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PREFERENTIAL TRADE AGREEMENTS: THE WRONG ROAD

JAGDISH BHAGWATI*

At the Conservative Party annual meeting in Blackpool in 1995, British Prime Minister John Major invoked George Orwell in his radical youth, when he went by his given name of Eric Blair, to tweak Labour Party leader Tony Blair as having changed everything except his name. I would like to invoke the later George Orwell and begin by suggesting that the widespread usage of the term “free trade agreements” (FTAs) to describe what are really preferential trade agreements (PTAs) is nothing but Orwellian Newspeak.

For FTAs are *not* the same as free trade, even though that is what most politicians and journalists believe. I sometimes amuse my audience by saying that politicians, fed on soundbites, cannot comprehend more than two words at one time and are therefore prone to equate “free trade areas” with “free trade.” In fact, the great international economist Jacob Viner, the founding father of the theory of preferential trading arrangements introduced in his celebrated 1950 book, *The Customs Union Issue*, attributed the support the free traders of his time had for discriminatory freeing of trade to “an unreflecting association on their part of any removal or reduction in trade barriers with movement in the direction of free trade.”¹

The nature of FTAs is to offer free trade only to members, not to non-members. Thus, FTAs are two-faced: they ensure free trade for members and (relative) protection against non-members. First-year students of international economics would be asked to shift to a different field if they could not grasp this elementary and elemental distinction, and yet today’s politicians imagine themselves to be states-

* Arthur Lehman Professor of Economics and Professor of Political Science, Columbia University. This text amplifies remarks made at a summer 1995 meeting in Stockholm on issues before the World Trade Organization (WTO), organized by Swedish Minister Mats Hellstrom. I am thankful to Magnus Blomstrom, Pravin Krishna, Arvind Panagariya, T.N. Srinivasan, and Alan Winters for helpful conversations. Some of the key arguments in the text have been developed in depth in two recent papers: a policy paper, Jagdish Bhagwati, *U.S. Trade Policy: The Infatuation with Free Trade Areas*, in JAGDISH BHAGWATI & ANNE O. KRUEGER, *THE DANGEROUS DRIFT TO PREFERENTIAL TRADE AGREEMENTS 1* (1995), and a theoretical analysis, Jagdish Bhagwati & Arvind Panagariya, *Preferential Trade Agreements and Multilateralism: Strangers, Friends or Foes?*, in *THE ECONOMICS OF PREFERENTIAL TRADE AGREEMENTS* (Jagdish Bhagwati & Arvind Panagariya eds., 1996).

1. See Arvind Panagariya, *Folly of Thinking All Trade Liberalization Can Be Good*, *FIN. TIMES*, Feb. 19, 1996, at 16 (letter to the editor).

men endorsing free trade when they embrace these inherently discriminatory PTAs.

As PTAs proliferate, the main problem that arises is the accompanying proliferation of discrimination in market access and a whole maze of trade duties and barriers that vary among PTAs. I have called this outcome the “spaghetti bowl” phenomenon.² (I must confess that I once used this analogy in an after-dinner speech when the chairman was an Italian who did not quite share my difficulty in handling spaghetti and seemed genuinely puzzled!) Mr. David de Pury, a distinguished representative of the globalized private sector and the chief executive officer of ABB, Switzerland, is among the renowned executives who have expressed themselves in public fora precisely on this point and on the advantage, even the necessity, of having uniform nondiscriminatory rules and barriers.³ I endorse this objective, which only multilateral WTO-sanctioned treaties make possible. In view of its importance, let me say a little more on this question.

I. THE SPAGHETTI BOWL: PROBLEMS WITH PREFERENTIAL TRADING ARRANGEMENTS

The spaghetti bowl proliferation of preferential trading arrangements clutters up trade with discriminatory focus on the “nationality” of goods, creating the inevitable costs that trade experts have long noted. In particular, consider the following points, some of which are relevant only for FTAs, others of which are more generally relevant.

Rules of origin, which are inherently arbitrary despite the extensive codifications that accompany them, multiply under FTAs because different members have different external tariffs. This makes the role of the lobbyist (who protects clients by fiddling first with the adoption of rules of origin and then with the estimates that underlie the application of these rules) and the customs officer (who can make money by assigning goods the origin suggested by those bearing gifts) immensely profitable at our expense.

More generally, it is increasingly arbitrary to operate a trade policy on the assumption that one can identify which product comes from which country. When I was a student at Oxford in the 1950s, there used to be a “Who’s Whose” that listed the bondings (or “steady relation-

2. See Jagdish Bhagwati, *U.S. Trade Policy: The Infatuation with Free Trade Areas*, in JAGDISH BHAGWATI & ANNE O. KRUEGER, *THE DANGEROUS DRIFT TO PREFERENTIAL TRADE AGREEMENTS* 1 (1995).

3. He spoke eloquently, in fact, on this theme at the Stockholm trade meeting mentioned *supra*.

ships," in our slang) among the undergraduates. Needless to say, the sexual revolution and the rise of uninhibited promiscuity put an end to that list. Similarly, the phenomenal globalization of investment and production makes a Who's Whose listing of which products come from which country more and more of an anomaly, tying up trade policy in knots and absurdities and facilitating protectionist capture of rules of origin.

Let's take some telling examples. In the United States, we have tried assiduously to tell the Japanese that exports to Japan from their transplants in the United States cannot be counted as U.S. exports. On the other hand, when the Europeans tried to include cars imported from these U.S.-based Japanese transplants in their VER quotas for Japanese cars, Carla Hills, U.S. Trade Representative at the time, was up in arms. Because European trade policy seeks to control imports from Japan rather than imports from all sources (as would be the case with a tariff or an auctioned VER), the European Union (EU) is in knots about whether Japanese transplants in the United Kingdom should be allowed freedom of access within the EU, and whether a car produced in Oxfordshire is British or Japanese.

As the globalization of the world economy increasingly muddies the idealized picture of distinctly Japanese, American, British, Indian, and Mexican goods that drives much of trade policy (particularly the pursuit of FTAs), we trade economists can see more clearly the wisdom of the great trade theorists of the past, who were strongly wedded to nondiscrimination and hence to most-favored-nation (MFN) and multilateralism. As usual, a quote from Keynes says it best. In 1945, after having renounced his earlier skepticism about nondiscrimination during the Britain-U.S. discussions of the design of the postwar Bretton Woods institutions, Keynes spoke before the House of Lords:

[The proposed policies] aim, above all, at the restoration of multilateral trade . . . [T]he bias of the policies before you is against bilateral barter and every kind of discriminatory practice. The separate blocs and all the friction and loss of friendship they must bring with them are expedients to which one may be driven in a hostile world where trade has ceased over wide areas to be cooperative and peaceful and where are forgotten the healthy rules of mutual advantage and equal treatment. *But it is surely crazy to prefer that.*⁴

4. See JAGDISH BHAGWATI, *THE WORLD TRADING SYSTEM AT RISK* 64 (1991) (emphasis added).

So, the question comes before us: Why *are* we crazy enough to go down the PTA route, as both EU and U.S. policy-makers are so keen to do?⁵ Before I turn to that, I first want to make an important distinction.

II. TWO TYPES OF PREFERENTIAL TRADE AGREEMENTS

I believe we should make a distinction between two different types of PTAs. First, there are PTAs among non-hegemonic countries (chiefly the developing countries), such as MERCOSUR, which contains Argentina, Brazil, Uruguay, and Paraguay, and the Association of Southeast Asian Nations (ASEAN). Second, there are PTAs that include hegemonic countries of the Triad, such as NAFTA and its proposed extensions, the proposed transformation of the Asia-Pacific Economic Cooperation (APEC) into a PTA, the proposed Trans-Atlantic Free Trade Agreement (TAFTA) (which would have a mix of hegemonic and non-hegemonic members), the EU, and the EU's association agreements with other countries.

I would say that the non-hegemonic (or, broadly speaking, developing country) PTAs are not of great concern. For one thing, they do not have much impact: what MERCOSUR or ASEAN does is of little consequence outside of itself, certainly compared to the impact of the big-ticket hegemonic PTAs. But the main reason for going along with non-hegemonic PTAs, despite the accompanying costs, is simply that in comparison to the protectionist policies of many developing countries, any freeing of trade is a desirable change. Furthermore, in light of the undisciplined, freewheeling, chaotic set of preferences these countries granted each other under the Economic Cooperation Among Developing Countries regime, their acceptance of Article XXIV discipline can only be seen as a progressive measure, despite the fact that the better and ideal thing would be for them to lower trade barriers in a nondiscriminatory fashion instead.

These arguments for tolerating preferential agreements do not

5. Arvind Panagariya's letter to the Financial Times, *supra* note 1, was prompted by U.S. Ambassador Stuart Eisenstat's denunciation of the EU for its partiality towards PTAs. These remarks inspired an EU spokesman to retort that "the pot was calling the kettle black," and Eisenstat retreated, claiming that he was against "partial" PTAs that exempt some sectors, but not against the "full" PTA that the North American Free Trade Agreement (NAFTA) claims to be. Aside from the fact that NAFTA has its own holes, including recent backtracking on Mexican trucks' access to U.S. roads, Ambassador Eisenstat has nothing but assertion on his side when he claims that full preferences are better than partial preferences. Indeed, some economic arguments suggest the opposite. But then, the distinguished Ambassador cannot be expected to be familiar with these issues, and, in any event, he must take his instructions from Washington.

apply, however, to PTAs that have hegemonic powers within their membership. The course of action taken by hegemonic PTAs certainly affects the system, and, unlike developing countries, hegemonic powers (especially the United States) have previously been wedded to multilateralism, so when they move to preferential agreements they are moving from an optimal to a suboptimal approach. For these PTAs, therefore, we must impose more drastic standards for approval.

III. TWO CRITERIA FOR APPROVING PTAS

What criteria should we impose for approving hegemonic PTAs? In essence, I would make an exception and permit such PTAs in two cases. First, I would permit a PTA that is building a common market with full factor mobility, a common external tariff, and even political integration. This is, of course, the core of the EU, and it offers the advantages that the United States already enjoys as a federal country with deep integration among its states. Second, I would permit a PTA where it represents the only way to achieve multilateral free trade among nations because the multilateral trade negotiations (MTN) process made available by the GATT/WTO is stalled. This is the option that the United States chose after finding the EC in a denial mode at the November 1982 GATT Ministerial, when the demand was made for a new MTN round. When the United States started negotiating the Canada-U.S. Free Trade Agreement in 1983, it was choosing an inferior (PTA) option only because the preferred (MTN) option was not available. The apt analogy might be that the United States took the dirt road because it could not take the turnpike.

Unfortunately, the United States has since abandoned this rationale for choosing the PTA route. Despite the fact that the Uruguay Round was in fact launched and successfully concluded and has led to a functioning WTO, and the world's attention is focused on determining what the WTO's next agenda should be, the United States remains poised to continue its pursuit of PTAs through NAFTA expansion and possibly through the eventual transformation of APEC into a PTA. In short, the United States is now committed to "walking on two legs": MTN and PTAs. My fear is that the United States is destined to get itself, and through unwitting example the rest of the world as well, to walk on all fours. As Under Secretary of the Treasury Lawrence Summers, a noted public finance economist, once wrote, "[e]conomists should maintain a strong, but rebuttable, presumption in favor of all lateral reductions in trade barriers, whether they be multi-, uni-, tri-, or

plurilateral.”⁶ Summers and others share the presumption that PTAs will exercise a benign, beneficial effect on the course of multilateral trade negotiations.

My own view is that this presumption is unpersuasive, and that the effect of the PTA path on the MTN path has been malign, not benign. I have already written on this issue at length in different places, so I will not repeat myself here, and instead I urge the audience to read the arguments in the original.⁷ I will, however, mention two of the many arguments to give you a flavor of the debate.

First, one proponent of the PTA approach, Fred Bergsten of the Institute for International Economics in Washington, D.C., has argued recently that the Uruguay Round was closed successfully because the Seattle APEC meeting served notice to the Europeans that the United States was ready and willing to go the alternative preferential route, which would cut the Europeans out. I consider this quite fanciful indeed. The notion that the Europeans would believe that the Asian members of APEC would play for the United States in competition against the EU, when they are in both markets in a big way and when Asia has for nearly two centuries been within Europe’s sphere of influence and interest, is a little hard to swallow. Besides, it is clear that in the end the Uruguay Round was settled almost entirely (I would say over 90%) along the lines of the Dunkel draft, because the U.S. administration decided to accept the advice of many, including myself: settle the Round for what you can get (from the French primarily) and go on to build on that result in the next set(s) of negotiations. But the desire to inflate the claims on behalf of PTAs is so strong on the Washington scene, especially now that the Clinton administration has firmly put itself on that side of the street, that it is hardly surprising to find that many who live close to that scene fall prey to it.

As for the malign impact of PTAs, it is not difficult to find examples. The effect of the NAFTA debate was to make the issue of what effect trade with poorer countries would have on jobs and wages in richer countries politically salient in the United States. The fact that Mexico was a source of millions of illiterate, ill-nourished, and impoverished illegal immigrants was enough to make many in the United States feel

6. See Jagdish Bhagwati & Arvind Panagariya, *Preferential Trade Agreements and Multilateralism: Strangers, Friends or Foes?*, in *THE ECONOMICS OF PREFERENTIAL TRADE AGREEMENTS* (Jagdish Bhagwati & Arvind Panagariya eds., 1996).

7. See Jagdish Bhagwati, *Regionalism and Multilateralism: An Overview*, in *NEW DIMENSIONS IN REGIONAL INTEGRATION* 22 (Jaime de Melo & Arvind Panagariya eds., 1993); Bhagwati & Panagariya, *supra* note 6.

that free trade with Mexico would lead indirectly to Mexico's masses having an adverse effect on jobs and wages as well. By contrast, the Uruguay Round did not stir up this issue, even though India and China have many more millions of poor in their midst, simply because those countries were too far away and the Uruguay Round was diffused over many issues and many countries. In fact, I would argue that if liberalization of trade with Mexico had been done under GATT auspices along with all the other countries of the GATT, it would not have unleashed the same worries that we are now burdened with and that Pat Buchanan exploited so much. Thus, the legacy of NAFTA (a PTA) is that all future liberalizations with poor countries will be much more difficult than they would have been if there had been no NAFTA.

IV. CAVEATS ON NAFTA, APEC, AND TAFTA

Let me conclude by arguing against the extension of NAFTA to Chile and other countries, and in favor of intensifying NAFTA into a common market for North America itself, something along the lines of the EC. Turning APEC into an FTA is an equally bad idea. Fortunately, the Asian members of APEC have shown little enthusiasm for such a prescription, opting instead for liberalization on an MFN basis, despite U.S. pressure to choose the FTA model and ambiguities in some of the pronouncements on the subject.⁸

As for TAFTA, I am happy to see that current WTO Director-General Renato Ruggiero, former WTO Director-General Peter Sutherland, and EU Trade Commissioner Sir Leon Brittan have been widely reported to be insisting that TAFTA be on an MFN basis; this, of course, is another way of saying that TAFTA should not really be an Article XXIV type of PTA. (A recent meeting in Madrid on the subject of U.S.-EC trade and investment cooperation did not endorse TAFTA in the form of a PTA.)

I would hope, therefore, that these sorts of very welcome initiatives continue to be prevented from being turned into PTAs. In fact, true statesmanship requires that, in full recognition of the advantages of nondiscriminatory multilateralism, these initiatives be folded instead into the next MTN, the first WTO Round, whose method of launching should be the first order of business in Singapore at the first WTO Ministerial in December 1996.

8. The APEC Osaka Summit, held after the Stockholm meeting discussed *supra*, did not announce anything other than MFN trade liberalization measures.