



**Economic Policy Programme**  
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**Customs unions and  
Free trade agreements:  
A general perspective**

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**Background Brief 2**  
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## **Background Brief**

### **CUSTOMS UNIONS AND FREE TRADE AGREEMENTS: A GENERAL PERSPECTIVE**

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The Economic Policy Programme is funded by the European Community (EC) and coordinated by the Ministry of Economy and Trade in collaboration with the London School of Economics and Political Science. The two-year project is an initiative launched as part of the European Community's programme of assistance to the Palestinian population of the West Bank and Gaza Strip. The objective is to provide the Palestinian Authority (PA) with policy support that will both assist it in clarifying and shaping trade policy and strengthen its capacity to negotiate with current and potential trading partners on economic and trade policy issues. The programme, which was launched in May 1996, works with a team of leading international experts - economists, political scientists and trade lawyers - in support of the ministry's policy agenda, and has held in collaboration with the ministry a number of roundtables on trade-related issues.

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## **Background Brief 2**

### **Customs union and free trade agreements: some general remarks from a trade policy point of view<sup>1</sup>**

Parallel with the development and deepening of the GATT, there has been a tremendous increase in regional integration agreements (RIAs). Between 1948 and today, more than 140 were notified to the GATT.<sup>2</sup> With more than 60 agreements notified since 1990 the rise has been especially significant in the last few years, both in the number of agreements concluded and the economic and political weight of the participating members.

Most RIAs have been established in the form of customs unions and free trade agreements. Of the two, the latter form has been resorted to much more frequently, however.

#### **1. RIAs and the GATT and WTO agreements**

##### *a) The principle: General Most-Favoured Nation Treatment (MFN)*

One of the key principles of the GATT 1947 has been that "any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties" (Article 1, General Most Favoured-Nation Treatment).

##### *b) The major exception: Article XXIV of GATT*

By definition, RIAs do not comply with the MFN rule because they accord one set of countries (the members of the agreement) a better treatment than others. However, the GATT contracting parties explicitly recognised "the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements" (Article XXIV)(4).

In Article XXIV, however, certain conditions were laid down concerning the form of the agreements, their notification to GATT and the verification to be followed by the GATT contracting parties, and the economic consequences for third countries.

(i) The following forms are mentioned and loosely defined: a customs union, a free-trade area, or an interim agreement necessary for the formation of a customs union or a free-trade area (Paragraph 5):

- \* A customs union consists of one customs territory composed of several constituent territories. Between these territories, "duties and other restrictive regulations" (with some exceptions) "are eliminated with respect to substantially all the trade...or at least with respect to substantially all the trade in products originating in such territories". Concerning trade with third countries, "substantially the same duties and other regulations of commerce are applied by each of the members of the union" (Paragraph 8 (a));
  - \* The definition of a free-trade area only covers the internal relations between members, which have to follow approximately the same rules as in the customs union. Relations with third countries are left, by implication, to the discretion of the members (Paragraph 8 (b));
  - \* An interim agreement has to contain "a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time" (Paragraph 5 (c)).
- (ii) The formation of a customs union or a free-trade area shall not result in higher duties or other commercial regulations for third countries (Paragraph 5 (a) (b)). If rates of duties need to be increased by a GATT contracting party as a result of the formation of a customs union, the procedure set out in Article XXVIII shall apply (Paragraph 6).
- (iii) A "contracting party deciding to enter into a customs union or free-trade area, or an interim agreement leading to the formation of such a union or area" has to notify the other GATT parties, which shall follow a certain verification procedure (Paragraph 7).

c) *The exceptions for developing countries: Part IV and the Enabling Clause*<sup>3</sup>

The discussion in UNCTAD and the GATT on the rights and privileges accorded to developing countries, which had already started in the 1950s and 1960s, included the question whether preferences could be given to developing countries without observing the conditions laid down in Article I of the GATT (General MFN). The results of these discussions were Part IV and especially the so-called Enabling Clause.

Part IV on "Trade and Development" (Articles XXXVI-XXXVIII) was added to the GATT in 1965. It introduced the principle of non-reciprocity in trade negotiations between developing and developed countries and committed the latter to take concrete actions to further imports from developing countries. In some cases, these provisions were invoked by developed countries to justify preferential, non-reciprocal agreements with developing countries. This line of reasoning was contested by other GATT contracting parties, however.<sup>4</sup>

The rights and privileges of developing countries were further developed in the Enabling Clause, which was put in force by a decision of the GATT contracting parties at the end of the Tokyo Round in 1979.<sup>5</sup> It has served as the legal basis for according developing countries special and differential treatment under the Tokyo Round Codes and for preferential agreements not conforming to Article I, both between developing countries<sup>6</sup> and between developed and developing parties.<sup>7</sup> Furthermore, the Clause has allowed for special treatment of the least developed countries. Arrangements based on the

Enabling Clause have to observe certain conditions (Paragraph 3) and are to be notified to the GATT for verification (Paragraph 4).

The decision of 1979 does not contain any reference to Article XXIV. As a result, views among GATT members have differed as regards the relationship between the two provisions and whether a given agreement should be examined under one or the other set of rules. Between 1979 and 1994, eleven agreements were notified under the Enabling Clause, including the MERCOSUR Agreement between Argentina, Brazil, Paraguay and Uruguay.<sup>8</sup>

d) *The WTO rules*

During the Uruguay Round of Negotiations, clarifications were added to Article XXIV in order to remove some ambiguities and to submit "any matters arising from the application of those provisions of Article XXIV relating to customs unions, free-trade areas or interim agreements" to the regime of the Dispute Settlement Understanding, which is part of the WTO agreements. Further changes concern paragraphs 5,6 and 12 of Article XXIV and the review procedure of agreements. They include a clarification that the "reasonable length of time referred to in paragraph 5(c) of Article XXIV should exceed 10 years only in exceptional cases".

The General Agreement on Trade in Services GATS, which also resulted from these negotiations, contains an Article V on Economic Integration that is modelled after Article XXIV of the GATT. See the relevant text below. On the other hand, the Agreement on Trade-Related Aspects of Intellectual Property Rights TRIPS contains certain exemptions from the MFN treatment (Article 4) but no general exception of the type provided for in Article XXIV of the GATT.

## **2. Some examples of customs unions and free trade areas**

The above description makes it evident that the rules concerning RIAs in the GATT/WTO agreements are rather general and in some cases incomplete. Accordingly, the review procedure has resulted in different interpretations of the GATT provisions and the necessary consensus to either approve or disapprove an RIA notified to the GATT has hardly ever been achieved.<sup>9</sup> This might explain why so many diverse arrangements exist under either of the two main forms of RIAs, i.e. the customs union and free-trade area.

a) *Customs unions*

Five examples of customs unions have been chosen to demonstrate the variety, without going into very much detail concerning the respective governments, however. As points of comparison their scope, the degree of supra-nationality built into the agreement, the internal decision-making mechanism for concluding agreements with third countries and the mode of conducting negotiations with such countries have been selected:

(i) The Rome Treaty and the subsequent agreements establishing the EU are much more than trade agreements. In addition to having achieved an integrated internal market on the basis of the four freedoms (free circulation of goods, services, capital and persons) and flanking and horizontal policies

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in a number of related areas, whose rules are implemented, supervised and enforced by an independent body with supranational powers (the Commission) and a Court, the EU has as its expressed objective the achievement of a political union.

With regard to trade agreements with third parties the member states decide on a negotiating mandate for the Commission and approve and, in some cases, ratify the negotiated agreement. The agreement is laid down in one document valid for all EU member states and the respective partner. Negotiations and implementation of the agreement fall on the Commission. Over the years, the EU has concluded with its partners agreements on customs unions, free-trade areas and non-reciprocal preferential treatment.

(ii) The Southern Common Market (MERCOSUR) Agreement of 1991<sup>10</sup> has the objective of establishing a common market between the member countries, involving inter alia free movement of goods, services, and factors of production, as well as the establishment of one external tariff and the adoption of a common trade policy in relation to third countries.

The member states take all decisions by consensus. No supranational body has been provided for. The chief executive organ (the Common Market Group), which is supported by an administrative secretariat, consists of representatives of the member states. The Common Market Group is also in charge of negotiating agreements with third parties.

(iii) The Czech Republic and the Slovak Republic decided to remain in a customs union upon dissolving their common state in 1993. A Council of Customs Union was created, which is composed of representatives of both sides. The Council is supported by a secretariat without supranational authority. Trade agreements are negotiated in parallel but concluded separately. They result in two different agreements. Coordination both during the preparations and the course of the negotiations is ensured through direct contacts between the two administrations and the customs union secretariat.

(iv) Switzerland and the Principality of Liechtenstein have been in a customs union since 1924, which in essence covers trade in goods. The two countries also have the same currency and closely cooperate in many other fields. There are no customs checkpoints between them whilst the external border around both countries is patrolled and serviced by Swiss customs officials. A Joint Committee is in charge of implementing the various agreements and to coordinate common activities under the customs union.

The customs treaty originally contained a provision according to which Liechtenstein delegated to Switzerland the right to conclude trade agreements on its behalf. In the meantime the customs treaty has been amended to enable Liechtenstein to become a party to international trade agreements alongside Switzerland or even independent of it. In the latter case, an explicit agreement between the two countries is necessary, however, to sort out the possible consequences for the customs union.

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two countries is necessary, however, to sort out the possible consequences for the customs union.

In line with these changes, Liechtenstein became a member in its own right of the European Free Trade Association EFTA and of the GATT/WTO. On the basis of a special agreement it was even possible for the Principality to become a party to the EEA Agreement (see below) although Switzerland had decided not to take this step.

(v) The Southern African Customs Union<sup>11</sup> exists since 1910 but its modified form dates from 1969. Trade between the members with regard to "goods grown, produced or manufactured in the common customs area" is unrestricted, save for some specified exceptional circumstances. Concerning trade relations with third parties, the South African tariff, duties and the sales tax are valid for the entire customs union. South Africa is to give the other members adequate time for consultations before it changes duties and charges. Customs revenues are pooled and distributed to its members. In the distribution formula a certain surcharge has been built in for the partners of South Africa to compensate them for accepting the latter country's tariffs and charges.

b) *Free trade areas*

Also the variety of free-trade areas is considerable. As already indicated, contracting parties in such areas are normally free to determine their own outer tariff and thus to decide independently about their foreign trade policy. However, voluntarily and often as a consequence of the degree of harmonisation achieved within the area, the members decided in some cases jointly to conclude trade agreements with third countries. The following examples of free-trade areas could be given:

(i) The European Economic Area EEA<sup>12</sup> of 1994 extends the EU internal market legislation to the contracting partners of the European Free Trade Association EFTA, establishes a mechanism of coordination for continuously integrating new EU legislation, and provides for surveillance of the implementation and enforcement of the rules by two independent bodies and courts (one each for the EU and the EFTA side). Agricultural products are dealt with in bilateral agreements between each EFTA country and the EEC. While third-country relations in principle do not fall under the agreement, the close integration achieved required special solutions in some cases where arrangements by one EEA party with a non-member might have consequences for the other EEA partners.<sup>13</sup> In addition, a general consultation requirement was included in the agreement in some areas.

(ii) The North American Free Trade Agreement NAFTA<sup>14</sup> of 1992 covers trade in goods (industrial and agricultural), investments, cross-border trade in services, competition policy, procurement, intellectual property rights and related trade matters. The implementation of the rules is supervised by the Free Trade Commission, comprising cabinet-level representatives of the member states. It is supported by a secretariat. In addition, the agreement contains extensive dispute settlement rules. No provision appears to be included in NAFTA concerning the possibility of concluding agreements with third countries. On the other hand, any other country or group of countries may accede to NAFTA on such terms as may be agreed upon with the existing member countries.

(iii) The agreement establishing the European Free Trade Association EFTA<sup>15</sup> covers trade in goods,

processed agricultural and fishery products but leaves trade in agricultural goods to bilateral arrangements between the members. The decision-making body of the organisation is the Council, in which all members participate as equals. The Council is supported by a secretariat.

In order to avoid competitive disadvantages in markets of countries with whom the Union has concluded preferential agreements, the EFTA states began to negotiate jointly Declarations of Cooperation and free-trade agreements with a number of third countries. The result of the negotiations is one document binding all EFTA countries and the respective partner, which contains, however, in some places different obligations for the EFTA countries.

(iv) The free-trade agreements concluded by the EU and the EFTA countries, respectively, with states from Central and East Europe and from the Mediterranean Basin normally aim at eliminating tariffs for industrial goods (subject to quotas in some cases) and the industrial element of processed agricultural products. Special regimes are usually negotiated with regard to fishery and agricultural products. In the case of the EU, the trade part of the agreement is complemented by cooperation in other sectors and often includes a financial package. The agreements concluded by the EFTA countries are entirely of a trade nature. The agreements are implemented by a joint body composed of representatives of the contracting parties (in the case of the EU the Commission) and contain a dispute settlement mechanism. These agreements are of a bilateral nature and normally do not include possibilities for being extended to third parties. The only third country element is provided by the possibility of cumulating origin with material from third countries if certain conditions are fulfilled.

c) *General conclusions*

Although being brief and incomplete this examination nevertheless allows the following general conclusions.

(i) It is not easy to extract from these examples an inventory of characteristics which can be clearly assigned to either a customs union or a free-trade area. This is especially the case as regards the internal relations between the members of the union or the area:

- \* The necessity to have origin rules is normally cited as *the* decisive distinguishing element between a free-trade area and a customs union, although origin rules are not mentioned in the definition for these two forms in Article XXIV of the GATT. In the case of established customs unions and free-trade areas, origin rules indeed play this role. However, in an interim agreement leading towards a customs union the necessity to have origin rules will persist until all the members have the same tariff. This might require several years from the conclusion of the agreement.
- \* The scope of the agreement does not seem to be related to its form. As proof can be cited that the customs union Switzerland-Liechtenstein essentially only covers trade in goods while the EEA (a free-trade area) is a very comprehensive agreement. Also the NAFTA covers a wide ground.
- \* Also the criterion of supranationality does not permit a clear distinction between the two forms. Both the EU (a customs union) and the EEA have supranational bodies while none of the other examples cited above have provided for them.

(ii) The situation is clearer with respect to relations with third countries. A common foreign policy is a logical consequence of a common external tariff, which is a basic element of a customs union.<sup>16</sup> However, also in this case a different arrangement needs to be found for the transitional period in an interim agreement leading to the establishment of a customs union. On the other hand, also the partners in some free-trade areas have found it useful and in their interest to conclude together trade agreements with third countries.

(iii) In all cases cited above, an internal consultation or coordination mechanism is provided for with regard to relations of the partners to an RIA with third countries. Where a party is not expected to co-decide on such questions on a basis of equality (e.g. in the case of the Southern Africa Customs Union) it is at least compensated for delegating this prerogative.

**Hanspeter Tschaeni**  
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**Notes:**

1. The following cannot claim to be a comprehensive and complete presentation of this complex topic. Rather, some key information and selected examples of agreements are given to illustrate both the common parameters contained in the GATT/WTO agreements and the variety of regional integration agreements existing all over the world. A useful and informative presentation of the wider issue of the trade implications of regional agreements is contained in "Regionalism and the World Trading System", published by the WTO Secretariat in April 1995.

2.. This number should not indicate that all of them are still in force. Some agreements have ceased to exist while others were superseded or modified. These changes were again notified and are thus included in the overall number.

3.. In addition to the exceptions discussed in more detail in this note, the possibility of obtaining a waiver to depart from obligations of the GATT (Article XXV) should be mentioned for completeness' sake. On occasion, this provision has also been resorted to for authorising RIAs, e.g. the European Coal and Steel Community in 1952, the Fourth Lomé Convention in 1994 (see below).

4.. For example, the EU based itself on Part IV as a justification for its so-called First Lomé Convention with African, Caribbean and Pacific countries. Since some GATT members never accepted this argument, a way out was found for the Fourth Lomé Convention by granting their members in 1994 a waiver until the year 2000. See "Regionalism and the World Trading System", published by the WTO Secretariat in April 1995, p.14/15.

5.. The full title of the decision is "Differential and more favourable treatment, reciprocity and fuller participation of developing countries", Decision of 28 November 1979(L/4903).

6.. See e.g. the Protocol Relating to Trade Negotiations Among Developing Countries concluded in 1971 under the auspices of the GATT and the Agreement on the Global System of Trade Preferences among Developing Countries concluded 1988 under the umbrella of UNCTAD.

7.. In this case, preferential treatment could be accorded autonomously by the developed countries or by way of an agreement between a developed and one or several developing countries. The most important example of the autonomous approach is provided by the Generalised System of Preferences (GSP) regimes of developed countries, which operate under the umbrella of UNCTAD. Examples for the contractual approach are provided by the EU e.g. in the case of its agreements with Jordan and Egypt, respectively, of 1977.

8.. See "Regionalism and the World Trading System", published by the WTO Secretariat in April 1995.

9.. So far, a consensus among all GATT members that a notified agreement was in full conformity

with GATT has only been obtained in six cases. On the other hand, in no case have all members agreed that an agreement was not in line with GATT provisions. As a result, the majority of the agreements in force today exist without the explicit blessing of the GATT. This may change as a result of the fact that matters with regard to customs unions, free-trade areas, etc. are now subject to the (stricter) WTO dispute settlement procedure.

10.. Members are Argentina, Brazil, Paraguay, and Uruguay.

11.. Members are South Africa, Lesotho, Swaziland, Botswana and Namibia.

12.. Parties are the 15 EU members, the EEC and the ECSC as such and the EFTA countries Iceland, Liechtenstein and Norway.

13.. An example would be the conclusion of a mutual recognition agreement by an EEA member with a third country that entails the use of a mark. If that mark cannot be distinguished from the one used in the EEA, the products of the third country might also gain access to the rest of the EEA. It was thus considered necessary that such agreements would be concluded by all EEA members.

14.. Members are the USA, Canada and Mexico.

15.. The Stockholm Convention of 1960. The membership of the organisation fluctuated considerably over time, reaching from a high of eight countries to its current level of four, i.e. Iceland, Liechtenstein, Norway and Switzerland.

16.. However, the customs union between the EU and Turkey can be cited as a case that leaves some room for an independent foreign trade policy of the two parties.

### **Hanspeter Tschaeni**

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From 1981 to 1995, he worked primarily with questions related to European integration and with trade relations between the EFTA states and Central and East European countries, Israel and Turkey. During that period he held posts with the Swiss administration and the EFTA Secretariat in Geneva where he worked as Director of Trade Policy Affairs. Aside from being closely associated with the negotiation and implementation of trade agreements, he conducted trade policy seminars in several of the partner countries as a means of preparing them for their tasks under the agreements.

Since July 1995, Mr Tschaeni works as Senior Advisor for the Secretariat of the Swiss Trade Initiative STIMENA, located in Geneva.

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