

## Dynamics and Politics in Regional Integration Arrangements: An Introduction

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*Overwhelming evidence links openness and economic growth. In recent years many developing countries have attempted to liberalize their trade and investment regimes, mostly through autonomous unilateral liberalization. At the same time, a growing number of governments have begun to explore and participate in regional trading agreements. The agreements grant reciprocal trade preferences to participating countries, resulting in discrimination against nonmembers.*

*The causes and consequences of regional integration have given rise to an extensive and vigorous debate among both scholars and policymakers. However, the quality of this debate has been seriously hampered by the absence of clear analytical models and empirical evidence on many of the factors under discussion. Few of the recent arguments in favor of regional integration arrangements have been satisfactorily formalized or tested. To address some of these issues, a World Bank research program focuses on new and developing country aspects of regionalism. The program explores lacunae in the traditional static analysis of regional integration arrangements; addresses the dynamic effects of integration, the economics of deep integration, and the politics and political economy of regional integration arrangements; and compares regionalism with multilateralism. The articles in this symposium address the topics of dynamics, politics, and political economy in regional integration agreements.*

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Overwhelming evidence links openness and economic growth. In recent years many developing countries have made efforts to liberalize their trade and investment regimes. To a great extent these reform efforts have been consistent with the policy prescriptions that emerge from economic first principles: trade barriers should be low, more or less uniform across sectors, transparent, and nondiscretionary and should operate through the price mechanism. Most developing countries have sought to apply these principles through a process of autonomous unilateral liberalization.

At the same time, a growing number of governments have begun to explore and participate in regional trading agreements. The agreements grant reciprocal trade preferences to participating countries, resulting in discrimination against nonmembers. Indeed, nearly every country in the world is a member of—or in the process of discussing participation in—one or more regional integration ar-

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rangements (RIAs), and some 55 to 60 percent of world trade now occurs within such trading blocs. Although most preferential trading arrangements are regional in the geographical sense, this is not necessary for most of the economic results we discuss. The term RIA loosely covers all reciprocal preferential arrangements.

The causes and consequences of regional integration have given rise to an extensive and vigorous debate among both scholars and policymakers. However, the quality of this debate has been seriously hampered by the absence of clear analytical models and empirical evidence on many of the factors under discussion. Few of the recent arguments in favor of RIAs have been satisfactorily formalized or tested. For example, analysts have not tested whether regionalism stimulates investment, whether it confers credibility on reform programs, or whether it leads automatically to multilateral liberalization. And no attempt has been made to weigh RIAs against one another in the circumstances of developing countries. Economists have not paid much attention to the noneconomic objectives that frequently underlie RIAs or to the role of trade preferences in achieving these objectives. Understanding the potential linkages between favoritism in trade and the pursuit of noneconomic political and social objectives can be crucial in a developing country's decision to participate in an RIA.

To address some of these issues, we initiated a research program focusing on new and developing country aspects of regionalism. The program explores lacunae in the traditional static analysis of RIAs (see, for example, Schiff 1997). It also addresses the dynamic effects of integration, the economics of deep integration, and the politics and political economy of RIAs. And it compares regionalism with multilateralism.

These six articles on the dynamics and political economy of regionalism and development constitute part of the output of the research program.<sup>1</sup> The articles do not so much develop new arguments for or against RIAs as analyze existing arguments that have figured in the popular and political debate. They deal with questions of industrial location, policy credibility, economic growth, political objectives, and pressure group politics. The authors make no claims to finality in these issues; rather they offer either the first formal analysis or the first rigorous empirical test of an argument.

## I. DYNAMICS

Dynamics play an almost mystical role in many discussions of economic integration. Having found small or even negative predicted static benefits, advocates of RIAs typically appeal to the dynamic benefits. However, what these constitute and how they come about are frequently rather vague, and evidence linking dynamic benefits with particular instances of integration are very difficult to pin down. The importance of economic growth for addressing poverty makes this a major area for investigation.

1. Details of the other research papers from the project, as well as many of the papers themselves, are available through the World Bank International Trade Team's Trade Web (<http://www.worldbank.org/html/iecit/iecit.html>).

For concreteness we think of dynamics as anything that affects a country's rate of economic growth over the medium term. Thus we define dynamics to include both permanent increments to the rate of growth and temporary but long-lived increases of, say, more than five years as countries move from one growth path to another. In this section we consider briefly recent results on investment and credibility, industrial location, and the empirics of convergence and economic growth.

### *Investment and Credibility*

Baldwin (1989, 1992) makes an early and striking application of neoclassical growth theory to regional integration. He models the effects of European integration on capital accumulation and introduces the notion of a medium-term growth bonus. An RIA makes trade easier and hence tends to raise the returns to at least some factors of production, especially for deep integration that lowers real trading costs. If the RIA affects only tariffs, the benefits to factors affected by lower tariffs tend to be offset by the effects of replacement taxes on other factors. If the cost of capital is unchanged, the economy responds with increased rates of return and thus increased capital stock. This increase leads to a temporary increase in growth rates as the accumulation shifts the economy onto a higher trajectory. At the new steady-state level of capital stock, there are higher levels of output per head, but growth returns to its original level. Baldwin (1989) suggests that the medium-term bonus could double or even treble an RIA's static efficiency effects on output.

Will an RIA raise or lower a developing country's rate of return to capital? A simple application of the Heckscher-Ohlin model suggests that in a North-South (industrial-developing country) RIA the rate of return to capital falls in the southern country because international trade tends to reduce the returns to the scarce factor. Mazumdar (1996) shows a similar problem if liberalization favors a labor-abundant commodity.

However, the basic Heckscher-Ohlin model is probably too simple to analyze the rate of return in this context. First, it applies only to a so-called square model with equal numbers of factors of production and goods. Second, this case of partial rather than complete liberalization could have rather different effects (see Falvey 1995). Third, the Heckscher-Ohlin model presumes homogeneous products, whereas experience suggests that many markets are better represented by differentiated products and intraindustry trade. In the latter case, the degree of substitutability of domestic and foreign goods becomes very important.

Building on these complications, Baldwin and a number of collaborators have suggested several reasons why economic integration might raise the rates of return on capital in both partners regardless of capital abundance (see Baldwin, Forslid, and Haaland 1996 and Baldwin and Seghezza 1996a, 1996b). For example, an RIA typically reduces the transaction costs on tradable goods more than those on nontradable goods.

If, as is commonly believed, tradables are more capital-intensive than nontradables, trade liberalization increases the demand for capital relative to labor. In addition, an RIA may reduce tariffs and trading costs on imports of capital equipment or, by opening it up, improve efficiency in the financial sector and so reduce the cost of funds. Finally, an RIA may improve the atmosphere for investment by inducing greater credibility in the government's willingness or ability to pursue sound policies.

Circumstantial evidence suggests that RIAs can generate investment booms, as occurred for example after the creation of the European Economic Community (EEC), the Iberian enlargement of the European Community, the European Community 1992, the North American Free Trade Agreement (NAFTA), and Mercosur (a regional trade agreement among Argentina, Brazil, Paraguay, and Uruguay). Table A-1 provides a list of regional trade agreements and their member countries. More formally, Brada and Mendez (1988) find significant effects when they estimate the effect on capital formation during 1960–77 in six RIAs—the European Free Trade Agreement (EFTA), the EEC, the Council for Mutual Economic Assistance, the Latin American Free Trade Area, the Central American Common Market (CACM), and the East African Common Market. Similarly, de Melo, Panagariya, and Rodrik (1992) find significant investment effects for the Central African Customs and Economic Union (UDEAC) and the Communauté économique ouest-africaine. However, neither study finds growth effects from the RIAs, possibly because of immiserizing investment in the presence of other distortions.

An important share of investment in some developing countries is foreign direct investment (FDI). Many economists see inflows of FDI, first, as the harbinger of confidence in the economy and, second, although this is not uncontested, as the route through which an economy can modernize. For example, modernization occurs through access to modern technology, modern management, marketing networks, and sources of inputs (see Blomstrom and Kokko 1997a). A simple RIA may reduce FDI flows between member countries because it makes trade a more attractive option. Alternatively, FDI from outside the bloc may increase as foreigners seek to exploit new investment opportunities and to use one member as a platform for serving the whole bloc. Blomstrom and Kokko (1997b) suggest that, although the Canada–United States Free Trade Agreement had little investment effect, Mercosur and NAFTA both coincided with increased inflows of FDI. In more complete RIAs—for example, the Iberian accession to the European Community—FDI in nontraded sectors (and provisions for capital inflows, repatriation of profits, and enhanced dispute settlement) may stimulate intrabloc investment flows. Overall, however, the principal requirement for attracting FDI is sound policies at home: the examples of China and Indonesia show that RIAs are not necessary for success; the example of Greece shows that they are not sufficient.

Fernández and Portes (this issue) combine elements of both dynamics and political economy to explore the argument that RIAs can improve the credibility

of members' policies through mechanisms that are not obtainable through unilateral or multilateral liberalization. The argument for increased credibility is now well known; see, for example, Whalley (1996) on NAFTA, Francois (1997) on the European Union–Mediterranean RIAs, and Baldwin, Francois, and Portes (1997) for empirical evidence. However, no other analyst has explained how RIAs enhance credibility, compared with other institutions and attitudes, or whether the arguments about credibility can be generalized beyond the classic cases of the European Union, the Europe Agreements, and NAFTA.

Developing countries' reforms frequently lack credibility because of time inconsistency and asymmetric information problems. A government (or future government) that maintains policy discretion may be tempted to surprise the private sector, including foreign investors, through unexpected changes in future policy. An RIA can help to resolve these problems by "locking-in" trade reforms. Fernández and Portes suggest that an RIA probably focuses the incentives to enforce liberalization commitments better than does the World Trade Organization (WTO) because the WTO has a larger constituency and thus retaliation has a larger element of public good. An RIA also offers more scope for punishment if it delivers benefits beyond the WTO in the form of, say, investment. Similarly, developing countries may be able to achieve a measure of "lock-in" for their access to partner markets because, even if RIAs do not preclude the imposition of, say, antidumping duties or health restrictions, they do at least frequently offer special dispute settlement facilities.

Whether RIAs discipline trade policy toward nonmembers is moot both theoretically and empirically (see Winters 1997a). For example, Mexico responded to the peso crisis of 1994–95 by raising tariffs on 500 items against non-NAFTA suppliers. Bhagwati and Panagariya (1996) see this as diverting protectionist pressure onto third parties. Others argue that previous crises witnessed far worse protectionism and that NAFTA has induced restraint, to which Bhagwati and Panagariya respond that the intellectual atmosphere is far more liberal now than previously.

It is even more difficult to find the source of credibility for policies that are not part of an RIA. Fernández and Portes identify two possibilities. First, an RIA may raise the cost of macroeconomic laxity because it typically increases marginal leakages to imports. However, Fernández and Portes note that the RIA also increases the (temporary) returns to competitive devaluation that pushes the opposite way. Second, if entering an RIA entails (political) sunk costs, and if it requires liberal or sound policies to make sense, entry provides the government with a signaling device, for only a government with liberal intentions would sign. Thus in the presence of asymmetric information about the type of government, an RIA could improve credibility. Whether it is the best means of such signaling, however, is not obvious.

Fernández and Portes conclude by examining how these mechanisms apply in the cases of NAFTA and the Europe Agreements. They argue that the principal mechanism in NAFTA was Mexico's improved security of access to the U.S. mar-

ket, while the time consistency argument appears much stronger in the case of the Europe Agreements. Although they do not pursue the point, Fernández and Portes's analysis also leaves a strong impression that credibility effects are not likely to be very large in South-South RIAs.

### *Industrial Location*

Many developing-country policymakers have contemplated the possibility that RIAs might have a dynamic effect on industrial location. Analytical interest in the topic originated mainly from efforts to predict the locational effects of the European Union's Single Market Program. This interest led, in turn, to theoretical developments combining the insights from international trade and industrial organization that have reinvigorated the study of economic geography (Krugman 1991 and Krugman and Venables 1990, 1995).

Puga and Venables (this issue) use techniques from the study of economic geography to extend their previous analysis (Puga and Venables 1997) to developing countries. They assume one northern and two southern countries, each with two sectors. Agriculture is perfectly competitive and freely traded and uses both a specific factor—land—and a sectorally mobile factor—labor. Industry has increasing returns to scale and imperfect competition. Although their only primary input is labor, firms also buy inputs from one another. Because these transactions are costly if they cross national borders, agglomeration benefits accrue to firms located close to other firms. These benefits generate pecuniary externalities between firms that, in turn, induce cumulative causation such that as one firm relocates, it creates incentives for others to follow. As industry relocates, agriculture adjusts by releasing or absorbing labor and maintaining external balance. Given the fixed factor in agriculture, wages rise as industrialization causes agricultural employment to fall. The increase in wages ultimately prevents all industry from agglomerating in one location.

Trade policy disturbs firms' locational decisions in three ways: through tariffs on inputs from abroad, through tariffs on sales (final and intermediate) abroad, and through the degree of competition in domestic markets. Puga and Venables (this issue) compare the effects of unilateral liberalization and various types of preferential liberalization. The unilateral liberalization of imports of manufactures by a southern country promotes the development of local industry by lowering the cost of imported intermediates. However, the gains from an RIA with the North are likely to be greater because the South also benefits from improved access to the northern market. The gains from South-South RIAs are likely to be smaller than those from North-South arrangements. They depend essentially on whether the size of the combined southern market is large enough to attract industry: the smaller it is, the smaller the degree of industrialization and the later it takes place. If the southern economies are small, concerted nondiscriminatory liberalization offers larger gains than a South-South RIA because it frees up input supplies from the North even as it increases northern competition for local firms. All told, the best policy for a single southern country is to sign a North-South

RIA. However, this imposes the costs of even later industrialization on the southern country that is excluded. Thus developing countries have an incentive to be among the founders of an RIA, not only because the earlier they join the sooner they attract industry but also because being excluded is positively harmful, at least temporarily. Ethier's (1996) model also generates such competition between developing countries as an incentive for joining RIAs.

In the examples given by Puga and Venables, the North always loses and the South always gains from North-South RIAs. Some of the starkness of this result stems from their assumption that initially all industry is located in the North. Because, in this model, industry confers higher incomes, the South gains from any liberalization that permits industrialization—even southern countries left out of the RIA—while the North is likely to lose from most arrangements.

These models are very stylized, but there is a little evidence of the effects they consider. Brulhart and Torstensson (1996) analyze the impact of European integration and find that industries with increasing returns already tend to be highly localized and concentrated in the core countries in the European Union. They argue that a further reduction in trade costs within the European Union will increase this concentration of scale-intensive activities, with the periphery specializing in constant-returns manufacturing and nonmanufacturing. They also argue, however, that the European Union has already experienced most of the scale-driven clustering that it will see and that, in line with experience in the United States, future clustering is likely to occur in relatively small-scale industries in which peripheral regions have some advantage. This scenario should be particularly relevant in the event of an eastward enlargement of the European Union and also possibly the extension of RIAs to neighboring developing countries.

### *Growth*

A large theoretical and empirical literature now exists on the relationship between a country's openness and growth—for example, Grossman and Helpman (1992); Edwards (1993); Sachs and Warner (1995); and Coe, Helpman, and Hoffmaister (1997). Although discussions of RIAs often casually appeal to this literature, doing so is rather risky (see Winters 1997a). Unfortunately, however, there are few RIA-specific analyses.

Walz (1995, 1997) makes an important contribution by extending to regional integration Rivera-Batiz and Romer's (1991) model of growth with a research and development (R&D) sector. Walz relates growth to the static concepts of trade creation and diversion. If a country has a comparative advantage in R&D, an RIA that results in trade creation (that is, expansion of the sector with the comparative advantage) implies reallocation to the R&D sector and consequently faster growth. If the RIA results in trade diversion (expansion of the traditional sector), the R&D sector shrinks and growth falls. For a country whose comparative advantage lies in the traditional sector, trade diversion raises growth and trade creation lowers growth, although welfare need not change in the same direction as the growth rate.

The empirical evidence that RIAs stimulate growth is actually rather weak. Henrekson, Torstensson, and Torstensson (1997) use a cross-sectional regression to suggest that European integration has enhanced members' growth rates. But others, including Brada and Mendez (1988) and de Melo, Panagariya, and Rodrik (1993), fail to find a positive association between RIAs and growth. Ben-David (1993) offers strong evidence that after signing RIAs, the EEC, the EFTA, and the Canada–United States Free Trade Agreement displayed marked increases in trade between member countries and dramatic increases in income convergence. He suggests that this convergence is upward, with the poorer members growing faster (Ben-David 1994), and that it owes more to convergence in rates of total factor productivity growth than in rates of investment (Ben-David 1996).

Vamvakidis (this issue) attempts to resolve some of these issues. He addresses two aspects of regionalism. The first is geographical: the impact on a country's growth rate of the characteristics of its neighboring countries, such as their size, level of development, and degree of openness. The second is policy-based: the impact on growth of belonging to an RIA.

Vamvakidis estimates cross-country and time-series growth regressions over 1970–90 and supplements the standard variables with variables on policies and neighbors' size and level of development. He finds several interesting results. For example, open economies grow faster; economies that have open and large neighbors grow faster, but the size of closed neighboring countries is of no account; economies that have open and developed neighbors also grow faster, but again the level of development of closed neighboring economies is not important; and the growth rate of neighboring economies has no significant impact on a country's growth rate.

Vamvakidis also examines the impact on a country's growth of the economic size and level of development of non-neighboring economies in the same region and finds no significant impact. The contrast with the result for neighbors presumably reflects the closer economic relations that countries have with neighbors through channels such as historical and cultural ties, similar languages and legal systems, and just plain familiarity. One of the implications of Vamvakidis's findings is that countries benefit from being located close to large, developed, open economies. This is regionalism in the geographic sense.

Vamvakidis examines the impact of five RIAs—the Association of South East Asian Nations (ASEAN), the Andean Pact, the CACM, UDEAC, and the European Union—on the growth rate of its members. He finds no significant impact for any of the RIAs except the European Union, whose impact is marginally significant but vanishes once its members' openness is taken into account. He concludes that South-South agreements among small, closed developing countries are unlikely to have a positive impact on growth and that, although North-South agreements are more likely to have a positive growth effect on the southern partner, even this is far from guaranteed. An interesting question is whether countries can use RIAs to overcome the geographical misfortune of having closed neighbors—for example, by opening up a neighbor just to themselves or by forging



closer links with a distant partner as a substitute for the neighbors. However, there are so few examples to study that direct empirical tests are impossible.

## II. THE POLITICS OF REGIONAL INTEGRATION ARRANGEMENTS

RIAs are far more than just economic policies. Winters (1997b), for example, argues that the commitment that stemmed from a political ideal was important in building an integrated Europe. Politics support many other RIAs, including NAFTA, Mercosur, the ASEAN free trade area, and the Southern African Development Community. The economics profession is not particularly well equipped to analyze the origins of such political motives and certainly is not qualified to comment on their legitimacy. It should, however, consider their economic implications and examine whether the tools adopted for political purposes are efficient. Too often the declaration that an RIA (or any other policy) is political in intent is used to dismiss economic contributions to the debate, with the result being that economically more costly policy alternatives are frequently preferred to less costly ones.

### *International Diplomacy*

Analysts argue that RIAs are an important tool of diplomacy in three ways. First, some RIAs help to stabilize neighboring countries and thus to reduce the probability that migrants or, indeed, bloodshed will spill across international borders. Second, RIAs respond to outside threats by cementing relations between the integrating partners. Third, RIAs between previously antagonistic states can potentially reduce tensions. The classic example of this is the precursor to the European Union, the European Coal and Steel Community of 1951. That community was explicitly seen as a way to reduce Franco-German tensions, making war not only unthinkable but materially impossible. Similar objectives are said to be present, if not so centrally, in Mercosur and in ASEAN.

These cases raise at least two questions. First, why would governments use trade as a diplomatic tool? Second, how do political objectives affect the RIA itself?

On the first question, Mansfield (1993) argues that trade is a natural instrument because the higher income obtained from formation of the RIA enables allies to spend more on defense. A weakness with this argument is that RIAs need not raise income and may have the opposite effect. Also, trade is a civilizing influence that fosters understanding between partners; this venerable view is associated with Richard Cobden and Wilfredo Pareto in the nineteenth century and with Cordell Hull, among others, in the twentieth. As regionalism spreads, often propelled by the rhetoric of international diplomacy, it is important for political scientists and economists to discover why (or whether) trade agreements dominate other, possibly economically better, approaches to rapprochement.

In Schiff and Winters (this issue), we take a first indirect step toward identifying the political returns to RIAs and directly attack the question of how politics

might affect the existence, shape, and evolution of RIAs. We accept at face value the premise that trade among neighboring countries provides security directly, for example, by raising the level of interaction and trust among the people of those countries, by increasing the stake that each country has in the welfare of its neighbor, or by increasing the security of access to the neighbor's strategic raw materials. These security effects are external to individual agents, so that private incentives do not induce their full exploitation. We show how, under these assumptions, a subsidy on intrabloc trade or, equivalently, an RIA accompanied by appropriate domestic taxes, maximizes welfare by providing an optimal way to internalize the security externalities.

In our article, we show that we can derive predictions about the development of RIAs. These predictions have implications for issues such as whether regionalism encourages multilateral liberalization. Through these predictions, which refer to observable phenomena, we can, in principle, test whether security plays a dominant role in the formation of an RIA. Identifying the motivation for an RIA does not alter its economic and political effects, but it does allow a more rational discussion of the policy options.

Our article presents the testable predictions that if security dominates the evolution of an RIA, its optimal external trade barriers decline over time and as member countries move toward deep integration. We also suggest that barriers tend to increase following enlargement of an RIA. Starting from a steady state, the institution of an RIA (accompanied by appropriate domestic taxes) increases the volume of trade among member countries and thus directly increases trust between their populations. As the level of trust rises, the marginal impact (externality) of further trade on security and the marginal value of additional security are both expected to fall, and the optimal subsidy to intrabloc trade—that is, the optimal external trade barrier—falls as well. Deep integration, which lowers the costs of trade between member countries and raises the natural level of intrabloc trade, has a similar effect, although precisely how and when depends on the exact nature of the deep integration. The pattern of declining external tariffs is exactly that observed in the European Union.

Our article analyzes the political dimension of RIAs by taking a popular argument and subjecting it to formal analysis and testing. In welfare terms, however, it is very much a first step. Political cooperation is perfectly possible without tariff preferences, and free trade does not guarantee peace—witness the U.S. Civil War, which was partially caused by disagreements over trade policy. Thus to justify an RIA on political grounds requires showing that trade preferences contribute to political rapprochement, that such a rapprochement is valuable, and that it would not have happened if the RIA had not been formed.

### *Internal Political Economy*

The term internal political economy describes how individual countries reach their decisions about what to seek in their relations with other countries. There are clear interactions between internal and external politics (see Putnam 1988).

In terms of economic analysis, internal politics can help to answer the question of what determines trade policy. This issue has been extensively studied both empirically and theoretically, although not in the context of RIAs.

Economists have long understood that interest groups can affect international trade policy and, by extension, RIAs. Early empirical work was mostly rather intuitive and relied on regressing tariff rates or other indicators of trade policy on proxies for the political pressures exerted on different parts of government. Magee, Brock, and Young (1989) make a major advance in theoretical formality by carefully modeling electoral competition in the presence of lobbying groups. They find empirical support for their models in tariffs in the United States over both historical and more recent periods. Magee and Lee (1997) apply this broad approach in their study of tariff formation as the EEC deepened its integration. They consider French and Italian tariffs over 1968–83 and try to determine the amount of the change that was due to integration-induced changes in internal political economy forces. They attribute much of the tariff reduction to external forces (the General Agreement on Tariffs and Trade), but an average tariff of 7.5 percent remained in 1983. Within that remaining tariff, they find that tariff creation was responsible for increases of 1.7 percentage points; EEC industries were able to exploit high adjustment costs politically and to organize themselves more effectively as the number of firms fell. They find that tariff diversion was responsible for decreases of 1.1 percentage points; lobbying organizations became more complex in the larger political arena, and some industries benefited from larger markets.

In a major advance in the theory of the political economy of trade policy, Grossman and Helpman (1994) model lobbying as the influence on governments in power regardless of their political hue. Their approach contrasts with that of Magee, Brock, and Young (1989) and Magee and Lee (1997) who model lobbying as the influence on political parties that have to fight elections. Helpman (1997) looks at the relationship between the two approaches (and others). The fact that lobbyists frequently contribute to both sides in an election as well as to incumbent politicians with large majorities lends credibility to Grossman and Helpman's view.

In Grossman and Helpman's (1995) application of their theory to RIAs, they suggest, among other things, that free trade areas are likely to arise either if they provide overwhelming consumer benefits that allow governments to ignore the lobbies or if they tend toward increased protection. The latter result, which correlates with high levels of trade diversion, arises because export lobbies will support a free trade area that allows them to sell in the partner country at higher prices. Their support will help to offset the resistance of import-competing groups that will arise in both trade-creating and trade-diverting sectors. Hirschman (1981) notes the political attractions of trade diversion relative to trade creation.

Grossman and Helpman (1995) also suggest that having exceptions to the free trade area—that is, sectors that retain their protection—will ease the politi-

cal task of getting the free trade area accepted by helping to obviate resistance from the worst-hit sectors. The government will most likely exempt sectors that feature much trade creation. Any tariff reduction will encounter resistance by import-competing producers. With trade diversion, partner exporters will push hard for the inclusion of the sector. But only consumers and third-country producers—neither of which generally has much clout—will champion the liberalization of trade-creating sectors.

Olarreaga and Soloaga (this issue) offer the first empirical operationalization and test of the Grossman-Helpman model. They implement the customs union version of Cadot, de Melo, and Olarreaga (1996, 1997) and apply it to Mercosur to explain the level of the common external tariff (CET), exceptions to it, and exceptions to internal free trade.

Mercosur was created in 1991. By 1995 it had achieved internal free trade with relatively few exceptions. It had held an extended debate on the CET, which concluded only in 1994, and admitted exceptions on well over one-quarter of the tariff lines. Consistent with theoretical predictions, Olarreaga and Soloaga find variations in the CET over industries that are significantly related to those industries' labor/capital ratios (reflecting a tendency for protection to accrue where capital shares are higher), average wages (protecting unskilled labor), and industry concentration (reducing the costs of organized lobbying). Also in line with theory, they find that these variables perform best when used as production-weighted averages of the corresponding four national variables, although they cannot reject the hypothesis that the CET reflects only the political wishes of Brazil plus (any) one of the other partners.

These results represent one of the few applications of endogenous tariff theory to developing countries and are unique in considering a CET rather than a national tariff. The authors show that Mercosur's CET is well grounded in political realities and suggest that Mercosur will survive. (Unfortunately, the increase of one-quarter in the CET that occurred in late 1997 came too late to influence Olarreaga and Soloaga's analysis.) It remains to be seen whether Mercosur's CET will block further liberalization, as predicted by some in the debate comparing regionalism and multilateralism (see Winters 1998).

Olarreaga and Soloaga find significant and plausible political economy effects with respect to exceptions. Their most robust result is that strong labor unions lead to positive exceptions to both internal free trade and the CET. Unions are national bodies and may find it difficult at first to organize across national borders. Thus it seems plausible that although their positive effect on the CET is not robust, their effect on exceptions is. Olarreaga and Soloaga also find robust and significant that exceptions to internal free trade increase with the degree of (predicted) trade creation—the first direct confirmation of Grossman and Helpman (1995). And they find that, as with the CET itself, labor/capital ratios and industry concentration cause positive deviations from the CET. These results suggest that eliminating the current exceptions to the customs union is likely to be politically sensitive because those exceptions seem to reflect estab-

lished political forces. However, removal of exceptions is likely to be worthwhile because it will reduce external protection somewhat. Also, convergence to internal free trade is likely to benefit sectors offering (welfare-enhancing) trade creation.

### III. CONCLUDING COMMENTS

The articles in this symposium aim to advance the debate on RIAs by subjecting existing arguments to rigorous theoretical analysis or empirical testing. The articles offer several important findings. The effect of an RIA on credibility depends on details such as its punishment mechanisms and the cost it implies for countries pursuing bad policy. An RIA may boost the industrialization efforts of a developing member but retard those of an excluded developing country. A country may derive growth benefits from being a neighbor to a large, developed, open economy, but South-South RIAs are unlikely to result in faster growth. When governments use RIAs to reduce conflict between neighboring countries, trade barriers are likely to fall over time and following deep integration. And the power of interest groups is quite evident in the patterns of developing-country RIAs' external tariffs and remaining internal trade taxes.

In addition to their individual contributions, the articles touch on several common themes. For example, Fernández and Portes analyze the economic mechanisms through which a developing-country member may gain policy credibility that is not obtainable unilaterally or multilaterally. Schiff and Winters's model contains a dimension about the credibility effects of solving the political problems caused by conflict between two neighboring countries. Credibility clearly also has a critical but implicit role in Puga and Venables's model of industrial location and in Vamvakidis's growth results. Moreover, Vamvakidis's conclusions on the benefits of desirable neighbors relate to credibility changes considering the geographical spillover effects of recent crises—the "tequila effect" in South America or the current "Asian flu." Combining these results suggests the possibility of virtuous and vicious circles in RIA formation. A strong, liberalizing RIA with the right partner may lead to a virtuous circle of increased credibility, increased investment and growth, more credibility and political stability, and so on. By contrast, a more-closed agreement or wrong choice of partner could lead in the opposite direction, with reduced credibility and lower investment and growth, resulting in less credibility and more political instability over time.

Another common theme concerns economic rents, the essential ingredient of Olarreaga and Soloaga's political economy and likely a significant outcome of the sort of processes analyzed by Puga and Venables. Relative size is another common theme. Fernández and Portes's and Puga and Venables's results clearly suggest the advantages of North-South RIAs over South-South ones, while Vamvakidis has a related finding about the benefits for developing countries of having large, open neighbors. By contrast, while not considering the

North-South issue explicitly, Schiff and Winters suggest a logic for South-South (or North-North) RIAs. That model is most relevant to countries with neighbors of around their own size. Olarreaga and Soloaga's results pertain to questions of size, showing that if one partner is very large, it will predominate in the policymaking process.

The articles in this issue are first steps and so lend themselves to several potentially fruitful extensions. Many more analytical and practical challenges remain on the broad topic of regionalism and development. We hope that these articles and the other output of the World Bank research program encourage other scholars and policymakers to explore this issue further.

Table A-1. *Regional Trade Agreements*

<i>Agreement</i>	<i>Acronym</i>	<i>Member economies</i>
Africa, Caribbean, and Pacific* (European Economic Community Fourth Lomé Convention)	ACP	Angola, Antigua and Barbuda, Bahamas, Barbados, Belize, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Congo (Republic), Congo Democratic Republic, Côte d'Ivoire, Djibouti, Dominica, Dominican Republic, Equatorial Guinea, Eritrea, Ethiopia, Fiji, Gabon, The Gambia, Ghana, Grenada, Guinea, Guinea Bissau, Guyana, Haiti, Jamaica, Kenya, Kiribati, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Papua New Guinea, Rwanda, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, Solomon Islands, Somalia, South Africa, Sudan, Suriname, Swaziland, Tanzania, Togo, Tonga, Trinidad and Tobago, Tuvalu, Uganda, Vanuatu, Western Samoa, Zambia, Zimbabwe
Andean Common Market (also called the Andean Pact or Andean Community)	ANCOM	Bolivia, Colombia, Ecuador, Peru, Venezuela*
Asia-Pacific Economic Cooperation	APEC	Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Singapore, Taiwan (China), Thailand, United States
Association of South East Asian Nations	ASEAN	Indonesia, Malaysia, Philippines, Singapore, Thailand

Table A-1. (continued)

<i>Agreement</i>	<i>Acronym</i>	<i>Member economies</i>
Association of South East Asian Nations Free Trade Area	ASEAN Free Trade Area	Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam
Caribbean Community and Common Market Economic Community	CARICOM	Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago
Central African Customs and Economic Union (Union douanière et économique de l'Afrique centrale)	UDEAC	Cameroon, the Central African Republic, Chad, Congo, Gabon
Central American Common Market	CACM	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua
Central European Free Trade Area	CEFTA	Czech Republic, Hungary, Poland, Slovak Republic, Slovenia
Communauté économique ouest-africaine	CEAO	Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, The Gambia, Mali, Niger, Senegal, Togo
Council for Mutual Economic Assistance (Common Market of the Centrally Planned Economies, COMECON; dissolved in 1991)	CMEA	Ghana, Guinea, Guinea Bissau, Liberia, Mauritania, Nigeria, Sierra Leone
East African Community	EAC	Kenya, Tanzania, Uganda
East Asian Economic Group (now called East Asian Economic Caucus)	EAEG	Brunei, China, Hong Kong (China), Indonesia, Japan, Republic of Korea, Malaysia, Philippines, Singapore, Taiwan (China), Thailand
Economic Cooperation Organization		Afghanistan, Azerbaijan, Kazakhstan, Kyrgyzia, Iran, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan
Europe Agreements		Foreign trade agreement signed between the EU and EFTA with several Central and Eastern European countries
European Community	EC	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, Sweden, Netherlands, United Kingdom
European Economic Area	EEA	EU and EFTA

(Table continues on the following page.)

Table A-1. (continued)

<i>Agreement</i>	<i>Acronym</i>	<i>Member economies</i>
European Free Trade Agreement	EFTA	Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, Switzerland
European Union	EU	Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, United Kingdom
Gulf Cooperation Council	GCC	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates
Latin American Free Trade Area	LAFTA	Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela
Latin American Integration Association	LAIA	Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela
Mercosur (Southern Common Market)	Mercosur	Argentina, Brazil, Paraguay, Uruguay
North American Free Trade Agreement	NAFTA	Canada, Mexico, United States
South Asian Preferential Trade Agreement	SAPTA	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka
Southern African Development Community	SADC	Angola, Botswana, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Swaziland, Tanzania, Zambia, Zimbabwe

a. Nonreciprocal regional trade agreement.

Note: The table lists only regional trade agreements among two or more countries.



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