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Multilateral Trade Liberalization, Political Disintegration,

and the Choice of FTAs versus Customs Unions

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GLOSSARY

ROW	–	Rest of the world
DC	–	Developed country
LDC	–	Less developed (or developing) country
MTL	–	Multilateral trade liberalization
RIA	–	Regional integration arrangement (or agreement)
FTA	–	Free trade area (or agreement)
CU	–	Customs union
CET	–	Common external tariff
CUSFTA	–	Canada-US FTA
NAFTA	–	North American FTA (between Canada, the U.S. and Mexico)
MERCOSUR	–	Southern Common Market (between Argentina, Brazil, Uruguay and Paraguay)
Group of 3 (G3)	–	FTA between Colombia, Mexico and Venezuela
CACM	–	Central American Common Market
Andean Pact	–	Common Market between Bolivia, Colombia, Ecuador, Peru and Venezuela
LAIA	–	Latin American Integration Agreement
CARICOM	–	Caribbean Community
ECSC	–	European Coal and Steel Community
EEC	–	European Economic Community
EC	–	European Community
EU	–	European Union
CEEC	–	Central and Eastern European Countries
FSU	–	Former Soviet Union
UEMOA	–	West African economic and monetary union
CEMAC	–	Central African economic and monetary community (ex UDEAC)
CBI	–	Cross Border Initiative (Sub-Saharan Africa)
GCC	–	Gulf Cooperation Council
EAC	–	East African Community between Kenya, Tanzania and Uganda
ECOWAS	–	Economic Community of West African States
COMESA	–	Community of Eastern and Southern Africa
AFTA	–	ASEAN FTA
SAARC	–	South Asian Association for Regional Cooperation

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Abstract

This paper combines two sets of arguments in order to examine the choice between different types of regional agreements. First, Ethier (1998, 1999) argues that the new 'open regionalism' should be viewed, not as affecting multilateral trade liberalization (MTL), but as a result of MTL. Second, Alesina et al. (2000) argues that global liberalization leads to political disintegration. It is argued here that these two sets of arguments may help explain why FTAs have proliferated compared to customs unions (CUs), and why North-South regional agreements are more likely to be FTAs while South-South agreements are more likely to be CUs. We also examine a number of cases where CUs led to losses for some members or to conflict between members when this might have been avoided if the member countries had formed FTAs.

1. Introduction

Since Jacob Viner's 1950 classic, it is a well-known fact that regional integration has an ambiguous impact on welfare. Despite this ambiguity, the world has seen a resurgence of regional integration agreements (RIAs) in recent years. Various reasons have been provided for this resurgence. One claim is that the EC Single Market Program (EC-92) led to a fear of a 'Fortress Europe' from which other countries would be excluded. Second, and possibly due to the former and/or to a decline in U.S. economic dominance, the U.S. formed first the CUSFTA with Canada and then the NAFTA with Canada and Mexico. The events on both sides of the Atlantic increased the cost of being excluded from these blocs and thus increased the power of the exporting lobbies in the excluded countries. This led to a 'domino' effect (Baldwin, 1995) where excluded countries decided either to join existing blocs or form new ones.[1]

The resurgence of regional agreements has also led to a fast-growing literature on regionalism and multilateralism. An excellent review of this literature is Winters (1999). Most studies examine the impact of regionalism on multilateralism. On the other hand, Ethier (1998, 1999) argues that the effect goes from multilateral trade liberalization (MTL) to regional integration rather than the opposite. In a different vein, Alesina et al. (2000) argue that MTL creates incentives for political disintegration. This paper examines whether the two types of arguments are consistent with each other and attempts to answer the following questions: Do we observe both regional integration and political disintegration as MTL takes place? And what are the implications of these two types of

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[1] The 'domino' effect theory does not explain why and under what conditions members of existing RIAs would allow excluded countries to join. This issue is examined in Andriamananjara and Schiff (2001). An excellent analysis of European and other regional integration projects, with emphasis on political economy and institutional aspects as well as economic ones, is Mattli (1999).

arguments for the evolution of various types of RIAs? And for their geographic distribution?

The paper is organized as follows. Section 2 describes the theories of Alesina et al. (2000) and Ethier (1998, 1999) in more detail. Section 3 examines the relevance of these theories. Based on these theories, Section 4 derives two propositions on the evolution of various RIAs and on their geographic distribution. Section 5 provides evidence supporting the two propositions. Section 6 examines cases where voluntary or involuntary customs union formation among unequal members can lead to losses and/or conflict that might have been avoided under FTAs. Section 7 concludes.

2. **Multilateral Trade Liberalization and Political and Economic Integration**

2.1 Multilateralism and political disintegration

Alesina et al. (2000) argue that economic integration should result in political disintegration, i.e., that MTL should result in an increase in the number of countries. They develop a simple model where the number and size of countries are derived endogenously as a function of the trade regime. Their argument goes essentially as follows. Countries entail both costs and benefits. Costs are related to the diversity of the population. The greater the diversity, the harder it is to manage public goods (laws, public policies, etc.). Diversity rises with country size, so costs increase with *country* size. The benefits are related to *market* size. In the model, a larger market size implies a larger variety of intermediate inputs, and input variety has a positive effect on productivity. The authors do not examine economies of scale, with a larger market size allowing a greater exploitation of economies of scale and resulting in productivity gains as well.

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In a world of trade barriers, large countries enjoy greater economic well-being because political boundaries determine the size of the market. At one extreme, if trade barriers are so high that no trade takes place, market size equals country size. With MTL, country size becomes increasingly less relevant for market size. With multilateral free trade, every country's market size is the world market. Thus, the benefits of country size fall following MTL and hence equilibrium country size is smaller. The authors conclude that MTL and political separatism are positively related, and that in a world of free trade, even small cultural or ethnic groups can benefit by forming homogeneous political jurisdictions.

Political disintegration has also been examined by Buchanan and Faith (1987) and Bolton and Roland (1997). Buchanan and Faith (1987) show how the threat of secession constrains government taxation policy, while Bolton and Roland (1997) emphasize political conflict over redistribution policies. Section 5.3 below examines cases where heterogeneity across regions of a customs union results in losses, separation or attempted separation.[2]

Alesina et al. (2000) also test the implications of their model by regressing growth on country size, openness and the interaction of the two variables. Country size is measured by either population or GDP, and openness is measured by exports plus imports over GDP. The sample includes 84 developed and developing countries, and the sample period 1960-1989 is divided into 6 five-year periods, for a total of 504 observations. The authors find a highly significant and positive growth impact of openness and country size, and a negative impact for their interaction. The results are robust to the various estimation methods used and to definitions of size, and to a series of control (structural)

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[2] For a brief survey of theories of break-up and integration of nations, see Bolton et al. (1996).

variables. The negative coefficient for interaction of size and openness implies that as openness increases, the impact of country size on growth declines. In other words, the benefits of size decline with openness, as predicted by their theory.

The authors argue that the historical record supports their model. For instance, unification of Italy (1861) and Germany (1871) can be viewed as attempts to build economies of reasonable size in a world of trade barriers, while minimizing heterogeneity costs through relative cultural and ethnic homogeneity. From 1875 to the Treaty of Versailles in 1919—a period of growing trade restrictions—few new countries were created while some disappeared. A similar pattern holds for the interwar period which coincided with a collapse of international trade and a major rise in protectionism.

Due to MTL, decolonization and the collapse of the Soviet bloc (another form of decolonization), the post-Second World War period witnessed an explosion in the number of independent countries, from 89 in 1950 to 192 in 1995. Decolonization may also have been affected by MTL in the sense that it might have taken place more slowly in a protectionist world where large nations would have remained more dependent on their colonies for raw materials and as markets for their output. As for countries of the former Soviet Union (FSU), they were able to substantially redirect their trade towards the West, something which would have been much harder in a world of high trade barriers.

The authors do not see the EU as a case of increased political integration. They view the true political change as being the increased separatism of sub-national regions in several member countries where cultural, linguistic and ethnic minorities feel increasingly viable economically in an integrated Europe. These include the Basque and

Catalan regions of Spain, the Flemish and Walloon regions of Belgium, Brittany, Corsica, Scotland, and the Northern region of Italy.

Thus, the authors argue that their model, empirical estimation, and the historical record all support the view that MTL leads to political disintegration, with an increase in the number (and decrease in the size) of countries.

2.2 Multilateralism and regionalism

Ethier (1998, 1999), on the other hand, examines the relationship between MTL and regional integration. He claims that trade theorists have so far examined regional integration from the old Viner (1950) perspective, and have obtained mixed answers about its impact on welfare and on MTL. He argues that recent episodes of regional integration are in fact caused by MTL, are beneficial, and help promote further MTL. His argument is as follows.

First, the international environment differs in three important ways from the one during the old regionalism: (i) MTL in manufactured goods among developed countries (DCs) is much more complete; (ii) many developing countries (LDCs) have abandoned the anti-trade, anti-market policies and are now actively trying to join the multilateral system; and (iii) FDI is much more prominent. Second, the new regionalism is characterized by (a) one or more small countries linking up with a large one; (b) the small countries having made significant unilateral reforms; (c) the degree of liberalization in the RIAs being modest and being primarily done by the small countries; and (d) a broadening of the range of instruments over which negotiation is feasible.

Ethier argues that these stylized facts offer a good representation of recent RIAs, including the Canada-US FTA (CUSFTA), NAFTA, the access of Austria, Finland and

Sweden to the EU, the Europe Agreements between the EU and the Central and Eastern European countries (CEECs), and MERCOSUR. One could probably add to this list the Euro-Med agreements (FTAs between the EU and a number of Mediterranean countries), the EU-Turkey CU (customs union), the EU-South Africa FTA, the Canada-Chile FTA, and the recent EU-Mexico FTA.

Ethier's argument that MTL causes regional integration goes as follows. LDCs start in autarky. Production of some DC products takes place in a two-step process, and the first step can be carried out away from where consumption takes place, i.e., in LDCs. As the DCs move from a non-cooperative (Nash) tariff equilibrium to a cooperative (multilateral) one, DC tariff rates fall. The greater degree of MTL raises the benefit for LDCs of joining the multilateral trading system. Hence, some LDCs, where the gains from reform are now sufficient to overcome resistance by special interests opposed to it, decide to reform. Those who succeed attract FDI from DCs who invest in order to produce there and export back to the North. Also, by reforming, they obtain access to superior DC technology and production methods.

The problem is that if several LDCs reform simultaneously, none can be sure to obtain any FDI. Regional integration with a large country provides an LDC with preferential and more secure access to that country's market (as well as with credibility by locking in its reforms in the RIA). This ensures that the developed partner country will invest in its partner developing country rather than in other ones. Thus, the successfully reforming LDCs enter a RIA with some DC, possibly with more than one LDC joining a DC. Though the DCs have little to gain, they are willing to enter the RIA since they have nothing to lose either, and side-payments from LDCs are possible. Thus, regional integration results in FDI flows and ensures that the reform succeeds. By helping to

remove the uncertainty about obtaining FDI, regional integration helps consolidate the reform. This clearly differs from the usual regional integration story which focuses on trade rather than on FDI.

Ethier concludes that the new regional integration is the consequence of multilateral success, and it in turn strengthens—rather than undermines—the basis for a commitment to the multilateral order. He also argues that though small countries are LDCs in his model, the results apply to other small countries as well. Finally, his model is especially designed to explain the explosion of RIAs in the 1990s.

3. **Relevance of these Theories**

3.1. Political Disintegration

In their description of the historical record, Alesina et al. (2000) argue that EU countries are not 'unifying' politically. Rather, the EU at most "… will be a loose federation of independent states joined in a common currency area … in addition to a free trade area supplemented by a harmonization of regulations and standards." (p. 24). Alesina et al. (2000) are right that multilateral and intra-EU market liberalization makes it easier for small political jurisdictions to flourish. But market liberalization only tells part of the story as to why separatism has been increasingly viewed as a viable alternative in the EU. The other aspect relates to the fact that authority over the provision of an increasing number of public goods has moved from national capitals to Brussels. First, with respect to trade, from the start the EU entailed more than a free trade area since it required establishing supra-national bodies in order to negotiate a common external tariff and revenue sharing among member countries. Second, it involves the free movement of labor and capital as well as that of goods and services. Third, it entails the creation of a

number of supra-national institutions. These include a legislature—the European Parliament, an executive—the European Commission, a cabinet—the Council of Ministers, a judiciary—the European Court of Justice whose decisions supersede national ones, a European Central Bank responsible for a EU-11 monetary policy, a European Investment Bank, an Economic and Social Committee, a Committee of the Regions, an Environment Agency, a Court of Auditors, and more. Thus, though EU integration may not result in a supra-national state in the classical sense of a 'nation state', it goes well beyond money and trade and involves a number of nation-like institutions. We would thus argue that EU integration is much deeper than described by Alesina et al.

The move from national to supra-national institutions in the EU has contributed to a weakening of the nation state not only from the top but also from the bottom. In other words, integration of member countries through supra-national institutions has also contributed to the increased separatism of sub-national regions. Sub-national regions have remained part of nation states because of the benefits of sharing national public goods. For instance, currency is a public good that is characterized by network externalities. Its value as a medium of exchange increases as the number of people who use it rises. In the past, separating into sub-national entities, each with its own currency, would have entailed a cost because currencies used by fewer people are less valuable. However, with the move to the euro, separating into sub-national entities does not affect the number of people using it as a medium of exchange and is therefore less costly. The same holds for a number of other public goods and institutions, including defense. As authority over them increasingly moves from the national to the supra-national level, the benefit for sub-national entities of remaining within a nation state declines. One example is Belgium, which has become an increasingly decentralized state in recent decades, with

regions having their own executive and legislature. Newhouse (1997) describes how regions (and cities) are taking advantage of European integration to assert their identity and develop ties across national borders, including opening up embassies abroad and negotiating their own trade agreements, and regional leaders are talking about bypassing national capitals and dealing directly with Brussels.

3.2. Regional Integration

Ethier's theory applies to RIAs between a large country or region (US, EU or Brazil) and smaller ones, though—as noted by Winters (1999) —not to RIAs between small countries of similar size such as UEMOA or CEMAC in Sub-Saharan Africa, the revived CACM or Group of Three (Colombia, Mexico, Venezuela) in Latin America, or AFTA (the ASEAN FTA) in Asia. Also, the case of MERCOSUR is unclear because, though Brazil is much larger than other member countries, it is not necessarily more liberal (Winters, 1999). Thus, Ethier's explanation of the recent resurgence of RIAs applies to some types of RIAs—essentially North-South and East-West ones—though not necessarily to others. This issue is examined in Section 5 dealing with evidence.

4. Implications for RIAs

Are the findings from Alesina et al. that MTL leads to political disintegration consistent with Ethier's findings that MTL leads to regional integration? If the two propositions are consistent, they can be so in several ways, two of which are examined below. First, do we observe regional integration and political disintegration occurring simultaneously in the sense that as RIAs are formed, member countries split up into smaller countries? The answer is clearly no, though cases of political disintegration

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associated with changes in trade policy are examined in Section 5.3, part 4. And, as discussed in Section 2.1, evidence from the 19th century indicates that some episodes of regional integration eventually led to political integration, including Italy in 1861, Germany in 1871 and Romania in 1881. However, the concept of nationalism, with its 'threshold principle' according to which nations had to be larger than a minimum or threshold size to be viable, differed markedly from that prevailing in the 20th century (Hobsbawm, 1990).[3]

A second implication of the two propositions is that as MTL progresses, countries want increasingly to pursue regional integration, but in a way that limits or reduces the degree of political integration. In other words, as MTL proceeds over time, one would expect a change in the composition of RIAs from more to less politically integrated ones. This implication is discussed below by distinguishing between customs unions (CUs) and FTAs and is examined empirically in the next section.

Customs unions typically entail a higher degree of political integration among member countries than FTAs. First, CUs entail supra-national bodies to negotiate the common external tariff (CET) and revenue-sharing mechanisms, which is not the case for FTAs. Second, CUs are often pursued by countries in order to attain some political objectives, including the creation of regional public goods such as security or democracy. This was the case for the EU and MERCOSUR (Schiff and Winters, 1998; World Bank,

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[3] According to 19th century writings, the idea that Belgium should be an independent nation was thought to be absurd because it was deemed to be too small to be viable (Alesina et al., 2000), while in today's integrated Europe, the viability of the smaller Flemish and Walloon regions seems plausible. Political integration in Europe in the 20th century did take place in the case of East and West Germany, though this was unrelated to regional integration but rather was a case of reunification of a divided country.

2000).[4] For instance, Robert Schuman and Jean Monnet—the founding fathers of the EEC—were explicit that the precursor of the EEC, the European Coal and Steel Community (ECSC), was to make Franco-German war not only "unthinkable, but materially impossible." In fact, the preamble to the 1951 Paris treaty establishing the ECSC "resolved to substitute for age-old rivalries the merging of their essential interests; [and] to create, by establishing an economic community, the basis for a broader and deeper community among peoples long divided by bloody conflicts." Later echoes of this view are expressed by Dr. Walter Hallstein, a former president of the EC Commission, who stated: "We are not in business at all; we are in politics" (Schiff and Winters, 1998; World Bank, 2000).

As for MERCOSUR, international security and strengthening democracy also seems to have played an important role. Argentina and Brazil signed nuclear cooperation and economic agreements in the mid-1980s with the expectation that this would help reduce tensions between them by curtailing the power of the military and help strengthen their fragile democracies. The creation of MERCOSUR in 1991 reinforced this process and bound smaller neighbors into it.[5] And being a democracy has become an explicit condition of membership in MERCOSUR or association with it (as in the case of Chile and Bolivia).

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[4] Schiff and Winters (1998) show that a RIA can be an Pareto optimum arrangement if it helps internalize some externality, including security or governance, with optimum external barriers falling over time and following deep integration measures.

[5] Rubens Ricupero, Secretary-General of UNCTAD and formerly a foreign minister in the Brazilian government, confirms the importance of MERCOSUR's security aspects: "Both countries were emerging from a period of military governments, during which considerable tension had characterized the bilateral relationship, centered on a long-standing controversy about competing hydroelectric projects in international rivers of the Plata Basin. Both militaries had also continued to pursue their secret nuclear programs. It was essential to start with agreements in the economic areas in order to create a more positive external environment that rendered it possible to contain the military nuclear programs, and to replace rivalry by integration. This effort was developed along successive stages and eventually led to signature by the two governments of Brazil and Argentina." (Ricupero, 1998, personal communication; and World Bank, 2000, p. 10).

Some CUs have evolved into something deeper over time, such as a common market (with free movement of factors), the harmonization of regulations and standards, and possibly with a host of supra-national institutions as in the EU. And going back to the 19th century, some CUs evolved into nation-states over time, such as the unification of Italy in 1861, the German Zollverein evolving into the German state in 1871, and Wallachia and Moldavia becoming Romania in 1881.

In conclusion, CUs entail the creation of public goods, whether it is common trade policy, security, governance, or some other aspects of deep integration--such as labor and capital market integration, tax policy or harmonization of standards--while this is not the case with FTAs (or at least much less so since members of FTAs must agree on exceptions and rules of origin). Thus, CUs require a greater degree of compromise than FTAs and are thus more costly.

Two main findings of this paper are that i) the willingness to pay the higher cost of CUs relative to the cost of forming a FTA falls with MTL, and the ratio of FTAs to CUs is thus likely to increase with MTL; and ii) the cost of forming a CU relative to that of forming a FTA is lower when member countries are less diverse, and CUs are thus likely to be more frequent relative to FTAs in South-South than in North-South RIAs.

5. Evidence

Customs unions entail a variety of measures of political integration which are not part of FTAs. Hence, one implication from the propositions advanced by Alesina et al. and by Ethier is that as MTL increased, so would the ratio of FTAs to CUs (and so would the total number of RIAs). Columns 2 and 3 of Table 1 show the number of new CUs and FTAs over five decades, from 1949-59 to 1990-98. Data are from the WTO. Column 4 shows the

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total number of RIAs or the sum of Columns 2 and 3, and Column 5 gives the ratio of FTAs to CUs or the ratio of Columns 3 to 2.

Three alternative series of numbers are presented for the 1990s. The first row (a) includes all countries; the second row (b) excludes South-South RIAs (as well as East-East RIAs between countries from the CEEC or the FSU); and the third row (c) excludes South-South (and East-East) RIAs as well as any East-West RIA involving countries from the CEEC or the FSU. The reason for including Row (b) is that Ethier's model does not explain the formation of South-South (and East-East) RIAs (except possibly for MERCOSUR where Brazil is much larger than the other member countries); and the reason for including Row (c) is that East-West RIAs involving CEEC and FSU countries would not have occurred without the collapse of the Soviet Union, and Ethier's model does not explain this collapse. On the other hand, Alesina et al. suggest that MTL made the collapse of the FSU easier as openness allowed them and the CEEC to have improved access to the EU. And Ethier argues that his model also fits the Europe Agreements between the EU and the CEECs. Thus, the RIAs included in either Rows (b) or (c) are closer to the concept of new regionalism that Ethier (1998, 1999) had in mind than is the case for Row (a).

Looking at Column 4, the total number of RIAs increased from an average of 7 per decade in the period 1949-89 to 84 in 1990-98 (Row a), or some 12 times. Excluding South-South (and East-East) RIAs (Row b), the total number of RIAs in the 1990s falls by 50%, from 84 to 42, or six times the average in 1949-89. Excluding also East-West RIAs with CEEC and FSU countries (Row c), the total number of RIAs in the 1990s falls another 50% to 21, which is 3 times the average in 1949-89. This large increase in RIAs in the 1990s is compatible with Ethier's argument of being the outcome of increased multilateral liberalization and globalization since the index of global openness (world exports over GDP,

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shown in Column 1, Table 1) increased by close to 50% between 1949-89 and the 1990s. However, it is also compatible with alternative hypotheses, such as the domino effect triggered by a fear of Fortress Europe (EC-92) and/or by the U.S. moving away from multilateralism and signing CUSFTA and NAFTA.

We now examine two main points, on the evolution of FTAs versus CUs (Section 5.1) and on their geographic distribution (Section 5.2). Section 5.3 shows cases where CUs resulted in costs for some members and/or conflicts between them.

5.1. Evolution of FTAs and CUs over time

Our hypothesis, based on Alesina et al., is that the ratio of FTAs to CUs increases over time as MTL increases. The ratio of FTAs to CUs is given in Column 5. The ratio averaged 1.31 in the first four decades, and jumped to 9.50 in the 1990s when all countries are included (Row a), to 6.00 when South-South (and East-East) RIAs are excluded (Row b), and to 4.25 when any East-West RIA involving CEEC or FSU countries are also excluded (Row c). In other words, the ratio of FTAs to CUs in the 1990s is 3.2 to 7.2 times larger than the average in 1949-89.

According to Ethier, the increase in RIAs is caused by MTL. The large increase in RIAs occurred in the 1990s when MTL increased by 20%. However, the large increase in MTL occurred in the 1970s (see Column 1, Table 1) and is not accompanied by an increase in the number of RIAs until the 1990s. This remains somewhat of a puzzle. One possibility is that regionalism does not respond to current increases in MTL but to the accumulation of past multilateral liberalization episodes. In fact, in describing how the new international environment differs from the old one, Ethier states that MTL in manufacturing goods among DCs is "much more complete." In other words, what seems to matter for the increase in

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RIAs is the current level of MTL rather than changes in MTL; or, relatedly, MTL may need to reach a threshold before countries find it worthwhile to form RIAs.

Though we have 50 annual observations (1949-98), no econometric analysis was undertaken. The reason is that annual data on the number of new RIAs are not very informative and exploring the relationship between new RIAs and MTL on an annual basis does not seem to make much sense. According to Ethier, regional integration follows multilateral liberalization. However, his model is essentially static and does not provide any indication of the time lag between MTL and regional integration or its determinants.

5.2. Geographic Distribution of FTAs and CUs

We have argued that we expect the ratio of FTAs to CUs to be larger in North-South RIAs compared to South-South ones because the heterogeneity between member countries is greater in North-South RIAs than in South-South ones. The main RIAs, organized by CUs or FTAs and by North-South or South-South RIAs, are listed below.

One question is whether bilateral agreements should be considered as RIAs or not. The World Bank Policy Research Report *Trade Blocs* (2000) does not include bilateral agreements in their list of RIAs (Table 1.1). Hence, calculations are made both with and without bilateral agreements.

North-South:

FTAs: NAFTA; EU-Tunisia; EU-Morocco; EU and CEECs (Hungary, Poland, Bulgaria, Romania, Estonia, Latvia, Lithuania, Czech Republic; Slovak Republic; Slovenia); EU-South Africa; EU-Mexico

CUs: EU-Turkey.

Bilateral FTAs: Canada-Chile.

South-South:

    FTAs: Group of 3; LAIA; CBI; AFTA; GCC; SAARC; Chile-MERCOSUR; Bolivia-MERCOSUR.

    CUs: Andean Pact; CACM; MERCOSUR; CARICOM; EAC; CEMAC; UEMOA; ECOWAS; COMESA.

    Bilateral FTAs: Chile with Bolivia, Colombia, Mexico, Peru, Venezuela.

    Excluding bilateral agreements, we find a ratio of FTAs to CUs of 16 (=16/1) for North-South RIAs and of 0.89 (= 8/9) for South-South RIAs, i.e., the ratio is 18 times larger for North-South RIAs than for South-South RIAs. SACU was not included because it is not clear whether it should be defined as a North-South or South-South RIA. If SACU is considered a North-South CU, then the ratio of FTAs to CUs for North-South RIAs falls to 8. If SACU is considered a South-South RIA, then the ratio of FTAs to CUs for South-South RIAs falls to 0.8. Thus, the ratio of FTAs to CUs is between 9 (=8/.89) and 20 (=16/.8) times larger in North-South RIAs than in South-South RIAs.

    Including bilateral agreements, the ratio of FTAs to CUs is 17 in North-South RIAs and is 1.44 (=13/9) in South-South RIAs. Thus, the ratio is 11.81 (=17/1.44) times larger in North-South RIAs than in South-South ones. If SACU is considered a North-South CU, then the ratio of FTAs to CUs in North-South RIAs is 8.5, which is 5.90 (= 8.5/1.44) times larger than in South-South RIAs. If SACU is considered a South-South CU, then the ratio of FTAs to CUs falls to 1.3 (13/10), and is 13.08 (=17/1.3) times larger in North-North RIAs.

Thus, whether with or without SACU or the bilateral agreements, the ratio of FTAs to CUs is always larger in North-South RIAs than in South-South ones. Our results indicate that the ratio of FTAs to CUs is between 5.9 and 20 times higher for North-South RIAs than for South-South ones. This confirms our prediction.

6. <u>CUs and Member Heterogeneity</u>

The superiority of an FTA over a CU in the case of a high degree of heterogeneity between member countries is particularly relevant for small and weak countries (or regions) in a RIA with a large country (or region). This point is illustrated with four sets of cases: 1) a voluntary CU and economic losses; 2) a voluntary CU and conflict between members; 3) an involuntary CU and economic losses; and 4) an involuntary CU, conflict and attempts to secede.

1.   A small member in a voluntary CU with a large partner(s) may experience a loss when compared with being in a FTA. As discussed in Section 4, Argentina and Brazil wished to form a Common Market in part to reduce tensions between them and resolve security problems, and to strengthen their fragile democracies. Once Argentina and Brazil decided to form a Common Market, Uruguay—which sold 35 percent of its exports to its neighbors Argentina and Brazil in 1990—realized it had little choice but to join. With Paraguay reaching the same conclusion, MERCOSUR was formed. However, the degree of heterogeneity between the member countries is large. For instance, given that Brazil is a more industrialized country and manufactures machinery and equipment behind a protective tariff, and given that Brazil was dominant in the determination of MERCOSUR's CET (Olarreaga and Soloaga, 1998), the small member countries were forced to raise tariffs on these important capital goods. This had a negative impact on their terms of trade and their

competitiveness. This cost would have been avoided if they had formed a FTA rather than a CU with the other MERCOSUR members. This is what Chile decided to do. It was offered membership in MERCOSUR but chose to form a FTA with it because it felt that its trade policy and interests differed markedly from those of the members of MERCOSUR.[6]

2.   Voluntary CUs among heterogeneous members may result in conflict if some members consider that the distribution of benefits and/or losses is unfair. Examples are drawn from World Bank (2000). For instance, the East African Community (EAC) was formed in 1967 between Kenya, Tanzania and Uganda. However, because Kenya had a more developed manufacturing sector than the other members, the common external tariff (CET) which protected manufacturing benefited Kenya at the expense of the others, both because Kenyan producers gained at the expense of Tanzanian and Ugandan consumers, and because of industry clustering in Kenya and moving away from Tanzania and Uganda. Disagreement about compensation for income losses by Tanzania and Uganda led to the collapse of the EAC, the closing of borders and the confiscation of EAC assets in 1978, and contributed to the conflict between Tanzania and Uganda in 1979. Another example is the Central American Common Market (CACM) where Honduran dissatisfaction with the distribution of benefits was an element behind the 1969 military conflict with (the more developed) El Salvador. After the war, El Salvador vetoed a proposed development fund designed to channel additional resources to Honduras. This prompted Honduras to leave the CACM.

3.   A small country may enter a CU involuntarily due to political and economic pressures exerted by a large neighbor. For instance, following the demise of the FSU, the CIS (Commonwealth of Independent States) was established between Russia and ten of the

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[6] Chile's tariffs are lower and more uniform than those of MERCOSUR.

former republics. Most former republics are small, poor and land-locked, and they had little choice but to join Russia in the CIS. The Baltic countries, which decided to reorient their trade toward Europe and the rest of the world, did not join the CIS and signed Association Agreements with the EU. Georgia also declined to join at first. Interestingly, the rebel forces which had been very successful and even reached the capital, somehow disappeared after Georgia agreed to join the CIS. Belarus, Kazakhstan and Russia established a CU in 1995. Though the Kyrgyz Republic joined in 1996, it never actually implemented the CET (equal to Russia's tariff schedule). Kazakhstan did implement the CU for some 8 to 10 months but, realizing how costly it was, it then stopped. Michalopoulos and Tarr (1997) advised the republics which had not yet joined the CU to maintain an open trade regime and accede to the WTO, the main reason being that the potential dynamic gains from access to new technologies would be much higher by opening to the world rather than opening to Russia and a few other republics. The other reason is that acceding to the WTO was seen as a way to deflect pressure from Russia to join the CU. The Kyrgyz Republic did accede to the WTO and bound its tariffs for a number of products below the level of Russia's tariffs, to the displeasure of the latter. Several other republics are close to acceding to the WTO.

4.   The final case is one of an involuntary CU resulting in conflict. The typical case is that of a less-developed region within a given country which is subjected to a costly trade policy determined by the dominant region, and therefore decides to secede. Example are drawn from World Bank (2000).

The first one is the American Civil War. The Northern states produced manufactures which they sold to the Southern states, and the Southern states produced cotton which they exported to Europe. Tariffs first nearly triggered civil war in 1828. The United States was already a customs union, but in that year Congress, dominated by

Northern interests, sharply raised the US import duty on manufactures. This increased the price that Northern manufacturers could charge in the South, and so generated a massive income transfer from the South to the North. And the increased tariffs paid by the South on its imports from (mainly) the British Empire accrued in significant part to the North as well. The policy was referred to in the South as the 'Tariff of Abominations'. South Carolina refused to collect it and threatened to secede unless it was rescinded. The Federal government sent in troops but Congress backed down before fighting developed. In 1860 Northern interests tried again, because the North had so much to gain from high tariffs. This time Congress would not back down. This (perhaps as much as slavery) led the Southern states to try to quit the Union.

A second example is the war between East and West Pakistan (World Bank, 2000). West Pakistan was selling manufactures to East Pakistan at prices forced well above world levels by tariff barriers, and the tariff revenue collected in East Pakistan was disproportionately spent in West Pakistan. When Pakistan was created in 1947, the per capita income in West Pakistan was 17 percent higher than in the East, but the differential grew steadily—to 32 percent in 1959/60, 45 percent in 1964/65 and 61 percent by 1969/70. East Pakistan's desire for secession—which resulted in Bangladesh—was in part motivated by resentment at the large income transfers the tariff barriers had created and the growing income differential.

The asymmetric distribution of the costs and benefits of CUs can be minimized by lowering tariffs with the ROW because this brings prices within the CU closer to world prices and reduces the transfers between member countries. The conflicts between the member countries of the EAC and the CACM and between the regions of the U.S. and Pakistan, as well as the economic losses in other CUs with a high degree of heterogeneity,

might have been avoided if they had formed FTAs. Of course, FTAs are not sufficient to prevent trade diversion, lower terms of trade and economic loss by member countries, but they enable them to freely determine their own trade policy in order to minimize these losses and satisfy their own interests. For instance, unilateral trade liberalization is one way for members of FTAs to minimize trade diversion and economic losses (Schiff, 1997). Thus, FTAs provide a useful alternative to the potential tensions and military conflicts which CUs may generate among heterogeneous RIA members. Note also that within CUs, tensions would have been lower if the CET had been lower because the latter would have resulted in smaller transfers among member countries. For instance, the CACM and the EAC were recently revived and have now lower CETs. Hence, the conflicts caused by the unequal distribution of gains and losses among member countries are less likely to occur in the more recent incarnations of these CUs.

7. Conclusion

This paper combines two models in order to derive implications about the evolution of various RIAs over time and about their geographic distribution. Ethier (1998, 1999) argues that MTL led to the recent wave of RIAs. On the other hand, Alesina et al. (1997) argues that MTL leads to political disintegration. Combining the two arguments, it was first hypothesized that as MTL proceeded and the number of RIAs increased, the ratio of FTAs to CUs would increase as well, and second, that this ratio would be larger for North-South than for South-South RIAs. The data show an increase in that ratio in the 1990s and a higher ratio for North-South than for South-South RIAs, and are thus consistent with both hypotheses. Finally, a number of CUs are examined where heterogeneity resulted in

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economic losses for some of the members and at times resulted in conflict. These problems might have been avoided under FTAs.

Table 1. Regional Agreements

Period	Openness	Number of			Ratio
	X/GDP in %	CUs	FTAs	RIAs	FTAs/CUs
	(1)	(2)	(3)	(4)	(5)
1949-59	9.03	2	2	4	1.00
1960-69	9.73	5	7	12	1.40
1970-79	16.7	2	3	5	1.50
1980-89	15.5	3	4	7	1.33
Average 1949-89	12.74	3	4	7	1.31
1990-98: a [1/]	18.8	8	76	84	9.50
b		6	36	42	6.00
c		4	17	21	4.25

[1/] a: All countries

   b: Excludes South-South RIAs (including East-East ones)

   c: Excludes South-South RIAs and RIAs involving CEEC and FSU countries.

Note: - Data are from the WTO. Specific information on the RIAs is available from the author.

   - Openness is defined as exports/GDP (x 100) and is reported for the last year of each decade except

   in the 1990s when it is reported for 1998.

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