

# Preferential Trade Agreements

## Stepping Stones or Stumbling Blocks for Free Trade?

*Robin Koepke*

The impact of preferential trade agreements (PTAs) on the multilateral trading system (MTS) is the subject of heated academic debate. PTAs have been reviewed in academic literature since as early as the 1950s. Only in recent decades, however, have they become such a controversial issue. Since the 1980s and 1990s, when the number of PTAs permeating the world trading system increased exponentially, the scientific debate as to whether PTAs are beneficial or harmful for global free trade has been approached from very rigorous positions. Some of the most distinguished international economists have taken a stance on whether PTAs are “stepping stones or stumbling blocks” for free trade, as the eminent Jagdish Bhagwati famously put it.<sup>1</sup> Some praise the virtues and merits of preferential liberalization, others call for putting an end to what they view as a disastrous epidemic of proliferating PTAs.

As multilateral trade rounds took longer and longer, PTAs began to flourish and are now a fact of life in the global trading system. One reason for their vast proliferation was indeed that multilateral negotiations were perceived as too slow and inefficient to reach free trade. A number of policymakers and economists saw preferential trade blocs as a viable alternative to multilateral tariff cutting. For them, “...the formation of such blocs appears to offer a

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<sup>1</sup> Jagdish Bhagwati and Arvind Panagariya. *Stepping Stones or Stumbling Blocks: The Economics of Preferential Trade Agreements* (AEI Press, 1996).

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path to liberalization with a much shorter timetable.”<sup>2</sup> Thus far, however, PTAs have fallen short of meeting these ambitious expectations. Instead, the exponential growth of PTAs in the last decades has profoundly transformed the MTS. Criss-crossing agreements with one-of-a-kind rules of origin have multiplied the complexity of regulations. Today, few observers would contend that the chaotic structure of preferential trading is an ideal way to organize international trade.

This paper provides an analysis of the medium and long-term impact that PTAs will have on the multilateral trading system. The main part is divided into three chapters, whose findings will be summarized at the end of this paper. The next section of this introduction presents an analytical framework explaining the structure and the logical approach used in the main part. This framework serves the purpose of guiding the reader through the various arguments discussed. In particular, it provides a coherent outline of how these arguments relate to each other.

First, however, I will present some background information on the recent history of PTAs and on their role in the multilateral trading system. This will lay the foundation for discussing the arguments for and against PTAs.

### *The Changing Dynamics of Preferential Liberalization*

The purpose of this section is to convey some indispensable factual knowledge about PTAs. First, I will describe the principal legal and historical cornerstones of preferential trading. Then, the recent growth in the number of PTAs will be explored. Finally, I will describe the main trends that mark the proliferation of PTAs to date.

#### LEGAL BACKGROUND

By nature, preferential liberalization is discriminatory because one trading partner is favored over another. Therefore, PTAs represent an exception to the most-favored nation (MFN) principle of the General Agreement on Tariffs and Trade (GATT). In Article XXIV of

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<sup>2</sup> Ross Garnaut and David Vines, “Regional free trade areas: sorting out the tangled spaghetti,” *Oxford Review of Economic Policy* 23 (2007): 514.

the GATT, its founders established this exception with the intent to allow countries to liberalize their markets at a faster pace than would be possible through multilateral negotiations. Interestingly, the original draft of the GATT limited this exception to creating customs unions (CUs); this provision, however, never came into force. Instead, the respective paragraph allows PTAs where tariffs “...are eliminated on substantially all the trade.”<sup>3</sup> This vague limitation opened the doors to today’s proliferation of PTAs because it turned out to be very difficult to apply legally. Throughout its history, the GATT only approved one PTA, though none were ever rejected.

Since the conclusion of the Tokyo Round in 1979, the so-called “Enabling Clause” has stipulated two more exceptions to MFN treatment. First, it allows developing countries to lower (rather than eliminate) tariffs in PTAs. Second, it allows developed countries to grant non-reciprocal preferences to developing countries. Both provisions were established to foster trade and development in poor nations. These original intentions are important for assessing the development that preferential liberalization took in the last decades.

### *Preferential Liberalization since 1948*

In the first decades after the conclusion of the GATT in 1948, *multilateral* liberalization proved highly successful in reducing tariffs. Eight rounds of multilateral trade negotiations effectively brought down average applied tariffs in developed countries from around 17 percent in 1950 to 7 percent in the mid-1980s, and down further to approximately 4 percent in 2000.<sup>4</sup> There are, of course, exceptions. Some developing countries maintain high tariffs for a wide range of products. In developed countries, sensitive sectors are still subject to significant protection, especially the agricultural and textile sectors. Nonetheless, the overwhelming multilateral progress towards free trade left little need for preferential liberalization. For

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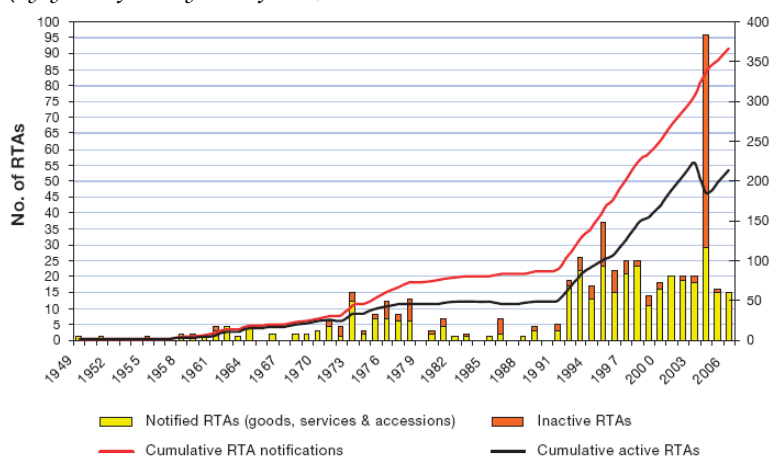
<sup>3</sup> GATT, *Text of the General Agreement* (Geneva: GATT Secretariat, 1986).

<sup>4</sup> Richard Baldwin, *Multilaterising Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade*. (Geneva: Graduate Institute of International Studies, 2006).

many years, the main purpose of PTAs was to promote economic and political integration on a regional level. Some examples are provided by the establishment of the European Economic Community (EEC) in 1957, the European Free Trade Area (EFTA) in 1960, and the New Zealand Australia FTA in 1965.

Since the lengthy and protracted negotiations that characterized the Uruguay Round (1986–1994), preferential liberalization has moved to the center stage of international trade policy. As a result, the number of PTAs in force has increased tremendously. The chart below illustrates the number of PTAs notified and in force since 1948.

*Figure 1: All PTAs Notified to the GATT/WTO (1948-2006)  
(by year of entry into force)*



Source: WTO, 2007

In particular, the chart illustrates the sharp rise in the number of PTAs in the early 1990s. In addition to the slow progress in multilateral negotiations, this sudden rise can be attributed to two events. First, the political and economic upheaval after the end of the Cold War with the dissolution of the USSR into many independent countries. This did not just lead to a fundamentally different international political landscape. It also resulted in a large number of PTAs being concluded between both the EU and EFTA

on the one hand, and Central and Eastern European Countries (CEECs) on the other. Second, the U.S. turned from a strong supporter of multilateralism into an avid participant in preferential liberalization. This triggered a similar trend in the Americas, with PTAs being demanded by countries such as Chile, Brazil, Argentina, Uruguay, and Paraguay. In a "...race for securing preferentially the neighbours' markets for one's exports," countries around the globe engaged in preferential negotiations.<sup>5</sup> As of May 2008, the WTO counts 205 PTAs that are currently in force.<sup>6</sup> According to a World Bank study, in the years from 2000 to 2002, approximately 32 percent of world trade took place between PTA partners.<sup>7</sup>

The stalemate in the current WTO Ministerial Round, called the Doha Development Agenda, has given further impetus to this trend. As a result, many scholars are united in thinking that "...regionalism is here to stay."<sup>8</sup> In the following chapters, I will analyze the implications of PTAs for the multilateral trading system. The analytical framework presented in the next section will serve as a guide for discussing the arguments.

### *Analytical Framework*

Figure 2 aims to give an overview of the analytical approach used in this paper. The discussion of the essential arguments for and against PTAs is divided into three chronological categories. These three categories correspond to chapters 2 to 4, respectively. The time frames are labeled *short term*, *medium term*, and *long term*. This trichotomy is of course stylized; in reality, the transition between any of these time frames will always be gradual. Nonetheless, these

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<sup>5</sup> Arvind Panagariya, "The Regionalism Debate: An Overview," *World Economy* 22:4 (1999): 481.

<sup>6</sup> WTO, "Regional Trade Agreements Notified to the GATT/WTO and in Force," [http://www.wto.org/english/tratop\\_e/region\\_e/regfac\\_e.htm](http://www.wto.org/english/tratop_e/region_e/regfac_e.htm) (accessed July 12, 2008).

<sup>7</sup> World Bank, *Preferential Trade Agreements and Their Role in World Trade* (World Bank Policy Research Working Paper 4038 (Washington: 2006).

<sup>8</sup> Richard Baldwin, *Multilaterising Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade* (Geneva: Graduate Institute of International Studies, 2006).

categories will prove helpful for organizing the arguments and for understanding the perspective taken in each chapter.

In the first part, Chapter 2, I will focus on the immediate effects arising upon the formation of a PTA. The first question is related to static welfare analysis and explores *whether PTAs are primarily trade creating or trade diverting*. Then, I will discuss *how regulatory complexity (called "spaghetti bowls") affects the global trading system*. As Figure 2 shows, these two key issues of trade diversion/creation and spaghetti bowls also bear on the medium and long term analysis. The third question is how a country's attitude towards multilateralism changes as an immediate result of a PTA formation. In other words, *do countries tend to raise or lower their multilateral barriers to trade?*

The focus of Chapter 3 is on the medium term. The analysis is geared towards the impact of PTAs on negotiations in a WTO Ministerial Round. The overarching question for Chapter 3 is *whether PTAs make a multilateral agreement more or less likely*.

There are two types of arguments. First, I will analyze changes in the political economy equilibrium. The question here is *how PTAs affect political support in the form of interest group lobbyism*. Second, I will dissect the impacts PTAs have on governments' institutional capabilities to conduct multilateral negotiations. More specifically, the question is *whether PTAs empower or distract governments from multilateral negotiations*.

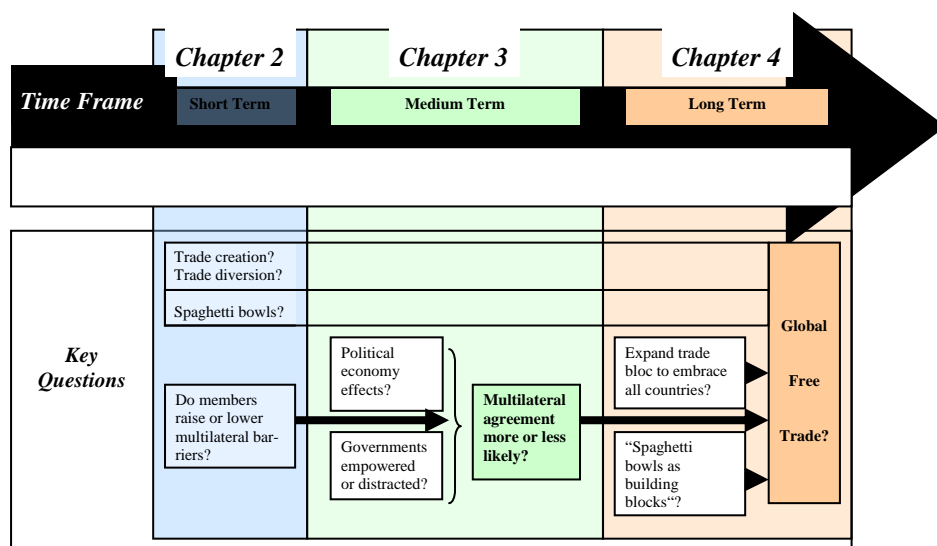


Figure 2: Analytical Framework

### Static, Systemic, and Short Term Effects of PTAs

This is the first chapter concerned with discussing the effects of PTAs on the multilateral trading system. It focuses on three central issues. The first section analyzes the changes in welfare a PTA brings about using static welfare analysis. The key question here is *whether PTAs are rather "trade creating" or "trade diverting."* Then, I will turn to the regulatory complexity ("spaghetti bowls") and expound the principal systemic risks it carries for the MTS. The third issue relates to how a country's attitude towards multilateralism changes after entering a PTA. The key question here is *whether countries tend to lower or raise their multilateral barriers to trade as a consequence of forming a PTA.*

### Static Welfare Analysis: Trade Creation and Trade Diversion

Static welfare analysis is an important criterion to judge the desirability of a PTA. In general, static welfare analysis is concerned with analyzing a change in economic conditions that results in a

change in welfare. "Static" in this context means that these changes are assumed to be constant over time. "Welfare" refers to economic well-being, i.e. the utility individuals derive from economic goods.

Welfare effects of PTAs can be analyzed on four different levels: first, for each of the PTA countries taken separately; second, for the PTA countries combined; third, for the outside world; and fourth, for the world as a whole.<sup>9</sup> This paper is concerned with the *overall* impact of PTAs on the international trading system; hence, I will focus on the last of these four levels, the welfare effects of PTAs on the world as a whole.

Static welfare analysis of PTAs is based on Jacob Viner's distinction of *trade creation* and *trade diversion*.<sup>10</sup> Trade creation refers to a country reducing its domestic production in favor of imports from a PTA partner. The overall welfare effect of trade creation is positive because production is shifted according to comparative advantage. Trade diversion, on the other hand, refers to products previously imported from a third-party country, but now imported from a PTA member. In other words, the source of imports merely shifts because tariffs are lower. Trade diversion is an ambiguous factor whose impact depends on the level of analysis used. For the world as a whole, trade diversion is always welfare-reducing because production is shifted against comparative advantage. Thus, it follows from Viner's distinction that PTAs that are primarily trade creating are beneficial to the international trading system, whereas PTAs that predominantly divert trade are harmful. An important question therefore is what factors determine if a PTA creates or diverts trade. The answer to this question will help in assessing if PTAs bring about positive or negative welfare effects. The key factors which determine the relationship of trade creation to trade diversion include political economy factors, geographical proximity, and the market sizes of member countries.

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<sup>9</sup> Jacob Viner, "The Customs Union Issue," *Carnegie Endowment for International Peace* (New York, 1950).

<sup>10</sup> Ibid.



*Political Economy Factors*

Several political economy factors can be identified that explain why PTAs tend to result in trade diversion rather than trade creation.

To start, political economy analysis of PTAs is often based on the assumption that "...producers play the central role in determining trade policies."<sup>11</sup> The fundamental reason for this is that political economy forces are asymmetric. This is because the strength of these forces depends on the distribution of the benefits from lobbying. The more concentrated the benefits from lobbying are, the stronger will be the efforts of an interest group to stake out its claims. Most trade issues have highly concentrated benefits on the producer side and very diffuse ones on the consumer side. For example, agricultural tariffs impute relatively small, but concentrated, benefits for relatively few farmers. The costs of agricultural tariffs, though larger than the benefits, are spread over many consumers. As a result, producer lobbies are much stronger than consumer lobbies. This asymmetrical set-up accounts for many economically sub-optimal outcomes in the politically optimal tariff choice.

Garnaut and Vines argue that the political economy of the policy-making process tends to push PTAs towards trade diversion.<sup>12</sup> The reason is that trade creation by definition involves increased import competition for domestic producers. As a consequence, import-competing firms will lobby against tariff cuts in their sectors. For sectors affected by trade diversion, there is no domestic lobby because trade diversion only affects producers in third-party countries. Therefore, political economy forces will tend to result in a disproportionate share of trade diversion.

In a similar line of thought, Panagariya argues that, by design, PTAs tend to foster trade diversion. He identifies a mechanism of adverse selection of PTAs which tend to divert trade. His starting point is that *uncompetitive industries are the ones that have the strongest*

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<sup>11</sup> Arvind Panagariya, "The Regionalism Debate: An Overview," *World Economy* 22:4 (1999): 498.

<sup>12</sup> Ross Garnaut and David Vines, "Regional free trade areas: sorting out the tangled spaghetti," *Oxford Review of Economic Policy* 23 (2007): 514.

*interest in protection.* Hence, they will make disproportionately high efforts to avoid liberalization in the first place. Therefore, they have greater success in lobbying against foreign competition. As a result, uncompetitive sectors that would create trade if they were liberalized tend to remain unaffected. This is why "PTAs get voted in precisely when trade diversion is the dominant force."<sup>13</sup>

### *Natural Trading Partners*

In the decades following Viner's seminal distinction, economists have tried to identify characteristics of countries which result in trade creation rather than trade diversion. Their findings, however, where only "...of limited practical applicability."<sup>14</sup> Only one characteristic proved useful: geographical proximity. Wonnacott and Lutz were the first to argue that trade between close countries that already exchange a high volume of products should be considered "natural."<sup>15</sup> This led to the natural trading partners hypothesis, which posits that "natural" trade can be liberalized largely without invoking the negative effects of trade diversion. As Summers put it, "...to the extent that blocs are created between countries that already trade disproportionately, the risk of large amounts of trade diversion is reduced."<sup>16</sup> The argument becomes clear if we employ a stylized example.<sup>17</sup>

Imagine a world of four countries, where two countries are each located on one continent. Further, intercontinental transport costs are assumed to be so high that, say, 99 percent of trade take place between continental neighbors, even in the absence of preferential

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<sup>13</sup> Arvind Panagariya, "The Regionalism Debate: An Overview," *World Economy* 22:4 (1999): 486.

<sup>14</sup> Pravin Krishna, *Trade Blocs: Economics and Politics*, ed. Jeffrey J Schott (New York: Cambridge University Press, 2005).

<sup>15</sup> Paul Wonnacott and Mark Lutz, *Is There a Case for Free Trade Areas?* *Free Trade Areas and U.S. Trade Policy*, (Washington: Institute for International Economics).

<sup>16</sup> Lawrence Summers, "Regionalism and the World Trading System," *Policy Implications of Trade and Currency Zones*. Symposium Sponsored by the Federal Reserve Bank of Kansas City, 1991, 297.

<sup>17</sup> Paul Krugman, "The Move to Free Trade Zones," *Policy Implications of Trade and Currency Zones*. Symposium Sponsored by the Federal Reserve Bank of Kansas City, 1991, 7-41.

tariffs. Under these conditions, a continental PTA would cause hardly any trade diversion, but potentially lots of trade creation. The reason is that the *absolute* level of trade with outsiders is so low that it hardly affects the welfare balance at all. For the two PTA members, on the other hand, the preferential tariff will liberalize their international trade almost entirely. Based on this type of reasoning, regionalism has often been argued to be a decisive factor for generating the benefits of preferential liberalization.

Since the 1990s, however, economists including Bhagwati, Panagariya, and Krishna have vehemently criticized the natural trading partners hypothesis.<sup>18, 19, 20</sup> They dispute the logic that welfare changes should depend on the absolute level of initial trade. Instead, they claim that trade diversion is purely about marginal changes. In their views, the scale of trade diversion depends entirely on how a partner country's exports change in response to preferential tariffs.

Moreover, as explained in more depth in Chapter 2.3, Panagariya argues that PTAs among natural trading partners tend to incur higher multilateral tariffs.<sup>21</sup> This argument especially applies to developing countries, where tariff cuts may produce a critical loss in tariff revenue. The greater the initial volume of trade, the larger the tariff revenue loss and thus the incentive to raise multilateral tariffs.

Further, Panagariya argues that the definition of natural trading partners is arbitrary. For example, according to the concept commonly used, "...the United States may be the natural trading partner of Mexico but the reverse is not true."<sup>22</sup> Finally, econometric analysis of empirical data has not been able to prove the natural

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<sup>18</sup> Jagdish Bhagwati, "U.S. Trade Policy: The Infatuation with Free Trade Areas," *The Dangerous Drift to Preferential Trade Agreements* ed. Jagdish Bhagwati; and Anne Osborne Krueger (Washington: American Enterprise Institute for Public Policy Research, 1995).

<sup>19</sup> Arvind Panagariya, "The Free Trade Area of the Americas: Good for Latin America?" *World Economy* (1996): 485-515.

<sup>20</sup> Pravin Krishna, *Trade Blocs: Economics and Politics*, (New York: Cambridge University Press, 2005).

<sup>21</sup> Arvind Panagariya, "The Regionalism Debate: An Overview," *World Economy* 22:4 (1999): 477-511.

<sup>22</sup> Op.cit. 485f.

trading partner hypothesis. As a result of a comprehensive study on U.S. trade data from 1965 to 1990, Pravin Krishna comes to the conclusion that “distance is not found to be significantly related to welfare change.”<sup>23</sup>

### *The Spaghetti Bowl Syndrome*

The original idea behind PTAs was that over time, regional preferences would be extended on an MFN basis, thus benefiting all WTO members equally. This, however, has rarely ever happened. Instead, the preservation of preferential margins has become a fact of life in the multilateral trading system, while the number of PTAs increased immensely. The “spaghetti bowl” metaphor describes the systemic problem that is connected to the chaotic structure of international preferential trading. Jagdish Bhagwati first used this metaphor in 1995 to draw attention to the hazardous implications of proliferating PTAs. The spaghetti denote the criss-crossing strings of preferential trade relations between countries and regions. In a narrow sense, the metaphor refers to the overlapping rules of origin, which are different for each PTA concluded. ROOs stipulate the proportion of the value added that must be created within the PTA for a product to be duty-free.

In order to gain a more intuitive understanding of the spaghetti bowl syndrome, it is helpful to have a look at the PTA patterns that have emerged as a result of the race to preferential liberalization. The map in Figure 3 illustrates the PTA network in the Western Hemisphere as a typical example of the spaghetti bowl. The distinctive pattern of criss-crossing agreements is made up of country-to-country bilaterals (such as the PTA between the U.S. and Chile), country-to-region bilaterals (such as the PTA between MERCOSUR and Chile), and cross-regional bilaterals (such as the PTA under consideration between MERCOSUR and CARICOM). One can clearly see how these multilevel schemes of tariff differentials make up what Bhagwati called a “messy maze of

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<sup>23</sup> Pravin Krishna, *Trade Blocs: Economics and Politics* (New York: Cambridge University Press, 2005).

preferences.”<sup>24</sup> The spaghetti bowl pattern also applies to each of Europe, Africa, and Asia. Furthermore, the pattern also repeats itself on the global level, with a regulatory spaghetti bowl composed of an impressive number of *cross-regional* agreements.

To understand the difficulties that arise with the enormous number of PTAs concluded in recent years, it is necessary to shed some light on the legal design of preferential agreements. Two basic set-ups of PTAs can be distinguished. Free Trade Areas (FTAs), on the one hand, provide for the duty-free exchange of internally produced goods. In customs unions, on the other hand, member countries additionally have a common external tariff. With only 8 percent of PTAs set up as customs unions, the vast majority of agreements in force in 2006 has no such common external trade policy.<sup>25</sup>

In the absence of a common external tariff, there is a risk that imports from outside countries destined to high-tariff members enter through low-tariff members. Similarly, firms in low-tariff countries might import products that are almost finished and re-export the final product to the high-tariff country. This *trade deflection* would effectively damage the high-tariff country because it would lose tariff revenue. To prevent this kind of arbitrage, countries have introduced rules of origin that govern the requirements of PTA products that are eligible for preferential treatment.

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<sup>24</sup> Jagdish Bhagwati, *Free Trade Today* (Princeton: Princeton University Press, 2002).

<sup>25</sup> WTO, *The Changing Landscape of Regional Trade Agreements: 2006 Update* (Geneva: WTO Secretariat, 2007).

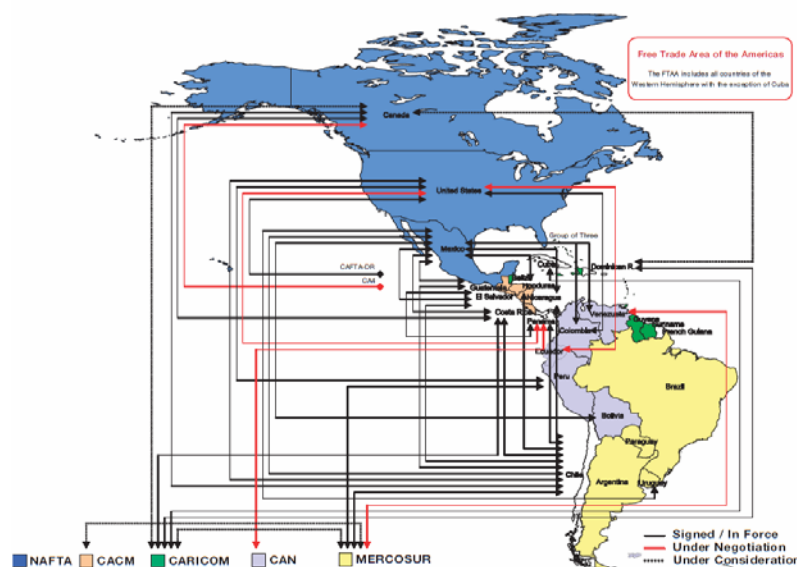


Figure 3: Spaghetti Bowl of American Intra-Regional PTA Network

In view of the described spaghetti bowl of criss-crossing PTAs, the problem becomes apparent: producers are faced with an enormous amount of regulations. This makes it virtually impossible for firms selling to various competing PTAs to fulfil all the different ROO specifications. As a consequence, these spaghetti bowls carry two critical systemic risks. First, they distort the economic incentives in the global production system. Indeed, the WTO acknowledges that there is a risk of “...shifting production from comparative advantage to competitive preferences.”<sup>26</sup>

Second, they add to regulatory complexity, from which particularly less well-endowed actors, such as small and medium-sized enterprises (SMEs), in developing countries, suffer.

### *Changes in a Country's Multilateral Trade Barriers*

PTAs not only have immediate welfare effects, they also directly affect a country's attitude towards its multilateral trade barriers. In

<sup>26</sup> Op.cit.

this context, the central issue is how governments are influenced in using overt and secret tools to alter trade restrictions. In other words, *what are the effects of preferential liberalization on countries' incentives to alter MFN tariffs?*

The answers the academic literature provides to this question are ambiguous. On the one hand, economists including Freund show that after concluding a PTA, countries tend to reduce their MFN tariffs.<sup>27</sup> On the other hand, Richardson and Panagariya argue the opposite is the case.<sup>28, 29</sup> The analysis set out below discusses the most frequent arguments cited in support of each view.

### *Tariffs*

When the GATT was set up, negotiators were well aware of the problem that countries might preferentially liberalize their market while increasing their MFN tariffs. They introduced a clause that should prevent such abuse of preferential trading, indicated under Article XXIV:5b. This clause stipulates that after the conclusion of a PTA, "...duties [...] shall not be higher or more restrictive than the corresponding duties [...] prior to the formation of the free-trade area."<sup>30</sup> However, as developing countries often charge tariffs below the stipulated MFN rates ("bound rates"), they are still able to increase applied rates up to the bound rates. An example of this is provided by Mexico's trade policy after the 1994/1995 peso crisis. Mexico raised multilateral tariffs on numerous items while leaving the NAFTA rates unchanged.<sup>31</sup>

The risk of PTA countries raising their multilateral tariffs is especially relevant in the case of developing countries. For many developing countries, tariff revenue constitutes an important source

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<sup>27</sup> Caroline Freund, "Multilateralism and the Endogenous Formation of Free Trade Agreements," *Journal of International Economics* 115 (2000): 1317-41.

<sup>28</sup> Martin Richardson, "Why a Free Trade Area? The Tariff Also Rises," *Economics and Politics* 6:1 (1995): 79-96.

<sup>29</sup> Arvind Panagariya, "The Regionalism Debate: An Overview," *World Economy* 22:4 (1999): 477-511.

<sup>30</sup> GATT, *Text of the General Agreement*, (Geneva: GATT Secretariat, 1986).

<sup>31</sup> Arvind Panagariya, "The Regionalism Debate: An Overview," *World Economy* 22:4 (1999): 477-511.

of income. Governments in developing countries often find it hard to substitute losses in tariff revenue for other sources of income. This lack of alternatives puts preferentially liberalizing developing countries in a difficult position. Panagariya argues that in many cases, developing countries counterbalance the loss of tariff revenue a PTA causes by increasing multilateral tariffs. In this case, regional preferences would be directly to the detriment of multilateralism. In particular, the formation of PTAs among natural trading partners (which by definition trade substantially with each other) implies an even greater loss in tariff revenue. As a consequence, the incentive to raise multilateral tariffs will also be greater. This effect increases the tariff differentials between natural trading partners on the one hand, and the rest of the world on the other, and thus fuels the formation of trade blocs.

### *Non-Tariff Barriers*

Even if the internationally agreed upon WTO tariffs pose a constraint to increasing trade barriers, governments have other means at their disposal to keep imports away. In the realm of non-tariff barriers, two measures are frequently used to deter third-party countries from accessing one's markets.

First, anti-dumping actions are measures taken against selling products at a price "...less than the normal value of the products."<sup>32</sup> In most cases, this "normal value" refers to the "...comparable price [...] in the exporting country."<sup>33</sup> Thus, governments can target specific firms and levy countervailing duties to offset the margin of dumping. As Bhagwati argues, "...it is precisely the fact that antidumping actions can be used selectively against, not just countries, but specific firms, and that dumping margins are often calculated arbitrarily through 'reconstructed' costs and even prices, that has made them the preferred method of protectionism."<sup>34</sup> As opposed to changes in tariff rates, the extent of anti-dumping

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<sup>32</sup> GATT, *Text of the General Agreement* (Geneva: GATT Secretariat, 1986).

<sup>33</sup> *Op.cit.*, p. 10

<sup>34</sup> Jagdish Bhagwati, *Free Trade Today* (Princeton: Princeton University Press, 2002).



actions is hard to quantify. This makes it difficult to assess the scale such measures have as a response to increased regional competition.

Second, voluntary export restraints (VERs) stipulated with domestic or foreign firms limit the volume of goods exported in particular sectors. VERs are not as voluntary as their name suggests: they are usually imposed by exporting countries under pressure from a powerful importing country's government seeking protection for sensitive sectors. As a result of the Uruguay Round, WTO members agreed to restrain from implementing new VERs and to phase out existing ones over a four year period. Nonetheless, it is the implicit nature of VERs that makes their proscription rather difficult.

As suggested in the previous paragraph, tariff barriers are limited by Article XXIV and can be monitored more easily. Therefore, it is hardly surprising that anti-dumping actions and VERs "...are precisely the form of protectionism that have become fashionable" after the surge of PTAs in the 1990s.<sup>35</sup> As a result, changes in non-tariff barriers constitute a type of clandestine protectionism, undermining the potentially beneficial impact of trade creation in PTAs.

### *Medium Term Effects of PTAs on Multilateral Negotiations*

This chapter analyzes the medium term effects of PTAs on the multilateral trading system. The perspective taken here focuses on how PTAs affect subsequent negotiations in a WTO Ministerial Round. The key question is *whether PTAs make a multilateral agreement more or less likely*.

The answer to this question is immediately relevant to the issue of PTAs being stepping stones or stumbling blocks for free trade. In the stepping stones scenario, PTAs would encourage a multilateral round of tariff cuttings, thus speeding up this classical approach of achieving global free trade. In the stumbling blocks scenario, however, PTAs would prevent multilateral agreements, potentially leaving the world with a suboptimal organization of global trade.

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<sup>35</sup> Op.cit.

The time frame is the medium term, i.e. it is not concerned with immediate welfare or tariff changes in PTA countries. Nor is it about the “final frontier” to global free trade, which will be explored in Chapter 4. The issues considered in this part are twofold: they are either attributable to political economy effects or pertain to changes in governments’ capabilities to conduct trade negotiations.

### *Political Economy Effects*

The effects PTAs have on domestic interest groups are of great importance. They determine to a large extent the domestic support governments have in multilateral trade negotiations. A political economy framework is helpful to assess the impact PTAs have on a country’s multilateral tariff choice.<sup>36</sup> In political economy terms, governments choose a tariff to balance the *supply and demand for protection* (i.e. for imposing a particular tariff), just like prices balance supply and demand in a competitive market. Interest groups lobbying for and against protection determine the demand. Thus, the demand curve for protection represents the marginal utility that firms derive from a tariff change. The supply of protection is determined by the political cost of imposing a tariff. *Ceteris paribus*, a shift in the demand curve leads to a change in the politically optimal tariff. Departing from this analytical approach, several points can be made about the political economy effects of PTAs.

### *PTAs Activate Interest Groups*

Especially in developing countries, PTAs are politically easier to achieve than multilateral agreements. Developing countries often have high barriers to international trade and may use PTAs as a first step to opening their markets. Historically, PTAs have been influential in getting government officials at the bargaining table for the first time. Regional agreements, especially bilateral ones, are

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<sup>36</sup> Richard Baldwin, *Multilaterising Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade*. (Geneva: Graduate Institute of International Studies, 2006).

“...the natural level for inward-looking countries with low international dependence.”<sup>37</sup> For developing countries, regional integration increases international interdependence, which in turn strengthens a country’s stake in international economic relations. Once these countries start to look beyond their national boundaries, economic agents will become more interested in participating in international trade. Producers of export goods will enter enduring relations with their governments and become established interest groups in the pursuit of freer trade. As a consequence, the demand for protection decreases and the politically optimal tariff is reduced.

In addition, higher international interdependence can add to the institutional capabilities of a developing country’s government in managing its economy’s stake in international trade. These internal adjustments related to regional agreements can “...make the constituting economies more competitive and better prepared to accept, economically and politically, multilateral liberalizations.”<sup>38</sup> In this sense, PTAs have historically been stepping stones for many countries to pave the way for freer trade. By now, the first steps towards international trade have been taken by virtually all countries around the globe.

### *Trade Diversion Strengthens Protectionist Lobbies*

Another political economy effect relates to the asymmetric interests firms have in lobbying for protection or liberalization. The argument particularly refers to relatively uncompetitive producers in PTA countries. Those firms unable to compete on a global level benefit disproportionately from regional preferences because their market is usually extended without an equal increase in competition. In such a setting, those firms benefiting from trade

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<sup>37</sup> Nicholas Bayne, Stephen Woolcock, and Colin Budd, *The New Economic Diplomacy: Decision-Making and Negotiation in International Economic Relations* (London: Ashgate Publishing Co., 2003).

<sup>38</sup> OECD, *Regional Integration and the Multilateral Trading System: Synergy and Divergence*. (Paris: OECD, 1995).

diversion are “...threatened by further multilateral trade liberalization” because they would lose their regional preferences.<sup>39</sup>

A similar argument relates to PTAs involving developing countries. More specifically, it applies to those PTAs formed under the “Enabling Clause” of 1979. As noted in Chapter 1.1, the Enabling Clause gave developing countries certain privileges in forming regional agreements by loosening the requirements PTAs have to meet. What becomes particularly relevant here are the unilateral preferences granted to developing countries. Developing countries with unilateral preferences can export products to industrialized countries duty-free. At the same time, other countries still have to pay tariffs for the same products. The design of these conditions has the effect that developing countries will lose from a *multilateral* liberalization of their export markets. Hence, these developing countries tend to oppose further multilateral liberalization.

An important qualification of this last argument has to be made to account for recent developments. Over the last years, many of the formerly unilateral preferences have been replaced by reciprocal agreements. The reason why developing countries have been willing to do this is that they perceived reciprocal agreements as more reliable in the long run.<sup>40</sup> This trend somewhat undermines the strength of the above argument. Nonetheless, the pattern of how protectionist interests are affected by preferential liberalization is still a critical stumbling block for further multilateral negotiations.

### *PTA Effects on Governments*

Another aspect of PTAs concerns their impact on governments and their ability to conduct economic diplomacy. The reasoning especially applies to developing countries. The two principal arguments are set out below.

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<sup>39</sup> Ross Garnaut and David Vines, “Regional free trade areas: sorting out the tangled spaghetti,” *Oxford Review of Economic Policy* 23 (2007): 515.

<sup>40</sup> WTO, *The Changing Landscape of Regional Trade Agreements: 2006 Update* (Geneva: WTO Secretariat, 2007).

### *PTAs Provide Expertise*

Developing countries' governments are often severely constrained in the expertise their personnel has in international trade policy. One indicator for this is that historically, trade negotiations have often been conducted by representatives of the foreign ministry rather than of a ministry of trade.<sup>41</sup> For a developing country's government, PTA negotiations may be a helpful training to alleviate this lack of expertise. Government officials can familiarize with the intricacies of trade issues and gain valuable experience. In this way, regional negotiations can serve as a preparation for more complex multilateral negotiations. From an institutional point of view, this may well pave the way for further liberalizations at the multilateral level.

### *PTAs Consume Scarce Administration Resources*

The direct counterargument to the case presented above is that developing countries have not only limited expertise, but also limited resources available for conducting trade negotiations at any given point in time. When PTAs are on their agenda, they consume these valuable resources by keeping ministers and administrative staff busy. As a consequence, governments may be limited in their ability to proceed on critical issues in multilateral negotiations. If PTAs exacerbate the scarcity of administrative resources they may well slow down a WTO Ministerial Round.

While this argument is relatively obvious in the case of developing countries, there are even cases where it applies to such advanced economies like those in the EU. There have been cases where members of PTAs were so engaged in regional issues of economic integration that they were unable to proceed on the multilateral level. A historical example is provided by the issue of

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<sup>41</sup> Nicholas Bayne, Stephen Woolcock, and Colin Budd, *The New Economic Diplomacy: Decision-Making and Negotiation in International Economic Relations* (London: Ashgate Publishing Co., 2003).

government procurement in the Uruguay Round.<sup>42</sup> In 1990, EU member countries were still busy working on a common regional position on this issue. They refused to proceed until such an internal agreement had been reached. As a result, the EU effectively blocked any progress on government procurement in the WTO Ministerial Round.

*Long Term Effects of PTAs: The Dynamic Time Path*

This chapter will shed some light on the possible long-run consequences of preferential trading. More specifically, it is concerned with the question of *how to get to global free trade*.

The classical and most straightforward way towards global free trade was analyzed in Chapter 3. It is based on multilateral tariff cutting. The long run mechanism of this scenario would involve a number of successive WTO Ministerial Rounds. As a result of successful multilateral negotiations, MFN tariff cuts are iterated until global free trade is reached. In view of the evolving landscape of PTAs, this solution is becoming less straightforward than it used to be. Given the ambiguous findings on the impact that PTAs have on the likelihood of future multilateral agreements, the viability of this scenario is uncertain. Therefore, this last part will explore alternative approaches of reaching free trade.

How can global free trade be achieved over time? This is what Bhagwati has called the “dynamic time path” issue.<sup>43</sup> With respect to preferential trading, Bhagwati’s initial metaphor becomes useful again in formulating the key question: *are PTAs stepping stones or stumbling blocks on the time path to global free trade?*

As opposed to the analysis presented in chapter 2, this question is not about PTAs developing in a way that world welfare increases monotonically. The key issue is rather how the final result of global free trade can be achieved *in principle*. Hence, it is important to

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<sup>42</sup> OECD, *Regional Integration and the Multilateral Trading System: Synergy and Divergence*. (Paris: OECD, 1995).

<sup>43</sup> Jagdish Bhagwati, “Regionalism and multilateralism: an overview” *New Dimensions in Regional Integration*, ed. Jaime and Panagariya, Arvind (Cambridge: Cambridge University Press, 1994).

consider the process and the outcome independently. Taking this distinction a step further, Bhagwati asks "...whether 'multilateralism is the best way to get to multilateralism,' therefore distinguishing between 'process multilateralism' and 'outcome multilateralism.'" <sup>44</sup> Outcome multilateralism is the ultimate goal of global free trade, whereas process multilateralism is only transitory and maybe suboptimal. In this sense, does *process regionalism* provide superior prospects?

There are two heuristic approaches of how PTAs could be used as stepping stones to achieve global free trade. The first is about expanding trade blocs until all countries on the globe are part of it. The second entails using spaghetti bowls as building blocks for free trade. Both of these approaches will be discussed below.

### *Expanding PTA Blocs*

In order to use PTAs as stepping stones for free trade, the question is if successive expansion of existing PTAs can include even more members and ultimately encompass all countries. The answer to this question depends on the incentive structure of PTA membership, both for members and for non-members. The condition for global membership in a PTA would require a monotonically positive incentive for outsiders to enter the PTA, and for members to let outsiders in. For an outsider country that considers entering a trade bloc, the incentive depends on the trade-off between the costs of opening one's own market to foreign competition and the gains from improved market access abroad. For a member country, on the other hand, the choice is determined by weighing preferential access to a new member's market with having to share the initial preferential market with another member. <sup>45</sup> To investigate the incentive structure of members and potential joiners, some formal models have been developed.

Focusing on the incentive structure of outsiders, Baldwin identifies a "domino effect" which makes *non-member* countries

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<sup>44</sup> Op.cit.

<sup>45</sup> Soamiely Andriamananjara, *On the Size and Number of Regional Integration Arrangements: A Political Economy Model* (College Park: University of Maryland, 2000).

successively want to join a PTA.<sup>46</sup> His argumentation is as follows. In a political economy framework, exporting firms are pro-joiners, while import-competing firms are anti-joiners. An initial formation of a PTA between two countries mobilizes non-member exporters to support joining, while non-member import-competing firms do the opposite. Further, Baldwin argues that export sectors are usually larger since they produce for both domestic and foreign markets. Hence, the support for joining grows relatively more. This argument applies to all potential member countries. As a consequence of the initial PTA formation, another country may find it politically optimal to join the PTA. Whenever another non-member country joins, the PTA becomes even more attractive to outsiders. This in turn further increases the political support in non-member countries to apply for membership. Other countries will join in due course. This mechanism repeats itself until a new equilibrium is reached. The new equilibrium does not have to be final. Another deepening of integration in the PTA may repeat the process. Thus, the domino effect describes a self-reinforcing effect which will make countries successively join a PTA.

Andriamananjara obtains similar results on the outsiders' willingness to join.<sup>47</sup> In his model, the access gain of non-members is always greater than the loss incurred through opening ones market. In addition, Andriamananjara models the incentive structure of *members* to give entry. He uses a Cournot oligopoly model, where all countries are assumed to be identical. In this model, profits of member firms serve as variables to determine insiders' accession policy. He finds that the maximum welfare for member firms is reached before the bloc encompasses all countries. In other words, although outsiders have an increasing interest to enter the PTA, insiders will block entry and the PTA will fail to reach global membership. Therefore, if member countries can decide upon accepting or rejecting new members, the expansion of the bloc is unlikely to yield global free trade.

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<sup>46</sup> Richard Baldwin, *A Domino Theory of Regionalism* (Geneva: Graduate Institute of International Studies, 1994).

<sup>47</sup> Soamiely Andriamananjara, *On the Size and Number of Regional Integration Arrangements: A Political Economy Model* (College Park: University of Maryland, 2000).



### *Spaghetti Bowls as Building Blocks*

In view of the difficulties that are likely to arise in the attempt to expand a PTA globally, is there another way to transform regionalism into multilateralism?

Richard Baldwin identifies an additional approach to “multilateralizing regionalism.”<sup>48</sup> The idea is to fade out the regional spaghetti bowl and thus make preferential distortions gradually disappear. This would in turn make PTAs more compatible so that ultimately, they could “collapse” into free trade. Baldwin illustrates a so-called “spaghetti bowls as building blocks” mechanism, citing the example of the Pan-European Cumulation System (PECS).<sup>49</sup>

The Pan-European Cumulation System was introduced in 1997 to tame the tangle of the spaghetti bowl of criss-crossing rules of origin. As explained in Chapter 2, the problem of the ROO spaghetti bowl is that producers are forced to comply with different, overlapping regulations in order to take advantage of preferential tariffs. This creates multiple distortions in the trading system.

To understand how ROOs can be overcome, some more background information is necessary. As noted before, ROOs pre-specify what proportion of the final product has to originate within the PTA. To calculate the actual proportion of the good, one needs to add up the various parts coming from within the region. This is called cumulation. The spaghetti bowl exists as long as ROOs stipulate bilateral cumulation. This means that only input goods originating in the respective PTA member countries count towards the pre-specified proportion. The PECS tamed the spaghetti bowl by making cumulation “diagonal.” Under diagonal cumulation, inputs from *all* countries accepting the PECS terms count towards the pre-specified proportion. This effectively led to a pan-European cumulation zone. As of 2006, PECS countries account for approximately 40 percent of world trade.<sup>50</sup> By 2010, the EU wants to

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<sup>48</sup> Richard Baldwin, *A Domino Theory of Regionalism* (Geneva: Graduate Institute of International Studies, 1994).

<sup>49</sup> Op.cit.

<sup>50</sup> Op.cit.

extend the PECS to the “Euro-Med” bilaterals (including Morocco, Algeria, Tunisia, Egypt, Israel, Jordan, and Lebanon).

The implication for the global trading system is that, in principle, there is a solution to the spaghetti bowl problem. If a consolidation of ROOs in other world regions would occur, a large proportion of the current regulatory chaos would disappear. This is what Baldwin dubs the “spaghetti bowls as building blocks” mechanism. But how could this mechanism repeat itself on the global level?

Baldwin’s analysis goes one step further, identifying the driving force that led to the establishment of the PECS. As he argues, vertically integrated *manufacturing processes were unbundled* in such a way that jobs were transferred to other countries. This off-shoring of jobs effectively undermined the interests that usually lead to PTAs. The increasing number of firms operating in various European countries with an integrated production process “...realigned the array of political economy forces that produced the spaghetti bowl in the first place.”<sup>51</sup> From a firm’s perspective, it meant that “them” became “us.” As a consequence, multinational corporations increasingly lobbied against the regulatory disorder. Thus, it became politically optimal to remove ROO protection.

In Baldwin’s view, unbundling will continue to be a driving force in the future. He argues that in the first phase of unbundling of manufacturing processes, off-shoring occurred primarily on a regional level. In the next phase, however, unbundling will increasingly take place on a global level. If the PECS process described above can repeat itself on a global level, it is possible in theory that “spaghetti bowls as building blocks” are the final step on the path to global free trade.

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<sup>51</sup> Op.cit.

## Conclusion

In this final outlook, I will briefly summarize the findings of the three main sections. Then, I will interpret the results, turning once more to the “stepping stones – stumbling blocks” question.

In the second chapter, the distinction between trade creation and trade diversion was used to point out that PTAs may enhance or decrease welfare. Several arguments were presented why *trade diversion* is likely to prevail. Furthermore, I analyzed the systemic problem of the spaghetti bowl syndrome, which increasingly appears to be a stumbling block for the multilateral trading system. Finally, the analysis of PTAs’ immediate impact on multilateral trade barriers has produced ambiguous results: while their impact is unclear with regards to multilateral tariffs, the possibility for governments to introduce non-tariff barriers is a stumbling block.

In the third chapter, the overarching question was *how PTAs affect multilateral negotiations*. I presented one political economy argument in favor of the stepping stones hypothesis and one against it. Subsequently, I discussed how PTAs affect governments’ abilities to conduct multilateral negotiations. Again, there were strong arguments on both sides. As a result, the findings of Chapter 3 do not provide a clear-cut answer on the “stepping stones – stumbling blocks” question.

The fourth chapter explored the “dynamic time path” issue, taking a long term perspective on the evolution of the MTS. The overarching question was *how to get to global free trade*. Two alternatives to multilateral tariff cuts were presented. First, I discussed whether a PTA could be expanded until it encompasses all countries. This scenario turned out to be unlikely. Second, I set out the possibility of using “spaghetti bowls as building blocks.” This scenario is still quite hypothetical, but might prove a viable alternative to achieve free trade.

Although these results do not yield an unequivocal answer to the “stepping stones – stumbling blocks” question, the findings are helpful in several ways. Most importantly, they show that PTAs and free trade are closely related, but that they are *neither complete substitutes nor complements*. This means that the relationship between

PTAs and multilateralism is too complex for a straightforward “stepping stone” or “stumbling block” answer. The fundamental reason for this is that their relationship is reciprocal: not only do PTAs influence the MTS, but the reverse is also true. Because of this reciprocal relationship, the impact PTAs have on the multilateral trading system depends not just on PTAs but also on the MTS itself. Both the multilateral trading system and the role PTAs play within it have evolved significantly in the last decades. As a consequence, the impact of PTAs on the MTS has changed over time.

This insight is helpful for drawing one more conclusion about PTAs based on the findings of this paper. As a general tendency, many of the impacts of PTAs were *initially beneficial* (or at least neutral), *but became harmful over time*. A typical example is the spaghetti bowl, whose harmful effects did not arise with one or several PTAs, but only after dozens or hundreds of PTAs had been concluded. Further, many of the arguments presented for and against PTAs referred to different “stages” in the evolution of the multilateral trading system. To illustrate this, I would like to cite the arguments brought forward in Chapter 3. The pro-PTA arguments (activating interest groups, the juggernaut effect, and providing expertise to governments) all refer to a relatively unintegrated trading system at a low level of development. The initial situation is premised on countries with little international interdependence, with virtually no membership in economic institutions, and with little governmental expertise. In this configuration of low international integration, PTAs seem to play the role of a *catalyst for initial liberalization*.

Conversely, the counterarguments (PTAs politicize and strengthen protectionist lobbies) refer to a more integrated trading system at a higher stage of international development. In this setting, the media and the public follow international trade negotiations closely, and lobbyists are already active in staking out their claims in negotiations. In this configuration of high international interdependence, PTAs seem to *block further liberalization*.

Thus, PTAs seem to accelerate the process of liberalization initially, but they slow it down later. In other words, the

relationship between regionalism and multilateralism is such that the *emergence* of PTAs is likely to be beneficial, while their *existence* is later harmful. From a historical perspective, a simplified answer to the “stepping stones – stumbling blocks” question could therefore be: the emergence of PTAs used to be a stepping stone, but their existence has now become a stumbling block for free trade.

This stylized answer, however, should not be understood as final. Today, PTAs increasingly appear to be a stumbling block for multilateral negotiations. But this does not mean that their impact cannot change in the future. As the last chapter showed, effects like Baldwin’s “spaghetti bowls as building blocks” mechanism may potentially transform the role of PTAs again. Ultimately, PTAs may not be a stumbling block for free trade. If the current difficulties persist, however, they will inevitably be a *circuitous route* on the dynamic time path to free trade.

