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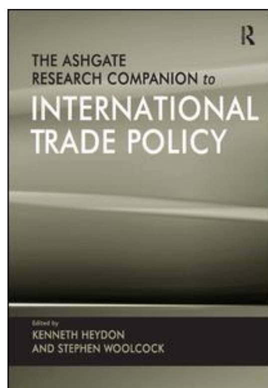

The Ashgate Research Companion To International Trade Policy

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Preferential Agreements and Multilateralism

Publication details
https://test.routledgehandbooks.com/doi/10.4324/9781315613086.ch22
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Published online on: 19 Jul 2012

How to cite :- Mark Manger. 19 Jul 2012, *Preferential Agreements and Multilateralism from:* The Ashgate Research Companion To International Trade Policy Routledge
Accessed on: 26 Mar 2023
https://test.routledgehandbooks.com/doi/10.4324/9781315613086.ch22

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Preferential Agreements and Multilateralism

Mark Manger

Introduction

One of the most noteworthy developments since the creation of the WTO in 1994 has been the rapid proliferation of preferential trade agreements (PTAs). PTAs come in various forms and guises, but their common denominator is that they are exceptions to the most-favoured-nation (MFN) principle that underpins the GATT and the GATS, and that features prominently in many other commercial treaties. In a PTA the members grant better (hence preferential) market access to their partners than to non-members. As reciprocal agreements, they are not to be confused with programmes such as the 'Generalized System of Preferences', through which developed countries unilaterally concede better access for imports from developing countries.

Although preferential trade agreements have a long history going back to the nineteenth century, for most of the post-Second World War period they remained few. Since the early 1990s, however, the number of PTAs has grown at a stunning pace. In 1990, a mere 30 or so PTAs were legally in force.[1] By the summer of 2010, this number had reached 202, counting only agreements covering trade in goods and notified to the WTO by their members.[2] About an additional 100 agreements have been signed by non-members. Perhaps even more surprising is that almost 90 per cent of these agreements are bilateral, producing a complex network of treaties with different rules and tariffs.

1 Author's calculations based on data from the McGill RTA database ptas.mcgill.ca/, Tuck Trade Agreements Database www.dartmouth.edu/~tradedb/trade_database.html, and WTO regional trade agreements gateway http://rtais.wto.org/.

2 The WTO counts agreements covering goods and services as separate entities. In practice, more and more PTAs cover both forms of trade, but there are no free-standing services agreements between countries that do not already have a PTA covering goods.

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Inevitably, a growing share of world trade is covered by preferential rather than non-discriminatory rules. The sizeable remainder is mostly trade between the major economic powers: the United States, the European Union (EU), Japan and China. Given the lack of progress in WTO negotiations, it is not an exaggeration to say that multilateral trade liberalization has become a sideshow.

The sudden, but all the more rapid, proliferation of PTAs has inspired a vast body of research in economics and international political economy. This chapter presents an overview of the key themes and findings of this research. At its centre is the question of how the multilateral trade system and preferential trade agreements interact, and what the implications of current trends are for the future of the WTO.

A Typology of PTAs

Before turning towards the analysis of PTAs, some definitions are in order. In GATT parlance, preferential trade agreements are referred to as 'regional trade agreements'. Governments give agreements various labels such as 'Association Agreements' (EU) or 'Economic Partnership Agreements' (Japan and the EU, although with substantially different meanings). For research purposes, it is more useful to classify PTAs in terms of the liberalization efforts required from their members.

Partial scope agreements, as the name suggests, only reduce the trade barriers for a small range of specific goods. A recent example is the Chile–India Preferential Trade Agreement. The agreement reduced (but did not eliminate) tariffs for 75 per cent of Chile's imports from India in terms of value, or 3.7 per cent of all different tariff lines, and eliminated duties on 0.5 per cent. The 'typical' reduction is from 6 per cent to just less than 5 per cent. India reduced (but did not eliminate) the tariffs on about 95 per cent of imports from Chile, but only by 1 or 2 per cent from a high baseline of 10 to 50 per cent in some instances. This outcome is not uncommon for partial scope arrangements. Often, they do not offer meaningful reductions of MFN tariffs.

South–South agreements, especially those involving low-income countries, fall mostly into this category. As they contribute little to the elimination of trade barriers, their effect on trade and the multilateral system is usually minimal. Creating trade institutions, however, can become an opportunity for patronage, so that these agreements are often a source of costs rather than benefits and are of questionable value for economic development (Gray 2010).

Most common among PTAs are Free Trade Agreements (FTAs). In an FTA, the partner countries eliminate tariff barriers between themselves, but retain different MFN tariffs vis-à-vis the rest of the world. Over 90 per cent of current PTAs fall into this category. The remainder of PTAs and partial scope agreements are customs unions (CUs). In a customs union, the members agree on a common external tariff. This is politically more demanding but has the advantage that no additional rules

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are required to determine through which country a good is first imported – a point we will return to later.

Preferential trade agreements can cover trade in goods only, but increasingly often also reduce barriers to trade in services and investment. Recently, PTAs have also incorporated chapters on investment rules that draw on bilateral investment treaties, trade facilitation and political cooperation.

Legally speaking, PTAs among WTO members that liberalize trade in goods are permitted under Article XXIV of the GATT and Article V of the GATS. Article XXIV prescribes that the agreement should: eliminate the tariffs on 'substantially all trade' between the partners, achieve this goal in a reasonable time of ten years (but 'exceptional cases' are possible), and not erect new barriers against those left outside. However, the latter is permitted provided the partners offer other WTO members 'compensation' in the form of reductions of other tariffs. The EU did so in 1995 when it admitted Sweden, as the country had to raise tariffs to bring its duties in line with the common external tariff of the European Union. GATS Article V gives equivalent clauses for trade in services, but as services trade barriers are mostly regulatory, its implications are unclear. It is noteworthy that although PTAs are regularly scrutinized by the WTO, no country or set of countries has been officially accused of violating Article XXIV of the GATT – perhaps because no one is willing to cast the first stone.

PTAs among developing countries do not have to adhere to these rules. The Enabling Clause, a product of the 1979 Tokyo Round, allows the partial liberalization under the rubric of 'special and differential treatment' at whatever pace the participants deem suitable. In practice, this means that developing countries can delay tariff reductions in a PTA indefinitely or not implement the provisions of a negotiated agreement at all.

The prescriptions of Article XXIV have a straightforward economic rationale. The very existence of the GATT stems from the experience of the interwar years, when the world economy was divided into competing trade blocs. With this experience in the background, the negotiators of the initial treaty faced the challenge of accommodating existing and proposed preferential arrangements such as the system of 'Imperial Preferences' proposed at the Ottawa conference of 1932, the US–Canada 'Auto pact' (effectively a partial scope agreement for auto parts), and the proposal for economic integration in Europe. Although these agreements would clearly violate the principle of non-discrimination, the GATT founders tried to limit their adverse effects.

The Economics of PTAs – Trade Creation and Diversion

PTAs that discriminate against the rest of the world may cause (net) *trade diversion*, that is, they can reduce imports from those outside the PTA by more than they *create trade* among the members.

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Consider the following situation: prior to the formation of a PTA, a particular good is imported from a supplier in a third country. Once the tariffs in the PTA are eliminated, the suppliers in the partner country may become relatively cheaper. The imports from the third country still carry a most-favoured-nation tariff, while those from within the PTA are tariff-free. In principle, this is a good thing, as it creates trade. Imports are now cheaper, so consumption can increase. However, if the producers from within the PTA are less efficient than those outside, the PTA is inefficient since the producers within the PTA earn an economic rent. What is more, it can even make the importing country worse off because tariff revenue is forgone.

Although the basic mechanism of trade creation versus trade diversion was identified decades ago (Lipsey 1957; Viner 1950), only recently have the data become available to conduct econometric studies that shed light on how relevant these concerns are in practice. In theory it is easy to devise trade agreements that are Pareto-efficient, making the PTA partners better off and leaving those outside unaffected (Kemp and Wan 1976). In practice, such considerations are second to the political requirements for striking a deal. Whether an agreement is trade-diverting therefore largely depends on the existing tariffs vis-à-vis the rest of the world. The higher the initial tariffs, the more likely that trade diversion materializes.

How relevant are these concerns in practice? Because of the importance of the US market for many countries, several studies have investigated whether the North America Free Trade Agreement (NAFTA) has diverted trade (Fukao et al. 2003; Krueger 1999), but have only found very limited evidence for specific product groups. In general, PTAs do not divert as much trade in the aggregate as is often feared — with some notable exceptions such as MERCOSUR (Adams et al. 2003). But by definition, even without *net* trade diversion, any PTA that influences trade must have a negative effect on some exporters outside of a PTA and thus be second-best to multilateral liberalization. Because these exporters lose out, they often seek some form of compensation. PTAs may therefore trigger a political reaction.

All else being equal, excluded countries have three possible ways to react to a PTA: join the existing agreement, form a PTA with the more important member(s), or negotiate an agreement with alternative trade partners to secure new export markets. All of these will result in even more agreements, creating a dynamic whereby PTAs are becoming endogenous; each new agreement begets others (Baldwin 1996; Egger and Larch 2008; Katada et al. 2009; Manger 2005, 2009; Solís 2003).

It is worth remembering that we may observe this effect even though trade agreements are not net trade-diverting. All that is necessary is that third-party exporters make a convincing case to their governments that they are facing trade discrimination.

And yet, there are plenty of reasons why trade-diverting agreements should be easier to negotiate. Any agreement that reduces trade barriers exposes some producers to competition. Naturally, these import-competing actors will oppose the PTA. To muster enough political support for a PTA, they must be counterbalanced by some other interest group. The obvious candidates are producers who would benefit from trade diversion, that is to say those who can only compete if they have

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a preferential tariff margin. Considering that the excluded countries do not have a voice at the negotiating table, it is tempting for politicians to favour producers within the PTA at the expense of those in non-member countries (Grossman and Helpman 1995; Hirschman 1981: 271) – precisely the scenario that GATT Article XXIV is supposed to prevent.

The Political Economy of PTA Formation

Aside from the growing evidence that PTA formation is partly interdependent, why do countries sign PTAs in the first place? This is not a moot question — through the six decades of its existence the multilateral trade regime has been astoundingly successful in reducing barriers to trade. Today, developed-country tariffs on merchandise imports are usually below 5 per cent, and are often zero. Perhaps even more impressively, most countries in the world are now WTO members with the remainder either isolated for political reasons (for example, North Korea) or because they are exporters of natural resources, such as some Central Asian countries. Compared to even small tariff reductions on an MFN basis, the gains from complete liberalization within a PTA are often minute. So why the enthusiasm for preferential trade?

Reasons to form PTAs fall into three categories: purely political grounds; the goal to stabilize economic policy and therefore increase trade flows and foreign direct investment (FDI); and different aspects of gains from trade. Often, these factors combine to precipitate a PTA.

Politics First, Economics Second

Clearly, a number of PTAs have only a limited economic rationale. Some are policies to lend economic support to allies (the US–Israel FTA), while others are used by major powers to reward states for compliant behaviour (the US–Jordan FTA). Yet others are largely symbolical because the partners are so small and so distant that they hardly trade with each other. Another dimension is to encourage development in order to stem immigrant flows, as in the case of NAFTA. Of the PTAs formed between former socialist countries, many merely re-established free trade between countries that had previously been a single economic entity, such as the Czech and Slovak Republics.

A further, primarily political reason is that liberalization efforts at the WTO have slowed to a glacial pace, or rather have joined the 'Samuel Beckett school of iterative stasis: "Let's go." "We can't." "Why not?" "We're waiting for Doha"'.[3] This is the most often cited reason given by trade negotiators, perhaps also because in the absence of a WTO deal, PTA negotiations secure their jobs. There is, however,

[3] Beattie (2009).

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solid empirical evidence that an increase in the number of WTO members has promoted PTA formation, and that PTA negotiations are often initiated during ongoing multilateral negotiations (Mansfield and Reinhardt 2003).

For developing country governments, one of the most important motivations during the last two decades has been to underpin domestic economic reforms. In this context a preferential trade agreement serves a dual purpose. First, it can help overcome domestic resistance to liberalization, because the government can use the 'external pressure' of a larger negotiating partner as leverage (and as an excuse) to pursue market-opening policies. Second, and perhaps more importantly, a PTA with a bigger, more developed partner can be used to lock in policies so that succeeding governments cannot overturn them (Fernández and Portes 1998). This should in principle encourage domestic and foreign investment and boost economic growth.

Preferential trade agreements are therefore part of a larger shift in developing country economic policies. Until the late 1980s, most developing countries pursued an industrial strategy of substituting imports with domestic production to stimulate economic development, sheltered by high tariff walls (Krueger 1995). The dismantling of the tariff barriers began slowly after the Debt Crisis of the early 1980s, as countries sought to attract foreign investment to improve their balance-of-payments position, at first directly through capital inflows and then indirectly through export-oriented manufacturing investment. Many governments, however, faced considerable resistance to such reforms because domestic industries saw themselves (usually correctly) as incapable of competing with imports from developed countries and the more successful East Asian industrializing countries. Moreover, countries in Latin America had a history and reputation for vacillating between periods of liberalism and economic populism and foreign investors therefore questioned the continuity of reforms.

Given this situation, negotiating a PTA with a major economic power such as the EU, the United States or Japan solved several problems at once. First, the more powerful partner would demand liberalization of inefficient sectors, which would then receive inflows of foreign capital to become more efficient or otherwise simply disappear. In the negotiations, the government of the developing country would point at these demands to deflect the ire of domestic interest groups. Second, the commitments made in the negotiations would be written into an international agreement and would be monitored and, if necessary, enforced by the bigger partner by threatening to withdraw market access. In terms of contract theory, the PTA functions as a 'commitment device'. As a result, foreign and domestic investors would be reassured that the liberal economic environment was here to stay.

The poster child for reforms leading to an important PTA is Mexico, long a champion of import-substitution industrialization and disassociation from the economies of the developed world. Following its default on sovereign debt in 1982 that marked the beginning of the Third World Debt Crisis, successive Mexican administrations implemented austerity packages and radically lowered trade barriers (Pastor and Wise 1994). By 1990, however, domestic resistance prevented further market-opening, while foreign investment inflows continued to disappoint.

In a surprising move, President Salinas proposed the negotiation of a free trade agreement with the United States the following year (Cameron and Tomlin 2000). During the negotiations, the Mexican government made strategic 'concessions' to the United States that in reality were key policy goals, but impossible to sell at home (Cameron 1997). Most sectors were opened up to foreign investment, with the exceptions of petroleum extraction which was protected by the Mexican constitution and telecommunications, where domestic interests prevailed.

Although Mexico suffered yet another major financial crisis at the same time as NAFTA entered into force, its causes can be found in economic policy choices made unrelated to the PTA. If anything, NAFTA meant that the United States had an enormous stake in Mexico's well-being and quickly assembled a bailout package (Cameron and Aggarwal 1996). Moreover, the rapid depreciation of the peso made exports from Mexico even more lucrative and stimulated investment, in particular in the Mexican automobile industry.

Crises have promoted PTAs in other parts of the world, too. In Southeast Asia, the experience of the 1997 Asian Financial Crisis meant that many governments preferred stable direct investment to volatile portfolio capital and bank lending. Shortly after the crisis, Southeast and East Asian countries embarked on a policy to negotiate PTAs with each other (Dent 2003, 2006), to deepen existing agreements such as the ASEAN Free Trade Area and to secure access to major markets like the EU and the United States.

Economics First, Politics Second

The motivations for PTAs described up to this point should not obscure the fact that the agreements are fundamentally about gains from trade. On purely economic grounds, three mechanisms make free trade attractive: gains from trade due to comparative advantage; intra-industry trade based on economies of scale and product differentiation; and vertical specialization within the same industry, but with different factor prices (Krugman 1980). Comparative advantage does not privilege preferential trade agreements. The other two types of trade, however, potentially favour preferential over non-discriminatory liberalization. Horizontal intra-industry trade based on economies of scale tends to make liberalization relatively easier, because rather than being displaced by more competitive imports, firms can choose to produce a different variety of product. Adjustment costs are therefore not borne by the whole sector or industry, but are specific to each firm (Gilligan 1997). If the same industries in two countries forming a PTA manage to specialize in different product varieties, liberalization is almost painless. But even if there are competing industries, the governments can 'trade off scale economies' across these industries bilaterally to negotiate a PTA (Milner 1997). This route is likely to be taken by countries with comparable GDPs and level of economic development, and helps explain much of the support of manufacturing industries for European economic integration. Most importantly, it does not in any way create a bias against subsequent multilateral liberalization. In fact, firms that were

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initially opposed to global free trade, after having 'moved down the cost curve' of production, may now become supporters.

By comparison, vertical specialization favours preferential (and often bilateral) agreements because the partners make relation-specific investments. Vertical specialization occurs when firms in the same industry produce goods with different capital intensity. An example would be the production of compact cars by French and German companies in the Slovak Republic for export to France and Germany, while the same companies manufacture their luxury models at home and export them in small numbers to Slovakia.

In principle, PTAs between developed and advanced transition or developing economies are highly beneficial because they promote capital flows from a capital-abundant economy to a relatively capital-poor partner. Unfortunately for the signatories' firms, these PTAs also open the backdoor for the competition. Continuing with the same example, when the Slovak Republic gained free market access to the EU through the 'Europe Agreements', it became attractive for Japanese firms to invest there to sell cars into the EU market.

To prevent this, the firms within a PTA will often demand a high local content quota that discriminates against outsiders. In our example, German firms can count German and Slovak components towards fulfilling such a requirement. Japanese firms can only count the Slovak components, not imported Japanese parts. This forces firms from outside the PTA to behave like local firms.

A related argument is that it matters if firms expect a move towards non-discriminatory free trade. Countries will then specialize according to their comparative advantage. If preferential trade agreements appear feasible, however, they are more likely to support them because they permit specialization within the PTA – inefficient but lucrative for firms that do not have to face global competition. Unfortunately, this also makes them less likely to support global free trade once a PTA has been formed because they have made investments – PTAs become 'insidious' (McLaren 2002).

In the legal language of PTA texts, local content quotas are a type of 'rules of origin' (RoO). RoO stipulate whether a good produced from parts from within and without the PTA qualifies for tariff-free shipping across intra-PTA borders. Usually, this is implemented by requiring a transformation of a good in one tariff group to another (for example, from pork to ham), or prescribing certain parts that have to be from within the PTA (such as LEDs for computer screens), or by requiring a minimum percentage of value added in a member country of the PTA. Infamously, NAFTA prescribes that 62.5 per cent of a car's value must be produced in a NAFTA country to allow the vehicle to be shipped from one country to another without paying tariffs.[4] Below this threshold, the car would be treated as a non-NAFTA import and would incur the respective MFN tariff

[4] Under NAFTA's predecessor, the CUSFTA, US customs officials found in 1991 that Honda Civics produced in Canada did not fulfil the applicable RoO and did not qualify for tariff-free exports from Canada to the United States.

of each country, ranging from 2.5 per cent for a Sedan to 25 per cent for a Sports Utility Vehicle in the United States.

Because RoO are relatively arcane, they have not attracted much attention among political economists until very recently. Theoretical exercises indicate that it is quite easy to structure RoO to become a form of 'hidden protectionism' (Duttagupta and Panagariya 2003; Krishna and Krueger 1995). And indeed, empirical research confirms that firms not only expend much time and energy on lobbying to obtain favourable RoO (Chase 2008), but that RoO also have quite strong effects on trade patterns (Anson et al. 2005). Perhaps most problematic, because RoO require elaborate documentation of what component comes from where, compliance with RoO is often only worthwhile for big firms producing large numbers of identical goods. Smaller firms and those from developing countries often do not use the tariff preferences available and chose to pay most-favoured-nation tariffs instead (Takahashi and Urata 2010).[5]

Efforts to simplify RoO by negotiating at the multilateral level have so far failed. However, there is a tendency among major economic powers to harmonize the RoO across their own PTAs. The leader is the European Union, having introduced a pan-European RoO regime for all 'Association' agreements. For decades, the EU Commission tolerated the absurd situation that inputs from one PTA partner could not be counted towards the RoO in another. Cloth from Morocco, for example, could not be used in garment production in Turkey, even though both had tariff-free access to the EU market. The new rules allow for 'cumulation', that is, the inclusion of inputs from other EU partners to meet a RoO threshold. Rules of origin represent one of the areas in which there is much variation across PTAs and which therefore cause concern for the negotiators who have to strike delicate bargains while keeping the developments of other PTAs in mind. This problem is less pronounced in other areas of PTAs.

The Economic Effects of PTAs

Although surely not an optimal policy choice on the path to global free trade, recent research shows that the economic benefits of PTAs are tangible. Whether it is because they offer access to large markets or because of the commitment device function of PTAs, countries that sign such agreements attract greater inflows of FDI, both from the partner country as well as from third countries (Büthe and Milner 2008). This effect may partly be driven by the reassurance that tariff rates are not going to change abruptly and so the volatility of trade volumes is reduced (Mansfield and Reinhardt 2008). Most importantly, preferential trade agreements often have surprisingly strong effects on trade — some estimates say that at the

[5] The same applies to preferential schemes through which developed countries offer unilateral concessions to poorer countries. Brenton (2003) shows that the majority of preferences under the EU's 'Everything But Arms' initiative are not used.

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end of the typical ten-year implementation period, PTAs on average double the members' bilateral trade (Baier and Bergstrand 2007).

What, then, is the main problem with the proliferation of preferential agreements? One area of concern is the multiplication of different rules, especially the aforementioned rules of origin. The devil, however, is in the detail. In general, PTAs tend to follow similar templates.

PTAs and Multilateralism

Legal Considerations

Despite the vast number of agreements, there is a degree of convergence in their fundamental principles. Most PTAs draw directly on the GATT and GATS and the specific legal definitions they have established. This tendency is unsurprising as the most active proponents of PTAs are also WTO members.[6] At the same time, it qualifies the claim that preferential trade agreements are a venue to develop and test new approaches to trade policy. The majority of PTAs have been negotiated after the WTO came into existence and so WTO members are required to make the policies implemented through PTAs consistent with WTO principles and obligations. The broad coverage of the Uruguay Round therefore implies that innovation takes place mainly in areas not covered by multilateral agreements. In practice, this means foreign direct investment, trade facilitation, and the establishment of links between trade policy and issues like labour and environment that are staunchly resisted at the WTO. However, even in the field of rules for FDI, most preferential trade agreements draw on existing rules negotiated in the over 2,500 bilateral investment treaties (BITs). The principal difference is that many recent PTAs incorporate chapters that liberalize the investment regimes of the partner countries.

One of the most prominent examples of innovative rule-making in a FTA is Chapter 11 on 'Investment' in NAFTA. Much of the text is taken directly from the template that the United States used for its bilateral investment treaties in the early 1990s, stipulating legal protection of foreign investments and investors. Beyond such standard language, however, Article 1106 bans the various kinds of performance requirements (for example, local content quota in production) that Mexico had previously applied. Article 1108 lists various exceptions and reservations. Finally, several annexes provide commitments to phase out regulations that limit foreign investment over time, especially those related to ceilings on foreign equity participation. By contrast, the Trade-Related Investment Measures (TRIMS) agreement only lists a small number of 'trade-related' performance requirements.

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6 The similarity of fundamental principles in GATT, GATS and PTAs can also be seen as an example of 'nesting' of international regimes (Aggarwal 1998).

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Throughout the NAFTA agreement, a 'negative list' approach prevails — only exceptions that are explicitly listed apply and what is not listed is deemed to be liberalized. Compare this with the approach in the GATS, still under negotiation at the time the NAFTA deal was sealed. In the GATS, only listed ('bound') sectors are liberalized, everything else is potentially subject to restrictions.

Subsequent FTAs negotiated by the United States have followed the same principle. It has not, however, been adopted at the WTO level, nor have the EU and Japan followed suit. Most developing countries prefer a 'positive list' approach, partly because it often allows for the retention of more restrictions, but also because cataloguing all restrictions 'in the books' is administratively challenging. In short, rule-making in PTAs tends to go beyond the WTO when a powerful actor (usually the United States or the EU) promotes these rules in a bilateral deal with a smaller, usually developing country, partner.

A further question is whether the tariff reduction that can be achieved in PTAs is more far-reaching than that in WTO rounds. Proponents of PTAs often argue that they can move ahead more quickly with 'willing partners'. In practice, however, there is evidence that PTAs fail to address the most entrenched protectionism, and that the 'gaps' in liberalization are much the same in PTAs and the WTO (Hoekman and Leidy 1993).

Policy Issues

Preferential trade agreements are here to stay. What are the implications for the multilateral trade regime? Will PTAs supplant the WTO, can they coexist, or can PTAs actually boost liberalization efforts?

Economists have usually framed this question as one of 'building blocks' or 'stumbling blocks' on the way to global free trade. In addition to the problem of trade diversion, domestic groups can often extend protection at the national level to protection within a PTA by using (or abusing) dispute settlement procedures and rules of origin. Moreover, as Levy (1997) shows, PTAs may make global free trade impossible to achieve. When a sufficiently large group inside each state that joins a PTA is satisfied with the economic gains, they will raise the bar for a global trade agreement so high that it becomes infeasible.

Others have countered that any trade agreement will exert some adjustment pressures and therefore strengthen pro-trade lobbies and weaken protectionists (Richardson 1993). Moreover, in a larger market, lobbies must organize at the regional level where they are relatively smaller and less geographically concentrated – although this only applies when the authority to set trade policy is transferred to a supranational body, as in the EU (Hanson 2003). Unfortunately, there is very little empirical research to investigate these claims – the exception being Kono (2007), who finds that PTAs between countries with similar comparative advantage promote free trade, while those between very different countries do not.

More complicated is the issue of whether PTAs impede or boost negotiations at the WTO. In the past, governments could craft coalitions of export-oriented sectors

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in line with the 'GATT-think' that 'exports are good, imports are bad' (Krugman 1991: 15). The key to achieve trade barrier reductions was then to link issues affecting different sectors, so that each country would lose a bit and gain a bit across the board (Davis 2004). These export sectors supported trade liberalization against import-competing sectors. Usually, the most active members were multinational firms (Milner 1988). These firms are also often the most important proponents of preferential trade agreements, whether because they achieve greater economies of scale within the PTA market or because they shift production into low-wage countries (Chase 2003).

Considering the rapid proliferation of North–South PTAs, bilateral and regional trade agreements may well satisfy the needs of these multilateral firms. This should be especially worrying when PTAs do not achieve broad liberalization of protected sectors such as agriculture – but given the asymmetries in North–South deals, it is unlikely that the smaller partner can obtain concessions that the more powerful partner is unwilling to make even in multilateral negotiations. And indeed, the exclusions and barriers to agricultural trade retained in North–South PTAs tend to mirror those in most-favoured-nation tariffs. Japan and the EU are notorious for maintaining protection that excludes the most competitive agricultural imports from their developing country partners. The United States does not impose such barriers, but instead heavily subsidizes exports (Manger 2009: 233). At the same time, as we have seen, such PTAs often move beyond WTO commitments in services and investment. This means that even those North–South PTAs that fully comply with GATT Article XXIV can diminish the chances of success in multilateral trade negotiations. In the past, progress in the liberalization of agricultural trade against Japanese and European resistance has only been achieved when the United States linked this issue with others where the EU and Japan had important export interests (Davis 2003). Such interests are now served by PTAs. As a result, the multilateral trade regime is saddled with the apparently intractable problem of liberalizing agricultural trade, but left with nothing that market-opening in protectionist countries could be traded off against. In this political sense, rather than because of the manifold economic concerns, the proliferation of PTAs is most likely to have an adverse effect on the multilateralism system in the short term.

In the longer term, multiple different rules of origin and divergent regulations in issue-areas not covered by WTO agreements will inevitably increase transaction costs, a point not lost on business leaders.[7] At this point, the WTO may be called upon to harmonize rules, or, as rules of origin lose their force when most-favoured-nation tariffs are eliminated, a new tariff round may come into sight. This has led to the observation that complementarity between PTAs and the multilateral trade system will only be achieved if that system is robust – strengthening rules and

[7] See, for example, the critical views of Victor Fung, chairman of Li & Fung, Hong Kong's largest export trading company, in the *Financial Times*, 3 November 2005, and Michael Treschow, chairman of Ericsson, the Swedish telecommunications company, in the *Financial Times*, 18 October 2006.

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reducing MFN tariffs – so that the distorting effects of PTAs are held in check (Heydon and Woolcock 2009: 260).

In the meantime, a division of labour between preferential and multilateral forums appears to be emerging. While trade barrier reductions mostly take place in PTAs at the moment, the WTO assumes the role of 'constitution' of the global trade system, with the dispute settlement procedure to support a 'rule of law' in international commerce. Although many PTAs include rules to arbitrate disputes, the most prominent cases are brought to the WTO. Preferential agreements and the WTO therefore coexist, but as stages for quite different shows.

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