff nomenclature that are addressed by the rule

(ii) in cases where the ad valorem percentage criterion is applied, the method for calculating this percentage shall also be indicated in the preferential rules of origin;

(iii) in cases where the criterion of manufacturing or processing operation is prescribed, the operation that confers preferential origin shall be precisely specified;

(b) their preferential rules are based on a positive standard. Preferential rules of origin that state what does not confer preferential origin (negative standard) are permissible as part of a clarification of a positive standard or in individual cases where a positive determination of preferential origin is not necessary;

(c) their laws, regulations, judicial decisions and administrative rulings of general application relating to preferential rules of origin are published

[4] This is the GATT most-favoured-nation clause. It states that with "respect to customs duties and charges of any kind imposed on or in connection with importation and exportation or imposed on the international transfer of payments for imports or export, 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".

as if they were subject to, and in accordance with, the provisions of paragraph 1 of Article X of GATT 1994[5];

(d) upon request of an exporter, importer or any person with a justifiable cause, assessments of the preferential origin they would accord to a good are issued as soon as possible but no later than 150 days after a request for such an assessment provided that all necessary elements have been submitted. Requests for such assessments shall be accepted before trade in the good concerned begins and may be accepted at any later point in time. Such assessments shall remain valid for three years provided that the facts and conditions, including the preferential rules of origin, under which they have been made remain comparable. Provided that the parties concerned are informed in advance, such assessments will no longer be valid when a decision contrary to the assessment is made in a review referred to in subparagraph (f). Such assessments shall be made publicly available subject to the provisions of subparagraph (g);

(e) when introducing changes to their preferential rules of origin or new preferential rules of origin, they shall not apply such changes retroactively as defined in, and without prejudice, their laws and regulations;

(f) any administrative action which they take in relation to the determination of preferential origin is reviewable promptly by judicial, arbitral or administrative tribunals or procedures, independent of the authority issuing the determination, which can effect the modification or reversal of the determination;

(g) all information that is by nature confidential or that is provided on a confidential basis for the purpose of the application of preferential rules of origin is treated as strictly confidential by the authorities concerned, which shall not disclose it without the specific permission of the person or government providing such information, except to the extent that it may be required to be disclosed in the context of judicial proceedings.

4. Members *agree* to provide to the secretariat promptly their preferential rules of origin, including a listing of the preferential arrangements to which they apply, judicial decisions, and administrative rulings of general application relating to their preferential rules of origin in effect of the date of entry into force of the WTO Agreement[6] for the Member concerned. Furthermore, Members agree to provide any modifications to their preferential rules of origin or new preferential rules of origin as soon as possible to the Secretariat. Lists of information received and available with the Secretariat shall be circulated to the Members by the Secretariat.

---

[5] This the transparency article of the GATT. It requires, *inter alia*, that "Laws, regulations, judicial decisions and administrative rulings of general application . . . pertaining to the classification or the valuation of products for customs purposes, or to rates of duty, taxes or other charges, or to requirements, restrictions or prohibitions on imports or exports or on the transfer of payments therefor, or affecting their sale, distribution, transportation, insurance, warehousing inspection, exhibition, processing, mixing or other use, shall be published promptly in such a manner as to enable governments and traders to become acquainted with them. . . "

[6] This is the agreement establishing the WTO in 1995.

Appendix 5: A stylised free-trade agreement

Here we finally come to a complete stylised agreement covering goods, services and investment. It only shows what the structure of such an agreement might be. The stylised agreement is based on many agreements already concluded and in force, but it does not reflect an actual agreement.

The stylised agreement is not meant to be an outline of a model agreement. It really is a checklist of chapters and articles that might go into an agreement. Many other arrangements are possible. Some chapters or articles may not be needed at all. In other cases, chapters can be combined to form a single chapter. The form of the agreement really depends on the wishes of the parties and the situations they wish to cover.

The articles are not drafted in the form of disciplines. It is a matter for the parties to decide what the appropriate level of rights and obligations in their agreement is. It is of course easy to imagine what the content of a national-treatment or most-favoured-nation article may be. Such fundamental disciplines are not likely to depart much from the well-established WTO provisions.

Articles on customs cooperation can vary considerably not only in their descriptions of areas for cooperation, but also on the extent to which the parties wish to cooperate. The content (rights and obligations) is less obvious for articles on intellectual property rights, electronic commerce or competition policy. An article on government procurement, for example, might simply exempt government procurement from the scope of the agreement. A full chapter, on the other hand, might lay down precise principles and rules on the handling of government procurement by the parties.

Some free-trade agreements contain chapters on environmental and labour standards. As there is no emerging common view on whether these two issues should be part of free-trade agreements, they are not included in this listing.

The numbering system used here is that initiated by the North American Free Trade Agreement (NAFTA) and adopted by other agreements since. It is included here for ease of reference only. Many agreements use other numbering systems. The parties can please themselves in the selection of a numbering system, but they should make sure that articles and paragraphs can be identified easily.

Most free-trade agreements have several annexes. This booklet does not indicate where annexes may be required since this depends on the wishes of the parties. However, some annexes are essential. Among these are the tariff schedules and the schedules detailing commitments on services, investment, government procurement, rules of origin, etc. It is also likely that side letters and exchanges of letters will be appended to the agreement.

Free-trade agreement between Party A and Party B

PREAMBLE

The preamble usually gives some of the background to the agreement. It does not contain any rights or obligations. The preamble can be as long or as short as the parties consider appropriate.

CHAPTER I : OBJECTIVES AND DEFINITIONS

Article 101 **Establishment of the free-trade area**
Declares that the parties are establishing a free-trade area between them.

Article 102 **Objectives**
Sets out the objectives of the agreement.

Article 103 **Territorial application**
Defines the territories to which the agreement applies.

Article 104 **General definitions**
Contains definitions of words and concepts used throughout the agreement.

Article 105 **Country-specific definitions**
Lists any definitions applicable to one party only.

CHAPTER 2: TRADE IN GOODS

Article 201 **Definitions**
Defines concepts and terms relating to this chapter.

Article 202 **Objectives**
Defines the objectives of the parties for trade in goods.

Article 203 **Scope**
Defines the subject areas to which this chapter applies.

Article 204 **National treatment**
The parties usually accord each other national treatment at least to the level required by GATT Article III.

Article 205 **Elimination of customs duties**
Explains the procedures under which the parties eliminate their tariffs, including any phase-in arrangements.

Article 206 **Waiver of customs duties**
This usually states that waivers of customs duties may not be made in support of a performance requirement.

Article 207 **Accelerated tariff elimination**
Enables the elimination of tariffs before the scheduled date, either autonomously or at the request of the other party.

Article 208 **Classification of goods**
Usually states that the customs authorities will use the Harmonised System for classification purposes.

Article 209 **Export duties**
Defines the situations when export duties may be levied.

Article 210 **Administrative fees and formalities**
Explains how the parties deal with administrative fees, etc.

Article 211 **Anti-dumping measures**
Covers the conditions under which the parties may take anti-dumping action against each other.

Article 212 **Subsidies and countervailing measures**

Defines the conditions under which the parties may apply subsidies and take countervailing measures against each other.

Article 213 **Agricultural export subsidies**

Defines the conditions under which the parties may apply agricultural export subsidies against each other.

Article 214 **Non-tariff measures**

States how the parties will deal with non-tariff measures.

Article 215 **Customs user fees**

Usually requires that customs user fees should be about equivalent to the cost of services rendered.

Article 216 **Shortage clause**

Describes the conditions under which the parties may restrict the export of goods to relieve critical shortages.

Article 217 **Temporary admission of goods**

Regulates the entry and re-export of goods needed for trade fairs, export promotions, etc.

Article 218 **Duty-free entry of certain commercial samples of negligible value and printed advertising materials**

Contains the conditions applying to the entry of such materials.

Article 219 **Goods re-entered after repair or alteration**

Usually obliges the parties to permit the duty-free re-entry of goods if they have been exported to the other party.

Article 220 **Review body for trade in goods**

Provides a forum for the discussion of any issues that may arise in the conduct of trade in goods under the agreement.

Chapter 3: Customs Procedures

Article 301 **Definitions**

Defines terms and concepts relevant to customs procedures.

Article 302 **Objectives**

Defines the objectives of this chapter.

Article 303 **Scope**

Defines the activities to which this chapter applies.

Article 304 **Customs valuation**

States the basis for customs valuation to be used by the customs authorities.

Article 305 **Customs procedures and facilitation**

Defines the approach to customs procedures by a party to preferential imports from the other party.

Article 306 **Express shipments**

Sets out any special rules applying to international express shipments.

Article 307 **Advance rulings**

Permits exporters and importers to seek advice on classification and preferential treatment of a good to be traded.

Article 308 **Treatment of goods entering under a Certificate of Origin**

States how goods traded under a Certificate of Origin and qualifying for preferential treatment will be dealt with by the customs authorities.

Article 309 **Paperless trading and use of automated systems**

Usually at least an undertaking to rely as much as possible on paperless trading and automated systems.

Article 310 **Risk management**

Usually an undertaking that the parties will rely as much as possible on risk management to improve clearance times.

Article 311 **Review and appeal**

Defines the conditions under which an exporter or importer may appeal against any decision by customs authorities against goods traded under the agreement.

Article 312 **Publication and enquiry points**

Usually the parties agree to publish all relevant customs regulations and to establish enquiry points where exporters and importers may obtain information on the customs regime.

Article 313 **Customs cooperation**

Sets out the framework for cooperation between the customs authorities to improve the flow of goods between the parties.

Chapter 4: Rules of Origin

Article 401 **Definitions**

Defines terms and concepts relating to the system of rules of origins in the agreement.

Article 402 **Originating goods**

Defines the conditions under which a good exported from the other party will qualify for preferential treatment by the importing party.

Article 403 **Regional value content**

If the system of rules of origin uses a value-added criterion, this article defines the threshold and the method to be used.

Article 404 **Intermediate materials**

Describes how material that is self-produced and used in the production of a good is to be treated in the calculation of the regional value content.

Article 405 **Accumulation**

Describes the conditions for considering a good produced partly in another party as part of the regional value content.

Article 406 **Calculation of values**

States what costs can be included In the calculation of the regional value content.

Article 407 **Recording of costs**

States what records a company must keep concerning the costs of imported components in goods, as well as records of any other costs.

Article 408 ***De minimis* provision (tolerance rule)**

Defines the extent to which the qualifying content of a good may fall short of the prescribed regional value content, and the situations when this may be acceptable or when a good meets the origin requirements even though it does not undergo a change in tariff classification.

Article 409 **Fungible goods and materials**

Describes how goods or materials that are interchangeable for commercial purposes and whose properties are essentially identical are to be treated.

Article 410 **Accessories, spare parts and tools**

Specifies when these are to be considered part of the regional value content of a good.

Article 411 **Indirect materials**

Describes how materials used in the production of a good, but not forming part of the good, are to be treated.

Article 412 **Packaging materials**
Describes the extent to which packaging material may be included in the calculation of the regional value content.

Article 413 **Insufficient processing or operations**
Lists the operations or processes which are considered insufficient to give a good preferential status.

Article 414 **Consignment criteria**
Describes the conditions under which a good transported from one party to another may pass through a third country.

Article 415 **Transshipment**
Prohibits the import of goods for the sole purpose of re-exporting them to the other party under preferential conditions.

Article 416 **Registration of exporters**
Defines the manufacturing sectors in which exporters must register to obtain preferential status for goods to be exported to the other party.

Article 417 **Certificate of Origin**
States who may issue a Certificate of Origin and what its form is.

Article 418 **Claim for preferential treatment**
Defines the steps an importer must take to obtain preferential treatment for goods.

Article 419 **Records**
States for how long importers and exporters must retain records relating to the international transactions falling under the agreement.

Article 420 **Verification of origin**
States what steeps may be taken in cases of doubt about the true origin of a good.

Article 421 **Suspension and denial of preferential treatment**
States under what conditions a party may deny preferential treatment to an importer or exporter.

Article 422 **Review and appeal**
Defines the conditions under which an exporter or importer may appeal against any decision by customs authorities against goods traded under the agreement.

Article 423 **Consultations and modifications**
Specifies how the parties should consult on the operation of this chapter, and how the rules of origin might be modified.

Article 424 **Committee on Rules of Origin**
Many agreements establish a body composed of representatives of all parties to deal with any difficulties that may arise in the administration of the rules of origin.

CHAPTER 5: TECHNICAL BARRIERS TO TRADE

Article 501 **Definitions**
Defines terms and concepts relating to technical barriers to trade.

Article 502 **Objectives**
Outlines the objectives of this chapter.

Article 503 **Scope**
Describes the range of technical barriers to which this agreement applies.

Article 504 **Conformity assessment procedures**
Outlines the procedures to be adopted by the parties concerning conformity assessments.

Article 505 **Registration of conformity assessment bodies**

Describes the procedures to be followed by the parties in proposing the registration of conformity assessment bodies, including notification of the other parties.

Article 506 **International standards**

Specifies any international standards the parties are expected to adopt by a certain date.

Article 507 **Mutual recognition of standards**

Outlines the extent to which the parties recognise each other's standards and any program they ay adopt towards negotiating mutual recognition agreements (MRAs).

Article 508 **Harmonisation of standards**

Outlines the conditions applicable to the harmonising of standards.

Article 509 **Equivalence of standards**

Outlines the conditions for considering one party's standards as equivalent to those of another.

Article 510 **Technical cooperation and contact point**

Usually consists of an undertaking to pursue technical cooperation activities in support of this chapter and to establish contact points for any enquiries from the other parties.

Article 511 **Committee on Technical Barriers to Trade**

Establishes a body to oversee the operation of this chapter.

CHAPTER 6: SANITARY AND PHYTOSANITARY STANDARDS

Article 601 **Definitions**

Defines terms and concepts relating to sanitary and phytosanitary standards.

Article 602 **Objectives**

Outlines the objectives of this chapter.

Article 603 **Scope**

Describes the range of matters to which this chapter applies.

Article 604 **Equivalence of standards**

Describes the conditions under which a party will consider the standards of the other party as equivalent of its own standards.

Article 605 **Harmonisation**

Outlines the conditions for harmonising standards and a possible work program towards that objective.

Article 606 **International standards**

Usually requires that sanitary and phytosanitary measures are based on international standards, where these exist.

Article 607 **Risk assessment**

Usually requires the parties to base their sanitary and phytosanitary measures on risk assessments.

Article 608 **Control, inspection and approval procedures**

Describes the procedures to be followed by the parties when they examine goods imported under the agreement.

Article 609 **Technical cooperation and contact point**

Usually consists of an undertaking to pursue technical cooperation activities in support of this chapter and to establish contact points for any enquiries from the other party.

Article 610 **Committee on Sanitary and Phytosanitary Matters**

Sets out the mandate and working procedures for the committee.

CHAPTER 7: SAFEGUARDS

Article 701 **Definitions**
Defines terms and concepts relating to safeguards.

Article 702 **Objectives**
Describes the objectives of this chapter.

Article 703 **Global safeguards**
Describes the attitude of the parties to safeguards available under GATT Article XIX.

Article 704 **Special safeguards**
Usually describes any system of safeguards applicable to some products only.

Article 705 **Transitional safeguards**
Usually describes any system of safeguards that will only remain in place during a specified implementing period.

Article 706 **Provisional safeguards**
Describes the situation in which short-term safeguards may be imposed before an investigation has been undertaken.

Article 707 **Compensation**
Describes the extent to which a party may be entitled to compensation if a safeguard action is taken against it.

Article 708 **Notification**
Prescribes how and when a party has to be notified of a safeguard action against it.

CHAPTER 8: TRADE IN SERVICES

Article 801 **Definitions**
Defines terms and concepts relevant to trade in services.

Article 802 **Objectives**
Sets out the objectives of the parties concerning trade in services.

Article 803 **Scope**
Lists the services activities to which the agreement applies.

Article 804 **Market access**
Sets out the conditions under which suppliers of the other parties have access to markets.

Article 805 **Local presence**
Sets out the conditions when some form of presence is required in the market.

Article 806 **National treatment**
Defines the situations when national treatment is accorded to suppliers of the other parties.

Article 807 **Most-favoured-nation treatment**
Often prescribes that in cases where national treatment is not possible, most-favoured-nation treatment will be given.

Article 808 **Service suppliers of third countries**
Describes the conditions under which a service supplier owned by a third-country person may be eligible to supply services under preferential conditions.

Article 809 **Monopolies and exclusive service suppliers**
Describes how monopolies and exclusive service suppliers will be treated under the agreement.

Article 810 **Quantitative restrictions**
Describes the conditions under which quantitative restrictions may be imposed.

Article 811 **Measures by sub-national levels of government**
Specifies whether the activities of states, provinces and/or local government authorities are covered by the agreement.

Article 812 **Schedules of specific commitments**

Specifies how the schedules of commitments attached to the agreement are to be interpreted, and whether the commitments are to be listed in positive or negative form.

Article 813 **Additional commitments**

Enables a party to make commitments going beyond the requirement of the agreement.

Article 814 **Modification of commitments**

Describes under what conditions a party may make changes to its inscriptions in the schedule of commitments.

Article 815 **Review of commitments**

Usually describes the mechanism to be used for a periodic review of the schedules of commitments.

Article 816 **Mutual recognition of qualifications and licensing**

Describes the procedures and criteria to be used in the case of mutual recognition.

Article 817 **Services originating from third-country suppliers**

Describes the conditions under which firms owned by third-country nationals established in one of the parties can supply services under preferential conditions.

Article 818 **Denial of benefits**

Specifies the conditions under which a party may deny preferential treatment to a service supplied from the other party.

Article 819 **Audiovisual services**

Some agreements have special provisions for audiovisual services, sometimes in the form of a separate chapter.

Chapter 9: Trade in Financial Services

Article 901 **Definitions**

Defines the concepts and terms used in this chapter.

Article 902 **Objectives**

Describes the aims of the partners in relation to this chapter.

Article 903 **Scope**

Describes the field of activities covered by this chapter.

Article 904 **National treatment**

Describes how national treatment for trade in services is to be understood.

Article 905 **Most-favoured-nation treatment**

Often prescribes that in cases where national treatment is not possible, most-favoured-nation treatment will be given.

Article 906 **Market access for financial institutions**

Describes the conditions under which financial institutions of the other party have access to one's markets.

Article 907 **Cross-border trade**

Describes the conditions applicable to the supply of financial services without a local presence.

Article 908 **New financial services**

Describes how market access for new financial services is to be dealt with under the agreement.

Article 909 **Treatment of certain information**

Specifies that information relating to customers or their legitimate commercial interest has to be safeguarded.

Article 910 **Cooperation and consultation**
Establishes the broad outlines of cooperation and requires a party to respond to requests for consultations from the other party concerning matters falling within this chapter.

Article 911 **Committee on Financial Services**
Establishes a committee to oversee activities falling within this chapter.

Chapter 10: Telecommunications

Article 1001 **Definitions**
Defines the concepts and terms used in this chapter.

Article 1002 **Objectives**
Describes the aims of the partners in relation to this chapter.

Article 1003 **Scope**
Describes the field of activities covered by this chapter.

Article 1004 **Access to and use of public telecommunications networks and services**
Describes the conditions under which a party has access to networks and services of the other party.

Article 1005 **Obligations relating to interconnection with suppliers of public telecommunications services**
Usually requires a party to provide interconnection with suppliers of public telecommunications services of the other party.

Article 1006 **Number portability**
Usually requires the parties to provide that end-uses of public telecommunications services may retain their existing numbers if they change to another supplier in the same location.

Article 1007 **Additional obligations relating to conduct of major suppliers of public telecommunications services**
Seeks to ensure that major providers do not abuse their market power.

Article 1008 **Universal service**
Requires the parties to administer universal service obligations in a non-discriminatory and competitively neutral manner.

Article 1009 **Independent telecommunications regulatory bodies**
Requires the parties to separate regulatory bodies from services suppliers.

Article 1010 **Licensing procedures**
Describes the procedures to be followed in a licensing application.

Article 1011 **Allocation and use of scarce resources**
Describes how the parties are to proceed in the case of scarce frequencies, numbers, etc.

Article 1012 **Conditions for the supply of value-added services**
Describes the extent of the conditions a party may impose on suppliers of value-added services.

Article 1013 **Flexibility in the choice of technology**
Usually permits suppliers to use their preferred technologies.

Article 1014 **Procedures for resolving domestic telecommunications disputes**
Describes the procedures to be followed in the case of a dispute over a domestic regulation.

Article 1015 **Enforcement**
Requires each party to ensure that its obligations are enforced.

CHAPTER 11: INVESTMENT

Article 1101 **Definitions**
Defines the concepts and terms used in this chapter.

Article 1102 **Objectives**
Describes the aims of the partners in relation to this chapter.

Article 1103 **Scope**
Describes the field of activities covered by this chapter.

Article 1104 **National treatment**
Defines the situations when national treatment is accorded to suppliers of the other parties.

Article 1105 **Most-favoured-nation treatment**
Often prescribes that in cases where national treatment is not possible, most-favoured-nation treatment will be given.

Article 1106 **Minimum standard of treatment**
Stipulates that the parties accord each other at least the minimum standard of treatment required under international law.

Article 1107 **Schedules of commitments**
Specifies how the schedules of commitments attached to the agreement are to be interpreted, and it prescribes whether commitments are to be listed in positive or negative form.

Article1108 **Investment promotion**
Describes any investment promotion activities that the parties agree to conduct under the agreement.

Article 1109 **Performance requirements**
Usually stipulates that performance requirements are not legal under the agreement.

Article 1110 **Senior management and boards of directors**
Outlines the obligations of a party concerning the filling of senior management positions to investments of the other party.

Article 1111 **Payments and transfers**
Describes the obligations concerning international transfers of capital, profits, interests, etc., relating to investment activities.

Article 1112 **Subrogation**
Describes the obligations arising if a party makes a payment to any of its investors under a guarantee.

Article 1113 **Expropriation and compensation**
Describes the conditions under which expropriation may occur, and the procedures to be followed to compensate for losses.

Article 1114 **Other measures having the effect of expropriation**
Usually prohibits the parties from imposing measures that would lead to expropriation by stealth.

Article 1115 **Investor-state dispute settlement**
Describes the conditions under which an investor may launch dispute settlement proceedings against a party to the agreement.

Article 1116 **Sub-national application**
Specifies the extent to which the laws, regulations, etc., of states, provinces and/or local government authorities are covered by the agreement.

Article 1117 **Denial of benefits**
Describes the conditions under which a party may deny the preferential treatment to investors of the other party.

Article 1118 **Review mechanism**
Many agreements establish a body composed of representatives of the parties to deal with any difficulties that may arise in the administration of the investment chapter.

Chapter 12: Movement of Natural Persons

Article 1201 **Definitions**
Defines terms and concepts relating to the movement of natural persons.

Article 1202 **Objectives**
Sets out the objectives of the parties concerning this chapter.

Article 1203 **Scope**
Describes the field of activities covered by this chapter.

Article 1204 **Short-term temporary entry**
Describes the obligations relating to short-term entry of business persons.

Article 1205 **Long-term temporary entry**
Describes the obligations relating to long-term entry of business persons.

Article 1206 **Review mechanism**
Describes how a review can be sought for decisions concerning the movement of natural persons and the review process to be followed.

Chapter 13: Electronic Commerce

Article 1301 **Definitions**
Defines terms and concepts relating to this chapter.

Article 1302 **Objectives**
Describes the objectives of the parties concerning this chapter.

Article 1303 **Scope**
Describes the fields of activities covered by this chapter.

Article 1304 **Customs duties on electronic transmissions**
Describes the obligations of the parties concerning customs duties on products ordered and delivered electronically.

Article 1305 **Non-discrimination for digital products**
Requires the parties not to discriminate between like digital products.

Article 1306 **On-line consumer protection**
Describes the measures to be taken to protect consumers adequately.

Article 1307 **On-line data protection**
Describes the measures to be taken to ensure that information transmitted electronically is protected adequately.

Article 1308 **Paperless trading**
Usually commits the parties to explore available opportunities for the expansion of paperless trading.

Article 1308 **Cooperation**
Sets out a mechanism for cooperation between the parties

Chapter 14: Intellectual Property

Article 1401 **Definitions**
Defines terms and concepts relating to this chapter.

Article 1402 **Objectives**

Describes the objectives of the parties concerning this chapter.

Article 1403 **Scope**

Describes the fields of activities covered by this chapter.

Article 1404 **Patents**

Describes the obligations of the parties relating to patents.

Article 1405 **Copyright**

Describes the obligations of the parties relating to copyright.

Article 1406 **Related rights**

Describes the obligations of the parties in relation to the rights of performers and producers of phonograms.

Article 1407 **Trademarks**

Describes the obligations applicable to trademarks.

Article 1408 **Geographical indications**

Describes the obligations of the parties concerning identification and enforcement of geographical indications.

Article 1409 **Domain names on the Internet**

Describes the obligations of the parties if there is a dispute over a domain name.

Article 1410 **Protection of encrypted program-carrying satellite signals**

Contains the disciplines for protecting these signals.

Article 1411 **Cooperation on enforcement**

Describes the obligations of the parties to enforce intellectual property rights.

Article 1412 **Multilateral conventions on intellectual property**

Usually requires the parties to ratify, by a certain date or as soon as possible, multilateral conventions specified in the article.

CHAPTER 15: COMPETITION POLICY

Article 1501 **Anti-competitive business conduct**

Usually requires the parties to adopt and enforce laws and regulations forbidding ant-competitive conduct.

Article 1502 **Designated monopolies**

Describes how the parties may designate entities as monopolies and requires the monopolies to behave in a certain way.

Article 1503 **State enterprises**

Gives rules of conduct for the behaviour of state enterprises.

Article 1504 **Information requests**

Usually requires a party to respond promptly to requests for information by the other party.

Article 1505 **Cooperation**

Sometimes establishes a program of cooperation between the parties.

Article 1506 **Consultation**

Usually requires a party to respond sympathetically to requests for consultations by the other party on any aspect of this chapter.

CHAPTER 16: TRANSPARENT ADMINISTRATION OF LAWS AND REGULATIONS

Article 1601 **Publication**

Usually requires the parties to publish promptly all laws, regulations, etc., relating to the matters covered by the agreement.

Article 1602 **Contact points**

Usually requires each party to establish a contact point for all matters covering by the agreement.

Article 1603 **Notification and provision of information**

Usually requires each party to notify the other parties of any important changes in matters covered by the agreement and to respond promptly to requests concerning such matters.

Article 1604 **Administrative proceedings**

Sets out the main steps to be taken when a natural or judicial person of the other party is subject to administrative proceedings.

Article 1605 **Review and appeal**

Sets out the rights of natural and judicial persons relating to reviews and appeals of administrative decisions.

CHAPTER 17: GOVERNMENT PROCUREMENT

Article 1701 **Definitions**

Defines terms and concepts relating to this chapter.

Article 1702 **Objectives**

Describes the objectives of this chapter.

Article 1703 **Scope**

Describes the fields of activities covered by this chapter.

Article 1704 **Publication of procurement measures**

Requires the parties to publish their procurement measures of general application and changes to them.

Article 1705 **Publication of notice of intended procurement**

Requires the parties to publish requests for tenders and purchases.

Article 1706 **Time limits for the tendering process**

Requires the parties to allow enough time for the submission of a tender to permit preparation of an adequate bid.

Article 1707 **Information on intended procurements**

Requires the parties to supply all necessary information to tenderers.

Article 1708 **Technical specifications**

Requires that technical specifications are not used as disguised restrictions on international trade.

Article 1709 **Tendering procedures**

Sets out the procedures the parties must follow when they advertise a tender.

Article 1710 **National treatment and non-discrimination**

Usually requires the parties to apply the national-treatment and most-favoured-nation principles to suppliers from the other party.

Article 1711 **Treatment of offsets**

Sets out the obligations of the parties regarding offsets.

Article 1712 **Procurement procedures**

Sets out the procedures the parties must follow when they make a purchase.

Article 1713 **Awarding of contracts**

Requires that normally a contract may only be awarded to a person that has submitted a valid tender.

Article 1714 **Information on awards**

Requires the parties to advise tenderers promptly of decisions.

Article 1715 **Bid challenge**

Sets out the rights of bidders and the obligations of the parties in cases where a bidder decides to challenge a decision on a tender.

Article 1716 **Modifications and rectifications**

Sets out the procedures to be followed by the parties when they wish to change the scope of activities under this chapter.

Article 1717 **Provision of information**
Describes the extent to which the parties are required to provide information on their purchasing practices and decisions.

Article 1718 **Technical cooperation**
Outlines the scope of technical cooperation activities that may be conducted in support of the aims of this chapter.

Article 1719 **Committee on Government Procurement**
Establishes a body for the discussion of any issues that may arise under this chapter.

CHAPTER 18: GENERAL EXCEPTIONS

Article 1801 **General exceptions**
Usually incorporates all or part of GATT Article XX and GATS Article XIV.

Article 1802 **Security exceptions**
Usually incorporates all or part of GATT Article XXI and GATS Article XIVbis.

Article 1803 **Disclosure of information**
Usually exempts the parties from having to publish information deemed confidential.

Article 1804 **Restrictions to safeguard the balance of payments**
Exempts the parties from certain obligations if specified criteria are met.

Article 1805 **Prudential measures**
Usually states that the parties may take prudential measures as they see necessary.

Article 1806 **Taxation measures**
Usually states that the agreement does not apply to taxation measures.

CHAPTER 19: INSTITUTIONAL PROVISIONS

Article 1901 **Establishment of a commission to administer the agreement**
This article usually creates a body named Free Trade Commission, Joint Trade Commission, Supervisory Commission, etc., which meets at regular intervals to oversee the working of the agreement.

Article 1902 **Establishment of a secretariat**
Describes the functions and staffing of a secretariat to administer the agreement.

Article 1903 **General reviews**
Mandates periodic general reviews of the operation of the agreement.

CHAPTER 20: CONSULTATIONS AND DISPUTE SETTLEMENT

Article 2001 **Scope**
Describes the extent to which the activities under the agreement are subject to the provisions contained in this chapter.

Article 2002 **Consultations**
Usually requires the parties to enter into consultations if a party requests this.

Article 2003 **Good offices, conciliation and mediation**
Invites the parties to use informal methods of dispute resolution.

Article 2004 **Dispute settlement**
Specifies when and how the parties may open dispute settlement

proceedings.

Article 2005 **Choice of forum**

Usually leaves it to the complainant to choose the forum for settling a dispute. It also usually states that once a choice has been made, the same dispute cannot be opened in another forum until the proceedings in the first forum have been completed.

Article 2006 **Request to establish an arbitral tribunal**

Describes how a party must proceed when it wishes to establish an arbitral tribunal.

Article 2007 **Establishment of an arbitral tribunal**

Explains how an arbitral tribunal is composed.

Article 2008 **Functions of arbitral tribunals**

Describes how the arbitral tribunal operates.

Article 2009 **Proceedings of arbitral tribunals**

Describes the form of proceedings to be followed by arbitral tribunals.

Article 2010 **Suspension or termination of proceedings**

Describes the conditions under which the parties may agree to suspend proceedings or to terminate them.

Article 2011 **Awards of arbitral tribunals**

Describes the nature of decisions that can be made by the tribunal.

Article 2012 **Implementation**

Describes the obligations of the parties once the tribunal has delivered its decision.

Article 2013 **Compensation and suspension of benefits**

Describes the conditions under which a party may be entitled to compensation and, as sometimes is the case, whether benefits under the agreement may suspended if compensation is not paid.

Article 2014 **Expenses**

Describes how the costs of arbitral and dispute settlement proceedings are to be met.

Chapter 21: Final Provisions

Article 2101 **Headings**

Defines the legal status of the headings in the agreement.

Article 2102 **Annexes and footnotes**

Defines the legal status of any annexes or footnotes to the agreement.

Article 2103 **Amendments**

Describes how the agreement may be amended.

Article 2104 **Application**

Defines to whom this agreement applies.

Article 2105 **Association with the agreement**

Permits other economies to apply for membership of the agreement.

Article 2106 **Financial provisions**

Outlines how any costs of cooperative activities, etc., conducted under the agreement are to be met.

Article 2107 **Relation to other agreements**

Usually states that the parties retain their rights under agreements of which they are a member.

Article 2108 **Entry into force, duration and termination**

States the conditions for entry into force, sometimes the duration of the agreement, and the notice to be given to the other parties in case of withdrawal.

Appendix 6: the vocabulary of rules of origin

Absorption principle: the principle that once materials have acquired the status of originating goods through specific processing requirements, they maintain this status when they are used as a component in a later transformation.

Accumulation: when a good is produced by two producers or more located in different parties to a free-trade area, the value added in both parties may be taken into account.

Adjusted value: in free-trade agreements concluded by the United States this refers to the value of the goods "as adjusted to exclude any costs, charges, or expenses incurred for transportation, insurance, and related services incident to the international shipment of the merchandise from the country of exportation to the country of importation". In other words, it is the FOB value.

Advance rulings: advice that may be obtained from the customs authorities before a good is exported on the view it will take concerning the classification of the good and/or whether it will qualify for preferential treatment.

Agreement on Customs Valuation: formally the WTO *Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994*. It contains the methods to be used by customs authorities when they value goods for the purpose of applying the tariff rate. The most important of these is the transaction value, i.e. the price actually paid or payable for the goods when sold for export to the country of import. If this method does not give a useful result, some other methods for valuing goods are available.

Agreement on Rules of Origin: a WTO instrument adopted in 1994 as part of the Uruguay Round outcomes. It established a work program on rules of origin.

Autonomous preferential rules of origin: rules applicable, for example, under GSP schemes, where the importing country has discretion to determine how the scheme should operate.

Averaging: a method of inventory management in which the average cost of goods bought over a given period is taken as the basis for valuation.

Bilateral cumulation: when the value added to a good by two economies can be combined to achieve the regional value content. This can occur, for example, in a free-trade agreement or under the GSP.

Build-down method: a formula in free-trade agreements (FTAs) concluded by the United States which is used for calculating the regional value content in a good. The formula is:

$$RVC = \frac{AV - VNM}{AV} \times 100$$

where RVC is the regional value content, expressed as a percentage
AV is the adjusted value; and
VNM is the value of non-originating materials that are acquired and used by the producer in the production of the good.

Build-up method: a formula in free-trade agreements (FTAs) concluded by the United States which is used for calculating the regional value content in a good. The formula is:

$$RVC = \frac{VOM}{AV} \times 100$$

where RVC is the regional value content, expressed as a percentage
AV is the adjusted value; and
VOM is the value of originating materials that are acquired or self-produced and used by the producer in the production of the good.

Certificate of origin: the document certifying that that the good about to be imported is the product of the free-trade area and that it satisfies the rules of origin.

Change in chapter heading: a method to determine whether substantial transformation has occurred. Strictly speaking, the change would have to occur from one two-digit chapter to another, but the term is often used to mean change in tariff classification.

Change in tariff classification: a method to determine whether substantial transformation has occurred. The change required is spelt out in a schedule attached to the agreement.

Change in tariff lines: a method similar to change in tariff classification to determine whether substantial transformation has occurred. The change required is spelt out in a schedule attached to the agreement.

Chapter: a two-digit entry in the Harmonised System.

CIF: cost, insurance and freight. The seller pays all costs relating to the good until its discharge at the port of destination. The buyer is responsible for the cost of unloading and the import duties.

Committee on Rules of Origin: a body established in the WTO to administer the Agreement on Rules of Origin.

Contractual non-reciprocal rules of origin: the rules used in agreements such as the ACP-EU Partnership Agreement where one side undertakes to accept goods from the other side without expecting similar treatment in return.

Contractual reciprocal rules of origin: rules applying equally to all parties to a free-trade agreement.

Country of origin: the country where a good was produced or where its last substantial transformation took place.

Cumulation: some rules of origin permit more than one country to contribute to the value added to a product.

Cumulation zone: describes the group of countries that may contribute to cumulation.

Customs Valuation Agreement: see Agreement on Customs Valuation.

De minimis: an amount so small that it is not taken into account when calculations are made.

Double transformation: when a good has to undergo two substantial transformations to qualify for preferential treatment.

Ex-factory cost method: a method for calculating the value added to a good by the exporter which includes the producer's expenditure on labour, overheads and materials made within the free-trade area. This amount is then compared with the cost that can be ascribed to producers outside the area.

Fabric-forward rule: a rule in the free-trade agreements (FTAs) concluded by the United States which says that textiles must be made of fabrics produced in one of the FTA partners if they are to enjoy the preferential tariff.

First-in, first-out: a method of inventory management which uses the cost of the oldest good in stock as the basis for valuation.

FOB: free on board. The seller pays all costs relating to the goods until it has been loaded aboard ship at the port of shipment. This includes export duties and other taxes and costs payable.

FOB method: a formula for calculating the regional value content where the valuation of non-originating materials is based on the FOB import price of these materials. In the Japan-Singapore free-trade agreement it is expressed in this way:

$$QVC = \frac{FOB - NQM}{FOB} \times 100$$

where QVC is the qualifying value content of a good, expressed as a percentage
FOB is the free-on-board value of a good payable by the buyer to the seller, regardless of the mode of shipment, not including any internal excise taxes reduced, exempted, or repaid when the good is exported; and
NQM is the non-qualifying value of materials used by the producer in the production of the good.

Full cumulation: when any processing of a good within a free-trade area is counted towards the qualifying content, regardless of whether a process is in itself enough to give the good originating status.

GAAP: see generally accepted accounting principles.

Generally accepted accounting principles: GAAP. These are accounting standards which enjoy consensus or substantial support within a country in respect to the recording of revenues, expenses, costs, assets, liabilities, disclosure of information and preparation of financial statements.

Harmonised System: the Harmonized Commodity Description and Coding System maintained and developed by the World Customs Organization (WCO).

Heading: usually a four-digit entry in the Harmonised System.

Insufficient working or processing operations: operations that do not change the nature of a good substantially, such as cleaning, diluting with water, changes in packaging or air-conditioned storage.

Item: sometimes used for a tariff line consisting of seven or more digits.

Last-in, first-out: a method of inventory management which uses the cost of the newest good in stock as the basis for valuation.

Last substantial transformation: refers to the requirement that the last substantial stage in the manufacturing or processing of a good must occur in the country of export.

Mark of origin: an indication affixed to a good which shows where it was made.

MFN tariff: normally the tariff applied to goods from countries that do not enjoy any kind of preferential market access.

Net-cost value method: a formula for calculating whether a good qualifies for preferential treatment. The formula is:

$$RVC = \frac{NC - VNM}{NC} \times 100$$

where RVC is the regional value content of a good, expressed as a percentage;
VNM is the value of non-originating materials used by the producer in the production of the goods; and
NC is the total cost occurred in respect of all goods produced by a producer, minus any costs related to sales promotion, marketing, after-sales service, packaging, shipping, etc.

Non-originating materials: materials used in the production of a good that do not satisfy the requirements of the rules of origin.

Non-preferential rules of origin: rules of origin that apply to goods traded under most-favoured-nation (MFN) conditions.

Non-qualifying value: used, for example, in the Japan-Singapore free-trade agreement to mean the part of the value of a good that does not meet the requirements for preferential treatment.

Originating goods: goods that satisfy the requirements for preferential treatment.

Pass-through operations: shipping goods into a free-trade area through the member country that has the lowest tariff and then forwarding it to its real market within that free-trade area. Virtually the same as transshipment.

Percentage criterion: the requirement that a certain proportion of a good is produced in the economy enjoying preferential treatment. This is usually expressed through setting a minimum percentage.

Preferential market access: the same as preferential treatment.

Preferential rules of origin: rules of origin under preferential trade arrangements, such a free-trade agreements and the Generalised System of Preferences (GSP).

Preferential tariff: a tariff rate lower than the MFN tariff.

Preferential treatment: a rate of duty that is lower than the MFN, usually zero in free-trade agreements.

Product-specific rules: rules of origin that apply to some products only, such as agricultural or textiles.

Qualifying value content: used in the Japan-Singapore free-trade agreement to describe the regional value content.

QVC: see ***qualifying value content***.

Regional value content: used in many free-trade agreements to describe the value added to a good by the exporting country.

"Roll-up" principle: the same as the absorption principle.

Rules of origin: in the case of non-preferential rules of origin they are defined in the *Agreement on Rules of Origin* as the "laws, regulations and administrative determinations of general application applied by any Member to determine the country of origin of goods. In the case of preferential rules of origin, their main purpose is to enable customs authorities to decide whether a good is allowed to enter under tariff preferences.

RVC: see ***regional value content***.

Sectoral rules of origin: rules of origin that apply to one sector only. Common examples are textiles, automotive products and chemicals.

Self-certification: a statement by the producer, exporter or importer of a good that the good satisfies the rules of origin under a free-trade agreement, and that it is eligible for preferential treatment.

Spaghetti-bowl effect: the possibility that membership of several free-trade agreements by a single country will mean that its exporters will have to observe several system of rules of origin. This could cause increased transaction costs. (After Bhagwati).

Split sub-heading: a six-digit tariff line in the Harmonised System divided further, for example, into two eight-digit lines.

Sub-heading: usually a six-digit entry in the Harmonised System.

Substantial transformation: the working of a product into new one that is significantly different. For example, a steel rod may be transformed into fencing wire.

Sufficient processing: virtually the same as substantial transformation.

Sufficient transformation: virtually the same as substantial transformation.

Takeover principle: the same as the absorption principle.

Technical test method: the requirement that a good must be produced in a certain way to become eligible for preferential treatment.

Tolerance rules: describe the extent to which the importing country can exercise discretion concerning the value added to a good.

Transaction value: defined in the WTO Agreement on Customs Valuation as "the price actually paid or payable for the goods when sold for export to the country of import".

Transaction value method: a method used in the Canada-Chile free-trade agreement to determine whether a good qualifies for preferential treatment. The method is:

$$RVC = \frac{TV - VNM}{TV} \times 100$$

where RVC is the regional value content of a good, expressed as a percentage;
TV is the transaction value of the good adjusted to a free-on-board basis; and
VNM is the value of the non-originating materials used by the producer in the production of the good.

Transshipment: either (a) transporting goods manufactured in a third country to one of the partners to a free-trade agreement with the aim of benefiting from that country's preferential trade arrangements, or (b) exporting a good from an FTA partner to another partner via third country. Some call this practice "pass-through operations".

Triple transformation: when a good has to undergo three substantial transformations to qualify for preferential market access.

Value-added method: measuring whether a good qualifies for preferential treatment by the amount of value that has been added to it in the exporting country.

Verification: checking whether the information given in the certificate of Origin conforms to the facts.

Wholly obtained materials: materials and goods that originate in their entirety in the territory of the exporting party. These are usually minerals, agricultural and fisheries products.

Yarn-forward rule: a rule in the free-trade agreements (FTAs) concluded by the United States which says that textiles must be made of yarn produced in one of the FTA partners if they are to enjoy the preferential tariff.

Appendix 7: Web-based resources

Many Internet sites contain useful and practical information on free-trade agreements. The following is a selection of them. Most of them have links to related sites.

www.apecsec.org
[Contains links to many free-trade agreements concluded by APEC economies and websites maintained by them.]

www.aseansec.org
Contains texts and background information on AFTA, the ASEAN Framework Agreement on Services, the ASEAN Investment Area, the ASEAN Economic Community, and more.

www.europa.eu.int
Lists the texts of the treaties creating the European Union and those of its preferential trade agreements with other countries. This is a huge site containing information on every aspect of the European Union's work. Be patient when you first use it.

www.oecd.org
Contains a great deal of research done by the OECD Secretariat on the effect of free-trade agreements on the international economy.

www.sice.oas.org
This is the site of the Organisation of American States. It is especially good for the text of free-trade and other preferential trade agreements concluded or under negotiation by North and South American countries.

www.unctad.org
Contains useful analysis of the impact of free-trade agreements. This is also the place to go to for material on the various GSP (Generalised System of Preferences) schemes.

www.ustr.gov
A gateway to the preferential trade agreements concluded or under negotiation by the United States.

www.worldbank.org
Contains a great deal material on trade policy, including preferential trade arrangements.

www.wto.org
Contains the all of the WTO rules and disciplines covering free-trade agreements, documents and reports of the Committee on Regional Trade Agreements (CRTA) and many other documents concerned with various

aspects trade rules relevant to preferential trade. This is a big site, and it is worth learning to use it.

Bibliography

Aust, Anthony, 2000, *Modern Treaty Law and Practice*, Cambridge University Press, Cambridge

Department of Foreign Affairs and Trade, Economic Analytical Unit, 2004, *Combating Terrorism in the Transport Sector: Economic Costs and Benefits*, Canberra

Department of Foreign Affairs and Trade, 2004a, *Australia – United States Free Trade Agreement: Guide to the Agreement*, DFAT, Canberra

Department of Foreign Affairs and Trade, 2004b, *A Business Guide to the Thailand–Australia Free Trade Agreement (TAFTA)*, DFAT, Canberra

Department of Foreign Affairs and Trade, 2004c, *The Singapore–Australia Free Trade Agreement (SAFTA): A Business Guide*, DFAT, Canberra

Estevadeordal, Antoni, and Kati Suominen, 2003, *Rules of Origin in the World Trade Trading System*, Paper Prepared for the Seminar on Regional Trade Arrangements & the WTO, 14 November 2003, World Trade Organization, Geneva

Gallagher, Peter, 2000, *Guide to the WTO and Developing Countries*, Kluwer Law International, The Hague, and World Trade Organization, Geneva

Lee, Yong-Shik, 2003, *Safeguard Measures in World Trade: The Legal Analysis*, Kluwer Law International, The Hague

Martin, Will, and L. Alan Winters, 1995, *The Uruguay Round and the Developing Countries*, World Bank Discussion Papers #307, World Bank, Washington, DC

OECD Secretariat, 2002, *The Size of Government Procurement Markets*, OECD, Paris

OECD Secretariat, 2003, *Quantitative Assessment of the Benefits of Trade Facilitation* (TD/TC/WP(2003)31/FINAL), OECD, Paris

Preeg, Ernest H., 1970, *Traders and Diplomats*, Brookings Institution, Washington, DC

United Nations Conference on Trade and Development, 2004, *Key Terms and Concepts in IIAs: A Glossary*, United Nations, New York and Geneva

United Nations Economic Commission for Europe, 2003, *Trade Facilitation: The Challenges for Growth and Development*, Carol Cosgrove-Sacks and Mario Apostolov, eds., United Nations, New York and Geneva

World Bank, 2004, *Global Economic Prospects 2005: Trade, Regionalism and Development*, World Bank, Washington DC

World Trade Organization,1999, *The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations*, Cambridge University Press, Cambridge