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Regionalism and Developing Countries: A Primer

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Abstract

This note discusses regionalism from the standpoint of
developing countries. Following a brief introduction of
terms and a short historical synopsis, part I turns to an
assessment of Preferential Trading Agreements (PTAs) with a
focus on the consequences of partner choice. Part II deals
with implementation issues, and other motives for regional
integration.

Regional Integration Arrangements (RIAs) are rising and, for many observers, have become the most promising route to market integration, perhaps more especially so for the developing economies which are the focus of this note. Is the current wave of RIAs a helpful step towards market integration for developing countries, and how it can be made to be so both by the choice of policies over which to integrate and the partners with whom to integrate are the two main issues dealt with here. How proliferating RIAs might affect the world trading system, in particular the World Trading Organization (WTO) in its various functions, is not considered here. Neither will I ask if RIAs are likely to continue spreading (or eventually collapse). I will just assume that they are here to stay, and will pay particular attention to:

- The choice of partner, i.e. are North-South RIAS (the majority among recent agreements) preferable to South-South?
- What do RIAs bring to developing countries that they cannot obtain from the WTO, and is this costly?

Background, controversies and historical perspective

The rise of RIAs. Figure 1 shows the number of notifications of RIAs to the GATT/WTO, and Box 1 defines accompanying terms. During the the sixties, RIAs were either of the South-South type (with an objective of industrialization by import substitution with PTAs) or of the North-North type (EFTA and the European Common market involving deeper integration). The second wave starting in the early eighties involved primarily North-South PTAs (with some notable exceptions such as MERCOSUR). (I return later to why there may have been a change in membership participation.) Of the 87 notifications to the WTO since 1990, only 13 had no European partner, and of the 162 RIAs notified to the GATT/WTO, as of August 1998, 143 were FTAs and 19 were CUs.[1]

Box 1 defines increasing order of market integration. Most S-S agreements were of the PTA type since rarely were all barriers to trade removed (the condition included in GATT article xxiv which states the conditions under which RIAs can be an accepted exception to the principle of non-

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[1] GATT article XXIV states that an FTA and a CU are compatible with GATT/WTO as an exception to the principle of non-discrimination so long as trade barriers between partners are substantially eliminated and that tariffs against non-partners are not raised.

discrimination). Most second-wave PTAs have been of the FTA type (i.e. EUROMED agreements, NAFTA and a host of developing country agreements notably in SSA). Note that shallow integration (i.e. anything less than a Common Market requires Rules of Origin (RoO) to prevent trade deflection (i.e. the importation of goods into the zone via the low tariff partner).

Box 1
Definitions and terminology

● Non-Tariff Barriers (NTBS): Core NTBs include quotas, price-fixing arrangements, import surveillance). Like tariffs, NTBs create rents. Technical Barriers to Trade (TBT): resource-using barriers to trade such as admission tests.
● Bilateral Investment Treaties (BITs); multilateral Investment Agreements (MIAs). BITs are reciprocal treaties that seek to remove barriers and uncertainty that affect investment. They are 'shallow' or 'negative' whereas MIAs will usually also add the National Treatment Instrument (but NAFTA is a BIT that provides for national treatment in establishment and operation).
● Rules of Origin (RoO): Rules that are necessary in PTAs and FTAs to prevent trade deflection (imports into the area) via the low tariff partner).
●RIAs by increasing order of market integration:
Preferential Trade Area (PTA): Partial reduction in trade barriers.
Free trade area (FTA): Complete elimination of tariff and quotas.
Customs Union (CU): = FTA + common external tariff
Common Market (CM): = CU + free movement of capital and persons.
Single Market (SM): = CM + mutual recognition/adoption of standards, norms.
Economic Union (EU):= SM + common currency and deeper policy coordination.

● 'Deep integration': any integration that goes beyond what would be attainable under multilateral negotiations; usually understood as any RIA beyond a CU.

Figure 1: RIAs Notified and Active, 1948-April 2002*
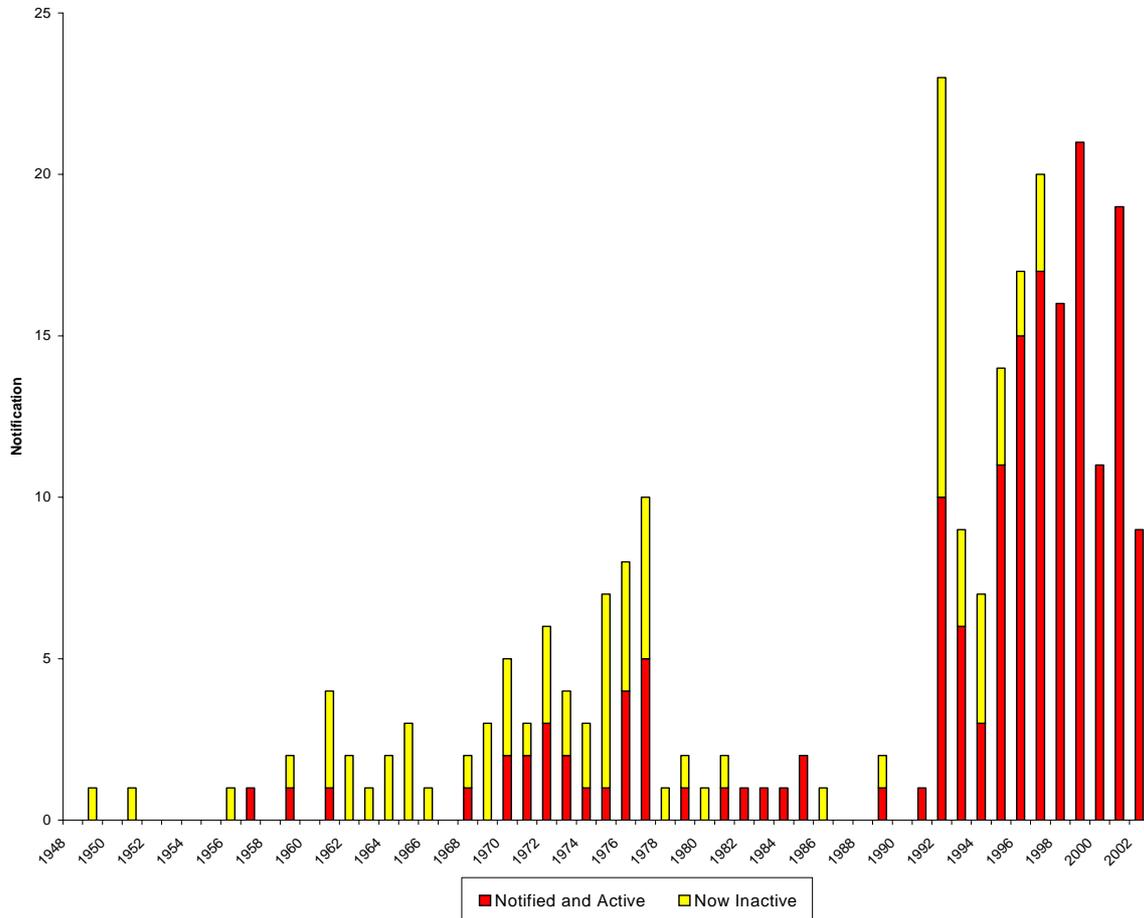
Source: Schiff-Winters (2003, figure 1.1) from WTO

* Note: Inactive data for years 2000-2002 are not available.

Regional Cooperation with and without discrimination. It is
useful to distinguish between two types of regional
integration arrangements (RIAs): non-discriminatory
arrangement (policy cooperation at the regional level) and
discriminatory (or preferential trading arrangements—
henceforth PTAs). Regional cooperation agreements often
serve to internalize externalities that arise at the
regional level via intergovernmental cooperation (e.g.
sharing power networks, building basic infrastructure, or
more generally coordination economic policies, or assigning

property rights such as sharing the use of water bassins).
Cooperative arrangements are non-discriminatory. This makes
them uncontroversial since, in principle, they can be set up
so as to provide some benefits to all participants and
create no spillovers for non-participants. Economists always
recommend the cooperative features of regionalism. However,
the great majority of regional agreements are discriminatory
(rather than being mainly cooperative) in design or
practice. This is not surprising since commercial
preferences require less trust among countries, and are
therefore easier to implement (this is why the overwhelming
number of GATT/WTO notifications are for FTAs rather than
CUs). Discriminatory trade agreements (henceforth PTAs or
RIAs) are controversial because they have ambiguous welfare
effects for participant members and often have negative
spillovers effects for non-participants. Part I deals with
the consequences of the discriminatory nature of PTAs.
Motives for integration extend beyond commercial
preferences. Part II deals with implementation issues, and
the other motives for integration.

Why is regionalism so contentious? Several controversies
surrounding RIAs will be raised below to give a flavor of
the debate about the merits of regionalism.

First, the basic economics of discriminatory reduction in
trade barriers is ambiguous for participating members in
spite of the fact that reducing trade barriers is a move in
the direction of reducing barriers to trade and hence
distortions in the allocation of resources across countries.

Second, it is difficult to ascertain what trade policy the
member countries would have followed if they had not chosen
a preferential approach to trade policy. Take for example
France and Germany when they formed the EC: it is not clear
what kind of agricultural trade policy would have emerged in
Europe in the absence of European integration. (In the
economic discussions of the effects of PTAs summarized below
in box 2, the usual assumption is that countries would have
maintained the status quo in their trade policy, i.e. no
reduction in their trade barriers).

Third, today PTAs are widespread and the negotiating agenda
goes beyond commercial preferences. Also any one country
will often participate in several PTAs simultaneously,
making it difficult to evaluate implementation costs when
integration is not 'deep' (See box 1 on definition of

terms). Indeed, some countries find themselves simultaneously engaged in a CU partnership (which involves a common trade policy) while at the same time participating in an FTA with another set of partners. RIAs, especially when they are deep, can bring benefits to the participating countries that extend beyond those that they might be expected to reap by sole participation in the international trading system as WTO members.

Fourth, with the spread of PTAs (see figure 1), regionalism may diminish the incentives to participate in future multilateral trade negotiations as countries perceive they have sufficient market access, and do not want to expose themselves to increased competitive pressures from non-members. Moreover, concern has been expressed that if the world gets divided in a few large trading blocs, the probability of trade conflicts would increase. Developing countries, with little negotiating power would be then be the main losers of the consequences of widespread regionalism.

The relation between regionalism and multilateralism will not be pursued further here, beyond noting that the tendency for countries to seek privileged trade partnerships with (usually neighboring) countries has been widespread throughout history. A prominent example is the near free-trade status enjoyed by the world trading system in the latter part of the 19th. Century which was the result of a 'domino' effect following the Anglo-French establishment of a FTA (the Cobden-Chevalier treaty of 1863) which set into motion a series of bilateral treaties between France and its major trading partners who did not want to be left out in the cold following the market access gained by the British.[2] So 19th Century regionalism was the mechanism by which goods markets were integrated around the world suggesting that PTAs could be a stepping stone towards a world-wide move to free trade. In the 19th- Century, the widespread application of the unconditional MFN clause (much like in the present-day WTS under the aegis of the WTO), was through the application of bilateral treaties. At the same time, while the WTS enjoyed quasi free-trade status, unlike today's system then, as noted by Irwin (1993), there were no limits

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[2] This domino view of regionalism has been put forth recently in evaluating the expansion in membership in the EU. Basically, as the EU enlarged, non-participating firms saw their demand shrink, leading them to lower their price-cost margins, lowering profits and from there to lobbying efforts at membership participation.

equivalent to today's tariff bindings for WTO members, which could have prevented the surge of protectionism that occurred in the early part of the 20th Century.

PART I
Efficiency Effects of PTAs

Trade creation and trade diversion: the 'standard' economics of PTAs.[3] It is here that the economics literature has concentrated on, at least until recently, when tariffs and NTBs were high. Box 2 uses a numerical example to introduce the notions of 'trade creation' and 'trade diversion' which are used in the evaluation of the welfare effects of PTAs.

Four comments on the numerical example are pertinent for developing countries. First, for the case of trade diversion (here shoes), note that if the difference in unit costs between B and C exceeded the tariff by A on shoes (here 20%), nothing would happen since C would continue to the low-cost supplier in A. This situation, coupled with the small reduction in tariffs, prevalent in many S-S RIAs of the first generation explains why trade among partners often did not increase significantly following the creation of the RIA. Second, if the partner,B, cannot flood A's market (i.e. it supplies shoes at increasing marginal costs), again a case prevalent for S-S PTAs, especially among small countries, then the price will not fall in A since it has to continue importing from C. In this case, A's welfare will unambiguously fall, while B's gain will be less than A's loss, so that overall (here the combined effects on A's and B's welfare since the welfare of C is unaffected), the FTA is welfare reducing. Third, note that in the case of a N-S FTA (typical of second wave RIAs), A's partner will typically be the EU or the US. In that case, when there is trade diversion, the welfare-reducing effect coming from the higher cost of B is likely to be small, since the partner will often be close to the low-cost supplier on a world-wide basis. Fourth, the numerical example in box 2 assumes that products were homogenous, while in practice products are typically differentiated. Then A will import both from B and C before and after the FTA.[4] Differentiated goods makes gains from an FTA more likely, as the price of the variety

[3] The seminal contributions are collected in the readings edited Bhagwati et al. (1999), and surveyed in Panagariya (1999). Citations are kept to a minimum as much of what is said here is relatively well-known, or at least discussed at greater length in Schiff and Winters (2003).
[4] For example, in the case of NAFTA, in 1991 before NAFTA was a real possibility, 70 percent of Mexico's imports came from the US (614 out of 4854 headings) while in 1996 78 percent of imports came from the US (296 out of 4854 headings).

supplied by the partner will have to fall, while at the same time, the link between tariff reduction and price reduction (the source of welfare gain) is weakened so the magnitude of the gains and losses are reduced.

Quantifying costs and benefits. The evaluation of the welfare effects of FTAs and CUs are either carried out ex-ante on the basis of simulation methods or ex-post on the basis of an analysis of the evolution of intra-bloc and extra-bloc trade shares. Each approach has advantages and drawbacks. Simulation methods give orders of magnitude of the effeciency (welfare effects) under alternative assumptions about market structures and elasticities. Unfortunately, the elasticities are rarely estimated, and the behavioral assumptions in the models are not confronted with the data. By contrast, the ex-post analysis relies on a detailed analysis of observed trade flows before and after usually relying on an econometric analysis of trade flows. While this method resolves the data confrontation issue facing simulating methods, it faces two additional problems of its own: (a) what trade policies would the countries have followed in the absence of the FTA (typically the assumption is no change in trade policy); (b) do the observed changes in trade flows represent an FTA effect, or do they represent the effect of some omitted changes that took place during the period and was not included in the model. Finally, it is quasi impossible to deduce the welfare effects one is interested in from the observed changes in trade flows.

Box 2
Trade Creation and Trade Diversion

The following example illustrates the concepts. Two countries A and B
consider forming an FTA, with the rest-of-the-world represented by
country C. The focus is on the welfare effects for A of alternative
trade policy options, with arrows indicating the source of supply in A.

Table 1: Trade Creation and Trade Diversion					
		B	A	C	
	c_0	11	13	10	
Shoes	$c_0(1+t_0)$	13.2	13	← 12	
	$c_1(1+t_1)$	11 →	13	12	Trade diversion
	c_0	18	15	20	Neither trade
Textiles	$c_0(1+t_0)$	21.6	15	24	Creation nor
	$c_1(1+t_1)$	18	15	24	trade diversion
	c_0	15	17	16	
DVDs	$c_0(1+t_0)$	18	17	19.2	
	$c_1(1+t_1)$	15→	17	19.2	Trade creation
Notes: c_0 = unit cost t_0 = A's tariff before the FTA ($t_0^A = t_0^B = 20\%$) t_0 = A's tariff after FTA with B ($t_0^A = 20\%$; $t_0^B=0\%$)					

In the case of shoes, the FTA results in a shift away of supply source
from the low-cost outside partner resulting in trade diversion with a
loss of tariff revenue for A (a transfer of rents to the inefficient
partner B leading to a welfare loss for A), but a lower price for
consumers in A (leading to a welfare gain for A). In this case, the
welfare effect on A is amgiguous: on the one hand, it goes up because
shoes sell in A at a price closer to their opportunity cost of 10 in the
C, while on the other hand it loses tariff revenue to shoe producers in
B who are in effect subsidized by consumers in A. In the case of
textiles, since A is the low-cost supplier, the FTA has no welfare
effect. Finally, for DVDs, the partner B is the low-cost supplier, and
there is a welfare gain since supply is from the low-cost partner (it is
as if A had reduced its tariff in a non-discriminatory way). In fact
there is both a transfer of government revenue from the government in A
to its consumers (of no welfare consquence), and a reduction in price
for consumers which is an ambiguous source of welfare gain. This
distinction, pioneered by Viner (1950) who coined the terms (still in
use today) of 'trade creation' and 'trade diversion' is the basis for
the evaluation of the economic effects of PTAs.

Ex-ante simulations. In the case of simulation analyses, it is recognized that efficiency effects go beyond the perfect competition case illustrated in box 2 to include efficiency effects operating in industries operating under imperfect competition. Typically, these extra effects include: (i) a pro-competitive effect coming from a reduction in protection which forces firms that have market power to lower their mark-up over costs as they face more elastic demand for their products; (ii) scale efficiency effect whereby firms operating at less than minimum efficient scale may move down (up) their average cost curve gaining (losing) scale efficiency. On balance, this effect is ambiguous since tariff reduction in the home market will make existing firms move up their cost curves due to less demand, but on the other hand, they get access to partners' market, an effect that raises scale efficiency; (iii) entry/exit effects. Here, if the industry becomes less profitable, firms will exit, thereby raising scale efficiency, while if it become more profitable due to sales in partners' market, entry will occur; (iv) a welfare-enhancing variety effect as consumers face more varieties, and varieties that are better suited to their needs while producers will have access to better-suited intermediate inputs thereby lowering production costs.

The results of these ex-ante exercises suggest three broad conclusions. First, if the elimination of protection favors, on average, industries with increasing returns to scale, all else equal, an FTA is likely to be welfare-enhancing. Second, for small developing economies engaged in a S-S FTA, the gains from market access to the protected partner's market is not likely to compensate for the trade diversion effects of switching to the less efficient partner. Third, unilateral trade liberalization is always superior to an equivalent trade liberalization on a discriminatory basis. As a corollary, additive regionalism is always preferable to single-partner regionalism for the country that engages in it.[5]

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[5] For example, Chile is engaged in 12 trade agreements. Simulations (see Schiff and Winters figure 3.2) show that Chile gains successively more as it enters NAFTA, NAFTA + MERCOSUR, and then NAFTA+ MERCOSUR+ an FTA with the EU. Of course, for partners that engaged in an FTA with Chile to get a preferential market access of 11 percent (Chile's uniform tariff) saw this additive regionalism with a different eye, as their preferential access was being eroded. Implementation issues will be considered later.

<u>Ex-post estimates.</u> The easiest, and most common method, is to compare average trade shares among RIA partners before and after implementation to try and detect any changes. Since trade may be growing anyway, these measures are augmented by indices of the intensity of trade to see if changes in trade intensity (the share of A in B's trade compared to A's share in world trade) are greater among partners than with the rest-of-the world. Finally, import propensities (the product of import shares in GDP and trade intensities) are used to compare the changes in import intensities within the bloc and with the outside the world. Calculations for the major S-S RIAs reveal a varied pattern: in some cases (e.g. MERCOSUR, UDEAC, GCC) increases in openness reflected in rising import shares in GDP and trade intensity for partners and non-partners alike; in others (e.g. CACM II, CARICOM, AFTA), intra-bloc import propensties declined.

Unfortunately these calculations make very simple assumptions about what the trade pattern would have likely been in the absence of the RIA (i.e. the 'counterfactual'): essentially that trade would have increased pari passu across partners in the absence of the RIA. A preferred approach to building the counterfactual is to estimate an econometric model prediction the intensity of trade in terms of country size, transport costs between partners, and other variables (common border, common language, landlockedness) and augment this model by dummy variables to capture the effects of RIAs. Known as the gravity model, this approach is more specific about what the likely trade pattern would have been under the alternative of no RIA, and is currently the prefered approach to estimate measure the sought-after Trade Creation and Trade Diversion effects. For substantial RIAs like the EU, MERCOSUR and NAFTA (but also for some S-S RIAs), estimates show that the RIAS resulted in intra-regional trade flows beyond those predicted by the gravity model, often coupled with reduction in imports from the rest-of-the-world and at times coupled with a reduction in exports to the rest-of-the-world, suggesting evidence of trade diversion (Carrère, 2004).

<u>Transport costs and agglomeration effects.</u> In the efficiency effects identified so far, there is nothing that suggests the superiority of a preferential approach to trade policy. Moreover, it appears that the N-S RIAs of the second wave are preferable to the earlier S-S RIAs. Are there other

efficiency effects that could overturn these conclusions. For reasons expounded below, these conclusions are not modified when one also takes into account transport costs and agglomeration effects.

Neighboring countries often trade more with each other (this will not be the case for poor countries with similar endowments), and are hence are sometimes termed 'natural partners'. Typically RIAs are formed between neighoring countries, but not necessarily countries that trade a lot with one another. A large trade flow does not need that it should be stimulated, indeed if might be large in the first place because of a distortion. Others have argued that preferences should be extended to neighbors because it would economize on transport costs. For the US at least, there is no correlation between geographic proximity or the volume of trade and the welfare effects of reductions in preferential tariffs (Krishna,2003).

With industrialization still occupying center-stage in developing countries, there are concerns that trade liberalization which modifies the interactions between the forces of agglomeration (centripetal forces associated with labor pooling, knowledge spillovers and forward/backward linkages) and dispersion (transport costs and other barriers to trade, and congestion effects) might work towards de-industrialization at the expense of the North. Illustrative simulations in which two small Southern countries can reduce protection either multilaterally with a large Northern country or the Southern neighbor suggest that a N-S partnership is likely to offer better prospects than a S-S partnership (though multilateral liberalization is less desirable because of competition in the Northern country is stiffer when the other Southern country also has market access).

The superiority of N-S on efficiency grounds also holds when one views trade as largely being driven on comparative advantage grounds: countries exports the services of factors they are relatively well-endowed with: (labor for the South and capital for the North). Suppose that the world consist of countries that either have a capital-labor endowment above the world average (Northern countries) or below averate (Southern countries). An FTA between two Northern (Southern) countries will lead to income convergence (divergence) as the richest (poorest) partner is engaging in a less efficient trade pattern as a result of preferences to

his partner. For partnerships between very rich and very poor countries, it is likely that the Southern partner will gain, though this is unlikely for partners close to the world average (Venables, 2003).

PART II
Implementation, Political Economy and Politics

Implementation.

<u>Integration of domestic policies</u> Most RIAs have on the
agenda some form of policy integration going from the least
demanding (coordination on an ad-hoc basis) to harmonization
of national standards and regulation (often driven by market
size effects) up to recognition of foreign regulatory
regimes and assessment procedures by Mutual Recognition
Agreements (MRAs). So far, only the EU has used MRAs, and
the process has taken 30 years to reach this relatively
advanced stage of policy integration. Again, much of the
benefits from policy integration such as reduction in red
tape, harmonization of standards to international norms
could be carried out on a non-discriminatory basis. Yet, in
this case, unlike for tariff preferences that lead to rents,
reduction in transactions costs will always lead to an
improvement in efficiency, at least in a competitive
environment, thereby avoiding the ambiguity associated with
preferential reduction in goods. Moreover, efficiency gains
are likely to be significant, since reductions in trade
transaction costs (border formalities, standards
certification, frictional or red tape costs) give rise to
rectangle (rather than triangle) gains. In today's world of
much lower barriers to trade in goods trade in many
developing countries, efficiency gains to be gained from the
reduction in unnecessary transaction costs are likely to be
of the same order of magnitude as eliminating remaining
protection.[6] Yet, because cooperation on policy requires
trust that takes long time to build, no RIA has made
progress on cooperation for standards beyond WTO rules.

Significant gains along the same lines could also be
obtained from preferential liberalization in services and
public procurement. For services, the scope for efficiency
gains via increased competition is very large. [7] Yet, even

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[6] For the EU and EFTA, efficiency gains from the removal of remaining
TBT have been estimated to about 2 percent of GDP, estimates of the same
order of magnitude as those for eliminating remaining protection in many
LDCs.
[7] Much like the enabling cause allows S-S RIAs to be exempt from the
economically sound constraints of article XXIV (not all trade must be
covered, NTBs can be used, and tariff reductions can be reduced as

though a services component is often included in RIAs, with the exception of NAFTA, little progress has been made. The same applies to public procurement where RIAs have made little progress (the EU and NAFTA provide for the application of the national treatment rule). However, this might be expected as governments may buy products locally either because they are non-tradable or because of asymmetric information that would require monitoring of suppliers calling for geographic proximity.

RIAs also often include Bilateral Investment Treaties (BITs). Generally, BITs are short agreements that only partially alleviate uncertainty affecting investment. Apart from the EU, NAFTA is the only instance of 'deep' integration beyond what might likely achieved multilaterally since it includes for national treatment in establishment, MFN treatment in establishment and operation, a ban on performance requirements and a phase out on old ones, and extensive dispute settlement provisions that allow private action against governments.

Does this example suggest that integration can enhance policy credibility? Even though RIAs treaties do not include macroeconomic and general domestic constraints, it is generally agreed that Mexican negotiators were far more interested in using NAFTA to lock-in ongoing domestic policy reforms than in exchanging concessions. Are credibility benefits likely to be widespread in other N-S RIAs? This is particularly important for African countries (and former European colonies—known as the ACP for African, Caribbean and Pacific), now engaged in negotiations for Economic Partnerships Agreements (EPAs) with the EU on a fully reciprocal trading agreements (the former Lomé conventions now WTO-inconsistent amounted to non-reciprocal preferences). The EPAs are likely to enhance credibility as ACP countries in bringing them to lower trade barriers and tariffs, since their tariffs are usually below bound levels at the WTO, it is hard to imagine that the EU will want to play the role of agency of external restraint and prevent former colonies to raise temporarily tariffs for, say balance of payments purposes. Neither can one expect the EPAs to signal that they will reduce their protection against third countries, since during the negotiations, ACPs have insisted on long adjustment periods and sought to obtain a waiver for Lomé arrangements (a waiver was obtained

wished) GATS article V (which is closely modeled on Article XXIV) also gives greater flexibility for S-S agreements.

until 2008). These remarks pointing out that credibility
gains from N-S RIAs will only be significant for countries,
like Mexico, that are committed to reform. This said, for
reasons discussed above, one can expect that the EPAs can
help countries integrate for reasons associated with the
more traditional economic effects.

Finally, the use of contingent protection such as anti-
dumping and countervailing duties could be banned in RIAs.
Yet, with the exception of the EU, the anti-dumping specter
hangs over virtually all N-S RIAs (NAFTA, APEC, the EU-
Turkey CU, and all other FTAs the EU is engaged in) not to
mention S-S RIAs like MERCOSUR. So N-S RIAs have not given
much reason for comfort for Southern countries in their
partners markets. Prospects also look dim for the FTAA
negotiations.

In sum, lack of policy integration should not be a surprise
since most RIAs have after all, a commercial objective
rather than an economic union like the EU which has taken
the step to create the necessary supranational institutions
with mandates to make policies in specific areas.

Rules of origin (RoO) Most RIAs are FTAs. Since each partner
maintains his own trade policies towards non-members,
establishing origin is necessary to prevent trade deflection
(imports entering into the area via the partner with the low
tariff). At the same time, even with RoO, nothing prevents
the low tariff partner from satisfying domestic consumption
by imports and exporting all its production to the high
tariff partner (called indirect trade deflection). RoO
occupy 80 pages in the FTA agreement between the EU and
Poland and no less than 200 for NAFTA. With countries
simultaneously engaged in several (sometimes overlapping
RIAs), administering dopted to identify origin (change of
tariff classification, technical requirements and
exceptions, various forms of regional content requirements)
becomes complex and burdensome. While RoO are necessary,
their complex design impose both economic costs beyond those
needed to meet reasonable definitions of origin, and
additional administrative costs associated with their
complexity.

As a result of these costs, it has been observed that in N-S
preferential market access schemes such as the Generalized
System of Preferences (GSP), utilization rates are often
quite low, even in sectors where preferential access in the

Northern country is substantial (over 10% in textiles & clothing). East European countries have also preferred using partial preferential access via the overseas processing trade arrangements than fuller preferential access via entry under FTA status, and utilization rates under NAFTA status for Mexican exporters in 2001 (when they faces zero duties in US market) was not particularly high (.e.g. 79% in textiles and clothing where the preferential access margin was 12%). Taking Mexican exporters under NAFTA as an example, it would appear that RoO in N-S FTAs are designed to give market access to inefficient US textile producers in Mexico thereby raising the costs of Mexican producers so that in the end NAFTA gives them little extra market access beyond what they would enjoy under MFN status. In sum, since RoO are not necessary under a full CU (that is a CU with both a CET and coordination on other trade policies), deeper commercial integration should be preferable to shallow integration.

Political Economy. There is more to RIAs than elimination of trade barriers since the process of integration is likely to affect trade policy stance towards non-members, especially for developing countries which have tariff bindings at the WTO well above actual levels. For example, in the case of the MERCOSUR, a CET had to be negotiated. Usually, in such negotiations the bigger partner takes the lead with the result that the CET is closer to its prevailing tariff which is also usually higher because large countries often have higher protection. Notwithstanding lobbying efforts devoted to designing favorable RoO (i.e. rules that generate rent transfers in an opaque way to avoid attracting opposition), resources for lobbying activity could be released for lobbying against non-members. Whether integration brings a reduction in lobbying activity (a dilution effect if diminish their activities because of higher costs since they have to be active over a larger jurisdiction) or not will depend largely on the extent to which coordination takes place across countries. For example in a S-S RIA among middle income countries, an initial lobbying game where agriculture and manufacturing lobbies cancel each other, could be transformed into a situation of cooperation among agricultural lobbies while manufacturing lobbies compete (as they produce the same things) so that a CU could lead to agricultural protection.[8]

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[8] Arrangements for supranational institutions under deep integration raises further the possibility of a bias towards a protectionist

It is difficult to assess the importance of the dilution effect in a CU. But examples of the results of lobbying activities in N-S and S-S RIAs show that the highly protected sectors obtain concessions resulting in trade diversion. Indeed trade creation is a mixed blessing for a negotiating government since it generates surpluses for its consumers and for exporters in partner countries at the expense of profits in import-competing industries where lobbies are the strongest (protection being a public good, free-riding will be least among producers than among consumers and among producers in concentrated activities). Trade diversion, by contrast, avoids the reduction in profits, and may be preferable for governments if producer's interests weigh more heavily in their objectives than consumer's interests (whose gains will be less under trade diversion).

Pushed to the extreme, suppose that negotiators care only about producers' profits when they negotiate an RIA. Krishna (1998) develops a three country model to show the implications if such a stance were held by negotiators. Starting from a non-discriminatory trade policy, let A and B contemplate an FTA. Will governments get the necessary support? Quite likely they will because producers might lose market share (and hence profits to each other) but they can well gain enough market share at the expense of C that they will support an FTA because their profits would go up. By the same reasoning, producers would be less likely to support participation in subsequent multilateral negotiations because this would essentially involve giving up market share and profits to C.

outcome. Two simple models of institutional failures show how this might occur. In the first, suppose that a country's benefit from a policy is proportional to its share in production (e.g. via a production subsidy) while its costs are proportional to its share in consumption GDP. In a CU where consensus is prized, countries deciding on a package of price increasing measures will end up adopting an all-encompassing package even, if, overall each country would preferred a no-subsidy policy outcome. (This is know as the 'restaurant bill' problem in reference to behavior in restaurants when the bill is split equal among hosts.) The second, known as universalism, is the situation where the share of the spoils are concentrated while the costs (which exceed the benefits because of the inefficiency of protection) are split evenly. Then, each government's negotiation position is best summarized in the statement: " we are opposed in principle to this measure, but if it passes, we want a share of the spoils".

The Politics of RIAs. For policy-makers, and certainly for politicians, there is more to regional integration than economics. Reflecting on the relative role of economics and politics, Walter Hallstein, president of the European Commission said: "We're not in business at all; we're in politics". Political scientists have concluded that the use of trade diplomacy in a regional context, and especially deeper integration like the EU, might assist political relations leading to lesser conflict. Preferential trading relations among neighboring countries (those that are most likely to enter into armed conflict) requiring more contacts would then diffuse tensions. Obvious in the case of tensions between France and Germany in the EU, tension diffusion between Argentina and Brazil under military rivalry was also an important objective for MERCOSUR.

But trade integration can also increase tensions, especially when it involves large transfers between unequal partners, as for example in the case of the East African Community (EAC), where the dominating country Kenya, was benefiting both from agglomeration effects in industry and from large income transfers from lost tariff revenue by Kenya and Uganda. The EAC was closed in 1978, and the resulting atmosphere of hostility contributed to conflict between Tanzania and Uganda in 1979.

The EAC example also indicates the importance of lump-sum (i.e. non-distortionary transfers) from the rich to the poor partners when per capita and economic differences between partners are huge (a commonplace among many S-S RIAs in Africa). Unfortunately, unlike the second enlargement of the EU where such transfers were available for the new entrants, for low-income countries, such resources are not available even among the richer members. This aspect too, points to the superiority of N-S RIAs for even if transfers are non-existent, at least they avoid the path taken by many first-wave S-S RIAs where partial compensation was accomplished by distortionary policies which exacerbated the already strong trade diverting effects of the RIA.

For rich country members in N-S RIAs, these are viewed as a means to stem the increasing migratory pressures, often perceived as threatening social stability. This was quite evident in the NAFTA negotiatons when President Salinas said that NAFTA would help Mexico export more goods and fewer people. Similar concerns were expressed in the EU's FTA

negotiations with East European countries. Recent research and observations, however, casts doubt on this view that trade integration and immigration are substitutes, suggesting instead that they may be complements so that an RIA could increase migratory pressures. First, by raising incomes of the poorest families who are the most promote to emigrate, trade liberalization may increase migratory pressures. Second, more information about the destination country for migrants reduces migration costs. Third, a N-S RIA may not benefit unskilled workers, as for instance in the case of NAFTA, where unskilled workers saw a decline in their real incomes of 10 to 15 percent between the mid-eighties and the mid-nineties.

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