Regionalism and Developing Countries: A Primer

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This article discusses regionalism from the standpoint of developing countries surveying the more significant recent contributions surrounding the contentious debate about identifying resulting benefits for Southern partners in the recent wave of North–South preferential trading agreements (PTAs). The primer starts with an assessment of efficiency effects of PTAs with a focus on the consequences of partner choice, then moves on to non-traditional aspects of regionalism. Implementation issues deal with the extent of integration and the implications of rules of origin for the extent of market access. The article closes with a discussion of the politics and political economy of trade policy decisions in PTAs.

Regional trading arrangements (RTAs, henceforth synonymous with preferential, i.e., discriminatory arrangements) are rising and, for many observers, have become the most promising route to market integration, in particular for developing economies that are the focus of this article (see Figure 1). According to a recent tally (World Bank, 2005, Table 2.1), the average number of RTAs per country is six, with 45 developing countries having signed bilateral trading arrangements with a Northern partner, and of the 109 North–South (N–S) preferential trading arrangements (PTAs), 90 having been created since 1990. At issue is whether the Multilateral Trading System (MTS), which replaces gunboat diplomacy by a rules-based system and a dispute-settlement procedure, is working well for developing countries. Also at issue is how much market access Southern partners get from the Northern partner. A huge literature on regionalism and development has spawned, and this article is a selective review (hence ''a primer'') of that literature asking what the developing countries can expect to obtain from preferential market access rather than relying on multilateralism.

If the MTS works as it is supposed to, primary beneficiaries are the developing countries, so anything that weakens it should be considered very carefully from their perspective. In other words, whether or not RTAs represent building blocs is a more important issue for countries with little bargaining power than for the United States or the European Union (EU). With some South–South (S–S) exceptions, the majority of RTAs are of the N–S variety. Yet, with lopsided bargaining power, there is concern that developing countries are not gaining much market access. Given the risks of an

FIGURE 1: THE PROLIFERATION OF RTAS

Source: World Bank (2005), figure 2.1.

unraveling of the MTS, it is necessary to examine carefully the benefits conferred to developing countries by the current wave of RTAs.

In addition, to the four basic principles of the MTS enshrined in the World Trade Organization (WTO),[1] the dispute settlement understanding supposedly establishes a credible mechanism to resolve disputes. Nonetheless, evidence is accumulating that the dispute settlement process under the WTO is not redressing the pattern of GATT-inconsistent activity that took place under the General Agreement on Tariffs and Trade (GATT), activity that was largely targeted against bilaterally powerless countries (Bown, 2004)).[2]

An RTA, which is almost always built around discriminatory preferential trade policy, is in direct contradiction with the spirit of Article I. Article XXIV, however, opens the door for exceptions, provided that substantially all trade barriers are removed, and that the partners do not raise their protection towards non-members. Furthermore, the MTS is supposed to be "favorable" to the developing countries by granting them special and differential treatment, which in the case of RTAs means that South–South (S–S) RTAs can be carried out under the so-called enabling clause which gives full leeway in the extent of reduction in trade barriers.[3]

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[1] The three basic principles of the MTS enshrined in the WTO are: non-discrimination, known as the most-favored-nation or MFN clause (in Article I); national treatment (Article III); transparent and foreseeable bound tariffs as the only instruments of protection (Article XI); and, participation of all members by reciprocity to avoid the free-riding inherent in the MFN clause (Article XXVIII). Reciprocity also limits terms-of-trade motivations since reduced protection at home and abroad leave terms-of-trade roughly unchanged and it also helps overcome internal political pressures since losses in import-competing sectors are offset by gains in exporting sectors.

[2] After controlling for market access interests, Bown (2005) shows that the determinants of participation in WTO dispute settlement between 1995 and 2000 continues to display an "institutional bias": under current rules developing countries with little power of retaliation or capacity to absorb substantial legal costs do not participate in the litigation. Neither do countries participate if they are particularly reliant on bilateral assistance from the respondent or are engaged in a PTA with the respondent.

[3] Sometimes, a distinction is made between non-discriminatory arrangements (policy cooperation at the regional level) and discriminatory (or PTAs). Regional cooperation agreements often serve to coordinate policies (e.g., sharing power networks, building basic infrastructure). They are non-controversial since, in principle, they provide some benefits to all participants without harming non-participants (internalization of externalities and no

This primer examines the implications of regionalism from the perspective of developing countries. Section I provides some background that sets up the issues. Section II discusses the efficiency effects of RTAs. Section III turns to implementation issues (depth of integration and rules of origin). Section IV deals with politics and political economy. Section V concludes with recommendations that would make regionalism more supportive of multilateralism.

I. Background, Controversies and Historical Perspective

During the 1960s, RTAs were of either the S–S type (with an objective of industrialization by import substitution) or the North–North (N–N) type (EFTA and the European Common Market) involving deeper integration, because it was essentially a political endeavor. The second wave starting in the early 1990s involved primarily N–S RTAs such as the several enlargements of the EU and the EU relations with developing countries (the EU has some form of PTA with all but 10 of its trading partners) (Sapir, 1998), or in the case of the US, NAFTA the several bilateral FTAs (with Chile, Jordan, Poland, etc.). The most notable exception was MERCOSUR, representing a case of substantial integration—a Customs Union (CU) among developing countries.

Why then is regionalism so contentious? First, despite 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, the basic economics of discriminatory reduction in trade barriers is ambiguous for participating members. 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 (e.g., what agricultural policy would have emerged in Europe in the absence of RTAs). Third, today RTAs are widespread (usually FTAs) and the negotiating agenda goes beyond commercial preferences (i.e., it involves some form of "deep integration" which is hard to quantify).[4] Fourth, with the spread of RTAs (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. Fifth, concern has been expressed that if the world gets divided in a few large trading blocs, the probability of trade conflicts would increase as each country exploits its market power (Krugman, 1991). Developing countries, with little negotiating power, would then be the main losers of the consequences of widespread regionalism.

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negative spillovers). Since almost all regional integration arrangements (RIAs) are discriminatory, we do not consider this non-controversial type of arrangement further.
    [4] Because of multiple memberships, it is difficult to evaluate implementation costs. 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.

The relation between regionalism and multilateralism will not be pursued further here,[5] 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 nineteenth century, which was the result of a "domino" effect following the Anglo-French establishment of an 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.[6] So nineteenth-century regionalism was the mechanism by which goods markets were integrated around the world, suggesting that PTAs could be a stepping stone towards a worldwide move to free trade. In the nineteenth century, the widespread application of the unconditional MFN clause (much like in the present-day MTS 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 equivalent to today's tariff bindings for WTO Members. This could have prevented the surge of protectionism that occurred in the early part of the twentieth century.

Since it is a safe bet to assume that regionalism is here to stay, in my focus on developing countries' interests, I pay particular attention to the choice of partner, that is, are N–S RTAs (the majority among recent agreements) preferable to S–S RTAs. Insofar as possible, my overall appreciation is in terms of an alternative under which developing countries would rely more heavily on the MTS, with the rules and conflict resolution mechanisms in the WTO.

II.   Efficiency Effects of PTAS

A.   Trade creation and trade diversion[7]

Since tariffs are still non-negligible for developing countries, it is sensible to start with the efficiency or welfare effects of PTAs. Efficiency effects are analyzed using the notions of "trade creation" and "trade diversion" (see Annex for a definition and a numerical example illustrating the welfare for country A of engaging in an FTA with country B).

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[5] For early views, see the contributions in de Melo and Panagariya (1993). For later comprehensive reviews see World Bank (2000, ch. 7), Schiff and Winters (2003, ch. 8), and World Bank (2005, ch. 6).

[6] This domino view of regionalism has been put forth recently in evaluating the expansion in membership in the EU (Baldwin, 1997). 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.

[7] The seminal contributions are collected in Bhagwati et al. (1999), and exhaustively surveyed in Panagariya (2000). Being a primer rather than a survey, this article keeps citations to a minimum and generally to the more recent contributions. Schiff and Winters (2003) and World Bank (2005) have extensive bibliographies.

Applying these concepts to RTAs involving developing countries suggests four comments. First, in the case of trade diversion (here DVDs in Annex Table A1), note that if the difference in unit costs between B and C exceeded the tariff imposed by A on DVDs (here 20 percent), 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 RTAs of the first generation, explains why trade among partners often did not increase significantly following the implementation of the PTA. Second, if the partner B cannot flood A's market (i.e., if it supplies DVDs at increasing marginal costs)—again a case prevalent for many S–S PTAs, especially among small countries—then the price of DVDs will not fall in A since it will continue importing from C. In this case, A's welfare will unambiguously fall because it is losing tariff revenue to B (in effect it is subsidizing inefficient partner producers), while B's gain will be less than A's loss. As a result, overall welfare (here the combined effects on A's and B's welfare since the welfare of C is unaffected) will fall. Third, note that in the case of an N–S FTA (typical of second wave RTAs), A's partner will typically be the EU or the United States. Then, when there is trade diversion, the welfare-reducing effect coming from subsidizing the higher-cost partner B is likely to be small since the partner will often be close to the low-cost supplier on a worldwide basis.

B. 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.[8]

Ex ante estimates. In addition to capturing the efficiency effects operating under the perfect competition case discussed above (and illustrated in the Annex), simulation models also include the following effects of trade policy changes for industries operating under imperfect competition: (i) pro-competitive effects coming from a reduction in protection which forces firms to lower their mark-up over costs as they face a more elastic demand for their products; (ii) scale efficiency effects whereby firms operating at less than minimum efficient scale may move up or down their average cost curve leading to scale efficiency effects; (iii) entry/exit effects; (iv) variety-related welfare effects (trade liberalization increases varieties offered to consumers and varieties of intermediate inputs for producers).

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[8] *Ex-ante* simulation methods give orders of magnitude of the welfare effects under alternative assumptions about market structure and elasticities. Unfortunately, the elasticities needed for the evaluation are rarely estimated and the behavioral assumptions in the models are not confronted with the data. *Ex post* methods rely on a detailed analysis of observed trade flows, and usually do not infer welfare effects. This latter approach is confronted with two problems: (a) considering what trade policies countries would have followed in the absence of the FTA (typically the assumption is one of no change in trade policy); (b) do the observed changes in trade flows attributed to an FTA in fact represent the effect of some omitted variables was correlated with a variable included in the model.

These simulation exercises highlight the relative importance of the following effects. 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.[9]

Ex-post estimates. Trade intensity and import propensity calculations for the major recent FTAs reveal the mixed patterns (under the counterfactual assumption that in the absence of the FTA, trade would have increased *pari passu* across partners). In some cases (e.g., MERCOSUR, UDEAC, GCC) increases in openness were 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 propensities declined. As a result, the recent experience reveals no general patterns.

A preferred approach to building the counterfactual is to estimate an econometric model predicting the intensity of trade in terms of country size, transport costs between partners, and other variables (common border, common language, landlockedness), and then augment this model by dummy variables to capture the effects of RTAs. Known as the gravity model, this approach is currently the preferred one to estimate the sought-after Trade Creation and Trade Diversion effects.

For many well-established RTAs such as the EU, MERCOSUR and NAFTA (but also for some S-S RTAs), recent gravity-based estimates show that the RTAs usually resulted in intra-regional trade flows beyond those predicted by the gravity model (i.e., those that would have prevailed in the absence of the RTA), often coupled with a reduction in imports from the rest of the world, and at times coupled with a reduction in exports to the rest of the world. Overall, this suggests evidence of trade diversion. As an example of a recent study, consider the evolution of the estimated trend in the dummy variables for intra-regional trade, exports and imports to and from the rest of the world in Figure 2. For both MERCOSUR and NAFTA, one notices a rather significant increase in intra-regional trade accompanied by a decline in trade with the rest of the world around the time of the implementation of the RTA.[10]

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[9] For example, Chile is engaged in 12 trade agreements. Simulations (see Schiff and Winters, 2003, fig. 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. Harrison *et al.* (2003) review the lessons from these simulation models.

[10] Trade diversion can also occur under non-discriminatory reduction in protection if tariff reduction increases the effective rate of protection. Among other recent studies of the efficiency effects of RTAs, Krishna (2003) finds that trade creation dominates trade diversion in 80 percent of the cases, while Yeats (1998) finds evidence of trade diversion for MERCOSUR.

FIGURE 2: PANEL GRAVITY ESTIMATES

Source: Carrère (2005), figure 2.

In the efficiency effects identified so far, there is nothing that suggests the superiority of a preferential approach to trade policy over a non-discriminatory one, and one could conclude that there is not much, if any, conclusive overall evidence of trade creation, even if it appears that the N–S RTAs of the second wave are preferable to the earlier S–S RTAs. Keeping in mind that there is no perfect counterfactual and that all the studies, be they *ex ante* or *ex post* rely on some counterfactual, are there other efficiency effects that could overturn these conclusions?

Some claim that because typically RTAs are formed between neighboring countries (sometimes described as ''natural trading partners'' to reflect large trade flows), this justifies their existence. A large trade flow, however, does not mean that it should be stimulated, indeed it 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. While this may be defended, especially if there are important economies of scale in transport involving irreversible investments,[11] there is no evidence so far of any correlation between geographic proximity or the volume of trade and the welfare effects of reductions in preferential tariffs (Krishna, 2003).

Finally, there is concern 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 lead to de-industrialization in the South. Does this justify preferential S–S partnerships? So far, as in the case of economies of scale in transport, convincing evidence is still lacking. However, illustrative simulations in a three-country world in which two small Southern countries can reduce protection either multilaterally or bilaterally (either with a large Northern country or with a small Southern neighbor) suggest that a N–S partnership is likely to offer better prospects than a S–S partnership because of better overall net market access.

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[11] Freund (2000) develops a simple model with economies of scale in transport involving sunk costs. She shows that if non-members reach a lower welfare level, members reach a higher welfare level under regionalism than under multilateralism. Hummels and Skiba (2004) give some evidence of economies of scale for transport in Latin America.

However, for each Southern partner, multilateral liberalization is less desirable because competition in the Northern country is stiffer when the other Southern country also has market access (Puga and Venables, 1998).

The superiority of N–S agreements on efficiency grounds also holds when one views trade as largely driven by comparative advantage effects where countries export the services of their abundant factors (labor for the South and capital for the North). Suppose then that the world consists of countries that either have a capital-labor endowment above the world average (Northern countries) or below average (Southern countries). An FTA between two Northern (e.g., Switzerland and Hungary) and Southern (e.g., Kenya and Uganda) countries is likely to lead to income convergence (divergence) as the richest (Switzerland) and poorest (Uganda) 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).

III. IMPLEMENTATION

Implementing an RTA always involves some form of policy coordination. This coordination may take place over so-called "behind-the-border" measures that are an obstacle to trade.[12] Then regionalism allows countries to go into deeper market integration than under multilateralism. But implementation also involves rules of origin when integration is less than a CU, and bargaining over a common external tariff under a CU.

A. INTEGRATION OF DOMESTIC POLICIES

Most RTAs have on their 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 and delegation of authority to supranational institutions. 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.

However, there is a fundamental difference with discriminatory trade liberalization: unlike for tariff preferences that lead to rents, reductions in transaction

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[12] "Behind-the-border" barriers to trade result from segmented labor markets, lack of coordination among regulatory institutions, and lack of harmonization on standards. See World Bank (2005, ch. 4) for further discussion.

costs only involve increases in efficiency. As such, they will always lead to an improvement in efficiency, at least in a competitive environment, thereby avoiding the ambiguity associated with preferential reduction in goods that involve rents. 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 large efficiency gains (rectangles that represent rents in welfare calculations now also reflect efficiency gains that are added to the efficiency triangles associated with tariff reductions). Because cooperation on policy requires trust that takes a long time to build (to delegate authority in decision-making), no RTA has made much progress on cooperation for standards beyond WTO rules.

Significant gains along the same lines would also apply from preferential liberalization in services and public procurement. For services, the scope for efficiency gains via increased competition could be very large.[13] Yet, even though a services component is often included in RTAs, with the exception of NAFTA, little progress has been made. Likewise, RTAs have made little progress on public procurement policies (the EU and NAFTA provide for the application of the national treatment rule).[14] Apart from the EU, NAFTA is the only instance of ''deep'' integration beyond what might be 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, as well as extensive dispute settlement provisions that allow private action against governments.[15]

The NAFTA example brings about the potential policy credibility enhancing effects in N–S RTAs for Southern partners.[16] Even though RTA treaties do not include macroeconomic and general domestic constraints, it is generally agreed that in the case of NAFTA, 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 RTAs? 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 quasi fully reciprocal

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[13] Much like the enabling cause allows S–S RTAs 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 wished) GATTS Article V (which is closely modeled on Article XXIV) also gives greater flexibility for S–S agreements. Fink and Mattoo (2002) discuss the distinctions (mostly relating to market structure) that must be taken into account when discussing the effects of RTAs in services.

[14] 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.

[15] In N–S FTAs, the Northern partner typically sets the agenda. The US FTAs typically involve the most explicit negotiations for market access in services and US-style rules for investment and intellectual property, not to mention a level of labor protection resulting in labor laws that are more stringent than those that the Southern partner would adopt. Market access agreements for EU FTAs contain provision for Services, but tend to reinforce international rules for intellectual property. For details, see World Bank (2005, table 5.1).

[16] Fernandez and Portes (1998) were the first to discuss these so-called non-traditional aspects of RTAs. Also see Schiff and Winters (2003 chs 4 and 6) and World Bank (2005, chs 4 and 5).

basis (the former Lomé conventions now WTO-inconsistent amounted to non-reciprocal preferences). In the case of the EPAs, since tariffs are below bound levels at the WTO, one must ask whether 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, following a crisis. Neither can one expect the EPAs to signal that ACPs 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 until 2008).

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

A natural question that arises is whether deep regional integration can arise without an RTA (i.e., a purely cooperative agreement). Monetary unions, for example, have at times occurred in isolation as in the case of Panama, Ecuador and El Salvador who have adopted the dollar. But monetary unions have as an objective to enforce monetary stability rather than to facilitate trade (though this may be a positive side-effect), and does not involve concessions from all countries as in the case of agreements to facilitate trade. In agreements necessitating concessions from all countries, deeper integration has typically been achieved through trade agreements.

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

B.   RULES OF ORIGIN (ROO)

Most RTAs are FTAs so that 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 rules of origin (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). Rules of origin 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) RTAs, administering RoO adopted 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, it is increasingly recognized that their complex design imposes both economic costs beyond those needed to meet

TABLE 1: PRODUCT-SPECIFIC RULES OF ORIGIN RESTRICTIVENESS INDEX AND PROTECTION

| | Index value[a] | |
	NAFTA	PANEURO
Tariff peaks[b]	6.2(257)	4.2(3,595)
Low tariffs[c]	4.8(1,432)	3.4(6,092)
Total number of tariff lines	3,555	19,720

Notes: A higher value of the index indicates a more restrictive product-specific Rule of Origin; [a] The index takes a value ranging from 1 (least restrictive) to 7 (most restrictive); [b] Tariffs that are three times above the mean; [c] Tariffs that are less than one third of the mean.

Source: Cadot *et al*. 2006(b), table 3.

reasonable definitions of origin, and additional administrative costs associated with their complexity.[17]

Because the rules for establishing origin are so complex, a recent (and growing) literature has sought to devise summary indices indicating the restrictiveness of the set of RoO and applied these indices at the tariff-line level. Table 1 uses one such index to summarize the restrictiveness of the product-specific rules of origin (PSRO) for the two main Northern countries instigators or FTAs with Southern partners: the EU and the United States. Note that the PSRO are more restrictive for the highly protected sectors suggesting that market access for the Southern partner is, indeed, limited.

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 partner is substantial (i.e., over 10 percent in textiles and clothing). Utilization rates under NAFTA status for Mexican exporters in 2001 (when they faced zero duties in US markets) was not particularly high (e.g., 79 percent in textiles and clothing where the preferential access margin was 12 percent). 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 (intermediates goods) in Mexico thereby raising the costs of Mexican producers of clothing (see Anson *et al.*, 2005). Moreover, there is increasing evidence that part of the rent associated with preferential market access goes to the Northern, rather than the Southern, partner (Olarreaga and Özden (2005), Cadot *et al.* (2005), and Özden and Sharma (2006)).

Under those circumstances, one is tempted to conclude that RoO in N–S FTAs almost end up yielding no market access for the Southern partner, resulting in the Southern partner being just about left on its "participation constraint". In sum, since RoO are not necessary under a full CU (that is a CU with both a CET and

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[17] See Brenton and Imagawa (2004) and Cadot *et al.* (2006a) for a compendium of contributions on various aspects of the costs of RoO and Cadot *et al.* (2006b) for a comparison of RoO by the two main users, the United States and the EU.

coordination on other trade policies), deeper commercial integration should be preferable to shallow integration.

IV. POLITICS AND POLITICAL ECONOMY

There is more to RTAs than elimination of trade barriers since the process of integration is likely to affect trade policy stance towards non-members, especially for developing countries that 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 that is also usually higher because large countries often have higher protection. Politics also plays an important role in RTAs. We review both below.

A. LOBBYING ACTIVITIES

Whether integration brings a reduction in lobbying activity (a dilution effect if lobbies 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 lobbies coordinate activities across countries. For example, in a S–S RTA 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.[18]

It is difficult to assess the importance of the dilution effect in an RTA. But examples of the results of lobbying activities in N–S and S–S RTAs show that the highly protected sectors usually obtain concessions resulting in trade diversion. This is not surprising since trade creation is a mixed blessing for a negotiating government because 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 less among producers than among consumers and least among producers in concentrated activities). Trade diversion, by contrast, avoids the reduction in profits, and may be preferable for governments if

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[18] Arrangements for supranational institutions under deep integration raises further the possibility of a bias towards a protectionist 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., by way of 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 prefer a no-subsidy policy outcome. (This is known as the 'restaurant "bil" l' problem in reference to behavior in restaurants when the bill is split equally 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". See Schiff and Winters (2003, box 3.2).

producers' interests weigh more heavily in their objectives than consumers' 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 RTA. Take again a three-country framework where producers are profit-making oligopolists. 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 while producers might lose market share (and hence profits) to each other, they may well gain more market share and profits at the expense of C so 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 (Krishna, 1998).[19]

B.   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 such as in 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 Tanzania 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 large (a commonplace among many S–S RTAs 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

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[19] There is, however, little evidence that RIAs represent a stumbling bloc for multilateralism. Using data for 50 countries, Foroutan (1998) both integrating and non-integrating countries have reduced their trade barriers so that regionalism would, so far at least, be benign. Estevadeordal and Robertson (2004) also find that MFN tariffs and preferential tariffs have been falling in tandem in Latin America during 1985–1997. More recently, Limaõ (2006) finds no evidence of a stumbling effect for the United States.

superiority of N–S RIAs for even if transfers are minimal or non-existent, at least they avoid the path taken by many first-wave S–S RTAs where partial compensation was accomplished by distortionary policies which exacerbated the already strong trade diverting effects of the RIA.

From a long list of political motives for regionalism, three deserve mention. The MERCOSUR protocol made democracy a precondition for membership with consultation procedures in the case of violations. Helping restore or strengthen democratic rule was also implicit on the EU's Southern and Eastern enlargements. Respect of democracy and human rights also figure in the current regional EPAs negotiated with ACP countries, though in this case, the credibility of enforcement mechanisms may be doubted because of lack of proximity and former colonial ties. Second for small countries engaged in an RTA who delegate authority at the regional level, such as the CARICOM members, there are cost savings from the pooling of resources, and the negotiation position with the outside world is strengthened. Third, some RTAs are also formed to deal with outside threats and regional hegemons (the GCC was partly formed in response to threats from Iran and Iraq, ASEAN in response to perceived threats from communism and the SADC was formed in 1980 to provide a united front against apartheid South Africa).

Political motives are also present for rich countries engaged in N-S RTAs. For rich country members in N-S RTAs, 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 negotiations 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, cast doubt on this view that trade integration and immigration are substitutes, suggesting instead that they may be complements so that an RTA could increase migratory pressures. First, by raising incomes of the poorest families who are the most likely to emigrate, trade liberalization may increase migratory pressures. Second, more information for migrants about the destination country reduces migration costs. Third, a N–S RTA 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.

V.   CONCLUDING REMARKS

Regional integration in the form of discriminatory trade preferences is controversial justifying the often-heard remark that a well-functioning WTS with low levels of protection relying heavily on non-discrimination and transparency would protect best the interests of developing countries. If the politics and political-economy aspects of RTAs show why they are so popular, efficiency considerations suggest that the biggest share of the gains from trade liberalization comes from non-discriminatory dismantling of domestic protection. Neglecting systemic issues, this would suggest that

the ideal trade policy for a developing country would then be unilateralism first, followed by multilateralism in second place (when political constraints limit the extent of liberalization, reciprocity is effective in furthering liberalization), with regionalism in third place. Unfortunately, led by the EU and the United States, most countries are following exactly the reverse strategy, a trend that is only likely to be reversed if multilateral trade negotiations resume and succeed.

This primer also suggests that, with regionalism here to stay, developing countries are likely to be best served by partnerships with Northern countries, even though in the end this results in little additional market access in goods markets because of the combination of falling worldwide protection and because of stiff RoO, but also because the industrialized countries largely control the agenda for ''deep'' integration. At the same time, to minimize the losses associated with trade diversion, they should maintain low protection towards non-partners. Nonetheless, in many instances, deep integration agreements which extend beyond reduction in trade barriers to include services and cooperation on ''behind-the-border'' measures should be encouraged because reduction of technical barriers to trade avoid the ambiguity of reducing rent-ridden measures such as tariffs. Thus, if an exchange of concession at the regional level can take place to remove ''behind-the-border'' measures, the resulting deep integration would enhance trade and welfare without the traditional costs of discriminatory RTAs.

Finally, WTO rules could be modified to make regionalism more supportive of multilateralism. First, the leniency of the Enabling Clause, which allows FTAs that are not all-inclusive, could be tightened. Second, the WTO forum should be used to enforce simple and uniform rules-of-origin across product categories and especially across RTAs. Third, when RTAs are implemented among WTO Members, they could be required to eliminate the gap between bound and applied tariff rates, thereby forcing members to a greater commitment to multilateralism and free trade. Fourth, in the absence of additional resources for the WTO, monitoring RTAs should be avoided and the WTO Committee on Regional Trade Agreements should strive to focus on devising rules that are more likely to be welfare improving.

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ANNEX: TRADE CREATION AND TRADE DIVERSION

The following example illustrates these two concepts. Countries A and B consider forming an FTA, with the rest of the world represented by C. The focus is on the welfare effects for A from eliminating its 20 percent tariff on imports from its partner B. Arrows in Table 1 indicate the source of import supply in A under the two trade policies: a non-discriminatory tariff of 20 percent and a tariff applied only to imports from C.

TABLE A1: TRADE CREATION AND TRADE DIVERSION

		B	A	C	
	C_0	11	13	10	
DVDs	$C_0(1+t_0)$	13.2	13	←12	
	$C_0(1+t_1)$	11→	13	12	Trade diversion
	C_0	18	15	20	Neither trade
Textiles	$C_0(1+t_0)$	21.6	15	24	Creation nor
	$C_0(1+t_1)$	18	15	24	trade diversion
	C_0	15	17	16	
Shoes	$C_0(1+t_0)$	18	17	19.2	
	$C_0(1+t_1)$	15→	17	19.2	Trade creation

Notes: C_0 = unit cost; t_0 = A's tariff before the FTA ($t_0^C = t_0^B$ = 20 percent); t_1 = A's tariff after FTA with B (t_0^C = 20%; t_0^B = 0%).

For DVDs, the FTA results in a shift of supply away from the low-cost outside partner. This is called trade diversion. Trade diversion always results in some welfare loss because of lower tariff revenues for A (a transfer of rents to the inefficient partner B). In the constant cost supply case illustrated here, the price for consumers in A is also lower. This effect is a source of welfare gain for A. In this case, the net welfare effect on A is ambiguous: on the one hand, it goes up because DVDs sell in A at a price closer to their opportunity cost of 10 in C, while on the other hand A loses tariff revenue to DVD producers in B who are in effect subsidized by consumers in A.

For textiles, since A is the low-cost supplier, the FTA has no welfare effect.

For shoes, B is the low-cost supplier. The FTA leads to a welfare gain since supply is always from the low-cost partner (in effect 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 consequence), and a reduction in price for consumers, which is a source of welfare gain.

Two caveats. First, in the numerical example in Table A1, products are assumed to be homogenous, while in practice products are typically differentiated. Then A will

import both from B and C before and after the FTA.[20] Differentiated goods make gains from an FTA more likely, as the price of the variety 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. Second, no spillovers are assumed to occur. Recent evidence (Chang and Winters (2002)), however, suggests that non-partners see their terms-of-trade deteriorate following the formation of an FTA or CU. In this case, the above results would need to be modified, with the possibility of gains from an RTA not available in the case of non-discriminatory trade liberalization.

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[20] For example, in the case of NAFTA, in 1991 before NAFTA was a real possibility, 70 percent of Mexico's imports came from the United States (614 out of 4,854 headings) while in 1996, 78 percent of imports came from the United States (296 out of 4,854 headings).