Always Look at the Bright Side of Non-Delivery

(WTO and Preferential Trade Agreements, Yesterday and Today)

by

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JEL Classification: F16 Key Words: Preferential Trade Agreements, WTO

Abstract

The disciplining of preferential trade agreements (PTAs) by the WTO has been 'relaxed' recently as a result of the new context (the *Transparency Mechanism*) within which notified PTAs are being multilaterally reviewed. This is probably a blessing for a number of reasons including the success of the multilateral trading system in bringing tariffs down over the years (and the ensuing reduced trade diversion), the fact that modern PTAs deal with many non-trade issues as well (for which no WTO disciplines exist), and recent empirical literature suggesting overall positive welfare implications for those participating in similar schemes. This paper discusses these and other reasons to support the view that the WTO should rather focus on the multilateral agenda instead of diverting its attention towards disciplining PTAs. In more concrete terms, this paper argues in support of the thesis that the *Transparency Mechanism* should not be simply a *de facto* substitute of the previous regime (where outlawing a PTA could not *a priori* be excluded), but the *de jure* new forum to discuss PTAs within the multilateral trading system, at least for the time being. A first do no harm-policy is one of the rationales for the thesis advocated here.

1. Clearing PTAs at the WTO Level

All PTAs must be notified to the WTO (Art. XXIV GATT).[1] The *Committee on Regional Trade Agreements* (CRTA), the successor to the Art. XXIV Working Parties, is the organ where all PTAs are being routinely notified. The CRTA is composed by delegates of all WTO Members and has always decided by consensus.[2] In principle, the CRTA has wide powers. Art. XXIV.7 GATT relevantly provides that it has the power:

> "… to make such reports and recommendations to contracting parties as they may deem appropriate."

In principle, thus, one cannot exclude the possibility that the CRTA concludes that a notified PTA is GATT-inconsistent. This conclusion is underscored by the explicit wording of Art. XXIV.7(b) GATT dealing with *interim agreements* leading to PTAs:

> "If … the CONTRACTING PARTIES find that such agreement is not likely to result in the formation of a customs union or of a free-trade area … the CONTRACTING PARTIES shall make recommendations to the parties to the agreement. *The parties shall not maintain or put into force, as the case may be, such agreement if they are not prepared to modify it in accordance with these recommendations.*" (emphasis added).

These provisions give the impression that the multilateral review was designed as an institution akin to a modern merger authority: PTAs would not be consumed unless cleared through the process established.

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[1] In this paper I do not deal with PTAs notified under the *Enabling Clause*, or under GATS (although much of the analysis is relevant to those schemes as well).

[2] In theory, if a consensus decision cannot be reached, the matter can referred to the higher organs which can decide by majority voting. This has neither happened, not threatened to happen. There is no study to my knowledge, measuring the impact of this threat, which, intuitively speaking should be low in light of the collective preference, explained *infra*, for not enforcing this provision.

2. Years Later: No Delivery

The numbers first: as of November 2010, 462 PTAs in total had been notified to the WTO, 345 of which under Art. XXIV GATT, almost 2/3 of which are now in force. Schott (1989) identifies four cases where PTAs were judged *broadly* consistent with the GATT. Since his study there has been one case where there has been a definitive and unambiguous acceptance, at the CRTA level, that the notified PTA was GATT-consistent: the CU between the Czech and the Slovak republics. We are simply in the dark as to the GATT-consistency of the remaining PTA currently in place. The inescapable conclusion is that the multilateral review has not delivered on its institutional promise. Non delivery has led to absence of outlawing a PTA so far.

Those unhappy with the outcome can of course, always litigate. Not much litigation has happened either; only a handful of disputes since the inception of the GATT (1947) have arisen where the consistency of a PTA with the GATT was the main or ancillary component. Mavroidis (2005) identifies a number of good reasons why this has been the case: collective action problems; non-enforcement might leave outsiders better off (because of the reduced trade diversion); strategic reasons (except for Mongolia, all WTO Members participate in PTAs, and they would have little incentive to undermine their options in this area by streamlining the various obligations embedded in GATT); the institutional design of panels (why trust amateur judges with interpretations of loaded terms, such as *substantially all trade*, that the trading nations have failed to clarify?)

3. No Delivery is Now *De Facto* Established

On December 14, 2006, the *General Council* of the WTO adopted a decision concerning the *Transparency Mechanism for Regional Trade Agreements*.[3] The *Transparency Mechanism* was supposed to *complement* the existing arsenal. *De facto*, the *Transparency*

[3]See WTO Doc. WT/L/671 of 18 December 2006. The WTO continues to use the term *Regional Trade Agreements* (RTA), against mounting evidence that there is often not much *regional* about new notifications, by-passing thus, the quintessence of such schemes, that is, their *preferential* character.

Mechanism did not *complement*, but *substituted* the previous arsenal: the multilateral review was narrowed down to a mere exercise in transparency. Since 2007 the procedures of the *Transparency Mechanism*, which calls for *consideration* of agreements rather than *examination* as before have been in place. This, in practice, means that agreements are no longer checked for consistency by the CRTA: once the factual presentation of a notified PTA has been distributed, WTO Members send in questions to which responses must be provided by the parties and circulated three working days before the meeting of the CRTA. There is also a written record of each agreement considered by the CRTA. The WTO Members' questions and the parties' responses as well as a record of the discussion is available on the WTO RTA database (http://rtais.wto.org/). There is however, no longer review of the consistency (from a legal perspective) of the notified PTA with the WTO rules. The exercise is meant to increase transparency and stop short of going any further.

Some might deplore this evolution. Indeed, as the numbers of PTAs increase by the day, one might legitimately ask whether it is indeed reasonable to reduce rather than enhance the penetration of the multilateral review: assuming that litigation numbers will remain constant, and there is no reason to think otherwise, is this really good strategy to stay idle against schemes that go against the heart of the multilateral trading system? In what follows, I advance some arguments why indeed, staying idle is probably wise strategy.

4. Non Delivery is Probably a Blessing

4.1 From Day One We Apply the Wrong Test

The GATT-test for consistency of PTAs with the multilateral rules aims at ensuring that PTAs will not be *à la carte*: absent the *substantially all trade*-requirement, PTAs could be formed on one tariff line only. This could severely undermine MFN, the cornerstone of the GATT-edifice. So the GATT framers could not live with a GATT *à la carte,* but could live with GATT-consistent PTAs which resulted in *trade diversion*, the evil Viner in his classic analysis warned us against. Indeed, especially in the '50s and the '60s when MFN

rates were high (and thus, the potential margin of preference large) PTAs that would take the intra-PTA tariff rates to 0% could create substantial trade diversion if the PTA partners were relatively inefficient (un-competitive): the GATT would applaud while Viner's worst fears would have been confirmed. One might legitimately ask the question whether the candle is indeed worth the flame? Should we, in other words, be enforcing an economics-uninformed test in the name of avoiding PTAs *à la carte*? How realistic is this risk anyway?

4.2 What is the Counterfactual to Trade Diversion?

The classic Vinerian analysis would request us to calculate the trade created through the establishment of a PTA (since intra-PTA trade would be liberalized)[4] and compare it to the trade diverted (since trade might be deflected from the *worldwide* most efficient source of supply to the *intra-PTA* most efficient source of supply). One of course, might cast significant doubt on the appropriateness of such measurement, since it *assumes* the counterfactual: what if countries refused to make the same MFN cuts if they were deprived of the possibility to go preferential? What if they refused to participate in the WTO altogether? This is not meant to put into question the classic Vinerian analysis: indeed, Viner was interested in measuring the *allocational impact* of discriminatory integration; the point here concerns *Realpolitik* and suggests that there is no reason to believe that MFN cuts would be the appropriate counterfactual to preferences.[5]

4.3 Is Trade Diversion an Issue as it Was?

Recent empirical studies provide us with mixed evidence regarding the extent of trade diversion resulting from the formation of PTAs. We lack a comprehensive calculation of

[4] I assume here a GATT-consistent PTA.

[5] There are few papers that discuss this issue. In two recent papers, Saggi and co-authors design models with endogenous cuts in order to ascertain whether MFN cuts are a counterfactual to preferential cuts: Saggi and Yildiz (2010) find that when countries have asymmetric endowments or when governments value producer interests more than tariff revenue and consumer surplus, there exist circumstances where global free trade is a stable equilibrium only if countries are free to pursue bilateral trade agreements. Saggi, Woodland and Yildiz (2010)

trade diversion for all PTAs (indeed one might wonder if one is feasible), but the on-going tariff liberalization of tariffs at MFN-level would strongly argue in favour of the thesis that the problem is not of the magnitude that it used to be.[6]

Scholarship points to the (missing) incentives to agree on MFN tariff cuts following establishment of a PTA; Bhagwati (2002), Krishna (1998) and Limão (2006) all have contributed in making the point that, besides trade diversion created through the establishment of PTAs, members of PTAs behave as enemies of non-discriminatory trade liberalization, since they are unwilling to cut tariffs on MFN basis for fear of eroding the margin of preference that they have granted to their PTA-partners: they become thus, *stumbling* (as opposed to *building*) blocs opposing MFN trade liberalization, and frustrating the achievement of the basic WTO objective. The fear was probably legitimate at some point, but the question is how relevant is it today? On the one hand studies like Karacaovali and Limão (2008) looking at the EU, and Limão (2006) looking at the US have provided empirical evidence that PTAs have behaved like stumbling blocs: they ask the question whether MFN tariff cuts during the *Uruguay Round* are related to their preferential tariffs. The stumbling bloc-thesis would suggest that trading nations would have cut tariffs less in areas where they had preferential tariffs, and indeed this what these authors finds. Other studies however find the opposite: Estevadeordal, Freund and Ornelas (2008) examine the Latin experience with PTAs and find that Latin nations cut their MFN rates most in products where they had preferences in place. Baldwin and Seghezza (2010) use tariff data for 23 large trading nations and find that MFN cuts and preferences are complements not substitutes: preferences tend be zero or close to zero where nations have high MFN tariffs; intuitively, one would associate the stumbling bloc-thesis with large preferences in similar cases, but the authors show that this is not the case. The authors discard thus, the stumbling bloc- without supporting the building bloc-

argue that if the players have asymmetric endowments Art. XXIV GATT (regionalism) might, on occasion, help further the cause of multilateral liberalization.

[6]Irwin (1998).

thesis. Acharya *et al.* (2011) in similar vein, find that the impact of plurilateral PTAs on extra-PTA imports and exports is large and positive. If at all, recent empirical evidence hardly supports the uni-dimensional conclusion that PTAs are stumbling blocs *per se*.
Of course trade diversion can result from instruments other than tariffs. It can result from say convergent environmental or public health policies across PTA partners. With respect to domestic instruments in general, nonetheless, there is no need for action: to the extent that a *trade advantage* has been conferred, it must be extended to all WTO Members automatically and unconditionally by virtue of Art. I GATT (MFN). PTAs in other words, cannot provide legal shelter for discriminatory domestic instruments since the latter were not meant to protect anyway, and hence, cannot be regarded as a *restrictive regulation of commerce* in the sense of the term embedded in Art. XXIV GATT.

Trade diversion can also result from say increased use of antidumping (AD) proceedings against non PTA partners, as the work of Prusa and Teh (2010) shows. Once again though, nothing much can be done about it: at a positive level, the only MFN obligation that WTO Members incur with respect to AD duties is to collect them on non-discriminatory basis;[7] at a normative level, the burden associated with proving that under similar circumstances PTA partners privileged AD proceedings against a sub-set of the WTO Membership (namely, outsiders to their PTA) is quite high: except for conceptual issues, those carrying the burden of proof (that is, the Members asked to pay them) will have to also address issues such as opportunity cost of conducting another investigation, scarcity of administrative resources etc.

4.4 Subject Matter for Which No Disciplines Exist

Horn *et al.* (2010) examine the subject matter of PTAs concluded by two hubs (EU, US) with various spokes between 1992-2008, and divide it into WTO+ (say tariff cuts beyond

the MFN-level), and WTOx (issues that do not come under the mandate of the WTO, say positive integration in fields such as environmental policy, fight against corruption etc.). The WTOx part of the PTAs is quite substantial. This paper thus, suggests that the rationale for going preferential should *also* be searched in WTOx-type of obligations. The problem however, is that we lack a test (other than MFN) to measure the consistency of WTOx provisions with the WTO.

Assume, for example, that US and Peru agree that the latter increases its level of environmental protection up to the level of the former. As a result, it now faces no barriers in the US market with respect to a number of goods. Irrespective of its participation in a PTA with the US, Peru would have faced no barriers had it unilaterally increased its environmental protection up to the US level. In other words, the US cannot have one environmental policy *vis-à-vis its* PTA partners and another (more onerous) *vis-à-vis* the rest of the WTO Membership. Environmental policies are covered by MFN (Art. I.2 GATT) and are not meant to protect domestic producer (since they fall under the ambit of Art. III GATT which is meant to ensure equality of conditions of competition within markets): an Art. XXIV GATT-defence cannot thus be raised to justify departures from MFN. Hence, the rise in the level of environmental protection in Peru, even if it takes place because of Peru's participation in the PTA should not mystify the CRTA. It should not concern it either.

Should this be the case at a *normative* level? Well, this is another story. But for a more substantive review of the new Peruvian policies to take place, one would first need to negotiate environmental policies at the WTO level. This should not be a priority, for the reasons discussed below.

4.5 PTAs can be Welfare Improving

[7]Moreover, relevant GATT/WTO practice has failed to clarify whether AD duties qualify as a *restrictive*

Subsequent (to Viner) economic theory culminating with the *Kemp-Wan* theorem (showing that trade diversion can be eliminated by reducing external tariffs so as to keep trade with non-members unchanged, keeping, in other words, prices constant) shows that trade diversion is not a necessary evil stemming from the creation of PTAs. The result in the *Kemp-Wan* theorem applies in a set of given circumstances. The *Kemp-Wan* theorem, nonetheless, is not a *passage obligé* in order to support a claim that PTAs can be welfare improving. A trading bloc, as Krugman (1991) observes will normally have more monopoly power in world trade than any of its members alone. By entering into a PTA, in other words, trading nations can improve their *terms of trade*.

But there could be other, less immediate reasons arguing in favour of establishing a PTA. Analysts routinely make the point that NAFTA was beneficial to Mexico not simply because the US lowered its tariff barriers to Mexican goods and services, but also because benefitted from other dynamic benefits, such as, increased investment over the years as a result of rationalization of its policies etc.[8] Baldwin (1993) correctly suggests that it is an onerous exercise to estimate the dynamic effects of preferential agreements; some of them, for example, might be shielded within the realm of private information that is never revealed to the rest of the world (e.g., side payments in the form of support for a permanent or temporary seat with the UN *Security Council*). In this vein, Winters and Schiff (1998) have argued that, under assumptions, trust can be built and conflict can be avoided through the formation of PTAs. As Baldwin himself notes, the difficulty of calculating similar benefits is no intellectual reason to outright exclude them from any calculation.[9]

Recently, there is some empirical support for this view when authors have calculated some of the perks: Baltagi *et al.* (2008) discuss the relationship between PTAs and FDI

regulation of commerce. If yes, then they anyway must be eliminated across PTA partners.
[8]Galiendo and Parro (2009). On the EU experience, see Sapir (1998).

(foreign direct investment) and conclude in an empirical paper discussing the *Europe Agreements* that removal of trade barriers can lead to substantial flows of FDI for those participating.

4.6 The Opportunity Cost of Re-negotiating Art. XXIV GATT

If the analysis above does not manage to persuade PTA-busters with enough arguments to hold their fire, then maybe they should reflect on what could be done to redress the current, disappointing in their view, equilibrium.[10]

PTA-busters should first ask the question whether going against PTAs is beneficial for current WTO Members? If their behaviour as litigators against PTAs is an indication, then, probably this is not the case. But one can always make the point that it is collective action[11] the dominant explanation for not litigating PTAs and not other factors such as strategic behaviour. If true, then WTO Members might be willing to do collectively in the context of a revamped multilateral review what they are not prepared to do individually by raising a complaint before a WTO Panel.[12]

The key stumbling bloc in clarifying the current text is the understanding of the term "*substantially all trade*". Past practice cannot serve as meaningful guidance since all sorts of interpretations have been advanced, none with quantifiable content. An Australian proposal to clarify this term during the *Uruguay Round* by introducing a quantifiable benchmark (95% of all trade at the six digit HS level) met the approval of the proposing

[9]There is a huge literature looking at many positive and negative implications of PTAs and I cannot do justice to it in this brief note, and looking exhaustively into this literature clearly goes beyond its limits.
[10]Bhagwati (2008).
[11]I understand this term here in its widest possible connotation: WTO Members would neither like to incur the financial cost of the litigation, nor the diplomatic cost of alienating their trading partners through hostile litigation where not a specific trade measure, but a wider development option is probably at stake.
[12]This is a rather unrealistic assumption. We proceed nonetheless with this thought experiment only to show that even if the assumption holds, not much can be achieved anyway.

state only.[13] Under the circumstances this does not emerge as a promising avenue.[14] One could avoid of course, many of the problems by following a different road: instead of clarifying the terms, introduce a change in the voting procedures, say consensus minus the PTA members. The inevitable argument would be why confine voting to the CRTA? But even if somehow this obstacle is addressed, many of those voting might prefer not to risk their political alliance with the PTA members and let political evaluations and not strict legal scrutiny guide their vote. Moreover, even if a way is found to address PTAs from now on, the question will arise what do with the existing PTAs? "Bygones are bygones" seems not to be an option in light of the sheer number of existing PTAs.

Now, the analysis above assumes that we want to keep the current WTO mandate constant. But doing that might lead to other problems: one might be say proclaiming a PTA GATT-inconsistent because it does not meet an agreed definition of the *substantially all trade*-requirement, and deny PTA participants of benefits in the form of FDI, technical assistance in a number of policies etc. Would the WTO Membership want to do that? If not, then it would have to negotiate a new multilateral framework to act as legal metric for the subject matter of PTAs. The extent of the new metric, as the work of Horn *et al*. (2010) shows, is quite vast. The ensuing negotiating cost would be correspondingly large. And in times when the Membership cannot deliver on a much narrower promise circumscribing the *Doha Round* mandate, it would be cavalier to go for the wider picture.

Finally, one might argue that in the absence of likelihood to obtain tangible results, then we should reduce the bite of existing remedies. But this is where we are now anyway, with the advent of the *Transparency Mechanism.*

[13]Mavroidis *et al*. (2010).

[14]Moreover, there is enough insurance policy in the WTO regime against obvious deviations: a PTA whereby partners lower their tariffs on one good only representing a very low volume of their trade could easily be found to violate the MFN obligations and not meet the *substantially all trade*-requirement, the lack of precise definition of the latter notwithstanding. Keep also in mind that dozens of empirical studies amply demonstrate that no similar PTAs exist.

5 Concluding Remarks

PTAs are formed for many, often idiosyncratic reasons. We cited some of the reasons *supra* and there are many more: Baldwin (1997), for example, tries to explore the validity of some of the rationales, and, more recently, Whalley (2008) attempts a similar endeavour. Some of the rationales advanced have even (persuasively) criticized. For example, the argument has time and again been advanced (and continues to do so) that countries have gone preferential because they were frustrated with the slow pace of multilateral tariff liberalization. I attach little value to this view: if true, then why did not they go for what Bhagwati has termed *open regionalism*, that is allow others to join their PTA assuming they had agreed on the tariff cuts decided? Other rationales hold more promise: Baldwin (2008), for example, develops a theory aiming to predict who goes preferential depending on the identity of the spoke and the hub that have already gone preferential. But we lack a dominant explanation that can serve as rationale across PTAs. This observation in and of itself would cast severe doubt on remedial action against PTAs since it is questionable whether the same remedy should apply to divergent situations.

The historic rationale for PTAs is of no much help either. Arguably, one reason for its inclusion is that the GATT negotiators were presented with a *fait accompli*: two CU participated in the negotiation, the Syro-Lebanese customs union (Syria, Lebanon), and *Benelux* (Belgium, Netherlands, Luxembourg). Institutional arrangements probably had to be made in order to accommodate these contracting parties. Chase (2006) drawing from a series of archival records, begs to differ and points to a different direction: the author persuasively demonstrates that it was the US negotiators that designed this provision in order to accommodate a trade agreement that they had secretly reached with Canada. The *US – Canada FTA* did not see the light of the day then but only 40 years later. On the other hand, the view held by many that the inclusion of a provision on FTAs was there to accommodate the European integration process must be discarded: in

Acheson's (1969) record, Jean Monnet revealed his plans on European integration after the *Havana Conference* had taken place.

We are still struggling with the rationale but recent research paints a much rosier picture for PTAs than what was the case before. One contributing factor is the success of the multilateral trading system: MFN reduction of tariffs results in reduction of trade diversion created through PTAs. So we are now facing a problem less acute than before. Moreover, the content of PTAs has changed drastically over the recent years and moved to areas escaping the current WTO mandate. Finally, empirical evidence shows that PTAs can be welfare improving. And while all these changes were happening, the WTO continued to enforce an ill-informed and out-dated to constrain PTAs. Against this background, the shift towards a mere exercise in transparency (facilitated by the WTO *Transparency Mechanism*) should be welcome with relief. If at all, it removes the risk for false positives which can have important institutional (negative) external effects.

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