



## **Sober Reflection: Considering the Rush to Regionalism**

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- Environment
- Human Development
- Economy

## Abstract

There are unmistakable signs of a rush to regionalism in international trade and investment. Of the 273 preferential trade agreements (PTAs) that had been notified to the World Trade Organization (WTO) as of December 2003, only 120 pre-date 1995.

This paper asks whether the rush benefits developing countries. It argues that PTAs are harmful to the multilateral trade regime in a number of possible ways. As well, their contributions to economic improvement are uncertain at best, and depend on the presence of a number of other factors. In some ways, PTAs may actually harm signatories (loss of tariff revenue, loss of policy space). However, they do provide a platform for negotiated progress on a number of important non-economic objectives, from cementing peaceful political relations to pursuing common environmental problems.

Developing countries need to pursue a new kind of regionalism: one that avoids the downside risks of the current model and concentrates on areas of high net payoff, such as lowering trade costs (trade facilitation, reduced costs of standards compliance). Such agreements could still provide the forum for the associated non-economic benefits, but with fewer costs.

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# 1. Introduction

There are unmistakable signs of a rush to regionalism in agreements on international trade and investment. In Asia, ASEAN-China and ASEAN+3 (ASEAN is the Association of South East Asian Nations) promise to link some of the most dynamic of the global economies in free trade and cooperation agreements, and long-standing policies are reversing in South Asia as liberalization and integration make tentative headway. The United States (U.S.) has been on a virtual rampage of bilateral and regional negotiations, while the European Union (EU) is busy negotiating with the Mediterranean countries, the former Lomé Agreement countries of the Africa, Caribbean and Pacific, and has found time to incorporate ten new members. In Africa, the Economic Community of West African States (ECOWAS) looks set to become a viable economic community, and the Southern African Development Community (SADC) is starting to work as a functional arrangement. Long-moribund treaties in Latin America, such as Mercosur (South American Common Market) and the Andean Community are taking on a new life. The number of agreements under negotiation or under consideration is for all intents and purposes incalculable, changing on a weekly basis. Of the 273 regional trade agreements that had been notified to the World Trade Organization (WTO) as of December 2003, only 120 pre-date 1995. If planned agreements conclude as planned under WTO notification, the end of 2005 will see almost 300 regional trade agreements in force.<sup>1</sup>

This paper leaves aside the questions on why the rush to regionalism,<sup>2</sup> asking instead whether the rush is of benefit to developing countries. The paper is laid out as an argument that proceeds as follows. Preferential Trade Agreements (PTAs), it argues, are harmful to the multilateral trade regime in a number of possible ways. As well, PTAs' contributions to economic improvement (focusing on developing countries, but the lessons are also more widely applicable) are uncertain at best, and depend for their results on the existence of a number of other factors. Some of these may be affected by the signing of a PTA (market size, for example), but many others are not. In some ways, PTAs may actually harm signatory countries (loss of tariff revenue, loss of domestic policy space), and these costs must be carefully balanced against any expected gains. South-South agreements, in particular, are expected to have few economic benefits.

However, it is noted that PTAs seem to provide a platform for negotiated progress on a number of non-economic objectives, from cementing peaceful political relations to pursuing common environmental problems. These benefits are not insubstantial.

The paper argues that developing countries need to pursue a new kind of regionalism: one that avoids the downside risks of the current model, and concentrates on areas of high net payoff, such as lowering trade costs (trade facilitation, efforts to help reduce the costs of standards compliance, etc.). Such agreements could still provide the forum for the types of non-economic benefits seen associated with traditional PTAs, but would carry few of the associated costs.

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<sup>1</sup> Information taken from the WTO web site as of October 12, 2004.  
[http://www.wto.org/english/tratop\\_e/region\\_e/region\\_e.htm](http://www.wto.org/english/tratop_e/region_e/region_e.htm), and from WTO (2003a).

<sup>2</sup> On that question, see Cosbey, Tay, Lim and Walls (2004).

## 2. PTAs are bad for the multilateral system of trade

To the extent that PTAs concentrate on trade liberalization, they carry a downside beyond the internal impacts. In the first place, they may create trade diversion, as per Viner's (1950) classic argument. Trade diversion occurs when the lowering of intra-bloc tariff levels makes a member's exports more attractive than imports from a non-member, even when the non-member is a lower-cost producer. That is, the non-member exporter may be more productive, but member tariff levels make its exports more expensive. World Bank (2005:60) surveys the results of 17 studies to conclude that "excluded countries almost always lose," though PTAs "are typically expected to create more trade than they divert, although this is not always the case." World Bank (2004) found that of 19 PTAs examined, 10 seemed to create trade diversion. Schiff (1997) finds that trade diversion is more likely in a PTA between two small developing countries.

While there may be intra-bloc economic benefits, the wider impact is a loss of global welfare, with goods now being sourced from less efficient intra-bloc producers. And even the intra-bloc effects may be negative, since resources may be diverted away from those sectors in which the bloc members are most productive and into sectors where they are less so. These types of impacts are discussed in the next section.

Trade diversion can be caused by other factors as well as tariff lowering; the key driver for this dynamic is the differential between intra-bloc trade barriers and external barriers. So restrictive rules of origin, for example, can also cause trade diversion, as can lowering of intra-bloc non-tariff barriers.<sup>3</sup>

PTAs also erode the principle of most-favoured nation (MFN)—a core principle of the WTO system. By definition, they offer preferential treatment to a select few members, not extending those same preferences to others. The General Agreement on Tariffs and Trade (GATT) Article XXX makes special exceptions for PTAs, but on terms that few agreements follow in practice. The rule most often violated is that trade rules and regulations must be eliminated for substantially all sectors.<sup>4</sup> Absent such broad liberalization, it is too easy for the sectors of coverage to be cherry-picked in a manner that constitutes protectionist barriers against the rest of the world.

It is argued by some that PTAs contribute to the multilateral system by means of "competitive liberalization."<sup>5</sup> The argument holds that progress in key areas at the regional level can drive progress at the multilateral level. It is hard to see this working in practice today, though it did work, for example, when North American Free Trade Area (NAFTA) rules on investment and services found their way into the Uruguay Round results.<sup>6</sup> But the difficult issues for the multilateral regime (such as agriculture) are typically left off the table in the modern PTAs. Indeed, one of the key stumbling blocks to progress in the Free Trade Area of the Americas (FTAA) talks has been the reluctance of the U.S. to negotiate on agriculture, on the grounds that this negotiation really needs to occur at the WTO level. The EU-Mercosur talks seem to be foundering on similar issues.

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<sup>3</sup> Schiff and Winters (2003:79)

<sup>4</sup> Cosby, Tay, Lim and Walls (2004)

<sup>5</sup> See Zoellick (2002).

<sup>6</sup> Ostry (2000).

It has been argued that regional agreements tend to allow policy space for differences in regulatory approaches and that, therefore, they constitute a barrier to multilateral agreements, which could never make that kind of accommodation.<sup>7</sup> Related to this is the argument that the PTAs are putting in place approaches on which countries could never attain consensus at the multilateral level. Several recent U.S. agreements on intellectual property right (IPR) protection, for example, seem to run counter to the spirit of the WTO's landmark August 30, 2003 agreement on the TRIPs Agreement (trade-related aspects of intellectual property rights) and public health. Cosbey, Tay, Lim and Walls (2004) argue that the WTO agreement could not have been reached had those PTAs been in force at the time. The U.S. and its partners would likely have contended that they could not sign on to something that ran counter to their existing obligations.

Another element of the competitive liberalization approach says that PTAs will drive WTO negotiators to a sense of urgency, grounded in a fear of loss of influence. Ostry (2000) argues that the Canada-U.S. FTA was designed to have this sort of impact in the Uruguay Round negotiations. Again, this may have worked in the past, when PTAs were less commonplace. But in these days of rush to regionalism, the urgency bred of novelty is gone, and all that is left is the loss of influence.

In fact, the reality of the rush to regionalism probably means less and less energy in the multilateral arena. In many countries, the lack of human resources makes it a zero-sum game; the more negotiators applied to a regional agreement, the fewer available to help push the multilateral talks. The process is in some ways self-reinforcing; as the multilateral influence erodes, there is less reason to put energy into it, further eroding its influence.

Why does this matter? What is wrong with a loss of influence of the multilateral system of trade rules? It matters in several important ways, and particularly to the weaker members of the WTO:

- It matters to states that are not in many or any PTAs. The MFN commitments they thought they were getting in the WTO negotiations become more and more compromised.
- It matters to states that are involved in PTAs, but are on the periphery of a hub-and-spoke arrangement with larger partners such as the U.S. or the EU. Schiff and Winters (2003:78) note that these sorts of arrangements bring greater benefits to the hubs than to the periphery, so for these states multilateral liberalization may be preferable.
- It matters to small states that lack the negotiating power in a bilateral context that they might have by dint of common interests at the multilateral level. These states would arguably get better deals from multilateral negotiations.<sup>8</sup>
- It matters to those countries that still have a raw deal in the WTO, such as developing country agricultural exporters. Issues of developed country domestic support, export promotion and market access will not be dealt with at anything less than the multilateral level.

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<sup>7</sup> Isaac (2003) makes this case in the context of food safety and ecolabelling rules.

<sup>8</sup> In the WTO context the influence of the G-20, particularly in the agricultural talks, is instructive. Outside the WTO context, the significant influence wielded in the climate change negotiations by the Association of Small Island States (AOSIS) also illustrates this dynamic.

### 3. The economic benefits of PTAs are uncertain at best

The overwhelming consensus of the literature on the economic benefits of PTAs is: it depends. In political science terms, they do tend to provide a safe haven for smaller trade partners, hedging against future protectionist moves by larger partners.<sup>9</sup> And they may accomplish any number of strategic, non-economic, goals discussed in the next section. This section will look only at the economic impacts that might be engendered by PTAs.

A full treatment of this issue is beyond the scope of this paper. The literature exploring the impacts of PTAs on investment, on trade and on growth is huge. But some elements of that literature can be synthesized and summarized here, particularly in the areas of foreign direct investment and economic growth.

*PTAs and Foreign Direct Investment:* There is some evidence that foreign direct investment (FDI) increases in response to PTAs<sup>10</sup> (though there is little evidence that it similarly responds to bilateral investment treaties<sup>11</sup>). There are, however, enough qualifications to this statement as to make it lose almost all of its force. First, PTAs are neither sufficient nor necessary to increase inward FDI flows. The size of the market and the climate created by domestic policies seem to matter as much or more.<sup>12</sup> Lederman *et al.* (2003:301) argue that “unstable countries with low productivity, distorted policies and weak institutions are unlikely to draw much FDI benefit from joining a [regional integration agreement].”

Second, it matters what kind of PTA we are talking about. The evidence seems to be that North-North and North-South PTAs will bring increased FDI to a much greater extent than will South-South PTAs.<sup>13</sup> The difference may stem from a number of factors: smaller integrated market size; lower credibility effect; and previously protected capital-intensive sectors, limiting the extent to which integration will raise the rate of return on capital (and investment).

Third, increased investment observed after many PTA formations seems to simply amount to a one-time shift, as firms adjust their views of the optimal capital stock in the PTA member countries. Thereafter FDI flows decline to a level that is slightly higher, commensurate with servicing the higher stocks of investment.<sup>14</sup>

Fourth, not all FDI leads to growth. If extra-bloc tariff and non-tariff barriers are high, increased FDI to the region will likely be directed to the most highly protected sectors, rather than those where productivity is highest. The net welfare gains are thus diminished. There is also evidence that where there is little government involvement in the composition of FDI inflows (as in Latin America in the last decades of the last century) FDI simply crowds out domestic investment, meaning no net increase in investment overall.<sup>15</sup>

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<sup>9</sup> This motivation is argued by Whalley and Hamilton (1996). Also see Ostry (2000).

<sup>10</sup> See Lederman, Maloney and Serven (2003) for an analysis of the NAFTA case. Also see Yeyati, Stein and Daude (2003).

<sup>11</sup> See UNCTAD (1998), Hallward-Driemeier (2003) and Nunenkamp (2003).

<sup>12</sup> Lederman, Maloney and Serven (2003), Baldwin and Segheza (1998), Globerman and Shapiro (2003), Asiedu (2004).

<sup>13</sup> Schiff and Winters (2003:Chapter 5), World Bank (2005: Chapter 3).

<sup>14</sup> Schiff and Winters (2003:121).

<sup>15</sup> See Gallagher and Zarsky (2004), and Agosin and Mayer (2000).

Finally, if FDI is market-seeking, it may be that existing investment in the less investment-friendly members of a new PTA will shift to more investment-friendly members, whence it can serve all of the new integrated market.<sup>16</sup> That is, regional integration may cause *decreases* in investment in some members.

*PTAs and Growth:* The evidence seems to be that North-North PTAs may stimulate growth, North-South PTAs will do so, and South-South PTAs will not.<sup>17</sup> The literature on endogenous growth—changes in long-term growth rates through the advances in knowledge and human capital that may come with openness to trade and investment—does find some relationship between openness and growth, but the findings for regional integration through PTAs are less convincing.

This is understandable. Endogenous growth theory sees several causes of growth:<sup>18</sup>

- Knowledge and human capital and, therefore, any international arrangements that increase them (as in trade agreements that bring foreign professionals into contact with domestic ones), or any domestic policies that do the same (as in strong education systems, support for research and development).
- Policies and institutions that foster innovation and accumulation, including strong legal systems of property rights, an effective regulatory framework, an honest bureaucracy, a stable political environment, and so on.

The question, then, is: what impacts can PTAs have on these factors? Certainly openness to investment and trade brings more opportunities for interchange of ideas and technologies, management practices, and strategies for marketing and production. But, of course, this effect is most forceful where the agreement includes at least one partner that is well advanced in all these areas—typically a developed country.

PTAs might also bring growth by forcing positive reform of policies and institutions. But outside of the EU, there are few examples of PTAs that have forced this kind of reform. They may also act as a sort of pledge to foreign investors that economic reforms will not be reversed, and will even continue. Krugman (1993) argues that NAFTA acted in this way for Mexico's reformist government.

The key issues are, first, that even where PTAs might be able to alter long-term growth rates, the same mechanisms by which they do so are likely to work even more effectively through *multilateral* liberalization. Second, in the context of PTAs, those mechanisms are unlikely to work in South-South agreements, and more likely to do so in North-South agreements. Third, if the objective is increased growth, it may make more sense to focus on directly affecting the causes of growth, since PTAs will only do so indirectly. That is, why not focus on reform of policies and institutions, or on increasing knowledge and human capital? It may well be that such a focus involves openness to trade and investment. Or it may not. The important thing is to first understand the objectives, and then to choose the means by which they can be achieved.

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<sup>16</sup> Yeyati, Stein and Daude (2003).

<sup>17</sup> Schiff and Winters (2003), World Bank (2005).

<sup>18</sup> There are, of course, other growth theories, but the theories of endogenous growth have been gaining increased acceptance as centrally important to explaining differences in growth rates across countries.

Another issue to consider is that trade liberalization, where it involves lower tariffs on goods and services, will involve a loss of revenue for importing governments. Konan and Maskus (1999) observe that, “As governments lose revenues from liberalized trade taxes they may be forced to raise domestic tax rates in compensation. The latter possibility is significant in developing economies, which tend to rely heavily on tariff revenues to finance central-government programs.” A more long-term dynamic scenario may see the lost revenues replenished in part by royalties from new investments, and from existing taxes on a rising economic base. But these are uncertain and more distant prospects than the immediate loss of revenues from tariffs.

#### **4. There’s a potential downside to commitments in areas of deeper integration: loss of policy space<sup>19</sup>**

A recent survey by the World Bank (2005) shows that a number of PTAs go further than the WTO commitments in areas of deep integration, specifically investment, intellectual property rights (IPRs) and services. This is confirmed in Cosby, Tay, Lim and Walls (2004) in the context of services and investment, and by Vivas-Eugui (2003) and Drahos (2001) in the context of IPRs.

In some cases, this is due to pressure from a PTA partner endowed with disproportionate negotiating power, as with the U.S. insistence on tough IPR protection in its post-NAFTA PTAs. In others, such as investment or competition policy, it is not a difficult matter to go beyond WTO rules, since those rules are weak or non-existent.

The common problem with such commitments is expressed by the United Nations Development Programme (UNDP, 2003) as the loss of policy space, or the limitation on the ability of governments to regulate in the public interest. This downside to deeper integration plays out in different specific ways in the various negotiating areas.

In the context of investment, many of the modern PTAs since NAFTA contain provisions for investor protection that are modelled on those in the modern bilateral investment treaties (BITs). Cosby, Mann, Peterson and von Moltke (2004) summarize the concerns related to these rules. While the specifics vary from treaty to treaty, many contain similar and troubling provisions, such as:

- Loosely-worded protections from expropriation that can be interpreted to mean protection from costly government regulations, however legitimate.
- Prohibitions on so-called performance requirements, by which governments compel potential investors to certain behaviours usually designed to boost the domestic benefits of the investment (e.g., requirements to source inputs locally).<sup>20</sup>
- Prohibitions on restricting outflows of capital, even in times of currency crisis.<sup>21</sup>

<sup>19</sup> This section and the next draw heavily on Cosby, Tay, Lim and Walls (2004).

<sup>20</sup> The jury is still out on whether such requirements in fact serve to promote linkages (and thereby, domestic development). Zampetti and Fredriksson (2003) find the evidence mixed. Moran (2001) finds some evidence that certain types of requirements (primarily those associated with joint venture, domestic content and technology sharing requirements) do not work. UNCTAD (2003) agrees, but finds evidence of effectiveness for export requirements. UNCTAD (2001) outlines a host of ways in which countries can work to promote linkages without violating their obligations under investment agreements.

<sup>21</sup> Only in the recent U.S. negotiations has this become a priority. For a summary of the arguments against this type of provision, see Economist (2003).

- Requirements to treat investors according to an undefined minimum international standard of treatment—a standard that seems to be rising over time to something difficult for most developing countries to meet (Mann 2004).
- Requirements for pre-establishment non-discrimination, meaning countries cannot screen investments, or give preference to investments going into certain sectors.<sup>22</sup>

In general, the agreements contain a number of elements that arguably go too far in protecting investor rights at the expense of the public welfare. The concerns are particularly acute for developing countries that are only now considering what forms of public regulatory models will work in their particular contexts; the commitments in most PTAs effectively foreclose future changes. Peterson (2004), for example, argues that the expropriation commitments in modern FTAs could well preclude allowing developing countries to eventually introduce public solutions in areas such as child care and health insurance.

These problems are amplified by concerns with the process of dispute settlement. The agreements usually contain a dispute settlement mechanism that allows firms to compel governments into binding arbitration, resulting in what can be substantial financial penalties for states in breach of their obligations. The mechanism is not particularly problematic in principle, but it typically contains flaws that make it so in fact. For the most part proceedings, arguments and even final decisions are closed to the public—something that was appropriate when the panels dealt with purely commercial concerns, but which is untenable in modern cases where the public good is being balanced against private rights. The selection and composition of the panels is flawed in ways that favour the investor.<sup>23</sup> And there is no effective mechanism for appeal.

In the context of services, a key concern stems from the provisions related to domestic regulation. The WTO's General Agreement on Trade in Services (GATS) (Article 6.4) mandates negotiations that are now ongoing, to ensure that domestic regulations applicable to services be "no more burdensome than necessary."<sup>24</sup> The recent *U.S.-Gambling* panel considered the definition of a similar necessity test in another part of the GATS and ruled that among other things it demanded that states achieve their objectives in the manner that is least-trade-restrictive, making the Article 6.4 test highly challenging and obtrusive (WTO 2004). Given that services can comprise a number of sectors of broad public interest, such as health, education, and water distribution and treatment, critics worry that this provision will subject a number of non-commercial policy goals (such as environment and human health and safety) to the primacy of commercial objectives.<sup>25</sup> It may, for example, be seen as more burdensome than necessary to cap medical fees for service in a mixed private/public health care system. A number of less trade-restricting alternatives exist to ensure affordability of services: medical voucher systems, medical "account" systems, increasing social welfare payments, and so on.

<sup>22</sup> The treaties that contain this obligation are in the minority. Most only grant non-discrimination post-establishment.

<sup>23</sup> Mann, Cosbey, Peterson and von Moltke (2004), a comment on a reform document by one of the major arbitral fora, outlines in some detail a number of these process problems.

<sup>24</sup> The regulations in question are broadly defined: measures relating to qualification requirements and procedures, technical standards and licensing requirements. Note that it is still under negotiation whether Article 6(4) will apply to all services, or only to those under which a country has undertaken specific commitments.

<sup>25</sup> See Grieshaber-Otto and Sinclair (2004).

The *U.S.-Gambling* case also gives rise to worries that GATS' exceptions will not have their intended force. While the U.S. successfully argued in that case that its restrictions on on-line gambling were needed to combat organized crime, money laundering, underage gambling and other acknowledged bads, it was unable to show that the restrictions were the least-trade-restrictive option available to achieve those ends. As such, it failed to win an exception on the grounds of protecting public order or morality. To many observers the ruling was unbalanced in favour of commercial policy objectives, against legitimate non-commercial objectives.<sup>26</sup>

PTAs present potentially a more compelling case for concern than does the GATS, since many of them have broader commitments in the area of services than are found in their GATS schedules. Almost all the U.S. post-NAFTA PTAs, for example, use a negative-list approach, where all service sectors are considered to be included except for those specifically listed. The GATS, by contrast, uses a positive approach, arguably giving it thinner coverage. Most modern PTAs deal with services, and very few of those vary from the GATS formulation of the domestic regulations provisions.

In the area of intellectual property rights, all the U.S. agreements starting with NAFTA create a wide range of WTO-plus obligations. The result is a narrowed ability of governments to act in the public interest—a narrowing justified by the purported wider public benefits of incentives for innovators to innovate.

The actual provisions vary from agreement to agreement. For example, the U.S.-Singapore PTA (Art. 16.8), like the U.S. agreements that come after it, protects the safety testing data from pharmaceuticals (whether patented or not) for five years, in effect meaning generic drugs produced during that time must do their own testing before gaining approval. Given the costs of safety testing, this is a significant requirement and, in effect, grants a five year protection from generic competition that is not granted in TRIPS. The U.S.-Morocco PTA (Art. 15.9.2) contains obligations to register patents on existing drugs if “new use” for those drugs is found. This practice, called “evergreening,” is used by patent holders to extend the life of their patent protection beyond that available under TRIPS. Practically all of the modern U.S. FTAs go beyond TRIPS in curtailing the ability of the Parties to deny patents on certain inventions.<sup>27</sup> TRIPS Art. 27.3(b) allows WTO members to exclude from patentability plants and animals other than microorganisms, provided some *sui generis* system of plant protection is used. This flexibility does not exist in any of the post-NAFTA U.S. agreements. A full analysis of the TRIPS-plus elements in the modern U.S. PTAs is beyond the scope of this paper, but the impacts on regulatory freedom—and thence on development—of these provisions is substantial. In the area of patents on pharmaceuticals, for example, the effect is to restrict the possibility of generic competition to patented pharmaceuticals, raising the price of drugs above what it would otherwise be.

In the end, the message is not that the PTA provisions on deeper integration are of necessity undesirable. Rather, the point is that they may carry costs that must, in the end, be balanced against any gains that such agreements produce. Most negotiators are unaware of the nature of those costs. This warning is particularly salient given the uncertainty summarized in the previous section over the economic benefits of PTAs.

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<sup>26</sup> See, for example, Gould (2004).

<sup>27</sup> For an overview of the TRIPS-Plus phenomenon, see Drahos (2001).

## 5. PTAs often result in progress on non-economic goals

The preceding sections may sound somewhat negative about the potential role of PTAs; their performance on economic criteria is uncertain at best, and they may entail a worrying loss of policy space when they include elements of deeper integration. If that were the end of the story, we might indeed wonder at the rapid proliferation of such agreements.

But it is not. PTAs can play an important role in fulfilling a number of goals that are only indirectly economic in nature. This section will examine those sorts of achievements.

One major strategic motivation for PTAs is to cement security and political relations between partners. So, for example, the EU's Euro-Med process is based on the understanding that a prosperous and integrated Mediterranean is in the strategic interests of the European states.<sup>28</sup> Similarly, the China-ASEAN negotiations, from the Chinese perspective, are an effort to assert greater influence in the region, and help cement its emerging role as a regional leader.<sup>29</sup> ASEAN itself was founded on a desire for reduced tensions, particularly between Indonesia and Malaysia.<sup>30</sup>

In a related vein, FTAs may also be concluded in an effort to stabilize potentially antagonistic relations.<sup>31</sup> The U.S.-Middle Eastern free trade negotiations are clearly motivated (on the U.S. side) by a desire to bring peace and stability through prosperity and greater U.S. influence in a relatively hostile region of key geopolitical interest.<sup>32</sup> And the EU's 1957 Treaty of Rome was motivated in no small measure by a desire for peace among countries ravaged by two world wars. The recent negotiations between India and Pakistan share similar motivations.

PTAs may also be seen as a way to increase sovereign power through agglomeration, in a time when the forces of globalization tend to erode the sovereign ability of any individual country to manage its own affairs.<sup>33</sup> In that sense, the proliferation of regional and bilateral FTAs in East Asia can be explained in part as a response to the Asian Financial crisis in 1997. This unexpected financial and economic meltdown contributed to a regional sense of insecurity and vulnerability in many Asian countries.

The Euro-Med agreements are driven by what seems to be a broad spectrum of economic and political goals. The Associate agreements with the EU are only one part of a larger process that also envisions a Mediterranean FTA and, as part of the "Barcelona Process," aims to "establish a common Euro-Mediterranean area of peace and stability based on fundamental principles including respect for human rights and democracy."<sup>34</sup> Clearly the EU sees the well-being and stability of its Southern neighbours as important to its own well-being, and is willing to invest the necessary resources to help make them good neighbours.

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<sup>28</sup> The 1995 Barcelona Declaration that initiated the Euro-Med process stresses the "strategic importance of the Mediterranean," and the "privileged nature of the links forged by neighbourhood and community." It also affirms that "the general objective of turning the Mediterranean basin into an area of dialogue, exchange and cooperation guaranteeing peace, stability and prosperity requires a strengthening of democracy and respect for human rights, sustainable and balanced economic and social development, measures to combat poverty and promotion of greater understanding between cultures."

<sup>29</sup> Lim (2003).

<sup>30</sup> Anwar (1994).

<sup>31</sup> Mansfield and Pevehouse (2000) find that the effect works best between countries that actually expand trade, but that even at low levels of trade there is an impact.

<sup>32</sup> Zoellick (2003).

<sup>33</sup> Gavin and van Langenhove (2003)

<sup>34</sup> Barcelona Declaration (1995).

A regional trade agreement, particularly if it encompasses a number of smaller powers, may afford increased bargaining power in multilateral trade negotiations by giving them a combined voice.<sup>35</sup> Note that this rationale for PTAs would predict the need to counter-balance that newly-created power through the establishment of other PTAs in other parts of the world.

A key feature of many PTAs is the scope for regional or bilateral cooperation on environmental matters. Environmental protection often requires regional cooperation, as with the problems encountered by states that share river basins, that border common seas, that co-host migratory species or that have shared air quality concerns. Regional or bilateral cooperation on trade matters, by creating the foundation of institutional cooperation, yields an opportunity to make related progress on issues of shared environmental concern.

This was the case for NAFTA, for example, where the Parties created side agreements on labour and environmental cooperation as an integral part of the final package. NAFTA's environmental side agreement has arguably been effective in creating a North American agenda for action on a number of key issues such as sound management of chemicals, state of environment reporting, toxic release inventories, migratory species, children's health and others. It is noteworthy, however, that the side agreement has not been as successful in marrying trade and environment concerns—cooperation between trade and environmental officials is practically non-existent,<sup>36</sup> and there is strong evidence that the scale effects of increased trade have swamped the positive effects of new technologies and practices.<sup>37</sup> Rather, the side agreement has succeeded primarily where it sought to focus on purely environmental issues.

In the Mercosur context, the Sub-Working Group Six (on environment) has been working since 1995 on an agenda that now includes:

- Eliminating environmental non-tariff barriers within Mercosur;
- Creating a bloc-wide system of environmental information;
- Guidelines for environmental emergencies;
- Work on competitiveness and environmental cost internalization;
- Work on international environmental standards such as ISO 14000;
- Sectoral work, such as on illegal trade in timber; and
- Creating a Mercosur system of ecolabelling.

Mercosur in 2001 signed a “Framework Agreement on the Environment in Mercosur,” aimed at fostering sustainable development and protecting the environment in the Mercosur countries. Chapter 3, on Environmental Cooperation, lists 14 types of environmental cooperation to be pursued, including fostering harmonization of national environmental standards, sharing information on environmental emergencies and promoting research into clean technology.<sup>38</sup>

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<sup>35</sup> Chang and Winters (2002) find this may be a significant effect in the Mercosur context. In the SAARC context, see *The Daily Star* (2004).

<sup>36</sup> Johnson *et al.* (2004).

<sup>37</sup> See Schatan (2003) for an analysis of the environmental impacts of NAFTA in Mexican manufacturing.

<sup>38</sup> The Agreement only entered into force in June 2004, three years after its signing—a symptom of the intense politics of its negotiation. As such, it is too early to assess the reality behind the promises.

In ASEAN, environmental cooperation has been extensive (though, as in NAFTA, cooperation on trade and environment issues is limited). On the shared concern of haze pollution, action on the Regional Haze Action Plan (RHAP) is being implemented through the newly-established ASEAN Specialized Meteorological Centre. The ASEAN Regional Center on Biodiversity Conservation has been running for five years. The Association has agreed to create a US\$10 million ASEAN environment fund.

PTAs seem to provide opportunity for addressing a wide variety of non-commercial objectives. The FTAA negotiations, for example, are occurring within the wider framework of the Summit of the Americas process—a process that aims to work toward progress in areas such as education, human rights, corruption, security, justice systems and democracy. The 2001 Quebec City Summit produced a formal democracy clause, making participation in the FTAA subject to a requirement of basic democracy. The EU has a similar clause, as does Mercosur.

And the negotiations surrounding trade agreements can occasion pressure on issues such as labour and human rights. The U.S.'s periodic renewal of Permanent Normal Trade Relation status with China, for example, has become a focal point for U.S. pressure on such issues. And the negotiations between the U.S. and Columbia have provided an opportunity for the U.S. to exert pressure on the Columbian government to address the wholesale killing of union leaders by paramilitaries.<sup>39</sup> These sorts of opportunities tend to be one-shot affairs, though; after the agreement is signed there is normally no venue for discussion of, or further pressure on, such issues.

The key factors in the success of achieving such non-economic goals in the context of PTAs seem to have little to do with the trade agreements themselves. In fact, the only necessary ingredient supplied by the PTAs seems to be an institutional forum for discussion of shared concerns, often (but not always) aided and abetted by PTA preambular language that sets out broad statements on the need for regional/bilateral cooperation in the pursuit of a wide array of public policy objectives.

## **6. A new kind of regionalism for developing countries**

The preceding sections suggest that:

- The economic benefits of PTAs are uncertain at best and depend heavily on parallel domestic reforms;
- Where PTAs contain elements of deeper integration, they may reduce policy space for development; and
- There may be a number of important non-economic benefits that derive from PTAs as exercises in cooperation.

In light of that analysis, this section suggests a new direction for regionalism, with a focus on the needs of developing countries. It argues that they should pursue negotiations that emphasize the positive potential, downplay the uncertain and minimize the negative. Two broad areas are proposed here as appropriate in that regard (though there are surely other candidates): lowering trade costs, and cooperation on non-economic imperatives.

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<sup>39</sup> See Forero (2004).

## 6.1. Lowering trade costs

It was noted above that the non-economic benefits deriving from PTAs tend to be founded on the platform of institutionalized dialogue on economic issues of mutual interest. If, as this paper argues, some forms of preferential trade liberalization bring few benefits and should be downplayed, does this also mean forgoing the non-economic benefits?

Not necessarily. There are areas of economic dialogue that avoid the downsides of the current models—damage to the multilateral system, loss of tariff revenues and erosion of policy space—and that concentrate on areas of largest potential economic payoff. These areas centre on lowering trade costs: costs of transport, costs of customs barriers and costs of meeting foreign standards. This section discusses each in turn, and section 6.2 discusses the types of non-economic cooperation that might “piggyback” on these economic discussions.

World Bank (2005:77), on the basis of a thorough review of the literature on the impacts and potential of PTAs, makes a remarkable observation:

“Because logistical, institutional, and regulatory barriers are often more costly than tariffs and generate no offsetting revenue, cooperative governmental efforts to improve customs procedures, minimize the trade distorting impact of standards, and reduce transport costs may have a higher payoff than reciprocal reductions in overt trade policy barriers.”

In other words, it is possible that in many cases there will be a higher payoff from efforts to improve customs procedures, lower transportation costs and jointly address difficulties in meeting standards than there will be to seeking the tariff reductions that are the bread and butter of most PTAs. These types of initiatives will tend to boost trade, make for a more investment-friendly environment, and involve none of the loss of tariff revenues or policy space associated with other forms of trade liberalization.

Transport delays act as a tax on trade equivalent to 0.5 per cent for each day lost (Hummels, 2000). They are typically caused by corruption, unnecessary complexity in customs procedures, or by poor transportation infrastructure. World Bank (2005: Box 4.2) gives graphic illustrations of the magnitude of the problems to be addressed:

- “In Southern Africa, delays at the main border crossing between South Africa and Zimbabwe (Beit Bridge) amounted to six days in February 2003, leading to an estimated loss of earnings per vehicle of \$1,750 (equivalent to the costs of a shipment from Durban to the U.S.).
- In Central Asia, on average, it takes more than 100 hours to cross the border between Uzbekistan and Turkmenistan. A truck traveling from Tashkent to Berlin, passing through Turkmenistan, Iran and Turkey, will spend, on average, a third of total transport time waiting at border crossings (UNESCAP 2003).
- In the Andean Community, trucks spend more than half of the total journey time at border crossings (Pardo 2001).
- Crossing a border in Africa can be equivalent to the cost of more than 1,000 miles of inland transportation; in Western Europe the equivalent is 100 miles (Arvis 2004).”

In the context of a *South-South agreement* there is obviously scope for addressing these types of problems, where they exist, at the bilateral or regional level. Regional and bilateral agreements might aim for standardized single customs documents across jurisdictions, for example, and publicize the procedures via the Internet.<sup>40</sup> There might also be a regional effort to harmonize procedures with international norms, whether across the board or (more likely) in specific sectors of interest. The World Customs Organization has developed a useful set of best practices in customs procedures, and there exist international norms for customs codes and tariff classifications that many countries still do not follow.

A handful of regional agreements already contain some sort of trade and transportation agreement. Of course, the difficulties of ongoing coordination across several ministries and at least two countries should not be minimized.

In the context of a *North-South agreement*, many of the same concerns are relevant, but the efforts need to focus less on cooperation toward solutions—which in many cases require cooperation among neighbours—but rather on funding of capacity building and institution building to make the solutions possible. The results of such work are in the interests of Northern exporters as well, as evidenced by the Northern interest in trade facilitation at the multilateral level.<sup>41</sup>

In the context of standards-related cooperation, there are similar potential payoffs to a coordinated regional or bilateral approach. Rotherham (2003) makes the case that most developing countries face a number of common problems in meeting the standards set by their developed country markets (both private standards and government-mandated technical regulations):

### **Poor systems of information dissemination on existing and draft standards.**

Exporters need to know what foreign standards exist, and need timely information on draft standards, so that they can offer comments on how the standards could be improved to better reflect their concerns. Under the WTO rules, all government standards must be notified, and there is a subsequent period during which standard-setting countries must accept and incorporate comments from foreign producers. In reality, though, this seldom takes place.

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<sup>40</sup> This was done as part of a larger effort in 2003 along the Trans-Kalahari Corridor, which spans South Africa, Namibia and Botswana. See World Bank (2005: 82).

<sup>41</sup> Trade facilitation is one of the four “Singapore issues” that have been strongly pushed by Northern countries as topics for negotiation in the WTO context.

## **High costs of conformity assessment, fuelled in part by the absence of domestic organizations accredited to perform the work.**

Conformity assessment is the process of certifying that a product or process meets the requirements set by a specified standard. The equipment necessary to perform this task across a wide range of disciplines is extremely expensive, and the highly-trained experts necessary to man that equipment are scarce. As a result, most conformity assessment in developing countries is performed by one of a handful of large multinational quality assurance bodies, who charge high field-work rates for their services.<sup>42</sup> Those national bodies that do perform conformity assessment are typically not accredited by importers to certify to their standards. Accreditation is a difficult and expensive process. Accreditation to the Organic Accreditation Service of the International Federation of Organic Agriculture Movements, for example, costs some US\$14,000 per year.<sup>43</sup>

## **Weak national standards bodies.**

National standards bodies (NSBs) should play three primary roles. First, they should participate in international standards formulation in such bodies as the International Organization for Standardization (ISO) and International Electrotechnical Commission (IEC). In this role, NSBs should be both seeking to modify the standards of others to best suit their national interests, and also propounding international standards that are in the interests of their own producers. Rotherham (2003) notes, for example, that there exist no international standards for formaldehyde residues in textiles, or for environmental practices in the production of cut flowers, both of which would benefit many developing country producers. The problem boils down to cost; participation in international standard-setting bodies is expensive, and proactive participation is even more so.

Second, they should be helping their local industries to become more competitive internationally. There are many ways to do so, including informing producers of standards, as discussed above, helping to identify and transfer technologies that will meet international standards, propounding national-level standards that correspond with accepted international standards, forcing technological transformation, building capacity to understand and comply with standards such as ISO 9000 and 14000 series, and so on.

Third, they should be helping to facilitate trade with other countries. The easiest way for a producer to have its products accepted as organic in the EU, for example, is to have its home country's certification system accepted as equivalent to EU certification. Otherwise, shipments must be certified on a one-off basis, raising costs significantly. But obtaining such third party status with the EU is something that requires the efforts of a national institution capable of bringing together various different ministries in a collaborative effort to meet the standards. In general, national standards bodies should be interacting with authorities in other countries to help ensure the smooth flow of standard-meeting exports.

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<sup>42</sup> Rotherham, 2003.

<sup>43</sup> Borregaard, Dufey and Ladron de Guevara (2003). For a full discussion of the difficulties faced by developing countries in meeting foreign standards, and the process of accreditation, see Cosbey (2004), chapter three.

All of these problems have similar results: reduced exports to developed country markets. And all have similar causes: not enough financial resources for governments to act effectively to promote their export interests. This seems like a natural case for regional cooperation.<sup>44</sup> Regional groupings of countries with similar export interests (for example, a South Asian grouping on textiles) could cooperate on a regional body for conformity assessment, on information dissemination on existing and pending standards, on a regional standards body that took on some of the international roles that individual national bodies could not afford to undertake, and so on.

As well, there is scope for regional cooperation to harmonize the standards used in intra-regional trade, preferably matching them to those used as international standards. ASEAN, for example, has agreed to align national standards for 20 widely-traded product groups with international standards propounded by the ISO, the IEC and the International Telecommunications Union. In the end, such harmonization helps companies producing for the regional market to break into markets beyond the region.

The focus suggested here—on lowering trade costs—may or may not be appropriate for any given context. It has particular potential in developing countries but even there it will have varying degrees of propriety. The key point is not the specifics of this approach, but its general thrust toward economic cooperation that has fewer downsides than the current model and as many or more benefits. Other possibilities certainly exist. The Euro-Med agreements, for example, have few immediate commitments to lowering tariffs or to deeper integration; most are simply frameworks for future liberalization efforts. But they do have a focus on technical cooperation, capacity building and development assistance. As such, they represent another form of economic cooperation dialogue—a framework discussion—on which it is possible to “hang” a number of non-economic collaborative initiatives.

## 6.2. Cooperation on non-economic imperatives

Section 5, above, argued that there are a number of important non-economic objectives accomplished in tandem with PTAs. Often, these are not part of the original objectives of the agreement. Mercosur, for example, was conceived as a trade and integration agreement, and at the outset it was never envisioned that the Parties would focus on environmental matters of shared interest. But, as a result of the institutional framework of dialogue and cooperation occasioned by the trade agreement, there arose the opportunity and inclination to work together on environmental issues, both trade-related and non-trade-related.

In other cases, it is clear from the outset that the agreements have a broad focus that includes matters beyond the purely economic. ASEAN’s 1967 Bangkok Declaration, for example, envisions cooperation to contribute to “peace, progress and prosperity in the region, conscious that in an increasingly interdependent world, the cherished ideals of peace, freedom, social justice and economic well-being are best attained by fostering good understanding, good neighbourliness and meaningful cooperation ...”

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<sup>44</sup> For arguments in favour of a regional approach, see Kotschwar, Hufbauer and Wilson (2001) and World Bank (2005) (chapter 4).

Section 5 surveyed a number of the non-commercial objectives to which PTAs currently contribute, either by design or by evolution. They include:

- Cementing security and political relations between partners, or stabilizing potentially antagonistic relations;
- Increasing the sovereign power of the Parties through the strength of association;
- Fostering stability in neighbour states, at least in part from self-interest;
- More effective efforts on social policies such as education and health;
- Coordinated efforts on corruption, security, justice systems, human rights and democracy; and
- Regional environmental integrity.

Pursuit of many of these objectives, while not directly contributing to economic growth, may contribute indirectly. One of the key findings of the literature on investment and growth discussed above is that FDI responds to strong domestic institutions of the type that might be bolstered by regional cooperation: for example, justice systems and education systems. Political and macro-economic stability are also a key attractants, and also are amenable to strengthening through regional cooperation. What investment does come creates more well-being where there are strong regulatory bodies to safeguard public well-being in areas such as the environment, the financial sector, power, water and communications.

Seen in that light, many of these are not merely objectives to be pursued on the sidelines of the economic objectives, as they have been cast to this point in the analysis. In the same way that there may be a greater payoff to focusing on reducing trade costs than on negotiating tariff reductions, there may be more potential for economic growth and increased well-being as a result of a focus on some of the fundamental non-economic objectives that contribute to making countries attractive destinations for investment. Before undertaking any regional efforts at liberalization, states need to at least evaluate the available policy options in light of their objectives. If the primary objective is increased human well-being, the current model of PTA is one option, but not the only option. Another obvious one is regional cooperation on non-economic objectives outside the framework of trade and investment agreements.

At a minimum, given the wide recognition that strong domestic institutions are a prerequisite to the full gains from any liberalization of trade and investment,<sup>45</sup> it may make sense to adopt a phased approach—focusing first on cooperation to strengthen those institutions, within a framework that envisions eventually liberalizing goods and services, and then pursuing deeper integration.

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<sup>45</sup> See Rodrik (2001), Hoekman (2002) (surveying the extensive life's work of Michael J. Finger), for example. Even those frequently associated with an "openness leads to growth" argument concur. The findings of Dollar and Kraay (2000) are not, as widely quoted, that trade openness leads to faster growth. They are, rather, "that increased participation in world trade, *together with good economic and social policies*, has worked well for a diverse group of poor countries." (Dollar and Kraay, 2002) (emphasis in original).

## 7. Conclusions

This paper has made the argument that the current model for PTAs has a number of potential drawbacks, both from the global perspective and from the perspective of the countries involved. These include trade diversion, damage to the multilateral system of trade rules, a possible loss of policy space for development and the protection of public interest, and loss of tariff revenues. The economic benefits from PTAs, on the other hand, tend to be highly uncertain, and depend strongly on domestic factors that determine attractiveness to investors, and the extent to which a country's entrepreneurs are export ready. For developing countries with weak domestic institutions this is a troubling equation.

It was asked why countries should bother with PTAs, since whatever economic benefits they might bring could probably be brought more forcefully through multilateral liberalization. In general, it was argued that whatever the motivation that impels PTAs, it might be more effectively pursued through direct policies. For example, if the goal is growth, focus on the determinants of growth, such as knowledge, human capital, and policies that foster innovation. If it is regional stability, focus on regional cooperation toward that end.

This recommendation, however, ignores the value of the PTA as a supporting forum for achieving these sorts of non-economic objectives. PTAs seem to be capable of helping bring about a number of non-economic benefits, born of the forum they provide for collaboration on matters of shared interest. Various PTAs have made progress on environmental and social issues, diffused regional tensions, cemented better political relations, and so on.

What is needed is a new type of agreement, focussed on those elements of economic cooperation that avoid the downsides of the current model, but which manage to capture the add-on benefits that stem from regional cooperation and dialogue. That is, the reason trade agreements seem to garner associated non-economic benefits is because they provide a platform for regional dialogue and cooperation. So why not provide such a platform using areas of trade negotiations that can be of immediate and unqualified benefit to the negotiating partners? This paper suggests agreements that focus on lowering trade costs as one possibility, given the suggestion that they may harbour large economic payoffs from increased trade.

There is also, of course, scope for amending the current model. The current U.S. model investment treaty, for example, incorporates new language to limit the extent to which provisions on expropriation can be used to attack government public interest regulations. And trade diversion can be minimized by keeping tariff and non-tariff barriers to the rest of the world at low levels, crafting liberal rules of origin and other measures.

In the end, however, this paper argues that a collaborative agenda is more likely to yield positive results than a narrow liberalization agenda. This is certainly true in the South-South context, where theory predicts few gains from free trade in any case, but it is also true in the North-South context. Northern partners, if they are serious about development in their Southern counterparts, should temper their demands for traditional market access and deeper integration demands, and focus instead on trade facilitation, and building institutions that will provide a fertile environment for their investments.

There is, of course, also a large agenda here for official development assistance agencies and development banks, in building up national-level institutions, in fostering regional cooperation to lower trade costs, and to achieve non-economic objectives such as those discussed above.

In the end, it is much more difficult to focus on domestic policies and regional cooperation than it is to simply sign a PTA. But the final result should be worth the effort.

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