An Evaluation of Trade Capacity Building Programs

Regional Trade Agreements: A Tool for Development?

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An Evaluation of Trade Capacity Building Programs

Regional Trade Agreements: A Tool for Development?

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Abstract

In the past, regional trade arrangements (RTAs) among developing countries have not lived up to the hopes of proponents as vehicles for promoting efficient industrialization. Newer approaches, notably including low tariffs for countries outside the RTA, have more promise. RTAs with developed countries also are more likely to produce favorable results. Therefore, USAID should approach supporting RTAs among developing countries with care.

There are advantages to assisting small countries through regional service centers or hubs so that USAID assistance does not have to rely on the narrower technical capabilities of small bilateral missions. Such regional hubs may be efficient tools for providing bilateral assistance. However, in the absence of clear benefits to regionalism, a hub is not a reason to promote regional integration or RTAs.

Introduction

Free trade with the world has always been viewed with suspicion by all but economists. The contrary tends to be true of free trade among neighboring countries. Economists have usually been skeptical, while others—including political leaders—have often been enthusiastic supporters. Support for regional free trade has waxed and waned. There was considerable enthusiasm in the 1960s. The Central American Common Market (CACM), the Latin American Free Trade Area, the East African Community (EAC), and the association of francophone West African countries (UOEMA) were established in that period. After some disappointment with results, and political changes that dissolved some efforts, RTAs generated little interest in the 1980s.

In recent years, there has been renewed interest in RTAs. The Southern Cone Common Market—Mercosur—was established in South America. Other efforts were reenergized through the Caribbean Community and Common Market (CARICOM) and the Organization of East Caribbean States (OECS). Several large African groupings emerged: the Common Market for East and Southern Africa (COMESA), the Southern Africa Development Community (SADC), and the Economic Community of West African States (ECOWAS). Most sought to achieve an “open regionalism,” with lower external tariffs than the earlier efforts.[1]

There are at least four ways to evaluate the impact of RTAs. First, there are the traditional static economic concepts of trade diversion and trade creation that economists use. Second are dynamic “infant industry” effects that may come from RTAs providing an initially protected environment for firms that may eventually achieve competitiveness in world markets. Third is to determine whether RTAs provide a reliable platform for firms to make investment decisions that would bring infant industry as well as other dynamic effects into play. Fourth, is to examine the potential of RTAs to promote peace and stability. The evidence on each of these four factors is discussed below. A final section considers the implications for USAID of the analysis.

Trade Diversion and Trade Creation

The Concepts

The traditional analysis of the impact of regional groupings by economists is based on the concepts of trade diversion and trade creation. Trade diversion occurs when a country ceases to import a product from the low-cost source on the world market in favor of buying a product from a country within the free trade area at a price higher than world market but lower than the world market price plus the external tariff imposed by the RTA.

[1] See the appended brief summary of the experience of the current regional groupings of developing countries.

A simplified numerical example illustrates the point. Suppose that country A has a 50 percent import duty on refrigerators, which are not produced locally. A small refrigerator costing $100 internationally will sell for $150, with the government collecting $50 for each refrigerator imported. Prior to the RTA, neighboring country B produced refrigerators that sold for $130 in its protected domestic market. When RTA refrigerators cost $130 in country A, there is an apparent benefit to consumers because refrigerator prices have gone down. Nevertheless, the $20 savings for the consumer has cost country A's government $50 in revenues. In effect, the government spent $50 to provide $20 in benefits to its citizens. The other $30 has gone to subsidize inefficient refrigerator production in country B. Country A did not pursue the most beneficial alternative for its consumers: eliminating the tariff on refrigerators imported from all countries. In this case, government revenues would have fallen by the same amount ($50) for each refrigerator imported, but country A's consumers would have received exactly that reduction in costs.

Trade creation, in contrast, occurs when production shifts from the domestic economy to that of another member of the RTA. Suppose now that country A's domestic refrigerator industry produces refrigerators at $140 per unit. As before, a 50 percent tariff means that consumers will buy the domestically produced item. Now the formation of the FTA with country B will produce trade creation. Country A will begin to import refrigerators at $130 each from country B, and will stop producing the high-cost domestic refrigerators. In this case, consumers are better off, because their refrigerators are now $10 cheaper. The shift in production thus results in greater efficiency. Since the government collected no import duties in either case, its situation is unchanged. Nevertheless, eliminating the 50 percent tariff on refrigerator imports from other countries would have produced even cheaper refrigerators at no cost in government revenues.

Two points should be made. First, trade creation occurs when one country stops producing a commodity and begins importing it from another. Welfare is increased by reduced production of some goods, with the attendant adjustments required (such as bankruptcies and layoffs of workers). Because the country may be able to export other products to partner countries total employment may increase, but the benefit comes from movement of workers and capital from some industries to others. Second, the potential for trade creation and trade diversion depends on the level of the RTA's external tariff: the higher the external tariff, the greater the trade diversion that is likely to occur. Had the external tariff in the case described above been only 20 percent, no trade diversion would have occurred.

Consider the following hypothetical example of an RTA between Nigeria and Benin. Nigeria's manufacturing sector is far larger than Benin's, but the sector exports almost nothing to world markets. That suggests that it is inefficient by world standards. Benin has a far smaller industrial sector, so the potential for trade creation is small. Again, trade creation for Benin will occur only when its production is replaced by lower-cost production in Nigeria.[2] On the other hand, Benin exporting to Nigeria presents a larger opportunity for trade creation. Entrepreneurs in Benin would have a far larger potential market for their products.

Unfortunately, in practice there has been a marked tendency for the industrialization from such a regional agreement to concentrate in the country (and city) that already has the most industry. This "agglomeration" effect results from the lower costs that firms encounter in such locations because of better infrastructure and better access to inputs and human resources. Less advanced countries—such as Tanzania and Uganda in the East African Community, Honduras in the CACM—have found they incur

[2] Even where there is potential for trade creation in this way, it is often resisted within RTAs. For example, Trinidad and Tobago feared that its apparel sector would be harmed by imports from other CARICOM countries, so it prohibited imports of such products from partner countries. RTAs among developing countries seldom have enforcement mechanisms to penalize such unilateral action.

the costs of higher prices and lower tariff revenues but do not obtain the benefits of increased investment and industrial employment. The most likely prospect for Benin, then, is a diversion of manufactured imports from low-cost producers in the rest of the world to Nigerian producers. Benin will then import higher cost (and probably lower quality) products from Nigeria that are exempt from import duties. Thus, Benin's duty-paying imports and tax collections fall.

The Empirical Evidence

For developing countries, the experience with RTAs has been that little trade creation occurs. Instead, imports that previously came from world markets now come from other RTA members. Schiff (2002) provides a compelling justification for this view. He argues that the increase in trade between RTA members has typically come from import substitution in new products, typically trade-diverting, and not from more efficient production of the products already being made in the member countries.

It is not possible to gain a comprehensive picture of the empirical record on RTAs, because most of the earlier generation of agreements failed to be sustained. Most of the recent RTAs are too new to draw many inferences. Nevertheless, some conclusions can be drawn from two RTAs with a substantial period of implementation, the CACM and Mercosur.

Few firms that had prospered in the CACM continued to do so when external tariffs were lowered and they were forced to compete in world markets. The CACM countries did demonstrate a capacity to export to world markets once trade liberalization occurred, but the new exports tended to come from either new indigenous firms or from foreign investors. This is exactly the outcome Keesing and Singer (1990) predicted, arguing that "hothouse" firms producing behind high tariff barriers learned three lessons that made them incapable of competing later in world markets: (1) quality didn't matter; (2) delivery schedules were unimportant; and (3) product presentation or packaging was irrelevant. These lessons do not prevent success where competition is prevented by high tariffs, but they make exporting to world markets impossible. The traditional economist's model, based on greed as the incentive to efficiency and productivity, is surely wrong. Rather, it is the fear that one's position in the marketplace will be displaced by a more efficient competitor that has shown itself to spur efficiency.

The net benefits of Mercosur in its initial years were subject to debate. Leipziger (1997) concludes that the benefits were "small but positive," while others suggest that it was probably negative (Sanguinetti, Pantano, and Posadas 2001; Yeats 1998). Yeats concluded that the expansion of trade was largest in products—notably capital goods—for which the region did not have a comparative advantage.

Some have argued (Salazar-Xirinachs 2002b; Inter-American Development Bank 2002) that the "new" regionalism—RTAs with a low common external tariff wall—is much more likely to yield positive results than the "old" regionalism, where tariff barriers to the products of nonmembers were very high. Using very low-powered tests, Salazar-Xirinachs suggests that the recent RTAs in Latin America have tended to be more trade-creating than trade-diverting. This view has some merit. In any case, low overall tariffs will limit the scope for trade diversion. To the extent that RTA negotiations caused countries to reduce tariffs on imports from nonmembers below their pre-RTA levels, the overall level of distortions in the economy might be reduced.

Infant Industries and RTAs

Many proponents of RTAs accept the trade diversion–trade creation dichotomy as true in a static sense but irrelevant in a dynamic one. The principal rationale used to justify RTAs is the "infant industry." Firms producing manufactured goods inside the RTA will initially have higher costs than the world market, but costs will come down as they learn. The firms will be able to compete in world markets, giving the country an export capacity.

The failure of past RTAs to support the infant-industry rationale should not be interpreted to mean that such infants do not exist. Indeed, the experience of the Asian tigers, among others, has shown that governmental promotion or subsidization of firms can produce dramatic and cumulative change in comparative advantage over several decades. It is a question of what is the most effective tool for promoting infant industries. The East Asian model emphasized direct or indirect subsidies to firms that exported to world markets. Apparently, firms learned enough during the subsidy period to permit some of them to compete later on world markets without subsidies.

Protection for infant industries is similar. It provides an implicit subsidy to the favored firms. It differs, however, in not requiring success in a competitive environment. This lack of a competitive spur to efficiency may be one reason that many such infants fail to grow up. In principle, it is possible to gradually reduce tariff protection to force such firms to become more efficient, but political economy makes this dubious. Indeed, in Central America, the architects of the CACM envisioned a gradual reduction in the common external tariff. When efforts were made to implement lower tariffs in the late 1960s, however, they were successfully resisted by the new class of import-substitution industrialists who saw lower external tariffs as a threat.

Furthermore, the trend toward global sourcing has meant that specific products are seldom made in one country. Rather, they are assembled in one country from components manufactured in several different places. The location of the production processes depends on the country's general policy environment, including receptivity to foreign investment, efficiency of its import and export infrastructure, and capacity of business firms to produce efficiently. Picking winners has proven to be a very hazardous enterprise for governments. Providing a supportive environment for business in general, including assurance to potential exporters that they can obtain raw materials and intermediate goods at world prices, appears to be a more promising approach.

Investment Generation by RTAs

Though RTAs might fail the two previous tests—trade creation vs. trade diversion and development of infant industries—there is a third possible benefit to participating countries. This could come from foreign investors who were initially unwilling to invest in the individual countries but are tempted by access to a larger regional market.

The potential for attracting investment is determined by the certainty of the RTA environment. Where the membership in the regional grouping and the rules of the game are seen as likely to be maintained for a long time, the members of the RTA are likely to be attractive for foreign investment aimed at long-term results. Such investment can bring new technologies and other benefits to the region. Only a few RTAs created in recent decades have provided this kind of expectation. Without it, companies that invested in one country with the expectation of serving the regional market could find themselves with closed borders and excess capacity.

Few RTAs have implemented the tariff reduction schedule announced at the outset. Elimination of nontariff barriers and arbitrary treatment of imports have been still rarer. RTAs have typically lacked any enforcement mechanism to require participating countries to live up to their obligations. When a country's government makes major policy shifts—as happened with Zimbabwe in COMESA—foreign investors have no recourse. The situation is untenable for those who invested in other RTA members on the basis of access to the Zimbabwean market. It is equally untenable for foreign investors in Zimbabwe who expected the country's exchange rate to keep up with inflation and that exports to other COMESA countries would be profitable. In essence, then, it is important that a prospective RTA establishes firm and unalterable timetables and to include countries committed to policy stability and the region.

The CACM is the one developing country RTA with a long history of relative stability. During the 1960s, the region was stable politically and economically, and substantial amounts of foreign investment flowed into it. Academic studies at the end of the 1960s concluded that the CACM had increased the growth rates of members by as much as 0.6 percent per year, largely because of increased foreign investment (Nugent 1974; Cline and Delgado 1978). A longer-term assessment, however, would have been more negative. The bulk of the evidence suggests that the CACM was a dead-end. Though it provided a temporary boost in investment, this did not lead to subsequent capacity to export the new industrial products to world markets. Foreign investors were attracted to the region, but their facilities produced almost exclusively for the domestic market. Firms considering exports outside of Central America often found the poor quality and high prices of raw materials and intermediate goods to be a severe obstacle to profitability of exports. Consequently, no move from import substitution to exports occurred, and the investment engine ran out of steam. Unless firms move from regional to world markets, the impulse to economic growth will be limited to the time before the regional market becomes saturated. In the case of the CACM, very few firms were able to make the leap.

In sum, RTAs can serve to attract foreign investment if the regional grouping is seen as stable and willing to live up to commitments. But this is only half of the battle. If foreign investment is to serve as a tool for technology upgrading and inserting the country into the world economy, the incentives for investors must convey this message. If producing for the domestic market is highly profitable and exporting is not, foreign investors will make production and investment decisions accordingly.

Peace and Stability from RTAs

While the above discussion suggests that the economic benefits of RTAs may often be questioned, there are other possible benefits from such groupings. They could reduce regional tensions by increasing interaction and understanding. They also may help promote good governance in individual members. In addition, they may help a country defuse conflicts between two other members of a regional grouping. Nevertheless, there are very great limits on the capacity of a regional grouping to enforce behavior on individual members.

Two cases might be cited:

- Mercosur appears to have contributed significantly to a reduction in tensions between its two largest members during its early years. By 2003, however, the governments responsible for the regional cooperation faced different problems than their predecessors who forged Mercosur. The future will tell what role, if any, Mercosur will have played in promoting peace and stability in the region.

- SADC observes elections in member countries. Though SADC observers concluded that the 2002 election in Zimbabwe was not free and fair, this conclusion had no impact on Zimbabwe, at least through the end of 2002 (Tungwarara 2002).

In sum, regional groups probably help, but their influence is likely to be small compared to the internal politics of the member countries.

Devlin and French-Davis (1998, 20) argue that the combination of all four factors considered here, along with others—such as regional integration's role in signaling intentions of member governments and its potential for "locking in" trade liberalization—can lead to substantial dynamic benefits. These benefits can far outweigh those measured by economic analysis with available tools. From a theoretical perspective, Devlin and French-Davis make an important point. However, the examples of actual integration processes described above suggest that entrepreneurs are wise to mistrust statements of intentions by governments with regard to regional integration. As a result, the actual amount of signaling and lock-in—at least based on the historical record—is doubtful.

North–South RTAs

While recent literature (Schiff 2002; World Bank 2000) has been skeptical of the value of RTAs among small developing countries, it has embraced the idea that poor countries would benefit substantially from RTAs with developed countries. Spain with the EU, Mexico with the North American Free Trade Agreement (NAFTA), and small southern African countries with SADC (viewing South Africa as a developed country) appear to have benefited significantly from RTAs with larger and more advanced economies. The smaller economies benefit from the tendency for developed-market economies to be much larger and more stable (less subject to policy shifts that close their borders). They also benefit from the attraction of lower labor costs to outweigh agglomeration effects for industry.

Implications for USAID

The preceding analysis suggests two conclusions for USAID programming. First, the Agency should be selective in its support for RTAs, taking a more nuanced position on when and where to support them. Second, USAID should be clear about its purposes in regional missions.

As discussed above, the analytical case for promoting RTAs is weak. Even when they work well, such arrangements are likely to worsen the economic welfare of their members in comparison with trade liberalization on a multilateral basis. To date, most RTAs have not worked well. Many developing countries lack the policy stability over the medium and long term that would make them candidates for investment in export-oriented production by neighboring countries. Developing-country RTAs lack the machinery to prevent unilateral interruptions of trade by members or compensate firms disadvantaged by such actions. Despite the various justifiable complaints about access to developed country markets, such markets are much more stable, predictable, and capable of absorbing increased exports than those of any grouping of developing countries.

RTAs with more advanced countries are a much more promising vehicle for national economic growth. Where RTAs among developing countries appear to offer clear benefits—such as reinforcing political commitments to good performance on economics or governance—USAID should press for low external tariffs and minimal regional bureaucracies.

Guidelines for USAID support for RTAs

1 Push for low external tariffs.

Where countries are committed to RTAs, the external tariff applied to nonmembers is low and uniform and economic distortions and trade diversion are minimized.

2 Connect with large, more developed countries.

Regional trade arrangements with advanced countries tend to yield more benefits to small countries than does free trade among poor countries. The participation of a large country in other cooperative arrangements also appears to have benefits. The “free rider” problem is solved by the large country paying a substantial portion of the costs, with small members effectively subsidized. Decisionmaking also tends to be facilitated by the presence of one major “shareholder.” Thus, the dominant position of South Africa has allowed SADC to move faster and farther than other African cooperative arrangements.

3 Work with a core of the most committed countries.

Rather than beginning with a larger group of countries with varying commitments to regional objectives, the regional group should include only the most committed so progress can be made quickly. After the group has made real progress, other countries can join—on the basis of the structure already agreed to by the earlier members. The EU began with a committed core of six countries that established the ground rules for later members. Had it begun as a cooperative effort by all of the current members, it would surely have failed.

4 Focus on concrete results, not commitments.

Broad promises of international cooperation are easy to make, and particularly easy for a subsequent government to ignore. A concrete action—such as a jointly funded WTO mission in Geneva or a cooperative trade promotion unit—is more likely to be judged later on its merits. If successful, the action lays the basis for cooperation on larger projects. U.S.-Canada free trade, the base for NAFTA, was preceded several decades earlier by the U.S.-Canada free trade agreement on motor vehicles and parts, a low-key arrangement for a single industry.

5 Clarify purposes in regional USAID missions.

There is a tendency for donors to equate regional missions with regional counterpart institutions. In dealing with the needs of regions with many small countries, donors are likely to wish to establish regional offices or hubs. These can conserve staff and overhead resources, even when most donor services are delivered bilaterally to each country in the region. This is quite distinct from delivery of donor services through regional institutions, either preexisting or newly created.

The largest danger in using regional institutions for delivery of services is that the donor may become in effect "captured" by the regional institutions it was meant to serve. The donor's office acquires a vested interest in strengthening the regional machinery and loses the capacity to look disinterestedly at the strengths and weaknesses—or the progress or lack thereof—of the regional machinery. In attempting to make regionalism work, the donor becomes caught up in a never-ending series of regional political negotiations. Regional agreements might be viewed as needing to be renegotiated. A new director general of the regional machinery might be thought to be needed. Individual members might be seen as needing to be convinced that the regional institutions are valuable and worth supporting.

In sum, regional programs that serve groups of smaller countries can economize on staff and overhead resources. But this advantage should not be pushed further into a justification for promoting regional vehicles that will simplify the work of the donor mission. Most development decisionmaking takes place at the country level. Regional institutions are no substitute for effective interaction with individual governments.

Appendix: Major Regional Groupings with Small Developing Countries

Caribbean Community and Common Market (CARICOM)

CARICOM was established in 1973 by four small Caribbean basin countries after 15 years of efforts to promote regional integration among former British colonies in the region. Membership has grown to 14, including the Organization of East Caribbean States (OECS). Regional free trade was to be achieved, but deadlines were replaced by new initiatives that implied commitments at a time farther in the future. The most recent manifestation of CARICOM is the Caribbean Single Market and Economy (CSME), founded in 1994. Nevertheless, Brewster et al. (2002, 9) state, "the lack of knowledge of regional affairs throughout the region is alarming. The bulk of the population knows little about CARICOM, let alone understands what the CSME entails. Regionalism has largely been an elitist occupation." Progress on even mundane matters such as trade statistics is limited by different tariff nomenclature categories in member countries.

Central American Common Market (CASM)

Established in 1960, the CACM has included five Central American countries. It quickly led to free trade in manufactured goods, but not agricultural products. The CACM was first interrupted in 1969 by war between Honduras and El Salvador, and again in the early 1980s by nonpayment of intraregional trade debts. Nicaragua was the primary culprit, importing large amounts from its neighbors after the Sandinistas came to power but exporting little. The CACM moved from an initially high external tariff at the outset to much lower but not fully harmonized tariffs. The CACM has never had a reliable means for settling trade disputes. Since 1999, Nicaragua has unilaterally imposed a 35 percent tariff on imports from Honduras, its grievance being Honduran ratification of a maritime boundary treaty with Colombia. The five countries are expected to try to negotiate a free trade agreement with the United States in 2003. Such an agreement would likely include enforcement mechanisms and formal structures to this RTA, anchored in the formalized trade procedures and practices of the United States.

Common Market for Eastern and Southern African Countries (COMESA)

The largest regional grouping in Africa, COMESA includes 20 countries of North, Central, and Southern Africa. It was established in 1994, replacing the Preferential Trade Area created in 1981. About half the member countries eliminated tariffs on intraregional trade in 2000, subject to rules of origin that have never been fully agreed upon. Goals for 2004 are full trade liberalization and establishment of a common external tariff. COMESA's progress in eliminating tariffs has been more rapid and complete than most other developing country groupings. Nevertheless, COMESA does not have an effective conflict resolution mechanism, and individual members have been able to treat imports from other members arbitrarily. Uncertainty about such matters and about political stability in some countries has meant that few businesses have been willing to invest based on access to a COMESA-wide market.

Economic Community of Western African States (ECOWAS)

Established in 1975, ECOWAS includes 15 West African countries. The target date for full customs union was 1990, then 2000, and is now set for 2005. Trade liberalization is still far from complete, and—if history is any guide—the 2005 deadline will also be postponed. Movement of goods is incomplete, even in some of countries of the region. Kufuor (2000, 138) cites a report by the ECOWAS Secretariat that 174 roadblocks existed along the road linkage Lagos-Cotonou-Lomé-Accra-Abidjan-Ouagadougou in 1999. Eight francophone countries that form the West African Monetary Union (UEMOA), a subset of ECOWAS, maintain a common currency. These countries have considerably more monetary stability than other West African countries. ECOWAS has proposed monetary union of the non-UEMOA countries, to be followed in 2004 by integration into a single monetary zone. As with

trade liberalization by 2005, this is highly unlikely. ECOWAS's prospects are limited by political instability and conflict, the expectation of future instability, and varying commitments to regional issues. More important, Nigeria, the largest member of ECOWAS, has serious internal political and economic problems that probably need to be resolved before it can be a regional anchor for the smaller countries.

Organization of East Caribbean States (OECS)

The OECS group includes nine small Caribbean states with populations ranging from 12,000 to 150,000. Together, the population of the grouping is less than 600,000. The states are also members of CARICOM. The OECS was established in 1981, following unsuccessful regional efforts that included the West Indies Federation and the Eastern Caribbean Common Market. The treaty establishing the OECS explicitly envisaged joint overseas representation and common services as well as economic integration.

Southern Cone Common Market (Mercosur)

Mercosur was established in 1991 as an economic and political agreement among four South American countries: Argentina, Brazil, Paraguay, and Uruguay. Chile and Bolivia subsequently became associate members. Mercosur's aims were to maintain and promote democracy and economic growth in the region through mutual support and free trade. It might be considered the first of the "new regionalism" agreements, for members agreed in 1994 to a common external tariff with a maximum rate of 20 percent, much lower than earlier RTAs. Mercosur initially led to an increase in trade among the members. It appears to have led to a general improvement in relations between Argentina and Brazil, including a decline in defense expenditures by both countries. Trade stagnated after 1997, and a major devaluation of Brazil's currency in 1999 led Argentina to impose restrictions on some Brazilian exports. The collapse of the Argentine currency system at the end of 2001 led to further declines in regional trade and in mutual confidence between its two major members.

Southern African Development Community (SADC)

SADC was originally established as a grouping of "frontline" states to reduce economic dependence on South Africa. With the end of apartheid, South Africa became a member, and SADC's focus became one of economic integration, encompassing such sectoral issues as transportation, communications, and energy, in addition to free trade. Nine SADC members are also members of COMESA. Though some steps have been taken toward harmonizing COMESA and SADC nomenclature and procedures, the two institutions still operate at substantial crosspurposes. Nevertheless, the size and stability of the South African market provides a more reliable basis for investment in smaller SADC countries than any other RTA grouping discussed here. A Southern Africa Customs Union (SACU) that includes South Africa, Botswana, Lesotho, Namibia, and Swaziland further complicates SADC. These five countries maintain a customs union where goods flow freely and tariff revenues are shared based on a mathematical formula. The SACU countries also have a single monetary unit, the South African rand. The United States and SACU announced in late 2002 the intention to negotiate a free trade agreement in 2003.

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