

## CHAPTER 7. REGIONAL INTEGRATION AS POLITICS

Countries sometimes form trade blocs for so-called non-economic reasons, such as national security, peace, and help in developing political and social institutions. These are public goods, and so are unlikely to be adequately provided in the absence of some form of intervention - of which creating an RIA is one. Such political objectives can be important for RIAs, sometimes overwhelmingly so, but it is still desirable that they be achieved efficiently and that policy makers pay heed to their economic cost. On the other hand, no economic analysis of an RIA is complete without taking the potential welfare benefits of political objectives into account. Thus this chapter examines some of the political objectives of regionalism, discusses their economic implications, and assesses whether trade preferences are a necessary part of achieving them. It is not a review of the political science of regionalism, but rather an assessment of how political objectives should shape our economic appraisal of regionalism.

Political benefits such as peace and security can sometimes swamp the simple material considerations that usually determine economic policy. Moreover, since such benefits are typically shared by only a limited number of countries —usually neighbors— they are likely to be better sought on a regional basis than multilaterally. Thus this issue forms a relatively more important part of the analysis of RIAs than of some other international issues.

Section 7.1 shows that under some circumstances, the formation of an RIA may be an effective way to deal with security tensions between neighboring countries; the argument is essentially that mutual trade fosters peace between countries and regionalism fosters trade. It shows that for an RIA designed to enhance security, the optimum external tariff (on imports from non-members) declines over time, as it also does as integration deepens.

Section 7.2 briefly considers the objective of using an RIA to reduce and manage pressures for migration. While such objectives have been frankly admitted to in practice – e.g. in NAFTA and the EU-CEEC Europe Agreements – their effectiveness in this regard is far from assured.

Section 7.3, argues that joining an RIA with large democratic countries can help a developing country to achieve or uphold democracy if the RIA imposes “club rules” such as democracy and civil rights on its members. This assistance is likely to be more effective if the other members are large economically because larger partners are generally able to impose greater costs (withdraw greater benefits) on recalcitrants than are smaller ones. It is also likely to be more effective if the developing country in question is of a reasonable size, and if its potential partners are close by. A partner country is likely to be far more concerned about possible spillovers from events in a

significantly-sized and nearby developing country than those resulting from ‘a quarrel in a faraway country between people of whom we know nothing.’<sup>1</sup>

Section 7.4 examines the connection between economic integration and political integration - in particular, whether increased regional integration is likely to weaken or strengthen the nation-state. It argues that resource-pooling and collective action can enhance the effectiveness of the state in small, or even medium sized, nations. They can assist in solving economic problems (e.g. pollution, as we saw in the previous chapter), strengthen countries against third-country security threats, and increase international influence by lowering negotiation costs and increasing bargaining power in dealings with the rest of the world. As we saw above, however, cooperation of this kind does not usually require trade preferences.

### **7.1 Regional Integration Can Help to Reduce Frictions between Antagonistic Neighbors**

The idea that trade between countries can be an important force for creating and maintaining peaceful relations between them is, indeed, an old one. It certainly dates from the eighteenth century – see Box 7.1 - and is probably a good deal older. Given that forming an RIA almost always increases trade between the partners, there seems to be a good chance that the pacific effects stretch to this particular form of trade relationship.<sup>2</sup> In fact, this is true only part of the time: when the RIA is between relatively evenly balanced partners whose governments genuinely wish to improve security and when the distribution of benefits from the RIA is relatively equal.

#### **Box 7.1 Trade and Peace: The Political Lineup Follows the Economic Lineup**

The notion of using international trade to diffuse tension and bring nations together dates back at least to the 1795 publication of Kant’s *Perpetual Peace* (1992, p. 157). The 19th Century British politician Richard Cobden persistently advocated that Britain trade freely with her neighbors to convince them of the advantages of free trade, and as a means of locking them more fully into the community of nations. Cordell Hull, US Secretary of State (1933-44), and one of the architects of the post-war international trading order, advocated this view throughout his public life. For instance, he states (1948, p. 84) that “if we could increase commercial exchanges among nations over lowered trade and tariff barriers and remove unnatural obstructions to trade, we would go a long way toward eliminating war itself.” And referring to World War I, he states (p. 365): “Yes, war did come, despite the trade agreements. But it is a fact that war did not break out between the United States and any country with which we had been able to negotiate a trade agreement. ... With very few exceptions, the countries with which we

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<sup>1</sup> This British Prime Minister Neville Chamberlain’s infamous phrase about the German invasion of Czechoslovakia in 1938 - Taylor (1979).

<sup>2</sup> Recall that the worry about RIAs is not that they reduce trade but that the extra trade that they cause reduces economic welfare.

signed trade agreements joined together in resisting the Axis. The political lineup followed the economic lineup.”

Diplomatic considerations were at the heart of the 1860 Anglo-French (Cobden-Chevalier) commercial treaty (Irwin 1992, pp. 95, 96). France was worried about offending protectionist interests, while Britain was somewhat reluctant to pursue an agreement that would violate its policy of unilateral free trade. Nevertheless, both governments saw a commercial treaty as a way of defusing tensions and improving diplomatic relations, and decided to sign it. In 1889, the Italian economist Vilfredo Pareto argued that customs unions were “a means to better political relations and eventual pacification” (Machlup, 1977, p. 41).

As early as 1943, Frenchman Jean Monnet – one of the founding fathers of the European Economic Community (EEC) - wrote: “There will be no peace in Europe if the states reconstitute themselves on a basis of national sovereignty with its policies of prestige and economic protection ... the constitution of large armies will again be necessary ... Europe will once again be recreated in fear ...unless the States of Europe join in a Federation or a ‘European entity’ that results in a common economic unit.” (Reflexion note, 5 August 1943).

He and Robert Schuman, the other architect of the EEC, were explicit that the precursor of the EEC, the European Coal and Steel Community (ECSC) was to make Franco-German war not only “unthinkable, but materially impossible” (Swann, 1992, p. 6). The preamble to the 1951 Paris treaty establishing that Community “resolved to substitute for age old rivalries the merging of their essential interests, [and] to create, by establishing an economic community, the basis for a broader and deeper community among peoples long divided by bloody conflicts.” Later, Walter Hallstein, a former president of the EC Commission, put it succinctly when he stated “We are not in business at all, we are in politics” (Swann, 1992, p ix).

Another potential approach to achieving peace in Europe was to deal with defense matters directly. However, past attempts—such as the European Political and Defence Communities—had already failed by 1956. Monnet and Schuman understood that, given the extent of mistrust after the war, the indirect approach of economic integration was the only one likely to be acceptable to all parties at the time.

### ***7.1.1 Trade Promotes Peace***

Increasing international trade might improve security in three related ways. First, more trade means greater economic interdependence between two countries. This increases the stake each country has in the welfare of its neighbor, and makes war more costly. It also increases the number of people who have an economic interest in peaceable relations and so helps to increase the political pressure against war-making.

Second, more trade means more interaction between the peoples and governments of the two countries, more familiarity with the neighbor’s goods and services, and greater familiarity with their cultural, political and social institutions. All of these are likely to raise trust.

Third, secure trading relations will reduce the likelihood of war by increasing security of access to the partner's supplies of strategic raw materials and reducing the threat of trade embargo. This concern is especially important in a world of high trade barriers where access to other sources is more difficult. This was the situation in Europe around 1950 when Monnet and other French leaders were concerned that the German coal barons in the Ruhr would have too much control over French industry (Duchene, 1994). As the post-World War I solution of direct control of German resources had been discredited and was not an option, Monnet pushed for the creation of the ECSC whereby Germany could rebuild its industry without being a threat to France. This sectoral approach to security was later expanded to the integration of general trade relations with the creation of the EEC.

Economists have examined some of the implications of uncertain access to strategic raw materials. Arad and Hillman (1979) show how a fear of being cut off from foreign sources of defense equipment can cause countries to over-invest in their own defense industries. Similarly, Hillman and Long (1983) consider the optimal exploitation of a mineral resource if the alternative foreign supply is uncertain. In both these cases, an RIA or a global institution that assured partner supplies would be both politically and economically advantageous.

A fourth possible strategic benefit of trade is that the greater trust generated by increased trade may, in time, pay a peace dividend as defence spending falls. Moreover, in all these cases one can envisage a virtuous circle whereby increasing trade permits closer integration, first through more thorough trade liberalisation and then through policy or deep integration, each step of which binds the parties closer together and facilitates yet further growth in trade, and so on (see also Box 7.2).

Although direct evidence of trade's impact on the likelihood of conflict between any pair of countries is limited, a large number of studies have confirmed the results of Chan (1984) that conflict is less prevalent between countries if *both* are democratic. Polachek (1992, 1996) explains this finding through the effect of democracy on international trade. He estimates that democracies trade more with each other than other countries, and—using detailed data from the Conflict and Peace Data Bank— finds trade to have a significant and negative impact on conflict. He estimates that a 6% increase in trade lowers his measure of conflict by about 1%. A key feature of his results is that Polachek tested for causality in this connection: he found that an increase in trade between partners caused a reduction in conflict but not the opposite.<sup>3</sup>

None of this subsection argues that trade always promotes peace, nor that trade is sufficient for peace. Quite clearly trade partners do fight and sometimes over trade issues – see below - but on the whole it is persuasive that trade will generally tend to foster peaceable if not friendly relations between countries.

### **7.1.2 Some RIAs can promote peace too**

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<sup>3</sup> While these tests are informative, it should be noted that they rely on a limited, temporal, notion of causality: A causes B if observing current and past outcomes of A helps to predict the current value of B.

The previous subsection concerned trade in general – implicitly, non-discriminatory trade – but it is widely held that discriminatory trade has the same effect. This seems highly plausible under certain conditions, but, as we see below, it is not always the case.

Political scientists have researched the use of trade diplomacy within a regional context, and concluded that trade relations, including RIAs, and especially deeper arrangements, might assist political relations between member countries by developing means for intra-mural conflict avoidance and management. The negotiations between leaders of neighboring countries that are required to form and operate an RIA tend to generate trust between them. This helps them to identify with each other, understand each others' problems and interpret each others' actions. Trade talks allow political and/or economic elites to form coalitions for subsequent collaboration and consensual action.<sup>4</sup> Wallace (1994, p.4) argues that the 'most striking phenomenon of formal European integration has been the interpenetration of national administrations, with ministers and officials from different governments in close and continuous contact.

The main motivation for creating the ECSC in 1951, and the European Economic Community in 1957, was to reduce the threat of war in Europe, especially between France and Germany. Similar motives are found in the creation of ASEAN (to reduce tensions between Indonesia and Malaysia; De Rosa, 1995), APEC and CACM, which include potential political/military opponents (Page, 1998). Anwar (1994) views ASEAN's role as promoter of regional peace, with intra-regional conflicts among the five founding members before ASEAN was founded, but not afterwards. Srinivasan (1994) argues that greater economic interdependence between South Asian countries would help defuse tensions between them. He states that "promoting freer movement of goods, services, people and capital in the region might also facilitate the resolution of political and territorial disputes" (p. 7).

Security also seems to have played an important role in the Southern Cone. The Argentine and Brazilian militaries long claimed resources based in part on potential threats from each other. The countries signed nuclear cooperation and economic agreements (covering steel and automobiles) in the mid-1980s with the expectation that this would help reduce tensions between them by curtailing the power of the military and strengthening their fragile democracies. The creation of Mercosur in 1991 reinforced this process and bound smaller neighbors into it.

Rubens Ricupero, Secretary-General of UNCTAD and formerly finance minister in the Brazilian government, confirms the importance of Mercosur's security aspects. "Both countries were emerging from a period of military governments, during which considerable tension had characterized the bilateral relationship, centered on a long-standing controversy

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<sup>4</sup> Others argue that friendly nations or allies, rather than enemies, will tend to form RIAs—that the order of causation is from friendship to regional integration. Mansfield (1993) argues that countries will lower barriers only with allies—rather than adversaries—because increased trade will raise incomes that can then be used to raise defense expenditures, and this only makes sense between allies. The fact that an RIA might as likely reduce income as increase it counts against this as a general theory.

about competing hydroelectric projects in international rivers of the Plata Basin. Both militaries had also continued to pursue their secret nuclear programs. 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 integration. This effort was developed along successive stages and eventually led to signature by the two governments of Brazil and Argentina” (private communication, 1998). Thus, as with the ECSC and European Community, the indirect path to enhancing security provided by economic integration was deemed an essential first step.

There is also possibly a related example from Africa. In 1986, 11 of 15 members of the Economic Community of Western African States (ECOWAS) ratified a mutual defense protocol. This authorizes military intervention by the community in conflicts between members or if conflict in a member country is instigated from outside and is likely to endanger peace and security in the entire community (Oxford Analytica Daily Brief, September 5, 1997). One interpretation of this is that by creating institutions that spanned the linguistic divide, an almost unique achievement in West Africa, ECOWAS allowed neighbors to develop cooperative behaviors that eventually allowed them to address mutual security concerns. In fact, under this view, ECOWAS has gone further than either Mercosur and the EU, for it uses an actual defense pact to bolster security while the others use only economic integration.

In cases where security is an issue and is amenable to trade-related policy, it can be shown that creating an RIA could be the optimal approach – Box 7.2. Under such circumstances we can also infer that the optimal level of protection that RIA-members maintain against imports from non-members will fall through time as trade grows and also following policy integration. This last observation serves two possible purposes: first, as a test for identifying countries’ unobservable motivations for creating an RIA: if security were the main motive, tariffs would fall; hence if tariffs do not fall, regardless of the rhetoric behind creation, we know that the efficient pursuit of security was not its main objective. Second, the observation serves as a policy prescription for ‘security-inspired’ RIAs.

### **Box 7.2 Modeling Trade and Security Externalities**

If increased trade between two countries reduces tensions between them because of increased trust and economic dependency, what can economists say about the type of intervention that can capture this security externality? Schiff and Winters (1998) examine this issue within a formal three-country model, with two small antagonistic countries and a large “rest of the world.” The model shows that, absent security externalities, non-discriminatory free trade is the optimal policy for the two small countries. But, if increased mutual imports provide additional security for small countries, it is worth subsidizing them by lowering their price relative to other goods. This could be done directly, but given the fiscal objections to subsidies, and their liability to capture, it is more frequently done by creating an RIA that taxes imports from the rest of the world, raises their price and therefore lowers the relative price of intra-bloc imports. The arrangement is optimal (welfare is maximized) when external tariffs are set so that the marginal benefit from security—including a “peace dividend” from reduced defense expenditures—equals the marginal cost

from trade diversion. Under these circumstances, the net welfare impact of forming an RIA is positive and not ambiguous, as it would be in the absence of security effects.

Strictly, to be equivalent to an import subsidy, the RIA should be accompanied by taxes on domestic sales to raise their price relative to member imports also, but even if this is not done, there will be security benefits from the trade preferences (though the optimal tariffs in this case are lower). The case for an RIA is strengthened if security is related to both imports from and exports to the potentially antagonistic partner and there may be yet further benefits because in this case full optimisation requires countries to co-operate.

Over time, the optimal tariff on imports from nonmembers is likely to fall in such a security-inspired RIA. As antagonism between the two countries diminishes due to increased intra-bloc trade, the subsidy on intra-bloc trade (or the optimal external tariff) falls. Thus, if security is the main motivation for forming the RIA, the RIA's external trade policy should become increasingly open over time. This is precisely what took place in the EU: average tariffs on manufacturing products fell from about 13% in 1958 to about 3% after the Uruguay Round.

Are trade preferences the only way to obtain security benefits? Since deep integration can also lower trading costs and increase trade flows, they can also add security even in the absence of trade preferences (and if external trade barriers are present, their optimal level falls following deep integration). But it seems likely that countries will engage in deep integration—which implies giving up a degree of sovereignty - only with countries they already trust. If trust is initially low, trade preferences may be the only available instrument until the degree of trust has increased. This, in fact, increases the warranted level of the external tariff in the early stages of an RIA, for preferences not only boost trade directly, but by creating conditions for future deep integration promise further security and economic gains later.

### ***7.1.3 But RIAs are not always effective routes to peace***

In the EU and Mercosur, integration helped to enhance security by internalizing security externalities associated with intra-bloc trade. The main reason for their success in achieving this goal is that the members were actually looking for arrangements to solve a security problem, not an economic one, and that defense pacts were not feasible given low trust at the time. Thus, the objectives of these RIAs were political rather than economic, and member countries structured the RIAs in such a way as to attain those objectives. Among other things, economic gains and losses were shared in ways that were perceived as being fair by member countries. On the other hand, many other RIAs are motivated by economics. In these cases, an asymmetric distribution of their benefits and costs may result in frictions among member countries. In other words, the pursuit of economic gain may result in security losses if the gains for one member come essentially at the expense of other members<sup>5</sup>.

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<sup>5</sup> Of course, tension due to the redistribution of rents is *not* specific to RIAs. For instance, Schiff (1998) argues that if moving all the way to free trade results in such a redistribution of rents across ethnic groups that it raises tensions among those groups (destroys social capital), then it may be harmful economically.

Thus, the result that trade enhances security does *not* allow us to conclude that policies which promote trade within a region will always improve the prospects of regional peace. Indeed, they may have precisely the opposite effect. This is because policy-induced integration promotes trade at a price. The tariff preferences which 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 which lose income or industry can be sufficiently resentful that separatist movements arise and the overall risk of conflict is increased. In such cases, disintegration may be the appropriate policy – e.g. East and West Pakistan.

A clear example of how integration can trigger conflict was the American Civil War. The Northern states produced manufactures which were sold to the Southern states, and the Southern states produced cotton, which was exported to Europe. Tariffs first nearly triggered civil war in 1828. The United States was already a customs union, but in that year Congress, dominated by Northern interests, sharply raised the US import duty on manufactures. The effect of this was to increase the price which 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, and this time Congress would not back down. This, perhaps as much as slavery, was the issue which led the Southern states to try to quit the Union, and led to the bloodiest conflict of the nineteenth century (Adams, 1993). Of course, the USA was deeply and politically integrated by this time, so that a less violent ‘divorce’ was probably impossible to achieve. However, the potential divisiveness of trade preferences is plain in the example.

A second example is the East African Common Market. In this case Kenya was the equivalent of the Northern states of America. Tanzania and Uganda complained about the income transfers which the common external tariff on manufactures created. 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 Jinja. Arguments about compensation for the income transfers led 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.

In these examples the trade policy used to promote regional integration was so unfair that it actually worsened intra-regional security. In this light, the success of the EU looks even more remarkable. In addition to the genuine desire for security noted above (due perhaps to Europe’s extraordinarily bloody history – three Franco-German conflicts in a century – and the failure of a number of alternative efforts at integration – e.g. the European Political and Defence Communities). France and Germany, the key players in the EEC, were relatively evenly balanced. Had they not been, an alternative solution to the security problem – hegemonic domination – would have been more likely than the reliance on mutual benefits that characterizes the RIA route.

Second, in reflection of the genuine wish for reconciliation, the European Community has always pursued regional integration in ways that avoid transfers large enough to trigger conflict. This was partly as a matter of negotiating style and partly as through detailed design (Winters, 1997). The style was consensual: negotiators were always looking for compromise and conciliation. When a country signaled that a Community policy would cause it major political or economic problems it was accommodated, either by being offered compensation, as with the British budget rebate negotiated by Mrs Thatcher, or by being granted a very gradual adjustment process, as with compliance with the rules on labor mobility by Spain and Portugal. The key design feature was that the Community's external tariffs were generally low and declining. Hence, the income transfers arising from producers in one nation exploiting consumers in another were relatively small.

The one exception to this was agriculture: it has been very highly protected and has generated large income transfers between countries; it has also been a source of some internal political conflict. In grand terms, however, even agriculture was part of the inspired peace-bargain. The policy arose because France wanted access to German markets at the high prices which German farmers also desired. The conflict over agriculture has not often been Franco-German, but rather between them and other members, especially the British.

The economic costs of forming a security-enhancing RIA are important, even if the objective is as apparently non-economic as securing peace. Before deciding whether to form such an RIA, it behooves policy makers to convince themselves that trade will enhance trust significantly – that contact will help not harm general relations and that it will create no new frictions. They should also ask whether an RIA is the most efficient mechanism to internalize them. Should they choose to form an RIA for security reasons, policy makers should ensure that tariffs are not set higher than is absolutely necessary to capture the security externalities that exist, and realize that these tariffs should decline over time and following deeper measures of integration.

## **7.2 RIAs May Help Address Social and Political Pressures such as Migration, but not very often**

The formation of an RIA is sometimes seen as a means of preventing or reducing the spread of civil disturbances or civil war from neighboring nations – or of controlling the migratory flows they induce. The EU has been concerned with such threats in North Africa and this has been one motivation behind the Euro-Med Agreements between these Mediterranean countries and the EU. The hope is that these agreements, including their associated aid protocols will improve the economic situation in those countries and help contain these problems. Similarly, both the US and Mexico have been concerned with the possibility of occasional social strife and violence in Mexico spreading northwards, and both hoped that NAFTA, by improving access to US markets, would help to improve Mexico's economic situation and reduce social tensions. Implicit in this hope is that NAFTA increases Mexican economic welfare.

Closely related is the manifest desire of rich countries to stem large-scale migration from poorer countries even if it does not immediately threaten political and social stability. This too has played a role in the formation of RIAs. It applies to the EC in its Europe Agreements with the CEECs, and to the US in NAFTA (OECD, 1995). Presidents Salinas and Bush argued that by helping Mexico to export more goods NAFTA would help it to export fewer people, thereby reducing the migration pressure. And the recent Euro-Med agreements also provide examples of such motivation.

However, whether RIAs do help to resolve migration problems depends on whether trade and migration are complements or substitutes. Standard trade theory holds that they are substitutes, so that increased trade integration is likely to reduce income or wage differentials and lower labor migration flows. More recent analysis, however, and some empirical results have concluded that North-South trade and migration may well be complements, so that integration may not lower migration, especially that of unskilled labor.

Four main arguments lead in this direction. First, one may plausibly argue that migration entails a fixed cost and that developing country capital markets are highly imperfect (Lopez and Schiff 1998). If so, very poor people may not be able to afford migration and a policy that increased their income could relax their capital constraint and allow them to move. Second, the costs of migration decrease as more information about the destination country becomes available. Since, for the reasons discussed above, this seems likely for an RIA, migration to the new partners could increase.

Third, even if an RIA is welfare improving overall – which, we have argued, one cannot take for granted – it may not benefit the unskilled workers, who are the real *bete noire* of the potential countries of immigration. For example, since the mid-1980s, unskilled workers have fared poorly in Mexico, with declines in real income of 10-15% - Hanson and Harrison (1999). To the extent that this is a result of NAFTA, the incentives for these people, if not their ability, to emigrate is increased by integration. Finally, the changes in the production structure induced by an RIA will cause some people to migrate internally within member countries. Evidence suggests that once they have been shaken loose from their ‘homeland’, peoples’ propensities to migrate internationally increase. That is, having once uprooted and, say, moved from rural areas to Mexico City or to the US borderlands, it is a small additional step to move further to the USA itself (Sewastynowicz, 1986, Morrison & Zabin, 1994).

Migration remains an issue even within Common Markets in which free mobility of labour is ostensibly an objective. Thus the EU required Portugal and Spain to wait through a thirteen year transition period before being permitted completely free access to other members’ labour markets. Similarly, it is widely accepted that a fear of migration is one of the reasons behind the long reluctance of the EU to consider Turkish membership seriously. Even among long-standing members of the EU, migration has not been made easy, and labour mobility is much lower in Europe than in the USA – Blanchard and Katz (1992). In part this is cultural, but in part it reflects a whole series of policy frictions, such as pension transferability, housing systems and health provision, that make effective migration complicated or worse.

### 7.3 Regional Integration Can Strengthen Democracy and Political Institutions

RIAs can also be useful tools to improve political institutions. Trade blocs with strong “club rules” can help anchor democratic reforms in member countries. Membership in an RIA can increase the likelihood of achieving or upholding democracy, especially if the bloc includes large and developed democratic countries. Newer or less politically developed countries may gain from joining an RIA that includes a large developed country or countries if accession is part of a strategy to pursue political, economic or social reforms (or prevent backsliding) that would not be feasible without the conditionality embodied in the RIA’s “club rules.” Those rules often include democracy and human rights.

Mercosur put its—then informal—democracy rule into practice in April 1996 when the commander of Paraguay’s armed forces was said to be contemplating a military coup. The bloc’s four presidents (with backing from the United States and the Organization of American States) reportedly quelled 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 FTAs with Mercosur, Chile and Bolivia accepted democracy as a condition for membership (Protocol of Ushuaia, July 24, 1998) (Box 7.3.).

#### Box 7.3 Democracy in Mercosur

The “Presidential Declaration on the Democratic Commitment in Mercosur” signed in San Luis, Argentina, on June 25, 1996 made democracy a condition of membership for the four member countries (Argentina, Brazil, Paraguay, and Uruguay). This condition was recently extended to the free trade agreements between Mercosur and Bolivia and Chile in the “Protocol of Ushuaia on Democratic Commitment in Mercosur, Bolivia and Chile” signed on July 24, 1998.

How credible is the “democratic commitment?” Are member countries likely to act on it and punish countries that deviate from democratic principles? One indication of the credibility of the commitment is provided by the specifics of the Protocol of Ushuaia. It sets the full validity of democratic institutions as an indispensable condition for the existence of the Mercosur agreements. It sets procedures for consulting on violations: if there is rupture of the democratic order in one of the states, the other countries will consult between them and with the affected state; if these consultations prove ineffective, the other countries will decide on the nature and extent of measures to apply. It lists sanctions, from suspension of the right to participate in the organs of the various agreements, up to suspension from Mercosur. These measures will be adopted by consensus and communicated to the affected state, which will not participate in the decision-making process, and will cease once it has been verified that democratic order has been fully re-established.

Mercosur and the associated countries have, thus, reduced ambiguity about the “democratic commitment” to a minimum. Punishment seems very likely, and the market of Mercosur plus Bolivia and Chile is important enough to the member countries that they are likely to consider the threat of retaliation seriously— i.e. the threat is likely to be effective.

It is generally thought that the framers of Mercosur borrowed the democracy idea and language from the 1957 Treaty of Rome establishing the EEC. However, though it seems understood that only democracies are eligible for (new) EU membership, democracy is not mentioned in the Treaty of Rome, although peace and liberty are.

Why a strong statement on democracy in Mercosur and not in the EEC? All EEC member countries had been democratic for over a decade in 1957 and the US acted as a sort of guarantor. This was not the case in Mercosur: member countries were emerging from long periods of military rule, there was no external guarantee, and preserving and consolidating fragile democracies was an important objective of the governments.

The EEC had no formal democracy requirement, although by convention and practice it was understood from the mid-1960s that such a condition existed, at least for new members. Bhalla and Bhalla (1997, p. 159) argue that it was generally understood that “the acceptance of the poorer economies of Greece, Spain and Portugal was motivated largely by the desire to help these restored democracies remain democratic by bolstering them politically and economically”. Similarly, the Europe Agreements with accession candidates in Central and Eastern Europe and the Baltics are designed to “facilitate” their “full integration into the community of democratic nations” (Title 1, Article 2). Latvia, one of the candidates for EU accession, is reviewing its citizenship policies for its Russian minority to meet EU concerns about human rights (Washington Post, 7/24/1998). The EU agreements with Mediterranean countries also include respect for human rights and the rule of law, as does the Cotonou Agreement between the EU and the ACP countries. In the 1992 Treaty on European Union, explicit reference was made to democracy, although not in any operational form.

Conditions for democracy and human rights will be truly effective only if the penalties for violating them are severe and their enforcement credible. As with the credibility of economic policies discussed in Chapter 4 above, it is difficult to pin down exactly what inspires credibility, but for developing countries an explicit statement of the club rule seems necessary, and an explicit and plausible plan for its enforcement highly desirable – see, for example, Box 7.3. In the absence of such conditions it is difficult to see how the result will be achieved, and, in particular, how it will be achieved without the need to resort to the sort of explicit political pressure described in the last paragraph but one.

The enforceability of such club rules depends on both the value of belonging to the bloc and the credibility of the threat of action. Regarding the value of belonging to the bloc, new members who obtain significant benefits when joining a large bloc, including access to a large market and greater bargaining power with the rest of the world, are unlikely to break the rules (or backslide) and risk losing the benefits of membership. It is

true that parties threatening democracy may not be moved by such considerations, but ordinary economic agents will be and so the condition will make it more difficult to build support for insurrection. Second, the credibility of the threat of action is likely to be greater if breaking club rules by new members entails a large cost to the other members. That cost may be direct and economic, or perhaps more likely, indirect and political, such as a demonstration effect.

The effectiveness of such “democracy only” rules is likely to vary with the nature of the membership. RIAs between small low-income countries, which typically trade very little with each other, are less able to impose major costs on recalcitrants by ejecting them. Hence choosing large (important) partners improves the chances of club rules being enforced. Because a country is likely to be more concerned with a nearby than with a distant country’s social and political institutions, enforcement of club rules is also likely to be more effective in RIAs between neighbors than one between distant partners.

Two other conditions will affect the credibility of enforcement. First, it seems unlikely that non-democracies, or even countries where democracy is very fragile, will prove stern disciplinarians even if a democracy rule exists. Second, the enforcer has to see enforcement as an important issue for itself. We have noted the importance of proximity in this, and it is also important that there be no other issues of greater importance. While the Cold War was in progress, western powers were far more concerned to ensure that client countries were securely anti-communist than with the details of their governance structures. Thus imposing democracy rules was just not an element of policy.

The question of distance is relevant to one current debate. The EU’s Cotonou Agreement with the ACP states intends eventually to replace the Lomé Convention by a series of Regional Economic Partnership Agreements (REPAs) with groups of ACP countries (McQueen, 1998). It includes, as an ‘essential element’, the developing partners’ respect for human rights and democracy, as well as injunctions to manage their economies properly (Council of the European Union, 1998). Some commentators (e.g. Winters, 2001) argue that the EU’s interest in enforcing good economic policy on the ACP countries, let alone ‘good’ political practice, is very doubtful. The ACP countries are too small and distant to affect any EU interest materially and different EU members frequently feel differently about any particular case. In addition, disciplining former colonies for pursuing economic or political policies that are not approved in European capitals looks like an international public relations nightmare. On this view, REPAs will generate no additional credibility for the ACP countries.

A contrary view – at least on economic credibility – is given by Collier et al (1997). They see the EU as the stern external agent of restraint that developing countries require in order to convince the world that they are reliable and will succeed economically. Their argument is essentially that the EU is so important to the ACP countries, that they would never flout it, so that the EU can do a little good to its partners at almost no cost to itself.

One of the interesting features of the club-rules/democracy argument for RIAs is that it is one case where there is clearly no multilateral substitute. Multilateral trade

arrangements can not propose and enforce these sorts of rules, because they are simply not part of the mandate of organizations such as the WTO. Other international organizations, such as the UN or regional and multilateral development institutions may be able to convince member countries to abide by some rules, but so far, these rules do not include democracy or other constraints on political regimes. It would appear that positive spillover effects in the political arena are only possible in large regional arrangements that include club rules.

#### **7.4 Regionalism Can Strengthen the Nation State**

Joining an RIA necessarily requires surrendering some immediate control over policy making and losing some political autonomy, if only over tariffs on partners' exports. (So, of course, does membership of the WTO.) Some RIAs, however, go deeper than this and create institutions for joint decision making. For example, as the European Union's integration has deepened, decision-making has increasingly moved away from national capitals to Brussels, and much of the current debate is shaped by the belief that some form of political unification must eventually follow the creation of an integrated economic unit (Box 7.4).<sup>6</sup> But such integration need not result in the suppression of the nation as an organizational framework or the loss of effective sovereignty. On the contrary, by pooling sovereignty, members of an RIA may be able to preserve and enlarge it, and thus strengthen the concept of national identity and integrity. Nation states can strengthen themselves by creating a united front against external forces, or by joining forces in international negotiations. Setting aside considerations of coalition-building and policy spillovers (see Chapters 6 and 7 above), however, such cooperation does not strictly require an RIA in the sense of trade preferences.

##### **Box 7.4 Trade Preferences Do Not Inevitably Lead to Political Integration**

Although few customs unions aim explicitly at political union, many have gone far beyond simple preferential trading arrangements to achieve a degree of political integration. Economic integration has often been a precursor to, and facilitator, of closer political association, as in the EEC, or even of state formation, as in the Zollverein, which was founded in 1834 and contributed to the creation of the German nation in 1871. Similarly, Moldavia and Wallachia formed a CU in 1847 before becoming Romania in 1878.

But economic integration is not needed for political integration. In the past—and today in some developing countries—nations had internal trade barriers, which meant they were politically, but not economically, integrated. In the Middle Ages customs collectors were frequently stationed not at the boundaries, but in the interior of political

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<sup>6</sup> After becoming president of the European Commission, Jacques Delors stated that one consequence of the Single European Act would be that four fifths of those decisions now taken in national capitals would eventually be taken in Brussels (Milward, 1992, p.2). The increasing number of lobbying groups setting up in Brussels seems to support the view of its increasing importance in decision making.

units, at important market centers, junctions of trade routes, or mountain passes. England and Scotland united under a single monarch in 1603 but attempts to reach agreement on commercial union failed until the Act of Union in 1707 (Irwin, 1992). Although politically unified under the king for centuries, France remained divided—even after several reforms—by 1,600 internal tolls and tariffs until the French Revolution enabled their abolition in 1790. Each Swiss canton retained tariff autonomy until 1848. More recently, Hong Kong and mainland China have achieved political unity without full economic integration—as there are still internal trade barriers and dual customs jurisdictions.

Not only is economic integration not necessary for political integration but it can also decrease regional political unity. In several RIAs, common external tariffs or rules of origins operate as irritants, and a stimulant to separatist movements. Such was the case with Western Australia in the Australian Commonwealth, the Prairie Provinces in Canada, and, as we saw in Section 7.1.3 between North and South in the ante-bellum USA.

#### **7.4.1 Regional Integration to Deal with Outside Threats and Regional Hegemons**

The normal approach to external security threats is for countries to form alliances independently of any trade preferences. However, it is possible to start with a trade pact, based on “hopes that economic union between the weak would ripen into political union, and that by the political union of the weak a power might be established strong enough to defend against aggression from outside” (Viner 1950, p. 92). Nations that feared being absorbed through coercion by larger states have united to forestall such coercion.

Thus, the Austrian emperor proposed (but eventually aborted) an economic union with Spain and Bavaria as a defensive scheme against France in 1665 (Viner, 1950, p. 93). More recently, the Gulf Cooperation Council (GCC) was created in 1981 partly in response to the potential threat of regional powers such as Iran and Iraq (Schiff and Winters, 1998), and ASEAN was partially 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 Russia.

The Southern African Development Coordination Conference (SADCC) also falls into this class. It was initially formed in 1980 to provide a united front against, and reduce dependence on, South Africa. After Apartheid ended South Africa was invited to join the group, now the Southern African Development Community (SADC). The difference was that, while SADCC entailed cooperation on trade matters in general, it did not involve mutual trade preferences *per se*. SADC, on the other hand, perhaps because it lacks the outside threat, is developing a trade protocol based around preferences.

#### **7.4.2 Regional Integration and Negotiations with the Outside World**

Regional cooperation (which can, but need not, involve trade preferences) can strengthen the voices of small nations, which often face severe disadvantages in dealing

with the rest of the world due to low bargaining power and high negotiation costs. Bilateral and multilateral negotiations often require substantial financial resources, time, and expert knowledge, which are limited in small countries. As the world has become more integrated and the number of issues to be dealt with in the international arena has grown, the incentive for small countries to co-operate with their neighbors has grown as well.

Small countries can substantially reduce their negotiation costs and, at the same time, increase their market and negotiation power, by pooling their negotiation resources and by acting together to articulate shared interests. This is more likely to come about (Andriamananjara and Schiff, 2000):

- if their interests are similar (so that intra-bloc negotiation costs are low),
- if the cost of international negotiations is high (greater incentives to co-operate), and
- if a large number of issues need to be dealt with (which both increases the incentives and makes it easier to construct packages in which every party can gain).

Establishing a regional grouping typically involves “logrolling” - “I’ll vote for your issue if you vote for mine”; by trading support for each other’s preferred issues, countries can get more than they could obtain unilaterally (Andriamananjara and Schiff, 2000). However, it is well to be aware that even with log-rolling such coalition-formation is neither easy nor common. Members will usually have to sacrifice some preferred positions even before the international negotiation process begins as the coalition settles priorities. These steps can be politically difficult, especially if the group is large and the countries differ widely. The coalition also needs to devise ways of responding to offers and set-backs in negotiations, for it is quite certain that they will not achieve all that they hope for initially. Setting up a secretariat and devising suitable institutional rules for decision-taking may help in these processes, but this requires significant time and resources up front.

Relatively shallow but highly successful examples of co-operation of this kind are the Scandinavian and ASEAN groups in the WTO. These blocs pool their resources to attend meetings, providing regular briefings for each other. If they agree on an issue (and they put some effort into discovering before-hand whether they do or not), the representatives may speak for the group, but if not, individual countries look after their own interests.

At a deeper level, small Caribbean nations increased their bargaining power by establishing the Caribbean Community (CARICOM) in 1973 to pool their negotiation resources and formulate common policy stances (Box 7.5). This allowed the member states to lower negotiation costs and have greater influence outside of the region than would have been possible if they had acted independently. The region acquired bargaining power at the very highest level of North-South politics. Representatives of CARICOM countries took the lead in formulating and articulating the positions of the

ACP Group in negotiating the Lomé Conventions. By pooling their support, the CARICOM nations succeeded in getting their nationals elected to key international positions such as Commonwealth Secretary General and ACP Secretary General. In the process, they ensured that the region's interests in commodity trade and development cooperation were taken into account. They also consolidated multilateral links with other parts of the developing world, and established themselves as full participants in the activities of the United Nations, despite that organization's earlier ambivalence on the issue of micro-state membership. CARICOM countries focused on getting UN organs to address the development needs of small island developing states. Finally, they succeeded in collectively negotiating a whole range of preferential market access agreements (e.g., CARIBCAN with Canada, CBI with the US, and Lomé and (along with other developing nations) GSP with the EU). Despite its relatively limited trade and investment impact, CARICOM was successful in serving as a political instrument in joint negotiations on trade and investment with larger countries and regional trading blocs.

#### **Box 7.5 The Caribbean Community (CARICOM) and International Negotiations**

All Caribbean states face problems of political and economic viability engendered by their extremely small size. CARICOM, created in 1973, between Antigua and Barbuda, The Bahamas, Barbados, Dominica, Grenada, The Grenadines, Jamaica, Montserrat, St Kitts and St Nevis, St Lucia, St Vincent, and Trinidad and Tobago, has populations ranging from 10 thousand to 2.55 million and GDPs from \$0.24 billion to \$6.3 billion.

CARICOM was intended to give the region a more powerful voice and presence to defend its interests in international affairs, and it has, indeed, often served as an effective political instrument in negotiations on trade and investment with larger countries or regional trade blocs (Byron, 1994; IADB, 1995). The group has three main areas of activity: economic integration; cooperation in non-economic areas (health, education and transport) and operating common services and coordinating the foreign policies of independent member states. CARICOM has been particularly active in negotiating preferential access to European and North American markets, negotiating for consistent and remunerative commodity prices, obtaining larger flows of concessionary finance for the region, and raising the Caribbean profile in multilateral institutions (Byron, 1994). CARICOM has been involved in the ACP-EU, GATT/WTO, FTAA, UNCTAD, UNCLOS (UN Conference on the Laws of the Sea) negotiations, in commissions or joint councils with Cuba, Canada, Japan, Mexico, US, the OAS, and the G3 (Mexico, Venezuela, Colombia). A micro-state would not have had the human, physical, or financial capacities to unilaterally conduct fruitful negotiations in so many areas.

The existence of a visible regional and supranational authority may attract more foreign assistance (or even foreign direct investment), as it is easier for the donor community to deal with the group as an entity than with each country individually. Inotai (1991) writes: "More recently, common activities emerged in order to attract higher

volumes of external financial resources. By 1988, SADCC could ensure external financing for 20 industrial projects, and is now working on getting additional resources for 11 more projects." And SADC – SADCC's successor – now acts as a regional coordinating mechanism with the donor community. For instance, in February 1996, the US Department of Commerce signed a memorandum of understanding with SADC that outlines six areas for cooperation in advancing commercial development in Southern Africa.

As for other RIAs, Japanese aid has played a major role in assisting regional industrial projects in ASEAN, such as automobile assembly and parts production (Bhalla and Bhalla, 1997). Similarly, following its vocation for regionalism as a principle, the European Union has actively assisted sub-regional integration – for example, in Central Europe, the Mediterranean and in the CACM.

Finally, the objective of strengthening negotiating and bargaining power is not limited to the formation of blocs by small countries. Whalley (1998) argues that this idea was shared by the countries involved in the creation of the EEC in the late 1950s who felt that individually they might have limited leverage in a negotiation with the US, but that together they would have much greater leverage. And similar arguments were made in Britain when she joined the EEC. Similarly, Whalley argues that the objective of increasing negotiating power has also been present in the formation of Mercosur, especially vis-a-vis NAFTA. The issue of market power, however, as opposed to negotiating efficiency, is taken up in the next chapter, which considers the effects of regional integration on the process of global trade liberalisation.

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