

# II. The WTO and preferential trade agreements: From co-existence to coherence

The World Trade Report 2011 describes the historical development of PTAs and the current landscape of agreements. It examines why PTAs are established, their economic effects, and the contents of the agreements themselves. Finally it considers the interaction between PTAs and the multilateral trading system.

# Contents

A. Introduction	42
B. Historical background and current trends	46
C. Causes and effects of PTAs: Is it all about preferences?	92
D. Anatomy of preferential trade agreements	122
E. The multilateral trading system and PTAs	164
F. Conclusions	196

# A. Introduction

The rapid increase in preferential trade agreements (PTAs) has been a prominent feature of international trade policy in recent times. PTAs constitute an exception to the general most-favoured nation (MFN) provision of the WTO, whereby all WTO members impose on each other the same non-discriminatory tariff. With the exception of Mongolia, all WTO members are party to at least one PTA. Interest in negotiating PTAs appears to have been sustained despite the global economic crisis. Indeed, the economic crisis itself may be spurring governments to negotiate new PTAs as much to preserve existing openness in the face of political pressure to reduce access as to generate new openness. The explosion of PTAs has triggered a parallel eruption of research on the subject. Nevertheless, this report provides fresh perspectives and insights into this important area of trade policy.

## Contents

1. Perspectives and insights in the World Trade Report 2011	44
2. Structure of the report	45

Although the term “regional trade agreement” has become widely used, this report uses the more generic term PTA, since a large number of agreements are not limited to countries within a single region. The report only covers reciprocal preferential agreements – regional, bilateral or plurilateral. Non-reciprocal agreements are certainly deserving of study, but almost 90 per cent of the global trade-weighted preference margin (i.e. the difference between the lowest applicable preferential tariff and the MFN rate applied to other trading partners) is related to preferential tariffs under reciprocal agreements (see Section B). PTAs may be free trade agreements, or customs unions with common external tariffs.

## 1. Perspectives and insights in the World Trade Report 2011

### (a) International production networks

Some explanations for why countries enter into PTAs have not received enough attention and deserve to be examined more closely. The international fragmentation of production, already present in the early 1960s, has expanded significantly. Data suggest that in the last two decades offshoring in both intermediate goods and services has grown at a faster pace than trade in final goods. In particular, growth in East Asia and the economic transformation of Eastern Europe appear to have significantly intensified these phenomena (Jones et al., 2005). This report links the increasing number of PTAs with the growing importance of international production networks and delves closely into this relationship.

### (b) Preferential trade flows and tariffs

The explosion of PTAs is not being matched by an expansion in trade flows that receive preferential treatment. This report provides what is probably the most systematic estimation of the magnitude of preferential trade and the result proves to be an eye-opener. Only 16 per cent of global merchandise trade receives preferential treatment if trade within the European Union is excluded. Perhaps this result should not be surprising in light of the huge reduction in tariffs that has occurred since the end of the Second World War (half of global merchandise trade has applied MFN tariff rates of zero). Onerous rules of origin procedures sometimes associated with free trade agreements have contributed to these low figures by making the costs of compliance requirements higher than the perceived worth of the underlying preference margins.

Benefiting from a newly created database on preferential tariffs, this report establishes that preferential margins are small when they are adjusted to account for the preferential access enjoyed by other exporters. The proliferation of PTAs means that the difference between the MFN rate and the PTA rate overstates the competitive advantage of a PTA member, since increasingly its

competitors will also enjoy preferential access to the market. The report estimates that in 2007, preference margins appropriately adjusted to take account of the presence of other preferential suppliers were no greater than 2 per cent in absolute value for the bulk (more than 87 per cent) of all merchandise trade. The implication of these results is that one has to look beyond tariffs to explain why countries enter into PTAs.

### (c) Beyond trade creation and trade diversion

While nearly all trade agreements contain provisions on preferential tariffs, most PTAs now cover a wide range of issues beyond tariffs, including services,<sup>1</sup> investment, intellectual property protection, and competition policy. These policy areas involve domestic regulations (or behind-the-border measures). In some of these new areas, the agreements are “deeper”, either in the sense that they commit members to a greater degree of market integration than the WTO (e.g. the removal of all barriers to service providers of PTA partners), or that some policy prerogative is delegated from a national to a supra-national level (e.g. the creation of regional standards).

Deep integration is likely to occur for several different reasons. First, trade openness increases policy interdependency (spillovers) that makes unilateral decision-making inefficient compared with decisions taken collectively. A second reason is that deep integration agreements may be necessary to promote trade in certain sectors and economic integration more broadly. This second explanation applies to international production networks which require a governance structure beyond low tariffs. If these agreements result primarily in changes to domestic regulations, one may need to think in terms of a framework distinct from trade creation and trade diversion because changes to domestic regulations are difficult to tailor so as to favour only certain trade partners.

### (d) A viable WTO agenda on PTAs

The significance of PTAs from the perspective of the multilateral trading system is inadequately captured by the old idiom of stumbling blocks and building blocks. The underlying question behind this approach was whether preferential tariff opening would eventually lead to multilateral opening. This analysis does not, however, mean that PTAs are an altogether benign phenomenon that can be ignored by the multilateral trading system. More subtle forms of discrimination may be embedded in PTAs, and PTAs can raise transaction costs.

A number of possible ways for the WTO to interact with PTAs are discussed in the report – some of which have been tried more than others in the past. These options include i) fixing deficiencies in the WTO legal framework (i.e. a “hard law” approach); ii) adopting a more nuanced and non-litigious approach to considering PTAs in the

context of transparency and information exchange in order better to understand mutual multilaterally based interests in relation to PTAs (a “soft law” approach); iii) accelerating a multilateral MFN-driven agenda on trade opening; and iv) multilateralizing (aligning and consolidating) PTA-related initiatives over time into the WTO framework. This last approach could involve revisiting WTO approaches to decision-making so as to contemplate non-discriminatory WTO-sanctioned agreements among groups of members (“critical mass”) that would support a multilateralization process. These approaches are not necessarily mutually exclusive. Moreover, they all aim to reinforce compatibility and coherence between PTAs and the multilateral trading system.

## 2. Structure of the report

The report is divided into four main parts.

### Historical background and current trends

This section provides both a historical analysis of PTAs and a description of the current landscape. It documents the large increase in PTA activity in recent years, breaking this down by region, level of economic development, and type of integration agreement. It provides a precise estimate of how much trade in PTAs receives preferential treatment.

### Causes and effects of PTAs

This section surveys the causes and consequences of PTAs, with a focus on both economic and political explanations. An important distinction is made between shallow integration, which focuses solely or mostly on border measures, and deep integration in which cooperation extends to “behind-the-border” measures.

Deep integration may be necessary to stimulate more trade. At the same time, the decision to sign deep agreements may be the result of trade openness itself and the structure of trade, such as the presence of international production networks. To flourish, these networks may require a degree of international governance that only deep integration can supply. Whatever the motivations for deeper integration, standard theory based on the notions of trade creation and trade diversion is inadequate for capturing the full picture. To the extent that deep integration in PTAs involves changes to domestic regulations rather than already low tariffs, trade diversion may not pose as serious a risk. The section argues that traditional theories do not fully explain the emerging pattern of PTAs and that the relationship between trade agreements and production networks, among other explanations, should be considered when analysing PTAs.

### Anatomy of PTAs

This section validates the hypothesis that more and more PTAs go beyond tariffs by examining the contents of the agreements. It establishes a key empirical result of the report, namely that preferential tariff margins, adjusted to take account of the proliferation of PTAs, are small. The section confirms the broadening sectoral coverage of PTAs and examines how far they contain legally enforceable commitments in services, investment, technical barriers to trade and competition policy, which are all likely to be crucial for production networks. The commitments in these policy areas are also deeper – whether measured relative to multilateral commitments or in terms of the degree of market integration aimed for.

Using trade in parts and components as a proxy for the degree of production networking among countries, empirical evidence is presented which demonstrates the strong link between these networks and PTAs. Deep PTAs increase the volume of trade in parts and components among members. Finally, the section examines several examples of preferential trade agreements in East Asia, Latin America and Africa to consider how well they fit the hypothesis of international production networks.

### The multilateral trading system and PTAs

This section identifies areas of synergies and potential conflicts between preferential trade agreements and the multilateral trading system and examines ways in which the two “trade systems” can be made more coherent. Preferential tariffs, although less important than in the past, can erode the motivation for multilateral trade opening. “Deep” PTA provisions often have non-discriminatory effects and international production networks can alter political economy forces that lead to the multilateralization of regional initiatives. The possibility of competing dispute settlement systems creates hazards of its own. Finally, the section reviews how the GATT/WTO has historically dealt with the subject of preferential trade agreements. Taking this history into account, the section concludes with a reflection on what the WTO’s future agenda on PTAs could look like.

## Endnotes

- 1 Some agreements only cover services and therefore contain no tariff commitments.