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The Preference for New Preferential Trade Agreements: Does It Lead to a Good Use of Scarce Resources?

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At the end of 2010 there are more than 100 new preferential trade agreements being contemplated. At the same time there are approximately 200 existing trade agreements whose provisions leave large additional potential gains from trade on the table. Despite these potential benefits, there appears to be little enthusiasm for recontracting efforts centred on existing agreements. This suggests that there is an inefficient deployment of scarce negotiating resources. Exceptions do exist, such as the European Union, which has strong institutional mechanisms – including, in particular, the Commission – that foster further market integration. While the EU's institutional model may not be suitable for all preferential agreements, incorporating a formal recontracting mechanism into new agreements will provide opportunities to garner additional gains from trade in the future.

Keywords: economic integration, institutions, preferential trade agreements, recontracting

NAFTA Commission Meeting Postponed, No New Date Announced

A meeting of the North American Free Trade Agreement (NAFTA) Commission scheduled for last week was postponed due to scheduling conflicts, according to a spokeswoman with the Office of the U.S. Trade Representative. The NAFTA Commission meeting was scheduled to take place in Mexico, although the agenda was unclear.

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Preferential trade agreements[1] are the current *flavour of the month* in international relations. All of the major economies are seeking out new partners with which to negotiate the lowering of trade barriers and other impediments to international transactions. The United States is in negotiations with a number of countries, with completed agreements awaiting ratification, e.g., agreements with South Korea, Colombia, and Panama, among others. The European Union and Canada are negotiating a Comprehensive Economic and Trade Agreement (Viju, Kerr and Mekkaoui, 2010). India and the EU are in talks that could bring together India's market of nearly a billion people with the world's largest developed-country market (Khorana, et al., 2010). Canada is also moving forward with a preferential trade agreement with India. China and Japan are separately pursuing economic partnerships with a range of countries. There is a major regional (broadly defined) effort being fostered by the United States to realize a Trans-Pacific Partnership. Politicians laud the jobs and other economic benefits they are assured will come and, of course, enjoy the photo opportunities. Business leaders often join the politicians on official trips to explore the potential opportunities, while protectionists fume and lobby. The media analyses, pundits make measured pronouncements and academics organize conferences. If it is not exciting, at least it is something new.

Currently more than two hundred preferential trade agreements have been notified to the World Trade Organization, and more than one hundred potential agreements are being negotiated (ICTSD, 2010). Illustrative of the focus on the new is the Trans-Pacific Partnership which is being negotiated between the United States, Australia, New Zealand, Chile, Singapore, Malaysia, Vietnam, Brunei Darussalam and Peru, with Japan and Canada still considering whether or not they wish to be party to the negotiations (ICTSD, 2010). There is a large overlap in membership between this group and the membership of the Asia-Pacific Economic Cooperation group (APEC), which is now old having been established in 1989. APEC was once considered a dynamic and innovative approach to trade liberalization that embraced open regionalism (Yeung, Perdikis and Kerr, 1999). Instead of attempting further progress towards liberalization through APEC, the United States, which is seen as the driving force behind the Trans-Pacific Partnership, has opted to negotiate a new agreement.

An APEC summit in November 2010, in contrast, was long on platitudes but short on any concrete action (ISTSD, 2010). Meanwhile, APEC members China, Japan and South Korea, which are not part of the prospective Trans-Pacific Partnership, are slated to begin negotiations on a preferential agreement in 2011. While there may be differences in the agendas for those separately negotiating new agreements to foster trade liberalization in the Pacific Region, there is a cost for the businesses that actually engage in trade activities of being faced with a plethora of rules.

Of course, some *new* initiatives have the potential for large liberalization payoffs. These opportunities relate to countries that have been largely closed to trade until recently – in particular, India and China. India is singularly active in attempting to overcome its previous economic isolation. It has completed negotiations with the Association of South East Asian Nations (ASEAN). It is currently negotiating bilaterally with the European Union (Khorana et al., 2010), Canada, Japan, Malaysia, Thailand, New Zealand, Sri Lanka and the European Free Trade Area (EFTA). It is contemplating agreements with Turkey, Indonesia and Australia.

China is also very active in seeking agreements to secure sources of supply for natural resources, but these types of agreements do not qualify as WTO-recognized preferential agreements. According to Article XXIV of the General Agreement on Tariffs and Trade (GATT), preferential trade arrangements – customs unions (CUs) and free trade areas (FTAs) – are allowed by the WTO. The GATT, however, requires that these agreements cover substantially all trade and that existing external tariffs should not be raised by the countries concluding the FTA.[2] Article XXIV of the GATT stipulates that

> A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (…) are eliminated on substantially all the trade between the constituent territories in products originating in such territories (WTO, n.d.).

It seems it is always easier to capture the imagination of those who have the ability to *make things happen* with something new. At universities, core teaching departments languish while new schools and institutions are founded, siphoning resources and talent. It is also true that universities are littered with institutes that are little more than nameplates on doors at the end of musty, dimly lit corridors – their money gone and the talented people decamped for newer opportunities. While much of what is cast aside in this somewhat deterministic process may have simply been the embodiment of the *flavour of the month* when they were established, and thus did not provide much of value, others that make important contributions are similarly allowed to *die on the vine* in this way only because they are no longer new and sexy.

The globe is littered with preferential trade agreements that are long forgotten by everyone but the academics that study these things. Many from the 1960s, while they remain on the books, were never actively implemented – the major benefit was probably the photo opportunity that accompanied their signing. Others, however, that were major forces of liberalization, economic expansion and market integration now languish – one shot deals that have become part of the institutional backdrop of the economic environment. In many cases, however, while there have been major benefits from the liberalization brought by the agreement, considerable benefits from further market integration among their existing members remain to be tapped.

One major example of this outcome for a preferential trade agreement is the North American Free Trade Agreement (NAFTA). As the quote that begins this paper indicates, the NAFTA is now low on the list of political priorities, with nothing particularly interesting or pressing to discuss. Negotiating resources are scarce and one suspects that the scheduling difficulties for the United States were related to the concerted attempt to complete the Korea-US Free Trade Agreement that was competing for those resources. The NAFTA Commission is the senior institutional forum of the agreement but is not taken particularly seriously by the three contracting parties. The unrealized economic potential from further liberalization of the North American market is immense, significantly larger than that available from, for example, a trade agreement between the United States and Korea, much less the economic benefits for the United States of an agreement with Colombia or Panama.[3] The NAFTA, however, is no longer new and sexy.

The NAFTA was the darling of its time, and its initial success may have been the spur for the major change in U.S. trade policy away from an almost exclusive focus on multilateralism to the multitracked, bilateral, regional and multilateral approach that has pertained over the first decade of the 21st century (Kerr and Hobbs, 2006). Aspects of the NAFTA such as its dispute settlement system and the investment chapter were to be models for the reformed GATT that grew into the World Trade Organization (Apuzzo and Kerr, 1988).[4] Although the success of trade agreements is very difficult to measure because agreements are implemented over long phase-in periods where many other factors affect trade flows and performance of the economy – meaning that holding everything else constant to isolate the effect of the trade agreement is a significant challenge (Abler, 2006)[5] – there is widespread acceptance that the NAFTA has led to increased economic activity. Trade liberalization, as with any change in public policy, creates losers and well as winners, and the NAFTA has many critics. Those critics make further progress on liberalization politically difficult, but the potential benefits remain large and currently represent a lost opportunity.

The NAFTA is a free trade area. Thus, it represents only the first step on the road to achieving a truly integrated market. The next logical step from an economic perspective would be the creation of a customs union with a common external tariff (Meilke, Rude and Zahniser, 2006). This would simplify trade among the three countries considerably by removing the barriers required to prevent circumvention of the tariffs of high-tariff countries – those pertaining to rules of origin. There are also likely gains from a wide range of regulatory harmonization – everything from the grading of agricultural products (Kerr, 1992; Kerr, 1997) to mutual recognition of professional qualifications. Government procurement remains restricted to a considerable degree. The list of professions that can take advantage of temporary work visas is short. The range of services which are open to firms from the other NAFTA partners is restricted. Hence, moving the NAFTA forward to new levels of market integration could have a large economic payoff, yet it is hardly being discussed in Washington, Mexico City or Ottawa.

One of the major problems is that the NAFTA has no recontracting provision. A recontracting provision provides an institutional mechanism to move the process of liberalization forward. For example, the WTO allows for the initiation of a new round of negotiations. A central feature of the WTO's recontracting mechanism is its *forward-only* or *no-backsliding* provision, which means members can be assured they will not lose any previously gained concessions if they agree to having a new round.

In the Doha Round, this principle is facing a major test. In the negotiations it has been agreed that as part of the *special and differential treatment* that developing countries are to be extended there is a *special safeguard* provision for agricultural product imports. In essence, this is an anti-surge mechanism to allow developing countries to better deal with market-disrupting short-run increases in imports. If a surge of imports meets the criteria set out in the *special safeguard* provisions, then the importing country is allowed to impose temporary duties to limit market access.

The Doha Round agriculture negotiations pertaining to the *special safeguard* have centered on questions of the appropriate *import quantity increase* trigger, the appropriate *price decline* trigger and the appropriate level of duties to be imposed once the trigger levels have been breached. Most of the attention has focussed on the *import quantity increase* trigger. The appropriate level of duties, however, will depend on the size of the quantitative surge and/or price decline. One of the proposals put forward by developing countries would allow, under certain circumstances, for the duties that could be imposed to exceed the current – Uruguay Round – bound tariffs. From the point of view of some members of the WTO this would be *backsliding* and, hence, they have vigorously opposed it. For them, violation of the *forward-only*

principle would set a very bad precedent – one that could threaten the future efficacy of the entire WTO. If *backsliding* were to be allowed, they suspect that obtaining an agreement to proceed with new rounds of negotiations in the future would be virtually impossible – for the same reasons that Canada and Mexico will not agree to renegotiate the NAFTA. Canada and Mexico perceive that the U.S. Congress would only agree to renegotiate the NAFTA if some of the current concessions could be clawed back. Given the unequal bargaining power between them and the United States, such demands would be hard to resist.

The inability of the negotiators to bridge the gap over backsliding was the formal reason6 given for the suspension of the Doha Round negotiations in 2008 (Valdes and Foster, 2008). After the collapse of formal negotiations, informal discussions on the issue have not produced any results. While it is clear that a recontracting provision cannot guarantee that there will be trade liberalization, having the ability to launch a new WTO round without fear of losing what has been achieved is a valuable mechanism from an institutional perspective.

The European Union has the strongest institutions to foster trade liberalization/market integration. The WTO is a relatively passive institution in terms of moving the trade liberalization agenda forward. The WTO provides a venue where the member states can negotiate when a round is agreed. Once a round is agreed, the Secretary General can exhort the member states to successfully conclude a round. It is the member states, however, that agree to having a round and to what will be on the negotiation agenda.

In the EU's institutional structure, the Commission has a formal responsibility to foster and promote the single market. The Commission draws up plans with the objective of moving towards achieving the single market. Of course there are a large number of checks in European Union governance, which means that simply because the Commission proposes measures that will lead to further market integration, they don't necessarily come to pass. Not all countries have adopted the Euro, even when they have met the criteria; not all countries have joined the Schengen Group of countries that have eliminated all internal border controls; and national referendums with negative results have forced the renegotiation of major proposals for EU constitutional changes. The European Parliament and the Council of Ministers have complex voting rules or vetoes over Commission proposals. The European Court also acts a check on the Commission's attempts to foster increased market integration.

The important point is, however, that there is an institutional mechanism with a formally defined role to devise the means to move toward evermore integration of the economies of the member states. This strong recontracting institutional arrangement

has, of course, yielded impressive results. The European Union has gone further along the process of deep economic integration than any other preferential trade agreement. It has also had sufficient success to make it attractive for new members to join. The prospect of joining the European Union generates genuine excitement among those slated for accession – even if it is far in the future. When additional countries join, it gives the EU a new look and new designations, e.g., EU-12, EU-15, EU-25, EU-27. Alternatively, in the early years of the NAFTA other countries expressed an interest in joining, e.g., Chile and some countries in the Caribbean and Central America. One no longer hears such interests being expressed.

The ability of the European Union to remain fresh is in no small part due to the key role given to the Commission. The momentum generated by the Commission leads to continuing recontracting, so that the EU never becomes *stale old news* but rather, if not new, it at least appears renewed. Certainly, the EU seeks out new preferential arrangements with other parties, but this does not detract from its central purpose of deepening integration.

In contrast, the NAFTA has no recontracting provisions. Its institutions purposely were kept weak (Meilke, Rude and Zahniser, 2006). There is no proactive institution such as the European Commission that can act as the NAFTA's voice (Kerr, 2002). Those who negotiated the NAFTA saw there was a need to continue the process of market integration through the removal of non-tariff barriers and the harmonization of standards. In the NAFTA they mandated the establishment of a number of committees that were to work toward further market integration. With a few exceptions, these have not worked as intended. They have simply become venues to *talk and talk* without any mechanism to force closure on issues (Kerr, 2006). After decades they have not accomplished even simple things such as the harmonization of beef grading. Thus, the NAFTA is essentially a *one shot deal*. While the NAFTA arrangement may represent the true appetite in the three countries for market integration, there is no mechanism to test that proposition. Without an institutional arrangement that allows formal proposals for recontracting, there is no way to establish whether progress on market integration is desired. It seems odd, given that the ambition of the NAFTA is quite modest, and hence the gains from further progress likely would be considerable (Meilke, Rude and Zahniser, 2006), that there would not be considerable support for a further deepening of market integration. As with the case of the European Commission, checks could easily be embedded in a new arrangement to ensure that proposals that did not have broad support would not be accepted.

As suggested above, there are more than one hundred new trade agreements being negotiated. Part of the enthusiasm for new preferential trade agreements is a result of

the apparent inability to successfully conclude the Doha Round of multilateral negotiations. What is hard to fathom is that there is little enthusiasm for recontracting within the two hundred preferential trading agreements that have already been notified to the WTO. Most of these agreements have only just scratched the surface in terms of the economic gains available from further liberalization. Although there has been a focus on the NAFTA in this paper, many other preferential agreements fail to garner any attention regarding the potential rewards from further integration. This failure represents considerable forgone opportunities.

The lesson is that those negotiating the hundred-odd new preferential arrangements should build in formal mechanisms for recontracting. This will allow these agreements to escape being relegated to being solely a backdrop feature of the international commercial environment and instead continue to foster the achievement of gains from trade. While the institutional model provided by the European Union, with its ever-proactive Commission, may be too deterministic for the members of many new preferential trade agreements, institutional arrangements for recontracting that provide opportunities for moving forward can be devised. Such arrangements will allow scarce lobbying and negotiating resources to be deployed where the potential gains from trade are the largest, whether through further deepening of existing agreements or agreements with new partners. Of course, the potential gains from trade must be tempered by assessments of the probability of success when decisions regarding where scarce resources should be committed are taken.

There would appear to be bias toward the negotiation of new preferential trade agreements relative to the recontracting of existing agreements. This bias likely leads to inefficient results in terms of the gains from trade that are available. Hence, institutional arrangements for recontracting should be included in new preferential trade agreements.

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Endnotes

1. The term *preferential trade agreement* has replaced the term *regional trade agreement* as countries seek out trading partners outside their regions. Of course, the term *regional trade agreement* as well as *bilateral trade agreement* are used when appropriate – all are preferential trade agreements.
2. This provision has never been tested at the WTO. Many preferential trade agreements, for example, exclude large segments of agricultural trade (Viju, Kerr and Mekkaoui, 2010; Kerr and Hobbs, 2006).
3. Of course, having preferential access to the U.S. market may be beneficial for smaller countries such as Colombia or Panama.
4. Despite considerable effort, NAFTA's Chapter 11 failed to inspire inclusion of a Multilateral Investment Agreement in the WTO (Loppacher and Kerr, 2006)
5. The required *ceteris paribus* conditions are difficult to achieve in empirical studies (Moodley et al., 2000).
6. Others think the problems with the *special safeguard* mechanism are only a convenient excuse for the myriad of issues where the member states of the WTO cannot reach agreement. *No backsliding*, however, was a sufficiently strong principle to force the issue.