ADB

How to Design, Negotiate, and Implement a Free Trade Agreement in ASIA

Asian Development Bank

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Office of Regional Economic Integration

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Foreword

The continuing spread of free trade agreements (FTAs) in the developing world—particularly in Asia—has spurred intense debate. Viewed pragmatically, against the backdrop of slow progress in global trade talks, FTAs can promote continued trade liberalization, induce structural reforms in the economies concerned, and widen market access across a vibrant economic region, where the demand for greater intra-regional trade is rapidly increasing.

On the negative side, the proliferation of bilateral FTAs can create the so-called "noodle bowl" effect as multiple rules of origin arising from overlapping agreements cause harm particularly to small and medium enterprises with limited capacity to comply with them. The resulting market fragmentation would be more costly even for major multinational companies because of rising transaction costs and regulatory barriers. The flow of foreign direct investment and the associated transfer of technology and know-how to smaller economies would also decline.

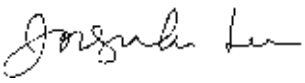
Nevertheless, FTAs are a growing reality. If we recognize that and hope to foster regional trade agreements as building blocks of global trade and investment integration, we cannot stand idly by and wait for a comprehensive global resolution. We strongly support the Doha negotiation process, while recognizing the need to consolidate and streamline regional and bilateral FTAs into an eventual Greater Asian FTA.

The recent proliferation of FTAs in Asia and the Pacific is placing mounting strain on the region's FTA negotiating capacity and on the knowledge and technical skills of government officials. The areas of interest now go beyond conventional trade in goods and services and extend to intellectual property rights, government procurement, and labor and environmental issues, among others.

The capacity constraints are especially acute in poorer countries, which also lack the institutions to train their officials.

This reference book is intended to be used mainly in present and planned FTA training courses of the Asian Development Bank, to increase the knowledge and capacity of officials who are active in designing, negotiating, and implementing FTAs. Building on theories of international trade economics and the good-practice FTA experiences accumulated by both front-runners and late beginners in this area, the book explains important facts and benchmarks to be considered when preparing, negotiating, and enforcing FTAs. Rather than going into the details of specific topics, this reference book covers the overall FTA process and its main features.

With this reference book, we expect to help shape common perspectives among government officials in Asia and the Pacific on what a desirable FTA should be, as we look forward to the eventual harmonization of FTAs in this region. This comprehensive version is the first step in that direction. We hope this reference book will serve the increasing demand for FTA knowledge in the region.



JONG-WHA LEE
Head
Office of Regional Economic Integration

Acknowledgments

The Office of Regional Economic Integration (OREI) of the Asian Development Bank (ADB) has conducted training courses in free trade agreements (FTAs) for mid-level government officials in Asia since October 2006. Starting with the second program in July 2007, we expanded participation to all ADB developing member countries to meet the growing demand for FTA training in the region. Around 100 government officials from all over Asia participated in the training.

From the outset, we felt a need for a reference book on FTA for the training course. Drafting a structured text material for the courses was the main objective of this project. But this book serves other purposes as well. Government officials who are or will be involved in FTA negotiations can get background knowledge and guidelines on practical issues from this reference book. The general public, including the academe and students who are interested in practical aspects of FTA, can also benefit from this. It avoids excessively academic or technical terms and is written in language that is accessible to everyone with basic, common-sense ideas about economics, international trade, and FTAs.

Negotiating free trade agreements: a guide, prepared by the Australian Department of Foreign Affairs and Trade, was the benchmark for this project. Nevertheless, we have tried to cover a wider scope of issues ranging from fundamental theories to actual components and practical issues related to FTAs.

Jong Woo Kang, Economist, OREI, organized this project and coordinated the overall production of the publication. Michael Plummer of Johns Hopkins University was overall editor of the project.

A group of international experts, ADB professional staff, and consultants contributed to this reference book. Michael Plummer of Johns Hopkins University and Ganeshan Wignaraja, Jong Woo Kang, and Rosechin Olfindo (staff consultant) of ADB wrote Part I: Economics of a Free Trade Agreement.

Several academics and experts contributed to Part II: Coverage of a Free Trade Agreement. Rachel MacCulloch of Brandeis University wrote on trade in goods and on environmental and labor standards; William James of ADB, on rules of origin; Aik Hoe Lim of Institute for International Trade, Adelaide University, on trade in services; Arthur Appleton of Appleton Luff Inc., on intellectual property, dispute settlement mechanisms, sanitary and phytosanitary standards, and technical barriers to trade; Siow Yue Chia of the Singapore Institute of International Affairs, on investment and FTA-plus issues, including government procurement and competition policy; and Dorothea Lazaro, ADB consultant on trade facilitation.

Finally, Part III: Negotiating, Implementing, and Evaluating Free Trade Agreements was written by Jong Woo Kang and Dorothea Lazaro of ADB.

Special thanks go to those who responded to our FTA questionnaire and to the resource persons and participants who gave valuable comments on Part III during the FTA training courses.

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Acronyms and Abbreviations

AD	antidumping duty
ADB	Asian Development Bank
AFTA	ASEAN Free Trade Agreement
AIA	ASEAN Investment Area
APEC	Asia Pacific Economic Cooperation
ARIC	Asia Regional Integration Center
ASEAN	Association of Southeast Asian Nations
BIT	bilateral investment treaty
BTA	bilateral trade agreement
CER	Closer Economic Relations (Australia–New Zealand free trade agreement)
COO	certificate of origin
CTH	change in tariff heading
CTSH	change in tariff subheading
DSU	Dispute Settlement Understanding
EC	European Community
EFTA	European Free Trade Agreement
EU	European Union
FDI	foreign direct investment
FOB	free on board
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GPA	Government Procurement Agreement
GSP	Generalized System of Preferences
HS	Harmonized System
IP	intellectual property
IPR	intellectual property rights
JCT	joint coordinating team
JMEPA	Japan-Malaysia Economic Partnership Agreement
JPEPA	Japan-Philippines Economic Partnership Agreement
JSEPA	Japan-Singapore Economic Partnership Agreement
JSG	joint study group
LDC	least-developed country
MAI	multilateral agreement on investment
MEA	multilateral environmental agreement

MFN	most-favored nation
MNC	multinational corporation
MRA	mutual recognition agreement
NAFTA	North American Free Trade Agreement
NGO	nongovernment organization
NTB	nontariff barrier
OECD	Organisation for Economic Co-operation and Development
PRC	People's Republic of China
ROOs	rules of origin
RTA	regional trade agreement
SAFTA	Singapore-Australia Free Trade Agreement
SEOM	Senior Economic Officials Meeting
SOE	state-owned enterprise
SP	specified process
SPS	sanitary and phytosanitary standard
TBT	technical barriers to trade
TPRG	Trade Policy Review Group
TPSC	Trade Policy Staff Committee
TRIMS	(Agreement on) Trade-Related Investment Measures
TRIPS	(Agreement on) Trade-Related Aspects of Intellectual Property Rights
USTR	United States Trade Representative
WCO	World Customs Organization
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

Part I: Economics of a Free Trade Agreement

TRADE TRENDS: REGIONALIZATION VERSUS REGIONALISM

Regionalism, which we will define generally here to include any formal preferential trading arrangement between two or more countries, came late to Asia.[1] Before the turn of the 21st century, there were few regional trading agreements in existence. While successful Asian economies by and large exploited the international marketplace effectively, they did so in the context of the General Agreement on Tariffs and Trade (GATT)/World Trade Organization (WTO) framework (see Box 1.1 for an overview of the evolution of the multilateral system). However, regionalization, which we will define as a market-led process of increasing economic interaction, has been building up momentum in Asia for decades, spurred by unilateral liberalization, market-oriented reforms, and successful economic growth in Asia consistently above the global average (with the exception of the Asian Crisis years, 1997–1998). Hence, formal preferential trading arrangements in the region, particularly in the form of free trade areas (FTAs), are being developed as a means of enhancing regionalism ("the flag following trade") rather than the other way around, as was true of such agreements as colonial preferences or even the early years of European economic integration. In most of Asia, regionalism is being used as part of the overall process of economic reform, to buttress the outward-oriented development strategies of the region's economies.

[1] Unless specified otherwise, "Asia" throughout the reference book is taken to include the Asian Development Bank's (ADB) 47 regional member countries (see list in http://aric.adb.org/technotes.htm#countrygroupings).

Box 1.1: A Brief History of Multilateral Governance under the World Trade Organization—From the GATT Rounds to Doha

The General Agreement on Tariffs and Trade (GATT) was signed in 1944, with the immediate objective of preventing future trade wars and the inconsistent commercial policies that had plagued international trade in the 1930s. It was originally intended to be a temporary body; the International Trade Organization (ITO) was supposed to replace it as a permanent body with international legal status, on a par with the other "Bretton Woods Institutions"—the International Monetary Fund and the World Bank. The ITO was never ratified; however, the GATT came into effect on 1 January 1948 as an ad hoc organization that would take a permanent, legal form only in 1994, with the creation of the World Trade Organization (WTO).

The GATT was designed to reduce international barriers to trade on a nondiscriminatory, or "most-favored nation" (MFN), basis. This would be achieved through concerted, multilateral negotiations called "rounds." Since the creation of the GATT, there have been eight rounds, i.e.: Geneva, 1947–1948; Annecy, France, 1949; Torquay, England, 1950–1951; Geneva, 1956; the Dillon Round, 1960–1962; the Kennedy Round, 1963–1967; the Tokyo Round, 1973–1979; and the Uruguay Round, 1986–1993. The current WTO negotiations have been dubbed the Doha Development Agenda, to underscore the importance of developing countries in this series of talks. Earlier GATT rounds were successful in reducing tariffs on manufactured goods. The Uruguay Round began to address more complicated issues, from quantitative restrictions in sensitive areas like agriculture and textiles and clothing to trade-related areas such as investment measures and intellectual property protection. The Doha Development Agenda was initiated to go further down the road of "deep" integration. The process has been difficult, given the political sensitivity of many of the key areas being addressed. In fact, the 2003 Ministerial Meeting in Cancun, Mexico ended without any agreement.

The Hong Kong Ministerial Meeting in December 2005 was successful in keeping the Doha negotiations alive. The WTO members agreed to undertake liberalization negotiations generally under four pillars: Non-Agricultural Market Access (NAMA), Agriculture, Services, and Rules (including those pertaining to administrative actions, e.g., antidumping and countervailing duties, and regional trading agreements). The primacy of the "development dimension" of the talks was reemphasized. The leaders at the meeting set April 2006 as the deadline for the Doha package. However, no agreement has yet been forthcoming.

Source: Updated from ADB (2006).

As we will see throughout this reference book, regionalism has both positive and negative elements. After all, FTAs all have discriminatory features and, therefore, are "second best." There are in fact no guarantees that a "free trade area" will be a movement in the direction of free trade, its name notwithstanding. It depends very much on the agreement. We will argue in this book that the current FTA movement in Asia is outward-oriented, and that the intentions of economies engaged in these agreements are pro-market and consistent with multilateral rules. However, to be certain that regionalism will support efficient regionalization and competitiveness, policy makers must understand the complicated nature of these agreements and learn to embrace the positive elements while minimizing the potentially negative ones. Part I was written with this in mind.

RISE OF FREE TRADE AGREEMENTS IN ASIA AND THE PACIFIC

The rapid spread of regionalism has become one of the most important recent developments in the global trade system. The proliferation of bilateral and plurilateral FTAs is fundamentally altering the world trade landscape. Trade between FTA partners now makes up nearly 40% of global trade, and new agreements increasingly address issues beyond trade.[2] Asia is a latecomer in the move toward FTAs compared with Europe, the Americas, and Africa, but has seen an unprecedented increase in total FTA activity since the 1990s. By Asian Development Bank (ADB) estimates, at least one Asian country[3] is

[2] World Bank (2005). However, the amount of trade that is actually preferential is smaller because of the costs of compliance with free trade agreements (FTAs), particularly those associated with the rules-of-origin requirement.

[3] Asia in the ADB FTA database refers to Asia and the Pacific.

involved in 204 FTAs in various stages of implementation: 95 concluded, 60 under official negotiation, and 49 being proposed (see Box 1.2 for information on ADB's FTA Database, which gives up-to-date information and analysis regarding emerging and existing FTAs). This is a dramatic increase from the fewer than 10 FTAs involving Asian countries in the early 1990s (see Figure 1.1).

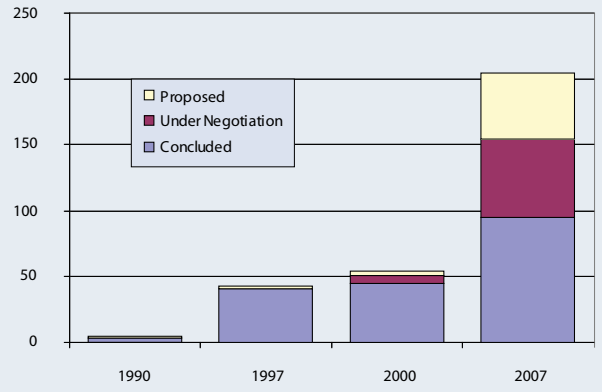
The rise in the number of FTA initiatives in Asia is driven by a number of factors including: (i) a defensive response to the proliferation of trading blocs and FTAs in other major regions; (ii) uncertainty over progress in global trade talks under the WTO framework; (iii) the need to improve productivity in the face of the heightened competitive pressure from the economic emergence of the People's Republic of China (PRC) and India, in particular with respect to economies of scale through market integration; (iv) the perceived need for deeper integration with trading partners, due in part to the demonstration effect of successful regional integration accords elsewhere; and (v) the promotion of "beyond the border" structural reforms as part of a competitiveness strategy (e.g., investment liberalization, promotion of domestic competition, harmonization of standards, and upgrading of technology development). The recent increase in FTAs has also been driven by the richest and largest economies in the region such as the PRC, Japan, Republic of Korea, Singapore, and, Thailand, suggesting a link between FTA growth and economic prosperity, although the exact causation still needs to be explored further.

Box 1.2: **ADB's Free Trade Agreement Database**

Launched in October 2006 by ADB and managed by its Office of Regional Economic Integration, the Free Trade Agreement (FTA) Database in the Asia Regional Information Center (ARIC) website (www.aric.adb.org) tracks FTAs of 47 regional members of ADB and provides three types of information: (i) FTA trends (statistical tables on the status and various categories of FTAs in Asia and the Pacific); (ii) available resources on each FTA (i.e., legal documents, official summary, studies and researches, news, opinions and editorials, FTA membership, and an external link to the UNESCAP database); and (iii) a comparative FTA toolkit—an innovative feature of the FTA database—which allows side-by-side comparison of around 80 chapters/provisions of more than 40 concluded FTAs. The list of FTAs on the ARIC website is based on official sources (joint statements, declarations, press releases, and government websites). The information about them is also from official sources, research sites, and online news items.

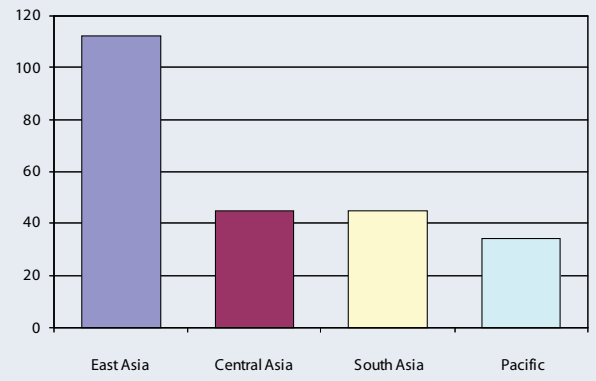
Source: ADB.

Figure 1.1: **Number of Free Trade Agreements Involving Asia and the Pacific Countries, 1990–2007**



Source: ADB FTA Database. Available: www.aric.adb.org

Figure 1.2: **Number of Free Trade Agreements Involving Asia and the Pacific Subregions, 2007**



Source: ADB FTA Database. Available: www.aric.adb.org

Among the Asian subregions, East Asia[4] is the most active in forming FTAs: at least one East Asian economy is involved in any of 112 FTAs, almost twice the number of FTAs involving Central or South Asian countries (see Figure 1.2).[5] The Pacific is the least involved in FTA formation among the four Asian subregions. Given the rise in the market-based regionalization of East Asian economies over the past 20 years, that is, the increase in the regional shares of trade and investment due to market-driven activity, the deepening of regional economic interdependence is the most fundamental rationale behind the recent economic regionalism in East Asia—an example of the "flag following trade." Since the Asian Crisis of 1997–1998, East Asian economies have embarked on various initiatives under the general rubric of economic regionalism in trade/investment and money/finance. The crisis prompted the subregion's economies to realize the importance of economic cooperation and to make efforts to institutionalize such interdependence.[6]

An important feature of the rise in the number of FTAs in Asia is the growing number of overlapping agreements and the so-called Asian "noodle bowl,"[7] that has emerged from the proliferation of bilateral and plurilateral FTAs in the region. Each FTA can be quite different in coverage, depth of liberalization, and the specific regulations that make the accord function (e.g., rules of origin). According to ADB estimates, Asian countries are involved in 156 bilateral and 48 plurilateral FTAs in various stages of implementation. Many of these agreements—especially the new ones, are with countries outside the region (see Table 1.1). The fact that many FTAs extend beyond the Asian region itself underscores the importance of external markets particularly for the export of final products. The formation of cross-regional agreements is driven by several factors including energy security, access to minerals and other natural resources, and efforts by countries to "lock in" reforms by making them part of a formal trade treaty with a major developed country or region.[8]

Table 1.1: **Types of Free Trade Agreements (FTAs) Involving Asia and the Pacific Countries, 2007**

Regional Coverage	Bilateral FTAs	Plurilateral FTAs	Total FTAs
Within Asia-Pacific	73	25	98
Outside Asia-Pacific	83	23	106
Total FTAs	156	48	204

Source: ADB FTA Database. Available: www.aric.adb.org

Around half of the established FTAs involving at least one Asian country have not been notified to the WTO. A large portion of the WTO-notified FTAs involve East Asian economies, indicating significant adherence in East Asia to WTO rules and procedures for FTAs. However, many of the provisions of recent agreements formed by East Asian economies extend beyond the WTO regulatory framework ("WTO-plus agreements") to include provisions related to a host of "deep" issues such as trade facilitation, investment, government procurement, competition, intellectual property, and environment and labor rules. Such provisions are often included in FTAs between developed and developing countries, no doubt reflecting the emphasis that developed economies give to these issues.

[4] Unless specified otherwise, "East Asia" in this reference book refers to the 10 Association of Southeast Asian Nations (ASEAN) countries plus the People's Republic of China (PRC); Hong Kong, China; the Republic of Korea; Mongolia; Taipei,China; and Japan.

[5] See Kawai and Wignaraja (2007).

[6] See Kawai (2005).

[7] The terms "noodle bowl" and "spaghetti bowl" are used interchangeably throughout this book.

[8] See ADB (2006).

Box 1.3: **GATT 1994, Article XXIV**

Free trade agreements (FTAs) represent a departure from the General Agreement on Tariffs and Trade (GATT)/ World Trade Organization (WTO) guiding principle of nondiscriminatory trade, i.e., most-fvored nation (MFN) treatment, among signatories. Article XXIV of GATT 1994 and the Uruguay Round "Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade" provide the rules governing free trade in goods. Article V of the General Agreement on Trade in Services (GATS) gives the corresponding rules for free trade in services.

Article XXIV recognizes the desirability of increasing trade through voluntary agreements between two or more members, but it also cautions countries that such an agreement should be to facilitate trade among the members and not raise barriers to trade with non-partner countries. This provision clearly restricts the common external tariffs imposed by the members of a customs union. However, the preferential margin created by a free trade area in effect raises barriers to trade with non-partner countries, resulting in trade diversion, i.e., the substitution of partner imports for lower-cost imports from non-partners. Some economists have suggested that countries forming free trade areas should be required to reduce MFN tariff rates to offset this tendency.

As defined in Article XXIV, a free trade area is a group of two or more countries ("customs territories") in which *duties and other regulations of commerce* are eliminated on *substantially all the trade* between them *in products originating* in the member countries. Article XXIV distinguishes between a free trade area, where trade barriers have been removed, and an agreement that will eventually lead to the formation of a free trade area. However, key concepts in this definition are left undefined. How much trade is "substantially all trade"? Should the amount of trade covered be measured in value terms or according to the percentage of product categories included? Other than tariffs, which "regulations of commerce," e.g., trade barriers, must also be eliminated? Exactly which goods are considered to have originated in the member countries? Here the agreement must spell out rules of origin for any good produced in the area but incorporating intermediates imported from non-members. Finally, how long a period is permissible between the signing of an agreement to form an FTA and the elimination of barriers on substantially all trade? Almost all FTAs are phased in over time, often allowing more than 10 years for some tariffs to be eliminated.

The 1994 "Understanding on the Interpretation of Article XXIV" was intended to reduce the ambiguity concerning the coverage and timing of free trade agreements. It begins by recognizing the importance of comprehensive coverage, i.e., the contribution to the expansion of world trade is "increased if the elimination of duties and other restrictive regulations of commerce extends to all trade, and diminished if any major sector of trade is excluded." Free trade areas that exempt significant areas, such as agricultural trade or a major manufacturing sector via highly restrictive rules of origin, appear to violate this coverage guideline. With respect to the time allowed for a new agreement to be phased in, the Understanding specifies that the "reasonable length of time" of Article XXIV "should exceed 10 years only in exceptional cases" and that "where… 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."

However, the Tokyo Round agreements, signed in 1979, contained more lenient rules on preferential trading accords between developing countries. These include the "Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries," known as the Enabling Clause. Under its terms, developing countries are subject to less scrutiny in complying with Article XXIV. Thus, developing countries can potentially agree to reduce but not eliminate tariffs and other trade barriers or be more selective in sectoral coverage. In practice, however, no FTAs among GATT or WTO members, whether developed or developing, have been challenged successfully by other members. This laissez-faire attitude could change in the future, given the increasing concern among WTO members about the effects of proliferating FTAs and their implications for progress in multilateral trade liberalization. The Doha Development Agenda includes negotiations aimed at "clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements." As an initial result of the effort, a "transparency mechanism" announced in 2006 provides for early announcement and notification to the WTO of any new FTA, with an eye to prompt review of its compliance with WTO rules. But whether prompt notification can affect the provisions of new FTAs remains to be determined. By mid-2006, when the transparency mechanism was announced, the process of assessing the consistency of FTAs with WTO rules had already created a growing backlog of cases awaiting evaluation.

Regardless of WTO scrutiny, countries planning to negotiate a free trade agreement should be aware of the potentially adverse economic and political effects, both on themselves and on their excluded trading partners, of arrangements that cover some but not all goods, specify an unduly long phase-in period, or divert trade from lower-cost sources.

Source: WTO website. Available: www.wto.org

This burgeoning number of agreements in the region has raised concern in the light of its potential to add greatly to the complexity of international trade and to the administrative costs of trade. The web of differing trade arrangements can tangle administrative procedures—e.g., customs procedures, technical standards, rules of origin—and thereby raise the cost for both enterprises and governments. To mitigate such adverse effects, some have called for the creation of a region-wide FTA with harmonized rules of origin among other business-friendly provisions. In this regard, the Association of Southeast Asian Nations (ASEAN) could form a natural hub for East Asia and for Asia in general.[9]

Given their complicated and inherently discriminatory nature, many of these subregional and regional initiatives would be more efficiently handled at the global level. After all, Article XXIV of the GATT/WTO was intended to be an exception to the MFN rule (see Box 1.3). But what happens when the exception becomes the rule? We address this and related issues in the rest of this section.

WHY ENTER INTO A FREE TRADE AGREEMENT?—POLITICAL AND ECONOMIC GOALS

As noted above, the major surge in FTAs is fundamentally changing the international commercial landscape, with Asian economies being an important part of this process. This trend did not develop by accident. In this section, we consider some of the general economic and political goals behind the formation of FTAs.

To begin with, we should stress that, while economics may be an important motivation in setting up an FTA, political circumstances generally dominate. In fact, while one can list a number of accords with a dubious economic rationale but strong political motivations, no major accord made good economic sense but was politically untenable. Hence, while this book emphasizes the economics of regional trading arrangements, the important political dimensions of each agreement should also be respected.

Gains from Trade

The "gains from trade" argument, first developed by the famous British economist David Riccardo, has been used to promote the need for trade liberalization over the past two centuries. In short, as a country specializes in the products that it produces most efficiently, compared with other countries, and then trades the goods in surplus, it is able to improve its standard of living. On the supply side, efficient structural adjustment takes place: the country uses its resources in the most productive way. On the demand side, firms are able to source the most cost-effective inputs and consumers are able to purchase imports at the lowest price. When all countries specialize in their "comparative advantage" products, the entire world is better off and global prosperity is maximized.

As Nobel Laureate Paul Samuelson has noted, the principle of comparative advantage might be the only proposition in the social sciences that is both true and nontrivial. It is also counterintuitive to many. For example, in the debates over the North American Free Trade Agreement (NAFTA) between Canada, Mexico, and the United States (US), opponents of the agreement in Mexico argued that there was no way Mexico could compete with a technological superpower like the US, and in the US those that opposed NAFTA insisted that the US could not compete with Mexicans, whose wages were only

[9] See Kuroda (2007).

a fraction of those at home. Riccardo demonstrated more than a century earlier that both were wrong. With free trade, the US and Mexico would produce the products in which they had inherent comparative advantage, and both would benefit. In a hospital, a medical doctor can perform all the roles of a nurse and much more specialized tasks. But there still is a role for the nurse, who can specialize in more routine, less specialized activities, leaving the doctor to specialize in more advanced tasks. In accepting this division of labor, each will prosper and the hospital will be more efficient.

This does not mean that the doctor and the nurse will be paid equally. The former will be more productive in the area requiring a high degree of expertise than the latter and, hence, will receive a higher salary. Likewise, countries with higher productivity will have a higher standard of living than lower-productivity countries. In addition, under a regime of free trade, countries do not decide what they will produce. Economics, rather than politics, dictates comparative advantage. But as the Hungarian economist Bela Balassa has noted, comparative advantage is man-made; policy matters. Japan, for instance, began after World War II as one of the world's most labor-abundant countries, and exported low-cost, labor-intensive products for decades. But its evolution over time, driven by forward-looking government policy, allowed it to shift its comparative advantage into high-tech, capital-intensive exports. Many other Asian countries are also moving up the development ladder.

Further, as economies evolve over time from low-skilled production, of agricultural and labor-intensive goods for example, into more sophisticated products, their comparative advantage tends to merge. Economic integration changes from inter-industry trade (say, oil for computer chips) to intra-industry trade (say, automobiles for automobiles). Recent trends in East Asia underscore this process. At first, trade was inter-industry—and, hence, there was not much of it. But particularly since the Asian Crisis, East Asian countries have been engaging much more in intra-industry trade, a process that is responsible in part for the rising intra-regional trade share and greater economic symmetry (Rana 2006). In fact, most of the world's trade takes place between developed countries (with the same economic characteristics) and is of the intra-industry variety.

This leads us to the distinction between "horizontal" and "vertical" specializations in production. Horizontal specialization relates to production according to comparative advantage in the traditional sense discussed above; vertical specialization focuses on the many parts and processes that make up the production of a final good, i.e., the "value chain." While efficient division of labor will always dictate specialization in what the country does best relative to other countries in the global trading system, multinational corporations (MNCs) have transformed radically how they organize productive processes and source inputs. For example, while in the 1950s and 1960s an MNC might have produced an entire automobile in the Philippines for sale in the local and international markets, today that same MNC would have operations in the Philippines that would be part of a global production process, in which the MNC would exploit the comparative advantages of each country in its network to produce the automobile most efficiently. This value chain would see labor-abundant countries producing labor-intensive components, capital-intensive countries producing capital-intensive components, high-skill-intensive countries producing high-skill-intensive components, and so on. The

production of automobiles and electronics is increasingly characterized by this sort of value-chain process in the modern economy. The rising importance—and, often, dominance—of electronics in the exports of most East Asian economies testifies to the importance of the vertical division of labor that is being created by these value chains, a process that in turn is driving economic integration and globalization more generally. It is still driven by comparative advantage; however, in addition to having comparative advantage in particular *products*, economies have comparative advantages in *processes and components* that are part of a vertical division of production.

Further, this process allows developing countries to tap more easily into global production chains. In the past, the production of an entire automobile in the Philippines would have required a demanding set of national economic prerequisites such as available inputs and skill sets that could have been discouraging to the MNC. Perhaps the Philippines would have been bypassed in favor of a more developed country with these attributes already in place. However, within the context of the vertical division of labor discussed above, the Philippines would only have to have comparative advantage in a subset of these skills to participate in the production chain. Hence, these value chains hold important advantages for less-developed countries, which can now tap into globalization far earlier than in the past.

In sum, the "gains from trade" argument, based on the principle of comparative advantage, explains the inherent logic of international free trade as the "first best" policy option, i.e., one that should lead to greater welfare for all countries. Comparative advantage is also a dynamic process, suggesting that, while trade increases efficiency and prosperity, government policy at the national level plays a key role in determining to what degree each will be successful.

But what is the difference between *free trade* and *FTAs*? Unlike multilateral liberalization under the GATT/WTO, FTAs tend to be controversial in economic and policy circles for a variety of reasons, most of which are linked to the fact that preferential trading arrangements, such as FTAs and customs unions, are by their very nature discriminatory. We explain the economics of FTAs in the rest of this section, and focus on political-economy-related issues in the next section.

Static effects

The "static effects" of FTAs generally refer to the effect on price changes induced by preferential tariff (and nontariff) liberalization. Free trade areas remove discrimination between partner countries and domestic firms, and, hence, home and country prices of tradable goods—that is, exports, imports, and import-competing products—tend to be equalized as barriers to trade are reduced. Relatively inefficient domestic production therefore contracts ("trade creation") in favor of production in partner countries. This is essentially the same efficiency-enhancing effect as in Riccardo's model. However, FTAs create a new form of discrimination, that is, between the exports of partner and non-partner countries. Partner-country exports will displace more efficient non-partner exports in the home market if the degree of preferential access is sufficient ("trade diversion"). Trade diversion implies a less efficient international division of labor, and, since the home country will lose tariff revenues and will pay a higher price for its imports, the importing country loses. Thus, the net (static) effects of an FTA will depend on the degree of trade

creation compared with trade diversion ("allocative efficiency"). Note that trade liberalization under the WTO should not involve any trade diversion, as MFN treatment implies nondiscrimination between sources of imports. This is why it is "first best" option. On the other hand, since FTAs discriminate in favor of partner countries, regionalism is the "second best" and, therefore, does not *guarantee* a more efficient division of labor in the grouping.

In comparing the economics of nondiscriminatory trade liberalization, such as that taking place under the auspices of the WTO on the basis of MFN treatment, on the one hand, and discriminatory trade liberalization in the context of an FTA, on the other, we should keep in mind the qualitative differences between accords. First of all, while trade diversion does exist in the context of an FTA, it is also true that FTAs tend to be more comprehensive in the coverage of goods (and services). In fact, Article XXIV of the GATT/WTO, which dictates minimal requirements for FTAs, insists on the coverage of substantially all goods. But no such requirement exists under the GATT/WTO. Countries include as many sectors as they deem fit through negotiations. This has led to a good deal of piecemeal liberalization under the GATT/WTO, leaving protection on some agricultural and labor-intensive products practically untouched after successive multilateral rounds. The exclusion of individual products can be problematic on efficiency grounds, particularly when it involves products that are used as inputs in the productive network. For example, duty-free inputs on steel will cause exaggerated protection of value added (the "effective rate of protection") in the automotive sector. The exclusion of tariffs on imported lumber will do the same in the furniture industry if the latter is excluded from liberalization. Free trade areas, on the other hand, are generally far more comprehensive in the treatment of sectors across the board. Thus, while FTAs lead to potential trade diversion because of discrimination between *countries*, the existing multilateral regime suffers from negative efficiency effects because of discrimination between *products*.

Second, regionalism holds another advantage over multilateralism in that it allows like-minded countries to address far more issues and in a shorter period of time. By choosing one or several partners with similar policy goals, countries are able to make more progress in deep integration than they could in the extremely diverse WTO context. The recent interest in regionalism on the part of OECD countries that have traditionally shunned it (the US, Japan, the Republic of Korea, Australia and New Zealand, and so on) derives from their desire to address these many issues and their understanding that they cannot resolve them in the context of the WTO, or at least not in the short or medium run. A successful conclusion to the Doha Development Agenda would, perhaps, give momentum to regionalism, but this is not certain. The incentives for entering into new bilateral and plurilateral accords, as well as for deepening existing ones, would remain.

Dynamic effects

Economists tend to focus on the static effects of economic integration. Price changes in FTAs drive the theoretical and empirical FTA literature mainly because they are easier to conceptualize and estimate than other effects of regionalism (see Box 1.4). However, the static effects of FTAs tend to be less important from the point of view of sheer economic impact and the implications of regionalism for economic development.

Box 1.4: **Computable General Equilibrium Models and Free Trade Agreements**

Computable general equilibrium (CGE) models are often used by the World Bank, the World Trade Organization (WTO), and ADB, among others, to estimate the welfare effects of free trade aggreements (FTAs) and other trading agreements. These models evolved from the earliest models of the economy that showed inter-industry links. While earlier models could capture only very simple general-equilibrium relationships, more recent models are able to incorporate market mechanisms and policy instruments that work through price incentives.

The earliest global trade model was the Michigan Model of World Production and Trade, which was designed to gauge the employment impact of the Tokyo Round. This model, with its set of equations extended to include the features of the New Trade Theory (imperfect competition, increasing returns to scale, and product differentiation), was also used in analyzing the effects of the US-Canada FTA. The extended Michigan Model was later applied to country groups selected from the original 34-country Michigan Model.

The MIRAGE model, another imperfect competition model, developed by the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII) in Paris, describes imperfect competition in an oligopolistic "Cournot" framework, which accounts for horizontal product differentiation linked to varieties and geographic origin. The modeling is done in a sequential dynamic setup, where the number of firms in each sector is progressively adjusted, and installed capital is assumed to be immobile even across sectors. Compared with other CGE models, MIRAGE explicitly describes foreign direct investment and trade barriers, on the basis of a unique database for tariff barriers (MacMap), and introduces vertical product differentiation.

The Global Trade Analysis Project (GTAP) model, constructed in 1992, is the applied general-equilibrium model in wide use. The standard GTAP model assumes perfect competition and constant returns to scale, while some extensions of the model assume imperfect competition. The dynamic model (GTAP-Dyn) extends the standard model to incorporate dynamic behavior. It includes all the special features of the standard model such as sophisticated consumer demands and inter-sectoral factor mobility, as well as new treatment of investment behavior and additional accounting relations to keep track of foreign ownership of capital. Backed by an international consortium of agencies and universities, GTAP created a consistent global data set for use in analyzing international economic policy issues and has become the basis for all global CGE models.

The LINKAGE model, developed by the World Bank, is a recursive dynamic applied general-equilibrium model with neoclassic features. It comes with an aggregation facility, which is used to aggregate the extensive GTAP database into a tractable data set for simulation. An extension of the LINKAGE model, the General Equilibrium Model for Asian Trade (GEMAT), is an applied general-equilibrium model of the global economy with a focus on Asia and is primarily used by ADB. It incorporates firm heterogeneity in production and fixed trading costs in modeling production and trade, thereby better capturing the extensive margin in international trade growth and trade-induced productivity enhancement.

The appendix to Part I gives a more explicit example of the theoretical foundations of a CGE and includes an actual application to various FTA scenarios. The exercise demonstrates how the results of these models should, and should not, be used by policy makers in negotiations.

Source: ADB (2006); World Bank (2004); Plummer and Wignaraja (2006)

After all, price changes induce one-time effects, and are called "static" for that reason. On the other hand, "dynamic effects" refer to the medium- and long-term implications of regional integration and, as such, tend to be more significant. Dynamic effects are also more pervasive, affecting almost all areas that relate to an economy's competitiveness. From articulated policy statements and the direction of FTA formation in Asia, we find that the economic policy goals of FTAs in the region focus on these dynamic effects, rather than mere price changes. Below, we consider some of the most important dynamic effects in the context of FTAs—economies of scale, technology transfer and foreign direct investment (FDI), and structural policy change and reform.

Economies of Scale. If a firm's average costs fall when its output expands, it will be able to sell at more competitive prices as its market grows. This type of production function would be characterized by "economies of scale," of which the degree depends on the product type. Economies of scale exist in the production of many agricultural, natural-resource-intensive, and manufacturing sectors, as well as services. This effect is intuitive to both business people and consumers, who are used to paying less for larger purchases.

The importance of economies of scale in the context of FTAs is also intuitive. By creating a larger market for firms operating in partner countries, an FTA will allow producers to take advantage of a larger customer base and, hence, produce at a lower average cost on all sales. Firms will even be able to lower prices for existing customers—the "cost-reduction effect" (Corden 1972). As a result, they will become more competitive not only at home but also in foreign markets.

It is clear that exploiting economies of scale is an important motivation for regional integration. Resource pooling and market sharing have been explicit goals of ASEAN essentially since its foundation. ASEAN has deepened economic integration considerably over time and is now creating an ASEAN Economic Community, in part to compete with the PRC and Indian markets, which otherwise would have an important competitive advantage in economic scale. Deep integration in the European Union (EU) has been pushed by the need to compete with the US for the same reasons.

Technology Transfer and Foreign Direct Investment. The link between FDI and technology transfer has been firmly established. It is one of the primary reasons why Asian countries seek to attract FDI inflows, through unilateral and concerted trade liberalization and other means. Bilateral and regional FTA formation attracts such long-term, risk-sharing investment flows by creating a more integrated marketplace within which MNCs can enjoy a regional division of labor with low transaction costs and exploit product-level economies of scale.

Greater FDI flows can have important salutary effects on the economy by bringing in long-term foreign capital and foreign exchange, providing ready-made international customers through the foreign firms' global networks, stimulating local competition, and putting pressure on government bodies to embrace "best practices" vis-à-vis investment measures and regulations. But perhaps the most important benefit from FDI, at least for developing Asia, is technology transfer.

The investment effect on trade creation and trade diversion is also worth noting. An MNC that believes an FTA between India and ASEAN will lead to greater economic dynamism in Asia will be compelled to invest more in India. Since the resulting investments would be consistent with India's dynamic comparative advantage, this is known as "investment creation," i.e., India (and the rest of the world) experiences a more efficient distribution of global investment. However, suppose that the MNC decides to invest in India not because of a perceived increase in dynamism in that country but because it will now have preferential access to the ASEAN market. In other words, although investing in, say, Bangladesh might have been more cost-effective, the MNC diverts investment to India because of this regional accord. The motivation would be the same as in "tariff hopping" FDI. This effect is known as "investment diversion." India may be pleased that it can draw in more FDI,

but Bangladesh will certainly suffer. Moreover, the investment in India could very well go into sectors in which India is not internationally competitive but merely competitive relative to ASEAN, producing negative efficiency effects even there.

While conceptually clear, investment creation and diversion is difficult to estimate. We observe a change in FDI flows empirically but are unable to trace directly the motivation for the investment—MNCs obviously do not announce their management strategies. However, we would expect investment creation to follow trade creation, and investment diversion to follow trade diversion. To demonstrate this, let us return to our India-ASEAN example and, further, let us focus on electronics. If tariffs on electronic products in ASEAN were equal to zero—they are indeed very low in the main ASEAN markets—there would be no incentive for investment diversion, as the MNC even with its newly gained preferential access would have no real benefit from investing in India; all countries would have tariff-free access. Hence, if it still speeded up its investments in India, we would attribute this to investment creation. On the other hand, if the electronics markets in ASEAN were highly protected, the potential for investment diversion would be great, as would be the potential for trade diversion.

Using an FTA to attract FDI from *third countries*, as well as partner countries, is often a key motivation for such an accord. This is certainly the case in ASEAN, whose free trade agreement (the AFTA) is thought of more as an investment agreement than as a trade agreement. In other words, the goal of AFTA is to reduce transaction costs to MNCs wishing to use ASEAN as an integrated production platform to exploit vertical division of labor. Note, however, that the goal of ASEAN (and other economies in Asia) is mainly to bring in third-country MNCs, that is, to attract greater FDI inflows from OECD countries. Developed countries are by far the most important global investors. In 1995–2005, intra-ASEAN FDI was only 14% of total FDI inflows, and almost half of that share was Singaporean investment in Thailand and Malaysia alone. Thus, it makes sense for FTAs to focus on non-partner countries as well as partner countries. Multinational corporations in developed countries also have the advantage of having the most sophisticated technologies, and their global reach can pave the way to ready-made export markets.

In fact, ASEAN has always placed emphasis, implicit or otherwise, on attracting non-partner FDI. The ASEAN Investment Area (AIA), which was founded in 1998 and will be an important pillar in building the ASEAN Economic Community, explicitly charts a path for the national treatment of partner- and non-partner country investors, albeit within different time frames—2010 for investors from partner countries and 2020 for those from non-partners.

Structural Policy Change and Reform in "New Age" Free Trade Agreements.

Modern FTAs, particularly those with OECD countries as partners, go well behind the traditional focus on tariffs to include other border and behind-the-border measures. These measures now receive far greater attention in negotiations and tend to be more important to the modernization and competitiveness of economic systems, in part because of the success of the GATT/WTO in bringing down tariffs and rendering them less significant. Examples of these behind-the-border areas are: complex measures specific to the service sectors; laws related to corporate and public governance; the national

treatment of partner-country investors; competition policy, including the reform of state-owned enterprises; and other "sensitive sectors" with important links to the rest of the economy. The inclusion of these nontraditional areas underscores how far FTAs have gone beyond mere commercial policy to include microeconomic policies that used to be considered the exclusive domain of national economic policy.

Policy harmonization issues are especially pertinent in this regard. Although the most significant effects of the Single Market program of the EU are held to be in many of the behind-the-border areas mentioned above, perhaps one of the most important areas of cooperation can be classified under the rubric of "harmonization issues," such as mutual recognition of product testing and professional certification, standards conformance, and customs and transit. Adopting universal harmonization standards would maximize gains in all of these areas. Doing so worldwide is, however, much more difficult, and that is why the GATT/WTO has made such little progress in these areas. On the other hand, like-minded countries in an FTA are able to address these nontraditional areas that improve the business environment by reducing costs, leveling the playing field for foreign investors, and pushing policy reforms toward best practices.

One final point pertains to the limits of harmonization. In many ways, "harmonization" implies creating a level playing field. However, the playing field must be in good shape, that is, the region should adopt not only compatible policies (harmonization) but also best practices. Otherwise, harmonization may only reduce diversity in a region while doing little to improve the business environment, which, after all, should be the overriding goal.

Competitiveness Incentives. As is the case with trade liberalization generally, greater exposure to international competition has important salutary effects on a partner country in an FTA. Increased exposure to competition from partner-country producers not only leads to trade creation, and, therefore, greater structural efficiency, but also increases the potential profits for competitive, or potentially competitive, firms. An important incentive to invest in more efficient productive processes and technology is thus created. In other words, the FTA enables the firms to adapt new technologies from abroad by increasing the potential for success in using those technologies to break into partner-country markets.

Political Economy of Protection

The areas covered by regional trading arrangements constitute a subset—though an increasingly large one, as mentioned above—of overall macroeconomic and microeconomic policies. Moreover, all existing and emerging trade accords in Asia are FTAs, rather than customs unions, meaning that the economic policies of member countries continue to be independent.[10] Thus, the question of how FTAs will affect the policy stance of acceding countries will be crucial to the ultimate success of the accord. For example, in the NAFTA debates discussed above, almost all American economists supported the agreement not out of any conviction that regionalism was the best way to go—a majority saw regionalism as a threat to the integrity of the multilateral system, in which they strongly believed—but rather because they felt it was the best way to lock in the progressive economy-wide reforms that Mexico had set in motion

[10] The one exception might be the ASEAN Economic Community initiative, which may ultimately have to create a customs union to reach its goal of a common market.

in the process leading up to NAFTA. In addition, accession to ASEAN has facilitated economic reform in the transitional ASEAN economies that joined in the 1990s, well beyond what was needed to meet the exigencies of ASEAN-based agreements. In this section, we consider some aspects of the complicated interaction between FTAs and policy-making.

Dynamic policy considerations

A government can try to protect its domestic market from foreign competition by levying tariffs on imported goods or erecting nontariff barriers such as quotas of various kinds, discriminatory sanitary requirements, or even administrative action (e.g., antidumping and countervailing duties).[11] While tariffs, along with internal tax sources such as income, corporate, and value-added taxes, generate tax revenue for importing countries, such a tax at the border can itself be used as a policy variable to influence the economy's industrial structure. Hence, tariff formation can be, and usually is, affected by various factors other than tax revenue maximization. After all, if revenue maximization were indeed the goal of a tariff regime, the country should favor an across-the-board tariff that does not discriminate across commodities when setting up its commercial policy regime. Such an approach would imply far less efficiency costs than a tariff structure that differs across commodities.[12] The fact that homogeneous tariffs are rarely in evidence implies that countries tend to use their tariff structure as a form of industrial policy. This aspect of endogenous tariff formation has been explored through political, rather than purely economic, models. In general, this approach focuses on the domestic government's *political* objective of maximizing national welfare as determined from its own point of view, rather than from the economy's perspective. In line with this, the government's objective function consists of three major variables, i.e., domestic firms' profit, aggregate consumer surplus, and tariff revenue, which can be represented in the simple objective welfare function $W(\pi_L, C, \tau)$. It should be noted that this "national welfare" function differs from what a neoclassical economy connotes.

In the political-support approach to trade-barrier formation, the government trades off political backing from consumers against higher industry profits because higher protection for domestic industry will inevitably lead to higher sale prices of goods (and, hence, will be opposed by consumers). If the government gives greater weight to consumers' surplus than to the domestic firms' profit, the effective tariff rate will be lower, and vice versa. The local firms will lobby their government for higher protection for their industries. If the tariff revenue collected is to be redistributed among domestic actors, an altruistic government would choose a tariff to maximize aggregate support from its constituents. The altruistic government endeavors to maximize social welfare under the political incentive to gain public confidence in order to win elections or carry favors from various constituents.

These policy considerations of the importing country government, in turn, have strategic implications for the exporting sector. Faced with the importing government's welfare maximization problem, exporting firms behave strategically to maximize profit under given constraints. An exporting firm not only competes against the local firms in the market of the host country, but also

[11] This does not mean that all sanitary requirements and administrative actions are protectionist. However, they have been used as "hidden" protectionist vehicles.

[12] The argument for an optimum tariff rate suggests that tariff rates should be set according to relative elasticity between the demand for and supply of the imported good to maximize terms-of-trade gains. Given the compliance costs and potential rent-seeking behavior, however, a uniform tariff can have great advantages over a complex one.

engages in strategic behavior in responding to trade barriers in the country to which the firm will be exporting (i.e., the destination country). This dynamic aspect of strategic behavior is most evident in firms' comportment under administrative protection regimes of the importing country. Even in the context of rapid globalization and with many FTAs that have emerged as important policy vehicles, administrative protection measures, such as antidumping and countervailing duties, have become the most important trade barriers in industrialized (and some developing) countries. The rationale and effects of these protective measures, as well as exporting firms' strategic behavior in facing the domestic government's threat of protection, must be explored in a political economy context. Although it is not yet proven whether this kind of strategic interaction exists in the real world, much research reveals that this political-economy context can explain a large portion of trade barrier formation. This approach is certainly more realistic than the logical neoclassic approach, which would suggest that all countries should adopt free trade, with the exception of "infant industries," strategic trade policy, and the (theoretical) optimal tariff argument. [13]

[13] The infant-industry argument suggests that temporary, short-term protection should be used to protect a certain industry in the case of a financial bottleneck in developing countries. While there are examples of successful infant-industry protection, often the argument is used merely as an excuse for traditional protection: most infant industries never grow up. Strategic trade policy refers to protection geared to encourage economies of scale in an industry by creating a captive domestic market (and, with lower average costs, enhance competitiveness in global markets) or to the protection of one (comparative-disadvantage) sector that is a necessary input to a comparative-advantage sector. This argument, too, is problematic; while the former argument would lead to retaliation, the latter has very weak theoretical foundations. Finally, while it would be logical for them to do so in theory, countries do not apply tariffs according to an "optimal criterion," that is, they do not apply tariffs to improve terms of trade by forcing down import prices. Besides, the criterion would not apply even theoretically to small and developing countries: as they cannot influence their respective terms of trade (they are price takers), the optimal tariff would always be zero.

These dynamic policy considerations in the formation of trade barriers suggest the possibility of suboptimal trade policy implementation. While freer trade is better for the economic welfare of both the exporting and the importing countries, policy considerations in the domestic market will inevitably lead the government to suboptimal policy decisions for protection. For example, antidumping protection is technically triggered when the sale price of an exported commodity is lower than its price in the country of origin, and this price differential causes material injury to the domestic industry of the importing country through unfair competition. However, with the emergence of many interest groups in the industrial sector, the governments become more vulnerable to external pressures from industry interests to say that dumping has occurred. After all, most businesspeople would define dumping as merely selling at a price that is lower than their domestic price. Furthermore, given the difficulty of forming organized consumer-interest groups, the balance of influence will tilt toward more heightened protection regimes at the cost of consumers' welfare and efficient allocation of global resources.

Implications of rent seeking

Except in the presence of market failure (e.g., where there exist externalities or imperfect competition), a standard result of economic theory is that government intervention in markets tends to lead to a less efficient outcome. Tariffs and, certainly, nontariff barriers are no different. As discussed above, a tariff distorts consumption patterns and the structure of production, thereby damaging the static welfare of the country. Tariff barriers raise revenue for the government, but other sources of revenue, such as value-added taxes and direct taxes

(e.g., income taxes), tend to be less distortionary. Nontariff barriers are even worse; they have the same negative effects on consumers and the productive structure but often do not produce any revenue at all for the government.

Still, there are strong political reasons for applying tariffs. In addition to the process described above in terms of dynamic policy considerations, support for protection is usually justified to the public in order to protect national security, jobs, the environment, even a way of life. After all, the economic case for free trade is so strong that it has essentially created a consensus in mainstream economics, a field where there is very little consensus in other areas. However, except for a few small states, no country completely embraces free trade. The political economy of protectionism, therefore, is obviously extremely important.

As long as there is protection, there will be an incentive for rent seeking.[14] Without hard-and-fast rules based on economics (e.g., free trade or uniform tariffs), comparative-disadvantage industries will always have a strong incentive to lobby government officials. This type of rent seeking is very costly to the economy.

The economic case for FTAs is actually strengthened in the context of rent seeking if the agreement is comprehensive. Trade creation will reduce the lobbying strength of the most inefficient domestic firms and, hence, their capacity to rent-seek. Moreover, if tariff revenues are being used inefficiently or, worse, are being diverted to the pockets of customs officials, the creation of an FTA, which obviously reduces tariff revenue from intra-regional trade, will have less of a fiscal impact. However, firms may try to include protection in the agreement itself to perpetuate protection and rents. Complicated rules of origin are a case in point.

Political and strategic considerations

Most existing preferential trading arrangements were either created as economic arrangements in support of political goals or at least consistent with the diplomatic strategy of the founding countries. Economic cooperation in these arrangements is seen as an important vehicle for the pursuit of political goals (which, in themselves, have important economic ramifications). The EU has been effective in using preferential trading arrangements as diplomatic tools over the past 40 years, in part out of necessity. Commercial policy was (and still is) the only truly unified policy at the regional level (Messerlin 2001).

To the extent that these regional accords add to the political stability of the region, they do service to economic development in general and to the goal of policy reform in particular, even if the arrangements have weak substance to them. This, of course, is an important part of the early success story of ASEAN. Although most ASEAN countries had only recently achieved independence and were struggling to create nation-states (complete with many territorial disputes), the arrangement established an important dialogue process that prevented overt hostilities between these countries. To say that the (intentionally) weak economic cooperation initiatives in ASEAN had nothing to do with the subsequent dynamic growth in the region is to seriously understate its role.

However, there is also danger in letting political goals dictate economic agreements. If the overriding goal

[14] The term rent seeking was first used by American economist Ann Krueger for a theory developed by economist Gordon Tullock. Tullock's theory addressed the active creation of monopolies, with the aim of achieving supernormal profits or market control, in competitive conditions. See A. O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review,* vol. LXIV (1974), 291–303.

is political, then the parties forming an agreement will tend to make it as restrictive as possible. This will mean that they will include sectors that will be trade-diverting and avoid liberalizing sectors that will be trade-creating, guaranteeing that the FTA will be inefficient. A "positive list" approach to trade liberalization, in which countries specifically offer the commodities that they would be willing to include in a package—as opposed to a "negative list" approach, in which all commodities are included apart from those that are explicitly excluded—is especially vulnerable to this problem. ASEAN's original Preferential Trade Agreement (PTA) and the South Asian Association for Regional Cooperation's South Asian Preferential Trade Area (SAPTA) used the "positive list" approach, and accomplished very little, if anything, in stimulating trade.

Moreover, in the more political accords, countries signing an agreement will list increasing intra-regional trade and investment as the main goal. But such an objective is political rather than economic. If the FTA reduces transaction costs and increases efficiency in the region, it will be successful. But this does not necessarily mean that it will increase intra-regional trade and investment. For example, if the accord brings in a great deal of FDI from outside the region, this would serve to improve the competitiveness of the member countries and, hence, would mean that the FTA is a success. But it could very well be that the production fragmentation associated with this FDI as part of a global production chain could also reduce intra-regional trade—and certainly, given the fact that the FDI came from outside the region, intra-regional FDI will fall. The important thing is that the economies have become more competitive, trade and investment has increased, and welfare has improved. The nationality of trade and investment flows is not particularly pertinent, at least from an economic perspective.

As is the case with multilateral liberalization, FTA negotiations produce a complicated matrix of political interaction. First, certain producers' interests will be pitted against those of consumer groups. Since free trade tends to favor producers that rely heavily on imported inputs, they will generally back FTAs (as well as the WTO) but, given the potential for trade diversion, special producer interests will attempt to reduce the scope and coverage of the agreement. Sectoral conflict will also take place: manufacturing industries, for example, that have dealt with many rounds of global trade liberalization may well favor a given FTA, as they expect to benefit from trade creation, that is, expansion into partner-country markets. However, sensitive manufactures will resist. Also, agriculture, which has been mainly excluded from GATT/WTO rounds, tends to be the most complicated sector of all because it is often the most protected. The OECD, for example, spends $300 billion per year protecting its agricultural producers, which constitute less than 5% of its workforce. Protection is easiest to sell to the public in this sector because of the need for a certain level of agricultural production for national security reasons, health issues, and the "multifunctionality" of agriculture (a term much favored by the French that suggests the need to protect agriculture not only for the reasons just cited but also because of its positive effects on protecting and beautifying the countryside).

There will also be conflicts due to firm size. Large firms, which produce with economies of scale, are often in favor of FTAs as the greater efficiencies from a larger market in an FTA will have a "cost reduction" effect (Corden 1972). Small and medium-sized producers, on the other hand, will tend to oppose preferential trade agreements as they anticipate being

vulnerable to partner competition. An FTA that opens up the retail-food sector, for example, will lead to a proliferation of supermarkets and a contraction in the number of "mom and pop" stores. Even immigration groups will have a role: trade can serve as a substitute for factor flows, and so anti-immigration groups tend to support FTAs (provided they do not liberalize labor flows). This was the case with NAFTA, which was generally supported by anti-immigration groups in the US.

In FTA negotiations, therefore, governments have to negotiate not only with their partners but also with a complex web of domestic interests. Compromises will have to be made across groups within a country and across countries in the FTA. Sometimes structural change in the FTA can be facilitated through a compensation mechanism (e.g., the Trade Adjustment Assistance program in the US): since the country is better off with trade creation, it makes good economic sense to compensate the losers. However, constructing efficient, well-targeted compensation mechanisms can be complicated, and certain interests will still oppose liberalization. This complicated mix of considerations underscores the critical importance of establishing channels of communication with different groups domestically before and during negotiations, as well as putting in place an astute, diverse negotiating team. These topics are dealt with in depth later in the book.

ECONOMICS OF CONSOLIDATION/ HARMONIZATION

Does regionalism support unilateral or multilateral reform goals, or does the discrimination inherent in a trade bloc lead to a "second best" outcome at best, or an inward-looking one at worst? This is the essence of the "building blocs" versus "stumbling blocs" debate. The literature would suggest that several possible negative policy consequences (i.e., inherent "stumbling bloc" tendencies) could emerge from an FTA, while other tendencies would be consistent with multilateral goals and market-friendly domestic liberalization. We review the general arguments for each side below.[15]

Stumbling Blocs

Maximizing terms-of-trade gains

Regional integration increases the size of an economic zone and, hence, increases market power. The potential benefits of exploiting such an advantage by imposing an "optimal tariff" (i.e., maximizing the difference between the terms-of-trade gains from a tariff regime against its costs in terms of efficiency) are familiar from the international trade literature. Moreover, FTAs and customs unions, because of the trade-diversion effect, improve the terms of trade of the region relative to the rest of the world. The larger the grouping, the larger the potential improvement in the terms of trade.

In reality, the first effect is probably not particularly relevant, as even customs unions do not impose tariff regimes according to optimum tariff rules.[16] Moreover, in the case of both customs unions and FTAs, changes in the external tariff regime cannot on average be more protective than the pre-integration

[15] See Frankel (1997), on which some of these topics are based.

[16] Nor are they at the country level, as noted earlier. While the optimum tariff argument is one of the three classic economic arguments in favor of protection (the others being the infant-industry argument and strategic trade policy), it is well recognized as a theoretical argument. Tariffs are generally implemented for political and political-economy-related reasons, not as a means of trying to extract terms-of-trade gains.

status quo, according to Article XXIV of the GATT/WTO. There can still be negative sectoral effects as some areas may see their tariffs rise, but in this case other GATT/WTO members can sue for compensation.

With respect to the terms-of-trade effect, since trade diversion undeniably results from preferential trading arrangements, it is certainly a concern. But trade diversion is a one-time price effect and, hence, static. In fact, as discussed above, it is *the* static cost of preferential trading accords.

Special interests manipulating the contents and scope of the agreement

This concern obviously also manifests itself in domestic policy formation. This is especially a problem in the context of accords between developed and developing countries, in which the former obviously have the upper hand, as special interests tend to be far better organized and funded. Article XXIV of the GATT/WTO is not particularly strict in regulating FTAs, and with special-interest groups free to rent-seek, the outcomes could be less efficient. Of course, this could also have a positive effect: for example, special-interest groups in developed countries no doubt push for better protection of intellectual property rights (IPR), competition policy, treatment of FDI, and better trade and investment facilitation, but these could also have important positive effects on efficiency and policy-making in developing countries.

Waste of scarce negotiating resources

Particularly (but not exclusively) in the case of developing countries, the scarcity of well-trained and well-experienced experts in trade negotiations implies an opportunity cost of less resources being devoted to multilateral negotiations if all the talent is engaged in regional deals. Critics of regionalism suggest that such a capacity constraint can only be detrimental to multilateral liberalization, and even policy reform at the national level. For example, after Viet Nam joined ASEAN in 1995, it worked not only to enter into AFTA but also to implement a number of other accords, including an extensive bilateral trade agreement (BTA) with the US in 2001. On top of that, it was working on "ASEAN+3" initiatives. Given its human-capital capacity constraints, this could very well have delayed its drive to join the WTO, which was realized only at the end of 2006.

Or perhaps not. A counterargument would be that Viet Nam was able to ready its economy for the WTO through the outward-oriented policies of ASEAN, and the BTA itself was essentially a means of preparing Viet Nam for WTO entry, including legal and administrative reforms that would in any event be necessary. The agreement is replete with references to WTO protocols and WTO-consistent reforms, from service liberalization to "TRIPS-plus." These negotiations have also sharpened the expertise of Vietnamese negotiating authorities.

Building Blocs

Locked-in policy change

Regional integration can be seen as a blueprint for market-friendly reform and increased competitiveness in the international marketplace. Without ASEAN (and eventually the BTA), one can easily argue that Viet Nam would not have made as much progress (and its joining the WTO would no doubt have been further delayed). This effect also applies to industrialized regions. When Greece (1981) and Spain and Portugal (1985) joined the EU, they

were essentially "newly industrialized economies," each having undergone political instability/transition only a few years before. They each made significant strides in modernizing their policies and economies as a result of EU accession, and today have significantly closed the gap with advanced industrial economies.

Improved negotiating power for smaller units

Traditionally, the possibility of small countries joining together and working as one cohesive unit in trade negotiations has always been considered an important advantage of regionalism. This would apply both to smaller countries as well as to larger units. Free trade areas are less effective in this regard relative to customs unions, as the former do not include a common external tariff and, hence, divergences in interests will persist and will make cooperation more difficult. However, a well-developed system of forming joint positions even in an FTA can ensure that the whole will be greater than the sum of its parts.

A dynamic weeding process as a first step toward free trade

It could very well be that the process of structural adjustment unleashed by a regional trading arrangement through trade creation could, in effect, facilitate multilateral accords. As the weakest (and, therefore, more resistant to any international competition) are weeded out, through an FTA or other means, the stock of opposition to trade falls in importance, thereby making multilateral initiatives easier.

Perhaps a heuristic example will illustrate the point. Suppose that the trade policies of a country (let us call it "home") are determined by domestic firms, and "home" trades with two other countries—"partner" (i.e., the country that will eventually form an FTA with "home") and "rest of the world." Furthermore, assume that, in autarky, there are six industries, with the linear cost structures of the firms in the home country being such that two are globally competitive (in goods A and B), two are competitive only regionally (in goods C and D, in a potential FTA with "partner"), and two will never be competitive with trade (in goods E and F). Now, assume that the "home" government puts to a vote whether or not the country should move to free trade. Firms producing A and B will vote yes, as they will benefit from a larger market, but the other four firms will vote against it, as free trade will put them out of business. We remain in an autarkic equilibrium. But suppose now that the home country votes on whether or not it should have an FTA with "partner." The firms producing goods A, B, C, and D will vote in favor, and those producing E and F, against. The FTA will pass. Eventually, competition from the partner country will force out the production of goods E and F in the home country (trade creation), and there will be no trade diversion (as we began in autarky). The remaining firms in the home country will, therefore, eventually produce only A, B, C, and D. Next, assume that the home country votes once again on whether or not it should have free trade. The votes will now be two in favor (A and B) and two against (C and D); assuming that consumers have even a little say would be sufficient to usher in free trade, because of the FTA "stepping stone" process.

Competitive liberalization to attract international capital, as well as a positive "threat"

Regional integration can be used as a means of rendering the component economies more efficient, competitive, and market-friendly. While a grouping

may or may not adopt global "best practices" in regulatory, legal, and other issues, it can reduce the stock of divergences across countries, thereby making it easier to integrate globally. By reducing transaction costs across countries, an FTA can enhance its attractiveness to MNCs. As an FTA "deepens," and policy externalities thus become increasingly important, the incentive to internalize them through monitoring, information sharing, closer cooperation, etc., increases. Because trade and financial links are becoming increasingly important and recognized, countries within an FTA soon find it useful—or even necessary—to further financial and macroeconomic cooperation. It may also be true that regional agreements can be used as implicit and explicit "threats," particularly since FTAs seem to have a tendency to grow over time.

In sum, both the "stumbling bloc" and "building bloc" arguments have *theoretical* merit. But in practice, the inclination of the regional accord tends to be extremely important. Clearly, if the group is being formed to enhance inward-looking development strategies or to isolate the region from global competition, this initial policy direction would set in motion many of the problems discussed above. In fact, this approach led to the downfall of many regional trading agreements in the past, especially in Latin America (e.g., the Latin American Free Trade Area). Yet, if outward-looking economies were to form a regional grouping, regionalism is likely to promote the goals of domestic policy reform and multilateral liberalization. These factors, among others, are responsible:

(i) It is unlikely that a country wishing to promote outward-looking policies, including extensive unilateral liberalization and active participation in the WTO, would contradict this stance in favor of a regionally closed system.

(ii) Reductions in trade barriers within a preferential trading arrangement make it more attractive for a country to reduce external barriers, in effect "MFN-izing" regional concessions, because the most important cost of regionalism, as noted above, is trade diversion and lower external barriers will reduce the associated costs.

(iii) "Weeding out" least-competitive industries, and making the political economy of trade liberalization more favorable over time, seems to have been important empirically.[17]

(iv) The membership of FTAs and other cooperative accords tends to expand and to become more diverse over time, thereby reducing regional sources of support for protectionism in a particular country and industry, as well as reducing the overall potential for trade diversion. This has been true for the EU, NAFTA, AFTA, the South American Common Market (Mercosur), and other agreements.

Inconsistencies between Agreements: "Spaghetti Bowl" Effect

The boom in the number of separately negotiated FTAs has often been blamed for the "spaghetti bowl" or "Asian noodle bowl" effect in the region. As mentioned earlier, these FTAs can be quite different from one another in coverage, depth of liberalization, and the specific regulations that make the accord function (e.g., the

[17] "Anecdotally" would perhaps be more accurate, as the empirical literature on this subject is not well developed.

"rules of origin" discussed below). Their inherent inconsistencies and (sometimes) contradictions could be a real problem in the global marketplace. A strong advantage of the WTO framework is that it generally, but not totally, avoids this problem.

Complicated "rules of origin" (ROOs) in FTAs are often cited as the most obvious example of the "spaghetti bowl" problem. Later in this reference we discuss ROOs at length. Suffice it to note here that they are necessary in FTAs to avoid "trade deflection." An example would best illustrate the point. Suppose that India and Malaysia were to form an FTA. Further, assume that tariffs on television sets are high in India but are low in Malaysia. Once the agreement is in place, Japanese exporters, for instance, will have an incentive to "deflect" their exports from India to Malaysia, where they will pay a low tariff, and then reexport the television sets to India from Malaysia to take advantage of duty-free access. This will lower the tariff costs for the Japanese exporter. To avoid this possibility, any India-Malaysia FTA should include ROOs for products that seek to take advantage of the FTA.

The problem is that ROOs can be used as a protectionist technique, with high ROOs being used as a way of protecting domestic interests. Each FTA tends to be unique and can choose its own ROO regime—Article XXIV is completely silent on the issue—but many of them tend to be extremely complicated, especially when the FTA includes an OECD country. NAFTA, for example, is a liberal FTA by most measures, but its ROO regime is infamous: the ROO for automobiles, for example, is 62.5% and for certain textiles, 100%.

Moreover, the diversity of these ROO regimes is problematic. A country with many FTAs could end up having different ROOs for trade in a certain product for each FTA, potentially creating confusion but also influencing the input-sourcing decisions of the firm in a way that could hamper efficiency. Thailand, for example, has FTAs with both Australia and New Zealand. And even though Australia and New Zealand themselves form one of the most advanced FTAs in the world (the Closer Economic Relations agreement), the set of ROOs for Thailand's FTA with each is different. Hence, a Thai producer that exports to both Australia and New Zealand may need to have a different production strategy for exports to each market. That would be costly in a number of ways to the Thai producer, which could lose scale economies, among others.

Exactly how costly these different ROO regimes are to any given country is unclear. Some economists estimate the compliance costs at 3–5% of the value of exports, but others suggest that the cost is lower. And governments can reduce the associated costs by providing information to exporting firms and importers. The Singapore Government, for example, puts out an interactive CD-ROM that provides details to Singaporean firms regarding the ROOs for any product and any FTA involving Singapore.

What is clear is that the "spaghetti bowl" effect—in terms of ROOs or other aspects of FTAs that tend to be inconsistent between countries—does have at least some economic cost. Greater harmonization of policies in these agreements, in ways that would be more consistent with economic efficiency ("best practices"), would obviously be advantageous, particularly as the number of FTAs in the region continues to grow. We consider a set of best practices in the next section.

Enhancing Consistency in Agreements: Best Practices

One way to avoid inconsistency associated with the "spaghetti bowl"

effect would be to have rules that govern FTAs. Article XXIV does have some general rules, but they are extremely general and have proven very difficult to tighten. At the Doha Development Agenda negotiations, for example, the problem of the growing number of FTAs was evident, but, even with a successful outcome, any improvement in FTA rules is likely to relate only to greater transparency. It would be useful to define a set of rules that would minimize the negative effects of FTAs and maximize the positive effects. This is especially important in the light of the FTA movement in Asia, where policies, rather than being inward-looking, are directed more toward efficiency goals. We might call such rules "best practices" of FTAs. Below are 10 major areas that might be considered in this regard: [18]

(i) **Product coverage: Goods.** *Comprehensive coverage is best, to be included within a reasonable period of time (defined as 10 years by the GATT/WTO).* Article XXIV of the GATT/WTO stipulates that, in an FTA or customs agreement, product coverage should include "substantially all goods." But the exclusion of individual products can be problematic on efficiency grounds, particularly when it involves products that are used as inputs in the production chain. Thus, to the greatest extent possible, the FTA should include all goods. Some will no doubt be excluded either temporarily or permanently, but such exemptions should be as few as possible and should take into account the important effects that they might have on the effective rate of protection, as well as on trade diversion.

(ii) **Product coverage: Services.** *Again, comprehensive coverage and a reasonable time period for implementation are best from an economic perspective, and transparency is important in some areas.* Services present some special and important challenges. Certain services are fairly easy to liberalize, e.g., in terms of allowing for the movement of professional persons, tourist-related services, and even high-tech/knowledge-based services. Others are extremely difficult. Educational services tend to be highly protected. Financial services are often the most difficult to include in any liberalization package. Still, the gains from trade in services are no less than those from trade in goods, and yet there has been far greater attention to the latter in multilateral agreements and most FTAs.

(iii) **Rules of origin.** *Rules of origin should be as low as possible as well as symmetrical.* As noted above, abuses of ROOs in FTAs are problematic. Stringent rules could have important trade-diversion and investment-diversion effects, with a potentially high cost to non-partners and greater inefficiencies in partner countries. To avoid this, generous and consistent ROOs are of the essence.

(iv) **Customs procedures.** *To the greatest extent possible, customs procedures should follow global best practices and GATT/WTO-consistent protocols.* Customs and related procedures are at the heart of "trade facilitation," a key priority in the Doha Development Agenda. They are obviously closely related to ROOs, as one of the key challenges of customs

[18] These best practices were developed by ADB; see Plummer (forthcoming 2007) for details.

officials is to clear countries of origin of imports. Regional trading agreements can be used as instruments to modernize customs laws, regulations, administrative guidelines, and procedures.

(v) **Intellectual property protection.** *IPR guidelines should be nondiscriminatory and consistent with TRIPS, TRIPS Plus, and related international conventions.* As will be noted later in this reference book, the protection of IPR is one of the most sensitive issues in negotiating FTAs. Developed countries, having a strong comparative advantage in IPR-intensive products, want to make sure that IPR is taken seriously both *de facto* and *de jure*. Developing countries often criticize the IPR stance of developed countries as being too severe and too favorable to innovators, e.g., granting patent monopolies for an exaggerated length of time, or being too insensitive in areas such as pharmaceuticals. On the other hand, it may be that stronger, more serious IPR protection can actually be positive for the development of a country's own innovative and artistic sectors, besides promoting more FDI and technology transfer.

(vi) **Foreign direct investment.** *Investment-related provisions should embrace national treatment and nondiscrimination, shun performance requirements, have a highly inclusive negative list, and provide the usual protection to foreign investors.* In particular, national treatment is critical in this regard, as it has important implications for creating a competitive environment and a "level playing field."

(vii) **Antidumping procedures.** *Antidumping procedures and dispute resolution need to be transparent and fair, and the process needs to be well specified and effective.* Antidumping and countervailing duties, also known as "administrative actions," were discussed briefly above. They may or may not be stipulated directly in an agreement; sometimes, the references may be exclusively directed to the WTO dispute resolution. Antidumping clauses in an FTA might be used to tighten antidumping evaluation procedures, promote transparency, and expedite processes. But it is also important that dispute settlement procedures are clearly identified and respected. Otherwise, confusion can follow.

(viii) **Government procurement.** *Government procurement should be as open and nondiscriminatory, and procedures as clear and open, as possible.* The size of the state sector varies across the region and internationally, but in most countries government procurement is a significant sector. There is a WTO Agreement on Government Procurement, but not all WTO member countries are signatories.[19] Moreover, the rules on market access in this agreement are relatively limited. The chapters on government procurement in the "deeper" FTAs tend to go much further. "Best practices" would require that the arrangement produce a transparent, open, and nondiscriminatory regime that grants national treatment as much as possible to partner countries,

[19] In this sense this World Trade Organization (WTO) agreement is sometimes referred to as a voluntary or plurilateral agreement.

with an excluded (negative) list as short as feasible and the threshold-bid level as low as practical.

(ix) **Competition.** *Policies related to competition should create a "level playing field" for both locals and partners, and they should not put non-partner competition at a disadvantage.* Many countries in Asia do not have a competition policy per se. But trade and investment liberalization is affected by industrial organization at the domestic level, and this becomes an especially important area in countries having active state-owned enterprises. Hence, it follows that "deep" FTAs should have basic rules and procedures designed to prevent anticompetitive behavior from state-owned enterprises, quasi-state firms, privately owned domestic monopolies/oligopolies, and the like, that would give them a competitive edge over foreign competition.

(x) **Technical barriers to trade.** *These should be kept to a minimum and harmonized in a nondiscriminatory way, with clear and transparent mechanisms for determining standards.* The WTO Agreement on Technical Barriers to Trade (TBT) attempts to "ensure that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade." TBT takes on particular significance at the global level, as many of its aspects, including harmonization of standards, "mutual recognition," definition of legitimate means of protecting animal and plant life and the environment, should have global rules of conduct. International standards, however, are bound to be general; FTAs, as they involve only a few or several countries, can potentially achieve far deeper means of integration and progress in this area. What would be critical for efficiency and outward orientation, therefore, would be TBT clauses based on international standards, having high levels of transparency, embracing best practices, and eschewing discrimination against outsiders as much as possible.

In sum, by adopting best practices, FTAs can generate significant gains in economic efficiency, well beyond the effects of traditional FTAs and, arguably, beyond what any realistic multilateral approach could possibly hope to generate.

SUMMARY

Trade policy is complicated. While economic theory strongly supports free trade and outward-oriented trade agreements, trade policy is decidedly in the political realm and, hence, economic arguments constitute only one—albeit essential—dimension of trade negotiations. Still, it is important that negotiators are aware of the economic benefits of liberalization and the economic costs to an economy of inward-looking policies. Rarely is the most efficient outcome forthcoming from any multilateral, regional, or bilateral negotiation. The trick is to maximize the efficient aspects of any given accord and minimize any potential negative implications.

This assessment of the costs and benefits of trade liberalization, at the global and bilateral/regional levels, was the main objective of Part I, which also considered

political determinants of trade policy. Moreover, given that Asian economies have explicitly expressed their desire for FTAs to be outward-looking rather than inward-looking, we considered rules of thumb that would be useful in creating such arrangements (or, perhaps, merging them in the future). In Parts II and III, we focus specifically on component parts of FTAs and practical issues.

Appendix to Part I: Application of a Computable General Equilibrium Model to FTAs

Trade models have become increasingly useful tools for analyzing the economic impact of trade agreements in recent years. Advances in theory, analytical techniques, and data processing power of computers have enabled analysts to assess the impact of trade agreements in quantitative terms and compare the effects under different scenarios. For instance, an estimate of the impact of the Doha Round shows global gains of $68.6 billion to $155.2 billion by 2025 (ADB 2006). Another estimate shows that full liberalization of merchandise trade would result in a $291 billion to $518 billion increase in world income by 2015 (World Bank 2004). Meanwhile, bilateral free trade agreements (FTAs) like the Japan-Singapore Economic Partnership Agreement have been estimated to increase the income of Japan by $6.9 billion and that of Singapore by $0.4 billion (Hertel et al. 2001). Given the wide range of estimates and possible impact on developing member countries, it is important to gain a basic understanding of the simulation models being used and their strengths and weaknesses.

As noted in Box 1.4 above, the most common trade model is the global computable general equilibrium (CGE) model. The CGE model is based on the concept of a general equilibrium, where supply equals demand in each market in the economy. The chart below presents an overview of the elements of a typical CGE model and shows the links between markets. To achieve market equilibrium, prices are assumed to adjust until demand for factors of production equals available endowments, consumers have chosen the desired basket of goods given their incomes, and firms have chosen production levels that maximize their profits. Because an FTA introduces a set of policy changes in an economy, CGE models simulate an economy where markets have adjusted and a new equilibrium has been reached.The effect of an FTA can be estimated by comparing incomes under the old equilibrium with those under the new equilibrium.

The attraction of a CGE model is that it arrives at a numerically exact answer (in the form of a change in income) while ensuring theoretically consistent results. A CGE model identifies the sources of income gains or losses from further opening up to trade and shows how these gains or losses are distributed across countries or regions. Hence, CGE simulations can be used in FTA negotiations to highlight, for example, the sectoral and production effects of some of the FTA provisions that could hurt vulnerable groups in an economy. This would give a good idea of how the government should target any assistance designed to facilitate restructuring and compensate the losers. Multiple simulations can also be undertaken to work out alternative scenarios that might turn national income losses from an FTA into gains. Because of the multiplicity of links in an economy, a simple diagram may not show all the effects of an FTA, whereas CGE and other computer-based models allow systematic tracking of all the interactions.

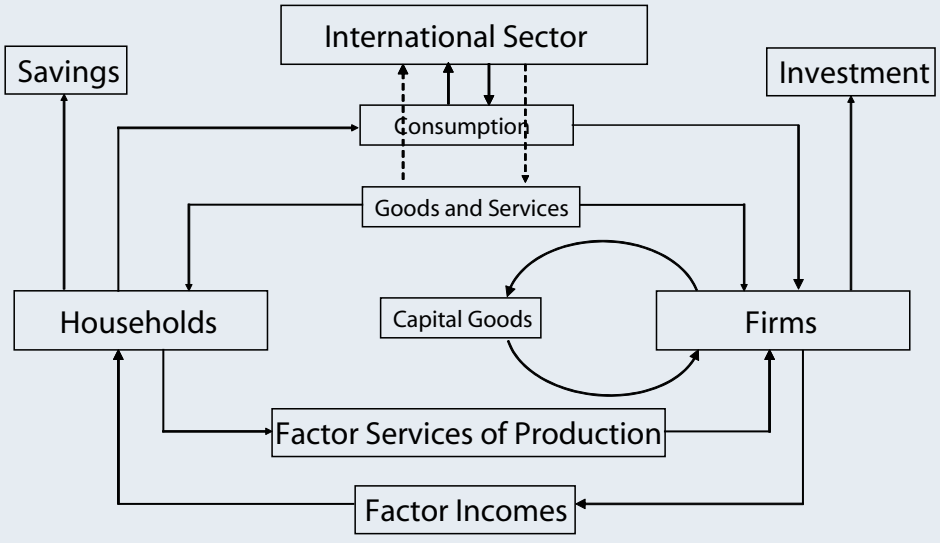
The CGE models used in empirical studies vary somewhat in their underlying economic structure, behavior of agents,

and focus. Box 1.4 presents different types of CGE models and their uses. With a CGE model, simulation exercises can be conducted to evaluate the welfare gains under different FTA scenarios. The primary focus of such policy scenarios is the removal of price distortions against imports that arise from trade barriers and other sources. An example of such an approach might best illustrate the point. A CGE model was used to evaluate gains from the following Asian FTA scenarios:

(i) *Fragmented scenario*: a continuation of the current wave of bilateralism, where the region is fragmented by several bilateral or small regional FTAs;
(ii) *ASEAN+3 FTA scenario*: free trade among Association of Southeast Asian Nations (ASEAN) countries, the PRC (including Hong Kong, China), Japan, and the Republic of Korea;
(iii) *Asia Pacific Economic Cooperation (APEC) FTA scenario*: free trade among APEC members; and
(iv) *Global trade liberalization scenario*: complete abolition of import tariffs and export subsidies.

The economic impact of these FTA scenarios was estimated with the use of ADB's General Equilibrium Model for Asian Trade (GEMAT) (see Box 1.4 above). The results for gross domestic product (GDP) and welfare with equivalent variation for the four policy scenarios are given in the table below. Expectedly, a fragmented reality of multiple bilateral and regional FTAs is the least attractive for all regions and countries. Among others, this scenario may give rise to the famous Asian "noodle bowl" effect, which refers to the higher transaction cost from multiple ROOs and standards in the growing number of FTAs in East Asia.

Elements of a CGE Model:
The Circular Flow in an Open Economy



CGE = computable general equilibrium.
Source: Plummer and Wignaraja (2006); Kawai and Wignaraja (2007)

Impact of Four FTA Scenarios, Change in Real Income (Equivalent Variation)

Region/ Country	Fragmented Scenario	ASEAN+3FTA Scenario	APEC FTA Scenario	Global Free Trade Scenario
	In $ million (2001 prices)			
Northeast Asia	(1,219)	21,724	56,734	72,944
ASEAN	8,869	10,375	8,341	11,319
Rest of Asia	(101)	(425)	(1,560)	4,288
US	(1,371)	(2,362)	12,035	22,884
Europe	(1,021)	(904)	(3,047)	25,325
Rest of the World	(555)	(464)	280	14,861
World	4,401	27,546	74,689	153,718
	In % of GDP			
Northeast Asia	(0.02)	0.37	0.96	1.23
ASEAN	1.72	2.02	1.62	2.20
Rest of Asia	(0.01)	(0.06)	(0.22)	0.61
US	(0.01)	(0.02)	0.12	0.24
Europe	(0.01)	(0.01)	(0.04)	0.30
Rest of the World	(0.01)	(0.01)	0.01	0.34
World	0.01	0.09	0.25	0.51

APEC = Asia Pacific Economic Cooperation, ASEAN = Association of Southeast Asian Nations, FTA = free-trade agreement, GDP = gross domestic product, US = United States of America. Source: ADB staff simulations.

Under the ASEAN+3 scenario, the welfare of members increases, with Northeast Asian GDP increasing by 0.37% and ASEAN GDP by 2.02%, while nonmembers (the rest of Asia, US, Europe, and the rest of the world) incur modest losses. An APEC FTA brings gains to Northeast Asia and the US but less gains to ASEAN than under a fragmented scenario. The rest of Asia and Europe, which would be excluded from an APEC FTA, also lose relative to the first scenario. Global free trade is the most attractive but unrealistic scenario since even the Doha Development Agenda process, which does not aspire to global free trade, has been beset by uncertainties regarding the timing and depth of multilateral agreements needed to reduce trade barriers (see Plummer and Wignaraja [2006] for an analysis of the impact of the different scenarios on East Asian economies).

While trade models like the CGE model are useful in quantifying the impact of FTAs, the drawbacks include their reliance on the quality of information fed into the model and on the assumptions used in simulations. Data may not always be of high quality and could be missing, links between markets in the economy may not always be accurately specified, and different scenarios and model specifications can mean different results. Moreover, existing CGE modeling frameworks do not include many aspects of trade agreements—barriers to services, competition policies, investment rules, and other nontariff measures (e.g., sanitary and phytosanitary standards and technical barriers to trade), which are likely to afford more protection for domestic industries than tariffs. Accordingly, the impact of these issues is not reflected in the simulation results.

CGE models are best used in conjunction with other empirical tools—notably analysis of the complex structure of FTAs, econometric methods, country or case studies, and policy analysis. For example, Gilbert et al. (2004) used both the CGE model and a gravity model to analyze regional trade agreements in Asia. A gravity model seeks to explain the pattern of bilateral trade and its evolution over time in terms of certain fundamental variables. While a CGE model can show the effect of an FTA in the future, a gravity model shows the historical pattern of trade. The findings from a CGE model could also be supported by country or case studies to highlight the possible microeconomic impact of FTAs not accounted for by the models. Nonetheless, the results of CGE simulations are useful in giving a sense of the order of magnitude that a change in policy can mean for economic welfare. Hence, CGE models are complements, not substitutes, for a thorough policy analysis of FTAs.

Part II: Coverage of a Free Trade Agreement

TRADE IN GOODS

Under the WTO rules, a member may enter into a trade arrangement[20] with one or more other members under which they grant more favorable access to exports from one another than to exports from other WTO members. As discussed in Part I, the basic rules governing this exception to the WTO's MFN clause, or nondiscriminatory treatment for trade in goods, are found in the GATT Article XXIV. Under this article, a free trade agreement (FTA) binds a group of two or more concurring countries[21] to eliminate tariffs and other trade barriers on substantially all the trade between them in products originating in any of the member countries, within a reasonable length of time.

Certain terms of Article XXIV are supplemented by the Understanding on the Interpretation of Article XXIV of GATT 1994 (hereafter, "Understanding"), which was endorsed as part of the Uruguay Round agreements. The Understanding, however, is more specific on some significant points. For instance, where Article XXIV indicates that tariffs should be eliminated within a "reasonable length of time," the Understanding is more explicit, stating that an agreement allowing more than 10 years would require "a full explanation to the Council for Trade in Goods of the need for a longer period." The Understanding is also more specific on the criteria and procedures for the required review of new or enlarged free-trade areas by the Council for Trade in Goods. For developing countries, the 1979 Decision on Differential

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[20] The WTO often uses the term "regional" to refer to FTAs and other integration arrangements even when the members involved are not part of the same region and are far apart geographically, as in the Republic of Korea–Chile and US-Australia FTAs.

[21] Article XXIV refers to "customs territories"—territories with their own schedule of tariffs and other trade regulations. Thus, customs territories are usually countries. However, a country may have two or more distinct customs territories, as in the case of the PRC and Hong Kong, China.

and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries (hereafter, "Enabling Clause")[22] gives these countries more leeway in the time allowed for complying with the GATT requirements, including Article XXIV, and generally takes a more lenient stand on the review of FTAs between such countries.

Provisions on trade in goods form the heart of an FTA, and the mutual desire to expand exports underlies every agreement. An FTA is a way for like-minded countries to reap the benefits of openness at a faster rate than is sustainable for the WTO, with its much larger and more diverse membership. From the point of view of beneficial expansion of trade in goods, potential partners may be compatible in several ways. First, they may have significant differences in comparative advantage, usually indicated by internal relative prices. The Republic of Korea–Chile FTA illustrates (see Case Study 2.1) such a pairing, with the Republic of Korea enjoying strong comparative advantage in manufacturing and Chile enjoying strong comparative advantage in agricultural products. Moreover, each country is highly competitive in these sectors at the global level, suggesting that losses due to trade diversion will be small relative to trade creation. But potential partners may also be compatible because one or both need access to a larger integrated market to benefit from scale economies in production or increased competition. In this case the dynamic gains may be important even if significant trade diversion implies losses in terms of the static effects.

The formation of an FTA may reduce the welfare of excluded trading partners, especially if significant trade diversion results, i.e., if tariff-free imports from partners replace lower-cost goods still subject to tariffs. But, as elaborated in Part I, trade diversion also implies a terms-of-trade loss to the importing country. This constitutes an important incentive for Asian countries to adopt "best practices" in FTA, as discussed at length above. That is, FTAs should seek to minimize trade diversion and maximize the potential gains from FTAs in terms of trade creation and various dynamic effects. In addition, FTAs should be inclusive. For example, APEC (2004) stresses that: "Consistent with Asia Pacific Economic Cooperation's (APEC) philosophy of open regionalism and as a way to contribute to the

[22] As part of the Tokyo Round agreements.

Box 2.1: WTO Disciplines in Trade-in-Goods Provisions

Aside from compliance with the minimum requirements of the exception to the most-favored nation (MFN) clause, most free trade agreeents (FTAs) also adopt or draw reference to WTO principles and disciplines. A number of Asian FTAs have the following provisions:

National Treatment

"Each Party shall accord national treatment to the goods of the other Party in accordance with Article III of the GATT 1994 and to this end Article III of the GATT is incorporated into and made part of this Agreement." The national-treatment clause affords no less favorable treatment of the goods of the other Party than the most favorable treatment the Party accords to its own goods.

Import and Export Restrictions

"Each Party shall not institute or maintain any prohibition or restriction other than customs duties on the importation of any good of the other Party or on the exportation or sale for export of any good destined for the other Party, which is inconsistent with its obligations under Article XI of the GATT 1994 and its relevant provisions under the WTO Agreement." [emphasis supplied]

Nontariff Measures

"Each party shall not introduce or maintain any nontariff measures on the importation of any good of the other Party or on the exportation or sale for export of any good destined for the other Party which are inconsistent with its obligations under the WTO Agreement." [emphasis supplied]

Source: Legal text of various FTAs.

Case Study 2.1: **Republic of Korea–Chile Free Trade Agreement**

In the mid-1980s, the United States began to negotiate free trade agreements (FTAs) with economically or geopolitically significant partners including Canada and Israel. However, Asian countries remained on the sidelines, with the most important countries refraining entirely from participation in FTAs until after the Asian financial crisis.[a] While the crisis itself had underscored the need for cooperation among the interconnected East Asian economies, two other developments around the same time were arguably more important. First, as FTAs proliferated, excluded Asian exporters found themselves at a disadvantage relative to other suppliers not subject to the same trade barriers. This created a strong incentive to form FTAs for "defensive" purposes. A second concern was the People's Republic of China's (PRC) rapid integration into world markets, which translated into strong competition for established export markets. By negotiating FTAs that excluded the PRC, other Asian countries hoped to gain a market advantage over their powerful new competitor.

In 1998, the Republic of Korea made plans to negotiate its first FTA, which was also the first trans-Pacific FTA. It chose Chile as its partner, even though the PRC, Japan, and the United States were each far more important in its trade. Two factors may have influenced the choice. First, while small, Chile had already succeeded in negotiating FTAs with several other countries. More importantly, the economy of Chile, whose exports were concentrated in agricultural products and minerals, was complementary with that of the Republic of Korea, an exporter of manufactured goods. This meant that reciprocal liberalization would most likely expand trade along the lines of comparative advantage, with minimal impact on protected domestic producers. Yet each partner had sensitive sectors that were exempted from liberalization. The Republic of Korea gained immediate tariff-free access for automobile exports to Chile while maintaining protection for some agricultural products that competed with products from Chile (apples, pears, rice). Similarly, Chile gained greater access to its partner's market for other agricultural exports, i.e., ones with little impact on farmers in the Republic of Korea, while maintaining tariffs protecting the local manufacture of washing machines and refrigerators.

The Republic of Korea–Chile FTA was completed in October 2002, was formally signed in February 2003, and entered into force on 1 April 2004. The agreement covers trade in goods, investment, trade in services, competition, government procurement, intellectual property rights, administrative issues, and dispute settlement.

For trade in goods, some tariffs were eliminated immediately (e.g., in Chile for exports of autos, mobile phones, and computers from the Republic of Korea), while most concessions were to be phased in over as much as 13 years in the case of Chile's imports of textiles and clothing. The Republic of Korea likewise eliminated some restrictions on Chile's exports of agricultural products immediately, but was to phase in other tariff concessions over a period of up to 16 years. Besides eliminating tariffs on most goods, the agreement also called for eliminating quantitative restrictions not covered by the General Agreement on Tariffs and Trade (GATT) Article XI, as well as import licensing and other nontariff barriers. Some sensitive goods were exempted on each side—as noted above, refrigerators and washing machines for Chile and apples, pears, and rice for the Republic of Korea.

Under the agreement, global safeguards applied must conform to Article XIX of the General Agreement on Tarrifs and Trade (GATT) and the World Trade Organization (WTO) Agreement on Safeguards. Special safeguards may be applied to agricultural products; if no other mutually acceptable solution is reached, safeguard measures include stopping the reduction in the preferential tariff reduction or increasing the tariff up to the most-favored nation (MFN) rate. This implies that other types of special safeguards, e.g., a price floor or quantitative restrictions, can be applied if both parties agree to the measure. Antidumping and countervailing duty actions must conform to Article VI of the GATT, the WTO Agreement on Antidumping, and the WTO Agreement on Subsidies and Countervailing Measures.

Provisions on sanitary and phytosanitary (SPS) measures and on product standards build on the corresponding parts of the WTO Agreement, i.e., such regulations should not constitute disguised protection, should be based on scientific principles, and should be applied in a way that does not discriminate among suppliers. However, the SPS Agreement goes further, requiring each partner to accept the procedures and standards of the other if those can be shown to achieve the required level of SPS protection. Both parties should base their own product standards on existing international standards unless these can be shown to be ineffective or inappropriate in achieving the country's "legitimate objectives."

continued on next page...

[a] The ASEAN Free Trade Area (AFTA) agreement, signed in 1992, expressed the intention of ASEAN members to establish a free trade area by 2008. The agreement, very brief by the standards of later FTAs, has since been amended to accommodate new ASEAN members and to expedite the integration of the original signatories.

Case Study 2.1 continued.

Case Study 2.1: Republic of Korea–Chile Free Trade Agreement

The FTA established a free trade committee to monitor and evaluate the effects of the agreement. The agreement sets out procedures for dispute settlement but defers to WTO dispute-resolution procedures regarding safeguard, antidumping, and countervailing duty actions taken under the GATT provisions governing their use.

Although expanding trade in goods by reducing applicable tariff rates was the paramount concern of negotiators on both sides, the FTA also put in place measures to stimulate investment by each party in the other country and to expand trade in services. Other parts of the agreement deal with government procurement, intellectual property rights, and rules of origin. Preferential rules of origin are based on those used in previous FTAs, including the North American Free Trade Agreement (NAFTA) and the FTA between the European Union (EU) and Chile. The Republic of Korea–Chile FTA calls for a single form, in English, to establish compliance with rules of origin.

Source: Korea–Chile Free Trade Agreement; Chung (2003).

momentum for liberalization throughout the APEC region," best-practice FTAs "are open to the possibility of accession of third parties on negotiated terms and conditions."[23]

A typical trade-in-goods agreement in FTAs primarily provides for tariff and customs duty reduction and elimination, basic principles (including transparency, national treatment, and some reference to WTO disciplines) (see Box 2.1), nontariff and other measures (sanitary and phytosanitary, safeguards, emergency measures), rules of origin, customs procedures, general exceptions, and institutional arrangements.

Tariff Elimination and Reduction

In general, the provisions of an FTA must indicate which goods will be included for elimination and reduction of tariffs as well as those to be excluded (i.e., sensitive products) from liberalization. It also must decide whether or not certain commodities should receive a longer phase-in period (and, in some cases, whether or not "special and differential treatment" will be granted to certain member states).

Under Article XXIV, tariffs must be eliminated on substantially all traded goods. While the meaning of "substantially all" has yet to be clearly spelled out,[24] in practice FTAs usually cover all but a few items (even though in practice this has not always been the case[25]). The Understanding notes that the value of an FTA is "diminished if any major sector of trade is excluded," and APEC best-practice guidelines call for "liberalization in all sectors."

FTA concessions on trade in goods include either reduction or elimination of tariffs through (i) immediate elimination[26]

[23] Asia Pacific Economic Cooperation (APEC). 2004. Best Practice for FTAs/FTAs in APEC. 16th APEC Ministerial Meeting, Santiago, Chile, 17–18 November.

[24] The interpretation of that expression has remained contentious. Two approaches, not mutually exclusive, are typical in that respect:
- The quantitative approach favors the definition of a statistical benchmark, such as a certain percentage of the trade between regional trade agreement (RTA) parties, to indicate that the coverage of a given RTA fulfills the requirement.
- The qualitative approach sees the requirement as meaning that no sector (or at least no major sector) is to be kept out of intra-RTA trade liberalization. This approach is aimed at preventing the exclusion from RTA liberalization of any sector where the restrictive policies in place before the formation of the RTA hindered trade, as could well be the case if a quantitative approach were used (see WTO Compendium of Issues Related to RTAs).

[25] For example, the European Community–European Free Trade Agreeent(EC-EFTA) FTA and the EC-Israel FTA accord included only manufactured goods.

[26] Even before the FTA negotiations are concluded, some countries already provide and implement immediate tariff reduction or partial tariff reduction in the form of "early harvest schemes" for selected products.

upon the FTA's entry into force; (ii) gradual and straight-line reduction or elimination thereof; (iii) substantial elimination in the first year, followed by gradual elimination or reduction (particularly for sensitive products); or (iv) an initial grace period of several years, followed by elimination of tariffs.[27]

In most FTAs entered into by the member countries of the ASEAN, tariff elimination follows certain modalities like the normal- and sensitive-track approach. In the case of the Asia Pacific Trade Agreement (APTA), tariff concessions may be negotiated (i) product by product, (ii) across the board, or (iii) for each sector. Concurrently, special concessions may be further granted to least-developed countries (LDCs) participating in the preferential arrangements (with respect to phasing or tariff elimination schedule and rates). Under the bilateral FTA between Thailand and New Zealand, some goods were freed when the FTA took effect, while other tariffs are to be eliminated either through progressive reduction or through immediate zeroing after a period in which duties are kept constant.

Product coverage

Success in negotiation requires each partner to be prepared to accept increased imports of many types of goods. Thus, from the standpoint of the negotiation, success is most likely when the partners do not hope to expand exports in the same industries, i.e., when the partners differ in comparative advantage products, giving rise to trade patterns such as the exchange of manufactured goods for agricultural products (interindustry trade), as in the case of the Republic of Korea and Chile. However, trade between two partners may expand even if their exports fall in the same broad category as long as the partners specialize in different segments of that category, as in the exchange of small gas-efficient vehicles for luxury high-performance vehicles (intra-industry trade). Intra-industry trade may also occur at successive stages of the value chain, as in the exchange of computer disk drives or semiconductors for assembled computers.

Although exceptions to free trade or slower phase-in for tariff cuts may help overcome political opposition to an agreement that is beneficial overall, these tactics should be used sparingly. Cutting or eliminating tariffs on some goods at a faster rate may actually raise rather than reduce the amount of protection enjoyed by a domestic industry ("effective protection" of a productive activity[28]). For example, reducing the tariff on cotton cloth more slowly than the tariff on raw cotton will increase the protection of cotton cloth production during the phase-in period. To the extent that the goal of the FTA is to increase exposure to world market forces at a manageable rate, the effect is exactly the opposite of the policy's goal. However, GATT Article XXIV does not require tariff elimination on the date when the agreement takes effect, and most agreements allow tariffs and other barriers to be eliminated in stages. In such a case, the provisions of the agreement must specify the schedule for tariff reductions. Policy makers, therefore, need to be aware of this phase-in problem

[27] See METI (2007) and Lee et al. (2006).

[28] The effective rate of protection (ERP) measures the extent to which the overall structure of protection on goods raises the value added of a specific industrial activity relative to free trade. The ERP rises with the tariff rate on the activity's output but falls with the tariff rate on the activity's purchased intermediate inputs. If inputs are used in fixed proportions, the ERP for the activity that produces good j expressed as a fraction of value added under free trade is given by:

$$(V_T - V_{FT}) / V_{FT} = (t_j - \sum a_{ij} t_i) / (1 - \sum a_{ij}),$$

where V_T and V_{FT} are value-added in production of good j under the current tariff structure and under free trade, the a--'s are the shares of each input i in the total cost of producing good j, and the t's are the tariff rates on each good.

and the potential (short-run) distortions in productive incentives.

Phase-in period

As noted above, the time allowed for phasing in often differs across product groups, with extra time allowed for sensitive products that are not excluded from preferential treatment. In the Republic of Korea–Chile FTA, some tariffs were eliminated immediately, while a phase-in period of up to 16 years was allowed for a few sensitive products. The NAFTA included phase-in times of up to 15 years. Such delays would be the exception in principle, given the 1994 Understanding, which insists on a 10-year maximum except in special cases. Under the US-Singapore FTA, each party eliminated customs duties on all originating goods of the other party when the agreement entered into force, but will reduce the customs duties on some products under the US tariff lines over 4, 8, or 10 years, depending on the product.

The Enabling Clause allows an even longer phase-in period for FTA members classified as developing countries. The AFTA, as well as the ASEAN-plus FTAs with the PRC and the Republic of Korea (which were notified, or are to be notified, under the Enabling Clause), classifies the tariff items according to their sensitivities under the normal- and sensitive-track approaches. Under the normal-track approach, some tariffs are eliminated when the agreement takes effect and some others are eliminated within specified time frames. Under the sensitive track, on the other hand, items protected or exempted by the member countries are classified into sensitive or highly sensitive lists. In the New Zealand–Thailand Closer Economic Partnership Agreement (New Zealand–Thailand CEPA), no overall implementation period is explicitly provided, but the schedule of tariff elimination is up to 20 years for Thailand and 10 years for New Zealand.

Members should keep in mind that a longer phase-in period means a longer wait until the full benefits of the FTA can be achieved, and, of course, differences in phase-in rates across goods may lead to inappropriate increases in some effective protection rates. Like the case of Thailand's FTAs with Australia and New Zealand, the FTAs may provide further that the elimination of customs duties may be accelerated unilaterally or as a result of consultations requested by either party, to provide flexibility in the tariff concessions of the FTA.

The Harmonized System

Since each country is likely to trade hundreds or even thousands of different products, negotiations on tariff elimination typically identify goods according to the Harmonized Commodity Description and Coding System, usually called the Harmonized System (HS). This is an internationally standardized method of classification developed by the World Customs Organization (WCO).[29] Broad categories of goods are first divided into sections, then into 97 chapters denoted by two digits, and then subheadings denoted by four or six digits. For example, Section II (vegetable products) covers Chapters 6–14. Chapter 10 (cereals) is further divided into four-digit subheadings that include 10.06 (rice) and then into four separate six-digit subheadings that include 1006.20 (husked rice). Some countries expand this system to eight or more digits. However, differences in treatment of goods within a given broad category should be kept to a minimum to prevent inefficiencies due to the diversion of trade across subcategories or increases in effective protection rates.

[29] www.wcoomd.org/ie/en/topics_issues/harmonizedsystem/DocumentDB/TABLE%20OF%20CONTENTS.html

Positive-list or negative-list approach

A positive-list approach to trade in goods enumerates specific tariff items to be included in the liberalization schedule, while a negative-list approach identifies selected tariff items to be excluded from negotiations for preferential tariffs. Most FTAs between developed and developing countries adopt a positive-list approach. For instance, the New Zealand–Thailand CEPA takes a positive-list approach. Tariff elimination schedules are then set item by item. However, since an FTA must cover substantially all trade, it is more convenient, though not popular, to use the negative-list approach.

Which tariff rates?

Preferential tariffs are negotiated from certain base rates, which usually are the MFN tariff rates of the negotiating parties. A procedural question regarding tariff rates in negotiations relates to whether negotiations should take as a starting point the current applied rates or the often higher bound rates of the participating countries (assuming the country does indeed bind its tariffs).[30] In order For real liberalization to begin as soon as the agreement takes effect, current applied rates are the appropriate starting point. But where current applied rates are already very low, negotiations could focus on binding rates at similarly low levels. Singapore began negotiating the US-Singapore FTA with applied tariffs of zero on most of its imports but agreed to reduce bound rates to zero as well.

Another potential area of confusion is whether a country's rates are applied to the "free on board" (FOB) value of imports or, as is more usual, to the cost, insurance, and freight (CIF) value. In the latter case, an ad valorem tariff rate is applied to the value of insurance and transportation costs, as well as to the cost of the goods themselves.

Treatment of Sensitive Products

Because of the very large number of tariff lines to be included in an FTA negotiation, broad liberalization principles are typically applied to most goods. For example, negotiators may agree that all tariffs already below a certain level will be reduced immediately to zero when the agreement takes effect. However, the participants in any trade liberalization negotiation must take into account the existence of "sensitive products," for which immediate adjustment or even adjustment at the rate allowed for most goods would cause severe problems in a particular sector or region. Such a disruption could cause harsh political and economic problems, at least in the short run. These goods would be exempted from the broad liberalization principles applied to most trade between the partners.

In the interest of transparency, each partner begins negotiations by presenting a preliminary list of sensitive products. Since WTO rules require an FTA to eliminate tariffs on substantially all traded goods, these sensitive products must be strictly limited in both number of tariff lines and total value.[31] The impact of liberalization on domestic producers of sensitive products may be mitigated by a later start to tariff cuts and extra time

[30] Applied rates are those currently in use, while bound rates are the maximum rates to which WTO members have committed themselves in accession agreements or multilateral negotiations. Thus, countries may raise their applied rates unilaterally without violating their WTO obligations if bound rates are higher than applied rates.

[31] A small value of current trade may not be relevant because sensitive sectors are usually highly protected. Thus, the current trade value may be very low or even zero.

allowed for tariffs to be eliminated.[32] The protocol for special treatment of sensitive products in ASEAN's Common Effective Preferential Tariff (CEPT) scheme[33] includes flexibility in the starting date of the phase-in process, with a later starting date and longer phase-in period for LDC members; rules for ongoing tariff cuts, with no rate change applied for more than 3 years, a reduction of at least 10 percentage points at each adjustment, and a final tariff rate of no more than 5%; and scheduled elimination of all quantitative restrictions and other nontariff barriers.

Imports of sensitive products are often restricted by a tariff-rate quota (TRQ) rather than a simple ad valorem tariff. Under a TRQ, imports up to a stipulated ceiling may enter at one tariff rate, while additional imports beyond that ceiling are subject to a higher rate. During the phase-in period for such goods, scheduled commitments should include gradual increases in the size of the lower-rate quota, as well as reductions in the tariff rates themselves. If tariff quotas are maintained, the agreement should be clear on how the lower-rate quota will be filled. An efficient option is for transferable import licenses to be distributed through a scheme that bases initial allocations on historical market shares.

For sensitive agricultural products, the applicable MFN tariff rate may be seasonal, with a higher rate applied during the part of the year when imports compete with a like product grown domestically. For example, the US, Canada, and Mexico all charge higher seasonal rates on imports of some fresh agricultural products like tomatoes. Under NAFTA, the tariffs on out-of-season tomatoes were phased out over 5 years; tariffs on in-season tomatoes were phased out over 10 years, with a tariff quota in effect during the transition period.

Trade Facilitation

Nontariff market access provisions are gaining wide attention in negotiations (multilaterally and bilaterally) and have become as significant as negotiations on tariff-related provisions. This is because customs procedures and other administrative hurdles can themselves be significant barriers to trade. To begin with, potential exporters and importers need information on their countries of origin and their partners' laws and procedures that affect trade. And when trade is between FTA partners (or involves other kinds of preferential arrangements), compliance with rules of origin usually involves additional administrative procedures beyond those ordinarily required in trade transactions, e.g., detailed production information in a specific format. Compliance with customs regulations requires time and effort, but basing procedures on best practices will lead to efficiency and reduced transaction costs. In a narrow sense, trade facilitation means applying customs procedures predictably, consistently, and transparently, by improving access to information and reducing the cost of complying with administrative procedures. In broader terms, trade facilitation includes reducing behind-the-border costs from inadequate or inefficient transportation, logistics, and storage facilities.

Multilateral negotiations

Multilateral negotiations on trade facilitation are aimed at simplifying cross-border procedures and increasing

[32] Because many goods are produced out of parts or intermediates imported from outside the FTA partner countries, the provisions include rules of origin (ROOs) that determine whether these goods are eligible for the preferential treatment (see the Rules of Origin section in this chapter on page 49). In practice, restrictive rules of origin for particular products are also used to limit the impact on sensitive sectors.

[33] ASEAN Protocol on the Special Arrangement for Sensitive and Highly Sensitive Products, Singapore, 30 September 1999.

the capacity of developing countries to participate in the global trade. Trade facilitation in the WTO context refers to *"simplification and harmonization of international trade procedures including the activities, practices and formalities involved in collecting, presenting, communicating and processing data and other information required for the movement of goods in international trade."* The focus is thus primarily on reducing the administrative costs[34] associated with trade.

The WTO Ministerial Conference in Singapore in 1996 requested the WTO Goods Council to begin exploratory work to simplify trade procedures. Negotiations in the WTO on trade facilitation began in 2004.[35] The negotiations are intended to "clarify and improve relevant aspects of Articles V (transit of goods), VIII (fees and formalities affecting imports), and X (publication and administration of trade regulations) of GATT 1994 with a view to facilitating trade among the members.[36] Since then, a number of trade facilitation measures have been proposed by WTO members.[37]

Negotiators also examine ways of providing technical assistance and support for capacity building, taking into account the differences in levels of development among WTO members. This is being explicitly discussed at the Doha Development Agenda under "aid for trade."

[34] These costs include compliance with rules-of-origin procedures discussed in detail in the Rules of Origin section of this chapter.

[35] The mandate for trade facilitation negotiations is set out in Annex D (Modalities for Negotiations on Trade Facilitation) of the July Package.

[36] www.wto.org/english/tratop_e/tradfa_e/tradfa_negoti_e.htm

[37] The proposals involve (i) the publication and availability of information; (ii) the time period between publication and implementation; (iii) consultation and commenting on new and amended rules; (iv) advance rulings; (v) appeal procedures; (vi) measures enhancing impartiality, nondiscrimination, and transparency; (vii) fees and charges connected with importation and exportation; (viii) formalities connected with importation and exportation; (ix) consularization; (x) border-agency coordination; (xi) the release and clearance of goods; (xii) tariff classifications; and (xiii) matters relating to goods transit.

Trade facilitation provisions of FTAs

Trade facilitation provisions may be part of the general principles, a section of the customs procedures chapter, or an independent chapter in FTAs. They often specify measures, for example, simplified requirements for documentation and methods of determining compliance with rules of origin (see the Rules of Origin section on page 49). These trade facilitation measures may be general or specific—depending on factors like the coverage of the FTA, geographic situation, and institutional and technical capacity.

While the Agreement of the Bay of Bengal Initiative for Multisectoral Techno-Economic Cooperation (BIMSTEC) does not specifically provide for trade facilitation, it nevertheless suggests the establishment of rules-of-origin mechanisms and the simplification of import and export formalities. In the case of the South Asia Free Trade Agreement, provisions call for the prompt publication of rules and regulations, the identification of "inquiry points" for the exchange of information, consultations on rules of origin, electronic means of reporting and the identification of low-risk and high-risk goods, customs cooperation, and technical assistance for LDCs.[38] Meanwhile, the CEPT Agreement for AFTA provides that "Member States shall explore further measures on border and non-border areas of cooperation to supplement and complement the liberalisation of trade." Since then, the ASEAN members have agreed to implement a Harmonized Tariff Nomenclature as well as to establish and implement the ASEAN Single Window to expedite customs clearance through single submission of information, documents, and formalities, single processing, and single decision making.

[38] See Chaturvedi (2007) for the detailed stocktaking of trade facilitation provisions in South Asia FTAs.

The trade facilitation provisions also differ even for the same bilateral partner. For example, Japan's bilateral agreements, on one hand, include commitments to facilitate the transport of goods, provide exporters and importers with information regarding requirements for documentation, increase transparency, and build capacity through training, technical assistance, and exchange of experts. Agreements like the Japan-Singapore, Japan-Philippines, and Japan-Thailand Economic Partnership Agreements (EPAs), on the other hand, provide further commitments to improve the speed and efficiency of customs procedures through "paperless trading."

Evolution of best practices in trade facilitation

Existing mechanisms and instruments[39] can provide for best practices in trade facilitation. A case in point is the International Convention on the Simplification and Harmonization of Customs Procedures (now commonly referred to as the Revised Kyoto Convention). The principles of the convention are explicitly recognized by negotiators of the WTO and are being incorporated in FTAs.[40] The Asia Pacific Economic Cooperation (APEC) member countries have also adopted the Trade Facilitation Principles (applicable to both goods and services), namely:[41]

(i) Transparency;
(ii) Communication and consultation;
(iii) Simplification, predictability, and efficiency;
(iv) Nondiscrimination;
(v) Consistency and predictability;
(vi) Harmonization, standardization, and recognition;
(vii) Modernization and use of new technology;
(viii) Due process; and
(ix) Cooperation.

Some of these principles have been introduced in a number of FTAs:

(i) **Customs cooperation.** Cooperation is promoted between customs authorities of FTA partners. It may take the form of exchange of information such as customs laws and procedures (especially for new and amended customs rules); establishment of joint committees to discuss and address trade facilitation issues; mutual administrative assistance and exchange of experts; and common customs declaration and joint customs control at borders.

(ii) **Release of goods.** Principles like simplification and standardization of procedures, risk management, and post-clearance audit allow customs to ensure the smooth and speedy flow of goods. Simplified procedures reduce formalities and documentation requirements to the minimum extent, aligned with international standards. Risk management involves the selective inspection of traded goods on a scientific basis. Post-entry audit allows goods to be released first and documents reviewed, thereby reducing the transaction costs of physical examination at borders.

(iii) **Advance rulings.** Also called "binding rulings," these are issued at the request of an exporter or importer to customs authorities to issue a decision relevant to the application of customs

[39] The World Customs Organization (WCO) website (www.wcoomd.org/home_about_us_conventionslist.htm) lists and contains the text of these instruments.
[40] See for example, Chapter 4 of the Singapore-Australia Free Trade Agreement.
[41] See www.apec.org/apec/ministerial_statements/sectoral_ministerial/trade/2001_trade/annex_b.html

procedures. Determining the tariff classification, customs valuation, and applicable duties and taxes on certain products, for example, would reduce clearance formalities and speed up the release of goods.

(iv) **Use of information and communication technology (ICT) and paperless trading.** Modern trade facilitation measures like the use of electronic filing and the transfer of trade-related information and electronic versions of bills of lading, invoices, letters of credit, and insurance certificates (a form of electronic data exchange) are alternatives to paper-based methods that enhance the efficiency of trade by reducing the cost and time involved. Although ICT is not indispensable, it facilitates the implementation of a "single window"[42] in customs procedures.

(v) **Temporary admission of goods in transit.** Most FTAs involving landlocked countries provide for simplified procedures for the temporary admission of goods in transit.[43] Other FTAs (like those of Japan) provide for the application of existing customs conventions,[44] as well as Article V of GATT. The effective implementation of these transit agreements requires partnership between government authorities, particularly customs and transport associations.

(vi) **Technical assistance and capacity building.** Trade facilitation measures must be relevant and must take into account the resource constraints and needs of smaller countries that are parties to FTAs. As part of the aid-for-trade agenda, developed countries could provide funding and technical support[45] for the implementation of multilateral or bilateral trade facilitation programs.

Technical Barriers to Trade, and Sanitary and Phytosanitary Standards

Regulations and standards often serve legitimate objectives including the protection of the environment; consumers; workers; national security; human, animal, and plant life or health; and the food and water supply. Nevertheless, regulations and standards also have a darker side—they may be employed as barriers to international trade. As tariffs have fallen, regulations have increasingly been used as nontariff barriers to protect domestic producers. Two WTO agreements—the Agreement on Technical Barriers to Trade (TBT Agreement) and the Agreement on Sanitary and Phytosanitary Measures (SPS Agreement), seek to balance the protection of legitimate objectives with the need to restrain nontariff barriers to prevent protectionism. Following is an introduction to the TBT and SPS Agreements, followed by an overview of TBT and SPS measures in FTAs.

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[42] A single window is commonly defined as "a facility that allows parties involved in trade and transport to lodge standardized information and documents with a single entry point to fulfil all import, export, and transit-related regulatory requirements." (United Nations Economic Commission for Europe Recommendation on Establishing a Single Window: Recommendation 33, ECE/TRADE/352)

[43] For example, the Kyrgyz-Kazakhstan FTA states that a "*Party shall provide free transit via its territory, of goods originating in the customs territory of the other Party or third countries and intended for the customs territory of the other Party or a third country*." (Article 10, para. 2)

[44] Such as the Customs Convention on the ATA Carnet for the Temporary Admission of Goods (ATA Convention) and the Convention on the International Transport of Goods under Cover of TIR Carnets (TIR Convention).

[45] See Part 3 and Annex 1 of the Pacific Agreement for Closer Economic Relations (PACER).

The TBT Agreement

The TBT Agreement is designed to protect human, animal, and plant life and health in specific instances when the SPS Agreement does *not* apply. Legitimate objectives for TBT measures include the protection of the environment, consumers (prevention of deceptive practices), workers, national security, and human, animal, and plant life and health. WTO members also apply TBT measures to ensure quality and to encourage product standardization. The TBT Agreement applies to "technical regulations" (which are mandatory), "standards" (which are voluntary), and "conformity assessment procedures" (testing to verify whether a product meets a particular technical regulation or standard).

TBT measures relate to a product's characteristics, packaging, marking, labeling, symbols, and terminology (among other aspects). A typical example of a *technical regulation* is a law requiring an automobile dealer to display the vehicle's fuel efficiency. Compliance is mandatory—the dealer may not sell the vehicle unless its fuel efficiency is displayed.

Compliance with a *standard* is voluntary and often gives a product a marketing advantage. A standard might set forth characteristics that a product must meet before a government permits the manufacturer to use a particular symbol on the product's label. A typical example would be rules governing the use of a symbol showing that a product is recyclable. If the product can be sold without the symbol, the measure is a standard and not a technical regulation.

The TBT Agreement establishes the following disciplines, some of which are familiar from the GATT Agreement:

- **Nondiscrimination.** WTO members must ensure MFN treatment and national treatment with respect to technical regulations, standards and conformity assessment procedures.
- **Avoidance of unnecessary obstacles to trade.** WTO members must ensure that adopting or applying technical regulations, standards, and conformity assessment does not create unnecessary obstacles to international trade.[46]
- **Harmonization.** Members must base technical regulations and standards on relevant international standards.[47] If resources permit, members must participate fully in the preparation of guides and recommendations for conformity assessment by appropriate international standardizing bodies.
- **Equivalence.** Members are encouraged to accept foreign technical regulations fulfilling the same policy objectives, as equivalent.
- **Mutual recognition of conformity assessment procedures.** Members must accept, whenever possible, the results of foreign conformity assessments, even when the procedures differ from their own, provided they are satisfied that the procedures offer assurance of conformity with technical regulations and standards equivalent to their own.
- **Transparency.** Members must provide information about proposed and adopted technical regulations, standards, and conformity assessment procedures through inquiry points, publication, notification, etc.

[46] The measures should be the least trade-restrictive measures reasonably available to fulfill a legitimate objective.

[47] An exception exists when international standards would be ineffective or inappropriate, for example, when fundamental climatic and geographic factors or fundamental technological problems make reliance on such standards inappropriate.

- **Technical assistance.** Upon request, members are required to provide technical assistance on mutually agreed terms.

The SPS Agreement

The purpose of the SPS Agreement is to ensure that food and beverages are safe for human and animal consumption (safe from pesticide residues, additives, toxins, etc.), and to prevent the spread of pests and diseases (bacteria, viruses, invasive species, etc.) among humans, animals, and plants, while at the same time ensuring that WTO members do not use SPS measures as disguised restrictions on international trade. Typical examples of SPS measures are slaughterhouse inspection requirements, quarantine requirements for sick animals, and pesticide and herbicide residue requirements.

The SPS Agreement grants all WTO members the right to implement SPS measures to protect human, animal, or plant life or health from SPS risks provided that the members comply with the disciplines set forth in the Agreement. Members that comply with the obligations of the SPS Agreement are presumed to be in compliance with the obligations of GATT 1994, including its Article XX(b).[48]

Unlike the TBT Agreement, the SPS Agreement does not classify trade measures as technical regulations, standards, or conformity assessment procedures. SPS measures nevertheless function like technical regulations—to the extent that compliance with SPS measures may be necessary to import or sell a particular product. Some provisions of the SPS and TBT Agreements are similar. The most important provisions of the SPS Agreement are the following:

(i) **Science-based agreement.** The SPS Agreement is a science-based agreement; hence, SPS measures must be based on sufficient scientific evidence and on risk assessment. Precautionary measures must also be based on some degree of scientific evidence. (The science-based nature of the SPS Agreement distinguishes it from the TBT Agreement.)

(ii) **Necessity.** SPS measures must be necessary to protect human, animal, or plant life or health (they must be the least trade-restrictive measures reasonably available to achieve the desired level of risk prevention).[49]

(iii) **No arbitrary or unjustifiable discrimination.** SPS measures must not result in arbitrary or unjustifiable discrimination between countries with identical or similar conditions. Measures must not be disguised restrictions on international trade.

(iv) **Harmonization.** SPS measures must be based on international standards, guidelines, and recommendations where they exist, unless there is scientific justification based on appropriate risk assessment to use a higher standard.

(v) **Equivalence.** Members should accept as equivalent foreign SPS measures that provide the same level of protection.

(vi) **Transparency.** Members must provide information about their SPS measures through inquiry points, publication, notification, etc.

(vii) **Technical assistance.** WTO members have agreed to facilitate the

[48] Article XX(b) provides a general exception for trade measures necessary to protect human, animal, or plant life or health. Some sanitary and phytosanitary (SPS) disciplines resemble those in the technical barriers to trade (TBT) agreement.

[49] Members must recognize the concept of disease-free or pest-free areas, and the possibility that the prevalence of pests and diseases could vary depending on geography, ecosystems, etc.

provision of technical assistance to other members, in particular developing countries.

Treatment of SPS and TBT measures in FTAs

Unlike customs unions, in which members generally harmonize SPS and TBT rules, FTAs have no single practice for the treatment of these regulatory matters. Because of the sensitivity of agricultural and food safety issues, many FTAs contain few SPS provisions and leave it up to the parties to apply the SPS agreement.[50] With respect to TBT matters, FTAs often contain stricter disciplines than those found in the TBT agreement.

FTAs take several different approaches with respect to regulatory matters, in particular TBT. Some FTAs acknowledge the parties' WTO obligations but create committees only to study SPS and TBT problems. Other FTAs are moving slowly toward mutual recognition of conformity assessment procedures. A third variant fosters greater integration by harmonizing certain regulations, recognizing measures in various sectors as equivalent, and providing for a degree of mutual recognition of conformity assessment procedures—often on a sectoral basis. Regardless of the approach taken, the starting point in FTAs is usually recognition that the parties' WTO commitments remain binding. The WTO Agreement thus serves as the lowest common denominator of commitments in FTA agreements. The following examples illustrate how SPS and TBT measures are handled in selected FTAs.

Agreements to Strengthen Cooperation and to Negotiate. ASEAN's 2002 Framework Agreement with the PRC reaffirms relevant WTO commitments, and provides for strengthened cooperation with respect to trade in goods by negotiating nontariff measures, scientifically unjustifiable SPS measures, and TBT measures.[51]

WTO as a Basis for Agreement to Negotiate. The New Zealand–Thailand FTA reiterates the parties' WTO commitments with respect to nontariff barriers, and more specifically with respect to SPS and TBT measures.[52] The FTA endorses equivalence, harmonization, and mutual recognition, and sets up a joint SPS committee to encourage consultations and negotiations. It establishes a framework for addressing SPS and TBT issues, and for negotiating additional arrangements and annexes.[53]

General Reaffirmation of the WTO Agreement with Enhanced Cooperation. The US-Singapore Free Trade Agreement (USSFTA) reaffirms the parties' WTO commitments and their shared commitment to facilitate bilateral trade by reducing or removing technical and SPS barriers to the movement of goods between the parties.[54] In Chapter 6 the parties establish an enhanced cooperation and coordination procedure for dealing with TBT issues.[55] The FTA

[50] This assumes that the parties are WTO members.

[51] See Articles 3.8(e) and 7.3(a), Framework Agreement on Comprehensive Economic Co-operation between ASEAN and the People's Republic of China (Phnom Penh, 5 November 2002) (www.aseansec.org/13196.htm). This agreement builds on the ASEAN-PRC FTA signed on 6 November 2001. The goal of the parties is to create a free trade area by 2010.

[52] See Articles 2.7 (nontariff measures), 6.4.1 (SPS agreement), and 7.3.3 (TBT agreement) of the Thailand–New Zealand Closer Economic Partnership Agreement (www.thaifta.com/english/index_eng.html).

[53] See generally Chapters 6 and 7.

[54] See www.iesingapore.gov.sg

[55] See page 1 of the introduction to the US-Singapore Free Trade Agreement, www.iesingapore.gov.sg/wps/wcm/connect/resources/file/ebfe4f42743d685/FTA_USSFTA_Agreement_Final.pdf?MOD=AJPERES. See also Chapter 6, on technical barriers to trade.

does not harmonize technical regulations, standards, and mutual recognition of conformity assessment procedures, except in the area of telecommunications, where the parties agree to implement Phases 1 and 2 of the APEC Mutual Recognition Arrangement for Conformity Assessment of Telecommunications Equipment.[56] The agreement also establishes a medical products working group to provide a forum for cooperation on regulatory issues of mutual interest.[57]

Sectoral Harmonization of Standards. ASEAN members have periodically selected sectors for harmonization. They agreed to harmonize standards in 20 priority product sectors in 1997 and completed the process in 2003. They also agreed to harmonize electrical safety standards for 71 additional products in 1999 and completed the process in 2004.[58] In 2003, the ASEAN members agreed to harmonize cosmetic standards.[59]

Broad Mutual Recognition. The Singapore-Australia Free Trade Agreement (SAFTA) builds on these countries' February 2001 mutual recognition arrangements for medicinal products, electrical and electronic equipment, and telecommunications equipment. It streamlines inspection and compliance procedures for certain products, and commits the parties to harmonize their technical regulations with international standards.[60] SAFTA contains provisions on the equivalence of mandatory requirements (particularly in the sectoral annexes),[61] cooperative activities in SPS matters,[62] and the negotiation of improved conformity assessment procedures.[63] The agreement also contains two important sectoral annexes providing for mutual recognition of food products and horticultural goods. The sectoral annex on food products reaffirms WTO commitments under the SPS and TBT Agreements and is applicable to certain standards relating to food products exported from one party to the other, and to conformity assessments of manufacturers or manufacturing processes of food products exported from one party to the other.[64] The sectoral annex on horticultural goods reaffirms the parties' obligations under the SPS Agreement,[65] and provides for mutual recognition of certain phytosanitary certificates.[66]

Safeguards, Antidumping Measures, and Countervailing Duties

WTO rules indicate when members may apply "trade remedies"—safeguards, antidumping measures, and countervailing duties—in response to specified actions by trading partners. While some FTAs merely indicate compliance with the relevant GATT articles, others modify these rules as they apply to trade among themselves. For example, the Republic of Korea–Chile FTA simply indicates consistency with the standard WTO treatment of

56 Article 6.3.1.
57 See Article 6.3.4 and Annex 6A of the US-Singapore Free Trade Agreement. Annex 6A, para. 1, provides for cooperation but excludes mutual recognition agreements or other binding commitments.
58 www.aseansec.org/15564.htm
59 www.aseansec.org/20607.pdf
60 See generally Chapter 5 on Technical Regulations and Sanitary and Phytosanitary Measures, and more specifically Article 4.
61 Article 5.
62 Article 6.
63 Article 7.
64 www.dfat.gov.au/trade/negotiations/safta/annex_5_a.pdf, at Articles 1.1 and 1.2.
65 www.iesingapore.gov.sg/wps/wcm/connect/resources/file/ebc2d1418bb5162/Annex+5B+-+Sectoral+Annex+on+Horticultural+Goods-+SAFTA.pdf?MOD=AJPERES, at Article 1.3.
66 Article 5.

safeguards, antidumping measures, and countervailing duties.

The application of trade remedies may give rise to trade disputes among members. An FTA may specify additional dispute settlement processes beyond those provided in the WTO through the creation of a regional body for this purpose (see Dispute Settlement Mechanism section on page 92). Where this is the case, the rules should establish which parties have standing to bring a dispute to this body, i.e., whether individuals, firms, or nongovernment organizations (NGOs) as well as countries may bring disputes for resolution. In the WTO, member countries are the only parties with such standing.

Global safeguards

GATT Article XIX authorizes members to use safeguard measures to provide temporary protection for a domestic industry when increased imports cause or threaten to cause serious injury to the industry. In contrast to the rules on antidumping measures and countervailing duties (see pages 47 and 48), access to safeguard protection does not require evidence that exporters benefited from unfair trade practices. The inclusion in the WTO of safeguard provisions, which basically allow countries to raise protection in particular sectors, is justified in terms of two functions. First, by allowing a country to pull back temporarily when liberalization causes greater problems than anticipated for domestic import-competing industries, safeguards provide a form of insurance or safety net to countries making liberalization commitments. Second, because internal political forces may push a government to protect a particular sector, safeguards offer a safety valve for protectionist pressure and thus maintain the integrity of the larger relationship. In practical terms, without a safeguard provision, it would be far more difficult to conclude substantive, comprehensive trade agreements. The key is to avoid abuse.

During the GATT era, safeguard protection under Article XIX was used only rarely. Some countries (notably the US and EC countries) applied "gray area" measures to deal with domestic adjustment problems. In cases including footwear, autos, and steel, importing countries negotiated "voluntary" restraint agreements with newer and highly competitive exporters like Japan and the Republic of Korea. The WTO Safeguards Agreement revived interest in safeguards by prohibiting the use of gray-area measures but also set a time limit for any safeguard action through a "sunset clause." However, because Article XIX requires safeguard-imposing countries to provide compensation to countries whose exports are restricted, most safeguards are eliminated before the required sunset review of the measures.

While some FTAs simply indicate compliance with the relevant WTO rules on safeguards, others modify these rules as they apply to trade among themselves. Under Article XIX, these safeguards—now often called "global" safeguards to distinguish them from "special" safeguards discussed below—are to be applied on a nondiscriminatory basis, i.e., according to the MFN principle of the WTO. But just as FTAs depart from MFN treatment in tariffs and other trade barriers, they may accord each other special treatment in the case of safeguards. For example, the Singapore–New Zealand agreement specifies that neither party will take safeguard measures against goods originating in the other, i.e., the partner is to be exempted from any safeguard measure taken under Article XIX. But, as noted earlier, the Republic of Korea–Chile FTA provides no

special status for partners when applying safeguard protection under Article XIX.

The justification for exempting partners is that the aim of an FTA is to achieve a single integrated market, and restricting partner imports as tariffs are being eliminated is a step backward from achieving that goal. On the other hand, exempting FTA partners or other groups (often LDCs are exempted) means that the remaining suppliers outside these preferred groups will be subject to an even larger reduction in access to the safeguarded market, exacerbating the trade diversion. This spillover effect could thus give rise to frictions with other important trading partners.

Transitional and special safeguards

Like global safeguards, these "special safeguards" permit access only when there is evidence of serious injury or threat of serious injury caused by imports, i.e., there is no presumption that exporters have violated WTO norms. Within the WTO, this type of safeguard has been associated with liberalization in a particular sector, e.g., the phase-out of the Multi-Fiber Arrangement, or with the entry of a new member, e.g., the PRC. An FTA sometimes includes a transitional safeguard to provide a "safety net" in case the effect of regional liberalization on an import-competing sector is particularly severe. The injury test would then require not only evidence of serious injury linked to increased imports but also partner imports accounting for a large part of the increase in imports. The Taipei,China–Panama and Thailand-Australia FTAs both include transitional safeguard provisions allowing the relevant tariff to be returned ("snapped back") to the MFN level for a 2-year period to start with. Special safeguards, where included, apply only to a particular sector, often certain agricultural products. For example, NAFTA included not only a long transitional period (15 years) for sensitive agricultural products but also special bilateral safeguards. These allowed the tariff facing a partner to be snapped back to the MFN level for a 3- or 4-year period in the case of actual or threatened serious injury as well as a "substantial" increase in imports from the partner.

Like product exceptions and slower phase-in periods for sensitive products, transitional and special safeguard provisions help achieve acceptance by domestic import-competing industries but also reduce the likely benefits from the FTA once in force. Because safeguards, by their very availability, increase uncertainty about the actual terms of market access, they may reduce incentives for investors to make new commitments that help partners to expand trade along the lines of comparative advantage.

Antidumping measures

GATT Article VI and the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (AD Agreement) allow countries to penalize imports sold in the domestic market "at less than the normal value of the products" when there is evidence that these imports are causing "material" injury to the competing domestic industry. Since antidumping complaints are specific to particular exporting firms in a particular country, the rules represent a departure from the principle of MFN treatment. In cases where dumping is found, import restrictions may be enacted by levying a supplementary tariff (antidumping duty) based on the difference between the import price and the normal value of goods from this source, or by negotiating a "price undertaking" with the exporter, i.e., an agreement to raise the price of the product to an acceptable level.

Dumping occurs when the product is sold at a lower price than at home or at a price below its cost of production, but neither criterion is straightforward in its application. Moreover, the economic justification for antidumping measures in the absence of predation is at best weak; almost all affirmative dumping cases involve pricing behavior that would be legal when practiced by a firm located in the domestic market. Many economists feel that the main case for antidumping policy is political rather than economic, and that the beneficiaries are largely firms reluctant to compete with lower-cost foreign producers. Moreover, in practice antidumping measures often serve as an attractive alternative to safeguard action. The injury criterion is less stringent (material versus serious injury), and no adjustment plan for the domestic industry is required. Moreover, because the injury is attributed to unfair pricing on the part of an exporting firm, antidumping measures entail no compensation of affected exporters and no limit to the length of time that the measures can stay in effect.[67]

Although many FTAs merely stipulate that partners retain their rights and obligations under GATT Article VI and the AD Agreement, some offer more favorable treatment to their FTA partners. Since most alleged dumping would be legal if the sale were carried out by a firm in the domestic market, this favorable treatment is consistent with the goal of creating an integrated market. Notably, EU members may not use antidumping measures against firms in partner countries, though they may pursue complaints if EU competition policy is violated. Australia's agreement with the US contains no chapter on antidumping measures, implying that WTO rules apply without modification. Its agreements with Singapore and Thailand refer explicitly to Article VI but impose additional limits on the use of such measures.

Subsidies and countervailing measures

The WTO Agreement on Subsidies and Countervailing Measures governs the use of countervailing measures when another country's subsidies cause injury to a domestic industry. As in the case of antidumping measures, WTO policy on subsidies allows a departure from MFN treatment. Here, however, the source of the injury to a domestic industry arises from a government's action to provide a subsidy rather than an exporting firm's pricing practices.

Under the subsidies agreement, subsidies requiring recipients to meet specified export targets or to use domestic inputs instead of imported inputs in production are prohibited because they are designed to distort international trade.[68] Outside of agriculture, most export subsidies violate current WTO rules and can be challenged in the WTO.[69] If a prohibited subsidy is not removed, the complaining country can impose an additional tariff (countervailing duty) based on the value of the subsidy provided by the government of the exporting country.

Most other subsidies are categorized as "actionable." Here the complaining country must show that the subsidy is

[67] The Antidumping (AD) Agreement contains a "sunset" requirement establishing that dumping duties should be applied for no more than 5 years unless a review indicates that removing the duty would be likely to lead to the continuation or recurrence of dumping and injury. The sunset provision also applies to price undertakings.

[68] The prohibition on export subsidies does not apply to least-developed countries (LDCs) and developing countries with per capita incomes below $1,000. Developing countries and transition economies are given extra time to eliminate export subsidies and subsidies to import-substituting industries; LDCs are allowed an even longer period to comply.

[69] A goal of the Doha Development Agenda is to phase out subsidies in agriculture as well.

causing an adverse effect on its interests by damaging (i) an import-competing industry, (ii) an export industry that competes in the subsidizing country's domestic market, or (iii) an export industry competing with firms in the subsidizing country for the same third-country markets.[70] Otherwise the subsidy is permitted. If a subsidy does have an adverse effect, it must be withdrawn or its adverse effect removed. Again, if domestic producers are hurt by imports of subsidized products, a countervailing duty can be imposed.[71] Alternatively, the subsidized exporter can raise the price of its products.

Many FTAs have no provisions modifying the treatment of subsidies provided in the WTO. However, Australia's FTAs with Thailand and Singapore go further than the WTO, prohibiting even agricultural export subsidies. This is in accord with APEC best-practice principles, which call for FTAs that "go beyond WTO commitments" by building on existing WTO obligations and exploring commitments in areas not yet fully covered by the WTO.

RULES OF ORIGIN

Rules of origin (ROOs) are a necessity in any preferential trade agreement, including all FTAs. Without ROOs it would be impossible to distinguish products that are eligible for tariff preferences from those that are not. Since FTAs allow members to set external tariffs independently, rules of origin are needed to prevent the transshipment of imports entering the customs territory of the member with the lowest tariff to the other members—a problem that is referred to in the literature of international trade as "trade deflection" (see Box 2.2 on the economics of preferential rules of origin). In essence, an FTA without ROOs would be equivalent to a customs union with the external tariff being that of the member customs territory or country with the lowest MFN tariff, undercutting revenue collection in the members with higher MFN tariffs.

It is important to recognize that governments regard ROOs not simply as a technical device to enforce preferential trade agreements but also as commercial policy instruments.[72]

Preferential Rules of Origin and the World Trade Organization[73]

The failure of the contracting members of the WTO to complete the negotiations aimed at harmonizing non-preferential ROOs, as provided for in the Uruguay Round Agreement (GATT 1994) on Rules of Origin, is an indication not only of the technical complexity of rules of origin but also of the members' desire to retain autonomy in setting product-specific ROOs to protect their industries. The refusal of contracting members to even negotiate the harmonization of preferential ROOs confirms the reservation of such rules as commercial policy tools—indeed as tools of protection of special interests and "sensitive" products.

Annex II (Common Declaration with Regard to Preferential Rules of Origin) to the Agreement on Rules of Origin (GATT 1994) is a nonbinding statement that WTO members shall clearly define

[70] An obvious example of this latter actionable subsidy would be the US' (successful) complaint against the EU for its subsidies of soybean exports to third markets.

[71] Developing countries receive preferential treatment if their exports are subject to countervailing duty investigations.

[72] Vermulst and Waer (1990) provide examples of product-specific rules of origin from the EC that are, in effect, instruments of commercial policy.

[73] This section draws on James (2005).

Box 2.2: **Economics of Preferential Rules of Origin**

Rules of origin (ROOs) are needed in any preferential trade agreement to determine which goods are eligible for preferential tariff treatment and which are not. Without ROOs it would be difficult to maintain the integrity of independent tariff regions in a free trade agreement (FTA) because of "trade deflection," or the transshipment of imported goods from nonmembers through the member country with the lowest most-favored nation (MFN) tariff rates. There is likely to be a trade-off between prevention of trade deflection and trade creation, assuming that member countries are able to administer ROOs effectively. The more restrictive the ROOs, the less is the potential for trade deflection. But this comes at a cost. Firms must choose whether or not to comply with ROOs, as documentation and accounting efforts may add the equivalent of 1.5–6.0% of the ex-factory price, or production cost of the goods receiving preferential tariff treatment. If the difference between MFN and preferential tariffs (referred to in the economics literature as the "margin of preference") is less than the cost of compliance, firms will simply ignore the ROOs and continue with shipments paying the MFN tariff, and the preferential agreement will be ineffective in boosting intra-FTA trade.

One measure of the effectiveness of a preferential trade agreement is the extent to which member partners' trade avails itself of the preferences or the utilization ratio (the volume of preferential trade divided by total intra-trade in an FTA). Typically, FTAs involving developed member countries such as the European Union or North America Free Trade Agreement have higher utilization ratios than those involving developing countries (e.g., ASEAN). One must be cautious in interpreting the economic welfare effects of increased intra-regional trade, as they may be due to welfare-improving trade creation or welfare-reducing trade diversion (see Part I). ROOs may also have an impact on firms' investment decisions in terms of choice of location for manufacturing processes or sourcing decisions. This is a relatively new theme and is at the frontier of research pertinent to FTAs.

The "spaghetti bowl" or Asian "noodle bowl" problem arises when a country enters into numerous bilateral FTAs with inconsistent, complex, and overlapping ROOs. Firms wishing to take advantage of more than one FTA may be faced with the difficulty of complying with inconsistent rules of origin and may literally have to invest in a separate production line for each FTA. Customs authorities may also have difficulty in administering multiple sets of ROOs in determining the eligibility of goods for reduced tariffs. The advantages provided by preferences dependent on customs rulings may encourage corruption and rent-seeking behavior. Hence, economists recommend that ROOs be consistent across agreements and be kept as simple and transparent as possible (Part I).

Source: James (1998); James (2006)

the ROOs in any contractual or autonomous trade regime that provides for preferential tariff treatment beyond the application of paragraph 1 of Article I of GATT 1994 (principle of nondiscrimination). The Common Declaration also stipulates the timely provision of preferential ROOs by members to the WTO Secretariat and the publication of such rules (and any changes) by members as if they were subject to paragraph 1 of Article X of GATT 1994. Upon request, members must provide assessments of origin for the purpose of obtaining preferences to interested parties within a set period (no longer than 150 days) and the assessments must remain valid for 3 years.

As the Interpretation and Application of Annex II finds "no jurisprudence or decision of a competent WTO body," there are no binding disciplines over WTO members concerning preferential ROOs. The APEC organization has suggested the adoption of best-practice principles in RTAs, FTAs, and other preferential arrangements.[74] APEC advocates the adoption of simple ROOs that facilitate trade. This implies that ROOs do not have high compliance costs for business and that each APEC member as far as possible adopts consistent rules of origin across its own preferential agreements. The APEC also notes that ROOs should be designed with a view to maximizing trade creation and minimizing trade distortion so that APEC members can promote regional integration and not disrupt efficient global production networks.

[74] APEC (2004) sets forth proposed best practices in RTAs/FTAs that APEC members are party to.

Table 2.1: **Product Origin—Wholly Obtained Principle**

Type of Tradable	Principle/Criterion
Primary	Wholly obtained in a single customs territory/country
Agricultural Goods	Unprocessed and harvested within customs territory/country
Marine Fisheries (outside territorial waters of member country)	Ownership of vessel/means of catch
Forestry Products	Unprocessed and harvested within customs territory/ country
Mineral Products	Extracted within territory or seabed in territorial waters
Scrap/Waste Products	Collected within and fit only for recovery of raw materials

Source: Author's compilation.

Table 2.2: **Tests for Determining Origin of Processed or Manufactured Goods**

Test for Processed/ Manufactured Goods	Principle of Last Substantial Transformation
Change in tariff heading (CTH) or change in tariff subheading (CTSH) test	A change from any four-digit HS chapter to any other four-digit HS chapter (six digits for CTSH)
Specified process test	Any manufacturing process deemed to confer origin
Value-added (percentage) test	Minimum regional content or maximum non-originating content
Mixed tests	SP test and CTH test; CTH test or value added test, or both

Source: Author's compilation.

Methods of Determining Product Origin

The determination of product origin for primary products and scrap or waste is fairly straightforward and is subject to the criterion of being wholly obtained in the territory of the country in question (see Table 2.1). Several caveats arise in marine fisheries and ocean-bed mining, however. Products obtained outside the territorial limits of a coastal entity may gain the origin of the vessel or platform that is used to extract, capture, or otherwise obtain the product in question.[75]

For manufactured and processed goods, the determination of origin is more complex and controversial, particularly for products with intermediate inputs and processing or manufacturing operations taking place in two or more countries or customs territories. The Kyoto Convention of the Customs Cooperation Council (now known as the WCO) of 1973 set forth the principle of a "last substantial transformation" for determining product origin in the case of processed and manufactured goods. Three types of tests were agreed on as applicable in satisfying (potentially) the principle of a last substantial transformation. These are (i) a change in tariff heading (CTH) test, (ii) a specified process (SP) test, and (iii) an ad valorem or percentage test. These tests and their permutations are shown in Table 2.2.

Examples of Alternative Tests for Substantial Transformation

A CTH test is used to determine origin if the manufacture or processing undertaken results in a product coming under a four-digit HS number different from the numbers under which the non-originating components or articles fall (Imagawa and Vermulst 2005: 607). For example, country A imports raw leather hide from country B (HS 41.01) and uses it to produce tanned leather hide (HS 41.06), which it then exports to country C. Country B is the origin of the product imported by country C. When the test is applied at the six-digit HS code this is known as a CTSH test. For example, under the Canada-US Free Trade Agreement of 1989, tomato paste (HS

[75] Whether a territory is confined to the 12-mile limit or to the extended limit provided for in the Law of the Sea is disputed. Whether the flag of the vessel or its actual ownership and control confers origin is also in question (Imagawa and Vermulst 2005).

2002.09) imported by Canada from Chile and used to produce catsup (HS 2103.20) that is later exported to the US originates in Canada and receives preferential treatment in the US. However, NAFTA adopted a rule of origin specifying that catsup (HS 2103.20) obtains its origin when transformed from any six-digit HS chapter *except from subheading 2002.09 (NAFTA Volume II, Annex 401-8, 1993)*. Hence, Canada can no longer import tomato paste from a source outside NAFTA and receive preferential treatment under NAFTA rules of origin. The 13.6% US MFN tariff on tomato paste put Chilean tomato paste at a distinct disadvantage versus Mexican tomato paste.[76]

The ad valorem or percentage criterion test may take place in any one of three forms (Imagawa and Vermulst 2005: 605): import content, domestic/regional content, or value of parts. The test specifies a maximum non-originating content or a minimum regional or domestic content requirement as a percentage of the FOB or ex-factory price of the product that must be reached if a product is to satisfy the last substantial transformation principle in the last territory where the product was processed or manufactured. The percentage test may or may not allow cumulation among members,[77] but allowance of cumulation is clearly more liberal than its disallowance. In the case of the Japan-Malaysia Economic Partnership Agreement (JMEPA), the following formula is applied in a percentage test:

QVC = [(FOB–VNM) / FOB)] * 100

where: QVC is the "qualifying value content" of a good as a percentage of its FOB value of a good payable by the buyer to the seller regardless of means of shipment (excluding taxes and duties), and VNM signifies the "value of non-originating material" used in the production of the good.

Item	Origin	Cost($)
Part A	Japan	100
Part B	Japan	100
Part C	Malaysia	400
Part D	India (non-originating)	300
Part E	Republic of Korea (non-originating)	500
Part F	PRC (non-originating)	400
Other Costs		200
FOB Price		2,000

$$QVC = \frac{\$2{,}000 - \$1{,}200 \text{ (Parts D, E, and F)}}{\$2{,}000} \times 100 = 40\%$$

In the case of JMEPA, the QVC must be 40% or greater for the item to attain origin in the region. JMEPA allows regional cumulation to reach the required minimum QVC percentage. An example of the application of this rule to a color-television receiver is given as follows (JMEPA 2006: Operational Procedures):

Thus, according to the JMEPA rules of origin, the color TV is eligible for preferential tariff treatment.

A technical or specified process test rounds out the acceptable criteria under the WCO Kyoto Convention. This test provides a detailed description of production or sourcing processes that do (positive test) or do not (negative test) confer origin. In most cases, simple

[76] This example is originally cited in Vermulst, Waer, and Bourgeois (1994).

[77] "Cumulation" allows value added for a group of countries rather than just in the exporting country. For example, suppose that product A produced in Singapore uses 50% of its inputs from Malaysia. When exported to a country with which Singapore has an FTA, allowance for ASEAN cumulation would suggest that 100% of the content would be accepted (and, hence, the produce would certainly qualify for preferential treatment), whereas with no ASEAN cumulation only 50% would qualify.

packing and unpacking operations are not sufficient to confer origin. Normally such negative test criteria are accompanied by a positive test to provide more certainty to businesses.

A technical test is frequently applied to preferential agreements in textiles and apparel. For example, the Japanese economic partnership agreements with Malaysia, the Philippines, Thailand, and Singapore apply a "double jump" or two-stage processing test requiring that apparel be produced either from fabric that is first dyed or printed in a member (stage 1), and then assembled into an article of apparel (stage 2). Alternatively, if originating yarn is used to produce fabric, then even if dyeing and printing processes are carried out in a nonmember, the test is satisfied, provided that the fabric is also woven and assembled into a garment article in a member country. The double-jump requirement in Japan's agreements is applied in a way that is rather liberal in that the processes need not be completed in only one country but may occur in both members. Furthermore, Japan allows any process occurring within ASEAN to count toward the double-jump test (i.e., "cumulative origin"). For example, if yarn from outside the region is woven into cotton cloth in Malaysia and the cloth is then cut and assembled into garments in the Philippines, the article becomes eligible for preferential treatment.

There is no perfect or universal test for determining the origin of a good produced in two or more locations. For this reason, it is important that agreements provide clear definitions of rules of origin and publish these rules. The CTH or CTSH criterion must clearly specify the HS chapter tariff headings or subheadings that are addressed by the rule. The percentage or ad valorem criterion must indicate the formula for calculating the percentage of originating and non-originating material and clearly define the price being used as the denominator. The SP or technical test criterion must be based on a positive standard and must precisely set out the operation that confers origin (negative standards may be set out to clarify the positive standard).

Administrative Requirements

It is quite useful for an FTA to include an annex with examples and guides for firms and traders. These may be set out in an operational manual on rules of origin containing illustrations and practical examples of the application of each type of test and any supporting documentation that the customs requires. The manual should have specimens of the required documents, including certificates of origin. JMEPA provides a detailed annex with administrative procedures for obtaining and completing certificates of origin (COOs) including procedural matters with regard to administration and enforcement of ROOs. The annex gives detailed information on seven rules associated with COO modification and minor errors, loss, or theft, as well as related provisions with regard to shipments that may pass through a third party. Four rules are also set forth to clarify administration and enforcement, including offices responsible, stamps and specimens of signatures and stamps used by the administering authorities, offices responsible for advance customs rulings, and matters pertaining to communication between responsible authorities.

The annex also contains appendixes with specimens of the COOs and instructions for completing the COO forms, examples of the calculation of the percentage of qualifying value content, and a clarification of product-specific ROOs including de minimis provisions; examples of documents required when

using ASEAN cumulation provisions; and a description of operations for dyeing or printing processes for textiles and clothing items (HS 50–63). In general, the inclusion of such a detailed annex on administrative aspects of ROOs greatly increases transparency and facilitates the use of agreements by private enterprises.

Rules of Origin for Services

FTAs are increasingly providing preferential access for commercial services in addition to goods. While there are no generally accepted principles or criteria for identifying the origin of a service, six types of tests tend to be used: nationality of service provider or service-providing entity, residency test, value-added test, ownership test, intellectual input control test, and "mixed" tests.[78]

In general, service agreements (notified under Article V of GATS) may extend preferences to any or all four modes of supply of commercial services (see Trade in Services section below). The ROOs for services would have to take into account which of the four modes of supply is relevant in the provision of the service.

Setting rules for determining the country of origin of an internationally traded service is essential for the implementation of an FTA notified under Article V of GATS. To the extent that countries demand reciprocity in extending MFN treatment to services (implying discriminatory barriers to countries not providing reciprocal access to their markets[79]), ROOs are again necessary. Article II of GATS codifies unconditional MFN treatment but allows members to maintain discriminatory measures, provided that these are listed and are consistent with conditions set forth in the Annex to Article II.

The principle of last substantial transformation, which is used to provide a basis for the tests used to determine the origin of manufactured goods, is irrelevant to international service transactions (Kingston 1994). This problem results from the difficulty in evaluating the different components that make up a service and the fact that the nationality of a service-providing firm or entity may not reflect the ownership and control of the firm or entity.

Of the six possible ways of determining the origin of a service outlined above, most countries adopt an ROO based on residency or ownership and control of the service-providing entity or, in cases where establishment is unnecessary, on the control of the essential input without which the service cannot be provided. The latter is simple in the case of services provided by natural persons. In contrast, determining non-originating value added of a service is likely to be extremely difficult. Similarly, if foreign investment is required to provide a service through establishment, the origin rule by residency test is rather straightforward. Residency is simply the place where the service firm is incorporated, provided the firm has a substantial presence in that location (Hufbauer and Schott 1993: 61). Selecting the origin of cross-border services, particularly network services, presents a difficulty similar to that encountered in determining the country of origin of a good produced in several locations in a global production and distribution network. In general, simple and transparent ROOs based on the residency test or ownership and effective control of the service are desirable on efficiency and fairness grounds.

[78] This section draws on James (1998).
[79] This is known as "conditional MFN treatment" (Grey 1990).

Costs of Compliance and Preferential Rules of Origin

Compliance with ROOs imposes costs on firms and traders. Firms must decide whether the benefits of receiving preferential tariff treatment are greater than the costs of complying with the ROOs.[80] Costly and complex rules of origin are an important consideration. This is accentuated when a large and important economy such as Japan, the EU, or the US negotiates numerous separate bilateral FTAs with differing sets of rules of origin. Development of "hub and spoke" systems of FTAs, where the hub economy has preferential access to each spoke but spokes lack connection, can isolate spokes, divert trade and investment, and raise trade costs (ADB 2006). Consistent and clear ROOs are desirable in avoiding the development of hub-and-spoke systems but such an outcome is unlikely when industry interest groups lobby for ROOs designed to protect their interests. Indeed a review of ROOs in bilateral agreements involving major Asian hub economies (Japan, Republic of Korea, PRC, Singapore, and Thailand) revealed that ROOs vary not only across hubs but even within hub-and-spoke systems (James 2006). The "spaghetti bowl" problem of complex, inconsistent, and overlapping ROOs is therefore on the rise and is likely to get worse before it gets better.

The costs of ROOs can be conceived of as being a direct addition to a firm's costs in the sense of requiring the firm wishing to avail itself of tariff preferences to incur added costs. For example, keeping records of all shipments of inputs and their prices in production is necessary to establish compliance with a value-added rule. However, the costs may also be indirect. For example, if firms are required to make fabric from originating yarn and to cut, trim, and assemble garments within the member territories under the SP test for textiles and apparel, this will discourage them from locating production outside the FTA, even if certain processes could be done at lower cost. Indeed, ROOs may discourage firms from undertaking outward processing arrangements in locations that would otherwise benefit them through low-cost, labor-intensive operations.

The CTH test is widely adopted as the basis for ROOs for processed primary goods and manufactured products in the WTO. However, the test is not perfect. First of all, the HS tariff classification was not designed with ROOs in mind, nor has any other tariff classification system been so designed. This means that products may undergo a last substantial transformation without changing tariff heading, particularly within machinery sectors where assembly is a very substantial transformation but does not constitute a CTH. In such cases, a CTSH rule may be used at the HS six-digit level, but this is usually supplemented by a minimal regional content or value-added rule. The value-added requirement is usually set high enough to discourage firms from outsourcing production to lower-cost non-members, thus indirectly adding to production costs. Second, tariff schedules used for purposes of CTH become obsolete and must be constantly revised and updated every 5 years.

[80] There are few ex post studies of the costs of compliance with rules of origin. See, for example, Productivity Commission (2004). The study estimated that costs of compliance with ROOs in the Australia–New Zealand Closer Economic Relationship (CER) were about 1.5–6.0% of the ex-factory price of manufactured goods. Herin (1986) reports that the costs of compliance with EC ROOs led one fourth of export firms in the EFTA to simply forgo attempting to comply. Palmeter (1993) finds the cost of compliance with EC rules of origin to be equivalent to 5% of production costs.

Countries often exercise large amounts of discretion in applying the CTH test and in selecting processed or manufactured products with rules of origin that are exceptions to a CTH or CTSH test.

The value-added test is widely regarded as the most objective test, but this is the case only if clear accounting principles are applied uniformly. The test sets a minimum threshold for regional content necessary to confer origin but may also set a maximum threshold for non-originating content as a percentage of the good's price. Price itself is variously defined as ex-factory, FOB, and CIF price in codes of rules of origin. The lack of precision of CTH-based rules often leads to the application of the value-added test as a supplement or as an alternative to the CTH rule for manufactured products. One drawback to the value-added rule is that higher value-added requirements are more difficult for less-developed countries to achieve than for more-developed countries, particularly where the former are engaging in labor-intensive activities using imported intermediate products.

The SP test is used in cases where product value chains are complex and operations take place in two or more countries. The SP rule is supposed to be based on a positive standard, that is, a statement of operations or processes that do confer origin, and not of those that do not.[81] However, in many cases the SP test can be used as a commercial policy instrument designed to protect domestic producers rather than as an objective test of rule of origin. The SP test is used often in HS Chapters 50–63 covering textiles and apparel and may involve a two-step ("double jump" such as fiber to fabric or yarn to clothing) or even a triple transformation. For example, to comply with the NAFTA rules of origin (see Box 2.3) clothing items must be cut and assembled from fabric that contains only yarn originating within the member countries, subject to a maximum of 7% by weight non-originating fabric or yarn. The exemption of the 7% is under the de minimis provision that allows a certain exemption by weight of various types of non-originating material (such as certain types of fabric or fiber in textile fabric and clothing that are not produced within the FTA), but careful and costly accounting is required of firms in complying with these requirements.

Cumulation and Flexibility in Satisfying Rules of Origin in PTAs

For developing countries to enjoy the benefits of preferential market access under unilateral preference schemes like the Generalized System of Preferences (GSP) and other preferential trade schemes, the EU, Canada, and Japan have modified their ROOs to allow "cumulation" between developing countries, in the form of value-added (as in Canada's GSP) or cumulative operations (as in the double-jump or two-stage processing ROOs in Japan's and EU's GSP). The US has also shown some flexibility in allowing apparel from sub-Saharan African countries to use non-originating fabric up to a limit under the African Growth and Opportunity Act. Japan allows ASEAN cumulation in its GSP rules of origin (that is, operations within ASEAN countries count toward regional content requirements) and its economic partnership agreement with Malaysia also allows operations that take place in another ASEAN country to count toward the double-jump rule for textiles and clothing. The EU has adopted a Pan-European Cumulation System (PECS) that permits inputs from any territory with an association agreement to be added to inputs from within the EU in

[81] However, the latter may be used to clarify a positive standard.

Box 2.3: NAFTA Product-Specific Rules of Origin—Textiles and Apparel

The North American Free Trade Agreement (NAFTA) of 1993 provides for special rules of origin (ROOs) for intra-NAFTA trade in fibers, yarns, textiles, and clothing. The agreement states that it takes precedence over all other agreements members have with regard to trade in textile products (including the Multi-Fiber Arrangement). Stipulating the immediate elimination of US import quotas on textile products from Mexico, NAFTA prohibits the imposition of new quotas on such goods, except as provided for in the safeguard provision during a "transition period."

One of the most interesting and most restrictive provisions of the NAFTA special ROOs is the adoption of a "yarn-forward" rule for most textile products. This rule requires textile and clothing products to be produced from yarn that originates within NAFTA member countries to benefit from preferential treatment. For clothing made from cotton or man-made fiber yarns, however, the rule is "fiber-forward." For such clothing articles a "triple transformation" is required: from cotton or man-made staple fibers to yarn, from yarn to fabric, and from fabric to clothing or made-up articles of textiles. For certain types of imported fabrics that are not produced within the NAFTA textile industry or that are deemed to be in short supply (particularly silk, linen, and certain shirting fabrics) exceptions are allowed. A de minimis provision also allows clothing using no more than 7% by weight of non-originating fabrics to qualify for preferences.

Source: NAFTA; James (2006).

meeting the value-added criterion for duty-free access.

Allowing firms to choose between complying through a CTH or CTSH test or meeting a minimal regional content requirement is an innovation in Japan's economic partnership agreements with Indonesia, Malaysia, the Philippines, and Singapore (see Appendix to Part II for Malaysia and the Philippines). Firms may comply through either type of test; this arrangement is more flexible than the "all or nothing" approach to rules of origin. An additional bit of flexibility could be gained in the case of value-added rules if the rule could be satisfied by taking the average percentage of regional content or of non-originating content over a number of shipments within a specified time frame (say, 1 year) rather than requiring every individual shipment to satisfy the value-added test.

TRADE IN SERVICES

While various models exist in FTAs pertinent to liberalizing trade in services, there is broad convergence on concepts, approaches, and disciplines. Many of these find their origin in the GATS but there has also been much experimentation over the last 10 years. A key element that distinguishes preferential trade in services is the approach to liberalization. Distinctions tend to be drawn, depending on whether a GATS-type or a NAFTA-type approach has been followed.[82] This section explains the key concepts and approaches in both models (including various hybrids). It begins by explaining how trade in services occurs and the types of preferences that can be negotiated through an FTA. It then examines the conformity requirements of Article V of the GATS and the usual provisions that are contained in the services chapter of an FTA. This provides the basis for explaining the various approaches used in FTAs to negotiate and schedule market access and national treatment commitments on services.

Preferential Trade in Services: Key Questions and Concepts

How are services traded across borders?

Understanding the different ways by which services are traded internationally is a fundamental starting point. For trade in goods, the exchange is relatively straightforward since goods are tangible

[82] See Organisation for Economic Co-operation and Development (OECD) (2002), Stephenson (2002), and Marconini (2005).

Box 2.4: How Services are Traded—The Four "Modes of Supply" in the GATS

Virtually all free trade agreements (FTAs) follow the General Agreement on Trade in Services (GATS) definition of trade in services. The GATS does not define what services are but defines instead the four modes of service delivery.

Mode 1: Cross-Border Supply

The service itself crosses the border, rather than the producer or consumer. Examples include services provided via post or the Internet.

Mode 2: Consumption Abroad

The service consumer crosses the border to where the service supplier is located to purchase and consume services. Examples include holidays abroad, foreign education, and overseas health care.

Mode 3: Commercial Presence

The service supplier establishes a commercial presence through a foreign-owned affiliate, subsidiary, or representative office in the country where the consumer is located. Examples are a French bank operating in Thailand, or a Malaysian telecommunications company in Malawi.

Mode 4: Movement of Natural Persons

A service supplier, in the form of a person, enters a foreign market to supply a service. The service supplier can be an independent supplier (e.g., a consultant, a health worker) or an employee of a service supplier (e.g., a consultancy firm, a hospital, a construction company). A nurse from the Philippines working on a contract in Japan, for instance, would be a natural person who moves to another country to supply a service for a defined period of time.

Source: World Trade Organization (WTO) website. Available: www.wto.org; author's compilation.

objects that can be stored, packaged, and transported across borders. Services, on the other hand, are by definition intangible and can be transacted and traded in more ways than goods. Some services can be exchanged across a border without either the producer or consumer moving. Examples are the use of the Internet to provide online services like distance learning, e-banking, hotel reservations, telemedicine, as well as many other Internet-based services. However, for some other services, the producer and the consumer of that service have to meet for the transaction to take place. This is because the service is often not created until it is delivered. To achieve this proximity, either the producer has to move to the consumer, or the consumer has to move to the producer (see Box 2.4 for the four modes of supply under the GATS).

While the four modes of supply defined in the GATS have been criticized for not necessarily reflecting transactions in real life, where a service may be delivered through more than one mode, most FTAs still use them as the basis for scheduling commitments. The share of individual modes in world trade in services has been estimated at: 40% each for modes 1 and 3, 20% for mode 2 (mainly tourism), and less than 2% for mode 4.[83] Mode 3 trade, mostly combined with FDI, has been the most dynamic component in recent years.

The advantage of distinguishing between the four modes of supply is that it gives flexibility to negotiators to liberalize only a certain type of activity within a sector. The existence of four possible ways of delivery, however, makes the structure and content of the services chapter of an FTA more complex than that of the goods chapter.

What are barriers to trade in services and how are preferences granted?

Unlike trade in goods, preferential treatment in services is granted not through tariffs but through the removal of regulatory restrictions on foreign services and service suppliers.[84] Many restrictions on foreign services and service suppliers typically occur in

[83] WTO Secretariat.

[84] See Sauve and Mattoo (2003) for a discussion of preferences in regional trade agreements that cover services. See also Goode (2005) for an explanation of the difference between eliminating discrimination and liberalizing trade.

technical regulations, licensing, and qualification requirements. Some of these restrictions may be discriminatory, with foreign providers having to fulfil more demanding or burdensome requirements than domestic providers. Others may be non-discriminatory since they apply equally to both domestic and foreign providers. Preferences are granted when discriminatory restrictions, such as national treatment restrictions on foreign ownership, the type of legal entity allowed, branching rights, performance requirements,[85] nationality, or citizenship requirements for managers, are eased or removed for an FTA party but not for non-parties. Similarly, preferences may occur when quantitative restrictions on service output or on the number of service suppliers are completely removed, or a larger quota is allocated, but only for an FTA party.

An important feature of reducing barriers to trade in services is that, unlike reducing barriers to trade in goods, it does not lead to a loss of tariff revenue. The removal of discrimination usually happens through a change in domestic legislation, the conclusion of mutual recognition agreements, or the harmonization of national laws and regulatory practices. Hence, implementing preferences in services may not always be easy or feasible. The nature of service regulations is such that many service restrictions, once removed for one country, may not continue to be applied to others, given the difficulty of putting in place different regulatory regimes for suppliers from different countries.[86] This means that many service sector reform measures, agreed to in the context of an FTA, could be relatively easy to "multilateralize" (that is, extend to all partners). It would, of course, generally increase economic benefits to do so.

Conformity with Article V of the GATS

When negotiating preferences in the context of an FTA, the parties need to be mindful of the requirements of Article V (economic integration) of the GATS (see Box 2.5). Article V, formally speaking, refers to economic integration arrangements and, unlike the counterpart Article XXIV provision of GATT, does not distinguish between customs unions and free-trade areas.

Article V does not define what might constitute "substantial sectoral coverage." It simply notes that the phrase is to be understood in terms of the number of sectors, volume of trade, and modes of supply, and that there should be no a priori exclusion of any mode of supply.

"Absence or elimination of substantially all discrimination" requires the parties to an FTA to remove measures, usually contained in laws and regulations, that discriminate against foreign services and suppliers. This condition is to be satisfied through the removal of existing discriminatory measures or the prohibition of new or more discriminatory measures, or both. It is important to note that what is being required is the removal of discriminatory treatment arising from the regulation and not the regulation itself. A timetable can be established for removing discrimination. Measures concerning payments and transfers, the safeguarding of the balance of payments,

[85] Performance requirements are measures that impose certain requirements on the way investors operate their business. These can include the proportion of output that must be exported, the amount of inputs that must be sourced locally, or requirements related to the transfer of technology. These measures, which affect trade in services, are typically prohibited in the investment chapter of an FTA. The WTO Agreement on Trade-Related Investment Measures also prohibits many of these measures. Under the General Agreement on Trade in Services (GATS), performance requirements, if they are to be maintained, have to be scheduled as market access or national treatment limitations.

[86] See Roy, Marchetti, and Lim (2006) for a discussion of why preferential arrangements could potentially be less harmful in services than in the goods trade.

Box 2.5: Meeting the Requirements of GATS Article V

Article V of the General Agreement on Trade in Services (GATS) permits World Trade Organization (WTO) member countries to conclude free trade agreements (FTAs) provided that certain requirements are met. The FTA has to provide for

(i) substantial sectoral coverage;
(ii) the elimination of substantially all discrimination in the sense of national treatment; and
(iii) not raising barriers against nonmembers as result of the agreement.

All three conditions are cumulative and have to be satisfied concurrently.

Rules of Origin and Developing-Country Flexibilities

Also contained in Article V is a liberal clause on rules of origin and additional flexibilities for developing countries. A service supplier from a third country incorporated in one of the parties to the FTA must be allowed to enjoy preferential treatment within the FTA as long as it engages in substantive business operations within the territory of the parties.

Developing countries have more flexibility in fulfilling the conditions of substantial sectoral coverage and eliminating discriminatory measures.[a] In agreements consisting entirely of developing countries, more favorable treatment may continue to be given to firms owned or controlled by their own nationals.

Notification Requirements

WTO members concluding FTAs in services must notify these agreements, and any subsequent enlargements or significant changes, to the WTO Council for Trade in Services. While the council is mandated to examine these notifications for their conformity to Article V it has, to date, not launched any conformity examinations. Under current practice, notified FTAs are forwarded by the Council for Trade in Services to the Committee on Regional Trade Agreements (CRTA) for any eventual examination. With the adoption of a new regional trading agreement transparency mechanism by the General Council on 14 December 2006, the WTO Secretariat is mandated to submit a factual report for discussion by WTO members in the CRTA.[b]

[a] It is not clear from GATS Article III(a) whether that flexibility also extends to developed countries that enter into agreements with developing countries, though the presumption is that it applies only to parties that are developing countries.

[b] The transparency mechanism is implemented provisionally. Members are to review, and if necessary modify, the decision, and replace it with a permanent mechanism adopted as part of the overall results of the Doha Round. The decision is available at www.wto.org/english/news_e/news06_e/job06_59rev5_e.doc

Source: WTO website. Available: www.wto.org.

general exceptions, and security exceptions may be maintained.

While an FTA lowers barriers between the parties to the agreement, it must not at the same time raise the overall level of barriers faced by nonparties as compared with the situation before the agreement. If significant changes occur, WTO members affected by them may seek compensation or even withdraw some of their MFN commitments.

Article V is meant to ensure that the FTA, although it may be discriminatory, contributes to further liberalization at the multilateral level. In practice, assessing conformity with Article V is difficult for a number of reasons. For one, there are severe data limitations on the service trade, making it almost impossible to accurately assess the volume of trade covered by an FTA on services.[87] There is also no agreement on the meaning of "substantial sectoral coverage" and "substantially all discrimination." Moreover, since Article V allows discrimination to be eliminated within a reasonable time frame, questions may arise as to what is "reasonable." These same questions have emerged in the context of the GATT/WTO Article XXIV in the context of goods. However, one should not make too much of these difficulties. An ordinary reading of the word "substantial" indicates that the FTA should be comprehensive in its coverage (not exclude sectors) and should remove nearly all discrimination between the parties. An FTA that reproduces commitments in the GATS with only a limited number of improvements would, on the face of it, not qualify. A "reasonable" time frame should also be one where phaseout periods are kept to a strict minimum.

[87] See Fink and Warren (2000).

Contents of a services chapter: scope, coverage, general disciplines, market access, and national treatment

There is a strong degree of convergence between FTAs and the GATS in scope, coverage, and general disciplines. FTAs also tend to follow the GATS structure of a framework of rules and disciplines and individual schedules of commitments. In some FTAs, additional sectoral commitments are taken in financial services, telecommunications, and the temporary movement of natural persons. It is also increasingly common for service-related disciplines to be found in separate chapters on investment, competition policy, and government procurement. In FTAs that follow a "negative list" approach (see below the discussion of scheduling approaches), the schedule of commitments typically includes reservations on existing and future nonconforming measures.

Scope and Coverage. Many FTAs follow the GATS and exclude air traffic rights and services supplied in the exercise of governmental authority from the agreement. Following GATS Article 1(3), governmental authority is defined as services provided neither on a commercial basis nor in competition with other suppliers. Other common exclusions are government procurement, subsidies, and grants. Similar to the GATS, the norm is also for FTAs to cover all measures affecting trade in services at all government levels including sub-federal authorities and nongovernment bodies exercising delegated authority.

There are some exceptions. In the NAFTA-type FTAs, measures taken by local governments (municipal level) are usually excluded, and air transport, although carved out of the services chapter, is covered by the investment chapter as far as mode 3 is concerned.

General Disciplines. After specifying scope and coverage, FTAs tend to contain a common set of general disciplines, usually derived from the GATS, on MFN treatment, transparency, payments and transfers, monopolies and exclusive providers, domestic regulation, safeguards, subsidies, government procurement, recognition, rules of origin, and general exceptions. Apart from a few innovations, there is often little difference between the FTA and GATS provisions on these general disciplines.

(i) **Most-favored-nation clause.** All FTAs tend to contain an MFN clause, which usually requires the parties to the FTA to provide treatment no less favorable than that accorded to non-partners. The purpose of this clause is to ensure that no party to the FTA will be disadvantaged if any other party to the FTA negotiates better concessions in another agreement with a nonparty. This is an interesting clause, as it essentially ensures that whenever an FTA commitment is negotiated, the parties can avail themselves of the best preferential treatment that its FTA partner is providing or may provide in any of its subsequent FTAs. There may, however, be legal and operational issues to consider when negotiating such clauses, since they may be providing a guarantee that extends beyond what the party originally intended. There is also the issue of the feasibility and consistency of extending MFN treatment between FTAs that may have significant differences in structure and content.

(ii) **Transparency.** As is the case under the GATS, FTAs typically contain obligations to publish relevant

measures and notify new (or changes to existing) measures affecting trade in services and to establish national inquiry points to provide information on measures affecting the service trade upon request. An innovation in FTAs involving the US is a clause requiring the opportunity for prior comment on proposed changes in service regulations.

(iii) **Monopolies and restrictive business practices.** Since some services are supplied by a monopoly provider in many economies, the FTA usually needs to specify what these services are and the extent to which competitors may supply ancillary services. It is also common to guarantee foreign service providers access under nondiscriminatory conditions to the services provided by a monopoly. There may also be additional transparency requirements including the obligation to provide additional information on the request of a party. In some FTAs, disciplines on monopolies and restrictive business practices are contained in a separate chapter on competition policy.

(iv) **Transfers and payments.** It is usually standard for FTAs to contain a clause that prohibits restrictions on transfers or payments subject to prudential exceptions. However, FTAs following the NAFTA model and AFTA, for instance, allow restrictions in the event of serious balance of payments and external financial difficulties. This is similar to GATS Article XII. In the Australia-Thailand FTA, the prohibition is restricted only to the extent that the restrictions would affect scheduled commitments.

(v) **Recognition.** An increasingly important feature of FTAs is mutual recognition agreements (MRAs) for professional services. An example of an MRA is the requirement in FTAs following the NAFTA model under which the parties are required to give equal opportunity to members of the agreement and eliminate citizenship or residency requirements for recognition or licensing within 2 years. AFTA allows for the recognition of equivalency in educational requirements or experience in the granting of licenses or certifications. GATS Article VII on MRAs requires WTO members that have either begun or concluded negotiations to notify the Council for Trade in Services and to provide adequate opportunity to any other WTO member to negotiate its accession to such an agreement. In practice, many countries appear to have taken the line that MRAs negotiated as part of an FTA are exempt from the Article VII requirement. It is argued that as the MRA was negotiated in the FTA, it falls under the Article V exception and Article VII does not apply. On the other hand, since the GATS does not explicitly provide for a link between economic integration agreements and recognition, it could also be argued that Article V does not exempt WTO members from their Article VII obligation.

(vi) **Rules of origin.** Unlike trade-in-goods, FTAs usually have liberal ROOs for services (reflecting the requirement in Article V). Third-country investors, provided they have substantial business operations in one of

the FTA parties, benefit from the preferential treatment. More details were covered in the Rules of Origin section above.

(vii) **Domestic regulation.** The provisions are often the same as those of the GATS. There has been no progress made in FTAs on sensitive issues like the "necessity test."

(viii) **Safeguards, subsidies, and government procurement.** In general, there has been little progress in FTAs on "unfinished" rule items like emergency safeguard measures and subsidies. The safeguard clause in FTAs typically refers to negotiations in the WTO. Negotiations on emergency safeguard measures in the WTO have, however, been inconclusive so far. On subsidies, with the exception of the EU and the Australia–New Zealand Closer Economic Relations, FTAs have not established any dedicated disciplines on subsidies.[88] Moreover, subsidies and grants are typically carved out from the scope of the general disciplines. There has been relatively more progress on government procurement, though this tends to feature in a separate chapter on government procurement rather than as part of services per se.[89]

(ix) **General exceptions.** A feature of all FTAs is general (i.e., public morals, human, animal, or plant life or health) and security exceptions similar to those contained in Articles XIV and XIV bis of the GATS.

Overall, FTAs do not go further than the GATS with respect to the rules area, e.g., safeguards, subsidies, or domestic regulation. Exceptions include additional disciplines on financial services and telecommunications, additional transparency provisions, as well as some sector-specific provisions relating to the temporary movement of natural persons and recognition. The most significant variance between FTAs and the GATS, as well as between FTAs themselves, tends to come in their liberalization commitments, which are discussed below.

Market Access and National Treatment.

The degree of liberalization that occurs in an FTA depends on the commitments made in respect to market access and national treatment. Article XVI of the GATS allows WTO members when making commitments to schedule four types of quantitative restrictions and limitations on the form of legal establishment and foreign equity participation. In general, FTAs using a positive list tend to include a GATS-like market access provision, while those using a negative list normally require only the notification of quantitative restrictions (see explanation of positive and negative lists below). It should be noted that the GATS market access provision does not appear in FTAs that follow the NAFTA model. In that connection, GATS goes further than NAFTA-based FTAs, as Article XVI includes nondiscriminatory quantitative restrictions.

A key element of all FTAs is the provision on national treatment, which is the building block of any agreement on services. The national treatment provision of the GATS is found in Article XVII. The provision contains the notion of treatment no less favorable than that accorded to locally owned service suppliers. The benchmark for national treatment in the GATS is not identical treatment but treatment that does not modify the conditions of competition in favor of national services and service suppliers.

[88] See OECD (2002).
[89] OECD (2002).

Unlike market access, there is no exhaustive listing of limitations that can be scheduled. Most FTAs have adopted the national treatment provision of the GATS. In FTAs that contain a separate investment chapter, there is usually a national treatment provision similar to that found in the services chapter.

It should be noted that FTAs following the NAFTA model usually have an important provision regarding the "standard of treatment" that does not find a parallel in the GATS.[90] Under the provision, the service suppliers of all parties must enjoy the better of national treatment and MFN treatment. In other words, if the PRC gets better MFN treatment in a particular state of Australia than Australian service providers, then Singaporean or Chilean service providers should also get MFN and not national treatment.

Positive versus Negative List

A key element that distinguishes between GATS-type and NAFTA-type models is the way commitments are scheduled. The GATS uses a positive list of specific commitments that are in turn subject to limitations or conditions inscribed. This is in contrast to a NAFTA-based negative list, where all services covered by the FTA are considered liberalized unless indicated otherwise through lists of reservations.[91]

Positive list

In a positive list, only services included in the schedule will enjoy preferential treatment to the extent that there are no limitations. National schedules list service sectors and modes of supply that enjoy market access and national treatment, subject to limitations. Countries are at liberty to impose trade-restrictive measures in all nonscheduled sectors, although those measures may still be subject to an agreement's general disciplines. The use of a positive list has various pros and cons.

Countries may prefer a positive list because its use in the GATS has already made them familiar with the approach. A positive list may also be easier to handle for countries that feel less confident about their regulatory regime and wish to have more time before committing an existing regulatory situation through a negative list.[92] The pace of liberalization is likely to be slower under such an approach, since progress is to be made through rounds of request-offer negotiations. Such negotiations typically take a longer time to reach a "critical mass." A major problem with a positive list is that it does not provide any information on services that are not included in the schedule or the actual regime since economies may choose not to bind at the status quo.

An example of a positive list used in the Singapore-India FTA is provided in Box 2.6. The example is a pure GATS-style positive list with a listing of services in the far left column and a breakdown of commitments into the four respective modes of supply. The commitment is subject to limitations on market access and national treatment. There may also be limitations in the horizontal section that are not shown in this example. The term "None" refers to a situation of full liberalization with no limitations. "Unbound," on the contrary, means that no commitment is provided and any

[90] Marconini (2005) discusses the North American Free Trade Agreement (NAFTA) inspired approach in some detail.

[91] NAFTA-type and GATS-type agreements also differ in that the former deal with different modes of supply in different chapters: disciplines for modes 1, 2, and 4 in a chapter on cross-border trade in services, and disciplines relating to mode 3 as part of a chapter on investment.

[92] This point is observed by many commentators including Goode (2005), Marconini (2005), Stephenson (2002), and Sauve and Mattoo (2002).

Box 2.6: A Traditional GATS-Style Positive List

This example is taken from Singapore's schedule of commitments in its free trade agreement with India.

Modes of supply: (i) Cross-border supply, (ii) consumption abroad, (iii) commercial presence, (iv) presence of natural persons

Sector or Subsector	Limitations on Market Access	Limitations on National Treatment	Additional Commitments
SECTOR-SPECIFIC COMMITMENTS			
1. Business Services			
A. Professional Services			
Legal consultancy services for Indian law (861**)	(i) Unbound (ii) None (iii) Unbound (iv) Unbound except as indicated in the horizontal section	(i) Unbound (ii) None (iii) Unbound (iv) Unbound	
Accounting, auditing, and bookkeeping services, except for financial auditing services (862**)	(i) None (ii) None (iii) None (iv) Unbound except as indicated in the horizontal section	(i) None (ii) None (iii) None (iv) Unbound	

limitation can be imposed. It is common in a positive list in mode 4 to refer to the horizontal section for the commitments. This is because mode 4 commitments tend not to be sector-specific but to apply to all sectors (see explanation of horizontal commitments below).

Variations on the positive-list approach

Some innovation has taken place among FTAs using the positive-list approach to simplify the schedule. These include removing the need to schedule commitments by mode of supply, and reducing market access and national treatment limitations to one column (see Box 2.7).[93] This is an interesting simplification of the schedule, since overlaps between market access and national treatment often give rise to considerable confusion.[94] Merging the market access and national treatment columns into one removes the problem of how to treat overlaps.

Not specifying how the service is delivered arguably does little to reduce the complexity of scheduling, since the parties still remain free to schedule limitations by mode of supply. On the other hand, having only one column for limitations is an interesting innovation, as a two-column schedule poses the typical problem of distinguishing between market access and national treatment.[95] Still, despite these attempts to simplify the schedule, very few GATS-plus concessions were actually granted in the Thailand-Australia FTA.

[93] Also discussed in Goode (2005).

[94] The convention in the GATS is to schedule limitations that relate to both market access and national treatment, in the market access column only.

[95] The guideline in the GATS is to schedule limitations in the market access column if there is an overlap with national treatment.

Box 2.7: **A Simplified Positive List** [a]

This example is taken from Thailand's schedule of commitments in its FTA with Australia. The market access and national treatment measures listed in the limitations column condition all the sector-specific commitments.

Sector or Subsector	Limitations
HORIZONTAL COMMITMENTS	
…….	**Local Government Measures** Thailand reserves the right to adopt or maintain any measure administered at the local government level unless that measure is applied on a discriminatory basis with the intention of nullifying or impairing the benefit accruing to Australia under the terms of the Agreement.
SECTOR-SPECIFIC COMMITMENTS Notes: (i) Commitments in this schedule are subject to the general limitations contained in the "Horizontal Commitments" section of this schedule. (ii) The (*) indicates that the sector-specific commitment for cross-border supply is unbound because of the lack of technical feasibility.[b] (iii) The (**) indicates that the service specified constitutes only a part of the total range of activities covered by the Provisional Central Product Classification (CPC) concordance.	
1. Business Services	
General management consulting services (CPC 86501) provided exclusively through regional operating headquarters, its associated company, or a foreign branch.	Equity participation of up to 100% by Australian investors/service suppliers is allowed.
Convention services (CPC 87909**) excluding catering and beverage services	Total area of not less than 4,000 square meters; and total area of the largest hall must not be less than 3,000 square meters.
International exhibition services (CPC 87909**)	Total area of not less than 50 rai (80,000 square meters) with an indoor exhibition area of not less than 25,000 square meters.

[a] With one column for market access and national treatment limitations and no modes of supply specified.
[b] The entry "unbound because of the lack of technical feasibility" is a convention borrowed from the General Agreement on Trade Services (GATS). Although reference is made to it in the Thailand-Australia FTA, it is not used in the schedule.

The Japan-Philippines Economic Partnership Agreement (JPEPA) introduces an interesting innovation: an additional column (Stand Still [SS]) in which parties can specify whether the limitation is an existing nonconforming measure. This is a helpful innovation, since it clarifies current measures and also encourages the parties to bind the status quo, if not to liberalize. Binding existing nonconforming measures is a feature that is normally found only in negative-list FTAs (see Appendix to Part II for an example).

Negative list

NAFTA pioneered the use of a negative list, where all services are considered liberalized unless otherwise indicated through lists of reservations. In other words, all measures and sectors are

Box 2.8: An Annex 1 Reservation List

This example is taken from the Australia-US FTA.

Sector	Telecommunications
Obligations Concerned	National Treatment (Article 11.3) Senior Management and Boards of Directors (Article 11.10)
Level of Government	Central
Source ofMeasure	Telstra Corporation Act of 1991
Description	**Investment** The maximum aggregate foreign ownership allowed in Telstra is 35% of the Telstra shares that are not Commonwealth-held. The maximum individual foreign ownership allowed in Telstra is 5% of the Telstra shares that are not Commonwealth-held. The Chairperson and a majority of directors of Telstra must be Australian citizens, and Telstra is required to maintain its head office, main base of operations, and place of incorporation in Australia.

Box 2.9: An Annex 2 Reservation on "Future Measures"

This example is taken from the US-Chile FTA.

Sector	Social Services
Obligations Concerned	National Treatment (Articles 10.2, 11.2) Most-Favored-Nation Treatment (Articles 10.3, 11.3) Local Presence (Article 11.5) Performance Requirements (Article 10.5) Senior Management and Boards of Directors (Article 10.6)
Description	**Investment and Cross-Border Services** The United States reserves the right to adopt or maintain any measure with respect to the provision 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.

considered free of restrictions unless there is a reservation listed in the "nonconforming measures" annex. The absence of any reservations indicates that the sector is fully liberalized. Reservations are typically for existing nonconforming measures (Annex 1) and for future measures (Annex 2). Negative lists have been used in all NAFTA-type FTAs. Such an approach can potentially provide a high degree of transparency since, subject to the number of Annex 1 and Annex 2 reservations, the actual level of openness is spelled out, along with an indication of the legal/regulatory framework in place.

FTAs using a negative-list approach also typically include a ratchet mechanism, whereby any future liberalization of Annex 1–type reservations is automatically locked in. In other words, whenever an FTA member removes any restriction, even without any negotiation, it must extend the benefit of that liberalization to all FTA parties. The ratchet mechanism thus automatically binds any liberalization within the FTA.

Clearly, countries that feel confident about their regulatory regime and have relatively few discriminatory measures tend to favor a negative-list approach.[96] Otherwise, countries would resort to using the Annex 1 and Annex 2 reservation lists, and thus defeat the point of using a negative-list approach. There is also sometimes fear that a negative list would bind the hands of governments, since it cannot possibly be known what services might be developed over time. However, it is worth bearing in mind that all FTAs, as with the GATS, recognize the right to regulate. What is required in a schedule is the removal of discriminatory measures, not necessarily deregulation.

A negative list has no schedules of commitments with sectors, modes of

[96] Marconini (2005).

supply, and limitations, since all services by definition are liberalized. The annex of the agreements contains lists of "nonconforming measures," i.e., those measures that for the time being continue to discriminate against foreign service suppliers. Box 2.8 gives an example of an Annex 1 list of existing "nonconforming measures" from the Australia-US FTA.

By expressing a reservation in Annex 1, the party exercises its right under the FTA to maintain the discriminatory measure in its current form, and is bound not to make the measure more restrictive at a later date. The format of an Annex 1 listing is fairly straightforward: virtually all FTAs using a negative list follow the NAFTA template. It is also possible to pre-commit in Annex 1 by setting a timetable for the lifting of the reservation. Since reservations are based on existing nonconforming measures, such precommitments to phase out restrictions are a good indication of actual liberalization (for examples of phase-out commitments in various FTAs, see Matrix 1 in the Appendix to Part II).

A second type of reservation—on "future measures"—allows parties to reserve the right to adopt new or more restrictive measures. In a sense, this is somewhat equivalent to the "unbound" situation in a GATS positive list. Annex 2 reservations on "future measures" provide important exceptions to the sweeping coverage of a negative list. Box 2.9 gives an example from the US-Chile FTA.

Whether negative-list FTAs liberalize more than positive-list FTAs depends on what is reserved in Annex 1 and Annex 2. In principle, it is possible to arrive at the same level of liberalization with either a negative or a positive list. In practice, however, FTAs using a negative list tend to show a significant degree of improvement over commitments taken in the GATS, compared with FTAs using a positive list.[97] It should nonetheless be kept in mind that a certain degree of self-selection may be involved in these results, since countries with the greatest motivation to liberalize may have chosen to use a negative-list approach. More recent studies are also starting to show that the choice of a negative-list or positive-list approach does not always indicate the extent of liberalization, contrary to what is sometimes argued.[98] For instance, some FTAs that are following a negative-list approach exclude a high number of sectors in their specific commitments.[99] Ultimately, what matters more is what is committed in the individual schedules rather than the form these commitments take.

Making Horizontal Commitments

There is often considerable confusion about the status of horizontal commitments in a schedule. To clarify, horizontal commitments in a GATS-type positive list bind all sectors listed in the schedule unless stated otherwise.[100] Essentially a formatting convention that removes the need to repeat the same binding in all the subsectors that follow, horizontal commitments are thus normally used for measures of general application that apply to all sectors (see Box 2.7: the limitation placed by Thailand on local government measures binds all the sector-specific commitments that follow). Neither horizontal commitments nor sector-specific commitments rank higher;

[97] See Roy, Marchetti, and Lim (2006).

[98] See Ochiai, Dee, and Findlay (2007); and Lesher and Miroudot (2006).

[99] See Ochiai, Dee, and Findlay (2007); and Lesher and Miroudot (2006). Percentages of sectoral exclusions in negative-list FTAs: Chile–Republic of Korea, 46.4%, Japan-Mexico, 53.3%, US-Singapore, 59.4%, Republic of Korea–Singapore, 59.8% (from Ochiai, Dee, and Findlay [2007]).

[100] The use of horizontal commitments in relation to mode 4 (refer to Box 4) sometimes creates confusion. The GATS convention is for members to specify in the horizontal section the market access and national treatment they grant for mode 4, but not for the other modes of supply. Entries like "Unbound except as indicated in the horizontal section" are thus common in the sector-specific section.

the two need to be read together. The horizontal section in a negative list follows a similar logic. It contains reservations of a general nature, which do not need to be repeated in all following subsectors. In terms of good practice, only commitments or reservations that are truly horizontal, in the sense that they bind all sectors, should be included in this section.

Sector-Specific Disciplines

Other interesting innovations in FTAs are found in sector-specific disciplines and liberalization modalities in financial services, telecommunications, and the temporary movement of natural persons.[101]

Financial services

Financial services tend to be heavily regulated for prudential reasons. The sector is also characterized by a large number of diverse services that are defined in the GATS Annex on Financial Services. Many of the standard provisions of a typical FTA could, of course, easily apply to financial services as well. However, there is clearly a distinct preference for a separate chapter because of the unique characteristics of the financial services sector. Box 2.10 lists typical contents of a financial services chapter and approaches taken.

In general, in developed and advanced developing countries, market access and national treatment restrictions in financial services have been substantially reduced through domestic reform, and most of the progress, especially for commercial presence, is reflected in the commitments made in the GATS 1997 Round of financial services negotiations. As a result, when it comes to financial services, there is greater emphasis in FTAs on addressing nondiscriminatory measures, licensing requirements, transparency, efficiency of the administrative process, and competitive safeguards.

Telecommunications

An increasing number of FTAs have a separate chapter dealing with the unique characteristics of the telecommunications services sector. It is also worth bearing in mind that in the extended GATS Telecommunication Services negotiations, which concluded in February 1997, many WTO members committed to open their national markets to international competition, thus removing the more important barriers to market access.

While there is no single approach to a telecommunications chapter, it is clear that the value added for telecommunications services for many FTAs comes in further developing the regulatory disciplines. NAFTA-type FTAs, especially those involving the US, for example, combine elements of the NAFTA, the GATS Annex on Telecommunications, and the WTO Reference Paper, to form a comprehensive set of regulatory disciplines, which are GATS-plus. Other FTAs, such as Thailand-Australia, Japan-Singapore, New Zealand–Singapore, Philippines-Japan, do not have a separate chapter on telecommunications services.

Network issues set telecommunications apart. Without access to the essential facilities of the network, it is impossible to provide telecommunication services. There is also a need to separate policy and regulation. A separate independent regulator must be established to ensure a transparent approach to the players in the market as well as regulatory certainty.

Provisions on telecommunications services are intended to ensure access to and use of the services without undue discrimination against service providers. This is important because public

[101] The examples given here of typical provisions in the telecommunications and financial services chapters of FTAs are drawn mainly from unpublished research by the Institute for International Trade. See also Goode (2005) for examples of typical provisions in these two sectors.

Box 2.10: **Typical Features of Financial Services Provisions of FTAs**

Scope and Coverage
Financial services are defined in the same way as in the Annex on Financial Services. Typical exclusions are government procurement of financial services, and activities or services forming part of a public retirement plan or statutory system.

Liberalization
The chapter specifies the approach—whether positive- or negative-list—to market access and national treatment. In all its free trade agreements (FTAs), the US combines positive- and negative-list approaches for financial services. On market access, the provision is modeled on General Agreement on Trade in Services (GATS) Article XVI, but applies only to mode 3. Liberalization is subject to the traditional negative-list approach (establishment is allowed in all financial service activities unless a reservation is made). However, cross-border trade (modes 1 and 2) is subject to a different approach, similar to the one adopted in the World Trade Organization's (WTO) Understanding on Commitments in Financial Services, i.e., a positive list of commitments.

Regulation and Supervision
The need for effective prudential regulation is well established in all FTAs. For instance, all prudential measures taken by central banks and monetary authorities are typically carved out of the FTA. The main principle as regards regulation and supervision, while recognizing the need for prudential regulation, is nondiscrimination. If the regulation is needed for prudential purposes, normally there is little justification for discrimination between domestic and foreign suppliers.

New Financial Services
An interesting issue that arises in FTA negotiations is how to treat "new financial services," that is, those services that are likely to be developed in the future and are unknown to the negotiators at the time the FTA is finalized. In cautious agreements, the approach taken is for the parties to consult on the possibility of covering new financial services at the request of one party. In more ambitious agreements, FTA parties already agree at the time the FTA enters into force.

Transparency
In addition to the usual transparency obligations, each party is required to publish in advance any regulations of general application relating to financial services. An important innovation is the requirement to provide interested persons and the other party a reasonable opportunity to comment on such proposed regulations.

Financial Services Committee
NAFTA-type FTAs form financial services committees to supervise the implementation of the chapter and its further elaboration, to consider issues regarding financial services that are referred to the committees, and to participate in dispute settlement process.

Dispute Settlement Provisions
Some FTAs lay down a distinct set of dispute settlement provisions for financial services. These emphasize the need for panelists to have financial services expertise and confine retaliatory measures, if applicable, to the financial services sector. There is also a procedural requirement for investor disputes on financial services to be referred to the financial services committee for decision.

Source: Institute for International Trade, unpublished case studies.

telecommunications services are often provided by a monopoly or under conditions where a former monopoly still dominates the market. As shown in Box 2.11, the telecommunications chapters also have provisions pertaining to the behavior of regulatory bodies, especially with respect to decision making, transparency, and technical standards.

Including a telecommunications services chapter in an FTA allows the parties to develop mutually beneficial interpretations of the general principles laid down in the GATS Annex on Telecommunication Services. The key challenge in developing such interpretations is that markets in an FTA are usually very different in nature, size, and stage of development. A regulatory issue that is important in one market might be less so in another.

Box 2.11: **Typical Features of Telecommunications Services Provisions of FTAs**

Free trade agreement (FTA) provisions on telecommunications services typically follow the structure and content of the World Trade Organization's General Agreement on Trade in Services (GATS) Telecommunications Reference Paper, with details added.

Scope and Coverage

The chapter usually applies to (i) measures relating to access to and use of public telecommunications services, (ii) obligations of suppliers of public telecommunications services, (iii) measures relating to public telecommunication networks, and (iv) measures relating to the supply of value-added services. Other provisions include no requirement for an enterprise to construct a network or provide a service not generally supplied by a public entity or for a broadcaster to make available its facilities as a public telecommunications network. Normally excluded from coverage are measures relating to broadcast or cable distribution of radio or television programming.

Regulatory Transparency

A set of good practices, such as in US-Oman, include prompt publication of the rules issued by the telecommunications regulatory body, an opportunity to comment on rules, and the availability to the public of information and measures relating to the provision of telecommunications services. Licensing must be fair and nondiscriminatory.

Actions of Independent Regulators

The independence of the regulatory authority is central, as it affects market access and national treatment. FTAs (e.g., US-Peru) typically require the telecommunications regulatory body to be separate from and not accountable to any supplier of public telecommunications services. All decisions by the regulatory body must be impartial and must not accord more favorable treatment to a supplier owned by the government. Universal service obligations must be administered transparently, fairly, and with competitive neutrality.

General Competitive Safeguards and Interconnection

Competition policy is vital to telecommunications services. FTAs generally include safeguards against anticompetitive practices such as anticompetitive horizontal arrangements, misuse of market power, anticompetitive vertical arrangements, and anticompetitive mergers and acquisitions. Public telecommunications services must provide interconnection at reasonable rates and protect the confidentiality of commercially sensitive information.

Obligations of Major Suppliers

A major supplier is typically defined as a supplier of public telecommunications services that can materially affect price and supply. FTAs, such as US–Central America Free Trade Agreement, oblige major suppliers not to discriminate against unrelated suppliers (i.e., not their own subsidiaries and affiliates); to charge reasonable rates; to unbundle network elements; and to provide fair treatment in interconnection, co-location, and rights-of-way. Major suppliers are also subject to anticompetitive safeguards, including anticompetitive cross-subsidy.

Source: Institute for International Trade, unpublished case studies.

Temporary movement of natural persons

Given the sensitivities surrounding the movement of labor, only very limited progress has been made in the GATS on mode 4 (the temporary movement of natural persons to supply a service).[102] These sensitivities are also present in FTAs, though there have been some interesting innovations with respect to professionals and business visitors (including intra-corporate transferees). Most NAFTA-type negative-list FTAs have a separate chapter on the movement of natural persons, which establishes disciplines for the entry of businesspersons active in the goods and services sectors. Also common is a review mechanism, which gives persons denied entry an opportunity to have their claims considered by an independent person or tribunal. The substantive disciplines and depth of commitments in these chapters vary from agreement to agreement (see

[102] Most FTAs apply the GATS definition of mode 4.

Box 2.12: Movement of Natural Persons—Provisions on Business Visitors

Sometimes a free trade agreement (FTA) will address business mobility issues for investment and services in separate chapters. As there is usually considerable overlap between the business mobility provisions in these chapters, it would seem appropriate (where possible) to combine relevant provisions in one chapter. In that case, the main provisions would tend to govern the following matters:

(i) a statement that the agreement does not apply to measures regarding nationality or citizenship, permanent residence, or permanent employment;
(ii) a listing of the chapters of the agreement to which the provisions on entry apply;
(iii) the conditions under which temporary entry for short-term business visitors and intra-corporate transferees may be granted;
(iv) the conditions under which temporary entry may be denied;
(v) an 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;
(vi) a provision enabling online lodgment of visa applications and their processing;
(vii) the exclusion of labor market testing in any of the parties;
(viii) an undertaking to exchange information on domestic laws and policies governing temporary entry;
(ix) an undertaking to handle appeals against decisions by immigration authorities expeditiously; and
(x) a description of the extent to which the agreement's dispute settlement provisions apply to the chapter.

Source: Institute for International Trade, unpublished case studies.

Box 2.12 for some typical provisions on business visitors). All such chapters include a GATS-style carve-out on access to the domestic employment market and the regulation of the entry of natural persons.

On the whole, most FTAs do not go beyond improving conditions of entry for business visitors and intra-corporate transferees. With respect to professionals, the progress made has come in the form of mutual recognition agreements. To be able to supply a service in a foreign market, professionals need to either have the mandated local qualifications or have their foreign qualifications recognized. Nonrecognition of qualifications is thus an important barrier to mode 4 access. The approach in many FTAs is to encourage their competent regulatory bodies to negotiate and conclude MRAs. Some FTAs identify specific professions for MRAs and establish negotiating time frames. A detailed examination of MRAs is beyond the scope of this chapter but it is clearly an area that holds much promise for the movement of natural persons. An example of an easing of restrictions on certain categories of mode 4 is given in the following case study (Case Study 2.2) of the Japan-Philippines Economic Partnership Agreement.

Summary

There is no one single FTA model to liberalizing trade in services that can be prescribed. Indeed, much will depend on the objectives and individual circumstances of the parties involved. This chapter provides an overview of some key issues that need to be considered when negotiating the services chapter of an FTA. It examines some of the key approaches used and the potential issues that may arise. In doing so, some examples of innovative practice that have arisen over recent years are illustrated and discussed. The increasing popularity of some of these innovations, such as in the scheduling of commitments or the treatment of specific sectors like telecommunications and financial services, is giving rise to what appears to be a body of prevailing, if not of best, practice.

It is, however, difficult to generalize. The FTAs that have been concluded in the recent past, not least the services

Case Study 2.2: **Specific Commitments for the Movement of Natural Persons under the Japan-Philippines Economic Partnership Agreement (JPEPA)**

JPEPA is a General Agreement on Trade in Services (GATS)-type positive-list agreement with the innovation of binding limitations at the level of existing nonconforming measures. In JPEPA, Japan took a number of significant commitments to ease the entry of Filipino mode 4 service providers.

Categories

Annex 8 of JPEPA defines the various categories included in the commitment on mode 4 and sets out the respective terms and conditions for the entry of short-term business visitors; intra-corporate transferees; investors; and natural persons who engage in professional services (legal, accounting, or taxation services), those who possess advanced or specialized skills, and nurses or certified careworkers. In terms of the last two categories, activities are to be conducted on the basis of a personal contract.

Lengths of Stay Granted

Short-term business visitors (90 days, which may be extended), intra-corporate transferees, investors, natural persons who engage in professional services, specialized/skilled workers (1 to 3 years, which may be extended), and nurses or caregivers (1 to 3 years; depending on whether stay was linked to the purpose of obtaining a qualification and on the type of service provided, period may be extended).

Qualification Requirements

Legal, accounting, or taxation service suppliers need to be qualified under Japanese law. In terms of service suppliers possessing advanced skills, there is a minimum requirement of having completed college education (i.e., bachelor's degree) or higher education, or have at least 10 years' experience in the area of speciality. For nurses and caregivers, qualifications obtained in the Philippines are recognized according to the following criteria: (i) a qualified nurse under Philippine law with at least 3 years' work experience; and (ii) caregivers must have graduated from a 4-year program of at higher-education institution and be a certified caregiver in the Philippines, or have graduated from a nursing school authorized by the Philippine Government. Japanese language proficiency is also required to satisfy the requirements for entry and stay as a qualified nurse (*kangoshi*) or caregiver (*kaigofukushishi*).

Immigration Laws and Procedures

All commitments on temporary entry and stay for natural persons are still subject to immigration laws and procedures. In other words, service providers may be required to obtain an appropriate visa or its equivalent prior to entry.

Source: Extracted from the text of the Economic Partnership Agreement between Japan and the Republic of the Philippines. Available: www.mofa.go.jp/region/asia-paci/philippine/epa0609/index.html

component of such agreements, are highly complex in architecture and are still evolving. But the race to conclude FTAs, and the inclusion of services as a central component, is showing no signs of slowing down. It would thus seem important to provide some normative guidance to those who may be involved in such negotiations. By way of conclusion, several points are worth reiterating:

(i) **Before embarking on mastering the technicalities and intricacies of negotiating services in an FTA it is important to ask: what are the ultimate goals that are to be served by the agreement?** This may seem to be an obvious question but the reasons why economies choose to conclude FTAs will be critically important in the selection of the approach. Indeed, an assessment of existing polices and circumstances may well reveal that a preferential deal may not be the best option. After all, if the objective of service liberalization is to reduce the costs of service inputs and to attract FDI, this may well be better served by undertaking multilateral commitments. Moreover, for practical reasons it is often difficult for economies

to have separate regulatory regimes for different supplier countries. If preferences cannot be implemented in practice, would it not be better to liberalize at the multilateral level where, it is generally agreed, gains would be greater than through preferential deals? Good policy should guide negotiating form and not the other way around.

(ii) **If the decision is taken to negotiate an FTA, in the context of services, a primary starting point is to ensure compliance with Article V of the GATS.** The substantive conditions of Article V are designed with the objective of ensuring that when economies depart from MFN treatment to negotiate preferential trade agreements, they do so in a way that minimizes trade distortions and harm to the multilateral trading system. The conditions of Article V can be met, for instance, by not excluding modes of supply or taking large sectoral carve-outs, and by substantially eliminating discrimination on national treatment.

(iii) **Much has been made of whether a positive- or negative-list approach should be adopted. While both approaches have their pros and cons, it is possible to arrive at the same level of liberalization, whichever approach is taken.** What is perhaps more critical is a thorough understanding of the implications and consequences of either approach, since this will have an important bearing on how to prepare for the negotiations. A negative list, since it automatically binds all sectors and measures unless reservations are taken, requires a thorough review and understanding of the regulatory regime in question. This does not mean that a positive list does not require a similar level of preparation, if an ambitious outcome is sought, but since market access and national treatment apply only to scheduled sectors there is less pressure to do so. In terms of outcomes, it cannot be assumed that a negative list will be far superior to a positive list. This is an empirical question that can be answered only by a thorough reading of the reservations in a negative-list schedule and of limitations in a positive-list schedule.

(iv) **Given that there is usually less familiarity with concepts and approaches used in FTAs as compared with those in the GATS, it is important to pay attention to definitions.** Some key concepts that are found in FTAs do not have exactly the same objective as in the GATS. For instance, in FTAs, the MFN clause acts as an "insurance policy" against an FTA party providing better treatment to a third party. NAFTA-inspired FTAs also often require the better of MFN or national treatment. In some cases, domestic suppliers actually get worse treatment than that given on an MFN basis, since the government's policy is to provide incentives to foreign investors.

(v) **Particular attention needs to be given to ensuring coherence and consistency between the various chapters of the FTA that deal with trade in services.** NAFTA-inspired FTAs typically contain disciplines for modes 1, 2, and 4 in the "services" chapter, while mode 3 is covered by a chapter on

"investment," which covers both goods and services. There may also be an additional chapter on certain categories of mode 4, such as business visitors. Managing overlaps and avoiding conflicts become an important challenge. For instance, in many NAFTA-type FTAs, core air transport services are carved out of the services chapter. However, the investment chapter, which applies to mode 3, does not exclude any particular service sector and would therefore apply to all air transport services. It then becomes necessary for a specific reservation to be taken in the relevant annex for the sectoral carve-out to apply.

INVESTMENT

International investment flows have grown more rapidly than international trade in goods or world GDP. A major contributing factor is the liberalization of FDI policies around the world and the global fragmentation of production. While the bulk of direct investment flows is still between developed countries, there is also a growing volume of direct investment flows to the developing economies.

In recent decades, FDI has been increasingly regarded as an important instrument for accelerated economic development. In East Asia, FDI has been used as an instrument to jump-start export manufacturing. It has led to the establishment of regional production networks and has been instrumental in linking the region to global supply chains. For some economies in East Asia, multinational corporation affiliates established via FDI account for over half of manufactured exports. In the more advanced East Asian economies, such as Hong Kong, China and Singapore, FDI in services is also a growing phenomenon.

The developing countries in East Asia and beyond compete with one another for FDI and try to improve their overall investment climate. The positive effects of FDI are being increasingly appreciated because of, among others, its ability to enhance productive capacity leading to higher incomes and employment, the building of manufacturing capabilities, and the upgrading of technological levels. However, countries remain concerned over the perceived negative effects, which include the "crowding out" by foreign investment of domestic entrepreneurship in strategic and sensitive sectors of the national economy. This has resulted in a broadly open national FDI policy coexisting with sectoral limitations on FDI entry and operations.

In this section, we first consider the FDI aspects of FTAs in the broader context of multilateral rules and approaches and other forms of cooperation. Then we consider best-practice approaches to FDI policies in FTAs.

FTAs and FDI Inflows

Location-specific factors contribute to the overall investment climate. These factors include an established legal framework and economic fundamentals. FTAs have different investment provisions reflecting differences in various location-specific factors. Investment provisions include pre- and post-establishment treatment of foreign investors and their differences with actual national investment rules, and the availability of effective dispute settlement mechanisms. Empirical studies show that investors want a predictable investment climate. Predictability may be enhanced when domestic policies and regulations are enshrined or locked into regional and bilateral treaties and agreements. It should also be noted that

trade rules (tariffs, nontariff measures, rules of origin) could affect investment flows. FTAs have different effects on extra-regional and intra-regional sources of FDI.

FDI from extra-regional sources

The lowering of regional tariffs may create incentives for extra-regional investors to establish a presence in the region to take advantage of the larger integrated market (horizontal market–seeking FDI). If individual member countries of the FTA were previously served through trade, this may then raise inward FDI. If individual member countries were already served through MNC subsidiaries, this may induce FDI flows to the least-cost location in the FTA. Further, as noted in the Rules of Origin section above, when the FTA has strict rules of origin, the extra-regional investor may need to set up manufacturing and processing operations in several member countries in the region. When most inward FDI is from extra-regional sources, the attractiveness of the enlarged market size depends also on the margin of preference between the MFN-applied tariffs and the FTA tariff preferences. For example, ASEAN is heavily dependent on FDI from extra-regional sources, yet these investors at present are not accorded the same treatment as investors from within ASEAN. A further concern arises when some national FDI policies are more generous than the regional ASEAN FDI policy.

FDI from intra-regional sources

FTAs may discourage horizontal "tariff jumping" FDI because it becomes cheaper to serve member countries through trade rather than by establishing a subsidiary and incurring plant-level and firm-level costs. The FTA region could be served most cheaply through exports from the single regional location, thereby realizing economies of scale. The tariff-jumping motive favors FDI over exporting; the higher the external tariff and the lower the fixed costs of a new plant, the greater the incentive for tariff-jumping FDI.

On the other hand, FTAs may encourage "export platform" intra-regional FDI, because lower trade costs favor the establishment of production networks and an efficiency-seeking subsidiary in a member country as it becomes cheaper to reexport regional production. There is likely to be more intra-regional FDI in countries with few manufacturing capacities and when flexible rules of origin allow for diagonal or full cumulation to enable non-members to supply the country that attracts intra-regional FDI.

Competition for FDI

An FTA could result in a highly uneven distribution of FDI among member economies. While increased intra-regional FDI enhances the regional integration process, competition for FDI between member states could be divisive and costly if fiscal incentives are involved. To minimize such competition, ASEAN, for example, emphasizes investment cooperation among its members. It has organized ministerial-level joint investment promotion activities in major developed economies promoting ASEAN as an investment region (the "ASEAN Road Show"). The ASEAN Secretariat has also undertaken several investment facilitation activities, including providing information through portals, databases, publications, and statistics.

WTO Provisions on Investment

While trade in goods and services is covered by WTO rules, there are no corresponding rules on international

investment flows. A number of efforts to establish international rules on investment have failed. The latest is the abandonment after the 2003 Cancun meeting of the Doha Development Agenda to establish a multilateral agreement on investment (MAI). The MAI was perceived as unbalanced and unacceptable to many developing countries since it sought to protect investors and there were no provisions on investor obligations. Developing member countries of the WTO were concerned that this would prevent or reduce their policy space to determine their own investment policies.

Without an overarching MAI, foreign investment provisions are dealt with in a fragmented fashion in several existing WTO Agreements.

1. In the General Agreement on Trade in Services (GATS), FDI is covered under supply mode 3 (commercial presence). GATS adopts a positive-list approach, that is, countries can decide which service sectors to commit. Once a sector is committed, horizontal (all sectors) market access and national treatment principles apply, unless otherwise notified.
2. Under the Agreement on Trade-Related Investment Measures (TRIMS), countries cannot impose trade-related performance requirements on firms that are inconsistent with the national treatment principle. The annex to TRIMS contains an illustrative list of prohibited performance requirements. Many governments have used local content requirements in the past to promote backward integration and domestic value added, such as in the automobile industry. TRIMS provides for the phasing out of prohibited performance requirements, with transition periods of 2 years for developed countries, 5 years for developing countries, and 7 years for LDCs.
3. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) sets minimum standards of protection for specific categories of intellectual property and includes national treatment, MFN treatment, domestic enforcement procedures, and international dispute settlement. It builds on existing conventions like the Berne Convention, the Paris Convention, and the Washington Treaty on Intellectual Property in Respect of Integrated Circuits.
4. Under the Government Procurement Agreement (GPA), tenders may not discriminate against foreign products and foreign suppliers and locally established suppliers that are foreign-affiliated or foreign-owned. The GPA disallows "offsets" in the evaluation of tenders and award of contracts.
5. The Agreement on Subsidies and Countervailing Measures (ASCM) prohibits the use of investment incentives that fall under the definition of a "subsidy" and cause "adverse effects." Subsidies contingent on the exportation of goods produced are prohibited. Adverse effects are defined in terms of distortions in the trade flows of subsidized goods.

Investment Provisions of FTAs

The investment provisions of FTAs are aimed at giving investors in the FTA member countries better market access and right of establishment and national treatment, as well as restraint in the use

of performance requirements. However, there are still substantial safeguard measures in the FTAs and in the national laws that restrict FDI. The investment provisions of FTAs usually go beyond those in the WTO, particularly the provisions on the right of establishment. Three categories of FTAs may be distinguished in this regard:

(i) Those that do not have investment-related provisions except for trade rules. This is the case with most FTAs between developing countries.
(ii) Those that include comprehensive investment provisions from the start, including pre-establishment national treatment and effective investor-state dispute mechanisms, such as NAFTA.
(iii) Those that evolved toward a common approach over time, introducing new provisions to promote regional investment cooperation and grant national treatment and MFN treatment to foreign firms, as is the case with ASEAN's AIA agreement, signed in 1998.

The investment provisions of FTAs can be categorized under definitions of investment and investors, treatment of investments and investors, and dispute resolution and settlement.

Definition of investment and investors

Investment. Investments are usually defined to be broader than FDI flows. There are two principal ways of defining investments. The enterprise-based method defines the enterprise that is to be covered and then defines the assets of the enterprise to be included. The assets-based method (NAFTA-type) itemizes the types of assets to be included, ranging from physical assets such as machinery and equipment, to intangible assets such as patents, know-how, and other intellectual properties, as well as the licenses and permits needed to carry out the investment. Usually what results is a combination of both definitions. Some agreements cover only FDI and specifically exclude portfolio investment, such as the AIA. This reflects ASEAN's aversion to portfolio investments after the 1997 Asian financial crisis. Some agreements include concession agreements and the right to search for natural resources. In ASEAN, only investments "approved in writing" are protected under the AIA, while other investments are protected either by the national laws of the host country, BITs (see Box 2.13), or the principles of international law on state responsibility.

Investor. Foreign investments can be made by natural persons or by corporate entities. Usually investment protection is confined to citizens, although the

Box 2.13: Bilateral Investment Treaties

Investment provisions can be contained in bilateral investment treaties (BITs) as well as free trade agreements (FTAs). Without an overarching multilateral agreement on investment (MAI), BITs remain the main instrument for negotiating investment rules between countries. There are currently well over 2,100 BITs in existence. They are usually designed to protect foreign direct investments (FDIs) from expropriation and ensure certain standards of treatment by the host country. The actual contents of BITs can vary. US BITs often include pre-establishment rights, while European BITs usually focus on post-establishment rights.

Most developed investing countries have already signed many BITs with developing host countries. They seek diplomatic protection of their nationals and their assets, and guarantees regarding repatriation of revenues earned. In particular, BITs are useful in ensuring FDI flows to developing countries that lack sufficient national legal safeguards for the protection of assets and property rights. ASEAN countries have entered into BITs that facilitate post-establishment rather than pre-establishment rights. Singapore's FTA investment chapters, however, tend to cover pre-establishment rights as well. There are even many BITs between ASEAN member countries.

Source: ADB staff.

Malaysia and Singapore agreements, for example, also include permanent residents. In common-law countries (such as Brunei Darussalam, Malaysia, and Singapore) the concept of corporate nationality is based on incorporation, so that any company that is incorporated in the country assumes its nationality. However, in civil-law countries (like the Philippines and Thailand), nationality is based on the location of the effective management of the company.

Treatment of Investors and Investments. While many FTAs would include "fair and equitable treatment," others provide national treatment and MFN treatment for pre-establishment and post-establishment. Some investment provisions apply to listed sectors only (positive approach), while others apply to all sectors with listed exceptions (negative approach).

National Treatment. National treatment means that the foreign investor should be treated on equal terms with local investors. National treatment is desired by foreign investors, but some host countries are reluctant to give it, preferring instead to support local firms. National treatment at the pre-establishment stage refers to the right of establishment or foreign ownership of corporate equity, other assets, and land. At the extreme, foreign ownership is prohibited from certain sectors and enterprises, while in most cases majority foreign ownership is controlled.

Exceptions to National Treatment. Many host countries, both developed and developing, impose sectoral limitations on foreign ownership and control to shelter their strategic and sensitive sectors from foreign investor competition and on national security grounds. Excluded sectors are commonly found in the land and natural resource and service sectors and include banking and finance, transportation, power and energy generation, media and telecommunications, land and natural resources, real estate, small-scale agriculture, and small and medium enterprises. Most agreements confine national treatment to the post-establishment phase only. Many agreements also exclude state enterprises from the national treatment rule. In addition, most agreements reserve the right to implement future measures concerning the limitation of national treatment to several sectors, especially in the service sectors.

Flexibility in National Treatment Provision. Some agreements seek to postpone national treatment to reflect the lower level of economic development of the host country, while other agreements confine national treatment only to those in "like circumstances." Some agreements provide for national treatment "as far as possible." In the APEC Non-binding Investment Principles, the national treatment provision states that such treatment is "subject to the exceptions as provided for in domestic laws, regulations and policies."

Fair and Equitable Standard. This usually means that certain rights and privileges usually regarded as having been accepted in customary international law should be accorded the foreign investor. As discussed below, Urata and Sasuya (2007) conducted a recent study of seven bilateral FTAs, covering the US, Canada, Mexico, Japan, Singapore, and Australia, and found that Canada, Mexico, and Australia have highly restrictive screening and approval of FDI projects. Under the Investment Canada Act, Canada requires a review of all acquisitions of Canadian businesses, with the value of the assets and the control being acquired. Japan highly restricts the movement of foreign investors. Australia, Canada, Chile, the

Republic of Korea, and Mexico are very restrictive in their service sectors. In the transportation sector, there are limitations on foreign ownership especially of oceangoing vessels and airlines; often, concessions for the domestic air transportation sector are provided only to domestic companies. In information and communications, Mexico, the Republic of Korea, and Singapore limit foreign ownership in newspaper publishing. Japan limits foreign ownership in Nippon Telegraph and Telephone Corporation (NTT) to less than one third of total share capital, and does not allow foreigners to serve as directors or auditors. The financial sector of Japan also has limitations on foreign ownership and market access. Singapore restricts foreign bank provision of retail customer services such as the establishment of automated teller machine (ATM) networking, but relaxes the restriction under the US-Singapore FTA.

Most-Favored-Nation Treatment. MFN clauses are commonly found in trade agreements. The foreign investor desires national treatment between himself and the local investors, as well as nondiscriminatory treatment with other foreign investors. This means that privileges created in other future agreements will automatically flow to nationals of the first agreement. For example, privileges accorded to US investors in the US-Singapore FTA would also be accorded to Japanese investors even though they were not included in the earlier Japan-Singapore FTA. However, privileges given by Singapore in the context of ASEAN do not automatically flow to Singapore's bilateral FTA partners.

Performance Requirements. These are imposed by host developing countries to ensure that the foreign investor contributes to expected benefits. They could cover a percentage of firm production that has to be exported, the purchase of local products and services, and the employment of local labor. Unlike TRIMS, which prohibits only trade-related performance requirements, FTAs seek to prohibit them altogether in their investment provisions.

(i) **NAFTA forbids the use of performance requirements.** Developed countries argue that performance requirements distort international trade. First, their imposition may result in the foreign investor using inefficient inputs or production processes, or both. Second, they may influence the type of investment, as they could affect the quality of inputs used and, hence, investment profitability.

(ii) **In the past, ASEAN countries, except Singapore, linked investment incentives to performance requirements.** However, *net* incentives matter to investors, and the performance requirements could negate the positive effects of investment incentives. TRIMS-inconsistent performance requirements have been removed under the WTO Agreement. It should be noted, however, that abolishing performance requirements alone is unlikely to attract FDI if other positive elements of the investment climate are absent.

Expropriation and Nationalization. International law and regulations normally allow expropriation of foreign assets only when it is in the public interest, is nondiscriminatory, and is made with adequate compensation. FTAs with such provisions aim at reducing the noncommercial risks of foreign

investment. Home countries require payment of prompt, adequate, and effective compensation.

Most agreements favor the "full compensation" formula. However, some developing countries seek an alternative flexible formula that would enable them to pay compensation within a flexible time frame in times of balance-of-payments difficulties. Many investment agreements have also addressed the issue that the protection of the environment or other interests of the state should not be construed as amounting to expropriation. For example, the side letter in the US-Singapore FTA reads: "Except in rare circumstances, nondiscriminatory regulatory actions, designed and applied to protect public welfare objectives, such as public health, safety and the environment do not constitute indirect expropriation."

Repatriation of Profits and Other Proceeds. Some countries insist on guarantees in agreements that assure the ready repatriation of profits as well as the proceeds of liquidated assets in a freely convertible currency and at the prevailing exchange rate. However, strong repatriation provisions may be resisted by host developing countries that face balance-of-payments problems, particularly occasioned by sudden flights of capital such as those that triggered the Asian financial crisis in 1997. Some safeguard provisions in investment agreements may provide for such situations. For example, Chilean agreements generally contain the provision that "equity capital can only be transferred one year after it has entered the territory of the Contracting Party unless its legislation provides for a more favorable treatment." The Japan-Singapore FTA provides for the suspension of repatriation rights "in the event of external financial difficulties or in other exceptional circumstances in which capital movements could result in serious economic and financial disturbance." There are agreements that refer explicitly to the right of a country under the IMF Agreement to impose exchange restrictions. Also, GATS (Article XII) provides that repatriation may be stopped in the event of serious balance-of-payments and external financial difficulties.

Use of Investment Incentives. Developing host countries, including many in ASEAN, often use a variety of fiscal and non-fiscal incentives to attract FDI. These incentives are largely given at the discretion of host governments and are normally not included in the investment provisions of FTAs or in BITs. Their use is controversial, as is the case with the use of performance requirements. Critics point to lack of evidence of their efficacy in attracting FDI, their distortionary effect on resource allocation, and their negative effect on tax revenues.

Responsibilities of MNCs. One major reason why the MAI failed to find acceptance among developing countries is its failure to incorporate the interests of developing host countries by also requiring investing MNCs to meet standards of performance. BITs and the investment provisions of FTAs also generally make no express reference to the responsibility of MNCs, particularly toward the environment. However, in Indonesian agreements, a foreign MNC that pollutes the environment would not be acting in accordance with Indonesian laws and would not enjoy investment protection. Additionally, the Indonesian investment agency (BKPM) could introduce conditions on foreign investors at the time of entry and the granting of license to operate.

Dispute resolution and settlement

Investment rules, including those on expropriation, need to be backed by an effective dispute settlement mechanism. This can be state-to-state or investor-to-state. Some host countries are averse to investor-to-state dispute settlement built into investment agreements. Disputes can be settled by national or regional courts, or referred to international arbitration under the Convention of the Settlement of Investment Disputes (ICSID) or the UN Commission on International Trade Law (UNCITRAL).

FDI Strategy and Best Practices

The investment provisions of FTAs are aimed at liberalizing the regulations and protecting investments to encourage freer and greater cross-border flows of investment, particularly of FDI. These provisions have to be negotiated, taking into account the laws, regulations, and policies governing foreign investment in the FTA partner countries. Often, investment commitments in FTAs require corresponding changes in national laws, regulations, and policies, which take time to put in place.

There is growing recognition that FDI can contribute to a country's economic development, more particularly to participation in regional production networks and global supply chains, and technological and marketing capabilities in manufacturing. This benefit is strongly exemplified by the role of FDI in the rise of the PRC as a manufacturing power in the past decade. Global competition for FDI has intensified as FTAs have become more global in reach and as individual countries have unilaterally liberalized. Besides liberalizing their policies and regulations, host countries must also ensure that other key elements of a favorable investment climate exist, that is: political and economic stability, a well-established and transparent legal and regulatory framework (including protection of intellectual property), and availability of cost-effective physical infrastructure and human resources. Countries that wish to attract FDI in high-tech activities have to ensure a favorable environment for research and development, while countries that wish to attract FDI primarily for employment creation have to ensure a favorable labor market. Likewise, to be effective, provisions on investment liberalization and protection have to be buttressed by liberal trade rules, fair competition laws, and protection of intellectual property rights (IPR).

National treatment and MFN treatment are the cardinal principles desired by foreign investors. FTAs seek to enshrine these principles. Nonetheless, economic and policy space will ultimately be necessary to enable the host country to protect key and sensitive sectors and businesses from free and open competition from foreign investors. However, these temporary and permanent exclusions from national treatment should not be lengthy and should be time-bound; otherwise, the liberalizing principles lose their meaning. Nondiscriminatory treatment of investments and investors would enable a country to attract investment from the best sources and assure a level playing field to all investors.

An equally important principle sought by foreign investors is the protection of their investments from arbitrary and unjustified expropriation and nationalization. However, host countries need to negotiate safeguard measures to cover themselves in "emergency situations." Dispute resolution could be undertaken under the impartial ICSID and UNICTRAL.

In the final analysis, the investment provisions of FTAs represent a fine

balancing act between a country's economic, political, and social benefits and the perceived costs of FDI. For example, ASEAN would do better to have a common template when negotiating the investment chapters in FTAs with its various dialogue partners. This would help ensure coherence among the various agreements and attract more external FDI.

FTA-PLUS CHAPTERS

Traditional FTAs as defined by economists focused almost exclusively on tariffs. Even the EC, which began as a customs union and ultimately evolved into an economic union, had diverse commercial policies (e.g., independent nontariff barriers and lack of national treatment in certain areas) even three decades after its foundation. It is clear from this reference book that modern FTAs are complicated; in certain areas they even go beyond what the EC included. In this section, we consider four additional key features typically included in modern FTAs, particularly in the context of FTAs in which at least one developed country is a party: government procurement, intellectual property protection, competition policy, and environmental and labor standards.

Government Procurement

Government procurement in the WTO

The WTO Government Procurement Agreement (GPA) is a plurilateral agreement among 27 WTO members that include the EU; the US; Japan; Hong Kong, China; the Republic of Korea; and Singapore. Few developing countries are members, and some OECD countries have not signed the GPA. It is essentially a market access agreement because it lowers trade barriers in government procurement through a framework of common procurement procedures, transparency at all stages of the procurement process, and the opportunity for aggrieved private bidders to challenge procurement decisions and obtain redress. At the 1996 Singapore Ministerial Conference, the WTO working group was mandated to look into the "transparency" aspects of government contracts. Many developing countries objected to a WTO agreement on government procurement covering national treatment, as they provide preferential treatment to national firms, suppliers, and contractors. The procurement issue was removed from the Doha agenda in 2004.

Government procurement in FTAs

Government procurement is a key feature of many FTAs. This reflects the failure to secure an agreement at the multilateral level and the recognition that foreign suppliers of goods and services require not only nondiscriminatory market access but also transparent and fair procedures that allow them to compete on a level playing field.

APEC developed a set of voluntary, nonbinding principles on government procurement. The principles, intended to promote the liberalization of government procurement markets and transparency, cover value for money, open and effective competition, fair dealing, accountability and due process, and nondiscrimination.

FTAs have gone beyond the GPA and include many developing (and some developed) countries that did not sign the plurilateral GPA. They are more comprehensive in coverage, involving transparency and information access, market access and national treatment, various tiers of government and various types of government business, and lower monetary thresholds for contracts.

Nondiscriminatory Treatment. Nondiscrimination requires each government to accord the suppliers, goods, and services of its FTA partner the same treatment that applies to domestic suppliers, goods, and services. Like the GPA, these agreements explicitly prohibit offsets.

Transparency. FTAs promote transparency through the collection and dissemination of all relevant information by electronic means. For example, the e-ASEAN Framework Agreement calls for the use of electronic means in the procurement of goods and services by members.

NAFTA adopts lower thresholds and a negative-list approach to service coverage. NAFTA seems to have influenced several bilateral agreements involving the US. In the US-Australia FTA, the procurement chapter sets out specific rules, procedures, and transparency standards to be applied in the conduct of government procurement. Australia becomes a "designated country" under the US Trade Agreements Act and, hence, enjoys a waiver from the Buy American Act, which enables Australian suppliers to compete in the US procurement market on equal terms with American suppliers and suppliers from other "designated countries." In the negotiations for the US-Malaysia FTA, government procurement has been one of the sticking points. In Malaysia, government procurement is a key pillar of affirmative action policy, and a nondiscriminatory government procurement policy would undermine such affirmative action.

There are no government procurement provisions in AFTA nor in the FTAs that ASEAN has concluded with the PRC and the Republic of Korea. However, there are government procurement chapters in Singapore's FTAs with New Zealand, Japan, the Republic of Korea, India, Australia, and the US. The Singapore–New Zealand FTA, for example, commits to implement the APEC nonbinding principles relating to transparency, value for money, open and effective competition, fair dealing, accountability and due process, and nondiscrimination. The US-Singapore FTA also makes reference to applying the APEC nonbinding principles. Thus, the APEC nonbinding principles appear to offer a common template for bilateral FTA negotiations on government procurement.

Intellectual Property

Intellectual property provisions of FTAs compared

The starting point for intellectual property (IP) rules in FTAs is the network of existing IP treaties[103] that bind almost all trading nations. Many provisions of these treaties are incorporated into the WTO TRIPS Agreement (discussed in the Investment section above), which is applicable to all WTO members. Together, these rules form the lowest common denominator of IP obligations. They bind both developed and developing countries, although LDC members of the WTO Agreement enjoy a waiver until 1 January 2016 before they must provide patent protection for pharmaceutical products.

FTAs often strengthen IP protection beyond that required by the WTO TRIPS Agreement. Such provisions are called

[103] The WTO incorporates parts of the Paris Convention for the Protection of Industrial Property (governing patents, trademarks, service marks, industrial designs, and utility models); the Berne Convention for the Protection of Literary and Artistic Works (Copyright and Related Rights); the International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations (Rome Convention); and the Treaty on Intellectual Property in Respect of Integrated Circuits (IPIC, or Washington Treaty), which governs layout designs/topographies). The text of these World Intellectual Property Organization (WIPO)–administered treaties can be found at: www.wipo.int/treaties/en/

"TRIPS-plus" provisions, since they exceed the minimum obligations contained in the TRIPS Agreement. TRIPS-plus provisions include (i) the implementation of higher IP protection than that required in the TRIPS Agreement, or (ii) an agreement to forgo transition periods and privileges that developing countries and countries in economic transition negotiated during and after the Uruguay Round of GATT.

The US and the EU in particular use FTAs as a vehicle for negotiating TRIPS-plus commitments. Typical commitments include agreements to accept the patentability of plants and animals other than microorganisms;[104] join the International Union for the Protection of New Varieties of Plants (UPOV) Convention;[105] grant additional protection to geographic indications beyond the weak protection granted in TRIPS Articles 22–24 (particularly in the alcoholic beverage sector);[106] limit parallel imports; extend industrial design, patent, and copyright protection;[107] limit compulsory licensing, particularly in the public health field;[108] increase penalties for breaches of IP rights (IPR), increase IPR enforcement rules; expand the scope of trademark protection to cover dissimilar goods identified with well-known trademarks; and protect new types of marks such as scent and sound marks.

The IP provisions of FTAs differ, depending on the level of development of the parties to an FTA. FTAs between developed countries frequently contain provisions requiring the ratification of post-TRIPS IP agreements, and cooperation in the implementation of TRIPS provisions, including the enforcement of laws protecting foreign intellectual property. The Singapore-Australia Free Trade Agreement (SAFTA) provides a good example of an FTA between a developed country and an advanced developing country.[109] Section 13 deals explicitly with IP protection. Article 2 of Section 13 reconfirms each party's commitment to the TRIPS Agreement (a common FTA provision) and obligates the parties to accede or ratify several post-TRIPS IP agreements: the World Intellectual Property Organization (WIPO) Copyright Treaty, the WIPO Performances and Phonograms Treaty, and the Geneva Act of the Hague Agreement Concerning the International Registration of Industrial Designs. Article 5 requires the parties to "cooperate with a view to eliminating trade in goods infringing intellectual property rights, subject to their respective laws, rules, regulations, directives or policies." In Article 6 the parties agree to cooperate on education and the exchange of information on the protection, management, and exploitation of IPR. More stringent IP obligations are found in the US-Singapore FTA.[110]

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[104] See The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) Article 27.3(b).

[105] www.upov.int/en/publications/conventions/index.html.

[106] TRIPS Articles 22–24 apply to "geographical indications"—a term defined in Article 22 of the TRIPS Agreement as "indications which identify a good as originating in the territory of a Member, or a region or locality in that territory, where a given quality, reputation or other characteristic of the good is essentially attributable to its geographical origin."

[107] The minimum periods of protection in the TRIPS Agreement for protection are 10 years for industrial designs (Article 26([3)]), 20 years for patents (Article 33), and 50 years for copyrights (Article 12).

[108] Compulsory licensing is a decision by a government to allow the use of the subject matter of a patent without the right holder's consent. Compulsory licensing is permitted by Article 31 of the TRIPS Agreement, in particular with respect to certain pharmaceutical products, subject to recent disciplines agreed on by WTO members. See generally the WTO instruments dealing with TRIPS and Public Health: www.wto.org/english/tratop_e/trips_e/pharmpatent_e.htm

[109] www.dfat.gov.au/trade/negotiations/safta/full_safta.pdf

[110] Chapter 16 (Articles 16.1–16.10) of the US-Singapore Free Trade Agreement contains a large number of TRIPS-plus provisions, including the ratification of many additional IP Agreements, and a considerable number of provisions directed at the enforcement of IP obligations. See www.ustr.gov/assets/Trade_Agreements/Bilateral/Singapore_FTA/Final_Texts/asset_upload_file708_4036.pdf

Chapter 13 of the Thailand-Australia FTA[111] provides a more typical example of the IP protection found in an agreement between a developed and a developing country. IP obligations are not as strong as those in either the SAFTA or the US-Singapore FTA, but are nevertheless present. In general, cooperation with respect to existing IP obligations is the theme. Article 1302 requires the parties to observe the TRIPS Agreement. Article 1303 requires the parties, upon receipt of information or a complaint, to take measures to prevent the export of goods that infringe copyright or trademarks, in accordance with its laws, regulations, or policies. Likewise, Article 1304 requires the parties to cooperate on enforcement, and Article 1305 requires cooperation on educational activities.

Framework of best practices and practical approaches to intellectual property

Developed countries and advanced developing countries are expected to conform to IP best practices. This means fulfilling their international IP obligations arising under the WTO Agreement and international IP treaties, in particular civil and criminal enforcement obligations.[112] Enforcement issues are a sensitive subject in many ADB member countries, as a result of the large number of TRIPS requirements concerning enforcement, the stringent enforcement provisions present in the US-Singapore FTA, and legislation such as Section 337 of the of the US Tariff Act of 1930 (19 U.S.C. §1337), which empowers the US International Trade Commission to investigate allegations of patent and trademark infringement.

Best practices also include fulfilling any TRIPS-plus obligations FTA members have accepted. The more a country develops and trades, the more pressure the developed world will place on it to meet its IP commitments, and to accept TRIPS-plus commitments. The fulfilment of IP commitments, in turn, requires educating the private sector, civil society, enforcement agencies, and the judiciary about IP protection. Good governance, including an effective judiciary, is necessary for an effective IP regime.

The priority a country places on IP protection will depend on its level of development, as well as demand from its own business, scientific, and cultural community. LDCs almost never receive serious foreign pressure to enforce IP rules. They also benefit from the temporary waiver of patent protection for pharmaceutical products enacted in the course of the Doha Development Agenda. This point should be considered by LDCs seeking to negotiate an FTA.

Policy recommendations and strategy for negotiating IP provisions in FTAs

The advanced developed countries already have solid IP protection in place and are important beneficiaries of the IP system. Their business interests are the main proponents of TRIPS-plus commitments. Because of the market access opportunities that developed countries can offer to developing countries, they are in a strong negotiating position vis-à-vis the developing world when they negotiate IP issues.

Nevertheless, developing countries have historically been hesitant to tighten IP protection, both in the WTO and in FTAs. IP protection is generally viewed in developing countries as favoring

[111] www.dfat.gov.au/trade/negotiations/aust-thai/tafta_toc.html

[112] Unlike many of the WTO's covered agreements, Articles 41–61 of the TRIPS Agreement require members to establish fair and equitable procedures for the enforcement of intellectual property rights (IPR).

developed countries and their business interests. IP protection is, however, of increasing importance to certain developing countries, in particular those that (i) seek to attract FDI (see the Investment section above); (ii) have innovators in particular technology sectors; or (iii) seek to protect their film, print, and music industries.

Developing countries that negotiate TRIPS-plus commitments with the developed countries should evaluate the merits of more stringent IP protection. In particular, they should look at access to technology, health issues (in particular access to medicines), the protection of domestic innovation, and the protection of domestic artists, software producers, etc. They should also evaluate the relative strength of their negotiating position in light of their existing TRIPS commitments; the economic importance of the FTA, either directly or as a vehicle to attract FDI and increase development; and the positive and negative effects of strengthened IP commitments on disadvantaged members of society. Developing countries should also consider IP commitments that they would like to receive from prospective FTA partners, such as the protection of traditional knowledge and folklore (including medicinal plants) and biodiversity.

There are strategies for strengthening a developing country's negotiating position when negotiating IP commitments in an FTA, such as the following:

(i) A developing country should enter FTA negotiations knowing what it wants to gain.

(ii) A developing country should study other FTAs that prospective FTA partners have signed, particularly FTAs signed by countries at a similar level of development. More recent FTAs are more likely to provide an indication of a country's real ambitions in the negotiations.

(iii) A developing country should study matters being discussed and negotiated in the WTO, including the review of Article 27.3(b) of the TRIPS Agreement on the patentability of plant and animal inventions, and the negotiations on the protection of traditional knowledge, folklore, and biodiversity.

(iv) If an FTA includes two or more developing-country members, the developing countries should consider working together to negotiate with prospective developed-country members. Economic blocs, like the EU, have stronger negotiating power than individual countries. Likewise, developing-country blocs are beginning to enjoy greater negotiating strength. Some developing countries are already beginning to work together on TRIPS-plus issues.[113]

(v) Prospective FTA partners from the developed world may expect at least minimal IP concessions from developing-country partners. Developing countries should identify the sectors in which they want market access or other concessions, in return for IP concessions.

(vi) If IP concessions are inevitable, the developing country should seek in return exemptions for sensitive sectors, long transition periods, technical assistance,

[113] For example in 2005, 10 Latin American health ministers issued a joint declaration calling for avoidance of TRIPS-plus provisions. (See Third World Network Info Service on WTO and Trade Issues. 2006. South American Ministers Vow to Avoid TRIPS Plus Measures. 1 June. Available: www.twnside.org.sg)

infrastructure (computers, etc.), and training programs for authorities working on IP-related issues, including training programs in developed countries.

(vii) The developing country should consult IP and FTA specialists at ADB, WTO, the United Nations Conference on Trade and Development (UNCTAD), the World Health Organization (WHO), and other international organizations before entering FTA negotiations.

(viii) The developing country should consult other relevant stakeholders and groups, including businesses, trade associations, chambers of commerce, and NGOs, before entering FTA negotiations.

Competition Policy

Hoekman (1998) distinguishes competition policies in general from antitrust or competition law. Competition policy refers to the broad set of measures and instruments pursued by governments to enhance the contestability of markets, of which antitrust law is a subset. Competition policy is directed at both government and private sector actions and includes privatizing state-owned enterprises (SOEs), deregulating activities, cutting firm-specific subsidies (industrial policy), and reducing policies that discriminate against foreign products and suppliers. Antitrust laws are directed at private sector behavior. They involve instruments that control or regulate the permissible behavior of private firms or natural persons. They prohibit anticompetitive practices like price fixing, collusion between firms to restrict output, or abuse of a dominant position.

Provisions on competition in the WTO

Competition-related provisions have been incorporated in the GATT and subsequent WTO agreements in a piecemeal manner. It appears in GATT Article VI on antidumping measures and countervailing duties; GATT Article XVII on state trading enterprises; GATS Article VIII on monopolies and exclusive service suppliers; GATS Article IX on business practices; and agreements on TRIPS, TRIMS, Safeguards, Technical Barriers to Trade, Application of Sanitary and Phytosanitary Measures; Preshipment Inspection, Government Procurement, and Trade in Civil Aircraft. Proposals have been made to extend the WTO rules to include multilateral disciplines in competition policies. A WTO working group has been mandated to focus on clarifying certain core principles, including transparency, nondiscrimination, procedural fairness, and provisions on hardcore cartels' modalities for voluntary cooperation, and support for the progressive reinforcement of competition institutions in developing countries through capacity building.

Provisions on competition in FTAs

Competition-related provisions are in widespread use in FTAs and they expand on the WTO disciplines. For example, APEC has produced a set of nonbinding principles on competition. The objective is to introduce and maintain "effective or adequate competition policy and/or laws and associated enforcement policies, ensuring the transparency of the above, and promoting cooperation among APEC economies, thereby maximizing, among other things, the efficient operation of markets, competition among producers and traders, and consumer benefits." The principles cover nondiscrimination,

comprehensiveness, transparency, and accountability.

Typically the competition chapter in an FTA would contain several important obligations, e.g., commitments to ensure that (i) anticompetitive business practices are proscribed, (ii) monopolies do not abuse their powers, (iii) there are avenues for complaints of unfair practices to be initiated, and (iv) the relevant authorities commit to cooperate and consult one another to facilitate enforcement and share best practices. Competition policy in FTAs is generally of two types: (i) supra-national coordination of specific competition rules, and (ii) general obligations against anticompetitive conduct.

Supranational Coordination of Specific Competition Rules. In the EU, enforcement of competition rules falls on the supranational institutions. At the same time, EU member states maintain separate and distinct national competition laws and national competition authorities. The EU also has trade agreements with third countries that call for the adoption and coordination of specific competition standards and rules.

General Obligations against Anticompetitive Conduct. These are general obligations to take action against anticompetitive business conduct. NAFTA Chapter 15 on competition policy, monopolies, and state enterprises requires member countries to "adopt or maintain measures to proscribe anticompetitive business conduct and to take appropriate action with respect thereto." FTA members are to consult and cooperate on the effectiveness of their national competition laws and to cooperate on the enforcement of those laws via mutual legal assistance, notification, consultation, and the exchange of information.

In the Australia–New Zealand CER (ANZCEFTA), complaints about the misuse of substantial market power may be filed, heard, and enforced in either jurisdiction. These are buttressed by a separate bilateral enforcement agreement with extensive investigatory assistance and exchange of information. ANZCEFTA phased out the application of antidumping remedies. In the US-Singapore FTA, the US was interested in how Singapore's SOEs competed and interacted with other companies and how they were regulated, particularly in view of their significant role in the Singapore economy. The Competition Policy chapter ensures that Singapore SOEs are subject to the same rules of fair competition as other companies, and that US companies in Singapore would be guaranteed a level playing field. The Singapore Government also committed to continue its policy of not intervening in the commercial operations of SOEs, reduce its stake in SOEs over time, and enact a competition law by 2005.

Environmental and Labor Standards

Almost every country adopts laws intended to maintain socially mandated environmental and labor standards. However, these standards vary across countries as a consequence of historical developments as well as economic and social factors. Standards tend to rise with per capita income; at higher income levels, citizens' demands move beyond basic necessities and begin to focus on issues like clean air and water and elimination of child labor that may have no direct effect on their personal living conditions. Differences across countries in environmental standards may also reflect climate and geographic factors.

Some FTAs include provisions on environmental or labor standards.

Specific terms may arise from one or more of three concerns. First, and especially when partners are at different stages of development, the partner with higher standards may fear that a trading partner's lower standards may translate into a cost advantage in production and thus a competitive advantage in trade ("social dumping"). Second, partners may fear that FTA commitments may restrict a member's ability to regulate activity, including FDI, within its borders so as to maintain its own desired standards. Finally, developing countries may seek technical or financial assistance in raising standards at home through participation in the agreement.

Some agreements, such as the Republic of Korea–EFTA FTA, have no provisions regarding environmental and labor standards. The Republic of Korea–Chile FTA does not provide for labor standards, but its provision on environmental standards reserves the right of either party to set appropriate standards for investment within its boundaries and warns against encouraging investment through the relaxation of domestic health, safety, or environmental measures. Beginning with NAFTA, all free-trade negotiations between the US and partner countries have incorporated provisions on both environmental and labor standards.[114] Typically these oblige each country to enforce its own environmental and labor laws, address consistency with multilateral environmental agreements, and affirm obligations under the International Labour Organization (ILO) (e.g., Australia-US FTA and Singapore-US FTA).

[114] The Canada-US FTA dealt only with potential conflicts with parties' trade obligations under various international environmental agreements. In NAFTA, environmental and labor provisions appeared as side agreements added late in the negotiation to overcome domestic political resistance in the US. Subsequent FTAs negotiated by the US have included environmental and labor clauses in the body of the agreement.

Environmental standards

While the Marrakesh Agreement establishing the WTO begins with a commitment to optimal use of the world's resources, sustainable development, and environmental protection, WTO rules place few restrictions on the environmental policies of its members. The basic principle underlying WTO rulings on disputes arising from national environmental policies is that such policies should not be applied in a way that distorts trade by discriminating between domestic and foreign producers or between different trading partners. Countries are free to use subsidies to achieve environmental objectives, and WTO agreements dealing with such issues as product standards, food safety, and IP protection acknowledge their relevance to environmental goals. Ongoing efforts in the WTO to reduce agricultural subsidies are likely to have important environmental benefits in addition to their primary goal of removing an important source of distortion in world trade flows.

The official stance of the WTO and of many WTO members is that the setting of international rules for environmental protection should be left to environmental agencies and conventions. While there are potential conflicts between terms of multilateral environmental agreements (MEAs) and the WTO over the use of trade policies such as sanctions or other import restrictions to enforce an environmental agreement, in practice no such conflict has arisen.

Most FTAs have no provision dealing specifically with environmental issues. A few others explicitly address the environment in chapters on other subjects. For example, the ASEAN-PRC FTA includes environment, fishery, and forestry among a large number of policy areas in which the parties commit to

extend cooperation. The investment chapter of the Taipei,China–Panama FTA includes a section on environmental measures, which affirms that the agreement should not prevent the parties from adopting and enforcing appropriate measures to protect the environment. It also recognizes that "it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures."

A major exception would be FTAs negotiated by the US, all of which include explicit sections dealing specifically with environmental issues. (These illustrate the propensity of the US to use FTAs to achieve a variety of non-trade objectives.) Provisions of the Canada-US FTA (Articles 104 and 105, Annex 104.1) indicate that, where the agreement conflicts with trade obligations under specified MEAs, the latter will prevail. Where a country can choose among equally effective means of complying, it will choose the one that conflicts least with its commitments under the agreement. NAFTA was one of the first international trade agreements to include a full treatment of environmental issues and thus set a precedent for the treatment of environmental issues in future agreements negotiated by the US. Although the NAFTA text addresses environmental concerns in several places, including a section on MEAs with language similar to that in the agreement with Canada, additional environmental provisions are contained in a side agreement. The North American Agreement on Environmental Cooperation calls for trilateral cooperation on environmental matters and includes provisions regarding the parties' responsibility to enforce their environmental laws. The US and Mexico agree to establish a bilateral commission to promote cooperation in achieving environmental goals and a North American Development Bank to assist in financing environmental infrastructure projects along the border.

The US-Singapore FTA is representative of environmental terms included in other US FTAs. The agreement includes a chapter (18) specifically dealing with the environment. However, the main terms generally call for each party to enforce its own environmental laws and to avoid using reduced environmental protection to promote exports or to attract investment. The environmental chapter also proposes the formation of a joint committee to deal with environmental matters, and calls for each country to encourage public participation.

Labor standards

Labor standards are norms for the way that workers are treated, including child labor and forced labor, the right to organize trade unions and to strike, minimum wages, health and safety conditions, and working hours. All WTO member governments are committed to a narrow set of internationally recognized "core" standards: freedom of association, no forced labor, no child labor, and no discrimination in the workplace. Beyond that agreement on core standards, the primary international organization dealing with labor issues is the International Labour Organization (ILO) rather than the WTO.[115] Nonetheless, some groups, especially in wealthier countries with higher wages and higher labor standards, assert that the much lower wages in developing countries constitute a form of unfair competition. For their part, developing countries understandably see the emphasis on common labor standards as a form of protectionism intended to keep their goods out of the markets of the developed countries.

[115] At the 1996 Singapore Ministerial Conference, WTO members identified the International Labour Organization (ILO) as the competent body to negotiate labor standards.

As with environmental issues, most FTAs contain no provisions on labor standards. FTAs negotiated by the US are the principal but not the only exception. While ASEAN FTAs contain no labor standards provisions, Malaysia's FTA with Japan includes provisions on encouraging human resource development and implicitly commits Japan to share the cost. Although the Republic of Korea's other FTAs contain no labor provisions, the agreement with Singapore does include a commitment to promote human resource development through such activities as exchange of government officials, cooperation between educational institutions, and special training programs (Article 18.10).

In contrast, all US FTAs beginning with NAFTA have included special provisions on labor standards. The NAFTA labor provisions are included in a side agreement, the North American Agreement on Labor Cooperation. Each party commits to "the freedom of association, the right to bargain collectively, the right to strike, prohibition of forced labor, restrictions on labor by children and young people, minimum employment standards, elimination of employment discrimination, equal pay for men and women, prevention of occupational accidents and diseases, compensation in case of work accidents or occupational diseases, and protection of migrant workers" consistent with its own domestic laws. The agreement also creates a tri-national labor commission to facilitate the achievement of its objectives and "to deal with labor issues in a cooperative and consultative manner that duly respects each nation's sovereignty." Subsequent FTAs place labor provisions in the main text but are similar in requiring each country to enforce its own labor laws without regard to whether those laws are consistent with internationally recognized labor standards. A new feature in the relevant article of the US-Jordan agreement (Article 6) subjects compliance with labor laws to the same dispute settlement process as other provisions of the agreement. However, the agreement only requires the parties "to strive to ensure that domestic laws are consistent with "internationally recognized labor rights… and to improve those standards."

DISPUTE SETTLEMENT MECHANISM

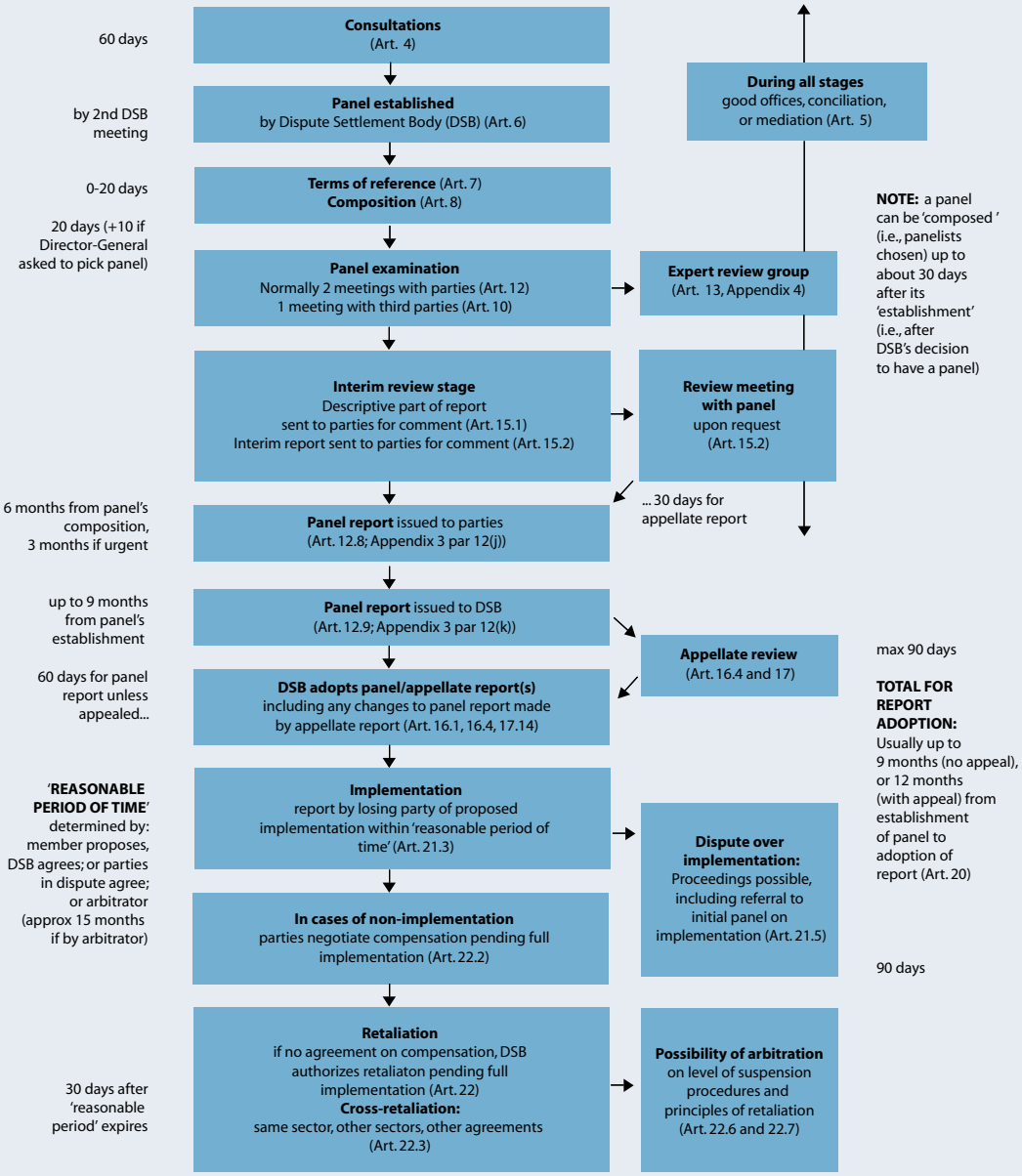
Scope of the WTO Mechanism

WTO dispute settlement is state-to-state, rule-based, and binding, and takes place within strict time limits. The Dispute Settlement Understanding (DSU) is illustrated in a flowchart in Figure 2.1.

The scope of the DSU is set forth in its Appendix I. The DSU applies to the agreement establishing the WTO; the multilateral trade agreements on trade in goods, trade in services (GATS), and trade-related aspects of IPRs (TRIPS); the DSU; and two plurilateral trade agreements still in force that cover trade in civil aircraft and government procurement.

As the flowchart suggests, WTO disputes may have up to four phases: (i) mandatory consultations; (ii) in the event of unsuccessful consultations, an arbitral procedure in which disputes are heard by a panel, composed usually of three persons serving as finders of fact and law; (iii) an appellate system under which the finding of the panel (the panel report) can be appealed to an appellate body; and (iv) an enforcement mechanism according to which the winning party may impose sanctions (withdraw trade concessions) until the losing party brings its trade measures into conformity with the recommendations of the WTO Dispute Settlement Body.

Figure 2.1: **WTO Dispute Settlement Flowchart**



Source: World Trade Organization (WTO) website. Available: www.wto.org/english/thewto_e/whatis_e/tif_e/disp2_e.htm

The WTO Agreement also provides for good offices, mediation, conciliation, and an independent arbitral system. But WTO members rarely use these procedures.

The WTO DSU has been a tremendous success. It is widely used by WTO members, which have lodged more than 300 disputes under it since 1995. WTO dispute settlement stands in strong contrast to the GATT dispute settlement system, where the losing party could block the adoption of a panel report (the findings of the arbitral process), delay was common, and the enforcement mechanism weak.

Despite the success of the WTO system, however, certain questions remain. Should WTO panels have exclusive jurisdiction in trade disputes, or can a panel decline jurisdiction when an FTA tribunal is seized with a dispute? The Appellate Body ruled in the Mexico–Soft Drinks dispute that Articles 3, 7, 11, 19, and 23 of the DSU require WTO panels to take certain actions and that a "decision by a panel to decline to exercise validly established jurisdiction would seem to 'diminish' the rights of a complaining Member to 'seek the redress of a violation of [WTO] obligations…."[116] The Appellate Body's decision in Mexico–Soft Drinks would appear to restrict the right of a WTO panel to determine freely whether or not it can exercise jurisdiction. In instances when WTO rights and obligations are at issue, particularly rights affecting "third parties," it is possible that the WTO dispute settlement mechanism may be elevated above dispute settlement mechanisms in FTAs.

Institutional structures of FTA dispute settlement mechanisms compared

FTA dispute settlement mechanisms vary considerably, yet almost always have several points in common with the WTO system. A few examples drawn from FTAs involving ADB members will demonstrate some of the similarities and differences in dispute settlement provisions, and better illustrate the jurisdictional question posed above.

ASEAN Free Trade Agreement. AFTA was the first major FTA in the East and Southeast Asian region. The ASEAN Protocol on Enhanced Dispute Settlement Mechanism governs disputes arising under ASEAN economic agreements, including AFTA. The protocol is based almost entirely on the WTO DSU. Like the WTO system, it provides for consultations, a panel process, appellate review, and suspension of concessions, under terms that are almost identical to those of the DSU. Minor differences do exist: panel reports are adopted at the Senior Economic Officials Meeting (SEOM). The SEOM plays a role similar to that of the WTO Dispute Settlement Body. Like the WTO, a reverse-consensus rule applies in the SEOM. Appeals are made to a seven-member Appellate Body appointed by the ASEAN economic ministers, with three members designated to hear a proceeding. Article 1:3 of the protocol allows ASEAN members to resolve a dispute involving fellow members in other dispute settlement forums (e.g., the WTO) at any stage before a party has made a request to the SEOM to establish a panel. This clause implies that the protocol becomes the exclusive means of resolving disputes between members once a request is made to the SEOM to establish a panel.[117]

Japan-Singapore Economic Partnership Agreement. As is clear from the above discussion, economic partnership agreements that incorporate FTA agreements have become relatively common in East Asia. Singapore has entered into several such agreements that provide for state-state dispute settlement, require consultations as a first step in the dispute settlement process, and provide for an arbitration

[116] Appellate Body Report, Mexico–Tax Measures on Soft Drinks and Other Beverage (Mexico–Soft Drinks), WT/DS308/AB/R, paras. 48–53 (quoting para. 53).

[117] The decisions of the Appellate Body in Mexico–Soft Drinks and the WTO Panel in Argentina–Definitive Anti-Dumping Duties on Poultry from Brazil (Argentina–Poultry), WT/DS241/R, bring into question when or even whether WTO rules would permit a panel to decline to hear a case pending or decided under the Protocol or other FTA mechanisms, and whether the doctrine of estoppel might be applied to prevent the WTO from hearing such a dispute.

mechanism if consultations prove unsuccessful. Investor-state disputes are usually regulated under separate dispute settlement provisions. For example, the Japan-Singapore Economic Partnership Agreement (JSEPA) is an FTA with a dispute settlement mechanism that provides for general consultations to avoid recourse to the dispute settlement system. Like the WTO Agreement, it makes arbitration, mediation, and conciliation available as options for settling a dispute. If the parties are unable to settle their dispute through means short of formal dispute settlement proceedings, JSEPA provides for "special consultations" as the first step in its formal dispute settlement process, before arbitration. JSEPA permits the parties to have recourse to other international dispute settlement agreements (such as the WTO) to which they are parties. Starting an action under one agreement makes that agreement the exclusive forum for the dispute unless "substantially separate and distinct rights or obligations under different international agreements are in dispute."

Comprehensive Economic Cooperation Agreement between the Republic of India and the Republic of Singapore. This agreement also provides for consultations, followed by arbitration to resolve disputes arising under it. It incorporates many WTO obligations. The parties affirm their rights and obligations under existing bilateral and multilateral agreements to which both are parties, including the WTO Agreement, but what is to be done in the event of a conflict between agreements is left vague. The agreement only provides that, in the event of an inconsistency, the parties should immediately consult with each other with a view to finding a mutually satisfactory solution.

Singapore-Australia Free Trade Agreement. Again, consultations followed by arbitration are used in the SAFTA. In the event of any inconsistency between this agreement and any other agreement to which both are parties, the countries are required to consult with each other with a view to finding a mutually satisfactory solution in accordance with customary rules of public international law.

North American Free Trade Agreement. Chapter 20 of the agreement is applicable to NAFTA disputes not involving investment, antidumping measures, or countervailing duties (which fall under other NAFTA dispute settlement rules). NAFTA members are required to try to resolve Chapter 20 disputes through government-to-government consultations. If consultations are unsuccessful, the parties may request a meeting of the NAFTA Free Trade Commission (comprising the trade ministers of the parties). If the commission cannot resolve the dispute, a party may call for the establishment of a five-member arbitral panel, which is entitled to seek assistance from scientific experts ("scientific review boards"). NAFTA permits parties to choose whether to resolve trade disputes through arbitration within the FTA or before the WTO. Disputes like the long-running *Softwood Lumber* case have been heard in both forums.

In summary, the above examples are representative of FTA dispute settlement provisions. They suggest that FTA dispute settlement systems

(i) are state-to-state;
(ii) require consultations;
(iii) usually make available good offices, mediation, and conciliation; and

(iv) provide for some form of arbitration if consultations are unsuccessful.

In addition, FTA agreements generally use an enforcement mechanism similar to that of the WTO Agreement (but based on the withdrawal of FTA, and not, WTO concessions).[118]

One area where FTAs differ is in forum selection between the FTA and the WTO in the event of overlapping obligations. Various options exist:

(i) Refrain from taking a position on this point and simply require the parties to consult.
(ii) Make the FTA the exclusive forum for the resolution of a trade dispute involving FTA members.
(iii) Allow FTA members to choose whether to have a dispute heard before an FTA tribunal or before the WTO (make the first forum before which the dispute is brought the exclusive forum).
(iv) Allow the exercise of concurrent jurisdiction.

The WTO Appellate Body decisions in the Mexico–Soft Drinks case (discussed above) raises questions concerning FTA provisions aimed at limiting an FTA member's recourse to WTO dispute settlement when WTO obligations are at issue, though the decision will not be the last word on the subject.

Framework and Practical Approaches for Best Practices in Dispute Settlement Mechanisms

Some salient recommendations of realistic best practices in dispute settlement would include the following:

(i) **Work within WTO rules.** Many FTAs draw inspiration from the WTO dispute settlement system and this is a good place to start when analyzing practical approaches and best practices in FTA dispute settlement mechanisms. The success of the WTO dispute settlement system has served as an inspiration for many FTAs. AFTA presents the clearest example of an FTA with dispute settlement provisions modelled on the WTO system. The framework applies consultations, a panel process (arbitration), and an appellate process. Enforcement is generally well understood by trading countries, and commonly used in FTAs, with the exception that FTA dispute settlement mechanisms do not always have an appellate stage of dispute settlement proceedings. At a minimum, FTAs should be in accord with WTO rules, including dispute settlement practices.

(ii) **Place importance on consultations.** The importance of consultations as a first step in dispute settlement must be stressed. A large number of trade disputes are resolved either bilaterally through informal consultations, or through formal consultation procedures. Likewise, although good offices, conciliation, and mediation are options that are only infrequently used, their inclusion in an FTA costs the parties nothing and their occasional use by the parties may, in certain cases, help to avoid recourse to formal dispute settlement proceedings. Resolving a trade dispute at an early stage, before the initiation of formal dispute settlement procedures, is

[118] The effectiveness of this remedy may be tempered by the existence of any bound concessions a party has made under the WTO Agreement.

cost-effective and efficient, and often the best solution for maintaining harmonious trade relations among FTA parties.

(iii) **Develop a choice of law strategy between WTO and FTA procedures.** Owing to the almost universal nature of the WTO Agreement, and overlapping obligations in the WTO and FTA Agreements, FTA members may find themselves in situations where the rules of both the FTA and the WTO apply. They must decide under which rules they want to seek relief. Dispute settlement proceedings might be heard under one or both systems, and the potential for inconsistent results exists. Parties negotiating FTAs frequently insert a clause providing that initiation of an action under the FTA excludes commencement of the same action in the WTO. Two WTO decisions have examined this type of clause,[119] and in each case WTO panels assumed jurisdiction despite the clause. Nevertheless, these two rulings, for a number of technical reasons, are not the final word on the question. FTA drafters should therefore continue to insert a provision on how conflicts between the two sets of rules should be managed, with the expectation that members will operate in good faith and not seek recourse in a second forum if they fail to prevail in the first forum.

(iv) **Use WTO dispute settlement rules as a model for FTA dispute settlement provisions.** Because of their common goals (trade liberalization), FTAs frequently draw on WTO principles and practices. The result is a framework of obligations that is familiar to the parties and may result in fewer disputes. Likewise, FTAs frequently draw on the dispute settlement rules of the WTO as a model for their own rules. The familiarity of trading countries with these rules, and the relative success of the WTO dispute settlement system, supports this choice, and may result in a desirable degree of harmonization among FTA dispute settlement systems.

(v) **Provide technical assistance on dispute settlement to developing-country FTA members.** Economically more advanced FTA members should recognize the importance of strengthening capacity and institutions in less-developed members. Capacity constraints can limit the ability of developing countries, in particular LDCs, to participate successfully in FTA dispute settlement proceedings. Technical assistance regarding dispute settlement practices and procedures is important in maintaining an equitable dispute settlement system. More broadly, investment in education in poorer member countries can help improve the success of the FTA in general, and its dispute settlement system in particular.

(vi) **Emphasize good governance principles, including transparency, in FTA dispute settlement procedures and practices.** Factors like good governance and transparency will influence the success of an FTA and will provide greater legitimacy for its dispute settlement system. The free flow of goods, services, investment,

[119] See the Mexico–Soft Drinks and Argentina–Poultry decisions (discussed above).

and capital can contribute to regional growth and development, as well as stability and prosperity. A dispute settlement system with fair and efficient procedures and practices is one way to lock in those gains.

Appendix to Part II:

Rules of Origin in Japan's Economic Partnership Agreements (EPAs) with Malaysia and the Philippines

Chapter	EPA with Malaysia	EPA with the Philippines
16 Preparations of Fish	CTH or WO (or wholly obtained in ASEAN)	CTH or WO (or wholly obtained by authorized vessel under Indian Ocean Tuna Commission)
18–20 Preparations of Cocoa, Cereals, Vegetables	CTH or WO (or wholly obtained in ASEAN)	CTH (19) or WO (or for Chapters 18 and 20 wholly obtained in ASEAN)
28–38 Chemicals	CTH or VA (regional, 40%)	CTH or VA (regional, 40%)
40 Rubber and Articles of Rubber	CTH or VA (Regional, 40%)	CTH or VA (Regional, 40%)
50–60 Textiles	CTH and two-step SP (or two-process SP in ASEAN)	CTH and 2 Step SP (or two-process SP in ASEAN)
61–63 Clothing and Articles of Textiles	CTH and two-step SP (or two-process SP in ASEAN)	CTH and two-step SP (or two-process SP in ASEAN)
64 Footwear	CTH	CTH
84–85 Electrical Machinery	CTSH or VA (regional, 40%)	CTH or VA (regional, 40%)
86–89 Transport Equipment	CTH or VA (regional, 40%)	CTH or VA (regional, 40%)
94 Furniture and Bedding	CTH or VA (regional, 40%)	CTH or VA (regional, 40%)

ASEAN = Association of Southeast Asian Nations, CTH = change in tariff heading, SP = specified process, VA = value added, WO = wholly obtained.

Source: Compiled from the World Trade Organization (WTO) regional portal. Available: www.wto.org

Binding Nonconforming Measures, Japan-Philippines Economic Partnership Agreement (JPEPA)

Modes of supply: (i) Cross-border supply, (ii) consumption abroad, (iii) commercial presence, (iv) presence of natural persons

Sector or Subsector	SS	Limitations on Market Access	Limitations on National Treatment	Additional Commitments
C. Telecommunication Services				
Basic telecommunication services: Voice telephone services (7521); Packet-switched data transmission services (7523**); Circuit-switched data transmission services (7523**); Telex services (7523**); Facsimile services (7521**, 7529**); Private leased circuit services (7522**, 7523**); and Other	SS	(i) None (ii) None (iii) None except that foreign capital participation, direct and/or indirect, in Nippon Telegraph and Telephone Corporation (NTT)[23] must be less than one third. (iv) None	(i) None (ii) None (iii) None except that board members and auditors in NTT and the regional companies must be Japanese nationals. (iv) None	Japan undertakes the additional commitments below.

SS = subsector.

Matrices of FTA Service Provisions

Matrix 1: Examples of Commitments Providing for the Phase-out of Restrictions in Various FTAs

Country	Sector	FTA Commitments Providing for the Phase-out of Restrictions in Place	Partner Country
Australia	Financial services	Foreign life insurers will be allowed to operate branches.	US and Singapore
Bahrain	Business services	Local presence requirements to be phased out within 3 years from the date of entry into force of the agreement for advertising, car rental, consultancy and management, and debt collection. For accounting, financial auditing and bookkeeping, architectural and engineering, and services incidental to mining, the phase-out will be within 7 years of the date of signature of the agreement. Branching and entity restrictions in advertising and publishing to be phased out within 5 years of date of entry into force of the agreement.	US
	Telecommunications	The existing two-operator limit on the number of mobile telecommunication suppliers to expire by 31 December 2005.	US
	Construction	Local presence requirements to be phased out within 3 years from the date of entry into force of the agreement.	US
	Financial services	Foreign insurers will be able to acquire new nonlife insurance licenses, with no restrictions, 6 months after the date of entry into force of the agreement.	US
	Tourism	Local presence requirements for travel agencies and tour operators, and travel guide services to be phased out within 3 years from the date of entry into force of the agreement.	US
	Transportation	Local presence requirements, including those for maritime, road, and rail transport services, to be phased out within 3 years from the date of entry into force of the agreement.	US
Chile	Financial services	Foreign insurance companies to be allowed to supply marine, aviation, and transport insurance 1 year after entry into force of the agreement on a cross-border basis.	US and EC
		Foreign insurance companies to be allowed to establish branches in Chile no later than 4 years after the date of entry into force of the agreement.	US
		Asset management by mutual funds, investment funds, and foreign capital investment funds to be allowed as of entry into force of the agreement, and management of voluntary savings plans to be allowed as of 1 March 2005.	US
China, People's Republic of	Professional services	Wholly owned operations in architectural, engineering, integrated engineering, and urban planning and landscape architectural services to be permitted as of December 2006.	Hong Kong, China and Macao
Colombia	Telecommunications	Resale of international telecommunications traffic to be permitted by 2007.	US
	Financial services	Financial companies to be allowed to establish branches no later than 4 years after entry into force of the agreement. Companies also to be allowed to provide cross-border supply of portfolio management services to collective investment schemes no later than 4 years after entry into force of the agreement.	US
	Audiovisual services	There will be no restrictions on the number of subscription television concessions at the zonal, municipal, and district levels once the current concessions at those levels expire and in no case beyond 31 October 2011. Quotas for broadcasting of locally produced programming on free-to-air national television services on weekends/ holidays to be reduced from 50% to 30% by 1 February 2009.	US

Country	Sector	FTA Commitments Providing for the Phase-out of Restrictions in Place	Partner Country
Costa Rica	Telecommunications	Direct supply to the customer of the following telecommunications services will be allowed: (i) private network services, by 1 January 2006; (ii) Internet services, by 1 January 2006; and (iii) mobile wireless services, by 1 January 2007.	US
	Financial services	Insurance sector to be fully liberalized and the existing monopoly to be eliminated in phases. Upon entry into force of the agreement foreign insurance companies will have access to the insurance sector on a cross-border basis. After 2008, the companies will be allowed to establish operations in Costa Rica, through branching and other means, but restrictions on third-party auto liability and on worker compensation will continue until 2011, after which the sector will be fully liberalized.	US
Dominican Republic	Financial services	Foreign life and nonlife insurance companies to be allowed to establish branches no later than 4 years after entry into force of the agreement. Currently, collective investment schemes are not regulated in the Dominican Republic. Nonestablished financial institutions (other than trust companies) will be allowed to provide investment advice and portfolio management services to collective investment schemes in the country as soon as these schemes are regulated.	US
El Salvador	Financial services	Foreign insurance companies to be allowed to establish branches no later than 3 years after entry into force of the agreement.	US
Guatemala	Financial services	Foreign life and nonlife insurance companies, as well as brokers and agents, to be allowed to establish branches no later than 4 years after entry into force of the agreement. Currently, collective investment schemes are not regulated in Guatemala. Nonestablished financial institutions (other than trust companies) will be allowed to provide investment advice and portfolio management services to collective investment schemes in the country as soon as these schemes are regulated.	US
Honduras	Telecommunications	Basic telecom services to be fully liberalized by 24 December 2005. Additional mobile operators may also be authorized by December 2005.	US
Morocco	Financial services	Foreign life and nonlife insurance companies to be allowed to establish branches not later than 4 years after entry into force of the agreement. Apart from reinsurance brokerage, foreign insurance companies will be permitted to supply marine, aviation, and transport insurance 2 years after entry into force of the agreement on a cross-border basis.	US
Nicaragua	Telecommunications	Monopoly on basic telecommunication services to be eliminated as of 13 April 2005.	US
	Financial services	Foreign insurance companies to be allowed to establish branches 4 years after entry into force of the agreement. However, members of the board of directors must be residents of Nicaragua.	US
Oman	Distribution	Full foreign ownership of retail enterprises worth more than $1 million to be permitted by 2011.	US
Panama	Telecommunications	Monopoly on basic telecom services to be eliminated by January 2003.	El Salvador
Peru	Financial services	Foreign nonlife insurance companies are allowed to supply marine, aviation, and transport insurance 2 years after the entry into force of the agreement. Services auxiliary to insurance, such as consultancy, actuarial, risk assessment, and claim settlement services, may also be provided on a cross-border basis 2 years after the entry into force of the agreement.	US
Singapore	Business services	Existing Singaporean laws to be modified so as to relax conditions under which US law firms are permitted to provide legal services.	US

Country	Sector	FTA Commitments Providing for the Phase-out of Restrictions in Place	Partner Country
		Foreign power companies to be allowed to supply electricity to non-household consumers in two phases: phase 1, 2 months after the opening up of the electricity market in the second half of 2002; and phase 2, 6 months after phase 1. In the final phase, scheduled for implementation by 2003, retail sale to the remaining consumers (mainly household consumers) to be fully opened up.	US
		For architectural services, the requirement of "residency" in Singapore to be phased out by April 2005. The requirement to have Singapore-registered or Singapore-allied professionals occupying at least two thirds of directorships in a corporation to be reduced to 51% by April 2005.	Republic of Korea
	Financial services	Current ban on new licenses for full-service banks to be lifted within 18 months, and within 3 years for "wholesale" banks that serve only large transactions. Licensed full-service banks able to offer all their services at up to 30 locations in the first year, and at an unlimited number of locations within 2 years. Locally incorporated subsidiaries of US banks can apply for access to the local ATM network within 2.5 years. Branches of US banks get access to the ATM network in 4 years.	US
Thailand	Tourism, education, and maritime transport	By January 2005, equity participation of up to 60% (subject to certain criteria) by Australian investors/service suppliers allowed in major restaurants or hotels, tertiary education institutions specializing in science and technology and located outside Bangkok, and certain maritime cargo services.	Australia

ATM = automated teller machine, EC = European Community, FTA = free trade agreement, US = United States.
Source: Roy, Marchetti, and Lim (2006).

Matrix 2: Key Approaches and Provisions of FTAs Involving East Asian Countries

Agreement	Scheduling Approach	MFN Clause	Sectoral Carve Outs	Rules of Origin for Judicial Persons*
ASEAN Framework Agreement on Services	Positive	MFN between ASEAN members subject to ASEAN-X formula***	None**	Yes. As far as services are concerned, benefits are also extended to juridical persons with substantial business operations in the territory of any party.
Australia-Thailand	Positive	More favorable treatment of non-parties to be extended to parties, but nonbinding.	None **	Yes (for chapter on promotion and protection of investments)
India-Singapore	Positive	More favorable treatment of non-parties to be extended to parties, but nonbinding.	Core air transport services	Yes (for services supplied cross border and through consumption abroad, although benefits can be denied). Several Singaporean banks are expressly listed as beneficiaries.
Japan-Malaysia	Positive	More favorable treatment of non-parties to be extended to FTA parties, subject to a negative list of reservations.	Core air transport services and cabotage in maritime transport	Yes (parties can deny FTA benefits to service providers from non-parties with which a party does not maintain diplomatic relations or where certain trade sanctions apply). The investment chapter of Japan-Malaysia does not extend benefits to branches of enterprises of third states.
Japan-Singapore	Positive	More favorable treatment of non-parties to be extended to parties (but nonbinding).	Core air transport services and cabotage in maritime transport	Yes. As far as services are concerned, benefits are also extended to juridical persons with substantial business operations in the territory of any party.
Australia-Singapore	Negative	None	Core air transport services	Yes
Chile–Republic of Korea	Negative	None	Core air transport services and financial services	Yes. But parties can deny FTA benefits to service providers from non-parties with which a party does not maintain diplomatic relations or where certain trade sanctions apply.
Japan-Mexico	Negative	More favorable treatment of non-parties to be extended to FTA parties, subject to a negative list of reservations.	Core air transport services, cabotage in maritime transport, and financial services	Yes. But parties can deny FTA benefits to service providers from non-parties with which a party does not maintain diplomatic relations or where certain trade sanctions apply.

Agreement	Scheduling Approach	MFN Clause	Sectoral Carve Outs	Rules of Origin for Judicial Persons*
Viet Nam–US	Positive	MFN obligation	None **	Yes. But parties can deny FTA benefits to investors from third country if the denying party does not maintain normal economic relations with the third party (investment chapter only).
Singapore-US	Negative, except for cross-border trade in financial services, for which a positive list is adopted.	Better treatment of non-parties to be extended to FTA parties, subject to a negative list of reservations.	Core air transport services	
Singapore-Panama	Negative, except for cross-border trade in financial services, for which a positive list is adopted.	Better treatment of non-parties to be extended to FTA parties, subject to a negative list of reservations.	Core air transport services	

ASEAN = Association of Southeast Asian Nations, FTA = free trade agreement, MFN = most-favored nation, US = United States.
* Extended to juridical persons constituted under domestic laws and having substantial business operations in the domestic territory.
** No explicit sectoral carve-out in the text of the agreement; coverage of the sector depends on what has been committed in the schedules of specific commitments (in the case of a positive-list approach) or what is included in the reservations list (for negative list FTAs).
*** ASEAN-X formula as described in Fink and Molinuevo (2007) is a 2003 amendment to the ASEAN Framework Agreement on Services that allows for the departure from MFN if two or more members agree to liberalize trade in services faster than the remaining ASEAN members.

Source: Compiled from tables in Fink and Molinuevo (2007).

EXAMPLES OF INVESTMENT AGREEMENTS

Key NAFTA Investment Provisions. Chapter 11 contains the most established regional investment regime. Investment is defined through a broad list of assets, along with a negative list of certain claims to money. Although investment provisions are applicable to all sectors in principle, each country has identified key sectors that are exempted. National treatment and most-favored nation (MFN) treatment are granted for the establishment (market access), acquisition, expansion, management, conduct, operation, and sale or other disposition of investments. In addition, there are prohibitions on restrictions on ownership and on use of performance requirements, and there are guarantees on free transfer of funds and protection from expropriation and nationalization. There is also a comprehensive dispute settlement mechanism for state-to-state and investor-to-state disputes, including access to international arbitration through the International Centre for Settlement of Investment Disputes (ICSID) and the UN Commission on International Trade Law (UNCITRAL).

(i) The obligations of the investment chapter in US FTAs go far beyond the provisions proposed at the WTO. For example, they require US investors and investments to be treated at least equally with locals (national treatment), in preestablishment rights and other matters, unless the exceptions are listed in the FTA (negative-list approach). Performance requirements such as transfer of technology are also prohibited except in certain circumstances or for listed exceptions.

(ii) US FTA negotiations with some ASEAN countries on the investment chapter have met with various difficulties. The expropriation provision requires compensation, including interest, for direct or indirect expropriation of an investment. As "investment" is defined very broadly to include tangible and intangible property, loans, shares, intellectual property, etc., investors can directly sue the state at an international tribunal for violations of the investment chapter, including the expropriation provision. "Indirect investment" could mean losses resulting from government regulation or policy. The investment chapter could affect a partner country's ability to put in place capital controls and other policies such as those used during the 1997 Asian financial crisis.

Key ASEAN Investment Provisions. These are contained in the 1987 ASEAN Agreement on the Promotion and Protection of Investment, and the 1998 Framework Agreement on the AIA. The latter introduced the concept of the "ASEAN investor" and covers investments from sources within and outside the ASEAN region. It provides for national treatment for ASEAN investors by 2010 (later advanced to 2003) and non-ASEAN investors by 2020 (later advanced to 2010) with respect to investments that are specifically approved in writing and registered by the host country; for preestablishment rights subject to a negative list of temporary and sensitive exclusions from each ASEAN state; and for state-to-state and investor-to-state dispute settlement at the national and regional (meetings of the ASEAN economic ministers) levels. Disputes may also be brought before the ICSID, UNCITRAL, the Regional Centre for Arbitration in Kuala Lumpur, or any other regional center. ASEAN has likewise entered into economic partnership agreements with its dialogue partners (the PRC, Japan, the Republic of Korea, the Australia–New Zealand FTA, India, and the EU). The investment chapter in each agreement is aimed at promoting liberalization, transparency, facilitation, and protection of cross-border investment. A concern, however, is the lack of coherence and consistency among the different agreements.

Key Investment Provisions of the Japan-Singapore Economic Partnership Agreement (JSEPA). In recent years Singapore has been prolific in signing bilateral trade agreements. The investment provisions of JSEPA (Chapter 8) are examined below.

(i) **Investment vs. Enterprise.** "Investment" is very broadly defined to cover every kind of asset owned or controlled, directly or indirectly, by an investor. It also includes profit, interest, capital gains, dividends, royalties, and fees. "Investor" covers nationals of Japan, nationals of Singapore, and permanent residents of Singapore. "Enterprise" means any legal person/entity and includes government-owned and government-controlled corporations. An enterprise is defined as "owned" by non-parties if more than 50% of the equity interest is owned by non-parties, and "controlled" by non-parties if such persons have the power to name a majority of its directors or otherwise to legally direct its actions.

(ii) **National treatment (Article 73):** Each party must accord investors/investments of its FTA partner

national treatment with regard to the establishment, acquisition, expansion, management, operation, maintenance, use, possession, liquidation, sale, or other disposition of investment. National treatment also extends to access to its courts of justice and administrative tribunals and agencies. National treatment applies as well to any restitution or compensation to investors that have suffered loss or damage to their investments due to armed conflict or revolution, insurrection, and civil disturbance.

(a) Japan has listed the following exceptions: horizontal exceptions on land transport; prior notification requirement in some sectors; public monopoly and state enterprises; subsidies designated for investments in research and development; and permanent residents of Singapore. Sectoral exceptions cover agriculture (plant breeder's rights); the mining industry, including oil and natural gas exploration and development; the water transport industry; financial services; and the telecommunications industry. National treatment and prohibition of performance requirements do not apply to fisheries within the territorial seas, internal waters, and exclusive economic zones; the manufacture of explosives; the nuclear energy industry; the aircraft industry; the arms industry; the space industry; the electric utility industry; the gas utility industry; and the broadcasting industry.

(b) Singapore has listed the following exceptions: horizontal exceptions on subsidies and incentives for all sectors; company registration formalities for all sectors (also exceptions to performance requirements); ownership of residential land and property; regulations on Singapore-dollar transactions; and privatization (also performance requirements). Sectoral exceptions cover investments in services; the printing and publishing sector; the arms and explosives sector; and certain industries/products in the manufacturing sector.

(iii) **Performance requirements:** These are prohibited, with exceptions.

(iv) **Expropriation and compensation (Article 77):** Investments/investors must be accorded fair and equitable treatment and full protection and security. Expropriation and nationalization can be undertaken only for a public purpose, on a nondiscriminatory basis, in accordance with due process of law, and upon payment of compensation. Compensation must be equivalent to the fair market value of the expropriated investments, must be paid without delay, and must be effectively realizable, freely transferable, and freely convertible at the market exchange rate prevailing on the date of the expropriation, and into freely usable currencies defined in the International Monetary Fund (IMF) Articles of Agreement. Investors have the right of access to the courts of justice or the administrative tribunals or agencies of the

partner making the expropriation, to seek a prompt review of the investor's case or the amount of compensation that has been assessed.

(v) **Settlement of state-investor disputes (Article 82):** Such investment disputes must, as far as possible, be settled amicably through consultations between the disputing parties. If an investment dispute cannot be settled through such consultations within 5 months, and if the investor has not submitted the dispute for resolution under administrative or judicial settlement, or in accordance with any agreed dispute settlement procedures, that investor may either request the establishment of an arbitral tribunal or submit the investment dispute to the ICSID or UNICTRAL for conciliation or arbitration.

(vi) **Temporary safeguards (Article 84):** A party may adopt or maintain measures inconsistent with its obligations on national treatment and on transfers in the event of serious balance of payments or external financial difficulties, or where, in exceptional circumstances, movements of capital result in serious economic and financial disturbance in the FTA partner. The measures must be consistent with the IMF Articles of Agreement, must not exceed those needed to deal with the circumstances, must be temporary and must be eliminated as soon as conditions permit, must promptly be notified to the FTA partner, must be nondiscriminatory, and must avoid unnecessary damage to the commercial, economic, and financial interests of the FTA partner.

(vii) **Intellectual property rights (Article 86):** National treatment applies only to the extent provided for in TRIPS Annex 1C to the WTO Agreement.

(viii) **Joint Committee on Investment (Article 88):** This committee will review and discuss the implementation and operation of this chapter, review the specific exceptions in Article 76, and discuss other investment related issues.

INVESTMENT PROVISIONS OF SELECTED FTAS COMPARED

The Urata and Sasuya (2007) study of seven FTAs involving the US, Australia, Japan, Singapore, Republic of Korea, and Chile reached the following conclusions:

(i) The Japan-Mexico and Chile–Republic of Korea agreements are the most restrictive to foreign direct investment (FDI). In the Japan-Mexico agreement, Mexico has more restrictions on FDI than Japan. In the Chile–Republic of Korea agreement, the two countries are almost equally restrictive. Restrictions cover foreign ownership and market access, national treatment, composition of management, performance requirements, entry of investors and businesspeople, and right to implement future restrictive measures.

(ii) The North American Free Trade Agreement (NAFTA) is also restrictive to FDI. Canada and Mexico maintain a high degree of restrictions. The US, while relatively more open, requires reciprocity from its FTA partners—

it opens up only those sectors that its FTA partner also opens up to US investors. Canada and Mexico have very high restrictions on agriculture and mining. All three NAFTA countries maintain high restrictions on the financial, transportation, and information and communications sectors. In contrast, the US agreements with Australia and Singapore are less restrictive than NAFTA.

(iii) Of Singapore's bilateral agreements with Japan, the US, and the Republic of Korea, the agreement with the Republic of Korea is most restrictive because of the latter's restrictions. In all sectors, the Republic of Korea reserves the right to prohibit or restrict ownership in state enterprises, to prohibit or limit the right of Singapore investors to control a company or investment created in the transfer or disposal of state assets, and to adopt or maintain any measure with respect to land acquisition by foreigners. Singapore restrictions are found in the financial sector and in its requirement for investments to have local managers. Both the Republic of Korea and Singapore have high restrictions on the electricity sector, transportation, information and communications, education, public administration, defense, and compulsory social security sectors. The Japan-Singapore agreement is more restrictive than the Japan-Mexico agreement, reflecting the fact that the former is Japan's first bilateral agreement and Singapore has limited bargaining leverage "because Japan had to ask more from Mexico than it did with Singapore, such as opening of the automobile market, Japan also had to give more."

The seven countries, ranked from the most to the least restrictive in the investment provisions of their FTAs, are Canada, Mexico, Chile, Republic of Korea, Japan, Australia, Singapore, and the US. The restrictions examined pertained to foreign ownership and market access, national treatment, screening and approval, corporate directorships, movement of people, and performance requirements. The US is the most open to FDI; its restrictions usually follow the reciprocity principle. It is relatively open in the primary, manufacturing, and most service sectors, except for the financial and transportation sectors. Singapore is relatively open to FDI, but imposes limitations on foreign ownership in state enterprises, certain types of housing, and financial services. Foreigners who wish to register a business firm in Singapore need to have a local manager, and a local resident for at least one of the directors, while all branches of foreign companies should have at least two local agents.

Part III: Negotiating, Implementing, and Evaluating Free Trade Agreements

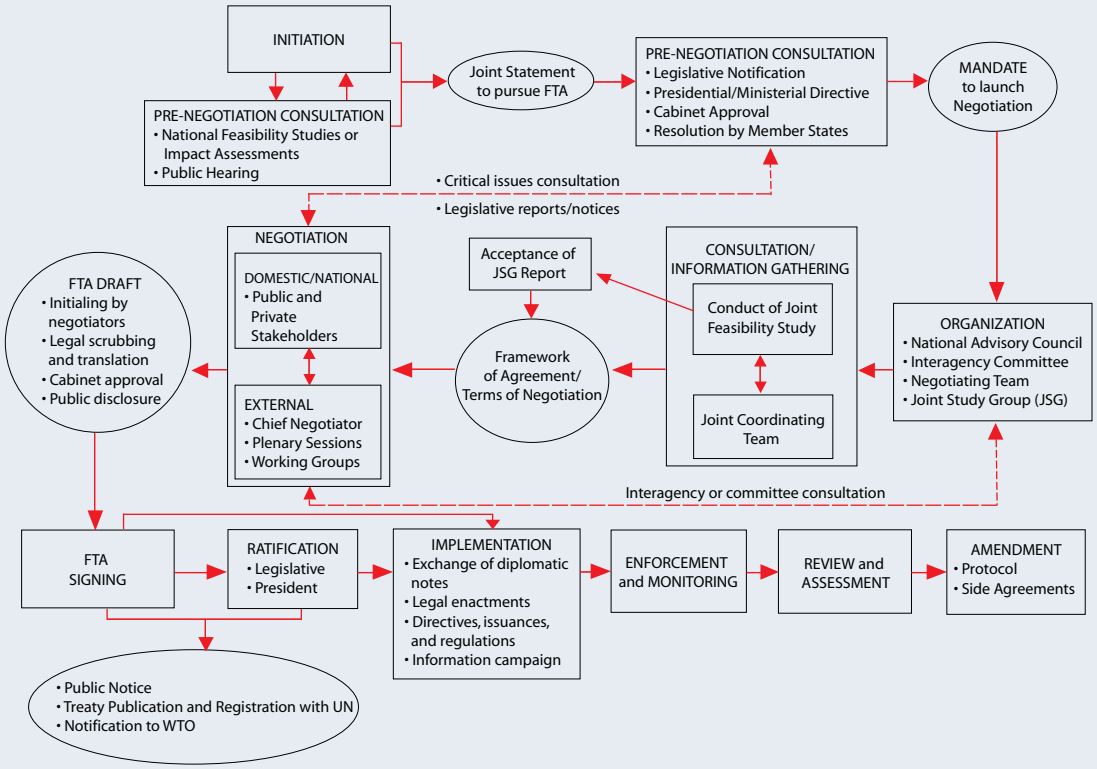
INTRODUCTION

A country's participation in a free trade agreement (FTA) does not begin and end with the actual negotiations. The FTA trail entails various pre-negotiation procedures and extends until its enforcement and evaluation. Understanding the whole process will assist the negotiators, implementers, and evaluators in effectively delivering their duties and properly coordinating their functions.

Part III[120] provides a general understanding of the entire FTA process, discusses the procedures and experiences at each step, and identifies good practices and practical approaches to the issues and challenges that face government officials and staff working on FTA and other FTA-related matters. A model FTA process is shown in Figure 3.1. Except for the substantive and procedural requirements established under the WTO framework, there is no firm sequence of events in preparing for,

[120] Part III is based on inputs from concerned ministries and agencies of ASEAN member countries, the Republic of Korea, and Australia. The authors are grateful to the ASEAN Secretariat for circulating the questionnaire to ASEAN member countries, and to the FTA training course speakers and participants for their valuable comments. Good practices and experiences especially from developed countries are incorporated.

Figure 3.1 **Model FTA Process**



FTA = free trade agreement, JSG = Joint Study Group, UN = United Nations, WTO = World Trade Organization.
Source: ADB Staff.

negotiating, and implementing FTAs. The procedures, however, are usually the same and are more often dictated by national laws and practices.

The starting point of an FTA process varies between countries. While most developed countries and some newly industrialized economies (NIEs) in Asia begin with pre-negotiation consultations or exploratory works, most developing countries (e.g., member countries of the ASEAN) begin with high-level government-to-government initiatives.

At the pre-negotiation consultation stage, national feasibility studies, domestic sensitivity analysis, scoping studies, or public hearings assess the desirability and viability of the proposed FTA and identify sectoral difficulties. When the FTA is found to be appropriate and timely, the country that conducted the feasibility studies proposes FTA negotiation. FTA initiation therefore involves an active player (the country that has determined the relevance of entering into an FTA and thereby proposes FTA negotiations with another party) and a passive player (the country that accepts the proposal from a prospective FTA partner to negotiate).

In many countries, the decision to enter into an FTA is politically motivated and is sometimes determined by the head of state. In this case, FTA initiation precedes the pre-negotiation consultations. The idea of entering into an FTA is usually introduced in bilateral meetings (such as state visits) to further the economic relations between the parties involved. ASEAN, for instance, has

typically acceded to FTA talks initiated by its external dialogue partners in the ASEAN-plus FTAs.

After the initiation or pre-negotiation consultation, the prospective FTA partners issue a joint statement declaring formally their intention to negotiate and enter into an FTA. Joint statements usually contain the rationale or significance of the FTA, its broad coverage, the target date of implementation, and sometimes a reference to the country's WTO commitments.

Some pre-negotiation procedures are then required and preliminary government-to-government contact is made. These internal government procedures are a precursor to launching FTA negotiations, which include legislative notification (especially where the parliament has a strong role in or influence on executive policies), the circulation of presidential or ministerial directives (as in most ASEAN countries), the submission of the overall FTA objectives and strategy to the cabinet for approval (as in the Republic of Korea), or formal adoption by member states (as in the case of the Australian Federal Government and the EU). In the process, the mandate to negotiate is obtained.

At the organization stage or as early as the pre-negotiation stage, several bodies may be organized or convened—national advisory committees (with representatives from the public and private sectors); legislative-executive and interagency committees (composed of public stakeholders, regulators, and policy makers); and the negotiating team (at the working and support levels). The committees (which are either decision-making or consultative bodies) will oversee and coordinate the policy aspects of the FTA and ensure that they are aligned with the national objectives of the country. The negotiating team is tasked to carry out their negotiation mandate.

A joint study group (JSG) (which will conduct the joint feasibility study) and a joint coordinating team (JCT) (which will agree on the terms of the negotiation) are organized on both sides of the negotiating table as part of the broader consultation and information-gathering stage. If the JSG report recommends entering into an FTA and this recommendation is accepted by the leaders of the prospective partner countries, a framework agreement is signed or formal negotiation ensues. The framework agreement specifies the outline or coverage of the proposed agreement, including areas for possible economic cooperation and possibly "early-harvest schemes."[121] With or without a framework agreement, the JCT agrees on the terms of the negotiation and moves on to the negotiation.

FTA negotiation (which takes 1–2 years, depending on the issues covered and the depth of the proposed agreement) occurs at two levels—*externally* with the negotiating counterparts, and *domestically* with national stakeholders. External negotiations are conducted between chief negotiators (especially on sensitive issues) and between sub-teams at plenary sessions and at working group level (for specialized or technical matters). Domestic negotiations take place with stakeholders from both the public sector (e.g., policy makers, cabinet members, and regulatory bodies) and the private sector (e.g., business or industry groups, NGOs, workers' unions, environmental lobbyists, civil society, and consumer groups). Part of the negotiator's task at this stage is therefore balancing external and domestic interests. While domestic negotiations are an integral part of the whole negotiation process in advanced

[121] A term used in trade negotiations for agreeing to accept the results of a portion of the negotiations before the rest of the negotiations are completed (e.g., early implementation of tariff liberalization of selected goods).

countries, external negotiations are still at the center of the process in many developing countries.

Concurrently, coordination and consultation with the interagency committee, the national advisory council, the cabinet, and the legislative body[122] continues. While some practical issues are addressed through meetings among the ministries concerned (at the director or director-general level depending on the level of authority needed to resolve the issues), critical issues are often elevated to the interagency committee, the national advisory council, or the cabinet. Highly critical issues that dictate the destiny of the whole negotiation are sometimes taken up at the level of the head of state, usually at the final stage of the negotiation. In some countries, regular legislative reports or notices provide an opportunity to discuss critical issues, arrive at new bargaining positions if necessary, and minimize possible conflicts or obstacles during ratification.

Sometimes the text of the agreement is based on previously signed agreements (e.g., agreements entered into by the US, Japan, and ASEAN) to which one of the countries is a party. This process, called "docking," saves time, as negotiators no longer need to renegotiate areas that do not present any material issue to either side. Docking may even result in more consistent or harmonized FTA agreements (especially in the matter of rules), lessening the so-called "spaghetti bowl effect" of FTA proliferation.

After the negotiation but before the signing of the agreement, the text of the agreement is initialled by the chief negotiators.[123] The initialled text then undergoes "legal scrubbing" to ensure that it reflects or is consistent with what was agreed on and intended during the negotiations. Consistency with and adjustments of domestic laws and regulations are taken into consideration. Legal scrubbing takes time: although the main agreement may not exceed a hundred pages, the appendixes could have thousands of pages.[124] Instances of ambiguity or oversight may have to be renegotiated. Negotiators must therefore be good drafters in the legal as well as the practical sense, since careful drafting

Box 3.1: How the US Negotiates a Trade Agreement

Before negotiations, the administration notifies the Congress, consults with relevant congressional committees and the Congressional Oversight Group (COG), and complies with additional consultation and assessment requirements (for negotiations in the agriculture, textiles and apparel, and fish and shellfish sectors). The Congress then considers implementing legislation for a trade agreement under expedited procedures.

During the negotiations, the Office of the US Trade Representative (USTR) consults closely with the COG and all committees of jurisdiction.

Before signing the agreement, the President reports to the revenue committees the proposed amendments to the US' trade remedy laws and then notifies Congress. Private sector advisory committees will thereafter submit reports to Congress, the President, and the USTR.

Within 60 days from entering into the agreement, the President submits to the Congress a list of the required amendments to US law. The International Trade Commission submits to the President and Congress an assessment of the impact of the FTA on the US economy and the industrial sectors.

Source: US Trade Representative website; Pregelj (2005).

[122] During FTA negotiations, US negotiators are mandated to coordinate at length with congressional committees. After the negotiations, the Congress examines the draft FTA text in the light of the negotiating mandate and either approves or vetoes the text but does not propose amendments.

[123] Chief negotiators of Japan's FTAs sign what is called an "agreement in principle."

[124] For example, the draft US–Republic of Korea FTA, deemed the most voluminous FTA entered into in the region, had 1,300 pages in Korean and 1,400 pages in English, 280 pages of reference materials, and a 30-page terminology guidebook.

(coupled with skillful legitimation) makes ratification and efficient implementation more likely. The pre-signing stage may also involve translation if the official language of one country is different from the common language used by the parties.

The full text of the FTA, as well as its annexes and list of commitments, may or may not be made available to the public at this stage. However, public disclosure before signing promotes transparency and provides an opportunity to clarify the contents of the agreement to the stakeholders. In some countries (e.g., Singapore), cabinet approval is mandatory before the FTA is signed. The signing of the agreement makes the FTA internationally binding between the parties involved.

Whether or not the agreement is already in effect or enforceable depends on the domestic laws of each country. After the agreement is signed, it is made available to the public and notified to the WTO.[125] Where required in some countries, legislative ratification precedes the notification to the WTO.

Ratification may or may not follow the signing of the agreement. Some countries classify FTAs as executive agreements, and thus binding and effective once signed by the president or the trade minister. Most countries' laws, however, require ratification by the legislature or approval by the president (if the latter did not sign the FTA) for FTAs to be enforceable, particularly when they are classified as treaties. As a treaty, the FTA is also recorded, published, and deposited as an international instrument at the United Nations.[126]

A note verbale or diplomatic note, from each of the parties notifies the other party that all domestic requirements for implementation (including ratification) have been complied with.[127] The date the FTA takes effect depends on the domestic laws of the member country or the agreement of the parties.

The implementation stage consists of (i) the passage of laws or amendments to domestic laws and regulations to comply with the countries' commitments in the FTA, and (ii) the issuance of directives and rules by the implementers or regulators (e.g., agencies dealing with tariffs, customs, or tax collection). Lack of proper legal and administrative measures or their delay could undermine the effectiveness of signed FTAs.

The FTA is enforced and monitored by implementing and regulatory agencies within the country with the assistance of overseas trade promotion offices (which collect information and concerns from traders and private sector groups abroad). Reports from these agencies and offices are useful in evaluating FTAs.

Most FTAs provide for their (interim or midterm) evaluation. On the basis of the assessments made by a review committee, the FTA may be revised or amended through protocols to the agreement. The amendment may require the same procedures as those carried out when negotiating an FTA, or a simple addendum or side letters to the agreement signed by the trade ministers, depending on the nature and coverage of the proposed changes.

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[125] The WTO Negotiating Group on Rules requires "Member parties to a newly signed RTA [to] convey to the WTO, in so far as and when it is publicly available, information on the RTA, including its official name, scope and date of signature, any foreseen timetable for its entry into force or provisional application, relevant contact points and/or website addresses, and any other relevant unrestricted information." [emphasis supplied, Annex 1.b]

[126] In Australia, after an agreement enters into force, it is recorded, archived, and published in the Australian Treaty Series and registered with the United Nations (UN).

[127] This notification is different from that made by a WTO member to the WTO.

PREPARING FOR FTA NEGOTIATIONS

Countries, at least in principle, have established systematic criteria for entering into an FTA and selecting an FTA partner. In most cases, the decision to enter into an FTA is primarily motivated by political rather than economic considerations. Nevertheless, each country needs a well-defined FTA strategy to maintain a consistent negotiating position and to guide its negotiators, especially where the negotiating mandate is insufficient or ambiguous.

General FTA Strategy

The need for an FTA strategy cannot be overemphasized. For active FTA players, the strategy states their primordial goal and approach to FTAs. For countries that passively enter into FTAs, it provides a framework for negotiating agreements that achieve the country's national economic development objectives, and ensures the effective management of scarce resources and skills in trade negotiation. The FTA strategy may be general (as in the case of the US, Japan, Australia, and the Republic of Korea) or specific to the FTA partner (as in the case of most developing countries).

The US puts forward its competitive liberalization strategy in its bilateral, regional, and multilateral agreements (Box 3.2). Japan's FTA approach, on the other hand, is two-track: it negotiates regionally with ASEAN as a whole, and bilaterally with individual member countries. Japan's economic partnership agreement strategy is likewise dual, providing for trade liberalization and facilitation, on one hand, and economic partnership enhancement (through cooperation and FTA-plus provisions), on the other (Box 3.3). Meanwhile, Australia pursues opportunities to negotiate better trade and investment conditions through the mutually reinforcing and complementary approaches of (i) negotiating globally through the WTO, (ii) cooperating with other countries in the region (e.g., the Asia Pacific Economic Cooperation), and (iii) negotiating with important trading partners including FTAs.[128]

Box 3.2: US Trade Strategy

Competitive liberalization is the core strategy of US trade policy. The US gives priority to the multilateral system but conducts parallel talks with global, regional, and bilateral partners to generate constructive liberalization. The main objective of negotiation is the removal of trade barriers in goods, services, and foreign investment, as well as the extension of the rules-based trading system. This broad objective is accompanied by a range of policy priorities, including the protection of intellectual property, the enhancement of transparency, support for e-commerce, and the continued incorporation of government procurement, labor, and environmental issues into US trade agreements.

While trade is not an immediate objective of some US initiatives and foreign policy considerations largely account for others, certain standards are nevertheless established. The US considers it a matter of utmost importance that its free trade agreements set the gold standard for free trade, investment, and economic reform.

Suggested Readings:

Bergsten, C. Fred. 1996. Competitive Liberalization and Global Free Trade: A Vision for the Early 21st Century. Working Paper 96-15. Washington, DC: Peterson International Institute for Economics.
Schott, Jeffery J., ed. 2004. *Free Trade Agreements: US Strategies and Priorities.* Washington, DC: Peterson International Institute for Economics.

Formulation of FTA Negotiation Strategy

The creation of a viable free trade area is a complex legal and economic process that requires strategic planning. Before beginning FTA negotiations, a country should consider its economic, political, and legal objectives—its reasons for wanting to join an FTA.

Is it seeking to join an FTA because of other FTA negotiations in their region? There may be a defensive need to negotiate an FTA with a major trading

[128] www.dfat.gov.au/trade/fta/fta-guide.pdf

partner if other countries in the region (competitors) have done so already. Is it seeking to join an FTA to increase market access, perhaps to increase its market for a particular product or group of products? Is it joining to cement a political relationship or gain a preference vis-à-vis a competitor? Which market sectors will benefit from an FTA? Which market sectors may lose? What are the economic results?

To answer these questions, a country should:

(i) Develop an economic model of the economy in its present state and project the economic results of commitments made in various sectors.
(ii) Consult industry and trade associations, consumer groups, farmers and farm groups, NGOs, and other stakeholders, and ascertain their FTA needs, objectives, and concerns.
(iii) Examine the objectives in terms of the country's trade relations with other countries, the needs of stakeholders, and the country's WTO obligations.
(iv) View objectives from an economic perspective:
  (a) Can the FTA be used to promote domestic economic reform and competition?
  (b) Will exempting sectors from coverage (protectionism) make a domestic sector inefficient?
  (c) Will exemptions raise the price of certain inputs and diminish competitiveness?
  (d) Will exemptions protect infant industries? Should long transition periods be used to protect such industries?

In effect, this exercise is a cost-benefit analysis to evaluate the potential gains and losses from the FTA, and to shape an appropriate negotiating strategy.

Determining the scope and coverage of the agreement

Consistency with WTO Rules.

Almost all trading nations are either WTO members or in the accession process; hence, WTO rules also influence the choice of strategies in trade negotiations. WTO rules provide opportunities for FTA members to protect key sectors. Members can seek to exclude products from the agreement, or to liberalize the covered products through gradual or transitional arrangements. A country must, however, strike an agreement on exemptions and phase-in periods in its FTA negotiations, and must bear in mind that sectoral omissions and phase-in periods could jeopardize the success of the negotiations and could have diverse short- and long-term economic implications.

The WTO rules that are applicable to free-trade areas serve as minimum requirements that all FTAs should meet, and specific WTO disciplines are a starting point for determining the scope and coverage of FTAs. The WTO Agreement permits FTAs, but subjects them to conditions designed to ensure that any free-trade area formed by the parties has substantial coverage—sufficient to justify the discrimination and trade distortion that is likely to result from the FTAs. [129]

Specifically, GATT Article XXIV sets forth rules for the formation of an FTA for trade in goods. Many of the same

[129] As illustrated in Part I and II, the GATT and the Understanding provide that (i) a free trade area should facilitate trade between the constituent territories and not raise new barriers to trade with other WTO members outside the FTA; (ii) an FTA must eliminate duties and restrictive commercial regulations on "*substantially all the trade*" between its members with respect to products originating in their territories; and (iii) an interim agreement to establish an FTA must include a plan and schedule for the formation of the FTA within a reasonable length of time.

Box 3.3: **Japan's FTA Strategy**

Japan views free trade agreements (FTAs) as a means of broadening the scope of its economic relationships with other countries while maintaining its commitment to the World Trade Organization (WTO). It considers economic, political, and diplomatic factors when promoting FTAs, and is guided by the principle of conformity with WTO agreements. Japan aims for a comprehensive agreement, based on its first bilateral FTA with Singapore. It maintains flexibility by considering "Singapore-plus" or "Singapore-minus" options. A selective approach is also possible, for advance agreement in specific areas such as investment and services. Japan has strategic priorities in determining which FTAs to negotiate, and has established specific objectives in each case. Negotiations with ASEAN countries, for example, should offer a broad range and high degree of liberalization to ensure economic integration comparable with that of other regions. Japan also uses FTAs to promote economic development by incorporating aspects of development assistance in FTAs with developing countries.

Template of Japan's Economic Partnership Agreements

Chapters		Objective
Trade in goods Rules of origin Customs procedures Paperless trading Mutual recognition Trade in services	Investment Movement of natural persons Intellectual property Government procurement Competition	Liberalization and facilitation
Financial services cooperation ICT Energy Science and technology Human resource development	Trade and investment promotion Small and medium enterprises Broadcasting Tourism	Economic partnership and enhancement

Source: Ministry of Foreign Affairs of Japan. 2002. Japan's FTA Strategy. October. Available: www.mofa.go.jp/policy/economy/fta/strategy0210.html

rules are applicable to customs unions, and WTO decisions interpreting the rules applicable to customs unions may have relevance for the negotiation of an FTA since both forms of regional trade agreements are often couched in similar language.

GATS Article V, on the other hand, sets forth rules for the scope and coverage of an FTA for trade in services.[130] Fundamental decisions regarding the modality of service commitments must be taken at the start of service negotiations. In particular, the parties must decide whether to use a "positive-list approach" like the WTO, or a "negative-list approach." (See extensive discussions in Part II of this reference book.)

Complementing Economic and Development Strategy. An FTA should be viewed as part of a country's overall political, economic, and development strategy. The FTA may strengthen a political relationship. It may also secure an economic advantage vis-à-vis other WTO members, or implement a regional development strategy. For example, Mexico's membership in the NAFTA secured preferential market access for Mexican exports to both the Canadian

[130] An economic integration agreement liberalizing trade in services among its members must have substantial sectoral coverage, and eliminate substantially all discrimination between or among the parties, in the sectors covered by (i) eliminating discriminatory measures; and/or (ii) prohibiting new or more discriminatory measures, either when the agreement takes effect or within a reasonable time frame.

and US markets, and resulted in FDI in Mexico from Canadian and US investors as well as from non-member country investors.

Japan decides to enter into an FTA on the basis of (i) economic, (ii) geographic, (iii) political and diplomatic, (iv) feasibility, and (v) time-related criteria. Similarly, US key trade agencies hold discussions with potential FTA partners with six broad factors in mind: (i) country readiness, (ii) economic and commercial benefits, (iii) benefits to the broader trade liberalization strategy, (iv) compatibility with US interests, (v) congressional and private sector support, and (vi) resource constraints of the US Government. Australia's FTA policy allows the country to negotiate an FTA only if it (i) will deliver substantial economic benefits including commercial gains for Australian businesses, (ii) will deliver benefits more quickly than multilateral efforts, (iii) is comprehensive in scope, (iv) is consistent with Australia's WTO commitments and objectives, and (v) will significantly enhance the country's broader economic, foreign policy, and strategic interests. [131]

Awareness of Ongoing Negotiations to Clarify and Improve FTA Disciplines. The Doha Declaration mandates negotiations aimed at "clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements. The negotiations shall take into account the developmental aspects of regional trade agreements." The clarification and improvement of disciplines may make it more difficult to negotiate WTO-consistent FTAs (perhaps by specifying what constitutes "substantially all the trade"). Alternatively, by taking development aspects into consideration, the negotiations may result in exceptions that are broader and more favorable to developing countries seeking to enter into FTAs.

Understanding the political and administrative process

The political and administrative process implicit in the negotiation of an FTA will differ for each country. Many countries follow the traditional route of granting power to government officials in FTA negotiation, signing, ratification, and implementation. Other political and administrative mechanisms, however, exist. For example, internal policy papers and guidelines are developed at relevant ASEAN forums to guide ASEAN-plus FTAs. In the case of the EU, the member states have granted the EC authority to negotiate FTAs, and are not directly involved in ratification (in contrast to ASEAN FTAs, where negotiations and implementation are primarily country-to-country).

Identifying the lead agency

The legislature or the constitution in many countries vests the authority for developing trade policy in the president or prime minister, subject to parliamentary approval. At the same time, the formulation of FTA negotiation strategy may be lodged with the president or executive department (e.g., in the Republic of Korea and the Philippines), a specialized body (in Brunei Darussalam), or a national or ministerial team comprising representatives of all government ministries (in Indonesia). In Australia, the Federal Government executive (the cabinet) decides the overall FTA negotiation strategy, and also sets the guidelines for each FTA negotiation.

[131] See www.mofa.go.jp/policy/economy/fta/strategy0210.html, US Government Accountability Office (2004), and www.fta.gov.au

Box 3.4: Useful Information and Sources for Negotiators

Economic analysis and country trade performance	Multilateral institutions (such as UNCTAD, IMF, and World Bank) and regional organizations like ADB and ASEAN Secretariat; national sources like the national statistics office and trade and finance ministries; private sector data providers (e.g., JP Morgan and Bloomberg); and various research institutions
Sector/Industry information, measures affecting trade, and nontariff barriers	International Trade Center, UN Commodity Trade Statistics database, UN Trade Analysis and Information System, WTO Trade Policy Review Reports, EU Market Access Sectoral and Trade Barriers database, ASEAN Nontariff Measures database, and USTR National Trade Estimate Report on Foreign Trade Barriers
FTA trends and useful resources	ADB ARIC FTA database, UNESCAP Asia Pacific Trade and Investment Agreements database, WTO RTA gateway, Tuck Trade Agreements database
Domestic and FDI policies and regulations	National legislation, finance and customs regulations
Domestic and trade priorities of the FTA partner	National development plans, FTA strategies
Sensitive issues including trade remedies filed and raised in dispute settlement mechanisms against prospective FTA partner	WTO, World Trade Law website, tariff commissions

ADB = Asian Development Bank, ARIC = Asia Regional Integration Center, ASEAN = Association of Southeast Asian Nations, EU = European Union, IMF = Integrated Monetary Fund, FDI = foreign direct investment, FTA = free trade agreement, RTA = regional trade agreement, UN = United Nations, UNCTAD = United Nations Conference on Trade and Development, UNESCAP = United Nations Economic and Social Commission for Asia and the Pacific, USTR = United States Trade Representative, WTO = World Trade Organization.

Source: ADB staff.

The FTA negotiation strategy is implemented by the agency that takes the lead in trade and FTA matters.[132] US trade agreements are negotiated and implemented by the President through the Office of the US Trade Representative (USTR). In other countries, the legislature takes a stronger role. Member states of the EU have delegated most trade policy competence to the European Commission.

The lead agency exercises general supervision and management over trade negotiations. It plays a major role from the time the FTA is initiated, when a dispute arises during implementation, and when a change in the circumstances of the parties requires a new agreement. The lead agency also takes the role of intermediary between the regulatory agencies that administer the implementation of the FTA. These duties are performed by an FTA staff ranging in size from 10 to 15 officers (as in international trade departments of some ASEAN countries) to 100 staff (as in the FTA Bureau of the Republic of Korea). Of the staff complement of 45 in the authorized department of one of the advanced countries in the region, around 15 are involved full time in a particular FTA.

[132] The ministries or departments of foreign affairs and trade (in Australia, Brunei Darussalam, Republic of Korea, and New Zealand); the department or ministry of (international) trade and industry (in Malaysia, Philippines, Singapore, and Viet Nam); the economic, trade and industry, and foreign affairs ministries (in Japan); and the ministry of (foreign) commerce (in the PRC, Pakistan, and Thailand).

Using information as a negotiation tool

Effective negotiation depends on the availability of essential data and the quality of the impact analysis of the

proposed FTA. Trade officials must be equipped with this information to make informed decisions in the negotiations. Negotiators are not expected to be technical experts in all FTA aspects. But they must at least have at hand the relevant information, such as economic or trade indicators and regulations not only of their country but also of the other party (see Box 3.4).[133]

Conducting a feasibility study to assess the prospective FTA

The feasibility study assessing the prospective FTA is conducted either internally (within the ministry) or externally (with the assistance of an independent government think tank or a private consulting firm). The study is carried out at the national level in the pre-negotiation stage or jointly with the FTA counterpart through a joint study group (JSG). The JSG, which is composed of government officials, economists, and business sector representatives, is gathered to examine potential complementarities between the negotiating countries in terms of further trade and economic cooperation through the FTA. The report and recommendations of the JSG are reviewed and studied closely by a joint task force or joint coordinating team (usually composed of members of the negotiating committee) for negotiation purposes.

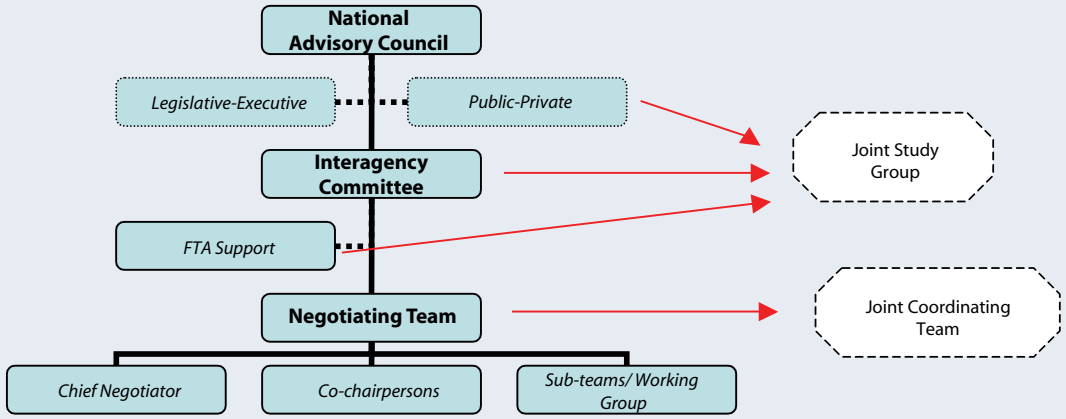
Feasibility studies are conducted by government, members of the academe, or groups of eminent persons endorsed by the government. In most countries, research institutions, law firms, and scholars are selected through private tendering to perform feasibility or econometric studies including CGE model analysis based on Global Trade Analysis Project (GTAP) simulations. To supplement the quantitative analysis of the impact of FTAs, some type of qualitative evaluation may be required. In some countries, a domestic sensitivity analysis is performed to assess the likely impact of the FTA on producers, consumers, and regulators before going through negotiation. Other types of studies are sectoral impact studies, political and social impact analyses, environmental impact assessments, and review of laws and regulations that are related to or that may be affected by the FTA. Econometric modeling may be commissioned by the government through external consultants, along with other qualitative assessments of the costs and benefits of the proposed FTA.

The breadth and relevance of the feasibility study, which takes from 6 months to a year to complete for bilateral FTAs (1–2 years for ASEAN-plus FTAs), depend on the scope and coverage of the proposed FTA and the length of its negotiation. The feasibility study may be conducted once at the pre-negotiation or joint feasibility study stage, and again during the negotiation process to gauge the impact of the scenario presented at the negotiation table.

The results of the feasibility studies are useful but sometimes do not provide the depth of sectoral or industry analysis and detailed information required during the negotiations. In this regard, the in-house capacity of the trade teams or FTA units to deliver up-to-date information at various stages of negotiations is crucial in coming up with appropriate bargaining positions. The trade negotiators may also tap the resources of other government agencies (through interagency cooperation) and industry and consumer groups (through public-private partnership) on specific issues and technical matters. The negotiating team, however, must have sustained competence and diligence to arrive at an independent and credible

[133] Also to avoid being surprised or embarrassed at having to face a counterpart negotiator who knows more about the laws and regulations of a particular country than the country's own negotiators.

Figure 3.2: **Three Levels of FTA Committees**



FTA = free trade agreement.
Source: ADB.

negotiating position based on their own assessment of facts and in accordance with their mandate.

STRUCTURING THE NEGOTIATING TEAM

Organizing a negotiating team involves not only enlisting those who will be at the negotiating table but also forming an advisory committee, an interagency committee, and other committees to guide and give technical support to the negotiators. The negotiators must be equipped with appropriate skills and information to be effective as mediators rather than mere messengers in the negotiation. A clear reporting line is also important for effective decision making during the negotiations.

Organizational Structure

Most countries establish committees at three levels when entering into an FTA (Figure 3.2). At the highest level is the national advisory council,[134] where policy and national priority issues related to FTAs are discussed. The council may comprise public-private representatives, a legislative-executive committee, or a combination of the two. At the second level is the interagency committee, which is composed of the cabinet members and agencies affected by and involved in the FTA negotiations. Other countries may provide for a subcommittee (for example, the FTA support committee in Thailand) to oversee FTA implementation, economic adjustment, and restructuring. Wide consultation is managed or conducted at these first two levels. Some members of these committees (together with distinguished members of the academe) are assigned or appointed to the JSG to identify the benefits and losses from the proposed FTA, and recommend the type and coverage of the agreement, if deemed desirable.

At the third level is the negotiating team, composed of the chief negotiator, co-chairpersons, and several sub-teams or working groups to negotiate with their government counterparts. In some countries, a task force for each FTA negotiation is created, to conduct all aspects of research, analysis, and consultation and even actual negotiations. Key members of each party's negotiating team together compose the JCT. Before

[134] Steering committee on international trade negotiations (Thailand) or ministerial or national team (Indonesia).

Box 3.5: **Typical Composition of Working Groups in the Negotiating Team**

Chapter/Provision	Ministry/Agency (as chair)
Goods (other than agriculture)	Trade and industry/Foreign affairs/Tariff commission
Rules of origin	Trade and industry/Customs
Agriculture and sanitary and phytosanitary measures	Agriculture
Services and investment	Finance/Economic affairs/Investment
Competition policy	Competition bureau/Fair trade commission
Technical barriers to trade	Standards, industry regulators
Trade rules and facilitation	Trade/Customs
Government procurement	Finance
Cooperation and development	Foreign affairs
Dispute settlement, institutional provisions, and intellectual property	Attorney general/Justice department/ International law/Intellectual property bureau

Source: Authors' compilation.

the negotiations, the JCT presents the negotiating foci, discusses the items for negotiation, and agrees on an indicative timetable for the negotiation.

The chief negotiator or head of delegation usually comes from the lead FTA agency (e.g., USTR in the US, the Ministry of Foreign Affairs and Trade in the Republic of Korea, and the Ministry of Foreign Affairs in Japan). In ASEAN-plus FTA negotiations, the organization structure is similar, with at least one lead negotiator from each member country assigned to each dialogue partner.

The chief negotiator is assisted by the co-chairpersons (director level), who head the sub-teams or working groups. The co-chairpersons usually come from ministries and regulatory agencies with responsibility for each chapter of the FTA, and may also be technical government experts (see Box 3.5, for example). In the case of Japan, the co-chairpersons come from the Ministry of Foreign Affairs, to ensure a unified and consistent perspective during the negotiations. In federal governments like the Australian Government, representatives of the state governments are also part of the negotiating team. Similarly, if negotiations are held abroad the negotiating team is supported by ambassadors and trade attachés assigned thereto.

The sub-teams or working groups hold specific and focused negotiations on each chapter or sector of the proposed FTA before these provisions are considered by the joint negotiating committee at the plenary. The members of each working group and their number vary depending on the resources of the negotiating governments (in size, most negotiating teams from developing countries stand in a 1:2 to 1:4 ratio vis-à-vis their counterparts from developed countries).

Government officials in the legal departments undoubtedly play a crucial role in the negotiating team. Aside from handling or co-chairing working groups on dispute settlements, competition policies, intellectual property rights, and institutional provisions, lawyers or the legal team warrant that the mandate to negotiate and the conduct of negotiation

is sanctioned by their constitution and is consistent with domestic laws; ensure that FTA provisions are carefully drafted (consistent with the agreement and flexible enough for situations that are not or could not have been reasonably foreseen during the negotiations); undertake proper and legal scrutiny of the complete draft; and classify the agreement and render a legal opinion on the need to have it ratified.

The Negotiators' Mandate

After the pre-negotiation consultations, a mandate in the form of directives or negotiating instructions is issued. In some countries, government departments prepare a submission to the cabinet, and the cabinet, after considering the options and recommendations, decides to negotiate. In the US, the Bipartisan Trade Promotion Authority Act of 2002 serves as the President's official mandate to negotiate FTAs. The negotiation mandate contains government approval to proceed with the formal negotiations, grants authority to represent the government, and delimits the negotiating team's authority (in terms of coverage of the agreement, negotiating position, and so on). The negotiators' mandate may change from time to time. Negotiators need a clear mandate from their ministries or at least a channel through which they can obtain the mandate promptly. In some cases, the lack of authority of negotiators drags out the negotiation process. Regular meetings involving all sectoral bodies may be conducted to guide the negotiating team and clarify or strengthen their mandate.

Quantity and Quality of the Negotiating Team

In a negotiation between a developed and a developing country, the latter is faced with negotiating constraints. For instance, while the Republic of Korea or Japan may assign a team of around 50 persons to each FTA negotiation, the developing country negotiating team is often less than half that number. Moreover, negotiators from developing countries handle more than one important area of negotiation or even several FTA negotiations, thereby causing conflicts and problems of overlapping sessions.

Although the size of the negotiating team could prove valuable in the negotiations, the quality of the negotiators (i.e., the appointment of the right persons) and the consistency of the core team members are much more important concerns. First, the negotiators in each working group must be capable of aligning the sectoral (or their agency's) position with the national negotiating position by interacting regularly with other working groups and consulting with the interagency committee through the co-chairpersons or the chief negotiator. The core negotiating team must be retained as much as possible for consistency and faster resolution of outstanding issues. This will make the negotiation process more efficient and serve the national interest. Lastly, the members of the negotiating team must have adequate technical, communication, and negotiating skills[135] to be effective negotiators and not mere emissaries every time a negotiating issue is presented at the table. Access to information and support from various sectors are also essential.

[135] Training and capacity building in the following areas would be useful to negotiators: (i) formulation of international trade negotiation positions and strategy; (ii) trade regimes and negotiation of international trade agreements; (iii) trade diplomacy and advocacy; (iv) policy and research analysis; (v) rules of WTO and other international agreements; and (vi) the art of managing political pressure and stakeholders' agenda(s).

Box 3.6: ASEAN Approaches to Negotiation

Association of Southeast Asian Nations (ASEAN) free trade agreement (FTA) negotiations are characterized by a sectoral approach to negotiations—first, agreement is reached on trade in goods, followed by trade in services and investment liberalization. Even though the dialogue partners are supposed to negotiate with ASEAN as a whole, negotiating with ASEAN involves bilateral negotiations between each ASEAN member country and the dialogue partner. This type of negotiation is crucial in cases of modalities and coverage of FTAs, particularly provisions on sensitive sectors. The process, however, tends to drag out the negotiation because the negotiators, having to weigh national versus regional objectives, find it difficult to reach consensus.

Source: ADB staff.

Box 3.7: Negotiation Approach under the GATS

Trade in services under the World Trade Organization (WTO) has quite different negotiation dynamics in terms of commitments and rules. On one side is the bilateral negotiation of specific national commitments, which takes the form of a bilateral bargaining process based on requests and offers, and on the other the multilateral (i.e., collective) negotiation of the governing rules, which involves an effort to build consensus on broad principles among member countries.

The steps in negotiating a proposal under the General Agreement on Trade in Services (GATS) are as follows:

(i) Develop requests under the request or offer procedure in the WTO.
(ii) Formulate negotiating proposals on rules in the GATS negotiation.
(iii) Negotiate sectoral and functional agreements.

Source: Monning and Feketekuty (2003).

THE NEGOTIATION PROCESS

Laying Out the Negotiation Rules and Timetable

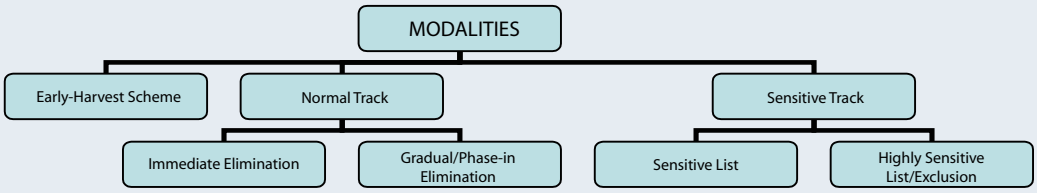
Unlike multilateral negotiations (i.e., within the WTO framework), FTA negotiations follow no established or internationally accepted procedure. They differ from country to country and may be deduced from past practices, protocol, or prior agreements entered into by the negotiating countries. At the very least, the JCT must agree on the rules of proceeding with the negotiations. In terms of sequencing, the negotiators may adopt a sectoral approach (see ASEAN example in Box 3.6), a dual approach (i.e., the modalities-and-rules approach in the GATS, Box 3.7), or a gradualist approach (from simpler to more complex issues). These are not the only options—negotiators sometimes agree to adopt a template FTA (another FTA previously signed by a party to the negotiation) and no longer negotiate items that are acceptable to both parties or are not otherwise disputed.

The sequence of negotiations logically affects the preparation of the indicative timetable for negotiations. The timetable must be flexible enough to take delays into account, especially in the negotiation of modalities (where the number of tariff lines is negotiated separately from the list of products; see Figure 3.3 and discussions under trade in goods in Part II), sensitive sectors, and exclusions. It must also provide for adequate consultation with domestic stakeholders and significant committees when critical issues are considered. There is no universal deadline for negotiation of FTAs. However, in the US the time limit set for the trade promotion authority serves as deadline for its FTA negotiation. The election cycle in many countries may also be a deadline for FTA negotiations. Negotiators are likewise faced with resource constraints (especially when some agencies are unable to attend negotiation meetings) and strong pressure to conclude the negotiations quickly.

Interagency Coordination

Aside from providing a venue for government departments to balance national interests and industry- and sector-specific concerns, interagency

Figure 3.3: **Tariff Elimination Modalities for Negotiating FTAs**



Source: Author's compilation from various free trade agreements (FTAs).

coordination facilitates at least two significant processes that are useful in negotiating and implementing FTAs. First, interagency coordination enables the consolidation of all the sectoral consultations of the different departments or agencies. Formal hearings are sometimes selective and infrequent, so the national advisory council or trade negotiation team can base its assessment only on sectoral information provided by the ministries or agencies.

Second, interagency coordination provides the necessary link in FTA enforcement and monitoring. For instance, the effective implementation of the trade facilitation provisions of an FTA requires interconnectivity and coordination among all cross-border agencies (customs, sanitary and phytosanitary, inspection, and quarantine agencies). In most cases, interagency coordination is required before FTA implementation (to itemize the products to be included in each modality of tariff liberalization). The interagency committee may be ad hoc and organized for each negotiation or may already be embedded in the government structure (see Boxes 3.8 and 3.9 for an overview of the interagency mechanisms in the US and the Republic of Korea).

Negotiation Techniques, Habits, and Role of the Chief Negotiator

There are various negotiation techniques, most of which can be learned through practice. Simulation exercises have been proven to be practicable and effective. In some countries, junior trade officers learn by observing actual negotiations. Exposure to FTA issues and involvement in actual FTA negotiations are effective ways of developing negotiation skills. Whatever the strategy or approach adopted by a negotiating team, certain guidelines and protocols must be followed to achieve smooth and successful negotiations (see Box 3.10). The chief negotiators on both sides must ensure this.

Most countries appoint a separate chief negotiator for each FTA rather than endorsing one for several FTAs. The chief negotiator must be clear about the country's national trade interests, maintain a strategic and holistic framework in the negotiations, and ensure that the country's negotiating position is clearly understood by the counterpart. However, simply sticking to a predetermined negotiating position may drive the negotiating process to an impasse; hence, negotiators are quite often advised to focus more on interest than on standing positions.[136] Unlike negotiations for private issues, FTA negotiations bind government officials more strongly to their mandates. Given that the ultimate goal of FTA negotiations is to maximize national interests, however, positions need to be properly adapted to changing negotiating conditions to best serve the national interest. The chief negotiator must, among others, possess credibility, patience, and sincere commitment to negotiate and arrive at an

[136] Fisher and Ury (1988).

Box 3.8: US Interagency Structure

The Office of the US Trade Representative (USTR) is the lead agency in formulating and coordinating US trade policy, negotiating trade agreements such as free trade agreements, and enforcing these agreements. It consists of three tiers of committees—the National Security Council (NSC) and the National Economic Council (NEC), the Trade Policy Review Group (TPRG), and the Trade Policy Staff Committee (TPSC). The presence of the NSC shows that security issues are considered in US trade policy.

The Office of the USTR consults with other government agencies on trade policy matters through the TPRG and the TPSC. These groups, administered and chaired by the Office of the USTR and composed of 19 federal agencies and offices, make up the sub-cabinet-level mechanism for developing and coordinating US government positions on international trade and trade-related investment issues.

If agreement is not reached in the TPSC, or if significant policy questions are being considered, then issues are taken up by the TPRG (deputy USTR and undersecretary level). The final tier of the interagency trade policy mechanism is the NEC, chaired by the President. The NEC deputies committee considers memorandums from the TPRG, as well as important or controversial trade-related issues.

Sources: US Trade Representative website; US Government Accountability Office Report (2005).

Box 3.9: Interagency Coordination Mechanism in the Republic of Korea

Interagency coordination is either managed by an ad hoc or permanent centralized interdepartmental committee, led in many cases by the ministry of foreign affairs. Some countries (e.g., the Republic of Korea) have a committee consisting of the ministers for international economic affairs and chaired by the finance minister. Sub-teams or back-office members working on different aspects of the free trade agreement meet when necessary with colleagues in other relevant agencies. While certain issues are discussed bilaterally between the lead agency and the agencies concerned, most issues are dealt with in committee meetings. The committees effectively coordinate different agency positions, although critics decry the frequent use of the process to share responsibility for certain sensitive issues among agencies.

Source: ADB staff.

agreement; maintain a good working relationship with the counterpart chief negotiator; have the ability to manage conflicting interest and views; employ sound judgment on the pace and rhythm of the negotiation; be able to effectively coordinate the team; and have the ability to energize domestic processes. The chief negotiator should also be able to communicate with the media since progress briefings are frequent. If the parties cannot reach a mutually beneficial agreement and the negotiations fail, it is crucial for the chief negotiator to be prepared with a best alternative to an agreement.[137] Developing one's best alternative to a negotiated agreement (BATNA) and considering the partner's BATNA are also very important in strengthening bargaining power during negotiation and strategizing the options available.[138]

MANAGING CONSULTATIONS

Building domestic consensus in FTAs is always difficult. A common issue raised against FTA negotiators is their failure to consult all stakeholders. Getting stakeholders to participate in consultation meetings may also be difficult. Managing consultations involves providing a venue for discussing the stakeholders' concerns and issues and sustaining such a mechanism.

Subjects and Types of Consultation

The overall objective of consultation is to consolidate varied interests, assess the country's FTA objectives, and build national consensus on the proposed FTA.

[137] Using a "cost-benefit" analysis of the negotiating team's options, strategy, or plan for solving the trade problem.

[138] See Fisher and Ury (1988).

Box 3.10: **Negotiating Skills and Good Negotiating Habits**

Listen Actively
Place information provided by other negotiators in the proper context. When in doubt, confirm what you thought you heard.

Ask Questions
The negotiation setting is an opportunity to learn about counterpart interests and determine where trade-offs or compromise might be appropriate.

Tactical and Timely Use of Silence
Information or compromise may be provided to fill the vacuum.

Take Breaks from the Negotiating Table
"Going to the balcony" to review an oral or written proposal, develop or formulate a response, and regain your composure is important.

Organize Brainstorming Sessions
Brainstorm to elicit reactions, ideas, and counterproposals. "What if" questions give the team or counterparts the power of choice and make acceptance of the proposal more likely.

Use Objective Criteria
Introduce fair standards and persuade the other party to support an argument or proposal by submitting evidence from independent experts.

Practice Role Reversal
Discuss what would work for the other party and why, to understand that party's bargaining position.

Listen to and Record All Proposed Options
Preserve the proposal for ongoing review and comment by creating a record of the session.

Be Sensitive to Cross-Cultural Dynamics, Gender, and Language
Diplomacy and careful use of language will determine the success or failure of the negotiation process.

Build a Reputation
Rapport and good working relationships with counterparts will generate long-term benefits.

Create a Win-Win Mentality
Aim to arrive at a mutually acceptable agreement such that both sides feel they have won.

Source: Monning and Feketekuty (2003).

Consultation involves two types of subjects. Public stakeholders who define national policies, implement government programs and measures in all sectors, and deliver services to the public are subjects of the first type. They are the members of the parliament, the cabinet, and regulatory agencies. In the second group are the private stakeholders, comprising chambers of commerce, trade groups, sector or industry representatives, consumers, labor groups, NGOs, and the general public. The level of participation of these groups varies (and existing mechanisms tend to be biased in favor of big pressure groups). At the very least, all of these sectors should be well represented during the negotiations.

Consultation mechanisms may be formal or informal. Formal consultations are institutionalized and involve the membership and participation of public and private stakeholders in the advisory council as well as in the interagency committee's FTA policy debates. Some countries convene public hearings before the official negotiation. Informal consultation is done through sectoral public hearings, opinion surveys, outreach and regional seminars, and other means (e.g., through invitations for comments on government websites).

Contrary to common perception, consultation is not a stumbling block but rather a building block (by providing inputs and outputs) in the negotiation process. In terms of inputs, consultation serves as a venue for discussing the issues and concerns of various sectors, identifying the key sensitive sectors, and managing conflict arising from the resistance posed by civil society and other vested groups. In some cases, strong opposition from interest groups is a defensive tool used to protect certain industries during the negotiation.

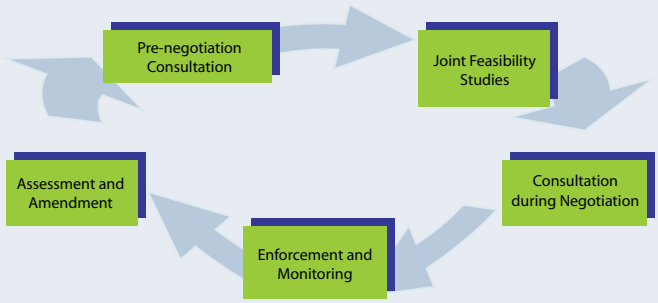
In terms of outputs, consultation becomes an instrument of advocacy for

the negotiators, not only in disseminating information on the FTA at various stages, but also in soliciting stakeholder support (thereby assisting in the legitimation of the FTA), understanding technical information, and drafting effective and non-trade-restricting measures to implement the FTA.

Although the type of consultation may vary in the stage of the FTA process, it should nonetheless be conducted from pre-negotiation to amendment (Figure 3.4). During pre-negotiation, public hearings are conducted to make a general assessment of the impact of the FTA. When feasibility studies are conducted, economic scholars, technical experts, and the business sector provide specific and quantitative analyses of the FTA. Politically sensitive items and other critical issues are discussed with the various stakeholders through available channels during the negotiation. Consultations during the implementation of the FTA assist the regulators as well as end users of government and trade services in improving the FTA-established mechanisms and in assessing whether or not the objectives of the FTA have been achieved.

The resources needed and the manner of consultation depends on the value accorded to the process by a country. To attain the expected effects described above, the consultation should be sufficient to help the stakeholders understand what is being presented at the negotiation and consult with their constituencies on the pros and cons of the proposals from their own perspective. This guarantees representation of all interests in policy debate and formulation.

Figure 3.4: **When Consultation Should Be Conducted**



Source: ADB staff.

Consultation Mechanisms

There are various models and ways of managing consultations on FTAs and trade-related issues (refer to Box 3.11). Most developing countries adopt a top-down approach, where those at the higher levels (e.g., ministries, chief executive officers) steer the flow of consultation and, ultimately, decision making. Developed countries, however, have established a bottom-up approach to consultation (beginning broadly with the general public and concerned sectors). Various stakeholders' views are constantly obtained through submissions and industry feedback (e.g., the Australia, New Zealand, and Singapore FTA websites elicit such feedback). The choice of the system usually takes into account the political, economic, and institutional circumstances of the country as well as the time and resources available. In any case, the design of the consultation mechanism should be systematic, continuous, and transparent. The amount and quality of information provided by the negotiators will determine and sustain the stakeholders' active participation in the consultation.

IMPLEMENTING AN FTA

After an FTA is signed, it undergoes several internal pre-implementation procedures such as ratification and legislative enactment to ensure that the

Box 3.11: **Examples of Consultation Mechanisms**

Agency-Led Consultations
The Republic of Korea (through the Ministry of Foreign Affairs and Trade) consults all private and public stakeholders before and during negotiation, thus giving them ample opportunity to voice their concerns and opinions. Consultations are conducted through public hearings, private sector advisory meetings, and online channels to gather industry views.

National Trade Consultations
Australia's national trade consultations provide a forum for consultation, coordination, and collaboration on trade and investment issues between the federal and state and territory governments. Once or twice a year, the trade minister chairs a meeting with state and territory ministers who are responsible for trade issues. Additional issue-specific meetings are arranged as necessary. Explicit consultation guidelines have been issued by the Council of Australian Governments, the agency that facilitates consultation, cooperation, and policy coordination.

Industry-Based Consultations
In India, extensive consultation is conducted by at least two major industry associations—the Confederation of Indian Industry (with over 4,800 company members) and the Federation of Indian Chambers of Commerce and Industry. These associations play an active role in delivering industry views and providing critical inputs to the Government on trade issues.

Public-Private Advisory Consultations
Established in 1974, the private sector advisory committee system in the US is aimed at providing information and advice with respect to negotiating objectives and bargaining positions before trade agreements are negotiated. Under the Trade Act of 2002, each advisory committee is required to prepare a report on proposed trade agreements for the Administration and Congress and make it public on the website of the Office of the US Trade Representative (USTR). The USTR's Office of Intergovernmental Affairs and Public Liaison administers the federal trade advisory committee system and provides outreach to, and facilitates dialogue on trade policy issues with, state and local governments, the business and agricultural communities, and labor, environmental, consumer, and other domestic groups.

Evaluation and Advisory Consultations
Australia's Productivity Commission (PC) is the Government's principal evaluation and advisory body on microeconomic policy and regulation. Once authorized to conduct an inquiry, the PC collects public opinions through hearings, submissions, and feedback on draft reports. Final findings and recommendations are based on extensive public input and feedback, which, in some cases, differ substantially from initial positions. This open process helps reduce the possibility of unexpected responses, which could lead to policy reversals.

Technology-Based Consultations
International Enterprise Singapore is an agency under the Ministry of Trade and Industry that is spearheading the development of Singapore's external economy. It maintains a free trade agreement portal providing information to Singapore-based companies exporting to Singapore's FTA partner countries, and collects industry feedback (through online surveys) to help the government negotiate FTA provisions that cater to the needs and interests of business.

Sources: Australian Trade Commission; FTA and Commonwealth-State Consultation on Treaties websites; International Enterprise Singapore website; Office of the US Trade Representative website; and Gallagher (2006).

signed FTA is within the mandate of the government.[139] These procedures, however, often unduly delay the FTA's implementation and, hence, also the attainment of its expected benefits. The implementation stage requires the active involvement of all government agencies concerned, if only to comply with the country's FTA commitments and gain from new market opportunities.

[139] This presupposes that the agreement is in accord with the country's constitution or requires no constitutional change.

Pre-implementation

The effectivity of an FTA depends on (i) the "entry into force" provision in the FTA, and (ii) the internal or domestic procedures of the signatories. Depending

on the nature of the agreement, the FTA may take effect on the date it is signed, or on the date one party gives notice to the other party that it has complied with all the legal requirements such as ratification (or the number of days after that notice is received by the other party), or on the date the FTA becomes effective and binding as domestic law.[140] The date of effectivity may also be agreed upon by the signing parties.

In the case of AFTA, member countries have different procedures for the FTA to be effective. While the act of signing by authorized officials (which could be the president or the trade minister as the president's alter ego) would make the AFTA effective in Brunei Darussalam, Malaysia, and Viet Nam, other ASEAN countries have additional requirements: a letter of acceptance signed by the President in the Philippines and Indonesia, and ratification by the legislature in Thailand. In Singapore, all necessary approval is obtained before signing; hence, no ratification is needed.

In the US, after an agreement is concluded, the US President is required to submit its final text to Congress together with the draft implementing bill, a statement of any administrative action proposed to implement the agreement, and other supporting information. Failure to comply with this submission requirement would prevent the agreement from entering into force.[141]

Ratification

The AFTA requirements, however, do not apply to ASEAN-plus agreements or bilateral FTAs entered into by individual member countries. Indonesia considers FTAs and all other international agreements (e.g., the WTO Agreement) as presidential decrees, thereby requiring in most cases, only the signature of the President. The Philippines, on the other hand, makes a distinction: agreements that primarily involve the reduction of tariffs are executive agreements and need not go through legislative ratification, but FTAs that are comprehensive in scope (covering items that could be subject to legal enactments or are constitutionally mandated) require legislative concurrence. Still, even if legislative ratification is not required, strong political pressure would necessitate "prior endorsement" of the legislature if only to legitimize the FTA (as in the case of the New Zealand–Singapore FTA).[142]

In Japan, executive agreements can be concluded by the executive under its power to manage foreign affairs. However, treaties that require the maintenance or adoption of legislative measures for their implementation or deal with financial matters require the approval of the Diet.[143] In the same vein, other Asian countries like Georgia have made it obligatory to ratify international treaties and agreements that require a change in domestic legislation or the adoption of laws and acts with the force of law to honor the international obligations undertaken.[144] If an agreement requires no change in domestic legislation, it may be accepted without parliamentary ratification.

In the US, Congress has delegated the tariff-negotiating authority to the President and authorized the latter to suspend existing duty-free treatment. By virtue of this delegation and the doctrine

[140] For example, when the FTA has provisions affecting the rights and obligations of citizens or imposes penalties, due process requires notice or publication. The FTA takes effect only after the publication requirements have been complied with. In this case international agreements have the standing of domestic law.

[141] Pregelj (2005).

[142] The New Zealand Constitution provides that the Parliament has no power to delay or alter an international agreement or ratify one. The Parliament only takes into consideration the FTA to identify and provide for necessary changes to law.

[143] Japan's two-house Parliament.

[144] Article 65, Constitution of Georgia.

Box 3.12: Australia's Treaty Approval Process

The Australian treaty approval process involves the following steps for all treaty actions (negotiating a new treaty, amending an existing one, or abrogating a treaty):

(i) The 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 the significant quantifiable and foreseeable economic and environmental effects of the treaty. Among several other points, the NIA must detail the consultations that have taken place with the states and territories, and with community and other interested partners.
(ii) The preparation of a regulatory impact statement, including an assessment of the impact of the proposed regulation (i.e., the treaty) and its alternatives on different groups and the community as a whole.
(iii) The tabling of the treaty before Parliament for 20 sitting days and consideration of the proposed treaty action by the Joint Standing Committee on Treaties.
(iv) The preparation and passage of the enabling legislation.

Source: Goode (2005).

of political agency, negotiators (with the approval of the President and designated political appointees of the President) can commit to an executive agreement without the approval of the Congress, but not to a treaty or an agreement that changes US law. An agreement classified as a treaty must be ratified by two thirds of the US Senate, while an agreement that changes US law must be approved by a majority of both houses of Congress.[145]

FTAs are considered as treaties in Australia, so the FTA must undergo treaty approval (see Box 3.12). After treaty approval and when the agreement enters into force it is recorded, archived, and published in the Australian Treaty Series and registered with the UN.

[145] Monning and Feketekuty (2003). See also Grimmett (2004) and Pregelj (2005).

WTO notification

A mandatory action for WTO members signing an FTA is to notify the agreement to the WTO. The following rules govern the notification procedure:

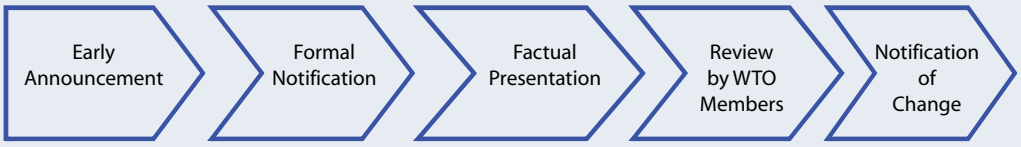
(i) The Decision on the Transparency Mechanism for Regional Trade Agreements, which calls for an early announcement by members participating in FTA negotiations;[146] and
(ii) GATT Article XXIV:7; the Understanding; and GATS Article V:7, which provides that a member must notify the WTO and submit details to the WTO regarding FTAs and interim agreements that the member is joining or intends to join.

Notification under the WTO may be under the Enabling Clause, GATT Article XXIV, or GATS Article V,[147] and may be made to the WTO's Committee on Regional Trade Agreements (those FTAs falling under GATT Article XXIV and GATS Article V) or to its Committee on Trade and Development (FTAs falling under the Enabling Clause). The types of agreements notified are preferential arrangements, free-trade agreements, customs unions, service agreements, and accession to any of these agreements. After the required notification, a working

[146] It also requires parties to specify the provision(s) of the WTO Agreement under which the FTA is notified, and to provide the full text of the FTA and any related schedules, annexes, and protocols, in one of the WTO official languages (English, French, and Spanish).

[147] WTO rules for trade in goods are found in Article XXIV of the GATT, and for trade in services, in Article V of the GATS. The Enabling Clause allows developed countries to accord more favorable treatment to developing countries without according such treatment to other countries. It also applies to preferential trade arrangements (PTAs) or FTAs between developing countries but not PTAs and FTAs between developed and developing countries. See Fiorentino et al. (2007).

Figure 3.5: **New RTA Transparency Mechanism**



RTA = regional trade agreement.
Source: World Trade Organization (WTO) website. Available: www.wto.org.

party is convened to examine the notified FTA, verify consistency with the WTO Agreement, and make appropriate recommendations. Furthermore, periodic reports on the operation of the FTAs, including significant changes and developments in the agreements, are required. A new regional trade agreement (RTA) transparency mechanism was adopted on a provisional basis in 2006. This refers to the early announcement of RTA and notification to WTO (see Figure 3.5 for the major steps involved).

Implementation

Legislative enactments and amendments

Most countries pass new legislation or amend existing laws to comply with their FTA commitments or to extend preferential treatment to traders from FTA countries. These procedures are necessary for FTAs to be effective as domestic laws and to fill the gaps left by the general provisions and even the implementation arrangements provided in the FTAs.

The legislative enactment presupposes that the FTA is consistent with the constitution and has passed the ratification stage. It is worth noting that the procedure and voting requirement when ratifying an FTA may be different from the requirement for passing legislation to implement the FTA. In some countries where the president has legislative powers, the requisite legislative enactment or amendment of laws may be made by the president's office.

The laws to be passed or amended are those covered by the FTAs that affect the rights and obligations of the citizens of the FTA member country. These laws either translate the international agreement into domestic law or clarify the issues presented in the new arrangement. This is especially the case where some restrictions are lifted or foreign entities are given preferential treatment by the FTA (see Box 3.13 for an example of legal changes adopted as a result of entering into an FTA). These new or amended laws are complemented by implementing rules and regulations, as discussed in the next section.

Directives, issuances, and regulations

Even after an FTA takes effect (and the requisite laws are passed or amended), some administrative procedures still need to be carried out to fulfill the requirements of the FTA. Some FTAs draw out uniform operational guidelines in implementing the customs procedure and rules of origin mechanism. In the Philippines, the executive order from the President is followed by issuances from the finance department and guidelines from the customs bureau. In Malaysia, a directive from the finance ministry would suffice. Meanwhile, in Indonesia, a decree from the finance ministry and an issuance from the customs agency on the procedures are mandatory. These

Box 3.13: **Legal Changes Made in Singapore**

Singapore has entered into a number of free trade agreements (FTAs) with its trading partners. As a result, Singapore laws have been amended to reflect commitments made under the various FTAs. Customs legislation has been amended to accord preferential tariff treatment and provide procedures for the issuance of preferential certificates of origin. Following the US-Singapore FTA (USSFTA), Singapore legislation has permitted the importation of chewing gum "with therapeutic value." Likewise, under the new Singapore import/export law, where any part of the manufacture of textiles and clothing products covered under the USSFTA is carried out or procured by any person in Singapore, to be exported to the US, that person must be registered.

As a result of Singapore's FTA commitments (namely, USSFTA, the Republic of Korea–Singapore FTA, and the Transpacific Strategic Economic Partnership concluded by Singapore with Brunei Darussalam, Chile, and New Zealand), it now offers its FTA partners a more attractive procurement environment, particularly in relation to the threshold values of procurement contracts. Singapore passed the Competition Act of 2004 and established the Competition Commission in 2005. Changes have been made as well in the regulation of entry into and activities in various service sectors such as banking and legal practice. The Trade Marks Act, the Patent Act, and the Copyright Act have been amended to reflect Singapore's FTA commitments.

Source: Hsu (2006).

Box 3.14: **Examples of FTA Websites**

Australia	www.fta.gov.au/
Japan	www.mofa.go.jp/policy/economy/fta/index.html
Singapore	www.iesingapore.gov.sg/wps/portal/FTA
Thailand	www.thaifta.com/english/index_eng.html
United States	www.ustr.gov/Trade_Agreements/Section_Index.html

Source: Author's compilation.

are common steps in implementing tariff reduction schemes. The procedures are more complex (where implementing rules and regulations follow a law that has been passed or amended) to implement the nontariff provisions of the FTA (e.g., services or investment liberalization provisions).

The directives, issuances, or regulations should serve as essential guides for regulators as well as traders/individuals especially in availing themselves of the preferences given under the FTA. They should not be too stringent or complicated so as to restrict or discourage the business sector from taking advantage of what the FTA has to offer.

Public information

Information dissemination has always been crucial in the implementation of an agreement. For instance, many observers have attributed the low utilization of preferential tariff rates to the lack of information on the AFTA tariff scheme.[148] The fact that the newly signed FTA will not impose any undue burden on exporters who value the reduction or elimination of nontariff barriers more than differential tariff rates should also be highlighted.

Information dissemination is traditionally conducted through brochures, newspapers and other publications, seminars, road shows, and trade discussions. However, there are modern approaches to introducing FTA to the public, including disseminating information through FTA websites (see Box 3.14 for a list of FTA websites). These sites are useful not only in providing one-stop online resource sites on the FTAs entered into by the country but also in soliciting feedback or conducting public consultation on proposed FTAs. FTA sites may also provide additional assistance by publishing the names of those who

[148] Other reasons given for the low utilization rate are the minimal margin between WTO or MFN rates and common effective preferential tariff (CEPT) rates, and the additional procedures required.

can render expert advice to exporters (e.g., in Singapore and Australia). In Australia, an FTA export advisory panel has been established to promote the benefits of FTAs, by offering advice on implementation and market access issues, and by identifying specific trade and investment opportunities created by such agreements. The panel is made up of senior representatives from a range of industry groups and includes input from a cross-section of specialists, business organizations, and community groups.

EVALUATING AN FTA

The review clauses of FTAs provide an opportunity to identify areas where the agreements can be further improved. This stage, however, requires proper mechanisms for monitoring and evaluation to assess whether the objectives of the FTA have been met in the first place and whether the scope of the agreement can be expanded and its terms improved.

Monitoring and Enforcement

Compliance monitoring requires resources and intensive effort not only from the lead agency but especially from the implementers and regulators. In the US, monitoring is primarily done by the same agency that negotiates FTA, although several other agencies, both domestic and overseas, are likewise involved (see Box 3.15).

In most countries, monitoring is lodged with the implementing agencies. Coordination among agencies is essential especially between those agencies that will put into operation the provisions of the agreements and those that will eventually review the agreements and provide for the necessary amendments. For example, although valuable, data on the actual utilization of the FTA are not always readily available. The directive to be issued by the customs or tariff agency could require traders that avail themselves of preferential rates under the FTA to report such use on the specified form directly to a specific unit or agency, to facilitate recording and monitoring. Such information will be handy in evaluating the impact of FTAs on traders.

Other possible mechanisms for monitoring and compliance are regular consultations with the private sector and full use of the technology (such as the internet and available mobile services) to gather comments from other sectors including consumers.

Assessment and Evaluation

Some FTAs provide review clauses to analyze the impact or progress of their implementation. Most countries use general indicators to assess the economic impact of FTAs, from macroeconomic indicators (in the Republic of Korea) to industry utilization indicators (in Singapore). The review, however, is often limited to analyzing whether tariff cuts have been made or whether the FTA has resulted in an increase in trade volume or growth in market shares between the FTA partners. The use of these indicators should be approached with caution since trade expansion need not be a direct result of the tariff liberalization and may be caused by other factors beyond what is covered by the FTA. There is also a growing interest in assessing FTAs by examining the existence or nonexistence of nontariff barriers to trade.

Another important aspect is identifying the proper agency to evaluate the FTAs. While some countries designate a specialized body, in others trade-related institutes or other organizations conduct annual studies on the economic effects of

Box 3.15: **US Monitoring and Enforcement System**

The monitoring and enforcement of trade agreements of the US involves four agencies and several units within each agency. Each agency has both domestic and overseas components, as well as several geographic, industry, and issue-specific units involved in monitoring and enforcement. The agencies coordinate monitoring and enforcement activities through an interagency network for trade policy development led by the Office of the US Trade Representative and involving at least 17 federal agencies. To improve interagency coordination, a regular forum is provided to allow federal agencies to share and discuss information, set priorities, assign responsibilities, and design and implement strategies. Trade agencies take advantage of technology (through e-mail and videoconferencing) to communicate information on trade compliance issues.

Agency	Main Unit at Headquarters	Overseas and Other Units Involved
US Trade Representative	Monitoring and Enforcement Unit	US Mission to the World Trade Organizations (WTO); trade policy officers; WTO and multilateral affairs; region-specific offices
Commerce	Market Access and Compliance Office	Trade promotion agencies; Foreign Commercial Service; market access and compliance officers overseas; Manufacturing Services; Import Administration; Patent and Trademark Office
State	Trade Policy and Programs	Economic section of embassies; country desk staff; issue-specific task forces
Agriculture	Foreign Agricultural Service	Animal and Plant Health Inspection Service; Food Safety and Inspection Service

Source: US Government Accountability Office (2005).

FTAs. Often the foreign affairs ministry is responsible for both implementing and evaluating FTAs. The frequency of reviews depends on each specific FTA. For example, the joint committee under the Australia-US FTA is supposed to meet annually to supervise the overall implementation of the agreement.

Even if the importance of this stage is well recognized among the countries, manpower and other resources are often limited. With this constraint, it is important to remember that there should be an independent assessment of the FTAs. At the very least, those who were directly involved in the negotiations should not be the ones who evaluate the FTAs.

Amendment Procedures

Like the review clauses, most FTAs have sections on amendments and modification. These amendments may take the form of exchanges of notes and protocol agreements. Where no substantial change is introduced, these protocols require only the endorsement of the parties (i.e., the signature of the trade ministers). There are countries that require cabinet approval, depending on the changes to be introduced. Some FTA amendments undergo the same domestic procedure as treaty amendments. In certain cases, amending FTAs involves ministerial approval and legislative change.

Appendix to Part III: Sample Questionnaire on the Negotiation, Implementation, and Evaluation of Free Trade Agreements

Preparing for FTA Negotiations

(1) Please choose the kind of FTA negotiation strategy that you use and identify its main components:

Type		Main Components	
General FTA negotiation strategy		Economic objective	
		Political consideration	
		Coverage of FTA	
Different strategy per FTA/ partner		Sensitive sectors to be protected	
		Sequencing of negotiation*	
		Others (please specify)	

* E.g., trade in goods first, then trade in services and investment.

(2) Who is responsible for formulating your trade (or FTA) negotiation strategy?

Legislature	
President/Executive department	
Specialized body (such as trade representative office)	
Others (please specify)	

(3) Do you have written laws, directives, guidelines, or policies regarding your FTA negotiation strategy? Please enumerate:

_____

_____

(4) In your previous/current and prospective FTA negotiations, please rank in descending order the factors that most affect—or would affect—your country's choice of FTA partner and arrangement, with the factor ranked "1" being the most significant and the factor ranked "4" the least significant.

Factor	Previous/ Current FTA	Future FTA
FTA Partner		
Type of FTA (regional or bilateral)		
Scope and Coverage of FTA		
Time Frame of FTA		

(5) Is there an agency designated to conduct feasibility studies on your prospective FTAs? If so, please identify the agency and the type of feasibility studies conducted (for example, CGE modeling, sectoral impact studies).

_____

_____

(6) Please describe your general FTA negotiation cycle,* including the sequencing of political or administrative procedures for initiating and implementing FTA negotiations, and the usual time spent on each step.

_____

_____

* E.g., feasibility study, public hearing, cabinet decision, consultation with the legislature, organization of the negotiation team, consultation with stakeholders (interest groups), drafting of laws, legislative approval, implementation and review procedures.

Organizing the negotiating team

(7) Which ministry/agency is the lead agency in FTA negotiations in your country? _____ Please identify the lead department/office in that ministry and the total number of staff of that department. _____

(8) Please describe the composition of your trade negotiating team in previous FTA negotiations (name, actual number of members, and composition of each sub-team or committee, and actual tasks performed).

Sub-team/ Committee	Number and Composition of Members	Tasks

(9) Please enumerate the strengths and weaknesses of interagency coordination in the negotiation process.

_____

_____

(10) Please describe the constraints on your negotiating team in previous/ current FTA negotiations.

_____

_____

(11) Do you have one chief negotiator for all FTA negotiations? _____What do you think are the most important characteristics and roles of the chief negotiator?

_____

_____

Managing Consultations and FTA Implementation and Monitoring

(12) To what extent and at what stage do public/private stakeholders participate in the negotiation process?

Stakeholders/Sectors	Stage of Negotiation	Major Input
Trade groups		
Business sector		
Consumer groups		
Sensitive industries (please specify)		
Marginalized sectors		
Others (please specify)		

(13) What are the advantages (or limitations) of your current system of managing consultations?

_____

_____

(14) Please describe the procedures after the FTA is signed (including legislative approval) and before it takes effective.

Mandatory Procedures	Optional Procedures
(i)	(i)
(ii)	(ii)

(15) What are the mechanisms used in disseminating information on the signed FTAs? Please tick all the applicable mechanisms.

FTA webpage	
Government websites	
Newspapers or other publications	
Brochures and FTA guides	
Seminars and trade discussions	
TV and radio	
Others (please specify)	

(16) Who is responsible for evaluating the implemented FTA? How often are the reviews conducted?

Legislature	
President/Executive department	
Specialized body (e.g., trade representative office)	
Others (please specify)	

(17) What indicators do you use in assessing FTAs?

_____

_____

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