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Review Article

A Critical Analysis of South Asian Free Trade Agreement and South–Asian Regionalism: Is Article 24 of GATT Enough?

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Abstract

The free trade initiatives led by The South Asian Free Trade Agreement (SAFTA) was claimed to be a gigantic step towards escalating the trade and economic cooperation in the South Asian region. It has been a long time since the commencement of SAFTA and the progress made in trade between SAARC countries has not been satisfactory. Keeping that in the mind, the author intents to evaluate the situation responsible for this scrawny progress in trade. However, before that it will be pertinent to analyze the provisions with respect to Regional Trade Agreements in WTO jurisprudence and then to put them in contrast with SAFTA, to give a clearer picture of South Asian Trade regionalism.

Keywords: SAFTA; SAARC; ASEAN and South Asia.

Introduction

The transition from feudalism to mercantilism proved nothing but continuance of elitist, protectionist and restrictive policies in Europe. It emerged in the age of exploration with the opening of overseas trade routes and colonies in Asia, Africa, Australia, and the Americas. With increasing foreign trade, the merchant class of traders and guildsmen hastily grew in number, in wealth, and in their ability to lobby for polices and regulations to restrict import, insistently promote trade, protect domestic industries and apply military forces to exert control over foreign economies and vital resources that were scare back home.

Mercantilism doctrine at its heart is of the view that maximizing net exports is the best route to national prosperity, narrowing down its interest to maximum acquisition of gold (bullionism) by limiting imports and increasing exports, thereby generating a net inflow of foreign exchange and maximizing country's gold stocks [1]. However, decline of mercantilism came with the work of Adam Smith wherein, he contended that unlike a merchant, a nation needed to focus on the gross instead of the net result of its economic activity[2]. According to him, the mercantile system was built on an erroneous and confused identification of wealth with money, based on rent – seeking behavior of vested actors [3]. He urged that dominant contributor to national wealth and power is economic growth which in turn depends on an efficient division of labor and not on positive balance of payment [4]. Nonetheless, mercantilism should not consider as an anti-trade doctrine. Rather, it is an anti-free trade doctrine that calls for government intervention to generate trade surplus [5].

With increasing popularity of Smith's idea of economic growth, a gradual shift from mercantilism to free trade was experienced. The work was later supported and modified by David Ricardo's famous Law of Comparative Advantage, wherein he argued that international trade is mutually beneficial for all the countries. These developments gave rise to the

theory of Free Trade, which in essence refers to unrestricted flow of goods and services across the border. It refers to a foreign policy completely devoid of tariffs, quotas, exchange restrictions, taxes and subsidies on production, factor use and consumption [6]. From this doctrine came the concept of "Free Trade Agreements" (FTA) [7].

Article 1 of GATT 1994 enunciates the Most Favored Nation (MFN) principle which states as follows:

"*Any advantage, favor, 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*"

However, derogations from this principle is permitted for forming FTAs under specific conditions as per Article 24 of GATT and Article 5 of GATS or using an enabling clause [8] by developing countries without adhering to provisions of WTO Agreements.

Nevertheless, there remains a basic difference between functioning of WTO and FTAs. For the purposes of FTAs, the "base rate" is the critical element in all aspects of negotiations / phasing that are carried out. The base rate is the applied MFN duty of any year which is decided mutually. In an FTA tariff reduction is generally undertaken with reference to the base rate i.e. from the applied MFN tariffs. However, the WTO negotiations are always based on "bound duty rates" and not the MFN applied duties.

The two most difficult yet interesting questions which are posed by the recent proliferation of RTAs are *why is happening* and *whether it is welfare-improving [9]*. They can be answered from three different points of views that is, from a pure economic analysis, political economic analysis and constitutional analysis (WTO jurisprudence).

Economic and Political Analysis of Regional Trade Agreements

Trade liberalization via RTAs is widely attributed for enhancing economic development amongst participating economies. By reducing barriers to trade, countries in the international trading system unleash their economic potential by empowering domestic industries to access foreign markets and strive for greater productivity. Reducing restrictions that are imposed at a government level has the beneficial effect of exposing businesses to global competition and persuasive domestic industry to greater innovation and efficiency [10].

Nevertheless, economists have two major concerns with RTAs. They are the theory of Second Best and Transaction Cost that is associates with such arrangements.

The general theorem for the second best optimum states that if there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, although still attainable, are in general, no longer desirable [11]. The optimum situation finally attained may be termed a second best optimum because it is achieved subject to a constraint, which, by definition, prevents the attainment of a Paretian optimum. If one of the Paretian optimum condition cannot be fulfilled a second best optimum situation is achieved only by departing from all other optimum condition. It is important to note that even in a single general equilibrium system where there is only one Paretian optimum, there will be a multiplicity of second best optimum positions. This is so because there are many possible combinations of constraints with a second best solution for each combination [12].

Let us understand this problem by an example. Until the 1980s Canada had a protected wine industry, where it was expensive but was not of high quality and was competing domestically only because of tariff and non-tariff barriers. However, as a result of Canada- US Free Trade Agreement of 1898, which liberalized the wine trade, the Canadian industry lost market share to California vintners. This is an example of welfare-improving trade creation: Canadian wine prices fell; consumers were able to purchase more; Canadian vintners ceased producing goods that could be produced more cheaply in California; this freed up resources for use elsewhere, government lost tariff revenue but consumers gained by virtue of lower prices on imports. Now the consumers pay tariff price only on French wine. Therefore, the agreement lead to substitution of French wines with California Wine, diverting trade from France to California. However, if Canadian consumers would have preferred more of French wine over California wine, switch would be welfare-reducing [13].

The problem of transaction cost relates to the differences among members with respect to habit, regulation, commercial practice and other such differences which the exporters has to familiarize themselves with. Such differences impose fixed costs on exporters that are part of the reason why small firms tend not to export [14].

Constitutional Framework of Regional Trade Agreements

Under the guises general public international law, states are essentially free to enter any agreement of any kind and consent. Equality of states (sovereignty) gives them power to choose partners and to discriminate against others. There are barely any limitations in international customary law on engaging in preferential or discriminatory treatment, beyond the Charter of the United Nations [15]. There is no codified general obligation to treat all states alike. Neither equal treatment nor Most Favored Nation (MFN) status is considered to be principles of general public international law [16]. Norms relating to *jus cogens [17]* hardly affect trade relations, except for the prohibition of slavery in its different forms, and of policies supporting racial segregation. The principle of *pacta tertiis nec nocent nec prosunt (*that a treaty binds only parties to it and not third party*)* is of equally limited effect. Devoid of specific treaty provisions certainly does not limit the conclusion of preferential and discriminatory trade agreements having distorting effects of trade diversion.

The principles and rules pertaining to regional integration and preferential trade agreements of the World Trade Organization, which binds its members, are consequently of supreme importance in light of the proliferation and complexity of preferential agreements. These principles and rules shape the conditions, requirements and limitations for such agreements on the basis of the General Agreement on Tariff and Trade 1994 [18] and the General Agreement on Trade in Services 1994 [19]. The WTO principles and rules pertaining to treaty law (from a functional point of view) assumes the role of overriding constitutional disciplines which shapes and contents the preferential agreements – all with a view to supporting trade creation as building blocks to trade regulation and liberalization, while at the same time limiting trade distortions and diversions. However it remains open to discuss whether these WTO disciplines provide sufficient guidance and force to bring about the desired effects, to regulate such agreements [20].

Members of the WTO who are negotiating and concluding RTAs are obliged to comply with a number of principles and rules of the multilateral system. Since preferential agreements by definition restrict the application of MFN, WTO rules rarely exceptionally allow for sectoral bilateral or multilateral treaties. WTO law thus provides the framework within which members may to conclude preferential agreements between themselves and other members. In the field of goods, the main exceptions to MFM are set forth in Article XXIV GATT 194 and the Understanding on the Interpretation of Article XXIV of the General Agreements on Tariff and Trade 1994 [21]. In the field of services, a largely parallel provision is contained in Article V GATS and Article V bis GATS for Labour Market Integration Agreements. These provisions relate to the creation of separate customs territories free trade areas, including interim agreements, and to economic integration agreements. They seek to balance objective of multilateralism and the need of RTAs by setting out a number of conditions which bilateral or multilateral preferential agreements are required to meet [22].

Preferential arrangements are only lawful and possible under the definitions of FTAs or CUs. While the former establish free trade among members, the latter, in addition, adopt a common external tariff and trade policy. WTO law does not allow for preferential and non – reciprocal preferences under Part IV of GATT, except for recourse to the general and temporary exceptions of waivers under Article IX: 3 of WTO Agreement [23], no provision was made to cover non-reciprocal agreements between developed and developing members [24].

Preferential agreements essentially need to meet following basic criteria: (a) Substantial Trade Coverage (b) Abolition of Internal Trade Restrictions (c) Avoiding Additional Barriers for Third Countries and lastly, (c) Minimum Requirements on Preferential Rules of Origin.

First, regional agreements need to cover considerably all the goods or services originating within members of the RTA. The policy of *pick – and - choose* among different products and sectors are inconsistent with WTO rules. Limited liberalization is excluded and discriminations are lawfully only when extensive areas of trade are covered irrespective of the fact that it may lead to greater distortions and sectoral agreements. Yet, the requirement serves the purpose of preventing selective agreements and limitations to goods or services of particular interest. It also serves to limit the number of RTAs, as comprehensive agreements are most difficult to negotiate than sector specific deals. The 'substantially all trade' and 'substantial sectoral coverage' requirements, If properly enforced, thus impede a gradual erosion of MFN trade and thus of the multilateral trading system [25].

Second, RTAs need to remove all tariffs and quantitative restrictions within a reasonable extent of time. Intermediary arrangements may extent for up to ten years and in exceptional cases such as in agriculture, may last even longer. The same is turn in

services. The elimination of discrimination and the granting of national treatment are required to take place either at the date of entry into force of the agreement or within a reasonable time frame. It is possible that the basic framework of ten years applied to goods will provide guidance in services as well.

Third, RTAs must not result in more server barriers to trade for third member states of the WTO. Liberalization must not be achieved at the expense of others. In GATT, market access rights for third parties vary slightly depending on whether the RTA formed is a CU or a FTA. In the former, trade restrictions shall not be on the whole more severe than the general incidence of the duties and regulations prior to forming the CU. In the case of FTAs, such restrictions must not be higher in any instance.

Last, it should be noted that Agreement on Rules of Origin is of particular importance. While this agreement primarily set the agenda for future negotiations in this filed with a view to applying equal rules in all areas, there are nevertheless several principles and provisions which apply immediately upon ratification and can potentially be used for a challenge before a dispute settlement panel. Article II offers a number of detailed against which preferential rules of origin can be assessed. They are of importance in arguments against arbitrary and discretionary determination by national customs authorities. To provide the discipline currently lacking in Article XXIV, the internal trade under an RTA should be based upon 'non-preferential rules of origin' (NPROO) so that trade barriers between RTA parties with respect to 'substantially all the trade' will be eliminated [26].

Introduction to SAFTA

South Asian countries, which has open economies in the immediate post-independence period in the 1940s, has become some of the most highly protectionist economies in the world by the 1970s. Tariff and, even more important, non – tariff barriers were extremely high, state interventions in economic activity had become pervasive, attitudes to foreign investments were negative, often hostile, and stringent exchange controls in place [27]. However this began to change with liberalization policy driven by across-the-border, unilateral liberalization by individual countries. However, a process of preferential trade liberalization also has been ongoing since the establishment in 1985 of the South Asian Association for Regional Cooperation (SAARC).

South Asian Free Trade Agreement came into force on 6th January 2004 at the 12th SAARC (South Asian Association for Regional Cooperation) Summit at Pakistan. SAFTA was result of South Asian Preferential Agreement (SAPTA) which was entered into on 7th December 1995. It was framed by the Inter – Governmental Group (IGG) which was established in the 6th SAARC summit held at Sri Lanka.

The main objective of SAFTA is to encourage and elevate common contract among the member states for tariff and non- tariff concessions to provide competition and equitable benefits to member states by increasing trade among member states.

SAFTA has following institutions: (1) Trade Liberalization program (2) Rules of Origin (3) Institutional Arrangements (4) Consultation and Dispute Settlement Process and (5) Safeguard Measures.

Trade Liberalization Program

SAFTA lays down for a trade liberalization program in Article 7, wherein the member states have to follow tariff reduction schedule. There should be a fall to 20% tariff from the existing tariff by the Non Least Developing Countries and 30% reduction from the existing tariff by the Least Developing Countries. However it craves out an exception got for the sensitive list because this list is to be negotiated among the members and traded. Such list will be review every four years by the SAFTA Ministerial Council (SMC) with view of reducing the items in the list [28].

Rules of Origin

Article 18 of the Agreement lay down that, the rules of origin shall be negotiated by the member states. Rules of Origin determine the criteria needed to determine national source of a product so as to extend benefits of tariff cut as determined in the FTA [29].

Institutional Arrangements

Article 10 enumerates upon institutional arrangements. It establishes SMC as the highest decision making body of SAFTA, responsible for administration and proper implementation of the agreement within its legal framework. SMC is supported by Committee of Experts (COE), with one nominee from each contracting state who is expertise in trade matters.

Consultation and Dispute Settlement Process

The COE shall act as Dispute Settlement Body as given under Article 10 (7), Article 19 deals with Consultation and Article 20 further enumerates upon its working and procedure, as settlement of dispute.

Any dispute that arises among the member States in regards to the interpretation and application of the provisions of this Agreement or any instrument adopted in reference to rights and obligations of the member states will be amicably settled among the parties concerned through a process initiated by a request for bilateral consultations [30].

Safeguard Measures

Article 16 enumerates upon safeguard measures. Accordingly, If any product is imported into the territory of a member state in such a manner or quantities as to cause or threaten serious injury to producers of like or directly competitive products in the importing member state, it may pursuant to an investigation by the competent authorities of that may suspend temporarily the concessions granted the Agreement. However such safeguard measures shall not be available if it's in liberalization process. This provision is to be in conformity with WTO's Agreement to Safeguard [31].

However, to date the SAFTA process has generated only limited enthusiasm. It suffers from significant shortcomings, primarily on account of cautions approach adopted to achieve the ultimate objective of free trade within the South Asian region [32]. Concerns about the very usefulness of SAFTA have been mounting in light of more bilateral free trade agreements as well as preferential access that could conceivable be granted through alternative trading arrangements among SAAR Countries [33]. The dynamics of regional integration in South Asia have also changed with the growing emergence of India not only as an Asian economic power, but also as a rapidly emerging world economic power. With India looking increasingly to strength economic relations with the wider Asian region through initiatives such as Association of Southeast Asian Nations (ASEAN) plus three plus India, the strategic interests of the all South Asian economies are likely to become inextricably linked to successful integration with the Indian economy. The evidence t date suggests that economic integration of the South Asian region is gathering pace, but that SAFTA remains fairly marginal in that process [34].

Conclusion

With the above analysis, it can be logically concluded that India's inclination towards preferential trading shall not be beneficial as India continues to have very high trade barriers so that the scope for trade diversion and the losses accompanying it are likely to be considerable [35]. To add to that, business lobbies are considerably powerful in most of the countries in the South Asian region which gives them sufficient scope to exploit the rules of origin and sectoral exceptions in FTA / PTA arrangements in a way that will maximize trade diversion and minimize trade creation, for their personal benefits [36].

Therefore, India should proceed along nondiscriminatory lines to achieve further liberalization. Coordination among the regional partners in a non-discriminatory manner may help speed up regional liberalization and assist in disciplining the adjustment costs [37]. A South Asian FTA / PTA may not be very useful, with a low-tariff country such as Sri Lanka benefiting and high-tariff country such as India hurting.

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