

Columbia Studies in WTO Law and Policy

Preferential Trade Agreements

A Law and Economics Analysis

EDITED BY

Kyle W. Bagwell

and Petros C. Mavroidis



CAMBRIDGE

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Preferential Trade Agreements

This book assembles a stellar group of scholars and experts to examine preferential trade agreements (PTAs), a topic that has repeatedly attracted the interest of analysts. It presents a discussion of the evolving economic analysis regarding PTAs and the various dysfunctions that continually place them among the priority items for (re)negotiation by the World Trade Organization (WTO). The book explores recent empirical research that casts doubt on the old "trade diversion" school. It debates why the WTO should deal with PTAs and if PTAs belong under the mandate of the WTO as we now know it.

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Introduction: The Law and Economics of Contingent Protection

An Introduction to the Volume

The chapters assembled in this volume deal with preferential trade agreements (PTAs), a topic that has repeatedly attracted the interest of analysts. One might naturally wonder why we need to revisit this issue once again. We believe that there are various good reasons, not necessarily mutually coherent. First, from a pure policy perspective, it is the World Trade Organization (WTO) through its Director General that has placed this item among the priority items for (re)negotiation. Obviously, the feeling must be that something has not been functioning as expected. We want to explore the legitimacy of this claim. On the other hand, recent empirical research casts doubt to the old “trade diversion” school: papers have seen the light of day arguing that no (or insignificant) trade diversion has resulted from the formation of recent PTAs. If so, why should we deal with PTAs at all? Then there is the issue of content of PTAs: many recent PTAs (i.e., after the advent of the WTO) have a subject matter that does not come under the mandate of the WTO as we now know it. The obvious question in this context is what the role should be of the WTO when dealing with issues such as environmental protection or macroeconomic cooperation.

We have put together a stellar group of researchers to discuss this topic.

In his introductory piece, **Alan Winters** provides a helicopter view of the economics and policy issues surrounding PTAs. He notes at the outset that virtually all countries are members of a trade bloc and many belong to more than one; he goes on to introduce some of the main arguments that have been advanced for and against such regionalism. The author considers not only the traditional economic issues such as trade creation and trade diversion, but also more recent economic arguments such as whether PTAs stimulate investment and growth or promote economic and political credibility, peace, and stability.

James Mathis was invited to write the corresponding legal introductory piece. In his chapter, he considers some implications of the process of legalization of Article XXIV (the legal provision that sets out the requirements that PTAs must meet to be judged consistent with the multilateral trading system) for the so-called friends-or-foes debate between regionalism and multilateralism.

He recounts some of the legal and systemic issues that have concerned General Agreement on Tariffs and Trade (GATT) Article XXIV to show the trend that Article XXIV has been clarified over time and has become a legalized regime in the sense that WTO members are becoming aware of its requirements and (maybe) responding accordingly in their PTA formations. He notes that the recent WTO case of *Brazil–Tyres* is another step in this process where the European Community (EC) made some direct claims challenging the qualification and legal status of the Mercosur customs union under Article XXIV. Also in this case, the author underlines the importance of the Appellate Body's issuing a ruling that establishes GATT Article XX requirements as having a distinct priority over inconsistent regional arbitral rulings.

Caroline Freund discusses third-country effects of PTAs. She asks the question of whether or not regionalism negatively affects nonmembers (of the PTAs). To answer this question, she examines the effect of regional trade agreements on imports from nonmembers and the tariffs that they face. Using data from six regional trade agreements in Latin America and Europe, she does not find evidence that implementation of the regional agreements is associated with trade diversion from third countries to regional members. Using detailed industry data on preference margins and most-favored-nation (MFN) tariffs for three trade agreements in Latin America over twelve years, she finds that greater preference margins do not significantly reduce imports from third countries. She also looks at the effect of preferences on external tariffs. She finds evidence that preferential tariff reduction tends to precede the reduction of external MFN tariffs in a given sector, offering evidence of tariff complementarity. Overall, the results suggest that regionalism does not significantly harm nonmembers.

Thomas J. Prusa and **Robert Teh** in their chapter examine the provisions on antidumping, countervailing duties, and safeguards in seventy-four PTAs. A number of PTAs have succeeded in abolishing contingent protection measures. In addition, about half of PTAs have adopted PTA-specific rules that tighten discipline on the application of contingent protection measures on PTA members. This is most especially the case for antidumping. There is less of an impact for countervailing duty; this is likely because the economic impact of subsidies is global and there is an absence of commitments in PTAs on meaningful curbs on subsidies or state aid. It is very difficult, they argue, to offer a simple summary characterization of the provisions in PTAs. PTAs vary in size, degree of integration, geographic scope, and the level of economic development of their members. Contingent protection provisions vary greatly from one PTA to the next. In fact, contingent protection provisions differ for the *same* country across different PTAs. Some PTAs have additional rules; some have no rules; and others prohibit the use of these actions. Even if we focus only on the PTAs that incorporate additional rules it is hard to characterize what happens; there is no consensus set of provisions that are found in all (or even most) PTAs. The results of the mappings suggest the need to be vigilant about increased discrimination arising from trade

remedy rules in PTAs. If nothing else, the complicated pattern of inclusion of these provisions threatens the delicate give-and-take balancing of incentives that is at the crux of the GATT/WTO agreements. An ongoing policy concern is that the elastic and selective nature of trade remedies may lead to more discrimination, with reduced trade remedy actions against PTA partners, but a greater frequency of trade remedy actions against nonmembers. The adoption of PTA-specific trade remedy rules increases this risk of discrimination, with trade remedies against PTA members being abolished outright or being subjected to greater discipline. In turn, this makes it more difficult for non-PTA members to agree to WTO liberalization because the requisite *quid pro quo* from PTA members may not be realized. Said differently, PTAs may erode the market access that nonmembers thought they had secured in prior WTO rounds, not primarily because of the discriminatory tariffs but rather because of contingent protection rules.

In his comment to the chapter by Prusa and Teh, **David Gantz** provides some contextual background on major trade remedies sanctioned by the WTO, antidumping actions, countervailing duty (antisubsidy) actions, and safeguards. He also examines in some detail the North American Free Trade Agreement (NAFTA) Chapter 19 dispute settlement mechanism for review of national administrative determinations in antidumping and countervailing duty cases and provides a few observations on specific aspects of the Prusa/Teh study.

Joel Trachtman provides a legal analysis of the significance of standards, technical regulations, and sanitary and phytosanitary provisions (collectively, TBTSPS provisions) in PTAs in relation to the multilateral trading system. He first examines the ways in which PTA regulation of national TBTSPS measures may contribute to or detract from liberalization goals. He then describes how GATT Article XXIV and the Understanding on the Interpretation of Article XXIV (the "Understanding"), as presently understood, regulate PTA regulation of national TBTSPS measures. This issue is increasingly important with the growth of PTAs, raising the question of whether and to what extent PTA internal integration is inconsistent with WTO law. There are two main concerns, in the author's view: first, PTAs may engage in internal integration of TPTSPS measures in a way that disadvantages suppliers from third states; second, PTAs may establish internal disciplines on TBTSPS measures by member-states that strike down these member-state measures as applied to suppliers from PTA partners, but not as applied to suppliers from third states. Thus, internal integration might require the nonapplication of a regulatory measure to a PTA partner, while allowing the application of the measure to third countries. For example, in the 2007 *Brazil-Tyres* case, one of the interesting questions was whether Brazil's Mercosur obligations provide it with an exception from its MFN obligations under GATT, allowing Brazil to discriminate in favor of Mercosur-origin retreaded tires. On the basis of this analysis, the author makes a series of recommendations regarding reinterpretation of some key GATT provisions.

Henrik Horn, Petros C. Mavroidis, and André Sapir argue that the growing concern about PTAs stems not only from their increasing number, but also from a perception that many recent PTAs go far beyond the scope of the current WTO agreements. This study examines in detail the coverage of all European Union (EU) and U.S. PTAs by distinguishing two categories of obligations: those already covered by the existing WTO agreements (WTO+), and those falling outside the current WTO (WTO-X). There are two main findings. First, both EU and U.S. PTAs cover a significant number of WTO+ areas, but EU agreements cover many more WTO-X areas than U.S. PTAs. Adjusting for legal inflation, U.S. agreements actually contain more legally binding provisions, both in WTO+ and WTO-X areas, than EU agreements. Second, although EU and U.S. PTAs go significantly beyond the WTO agreements, the number of legally enforceable WTO-X provisions contained in these agreements is in fact quite small. Provisions that can be regarded as really breaking new ground compared to existing WTO agreements only concern three regulatory issues: environment and labor standards for U.S. agreements and competition policy for EC agreements. Both sets of agreements also contain legally enforceable WTO-X provisions in three other regulatory areas, but these are already partly included in existing WTO agreements: investment, capital movement, and intellectual property.

In his comment, **Nuno Limão** states that the chapter provides a careful and systematic classification of the policy areas covered by the reciprocal preferential trade agreements of the United States and European Union as well as the extent of their legal enforceability. Given how unexplored this topic is, he provides suggestions for further research regarding the scope of agreements and countries that could be analyzed and the implications of the analysis for the interaction between preferential and multilateral trade liberalization.

Jeff Kenner deals with labor clauses in EU PTAs focusing on the Cotonou Partnership Agreement. The EU, as the world's largest trading bloc and foremost donor of development aid, seeks to exercise its expanding external powers to promote partnerships with countries that are willing to share its common values. To achieve consistency in its policy approach, the EU has adopted the mainstreaming method to balance the imperative of trade liberalization, in accordance with its WTO obligations, with the promotion of sustainable development, human rights, and foreign policy objectives. Requiring labor clauses as a standard feature of trade agreements has emerged as a central feature of this strategy, justified on the basis that it addresses the social dimension of globalization and is consistent with the International Labor Organization's (ILO) agenda. The Cotonou Partnership Agreement with the African, Caribbean, and Pacific (ACP) group of countries represents the EU's most ambitious attempt to promote market liberalization and development cooperation hand in hand with "positive conditionality, including "fundamental social rights" and international labor standards. Analysis of the agreement reveals that, although the location of the labor clause is somewhat remote, it provides a basis for promoting the ILO's

Core Labor Standards in addition to the parties' obligations under ratified conventions. Complex procedures and the difficulty of warding off charges of protectionism are likely to preempt a sanctions-based response to violations of labor rights. The alternative is a positive approach under which the EU recognizes that it is the stronger partner and should not coerce developing countries by seeking to promote its own values as universal or by exporting its social model. The recent Economic Partnership Agreement between the EU and Caribbean ACP countries could yet prove a model for just such a positive shift under which more confident partners recognize that improvements in labor standards have a beneficial effect on both economic efficiency and competitiveness within a more equitable trading framework.

Juan A. Marchetti deals with preferential liberalization of trade in services. He notes at the outset that it is not a new phenomenon but has become a more common and prominent feature of the latest generation of bilateral PTAs negotiated in this decade. As of September 15, 2010, fifty-six such accords have been notified to the WTO under Article V of the General Agreement on Trade and Services (GATS). Most of those notifications arrived after 2001, and many more agreements are currently being negotiated. One might expect, the author argues, that countries entering these PTAs do so with the objective of eliminating barriers to trade in services, but more importantly, in the hope that the agreements will actually increase bilateral services trade between the parties. Lack of reliable data on trade in services (especially of bilateral flows) has made it almost impossible to carry out empirical studies of the determinants of bilateral services trade flows and – in particular – of the effects of PTAs on trade flows in services. However, the availability of statistics on trade in services has improved over the last year, particularly among Organization for Economic Cooperation and Development (OECD) countries. Taking those developments in the statistical field into account, the main purpose of this chapter is to provide an initial quantitative estimate of the effect of PTAs on bilateral trade in services, using the standard gravity model. Another very important question, particularly when analyzing PTAs from a law and economics perspective, is whether different PTAs have a different impact on trade in services – in other words, whether some of them are more effective than others in promoting trade in services. This question will also be addressed in the chapter by first describing the different modalities adopted by PTAs and second by factoring those differences into the gravity equation.

William J. Davey, in his chapter, tries to advance some thoughts on a model GATT Article XXIV. He notes that the 1995 creation of the WTO in the Uruguay Round of multilateral trade negotiations was a spectacular success, and it appeared to usher into existence a new era of comprehensive multilateralism in world trade. However, viewed a decade and a half later in 2010, the plodding, on-again, off-again WTO Doha negotiations do not compare well at all in terms of effectiveness with the negotiating processes that have led in recent years to

a rapid expansion in the number of PTAs. PTAs pose a serious problem for the WTO. Although their economic impacts may not be that negative, they undermine the multilateral trading system in various ways. They create trade diversion and discrimination problems, lead to greatly increased trade complexity through detailed origin rules and varying standards, lead to instability because each new PTA reshuffles the deck in terms of comparative advantage, and directly undermine the multilateral system by competing for negotiating resources and weakening coalitions in favor of multilateral trade liberalization. Because of the inherent superiority of the multilateral trading system, it is essential to blunt the deleterious effects of PTAs on that system and to try, at a minimum, to ensure that PTAs comply with existing WTO rules. Unfortunately, that may be difficult to do. Whereas it would be preferable to strengthen and clarify the existing WTO rules, that does not seem achievable in the near-to-medium term. Indeed, two recent high-profile reports of leading experts on the future of the WTO have concluded that PTAs represent a serious problem for the multilateral trading system, but they were unable to come up with viable proposals to improve the situation. Thus, this chapter attempts to fashion some more modest proposals that are more likely to be acceptable and yet still have some desirable benefits for the multilateral system in its struggle with the proliferation of PTAs.

In his comment to the chapter, **T. N. Srinivasan** underlines the importance of nondiscriminatory trade liberalization and briefly goes through the danger posed by PTAs. In his view, most of the PTAs in force are not only not free trade agreements (FTAs), but some also go beyond matters relating to trade in goods and services and into investment, competition policy, labor, and environmental standards and intellectual property that may or may not be trade related. He concludes that merely improving Article XXIV, which at best covers Customs Unions (CUS) and FTAs limited to trade, is not enough. Moreover, he is not convinced that clarifying the terms used and making other technical improvements in Article XXIV will obviate all the "long-standing, institutional, political, and legal" difficulties. Although he had no expectation that the Rules negotiations in the Doha Round would have effectively addressed them, as Professor Davey points out, the latest negotiation draft of the chair of the Rules negotiation group does not say anything on Article XXIV.

1 Preferential Trading Agreements: Friend or Foe?

Preferential trading agreements (PTAs) have proliferated inexorably during recent years. Virtually all countries are members of a trade bloc and many belong to more than one; more than two-fifths of world trade takes place within such agreements; PTAs are often advanced as a route to development for poor countries, both PTAs with other poor countries and with richer neighbors.

This chapter introduces some of the main arguments that have been advanced for and against such regionalism, especially, because this is my principal interest, as a tool of development policy. It briefly considers not only the traditional economic issues such as trade creation and trade diversion, but also more recent economic arguments such as whether PTAs stimulate investment and growth or promote economic and political credibility, peace, and stability. PTAs matter for individual countries: for potential members there are questions of whether to join (or perhaps with whom to join) and on what terms; for non-members, questions of whether others' PTAs will have adverse effect on them. In addition, PTAs matter systemically: here the issue is whether they strengthen or weaken the multilateral trading system that has served the world well for the past six decades. In the terminology of Baldwin's (2008) excellent recent survey, there are both "small-think" (individual) and "big-think" (systemic) dimensions to the question of regionalism, although I do not accept the implication that the former are uninteresting or unimportant.

The literature on PTAs has proliferated even faster than the phenomenon itself, but not the set of convincing general results to which one can appeal for policy guidance. There are at least two reasons for this. First, the question is complicated compared with normal trade policy analysis: it necessarily involves three parties – a home country, a partner country, and an excluded country – and it inevitably involves the general theory of second best where one set of distortions to trade (tariffs on the partner's sales in the home country) is examined

in the presence of another (tariffs on excluded country sales).¹ The analysis of PTAs now also wrestles with inherently complex issues such as multidimensional negotiations and the effects of regulation.

Second, there is not a great deal of experience from which to draw empirical conclusions. Partly this is because (nearly) every PTA is *sui generis* to a significant extent, and it is not clear how to simplify them analytically into a common form in an innocuous way. In addition, for systematic questions, which are generally of a very long-term nature, we have no data on a trading system containing a large number of effective PTAs. Because the big question is whether to head further in this direction, this is a serious shortcoming. Thus, this introduction is neither comprehensive nor unambiguous. I will – simply, I hope – lay out a few theoretical constructs, consider some of the more important empirical results, and sketch some of the policy debate. I hope that this chapter will provide a context into which to fit the more specialized chapters that follow.

1. Member Countries

1.1. Trade Effects

The modern economic analysis of tariff preferences dates back to Viner (1950).² As many economists have observed, Viner's formal treatment is incomplete and rather confusing (the book is nonetheless a great and wise contribution), but it is so intuitive and so central to the discourse that I reiterate it here.

A PTA, by removing barriers on trade between members of the PTA but not on trade with excluded (nonmember) countries, almost always increases trade between the members. The issue, however, is whether it “creates” trade by allowing cheaper products from other bloc members to substitute for more expensive domestic production, or “diverts” it by substituting intra-bloc imports for imports from outside the group. The latter can happen when outside goods would be cheaper if all suppliers faced equal tariffs, but because inside goods no longer face tariffs this gives them a competitive edge. In that case, the preference-granting country ends up paying more for the imports, the increase being financed by monies that were initially going to the government in tariff revenues now accruing to producers in the partner countries. Part of this extra cost is a simple transfer from the taxpayers in the importing country to producers in the newly exporting partner, but because the real cost of imports has risen (the partner is less efficient than outside producers, for otherwise it would have been supplying the goods in the first place), real resources are also wasted by the

¹ Second-best theory argues that although removing all distortions in an economy may be shown to be welfare improving, removing some while leaving others may or may not be.

² Baldwin (2008) cites earlier contributions, notably Adam Smith's “certainty” that partners gain when they get preferential access to home markets, and Gottfried Haberler's “spillover,” which indicated that excluded countries lose from this.

diversion. When all the commodities covered by the PTA are considered together, if trade diversion predominates, a PTA can reduce the welfare of all or some of the member countries.

Identifying and distinguishing between trade creation and trade diversion is not straightforward empirically. The greatest difficulty is deciding what trade would have looked like if no PTA had been formed – the counterfactual or what the Europeans refer to as the *anti-monde*. This is more a matter of judgment than of science, particularly when it comes to considering whether regionalism is central or incidental to the general liberalization of trade. The evidence on the balance between trade creation and diversion in trade blocs is mixed, but recent research shows that diversion can be quite significant – see for example Soloaga and Winters (2001).

A common way of establishing the *anti-monde* is by comparing the trade of PTA members with that of nonmembers, allowing for various other explanatory factors. These days, the standard tool for doing this is the so-called gravity model of international trade, which explains trade between countries in terms of their gross domestic products (GDPs), populations, distance from each other, contiguity, remoteness from markets, and various trade agreements.³ Over time, these exercises have shown quite mixed results on the extent to which PTAs increase trade between members and reduce it between members and nonmembers. Recently, however, it has been observed that this ambiguity might be because PTAs are “endogenous,” that is, caused by the same set of factors as determine trade flow. Suppose that countries sign PTAs with countries with whom their trade is significantly below what one might expect on the basis of gravity model (i.e., with partners with whom they apparently have a high potential to increase trade). The PTA might bring trade up to normal levels, but precisely because it now looks normal the estimated gravity model will not find anything special about having a PTA and suggest that PTAs have no effect. Baier and Bergstrand (2007) make this argument and find that, allowing for it, PTAs roughly double the amount of trade between members. (I will return to the factors that influence PTA formation in a later section.)

The traditional analysis of trade creation and diversion is based on a view of the world in which intercountry trade is driven entirely by differences in productivity and factor endowments. In fact, trade can also arise from product differentiation and economies of scale, which reduce costs as production grows. Import barriers in such worlds are additionally costly because competition between firms is weakened and consumers lose from the resulting cuts in output and increases in price. International trade offers an important means of increasing competition by allowing new suppliers to enter markets. PTAs can generate such benefits by fostering trade between members, combining larger firm sizes (which increases economies of scale) with competition between larger numbers of firms

³ See Winters (1987) for an accessible discussion of other approaches to the *anti-monde*.