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Preferential Trade Agreements World Trade Forum

Edited by Andreas Dür and Manfred Elsig

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Introduction

The purpose, design and effects of
preferential trade agreements

ANDREAS DÜR AND MANFRED ELSIG

A. Introduction

Preferential trade agreements (PTAs), defined as agreements that liberalise trade between two or more countries but that do not extend this liberalisation to all countries (or at least to a majority of countries), are mushrooming around the globe.¹ The European Union (EU) is currently negotiating trade agreements with countries such as India, Japan, Malaysia, Thailand, the United States and Vietnam. The Transatlantic Trade and Investment Partnership (TTIP) envisaged by the EU and the United States might eventually cover one-third of world trade. This mega project is mirrored by the negotiations for a Trans-Pacific Partnership (TPP), with participating countries such as Australia, Brunei Darussalam, Chile, Japan, Malaysia, New Zealand, Peru, Singapore, the United States and Vietnam. The TTIP and the TPP are currently the most high-profile PTA negotiations under way, but a large number of smaller PTAs are being negotiated in parallel.

Together, the many smaller and larger agreements that have already been signed, or that are currently under negotiation, make PTAs the most prominent and important governance instrument of our times for regulating trade and investment flows. They have become the main tool for

We are grateful to Marcelo Olarreaga for helpful comments on an earlier version of this chapter. We also acknowledge financial support from NCCR Trade (www.nccr-trade.org).

¹ Many terms have been used for these agreements, including *regional trade agreements*, *free trade agreements* and *economic integration agreements*. We use the term *preferential trade agreements* to stress the preference given to partners in the same agreement. Our definition excludes nonreciprocal agreements, where one side makes unilateral concessions (e.g. the General System of Preferences), and the 'open regionalism', where a group of countries unconditionally extend trade-liberalizing measures on a most-favoured-nation basis.

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achieving market opening and for providing regulatory innovation as multilateral negotiations within the ambit of the World Trade Organization (WTO) have produced only modest results for the last two decades. Moreover, negotiations on plurilateral agreements in the areas of investment (for the Multilateral Agreement on Investment) and intellectual property rights (for the Anti-Counterfeiting Trade Agreement) have failed to produce results that would have been acceptable to a larger number of countries and important segments of civil society. Countries have thus relied on PTAs to regulate issues ranging from trade in goods and services to investment, intellectual property rights, competition, standards and government procurement rules.

Although PTAs have attracted considerable scholarly attention, the jury is still out on several key questions. Why do countries sign PTAs? What explains variation in the design of PTAs? How effective are PTAs in promoting trade and changing domestic law and institutions? And what are the consequences of the spread of PTAs for the world trading system? This volume attempts to give answers to these questions and in doing so breaks new ground in several respects. First, the book brings together innovative research by economists, lawyers and political scientists. A multidisciplinary approach seems highly promising for a topic such as PTAs, which involves economic, legal and political aspects. Nevertheless, the various disciplines studying PTAs have produced literatures that hardly talk to each other. The purpose of this volume is to take stock of the empirical and theoretical advances that have been made in the study of trade agreements in the three disciplines. It also aims to stimulate cross-fertilisation across these literatures, by showing how researchers from different disciplines tackle the same substantive questions.

Second, so far much of the literature on PTAs has failed to recognise that PTAs are very heterogeneous. Some PTAs include many member countries, others few; some PTAs cover a large number of different issues, from trade in services to government procurement, whereas others are very narrow; and some PTAs include very far-reaching provisions, whereas others are relatively shallow. A substantial proportion of the existing literature on PTAs consists of either case studies that fail to put the key features of a specific PTA into a broader context or quantitative studies that operationalise PTAs in the form of a dichotomous variable, that is, a variable that only captures the presence or absence of a PTA. This state of the art is problematic as both the causes and consequences of PTAs should vary across agreements of different scope, depth and flexibility. In

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this volume, we take stock of and contribute to a recent literature that zeroes in on design differences across PTAs.

Finally, compared to the 1990s, when research on PTAs first started to pick up, the phenomenon under study has changed considerably. As discussed previously, not only have many new agreements been signed over the past 10 years but also these agreements differ in key respects from the agreements signed even a decade before. By taking into account agreements signed in the 2000s, this volume allows for an assessment of which of the findings of the early studies remain valid, based on a much richer empirical foundation.

In the remainder of this introduction, we first put current PTAs into their historical context, illustrating how they have changed over time, before introducing four major questions that provide the structure for this volume. We discuss the literature related to these guiding questions and highlight the contribution of the various chapters to advancing our knowledge related to PTAs.

B. PTAs, past and present

Countries have been signing trade agreements for a long time. The nineteenth century, in particular, saw the spread of trade agreements in Europe (Pahre 2008). The Anglo-French commercial treaty of 1860 was of great significance, as it ushered in a period of relatively free trade in Europe that lasted until the 1880s. In the period between the two world wars, countries also resorted to PTAs. In the Ottawa agreements (1932), for example, the United Kingdom exchanged preferential tariff concessions with its dominions and colonies. In parallel, the United States used the Reciprocal Trade Agreements Act (1934) to conclude trade agreements with Latin American countries, as well as with Canada and the United Kingdom. The effects of these agreements, however, have been seen as far less benign than the agreements signed in the nineteenth century; many observers have blamed them for accentuating the negative effects of the Great Depression (Kindleberger 1973).

After World War II, with a few prominent exceptions, multilateral trade agreements within the framework of the General Agreement on Tariffs and Trade (GATT, 1947) trumped the formation of PTAs. The GATT itself, of course, was originally only a plurilateral agreement signed by 23 countries. But since most countries that engaged in significant amounts of international trade at that time were covered by the GATT's provisions, its discriminatory aspect was limited. Internally, the GATT was

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built on the principle of nondiscrimination, meaning that any concessions towards one member had to be extended to all members of the GATT.² Under Article XXIV of the GATT, however, states were allowed to enter into PTAs, but only if these agreements removed ‘substantially all’ barriers to trade and if the agreements did not increase trade barriers against third countries (Jackson 1997). Only a few countries made use of this exemption in the first four decades of the GATT, the European Economic Community being the main exception.

In 1979, GATT contracting parties agreed upon the so-called enabling clause, which allowed less-developed countries to grant each other preferences that do not meet the criteria specified in Article XXIV.³ Under this cover, Latin American countries exchanged preferences in the framework of the Latin American Integration Association and south-east Asian countries in the context of the South Asian Free Trade Agreement. Moreover, developed countries could grant developing countries one-sided preferences. Nevertheless, the number of agreements notified to the WTO under this clause remained limited; before 1990, only nine such enabling-clause agreements were notified to the WTO.⁴

Not until the early 1990s, therefore, did PTAs become a prominent tool for economic cooperation. The rediscovery of PTAs started with the deepening of European integration as a result of the Single Market Programme and the signing of the North American Free Trade Agreement (NAFTA) in 1992. In Europe, the end of the Cold War and the dissolution of the Soviet Union created demand for PTAs in the form of association agreements to manage economic relations with former members of the Warsaw Pact. In the Americas, countries started to sign PTAs in the wake of the creation of NAFTA. What followed was a spread of PTAs known in the 1990s as ‘new regionalism’ (De Melo and Panagariya 1992). Although initially Asian countries hardly participated in this new wave of PTAs, this situation changed radically around the year 2000. Currently, the majority of the agreements under negotiation involve Asian countries.

More than 700 PTAs were signed between the end of World War II and 2013, the large majority since 1990 (see Figure 1.1).⁵ More recently, the

² Dür (2010) shows how the principle of nondiscrimination was a response to the proliferation of PTAs in the interwar period.

³ www.wto.org/English/docs/e/legal_e/enabling1979_e.htm [last accessed 10 February 2014].

⁴ <http://rtais.wto.org/ui/PublicMaintainRTAHome.aspx> [last accessed 10 February 2014].

⁵ We draw on data from Dür, Baccini and Elsig (2014). The data can be downloaded from the Design of Trade Agreements (DESTA) Database at www.designoftradeagreements.org [last accessed 10 February 2014].

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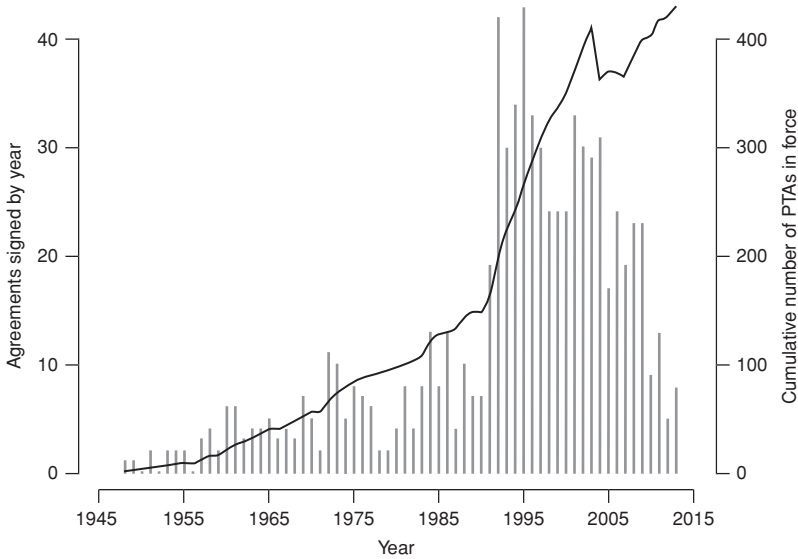


Figure 1.1 Number of PTAs over time, 1945–2013

Source: authors' illustration based on data from Dür *et al.* 2014.

number of agreements concluded per year has again been falling, indicating that many of the country pairs that can benefit from a preferential trade link already have a PTA. Up to the early 1990s, European countries were by far the most avid signers of PTAs (see Figure 1.2). In fact, by 1992, major countries such as China and Japan had not yet signed a PTA.⁶ By 2013, countries in the Americas had nearly caught up with their European counterparts with respect to the number of agreements signed. Moreover, as noted previously, Asian countries, such as Singapore, have become prominent actors in the spread of PTAs. Most recently, China has shown increasing interest in negotiating PTAs. Illustratively, Switzerland signed a PTA with China in 2013, and Australia and Norway are currently engaged in negotiations with that country.

Even more striking than the shift from Europe to the Americas and Asia as the hot spots of PTA negotiations is the fact that many of the new agreements are signed by countries from different continents. No fewer than 26 of 39 PTAs currently (as of November 2013) listed by the WTO

⁶ We compare here to the situation in 1992, because this is the first year after the dissolution of the Soviet Union, meaning that most countries that are in existence in 2013 also existed in 1992.

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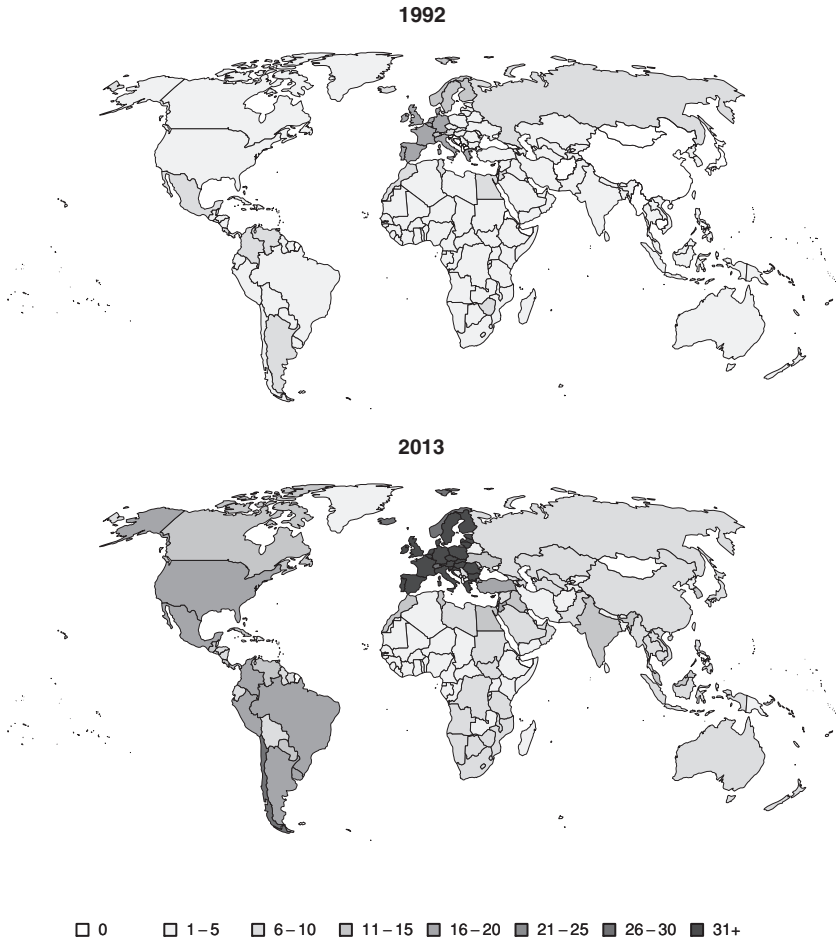
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**Figure 1.2** PTAs 1992 and 2013*Source:* authors' illustration based on data from Dür *et al.* 2014.

under the label of 'early announcement' go beyond a continent.⁷ This includes the TTIP and the TPP but also less obvious pairings, such as Canada–Ukraine. 'Regionalism' thus is no longer an appropriate label for this development.

PTAs also vary in terms of type and number of members (see Figure 1.3). The term *PTA* encompasses partial free trade agreements, full free trade agreements and customs unions. Partial agreements cut

⁷ See <http://rtais.wto.org/UI/PublicEARTAList.aspx> [last accessed 10 February 2014].

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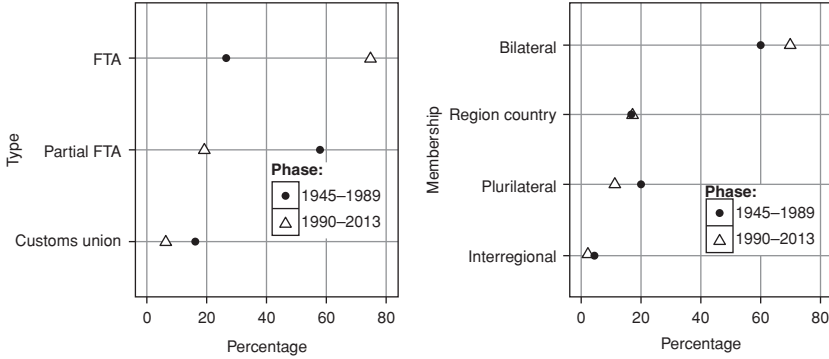


Figure 1.3 Change in type and membership over time

Source: authors' illustration based on data from Dür *et al.* 2014.

tariffs for only a select number of products, and often these cuts do not reduce tariffs to zero. Full free trade agreements, by contrast, liberalise all or substantially all trade among member countries after a negotiated transition period. Customs unions add a common external tariff to a free trade area. Whereas early agreements were mainly of the partial free trade agreement type (with a few customs unions), most recent agreements establish full free trade areas, with customs unions particularly having become very rare.

Moreover, a substantial number of the early agreements were of a plurilateral type; that is, they had more than two member countries (see the right-hand pane of Figure 1.3). Many of these agreements are open to new members. The Rome Treaty that established the European Economic Community (1957), for example, was originally signed by 6 countries, and then expanded to include 28 member countries by 2013. Similarly, the agreement creating the Central American Common Market (1960) was signed by 4 countries and then expanded to also include Costa Rica in 1962. More recent agreements, by contrast, are slightly more likely to be of a bilateral nature. The membership of bilateral agreements does not tend to expand; rather, we see that existing members of bilateral agreements sign new agreements with third countries. Not yet captured by the data shown in Figure 1.3, the ongoing negotiations for 'mega-regionals', namely, the TTIP and the TPP, may suggest a return to plurilateral agreements in the near future.

But arguably the largest shift in the negotiation of PTAs has been with respect to the contents of these agreements (see Figure 1.4). With a few notable exceptions, most agreements prior to NAFTA covered only trade

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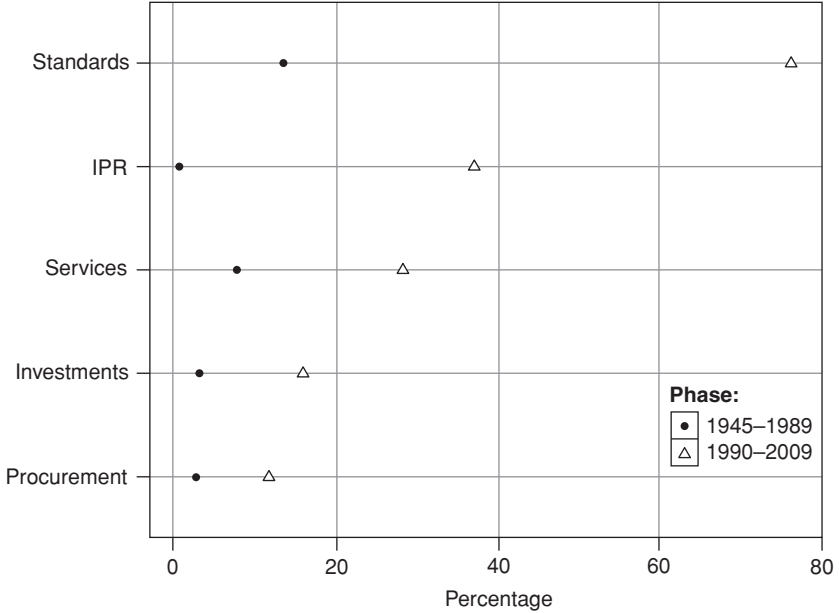


Figure 1.4 Change in the contents of PTAs

Source: authors' illustration based on data from Dür *et al.* 2014.

in goods. NAFTA heralded a much more encompassing type of PTA that contains not only provisions on trade in goods but also on behind-the-border issues such as technical barriers to trade, government procurement, investment, services, competition law and intellectual property rights (IPRs). As shown in Figure 1.4, many PTAs now have a similar breadth to NAFTA.

Increasingly, the scope of PTAs even goes beyond the regulation of economic issues: nontrade issues have become more prominent, ranging from environmental concerns and the promotion of human and labour rights to addressing new and old security threats (e.g. Hafner-Burton 2005; Spilker and Böhmelt 2013). It is this increasing scope and variation in actual commitment levels that makes PTAs such a fascinating object of study. Building on this discussion, we now move on to present the four key questions that inform this volume and then briefly outline the contributions by the authors.

C. Why do countries sign PTAs?

The question why countries sign PTAs started to attract scholarly attention at the time of the formation of the first PTAs in the decades following

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World War II. A prominent early explanation for the creation of the EU (originally the European Economic Community, which in turn followed the European Coal and Steel Community) focused on the key actors' pursuit of geopolitical goals such as peace and security. As summarised by Andrew Moravcsik (1998: 6), these arguments suggest that 'postwar European leaders who constructed and extended the EC [European Community] sought to tie down the Germans, balance the Russians, establish a third force against the Americans, overcome right-wing and Communist extremism at home, or suppress nationalism to realise a distinctive vision of European federalism'. Similar arguments have been made for other PTAs. A government may value a PTA for geopolitical reasons if it can use the PTA to increase another country's dependence, allowing it to extract concessions from that country (Hirschman 1945). Alternatively, the aim of a PTA can be to increase a country's military capacity by creating more trade and thus increasing national income (Gowa 1994). A final geopolitical motivation for trade agreements may be to tackle new security threats, including terrorism and organised crime.

PTAs may also be created to generate welfare gains for the participating countries. In fact, Scott Baier and Jeffrey Bergstrand (2004) found that variables that capture the net aggregate economic gains of the participating countries alone can successfully explain the overwhelming majority of PTA ties.⁸ A specific welfare-related objective for PTAs may be to allow governments to reduce tariffs without incurring negative terms of trade effects (Bagwell and Staiger 1998). Countries may also benefit in welfare terms if PTAs give firms the opportunity to exploit economies of scale. PTAs offer firms a larger market for their products. A larger market, in turn, allows firms to increase their production and thus to reap gains from lower unit costs. Even if a government is indifferent to its country's welfare, lobbying by firms that expect gains from economies of scale may motivate it to sign PTAs (Chase 2005). Pressure in favour of a PTA may also come from exporters that expect gains from a PTA (Grossman and Helpman 1995). Such exporter lobbying may be particularly strong in countries that are excluded from existing PTAs. Discrimination may impose costs on exporters in these third countries, creating an incentive for them to become politically active and to push their governments to also pursue PTAs (Baccini and Dür 2012; Baldwin 1993; Dür 2010).

Moreover, governments may sign PTAs to tie their hands or lock in specific policies. In the words of John Whalley (1998: 71), 'by binding

⁸ Some of these variables, such as geographic distance, may also capture other factors, such as geopolitics.

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the country to the masthead of an international trade treaty, any future reversal of domestic policy reform becomes more difficult to implement'. Finally, democratic governments may use PTAs as a signal to domestic audiences (Mansfield and Milner 2012). The argument is that voters have limited information about government preferences and policies. When the country experiences economic difficulties, the median voter may then punish the incumbent, not knowing whether government policies or an exogenous shock is responsible for the economic downturn. Voters do not oust governments that signed PTAs, however, because signing PTAs is a credible signal that the government is pursuing economically sound policies.

In the first part of this volume, five chapters contribute to this literature. In Chapter 2, Moonhawk Kim argues that changes in what he calls the technological and political infrastructure can explain the broad patterns of the historical development of PTAs. The available technology determines the ease with which goods and services can be traded across borders, and thus the demand for PTAs; and the number of states in the international system, the distribution of power among states and the presence of war shape the supply of PTAs. Based on an analysis of five periods (1840–1914, 1920s and 1930s, 1947–90, 1991–2000 and 2001–13), he finds support for this argument. Edward Mansfield and Helen Milner (Chapter 3) then test a series of explanations for the creation of PTAs, including the role of economic factors, international politics and domestic politics. Based on a data set that covers PTAs signed up to 2011, they find support for all three explanations. Most importantly, they reconfirm their previous finding that domestic institutions matter: democratic countries are more likely, and countries with many veto players are less likely, to sign PTAs.

In Chapter 4, Jean-Louis Arcand, Marcelo Olarreaga and Laura Zoratto take up the idea that governments may use PTAs to lock in specific policies. They not only find empirical support for this argument but also estimate the welfare benefits that accrue to a country from applying this lock-in strategy. Among their more specific findings is the notion that credibility reasons are particularly important for weak governments and for small countries that sign PTAs with large ones. Importantly, PTAs signed for credibility reasons lead to an increase in imports that is substantially larger than that from comparable agreements. Víctor Umaña, Thomas Bernauer and Gabriele Spilker (Chapter 5) then use a survey experiment to investigate to what extent public opinion may explain different aspects of the new regionalism. Among other things, they find that voters in