BU The Frederick S. Pardee Center
for the Study of the Longer-Range Future

009

SEPTEMBER 2009

ISSUES IN BRIEF

Preferential Trade Agreements: "Free" Trade at What Cost?

Rachel Denae Thrasher is a Pardee Center Research Fellow whose work focuses on international trade agreements and their implications for economic development in the developing countries of Latin America. She holds both a law degree and a master's degree in International Relations from Boston University.

www.bu.edu/pardee

Rachel Denae Thrasher

Today, countries increasingly turn to preferential trade agreements (PTAs — also known as bilateral or regional trade agreements) as the primary method of liberalizing trade between nations. Some World Trade Organization (WTO) members have even proposed that the on-going multilateral negotiations focus on maintaining existing tariff schedules, rather than making progress on the more challenging development issues of the Doha Round (Bridges, 2009a). Challenged by the difficulty of negotiating an agreement, these countries have lowered their expectations for multilateral trade liberalization, and diverted their resources — and their hopes — to bilateral or regional efforts.

> "... liberalization through bilateral and regional agreements will lead to higher trade costs, greater susceptibility to international litigation, and incoherent national legal institutions."

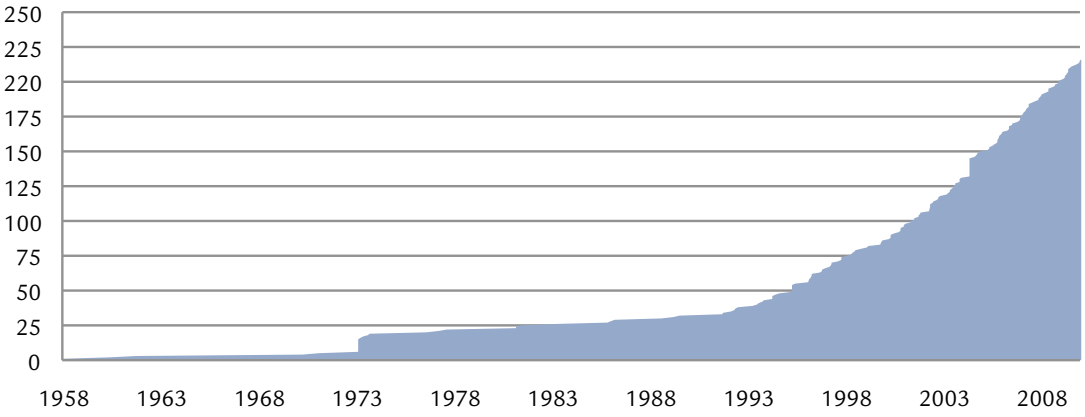
For this and other reasons, PTA formation has soared in recent decades. Yet aside from the ongoing discussion of the tangled rules of origin, relatively few papers have delved into broader aspects of legal incompatibility among various agreements (Estevadeordal and Suominan, 2004: 1). This issue brief argues that in the long run, increased reliance on PTAs for trade liberalization will force countries to maintain inconsistent legal standards. In turn, liberalization through bilateral and regional agreements will lead to higher trade costs, greater susceptibility to international litigation, and incoherent national legal institutions. Instead of achieving piecemeal liberalization through PTAs, member states should abandon preferential agreement negotiations and redouble their efforts at the multilateral level.

Trends in "Regionalism"

The most recent wave of regional and bilateral trade agreements goes broader and deeper than the agreements of earlier years (Carpenter, 2009). Preferential trade agreements since the conclusion of the WTO's Uruguay Round in 1994 have covered more trade-related topics and deepened existing commitments to tearing down trade barriers. Furthermore, the current wave of agreements contains many developed-developing country partnerships, indicating that developed countries are entering into more reciprocal relationships than previous preferential schemes (e.g., the Generalized System of Preferences) (Fiorentino, 2009).

Some view this proliferation as a boon to broader and deeper trade liberalization. Others, however, view it as a threat to the multilateral trading system and especially to the current development agenda (Fiorentino, 2009). Ironically, many of these PTAs come into force under the purview of the WTO. Article XXIV of the General Agreement on Tariffs and Trade (GATT), as well as subsequent WTO legislation, makes room for such preferential arrangements and attempts to regulate them by imposing notice and formation requirements. According to WTO data, more than 150 of the 200-plus agreements in force today were concluded and notified in the wake of the Uruguay Round. With the increase in PTA notifications, WTO members have moved to clarify existing substantive rules and streamline the process for notification and examination.

PTAs in force and notified to the GATT/WTO



Source: WTO data on Regional Trade Agreements (2009). Note that the cumulative numbers in the charts are not equivalent due to varying ways of calculating PTA notifications.

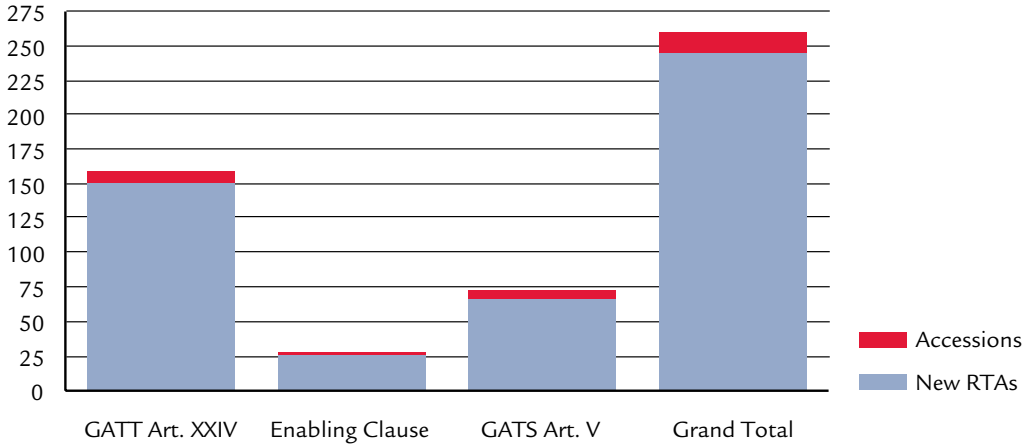
By and large, however, these efforts have failed. The application of Article XXIV and subsequent standards has done virtually nothing to shape preferential agreements between members. Since the Treaty of Rome in 1957, only one PTA yielded a clear finding of consistency with the WTO rules. In early 1996, the Committee on Regional Trade Agreements was formed to consider questions of consistency and reflect on the larger implications of regional agreements on the multilateral system (Fiorentino, 2009). On both accounts it proved unsuccessful.

The current Doha Round brought the rules regarding PTAs to the negotiating table for the first time since the signing of the GATT in 1947 (Fiorentino, 2009). As a result, the members came to a preliminary Decision on a Transparency Mechanism for Regional Trade Agreements. And while the Transparency Mechanism has streamlined the notification process and improved the availability of information about preferential agreements, failed attempts have shown that WTO members can come to no mutually agreed conclusions about the proper regulation of PTAs between members. Some would like to strengthen the rules, by raising the requirement for "substantially all the trade," while others would prefer less meddling from the WTO (Fiorentino, 2009). Focusing on WTO management of PTAs has simply put another issue on the table that will thwart multilateral consensus.

Pros and Cons

Despite repeated failures, countries still hope for an agreement on WTO oversight while they seek out new preferential trade partners because preferential agreements carry several advantages over the multilateral system. They can exceed both the subject matter and the scope of current disciplines under the WTO. When formed within regions, PTAs can promote intra-regional trade, promising economic growth, improved balance of payments, and even increased foreign direct investment (Khan, 2009). PTAs can also act to meet the specific needs of a few countries, making agreements more quickly and using fewer resources to achieve an accord. Furthermore, developing nations can work together to negotiate common interests and gain bargaining power in multilateral talks. But perhaps the most convincing reason for clamoring to form these agreements is that nations realize they will be left out of the preferential "inner circle" if they hesitate (Carpenter 2009).

PTAs in force and notified to the GATT/WTO, by WTO coverage



Source: WTO data on Regional Trade Agreements (2009). "Accessions" refers to countries joining existing preferential arrangements. Note that the cumulative numbers in the charts are not equivalent due to varying ways of calculating PTA notifications.

Though the immediate benefits are clear, the growing, overlapping web of agreements also presents many challenges both to individual countries and to the multilateral trading system as a whole. Elsewhere, I (and others) have argued that many PTAs, especially those between developing and developed nations, go so much deeper than the multilateral system and have such a broad scope of trade coverage that they leave very little policy space for developing countries attempting to grow their economies (Thrasher and Gallagher, 2008). Others have pointed out that for the developing world, bilateral trade negotiations give countries more "voice," (opportunity to speak) but less "say" (ability to influence the final agreement) (Najam and Swart, 2005).

The protectionist nature of these preferential agreements presents an even more fundamental problem for free trade enthusiasts. Ironically dubbed "free trade agreements," these arrangements, by including some countries and excluding others, threaten to "render most favored nation (MFN) the least favored status in the world" (Carpenter, 2009: 22). Contrary to popular belief, free trade agreements derive from a mixture of trade liberalization and protection (Bhagwati, 2008). Trade agreements eliminate barriers between member nations, but effectively raise barriers toward nonmember countries. As economists have shown, these free trade areas actually threaten to lower global welfare by diverting trade away from more efficient nonmembers to less efficient FTA members (Bhagwati, 2008). Finally, as preferential agreements proliferate, the likelihood of trade policy inconsistency increases. Interlocking

> "...as preferential agreements proliferate, the likelihood of trade policy inconsistency increases."

trade agreements and discordant legal standards will likely give rise to unforeseen trade costs, litigation over inconsistent legal standards and even inconsistent national legal institutions in the long run.

Trading Costs

Just as the promise of low-cost negotiation draws many countries to trade liberalization via preferential agreements, the high cost of implementation should drive them away. Interlocking, inconsistent trade agreements can increase the costs of trade in a variety of ways, many of which are unforeseen at the signing of these agreements. Already, overlapping trade-related agreements have begun to wreak havoc on the neighboring countries of Uruguay and Argentina as they have attempted to attract foreign investment into their territories.

In 2005, plans to build a pulp mill on the Uruguay River between Uruguay and Argentina mobilized the people of Gualeguaychú, Argentina in protest against the perceived environmental impact of the mill (Chidiak, 2009). The conflict began small, but soon the stakeholders saw the international implications of the mill. Over the course of five years, four international agreements have acted to bind government hands rather than resolve the issue. Neither the Uruguay River Statute nor the Common Market of the Southern Cone (MERCOSUR), which govern use of the river resources, has been able to resolve the rights of the parties (Chidiak, 2009). The Stockholm Convention on Persistent Organic Pollutants places constraints on Uruguay's pulp mill regulations and emissions. Meanwhile, a bilateral investment treaty (BIT) between Uruguay and Finland prohibits policymakers from unduly interfering with the Finnish firm, Metsä Botnia Oym, who contracted to build the mill. As a result, Uruguay's tourism industry has been severely affected (Chidiak, 2009).

> "In the presence of conflicting trade agreements, where the scope of overlapping subject matter is much greater, the danger of unforeseen trade and litigation costs is even higher."

Argentina likewise faces the unforeseen consequences of signing multiple trade-related treaties in an effort to integrate into the global economy and attract foreign investors. In 2001, Argentina experienced an economic collapse likened to the Great Depression, suffering extreme economic and political instability (Burke-White, 2008). In response, Argentina's policymakers imposed certain currency and tariff measures to stabilize the economy and the country as a whole (Burke-White, 2008). Unfortunately, the measures caused foreign investors in the public utilities sector to lose a significant percentage of their investment and expected returns. To compound the problem, according to the International Centre for the Settlement of Investment Disputes (ICSID), Argentina is party to 56 BITs, exposing the country to international arbitration for breaching its treaty commitments. As a result of the crisis, Argentina has faced over 40 claims by private investors worldwide (Burke-White, 2008). And these claims do not belong in small claims court. The U.S. firm CMS Gas Transmission Company was awarded $133.2 million by one arbitration panel and another panel awarded BG Group, a U.K. energy company, $185 million (Peterson, 2009).

Paying High Costs for Uncertain Outcomes

In the presence of conflicting trade agreements, where the scope of overlapping subject matter is much greater, the danger of unforeseen trade and litigation costs is even higher. It would be

one thing if the price to pay for dispute resolution was well worth it — if disputes were final and conflicts were resolved. However, too often, countries pay handsomely for uncertain and inconsistent outcomes.

As discussed above, the Uruguay River Statute and MERCOSUR each govern the use of river resources applying a different legal standard and resorting to distinct adjudicative bodies. Consequently, the outcome of the Uruguay-Argentine conflict remains highly uncertain. In the context of investment arbitration, a case against the Czech Republic first brought this concern to the public eye. Lauder v. Czech Republic presented two separate arbitrations, one under the U.S.-Czech BIT, and the other interpreting the Netherlands-Czech BIT, that reached opposite conclusions on the same question of law (Burke-White, 2008). In Argentina's investment conflicts, separate panels hearing identical claims, even under the same treaty, have returned contradictory decisions (Peterson, 2009).

This problem is not unique to the southern hemisphere. Even the developed world will become vulnerable to costly procedures and uncertain outcomes. In agreements formed with the United States, for example, very small textual differences can make a difference in a dispute outcome. Although known for their uniformity and legal consistency, the investment chapters in U.S. free trade agreements (FTAs) have evolved over time, creating small discrepancies in the legal standards (Edsall, 2006).

> "In state-to-state dispute resolution, undeterminable case results could undermine the legislative process — where a country and its citizens are never sure that they can rely on their own laws."

One such discrepancy revolves around the question of whether and when a government may indirectly decrease the value of a foreign investment without compensating the investor. Under the North American Free Trade Agreement (NAFTA), arbitral panels have protected states' rights to impose non-discriminatory public regulations except where the state made "specific commitments" otherwise (Edsall, 2006). In later agreements, however, the U.S. has leaned more in favor of the private investor. The Dominican Republic - Central American Free Trade Agreement does this, among other ways, by emphasizing the importance of the economic impact on the investor in determining whether nationalization has occurred.

If international legal outcomes are uncertain, then government investment regulation may increasingly come under attack and countries may have to pay unforeseen damages to private investors for previously approved domestic legislation. Although sympathies run low when discussing the fate of the U.S. in a dispute against a foreign investor, it is the developing world that more often has had to pay for their regulations that affect private investors, and it is the developing world that will remain more vulnerable to indefinite legal standards.

Tangling Regulation and Tumbling Institutions

As PTAs continue to proliferate, countries will have to pay with more than just dollars, pesos, and yen to resolve conflicts. In state-to-state dispute resolution, undeterminable case results could undermine the legislative process — where a country and its citizens are never sure that they can rely on their own laws. In countries that are still attempting to build up coherent institutions, conflicting PTAs pose a stumbling block.

Many developing nations, as they form trade alliances with the developed world, are beginning to see how these North-South trade agreements conflict with existing developing world trade

arrangements. In Peru, for example, civil society has given voice to various concerns over the recent U.S.-Peru FTA (Amazon Watch, 2009). One main concern lay in the increased level of intellectual property protection required, relative to the level permitted under the Andean Community Intellectual Property Regime, of which Peru is a member.

And the conflict isn't catching anyone by surprise. After multiple meetings of the Andean Community Commission, the first nonconsensual vote of the parties made room for Andean countries to make future adjustments to "develop and deepen" intellectual property protection (Ramirez, 2008). On the surface, the Commission's new decision aims at harmonizing PTA legal standards to avoid the problems of conflicting agreements.

Yet some conflicts remain unresolved. The FTA requirement that Peru pursue "reasonable efforts" to provide plant patenting, for example, leaves open the question of how that obligation might coexist with the Andean Community provisions that prohibit patent protection for all living organisms (García, 2008: 10). Negotiating trade agreements with Canada and the European Union as well, Peru is vulnerable to variable standards that could undermine its national legal institutions, making even domestic law difficult to rely on (Bridges, 2009b).

Deepening Trade and Avoiding Legal Inconsistency in the Long Run

The concern over PTA proliferation is particularly poignant for the developing world; it is the developing world that has the most to lose from increasing trade costs. Developing countries often lack the infrastructure and expertise to defend themselves in international courts of law. And many developing countries are still attempting to build up strong, coherent institutions. Uruguay has already begun to reap the consequences of declining trade from unresolved international conflict. Meanwhile, Argentina faces the high costs and uncertain outcomes from signing bilateral investment treaties with multiple partners. Peru and the rest of the Andean Community face an escalation of legal inconsistency as they pursue new trade agreements with the European Union and others (Bridges, 2009b). Although joining hands with the developed world promises to bring Peru up to the next level in development, it is more likely to undercut the stability of Peru's domestic legal institutions by conflicting with existing laws and treaties.

> "By liberalizing trade at the multilateral level, countries can avoid the long-term costs of maintaining inconsistent trade agreements."

Some countries have anticipated these difficulties and tried to protect themselves. Guyana's president resisted signing the Economic Partnership Agreement with the European Union until he received reassurance that the law of the Caribbean Community will take precedence in cases where the two conflict (Jamaica Gleaner, 2008). Nevertheless, the web of PTAs is becoming more, not less, complex.

For obvious reasons, negotiating bilateral trade pacts costs much less in terms of time and financial resources than successfully negotiating multilaterally. With only two or three trade partners at the table, agreements can be reached more quickly, providing both negotiators and policymakers with more immediate gratification. Negotiating with only a few partners could also make the domestic legal changes more politically palatable. By contrast, negotiating at the multilateral level admittedly places high human and financial resource demands on countries. If the Doha Round is any indication, discussions take place over years, sometimes decades, of protracted negotiations. These talks, while making some progress,

often lead to a stalemate on one issue or another, forcing negotiators to return to the same ground a year or two later.

Yet the high initial cost of multilateral negotiation will be well worth it in the end. By liberalizing trade at the multilateral level, countries can avoid the long-term costs of maintaining inconsistent trade agreements. Uniform international standards will protect countries from unnecessary exposure to international disputes. Likewise, clear, consistent rules will protect them from declining trade volumes as a result of those conflicts. More fundamentally, focusing on multilateral trade liberalization will make more space for countries to establish and maintain coherent national institutions by eliminating the obstacle of inconsistent laws and treaties.

Going forward, then, members of the multilateral trading system should abandon negotiations at the bilateral and regional level and take another look at the current Doha Round. They must recommit to negotiating and coming to agreements. Because in the long run, only a multilateral system can lead to stable, consistent and truly free trade.

Bibliography

Amazon Watch. 2009. "Protests Target Peru's UN Mission in New York: Call for Indigenous Rights over US Free Trade Agreement." Press Release, May 22. Available at http://www.amazonwatch.org/newsroom/view_news.php?id=1810 (accessed on June 30, 2009).

Bhagwati, Jadgish. 2008. *Termites in the Trading System: How Preferential Agreements Undermine Free Trade.* A Council on Foreign Relations Book. New York: Oxford University Press.

Bridges Weekly Trade News Digest (Bridges). 2009a. "Kirk's Geneva Visit Signals US Engagement on Doha." Vol. 13, No. 20. Geneva, Switzerland: International Center for Trade and Sustainable Development.

Bridges Weekly Trade News Digest (Bridges). 2009b. "EU-Andean Talks Inch forward, but Ecuador Threatens to Pull out." Vol. 13, No. 19. Geneva, Switzerland: International Centre for Trade and Sustainable Development.

Burke-White, William W. 2008. "The Argentine Financial Crisis: State Liability under BITs and the Legitimacy of the ICSID System." *Asian Journal of WTO and International Health Law and Policy,* Vol. 3, No. 1, pp. 199-234.

Carpenter, Theresa. 2009. "A historical perspective on regionalism" in *Multilateralizing Regionalism: Challenges for the Global Trading System.* Richard Baldwin and Patrick Low, eds. Geneva, Switzerland: The Graduate Institute.

Chidiak, Martina. 2009. "Investment Rules and Sustainable Development: Lessons from the Uruguayan Pulp Mills case" in *Rethinking Foreign Investment for Sustainable Development.* Kevin P. Gallagher and Daniel Chudnovsky, eds. London: Anthem Press.

Edsall, Rachel D. 2006. "Indirect Expropriation Under NAFTA and DR-CAFTA: Potential Inconsistencies in the Treatment of State Public Welfare Regulations." *Boston University Law Review,* Vol. 86, pp. 931ff

Estevadeordal, Antoni and Kati Suominan. 2004. "Rules of Origin: A World Map and Trade Effects." *Paper prepared for the Seventh Annual Conference on Global Economic Analysis: Trade, Poverty,*

Additional Pardee Center publications:

Issues in Brief, No. 5, March 2009
Sustainable Development in Africa: Agriculture, Trade and Climate Change
Kati Kulovesi

Issues in Brief, No. 1, April 2008
The Future of the WTO
Kevin P. Gallagher

The Pardee Papers, No. 4, January 2009
Beyond GDP: The Need for New Measures of Progress
Robert Costanza, Maureen Hart, Stephen Posner, John Talberth

The Pardee Papers, No. 2, September 2008
21st Century Trade Agreements: Implications for Long-Run Development Policy
Rachel Denae Thrasher and Kevin P. Gallagher

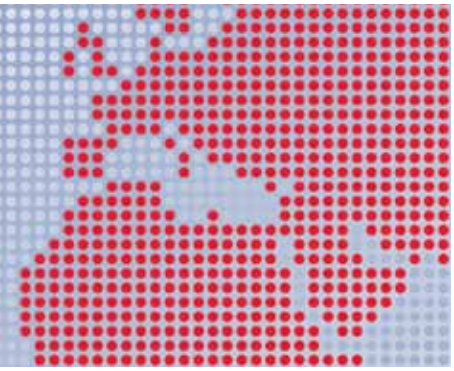
Pardee Center Conference Series, Spring 2004
Economic Development, Human Development and the Pursuit of Happiness

For a complete list and PDF versions of publications by the Frederick S. Pardee Center for the Study of the Longer-Range Future, visit: **www.bu.edu/pardee/publications/**

The Frederick S. Pardee Center
for the Study of the Longer-Range Future

Boston University
Pardee House
67 Bay State Road
Boston, MA 02215 USA

pardee@bu.edu
617-358-4000 (tel.)
617-358-4001 (fax)
www.bu.edu/pardee



Analysis for a better tomorrow, today.

The Frederick S. Pardee Center for the Study of the Longer-Range Future *at Boston University convenes and conducts interdisciplinary, policy-relevant, and future-oriented research that can contribute to long-term improvements in the human condition. Through its programs of research, publications and events, the Center seeks to identify, anticipate, and enhance the long-term potential for human progress, in all its various dimensions.*

www.bu.edu/pardee

and the Environment. Integration, Trade and Hemispheric Issues Division, Integration and Regional Programs Department, Inter-American Development Bank. Washington, D.C.: The World Bank.

Fiorentino, Roberto V., Jo-Ann Crawford and Christelle Toqueboeuf. 2009. "The landscape of regional trade agreements and WTO surveillance" in *Multilateralizing Regionalism: Challenges for the Global Trading System.* Richard Baldwin and Patrick Low, eds. Geneva, Switzerland: The Graduate Institute.

García, Luis Alonso. 2008. "Intellectual Property in the U.S. - Peru Trade Promotion Agreement." *Intellectual Property, Bilateral Agreements and Sustainable Development Series: 3.* Washington, D.C.: Center for International Environmental Law (CIEL).

Jamaica Gleaner. 2008. "Two Caribbeans emerge at EPA signing." Available at http://www.bilaterals.org/article.php3?id_article=13512&var_recherche=guyana (accessed June 3, 2009).

Khan, Shaheen Rafi. 2009. *Regional Trade Integration and Conflict Resolution.* Ottawa, Canada: International Development Research Centre.

Najam, Adil and Dirk Swart. 2007. "Expert Opinion: The "shadow" trading system of RTAs" in *Trade and Environment: A Resource Book.* Adil Najam, Mark Halle, and Ricardo Meléndez-Ortiz, eds. International Institute for Sustainable Development, International Centre for Trade and Sustainable Development and the Regional and International Networking Group.

Peterson, Luke Eric. 2009. "Argentine Crisis Arbitration Awards Pile Up, but Investors Still Wait for a Payout." *Focus Europe.* Available at http://www.law.com/jsp/article.jsp?id=1202431736731&thepage=3 (accessed July 3, 2009).

Ramírez, Marienella Ortiz. 2008. "El Perú logra allanar el camino para TLC con Estados Unidos." ElComercio.com.pe. Available at http://www.elcomercio.com.pe/edicionimpresa/Html/2008-08-15/el-peru-logra-allanar-camino-tlc-estados-unidos.html (accessed June 2, 2009).

Thrasher, Rachel D. and Kevin Gallagher. 2008. *21st Century Trade Agreements: Implications for Long-Run Development Policy. The Pardee Papers No. 2.* Boston: The Frederick S. Pardee Center for the Study of the Longer-Range Future, Boston University.