C H A P T E R 2

# Politics and Policymaking

## Introduction

REGIONAL INTEGRATION IS GOOD POLITICS: IT MEETS political needs, such as security or enhanced bargaining power, and it satisfies influential lobbies. Indeed, the purpose of integration is often political, and the economic consequences, good or bad, are side effects of the political payoff. The most successful regional integration to date has been the EU. Here's how a president of the European Commission, Walter Hallstein, saw the balance between economic and political objectives in what he was doing: "We're not in business at all; we're in politics."

In this chapter we explore these political payoffs. When are they important, when are they illusory?

However, there is another and more worrying reason why regional integration is good politics. This is because those economic effects that are most apparent—larger markets and economies of scale—happen to be favorable. As we show, other effects make the net economic impact of integration ambiguous, but these are often overlooked in political discourse. So, regional integration is good politics partly because it is "soundbite economics," based on only those effects that are easiest to grasp. Sometimes the net effects will be highly favorable, but sometimes "soundbite economics" is seriously misleading: the illusion of gain collides with the reality of large costs and major redistributions.

The combination of political payoffs and soundbite economics is tempting, and goes far to explain the popularity of regionalism. Regional integration *may* also be good economics, but the impetus for integration has usually not been the economics. Sometimes, good politics delivers bad economics. The political payoff may nevertheless be worth it: If a country can substantially increase its security or lock in to democracy by joining a regional integration scheme, then it may be willing to accept a few hundred million dollars of costs as worthwhile. But sometimes the political benefits are ephemeral and the economic costs high. We show that the economic effects can vary enormously depending upon the characteristics of the country, the countries it chooses as partners, and the detailed design of the integration arrangement. Only by attending to these economic choices can the political momentum behind regional integration avoid the risk of driving an economy into costly mistakes.

## 2.1 Integration for Security

### Intraregional Security

The politics that most concerned President Hallstein and his colleagues in building the EU was security. The preamble to the 1951 treaty establishing the European Coal and Steel Community, out of which the EU grew, stated its aim as follows: "To create, by establishing an economic community, the basis for broader and deeper community among peoples long divided by bloody conflicts." Written shortly after the third bloody conflict between France and Germany in 70 years, it was not surprising that security was paramount.

Security also played an important role in initiating regional integration in the Southern Cone. The Argentine and Brazilian militaries had long perceived each other as potential threats. Economic agreements covering steel and automobiles were signed in the mid-1980s as part of an attempt to reduce tensions, and the creation of MERCOSUR in 1991 reinforced this process. Rubens Ricupero, a former finance minister of Brazil (and now Secretary General of the United Nations Conference on Trade and Development) confirms the importance of MERCOSUR's security role:

> Both countries were emerging from a period of military governments, during which considerable tension had characterized the bilateral relationship… It was essential to start with agreements in the economic areas in order to create a more positive external environment that rendered it possible to contain the military nuclear programs, and to replace rivalry by cooperation (Ricupero 1998).

The political impetus to European and Southern Cone integration was thus based on the belief that increasing trade would reduce the risk of intraregional conflict. Similar motives are found in the creation of the Association of Southeast Asian Nations (ASEAN)(to reduce tensions between Indonesia and Malaysia; see De Rosa 1995), APEC, and the Central American Common Market (CACM), which include potential political and military opponents (Page 1996). Anwar (1994) argues that ASEAN has promoted regional peace, with intraregional conflicts among the five founding members before ASEAN was founded, but not afterward.

The idea that increasing trade reduces the risk of conflict has a distinguished pedigree. It goes back to Emanuel Kant's *Perpetual Peace* (1795). In the nineteenth century it was taken up by the British politician Richard Cobden, who put his belief into practice as an architect of the Anglo-French commercial treaty of 1860 (Irwin 1993). In the twentieth century, Cordell Hull, a U.S. secretary of state, also put belief into practice as one of the architects of the postwar international trading order. The idea turns out to be supported by some evidence. Polachek (1992, 1997) used the Conflict and Peace Data Bank to investigate both the association between trade and security and the direction of causation. He found that a doubling of trade between two countries lowers the risk of conflict between them by around 17 percent.

There are various reasons why this might happen. Political scientists suggest that negotiations between political leaders on trade issues gradually build trust, so that elites learn to form cross-national coalitions for subsequent collaboration. The founding fathers of the European Community, Robert Schuman and Jean Monnet, went further. They considered that economic integration would make war "materially impossible," meaning that interlocking of steel, coal, and other strategic industries would leave countries unable to wage war against each other (Milward 1984).

Thus, regions that are economically highly integrated may tend to have less internal conflict. It seems an obvious step from this result to the proposition that policies that promote trade within a region will increase intraregional security. If so, regional integration may provide a first-best solution and external trade barriers must fall over time and following deep integration (Schiff and Winters 1998a,b). Sometimes economic integration paves the way for full political integration so that the risk of internal conflict is greatly reduced. An example is the Zollverein of 1834, a customs union among the then-numerous German principalities, which was the precursor to gradual political unification over the next 37 years and the end of intra-German conflict. A second example is the customs union formed between Moldavia and Wallachia in 1847, which led to the creation of Romania 34 years later (Pollard 1974; Milward and Saul 1973).

Unfortunately, the result that trade enhances security does *not* allow us to conclude that policies that promote trade within a region will necessarily improve the prospects of regional peace. Indeed, they may have precisely the opposite effect, particularly when enhancing security is not the main concern. This is because policy-induced integration promotes trade at a price. The tariff preferences that induce regional trade can create powerful income transfers within the region and can lead to the concentration of industry in a single location. The countries or regions that lose income and industry can be sufficiently resentful that separatist movements arise and the overall risk of conflict is increased.

A clear example of how trade preferences can trigger conflict was the American Civil War. The Northern states produced manufactures that they sold to the Southern states, and the Southern states produced cotton that they exported to Europe. Tariffs first nearly triggered civil war in 1828. The United States was already a customs union, but in that year the U.S. Congress, dominated by Northern interests, sharply raised the U.S. import duty on manufactures. This increased the price that Northern manufacturers could charge in the South, and so generated a massive income transfer from the South to the North. The policy was referred to in the South as the "Tariff of Abominations." South Carolina refused to collect it and threatened to secede unless it was rescinded. The federal government sent in troops but Congress backed down before fighting developed. In 1860 Northern interests tried again, because the North had so much to gain from high tariffs. This time Congress would not back down. This (perhaps as much as slavery) was the issue that led the Southern states to try to quit the Union, and led to the bloodiest conflict of the nineteenth century (Adams 1993).

Protective barriers also played a role in the conflict in which Ireland broke away from the Union of 1807 with Britain. Although there were many contributing factors, the single most decisive was probably the Irish famine of the 1840s. As part of the Union, Ireland and Britain were regionally integrated behind high tariff barriers for grain (the "Corn Laws"). The Corn Laws enabled British grain producers to sell to Ireland at well above the world price. This income transfer from Ireland to Britain became most acute during the Irish potato blight because Ireland needed to import more grain during that time (Irwin 1996). Resentment at the profits from famine forced the repeal of the

Corn Laws, but not before mass starvation and emigration had taken place, sowing the seeds of future conflict.

A further example is the war during which East Pakistan broke free from West Pakistan to become Bangladesh. Here West Pakistan was equivalent to the Northern states during the Civil War, selling manufactures to East Pakistan at prices forced well above world levels by tariff barriers. When Pakistan (East and West) was created in 1947 the per capita income in West Pakistan was only 17 percent higher than in the East, but the differential grew steadily—32 percent in 1959–60, 45 percent in 1964–65, and 61 percent by 1969–70. Islam (1981) attributes the growing disparity to high levels of external tariff and quota protection, the concentration of regional development and investment in Karachi, together with the lack of labor mobility due to the distance between East and West Pakistan. East Pakistan's desire for secession was in part motivated by resentment at the large income transfers the tariff barriers created and this growing income differential.

Conflict within regional integration agreements is illustrated by the East African Common Market. In this case Kenya was the equivalent of the Northern states during the Civil War. Tanzania and Uganda complained about the income transfers that were created by the common external tariff on manufactures. They also feared that there would be increasing agglomeration of manufacturing in Nairobi, which had a head start on industrialization compared with the smaller industrial centers of Tanzania at Dar es Salaam and Uganda at Jinga. Arguments about compensation for the income transfers contributed to the collapse of the Common Market, the closing of borders, and the confiscation of Community assets in 1978. In turn this atmosphere of hostility contributed to conflict between Tanzania and Uganda in 1979 (Robson 1998; Venables 1999; and Schiff 2000).

In the CACM, Honduran dissatisfaction with the distribution of benefits was one of the factors behind the 1969 military conflict with El Salvador. After the war, El Salvador vetoed a proposed special development fund to channel additional resources to Honduras, prompting Honduras to leave the CACM (Pomfret 1997).

These examples show that trade policy can redistribute income and produce outcomes that worsen intraregional security. The genius of the European Community has not been simply that it promoted regional integration but that it did so without generating the large transfers that trigger conflict. How did the European Community avoid the problem? Partly it was a matter of negotiating style and partly a matter of detailed design. The style was consensual: negotiators always looked for compromise and conciliation. When a country signaled that a Community policy would cause it major problems it was accommodated, either by being bought off with compensation, as with the British budget rebate, or by being granted a gradual adjustment process, as with compliance with the rules on labor mobility by Spain and Portugal (Tsoukalis 1993). A key design feature that eased the problem was that the Community's external tariffs were generally low and declining. Hence, there were no large unfair income transfers with producers in one nation able to exploit consumers in another by selling at prices well above world levels. The one exception to this is agriculture, which has been very highly protected and which has generated large income transfers between countries. But the reactions to this exception support the idea that the transfers generated by high protection create conflict. Agriculture has been the most contentious of the Community's policies.

Thus, it seems that regional integration can sometimes promote intraregional security and sometimes worsen it. The net effect depends, in part, upon the economic characteristics of the members of the region and upon the style and design of the integration arrangement. Unless the economics is right, the belief that regional integration enhances security can indeed be nothing better than "soundbite political science."

## Extraregional Security

The political impetus for regional integration is sometimes not *intra*regional security, but the need to unite to face a common external threat. The underlying idea is that common action in the economic sphere makes common action for security easier and more credible. The country perceived as a potential threat is typically the regional hegemon.

A good example of such a response was the formation of the Southern African Development Coordination Conference in 1980 to provide a united front among the small countries of the region against the apartheid regime in South Africa. Part of the strategy was to reduce economic dependence on South Africa both as a trading partner and as a conduit for the Southern African Development Coordination Conference trade with the outside world. Hence, an objective was actually to reduce trade with the hegemon (Foroutan 1993).

The Gulf Cooperation Council (GCC) was created in 1981 partly in response to the potential threat of regional powers such as Iran and Iraq (Kechichian 1985), and ASEAN was partly motivated by a perceived need to stem the threat of spreading Communism in the region. A major motive of Central and Eastern European countries in applying for membership to the EU is as protection against a perceived threat from the Russian Federation.

Sometimes regional integration combines the objectives of intraregional and external security. An example of how economic cooperation can be the precursor to military cooperation is the Economic Community of West African States (ECOWAS), originally formed in 1975. In 1986, 11 of ECOWAS's 16 members ratified a mutual defense protocol that authorized military intervention by the Community both in conflicts between members and if conflict in a member country was instigated from outside the membership. Clearly, 11 countries are unlikely to reach a military agreement without some prior experience of mutual negotiation and trust building. While the nations of West Africa have many subregional organizations through which they can build trust, most do not span the francophone-anglophone divide. ECOWAS was one of the few spanning organizations (Pomfret 1997) and so played an important, although indirect role in the establishment of the defense protocol.

While there is evidence that induced regional integration is a two-edged sword with respect to intraregional security, there is too little evidence to evaluate the effects on extraregional security. However, it is clear that security considerations of one type or another have often been an impetus for regional integration. The economic consequences of such integration are thus side effects of political decisions. A prime purpose of this report is to show how to assess these side effects. Sometimes the economic effects will be favorable so that integration offers politicians both political gains, such as enhanced security, and economic gains. Sometimes the economic effects will be unfavorable, facing decisionmakers with a tradeoff.

## 2.2 Integration for Bargaining Power

BY JOINING TOGETHER, THE WEAK CAN BECOME STRONG. JUST as workers band together in unions to increase their bargaining power against their employer, so small countries can band together to increase their bargaining power in trade negotiations.

How important has the motive of solidarity been in regional integration, and how effective is solidarity in trade bargaining?

The classic example of regional solidarity exerting economic power is that of the Organization of Petroleum Exporting Countries (OPEC). The OPEC agreement is not strictly regional and does not involve economic integration, but it does illustrate what solidarity can achieve. Its objective was not to increase trade among its members but rather to coordinate a restriction in oil export volumes, equivalent to a coordinated increase in export taxation. Hence, it was certainly a trade agreement. This was a successful bargaining strategy in that it raised the price of oil.

There is some evidence that one motivation for the formation of the original European Economic Community (EEC) in 1957 was the desire to increase bargaining power relative to the United States (Milward 1984, 1992; Whalley 1996). Some commentators argue that the formation of the EEC influenced the U.S. negotiating position during the Dillon and Kennedy rounds of GATT negotiations as the United States sought to mitigate the trade-diverting effects of European integration (Lawrence 1991; Sapir 1993; WTO 1995). The members of the EEC probably achieved two important bargaining objectives. They accelerated United States-Europe trade liberalization in manufactures; Europe is a net exporter of manufactures to America and reciprocal liberalization improved European access to American markets, and they delayed trade liberalization in agriculture. This raised the incomes of Europe's farmers at the expense of the rest of its population; although not good economics, this met the political demands of agricultural lobbies.

While this evidence for enhanced bargaining power may exaggerate the effects of integration, it suggests that there is indeed sometimes strength in numbers. How well might this result generalize to developing countries integration arrangements? We should expect that things will look different. OPEC dominated oil supplies. The EU created a grouping with a larger economy than the United States. No developing country regional grouping can hope to be in this league in terms of sheer economic power. In practice, developing country groupings have not succeeded in negotiating as groups. During the Uruguay Round, despite the existence of so many regional blocs of developing countries, most did not negotiate as a group. The exceptions were customs unions that, by virtue of having a common external tariff, are required to have a single negotiating position.

One reason why the regional blocs did not negotiate as single entities is that shared location often does not mean shared economic interest. The most successful negotiating blocs have been groups of countries with common exports, whether or not they were in regional agreements. OPEC is indeed an example of such a product-based alliance. During the Uruguay and Tokyo Rounds the most important such bloc was the Cairns Group of agricultural export countries, which had a common interest in achieving trade liberalization in agriculture and which was highly influential in negotiations.[1] It is suggested that it was only because of pressure from the Cairns Group that the United States maintained pressure on the EU.

Potentially, regional blocs can achieve a common negotiating position by logrolling, even if the interests of member countries differ. Each country agrees to support a long list of negotiating objectives—only one or two of which it has an interest in—to get other countries to support its own concerns. However, in practice, logrolling deals are easy for opposing negotiators to unravel by making offers that suit some members enough to tempt them to defect. Only if the parties to a logrolling deal are regularly making similar deals will they have an incentive to sacrifice the short-run gains offered by defection to preserve the longer-run benefits of cooperation.

The bargaining triumphs of OPEC and the EEC/EU are therefore a tantalizing, but ultimately misleading, role model for developing country regional groups. However, this need not imply that there is no scope for collective regional action. Even if a regional group cannot aspire to this much economic power, it can still work toward raising countries' visibility. After all, bargaining is not only about threats—it is also about the discovery of mutually beneficial deals. Even if regionalism cannot confer the power to be *menacing*, it can sometimes confer the power to be *noticed*.

In trade bargaining, countries win gains from an agreement by making concessions. When groups have the power to menace, they can use their power to make fewer concessions. However, paradoxically, when groups get together with the more modest objective of creating the power to be noticed, the ultimate test of success is whether or not they end up making more concessions. This is not because solidarity weakens their bargaining power: Rather, it is that if small countries act individually they may have so little bargaining power that they cannot negotiate attractive deals. They find themselves on the sidelines, with their offers of concessions seen as too unimportant to invite useful concessions in return. By combining their forces, they can cumulate potential concessions to a significant scale and so cut more deals.

The clearest example of regional solidarity with the objective of getting noticed is the Caribbean Community and Common Market (CARICOM), the alliance of small Caribbean island-states. CARICOM is not focused on achieving regional integration—rather its objective is common action. Without solidarity it would be quixotic for any single island to spend resources on international negotiations, and so it was evident that there were gains from pooling the costs of negotiation. CARICOM has been strikingly successful in getting its members noticed. For example, they have taken the lead in formulating and articulating the position of the African, Caribbean, and Pacific countries group in negotiating the Lomé Conventions. By pooling their support the CARICOM countries succeeded in getting their nationals elected to key international positions such as Commonwealth Secretary General and the African, Caribbean, and Pacific countries Secretary General. They also succeeded in negotiating a whole range of preferential market access arrangements with Canada, the United States, and the EU.[2]

Africa is the region most fragmented into small economies. There is thus a strong case for some cooperation in negotiations through bargaining units, whether through participation in product groups such as the Cairns Group, or through regional blocs. The national representation structure of the WTO tends to favor small countries, somewhat analogous to the United Nations, and so the existence of the WTO reinforces the "strength in numbers" argument for African collaboration. However, realistically the rationale would be to get noticed rather than to menace. Were Africa to use blocs to negotiate more effectively, it would be able to grant more concessions and thus cut more beneficial deals than it has done to date.

In one important respect regional integration can actually *reduce* the bargaining power of small developing countries. Consider the negotiation between a large multinational firm that is considering making an investment and demands tax concessions from the government of a small country. If the country is part of a regional trade bloc the firm can locate in any country within the bloc and still get access to the entire market. Governments within the bloc will tend to compete against each other to offer tax concessions: To each individual government a little tax revenue looks better than no tax revenue. By creating a regional trade agreement they set themselves up for a "race to the bottom." Hence, multinational firms can be expected to favor regional integration not just because it offers larger markets, but because it enhances their bargaining power. The only way for governments to prevent this effect of a regional trade agreement is for it to be extended to control such tax concessions; this goes well beyond the scope of most regional agreements.

A rare exception is a recent agreement on charges for cruise liners in the Caribbean. Until recently, cruise ships could discharge waste without charge at any island. Waste discharge inflicted cleanup costs on island governments, yet no individual island dared to levy a charge because the cruise companies threatened simply to divert their ships to other islands. In effect, the island governments found themselves stuck "at the bottom" in the charges race, because ships could choose freely between islands and each offered the same attractions. Analytically, this is precisely the same as the tax race within a regional trade bloc. Building on their previous extensive experience of solidarity, the island governments were able to coordinate the imposition of a cleanup charge. Despite threats of a generalized boycott from the cruise companies, the governments won their struggle. Hence, sometimes it is possible to counter the erosion of bargaining power that regional integration implies.

## 2.3 Project Cooperation

COUNTRIES CAN BENEFIT GREATLY FROM COOPERATION WHEN they share resources—such as rivers, fishing grounds, hydroelectric power, or rail connections—or when they join to overcome problems—such as pollution and transport bottlenecks. Failure to cooperate in these areas can be very costly. For instance, the uncoordinated exploitation of the Aral Sea by the five Central Asian riparian countries resulted in one of the world's worst environmental disasters, with the sea's desiccation, destruction of ecosystems, the pollution of surface and ground water, and more.

However, finding equitable ways to share the burdens and benefits of cooperation can be difficult. Countries sometimes find themselves unwilling to cooperate because of national pride, political tensions, lack of trust, high coordination costs among a large number of countries, or the asymmetric distribution of costs and benefits. Regional cooperation agreements are typically harder to achieve than national ones: they must be self-enforcing because of absence of regional courts or authorities to enforce them. The fact that these agreements must be self-enforcing reduces the set of feasible cooperative solutions and their benefits. International organizations, such as the World Bank—with high international credibility, expertise to deal with the complex issues involved, and the ability to mobilize financing—have often helped achieve an agreement where it might not have been possible otherwise.[3]

Regional integration agreements can help, because the ties of collaboration and frequent policy-level contact can raise the degree of trust among the parties. Moreover, regional agreements also help by putting more issues on the table and embedding them in a wider agreement, both of which lower the size of compensatory transfers required and make it easier to reach an agreement.

Regional integration was crucial in achieving project cooperation in the support the Southern African Development Community (SADC) provided to the Southern African Power Pool. The Southern African Power Pool provides for regional exchanges of electricity. Such pools offer large potential gains because peak loads do not always coincide, so that by pooling each country can meet peak demand while maintaining a smaller generating capacity. The gains over the period 1995–2010 are estimated at an astonishing $785 million, a 20 percent saving. However, cooperation is intrinsically difficult because each country has an incentive to underprovide expensive spare capacity, hoping to free-ride upon the spare capacity of others. Agreements can devise rules that forbid such behavior, but the rules must somehow be enforced. It seems that the framework provided by the SADC has provided this. The agreements between the EU and the East European and Mediterranean countries also include numerous initiatives for joint cross-border projects, covering transport networks, energy, environment, and other infrastructure projects.

Thus, though the support from the international community is often crucial for the success of cooperation agreements, regional integration is likely to help by increasing trust between the parties and by embedding the issues in wider negotiations where tradeoffs are more feasible and agreements easier to reach.

## 2.4 Integration for Lock-in to Reform

THE ARGUMENTS SO FAR HAVE ALL HAD TO DO WITH international relations, but integration can also help domestically, as a government seeks to implement its political agenda.

Reform plans can often be thwarted by the mere possibility that they will be reversed. Adjusting to reform typically involves investments, but these investments will not be made unless investors are confident that the reform will persist. Confidence in the persistence of the reforms may be low, particularly if the country has no track record of reform or, worse, a history of reversing reform. If the investments are not made, then government is likely to face increasing pressure to reverse the reforms—a "catch-22" situation (also known as policymakers' time-inconsistency problem). To escape from this trap governments often need institutions that enable them credibly to lock in to decisions. These are sometimes referred to as *commitment mechanisms*.

How good are regional integration agreements as commitment mechanisms? For trade liberalization, regional agreements are a well-designed piece of commitment mechanism because they are built upon reciprocal preferences: I reduce tariffs against you only if you reduce tariffs against me. As a set of self-enforcing rules this is quite efficient, especially if trade between members is large. The agreement reduces the likelihood of a country reversing its trade liberalization, because if it reneges on the trade preferences it has granted, it can be sure that its partners will respond by canceling the preferential access they grant. MERCOSUR provides a good example, where Brazil has had to back down on its attempts to deviate from the agreements after coming under pressure from Argentina.

Paradoxically, although regional integration works best as a commitment mechanism for trade policy, this is the area of policy where it is least necessary. This is because trade policy is the only area for which there is a well-established multilateral commitment mechanism, namely the WTO. Any country that wishes to reassure investors that trade reform will not be reversed can do so very simply by "binding" its tariffs to their reformed levels. This commits the country not to raise tariffs above bound levels, and is enforced by a clear and straightforward set of penalties. Indeed, a good case can be made that WTO enforcement mechanisms are stronger than those found in many regional agreements (Hoekman and Kostecki 1995).

But there is no equivalent to the WTO in other spheres of policy. Thus, regional trade agreements can be useful as a commitment mechanism if they are used as the foundation of reciprocal behavior on which other agreements are then built.

For example, the wave of democratization that swept the world post-1989 created a need for constitutional lock-in. Some regional trade arrangements have explicitly added a commitment to democracy to their original design. MERCOSUR put its—then informal—democracy rule into practice in April 1996 when the commander of Paraguay's armed forces was contemplating a military coup. The bloc's four presidents (with backing from the United States and the Organization of American States) reportedly quashed the rumored coup with a strong joint statement that democracy was a condition of membership in the bloc. Two months later MERCOSUR amended its charter to formally exclude any country that "abandons the full exercise of republican institutions" (Presidential Declaration on the Democratic Commitment in MERCOSUR, San Luis, Argentina, June 25, 1996; Talbott 1996; Survey on MERCOSUR, *The Economist*, October 12, 1996). In forming free trade areas with MERCOSUR, Chile and Bolivia accepted democracy as a condition for membership (Protocol of Ushuaia, July 24, 1998). However, this condition is only truly binding if the penalties for violating it are severe and effectively enforced.

Even without such explicit commitments, membership in a regional grouping can be understood to be restricted to democracies. This has clearly been the case with the EU, and the granting of membership to the new democracies of Portugal, Greece, and Spain is widely seen as an example of the use of a regional group as a commitment mechanism. We also see it with the eastern expansion of the EU, in which the EU Articles of Agreement with accession candidates are proving effective in promoting "full integration into the community of democratic nations" (Title 1, Article 2). For example, Latvia, which is a candidate for accession, is reviewing its citizenship policies for its Russian minority to meet EU concerns about human rights (*The Washington Post*, July 14, 1998). The preambles of the EU association agreements with Mediterranean countries include "the importance the Parties attach to the principles of the UN Charter, particularly the observance of human rights, democratic principles and economic freedom, *that form the very basis of the Association*" (Commission of the European Communities 1995, emphasis added).

Regional groups also sometimes use their potential as commitment technologies to lock in to economic policies other than trade. The most important example of this is probably NAFTA. Although NAFTA was ostensibly about trade policy, its underlying motivation was the desire on the part of both the Mexican and U.S. governments to lock in the broad range of economic reforms that the Mexican government had undertaken in the preceding years. The implicit agreement was that if Mexico maintained its policies it would have access to the U.S. market and also would have a more general claim on U.S. assistance (Francois 1997). One motivation for the U.S. government was that it had a strong interest in encouraging Mexican economic growth in order to curtail Mexican emigration to the United States. By making the Mexican reforms more credible it hoped to raise the Mexican growth rate.

Do regional agreements work as commitment mechanisms? The enforceability of bloc rules depends on both the value of belonging to the bloc and the credibility of the threat of action if rules are broken. If a country suffers little from leaving—or being expelled from—the bloc, then membership will not provide a credible way of committing to its rules. This suggests that regional agreements between smaller low-income countries, which typically trade very little with each other, add little to credibility (Collier and Gunning 1995). Credibility will be achieved only if a country that breaks the rules is likely to be penalized by other members of the bloc.[4] This will occur only if partner countries are sufficiently concerned to be willing to act to enforce bloc rules—for example, by expulsion or other sanctions. For instance, Mexican membership in NAFTA lent credibility to Mexico because the United States has a clear interest in a neighboring country with a pool of potential emigrants. But when members are more remote, engaged in less trade, or themselves less committed to the rules of the bloc, then enforcement becomes less likely.

Have regional agreements worked as commitment mechanisms in practice? For trade, the answer is broadly yes, although there have been reversals. Most agreements involving high-income countries have survived, successfully locking in their policies. Among developing countries the record is less good; a number of regional agreements have collapsed, or never moved far from paper to practice. When regional trade agreements have been used as the foundation for other types of commitment they have had some important successes, as shown by Mercosur's continuing commitment to democracy and Mexico's persistence with economic reform. Shortly after the NAFTA agreement in 1994 the Mexican peso was subject to speculative attack. NAFTA was evidently not sufficient to prevent this run on the currency. However, it probably was instrumental in determining the policy response of both the Mexican and the U.S. governments. Until 1994 the most common Latin American response to a major run on the currency had been to impose high trade restrictions and retreat into a controlled economy. This time the Mexican government basically maintained the reforms, although it raised some tariffs on non-NAFTA imports. The U.S. government also demonstrated that NAFTA meant more than just trade policy. It responded with a massive $15 billion rescue package, wholly out of line with its previous behavior.

In developing countries NAFTA is often seen as the model for a *continental* agreement. However, its true significance is not that it spanned a continent but that it spanned the North and the South. By using a major Northern economy that had a direct interest in its own performance as its commitment mechanism, Mexico increased its credibility. While there have been some attempts to create an equivalent arrangement between the United States and Africa, the underlying politics are less well suited. The United States does not have the same migration interest in the growth of Africa as it has in Mexico, and the U.S. market is far less important for Africa than it is for Mexico. A commitment mechanism for Africa that could be equivalent to the United States for Mexico is perhaps agreement with the EU, though there are some differences including the number and size of African economies and their distance from the EU. There are signs that Africa-EU trade agreements may in the future evolve to something more like NAFTA and away from the nonreciprocal concessions of past Lomé Agreements, although these agreements have recently been extended.

Thus, paradoxically, regional trade agreements may sometimes be more important for what they can do for the credibility of other policies, than for what they can do for trade policy. If governments want to lock in to trade policy they can most do so through the WTO.

## 2.5 Lobbying for Integration

GOVERNMENTS' POLICYMAKING IS LIKELY TO BE SHAPED BY the competing demands of different lobbies, which is why firms invest heavily in lobbying bureaucrats and politicians. Some interest groups will have much more influence than others will. Paradoxically, if the benefits of a policy change are spread very wide, no single beneficiary has an incentive to spend resources lobbying (an example of the "free-rider" problem). By contrast, if the benefits are concentrated, then it pays the few beneficiaries to spend heavily. Because of this, lobbies tend to promote policies that cause transfers from the many to the few, and this usually means that it is producer groups that dominate the lobbying scene. Usually also, producers competing against imports are more powerful than exporters; from a status quo with trade barriers, the import-substituting producers are already in business, while export sectors may be relatively small and undeveloped (Hillman 1989).

To producer groups, regional integration may appear an attractive option, particularly compared to unilateral nonpreferential liberalization. First, it limits the increase in international competition to which home country industries are subjected, since liberalization is only with the partner countries. Second, the agreement is reciprocal, with the home country obtaining improved market access in partner countries' markets. Since these markets also may be protected from competition from the rest of the world quite large profits may be possible; (we will see in the next chapter that preferential trade agreements can sometimes transfer tariff revenue from the government to importing firms). Indeed a number of authors have argued that politically sustainable agreements tend to be those that are "trade diverting"—maintaining high external protection, delivering minimal benefits to consumers, but raising returns to producer groups (Hirschman 1981; Bhagwati 1993; Grossman and Helpman 1994, 1995).

Political economy reasons may therefore make it easier for countries to liberalize trade on a regional basis than unilaterally, or through the multilateral process. Thus, for a government seeking trade reform, regional integration may be seen as the only politically feasible way to liberalize its economy, and perhaps also as the first step in a process of further liberalization. The former minister of industry in Morocco, Hasan Abouyoub, has mentioned (Abouyoub 1998) that trade liberalization would have been infeasible without first entering into a free trade arrangement with the EU. These arguments apply both for initial tariff cuts, and for the commitment not to reverse policy. We saw in the preceding subsection that it is possible for a country to use the WTO as a commitment mechanism, by setting its bound tariffs at low levels. But in reality many developing countries—including those that have made substantial trade liberalizations—have not used this option, but have instead left bound tariff rates at high levels, often much higher than actual tariffs. In a regional agreement the binding—to free internal trade—is reciprocal, and thus more acceptable to the lobbies that influence the political process. Olarreaga and Soloaga (1998) provide an empirical confirmation of this view for MERCOSUR.

## 2.6 Conclusion: So…Integration Is Political

Trade policy gets shaped by the political needs of governments and by the political pressures exerted by well-funded lobbies. Adding a regional dimension to trade policy, meets some political needs and changes lobbying opportunities. Sometimes the political needs met by regionalism are highly valuable, such as the lock-in to democracy or to policy reform. Regional integration can also serve as an efficient tool to enhance security among member countries, as has occurred in some of the largest regional agreements. However, the political effects can sometimes be unexpected or opposite of the aspirations, as when regional preferences create such unfair redistributions that they provoke conflict.

It is not surprising if the economic impact of these policies, good or bad, is not very influential in the decision to join a regional integration agreement. Ordinary people will be made poorer or better off, but to date these effects have usually been incidental to the political debate. When regional integration makes ordinary people better off, the neglect of economic analysis does not matter. But sometimes regionalism comes at a cost. To know whether that cost is worth paying we need to know how large it might be. For this, there is no alternative but to understand the economic effects of regional trade preferences.

## Notes

1. The Cairns Group consists of 15 developing and industrial countries comprising Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Indonesia, Malaysia, New Zealand, Paraguay, the Philippines, South Africa, Thailand, and Uruguay.

2. See Andriamananjara and Schiff (2000) for a discussion of the costs of benefits for microstates of joint negotiation.

3. The international community helped overcome seemingly intractable problems between India and Pakistan over the waters of the Indus River. India and Pakistan were unable to agree on a division of the Indus River Basin waters after the 1947 partition. In 1954, the World Bank proposed a solution based on dividing the Indus and its five tributaries.

4. See Fernandez and Portes (1998) for a thorough analysis of the conditions under which a regional agreement will enhance the credibility of policy reform.