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REGIONALISM AND THE WORLD TRADE ORGANIZATION: IS NON-DISCRIMINATION PASSÉ?

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Abstract

The principle of non-discrimination as enunciated in its Articles I on General Most Favoured Nation Treatment (MFN) and III on National Treatment (NT) is the foundation of the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO). Yet, articles of GATT included many exceptions to MFN, of which one of the most serious was Article XXIV relating to Customs Unions (CU) and Free Trade Areas (FTA).

Clearly there was a tension, if not contradiction, between the fundamental principle of non-discrimination and inherently discriminatory preferential trading arrangements (PTA's) such as CU's and FTA's. This tension was not a serious practical one as long as a few PTA's were proposed, let alone implemented, as was the case four decades until the start of the Uruguay Round of multilateral trade negotiations in 1986. The continuing proliferation of proposed PTA's covering several regions of the world since then is a potential threat to progress towards a non-discriminatory multilateral trading system.

The paper begins with a discussion of the reasons for the failure of the Working Party mechanism set forth in Article XXIV for examining the consistency of proposed PTA's with GATT. It then briefly surveys the recent literature on regionalism and multilateralism, focusing more on the issues raised than on analytical models. It critically examines the concept of "open regionalism" that has been enthusiastically advanced by the United States in particular and finds it problematic, if not an oxymoron. The paper concludes with a discussion of how further progress towards a non-discriminatory world trading system could be made, even as preferential regional liberalization initiatives proliferate.

Keywords: Most Favoured Nation (MFN), National Treatment (NT), Non-Discrimination, General Agreement on Tariffs and Trade (GATT), World Trade Organization (WTO), Multilateralism, Regionalism, Open Regionalism, Customs Unions (CU), Free Trade Areas (FTA), Preferential Trading Arrangements (PTA).

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1. Introduction

It is widely accepted that the foundation of the architecture of the World Trade Organization (WTO) and its predecessor, the General Agreement on Tariffs and Trade (GATT), is the principle of non-discrimination as enunciated in Article I (General Most Favoured Nation Treatment or MFN) and Article III (National Treatment NT) of GATT. Indeed, MFN and NT are incorporated in two of the major components of the Uruguay Round of Multilateral Trade Negotiations (MTN) that led to the founding of the WTO, viz. the Multilateral Agreements on Trade in Goods and the General Agreement on Trade in Services (GATS).

Yet GATT was full of exceptions to MFN, many of them minor but a few major ones as well. At its very beginning, it "grandfathered" a number of preferential trading systems then in existence, allowed a prior Contracting Party to the agreement to "opt out" of its MFN obligations to a new contracting party at the time of the latter's entry into GATT, authorized several actions on a discriminatory basis under some of its dispute settlement provisions, and included a procedure under Article XXV for obtaining a formal waiver from the MFN clause. These have been carried over into the charter of the WTO. Nonetheless, almost all these authorized departures from non-discrimination were really "exceptions that proved the rule" in the sense that recourse to them was meant to be (and

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mostly was sufficiently) infrequent and inconsequential (in terms of the volume of trade affected) so as not to undermine the principle.

However, the exceptions from MFN for Customs Unions (CU) and Free Trade Areas (FTA) under Article XXIV of GATT (and its updated version in WTO), under Part IV of GATT relating to Economic Development adopted in 1965, and under the "enabling clause" of the Tokyo Round of MTN in 1979 on "Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries" are much more serious, since any preferential and discriminatory trade agreements that were found consistent with these clauses could last indefinitely. The enabling clause in effect exempted the developing countries from many GATT obligations, allowed them to engage in preferential trade among themselves as well as to receive preferential treatment by developed countries. Far from helping developing countries integrate with the world economy, these departures from MFN in fact slowed such integration.

Interestingly, Article XXIV reflects the positive view of CU's that prevailed in 1947 when the GATT was reached and the charter for the International Trade Organization (ITO) was adopted by the International Conference on Trade and Employment in Havana in 1948. As is well-known, the ITO did not come into being, and the GATT, which was to be subsumed under ITO, governed world trade from 1947 until WTO came into existence on January 1, 1995. Basically, two criteria were laid down in Article XXIV for a CU or FTA to be granted waiver from MFN obligations: first, "substantially all trade" among members of a CU or FTA must be free, and second, post-union (or post-FTA) barriers on trade with non-members are not on the whole more restrictive than those that members had prior to their forming a CU or PTA. In his classic work on the charter of the ITO, Wilcox (1949, p. 70) noted the logical inconsistency between being against any discriminating preferential trading arrangements, even if only partial in coverage of trade, and being in favour of a CU, which is not only such an

arrangement, but also one in which the discrimination against non-members is total. He explains the then dominant view in favour of CU[1]:

> "A customs union creates a wider trading area, removes obstacles to competition, makes possible a more economic allocation of resources, and thus operates to increase production and raise planes of living. A preferential system, on the other hand, retains internal barriers, obstructs economy in production, and restrains the growth of income and demand. It is set up for the purpose of conferring a privilege on producers within the system and imposing a handicap on external competitors. A customs union is conducive to the expansion of trade on a basis of multilateralism and non-discrimination; a preferential system is not."

The thrust of Wilcox's argument in favour of a CU is the belief that any expansion of area within which all trade is free of barriers is desirable in the sense of improving welfare of one or more of its members while hurting no other country, as long as barriers to trade in the countries outside of the area are not raised. Indeed, this is the rationale for the two criteria laid down in Article XXIV for a proposed CU or FTA to be consistent with GATT. Recognizing, on the one hand, that the internal trade barriers will be gradually reduced so as to minimize adjustment costs and, on the other hand, the possibility such gradualism may stop well short of their complete elimination of barriers, Article XXIV also insisted on a plan and schedule for their complete elimination within a reasonable time. Although barriers (tariff and other measures) against non-members after the formation of a CU or FTA in fact meet the requirement that they are "on the whole" no higher or more restrictive than they were in the constituent territories of the CU (or FTA) prior to its formation, it is possible that the common external tariff of a CU could exceed some individual member's previously bound tariffs. For raising its previously bound tariff, such a member was to follow the procedures for withdrawal of any previously negotiated concessions, such as bound tariffs, as set forth in Article XXVIII.

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[1]The possible reasons for this approach that favoured 100% preferences but opposed lesser preferences have been discussed by Bhagwati (1991) and Snape (1993). Students of Meade's analysis know that he showed, within his model, that successive reductions of tariffs preferentially towards zero will, beyond a point, lower welfare and that 100% tariff removal preferentially may even lower welfare below the initial level; cf. the discussion of this model in Bhagwati and Panagariya (1996).

Any proposed CU or FTA agreement was required to be promptly notified to GATT for examination by a working party. In all, 98 agreements were notified under Article XXIV during the life of GATT from 1947 to the end of 1994, including the most enduring of all, namely the European Community (EC) and the European Free Trade Area (EFTA). A further 11 agreements were notified by developing countries under the 1979 Enabling Clause. Working parties were established to examine virtually all agreements. While 15 working parties had not completed their examinations as of the end of 1994 and five did not report for various reasons, out of the 69 which had submitted their reports, only six explicitly acknowledged conformity with Article XXIV of the Agreement, and this six does not include the European Community (EC) or the European Free Trade Area (EFTA), and only two of the six are still active! (WTO, 1995, p. 16). In fact,[2]

> "no agreement was reached on the compatibility of the Treaty of Rome with Article XXIV, and the contracting parties agreed that because "there were a number of important matters on which there was not at this time sufficient information..to complete the examination of the Rome Treaty...this examination and the discussion of the legal questions involved in it could not be usefully pursued at the present time". The examination of the EEC agreement was never taken up again." [WTO (1995), p. 11]

The main reason for failure to pronounce on compatibility was that required consensus to decide on the issue of compatibility could not be reached, with often strong opposition against declaring the notified agreements as compatible with Article XXIV. As the WTO report emphasized

> "<u>making no pronouncement on the key matters they were charged to examine has been the rule for Article XXIV working parties</u>. The absence of such recommendations has

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[2]Richard Pomfret is certainly right in pointing out that the fundamental reasons for the formation of the European Coal and Steel Community, which later became the European Community, were political, viz. to preclude a third European war in the twentieth century and to contain the Soviet Union, and not economic. As such, the EC had the strong backing of the United States. It is extremely unlikely that a finding by a GATT working party that EC was inconsistent with Article XXIV would have prevented its coming about. More generally, there are political as well as economic motives for countries to form or join a CU or FTA. But the assertion that economic losses, if any, from departures from free trade must have been outweighed by political gains for members of a CU or FTA as well as non-members who supported or acquiesced in its formation is tautological. Carrying out a convincing empirically-based analysis of the political economy of the formation, the success or failure once formed, of real world CU's and FTA's is a complex task that has rarely been done.

> been interpreted by several contracting parties as meaning that it must therefore be presumed that the agreement in question is in conformity with Article XXIV, while others have considered that, in the absence of any final decision by the contracting parties acting jointly on the conformity of a particular agreement with the provisions of Article XXIV, the legal status of such an agreement remains open." [WTO (1995), p. 17 emphasis in original]

As the chairman of the Working Party on the Canada-US Free Trade Agreement put it,

> "One might... question what point was there in establishing a working party if no one expected it to reach consensus findings in respect of specific provisions of such agreements, or to recommend to the participants how to meet certain benchmarks." [WTO (1995), p. 11]

Whether or not a CU or FTA that is consistent with Article XXIV would have increased global welfare, it is abundantly clear that the procedures laid down for examining such consistency have not worked. There are several reasons for this failure, apart from the consensus needed in the Working Party for a decision. The most important of these arise from the vagueness of the wording of Article XXIV itself, in particular, the lack of a precise definition of the phrase "substantially all trade" in the requirement for liberalization within a CU or FTA, the lack of a well-specified procedure for determining whether the post-union FTA barriers on trade with non-members are not "on the whole higher or more restrictive" than those that member countries had prior to their forming a CU or FTA, and the absence of any explicit attempt to ensure consistency of the approach to permitted deviations from MFN under Article XXIV, Part IV on Development and the Enabling Clause of the Tokyo Round. Apart from specifying a tariff averaging procedure to enable a comparison of pre- and post-CU or FTA tariff barriers and a period of ten years as a reasonable time span within which internal barriers are eliminated within a CU or FTA, the Understanding reached in the Uruguay Round relating to the interpretation of Article XXIV did not substantially change the situation. The WTO report rightly concludes that:

> "While the purpose of the Understanding on Article XXIV is to clarify certain of the areas where the application of Article XXIV had given rise to controversy in the past, and particularly as regards the external policy of customs unions, it fell short of addressing most of the difficult issues of interpretation noted above. For example, no consensus emerged in the Uruguay Round Negotiating Group on GATT Articles

> concerning proposals made by several participants (notably Japan), to clarify the substantially-all-trade requirement. It is evident, therefore, that most of the problems that have plagued the working party process were not solved in the Uruguay Round." [WTO (1995), p. 20]

Article V of GATS, which corresponds in many ways to Article XXIV on goods trade, shares many of the unsolved problems of Article XXIV.

In sum, the WTO articles and procedures as they are now are unlikely to succeed in the future in resolving, any more than GATT articles and procedures did, the tension, if not outright contradiction, between discrimination which is an inherent feature of CU's and FTA's and the fundamental principle of non-discrimination.

This tension was not a serious practical issue, as long as relatively few preferential trading arrangements such as CU, FTA and others were proposed and implemented and fewer still endured. This was indeed the case until the final stages of the Uruguay Round. In all, 68 agreements under Article XXIV and six under the enabling clause were notified and came into force in roughly four decades between the birth of GATT in 1947 and the Punta Del Este Conference that initiated the Uruguay Round of MTN in 1986. Of the significant ones, only the EC, EFTA and the Australia-New Zealand agreement continue to exist now. However, in just one decade between 1986 and January 1, 1995, when the WTO came into existence, 30 agreements under Article XXIV and five under the enabling clause have been notified, and all but one have entered into force.[3] What is more, in just one year of operation of the WTO, eight more working parties were established under Article XXIV.[4] An

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[3]Pomfret, in his comments as discussant, suggested that the count of regional agreements in the 1990's may be inflated by the collapse of the Council for Mutual Economic Assistance (CMEA) to which the countries of Eastern Europe belonged. I am not as optimistic that the new wave of regionalism will collapse just as most of the regional agreements of the 1960's and 1970's did.

[4]Wilcox (1949, p. 69-70) noted that the distinction in the charter for the International Trade Organization between then existing preferences, which were not to be increased and to be reduced or eliminated through negotiation, and the prohibition of any new preferences (other than CU's and FTA's) was subject to much debate in the Havana Conference. Some countries proposed the abolition of all preferences, and others proposed creation of several new ones! Burma (now Myanmar) proposed a South East Asian preferential grouping arguing "The tendency of the countries represented in this

overwhelming majority of these agreements involve countries that are close to each other geographically, and, as such, regional integration is an appropriate term in describing them. Not all of the proposed groupings, such as APEC (Asia Pacific Economic Cooperation), Hemispheric Free Trade Area covering all of the Western Hemisphere and TAFTA (Transatlantic Free Trade Area), obviously can be described as regional groupings. Nonetheless the term "regionalism" has come to be applied to describe liberalization of trade and investment within such groupings.

The WTO report suggests that

> "In the face of the wide range of views on whether the world is moving inexorably towards integration on a global scale or towards a geographic concentration of trade, with the attendant risk of trade conflicts among the regional groups, the only sensible course of action is to accept that there is movement along both tracks." [WTO (1995), p. 23]

Its conclusion that

> "the relative lack of success in enforcing the rules and procedures for customs unions and free trade areas is a concern, both as regards the specific issues involved and because of the implications it has for the broader credibility of the WTO system and its rules. This is especially true at a time when the number of actual or planned regional integration agreements, and the attention they are getting from third countries, is large. Moreover, even if there is an affirmative answer to the question of whether regional integration agreements have been complementary to the multilateral process, experience cautions against assuming that the post-Uruguay Round rules and procedures will be sufficient to guarantee that this will be the case with future agreements or, for that matter, with the evolution of current agreements." [WTO (1995), p. 23]

can hardly be overemphasized. However, while credibility of the WTO will be certainly compromised if any of its rules, including those relating to CU's, are not enforced, it should also be noted that whether rules regarding preferential trading arrangements, such as CU's, make sense is also an important issue.

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conference being to favor groupings on a regional basis and the manifestation of such tendencies being such that the whole world except South East Asia has been covered in such regional groupings, it is felt that countries of South East Asia should not lose by default and should have the right to form such groups if they desire to do so." Apparently the recent trend towards regionalism is more of a revival, and not something new.

The literature (relating to regionalism and multilateralism) is vast, and several volumes have appeared in which almost all conceivable issues have been discussed from several perspectives: economic theory, domestic and international political economy, systemic aspects, including legal aspects and empirical evidence. A splendid survey of theory and models is available in Winters (1996a). The WTO report (1995), from which I have drawn extensively, also provides an excellent and balanced analysis.[5] The bibliography in these two surveys lists all the major contributions to the literature. I have little to add to these works, and instead, selectively focus on some issues. In what follows, in Section 2, I briefly discuss the recent literature on regionalism and multilateralism, focusing more on the issues raised than on the analytical models. In Section 3, I critically examine the concept of "open regionalism," originally proposed by the Eminent Persons Group (EPG) of APEC and now embraced by the Director-General of the WTO, and find it problematic, if not altogether an oxymoron. Section 4 concludes the paper with a discussion of how further progress towards the goal of a non-discriminatory and liberal world trading and investment system could be achieved, even as regional liberalization initiatives proliferate.

[5]A forthcoming volume, edited by Bhagwati et al. (1997), collects together the principal analytical contributions to the theory of preferential trading agreements since, and including, Viner's seminal 1950 work. The different contributions are distinguished and grouped by their analytical approaches.

2. Regionalism and Multilateralism

In his excellent survey, Winters (1996a) laments that while the topic of "Regionalism versus Multilateralism" is much discussed by trade economists, the literature is "surprisingly short on precise measures," by which he means quantitative indices of the extent of regionalism or multilateralism in the outcomes of trade policies of countries. But, as he himself recognizes, the more serious problem is in defining the terms regionalism and multilateralism. Bhagwati (1993) and Winters (1996a) (who points to the looseness of the definition) define "regionalism" as preferential reduction of trade barriers among a subset of countries which might, but need not, be geographically contiguous. The emphasis, presumably, is on the fact that preferences are restricted to a subset, indeed to a proper sub-set, and not extended to the whole set of countries of the world trading system. Thus, discrimination in liberalization is the essential feature of regionalism under this definition. As such, if multilateralism is to be viewed as the antithesis of regionalism, then it has to be defined as a non-discriminatory reduction of trade barriers. But then unilateral reduction of trade barriers by one or more countries on a non-discriminatory basis will also be deemed multilateralism.[6] However, one can distinguish MFN or non-discrimination from multilateralism following Jackson (1992, p. 134). According to him, multilateralism

> "is an approach to international trade and other relations which recognizes and values the interactions of a number, often a large number, of nation states. It recognizes the dangers of organizing relations with foreign nations on bilateral grounds, dealing with them one-by-one. MFN, on the other hand, is a standard of equal treatment of foreign nations."

I return to this view of multilateralism as a process below.

It is instructive to view non-discrimination and multilateralism from the perspective of the fundamental objectives subserved by the WTO. The charter of WTO is of course a constitution that

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[6]Bhagwati (1993) distinguishes between multilateralism as a "process" (i.e., MTN) for liberalization and multilateralism (i.e., MFN) as an outcome. Unilateral liberalization on an MFN basis, as with Peels's repeal of the corn Laws, is then a multilateral outcome.

enunciates the "rules of the game," so to speak, for international trade in goods and services as well as trade-related investment measures and intellectual property rights. It also includes, most importantly, a mechanism for settlement of disputes among countries on the observance of rules. But all constitutions are frameworks for achieving more fundamental goals on the basis of accepted rules and for containing exercise of power by those endowed with it. In the case of WTO, it is fair to say that the fundamental objective is a global trading (and presumably also investment) system that is free of policy created barriers to flows of goods, services and capital between countries. Arguably, even this is not the ultimate objective, which is a global welfare in the sense of a Pareto Optimum. Efficient allocation of resources through unimpeded trade in competitive international markets is an instrument to achieve it. Given that a global competitive equilibrium (over time and under uncertainty) will be a Pareto Optimum only under a set of assumptions about the existence of a complete set of markets, absence of externalities and so on, I do not wish to pursue this line of argument, although not doing so leaves open the issue of non-instrumental justifications for a free trading system.

A system that is free of trade barriers is by definition non-discriminatory with respect to the use of trade policy instruments. But, to the extent other non-trade, i.e. purely domestic, policy instruments are effective substitutes for trade policy instruments in achieving discrimination in trade among a country's trading partners, eliminating trade barriers need not result in non-discrimination in trade outcomes. Indeed, this issue has been highlighted in the debate about trade effects of domestic policies with respect to environment, labour standards and market structure. Analogously, domestic corporate tax policies have effects on international flow of capital. The belief that labour, environmental and competition policy standards in all countries of the global trading system have to exceed some internationally agreed minima, if not the same everywhere, for free trade to be beneficial has been politically powerful. Non-governmental groups have been pushing these issues on the agenda of the WTO with only a limited success so far. They have had greater success in influencing regional free trade agreements, such as NAFTA. In fact, this success has been viewed by some as a strength of a

regional approach to trade liberalization. Without delving into the burgeoning literature on the international effects of domestic policies, let me just assert (citing Bhagwati (1996, p. 24) in support) that GATT Article XXIII on "nullification and impairment" could be used to address the problem arising from the deliberate use of domestic policy instruments by one or more countries to deny trading partners of benefits from their earlier nondiscriminatory liberalization.

One of the many issues raised in the recent literature is whether a regional or multilateral approach (or a combination of both) to reduction in pre-existing barriers is superior for eventually achieving non-discriminatory free trade for all. Bhagwati (1993), who is the originator of several felicitous phrases in this literature, has called this "the dynamic time-path question." In an earlier work (Bhagwati (1991)), he had raised the same question by asking whether trade blocs, i.e. preferential trading arrangements (regional and others), are "stumbling" or "building" blocks towards free trade for all. Of course, to be able to answer the question a norm for establishing the superiority of one approach or path over another has to be specified.

A number of alternative norms are found in the literature, though not always in an explicit form. For example, Summers (1991) in his oft-quoted and criticized remark, took the "building block" view in saying that

> "Economists should maintain a strong, but rebuttable, presumption in favor of all lateral reductions in trade barriers, whether they be multi-, uni-, bi-, tri-, plurilateral. Global liberalization may be best, but regional liberalization is very likely to be good." (p. vii)

Implicit in this assertion is a norm for comparison, viz. global welfare (presumably in a utilitarian sense), so that global gains from Vinerian trade creation can be compared to global losses from trade diversion. As Barfield (1995) points out,

> "Summers and other proponents of regionalism base their case on a belief that total trade creation will outweigh trade diversion in most cases, that the multilateral process is too slow to produce substantial progress toward further trade liberalization, and that regional free trade arrangements will allow some nations to speed up liberalization and ultimately produce a self-reinforcing process toward more open markets." (p. vii-viii)

Kemp and Wan (1976), on the other hand, explicitly use a partial ranking based on the Pareto principle, rather than the implicit complete utilitarian ranking of Summers, to show that as long as lump sum income transfers among consumers within a CU are feasible, it is possible to choose the common external tariff for a CU of an arbitrary collection of countries in such a way that no consumer in any non-member country is made worse off, and at least one consumer in the CU is made better off as compared to the pre-CU trading equilibrium. Thus, progressive Kemp-Wan style enlargement over-time of CU's ending up with the whole world within a CU, i.e. global free trade, is a dynamic time-path in which the trading equilibrium at each point of time Pareto dominates earlier equilibria. In general, Kemp-Wan tariffs are not unique.[7] Being just a possibility and existence theorem, the Kemp-Wan result has no direct operational implication for the pursuit of regionalism in the real world.

An alternative way of assessing the entire time-path of equilibria is to define a norm for the whole path. One, admittedly extreme, approach is to rank time paths according to the time each takes to reach a global free trading equilibrium. Thus, the answer to another of Bhagwati's (1993) questions, viz. "Is regionalism quicker?," is in the affirmative, if one can show that a time-path, based on some version of regionalism, minimizes the time to global free trade among all other feasible time-paths to the same goal, including ones based on multilateralism. However, an alternative welfare-oriented norm for a path of equilibria is the appropriately discounted sum of global welfare over the indefinite future along that path, whether or not it leads to global free trade in finite time or asymptotically. The presumption, however, is that a time-path that maximizes intertemporal welfare in this sense will be one that achieves global free trade at least asymptotically.

It should be clear in comparing alternative time-paths using the criterion of discounted sum of global welfare that along any such path of multilateralism and regionalism could, in principle, be pursued in any sequence, for any length of time, or even simultaneously. Indeed, even the possibility

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[7] I have elsewhere (Srinivasan (1996)) characterized Kemp-Wan tariffs.

that pursuit of one initially precluding the pursuit of the other subsequently is not ruled out. Thus, paths corresponding to what Bhagwati and Panagariya (1996) call independence and interdependence between the pursuits of multilateralism and regionalism, are in principle included among the alternative time-paths. Interdependence could arise in two senses. First, the pursuit of, say regionalism, could trigger and ease the pursuit of multilateralism. Second, the outcomes of the option pursued later in time could depend on that pursued earlier.

Instances of interdependence in both these senses are cited in the literature. For example, Winters (1996a) points to many commentators having argued that the creation of EEC, i.e. regionalism, led directly to the Dillon and Kennedy rounds of multilateral trade negotiation, although Winters himself does not share this view. It is also said by some, though denied by others, that the Seattle APEC summit in November 1993 was perceived by the European Union as a threat by the US to go the route of regionalism and spurred it to compromise enough in those areas where it differed from the US in the Uruguay Round negotiations for the Round to be successfully concluded in December 1993. These are two instances of interdependence in the first sense. WTO (1995) flatly asserts that "There is little question that the failed Brussels Ministerial in December 1990 and the spread of regional integration agreements (especially after 1990) were major factors in eliciting the concessions needed to conclude the Uruguay Round" (WTO, 1995, p. 54, emphasis added). This is an example of interdependence in the second sense in so far as the outcome, i.e. the failure or success of the multilateral negotiations of the Uruguay Round, was influenced by the prior spread of regional agreements.

The results from the analytical models so ably surveyed by Winters (1996a) are unfortunately extremely fragile and model dependent. A few examples will suffice. In the symmetric model of Krugman (1991a,b) without room for comparative advantage to play a role, global welfare is minimized when the world consists of two or three blocs. Srinivasan (1993) and Deardorff and Stern

(1994) show with different non-symmetric models, in which comparative advantage plays a significant role, that Krugman's result need not hold.[8]

Levy (1997) examines whether incentives for multilateral trade liberalization are blunted by the possibility of concluding regional trade agreements in a median-voter-political-economy model of trade policy determination. More precisely, he considers two periods, during the second of which an opportunity for multilateral liberalization arises, and asks whether two countries concluding bilateral trade agreement in the first period will retain any interest in multilateral liberalization in the second period. In a standard Hechscher-Ohlin-Samuelson model with median voter politics, the answer is in the affirmative, since the only effect of trade liberalization, bilateral or multilateral, is the Stolper-Samuelson effect on factor prices induced by terms of trade changes. However, if the model is one of differentiated-product-monopolistic-competition, there is an additional effect to consider, namely, the expansion of the varieties of the product available for consumption with trade liberalization. In such a model, concluding a bilateral agreement in the first period might result in the two countries losing interest in multilateral liberalization in the second period. Thus, the answer to the time-path question depends on the model of trade!

Krugman (1991a,b) and several others have contended that countries that trade with each other in larger volume than with other nations are "natural" trading partners and hence that preferential trading arrangements (PTA's) among them are likely to be welfare enhancing. It is further argued that countries that are contiguous are likely to trade more with each other and hence are "natural" partners to each other so that "regional" PTA's are welfare enhancing. A related assertion is

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[8]Hamada and Goto (1996) show that in a symmetric world in which all trade is in differentiated products, and market structure is one of monopolistic competition, the formation of a CU, that is consistent with Article XXIV in the sense that its common external tariff is no higher than the common (because of symmetry) tariff that each individual member had in place prior to the formation of the CU, worsens the welfare of non-members.

that regional PTA's are likely to improve welfare by minimizing transport costs. The models of Bhagwati and Panagariya (1996) challenge each of these assertions.

Bagwell and Staiger (1996a,b,c,d,e) have analyzed the dynamic time-path question using a repeated-game-dynamic framework, in which any deviation from cooperation (for example, maintaining low multilateral tariffs) is punished by reversion forever after to non-cooperative Nash tariffs. Since they explicitly rule out enforcement of agreements by third parties and focus exclusively on self-enforcing contracts, their analysis assumes that any WTO enforcement mechanism is unlikely to be effective, and hence is not entirely relevant for assessing the relative strength of multilateralism. Be that as it may, the conclusion of Bagwell and Staiger (1996c) is sufficient to illustrate the non-robustness of the results of their model:

> "Our analysis suggests that the consequences of regional agreements for multilateral tariff cooperation need not be clear cut: Effects exist under which regional agreements complement multilateral liberalization efforts, and effects also exist under which regional agreements undermine the multilateral liberalization process." (p. 1)

There have been many attempts to evaluate empirically the likely effects of multilateral trade liberalization of the Uruguay Round. WTO (1995, p. 45) refers to numerous ex ante and ex post attempts to estimate the trade and other economic effects of regional integration agreements, principally those among developed countries. Again, because of differences in modeling, data used, degree of aggregation, etc., the estimated effects often differ not only in magnitude but even in sign. A brief survey of empirical evidence on regionalism vs. multilateralism leads Winters (1996a, p. 24) to conclude "Regrettably it seems as ambiguous as the theory, at least so far as issues of current policy are concerned." Thus, neither theory, nor evidence, provides a robust guide to the choice between regionalism and multilateralism. Obviously, merely counting a priori arguments in favour of one or the other is not much of a guide either. Inevitably, an overall judgment implicitly weighing all three has to be made.

3. Open Regionalism: An Oxymoron or a Fruitful Concept?

The United States, under the Clinton Administration, has been actively pursuing the regional route.[9] The Council of Economic Advisers (CEA) to the President in their annual report for the year 1995 claimed that "possibly the most distinctive legacy of this Administration in international trade is the foundation it has laid for the development of open, overlapping plurilateral trade agreements as stepping stones to global free trade. The Administration's plurilateral initiatives in North America, the rest of the Western Hemisphere, and Asia embody principles of openness and inclusion consistent with the GATT" (CEA (1995), pp. 214-215). I have elsewhere (Srinivasan (1995)) critically examined several of the arguments offered by the CEA in favour of plurilateralism and found them unpersuasive.

The CEA also defined the term "Open Regionalism" that had been earlier advocated by the Eminent Persons Group (EPG) of APEC. According to the CEA

> "Open regionalism refers to plurilateral agreements that are nonexclusive and open to new members to join. It requires first that plurilateral initiatives be fully consistent with Article XXIV of the GATT, which prohibits an increase in average external barriers. Beyond that, it requires that plurilateral agreements not constrain members from pursuing additional liberalization either with non-members on a reciprocal basis or unilaterally. Because member countries are able to choose their external tariffs unilaterally, open agreements are less likely to develop into competing bargaining blocs. Finally, open regionalism implies that plurilateral agreements both allow and encourage non-members to join. This facilitates the beneficial domino effect described above." [CEA (1995), p. 220].

In assessing these claims, it should be noted that by its very definition any plurilateral free trade agreement provides preferential market access to members and, as such, violates the MFN principle. Even if, in the face of experience to the contrary, such agreements are declared to be in

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[9]Pomfret disagrees with this. He claims that the conclusion of NAFTA and the hosting of APEC summit in Seattle in 1993 by the Clinton administration were in fact reversals of the earlier Republican administrations' aggressive unilateralism and pursuit of regionalism through the Caribbean Basin initiative and free trade agreements with Israel, Canada and Mexico. He argues that concluding NAFTA was essential to gain support for the Uruguay Round and the US embrace of APEC was in fact a signal that the U.S. was not wedded to Eastern Pacific regionalism. This is a very imaginative reading of the events! I prefer to rely on what the administration spokesmen have said or written!

conformity with the updated Article XXIV, any extension of any liberalization among parties to the agreement to others, except on an MFN basis, cannot possibly be viewed as other than conditional and preferential market access. It is available to only those non-members who are willing to meet whatever conditions (e.g., reciprocity) are attached to such an extension. Viewed in such a perspective, Open Regionalism is nothing but an oxymoron.

Although the EPG recommended "unilateral liberalization to the maximum extent possible" and recognized that any individual APEC member can unilaterally extend its APEC liberalization to non-APEC members on an unconditional MFN basis, they do not think that either is likely or even desirable.[10] For example they point out that

> "the largest members, including the United States, are unlikely to liberalize unilaterally when they can use the high value of access to their markets to obtain reciprocal liberalization from others. The same view applies in other economies in the region ... we would note ... that the region would give away an enormous amount of leverage ... if its members, especially its largest members, were to liberalize unilaterally to any significant degree" [APEC (1994, p. 29].

The EPG candidly admit that

> "We rejected the concept of unconditional MFN treatment of non-members as the sole means of implementing open regionalism for the economic and political reasons...." [APEC (1994), p. 34]

The main reasons were the familiar free rider problem and the claim that it is rare that benefits of politically negotiated trade liberalization, multilateral or regional, have been extended to non-participants on a non-reciprocal basis.

The 'free rider' argument and the demand for reciprocity reflect a mercantilist view (unfortunately enshrined in GATT!) of trade liberalization, namely, that a country's offer of liberalized

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[10]Pomfret draws a distinction between the U.S. and Western Pacific members of APEC. In his view, while the U.S. is wedded to reciprocity, governments of some Western Pacific nations apparently have accepted that trade liberalization is good for the liberalizer even without reciprocity. Be that as it may, APEC leaders have disbanded the EPG, and its chairman, Fred Bergsten, has acknowledged that the disappointing results of APEC liberalization thus far threaten to make the Manila summit of November 1996 a failure, thereby undermining APEC's credibility (Financial Times, November 18, 1996).

access to its markets is a costly 'concession' for which it has to be compensated by reciprocal liberalization by its trading partners. Except in cases where significantly adverse terms of trade effects are induced by liberalization (an unlikely event certainly for small countries, and most probably even for as large a grouping as APEC), this argument does not carry much weight. One should have thought that if indeed the goal of EPG is globally free and open trade, far from bowing to political expediency, they should have used their prestige to educate the political leaders of APEC that their fears of unconditional MFN extension of their liberalization to non-members are unwarranted.

It is thus difficult to avoid the conclusion that 'Open regionalism,' if not an oxymoron, is not a particularly fruitful new concept in the arena of trade liberalization. If the smaller developing countries of APEC, instead of pursuing their unilateral liberalization on an MFN basis, succumb to the 'Open regionalism,' they will be subjecting themselves to what Bhagwati terms "a process by which a hegemonic power [and often manages] to satisfy its multiple trade-unrelated demands on other weaker trading nations more easily than through multilateralism" (Bhagwati (1995), pp. 13-14).

It is unfortunate that the regional route to liberalization and a version of open regionalism have been embraced by Mr. Renato Ruggeiro, the Director-General of the WTO. He recently suggested

> "The regional liberalizing impulse is not in itself cause for alarm among the upholders of the multilateral system. Regional initiatives can contribute significantly to the development of multilateral rules and commitments, and in regions such as Sub-Saharan Africa they may be an essential starting-point for integration of least-developed countries into the wider global economy. At the most basic level the real split is between liberalization, at whatever level, and protectionism. Viewed from this perspective regional and multilateral initiatives should be on the same side, mutually supportive and reinforcing." [WTO (1996), p. 10]

But he added

> "However the sheer size and ambition of recent regional initiatives means we can no longer take this complementarity for granted, if indeed we ever could. We need a clear statement of principles, backed up by firm commitments, to ensure that regional schemes do not act as a centrifugal force, pulling the multilateral system apart. The answer is to be found, I suggest, in the principle which some of the newer regional groupings have enunciated -- Open Regionalism." [Ibid, p. 10]

Ruggeiro contrasted two interpretations of Open Regionalism. The first essentially required that any regional preferential trade arrangement be consistent with Article XXIV of GATT 1994 and the understanding on its interpretation incorporated in the UR agreements on Trade in Goods. In the second

> "... the gradual elimination of internal barriers to trade within a regional grouping will be implemented at more or less the same rate and on the same timetable as the lowering of barriers towards non-members. This would mean that regional liberalization would in practice as well as in law be generally consistent with the m.f.n. principle." [Ibid, p. 11]

He concluded

> "The choice between these alternatives is a critical one; they point to very different outcomes. In the first case, the point at which we would arrive in no more than 20 to 25 years would be a division of the trading world into two or three intercontinental preferential areas, each with its own rules and with free trade inside the area, but with external barriers still existing among the blocs." [Ibid, p. 11]

He clearly expressed his preference for the second, arguing, in sharp contrast to the CEA, that it

> "...points towards the gradual convergence of regionalism and multilateralism on the basis of shared aims and principles, first and foremost respect of the m.f.n. principle. At the end, we would have one free global market with rules and disciplines internationally agreed and applied to all, with the capacity to invoke the respect of the rights and obligations to which all had freely subscribed. In such a world there could and must be a place for China, Russia and all the other candidates to the WTO." [Ibid, p. 11]

Notwithstanding the Director Generals' preference for the second interpretation, it seems odd: after all, if regional liberalization is to be extended on the same time table "in practice and in law" to non-member countries on an MFN basis, it would be multilateral and not regional. If that is the case, why would any group initiate it on a regional basis in the first place?

The concern of the Director General that mere consistency with Article XXIV is not enough to preclude the possibility of a world of trade blocs is well taken. Whether a changed Article XXIV would prevent such an outcome is an open question.[11]

4. Saving Non-Discrimination: Enhancing Credibility of WTO Processes Relating to Preferential Trading Arrangements

The dismal failure of the GATT Working Party mechanism for examining the consistency of proposed PTA's with the conditions laid down in Article XXIV and making recommendations to the governing council of GATT was documented in Section 1. The reasons for the failure, as noted earlier, were largely in the vagueness of the conditions in Article XXIV itself. Under the circumstances, one approach to reform is to replace Article XXIV by a better alternative which is precise, transparent and predictable in its application.

An attractive alternative is one which retains the notification requirements of Article XXIV and lays down a precise time limit (say five years) within which, first, any and all preferences (tariff and non-tariff) that are included in any existing or proposed PTA's are required be extended to all members of the WTO on an MFN basis; second, in the case of Customs Unions, if the common external tariff structure results in an increase in tariff relative to what prevailed in any country prior to its becoming a member, such increases are to be rescinded within the same period; third, in the case of FTA's any increase in the applied external tariffs of a member following its formation, even if it is within its previously bound levels, are to be rescinded within the same period. Any disputes relating to the observance of these conditions would be resolved using the Dispute Settlement Mechanism of the WTO. This alternative restores non-discrimination within a set time limit and avoids having to

[11]Among recent contributors to the literature related to Article XXIV are Bhagwati (1991, 1993), Bond et al. (1995), Finger (1993), Jun and Krishna (1996), McMillan (1993), Roessler (1993), Snape (1993), Syropoulos (1995a, 1995b) and Winters (1996b).

examine whether PTA's satisfy specified conditions to be given a permanent waiver from MFN. It is extremely unlikely, however, that this proposal will attract support from countries that are members of existing PTA's such as EU and NAFTA. As such, one has to examine possible ways of strengthening Article XXIV.

The imprecision of the requirement of Article XXIV that duties and other regulations of commerce should be eliminated with respect to substantially all the trade between members in products originating in them has led to serious problems of interpretation (WTO (1995), p. 13): should the word 'substantially' be interpreted qualitatively (i.e., no major sectors are excluded) or quantitatively (i.e., share of trade of the members covered)? Does exclusion from elimination of barriers with respect to trade among members in unprocessed agricultural commodities, as in most PTA's, violate the "all-the-trade" requirement? Are all types of non-trade barriers to be eliminated, whether or not such barriers are sanctioned under other Articles, for example, those relating to safeguards, anti-dumping and national security? Are other members of a CU or PTA to be exempted when one member takes actions in the form of quantitative restrictions under the safeguard clause, actions that would otherwise have been non-discriminatory?

The fundamental objective that prompted the inclusion of the "substantially all" trade condition was to "avoid a mass of protectionist oriented a la carte agreements that exclude a broad range of "sensitive" sectors" (WTO, 1995, p. 66). One way to achieve it while avoiding problems of interpretation is, first, to substitute the phrase "substantially all trade" by "trade in all products and services except those explicitly exempted from MFN or NT requirements under other articles or understandings of WTO." Second, if a member of a CU or FTA avails of administered protection permitted under WTO articles which is required to be applied on a non-discriminatory basis, other members should not be exempted from its application.

The second major problem of interpretation of Article XXIV arises with respect to the requirement that the common external tariff and other restrictive regulations imposed at the time of

the formation of CU not be "on the whole higher or more restrictive" than those imposed by its members prior to its formation. The Understanding reached in the Uruguay Round with respect to Article XXIV clarified that for purposes of comparison,

> "... the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union shall in respect of duties and charges be based upon an overall assessment of weighted average tariff rates and of customs duties collected. This assessment shall be based on import statistics for a previous representative period to be supplied by the customs union, on a tariff-line basis and in values and quantities, broken down by WTO country of origin. For this purpose, the duties and charges to be taken into consideration shall be the applied rates of duty."

The substitution of the vague phrase "general incidence" by a much more precise criterion for comparison of pre- and post-union tariff structures was a step in the right direction. However, no rationale for the proposed criterion was offered. Nor was it established that one can infer how the welfare of non-members is affected by the formation of CU by using the suggested comparison.

Two of the proposals for reform of Article XXIV in this context are by Bhagwati (1991) and McMillan (1993). Bhagwati proposed that a CU should be approved only when its common external tariff is set at the minimum of the pre-union import tariffs of the member countries. An implication of this is that the CU will engage in free trade with <u>all</u> non-members, if at least one member had a zero pre-union tariff for each of the traded commodities! Even if this were not the case, the Bhagwati proposal could <u>lower</u> welfare of some members of the CU and <u>raise</u> that of non-members (Srinivasan (1996)). Since such a possibility could deter the formation of a union, the Bhagwati proposal may still be treated as a desirable reform which in effect sets a price or hurdle on WTO members who wish to enter a customs union and thus compromise the MFN principle.

McMillan (1993) suggests that

> "A proposed RIA [Regional Integration Agreement], in order to get GATT's imprimatur, would have to promise not to introduce policies that result in external trade volumes being lowered. And, if after some years the RIA is seen to have reduced its imports from the rest of the world, it would be required to adjust its trade restrictions so as to reverse their fall in imports." (p. 300)

Measuring trade volumes is certainly more workable. But changes in aggregate volumes of trade with non-members need not necessarily indicate changes in global welfare. Besides, by substituting outcome variables (viz. trade volumes for instrument variables, viz. tariff rates) when in fact outcomes are impossible to predict with any accuracy, the McMillan proposal runs into problems similar to those afflicting the malodorous "managed-trade" approach to trade policy.

The Kemp-Wan (1976) tariff structure by a CU, as mentioned earlier, is sufficient to ensure that the welfare of non-members is not adversely affected by its formation. It is certainly not necessary--after all, one cannot rule out the possibility that in spite of the change in the prices faced by non-members incidental to the adoption by a CU of a tariff structure that differs from a Kemp-Wan structure, welfare of non-members is not adversely affected. Even if a theoretically more satisfactory averaging of pre-union tariffs could be specified, still the facts that tariffs are not the only barriers to trade, non-tariff barriers cannot always be converted to equivalent tariffs, and most important, that pre-union barriers could reflect expectations then about the future evolution of the world economy, suggest that whatever tariff averaging procedure is suggested for comparing pre- and post-union barriers with respect to trade with non-members, it is difficult to ensure that it will guarantee that the welfare of non-members in the post-union future is no lower than what it would have been in the counterfactual world without such a union. Thus, from the only appropriate perspective, viz. in determining whether a proposed CU or FTA adversely affects the future welfare of a non-member relative to what it would have been in the absence of that CU or FTA, none of the proposed modifications of Article XXIV are of much help.

A third and equally thorny issue that arises with respect to FTA's is their rules of origin (ROOS) which determine which products receive duty-free treatment when such products use intermediates imported from non-member countries in their production. The Uruguay Round agreement on ROOS envisages a work program for harmonizing rules of origin and the establishment of a Technical Committee with responsibilities, inter alia to examine technical problems in the day-to-day administration of ROOS and to prepare and circulate periodic reports on technical aspects of the agreement on ROOS. My reading of this agreement is that it can at best bring transparency and technical coherence to ROOS. But it does not come to grips with the crippling conceptual issue whether ROOS can ever be harmonized in a meaningful sense in a world where several countries are members of more than one overlapping preferential trade arrangements.

I should also mention technical difficulties involved in determining the local (i.e., FTA) content for products when there is local production as well as imports of several intermediates from third countries. It is natural to consider using an input-output matrix for this purpose, thereby assuming that input coefficients are technological constants. A typical coefficient a_{aj} of the input-output matrix A represents the amount of <u>input</u> of commodity I needed to produce a unit of <u>output</u> of commodity j. But there is no way to decompose a_{ij} into domestically produced and imported quantities of I if there is import competing domestic production of I. Besides, the constancy of the coefficients of the A matrix is itself a strong assumption. Krueger's (1992, 1995) analysis of ROOS and overlapping FTA's illustrates how in establishing ROOS, non-transparent lobbying by protectionist interests is very likely. But the problem goes deeper and arises also in a CU. For example, the French apparently worry about and insist on value added rules in determining whether an automobile <u>produced in the U.K.</u> in a Japanese-owned plant should be allowed duty free. Of course, if Article XXIV is replaced a time-bound phasing out of preferences, the problem of ROOS will become moot as well.

To the extent that PTA's are driven primarily by political objectives (e.g., the fundamental reason for the establishment of European Coal Steel Community and later the European Community

was to reduce the prospects of yet another European war) and those objectives are shared widely, the past "practice of looking the other way when Article XXIV runs up against overriding political goals" (WTO, 1995, p. 65) will continue whether or not Article XXIV is strengthened. Nonetheless, requiring that any proposed PTA be notified prior to its being ratified member countries so that the WTO can weigh in with its recommendation, as suggested in WTO (1995), is a sensible idea even though WTO's efforts could be wasteful in those cases where the proposed agreement is not ratified.

The recommendations in WTO (1995) on improving transparency and surveillance are also sensible. Indeed, the GATT had a biennial reporting requirement for developments within individual PTA's but this was not met. A revised and stricter enforcement of this requirement would be helpful. Perhaps instead of requiring CU's or FTA's to submit reports, a better procedure would be for the WTO itself to draw up such reports using the Trade Policy Review Mechanism.

There are also claims that recent regional agreements go beyond conventional trade arrangements, addressing not only trade in goods, but also the liberalization of trade in services, movements of labor and capital, the harmonization of regulatory regimes, and the coordination of domestic policies that influence international competitiveness. It is arguable that such harmonization is not always beneficial and, even if it is, there are perhaps more efficient ways of achieving it. All said and done, in my judgment the adverse systemic and other effects of discriminatory PTA's far outweigh any beneficial effects.[12] Rather than try to reform Article XXIV, a better approach, as suggested earlier, will be to ensure that all PTA's, regional or otherwise, are temporary features of the global trading system. In fact, the best approach for WTO members could well be, first, to follow the advice of

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[12]Pomfret argues that governments of member countries of CU's code sovereign power over external trade policy and tax revenue to the Union and as such are inevitable precursors of some form of federation. To expect them to multilateralize their preferences is utopian in his view. While there is merit in his argument, it seems to be based essentially on the experience of the European Union. Even in this case, as the saga of the implementation of social clauses and of steps towards a monetary union indicates, any form of federation is far from inevitable and, if it is, it is a long way off in the future.

Nancy Reagan and "Just say no" when presented with any proposed PTA for approval and, second, to follow the advice of Senator Robert Dole when he suggested to the proponents "Just don't do it"!

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