

# Deepening Integration in MERCOSUR

## Dealing with Disparities

Juan S. Blyde, Eduardo Fernández-Arias, Paolo Giordano, Editors



Inter-American Development Bank

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Eduardo Fernández-Arias  
Paolo Giordano  
*Editors*



Inter-American Development Bank

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1300 New York Avenue, N.W.  
Washington, D.C. 20577  
**www.iadb.org**

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Produced by the IDB Office of External Relations

The views and opinions expressed in this publication are those of the authors and do not necessarily reflect the official position of the Inter-American Development Bank.

**Cataloging-in-Publication data provided by the  
Inter-American Development Bank  
Felipe Herrera Library**

Deepening integration in MERCOSUR : dealing with disparities / Juan S. Blyde, Eduardo Fernández-Arias, Paolo Giordano, editors.

p. cm.

Includes bibliographical references.

ISBN: 978-1-59782-072-1

1. Southern Cone of South America—Economic integration. 2. Regional disparities—Southern Cone of South America. 3. MERCOSUR (Organization). I. Blyde, Juan S. II. Fernández-Arias, Eduardo. III. Giordano, Paolo (Paolo Maria). IV. Inter-American Development Bank.

HC167.S67 D823 2008  
338.98 D823--dc22

LCCN: 2008940951

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## Preface

This volume is the result of a research project coordinated by the Inter-American Development Bank to analyze the most important issues of economic integration and policy coordination that countries face when they advance towards deeper integration and need to address development disparities among partner countries. The analytical issues studied in this book explore the various facets of an integrated approach, both to uncover the challenges that disparities pose for integration agreements and to propose actions for dealing with them.

In order to provide a concrete angle for the investigation, the studies in the volume build on the experience of MERCOSUR. However, the results and lessons learned are certainly applicable to other integration agreements—particularly those of the South-South type, such as the Andean Community and the Central American Common Market. Like MERCOSUR, these other agreements face specific challenges in dealing with disparities among their partner countries.

The collection of studies presented in this book merges rigorous but accessible theoretical frameworks with empirical analyses of the main issues, creating a good balance between theory and practice. The multiplicity of approaches also provides a rich and comprehensive view of a complex topic. The chapters have been prepared by highly regarded economists from Europe and Latin America, who were selected for their international experience, their expertise in the field, and their capacity to produce innovative work.

The Integration and Trade Sector is pleased to present, in this volume, the results of the aforementioned research project, carried out in collaboration with the Southern Cone Country Department. We hope that the book makes a significant contribution to the understanding of how progress in finding solutions to address the challenges that disparities pose to deeper integration.

Santiago Levy Algazi  
Vice President for Sectors and Knowledge

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Manager, Integration and Trade Sector

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## Acknowledgments

**W**e acknowledge the essential contribution of Robert Devlin, former Deputy Manager of the Integration and Regional Programs Department, who led and coordinated with us the research project that has culminated in this book's publication.

We are also indebted to Mauricio Mesquita Moreira and Fernando Quevedo, whose comments and suggestions in different phases of the project were fundamental in bringing this book to fruition.

We thank all the participants in the Technical Workshop held in Washington, D.C., and in the General Conference in Rio de Janeiro in 2005 for providing helpful comments on earlier versions of the volume's chapters. In particular, we are indebted to Carlos Amorín, Reginaldo Braga Arcuri, Eliana Cardoso, Christian Daude, Atish R. Ghosh, Ilan Goldfajn, Hernán Lacunza, Gerardo Licandro, Mario Marconini, João Bosco Mesquita Machado, Felix Peña, Luis Porto, Marcelo Olarreaga, Didier Opertti, Javier Ortiz, Luiz A. Pereira, Rubén Ramírez Lescano, Ricardo Rozemberg, Pablo Sanguinetti, André Sapir, Darío Saráchaga, Jeffrey Schott, Alexandre Schwartzman, Eduardo Sigal, Rogério Studart, Ricardo Varsano, and Luiz Villela for their valuable insights.

We would like to thank Nohra Rey de Marulanda and Ricardo Santiago, former Managers of, respectively, the Integration and Regional Programs Department and the Regional Operational Department 1, who supported the launching of the research project on which this book is based. We also acknowledge the generous contribution of Ricardo Carciofi, Director of the Institute for the Integration of Latin America and the Caribbean (INTAL), who was instrumental in organizing the conference in Rio de Janeiro.

Finally, we thank Mariana Sobral de Elía, María de la Paz Covarrubias, and Carolina Saizar, who helped in countless ways in the preparations for the workshops and the development of the book. We also thank Andrew Crawley for a thoroughly professional job during the editing and proofreading processes.

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*Editors*

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## Introduction

Regional trade integration in the Southern Cone has seen significant progress since Argentina, Brazil, Paraguay, and Uruguay established the Southern Common Market (MERCOSUR) in 1991. Regional trade has increased substantially and the favorable evolution of the trade agreement has attracted neighboring countries. As of January 2008, associated members of the trading bloc included Chile, Bolivia, Ecuador, Colombia, and Peru. Venezuela was in the process of becoming a full member.

Understandably, MERCOSUR has encountered setbacks that have hindered full economic integration, stalling original plans for a common market. Macroeconomic instability following the Asian crisis of 1997, and the establishment of separate exchange-rate regimes by the two largest trade-bloc members (Brazil and Argentina) have spurred recurring conflicts in trade relations among partners. Even prior to this unstable period, MERCOSUR faced challenges to satisfactory progress. Examples include failure to create a customs union within the approved schedule, and low levels of protocol ratification by national legislators. Indeed, these factors reveal the presence of preexisting disparities among partners—disparities that severely limited advancement toward fuller integration. It is critical for the MERCOSUR project to examine the serious nature of these obstacles, and to determine whether the conditions for their removal exist.

Disparities among member countries of a trade agreement can impede policy harmonization and significantly hinder the coordination process that is required to deepen integration. Perhaps even more importantly, when trade members feel that they benefit unevenly, the presence of disparities can erode the sense of a common purpose, thus weakening members' will to move forward.

Undoubtedly, not all differences or disparities among countries are reason for concern. For example, the presence of differences in countries' production structures constitutes a fundamental reason why trade flows are mutually beneficial, as set forth by models grounded in traditional international trade theory. It is also true, however, that certain structural differences encouraged by the regional integration process may, in some cases, trigger unbalanced development processes that do not satisfy the social preferences of weaker countries. Additionally, national public policies uncoordinated with partner interests can be detrimental to the trade bloc as a whole, especially as economic integration increases. The obstacles to integration are particularly serious in the case of artificial disparities—those disparities created by national public policies with a protectionist bias, or that favor competition in attracting foreign investment, substituting imports, or protecting specific national production niches against trading partners. Such disparities may have negative effects and jeopardize the viability of the MERCOSUR project.

The deepening of MERCOSUR integration in every aspect of the trade bloc's agenda requires an evaluation of how and when the presence of disparities should be considered relevant, and what solutions should be sought for each individual case. To produce such an

evaluation is the main purpose of this book. The authors address not only topics related to customs union trade, but also those relevant to the deepening of the agreement, such as competition policy, macroeconomic policy, and the institutional aspects of the trade bloc. This study intends to explain the efforts bloc members must make to successfully achieve the deepening of MERCOSUR integration, and explores the particular challenge that disparities pose to members' collective will to achieve integration.

The chapters of this book follow a logical sequence specially designed to analyze the subject of disparities in those areas most relevant to integration. The book's first two chapters introduce the topic of disparities and the challenges they represent to regional integration agreements. In the first chapter, "The Treatment of Asymmetries in Regional Integration Agreements," Paolo Giordano, Mauricio Mesquita Moreira, and Fernando Quevedo review the treatment of asymmetries in trade integration agreements, and present a preliminary discussion of some of the more salient disparities in MERCOSUR. Juan S. Blyde and Eduardo Fernández-Arias delve deeper into the subject in "Disparities and Integration in MERCOSUR," analyzing the asymmetries that different disparities generate in the agreement's distribution of gains. Both of these studies introduce topics that are analyzed in greater depth in subsequent chapters. In this respect, they constitute an introduction to the rest of the book.

In Part II, the book's aim is to show the forces behind regional integration processes that can create income disparities among members, and how diverse policy instruments serve to shape the distribution of those gains. This part of the book also addresses the subject of disparities from the viewpoint of their effect on customs union common trade policy.

Specifically, in Chapter 3, "Regional Disparities in Regional Blocs: Theory and Policy," Anthony Venables presents an analytical framework for identifying the forces behind the spatial patterns of economic activity in MERCOSUR. The chapter provides a solid theoretical framework for understanding the potential effects that disparities can have on countries integrating their trade, and the policy implications that derive from the analysis. In Chapter 4, "National Disparities and the Regional Allocation of Resources: A Positive Framework," Gianmarco Ottaviano takes the modeling process a step further and proposes a theoretical model—using parameters distinctive to MERCOSUR—for industry location in the face of disparities. Within the context of a positive framework, Ottaviano analyzes the economic impact and welfare implications of deeper MERCOSUR integration, and also discusses the implications of dealing with existing disparities.

In Chapter 5, "MERCOSUR: Asymmetries and Strengthening the Customs Union: Options for the Common External Tariff," Silvia Laens and María Inés Terra examine the welfare effects of different structure and level options for the common external tariff, and demonstrate how the current unbalanced structure is not optimal for the bloc as a whole, fostering tension among its members. In turn, in Chapter 6, "Asymmetries and Disparities in the Economic Integration of a South-South Customs Union," Marcel Vaillant argues that countries can facilitate the free movement of goods through the agreement, and progress toward an income-distribution system for common customs revenue in the presence of disparities.

In Part III, the book addresses the subject of microeconomic policy coordination. In Chapter 7, "National Policies and the Deepening of MERCOSUR: The Impact of Competition

Policies,” Gustavo Baruj, Bernardo Kosacoff, and Fernando Porta begin by examining the experience of competition policy in the European Union (EU) and move on to analyze whether national competitiveness policies in MERCOSUR are neutral, beneficial, or detrimental to the integration process. In Chapter 8, “Tax Harmonization and Economic Integration,” Fernando Rezende examines how uncoordinated fiscal policies can distort trade flows, affect investment decisions, aggravate regional disparities, and create strains hindering progress toward deeper integration. In this chapter, Rezende also discusses alternate fiscal harmonization scenarios in MERCOSUR.

Beyond the coordination of national policies, the members of a regional agreement must also consider the establishment of regional or community policies. In Chapter 9, “Regional Competitiveness Policies for Deeper Integration in MERCOSUR,” Renato Flôres, Jr. offers a series of recommendations on how to deepen integration and create common regional policies to foster competitiveness in MERCOSUR in the presence of disparities.

In Part IV, the book addresses the subject of macroeconomic policy coordination. In the first chapter of this section, “MERCOSUR in Transition: Macroeconomic Perspectives,” Daniel Heymann and Adrián Ramos analyze the regional spillover effects of national macroeconomic thrusts, and discuss the incentives and restrictions needed to carry forth macroeconomic cooperation policies in MERCOSUR countries. In Chapter 11, “Macroeconomic Coordination Policies: From Europe to MERCOSUR,” Diego Moccero and Carlos Winograd review the EU experience managing macroeconomic interdependencies in the face of disparities, and assess MERCOSUR’s macroeconomic coordination options in light of the European experience.

Finally, in Part V, the book sets out to analyze the institutional dimensions of MERCOSUR. The effectiveness of regional trade blocs in dealing with member disparities is intimately tied to institutional architecture. In “Regional Governance Institutions, Asymmetries, and Deeper Integration in Mercosur,” Roberto Bouzas analyzes MERCOSUR’s regional decision-making mechanisms and their ability to promote deeper integration. In turn, Deisy Ventura examines how the agreement’s guidelines are incorporated into national legislation, and how this process influences the efficiency of MERCOSUR law, in “Overlapping Asymmetries or Normative Cubism? The Transposition of Norms in MERCOSUR.” In both chapters, the authors make recommendations on how to strengthen MERCOSUR’s institutional architecture so as to best assimilate the existence of disparities.

The papers collected in this book were originally prepared for a conference organized by the Inter-American Development Bank (IDB) and held in 2005, when the topic of disparities was already seen as critical for deeper integration of the trade bloc. Naturally, the book is based on information and circumstances from that time period. But the original relevance of the topics addressed is valid in the present, and in some cases has gained greater importance. The chapters contained in this book were reviewed by the authors with the goal of adding current information and addressing pertinent exceptions.

The subject of how to address disparities among member countries in any integration process requires a comprehensive analysis. With this purpose in mind, the book combines a selection of methodologies and analyzes a broad range of dimensions on the subject of disparities. Although the book’s focus is the MERCOSUR experience, the lessons learned gener-

ally transcend the scope of the regional bloc. In this sense, the chapters can be understood as practical discussions of elements crucial to the deepening of economic integration in the MERCOSUR case, and its disparities, whose lessons are equally relevant for other integration agreements. For this reason, we hope that the book will contribute to the general analysis of integration processes and the decisions necessary for their achievement.

PART I:

**Overview.  
The Challenge of Disparities**

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## **The Treatment of Asymmetries in Regional Integration Agreements**

*Paolo Giordano, Mauricio Mesquita Moreira, and Fernando Quevedo*

### **Introduction**

Although much of the theoretical literature focuses on the distributive aspects of preferential trade policies, there is little in the recent literature regarding the practical aspects of applying policies to address asymmetries in regional integration processes. This deficiency is especially apparent if the analysis is confined to developing countries. With respect to Latin America, this gap in the literature probably stems from (i) a change in the regional integration paradigm since the 1990s, and (ii) optimism accompanying the rise of the “new regionalism” in political, economic, and academic circles.

In the past, Latin American approaches to regional integration were based on complex legal and institutional structures, with a high degree of political sensitivity that focused on ensuring equal distribution of integration’s benefits. In the context of new regionalism, however, integration processes have sought to avoid excessive fragmentation and programmatic inefficiency, in such a way as to favor the adoption of principles of reciprocal obligations and mechanisms for automatic convergence toward common trade policies (Devlin and Giordano, 2004).

The Southern Common Market (MERCOSUR) is a prime example of this new type of integration agreement. Its initial success may in large part be due to the rapid adoption and implementation of a universal trade-liberalization program that was linear, automatic, and irreversible. This process created a sense of commitment to structural reforms, and to opening and building an integrated regional market. Associated with the adoption of a common external tariff (CET), the process resulted in a significant expansion of intra- and extraregional trade, triggering an increase in intraindustrial trade and attracting substantial flows of foreign direct investment (FDI). Beyond the realm of trade itself, the increase in interdependence created incentives for cooperation in several areas of common interest, most notably in strengthening a democratic political process in Paraguay.

The expansion of trade, associated with a relatively balanced distribution of the benefits of integration, also helped create a climate of optimism and confidence in the agreement’s political sustainability. Nonetheless, a crisis in the integration process after 1999, coupled with

the expiration of measures to create a customs union, and successive deferrals in completing those measures, revealed that the substantially balanced distribution of benefits was mainly coincidental.

This is unsurprising. Preferential trade theory demonstrates that there is no guarantee that the costs and benefits of integration will naturally be distributed in a balanced manner among the countries or regions involved in an integration agreement. From a static viewpoint, in each member country the tally of advantages and disadvantages depends on the net creation or diversion of trade in response to an ascending or descending convergence toward the CET, or, more generally, on the distribution of the efficiency costs associated with trade preferences. In a more complex analytical framework, regional integration can produce polarization or economies of agglomeration, impeding convergence in the growth rates of output or per capita income. This could exacerbate initial regional disparities. Venables (2003) argues that such effects are more likely to surface in South-South integration agreements.

The lessons learned from MERCOSUR, combined with indications from economic theory, raise the need to identify asymmetries that could affect the long-term political sustainability of a regional integration agreement made on a voluntary basis. Using the guidelines developed by Bouzas (2003), a distinction can be made between asymmetries rooted in structural factors, on the one hand, and those that result from preferential policies or regulations, on the other.

Structural asymmetries spring from factors such as the size of an economy, geographic location, access to regional infrastructure, institutional quality, and level of development. These factors affect an economy's capacity to benefit from greater market integration. Policy asymmetries stem from differences in national social preferences regarding the provision of public goods. Asymmetries in policies can propagate within an economically integrated region through cross-border spillovers that are macroeconomic in nature. Furthermore, if the collective rules are absent or deficient, resource allocation could be adversely affected. In general terms, policy asymmetries can create negative regional externalities that are not sufficiently internalized by national decision makers, leading to efficiency losses and exacerbating problems affecting the group's political cohesion.

In light of these considerations, policies to counteract asymmetries cannot be adopted in the abstract. The justification for such policies is precisely the need to attenuate disparities in structural conditions, so as to ensure that the benefits of integration are delivered and that decision-making processes address the negative externalities associated with policy asymmetries.

It should be noted that the importance of such policies does not lie mainly or exclusively in ethical or political motivations, but fundamentally in the need to guarantee a dynamic equilibrium in the member countries' desire to participate in a voluntary integration process. Hence it is crucial to consider asymmetries so that regional integration will effectively contribute to creating sustainable benefits for the region and its member countries.

This chapter seeks to help identify policies that can offset asymmetries and foster structural convergence in MERCOSUR. The next section identifies specific objectives attainable through special and differential treatment in trade policies. Particular attention is paid to policy instruments available in deep integration projects, such as customs unions and common

markets. The discussion then turns to an outline of the main asymmetries in MERCOSUR. In conclusion, the critical elements needed to promote structural convergence and cohesion in MERCOSUR are identified.

## **The Treatment of Asymmetries in Trade and Integration Agreements**

The existence of asymmetries among the signatories to trade agreements has been a persistent concern in international trade negotiations during the post-World War II era. Nonetheless, the ways in which this issue has been tackled has led to policies of widely varying scope. In general terms, it is useful to distinguish between two matters. On the one hand, in the realm of international agreements that are strictly limited to trade, special and differential treatment may be granted to countries with a relatively lower level of development. On the other hand, certain structural policies may be designed to favor convergence among member countries and/or regions of more complex agreements, such as customs unions or common markets.

### ***Special and Differential Treatment in Trade Policies***

In the past few decades, special and differential treatment in trade policies has evolved in both multilateral agreements and preferential accords.

#### **Taxonomy of Special and Differential Treatment Measures**

In order to define a taxonomy of clauses through which modern free-trade agreements grant special and differential treatment to certain members, the following five major categories have been delineated.<sup>1</sup>

- (i) *Limited time extensions and extended periods to comply with obligations.* This refers to common obligations for all the parties to the agreement. Such measures do not involve adjustments or variations in the rules associated with the size or development level of the economies involved. This approach is frequently adopted in programs to reduce and eliminate tariffs, or to converge toward a CET. This category also covers extensions for compliance with certain rules and/or temporary exemptions, permitting prohibited practices such as subsidies or performance requirements to secure FDI.<sup>2</sup>

<sup>1</sup> This taxonomy is based on information compiled by the Inter-American Development Bank (IDB), the Economic Commission for Latin America and the Caribbean (ECLAC), and the Organization of American States (OAS) in the framework of the Tripartite Committee.

<sup>2</sup> These kinds of measures are present—in market access, agriculture, government procurement, investment, intellectual property, subsidies, and countervailing measures—in several multilateral agreements of the World Trade Organization (WTO). In Latin American preferential agreements, they are found with respect to market access in the Andean Community, MERCOSUR, and the Latin American Integration Association (LAIA), as well as in the Andean Community and the Caribbean Community and Common Market (CARICOM) in terms of services.

- (ii) *Differential thresholds for meeting certain commitments.* Differential thresholds contemplate different requirements that apply to common rules, based on the development level or size of the economy. This category includes, for example, differential quantitative levels for defining minimal internal agricultural support measures, local content requirements for compliance with rules of origin, timeframes for the imposition of safeguards, and so on.<sup>3</sup>
- (iii) *Flexibility in obligations and procedures.* This includes measures that grant greater generic flexibility (unrelated to specific quantitative thresholds) and less burdensome procedures. For instance, the use of protective instruments or prohibited domestic support mechanisms might be authorized, lesser commitments might be permitted, special regulatory restrictions might apply, and administrative procedures for the application of certain regulations might be simplified.<sup>4</sup>
- (iv) *Maximum performance clauses and other provisions.* These include generic, nonbinding provisions concerning efforts to meet the demands of less developed countries in the application of international trade agreements.<sup>5</sup>
- (v) *Technical assistance.* As mentioned above, in parallel to the growing acceptance of the principle of reciprocity in trade agreements, there is increasing recognition of the need to provide technical assistance geared toward overcoming the obstacles to compliance with reciprocal obligations. Such technical assistance provisions reflect the idea that more developed countries have an interest in helping their relatively less developed partners to comply with the agreed-upon reciprocal obligations.<sup>6</sup>

Measures in special and differential treatment have been adopted in the multilateral General Agreement on Tariff and Trade (GATT), the subsequent World Trade Organization (WTO) agreements, and in preferential reciprocal accords.

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<sup>3</sup> These kinds of measures, pertaining to market access (textiles and clothing, and safeguards), agriculture and subsidies, and countervailing measures, are found in WTO agreements. In preferential Latin American agreements, they are found in the Andean Community and LAIA with respect to market access, and in CARICOM with respect to agriculture.

<sup>4</sup> Such measures are found in WTO agreements in relation to market access (import licensing procedures and customs valuation), agriculture, sanitary and phytosanitary measures, government procurement, services, and dispute resolution. In preferential Latin American agreements, they are found in the Andean Community, the Central American Common Market, CARICOM, and LAIA relating to market access, in the Andean Community for agriculture, and in CARICOM for services and investment.

<sup>5</sup> WTO agreements include such measures for market access, agriculture, services, antidumping, subsidies, and countervailing. In preferential Latin American agreements, they are in the Andean Community and LAIA with respect to market access, as well as in the Andean Community and CARICOM with respect to agriculture.

<sup>6</sup> These measures are in all the WTO agreements considered, with the exception of agreements on investment, antidumping, subsidies, and countervailing measures. In preferential Latin American agreements, they are found exclusively in the Andean Community, CARICOM, and LAIA for market access.

## Multilateral Preferential Trade Policies

The conceptual basis justifying asymmetric rules for developing countries changed substantially between the years of the first GATT and the creation of the WTO. In the past, the idea prevailed that liberal trade policies could constrain the development of infant industries and lead to crises in the balance of payments, given the resulting specialization in products that make intensive use of raw materials. As a result, it was argued, exports would suffer from excessive volatility and the terms of trade would deteriorate.

These concerns were addressed in the revision of Article XVIII of the GATT of 1955, which authorized the imposition of quantitative controls in order to support nascent industries and prevent disequilibria in the balance of payments. Part IV was added to the GATT in 1964. This outlined a specific legal framework for special and differential treatment based, among other things, on the principle of nonreciprocity of obligations and on general calls to consider the demands of developing countries. This set of rules—in large measure nonbinding—fell short of the beneficiary countries' expectations.

An exemption to Article I of the GATT (the most-favored-nation clause) was negotiated, and in 1971 a unilateral system of nonreciprocal preferences (the Generalized System of Preferences, GSP) was legalized. Nonetheless, the developing countries did not actively participate in the Kennedy Round (1967) or the Tokyo Round (1979), and hence the resulting liberalization affected their interests asymmetrically (Hudec, 1987). During that period, emphasis was placed on negotiating the enabling clause, which authorized, among other measures: (i) preferential access to developed-country markets on a nonreciprocal and non-discriminatory basis (principally the GSP); (ii) more favorable treatment in the application of GATT rules on nontariff barriers; (iii) the introduction of preferential regimes among developing countries; and (iv) the possibility of not signing certain multilateral agreements on subsidies, technical barriers to trade, government procurement, and so forth. Although the enabling clause reinforced inclusion of the concept of special and differential treatment in the GATT, such treatment continued to be applied through discretionary actions more than through legally binding provisions.

The Uruguay Round (1994), which culminated in the creation of the WTO, marked a change of attitude toward mechanisms of special and differential treatment among the developing countries involved. Without formally renouncing the principle of nonreciprocity, the developing countries participated in the exchange of reciprocal concessions on goods and services, embodied in the concept of a "single undertaking." As well as maintaining the legal basis of the GSP and granting some flexibility in the application of certain reciprocal commitments—for example, the consolidation of tariffs at levels considerably higher than the applied tariffs, and the maintenance of prohibited practices related to agriculture or subsidies—the 1994 GATT introduced new elements such as longer transition periods to comply with reciprocal commitments, and technical assistance programs for compliance with several WTO agreements.

In this context, the most important matter to note is the change in focus—from a strategy based on exemptions and nonreciprocal disciplines to one centered on the principle

of reciprocity, accompanied by flexibility and technical assistance. Current WTO agreements mainly grant special and differential treatment through two mechanisms: (i) positive actions on the part of developed countries in favor of developing countries;<sup>7</sup> and (ii) differential obligations for developing or less developed countries.<sup>8</sup>

Assessing the special and differential treatment provisions of multilateral trade agreements prompts conclusions both general and specific (Michalopoulos, 2000). In general terms, experience shows that in countries with a relatively lower development level, the institutions responsible for implementing national commitments are particularly weak and deficient in enforcing negotiated trade disciplines. Moreover, these countries have supply-side constraints that impede effective participation in international trade. Special and differential treatment can facilitate the transition to freer trade regimes. Nonetheless, there is no analytical or empirical justification for a distinction, in principle, between the policies applied in developed countries and those applied in developing countries.

In specific terms, special and differential treatment needs to be applied through effective instruments, including but not limited to: (i) significant support of institution building by means of mandatory commitments and sufficient funds; (ii) a realistic evaluation of the time needed to converge toward common regulations; (iii) a restriction on flexibility in the application of protective instruments; (iv) a clear functional distinction between countries to define graduation mechanisms; and (v) a correlation between special treatment in the multilateral trade system and in other regional preferential systems.

The history of special and differential treatment in preferential reciprocal trade agreements, and particularly in Latin American customs unions, is long and complex. The rules on such treatment have evolved in a manner similar to those of multilateral accords. For example, Chapter XII of the Cartagena Agreement (1969), which created the Andean Pact, defined a special regime for Ecuador and Bolivia, including nonreciprocal trade preferences, the adoption of nonsymmetrical trade liberalization programs, extended periods for eliminating exemptions, preferential treatment for products covered by the regional industrial planning

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<sup>7</sup> Positive actions on the part of developed countries are divided into: (i) granting of preferential, nonreciprocal market access; (ii) provision of technical assistance to surmount institutional weaknesses that affect the capacity to comply with WTO rules, mainly in the areas of technical and phytosanitary barriers, customs valuations, dispute settlement, intellectual property, and so on; and (iii) application of rules with modes favorable to the developing countries, specified mostly through “best endeavor” clauses and, in some cases, specific obligations, which in large measure are nonbinding (Kessie, 2000).

<sup>8</sup> The distinction in commitments and obligations for the developing countries, on the one hand, tends to allow otherwise prohibited market access restrictions or subsidies for production/exports and, on the other hand, grants longer timeframes to comply with reciprocal obligations. This mostly takes shape through: (i) exemption from disciplines on market access for goods and services, reflecting the principle of nonreciprocity; (ii) flexibility in the application of multilateral disciplines on, for example, the protection of specific sectors with nascent industries; balance of payments problems, rules for establishing free trade areas or customs unions; the method for calculating the aggregate measurement of support in relation to agriculture, and so forth; (iii) flexibility during the transition period towards multilateral reciprocal regimes, called for in almost all WTO agreements, except for accords on antidumping and preissuance inspection. Unlike the provisions that call for actions by the developed countries, these are legally binding (Kessie, 2000).

system, and technical and financial cooperation. In the 1990s, however, these disciplines tended to disappear, and special and differential treatment was mainly granted through provisions marked by the principle of reciprocity. The Asunción Treaty (1991), which created MERCOSUR, is paradigmatic of this change in approach. It is founded on a reciprocity of rights and obligations, and only recognizes extended periods for Uruguay and Paraguay to comply with the common discipline. Today, only one integration scheme in the region is based on the formal recognition of asymmetries: the Caribbean Community (CARICOM), which identifies disadvantaged countries, regions, and sectors that may receive special treatment.<sup>9</sup>

### ***Convergence Policies in Common Markets***

In regional agreements that go beyond mere trade liberalization—specifically customs unions and common markets—the treatment of asymmetries is more complex and critical. Convergence toward common development levels and the reduction of disparities among members are among the main goals of most common markets’ founding agreements. Instruments to address asymmetries are among several convergence policies that seek to go beyond trade policy, and that may include facilitating the transition to a customs union and guaranteeing the structural convergence of members of a common market. In this regard, the transition to a single market in the European Community (EC) provides a useful reference for other integration processes.

#### **Transition to a Customs Union**

Trade among EC members has been a powerful impetus to growth and to convergence of the economies’ growth rates (Ben-David, 1993). The European experience helps in outlining the steps needed for transition to a customs union (Goizueta, 2003).

The most important stage in that transition is the elimination of tariffs among the countries forming the common customs territory and the adoption of a CET. Without question, this is the most delicate process from a technical viewpoint, as well as in political and economic terms. In order to grant more flexibility in the transition to a harmonized regime, exceptional instruments may be considered. Nonetheless, when relevant safeguard clauses are designed, it is important to specify “sunset” clauses, so that the temporary protection does not spur political economy resistance that would result in an indefinite deferral of convergence. It is also advisable to identify parallel tax-system reforms.

The harmonization of customs legislation through the adoption of a common customs code is also indispensable in the formation of a customs union. In this regard, the common code must be directly applicable in its entirety or, at the least, should not leave room for

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<sup>9</sup> It is interesting to note that the Protocol on Disadvantaged Countries, Regions, and Sectors amending the treaty that established CARICOM formally recognizes the operation of the single market as a cause of disadvantage and as making countries eligible for special and differential treatment.

varying interpretations or delay in its application. To establish legal certainty, it must also be accompanied by a system of sanctions for violations.

Eventually, the transition to a customs union must also eliminate national disparities in the treatment of products originating in third countries, thereby eradicating customs formalities within the common customs territory. It is important to note that only in an integrated economic area, with the consequent increase in trade flows and the removal of segmentation—which tends to polarize investment and growth—is it possible to unleash the endogenous forces that guarantee growth through trade.

Finally, as a preliminary step in the implementation of common policies in a common market, customs-revenues distribution mechanisms should be devised. Theoretically, it is possible to consider duties as national resources, and to create a system in which each country collects those revenues independently. Such a system, however, does not correspond to the spirit of a customs union transitioning to a common market. It is also detrimental to countries with poorer access routes to international markets, or those whose size precludes their taking advantage of economies of scale in the logistics of international trade. Furthermore, treating customs duties as independent national resources could spur competition among the members of a customs union and distort its operation. It is better if all such revenue is handled jointly, the parameters of distribution being determined on the basis of shared objectives—including the financing of common policies, as has happened in the European Union (EU).

## Structural and Cohesion Policies

The European approach has resulted in a group of member countries that not only have close economic and commercial ties in the customs union, but jointly manage matters of common interest in the framework of the common market. The European concept of integration places great emphasis on the attainment of economic and social cohesion among members; thus, harmonious development is one of the EU's main goals.

The creation of a common market was based on the principle of fostering the development of member countries and eliminating differences in development levels among certain regions. In this regard, the Treaty of Rome called for the creation of a European Social Fund (ESF) to help create jobs and promote the mobility of workers within the EC. Given rapid growth and low unemployment in the 1950s and 1960s, the function of the fund was initially limited. The economic crisis of 1973 and consequent economic restructuring, however, brought to light differences in development among some members. Those differences increased further following the accession of the United Kingdom, Ireland, and—later—Greece, Portugal, and Spain. A structural policy geared toward reducing differences in development and living standards became indispensable. In addition to the ESF, other funds were created over time. These were known as *structural funds*, and each had a specific objective.<sup>10</sup> Finally, in 1993, a

<sup>10</sup> The European Agricultural Guidance and Guarantee Fund (EAGGF) for financing the common agricultural policy; the European Regional Development Fund (ERDF), whose interventions target less developed regions; and the Financial Instrument for Fisheries Guidance (FIFG).

Cohesion Fund was created to finance transportation and environmental infrastructure in the poorest member states.

The concept of economic cohesion appeared for the first time in the Single European Act (1986). With the conclusion of the Treaty on European Union (1992), this concept became one of the three pillars of the EC, on the same level as the single market and the European Economic Union. In this regard, it is important to note that the priority given to cohesion policies has paralleled the task of applying policies to strengthen the single market, on the basis of a quantitative assessment of the costs of incomplete integration (Cecchini, 1988).

Cohesion is a priority, with its own budget allocation. Indeed, this structural policy accounts for the EU's second-largest expenditure (after the common agricultural policy). Griffith-Jones et al. (2003) estimate that, in 1999, structural and cohesion funds represented one-third of the EU budget, amounting to 0.5 percent of the Union's gross domestic product (GDP) and a huge proportion of the GDP of poorer countries (4 percent for Greece and Portugal). Moreover, structural funds are based on cofinancing with national resources, and therefore act as a significant catalyst to leverage the national resources of more depressed areas.

Structural funds have a clear regional focus and, following the reform of 1999, are allocated:

- (i) To less developed regions (whose average per capita GDP is less than 75 percent of the EU average), with the aim of promoting development and structural adjustment (Objective 1)
- (ii) To areas facing specific structural difficulties, so as to foster economic and social reconversion (Objective 2)
- (iii) To activities that promote human resource development and that are not included in the areas covered by Objectives 1 and 2 (Objective 3)

These general lines of action are complemented by special initiatives that seek to promote cross-border cooperation, rural development, the fight against discrimination in the labor market, and the economic and social revitalization of urban areas in crisis.

Cohesion Fund resources are allocated to countries where per capita GDP is less than 90 percent of the EU average (at the time of this writing, Spain, Greece, Ireland, and Portugal). The resources are used to finance projects that have cross-border spillover effects at the Union level. Originally, receipt of these funds was conditional on the beneficiary countries' meeting performance targets. After the reform, certain requirements were set to guarantee the projects' quality: the creation of midterm economic and social advantages proportional to the funds received, in line with the priorities of the member states; a significant and balanced contribution to EU environmental policies, including the "polluter pays" guideline; the creation of trans-European networks; and compliance with other EU structural measures.

The EU's structural and cohesion policies have been complemented by the operations of the European Investment Bank (EIB), whose mission is to channel long-term financing to investment projects that strengthen the EU's poorest regions. EIB loans typically cover

one-third of the investment cost, often in partnership with other public or private credit organizations, including international financial institutions.

It is worth noting that the European philosophy on structural and cohesion policies has been maintained in the EU's enlargement to include several Central and Eastern European countries. Enlargement poses significant challenges, since it heightens the EU's heterogeneity and entails problems of sectoral and regional adjustment that demand proper preparation. Several instruments have been created to those ends.<sup>11</sup> These seek to enable the accession countries to participate in the structural funds and the Cohesion Fund, which replaced pre-accession assistance when the new members joined the EU. These instruments provide insights into how to oversee accession to an integration agreement, in the form of "assisted transition" to free trade (Peña, 2004).

Despite some recent debate, several studies have shown that the structural policies have positively affected growth and jobs, favored commercial and financial liberalization, and fostered growth-rate convergence among regions within the EU (Griffith-Jones et al., 2003). Indeed, economic conditions in the EU's four poorest countries (Spain, Portugal, Greece, and Ireland) have improved. The clearest example is Ireland, whose per capita GDP rose from 64 percent of the EU average in 1983 to almost 90 percent in 1995. For developing countries, the European system is unquestionably an important reference point. In drawing conclusions or making recommendations, however, lessons should be learned not only from the EU's successes but also from its weaknesses (Sapir, 2003).<sup>12</sup>

## An Overview of Asymmetries in MERCOSUR

The way to deal with asymmetries is a recurring theme in discussions of MERCOSUR's consolidation.<sup>13</sup> After more than a decade of formal integration efforts, decision makers in all

<sup>11</sup> Such as the Phare Programme for institutional strengthening and convergence to the EU rules, known as the *acquis communautaire*; the Instrument for Structural Policies for Pre-Accession (ISPA) for environmental and transport sectors; and the Special Accession Programme for Agriculture and Rural Development (SAPARD).

<sup>12</sup> The Sapir report summarizes the work of a high-level independent commission established at the initiative of the president of the European Commission. This report contains information that is very important in designing cohesion policies in other parts of the world. It positively assesses the performance of European policies, but also identifies the need for certain reforms. Among the general principles applicable to the design of the reforms were: the need to modify the cohesion policies on a regional and national level, with emphasis on the operation of factor markets; the need to attribute a single objective to each instrument; and the need to adapt community policies to the enlargement of the EU. Notable among the principles applicable to policy implementation were: the need to decide on the appropriate degree of decentralization as a function of each policy's specific goals; the need to provide incentives to national and local authorities to encourage compliance with EU objectives; the need to create a sense of ownership among local actors; and the need to clearly define the aims and operational mechanisms of the variable geometry of the commitments. The specific recommendations include: the need to advance in strengthening the single market through coordination between regulatory policies and competition policies; giving priority to technical development policies; the need to strengthen macroeconomic coordination mechanisms; the need to modify criteria for the allocation of structural and cohesion funds, emphasizing a national rather than a regional approach; and periodic reviews of eligibility criteria, with priority being given to investment in institution building and human capital (in order to facilitate production reconversion for declining sectors).

<sup>13</sup> With some changes, this section is based on Moreira (2003).

the member countries are showing renewed interest in the economic implications of country size. There is broad agreement that extreme differences in member size pose an obstacle to the attainment of common objectives, and that effective responses are needed (Bizzozero and Abreu, 2000; Masi and Bittencourt, 2001). This assessment, which coincides with concerns that the smaller countries have voiced about the distribution of the costs and benefits of integration, has been expressed along with recurring threats to break the bloc's unity in external trade negotiations, following devaluations in the larger countries.

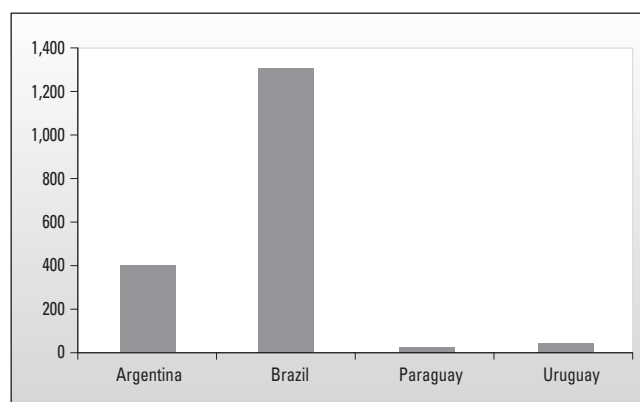
### ***Economic Size and Development Level***

Asymmetries in MERCOSUR are clearly important. Because of the particular configuration of national disparities, however, size cannot be viewed as the sole criterion for defining policies to address those asymmetries.

Analysis of the size of the economies (Figure 1.1) reveals the enormous difference between Argentina and Brazil, on the one hand, and Paraguay and Uruguay, on the other. The Paraguayan and Uruguayan economies are equivalent, respectively, to 1.9 percent and 3.1 percent of Brazil's economy, and to 6.1 percent and 10.2 percent of Argentina's. A review of demographic weight prompts similar conclusions. If wealth is considered, however, the conclusion is different (Figure 1.2). From that perspective, Brazil is the second-poorest country in the region, above Paraguay but below Uruguay and Argentina. Furthermore, within Brazil (and, to a lesser extent, in Argentina)<sup>14</sup> enormous regional disparities reinforce the conclusion that asymmetries in size are not correlated with asymmetries in wealth.

The noncorrelation between population size and the welfare of inhabitants is not peculiar to the region. As indicated by Wacziarg, Spolaore, and Alesina (2003), "among the ten countries in the world with the highest per capita income, only four have a population exceeding one million inhabitants." Nonetheless, this noncorrelation poses a formidable obstacle to designing policies that address asymmetries. On the one hand, a larger market provides advantages in exploiting economies of scale and agglomeration, which are particularly effective in attracting FDI. On the other hand, MERCOSUR's largest country (Brazil) is also one of its poorest. In these conditions, a policy that transfers

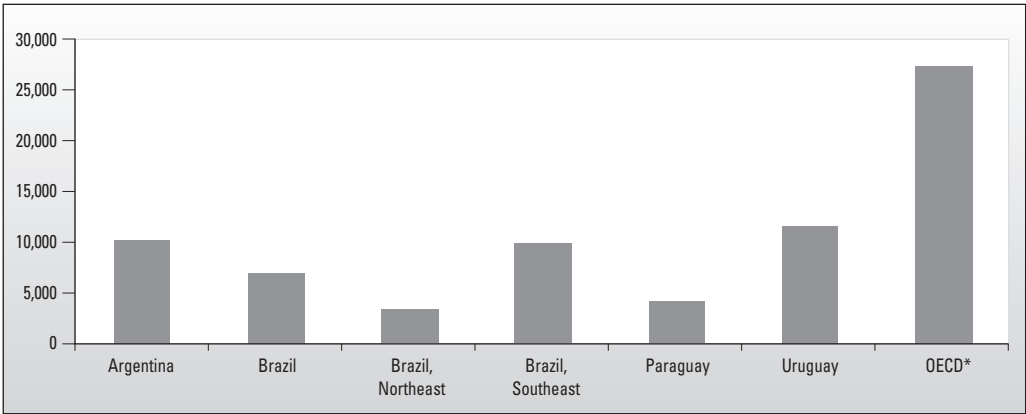
**Figure 1.1. GDP, 2002 Purchasing Power Parity (PPP)**  
(current international dollars)



Source: World Development Indicators (WDI), World Bank.

<sup>14</sup> No disaggregated information is available on a regional level for Argentina.

**Figure 1.2. Per Capita GDP, 2002 Purchasing Power Parity (PPP)**  
(current international dollars)



\* Countries of the Organisation for Economic Co-operation and Development (OECD).  
Source: World Development Indicators (WDI), World Bank, and the Brazilian Institute of National Statistics and Geography.

resources from larger countries to poorer ones—with the aim of offsetting size disadvantages—might accentuate income disparities among MERCOSUR’s members.

Similarly, a policy geared toward reducing income disparities—which would promote cohesion in the bloc—would accentuate size disadvantages. This could cause friction, since the richest countries of the region are not rich on a global scale. In fact, the GDP of the richest MERCOSUR country is less than half the average of that of the countries of the Organisation for Economic Co-operation and Development (OECD). MERCOSUR members are mainly middle-income countries with limited fiscal margins to finance policies based on resource transfers.

Of course, a possible solution would be an approach that combines aspects of size (for example, GDP) and wealth (for example, per capita GDP) while accounting for disparities between and within countries (as is done in the EU’s Cohesion Funds). Such an approach would respond to the demands of the smaller members—Paraguay, which is small in size and wealth, and Uruguay, which is small in size. It would also respond to the interests of the larger members—Brazil, with a large GDP but depressed regions, and Argentina, with depressed regions. This option, however, would not resolve budgetary constraints arising from the fact that the largest country is not the richest and the “richest” is not rich enough to finance such policies. In Europe, the richest countries are also the richest in global terms, and there is a reasonable correlation between size and wealth (for example, France, Germany, and the United Kingdom compared with Portugal, Spain, and Greece). Those circumstances facilitate the formulation of cohesion policies.

***Asymmetries and Trade Policies***

The difficulties of implementing convergence policies through transfers of financial resources suggest that emphasis should be placed on trade-related policies. More specifically, initiatives

that promote the completion and strengthening of MERCOSUR could help reduce asymmetries and foster regional cohesion. This is particularly true in matters of size. In MERCOSUR, disadvantages of smallness are more related to economic size (that is, the scale of domestic markets) than to geopolitical size. For that reason, it is precisely through trade and regional integration that the small countries can mitigate the disadvantages of their small domestic-market size.

Despite the progress made in regional integration, MERCOSUR does not guarantee that the smaller countries will have unrestricted access to a completely unified regional customs territory. The challenge is considerable: (i) nontariff barriers pose significant obstacles to access; (ii) institutional deficiencies in the areas of technical standards, the regulation of utilities, the domestic transposition of common disciplines, oversight of competition, and dispute resolution mechanisms create uncertainty and hamper trade and investment; (iii) regional infrastructure is weak and poses a major barrier to the expansion of trade flows; (iv) widespread exemptions to the CET cloud the outlook for intraregional trade that is free of rules of origin; (v) macroeconomic coordination has improved more by happenstance than by design; and (vi) the tendency to take unilateral action has weakened the bloc's political cohesion, creating uncertainty for investors and weakening MERCOSUR's position in external trade negotiations.

Externally, the CET's level and structure entail a substantial cost to the smaller countries, thereby reinforcing the structural disadvantages. The current CET, for example, gives a high degree of effective protection to capital goods, and increases the cost of investment and of access to technology. Thus, investment and productivity, the two most powerful vehicles of sustainable growth—which any country would have to pursue, irrespective of size—are weakened.

In this context, MERCOSUR has adopted special and differential treatment practices in favor of smaller economies. The granting of exemptions to the CET, rather than a substantive review of level and structure, is questionable: it weakens the regional single market and the harmonization of trade policy toward third parties, which are the main instruments used by small countries to overcome asymmetries associated with modest market size.

It should be noted, however, that not even a perfectly unified market eliminates the agglomeration of activities—with increasing returns and positive externalities—in larger countries, especially in an environment marked by distortions arising from the capacity to provide tax and credit incentives. It is therefore crucial that initiatives to further integrate the common market be accompanied by measures aimed at reducing the asymmetries generated by national public policies. The goal of fostering cohesion in MERCOSUR, therefore, must provide the impetus to devise a common incentives regime, one that reflects the need to offset asymmetries in size and wealth in a general framework of fiscal responsibility.

In sum, strengthening the common market and creating a system of tax and credit incentives that favor smaller countries and economically depressed areas are central elements of a strategy to confront size and wealth asymmetries in MERCOSUR. Special and differential treatment offered by trade policies should aim to expand and improve integration in the single market by increasing trade flows, instead of contributing to the marginalization of smaller

economies through restrictive measures. Furthermore, particularly in smaller, relatively less developed countries, regional strategies must be complemented by national policies centered around the strategic objective of improving participation in regional and international markets. The case of Paraguay reveals the need to implement parallel and complementary regional and national initiatives (Giordano, 2004).

## **Conclusion: Critical Elements for Convergence in MERCOSUR**

This chapter has examined the forms of tackling asymmetries in multilateral and preferential trade agreements, the policies adopted to foster convergence in common markets, and the main asymmetries in MERCOSUR. The foregoing analysis prompts the consideration of certain elements critical to designing policies that promote convergence among MERCOSUR members.

*Market access guarantees.* Market access is the key to promoting the convergence of growth rates and development through trade. Certainty regarding market access conditions creates endogenous forces that promote progress to higher forms of integration (regional public goods). Unrestricted access to the regional market is clearly the first prerequisite, one that helps foster convergence among the members of an integration project.

*Credibility and efficiency of rules.* The sustainability of an integration project depends on its capacity to build confidence in credible, predictable rules favoring long-term investment, as well as to generate trade flows originating in the most efficient geographic locations. But the effects of integration will not be fairly distributed unless the inefficiencies caused by preferential trade policies are also distributed in a balanced manner. In this sense, the CET and trade policy toward non-member countries have a major impact on the internal cohesion of MERCOSUR members. Regional integration can help increase collective welfare and support the process of insertion into the global economy, but it is crucial to avoid excessive efficiency costs and unduly restrictive trade practices that lead to isolation from international markets.

*Effectiveness in designing the rules.* Mechanisms for developing common rules are essential to the common market's proper operation and to the fair distribution of the benefits of integration. A system for developing effective rules, accompanied by a timely and credible dispute-settlement mechanism, is the best guarantee against conflicts over interpretation of the law, thereby avoiding discretionary decisions, uncertainty, and asymmetrical efficiency costs.

*Transposition and respect for the rules.* The credibility of the common rules depends mainly on their insertion into national law and on curbing unilateralism, particularly in agreements whose institutional architecture is intergovernmental. Success in reducing asymmetries, and in advancing toward a common goal in an increasingly solid integration project, is closely related to coordination and collective action in areas of common interest.

*Collective regional institutions.* Technically competent, well-financed collective institutions that can take the initiative are fundamental to creating environments that promote the development of regional public goods. Such institutions also function as anchors to curb national policies that generate asymmetries. Thus, appropriate representation from all MERCOSUR countries is needed among institutions' full-time staff. Institutional capacities to assess the impact of regional and national policies on the integration process must also be strengthened.

*Special and differential treatment.* Special and differential treatment in trade matters can facilitate convergence toward a regime of reciprocal preferences. The main aim of these rules must be to expand trade, not constrain it. Moreover, care should be taken to avoid the creation of a permanent system of differential obligations. There is a need to define the timeframes for exceptions, to avert resistance spurred by protection policies, and to provide adequate technical assistance that ensures convergence toward a set of reciprocal commitments—particularly in countries that are institutionally weaker.

*National policies and institutions.* There is a need for active national policies that are compatible with and complementary to regional policies. National institutions must also be strengthened so that full advantage can be taken of regional policies. Particularly in countries that are more susceptible to regional asymmetries, auxiliary integration policies should be incorporated into national development strategies. This requires national-level incentives to promote local policies that are aligned with those of other countries of the region.

*Technical and financial assistance.* The process of strengthening integration must be accompanied by sufficient technical and financial assistance to support convergence. The MERCOSUR countries face significant institutional obstacles to the development of an integrated common market. Because markets are incomplete, there is insufficient private production of certain public goods that are crucial to promoting competition. Mobilizing technical and financial support to strengthen institutions and promote competition is critical to ensuring the effectiveness of initiatives that seek to offset asymmetries.

*Development of regional infrastructure.* The pillars of integration proposed as part of the Initiative for the Integration of Regional Infrastructure in South America (IIRSA) seek to strengthen the interconnections between areas in the interior with the lowest development levels, granting them greater access to the exterior in order to sell their products. The development of regional infrastructure, and harmonization of the rules for infrastructure use, would be particularly helpful in reducing asymmetries in MERCOSUR, especially for landlocked countries.

*The role of international financial institutions.* International financial institutions, especially those of regional scope that focus on supporting regional integration, can promote convergence among the MERCOSUR countries in collaboration with local financial institutions

such as the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) in Brazil or the Banco de Inversión y Comercio Exterior (BICE) in Argentina. These institutions, in addition to their traditional role in promoting regional infrastructure, can help strengthen collective regional institutions in identifying and promoting regional public goods, with particular attention to the treatment of asymmetries. It is important to note, however, that support on a regional scale must be complemented by national efforts, particularly considering capacity to (i) foster national policies for capturing the benefits of regional integration, and (ii) create incentives to encourage implementation of an integrated system of national and regional policies of this type.<sup>15</sup>

In sum, MERCOSUR's members need to perceive an equilibrium in the costs and benefits of integration for the further consolidation and strengthening of the integration process. The dynamic impact of the asymmetries should be taken into account, and there should be agreement on how to reduce these asymmetries, with consideration given to all possible lines of action, as presented in these conclusions.

All such measures require significant political will on the part of each member, and, in particular, they call for strong leadership from the bigger countries. MERCOSUR's current political harmony will pave the way for progress on several agreements in each of these areas. For that political will to be sustainable, however, the benefits of the process must become apparent. This means that trade must expand, rules and institutions must be strengthened, and MERCOSUR's institutional architecture must be perfected.

Finally, it is important to note that no integration initiative moves forward in a straight line. There will be ups and downs, periods of progress and periods of setback. Since 2003, MERCOSUR has been moving toward greater integration and expansion of its intra- and extraregional trade. This, together with political harmony, may make it easier to deal with certain asymmetries. But experience indicates that negative cycles may eventually surface. It is necessary to agree on and apply mechanisms for minimizing negative impact on the policies pursued.

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<sup>15</sup> The 25th meeting of the Common Market Council (Montevideo, December 2003) issued Decision 27/03, which seeks to promote "studies for the establishment of structural funds to enhance the competitiveness of the smaller partners and least developed regions." Beyond technical matters, which must be assessed through studies, in a context of scarce resources (as is characteristic of the MERCOSUR countries) the financing of those funds is an obstacle. Financial instruments provided by international financial institutions to support competitiveness and integration might help the MERCOSUR countries overcome these financial constraints. In line with MERCOSUR's intergovernmental nature, the four member countries, in a coordinated manner, could access national credit lines to enhance competitiveness through trade. Part of these funds could be earmarked for initiatives to correct asymmetries in MERCOSUR as a function of the goals identified in national action plans developed in coordination with regional trading partners. International financial institutions could complement those financial instruments with grants and technical assistance to finance and strengthen projects that offer significant positive externalities in relation to the integration process. For example, such mechanisms have been proposed by the IDB in preparatory studies for the Bank's country strategy with Paraguay (see Giordano, 2004).

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## Disparities and Integration in MERCOSUR

*Juan S. Blyde and Eduardo Fernández-Arias*

### Introduction

As an integration agreement between sovereign countries, the Southern Common Market (MERCOSUR) is viable only if each member benefits equally. Moreover, the agreement is sustainable only if (1) global gains are distributed evenly among partners and (2) the agreement is accepted in cooperative fashion. The global gains derived from the deepening of regional integration will not be achieved if their distribution across countries is unbalanced.

Structural asymmetries and macroeconomic differences among MERCOSUR member countries create salient disparities in the distribution of gains in the agreement—gains that are not aligned with the expectations of countries that benefit relatively less. These disparities are the basis of disagreement among MERCOSUR countries and risk both the very existence of the trade bloc and consensus needed to improve integration.

This chapter analyzes the challenges posed to the MERCOSUR regional integration project by the asymmetries across countries, particularly in view of the disparities they generate in the agreement's distribution of gains. The reduction of structural asymmetries would lessen these challenges, but that is not necessarily a reasonable or even feasible objective for economic policy. For this reason, the analysis focuses on the effects of structural asymmetries on integration and on how to neutralize them so they do not impede further integration. Without prejudice to policy coordination, economic policy alternatives must also include (1) the design of integration agreements that are less vulnerable to structural asymmetries and (2) a system for economic compensation among countries.<sup>1</sup>

In this chapter, concern over disparity of benefits across countries aims not to address an equity issue, but rather to address the negative impacts such disparity has on the incentive to participate in and deepen the agreement. An equity-based approach may be appropriate as a regional development strategy for one country, but it may not be a relevant objective for

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<sup>1</sup> Surely, close attention must be given to the cost efficiency of these policies. The design of agreements that are immune to macroeconomic asymmetries, such as preventing the localization of foreign investments where they are most profitable so as to avoid an unfair distribution of gains, may not be convenient for reasons of economic efficiency. Similarly, indirect trade-offs such as granting special exceptions to the common external tariff (CET) threaten the integrity of MERCOSUR.

the purposes of an agreement among sovereign countries at this precise historic moment in MERCOSUR.

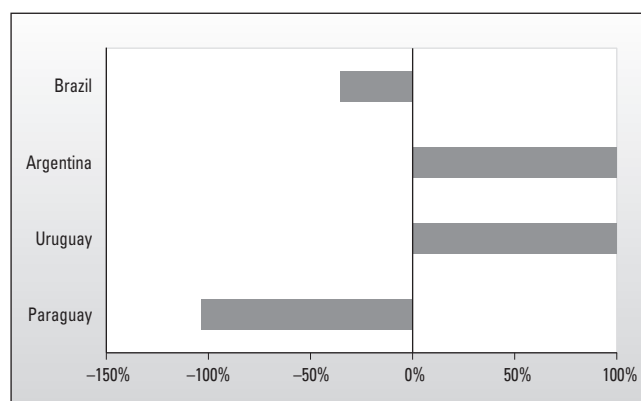
According to this perspective, funds transfers among countries should serve as compensation for balancing agreement profits and aligning country incentives toward regional integration participation rather than to reduce regional income inequalities. Additionally, in contrast to the European Union where, as a general rule, wealthier countries are also the larger ones (high product per capita and national product coincide) and transfers for equity purposes go hand in hand with transfer capacity, this correlation is not present in MERCOSUR: Brazil is clearly the country with greater economic power, but it is as poor as the rest of the bloc.<sup>2</sup> In fact, if MERCOSUR were to apply European Union rules for its structural and cohesion funds, Brazil would not be a donor but an aid receiver (see Figure 2.1).

The introduction to this chapter reviews the most relevant dimensions of the MERCOSUR disparity and integration debate. The next section begins by addressing the challenges imposed on integration by macroeconomic policy asymmetries, especially exchange rate policy.<sup>3</sup> The effects and challenges that large asymmetries have on regional trade and investment are set out in the following section. The next section addresses asymmetries in extraregional comparative advantages. The last section reflects on the main effects of asymmetries and how disparities in bargaining power among partners complicate efforts to strengthen community institutions that could serve to neutralize them.

## Macroeconomic Policy Asymmetries

The lack of coordination between exchange-rate regimes is probably the main asymmetry of macroeconomic policy. It causes significant monetary misalignments among MERCOSUR member countries and high volatility of real exchange rates in the region (see Figure 2.2, which shows substantial volatility of the regional real exchange rate for each country).<sup>4</sup>

**Figure 2.1. Simulation: Net Contributions to MERCOSUR**  
(% of contributions)



Source: Authors' calculations.

<sup>2</sup> Additionally, it has vast poverty subregions.

<sup>3</sup> Macroeconomic policy asymmetries are not included in this brief review but deserve to be regarded as potential obstacles to the deepening of MERCOSUR.

<sup>4</sup> The real effective exchange rate (multilateral) for Mexico is used as a point of reference.

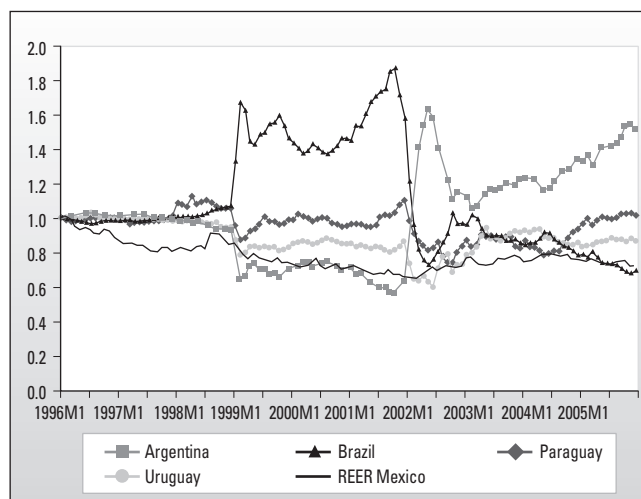
It is well recognized that when a country loses competitiveness as a result of exchange-rate appreciation within the bloc, this leads to protectionist pressures that defy the integration agreement, often induced by national economic sectors that are antagonistic toward international trade and wish to turn things to their advantage. These protectionist pressures can lead to hidden administrative measures within the bloc such as antidumping or increased protectionism outside of the bloc, causing greater

trade diversion and poor integration. Additionally, this can trigger competitive devaluations or exchange-rate crises within the bloc, which may lead to even greater exchange-rate volatility. The January 1999 devaluation of the Brazilian real and the 2001 devaluation of the Argentine peso (and their consequences in Paraguay and Uruguay) clearly illustrate the challenges that this asymmetry represents.

Evidence shows that these exchange-rate incompatibilities are particularly harmful within the framework of trade agreements (Fernández-Arias, Stein, and Panizza, 2004). It is known that exchange-rate overvaluation leads to the reduced trade openness of a country, the displacement of foreign direct investment toward the most devalued country, and a greater probability of exchange-rate crisis (that is, substantial real depreciations). The article demonstrates that if one separates regional and extraregional exchange-rate overvaluation, regional overvaluation turns out to be more significant in terms of these effects. Consequently, regional exchange-rate misalignment and excessive volatility substantially defy integration.

It is worth noting that reduced trade openness of a country whose exchange rate appreciates regionally is observed in levels of total exports, not only within the trade bloc or with respect to the country whose exchange rate depreciates (a result that would be considered trivial). That is, this effect is measured once exports directly affected are allowed to be directed to extraregional markets that maintain exchange-rate competitiveness. A contraction in global exports is precisely linked to the additional costs of penetrating new markets. Exchange-rate appreciation that originates within regional integration agreements is particularly harmful in this regard because preferential treatment allows the development of regional goods that are not competitive in other markets and cannot be relocated elsewhere with benefit (see Bevilaqua, Catena, and Talvi, 2001). Fernández-Arias, Stein, and Panizza (2004) sustain this theory, showing that the effects on trade flows are harsher when the external protection of

**Figure 2.2. Intra-MERCOSUR Real Effective Exchange Rate, 1996–2005**



customs unions is greater. For this same reason, the resulting devaluation pressure of intraregional appreciation is greater.

Exchange-rate misalignment that grows out of trade agreements also has important consequences for direct foreign investment flows. The increased attraction of foreign investment in a partner that depreciates (and decreased attraction for partners whose exchange rate appreciates) arises from greater competitiveness in national production, whether it is to supply the internal market rather than import (“tariff jumping” FDI) or to supply the world on the basis of more competitive domestic factors. The “world” in this case can mean the region, whose market is protected by the trade agreement, and is consequently a natural destination for the production supplied by a single country in the region, creating rivalry among trade partners. In fact, Fernández-Arias, Stein, and Panizza (2004) have found that these effects are significantly more powerful when they originate with exchange-rate variations within a trade agreement. Plant relocation from a country whose currency appreciates to a country whose currency depreciates is an extreme illustration of this challenge to integration.

Other macroeconomic policy coordination policies could reduce specific economic asymmetries that hinder integration. For example, the European Union has coordination mechanisms like the Stability Pact based on limits placed on fiscal results. Other relevant aspects in the context of MERCOSUR could be limits placed on the size and structure of public debt. These dimensions of macroeconomic coordination policy, among others, will take on greater importance as integration deepens. But without strong monetary coordination (or a monetary union such as the EU), these macroeconomic policy asymmetries have a spillover effect on partners primarily through exchange-rate instability. Coordination therefore remains a top priority for the challenges of integration.

Surely the challenge posed by an asymmetry in exchange-rate regimes does not imply that the solution is a monetary union, because more monetary coordination implies less monetary independence for each country. The evidence set forth by Eichengreen (1998) and Montiel (2006) does not suggest that MERCOSUR presents a case for optimal monetary union, although it is possible that a union could help to synchronize participating economies, satisfying the prerequisites of optimal monetary union (Rose and Stanley, 2005). In any case, compatibility in exchange-rate regimes is an important factor to consider when admitting new members that are economically powerful. At the same time, the absence of monetary harmonization can be an insurmountable impediment to sustaining a deep integration agreement in which exchange-rate volatility can strongly affect not only trade, but also the movement of factors.

### **Size Asymmetries: Regional Trade**

Smaller economies benefit disproportionately from a trade agreement that on the one hand ensures preferential access to large regional markets but on the other are more vulnerable to agreement imperfections owing precisely to their increased exposure to regional trade. The heightened exposure of smaller economies to regional trade arises from two main factors: (a) their economies are more open because less diverse resources create greater specializa-

tion; and (b) the fraction that regional trade represents is greater because regional trade partners are more economically relevant than the rest of the world. These factors are clearly verified in the case of MERCOSUR (see Table 2.1).

In this context, an imperfection in the trade agreement is any factor that adds a cost to transborder

trade. A clear example is the uncertainty with respect to the real effective exchange rate in MERCOSUR (and its possible ruinous consequences for export activities). The macroeconomic asymmetry discussed in the previous section generally ends up being more costly for smaller economies owing to greater regional trade exposure. From this standpoint, the consequence is that a lack of exchange-rate coordination implies a greater cost for smaller economies. According to this perspective, the deepening of integration toward a monetary union (on the realistic basis of an agreement between Brazil and Argentina with the adherence of Paraguay and Uruguay) could be of less interest to the bigger countries whose agreement is required.

The effects of exchange-rate coordination in MERCOSUR are shown in simulations of volatility (see Table 2.2) of the real effective exchange rate by country if all countries were to implement the use of the Brazilian real or the SUR (the average weighted value of the currency basket for all four countries). These simulations assume that the real effective exchange rate of these currencies will have remained constant over the observed period. These scenarios go beyond the coordination involved in a monetary union (a common currency allowing constant nominal exchange rates among member countries) and assume effective monetary coordination (constant real effective exchange rates among member countries), which completely eliminates intra-MERCOSUR effective exchange-rate volatility. These scenarios are also compatible with the supposed monetary leadership of bigger countries.

Given the heightened exchange-rate instability experienced by larger countries during the period associated with the collapse of overvalued fixed-type exchange regimes, it is worth noting that a monetary union inheriting such instability would not necessarily have benefited smaller countries. Under simi-

**Table 2.1 Indicators of Size and Trade, 2006**  
(percent)

	Size <sup>a</sup>	Openness <sup>b</sup>	Regional Bias <sup>c</sup>
Argentina	18	39	25
Brazil	79	26	9
Paraguay	1	79	43
Uruguay	2	57	46

a. National GDP as a percentage of total MERCOSUR GDP.

b. (Exp + Imp)/GDP.

c. (Regional Exp + Imp)/(Total Exp + Imp).

**Table 2.2 Volatility of the REER**

	Argentina	Brazil	Paraguay	Uruguay
Actual	0.077	0.055	0.026	0.030
Brazil as reference <sup>a</sup>	0.038	0.048	0.024	0.031
MERCOSUR average as reference <sup>b</sup>	0.029	0.037	0.018	0.023

Note: Vol = {Stdev [ln(TCR)<sub>t</sub> - ln(TCR)<sub>t-5</sub>] / {(5)<sup>1/2</sup>}}

a. Brazil's extra-MERCOSUR real exchange rate was taken as reference.

b. A weighted average real exchange rate of MERCOSUR was taken as reference. (It measures the size of an individual country's trade in relation to overall regional trade.)

lar conditions, despite the fact that smaller countries benefit most from coordination aimed at eliminating intra-MERCOSUR exchange rate-volatility, the resulting transfer of instability originating in large countries tends to predominate in the scenarios illustrated in Table 2.2. In fact, during these experiments, smaller countries benefit little or not at all (while Argentina improves substantially by avoiding the convertibility regime and its collapse). These simulations illustrate that, beyond the cost MERCOSUR countries incur of losing monetary autonomy to attend an economic cycle by adhering to anchor currencies within a monetary agreement, exchange-rate coordination would not even constitute a guarantee of greater global exchange-rate stability if these anchor currencies have high real exchange-rate volatility. Anchors ought to be steady.

In addition to the exchange-rate issue, any barrier to cross-border trade is also an imperfection that proportionally affects smaller economies. It does so in the form of rules of origin, regulatory considerations, or any other impediments to free transit (including the lack of credibility with regard to fulfilling agreements). By the same token, the same is true of deficiencies in physical or financial infrastructure.

These imperfections in the integration agreement are, in all cases, potential motives for nonconformity within smaller economies. However, while becoming a challenge to the status quo, they are also a motive for the understandable interest that these smaller economies have in advancing seriously toward deeper integration. In this sense, the size asymmetry in regional trade is a positive challenge for the integration agreement: smaller countries that are unsatisfied with the status quo presumably have an interest in deepening regional integration.

### **Size Asymmetries: Regional Investment**

As with trade, a deep integration agreement—one that creates a common economic space in MERCOSUR—represents a valuable development opportunity for smaller countries. In fact, smaller countries can produce goods with larger economies of scale to supply the whole region, provided that (1) local production is competitive in terms of comparative advantages and (2) transportation costs are limited. Efficient localization in small economies can occur in the presence of investment subsidies drawn either from national industrial policies that intend to capture positive externalities, or even from the very existence of such public subsidies. (See Fernández-Arias, Hausmann, and Stein, 2001, regarding the efficiency gains arising from competition on investment.) In this case, the only issue that needs to be addressed is the coordination of limits on investment subsidies in MERCOSUR with the purpose of limiting global fiscal costs and therefore maximizing global net benefits.

This result assumes that all countries have sufficient financial muscle to support the subsidies of such industrial policies; otherwise countries with comparative advantages may possibly not be able to attract investment, and investment localization may prove to be inefficient. Disparities in fiscal and financial capacity can be addressed by a regional finance agency that levels out financial resources for national promotion policies. But a compensation system is needed, if the countries want to implement the optimal mechanism (one suggested

by Fernández-Arias, Hausmann, and Stein, 2001) that maximizes the net benefits of foreign investment localization within an economic union (even in the absence of financial restrictions on industrial policy). This compensation system would distribute the benefits among those that are not recipients of the investment, keep the incentives aligned, and avoid subsidy wars that might damage the union.

In other words, in addition to disparities in the financial power to attract investment, disparities in economic structure among MERCOSUR countries (discussed below) justify the need for a compensation mechanism in favor of the countries less attractive to foreign investment, even in the case of an economic union that is free of trade imperfections.

The integration imperfections discussed in the previous section, however, substantially modify the premises that adequate national industrial policies lead to the efficient localization of investments. In particular, trade barriers could have a major negative effect on investment localization causing efficiency losses in smaller economies. Indeed, the existence of a border cost ( $f > 0$ ) impacts private and social investment returns asymmetrically, depending on the market size of the country in which such investment is established, to the detriment of smaller economies. As we discuss later, this effect can favor the location of the investment in the larger country, even though production costs are lower in the smaller country.

To simplify matters, let us suppose the economies of scale are such that production occurs in a single plant, located either in the smallest or largest country, and that transportation costs are zero. Even when production costs are lower in the smaller country ( $c < C$ ), the effective cost of production for the export market can be greater than the one for local market production ( $c + f > C$ ). Of course, the border cost is also an additional cost for whoever produces in the larger country and exports to the smaller country, but this extra cost is less important to the producer because it is applied to a smaller volume of production. In effect, if the volume for the smaller market is  $m$  and the volume for the larger market is  $M$ , the effective production cost of the firm is  $c + pf$  and  $C + (1 - p)f$ , respectively, where  $p$  is the ratio of the larger market to the total regional market, meaning that  $p = M/(m + M)$ .

If the disparity in market size is sufficiently large—that is, if  $p$  approximates 1 (which is certain for MERCOSUR in the case of Paraguay and Uruguay)—then the effective cost in the smallest country is higher than it is in the largest country [ $c + pf > C + (1 - p)f$ ]. According to analysis provided by Fernández-Arias, Hausmann, and Stein, this shows the smaller economy as being less productive, thus implying that this inefficiency cannot be solved through industrial policy. As integration deepens (when  $f$  approximates zero), obviously, this situation can be avoided.

A similar phenomenon is observed in the economic geographical analysis of the advantages of market access and location in high-density activity poles, to the extent that the larger country has development poles with those characteristics (Duranton and Puga, 2005). São Paulo is a good example, as a pole of attraction for MERCOSUR enterprises. These forces of agglomeration reinforce the attraction of physical and human capital induced by the trade imperfections analyzed above. It is noteworthy, however, that despite border or trade costs, investment (and labor force) migration produced by agglomeration could be an efficient result. Consequently, instead of trying to impede localization of production factors where they

are most productive, compensation could be used to redress the damage to GDP sustained by a smaller country.<sup>5</sup>

In any case, the equilibrium between the agglomeration and dispersion forces (which are generated by the market because of the congestion and pressure of low-mobility production factors) depends on the degree of commercial integration. In that sense, it continues to be valid to assert that the deepening of trade integration is the remedy for the flight of capital and labor from smaller countries (Venables, 2005).

The issue of what happens with the localization of economic activity inside each member country relates to the previous one. For example, the economic geography models developed by Fujita, Krugman, and Venables (1999) analyze the matter from the point of view of a country integrating with the rest of the world. As mentioned above, centripetal forces tend to concentrate economic activity (for example, companies benefit from their proximity to downstream suppliers and upstream consumers). Centrifugal forces tend to disperse economic activity (that is, congestion). As integration advances, the equilibrium is achieved by a weakening of the relative weight of centripetal forces. This is because a larger proportion of company inputs ends up deriving from imported goods and a greater portion of sales is destined to other countries.

This effect reduces concentration and the resulting argument is used to explain the reduction of industrial concentration observed in Mexico City after the signing of NAFTA (Hanson, 2005), suggesting that a deepening of integration and greater openness of MERCOSUR to the world would erode productive concentration poles.

Although these models generally anticipate a decentralization of industry from the center to the periphery, this does not mean that economic activity is distributed homogeneously throughout the territory. In fact, the second prediction made by these models is that economic efficiency drives regions to specialize in specific industries, which leads to unbalanced development that favors some regions over others. For example, empirical evidence taken from the case of the European Union indicates that regardless of the convergence observed between countries, there is a trend towards income disparities across regions within countries (see Duro, 2001, and Puga, 2002).

MERCOSUR countries show a trend toward increased inequalities in cross-regional income within each country, with the exception of Brazil where it has remained fairly stable (see Figure 2.3).

Without denying the need for a more detailed analysis to ascertain the degree to which the integration agreement has caused these trends (which at any rate may be compatible with economic efficiency), it is important to recognize that the trends can be intensified by a deepening of MERCOSUR. Further, they might provoke tensions inside each country—tensions that would weaken their political will to proceed with the integration process. This is another reason

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<sup>5</sup> There are other pertinent areas of policy coordination, such as the harmonization of industrial and tributary policy. Asymmetries in these areas of microeconomic policy are also challenges to integration. See Chapter 7 in reference to industrial policy and Chapter 8 on tax harmonization.

for thinking of compensation mechanisms or supports that facilitate the transition toward a new economic geography.

### Extraregional Comparative Advantage Asymmetries

Like all other regional trade agreements, MERCOSUR creates a certain degree of trade diversion. The relevance of this cost is that it can be distributed asymmetrically, depending on the comparative advantages each country has inside and outside the trading bloc. These costs can easily exceed the benefits of individual country trade development, resulting in a core challenge to integration.

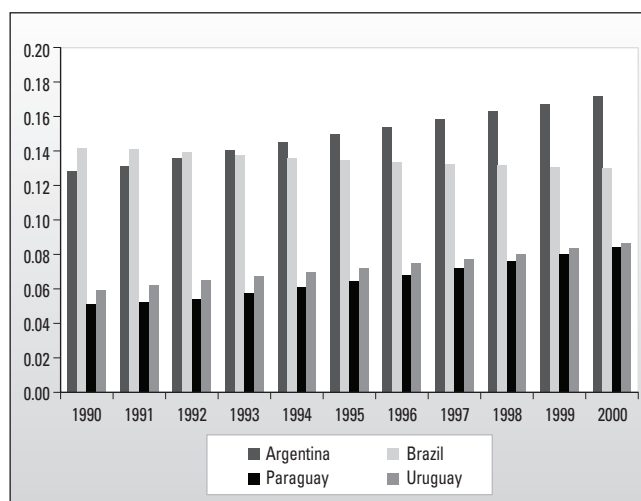
The productive profiles for MERCOSUR countries are highly asymmetrical (see Figure 2.4, which shows level decompositions of production factors as a percentage of those for the United States, based on calculations found in Blyde and Fernández-Arias, 2005). Paraguay is ostensibly the poorest country. In particular, its capital per worker and total factor productivity are significantly inferior. In comparison with Argentina and Uruguay, Brazil has factors of production that, on average, are less developed. The country's size allows it, however, to have diversified industrial segments of production, an export basket that includes sophisticated products such as airplanes, and a development pole such as São Paulo with a per capita income equivalent to that of developed countries.

It is believed that in South-South agreements such as MERCOSUR, countries that are relatively poorer absorb greater trade-deviation costs (Venables, 2003, 2005). Should this belief be confirmed, this disparity not only would lead to a potentially unbalanced distribution of net trade benefits in favor of weaker partners but would also imply an important asymmetry of incentives relative to opening MERCOSUR to the world: the poorer countries have more to gain from agreements with the North. The rich countries would rather extend the agreement further to countries in the South.

More in-depth studies are needed to determine how to apply this analysis on comparative advantage disparities to the context of MERCOSUR countries, but it seems clear that Paraguay is on the lower end of the scale of competitive advantages. Brazil is not the richest MERCOSUR country. Nevertheless, one can argue that because it is less specialized and has a production offer marginally similar to those of the rest of the world, the other countries in the bloc are likely to see their imports from developed countries diverted to Brazil. Moncarz

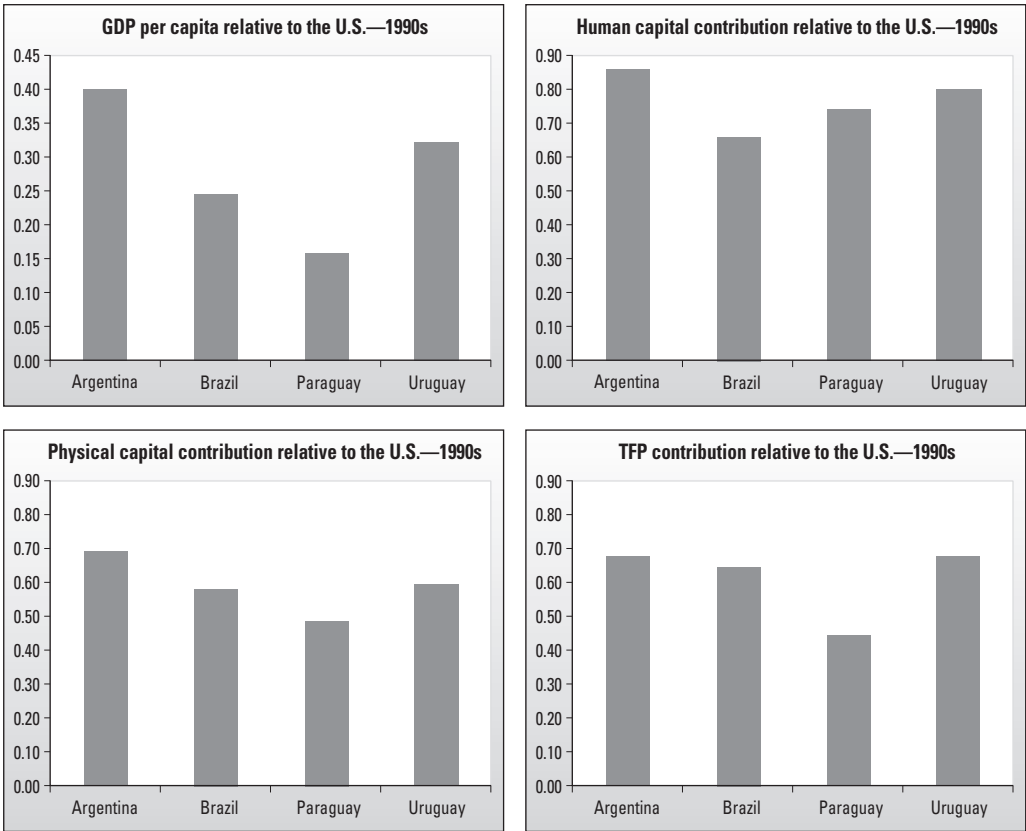
**Figure 2.3. Subnational Income Disparities**

*(Theil index based on per capita GDP at state and provincial levels)*



Source: Blyde (2006).

**Figure 2.4. Decomposition of Production Factors in MERCOSUR Countries as a Percentage of Those for the United States**



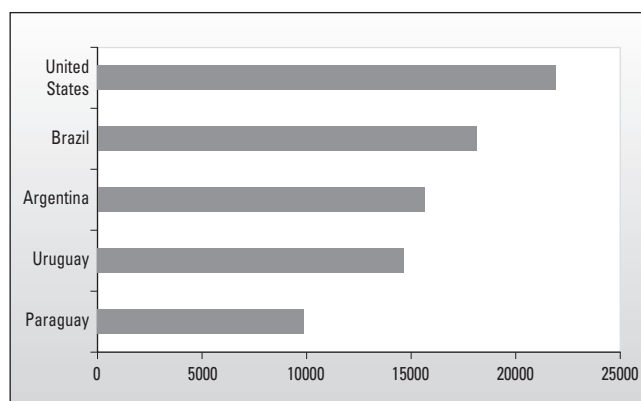
and Vaillant (2007) set forth empirical evidence to support this trade-deviation pattern. If their finding is accurate, efforts to protect MERCOSUR from competition with developed countries would favor Brazil. In any case, the main point is that disparities in the structure of comparative advantages among members lead to major differences in the distribution of net benefits and in the incentives to deepen the agreement, especially its openness toward other agreements with developed countries.

Analysis of MERCOSUR country export baskets indicates that the comparative advantages in relation to the United States can be ranked as noted previously: Brazil, Argentina, Uruguay, and Paraguay. In fact, the Spearman rank correlation coefficient for export vector values between MERCOSUR and the United States (with six-digit products) is, respectively, 0.56, 0.53, 0.32, and 0.27. In addition, a methodology similar to that developed by Hausmann, Hwang, and Rodrik (2006) for measuring the level of sophistication of exports on the basis of their similarities with the export baskets of wealthier countries (as measured by GDP per capita) corroborates these findings (see Figure 2.5).

Note that the treatment of asymmetries implemented to date in MERCOSUR is consistent with the stated problem. For example, one measure granted Paraguay and Uruguay greater exceptions on the common external tariff (CET). This measure can be justified as a way to avoid the costs of trade deviation, which, as we noted earlier, could translate disproportionately to smaller economies. But this way of addressing asymmetries through mechanisms

(including tariffs on extra-zone imports of goods other than the CET) generates the need for origin requirements and customs controls that limit the ultimate objective of the integration process, which is the free movement of goods. In this way, the instrument chosen to address the asymmetry introduces a distortion, as a consequence of origin requirements, by increasing the transaction costs of the expanded market (Sanguinetti, 2007).

**Figure 2.5. Sophistication Level of Exports of United States and MERCOSUR Countries**



Source: Authors' calculations based on the methodology by Hausmann, Hwang, and Rodrik (2006).

## Final Reflections: Bargaining Power Asymmetries

The premise here is that promoting sustainability and deepening integration is viable only to the extent that the global gains of the agreement are distributed equally among its members, so that all parties have an interest in moving forward through mutually beneficial actions. This study has shown how certain structural and macroeconomic policy disparities go against this objective. The main concern of this chapter is not the fairness of the agreement but rather the corrosive consequences that these disparities have for the collective will to deepen the agreement and open MERCOSUR to the world.

The lack of exchange-rate policy coordination among member countries implies that the conditions for regional trade profitability are highly unstable, which creates barriers to regional trade integration. In general, this lack of monetary coordination constrains global trade and financial openness, especially for smaller countries, which are more dependent on MERCOSUR and consequently suffer regional exchange-rate instability in greater measure. In addition, from the perspective of more stable countries, exchange-rate coordination and monetary union imply a loss of national monetary autonomy and the risk of importing instability. There appears to be room to create preconditions for greater coordination, which may give way to the coordination of macroeconomic policies for fiscal and public debt issues.

The huge disparities in size between MERCOSUR member countries create different sensitivities about imperfection in the regional trade agreement. Smaller economies are pre-

dominantly more open to MERCOSUR and therefore suffer imperfections in regional trade to a greater degree (for example, obstacles and unpredictability) and have greater incentives to deepen the agreement (by eliminating obstacles and consolidating predictability). These imperfections have particular impact on the localization of investments because a more segmented trade in MERCOSUR benefits larger national markets. Likewise, the imperfections of the movement of production factors within MERCOSUR—labor, for example—could impair the larger economies insofar as they have development poles that can seize on advantages of agglomeration. In principle, in all cases, the elimination of trade imperfections would be efficient and allow gains for the bloc, but a deepened agreement may require that the losers be compensated so that in the end everyone wins.

Disparities in economic structure and comparative advantage across countries involve (1) the unequal distribution of customs union net benefits and (2) incentives that are not aligned with respect to negotiating as a bloc with the rest of the world. Because MERCOSUR is a South-South agreement, it is expected that with respect to the gains from trade specialization it will generate large trade diversion costs to smaller partners. These are less competitive with the Northern Hemisphere and consequently give greater net benefits to those members that are most competitive with the North. Although negotiating as a bloc benefits MERCOSUR as a whole, it still requires a mechanism for distributing the benefits among partners, one that encourages all members to move forward collectively toward actions that benefit the group and make efficient use of the bloc's bargaining power.

How does one implement a system that neutralizes the adverse effects of these structural disparities on integration and allows MERCOSUR members to negotiate and come to agreement? The great asymmetry in the bargaining power of MERCOSUR's four member countries derives from their respective sizes, which confer disparate economic power for reasons examined above. For the smaller countries, this asymmetry is relevant because cohesion grants them greater bargaining power when negotiating with the rest of the world. At the same time, this asymmetry represents an important challenge for regional integration to the extent that the bloc's decision-making process is not subject to an institutional design that guarantees that smaller partners are adequately taken into account when their interests do not coincide with those of larger partners.

MERCOSUR's institutional design has intergovernmental rather than supranational features. The agreement's institutions were created so that national governments could keep control over the process of integration while relinquishing some autonomy and discretion. An example is the system for the creation of norms, which adopted a procedure that gives national authorities a second veto opportunity. The governance structure of the bloc involves weak and barely independent regional institutions, which is a response to asymmetries among the countries. For instance, owing to the size asymmetries between countries, there are few incentives for the larger countries to develop institutional mechanisms that imply the surrender of autonomy when the alternative is to lend weight to bargaining power in casuistic negotiations. The collective will to strengthen MERCOSUR institutions will require strategic vision from its leaders, which should recognize the limitations of the current system.

Continuous renegotiations, observed a number of times in MERCOSUR, not only fail to guarantee the balanced outcome required to deepen integration but also impose additional costs. In fact, such a process creates uncertainty and impedes larger countries from committing to respect the collective interests of arrangements that with time are altered through renegotiation. Both these factors corrode the predictability needed for deeper trade integration. The enormous asymmetries that exist in the bargaining power of MERCOSUR countries mean that an institutional design is fundamental. This institutional design bases decision making and conflict resolution on rules or independent bodies. These in turn grant the agreement greater stability and may guarantee the balanced distribution of gains so that the deepening of the agreement has win-win outcomes for all of its members.

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## PART II

### **Deeper Integration and Economic Disparities**

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## **Regional Disparities in Regional Blocs: Theory and Policy**

*Anthony J. Venables*

### **Introduction**

Policy makers in regional blocs have long been concerned that regional integration might be associated with widening disparities among member countries or subregions. In Europe, Italian concerns about the threat that integration posed to the Mezzogiorno led to the establishment of the European Investment Bank (EIB) in the 1950s, with an obligation to contribute to regional development. A regional directorate was added to the European Commission in 1974, and regional policy now accounts for over a third of spending in the European Union (EU). The EU's historical record shows considerable convergence of per capita income levels among countries, although the record is patchy (Greece's performance, for example, compared to Ireland's). In many countries, internal regional disparities have widened at the same time as intercountry disparities have narrowed. Elsewhere in the world, a number of developing and middle-income regional blocs have experienced strains because of the perception that gains are accruing to one region rather than—or even at the expense of—others. The Southern Common Market (MERCOSUR) is now alert to these possibilities.

This chapter explores the forces that may create disparities within a regional bloc, and assesses their policy implications. The thesis is that it is quite possible for regional integration to create disparities. Indeed, it can be expected to promote differences in countries' economic structures, affecting differences in factor prices and income levels. But the policy response to such integration-induced disparities is, loosely stated, more integration. This may sound contradictory, but it is based on the idea that disparities are most likely to develop when some—but not all—barriers to trade or factor mobility are reduced.

There is no existing unified theory or evidence base concerning the effect of regional integration on disparities among member countries subregions. This chapter develops a number of arguments in a series of related models, and focuses on four main mechanisms. The first mechanism is that, even when all countries gain from trade, trade liberalization will change factor prices and may cause them to diverge. This in turn can induce factor mobility, such that a country or region may experience a decline in per capita income. The second mechanism arises from the logic of trade diversion. Preferential trade liberalization brings with it

the costs of trade diversion. If these are unevenly distributed among member countries, it is possible that inequalities will increase and that some regions will suffer a real income decline. The third mechanism concerns the location of firms in imperfectly competitive industries. Locations with good market access will tend to attract firms—a circumstance that can cause disparity. Finally, the chapter addresses cumulative causation mechanisms. From the early work of Perroux (1955) on “growth poles” to recent work on geographical economics, the idea has persisted that regional integration might lead to a concentration of activity that favors established centers at the expense of the periphery.

This chapter reviews these mechanisms, in turn. Each of them may be more or less relevant to different contexts, and country experts will be able to judge their applicability to specific cases. The purpose of the chapter is to set out the arguments and thereby provide a tool kit to facilitate such analysis. All of the mechanisms discussed here suggest, in broad terms, a similar policy response: more trade liberalization might be the cure for integration-induced disparities. The formulation of detailed country- or region-specific policies, however, requires an in-depth analysis of local conditions that is beyond the scope of the chapter.

## Factor Prices and Factor Mobility

Deeply ingrained in the thinking of many economists is the idea that integration moves economies toward factor price equalization, so the effect of trade is to reduce any initial differences in factor prices. This result holds under well-known but extremely restrictive conditions.<sup>1</sup> If such conditions are absent, it is quite possible that trade liberalization will disequalize factor prices. Indeed, there is a powerful argument that factor price disequalization is quite likely. The argument is that, in a closed economy, the costs of an inefficiency in one sector are shared across the entire economy because they are reflected in goods prices. Once goods prices are determined in world markets, however, the inefficiency falls entirely on factors specific to the inefficient sector, so trade depresses returns to these factors. If trade triggers outflows of these factors, it may reduce the size of the economy concerned.

The relationship between trade and factor prices is sometimes stated in terms of the substitutability or complementarity of goods trade and factor mobility. If trade moves countries toward factor price equalization, then the relationship is one of substitutability. In this case, trade liberalization reduces the incentives for factors to move internationally (and, symmetrically, factor mobility would reduce the volume of trade).<sup>2</sup> Complementarity arises when trade increases international differences in the prices of mobile factors, thereby increasing incentives for factor movements.

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<sup>1</sup> These include the requirement that countries have identical technologies, and that there are at least as many traded activities (goods or mobile factors) as there are immobile factors.

<sup>2</sup> Markusen (1983) poses the question of complementarity/substitutability in terms of the effects of factor movement on trade flows. There is an exact mathematical symmetry between the effect of goods prices on factor prices and the effect of factor movements on trade.

Under what circumstances might there be a complementary relationship between trade and factor mobility, such that economic integration causes flight of the mobile factor? This may be thought of as capital flight, covering both physical and human capital, and it will be seen that it can occur in a country that has comparative disadvantages in the capital-intensive sector. In this case, trade depresses the return of capital and thus (in the absence of factor price equalization) may lower it below that of trading partners. This section explores two possible reasons for this comparative disadvantage: the first is based on endowment differences between trading countries, and the other on technical efficiency differences.

Both of these cases are developed using the simplest possible specific-factors model. There are two goods: manufacturing and agriculture. Manufacturing uses capital and labor, while agriculture uses land and labor. This is the usual specific-factors structure of one factor (labor) that is mobile between sectors, while the other factors are sector specific. For simplicity, the focus here is on a small country that has a large trading partner. Furthermore, it is assumed that this country has Cobb-Douglas preferences and technologies and is symmetric, so the share of capital in manufacturing is the same as the share of land in agriculture. These assumptions are not necessary to the argument, but they facilitate it.

The first case rests on the country being land abundant, relative to its trading partner. What is the impact of integration on this land-abundant economy? In an initial situation in which trade barriers are large enough to prohibit trade, the country (small and land abundant) has a lower price for agriculture relative to manufacturing, and a lower land price than the partner country. Real wages and returns on capital are higher, since the benefits of the additional land (relative to other factors) are passed on to the other factors.

As trade barriers fall, the relative price of agriculture increases. The country becomes an exporter of agriculture, and labor is reallocated from manufacturing to agriculture. As this happens, the wage increases and the return on capital therefore falls. Furthermore, it must be the case that the return on capital now falls below that of the partner country.<sup>3</sup> Factor price equalization does not take place because there are more nontraded factors of production than there are traded goods, and the economy's land abundance translates into a relatively high wage, putting owners of capital at a disadvantage.

What if capital mobility is now allowed? Capital flows out of the country, reducing the wage and raising returns on the specific factors. The tradability of capital gives factor price equalization, but only by means of capital outflow. The upper half of Table 3.1 gives illustrative numbers for the symmetric Cobb-Douglas economy in which the share of labor in each sector is two-thirds. All numbers are expressed relative to the case in which the country under analysis differs from its partner only by a scale factor (and therefore has the same prices). Under autarky, this land-abundant country has a lower price of land, but higher prices of other factors and higher real domestic income. Free international trade (without capital mobility) raises the return on land, but reduces the return on capital. Allowing capital mobility achieves factor

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<sup>3</sup> The price of land remains relatively low in the land-abundant economy. Since the price of agricultural output is the same in both countries and equal to average costs, the wage in the land-abundant country must be relatively high. Manufacturing is competitive at this wage only if the return on capital is low.

price equalization, but this occurs through capital outflow. The economy becomes somewhat smaller and the wage somewhat lower than in the initial autarkic situation. This recalls the literature on Dutch disease. Land is a source of initial advantage and there are gains from trade, as there have to be in this perfectly competitive economy. The combination of trade and factor mobility, however, gives rise to “deindustrialization,” reducing domestic income to below its initial level. Of course, if national residents are owners of the capital that is now employed abroad, then national income is greater than domestic. Alternatively, the mobile factor may be human capital, so the loss of capital is associated with a loss of skilled labor.

The potential effect of trade in disequalizing factor prices can be seen even more clearly if the country’s comparative advantage in agriculture derives not from a large land endowment but from a low level of technical efficiency in manufacturing. Under autarky, this inefficiency is divided among all factors. The price of manufacturing is raised and, in the symmetric example, all factors experience an identical reduction in real income, as illustrated in the lower part of Table 3.1. Conditions are dramatically different once trade occurs. As before, the relative price of manufacturing falls and labor moves out of the sector, thus reducing the real return on capital while raising the returns on land and labor. In the example, a 10 percent efficiency difference causes the return on capital to fall to 20 percent below that of the partner country while, before trade, it was only 5 percent below. Adding international capital mobility now causes a large outflow: in the example, two-thirds of the country’s capital stock has to leave in order to yield a rate of return equal to that of the partner country. Both the wage rate and total income fall from just 5 percent below those of the partner country to 15 percent below.

This second example clearly demonstrates how trade concentrates the cost of a technical inefficiency previously dispersed throughout the economy. Once the cost is concentrated in a mobile factor, the factor may relocate, and its outflow reduces wages and income. Other mechanisms could produce the same effect. A subsidy to the agricultural sector, for example, would tend to raise land rents and wages, and reduce the return on capital. Inefficiency in manufacturing could arise from a geographical disadvantage if, for instance, manufacturing

**Table 3.1 Factor Price Disequalization and Capital Flight**

	Real Wage	Real Return on Land	Real Return on Capital	Capital Stock	Real Domestic Income
<b>10% more land endowment</b>					
Autarky	1.0160	0.9236	1.0160	1	1.0160
Trade	1.0164	0.9680	0.9680	1	1.0164
Trade and capital mobility	1	1	1	0.9	1
<b>10% lower efficiency in manufacturing</b>					
Autarky	0.9487	0.9487	0.9487	1	0.9487
Trade	0.9526	1.1021	0.8032	1	0.9526
Trade and capital mobility	0.8539	1.3722	1	0.336	0.8539

*Note:* Symmetric Cobb-Douglas economy, labor share each sector = two-thirds. All values expressed relative to a situation in which the country has the same technology and relative factor endowments as its partner.

requires inputs imported from parts of the world where they are more expensive than in the partner country.

The point of these examples is to show that it is quite possible, even in a “perfect” economy with no distortions of any sort, for trade liberalization to change factor prices in a way that causes capital outflows and income reductions. What about policy responses to this kind of trade-induced disparity? There are no market failures in this model, so from the viewpoint of the trading bloc as a whole, any attempt to restrict trade or factor mobility would be a source of inefficiency and real income loss. A better policy arises from thinking about the logic of factor price equalization, which requires that there are at least as many traded goods as there are immobile factors. In the examples outlined above, trade by itself does not secure factor price equalization because not enough things are traded—there are three nontraded factors and only two traded goods. Trade causes sectors with comparative disadvantage to contract, and the factors released encounter diminishing returns as they are redeployed in other sectors. The more alternative tradable activities there are, the less likely it is that reemployment of factors will run into diminishing marginal returns. The policy response is to therefore make more goods tradable before liberalizing the mobility of factors.

How this works becomes apparent if it is assumed that manufacturing production can be fragmented into parts, such as components and assembly, each of which is separately tradable and has different factor intensities. A low price of capital (human or physical) would then attract the capital-intensive production fragment, raising the price of capital. Making more things tradable would therefore have a direct, efficiency-enhancing effect (the usual gains from trade) and would also reduce factor price disparities and the incentives for factors to move.

In practical terms, this idea indicates the importance of diversifying export sectors before liberalizing factor mobility. The experience of some European countries is instructive. For example, Ireland suffered significant outflows of skilled labor that could not be employed in a manufacturing sector that was weak compared to its trading partners in a customs union (first with only the United Kingdom, and then with the EU as a whole). Only after Ireland strengthened its manufacturing sector in the 1990s, mainly through inflows of foreign direct investment (FDI), was the brain drain reversed.

In summary, therefore, this section shows that even without any market failures, it is possible for trade to disequalize some factor prices. If regional integration also increases the mobility of factors, then countries or regions may experience factor outflow, with negative consequences for the incomes of some of the remaining factors. Whether this occurs depends on the patterns of factor endowments, technical differences, and goods tradability. Should it occur, the policy response is to widen the range of products for which trade is liberalized and trade flows occur, in an effort to drive the region toward factor price equalization.

### **Whose Trade Is Diverted?**

The second argument hinges on an imperfection at the heart of preferential trade liberalization: trade diversion. The point of departure for analysis of preferential trading arrangements is Viner’s (1950) study of trade creation and trade diversion. His analysis shows that while a

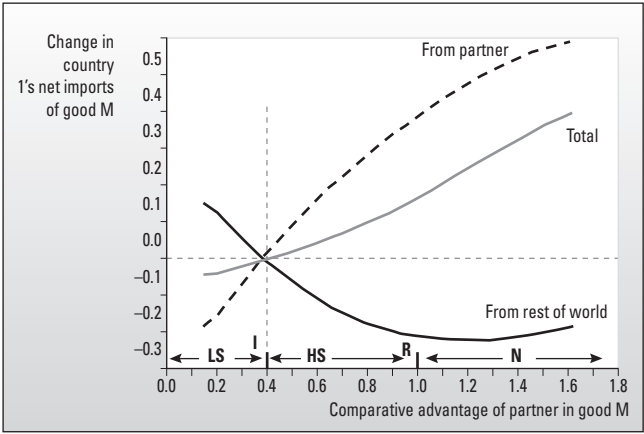
reduction in tariffs with all trading partners *increases* welfare, a preferential reduction affecting only partners in the regional integration agreement (RIA) may *reduce* welfare. The reason is that, in addition to creating trade, such a tariff change would also tend to divert it, possibly causing import supply to switch from the lowest-cost source to a higher-cost partner country whose exports benefit from preferential market access.

In general, the costs of trade diversion will be uneven across members of an RIA. In particular, in an RIA between developing or middle-income countries, the poorer countries bear the costs of diversion, and thus the initial income disparities are magnified. The argument is based on Venables (2003) and outlined below.

As a framework for thinking about this, suppose that there are three countries. One is large and represents the world average, and the other two (countries 1 and 2) are those that are considering forming an RIA. The analysis here concentrates on country 1 and refers to country 2 as the partner. Country 1 is assigned a particular comparative advantage and a range of different potential partners are examined. The horizontal axes in Figures 3.1a and 3.1b give all possible partner types, ranked according to their comparative advantage. At the right-hand end of this axis are high-income northern partner countries, whose endowment (abundant in human and physical capital) gives them a comparative advantage in a composite of goods here called M. At the left-hand end are low-income southern countries with comparative advantage in another good, called A. Country 1 has comparative advantage fixed at point I, and the world average is at point R. Thus, if the partner is at point I, the two countries in the RIA have the same comparative advantage. If the partner is in range N, then country 1 forms an RIA with a high-income northern partner. If the partner is in range HS, then country 1 forms an RIA with a higher-income southern country. In the range LS, the partner is lower-income than country 1.

The vertical axis of Figure 3.1a features (as a function of the partner country's comparative advantage) the change in country 1's net imports of good M from the rest of the world, from the partner, and in total. If country 1 forms an RIA with a partner in set N, it will experience a large increase in imports of good M from the partner, as indicated by the dashed line, and a fall in imports from the rest of the world, as indicated by the lower solid line. Total imports increase (and so, correspondingly, do exports of good A). There are unambiguous welfare gains to country 1 from this change in trade, since it is an increase in imports of good M from a

**Figure 3.1a. Trade Creation and Diversion with Different Partners**



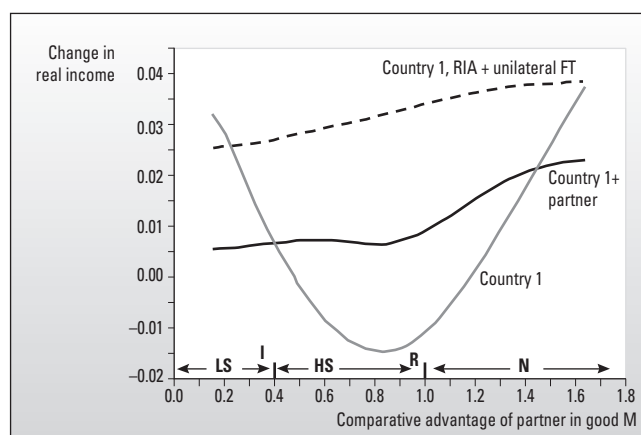
country that has a comparative advantage in good M, relative to country 1 and relative to the rest of the world.

If the partner's comparative advantage is in set HS, then the qualitative change in the direction of trade is similar, since it is determined by the partner's comparative advantage relative to that of country 1. There is an increase in imports from the partner, a fall in imports from the rest of the world, and an increase in overall imports of M (and exports of A). The welfare economics, however, is quite different. A partner in HS has a comparative advantage in good M relative to country 1, but a comparative disadvantage in this good relative to the world. Since it displaces imports from the rest of the world, this is an example of Vinerian trade diversion that reduces real income. Preferential treatment is causing country 1 to divert the sourcing of its imports from the rest of the world (the lowest-cost source of supply) to country 2.

What if the partner is a country with comparative advantage in set LS? In this case, country 1 has a comparative advantage in good M, relative to partner country 2, and will increase its exports of good M to country 2, evident as a reduction in net imports. Since country 1's increased exports of good M to country 2 raise the price of good M in country 1, there is also an increased flow of imports of good M into country 1 from the rest of the world. This improves welfare because country 1 still has a tariff on these imports.

The welfare effects of these changes are illustrated in Figure 3.1b (giving full general equilibrium welfare effects, including changes in trade in good A). The U-shaped solid line is the change in country 1's welfare, and reflects the discussion above. There are gains from forming an RIA with a northern country, as country 1 expands its imports from a country with comparative advantage relative to country 1 and relative to the rest of the world. Turning to South-South agreements, country 1 is likely to gain if it is the intermediate country, but lose if it is the extreme one. Thus, if the partner is in range LS, country 1 gains as it increases imports of good A from the partner, which has world comparative advantage in this good. But if country 1 is extreme, so that its partner (in HS) lies between it and the world average, then trade diversion occurs, bringing welfare loss to country 1. Intuitively, country 1 is vulnerable to trade diversion when its partner has comparative advantage between that of country 1 and that of the rest of the world.<sup>4</sup>

**Figure 3.1b. Real Income Change**



<sup>4</sup> The other solid line in Figure 3.1b gives the welfare change of the RIA as a whole. For South-South agreements, one of the countries has to be extreme, experiencing diversion, and thus the RIA as a whole gains little. For North-

The main point of this analysis is that it is always the extreme country that is prone to diversion. Thus, a South-South integration scheme tends to increase any existing income differentials between the two countries, since it is the poorer of the member countries whose trade is diverted to a partner that is intermediate between it and the world average. The opposite is true for a North-North integration scheme: the extreme country is the one with the higher income, and its imports are diverted to come from the intermediate country.

It is also noteworthy that in a South-South agreement, the production structure of the country that does better (the intermediate country) moves in the opposite direction from what would happen with external trade liberalization. This occurs as it exploits its comparative advantage over the poorer country, not over the rest of the world. In terms of the static model outlined here, this is not in itself damaging to real income. But it is clearly problematic in a dynamic setting where regional integration is a way of developing the capacity or efficiency of export industries, perhaps before broader trade liberalization. The wrong sectors are being developed.

The policy response to these problems is evident. External trade liberalization will reduce the potential for trade diversion, the root of the problem. The dashed line in Figure 3.1b gives the effect on country 1's income of forming an RIA and implementing unilateral free trade with the rest of the world. This is beneficial, as it must be for small countries in a perfectly competitive setting. Once again, the problem is with partial trade liberalization, in this context preferential, rather than most-favored-nation (MFN) reductions in trade barriers. Wider liberalization removes trade diversion and the disparities that it creates.

## Market Access and Industrial Location

Further insights into regional disparities come from analyzing the location decisions of individual firms. These decisions are guided both by factor costs and by proximity to consumers (market access). Trade liberalization changes the geography of market access and thereby induces changes in the location of firms, with consequences for factor demands, incomes, and regional disparities. This section continues to outline the forces at work, then discusses possible policy responses.

The basic structure is a model with two sectors. One is perfectly competitive (often referred to as "agriculture"). The other is monopolistically competitive and contains firms that produce with increasing returns to scale and that set price in excess of marginal cost ("manufacturing"). Firms engage in intraindustry trade, with each firm supplying all countries, although transport costs skew firms' sales toward their home market. The standard workhorse model for analyzing this is the Dixit-Stiglitz (1977) model of product differentiation and monopolistic competition, although other forms of oligopolistic interaction are possible. It is well known that in such models, firms have a bias toward locating in a region with good market access. Thus, if two regions or countries are identical except that one is  $k > 1$  times

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South agreements (partner to the right of R), the changes in trade are in line with global comparative advantage and the aggregate gains are considerably larger.

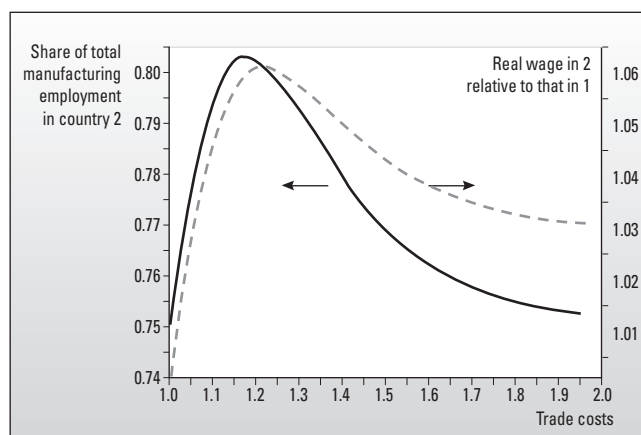
larger than the other, then (given transport costs between the regions) manufacturing production in the larger will exceed that in the smaller by a factor greater than  $k$ . Furthermore, this fraction will vary with the level of trade costs.

To aid understanding of the basic logic, the countries are labeled 1 and 2 and the latter is  $k$  times larger than the former. Could there be an equilibrium in which firms are located in proportion to the size of the countries, so 2 has  $k$  times more manufacturing firms than 1? If transport costs are prohibitively high, the answer is yes. Each market is supplied by only local firms, and the number of firms is proportional to the size of the market.<sup>5</sup> As trade costs are reduced, two things happen. First, the country 1 market comes to be supplied by a large number of importers, while the country 2 market is only supplied by  $1/k$  as many importers, thus reducing the profitability of producers in 1. Second, each firm in 2 will pay transport costs on only a small part of its output (sales to the small country 1 market), while firms in 1 will pay transport costs on a larger part of their output (sales to the larger country 2 market). Both arguments suggest that firms in 2 become relatively more profitable, implying that in equilibrium with free entry, the number of firms in 2 must exceed the number in 1 by a factor greater than  $k$ . The large country therefore has a disproportionately large share of manufacturing production, and is a net exporter of manufactures and importer of agriculture.

Note several more points about this argument. First, it holds only if transport costs lie strictly between zero and a prohibitive level. If transport costs are prohibitive, no firms ship any exports; autarky production has to equal local consumption and the location of industry is in proportion to the size of the countries. Conversely, if transport costs (and all other frictions) are zero, then obviously the argument collapses, since firms in all locations have equally good access to all markets. The argument shows that it is at intermediate levels of transport costs that manufacturing is disproportionately pulled into the large country or region.

What are the implications for factor prices? Unless factors are in perfectly elastic supply, the changes in demand for factors in manufacturing tend to raise factor prices in the larger country and reduce them in country 1. This is illustrated in Figure 3.2. The horizontal axis is the transport cost factor (a value of 1

**Figure 3.2. Relative Manufacturing Location and Real Wages**



<sup>5</sup> Notice that this argument uses the Dixit-Stiglitz property that all firms are the same size in equilibrium.

corresponding to free trade, and 1.5 corresponding to transport costs equal to 50 percent of the value of output). The left-hand vertical axis of the figure is the share of manufacturing in the large country, and the right-hand vertical axis is the real wage in this country relative to that in the small. In the example, the large country is assumed to be three times larger than the small,  $k = 3$ . Labor is the only factor used in manufacturing, while the other sector of the economy ("agriculture") uses labor and a specific factor.

Figure 3.2 shows both the pull of the larger market and the nonmonotonicity of this effect. The larger country gets a share of manufacturing equal to its share of income,  $(k/(1 + k) = 0.75)$  at free trade and at autarky, and its share peaks at transport costs of about 15 percent. A large manufacturing presence increases wages in the larger country, and several effects underlie the relative real-wage curve in the figure (the dashed curve). Real wages in country 2 are higher than those in country 1 under autarky because of a variety effect—the large country has more varieties on offer. At intermediate transport costs, the relative real wage in country 2 is further increased because of high labor demand created by the relocation of manufacturing. The magnitude of this effect depends on the elasticity of labor supply: the less elastic the supply, the greater the effect. If several primary factors are used in manufacturing, moreover, this may well amplify some factor price disparities. For example, suppose that a fraction of manufacturing costs is met by a factor in perfectly elastic supply (capital), with the remainder being labor. In this case, a similar divergence of firms' unit costs would be associated with a much larger divergence of wages, now only a fraction of unit costs.

As transport costs fall below the turning point, the wage gap narrows for two reasons. First, the strength of the market-access effect on labor demand declines. And second, as transport costs fall, so do the international differences in the consumer price index due to transport costs. In the limit of perfectly free trade, there is factor price equalization.

Application of the insights from this basic model requires a much richer geography than is presented in the two-location example. Consider, for example, the implications of one of the countries or regions containing a port that trades with the rest of the world. This region has good market access, but it also faces import competition. It will therefore tend to attract industry if comparative costs are such that the region is a net exporter of manufactured goods to the rest of the world. By contrast, if it is a net importer, local manufacturing will seek the natural protection of the region without the port. But the general point remains. The geography of market access is a force shaping industrial location and interindustry wage differentials.

Finally, what of the policy implications? As regional integration widens the income gap between countries, what might policy do? One possibility is to freeze manufacturing, for example, by using subsidies and taxes. Any self-financing scheme is inefficient and will certainly reduce aggregate real income compared to the outcomes described above. This follows from the fact that equilibrium in the Dixit-Stiglitz model is efficient, given the constraint that firms, in aggregate, earn zero profits. But the nonmonotonicity that this model exhibits points to the obvious policy conclusion. Inequalities are greatest when there is *partial* integration of goods markets, and are reduced by full integration. Of course, the policy maker does not know the exact level of trade costs at which a turning point in the wage schedule is

encountered. Furthermore, trade costs themselves are a complex mixture of barriers, some artificial—tariffs and border controls—and others real; costly investments are required to reduce these. Nevertheless, the fundamental logic of these effects is that, while integration can create disparities, further integration can reduce them.

## **Clustering and Agglomeration**

The most striking feature of MERCOSUR's economic geography is the presence of massive concentrations of economic activity, most prominently in the São Paulo region. An understanding of such centers requires analysis of the clustering and agglomeration forces that support them. The following subsection, "Clustering and Dispersion Forces," outlines these forces, and the subsection "Outcomes" returns to the effects of regional integration. Reducing trade costs facilitates clustering, inasmuch as it makes it cheaper to supply dispersed consumers from a single cluster of activity. At the same time, falls in trade costs might make it easier to move some activities out of clusters. Net effects are ambiguous; this part of the chapter discusses possible outcomes and policy implications.

### ***Clustering and Dispersion Forces***

Proximity facilitates many sorts of economic interactions and creates benefits from the clustering of economic activities. The preceding section showed how market-access effects cause firms to disproportionately locate in large centers of demand. This market-access mechanism can be amplified because demand for manufactured goods comes not just from final consumers but also from intermediates. A location with many firms has a high demand for intermediates, making it an attractive location for intermediate producers. And the presence of intermediate producers makes the location profitable for firms that use intermediate goods, since they economize on transport costs for inputs. There is thus a positive feedback between the location decisions of upstream and downstream firms, tending to draw both types of firms together in the same location (agglomeration). These forces are the backward (demand) and forward (cost) links that figured so prominently in an earlier generation of development economics, especially the writings of Hirschman (1958) and Myrdal (1957). Note, however, that they constitute a force for clustering only if they are combined with increasing returns to scale, without which upstream and downstream firms can be broken into many small plants to meet local demand.

In addition to interfirm links, a number of other arguments have been put forward to suggest the value of locating in a dense cluster of activity (for a recent survey, see Duranton and Puga, 2004). One important set of arguments concerns the efficiency advantages of thick labor markets. Pools of specialist workers, and of the firms that use these skills, benefit both from a better matching of aptitudes with requirements and from risk-sharing if there are firm- or worker-specific fluctuations in demand or supply. Furthermore, incentives to acquire skills are greater if the skills are sought by several firms, with workers less likely subject to the monopsonistic power of a single employer. Labor turnover is one—but not the only—

mechanism through which firms in a dense cluster of activity can benefit from the skills and knowledge of other firms. There is considerable evidence of productivity spillovers among firms, since they are able to learn about and imitate the practices of industry competitors. Silicon Valley provides an example in which knowledge exchange—formal and informal—is quite widespread. The knowledge may be about production methods, marketing skills, or simply location. Multinational firms therefore tend to cluster in particular locations, partly because one firm, observing the success (or failure) of another, learns about the quality of the business environment in the location. Hausmann and Rodrik (2002) argue that very narrow patterns of specialization in developing countries (for example, specialization in soccer-ball production) arise as producers learn about the efficiency of a particular location for producing a particular good.

Agglomeration forces can operate across more or less broad ranges of activity. For example, key externalities and links might occur among firms in a particular industry, or between firms that engage in a narrow field of research and development (R&D). Sectorally narrow effects of this type are sometimes referred to as “localization” economies. Alternatively, they might operate at a much broader level—through aggregate demand as a whole, the development of general labor skills, or the provision of basic business infrastructure and inputs that can be used by wide sectors of the economy. It is also argued that they may stem not from specialization but from diversity in the activities of a location. Such sectorally broad effects are referred to as “urbanization” economies, although it should be noted that they can also occur over a wider spatial area than a single city, such as across a metropolitan area or a country.

Pulling in the opposite direction are forces of dispersion. These are of essentially three types. One is the supply of immobile factors, the prices of which will be bid up in centers of activity, encouraging firms to move to lower factor cost locations. The second is the extent of the market; geographically dispersed demand and the costs involved in shipping goods create a force for dispersion. Thus, if labor is dispersed it encourages a dispersed location of firms for both supply and demand reasons. Finally, there may be other costs associated with the concentration of activities, such as the costs of commuting or congestion.

## **Outcomes**

Outcomes are determined by the balance between agglomeration and dispersion forces. The key point is that if agglomeration forces are strong enough, then locations whose underlying characteristics are identical may nevertheless have quite different equilibrium outcomes. Equal dispersion of economic activity across locations is not a stable equilibrium, since cumulative causation forces will concentrate activity in a subset of locations. There are typically multiple equilibria—the cluster could occur in any one of a number of locations, and its actual location is determined by history.

Table 3.2 lists some of the possible forms of agglomeration. If dispersion forces are quite weak, in particular if labor is mobile, then cities or metropolitan areas will develop. This is the sort of outcome predicted in the urban economics literature, and also by Krugman's

(1991) core-periphery model. While the spatial pattern of activity is extremely concentrated, real factor price differences are likely to be small. Labor migration narrows real wage differences, although the prices of other immobile factors (such as land prices) may vary widely.

In the international context, it is generally more appropriate to think of labor as being relatively immobile.

While this is a force for dispersion of activity, it may nevertheless be the case that particular sectors (narrow or broad) cluster together. If the agglomeration economies are within fairly narrowly defined sectors, then this is consistent with small differences in factor prices; one region has engineering, another has financial services, and so on. But if links are strong between—as well as within—sectors, then agglomeration will be associated with large spatial differences in labor demand and in equilibrium wages. Hence, agglomeration forces lead not just to spatial disparities in the concentration of activity, but also to spatial disparities in real incomes, as in Krugman and Venables (1995).

**Table 3.2 Agglomeration: Outcomes**

Dispersion Forces			
Agglomeration forces		Weak (mobile factors)	Strong (immobile factors)
	Narrow, “localization”	Specialized cities (Henderson, 1974)	Industrial clusters vs. comparative advantage (Krugman and Venables, 1996)
	Broad, “urbanization”	City formation (Fujita, 1988) Core-periphery (Krugman, 1991)	International income inequalities (Krugman and Venables, 1995)

### ***Agglomeration and Regional Integration***

How does regional integration change the balance of forces involved in clustering, and how does it change outcomes? Reductions in trade barriers unambiguously weaken one of the dispersion forces: lower trade costs make it easier to supply dispersed consumers from a single location. But it may also weaken some of the agglomeration forces, and thus its effect on industrial location and spatial disparities is ambiguous. To explore the matter, this subsection outlines some of the ideas developed in Fujita, Krugman, and Venables (1999). Throughout, the focus will be on the international dimension, maintaining the assumption of labor immobility.

#### **Links: Concentration and Deconcentration**

One of the few models of agglomeration that explicitly addresses the effects of changes in trade barriers between areas is that of Krugman and Venables (1995); see also Fujita, Krugman, and Venables (1999). The model's structure is similar to that of an industrial location, as presented in the section “Market Access and Industrial Location,” containing a perfectly competitive sector (agriculture, using labor and a specific factor) and an imperfectly competitive sector (manufacturing, using labor alone). However, it adds links between firms in manufacturing

by assuming that each kind of product is used both as a final good and as an intermediate, and that each firm uses all varieties of intermediates. As suggested earlier, such links can create agglomeration forces, as firms seek to locate close to other firms that use their output (demand link) and that produce their inputs (cost link).

The cleanest analysis of clustering assumes that there are two countries, both *ex ante* identical. Clustering, however, may cause manufacturing to locate asymmetrically, with a cluster in one country and a smaller (possibly zero) level of activity in the other. Figures 3.3a and 3.3b illustrate possible outcomes. The horizontal axis is the level of trade costs, and the vertical axis in Figure 3.3a is the share of manufacturing in each country. Since the two countries are symmetric, there is always an equilibrium in which manufacturing is divided 50–50 between the two locations. For an intermediate range of trade costs, however, this symmetric equilibrium is unstable (dashed line). There is a new stable equilibrium in which shares of manufacturing employment in each country are traced out by the solid lines. Thus, as illustrated, most manufacturing firms cluster in country 2. It is not profitable for a firm to relocate from country 2 to country 1, since any savings in labor costs would be offset by the costs of being outside the cluster—the firm would be distant from its main market and from its input suppliers.

The corresponding real wages are given in Figure 3.3b. Reducing trade costs has a real benefit, hence the slope of these lines. But when clustering occurs, the country with the cluster has higher real wages and the other country experiences real income decline. As before, two forces underlie this. Most important is the higher demand for labor in country 2 than in country 1, supplemented by the fact that the cost of living is lower in 1 because few manufactures have to be imported and bear trade costs.

Figure 3.3a. Trade Costs and a Manufacturing Cluster

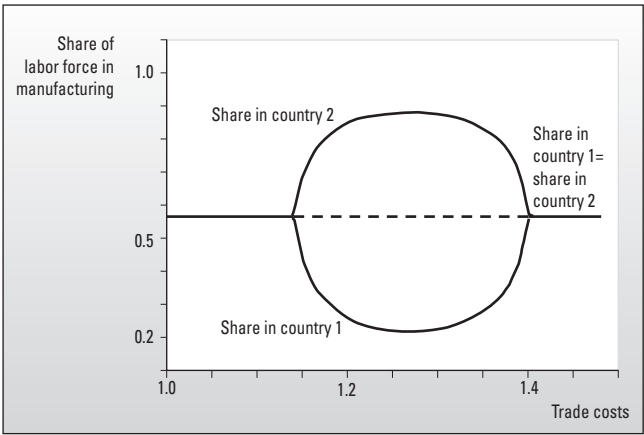
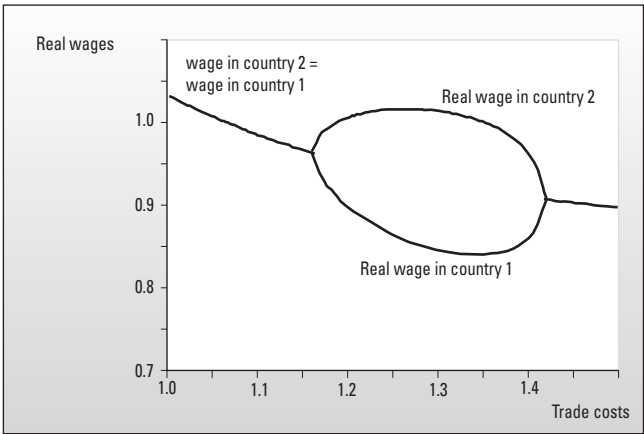


Figure 3.3b. Real Wages



For present purposes, the main point to note is that integration can create disparities, and that further integration can eliminate them. What can be observed is that when trade barriers are high, each location has manufacturing to supply local consumers. When trade barriers are very low, there is “death of distance”; a symmetric location of industry is driven by the two countries’ equal factor endowments. When trade barriers take “intermediate” values, the clustering forces are most powerful.<sup>6</sup>

### Localization and Sectoral Specialization

In the previous example, the only forces supporting agglomeration were links within manufacturing as a whole; reducing trade barriers to zero removed the agglomeration force. As an alternative case, suppose that there are also localization economies within industrial sectors, arising, for example, because of thick labor market effects. It is easy to speculate about the location of manufacturing, since economies with this structure reduce trade barriers. At high trade costs, all industries are present in all countries. At intermediate trade costs, there is a tendency for all industries to cluster together. Since this raises wages, however, it may become profitable for firms in some sectors to leave the agglomeration and form sectorally specialized clusters. Thus, if there are many locations and many sectors, deconcentration from a single center to a number of sectorally specialized centers of activity might be expected. As this occurs, and manufacturing employment becomes more widely dispersed, wage disparities are reduced.

To the extent that inequalities are driven by agglomeration forces, what policy implications follow? The first point is that further integration, reducing trade barriers or transport costs, will reduce the cost of being outside an existing agglomeration. Wages typically decline as a function of the distance from centers of economic activity.<sup>7</sup> The slope of these “wage gradients” can be flattened by better integrating the hinterland with the center of agglomeration. The second point follows directly from the analysis above. Clustering is most likely to occur at intermediate levels of trade costs (Figure 3.3a). The U-shaped nature of these relationships means that, once again, further integration might reduce or eliminate the disparities created by integration.

An important difference between this case and the one in the section “Market Access and Industrial Location” is that agglomeration mechanisms are all sources of positive externality—either technological or pecuniary. As a result, the real income gains from policy changes that facilitate clustering are typically quite large: agglomeration comes with real efficiency gains, even if these gains fall unequally across regions. But this also means that there is a potential for using policy to try to correct agglomeration externalities.

<sup>6</sup> If the supply of labor to manufacturing was perfectly elastic, then any degree of intermediate goods linkage within manufacturing, however small, would create agglomeration. With less than perfectly elastic labor supply, agglomeration forces must be sufficiently large relative to the response of wages to industrial relocation, if agglomeration is to occur.

<sup>7</sup> See Redding and Venables (2004) for estimates of these wage gradients from international data.

Urbanization provides a good example of these market failures. While there are efficiency gains in large cities, it may well be the case that cities in developing countries become larger than is socially efficient. The reason is that the incentives for a firm to move to a new location are too low, essentially for two reasons. One is that firms fail to internalize the externalities that they create. The other is that in moving out of an established center to a smaller city, they fail to anticipate (or discount too heavily) the benefits of externalities that they will receive as the new city grows (Henderson and Venables, 2004). Does this mean that active policy action should be taken? It is difficult to design policy to address this coordination failure; Pigovian subsidies for every source of externality are neither feasible nor desirable, and attempts to manage the creation of new cities have been generally unsuccessful. The policy message, however, is that there is a need to design institutions that reduce some of the distortions that keep firms in existing centers (such as regulatory regimes that put a premium on access to government). Policy also needs to facilitate decentralization through infrastructure investments and through decentralized institutions that can initiate and fund policies to overcome the coordination failure.<sup>8</sup>

## Conclusions

This chapter has argued that regional integration can create factor price disparities between countries in a trading bloc. The gains from economic integration come from allowing firms to relocate to exploit comparative advantage or achieve economies of scale and agglomeration. Relocation, however, changes factor demands in each country and can thereby open up wage gaps.

The worst disparities may be at partial levels of integration. Disparities occur if factor price equalization is impeded by a large number of nontraded goods, or if external trade barriers create trade diversion that harms the poorer countries in the integration agreement. They can also occur as changing patterns of market access interact with increasing returns to scale to favor some areas relative to others. In each of these cases, perfectly free trade can bring factor price equalization, but partial liberalization might lead to increasing disparities.

The foregoing suggests that a way to mitigate regional disparities is to extend both the width and the depth of economic integration. This does not necessarily mean that there is no scope for measures designed specifically to address regional disparities, although such measures must always be assessed using the sort of general equilibrium context developed in this chapter. For example, transport improvements may well narrow regional disparities, although each case needs to be studied in detail. Developing human capital is valuable, but if skilled labor is mobile, such development may simply be training workers for emigration. It is also important to facilitate the growth of new clusters of activity and urban centers, particularly since a range of market failures suggest that urban agglomerations in developing countries may be larger than is socially efficient.

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<sup>8</sup> For further discussion see Overman and Venables (2005).

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## **National Disparities and the Regional Allocation of Resources: A Positive Framework**

*Gianmarco I. P. Ottaviano\**

### **Introduction**

The purpose of deeper trade integration among the members of the Southern Common Market (MERCOSUR) is to reduce barriers to the international mobility of goods, factors, and ideas, as well as to promote effective policy coordination. Lower barriers make customer-supplier interactions in the integrated area more efficient, thus fostering the creation of a common market in the region. This chapter proposes a theoretical framework for assessing the economic impact and welfare implications of the resulting reallocation of resources, both among and within countries. Its final purpose is to answer the central questions of whether and how the distribution of integration's associated costs and benefits might prompt member countries to resist deeper integration because of national interests. In particular, as argued in the section "Disparities in MERCOSUR," one of the greatest obstacles to deeper integration is increasingly represented by asymmetries among member countries, specifically smaller countries' dissatisfaction with the distribution of related gains and losses.

The foregoing issues are tackled from the specific viewpoint of new economic geography (NEG), an approach to economic geography grounded in recent developments in mainstream industrial organization and international trade theory. More than a decade after the seminal work of Krugman (1991), NEG has been outlined in a mature body of literature, including that of Ottaviano and Puga (1998); Fujita, Krugman, and Venables (1999); Neary (2001); Ottaviano and Thisse (2001, 2004); Fujita and Thisse (2002); Baldwin et al. (2003); Ottaviano (2003); and Ottaviano and Pinelli (2004).

On the basis of these last two studies, the section "Agglomeration Forces as the Source of Disparity" presents the building blocks and main insights of this literature, with

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\* The author is grateful to Mauricio Mesquita Moreira and Christian Volpe Martincus for advice on stylized facts concerning MERCOSUR. He is also indebted to seminar participants at the Inter-American Development Bank (IDB) in Washington, D.C., to those at the conference "Deepening Integration in MERCOSUR: Dealing with Disparities" in Rio de Janeiro, and to staff in the IDB's Integration and Regional Programs Department and Regional Operations Department 1 for helpful comments.

particular reference to how firms interact in imperfectly competitive markets: (i) all else equal, product-market competition promotes the geographical dispersion of economic activities; (ii) international differences in production costs foster agglomeration in low-cost countries; (iii) international differences in local-market size foster agglomeration in larger countries; (iv) productivity differences across firms foster dispersion; (v) trade barriers have a nonlinear impact on the balance between agglomeration and dispersion forces; and (vi) agglomeration forces may generate “cumulative causation” in firms’ location decisions.

NEG models, however, typically neglect some important microeconomic effects of trade integration. Indeed, the section “Disparities in MERCOSUR” argues that, surprisingly, MERCOSUR seems to have had little impact on the aggregate economic performance of member countries. The reason is the parallel implementation of other important policy reforms involving both labor and financial markets. The separate impact of trade liberalization can be detected at the finely disaggregated level. For instance, recent empirical research on Argentina and Uruguay reveals that policy reforms have caused intense capital and labor reallocation within—rather than between—sectors. That is, most action has involved the contraction of less productive establishments and the expansion of more productive ones within the same industries. In this respect, among all policy reforms, the greatest impact comes from trade liberalization rather than from financial and labor reforms.

To illustrate the theoretical underpinnings of these microeconomic dynamics, the section “Trade Liberalization, Agglomeration, and Firm Selection” enriches the analytical framework of NEG following the work of Melitz (2003), Melitz and Ottaviano (2005), and Bernard, Redding, and Schott (2004). The result is a rich set of predictions on the effects of trade liberalization in terms of industry-performance measures. These highlight the role of available technologies (cost-saving attraction), local market size (market-seeking attraction), and access to other markets (accessibility). As shown in the section “Integration and Disparities: A Numerical Example,” the enriched analytical framework has the following implications:

- (i) Because of market-seeking attraction, larger local markets are characterized by tougher competition. This leads to richer product variety, higher productivity, lower prices, and greater welfare.
- (ii) Because of cost-saving attraction—in absolute terms—technologically advanced regions are characterized by tougher competition. In relative terms, regions feature tougher competition in sectors of comparative advantage. This leads to richer product variety, higher productivity, lower prices, and greater welfare.
- (iii) Because of accessibility, “hubs” (that is, regions that occupy a central place in trade networks) are characterized by tougher competition and, therefore, richer product variety, higher productivity, lower prices, and greater welfare. This is because such regions are better export bases and thus attract firms.
- (iv) Multilateral trade liberalization reinforces competition in all regions. This leads to richer product variety, higher productivity, lower prices, and greater welfare everywhere. Preferential trade liberalization increases the productivity of insider countries while diminishing the average productivity of outsiders. The result is a parallel change

in product variety, industrial activity, and welfare. The liberalizing countries become better export bases: they gain better access to each other's markets while maintaining the same ease of access to third-party markets. Average costs, prices, and markups move accordingly, decreasing for insiders and rising for outsiders.

Finally, the concluding section stresses the chapter's key message: trade liberalization induces a reallocation of resources from less productive to more productive firms, from smaller to larger countries, from high-cost to low-cost countries, and from outsiders to insiders in preferential trade agreements. This delivers long-run efficiency gains to liberalizing countries through selection among heterogeneous firms, which eventually leads to higher average productivity, lower average prices, larger average firm size, higher profits, richer product variety, and lower markups. At the same time, it generates tensions between prospective short-run winners (such as more efficient firms, larger and more developed countries, larger and more developed regions within countries, and insiders in preferential trade agreements) and prospective short-run losers (such as less efficient firms, smaller and less developed countries, smaller and less developed regions within countries, and outsiders in preferential trade agreements). Financial liberalization and labor market reforms can reduce the asymmetric distribution of gains and losses by speeding up the transition.

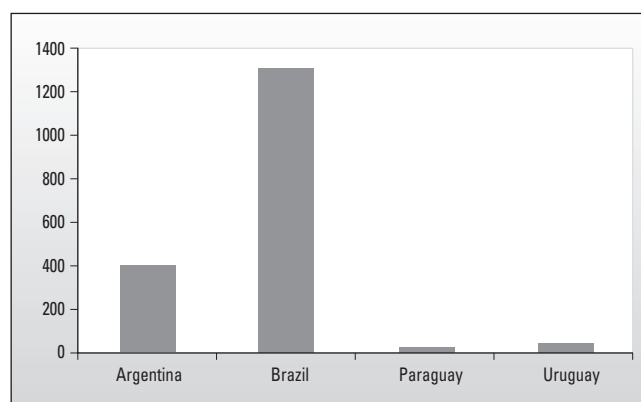
## Disparities in MERCOSUR

Nearly two decades since MERCOSUR was created, asymmetries among member countries pose one of the greatest obstacles to deeper integration. The smaller members have brought this issue to the forefront because of their growing dissatisfaction with the distribution of MERCOSUR-related gains and losses. There is some substance to this dissatisfaction, since asymmetries are real in areas such as economic size, individual wealth, specialization in production, and patterns of trade. Moreover, there is little evidence that asymmetries have been narrowing since MERCOSUR was established.

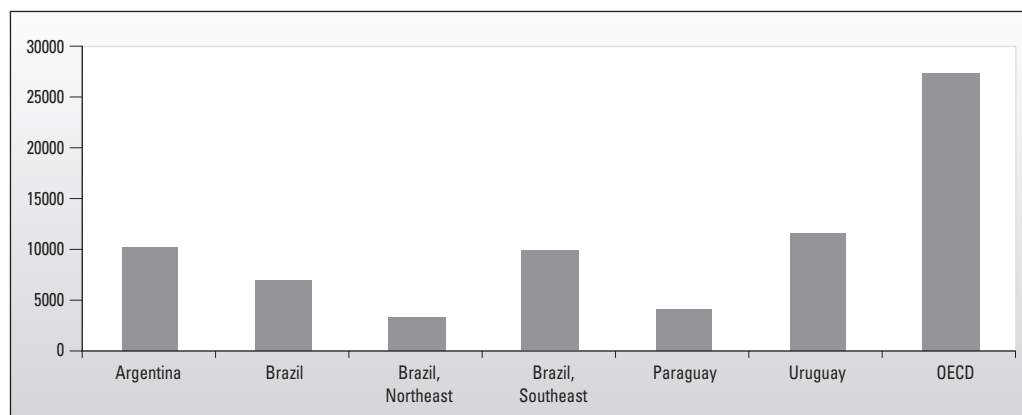
### Size and Wealth

As discussed by Moreira (2003), disparities among MERCOSUR countries are large in terms of both economic size and individual wealth. For the former, disparities are measured by comparing gross domestic product (GDP). Figure 4.1 shows that the difference between Brazil

**Figure 4.1. GDP, 2002 PPP**  
(current international \$)



Source: Moreira (2003).

**Figure 4.2. GDP per Capita, 2002 PPP***(current international \$)*

Source: Moreira (2003).

and the other partners is huge. Brazil's GDP is more than three times that of Argentina and more than 30 times that of Uruguay or Paraguay.

Individual wealth is measured by GDP per capita. In this respect, Figure 4.2 shows that the countries are more equal in this respect. Uruguayans are the richest, on average, being slightly richer than Argentines, one and a half times as rich as Brazilians, and more than twice as rich as Paraguayans. The Brazilian national figure itself masks deep internal differences between a richer southeast and poorer northeast.

### ***Production and Trade***

Economic size disparities also impact production and trade patterns. Sanguinetti, Traistaru, and Volpe Martincus (2004), as well as Volpe Martincus (2004), show that Brazil is less specialized than other member states in production and trade patterns. Its industrial structure more evenly covers a richer set of industries, allowing for a more balanced distribution of trade shares across sectors. Moreover, Brazil's trade pattern does not vary much between MERCOSUR and non-MERCOSUR countries. Other members are much more specialized, and the trade shares of different industries are very different across destinations and reveal an increasing regional bias.

In terms of output composition, over the years MERCOSUR countries have moved away from labor-intensive sectors such as textiles, clothing, and footwear toward food products, chemicals, petroleum refineries, and transport equipment. This reorganization has followed member countries' comparative advantages, driven by the relative abundance of factors and natural resources. For example, Argentina and Uruguay have increased their specialization in food and leather products; Brazil in wood and paper products; Argentina in petroleum refineries; and Brazil and Uruguay in labor-intensive footwear, textiles, and clothing. When

countries specialize in sectors with no obvious comparative advantage, state intervention is often the explanation.

Regarding trade with the rest of the world, the overall tendency is toward a decline in specialization because sectors characterized by extreme comparative advantage are losing ground to sectors of milder comparative advantage. This is due to the rise of intraindustry trade.

### *Intraindustry Dynamics*

It is quite surprising that, apart from increased regional bias in trade, MERCOSUR seems to have had little impact on the aggregate economic behavior of its member states. The reason is probably that, in parallel to trade liberalization, other important policy reforms have been implemented in both the labor and financial markets.

The separate impact of trade liberalization, however, is evident from a microlevel examination. Though few studies are based on firm-level data in MERCOSUR countries, those that exist are starting to show some clear tendencies.

In the case of Argentina, for instance, Sánchez and Butler (2003) show that reforms have led to resource reallocations more often *within* than *between* sectors. That is, most of the observed structural change has involved the contraction of less productive establishments and the expansion of more productive ones within the same industries. Moreover, among all policy reforms, trade liberalization has had the largest effect on reallocation and productivity, followed by financial and labor reforms.

Casacuberta, Fachola, and Gandelman (2004) study Uruguayan firms. They argue that, in principle, trade liberalization within an industry may foster productivity through three main channels: (i) improved access to foreign intermediate inputs and capital goods; (ii) tougher import competition, fostering innovation; and (iii) the exit of the least productive firms. The dominance of this latter channel is supported by the fact that liberalization has increased job creation, job destruction, and capital destruction, while it has lowered capital creation. Indeed, there is also some direct evidence that exiting firms tend to have lower productivity.

These examples match a more general conclusion from recent studies on several non-MERCOSUR countries (see, for example, Tybout, 2002): research into the microeconomics of competition and innovation within specific sectors is the strategy that currently offers the greatest understanding of the origin and outcome of asymmetries among countries involved in common integration processes. This calls for a theoretical approach that should be firm based rather than sector based. To summarize: *The separate impact of MERCOSUR on asymmetries among member countries is hard to detect at the macro level. Accordingly, analysis of the microeconomics of competition and innovation within specific sectors is necessary to understand the origin and outcome of asymmetries among countries involved in common integration processes.*

## Agglomeration Forces as the Source of Disparity

Observation of geographical asymmetries in economic development spurs an obvious explanation of their cause: regions differ in their relative abundance of natural resources, their proximity to natural means of communication, and their climatic conditions. All these characteristics define a region's exogenous attributes, what Cronon (1991) calls "first nature," and they take center stage in traditional trade theories of comparative advantage along the lines advanced by Ricardo, Heckscher, and Ohlin. In particular, these theories argue that:

***Insight 1:*** *International cost differences foster the concentration of industries in countries where the corresponding costs are lower.*

For a specific sector, these are regions that: (i) use relatively advanced technologies in the sector; (ii) are relatively abundant in the factor in which the sector is relatively intensive; and (iii) offer better local infrastructure for transporting intermediate goods.

Dramatic differences in economic development, however, can be observed even between areas that do not differ greatly in these exogenous attributes. This suggests that the observed regional imbalances must be driven by other forces ("second nature") inherent in the functioning of economic interactions, and that, in principle, these forces can cause uneven development across initially identical places.

As discussed by Fujita and Thisse (2002), second-nature explanations have a long history in economics, geography, and regional studies. In the past ten years, however, the debate within mainstream economics has been dominated by NEG. Relative to alternative approaches, the defining feature of NEG is its focus on market, rather than nonmarket, interactions. This is pursued within a "general equilibrium" framework that stresses the endogenous determination of goods and factor prices and the importance of economy-wide budget constraints. In the words of Fujita and Krugman (2004), "You want a general-equilibrium story, in which it is clear where the money comes from and where it goes." The aim of this section is to illustrate the theoretical foundations of NEG.

### ***A Firm-Based Approach***

Based as it is on market interactions, NEG places the location decision of the firm at the heart of its approach. The decision is not trivial when two things are true. First, goods and factors can be transported across space only at some cost. Second, the fragmentation of the production process reduces its efficiency, which happens when returns to scale are increasing at the plant level. Without transport costs, space would be immaterial. Without plant-level scale economies, when firms are faced with dispersed customers and suppliers, they would use the geographical fragmentation of production to circumvent transport costs by patronizing scattered demand and intermediate supply through many small local plants ("backyard capitalism"). Thus, both transport costs and scale economies are necessary for a location problem to arise: costly transport gives physical substance to the concept of geography, and

increasing returns generate an economic trade-off between proximity to customers and the concentration of production in as few plants as possible. Scotchmer and Thisse (1992) call this the “folk theorem of spatial economics.”

The centrality of scale economies has important implications in terms of market structure. As Starrett (1978) has pointed out, since plant-level returns to scale are necessarily associated with market power, imperfect competition is inherent in the question of location. Indeed, the tension between proximity and concentration creates a location problem for any firm, irrespective of whether it interacts with other firms. The problem, however, becomes more complicated once firms face competitors, because firms can use geographical positioning to ease competitive pressures and enhance market power. Using Chamberlin’s (1933) terminology, this is the case both when competitors form a small group (oligopoly) and when they form a large group offering differentiated products (monopolistic competition). In both cases, location is crucial to profit maximization, since it allows firms to increase their market power by careful positioning.

On the one hand, firms are attracted to markets with large local demand because, by locating close to customers, they can save on trade costs. Hence:

***Insight 2:*** *International differences in local market size foster the agglomeration of industries in larger countries.*

This is sometimes called the “home market effect” (Krugman, 1980; Helpman and Krugman, 1985), whereby firms tend to solve the trade-off between proximity and concentration by serving the smaller market from the larger one.

On the other hand, for a given size of local demand, crowded markets are likely to repel firms. The reason is that market power is hampered by the presence of many competitors, so firms can increase their profits by fleeing markets with a high density of firms in their same sectors. The more this is the case, the greater the similarity of competing products. Accordingly:

***Insight 3:*** *Product-market competition promotes the geographical dispersion of industries.*

Through imperfect competition, plant-level scale economies also have crucial welfare implications. This is because when firms have market power, the prices on which consumers and firms base their consumption, production, and location decisions do not fully reflect the corresponding social values. Hence market interactions have side effects for which no *quid pro quo* is paid. Since they are associated with market transactions, these side effects are called pecuniary externalities (Scitovsky, 1954).

Three possible scenarios are especially relevant. In the first, when a firm relocates, it reduces competition in the place of origin and increases competition in the place of destination. Accordingly, the profits of competitors rise in the former and fall in the latter. A pecuniary externality materializes in both places, insofar as the relocating firm disregards those effects. In particular, the relocating firm imposes a positive externality on its competitors in

the place of origin and a negative externality on its competitors in the place of destination. By decreasing profits in places crowded by firms, competition acts as a dispersion force (Ottaviano, Tabuchi, and Thisse, 2002).

The second scenario considers the effect of firm relocation when matched by labor migration. In this case, as the firm moves, it reduces demand in the place of origin while increasing it in the place of destination. In so doing, as profits rise with demand, the firm imposes a negative externality on competitors in the former place and a positive one on competitors in the latter. By raising profits in places crowded by firms, migration acts as an agglomeration force (Krugman, 1991).

In the third scenario, firms are connected by input-output links: what is output for one firm is input for another and *vice versa*. Here, when a firm relocates it depresses both final demand and intermediate supply in the country of origin, whereas it reinforces them in the country of destination. Accordingly, other firms' profits suffer in the former country (where the firm imposes a negative externality) and thrive in the latter (where it imposes a positive externality). By raising profits in places crowded by firms, input-output links act as an agglomeration force (Krugman and Venables, 1995; Venables, 1996).

Unlike NEG, other approaches stress the role of technological rather than pecuniary externalities (see Marshall, 1890; for recent reassessments, see Henderson, 1978, and Ciccone and Hall, 1996). Technological externalities differ from pecuniary ones in that they materialize through sheer physical proximity, independent of any market transaction (Scitovsky, 1954). Since they arise from nonmarket interactions, for them, too, no *quid pro quo* is paid. In the textbook case, the productivity of a firm is influenced by the presence of other firms nearby, even if there is no market relation with them. Like pecuniary externalities, technological ones can be either negative or positive. On the one hand, nearby firms may reduce a firm's productivity through the pollution they generate, or through the congestion they cause in the use of local public goods and infrastructures. On the other hand, nearby firms may increase a firm's productivity through informal knowledge transmission (spillover) that is generated as a by-product of their contacts with the surrounding environment.

To summarize, the geographical distribution of demand and the position of other firms determines the relative attractiveness of alternative firm locations through market or nonmarket interactions. This creates a feedback mechanism among firms' location decisions, through which firms' interactions ("second nature") may alter the economic landscape implied by natural resources, natural means of communication, and climatic conditions ("first nature"). In addition, since "second nature" is driven by localized externalities, in a free market the location of firms is generally inefficient and appropriate public intervention is generally needed.

### ***Micro-Founded Agglomeration***

The finding that the location decisions of firms are intertwined, and that this may cause disparities and inefficient location, follows from both pecuniary and technological externalities. The former externalities, however, have a logical advantage over the latter, which lies in the

possibility of relating their emergence to a set of well-defined microeconomic parameters. This has proven to be quite difficult in models based on technological externalities, since these still remain mostly “black boxes” (for recent assessments see, for example, Ottaviano and Thisse, 2001; and Duranton and Puga, 2004).

To explain this point, note one of the previous examples that involved input-output linkages. In particular, following Venables (1996), consider a production chain consisting of three vertically linked activities: intermediate production, final production, and consumption. For simplicity, assume that final production uses only intermediate inputs, intermediate production employs only labor, and workers are the only source of final demand and are geographically immobile. If, for any reason, a new firm starts producing intermediates, it will increase labor demand and intermediate supply. Because of excess demand and supply, respectively, wages will rise while intermediate prices will fall. This is bad for the other intermediate producers because of competitor proximity. But it is good for final suppliers, who face falling production costs and higher demand from richer workers. As new final producers are lured into the market, the expansion of final production will feed back into stronger intermediate demand, so that intermediate suppliers will also benefit because of customer proximity. Clearly, when the latter effect dominates the former, both final and intermediate firms will be agglomerated in the same place. Accordingly, circular causation among firms’ location decisions can generate persistent differences even among initially identical places (“second nature”).

The crucial contribution of NEG is that such simple arguments are translated into general equilibrium models with solid microeconomic foundations. This allows the evolution of the spatial landscape to be related to observable microeconomic parameters. NEG predicts agglomeration is more likely to happen in sectors where market power is strong. This is the case when there are intense, plant-level scale economies, and pronounced product differentiation, because stronger market power weakens the dispersion effect of competition. To put it differently, market power gives strength to “second nature” against “first nature,” which detaches the emerging economic landscape from the physical attributes of its underlying geography. Thus, *a priori*, there is great flexibility as to where particular activities locate. Nevertheless, once the agglomeration process has started, spatial differences take shape and, as localized pecuniary externalities materialize, economic geography becomes quite rigid. This is what Fujita and Thisse (1996) call “putty clay” geography. To summarize:

***Insight 4:*** *Increasing returns and product differentiation enhance the attractiveness of larger markets to both firms and workers. As firms and workers move, those markets become even larger, which may generate cumulative agglomeration processes.*

For example, in the presence of local spillovers, country-specific cost differences may arise endogenously from the spatial concentration of firms (see, for example, Martin and Ottaviano, 2001). Analogously, in the presence of migration (Krugman, 1991; Ottaviano, Tabuchi, and Thisse, 2002) and capital accumulation (Baldwin, 1999; Baldwin, Martin, and Ottaviano, 2001), relative factor endowments and market sizes may be endogenously determined by firm

clustering. Finally, in the presence of input-output linkages, the overall transport bill may be reduced by the spatial concentration of customers and suppliers (Krugman and Venables, 1995; Venables, 1996).

### ***Attraction and Accessibility***

Together with the role of plant-level scale economies and product differentiation in generating localized externalities, perhaps the most celebrated insight of NEG is the impact of transportation improvements and trade liberalization on the economic landscape. This is because, unlike other approaches, micro-foundation allows NEG to reach a deeper understanding of how economic geography changes as trade obstacles are gradually eliminated. In particular, NEG argues that the level of trade barriers affects the balance between the agglomeration push of market size and the dispersion pull of competition.

With extremely high trade barriers, competition leads to dispersion because markets can be reached only through local production. Trade liberalization, however, weakens the dispersion force due to competition more than it weakens the agglomeration force due to international size differences. This promotes agglomeration as trade barriers are reduced from initially high levels. At the same time, as trade barriers continue to fall, both forces vanish. What is eventually left is the agglomeration force due to international cost differences, so dispersion may reappear for low levels of trade costs.

***Insight 5:*** *Trade liberalization has a nonlinear effect on the spatial concentration of economic activities by promoting agglomeration at early stages and dispersion afterwards.*

This behavior is sometimes called the “bell-shaped curve of spatial development” (Ottaviano and Thisse, 2004).

In a realistic set-up with many countries, the basic concept underlying the analysis is the so-called market potential (Harris, 1954). This has both nominal and real definitions (Head and Mayer, 2004). Whereas the nominal market potential (NMP) is a measure of customer proximity, the real market potential (RMP) is a combined measure of customer and competitor proximity. Consider a group of locations. The NMP of a certain location,  $H$ , is the weighted average expenditures across all locations that plants can tap if located in  $H$ . By contrast, the RMP of  $H$  is the weighted average of real expenditures (“purchasing power”) across all locations that plants can tap if located in  $H$ . In both cases, the weight of each location is a decreasing function of its distance from  $H$ . The underlying idea is that NMP is a good proxy of the value of sales that plants can expect to make on average if located in  $H$ . For its part, RMP is a good proxy of the profits than an average firm can make if located in  $H$ . In the long run, since firms can freely pick plant locations, profits should reach the same normal level everywhere. Over the long term, therefore, RMP differences should eventually vanish as NMP differentials are capitalized in local price differences. Accordingly, short-run RMP differences should predict the future evolution of the economic landscape as firms are attracted to areas that temporarily boast higher RMP.

As Behrens, Lamorgese, and Tabuchi (2004) have pointed out, the concepts of NMP and RMP are closely related to spatial interaction theory. The NMP of a certain area captures both the size of its local market (attraction) and its connection to other markets (accessibility). In addition, the RMP captures the intensity of competition faced by firms located in that area (repulsion). Attraction, accessibility, and, to a lesser extent, repulsion are also the main ingredients of gravitational models of international trade (Head and Mayer, 2004). To summarize, according to NEG:

***Insight 6:*** *The evolution of the economic landscape is driven by relative changes in the market potentials of alternative locations.*

Since the market potential of a location is determined by its attraction and accessibility, any changes in the overall distribution of country sizes and/or in the exchange network are bound to affect the spatial allocation of economic activities. As discussed in the section “Integration and Disparities: A Numerical Example,” this is crucial for regional trade agreements such as MERCOSUR.

### **Trade Liberalization, Agglomeration, and Firm Selection**

According to traditional theories, trade liberalization allows countries to specialize in sectors in which they enjoy a comparative advantage because of better technology or suitable factor endowments. This is because they can buy, in international markets, products that are no longer supplied by domestic firms. Specialization takes place through the reallocation of productive factors from sectors that are relatively high cost to sectors that are relatively low cost when compared to international standards.

As discussed in the “Introduction,” this sort of intersector reallocation is taking place in MERCOSUR. But any relevant and separate impact of regional trade liberalization itself is hard to see. By contrast, trade integration seems to be the main driving force behind very visible intrasector reallocations. This matches the existing international literature on episodes of rapid liberalization, as surveyed by Tybout (2002). That literature concludes that, within sectors, trade liberalization forces less productive firms out of the market and thereby increases average productivity. This is called the *selection effect* of international trade, and is accompanied by higher average firm size (scale effect) and lower average price and markup (procompetitive effect).

### **Market Potential Matters**

To understand the basic mechanism behind the selection effect, consider what happens to firms’ profits after trade liberalization (see, for example, the models of Melitz, 2003; Bernard, Redding, and Schott, 2004; and Melitz and Ottaviano, 2005).

Suppose that a sector is active in two autarkic countries that are identical in preferences, technologies, and factor endowments. Firms are differentiated horizontally by the products

they sell and vertically by their productivities (or, equivalently, by the quality of their products). More productive firms—firms able to sell at lower prices and quote lower markups but still make higher profits because of their larger size—have stronger market power. For a given productivity, market power is also positively related to the total number of competitors, so all markups fall as the number of competing firms increases. Finally, there are increasing returns to scale at the firm level because of fixed cost, and both entry and exit are free. The least-productive firms are just able to break even, since their fixed costs are just covered by the operating profits associated with positive markups.

Consider now what happens when trade is liberalized, distinguishing between the short run (when firms are unable to enter or exit the market) and the long run (when entry and exit take place). The length of the long run depends on financial and labor market institutions whose rigidities may hamper capital, job destruction, and job creation.

As the two countries move from autarky to free trade, the two national markets merge into a common international market. Since the countries are identical, initially in the new market there are twice as many firms as in each autarkic market, so markups have to fall. In the short run, firms cannot enter or exit, so operating profits fall for all firms no matter how productive they are. But this is a more serious problem for the least-productive firms. Since they were just breaking even in autarky, they are now suffering losses. In the long run, therefore, their position in the market will become unsustainable and they will have to exit. Their lost market shares will be captured by more productive firms, whose larger scale will more than offset the fall in markups. In the end, average productivity and firm size will be higher, whereas average markup, and therefore average price, will be lower. This corresponds to the “survival of the fittest” in a competitive environment, and selection will be harsher when market power is not shielded by product differentiation and increasing returns to scale.

These results can also be interpreted as implying that a larger market or a market with lower behind-the-border restrictions is more selective and therefore supports a more productive group of firms. Hence:

**Insight 7:** *Larger integrated markets are characterized by firms that on average are more productive, operate at a larger scale, and quote lower prices. The less differentiated the products are and the weaker the returns to scale, the more this is the case.*

This result can be extended by analogy when liberalization falls short of free trade so that some additional trade barriers persist—for instance, because of additional costs of transport and distribution of foreign sales. As discussed earlier, when some export costs persist, the intensity of local competition depends not only on the attraction of a country’s domestic market but also on its accessibility to and from other countries. Hence, from Insight 7:

**Insight 8:** *Countries with higher market potential host firms that on average are more productive, operate at a larger scale, and quote lower prices. This happens especially in sectors with little product differentiation and weak returns to scale.*

## ***Trade Integration and Financial Liberalization***

When liberalization does not dismantle all trade barriers, the selection effect intensifies. When reform leads the economy from autarky to free trade, all surviving firms sell to all customers, foreign as well as domestic. Residual trade barriers cause, instead, a second round of selection within the group of surviving firms, called “selection into export status.” The reason is that two effects are at work. On the one hand, lower trade barriers make it easier for foreign firms to gain access to domestic markets. This creates import competition, which cuts into firms’ profits. On the other hand, lower trade barriers also make it easier for domestic firms to reach foreign markets, and improved export access increases their profits. The former effect is bad for all firms, no matter how productive they are. By contrast, the second channel is good for some firms only: those that are productive enough to cover the additional export costs with their higher operating profits. Accordingly, the firms that were active in autarky are partitioned by trade liberalization into three groups: (i) those with low productivity that leave the market, (ii) the very productive ones that sell in both domestic and foreign markets, and (iii) those with medium productivity that sell only in their domestic market. Hence:

***Insight 9:*** *Trade liberalization causes the exit of the least-productive firms and the selection of the most-productive survivors into export status. Other surviving firms are confined to their domestic markets.*

As a result, trade liberalization increases average productivity and firm size, and decreases average prices. The less differentiated the products are, and the weaker the returns to scale, the more this is the case.

As mentioned earlier, the speed of all these effects depends on the functioning of financial and labor markets, since these mediate the reallocation of capital and labor from failing to thriving firms. They also foster innovation and the creation of new firms. In this respect, for emerging countries that face a shortage of internal capital, it may be crucial to match trade integration with financial liberalization: international capital flows and foreign direct investment (FDI) can smooth the process of adjustment through selection. Thus:

***Insight 10:*** *Financial liberalization and FDI hasten the reallocation of resources from less productive to more productive firms triggered by trade liberalization.*

The credibility of trade liberalization and the associated reduction of uncertainty about possible reversals of the process would have a similar smoothing effect by making workers and firms more willing to incur the costs of adjustment.

## ***Comparative Advantage***

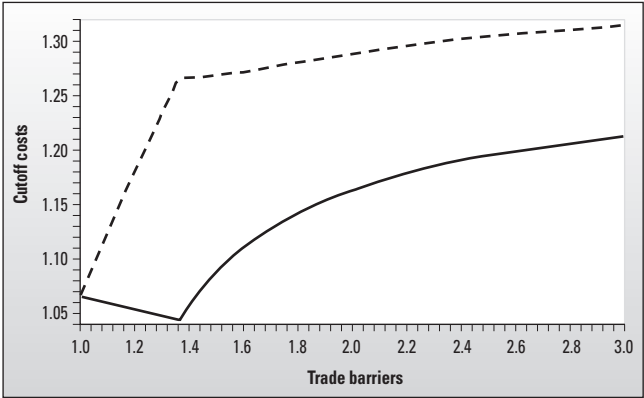
Moving away from autarky, firm selection is affected not only by market potential but also by comparative advantage. Intuitively, for a given size, a more technologically advanced country

represents a tougher competitive environment. Because of stronger selection effects, it will host firms with higher average productivity, reach larger scale, and quote lower prices. In this sense, selection magnifies comparative advantage. Thus:

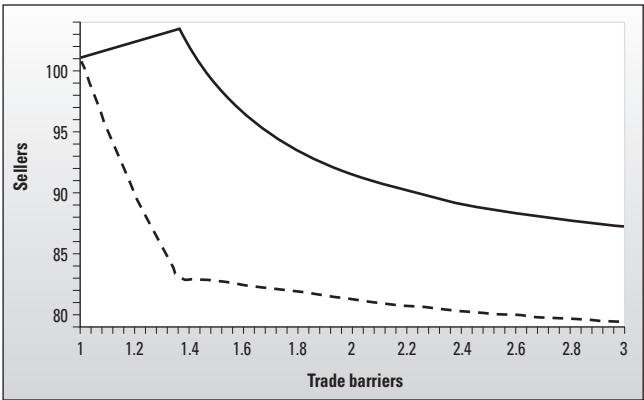
***Insight 11:** In sectors in which they enjoy a comparative advantage, countries host firms that are more productive on average, operate at a larger scale, and quote lower prices.*

As an example, Figures 4.3, 4.4, 4.5, 4.6, and 4.7 show the impact of trade liberalization between a larger country, H, and a smaller country, F. The focus is on a sector in which country H has a comparative advantage, so H offers both larger market size and lower production costs. For each country, the figures depict, respectively, the maximum feasible production cost (that is, the “cutoff” cost at which the least productive firms just break even); the numbers of sellers, entrants, and producers; and the levels of welfare in the two countries as functions of trade barriers. Solid lines refer to country H, dashed lines to country F, and, when present, dotted lines to the whole economy. The figures indicate that, even though the small backward region loses its industrial base as trade becomes freer, welfare levels nonetheless converge since the location of producers becomes progressively immaterial.

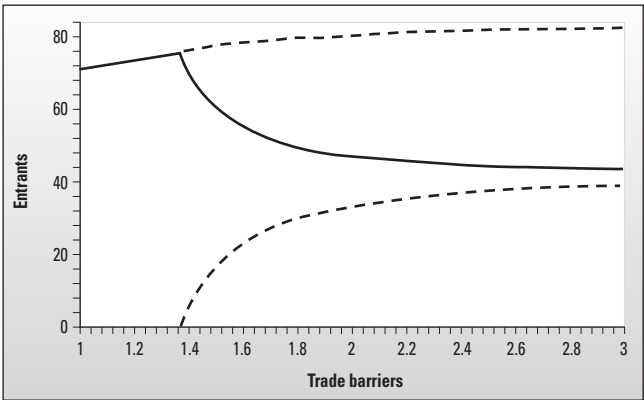
**Figure 4.3. Two Countries: Selection**



**Figure 4.4. Two Countries: Variety**



**Figure 4.5. Two Countries: Entry**



## Integration and Disparities: A Numerical Example

To add concrete substance to the foregoing insights, it is interesting to present the results of a numerical investigation of a stylized economy, embedding all the effects highlighted in previous sections. The model is adapted from Melitz and Ottaviano (2005).

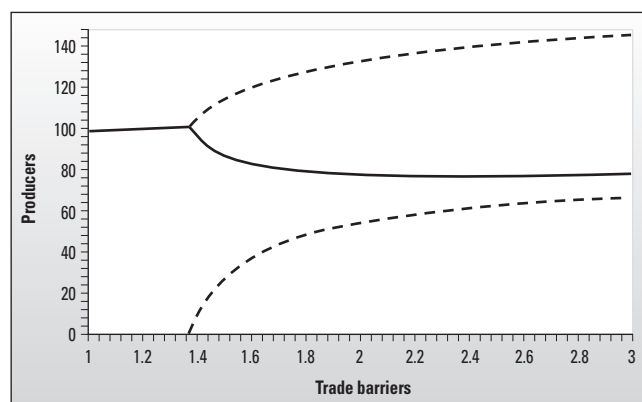
The main idea discussed above is that three features shape the attractiveness of a country to firms: locally available technologies and inputs (cost-saving attraction), the size of the local market for final products (market-seeking attraction), and access to and from foreign markets (accessibility). In turn, the interactions among these three features determine the individual characteristics of local firms, and these determine the wealth of the country. Using the terminology introduced in the section “Agglomeration Forces as the Source of Disparity,” technologies and inputs determine the “first nature” of the country, while the size of its local market and its access to foreign markets shape the country’s “second nature” in terms of the technologies that are actually adopted. This happens through a selection process that sets a lower limit on the productivity (that is, a higher limit on the marginal costs) of firms that are able to operate locally. Most naturally, trade agreements affect accessibility and, therefore, the selection process.

### *Attraction and Accessibility*

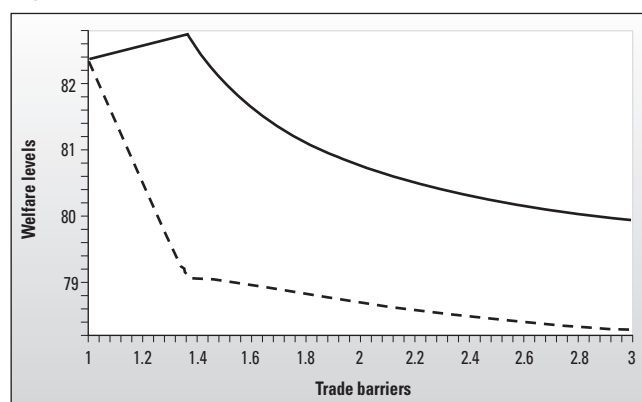
Consider six countries and nine regions. The regions are called LA, SA, CO, BA, AS, MO, PA, SP, and BR. The regions CO and BA belong to one country. PA, SP, and BR belong to another country. All other regions coincide with their own countries.

Labor is the only factor of production, and there are two industries. In one industry, workers are employed by firms with no market power, which produce a freely traded homo-

**Figure 4.6. Two Countries: Production**



**Figure 4.7. Two Countries: Welfare**



geneous good under constant returns to scale. In the other industry, labor is employed by firms with market power, each producing a variety of a horizontally differentiated good under increasing returns to scale. Regions differ in terms of size, accessibility, and comparative advantage, as illustrated in Figures 4.8 and 4.9. The former figure reports the hierarchy of regions by size. The latter shows the hierarchy in terms of a joint measure of accessibility and comparative advantage. For region H, that measure is constructed as the weighted average of the maximum possible production costs across regions, with weights determined by the relative position of regions within the trade network. Specifically, the production cost of each region enters the average with a weight that is inversely related to its trade costs with H. All else being equal, the

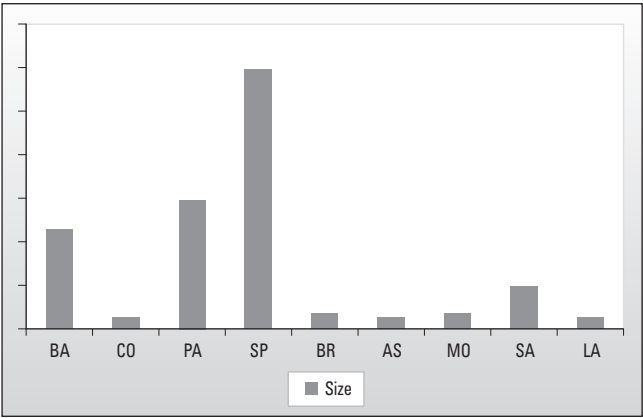
higher this measure is with respect to other regions, the more competitive firms in region H are likely to be (for details, see Melitz and Ottaviano, 2005, Appendix B).

In general, trade costs include all distance-related costs such as transport costs, administrative barriers, and currency conversion costs. Figure 4.9, however, abstracts from international trade barriers and currency conversion costs in order to focus on the inertial part of trade costs that cannot be instantaneously changed by fiat, and is thus less responsive to policy shifts. It shows that, whereas regions BA, PA, and SP stand out in size terms (see Figure 4.8), their lead is challenged by BR and CO in the areas of accessibility and comparative advantage.

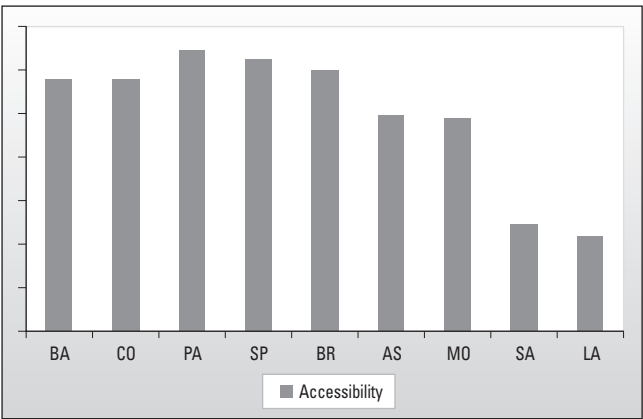
**Integration Scenarios**

Four scenarios are investigated: no trade integration (NO); preferential trade integration, excluding LA and SA (MER); enlarged integration, in which trade integration is extended

**Figure 4.8. Regional Integration: Market-Seeking Attraction**



**Figure 4.9. Regional Integration: Cost-Saving Attraction and Accessibility**

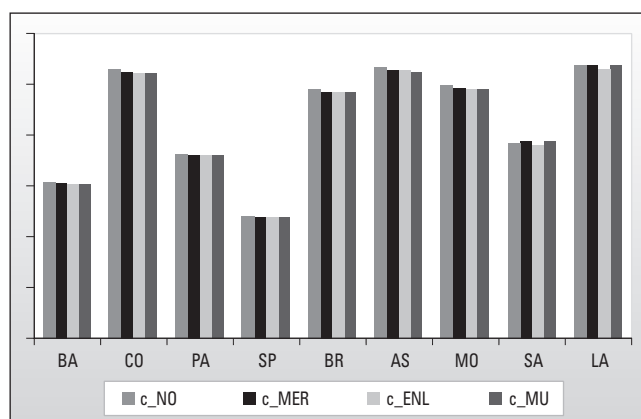


also to LA and SA (ENL); and a monetary union, in which MER countries also share a common currency (MU). These scenarios have different trade costs, which are constructed by using the values reported by Anderson and van Wincoop (2004). These authors provide a consensus estimate of the average trade cost for developed countries (and a lower limit for the average trade cost for developing countries) and their decomposition in local distribution costs, transportation costs, and border costs. These are further decomposed into components stemming from policy barriers, different currencies, different languages, information barriers, and security barriers.

Figures 4.10 to 4.14 show the outcomes of the different trade reforms. Figure 4.10 depicts the cutoff costs (that is, an inverse measure of average productivity) under the various scenarios. Without trade integration, average productivity is higher in places blessed by large local markets, good accessibility, and comparative advantage. Preferential trade liberalization improves the average productivity in member countries while reducing it in excluded ones. A common currency gives an additional boost to members' productivity while having negligible effects on excluded countries. Enlarged integration makes average productivity grow in the new member countries while having no impact on old ones. Mirror results are reported in Figure 4.11 for product variety.

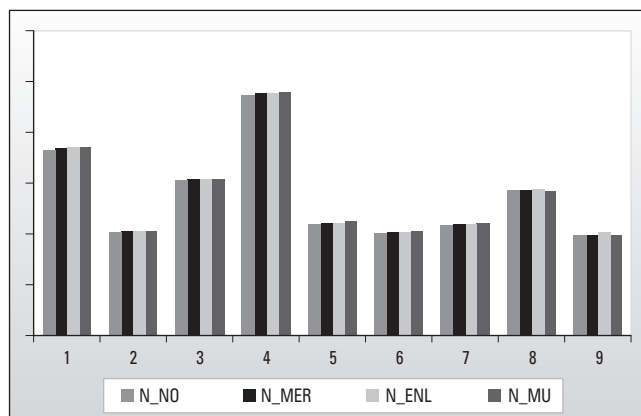
Figures 4.12 and 4.13 show that the somewhat limited asymmetries in terms of products available in each local market hide extreme asymmetries in industry dynamics. Most entry and production is in large, low-cost, and accessible markets. Trade liberalization boosts industrial activity only in PA and SP, thanks to their large local markets. Enlargement promotes

**Figure 4.10. Regional Integration: Selection**



Scenarios: No trade liberalization (NO), preferential trade liberalization excluding LA and SA (MER), enlarged trade liberalization (ENL), preferential trade liberalization plus monetary union excluding LA and SA (MU).

**Figure 4.11. Regional Integration: Variety**



Scenarios: No trade liberalization (NO), preferential trade liberalization excluding LA and SA (MER), enlarged trade liberalization (ENL), preferential trade liberalization plus monetary union excluding LA and SA (MU).

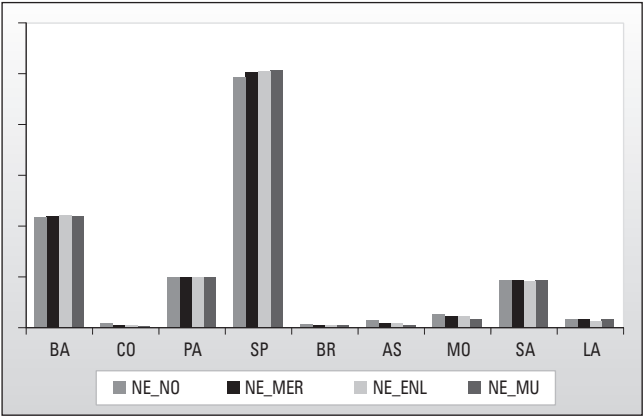
industry in the old members while putting pressure on the industrial bases of the new members. The adoption of a common currency has a positive impact on entry in the larger regions but little impact on production patterns.

Figure 4.14 completes the overall picture by showing that, notwithstanding the geographical polarization of industry, no region loses and most regions gain from preferential trade liberalization, from enlargement, and from the adoption of a common currency. This is because, in an integrated economy, the actual location of production loses importance relative to cheap access to a wide variety of goods wherever they are produced.

Before concluding, two issues are worth commenting upon. First, if one cares about the actual location of producers, a key insight is that the initial disadvantage in size could be offset by advantages in comparative costs and accessibility. This has important implications for small regions. Using the current numerical example, it is possible to calculate by how much small regions need to improve their initial cost-saving attraction and accessibility in order to compensate for the disadvantage of being small. Consider, for instance, AS and MO, which are small (Figure 4.8) but have fairly good cost-saving attraction and accessibility (Figure 4.9). Starting with NO, liberalization leads to a 30 percent loss in the number of producers in AS and a 20 percent loss in MO. These losses could be avoided if the joint measure of accessibility and comparative advantage increased by 5 and 7.5 percent, respectively, relative to other regions.

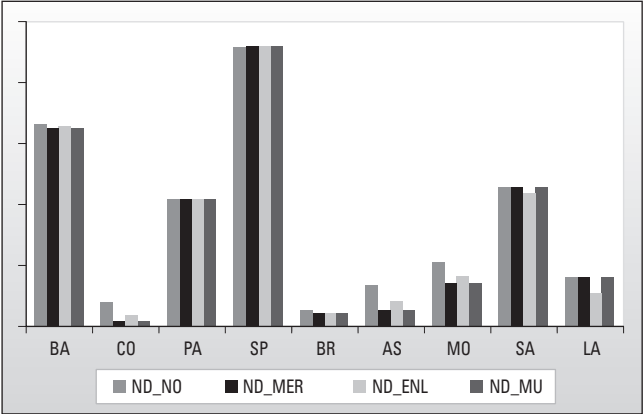
Second, the figures show only the long-term effects—that is, what happens after firms have had enough time to enter or exit the market (see the section “Trade Liberalization,

Figure 4.12. Regional Integration: Entry



Scenarios: No trade liberalization (NO), preferential trade liberalization excluding LA and SA (MER), enlarged trade liberalization (ENL), preferential trade liberalization plus monetary union excluding LA and SA (MU).

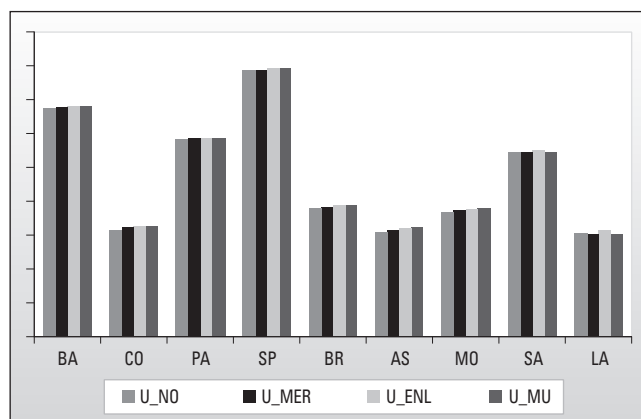
Figure 4.13. Regional Integration: Production



Scenarios: No trade liberalization (NO), preferential trade liberalization excluding LA and SA (MER), enlarged trade liberalization (ENL), preferential trade liberalization plus monetary union excluding LA and SA (MU).

Agglomeration, and Firm Selection”). As reported by Melitz and Ottaviano (2005), notable deviations would take place in the short run only if liberalization were not simultaneously undertaken by all countries. In particular, countries that liberalize unilaterally would be hurt in the long run but not in the short run when entry and exit are restricted. The same would happen for outsiders in preferential trade agreements. In cases of initially asymmetric trade liberalization, therefore, the speed with which the integration process is completed is crucial: slow processes sustain asymmetric gains and losses that fast processes do not.

**Figure 4.14. Regional Integration: Welfare**



Scenarios: No trade liberalization (NO), preferential trade liberalization excluding LA and SA (MER), enlarged trade liberalization (ENL), preferential trade liberalization plus monetary union excluding LA and SA (MU).

## Conclusion

What obstacles lay ahead for MERCOSUR? Can the distribution of the associated costs and benefits cause resistance to deeper integration from among national interests? To answer these questions, this chapter has proposed a theoretical framework to assess the economic impact and welfare implications of the resulting reallocation of resources across firms and countries. The proposed framework merges the key insights of NEG with more recent developments in the field of the selection effects of trade liberalization.

The main result is that trade liberalization induces a reallocation of resources from less to more productive firms (selection), from smaller to larger regions (market-seeking attraction), from high- to low-cost regions (cost-saving attraction) and from outsiders to insiders in preferential trade agreements (accessibility). This delivers long-run efficiency gains to liberalizing countries as tougher selection leads to higher average productivity, lower average prices, larger average firm size, higher profits, richer product variety, and lower markups. At the same time, it generates tensions between short-run winners and short-run losers by putting pressure on small, remote, backward countries, and—within countries—on small, remote, backward subregions, as well as on low-productivity firms and workers. Financial liberalization, labor market reforms, and an improvement in the credibility of further trade liberalization can lessen these tensions by reducing the costs of adjustment.

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## **MERCOSUR: Asymmetries and Strengthening the Customs Union— Options for the Common External Tariff**

*Silvia Laens and María Inés Terra\**

### **Introduction**

The operation of the Southern Common Market (MERCOSUR) as an imperfect customs union is determined by the existence of a common external tariff (CET) that has not been fully applied to date. The definition of the CET has spurred disputes because of the marked asymmetries among the member countries, not only in economic size, but also in production and trade specializations. The smaller members are more open and more specialized, and a larger share of their total trade is within the bloc. Their integration in MERCOSUR strongly affected their external relations and the composition of their output. For the bigger countries, especially Brazil, integration in MERCOSUR has had much less impact on production and trade.

Several studies show that the CET approved in Ouro Preto was more consistent with Brazil's interests than with those of the other members. Olarreaga and Soloaga (1998) reveal that the activities of national lobbies, weighted by country size, had been the strongest determinant of the CET structure approved by MERCOSUR in 1994. Brazil's interests thus prevailed over those of the smaller countries. These authors conclude that it is highly likely that the structure of the CET will be maintained in the future, since that structure responds to the concerns of the main interest groups in MERCOSUR.

The small countries tried to protect their interests by means of exceptions that delayed the full enforcement of the CET, thereby preserving the protection afforded to local industries. As a result, the CET was accompanied by several lists of exceptions that have not been completely annulled.

Given the dispute among members over the structure and level of the CET, it is unclear whether MERCOSUR will advance toward a customs union or revert to a free trade area. Although most exceptions have been eliminated and some bilateral agreements have been

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\* The authors acknowledge the collaboration of Carmen Estrades, who participated in different phases of this study.

renegotiated, the most critical discrepancies persist and there are still many exceptions to the tariff.

Previous studies found that although MERCOSUR is a small bloc relative to the world economy, it has had a significant impact on terms of trade. Chang and Winters (2002) conclude that the price effects of MERCOSUR's creation have been significant for nonmember exporters to Brazil. Olarreaga, Soloaga, and Winters (1999) also found that MERCOSUR has had a substantial effect on terms of trade. This finding could be an argument in favor of a CET that is not too low, but members' interests may diverge on this issue because the composition of their trade differs.

This chapter seeks to assess the effects of different options for the CET on each of the MERCOSUR countries. More precisely, it uses a computable general equilibrium (CGE) model to examine the welfare effects and the impact on economic activities of several options for each MERCOSUR country.

The section "MERCOSUR's Common External Tariff and Its Exceptions" briefly summarizes the CET's chief characteristics and the way in which it has been applied, emphasizing the main issues in this area. The next three sections of this chapter describe the model used, how it was calibrated, and the way in which the simulations were designed. And the final two sections discuss the results obtained and present the main conclusions.

## **MERCOSUR's Common External Tariff and Its Exceptions**

In 1994, the MERCOSUR countries agreed to create a customs union that would enter into force on January 1, 1995. Central to this agreement was the approval of a CET that would be the cornerstone of the bloc's common trade policy. Originally, the CET varied between 0 percent and 20 percent, with an average of 11 percent. Tariffs would increase as goods got closer to final demand: for intermediate goods they varied from 0 to 12 percent; for capital goods, from 12 to 16 percent; and, for finished goods, from 18 to 20 percent (Kume and Piani, 2001). Many exceptions were allowed, however, since there was no agreement on the number of items.

Most exceptions have been eliminated, but those on capital goods and on computing and telecommunications products persist. This is the most contentious issue: the smaller countries want their tariffs on such goods to be kept as low as possible in order to preserve their competitiveness, while Brazil wants to raise tariffs as high as possible in order to protect local production of these goods.

The tariffs currently applied by the MERCOSUR members differ from the agreed-upon CET in several ways. In addition to the exceptions agreed to in Ouro Preto and those still in force, imports through several special regimes remain exempted from enforcement of the CET, thus causing numerous perforations of the tariff. Most exceptions of this kind stem from bilateral agreements that the MERCOSUR countries had previously signed with other members of the Latin American Integration Association (LAIA). The renegotiation of these agreements has been more complicated than expected because they made provision for asymmetries by accepting differences in the preferential treatment granted to each coun-

try. Moreover, some specific duties and the use of trade defense instruments have also given rise to discrepancies between the CET and the applied tariffs.

Table 5.1 shows the weighted average of total and extrazone tariffs applied in

2000 in each country. The smaller countries have a lower level of protection because they apply lower tariffs to capital goods and to computer and telecommunication products, and also because the share of intrazone imports in their total imports is significantly higher than in Argentina or Brazil. As a result, their average tariff is half of that imposed by Brazil, where the average tariff is the highest among the four countries.

Table 5.2 shows the CET and the applied tariffs in each country, by sector of origin. The common tariff is higher for final consumption goods than for intermediate and capital goods, but the highest tariffs are on vehicles. The average tariff applied to the automotive sector is

**Table 5.1 Applied Tariff by Country in 2000**  
(weighted average, percent)

	Extrazone	Total
Argentina	12.9	9.4
Brazil	14.2	12.2
Paraguay	11.4	5.9
Uruguay	10.2	6.1

**Table 5.2 CET and Applied Tariff by Sector and Country in 2000**  
(weighted average, percent)

	CET	AR	BR	PR	UR
Rice and Wheat	8.1	10.5	10.5	10.5	10.5
Corn and Other Grains	4.9	6.6	6.6	6.6	6.6
Vegetables and Fruits	8.5	11.1	11.1	11.1	11.1
Soybeans	4.0	5.5	5.5	5.5	5.5
Oil Seeds	4.4	6.0	6.0	6.0	6.0
Sugar	15.0	19.0	17.2	22.1	17.7
Coffee and Other Crops	7.4	9.7	9.7	9.5	9.6
Livestock and Animal Products	7.3	9.8	9.3	9.3	9.3
Mining	3.1	5.8	6.0	5.8	5.8
Bovine Meat	10.4	13.4	13.4	13.4	13.4
Poultry Meat	10.0	13.0	13.0	13.0	13.0
Dairy Products	15.3	20.3	20.3	17.9	18.3
Beverages and Tobaccos	18.1	21.1	21.2	19.7	21.2
Vegetable Oils and Other Food	11.5	14.7	14.7	14.4	14.7
Textiles and Leather and Footwear	17.2	20.3	20.0	19.7	20.0
Light Manufactures	12.6	15.4	15.4	14.3	15.4
Petroleum and Chemicals	7.5	10.6	10.6	9.8	10.1
Metals	11.1	15.1	15.0	13.6	14.6
Automobiles	14.5	16.0	19.8	10.0	11.9
Machinery and Equipment	12.4	13.3	16.5	9.2	9.8

Source: Based on IDB database.

higher in Argentina and Brazil than in the other countries. For capital goods, Brazil has the highest average applied tariffs.

The sectors with the highest tariffs in all countries (above 14 percent, which is the average CET) are dairy products, beverages and tobacco, textiles, leather and footwear, and sugar (Table 5.2). The automobile sector is heavily taxed in Brazil. The sectors with the lowest tariffs (below 7 percent) are corn and other grains, soybeans, oilseeds, and mining.

The differences between the CET and the applied tariffs are greater in Paraguay and Uruguay than in Argentina and Brazil. The differences are also greater in the case of capital goods, intermediate goods, and vehicles than in other sectors. Argentina and Brazil apply high tariffs on vehicles while the smaller members apply the lowest tariffs on capital goods and telecommunication goods.

## The Model

The analysis is based on a CGE model, a methodology used widely in discussions of trade policy issues. It was inspired by the work of Mercenier and Cavalcante (1997), but the model used here is much simpler than their model, which deals with imperfect competition and dynamic behavior.

The model takes full account of the variety and disparities within MERCOSUR, since it considers each of the four members separately. The disaggregation of the four countries allows each of their trade policies to be analyzed, and facilitates identification of the disparities between the large and small countries.

CGE models include structural features that are absent in macromodels, but they still remain a stylized representation of the real world. Many aspects of the economic behavior of different agents are ignored or simplified, and the focus is on the features most relevant to the issues under study. So simulation results cannot be interpreted as predictions of what will eventually happen, but rather as indicators of the direction and relative scale of the possible effects of a given policy—as long as exogenous or excluded variables remain unchanged.

The trade model used here considers only real flows and ignores money and financial flows. As is well known, and as the most recent crisis shows, financial flows are very important in the MERCOSUR economies. The model also does not take some significant features of modern economies into account, such as imperfect competition, economies of scale, segmented labor markets, or other market failures. If some of these factors were considered, the impact of the simulated policy changes would probably be greater than under perfect competition. Additionally, since this is a static model, it can only show the impact of trade policy on the reallocation of resources and the redistribution of income. Despite these limitations, CGE models are useful in assessing the effect of trade policy on trade flows, resource allocation, and specialization.

The model is presented in detail in appendix 5.1. It is a multicountry, multisector model that includes 12 countries or regions and 22 sectors. Perfect competition and constant returns

to scale are assumed for all sectors. Goods are not homogenous, however, since they are differentiated by geographic origin, using Armington functions (Armington, 1969).

In every country, output for each sector is obtained by combining intermediate inputs from different origins with primary factors (land, capital, and labor). The supply for each factor is fixed in each country and there is no international factor mobility.

In each country, there is only one representative consumer. Government is not explicitly modeled, so tariff and tax revenues are directly allocated to the only representative consumer in each country. Total income in each is obtained by adding all factor payments received by the representative consumer, plus production taxes and tariffs.

The representative consumer allocates his income to different goods so as to maximize his utility, subject to his budget constraint. He also chooses how much of each good to buy from domestic production and from imports from different countries. Total demand by sector in each country is composed of intermediate and final demand in the domestic market and exports to each trading partner. Total supply by sector includes domestic production and imports from all trading partners.

When the model is solved, simultaneous equilibrium in all goods and factor markets is found. Equilibrium is obtained in factor markets when the sum of demands from the different sectors is equal to factor supply, which is fixed in each country. External equilibrium is reached when foreign debt in every country is equal to the difference between domestic income and consumption. The assumption made for the model closure is that foreign debt is fixed.

## Calibration of the Model

The model parameters were calibrated from a database obtained from the Inter-American Development Bank (IDB). The data used in this study were provided by the Bank's Integration and Regional Programs Department (INT). The social accounting matrices (SAMs) benchmarked at year 2000 are based on the Global Trade and Analysis Project (GTAP) version 5 (1997) data set and updated using the gross domestic product (GDP) and consumer price index (CPI) deflators when possible or estimated by IDB-INT. The main data sources are as follows. Trade data have been taken from the DATAINTAL, Free Trade Area of the Americas (FTAA), and United Nations Commodity Trade Statistics (UN COMTRADE) databases. Protection data have been taken from the FTAA database, supplemented by the Foreign Trade Information System (SICE) of the Organization of American States (OAS) and information from MERCOSUR's official website. Ad valorem equivalents of specific and mixed tariffs and tariff rate quotas (TRQs) have been estimated by the IDB, using tariff information at the eight-digit level of the Harmonized System (HS) and information provided by the United States International Trade Commission (USITC) and Jank (2004). Supplemental data sources include government finance statistics and the *International Financial Statistics Yearbooks* of the International Monetary Fund (IMF). Additional data have been provided by the Central Banks of Paraguay and Uruguay. The 12 countries or groups of countries considered are presented in Table 5.3, and aggregation by sectors is shown in Table 5.4.

**Table 5.3 Countries or Regions in the Model**

Code	Country or region
ARG	Argentina
CAC	Central America and Caribbean
BR	Brazil
MEX	Mexico
PRY	Paraguay
CAN	Canada
URY	Uruguay
USA	United States
CHL	Chile
EU	European Union
AC	Andean Community
ROW	Rest of the World

**Table 5.4 Sectors in the Model**

Code	Sector
WHEAT	Rice and Wheat
DAIRY	Dairy Products
CORNS	Corn and Other Grains
BVTBC	Beverages and Tobaccos
VEGET	Vegetables and Fruits
OTHFD	Vegetable Oils and Other Food Products
SYBNS	Soybeans
TXTIL	Textiles and Leather and Footwear
OSEED	Oil Seeds
OTLMF	Light Manufactures
SUGAR	Sugar
PETRO	Petroleum and Chemicals
COFFE	Coffee and Other Crops
METAL	Metals
LVSTK	Livestock and Animal Products
VEHCL	Automobiles
MNING	Mining
MCHNY	Machinery and Equipment
BVNMT	Bovine Meat
UTLTY	Utilities and Construction
OMEAT	Poultry Meat
SERV	Trade and Services

country. In general, trade is biased toward goods with low tariffs, while domestic output is biased toward goods with high tariffs. Simple averages are clearly unrealistic but at least they are free of those biases.

The database contains information for 2000 and disaggregates data for the four MERCOSUR countries. The tariff data include applied tariffs, taking into account some of the agreements in the framework of LAIA (MERCOSUR, Chile-MERCOSUR, Andean Community, Andean Community-MERCOSUR). They do not consider the agreements between Mexico and the MERCOSUR countries. This is an important advantage of this database, because a previous study by Laens and Terra (2005) showed the incidence of preferences on the results from different simulations related to the FTAA, especially for countries like Uruguay and Chile. Therefore, in order to analyze the asymmetries in MERCOSUR, it seemed important to take all of these preferences into account.

For each sector and country, the tariffs applied are simple averages of those applied to all goods belonging to that sector. This solution has some underpinnings, since it represents neither the average tariff for goods that are actually traded, nor the average tariff for goods that are actually produced in each

## Simulations

The simulations were intended to illustrate the effects of several options that are commonly discussed in relation to MERCOSUR's common tariff. Debate frequently focuses on the desirable tariff level, the convenience or otherwise of a flat tariff, the adequacy of the approved CET to each country's interests, and the need to establish high or low tariffs for particular sectors. Many experts argue that the CET approved in Ouro Preto is too high and has an excessive number of levels. The simulations were designed to provide some insights that may help clarify what is at stake in this debate.

The first option was to change the internal structure of the external tariff currently applied by simulating a flat rate (FLAT). A second option was to simulate the full enforcement of the approved CET. Two different options for the CET were then considered, taking the controversy between the large-country interests (namely, those of Brazil) and the interests of Paraguay and Uruguay into account. In order to simulate these diverging standpoints, the third simulation assumed that all four countries impose the external tariff now applied by Uruguay (CETUR). In this case, the CET exceptions are taxed with much lower tariffs than in the previous simulation. In the fourth simulation, it was assumed that all four countries apply the external tariff presently applied by Brazil (CETBR). Therefore the CET exceptions (mainly capital goods) are taxed as they are now done in Brazil. In the CET, CETUR, and CETBR simulations, the 3 percent rise accepted in 1997 was completely eliminated. Tariffs applied to intrazone trade remained unchanged in every scenario.

Additionally, the effects of a mere change in the tariff level were considered by simulating different levels for the four tariff structures described in the previous paragraph. For the flat tariff, the simulated tariff levels were 0 percent, 6 percent, 10 percent, 15 percent, and 20 percent. For the CET, CETUR, and CETBR options, a 50 percent and a 100 percent cut and a 50 percent and 100 percent increase were simulated. The same experiments were performed assuming a unilateral tariff change in Uruguay and Paraguay.

The simulations were carried out with different values for the elasticity of substitution between domestic and imported goods. First used were the set of elasticities commonly employed in the GTAP model (elasticity S1). The second set of elasticities (S2) was the GTAP vector multiplied by two for developing countries (all of Latin America and the Caribbean), leaving the United States, the European Union (EU), Canada, and the rest of the world unchanged. Finally, the third set of elasticities (S3) is equal to the GTAP vector multiplied by four in the case of those countries.

Several studies have used elasticity values much higher than those used here (Harrison, Rutherford, and Tarr, 2002, 2004; Sánchez, 2001; ALADI, 2004; CEI, 2002). The rationale for these high elasticity values stems from empirical studies that have found very high values for demand elasticity in developing countries (Reidel, 1988). Although Reidel has been strongly criticized by several authors, among CGE experts there is a widespread feeling that the Armington elasticities estimated by econometric methods are too low and generate too large effects on the terms of trade. A study by Panagariya, Shah, and Mishra (1996) finds very high

elasticities for the demand of textile exports from Bangladesh. The literature is not conclusive on this issue but shows that these models are very sensitive to the Armington elasticity.

In all cases, the comments herein are based on the results obtained when the S2 set of elasticities was used. In the first set of experiments described above, the tariffs of the four partners are changing simultaneously, so consideration is being given to the direct effects of changes in a given country's tariff, and to the indirect effects of the tariff changes on the other MERCOSUR members. The second set of experiments isolates the direct effects of changes in their own tariff for the smaller MERCOSUR countries.

The model and the simulations were run using the general algebraic modeling system (GAMS). The GAMS code used was adapted from Mercenier's code for a multicountry, dynamic model.

Results of the Simulations

Tables 5.5 to 5.8 show the overall results for the simulations on which the analysis is focused: FLAT (6 percent flat tariff), CET (full enforcement of the CET), CETUR (tariff structure applied in Uruguay in 2000), and CETBR (tariff structure applied in Brazil in 2000).

Overall Results

For MERCOSUR as a whole, the four simulations cause a reduction of the external tariff, which was 13.9 percent in the benchmark (see Table 5.5). When a 6 percent flat tariff is simulated (FLAT), the average tariff is cut by more than half. The reduction is also significant in the simulation based on the CETUR. At the other end, when the CETBR is applied as the CET,

Table 5.5 Average Tariff for MERCOSUR and Each Member Country (percent)

Simulation code	Baseline BASE	6% flat tariff FLAT	CET enforcement CET	Uruguay's external tariff CETUR	Brazil's external tariff CETBR
Average tariff					
MERCOSUR		5.2	8.9	6.5	9.6
Argentina	9.4	4.9	8.2	6.4	8.7
Brazil	12.2	5.4	9.4	6.7	10.3
Paraguay	5.9	3.5	5.9	4.3	6.1
Uruguay	6.1	4.0	5.5	4.7	5.7
Average external tariff					
MERCOSUR	13.9	6.0	10.7	7.6	11.7
Argentina	12.9	6.0	11.0	8.1	11.9
Brazil	14.2	6.0	10.6	7.4	11.7
Paraguay	11.4	6.0	12.2	7.7	13.0
Uruguay	10.2	6.0	9.4	7.7	10.0

the average falls by only 2 percentage points. Full enforcement of the CET also brings about a small reduction of the average external tariff.

The results for Argentina and Brazil are similar to those for the bloc as a whole, but the reduction in the external tariff is higher for Brazil. In contrast, for Paraguay and Uruguay, both full enforcement of the CET and the application of the Brazilian tariff would lead to a very slight reduction (or even an increase) in the average external tariff. This is because both countries have much lower tariffs on capital goods and vehicles than the CET agreed in Ouro Preto, or than the tariff applied by Brazil to such goods.

The flat tariff and the application of the Uruguayan tariff in all countries would bring the total average tariff to very low levels in Paraguay and Uruguay. This total average was around 6 percent in the benchmark but falls to around 4 percent in both countries. These average tariffs are much lower than those in Argentina and Brazil because of the much higher ratio of intrazone trade in the smaller countries.

The overall indicators in Table 5.6 show slight variations in welfare, terms of trade, and GDP in all simulations. As mentioned earlier, static CGE models can only show the reallocation and terms of trade effects; the welfare changes are usually very small. This is particularly true when perfect competition is assumed.

The results indicate that changes in welfare (measured by equivalent variations) are negligible for all the simulations and all countries. The same happens with the terms of trade and production effects. There is a welfare loss for MERCOSUR, Argentina, and Uruguay in every scenario. Brazil, however, improves its welfare when the external tariff declines only slightly (CET and CETBR scenarios), and Paraguay has a welfare gain when the tariff falls (FLAT and CETUR scenarios).

The negative sign in EV can be explained mainly by the deterioration of the terms of trade observed in every simulation, except in Paraguay. The effect on GDP is positive for all countries (and for MERCOSUR) in the FLAT simulation, when the average tariff decreases the most. Brazil shows an efficiency gain in every simulation, because its protection level declines in all of them. In the other countries, the sign of the effect varies: Argentina increases its GDP in the CET and CETUR simulations, while Paraguay only in the latter, since the average tariff is lower. For Uruguay, GDP declines in the three scenarios.

The effects on trade are much larger than those observed for GDP. Trade increases whenever the average tariff is reduced, and thus Brazil benefits the most because it has the largest tariff cuts. In the smaller countries, trade growth is relatively modest (or even negative for Uruguay, except in FLAT). This is unsurprising, since the small countries have a higher share of trade within the bloc and thus the portion of trade affected by the tariff change is less significant. In the small countries, the percentage of exports and imports to and from the rest of the world reaches its maximum level with the flat tariff. Trade declines in Uruguay, even when tariffs are cut, because the deterioration of the terms of trade offsets the increase in relative prices of exportable goods that the tariff cut brings about. Consequently resources are reallocated to import-substitution sectors and the economy becomes less open.

**Table 5.6 Overall Results for MERCOSUR and Each Member Country**  
(percent)

Simulation code	6% flat tariff FLAT	CET enforcement CET	Uruguay's external tariff CETUR	Brazil's external tariff CETBR
<b>MERCOSUR</b>				
Equiv. Variations (EV)	-0.09	-0.02	-0.08	-0.02
Terms of Trade Effect (TOTX)	-0.21	-0.08	-0.16	-0.05
GDP Effect (GDPX)	0.12	0.06	0.07	0.03
Real Exports	9.34	3.23	6.87	2.07
Real Imports	6.07	2.13	4.51	1.40
<b>Argentina</b>				
Equiv. Variations (EV)	-0.12	-0.06	-0.11	-0.06
Terms of Trade Effect (TOTX)	-0.20	-0.08	-0.15	-0.05
GDP Effect (GDPX)	0.08	0.01	0.04	-0.01
Real Exports	5.07	0.53	2.67	0.05
Real Imports	2.59	-0.17	1.04	-0.32
<b>Brazil</b>				
Equiv. Variations (EV)	-0.07	0.01	-0.07	0.01
Terms of Trade Effect (TOTX)	-0.22	-0.08	-0.16	-0.05
GDP Effect (GDPX)	0.14	0.09	0.10	0.06
Real Exports	11.93	4.74	9.29	3.17
Real Imports	8.00	3.29	6.33	2.26
<b>Paraguay</b>				
Equiv. Variations (EV)	0.13	-0.05	0.03	-0.13
Terms of Trade Effect (TOTX)	-0.05	0.02	0.00	0.00
GDP Effect (GDPX)	0.18	-0.07	0.02	-0.13
Real Exports	2.67	-0.28	1.85	-0.48
Real Imports	1.26	-0.11	1.04	-0.31
<b>Uruguay</b>				
Equiv. Variations (EV)	-0.17	-0.10	-0.17	-0.11
Terms of Trade Effect (TOTX)	-0.22	-0.06	-0.14	-0.04
GDP Effect (GDPX)	0.05	-0.04	-0.03	-0.07
Real Exports	0.75	-0.29	-0.31	-0.32
Real Imports	0.13	-0.33	-0.46	-0.34

Trade openness does not show a significant change because when trade increases, GDP also rises (see Table 5.7). The largest change in trade openness is in Brazil when the 6 percent flat tariff is simulated. In this simulation, Brazil has the largest tariff reduction in absolute terms (8 percentage points). In addition, Brazil has the highest share of extrazone trade in total trade. Both factors amplify the effects of the tariff change as compared to those obtained for the other countries.

These results are very much influenced by the Armington assumption adopted in the model, which implicitly considers every country as a price maker. Although some authors

**Table 5.7 External Trade Results for MERCOSUR Member Countries**  
(percent)

Simulation code	Baseline data BASE	6% flat tariff FLAT	CET enforcement CET	Uruguay's external tariff CETUR	Brazil's external tariff CETBR
<b>Argentina</b>					
Trade openness	21.39	22.17	21.43	21.77	21.37
Share of extrazone exports in total exports	71.96	78.64	75.43	77.74	74.22
Share of extrazone imports in total imports	79.28	85.83	80.49	83.10	79.19
<b>Brazil</b>					
Trade openness	25.40	27.84	26.38	27.32	26.07
Share of extrazone exports in total exports	88.74	92.58	89.56	91.14	88.77
Share of extrazone imports in total imports	89.78	92.68	91.49	92.44	90.98
<b>Paraguay</b>					
Trade openness	52.87	53.68	52.82	53.56	52.75
Share of extrazone exports in total exports	67.74	71.63	69.25	69.81	69.09
Share of extrazone imports in total imports	61.50	66.57	58.86	63.85	57.80
<b>Uruguay</b>					
Trade openness	41.40	41.60	41.30	41.29	41.30
Share of extrazone exports in total exports	71.53	79.44	74.21	77.33	73.27
Share of extrazone imports in total imports	67.86	72.43	66.89	68.32	66.12

consider that the elasticities assumed for the Armington function might be overstating the terms of trade effect, to some extent these results seem to be consistent with the findings of Chang and Winters (2002). If the creation of MERCOSUR caused an improvement in its terms of trade, a reduction in the external tariff would lead to their deterioration. Table 5.8, however, reveals some matters that were not considered by these authors, since the main factor explaining the terms of trade deterioration is the fall in export prices and not, as they argue, the rise in import prices.

When tariffs fall, Brazil's trade increases, and export supply and import demand rise. Tables 5.5 and 5.6 show that trade growth is greater when the tariff reduction is larger (FLAT and CETUR scenarios). Table 5.8 shows that both export and import prices fall, but the terms of trade effect is mainly explained by the fall in export prices. Although both the theoretical and empirical literature on customs unions focus on the behavior of import prices, the effect on export prices seems to be quite reasonable in the case of MERCOSUR.

**Table 5.8 Terms of Trade Effect Decomposition**  
(percent)

Simulation code	6% flat tariff FLAT	CET enforcement CET	Uruguay's external tariff CETUR	Brazil's external tariff CETBR
<b>MERCOSUR</b>				
Terms of Trade Effect (TOTX)	-0.21	-0.08	-0.16	-0.05
Exports Price Variation	-0.27	-0.10	-0.20	-0.06
Imports Price Variation	-0.06	-0.02	-0.04	-0.01
<b>Argentina</b>				
Terms of Trade Effect (TOTX)	-0.20	-0.08	-0.15	-0.05
Exports Price Variation	-0.27	-0.10	-0.20	-0.06
Imports Price Variation	-0.07	-0.02	-0.05	-0.01
<b>Brazil</b>				
Terms of Trade Effect (TOTX)	-0.22	-0.08	-0.16	-0.05
Exports Price Variation	-0.26	-0.10	-0.19	-0.06
Imports Price Variation	-0.05	-0.02	-0.03	-0.01
<b>Paraguay</b>				
Terms of Trade Effect (TOTX)	-0.05	0.02	0.00	0.00
Exports Price Variation	-0.35	-0.09	-0.21	-0.06
Imports Price Variation	-0.30	-0.11	-0.22	-0.07
<b>Uruguay</b>				
Terms of Trade Effect (TOTX)	-0.22	-0.06	-0.14	-0.04
Exports Price Variation	-0.42	-0.13	-0.28	-0.08
Imports Price Variation	-0.20	-0.07	-0.14	-0.04

Table 5.9 shows MERCOSUR's share of world exports and imports for all goods and for selected goods. This overall share of world trade is small, but far from negligible in the case of goods in which the bloc has clear comparative advantages. Hence, when tariffs fall and resources are reallocated from the import-substitution sectors to the export sectors, the world supply of those goods increases, lowering their export prices. Given its trade composition, MERCOSUR has a greater capacity to influence its export prices than its import prices.

The results for Brazil are basically attributable to the changes in the Brazilian tariff, but those of the other partners cannot be analyzed without considering the indirect effect of the variation in the tariffs of the rest of the bloc, especially those of Brazil.

Argentina's results are similar to those of Brazil. In fact, Table 5.6 shows that the terms of trade effect is very similar for Argentina, Brazil, and Uruguay. The main reason for the decline in the Argentine and Brazilian terms of trade is the decrease in production and export prices as a result of trade openness, while the variation of import prices from the rest of the world is small.

**Table 5.9 MERCOSUR's Share of World Trade**

Sector		Share in world export (%)					Share in world import (%)				
		ARG	BR	PRY	URY	MERC	ARG	BR	PRY	URY	MERC
Rice and Wheat	WHEAT	13.4	0.1	0.1	1.8	15.4	0.0	11.6	0.1	0.0	11.8
Corn and Other Grains	CORNS	10.8	0.5	0.3	0.0	11.6	0.2	2.9	0.1	0.4	3.6
Vegetables and Fruits	VEGET	2.9	2.0	0.0	0.2	5.0	0.6	1.2	0.1	0.1	2.0
Soybeans	SYBNS	9.4	23.6	3.3	0.0	36.3	0.4	1.5	0.0	0.0	2.0
Oil Seeds	OSEED	8.2	0.1	0.1	0.0	8.4	0.4	0.4	0.1	0.1	0.9
Sugar	SUGAR	1.4	19.5	0.3	0.1	21.2	0.0	0.0	0.0	0.4	0.5
Coffee and Other Crops	COFFE	1.0	8.3	0.3	0.2	9.8	0.4	1.4	0.1	0.2	2.2
Livestock and Animal Products	LVSTK	2.7	4.3	0.1	1.0	8.1	0.6	0.8	0.0	0.1	1.5
Bovine Meat	BVNMT	6.4	6.0	1.0	4.4	17.8	0.2	1.2	0.0	0.0	1.4
Poultry Meat	OMEAT	0.2	9.7	0.0	0.0	9.9	1.1	0.0	0.0	0.1	1.2
Dairy Products	DAIRY	3.7	0.1	0.0	1.5	5.4	0.4	4.5	0.1	0.0	5.1
Beverages and Tobaccos	BVTBC	1.2	0.5	0.0	0.4	2.1	0.3	1.2	0.7	0.1	2.3
Vegetable Oils and Other Food Products	OTHFD	6.1	6.2	0.1	0.3	12.7	0.7	1.3	0.1	0.2	2.4
Mining	MNING	1.3	1.7	0.0	0.0	3.0	0.2	1.6	0.0	0.1	1.9
Textiles and Leather and Footwear	TXTIL	0.5	1.5	0.0	0.2	2.3	0.5	0.7	0.0	0.1	1.3
Light Manufactures	OTLMF	0.3	2.0	0.0	0.0	2.4	0.6	0.7	0.1	0.1	1.5
Petroleum and Chemicals	PETRO	0.6	1.1	0.0	0.1	1.8	1.2	3.2	0.1	0.2	4.7
Metals	METAL	0.6	3.1	0.0	0.0	3.7	0.6	1.2	0.0	0.1	1.9
Automobiles	VEHCL	0.4	1.6	0.0	0.0	2.0	0.7	1.4	0.0	0.1	2.1
Machinery and Equipment	MCHNY	0.1	0.5	0.0	0.0	0.6	0.7	1.6	0.0	0.1	2.3
Trade and Services	SERVIC	0.4	0.9	0.1	0.1	1.5	0.7	2.1	0.1	0.1	2.9
	<b>Total</b>	<b>0.6</b>	<b>1.4</b>	<b>0.0</b>	<b>0.1</b>	<b>2.2</b>	<b>0.7</b>	<b>1.7</b>	<b>0.1</b>	<b>0.1</b>	<b>2.5</b>

To understand the results for the small MERCOSUR partners, some additional simulations were carried out in order to separate the impact of the change in their own tariffs from the effect of the change in their partners' tariffs. Table 5.10 shows how equivalent variations, terms of trade, and GDP change in Uruguay and Paraguay when their tariffs change without a simultaneous variation in the other members' tariffs. In all the experiments where tariffs are reduced, welfare and GDP rise in both Uruguay and Paraguay. In every scenario, the same change in extrazone tariffs brings about a welfare and efficiency gain if the change is carried out by these countries alone, without a simultaneous variation in the tariffs of the other partners. This shows the importance of the effect of their preferential access to the other members' markets. The positive effect of their own opening is partially offset by the loss of their preferential access to the markets of the large MERCOSUR countries when the latter also lower their tariffs simultaneously.

**Table 5.10 Unilateral Tariff Variation Results: Uruguay and Paraguay**  
(percent)

Simulation code	6% flat tariff FLAT	CET enforcement CET	Uruguay's external tariff CETUR	Brazil's external tariff CETBR
<b>Paraguay</b>				
Equiv. Variations (EV)	0.21	-0.01	0.05	-0.09
Terms of Trade Effect (TOTX)	-0.11	0.00	-0.07	0.01
GDP Effect (GDPX)	0.32	-0.01	0.12	-0.09
Real Exports	4.42	0.05	2.27	-0.12
Real Imports	2.29	0.04	1.15	-0.05
<b>Uruguay</b>				
Equiv. Variations (EV)	0.14	0.01	0.06	-0.04
Terms of Trade Effect (TOTX)	-0.08	-0.01	-0.04	0.00
GDP Effect (GDPX)	0.22	0.02	0.09	-0.03
Real Exports	3.80	0.41	1.56	0.03
Real Imports	3.00	0.31	1.23	0.01

In the small countries, both import and export prices decline because those countries have a large share of intrazone exports, and thus when tariffs are cut in the whole bloc, their partners' prices fall (see Table 5.7). Nevertheless, the terms of trade deterioration in Uruguay is explained by the fall in export prices, while in Paraguay import prices decline even more than export prices, so there is an improvement in the terms of trade. The small partners' export prices decline even when the average external tariff increases, because they are strongly affected by the fall in Brazilian and Argentine prices.

In Paraguay and Uruguay, there is a positive effect on GDP when trade increases (the FLAT or the CETUR in the case of Paraguay), but the result is otherwise negative. For Paraguay, this is because in the other two simulations the average tariff increases, and thus the efficiency gains of trade are lost. In the case of Uruguay, even when tariff protection declines, trade decreases in all scenarios except in the flat 6 percent tariff. This is because the terms of trade deterioration leads to a reallocation of resources from export-oriented sectors to import-substitution sectors, thereby offsetting the positive impact of tariff reduction.

### **Results by Sector**

Table 5.11 presents output variations by sector in the four countries for each of the simulations. Only the sectors with variations larger than 1 percent in any of the simulations are reported. Tables 5A.1 to 5A.8 in appendix 5.2 show the percentage variations of exports and imports by sector and scenario for each country.

The adoption of a low tariff (as in the simulation of a flat 6 percent tariff) would reinforce the specialization pattern based on agricultural production to the detriment of manufacturing production in all MERCOSUR partners. This is particularly worrisome for

**Table 5.11 MERCOSUR: Output by Sector**  
(percent)

		Variation by scenario				
		Share in total output in baseline	6% flat tariff FLAT	CET enforcement CET	Uruguay's external tariff CETUR	Brazil's external tariff CETBR
<b>Argentina</b>						
Rice and Wheat	WHEAT	0.9	1.8	0.8	0.6	0.4
Corn and Other Grains	CORNS	0.6	3.3	1.4	2.4	0.7
Soybeans	SYBNS	1.2	2.0	0.9	1.8	0.5
Oil Seeds	OSEED	0.3	2.3	1.0	1.8	0.5
Livestock and Animal Products	LVSTK	0.7	1.7	0.7	1.4	0.4
Vegetable Oils and Other Food Products	OTHFD	6.4	1.4	0.6	1.3	0.3
Mining	MNING	1.9	6.0	-0.2	2.3	-0.7
Textiles and Leather and Footwear	TXTIL	7.5	-0.6	0.1	0.5	0.0
Automobiles	VEHCL	5.6	-7.2	-2.7	-6.0	-0.7
Machinery and Equipment	MCHNY	4.2	-2.8	-0.3	-2.7	0.4
		<b>29.4</b>				
<b>Brazil</b>						
Soybeans	SYBNS	0.8	1.8	0.7	1.4	0.4
Coffee and Other Crops	COFFE	1.1	2.0	0.8	1.6	0.3
Beverages and Tobaccos	BVTBC	0.7	-1.1	-0.1	-1.0	-0.1
Mining	MNING	1.4	4.6	0.7	2.7	0.1
Metals	METAL	5.6	1.30	0.61	1.17	0.54
Automobiles	VEHCL	3.6	0.8	0.9	0.1	1.7
Machinery and Equipment	MCHNY	4.8	-1.7	-0.2	-2.0	0.2
		<b>18.0</b>				
<b>Paraguay</b>						
Rice and Wheat	WHEAT	1.0	-0.5	-0.35	-1.02	-0.23
Soybeans	SYBNS	5.2	1.3	0.36	0.82	0.42
Coffee and Other Crops	COFFE	6.6	-0.6	-0.86	-0.94	-1.15
Beverages and Tobaccos	BVTBC	1.5	-5.9	-0.5	-8.5	-0.2
Mining	MNING	0.5	-0.1	-1.2	-0.4	-1.1
Textiles and Leather and Footwear	TXTIL	3.1	-7.6	-1.7	-0.4	-1.7
Light Manufactures	OTLMF	3.7	-2.3	-0.9	0.1	-1.0
Petroleum and Chemicals	PETRO	1.6	0.4	-1.1	0.1	-1.2
Metals	METAL	0.7	-4.9	-2.9	-2.3	-2.2
Automobiles	VEHCL	0.1	-6.0	9.5	0.3	14.9
Machinery and Equipment	MCHNY	0.2	-0.6	2.9	-0.8	3.8
Services	SERV	44.8	1.1	0.3	0.6	0.2
		<b>68.9</b>				

(continued on next page)

**Table 5.11 MERCOSUR: Output by Sector** (*continued*)  
(percent)

		Variation by scenario				
		Share in total output in baseline	6% flat tariff FLAT	CET enforcement CET	Uruguay's external tariff CETUR	Brazil's external tariff CETBR
<b>Uruguay</b>						
Livestock and Animal Products	LVSTK	2.3	2.3	0.4	1.3	-0.1
Bovine Meat	BVNMT	2.4	3.6	1.1	2.2	0.3
Dairy Products	DAIRY	2.7	-0.9	-0.4	-4.1	-0.2
Beverages and Tobaccos	BVTBC	3.1	-5.6	-0.8	-5.9	-0.7
Mining	MNING	0.2	3.0	-3.0	-1.4	-2.8
Textiles and Leather and Footwear	TXTIL	3.9	-0.1	0.5	3.4	-0.4
Light Manufactures	OTLMF	2.9	-4.2	-1.2	-0.7	-1.3
Petroleum and Chemicals	PETRO	4.9	-1.4	-1.4	-0.6	-1.2
Metals	METAL	2.0	-2.8	-0.8	-1.5	-0.1
Automobiles	VEHCL	1.8	-21.6	-5.4	-16.8	1.5
Machinery and Equipment	MCHNY	1.4	-2.2	2.0	-2.4	3.3
<b>27.5</b>						

countries like Argentina and Uruguay, whose comparative advantages are in agricultural goods that are heavily protected in developed economies and where they have greater capacity to affect the terms of trade. In the smaller countries, this would cause an output decline in agroindustrial exports within the bloc, such as those of the dairy industry or other light manufactures that have a relatively high share of total output (the food, textile, and leather industries, among others).

The adoption in all countries of an external tariff like that applied in Uruguay (CETUR) would not have a negative effect on light manufacturing in Argentina or Brazil, but it could have a strong negative effect on heavy industries with a high technological content. This effect would be more significant in Argentina and Brazil, because vehicles and capital goods have a greater weight in their output composition. In the small countries, these industries do not have a significant share in total output.

On the other hand, the adoption of the CETBR would not lead to great changes in the productive structure of the largest MERCOSUR partners, but it would have a negative impact on GDP in Paraguay and Uruguay. In those countries, the tariff increase would only have a positive effect on some sectors with a small share of total output, such as automobiles, and machinery and equipment. The output effect of an increase in protection would be negligible, even if the percentage variation relative to the baseline is high.

The full enforcement of the CET does not bring about significant changes in resource allocation in Argentina. The most significant change is a 2.7 percent fall in vehicle production and a 1.4 percent increase in the production of corn and other grains. Exports rise in almost

every sector because protection of the domestic market falls. The exception is the automobile sector, whose exports decline. Imports of manufactured products and some agricultural goods increase significantly. On the other hand, imports of machinery and equipment, as well as of soybeans and oilseeds, would fall because of the tariff increase in those sectors.

As in Argentina, enforcement of the CET in Brazil would not have significant effects on output composition, but would lead to an increase in exports from all sectors, especially metals, vehicles, and machinery and equipment.

In Paraguay, full enforcement of the CET would lead to a change in the tariff structure and an increase in protection. The outcome is an export decline in almost every sector, especially agricultural goods and metals. In addition, imports would rise in almost every sector, except for machinery and equipment, vehicles, and services. The former would be the sectors with the highest tariff increase. The result would be an increase in the production of vehicles, and machinery and equipment, and a fall in others—such as beverages and tobacco, mining, textiles, light manufactures, petroleum and chemicals, and metals. It should be noted that in the baseline, the automobile and machinery industries are almost nonexistent in Paraguay (amounting to only 0.2 percent of total output), and thus a 10 percent increase is meaningless. The most affected sectors (positively or negatively) account for 69 percent of initial output.

In Uruguay, the sectors most affected by full enforcement of the CET would be mining, light manufacturing, and petroleum and chemicals. Production of machinery and equipment would increase. Total exports would remain almost unchanged, but there would be an increase in exports from several agricultural sectors, and manufacturing exports would fall. Imports would rise in almost every sector, but would decline in the case of machinery and equipment and vehicles, because tariffs rise in these sectors.

In both Paraguay and Uruguay, output variations are much higher than in Argentina and Brazil, and therefore the adjustment costs stemming from the change in the allocation of resources could be higher than in the larger countries.

### ***Level and Structure of the CET***

The four simulations entail different CET levels and structures. The results show that for all four countries, the adoption of a 6 percent flat tariff (FLAT) is the best option in terms of its effects on productive efficiency (measured by GDP growth). Application of the CETUR to the whole bloc, full enforcement of the CET, and the application of the CETBR are ranked in that order in terms of their efficiency effects. The last is the worst option for the four members and for MERCOSUR as a whole.

When the effects of a change in tariff level and structure are analyzed separately, however, the ranking basically depends on the differences in the tariff level of each option. The lower the tariff, the greater the trade increase and efficiency in resource allocation, except for very low tariff levels. This does not mean that a tariff structure with low protection levels on capital goods (such as the CETUR option) would be superior to one with a high level of protection in that sector (such as the CETBR option), if they had similar average levels of protection.

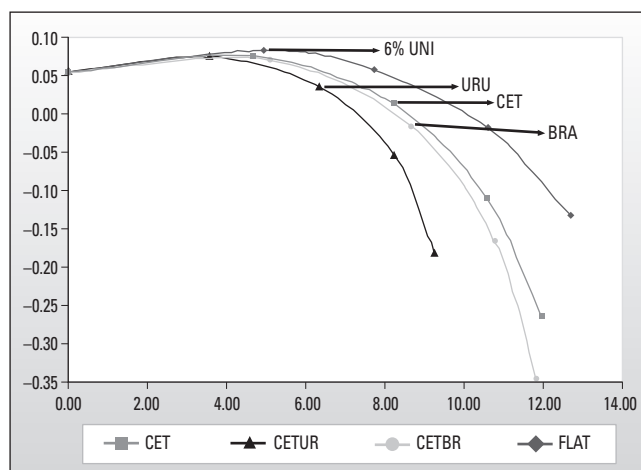
Figures 5.1 to 5.5 show the real GDP variation by average tariff level in the four options for MERCOSUR and for each member. The flat tariff (FLAT) appears as a clearly superior option in every case, followed by the CET option, the CETBR, and finally the CETUR. As the average tariff falls, however, the tariff structures become more uniform and the differences between them are smaller.

Adoption of the CET approved in 1994, despite the exceptions, marked a great change in the structure and level of protection for the smaller MERCOSUR countries. They reduced their tariffs on the most sensitive goods, even though they maintained the exceptions for goods with lower tariffs than the CET (like capital goods). For these countries, opening to MERCOSUR triggered a very significant fall in average protection, because a large share of their total trade is intrazone. As a result, the tariff level in these countries is lower than in the large countries, the degree of tariff dispersion is smaller, and they have paid the costs of adjusting their economies to that increased opening.

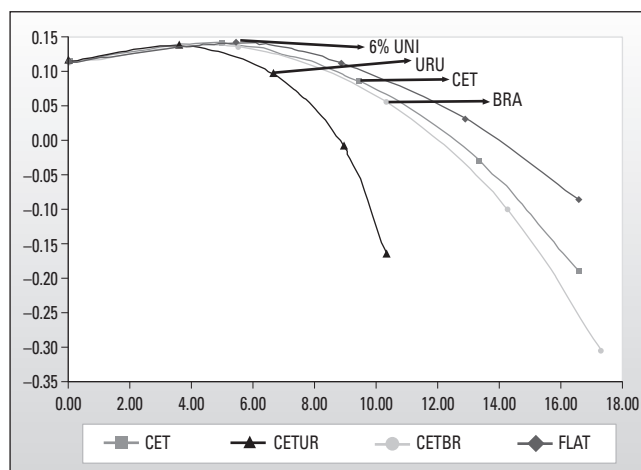
The simulation results also show that although the changes in total trade would be smaller in the small countries, the effects on output would be larger than in Argentina or Brazil. Any tariff change that alters the average level should be studied carefully, since the adjustment costs in the smaller economies can be very significant.

Nevertheless, a change in the tariff structure leading to a more uniform tariff could have no negative consequences as long as it does not raise the level of protection. Moreover, a more uniform tariff structure could help increase efficiency for all members. This does not

**Figure 5.1. Argentina**  
**Real GDP Variation by Scenario**



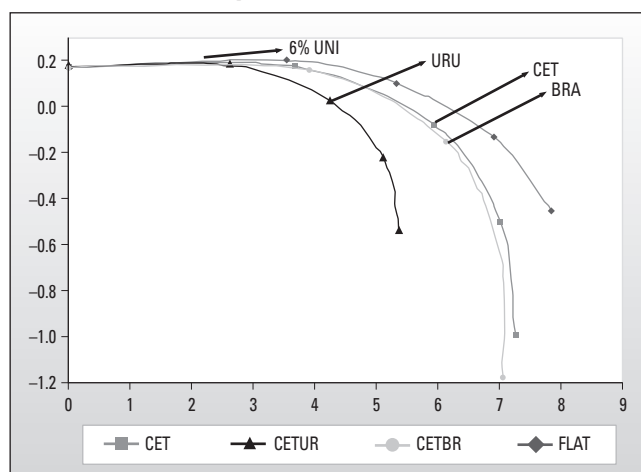
**Figure 5.2. Brazil**  
**Real GDP Variation by Scenario**



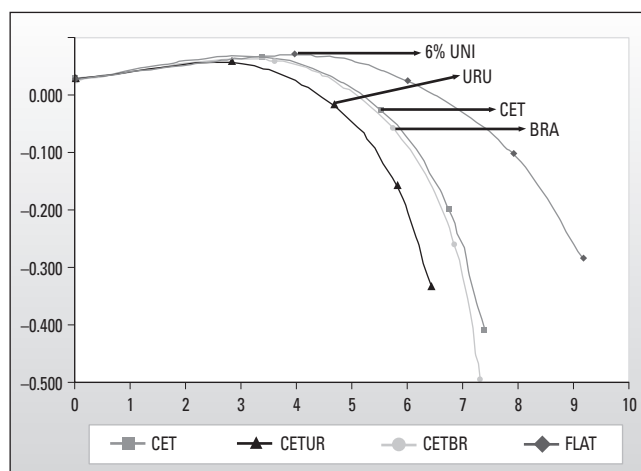
necessarily mean that there will be a welfare gain, because the terms of trade effect is higher when the specialization in agricultural goods is more significant. In addition, production of manufactured goods could have other externalities that could increase welfare. All these arguments should be taken into account, but they are beyond the scope of this chapter.

In terms of efficiency and resource allocation, the CET agreed upon in Ouro Preto is superior to a tariff structure with very low tariffs on capital goods (as the small countries want). The figures, however, show that full enforcement of the CET would lead to GDP growth in Argentina and Brazil, and a decline in Paraguay and Uruguay. They also show that an option that cuts the average tariff by about 2 percentage points, as compared to the CET, could be beneficial for the four MERCOSUR members.

**Figure 5.3. Paraguay  
Real GDP Variation by Scenario**



**Figure 5.4. Uruguay  
Real GDP Variation by Scenario**



## Conclusions

It could be argued that there are no theoretical arguments in favor of a high tariff level for capital goods or for computer and telecommunication products (Kume and Piani, 2001). The only exception is the “infant-industry” argument, which always has to be treated with caution. Even granting the existence of a learning process or other types of externalities associated with the production of these goods, more empirical elements would be needed to support a tariff increase.

On the other hand, there are theoretical arguments in favor of adopting a low tariff for capital goods and for computer and telecommunication products. The main argument

concerns investment incentives. De Long and Summers (1991) and Jones (1994) show that the growth rates in different countries are more closely associated with the relative price of capital goods than the savings rate. The model used here is not appropriate for this discussion because a dynamic model would be needed to capture these effects.

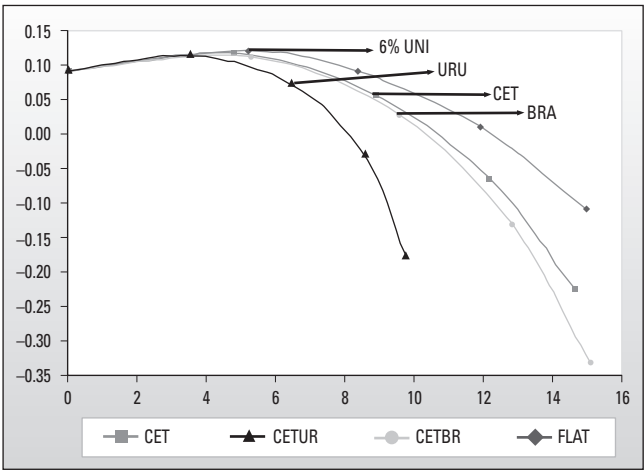
In addition, Hsieh (2000) finds a negative correlation between the relative price of capital goods and the share of imports in the total supply of such goods. The adoption of high tariffs in capital goods would hinder the introduction of the technical change embodied in those goods, and would delay technical progress. Developed countries, with an abundant supply of skilled labor, have comparative advantages in goods that require intensive research and development (R&D). Thus the incorporation of technical progress in MERCOSUR would be associated with the capacity to import machinery and equipment. Several studies consider this issue, specifying trade models with technological externalities associated with machinery and equipment imports (Monteagudo and Watanuki, 2003; ALADI, 2004).

Another issue to consider is that MERCOSUR has the power to change the terms of trade for agricultural goods, even though it may be regarded as a small bloc in the world economy. This effect on the prices of agricultural goods would be added to the price distortion caused by the agricultural protection policies of developed countries. Instead, in the case of trade with developing countries, the MERCOSUR members have shown comparative advantages in manufactured goods, in which the MERCOSUR has less capacity to change its terms of trade. Hence a specialization based on agricultural goods would have greater terms of trade effects than a specialization with greater emphasis on manufactured goods. In any case, a dynamic model could explore some of these effects in a more appropriate way.

The overall effects on GDP, welfare, and consumption are scant in every simulation for all the MERCOSUR members. But the effects on global trade are not negligible, especially for the larger countries, on which the impact of trade liberalization is greatest. This is because their share of extrazone trade is much higher than that of the smaller partners.

In the simulations that involve tariff reductions, there is an increase in trade flows, together with more efficient resource allocation and an increase in GDP; when tariffs rise, the effect is the opposite. This happens in all the simulations, except some for Uruguay. There,

**Figure 5.5. MERCOSUR  
Real GDP Variation by Scenario**



trade declines even when the tariffs fall, because the negative terms of trade effects offset the positive impact of tariff reduction on domestic prices.

The welfare effects are less clear. In general, tariff reduction causes a deterioration in the terms of trade, which offsets the positive effect of the efficiency gain. This effect is smaller when the substitution elasticity between domestic and imported goods is higher. The literature is not conclusive on this matter. In any case, the sensitivity analyses show that models are sensitive only for very large variations of the elasticity values.

For the elasticity values used, the price effects of a tariff change in MERCOSUR on the rest of the world are not negligible. This is a crucial issue for policy making. Although MERCOSUR's share of world imports is very small, several econometric studies show that the effect of its creation on import prices was not negligible. There are no empirical studies analyzing the effects of MERCOSUR's creation on export prices, but this chapter finds that a tariff cut in MERCOSUR would have a negative impact on the terms of trade because of a significant decline in its export prices. This result is consistent with MERCOSUR's importance in world markets for its main export goods.

For the smaller MERCOSUR countries, strengthening the customs union must be followed by a significant improvement in the free movement of goods within the bloc so as not to offset the erosion of preferential access. Uruguay would be in a better position if it avoided convergence to a CET. Unless the convergence brings about other benefits not considered in this chapter, Uruguay and Paraguay would prefer that their own tariffs be low and their partners' relatively high. This finding should be treated with caution, however, because the free movement of goods may significantly reduce the costs of access to the partners and obviate the use of rules of origin.

The arguments for maintaining positive tariff levels follow different lines: (i) political reasons that point to the capacity to improve market access through negotiation; (ii) effects on production specialization and other dynamic effects; and (iii) effects stemming from the existence of economies of scale. None of these have been explored in this chapter, so the results obtained from the model used here should be considered cautiously and complemented by other types of studies.

In sum, the effects of different options for the MERCOSUR external tariff are not the same for the larger and smaller countries. The latter might experience a greater impact on their real output, and therefore any change in policy should be studied carefully so as to avoid (or offset) high adjustment costs.

## APPENDIX 5.1

### The Model

The model used in this chapter is a static, multisector, and multicountry CGE model with perfect competition, constant returns to scale, and goods differentiated by geographic origin. There is no modeling of the government sector, so that tariff and tax revenue is assigned directly to the only representative consumer in each country. Transport costs are iceberg type, so that they are lost in transit between the exporting and the importing country.

Production  $Z$  is obtained by combining intermediate inputs and primary factors (land, labor, and capital) following a Cobb-Douglas production function. Variable unit cost  $V$ , obtained through optimization, is as follows:

$$\log V_{j,sd} = \sum_s (\alpha_{j,s,sd} \cdot \log PI_{j,s,sd}) + \alpha_{j,sd}^W \cdot \log W_j + \alpha_{j,sd}^R \cdot \log R_j + \alpha_{j,sd}^T \cdot \log RT_j + tax_{j,sd} \log V_{j,sd}$$

where  $i$  and  $j$  indicate countries,  $s$  and  $d$  indicate sectors,  $PI$  is the average price of intermediate inputs,  $W$  is the wage,  $R$  is the return to capital, and  $RT$  is the rent on land. The alphas are parameters that represent the shares of factors and inputs on total production and  $tax$  is the tax (or subsidy) rate on production.

The producer price  $P$  is equal to the variable unit cost  $V$  divided by  $G$ , being

$$G_{i,j,s} = \frac{1}{1 + g_{i,j,s}}$$

and  $g$  is the transport cost obtained as the difference between trade flows valued at CIF and FOB prices.

$$P_{ijs} = \frac{V_{is}}{G_{ijs}}$$

The average price of intermediate inputs is obtained by the optimization of a nested Armington function that combines domestic and imported goods, as well as goods from different geographic origins,  $\eta$  being the distribution parameter of the Armington function,  $\sigma$  the substitution elasticity between goods from different origin, and  $TAR$  the tariff applied by country  $j$  to imported goods coming from country  $i$ :

$$\begin{aligned} PI_{j,s,sd}^{1-\sigma_{j,s}} &= \gamma_{j,s,sd} PD_{j,s}^{1-\sigma_{j,s}} + (1-\gamma_{j,s,sd}) PCI_{i,s,sd}^{1-\sigma_{j,s}}, \\ PCI_{j,s,sd}^{1-\sigma_{j,s}} &= \sum_i \eta_{i,j,s,sd}^{\text{int}} \left[ P_{i,s} \cdot (1 + TAR_{i,j,s}) \right]^{1-\sigma_{j,s}} \text{ and} \\ PD_{j,s} &= V_{j,s} \end{aligned}$$

The quantities of intermediate inputs used by each sector  $sd$  are determined through the expressions

$$\begin{aligned}\log EI_{i,j,sd} &= \log \eta_{i,j,sd}^{INT} + \sigma_{j,s} \left( \log PCI_{j,s,sd} - \log P_{i,j,s} - \log(1 + TAR_{I,j,s}) \right) + \log CIM_{i,s,sd} \\ \log CID_{j,s,sd} &= \log \gamma_{i,s,sd} + \sigma_{a,s} \left( \log PI_{j,s,sd} - \log PD_i \right) + \log \alpha_{j,s,sd} + \log V_{j,sd} + \log Z_{j,sd} - \log PI_{j,s,s} \\ \log CIM_{j,s,sd} &= \log(1 - \gamma_{i,s,sd}) + \sigma_{a,s} \left( \log PI_{j,s,sd} - \log PCI_{i,s,SD} \right) + \log \alpha_{j,s,sd} + \log V_{j,sd} \\ &\quad + \log Z_{j,sd} - \log PI_{j,s,SD}\end{aligned}$$

where  $Z$  is the output of sector  $sd$  in country  $j$ .

The representative consumer in country  $j$  maximizes a Cobb-Douglas utility function that combines goods from different sectors. In turn, in each sector, the consumer chooses a nested Armington combination of domestic and imported goods and goods coming from country  $i$ , its average price being  $PCFC$ , equal to

$$PCFC_{j,s}^{1-\sigma_{j,s}} = \sum_i \eta_{i,j,s}^{FC} \cdot \left[ P_{i,s} \cdot (1 + TAR_{i,j,s}) \right]^{1-\sigma_{j,s}}$$

and the quantities of final goods consumed  $EC$  are obtained as follows:

$$\begin{aligned}\log EC_{i,j,s} &= \log \eta_{i,j,s}^{FC} + \sigma_{j,s} \left( \log PCFC_{j,s} - \log P_{i,s} - \log(1 + TAR_{i,j,s}) \right) + \log \rho_{j,s} \\ &\quad + \log CON_j + \log PCON_j - \log PCFC_{j,s}\end{aligned}$$

where  $CON_j$  is total consumption in country  $j$  in volume and  $PCON$  is the price of aggregate consumption in that country,  $\eta^{FC}$  is the distribution parameter of the Armington function, and  $\rho$  is the share parameter of each sector  $s$  in consumption in country  $j$ .

$$\log PCON_i = \sum_s \rho_{i,s} \cdot \log PCFC_{i,s}$$

Total imports (exports) of country  $j$  ( $i$ ) are equal to the sum of intermediate and final imports (exports):

$$E_{i,j,s} = \sum_{sd} EI_{i,j,s,sd} + EC_{i,j,s}$$

Total income  $REV$  in country  $i$  is obtained by adding factor payments, production taxes and tariffs:

$$REV_i = \sum_s \left[ \left( \alpha_{i,s}^W + \alpha_{i,s}^R + \alpha_{i,s}^{RT} \right) \cdot V_{i,s} \cdot Z_{i,s} \right] + \sum_s tax_{i,s} \cdot V_{i,s} \cdot Z_{i,s} + \sum_{s,j} \left[ E_{j,i,s} \cdot TAR_{j,i,s} \cdot P_{j,s} \right]$$

Equilibrium in goods market is obtained when output  $Z$  is equal to total demand (domestic market and exports):

$$Z_{i,s} = \sum_j E_{i,j,s} / G_{i,j,s}$$

In the factors markets, equilibrium is obtained when the sum of demands from the different sectors is equal to each factor supply, which is fixed ( $LSUP$ ,  $KSUP$  and  $TSUP$ , respectively, for labor, capital, and land):

$$\begin{aligned} LSUP_i &= \sum_s \frac{\alpha_{i,s}^W \cdot V_{i,s} \cdot Z_{i,s}}{W_i} \\ KSUP_i &= \frac{\alpha_{i,s}^R \cdot V_{i,s} \cdot Z_{i,s}}{R_i} \\ TSUP_i &= \frac{\alpha_{i,s}^T \cdot V_{i,s} \cdot Z_{i,s}}{RT_i} \end{aligned}$$

Finally, external equilibrium is reached when the external balance  $DET$  is equal to the difference between income and consumption in each country:

$$0 = DET_i + REV_i - CON_i \cdot PCON_i$$

The model closure assumes a constant debt.

## APPENDIX 5.2

**Table 5A.1 Argentina: Export Variation, by Scenario**

		6% flat tariff FLAT	CET enforcement CET	Brazil external tariff CETBR	Uruguay external tariff CETUR
Rice and Wheat	WHEAT	3.960	1.686	0.825	0.523
Corn and Other Grains	CORNS	8.364	3.343	1.741	6.012
Vegetables and Fruits	VEGET	8.594	2.992	0.878	5.634
Soybeans	SYBNS	8.671	3.581	2.194	6.855
Oil Seeds	OSEED	10.386	4.065	2.408	7.678
Sugar	SUGAR	11.483	4.368	2.718	8.660
Coffee and Other Crops	COFFE	10.579	3.732	1.426	7.742
Livestock and Animal Products	LVSTK	13.295	5.133	2.849	10.088
Bovine Meat	BVNMT	8.526	3.468	2.128	6.620
Poultry Meat	OMEAT	11.265	4.354	2.653	8.546
Dairy Products	DAIRY	-9.213	-1.847	-0.429	-25.255
Beverages and Tobaccos	BVTBC	-7.958	2.206	0.294	-11.079
Vegetable Oils and Other Food Products	OTHFD	9.571	3.652	1.930	7.957
Mining	MNING	15.073	0.019	-1.295	5.773
Textiles and Leather and Footwear	TXFIL	4.412	4.283	1.193	12.347
Light Manufactures	OTLMF	3.945	2.474	-0.109	9.298
Petroleum and Chemicals	PETRO	4.990	-0.925	-1.895	4.559
Metals	METAL	13.862	4.458	2.242	11.447
Automobiles	VEHCL	-42.910	-23.856	-10.869	-40.912
Machinery and Equipment	MCHNY	-6.218	-2.434	-0.778	-9.100
Utilities and Construction	UTLTY				
Trade and Services	SERV	12.181	4.303	2.403	8.720

**Table 5A.2 Brazil: Export Variation, by Scenario**

		6% flat tariff FLAT	CET enforcement CET	Brazil external tariff CETBR	Uruguay external tariff CETUR
Rice and Wheat	WHEAT	2.628	1.004	0.560	2.137
Corn and Other Grains	CORNS	7.147	2.465	0.798	4.548
Vegetables and Fruits	VEGET	7.413	2.407	0.902	5.157
Soybeans	SYBNS	6.020	2.197	1.264	4.485
Oil Seeds	OSEED	7.560	2.620	1.468	5.618
Sugar	SUGAR	7.568	2.773	1.623	5.633
Coffee and Other Crops	COFFE	8.628	3.123	1.666	6.341
Livestock and Animal Products	LVSTK	9.964	3.418	1.703	7.154
Bovine Meat	BVNMT	5.600	2.036	1.204	4.233
Poultry Meat	OMEAT	7.573	2.623	0.520	5.011
Dairy Products	DAIRY	-16.029	-5.370	-1.690	-31.191
Beverages and Tobaccos	BVTBC	-1.450	2.556	1.048	-4.449
Vegetable Oils and Other Food Products	OTHFD	7.477	2.608	1.343	5.963
Mining	MNING	11.802	3.842	2.166	8.536
Textiles and Leather and Footwear	TXTIL	9.127	4.018	1.611	10.172
Light Manufactures	OTLMF	8.834	3.407	1.524	8.421
Petroleum and Chemicals	PETRO	5.094	1.143	0.230	4.715
Metals	METAL	12.144	4.206	2.327	9.977
Automobiles	VEHCL	31.210	12.815	10.381	22.824
Machinery and Equipment	MCHNY	11.572	7.228	6.686	8.183
Utilities and Construction	UTLTY				
Trade and Services	SERVIC	8.796	2.947	1.573	6.416

**Table 5A.3 Paraguay: Export Variation, by Scenario**

		6% flat tariff FLAT	CET enforcement CET	Brazil external tariff CETBR	Uruguay external tariff CETUR
Rice and Wheat	WHEAT	-3.196	-3.070	-1.712	-7.770
Corn and Other Grains	CORNS	-2.060	-2.696	-1.629	-5.885
Vegetables and Fruits	VEGET				
Soybeans	SYBNS	2.378	0.535	0.661	1.417
Oil Seeds	OSEED	7.355	0.047	-0.528	-2.488
Sugar	SUGAR	7.604	2.048	1.600	4.924
Coffee and Other Crops	COFFE	-2.646	-5.793	-7.737	-5.736
Livestock and Animal Products	LVSTK	0.039	-3.100	-4.240	-4.076
Bovine Meat	BVNMT	-1.061	-1.458	0.052	-1.774
Poultry Meat	OMEAT				
Dairy Products	DAIRY				
Beverages and Tobaccos	BVTBC				
Vegetable Oils and Other Food Products	OTHFD	0.866	-1.595	-1.187	2.118
Mining	MNING	11.533	-10.100	-9.435	-3.752
Textiles and Leather and Footwear	TXTIL	-10.963	-3.327	-3.116	0.119
Light Manufactures	OTLMF	-2.630	-2.244	-2.459	1.092
Petroleum and Chemicals	PETRO	2.626	-3.381	-3.619	0.915
Metals	METAL	-21.280	-13.356	-10.031	-10.285
Automobiles	VEHCL				
Machinery and Equipment	MCHNY				
Utilities and Construction	UTLTY				
Trade and Services	SERVIC	7.565	1.782	1.210	4.695

**Table 5A.4 Uruguay: Export Variation, by Scenario**

		6% flat tariff FLAT	CET enforcement CET	Brazil external tariff CETBR	Uruguay external tariff CETUR
Rice and Wheat	WHEAT	3.066	0.455	0.467	0.040
Corn and Other Grains	CORNS	-0.021	-1.297	-1.075	-3.534
Vegetables and Fruits	VEGET	8.898	2.954	1.821	6.267
Soybeans	SYBNS	8.479	2.789	1.837	5.609
Oil Seeds	OSEED	35.949	0.406	-19.866	-19.914
Sugar	SUGAR	9.427	2.868	1.702	6.516
Coffee and Other Crops	COFFE	8.217	2.167	0.895	5.715
Livestock and Animal Products	LVSTK	7.277	1.067	-0.572	4.109
Bovine Meat	BVNMT	7.593	2.220	0.714	4.559
Poultry Meat	OMEAT				
Dairy Products	DAIRY	-6.825	-2.882	-0.961	-21.806
Beverages and Tobaccos	BVTBC	-40.524	-5.987	-5.105	-46.755
Vegetable Oils and Other Food Products	OTHFD	5.358	1.022	0.208	4.975
Mining	MNING	11.964	-1.636	-2.216	3.442
Textiles and Leather and Footwear	TXTIL	5.293	1.826	0.111	7.653
Light Manufactures	OTLMF	-14.800	-4.703	-5.494	-0.053
Petroleum and Chemicals	PETRO	-3.865	-5.805	-5.227	-1.767
Metals	METAL	1.813	-2.137	-2.541	3.099
Automobiles	VEHCL	-58.246	-20.913	-3.247	-48.954
Machinery and Equipment	MCHNY	-10.947	-3.570	-0.052	-14.259
Utilities and Construction	UTLTY				
Trade and Services	SERVIC	9.181	2.683	1.585	6.084

**Table 5A.5 Argentina: Import Variation, by Scenario**

		6% flat tariff FLAT	CET enforcement CET	Brazil external tariff CETBR	Uruguay external tariff CETUR
Rice and Wheat	WHEAT	-0.121	-0.138	-0.076	-0.223
Corn and Other Grains	CORNS	-3.361	1.425	10.608	8.223
Vegetables and Fruits	VEGET	-1.421	1.001	3.226	1.380
Soybeans	SYBNS	-0.356	-0.443	-0.089	-0.462
Oil Seeds	OSEED	-9.173	-0.477	7.331	7.598
Sugar	SUGAR				
Coffee and Other Crops	COFFE	-1.173	0.677	2.578	1.267
Livestock and Animal Products	LVSTK	0.155	1.425	3.185	1.819
Bovine Meat	BVNMT	0.235	-0.568	5.982	4.533
Poultry Meat	OMEAT	-1.903	-0.647	2.340	0.242
Dairy Products	DAIRY	7.213	1.557	0.482	23.146
Beverages and Tobaccos	BVTBC	23.862	1.817	4.417	26.408
Vegetable Oils and Other Food Products	OTHFD	4.177	1.331	1.841	0.288
Mining	MNING	-5.294	2.430	2.463	0.524
Textiles and Leather and Footwear	TXTIL	16.264	1.343	1.908	0.687
Light Manufactures	OTLMF	6.858	1.314	2.041	-0.587
Petroleum and Chemicals	PETRO	0.940	2.027	2.025	0.385
Metals	METAL	4.635	2.186	2.250	-0.456
Automobiles	VEHCL	14.192	-0.576	-3.042	8.402
Machinery and Equipment	MCHNY	4.844	-0.766	-1.827	4.460
Utilities and Construction	UTLTY				
Trade and Services	SERVIC	-5.422	-2.006	-1.142	-3.976

**Table 5A.6 Brazil: Import Variation, by Scenario**

		6% flat tariff FLAT	CET enforcement CET	Brazil external tariff CETBR	Uruguay external tariff CETUR
Rice and Wheat	WHEAT	0.908	0.557	0.415	1.749
Corn and Other Grains	CORNS	0.805	0.613	0.556	1.541
Vegetables and Fruits	VEGET	0.800	1.136	2.125	2.908
Soybeans	SYBNS	0.228	-0.107	0.153	-0.020
Oil Seeds	OSEED	-2.062	1.166	1.867	5.430
Sugar	SUGAR				
Coffee and Other Crops	COFFE	1.607	1.895	3.073	2.426
Livestock and Animal Products	LVSTK	1.854	1.705	2.722	3.220
Bovine Meat	BVNMT	0.001	-0.029	0.113	0.121
Poultry Meat	OMEAT				
Dairy Products	DAIRY	5.333	1.321	0.678	15.356
Beverages and Tobaccos	BVTBC	24.531	2.807	2.723	27.662
Vegetable Oils and Other Food Products	OTHFD	7.145	2.422	2.320	2.212
Mining	MNING	-3.086	3.278	3.300	2.213
Textiles and Leather and Footwear	TXTIL	24.527	3.257	3.357	2.489
Light Manufactures	OTLMF	13.920	3.500	3.924	1.903
Petroleum and Chemicals	PETRO	3.247	3.197	2.836	1.786
Metals	METAL	13.102	5.807	4.753	5.733
Automobiles	VEHCL	39.257	12.249	5.282	31.681
Machinery and Equipment	MCHNY	15.251	5.777	3.593	13.891
Utilities and Construction	UTLTY				
Trade and Services	SERVIC	-4.085	-1.424	-0.774	-3.048

**Table 5A.7 Paraguay: Import Variation, by Scenario**

		6% flat tariff FLAT	CET enforcement CET	Brazil external tariff CETBR	Uruguay external tariff CETUR
Rice and Wheat	WHEAT	0.693	0.770	0.320	0.869
Corn and Other Grains	CORNS	0.192	0.441	0.066	0.400
Vegetables and Fruits	VEGET	-0.217	0.421	0.602	0.484
Soybeans	SYBNS	0.015	0.346	0.011	0.316
Oil Seeds	OSEED	1.188	0.929	0.402	1.328
Sugar	SUGAR	1.833	1.210	0.533	1.583
Coffee and Other Crops	COFFE	0.743	0.797	0.565	0.985
Livestock and Animal Products	LVSTK	0.319	0.653	0.161	0.617
Bovine Meat	BVNMT				
Poultry Meat	OMEAT				
Dairy Products	DAIRY	0.825	1.034	0.658	1.153
Beverages and Tobaccos	BVTBC	6.229	0.839	0.576	12.769
Vegetable Oils and Other Food Products	OTHFD	1.275	0.855	1.067	1.093
Mining	MNING	-0.093	1.028	0.359	0.846
Textiles and Leather and Footwear	TXTIL	13.618	1.488	1.665	1.432
Light Manufactures	OTLMF	4.766	0.963	0.772	0.655
Petroleum and Chemicals	PETRO	0.484	0.711	0.448	0.722
Metals	METAL	0.641	0.391	0.171	0.470
Automobiles	VEHCL	1.868	-0.728	-0.979	0.473
Machinery and Equipment	MCHNY	0.992	-1.471	-2.164	0.723
Utilities and Construction	UTLTY				
Trade and Services	SERVIC	-3.172	-0.747	-0.539	-2.044

**Table 5A.8 Uruguay: Import Variation, by Scenario**

		6% flat tariff FLAT	CET enforcement CET	Brazil external tariff CETBR	Uruguay external tariff CETUR
Rice and Wheat	WHEAT	0.669	0.595	0.210	0.384
Corn and Other Grains	CORNS	0.122	0.522	1.909	0.188
Vegetables and Fruits	VEGET	0.382	1.350	1.843	0.441
Soybeans	SYBNS				
Oil Seeds	OSEED	-0.075	0.514	0.242	0.153
Sugar	SUGAR	-0.781	0.077	-0.056	-0.718
Coffee and Other Crops	COFFE	-0.054	0.678	0.911	0.190
Livestock and Animal Products	LVSTK	0.304	1.870	1.723	1.797
Bovine Meat	BVNMT				
Poultry Meat	OMEAT	-1.014	0.311	4.883	0.286
Dairy Products	DAIRY	0.722	0.605	0.282	0.012
Beverages and Tobaccos	BVTBC	13.850	1.899	1.272	0.979
Vegetable Oils and Other Food Products	OTHFD	1.852	0.942	1.041	0.513
Mining	MNING	-3.717	1.761	1.662	0.605
Textiles and Leather and Footwear	TXTIL	13.064	1.724	1.549	1.449
Light Manufactures	OTLMF	2.787	0.820	1.062	0.124
Petroleum and Chemicals	PETRO	0.959	1.291	1.072	0.615
Metals	METAL	1.731	2.132	2.600	-0.991
Automobiles	VEHCL	1.703	-2.550	-2.895	-0.730
Machinery and Equipment	MCHNY	0.713	-3.030	-3.851	0.598
Utilities and Construction	UTLTY				
Trade and Services	SERVIC	-4.538	-1.360	-0.804	-3.030

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## **Asymmetries and Disparities in the Economic Integration of a South-South Customs Union**

*Marcel Vaillant\**

### **Introduction**

The Southern Common Market (MERCOSUR) is a trade agreement in transition. Its goal is to create a customs union in which goods from any member country can move in the integrated zone free of import tariffs and without requiring a certificate of origin.<sup>1</sup> Ideally, an allocation rule would distribute the revenue from the common external tariff (CET) among member countries, but MERCOSUR does not yet function as a customs union because the agreement that would govern this is still being worked out.

The challenge is to make the integration agreement more consistent, so as to determine an objective path toward a customs union that provides for free movement within the zone. Appropriate steps are needed to move the agreement forward and to find a viable technical solution for the transition period. The transition process is complex, but without a common trade policy (CTP) or a clear direction for making one, negotiations with third parties will not advance.

For any country or bloc of countries negotiating an agreement with another trade bloc, it is a prerequisite that this process be clearly established. Given the repeatedly stated goal of signing common trade agreements with third parties, it is important to tackle the problem of the redundant collection of the CET.

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\* The author is grateful to the participants of the workshop “Deepening Integration in MERCOSUR: Dealing with Disparities” held in February 2005 at the Inter-American Development Bank (IDB) in Washington, D.C., for their remarks and suggestions, especially Luiz Villela for comments on a preliminary version of this chapter.

<sup>1</sup> In fact, in a complete customs union, the requirement of a certificate of origin for trade within the union is considered to be equivalent to the existence of a nontariff barrier. For example, in the European Union (EU), a mandatory request for a certificate of origin is prohibited for intraregional trade. Mattera (1991) points out that “certificates of origin (import documents that provide proof of the origin of the product) must be included in the formalities prohibited by Article 30 of the EEC Treaty and those for which no exception is provided under Article 36 of EEC Treaty, whether they are demanded for products originating in the European Community or for products originating in third countries and placed in free circulation.”

This chapter analyzes the changes that MERCOSUR could make to improve the movement of goods and the allocation of customs revenues, and assesses the impact of these changes on the current disparities among the member countries. The next section analyzes the CTP and the current rules governing the movement of goods (the status quo). The section following that examines changes to the rules that would progressively implement free movement, as well as the asymmetries associated with those rules. The section “Common Revenues from the CET” considers the common customs revenues, examines the alternatives to their allocation, looks at the direction that MERCOSUR is taking, identifies the pertinent asymmetries that need to be addressed, and explores a proposed distribution rule. The final section offers conclusions.

## **Trade Policy and Rules of Movement in the Customs Union**

### ***Common Trade Policy***

MERCOSUR’s current CTP includes a CET and common tariff preferences with third-country markets.<sup>2</sup> For example, a trading partner with a common tariff preference that exports to the integrated zone expects goods to move freely without duties and without requiring an additional certificate of origin.<sup>3</sup> The current discussions suggest a trend toward common guidelines that favor a more universal movement of goods in the integrated area.

Many aspects of a CTP must be harmonized in the process of building a customs union. The administrative and operating procedures of the various national customs agencies must be harmonized as far as possible, since import duties depend on tariff levels and customs regulations, including the classifications of products and the values (customs value rule) on which duties are applied. Special trade regimes with third countries must similarly be harmonized as far as possible, since protectionist measures differ, especially regarding anti-dumping measures. The MERCOSUR countries still have some unharmonized preferential trade agreements, and member countries can still apply promotion policies and protective trade policies to their exports in intraregional trade.

A CTP goes beyond a CET. MERCOSUR’s CET was created as part of the transition process with an 11-step structure from 0 percent to 20 percent, with 2 percent increments. This design was predicated on the principle that the more added value, the higher the duty. The transition also included a plan for converging with the CET by including national exceptions sector lists. The procedure was to have each country make and submit its list to MERCOSUR, though in fact the number of CET exceptions is defined by Common Market

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<sup>2</sup> In MERCOSUR, commitments have been made to negotiate jointly with third countries. See Decision 32/00 of the Common Market Council (CMC).

<sup>3</sup> This is being discussed with the EU, but MERCOSUR must resolve the issue. If a solution is found for trade with the EU, the lessons learned should be applied universally to address redundant charging of the CET on the basis of experience.

Council (CMC) Decision 31/03.<sup>4</sup> The sector exception lists defined a period of convergence to capital goods (CG) and information technology and telecommunications goods (ITG). The initial CET was 14 percent for CG and 16 percent for ITG goods on which countries are not obliged to apply the CET. Table 6.1 presents the simple average CET for nonagricultural and agricultural products.

A CTP also needs a set of instruments and rules that define their application by individual countries. The application criterion can be either restrictive, in which case all countries apply the CET in the same way, or inclusive, in which case at least one country applies the CET.

The restrictive criterion implies that any deviation from the CET might indicate a preference for more or less protection from imports of a particular product from outside the area. Were the product to move freely through the area, different preferences among member states could produce conflict. The only real problem, arguably, is when one country has a higher tariff on a given product and another country applies the CET, which would limit the free movement of the good. A downward deviation from the CET would not create the same problem. These two criteria could be taken together to allow products complying with the CET to move freely in the importing country, provided that no other member state were to apply a higher tariff.

The less restrictive criterion implies that incentives are needed to ensure that countries comply, especially when a country applies the CET, and products entering the zone under that tariff move more freely. Both the original products to which the CET was applied and the products produced with inputs or raw materials imported from outside the zone into a member state complying with the CET should be duty-free. Table 6.2 shows the degree to which MERCOSUR overall, and each member country, applies the CET.

The CET is applied to nearly three-quarters of all CMN items (74.5 percent). Brazil applies it most frequently (95.3 percent of all cases), whereas Paraguay applies it to 78.1 percent of items. The automobile sector was negotiated separately and maintains a bilateral format, and the sugar sector is not being negotiated currently; accordingly both of these sectors are excluded from the analysis. The CET is applied to 76 percent of products under category *b* in Table 6.2. Under *c*, excluding CG and ITG goods, it rises to 87.5 percent. Finally, excluding items on the national exception list, very few items remain: 43 in Argentina; 3 in Brazil; 180

**Table 6.1 Common External Tariff and National Tariffs, 2004**  
(simple average in percent)

	All Products	Nonagricultural Products	Agricultural Products
<b>MERCOSUR</b>	10.0	10.8	10.1
Argentina	9.6	9.6	10.1
Brazil	10.9	11.0	10.3
Paraguay	8.9	8.7	10.1
Uruguay	9.1	8.9	10.2

Source: SM-SAT-CE, based on MERCOSUR norms and information from member states.

<sup>4</sup> 100 for Argentina and Brazil, 649 for Paraguay (100 basics, 150 extra and 399 established in Article 4 of CMC Decision 07/94), and 225 for Uruguay (100 basics and 125 extra).

**Table 6.2 Application of CET in MERCOSUR Countries**  
(number of items and percentage)

	CMN <sup>a</sup>	Applied	Nonapplied	Percent applied
<b>a. All products</b>				
MERCOSUR	9750	7259	2491	74.5
Argentina	9750	8625	1125	88.5
Brazil	9750	9292	458	95.3
Paraguay	9750	7616	2134	78.1
Uruguay	9750	8419	1331	86.3
<b>b. All products excluding sugar and the automobile sector</b>				
MERCOSUR	9323	7097	2226	76.1
Argentina	9323	8256	1067	88.6
Brazil	9323	8918	405	95.7
Paraguay	9323	7444	1879	79.8
Uruguay	9323	8046	1277	86.3
<b>c. All products excluding sugar, the automobile sector and CG-ITG</b>				
MERCOSUR	7708	6748	960	87.5
Argentina	7708	7566	142	98.2
Brazil	7708	7610	98	98.7
Paraguay	7708	7018	690	91.0
Uruguay	7708	7593	115	98.5
<b>d. All products excluding sugar, the automobile sector, CG-ITG and national lists<sup>b</sup></b>				
MERCOSUR	6953	6732	221	96.8
Argentina	7609	7566	43	99.4
Brazil	7611	7608	3	99.96
Paraguay	7182	7002	180	97.5
Uruguay	7608	7592	16	99.8

Source: SM-SAT-CE, based on information from the countries.

a. CMN = MERCOSUR Common Nomenclature.

b. The national list excluded from the MERCOSUR line combines four national lists. In each country, the respective national list is excluded.

in Paraguay; and 16 in Uruguay. The CET is thus applied to more than 99 percent of goods in each country except Paraguay (97.5 percent).

### ***Status Quo: Redundant Collection of the CET***

The current rules stipulate that only goods complying with the rules of origin (native products) can move freely within MERCOSUR,<sup>5</sup> while all others are subject to duties.<sup>6</sup> If an imported

<sup>5</sup> The need to maintain rules of origin universally is fundamentally based on the very real possibility that the countries will not apply the CET. CMC Decision 69/00 authorized the member countries to continue applying the rules of origin to all tradable goods until December 31, 2005. In addition, failure to implement MERCOSUR's customs code (which is undergoing review) poses technical difficulties to applying a different criterion.

<sup>6</sup> Nonetheless, movement is restricted to the extent that internal customs become involved at any event, even if duties are not paid. In practical terms, such involvement is an additional restriction and could result in allowing

Table 6.3 Redundant Common External Tariff: Typology of Goods

Country A = Exporter; Country B = Importer	Pays CET in B	Pays no CET in B
<b>a. Produced in A and meeting rules of origin in A</b>		
Inputs imported with CTP in A		1
Inputs imported without CTP in A		2
<b>b. Produced in A, does not meet rules of origin in A</b>		
Inputs imported with CTP in A	3	
Inputs imported without CTP in A	4	
<b>c. Not produced in A, originates elsewhere in the region (not A)</b>		
With CTP in the region	5	
Without CTP in the region	6	
<b>d. Not produced in A and not originating in the region</b>		
With CTP in A	7	
Without CTP in A	8	

Source: Author.

good enters a member country and then crosses into another member country, the CET must be paid a second time. The redundant CET collection and the certificate of origin requirement for the free movement of products in the zone are related, since the rule of origin allows only native products to move freely and makes the collection of import tariffs on all nonnative goods redundant.

This situation can be represented by describing the various types of goods traded in a given region by their place of origin, and by whether the importing country imposes a duty on them. This analysis limits the definition of free movement to whether duties are paid, whereas free movement is far more than this, depending on the involvement of a customs authority. Where no customs authority is involved, no duties are collected and other customs measures that could have the same effect as a duty are precluded.

Table 6.3 gives the trade options between countries A and B. The rows list the types of goods in exporting country A, specifying their origin in terms of the level of processing undertaken in the integrated zone. The four categories specify whether (i) processing is greater or less than the minimum established by the rule of origin, whether it be general or specific to the product; (ii) there is processing, but it is less than the minimum required; (iii) there is no processing in country A but the goods originate in the region—albeit not from country A; and (iv) there is no processing and the goods come from country A but are produced elsewhere in the world.

Each category requires a second classification criterion to distinguish between inputs (or the product itself) entering the zone under the CTP applied by exporting country A.

non tariff barriers. These notes make an abstraction of this phenomenon and liken free movement to the nonpayment of duties in intraregional trade.

These eight categories reflect the current status quo, whereby the CET needs to be paid when a product enters country B as an import—that is, whether or not there is free movement in the zone (columns 2 and 3).

Goods in categories 1 and 2 pay no CET because they meet the rules of origin and can move freely within the zone according to the free trade agreement among the member countries. For type 2 goods, however, a duty other than the CET was paid on the inputs to the final goods, and is lower. Type 2 goods still move freely within the zone, which amounts to an accepted exemption from the CET.

As the certificate of origin requirement is indispensable in the current transition, the other categories of goods (produced without meeting rules of origin, originating in another country of the region, or imported through country A from elsewhere in the world) are subject to the CET when entering country B. This applies even if the inputs for the product or the product itself entered country A under the application of the CTP, which might be the levying of the CET. This is the situation for goods in categories 3, 5, and 7, revealing that the levying of the CET is redundant.

This is locally referred to as “double charging.” In general, a good enters the region under the CTP and is incorporated into a production process in country A or does not undergo any processing, and then moves to country B, where the (redundant) CET is paid. CET redundancies need to be resolved so that goods of types 3, 5, and 7 move freely in the zone.

A statistical approximation of the magnitude of double charging clearly underestimates its significance (see SM-SAT-CE, 2004c). To the extent that double charging is possible, economic actors will naturally seek to avoid it. When the rules are modified, the change will probably affect the trade flow and increase trade in goods of types 3, 5, and 7. Some goods might still fall into categories 4, 6, and 8, but the integrated area needs a mechanism to certify origin and/or to determine when the CTP is applied to a good or its inputs.

### ***The European Approach: The Free Movement Rule***

Articles 9 and 10 of the Treaty of Rome establishing the European Economic Community (EEC)<sup>7</sup> define a general free movement rule.<sup>8</sup> This stipulates that goods move freely from third countries where import formalities have been complied with and all customs duties or charges with an equivalent effect have been levied in a member state, if the goods have not benefited from a total or partial drawback of duties or charges. Freely moving goods are treated like goods originating in the region.

Magariños (2000) points out that Europe’s free movement rules do not distinguish goods by origin. All goods, whether produced in the common market or imported, can freely

<sup>7</sup> Pursuant to article 10, paragraph 1 of the EEC Treaty, “products coming from a third country shall be considered to be in free movement in a member state if the import formalities have been complied with and any customs duties or charges having equivalent effect which are payable have been levied in that member state, and if they have not benefited from a total or partial drawback of such duties or charges.”

<sup>8</sup> *Libre pratique* in French, and *libre práctica* or *libre circulación* in Spanish.

move in the integrated customs area. For imported goods the following conditions apply: (i) import formalities have been complied with; (ii) all payable customs duties or charges with an equivalent effect have been levied in a member state; and (iii) the goods have not benefited from a total or partial drawback of such duties or charges.

According to Torrens (personal communication), free movement is a status or legal condition that goods acquire when they meet these criteria, as distinct from being free from customs procedures (for nontariff controls, from phytosanitary to tax controls). In Europe, customs controls on goods traded in the zone (whether produced in member states or imported and in free movement) were maintained until 1993.

Mattera (1991) points out that products introduced into a member state that meet the following criteria should be considered to be in free movement: (i) duties and charges of an equivalent effect have been paid; (ii) there has been no total or partial drawback of customs duties or charges (for example, by the exporting state); and (iii) import formalities in the importing member state have been respected (in particular, regional or national formalities compatible with the treaty governing the importation of the products in question). The *Donckerwolcke* decision in the European Court of Justice confirms the concept that goods in free movement are treated as originating goods.<sup>9</sup>

For Torrens (personal communication), “being in free movement” must be distinguished from measures applied to goods subject to national exemption rules instead of to a CET. The EEC Treaty applies a “procedure/mechanism” to prevent country A, which has more permissive importing rules, from being used to place goods in country B, which has more restrictive rules (Article 115 of the treaty establishing the EEC).<sup>10</sup>

<sup>9</sup> See ECJ Decision of December 15, 1976, *Donckerwolcke* Case 41/76, Rec. 1976, p. 1921 (§§16–18): “Products in free circulation are to be understood as meaning those products which, coming from third countries, were duly imported into any one of the member states in accordance with the requirements laid down by article 10.

“It appears from article 9 that, as regards free circulation of goods within the [European] community, products entitled to ‘free circulation’ are definitively and wholly assimilated to products originating in member states.

“The result of this assimilation is that the provisions of article 30 concerning the elimination of quantitative restrictions and all measures having equivalent effect are applicable without distinction to products originating in the Community and to those that were put into free circulation in any one of the member states, irrespective of the actual origin of these products.”

<sup>10</sup> Article 115 of the EEC Treaty states that “in order to ensure that the execution of measures of trade policy taken in accordance with this treaty by any member state is not obstructed by deflection of trade, or where differences between such measures lead to economic difficulties in one or more of the member states, the Commission shall recommend the methods for the requisite cooperation between member states. Failing this, the Commission shall authorize member states to take the necessary protective measures, the conditions and details of which it shall determine.

“In cases of urgency, member states shall request authorization to take the necessary measures from the Commission, which shall take a decision as soon as possible; the member states concerned shall then notify the measure to the other member states. The Commission may at any time decide that the member states concerned shall amend or abolish the measures in question.

“In the selection of such measures, priority shall be given to those which cause the least disturbance to the functioning of the common market.”

In this regard, Mattera (1990) suggests that Articles 9 and 10 do not undermine the right granted to member states to invoke Article 115, and request EC authorization to exclude the products in question in whole or in part from the benefit of free movement, when the requirements established by the article are met.

In the Tezi decisions, the European Court of Justice (ECJ) determined that a CTP must be in effect for free movement to apply to products. The Tezi I decision indicates:

The court recognized that the incompleteness of the CTP, together with other circumstances, was likely to maintain differences in trade policy between the member states capable of causing deflections of trade or economic difficulties in some member states. The court stated that Article 115 enabled difficulties of this kind to be overcome by giving to the Commission the power to authorize member states to take protective measures, particularly in the form of derogations from the principle that goods originating in nonmember countries and released into free circulation in one of the member states should circulate freely in the community.<sup>11</sup>

Member states can apply Article 115 in the case of differences in trade policy and the resulting trade deflection or economic difficulties. The three most frequent differences in trade policies in the former EEC include: (i) national restrictions compatible with community law (measures in effect before the entry into effect of the treaty, such as quantitative restrictions on imports of Japanese automobiles in Italy); (ii) quotas under the Multifiber Agreement; and (iii) regional protective measures (quartz watches in France).

These differences can deflect trade and therefore jeopardize the application of the trade policy measures. Free movement then becomes a means of avoiding the trade policy measures adopted by a member state, given that, if the EEC did not intervene under Article 115, goods could be diverted to another member state that does not apply restrictive measures on the third country's goods.

For Pelkmans (1997), when national quotas on various industrial products (textiles and clothing, automobiles, footwear) were reintroduced in the 1970s and the early 1980s, the EEC seemed more like a free trade area than a customs union with respect to intraregional movement. Prices in these sectors differed, despite the fact that there was intraregional trade. Member states could request that the EEC apply Article 115 when national quotas were still in effect, and authorization was granted in 80 percent of cases for the clothing and textiles sectors (Pelkmans, 1997).

Free movement was a basic instrument during the transition to a customs union in the EEC, while the CTP was being developed. Article 115 of the Treaty of Rome was used as a corrective mechanism for possible trade diversion and was broadly applied in some sectors. In Europe, national trade policies and the CTP were more similar than in MERCOSUR where, given the various sources of divergence, the goods to which the CTP applies probably cover a smaller proportion of trade with third parties. A general rule of free movement can be applied, but it is important to know which products are affected. In the EEC, all goods circulated

<sup>11</sup> See ECJ Decision of March 5, 1984, Tezi I, Case 59/84, (Rec. 1986), p. 887 (§§32–33).

freely and Article 115 was designed to exclude those presumed to deflect trade because of the disparities among member states' trade policies.

### *New Rules of Movement*

In MERCOSUR, the only goods moving freely are those meeting the origin requirements, subject to the direct issuance of certificates of origin between the exporting and the importing countries.

### **The Problem**

Any change to this rule can affect the distribution of customs revenues and the structure of protection in the bloc. Short- and long-term alternatives have been developed. The short-term phase consists of adopting three general principles:

- (i) Allow goods originating in MERCOSUR to move in the region on the basis of the direct bilateral issuance of the certificate of origin considered valid in all intraregional trade.<sup>12</sup>
- (ii) It must be possible to determine which products entering the member countries comply with the CTP and which do not<sup>13</sup> through certification by the customs agency of the member state through which they are introduced.
- (iii) Goods complying with the CTP should become the equivalent of native or originating goods and should move duty-free within the region. They should be treated as originating goods in any production process that transforms them in MERCOSUR, and thus should move freely.

This procedure resolves the problem of duty-free movement for native goods and for goods complying with the CTP, and eliminates the redundant levying of the CET. In addition,

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<sup>12</sup> Some goods originate in the region but not in the country of the exporter. Given that certificates of origin have thus far been valid when directly issued by the exporting country to the importing country, in the case of regional trade, as is seen in Table 6.3, category (c), goods originating in the region but not in the country of the exporter would pay the CET in the importing Country B (see Table 6.3, types 5 and 6). Nonetheless, as stated at the end of article 10 of CMC Decision 1/04, following letter (d), "The certificate of origin issued by one of the member states of MERCOSUR allows for the circulation of the goods among the member states with the same preferential tariff treatment and the same certificate of origin, provided that the goods are coming from any MERCOSUR member state." If in the near future this part of said article is regulated and customs procedures are adopted to implement it, then in the future this category of goods would not pay the CET in intraregional trade. The restriction on the movement of originating goods is consistent with the application of certain fiscal exemption instruments in intraregional exports. If the exempted goods can return to the country that exported them, then this would be equivalent to extending the validity of the benefit to the domestic market. A typical example is the application of temporary admission in intraregional trade. On the other hand, if the originating goods could circulate freely, the trade defense instruments applied in intraregional trade (antidumping) would no longer be logical, since it would not be possible to sustain price discrimination.

<sup>13</sup> A product is understood to be a good classified up to eight digits in the MERCOSUR common nomenclature.

this rule could help resolve the problem of accumulating production processes, which has arisen in the MERCOSUR negotiations. For inputs or raw materials entering a member state pursuant to the CTP, once the good is integrated into a production process, whatever the level of transformation, the processed good should be able to move duty-free in MERCOSUR. It could then undergo successive transformations culminating in a finished product for consumption in or outside the region.

Different rules for free movement need to be accompanied by incentives for the agreement to progress toward the final goal of creating a complete customs union. The mechanism should be generally self-reinforcing so that once it is applied, private and public incentives lead to its progressive application, with a view to intensifying the coverage of the CTP.

The long-term alternative is to build a unified customs territory that crystallizes into a customs union. This requires several additional trade policy instruments, including special common trade regimes and a common trade defense relative to third countries; elimination of export promotion and trade defense policies in intraregional trade; and a uniform customs code. It would also be advantageous to have a common policy to defend competition.

The MERCOSUR texts describe this scenario as the final goal. MERCOSUR is moving in this direction, but the process requires political, institutional, and technical efforts that are difficult to make in the short term. For this reason this option will not be developed further here, since this chapter seeks to find a solution that MERCOSUR could in fact adopt at the current development level of its integration process. If it is determined that such an option is the best one, then steps should be taken to establish each of the preliminary instruments needed to form a common customs territory, as listed above.

## The Solution Found

A customs union should be expected to give rise to freer intraregional trade. MERCOSUR took a gradual approach to this. In 1994, as soon as the CET was created, discussions began during the convergence process about modifying the rules of movement and the “double charging” problem.<sup>14</sup> In 2000, when MERCOSUR was being relaunched, the CMC asked the MERCOSUR Trade Commission (MTC) to address double charging and distribution of the corresponding portion of the customs revenues.<sup>15</sup>

Three approaches were evident. Argentina and Uruguay expressed an interest in securing more widespread conditions of movement, and promoted the idea of finding a solution that could be implemented given the current state of the integration process. Brazil’s position evolved from a prudent and restrictive position on double charging to a recognition that the problem had to be solved. Brazil has advocated applying the rules of origin to the full range

<sup>14</sup> The discussion on double charging has a long history in MERCOSUR, starting in 1995 with a request for consultation from Argentina to Brazil. See request for consultation 70/95 in the realm of the Trade Commission, “Double Charging of the CET,” presented by Argentina, addressed to Brazil. Record 5/95, VI MTC.

<sup>15</sup> See CMC Decision No. 27/00 (Article 3), Buenos Aires, June 29, 2000.

of goods during the transition. Paraguay systematically pointed out the deficiencies hampering MERCOSUR's operation as a customs union and has advocated progress on those issues, insisting that the weaknesses be tackled in overall terms before a solution to double charging is considered. Paraguay's concern is that fiscal income might be lost if double charging is resolved in isolation, without also addressing the collection of custom revenues.

In early 2004, the MERCOSUR Secretariat was asked to propose a mechanism to eliminate the double collection of the CET and to distribute customs revenues.<sup>16</sup> It produced a series of studies to give greater substance to the discussion (see SM-SAT-CE, 2004a, 2004b, 2004c, and 2004d). Many alternative versions of the new regulations were considered during the Argentine *pro tempore* presidency of 2004.

During the Brazilian presidency, at the Belo Horizonte Summit in December 2004, the CMC approved a norm regulating movement toward a customs union from 2005 to 2008. This was a milestone.<sup>17</sup> The first four articles of this complex regulation set forth the key aspects.

Article 1 clearly defines free movement. Foods imported from third countries entering under the CTP (CET, common preferential treatment or common trade defense) are treated as originating goods in intraregional trade. Article 2 limits the range of application to goods entering with a 0 percent CET or with a common customs preference of 100 percent. This distinction makes it possible to implement the regulation within a year (see Article 3). Article 3 calls for the MTC to prepare regulations for Articles 1 and 2 before December 31, 2005, and a positive list of goods that meet the criteria of Article 2.

These measures have no impact on customs revenues, since they affect a class of imported goods on which the revenues are zero. Nonetheless, Article 2 provides a useful instrument for negotiations with third countries, since goods entering the region with 100 percent preference may move within MERCOSUR as originating goods. This meets one of the objections raised during negotiations with the European Union (EU).

Article 4 refers to requirements needed to extend the free movement rule to goods not covered in Article 2. The timeframe for considering and resolving the issue is mid-2005 to 2008. The requirements include a MERCOSUR customs code; the interconnection of customs administrations' computer systems; and distribution of customs revenues. Five other articles cover procedural matters.<sup>18</sup>

The solution partially addresses the concerns of all member states. In the short term, it allows for certain changes in the movement of goods. Those entering with a 100 percent

<sup>16</sup> See Work Schedule 2004–2006 CMC Decision 26/03, Chapter 1, “MERCOSUR Económico Comercial,” Section 1.1, “AEC.”

<sup>17</sup> See CMC Decision 54/04.

<sup>18</sup> Article 5 entrusts the MTC with defining the schedules for all products not covered in article 2 within 180 days, following compliance with the requirements set forth in article 4. Article 6 refers to implementation schedules. Article 7 instructs the MTC to take the necessary actions to satisfy the requirements of article 4. Article 8 refers to goods in transit and states that their final destination will be considered the first port of entry into MERCOSUR territory. Article 9 states that the MTC shall make the necessary changes in the rules of origin by December 31, 2005 to comply with this decision (CMC Decision 54/04).

preference will move freely, strengthening MERCOSUR's position in joint negotiations with third-country markets. A deadline is fixed (2008) and, for the other products not mentioned in Article 2, certain requirements are set for a new integration schedule. The year 2005 is important, since that is when regulations should be developed to bring about free movement for goods defined in Article 2 and in general.

Changing the Rules of Movement and Asymmetries in Market Size

The integration process gives each MERCOSUR country preferential access to a market larger than its own. Table 6.4 shows the importance of this regional market in terms of intra- and interregional trade, output, and population, revealing the significant differences for each member. For Brazil, the region's population is only 0.3 times its own. For sparsely populated Uruguay, MERCOSUR's population is 64.6 times greater than its own. As regards output, the regional economy is almost 124 times greater than Paraguay's. Argentina gains access to a market several times larger than its own (almost three times in terms of output and five times in terms of population), whereas for Paraguay and Uruguay, the regional market has considerably more weight.

Relationships are more balanced in terms of intraregional trade. Combined intraregional imports into Argentina, Paraguay, and Uruguay are equal to Brazil's imports from the other members. For Argentina, the ratio is slightly less than 2:1. The smaller and medium-sized countries are more geared to buying within the bloc than from outside it.

Argentina, Paraguay, and Uruguay are structurally specialized, consuming small quantities of a wide array of products and producing large quantities of a few products that they must be able to sell. This specialization is associated with external vulnerability, since they depend on access to foreign markets for the goods in which they specialize. International markets for the products that provide the smaller countries' core comparative advantages are sensitive to international conditions, and thus their external insertion may be problematic.

This external vulnerability could be reduced by increasing the size of the market for free trade and expanding the range of products and sectors of specialization. For the smaller economies, economic integration provides one more instrument to help overcome the constraints inherent in a small domestic market. Modern manufacturing technology is such that

Table 6.4 Ratios of Imports to Output and Population<sup>a</sup>

	Imports			Output	Population
	Total	Intraregional	Extraregional		
Argentina	3.5	1.9	4.1	2.7	4.8
Brazil	0.4	1.0	0.3	0.4	0.3
Paraguay	35.7	11.0	67.6	123.9	41.7
Uruguay	27.6	10.6	41.8	45.7	64.6

Source: Author's estimates based on various data sources.  
a. Average data for 2000–03.

economies of scale have a dominant role in determining competitive production conditions. The larger the scale (the more that is produced), the lower the average costs of production. International trade makes it possible to exploit these improvements in efficiency, and regional integration plays a central role in this.

The three smaller MERCOSUR countries have yet to benefit from their integration into a larger market. Initially, integration had been associated with industrial products' loss of share. Some recent studies have documented this for Paraguay and Uruguay (see Sanguinetti, Triastaru and Volpe Martincus, 2003, and Labraga and Lalanne, 2004). For Argentina, the evidence is not clear. Over the last two decades, Argentina has had a falling share of total regional manufacturing output. The trend was reversed briefly in the 1990s but recently the contraction has intensified.

Table 6.5 outlines trends from 1980 to 2002 in the geographic concentration of manufacturing in the MERCOSUR countries, and confirms the effect. In particular, note what has happened in Argentina and Brazil, so as to make more relevant comparisons of trends in the geographic agglomeration of industrial centers in MERCOSUR and their development relative to the integration process (Terra and Vaillant, 2000).

The performance of manufacturing activities is relevant from various points of view: (i) the sector is greatly affected by economies of scale; (ii) the share of manufacturing is an indicator of capacity to incorporate technology into production; and (iii) better manufacturing performance allows for a more dynamic labor market, fosters growth, and creates high-productivity jobs.

Two essential characteristics of the economic integration process explain the poor industrial performance of the three smaller MERCOSUR countries. First, import duties on intraregional trade were eliminated progressively, but nontariff barriers (NTBs) continued to affect such commerce. Their presence (see Berlinski, Kume, and Vaillant, 2003; and Vaillant, 2001) provides an incentive to concentrate investment and production in the large market, since NTBs affect prices and create uncertainty about the future. The damage caused by barriers is not simply the direct effect of limiting the flow of trade. They also influence decisions on where to locate manufacturing because of perceptions that such barriers will also be created in the future.

**Table 6.5 GDP of Manufacturing Industry in MERCOSUR**  
(billions of constant 1995 dollars and percent)

	1980–82		1990–92		2000–02	
	\$ billions	%	\$ billions	%	\$ billions	%
Argentina	36.350	22.9	36.507	22.3	39.440	20.5
Brazil	117.415	74.1	121.986	74.6	148.008	77.1
Paraguay	0.991	0.6	1.218	0.7	1.300	0.7
Uruguay	3.798	2.4	3.772	2.3	3.207	1.7
<b>MERCOSUR</b>	<b>158.554</b>	<b>100.0</b>	<b>163.483</b>	<b>100.0</b>	<b>191.955</b>	<b>100.0</b>

Source: Author's estimate based on data from the Economic Commission for Latin America and the Caribbean (ECLAC).

Second, despite having opted to form a customs union, more than a decade after the Ouro Preto Protocol, MERCOSUR still functions as a free trade area with regard to the rules regulating the movement of goods. So the only goods for which the customs preference is applied in intraregional commerce are those considered to be originating goods under the rules of origin (RO) in effect. This has a significant impact on the capacity to attract industrial processes to economies with smaller markets. Their industrial structure is less vertically integrated as a result. The RO translate into higher prices for regional inputs, demand for which is bolstered by the origin requirement. Smaller economies that might have been able to benefit from shorter production chains cannot do so under these conditions. If the goods are not originating goods, even if they comply with the CTP (CET and common preferences with third countries), duty must be paid again once they cross another border (redundant charging of the CET). The presence of NTBs and the application of RO to the entire tariff schedule mean that the obstacles to and constraints on intraregional trade are only half eliminated.

MERCOSUR made some progress in the 1990s in eliminating duties on intraregional trade. But duties are an incomplete measure of protection and provide little information on the extent of restrictions in market access. This can be measured in two ways: (i) broaden and deepen the measuring instruments that can discriminate domestic production from production in the rest of the world, or (ii) develop indirect methodologies that can infer degrees of difficulty in securing market access using available information on production and trade. Zignago and Mayer (2005) took this second approach and estimated the impact of borders on discriminating domestic production from that of the rest of the world. They proposed a microfounded gravity-type model based on a well-known model of international trade that introduces the effects of border-related costs to estimate border effects (see Table 6.6).

The table estimates border effects for the 1990s. For the international economy, an average country buys 273 more times from itself than from any other country, given similar control variables—market size, distance, duties, and so on. For countries with a preferential trade agreement, the border effect is only 42 times. The results are very clear: preferential

**Table 6.6 Estimated Border Effects in Trade Agreements: Number of Times a Country Trades with Itself Relative to Trade with a Partner (1992–99)**

	All countries	North-North	South-South	North-South	South-North
<b>All</b>	<b>273</b>	<b>130</b>	<b>327</b>	<b>77</b>	<b>821</b>
Regional trade agreements	42				
European Union		47			
Canada/United States		52			
MERCOSUR			120		
ASEAN <sup>a</sup>			81		
Andean Community			330		
NAFTA <sup>b</sup>				20	90

Source: Author's estimates on the basis of Zignago and Mayer (2005).  
a. Association of Southeast Asian Nations.  
b. North American Free Trade Agreement.

trade agreements lead to significantly lower border effects for the regions considered in this empirical analysis. This is particularly true for the four MERCOSUR economies, although as Table 6.6 shows, the scale of the border effect continues to be significant in MERCOSUR, where the ratio of domestic to foreign trade is 120:1.

Zignago and Mayer (2005) also undertook a long-term analysis of the evolution of border effects on the international economy and regional groups. Border effects are marked by a declining tendency, especially within the area of a preferential trade agreement: the EU and the North American Free Trade Agreement (NAFTA) are the two most successful experiences. For MERCOSUR, the border effect was considerably reduced during the 1990s, but remains high.

New geographic models that specify the complex interaction among economies of scale, trade costs (including transportation costs), and market size demonstrate that the degree of industrialization of peripheral economies (outside the industrial core) has a nonmonotonous U-shaped relationship to the depth of the integration process (Krugman and Venables, 1990). Venables (2005), analyzing the link between market access and industrial location, states, “if two regions or countries are identical except that one is  $k > 1$  larger than the other, then (given the transport cost between the regions) industrial production in the larger region will exceed that in the smaller by a factor greater than  $k$ . Furthermore, this fraction will vary with the level of trade cost.”

Very low levels of integration mean that industry is geographically dispersed. As integration deepens, there are strong incentives to concentrate production in places where the market is larger. If the degree of integration intensifies effectively, then initially peripheral economies move closer to the industrial core and increase their capacity to retain manufacturing production in their territory.<sup>19</sup> In conclusion, if the smaller, peripheral economies of MERCOSUR have deindustrialized because of economic integration, it was because there was too little integration rather than too much. The regional integration process only made a few initial steps, and created a negative incentive for industry in the smaller economies to concentrate geographically, confirming the theory (the U-shaped pattern). Economic integration does not have a monotonous effect on disparities in the geographic concentration of industry, considering the original asymmetries in market size. As Venables (2005) points out, “the fundamental logic of this effect is that, while integration can create regional disparities, further integration will reduce these disparities.”

Changes in the rules of movement that tend to relax the rules of origin help reduce disparities in the geographic concentration of industry related to asymmetries in market size. Domestic market asymmetries are associated with the degree of vertical integration of each economy. The rule of origin acts like a subsidy on exports of regional inputs: very strict rules of origin benefit the larger economies. Making those rules less restrictive would narrow

<sup>19</sup> Terra and Vaillant (1997) calibrated the core-periphery model for the economic geography of Argentina, Brazil, Paraguay, and Uruguay. Simulations with low and intermediate levels of integration gave this type of result for the smaller countries.

disparities related to asymmetries in the market size of member states as integration moves toward a customs union.

Common Revenues from the CET

Common customs revenues are generated whether the rule of free movement or a unified customs territory is chosen. In either case, the member states must determine their allocation.

Definition and Estimate

In a unified customs territory, common customs revenues include all fiscal revenues generated in accordance with the union’s CTP, resulting fundamentally from applying the CET to imports originating in nonpreferential third markets. For the short-term transition alternative, customs revenues must be defined as the sum of the value of the collections under the CTP (basically, the CET) on imports affected by the rule of free movement. These revenues would be distributed as a function of the share of the duty revenues where the CTP was applied on imports that move freely in the region. The guidelines established by the free movement regulations set these revenues as zero until 2008, since no fiscal revenues will be collected on goods allowed to move freely (which must either have a 0 percent CET or a common customs preference of 100 percent). The gradual application of the rule of free movement means that the distribution of customs revenues changes in the short term.

Table 6.7 shows the magnitudes of duty revenues for the MERCOSUR countries in 2000–03. These figures do not represent revenues that come only from the CET, because they are calculated by adding the customs revenues corresponding to the application of each member state’s trade policy, considered separately, at the current level of conver-

gence. Nonetheless, given that a duty-free trade area nearly exists, the approximated revenues are the fiscal revenues associated with the import duties of an eventual customs union. It is important to consider both their total amount and their distribution. As Table 6.7 shows, duty revenues measured in dollars at the current exchange rate fell sharply during the period, in part because imports declined.

In 2000–03, the estimated average customs revenues for the MERCOSUR countries together were \$4.806 billion. The weighted average tariff for the period was 7.7 percent, considering only extraregional imports. The ratio of the tariff revenue to the aggregate gross

Table 6.7 MERCOSUR Tariff Revenues 2000–03 (\$ billions)

	2000	2001	2002	2003
Argentina	1938	1548	372	555
Brazil	4609	3837	2689	2632
Paraguay	140	122	86	103
Uruguay	158	179	125	131
MERCOSUR	6844	5685	3273	3422

Source: Author’s estimates on the basis of SM-SAT-CE (2004a).

domestic product (GDP) of the MERCOSUR countries over a similar period was 0.6 percent. Finally, the average overall customs revenues were \$22 per person per year.

### ***Customs Revenues: What to Do with Them?***

Common revenues can be allocated in several ways: they can be transferred to each member state on the basis of the destination of the imports, distributed according to a general rule, or used to finance a common policy. The alternatives can be grouped into four options from a theoretical viewpoint:

- (i) *Status quo.* The member state collecting the CET takes the revenues (the current situation).
- (ii) *Exact fiscal offset.* The final destination of the imported or extraregional goods would determine which country is credited with the CET.
- (iii) *Rules on revenue distribution.* The CET revenues would be determined and distributed among member states on the basis of an accepted general rule.
- (iv) *Fund for financing common policies.* Countries would collaborate, contributing customs revenues to a common fund to finance joint policies.

The choice depends on the goal of the integration process. Changes in rules of movement (associated with the operations of the customs union) could be fiscally neutral because they do not affect the public finances of member states. Another objective would be to use a distribution mechanism to create a transfer system that could reduce some disparities among countries (transfers from rich to poor, or from large to small countries). A third objective might be to create a fund to finance common policies that are conducive to integration. There are four main alternatives:

- (i) Maintaining the status quo might inflict fiscal harm on the member states with fewer extraregional imports under the new free movement rules compared to the status quo. A diversion of the duty revenues would favor some countries to the detriment of others. Though the change in the rules of movement would have favorable effects by reducing economic disparities associated with asymmetries, the maintenance of the status quo might increase economic disparities in ways as yet unknown.
- (ii) Exact fiscal offset means considering a criterion to distribute revenue on the basis of the final destination of freely moving imports. A customs procedure would have to be established on each operation. This would disclose the content of the CET collections corresponding to freely moving goods incorporated into the goods exported in intraregional trade. After that, an offsetting mechanism would have to be established for the transfers.
- (iii) Revenue distribution rule. This would require calculating the common customs revenues corresponding to CET collections, which would be turned over to a common institution. This institution could distribute the collected revenues in line with an

agreed rule that would take into account the characteristics of each member state. Most customs unions use this alternative and make general rules for distributing customs revenues. Rules could be based on each country's share of the region's total population,<sup>20</sup> consumption<sup>21</sup> approximated by GDP, total imports, extraregional imports,<sup>22</sup> intraregional imports,<sup>23</sup> or extraregional imports entering the region under the CTP. A reference period and a methodology for updating the distribution rule are needed to quantify these.

- (iv) Capitalize a fund to finance common policies among the member states. In this case, the common customs revenues could be the source for the fund but member states could also contribute other resources. The distribution of customs revenues is neither explicit nor direct, since the aim is to have the fund finance common policies or institutions so as to improve the management of integration (cooperation and customs coordination); to develop regional public goods (infrastructure for integration, connectivity and energy resources); or for structural convergence policies at the MERCOSUR level to support the development of disadvantaged regions and countries.

The European integration process created a common fund to finance shared policies. This is the most ambitious way of pursuing integration. Europe moved from less to more, in terms both of the scale of the resources and of the mechanism instituted to create the fund. The first stage (1958–70) was based on the Treaty of Rome and a fund was created using a system of governmental contributions.<sup>24</sup> A second period beginning in 1970 used the European Economic Community's resources, as called for in the original agreements,<sup>25</sup> which are classified into traditional Community resources (customs revenues, agricultural taxes or fees) and others. The second category includes another kind of resource defined later on the basis of a uniform percentage of the base for the value added tax (VAT). In the late 1980s, a fourth category of resource was created, calculated on the basis of each member state's gross national product (GNP). This category is gradually becoming the main source of EU revenues, overtaking the VAT-based contribution.

The offsetting mechanism, distribution rule, and the common fund are all relatively demanding in terms of institutional requirements, and they demand new joint structures to manage and allocate CET revenues. It may be possible to increase the institutional density

<sup>20</sup> Distribution rule for customs revenues used in the Germanic Zollverein.

<sup>21</sup> Distribution rule for customs revenues applied in the Commonwealth of Australia.

<sup>22</sup> Distribution rule for customs revenues applied in the Franco-Italian Customs Union in the late 1940s.

<sup>23</sup> Distribution rule for customs revenues used by the Southern African Customs Union (SACU).

<sup>24</sup> See Treaty of Rome (1957), article 200. Contributions from the countries to finance the Community budget were set as follows: Belgium 7.9 percent; Germany 28 percent; France 28 percent; Italy 28 percent; Luxembourg 0.2 percent; Netherlands 7.9 percent. The contributions for the European Social Fund were slightly different: Belgium 8.8 percent; Germany 32 percent; France 32 percent; Italy 20 percent; Luxembourg 0.2 percent; Netherlands 7 percent. The decision on Community contributions is dated April 21, 1970.

<sup>25</sup> See Treaty of Rome (1957), article 201.

and levels of commitment of member states gradually, starting with the second option and moving toward the fourth.

The third and the fourth alternatives require countries to transfer common customs revenues to a fund that manages their allocation. But simplicity and ease of implementation are important attributes to consider when making a choice. One method may be better than another in a given respect, but hard to implement and therefore not advisable. Creating new institutions or expanding the role of current ones could create unforeseen challenges.

### ***The MERCOSUR Choice***

MERCOSUR's approach is not a simple one that can be classified within any of the general alternatives above. MERCOSUR implicitly adopted a strategy of separating discussions about how to create a fund to finance common policies from discussions about what to do with customs revenues.

In February 2003, during the Paraguayan presidency, the Paraguayan government took the initiative to address regional asymmetries.<sup>26</sup> In 2004, there were intense negotiations in a high-level group created to develop a proposal on the matter.<sup>27</sup> In December 2004, the CMC decided to establish the MERCOSUR Structural Convergence Fund, which is known as FOCEM.<sup>28</sup> In its final meeting in Asunción, in June 2005, the CMC defined the source, use, administration, and management of the fund,<sup>29</sup> which would be earmarked to finance four programs:

- (i) *Structural Convergence Program* for the construction of highways and bridges, the development and improvement of waterways, and innovations in and improvements to communications systems.
- (ii) *Development of Competition Program* to enhance the integration of production chains, improve production processes and quality, promote research and development for new products and production processes, and increase cooperation between private companies and public organizations.
- (iii) *Social Cohesion Program* to improve the quality of human capital, reduce poverty and unemployment, upgrade health systems, and institute training and retraining programs.
- (iv) *Strengthening Institutional Structures and the Integration Process Program* to finance MERCOSUR operations and strengthen its institutional structure.

The size of the fund was not clearly defined in the first stage, though some preliminary figures of about \$80 million were considered. The reference amount of 0.02 percent of gross

<sup>26</sup> See *Tratamiento de las Asimetrías en el MERCOSUR, Propuesta del Paraguay*, Meeting XXIV of the CMC in June 2003, Minutes 01/03, Attachment 5, Working Document 01/03.

<sup>27</sup> The high-level group was created by CMC Decision 19/04 under the Argentine presidency.

<sup>28</sup> See CMC Decision 45/04.

<sup>29</sup> See CMC Decision 18/05.

regional product (slightly more than \$220 million) was also mentioned. Finally, the norm adopted (18/05) established the size of the fund, \$100 million, and a phased path to achieve it (50 percent the first year, 75 percent the second year, and 100 percent in the third year). Table 6.8 presents the amounts and percentages expected to apply to collections and disbursements among members.

The distribution of contributions depends on country size, measured as share of GDP for the average of 1998–2000. The allocation of use by country did not conform to a clear criterion, although it seems to favor the smaller economies. If this model were implemented, Brazil would contribute 78 percent of the net transfers and Argentina would provide 22 percent. The beneficiaries would be Paraguay, which would receive 61 percent of the funds, and Uruguay, which would receive 39 percent of the net transfers.

The idea of establishing a common fund arose in response to a demand to address MERCOSUR asymmetries, particularly the size and wealth of the economies, which would be considered for both contributions and disbursements among the member states. It is important to consider asymmetries when deciding where to channel net transfers. But the common or integrationist objective for the use of the fund is fundamentally expressed in terms of the programs whose projects would qualify for financing. For the first five years, the fund would be used exclusively for convergence and institutional strengthening programs. The latter would have a double ceiling: only a certain proportion of the fund may be used, and only up to an absolute limit. In its first stage, therefore, the fund will be earmarked for the same program that will always represent the largest budget disbursement (70 percent following this first stage).

MERCOSUR has not made significant progress on the question of how to use customs revenues, beyond the decision on free movement. This states that one of the three requirements for applying a universal free-movement rule is to have developed a customs revenue distribution rule before 2008. Again, in general terms the three alternatives remain open (fiscal offsetting, distribution, and a fund), since the status quo is not an alternative. The main concern is to ensure that the changes in movement are fiscally neutral, considering the asymmetries and their potential effects.

***Asymmetries to Consider: Fiscal, Geographic, and Relative Development***

Choosing how to allocate common revenues requires that the objective be defined and that thought be given to the distinct effects of each alternative on the structure of extra- and in-

**Table 6.8 Sources and Use of FOCEM Funds**  
(\$ millions and percent)

	Sources	Uses	Net Transfers	Structure of Net Transfers (percent)
Argentina	27	10	–17	22
Brazil	70	10	–60	78
Paraguay	1	48	47	61
Uruguay	2	32	30	39
	100	100	0	

Source: Author's estimates based on minutes of the high-level group meetings.

traregional imports; the fiscal impact on public finances; and the effects on CET preferences, and therefore on the new equilibrium of the CET.

Asymmetries among countries have several dimensions that have to be considered. Accordingly, the allocation of customs revenues should take into account the different effects (widening or narrowing economic disparities) that such measures could have. The asymmetries can be grouped into five categories: (i) fiscal dependence on import tariff revenues, (ii) geography, (iii) relative development, (iv) market size, (v) relative factor endowments.

The contribution of tariff revenues to overall public revenues is fundamental to the debate, and should be analyzed with geographic and relative development asymmetries.<sup>30</sup> Finally, factor endowments and the distinct trade specializations of member countries vary. Some countries export goods in which the customs union is a net importer and protects them by means of the CET. These countries will prefer a higher import tariff on those kinds of goods. In the literature, this type of asymmetry has been discussed only theoretically (Syropoulos, 2003). Such an asymmetry has to be considered, but is not the most immediate problem under discussion. The main focus has been on the fiscal repercussions for public finances, and on geographic and developmental asymmetries. For that reason, factor-endowment asymmetries are not addressed in this chapter.

Proportional Relationship to Fiscal Revenues

Table 6.9 shows the relevance of foreign trade revenues relative to total fiscal revenue in each country.<sup>31</sup> In the 1990s, the trend was toward an overall decline in the share of the tax revenues associated with foreign trade in most countries. For Brazil, however, the picture is different; at the beginning of the 1990s, the level was extremely low, but it was just over 3 percent by the end of that decade. Trade liberalization in the 1990s, in its discriminatory and nondiscriminatory forms, led to a simultaneous fall in duties and increase in imports. In other words, trends in tax revenues go in the opposite direction of trends in foreign trade. During this period, revenues from foreign trade consisted mainly of income from import duties.

Table 6.9 Revenues from Foreign Trade as a Proportion of Overall Current Revenues in the 1990s (percent)

	1990	1995	2000
Argentina	12.9	4.3	4.1
Brazil	1.8	3.8	3.4
Paraguay	19.2	22.3	13.5
Uruguay	8.3	4.1	3.1

Source: SM-SAT-CE (2004a).  
Note: Revenues from the provinces, departments, and states of the federation are not considered.

<sup>30</sup> The previous section discussed asymmetries in country size relative to changing the rules of movement. This issue is not addressed again in this section.  
<sup>31</sup> Figures in Table 6.9 were estimated by the Institute for the Integration of Latin America and the Caribbean (INTAL). See Barreix and Villela (2003).

Fiscal information was used to update the figures for 2000–03. Revenues from imports were calculated as a proportion of current revenues and of tax revenues for the central government.<sup>32</sup>

Table 6.10 presents trends in import duties and their proportional relationship to the current revenues and tax revenues of each country. For Paraguay, these revenues average about 17 percent of tax income, with no clear tendency to fall during the period. In the other countries, the figure is between 6 percent (Argentina and Uruguay) and 9 percent (Brazil). In Brazil, import duties are significant relative to tax revenues but not to current revenues. Furthermore, these figures only consider revenues from the central government, whereas state, provincial, and departmental revenues are significant in Brazil.

### Geographic Asymmetries

The new rules of movement could cause a change in trade flows, related to changes in the structure of extraregional imports. A reconfiguration of the distribution channels for extraregional imported goods is likely. Magariños and Terra (1998), in considering the relationship between the structure of the trade flow and the trade rules in the region, commented, “Recently, the view has been voiced that in the near future, for technical and operational reasons, shipping services to the Atlantic coast of the Southern Cone will have to focus on no more than two ports, one in Brazil and another along the Río Plata, in response to modern-day demands of transportation and cargo handling. The possibility of going through customs processing at the selected ports in a single act for goods bound for the entire subregion clearly encourages this tendency.”

Furthermore, production activities may shift where the transformation is below the threshold for an originating good. Changes in the structure of imports by a member country

**Table 6.10 Share of Import Duties in Tax Revenues and Current Revenues**  
(percent)

	2000	2001	2002	2003	Average
<b>Argentina</b>					
Import duties/taxes	4.9	4.2	3.3	3.8	4.0
Import duties/current revenues	3.6	3.1	2.4	3.0	3.0
<b>Brazil</b>					
Import duties/taxes	10.7	9.8	7.3	7.0	9.1
Import duties/current revenues	3.3	3.1	2.3	2.1	2.9
<b>Paraguay</b>					
Import duties/taxes	18.2	17.5	16.7	18.1	17.4
Import duties/current revenues	11.5	10.0	9.6	11.2	10.3
<b>Uruguay</b>					
Import duties/taxes	5.2	6.1	7.0	5.5	6.1
Import duties/current revenues	4.1	4.9	5.1	4.5	4.7

Source: See SM-SAT-CE (2004a).

<sup>32</sup> In 2000–03, export fees took on unusual importance in Argentina because convertibility collapsed and led to macrodevaluation in early 2002.

affect the allocation of CET revenues, given the current structure. In practice the distribution rule for the CET is currently linked to imports; the country collecting the duty appropriates the revenues.<sup>33</sup>

Geographic factors affecting ease of contact with the rest of the world will be important in this new import structure. If the rules of movement change but the rules for distribution do not, the most isolated countries may be adversely affected. Argentina, Brazil, and Uruguay have Atlantic coastlines, while Paraguay is landlocked. That could be a disadvantage if the current rules on the allocation of customs revenues remain unchanged.

### Relative Development Levels

Per capita incomes can be taken as proxy variables for a country's relative development. The three alternative measures—per capita GDP (in current U.S. dollars), per capita GNP (in current dollars) and per capita GNP at purchasing power parities (PPP)—account for the significant asymmetries among countries.

In 2002, MERCOSUR's per capita GDP was \$2,586 (current dollars). In Argentina, it was 104.27 percent of the average; in Brazil, 100 percent; in Uruguay, 140 percent; and in Paraguay, it was just 40 percent of the MERCOSUR average (SM-SAT, 2004). Table 6.11 presents alternative per capita income measurements using both GDP and GNP in current dollars<sup>34</sup> at PPP.<sup>35</sup>

In 2003, MERCOSUR's per capita GDP was \$2,853 (current dollars). Argentina and Uruguay were at 118 percent and 116 percent, respectively. GDP in Brazil was 98 percent of the average and Paraguay's was at 36 percent (see Table 6.11). For per capita GNP at PPP, the order is somewhat different. Argentina remains first at 136 percent, while Uruguay is at the exact average for the region. Paraguay has the lowest per capita income at 59 percent of the average, while Brazil is slightly below average at 93 percent.

As the data show, there were significant changes between 2002 and 2003 in per capita income among MERCOSUR countries because of huge exchange-rate swings. As of 2003, all MERCOSUR countries had a floating exchange system and their bilateral exchange rates in real terms had tended to stabilize. Certain common structural traits, however, remain unchanged. Paraguay is still the poorest country in the region; Brazil is in the middle or slightly below average; for Argentina and Uruguay, the order changes according to whether data for 2002 or 2003 are used. In 2003, Argentina had the highest per capita income under any measurement, while Uruguay was either average or slightly above average, depending on the method used.

<sup>33</sup> More precisely, this rule may not apply in some cases, since countries can deviate upwards or downwards from the CET. There is a mixed trade policy regarding the tariff that one country sets on imports from third parties. That way of applying the trade policy on these imports by each member country generates duty revenues when those imports are traded within the group.

<sup>34</sup> *World Bank Atlas* method. Data is converted from national currency to current U.S. dollars using the average exchange rate over a three-year period to attenuate the effects of temporary changes in the rate.

<sup>35</sup> PPP used by the World Bank.

**Table 6.11 Per Capita Income of MERCOSUR Countries in 2003**  
(\$ current and PPP)

(a) Levels				
	GDP Per Capita (current \$)	GDP Per Capita (\$ at PPP)	GNP Per Capita (\$) <sup>a</sup>	GNP Per Capita (\$ at PPP)
Argentina	3,381	11,586	3,651	10,920
Brazil	2,788	7,767	2,712	7,480
Paraguay	1,030	4,724	1,101	4,740
Uruguay	3,308	8,280	3,818	7,980
MERCOSUR <sup>b</sup>	2,627	8,089	2,820	7,780
MERCOSUR <sup>c</sup>	2,853	8,352	2,849	8,008

(b) Deviations				
	Deviation in GDP Per Capita (current \$)		Deviation in GNP Per Capita (\$ at PPP)	
	Simple	Weighted	Simple	Weighted
Argentina	129	118	140	136
Brazil	106	98	96	93
Paraguay	39	36	61	59
Uruguay	126	116	103	100
MERCOSUR	100	100	100	100

Source: Author's estimates based on the World Development Indicators database.

a. *Atlas* method.

b. Simple average.

c. Average weighted by population.

## A Distribution Rule for MERCOSUR

A general rule for the distribution of customs revenues could help resolve the geographic asymmetries if a nongeographic criterion were used. If the rule guarantees revenues by collecting duties on extraregional imports greater than or equal to those in place before the rule went into effect, there will be no adverse fiscal effect relating to fiscal dependency. A distribution rule in relation to the exact offsetting mechanism requires less information and fewer additional customs procedures.

Given that the MERCOSUR country with the greatest fiscal dependency on customs duties also has the lowest per capita income, a formula was considered to converge in terms of per capita income through transfers from richer to poorer countries.

Regarding other developing countries that built customs unions and had asymmetries similar to those mentioned above, the Southern African Customs Union (SACU) was the benchmark (see the appendix to this chapter). Its formula was adapted to the MERCOSUR agreement and gave the following equation:

$$RA^e = RA^R (\alpha \rho^e + (1 - \alpha) \frac{P^e}{P^R} \frac{((k+1) - (\frac{y^e}{y^R}))}{k}) \quad (6.1)$$

where superscript  $e$  indicates the country (member state) of reference; superscript  $R$  indicates a regional aggregate;  $RA$  = customs revenues;  $P^e$  = population of the member state and  $P^R$  = regional population;  $y^e$  = the country's per capita income and  $y^R$  = regional per capita income calculated as the sum of all income divided by total population;  $\rho^e$  = the scale of country measured by imports, consumption or population;  $\alpha$  = proportion of customs revenues distributed by the rule of scale of the country; and  $k$  is a parameter determining the degree of distribution of the rule's relative development component.

The formula distinguishes the revenues to be distributed into (proportion) considering the scale of the country ( $\rho^e$ ) and  $(1 - \alpha)$ , the deviation in per capita income with respect to the regional average. The weighting factor ( $\rho^e$ ) is of utmost importance and can be done with any of the rules used for the simple distribution alternatives: population, consumption, and total extra- or intraregional imports.

Small economies are considered in three different ways under the distribution formula. In the first case, the criterion for distributing common customs revenues according to intraregional import shares gives greater weight to smaller economies that participate relatively more in intraregional trade than larger economies with a relatively lower level of development. For  $\alpha$ , the smaller the parameter, the greater the proportion of revenues from special domestic taxes distributed according to a formula responding to asymmetries in per capita income levels. Finally, parameter  $k$  modulates distributive intensity in line with the chosen response to relative levels of development. If this parameter is very large, then the term tends toward equidistribution, reducing the importance of the magnitude of the deviation. At the other extreme, as parameter  $k$  tends to 1, the distribution becomes more favorable for poorer economies. The calculations have used a parameter of  $k = 1$ .

Table 6.12 gives the results of a simulation using the rule proposed in equation (6.1). To calibrate the weighting information with the relevant magnitudes and with each country's contribution to customs revenues, simple average information was used from 2000, 2001, and 2003.<sup>36</sup>

Deviations were considered in per capita GDP using current dollars in relation to the regional average for 2000, 2001, and 2003. Two values were considered for  $\alpha$  (1 and 0.75). When  $\alpha$  equals 1, the simulation reproduces the results of applying the simple rules referred to above (distributing alternatively by population, consumption or imports). Estimates were made of collections of customs revenues corresponding to the status quo. These revenues would be those that the countries should give up in order to comply with the distribution rule.

<sup>36</sup> 2002 was not considered and was understood as exceptional from a macroeconomic viewpoint for many of the region's countries. An in-depth analysis of that period is needed for the calculations, given that the results could change significantly because of major fluctuations in relative prices.

**Table 6.12 Structure of Contributions to Customs Revenues and Alternative Weightings for the Distribution Formula: Average, 2000, 2001, and 2003 (percent)**

	Argentina	Brazil	Paraguay	Uruguay
Contributions to the fund (percent)	25.30	69.40	2.30	2.90
Population (percent)	17.20	79.00	2.30	1.50
Deviation in per capita income (ratio)	1.70	0.86	0.33	1.40
<b>a. Total imports</b>				
<b>Distributed revenues</b>				
• simple rule ( $\alpha = 1$ )	22.3	71.5	2.7	3.5
• adjusted for per capita income ( $\alpha = 0.75$ )	18.0	76.2	3.0	2.8
<b>Estimated transfer</b>				
• simple rule	-3.1	2.1	0.4	0.6
• with adjustment for per capita income	-7.4	6.7	0.7	-0.1
<b>b. Extraregional imports</b>				
<b>Distributed revenues</b>				
• simple rule	19.6	76.7	1.5	2.3
• with adjustment for per capita income	15.9	80.0	2.1	2.0
<b>Estimated transfer</b>				
• simple rule	-5.8	7.2	-0.8	-0.6
• with adjustment for per capita income	-9.4	10.6	-0.2	-0.9
<b>c. Intraregional imports</b>				
<b>Distributed revenues</b>				
• simple rule	36.4	47.0	8.2	8.5
• with adjustment for per capita income	28.6	57.7	7.1	6.6
<b>Estimated transfer</b>				
• simple rule	11.1	-22.5	5.9	5.5
• with adjustment for per capita income	3.2	-11.7	4.8	3.7
<b>d. Consumption</b>				
<b>Distributed revenues</b>				
• simple rule	29.3	67.8	0.8	2.1
• with adjustment for per capita income	23.2	73.4	1.6	1.8
<b>Estimated transfer</b>				
• simple rule	3.9	-1.6	-1.5	-0.8
• with adjustment for per capita income	-2.1	3.9	-0.7	-1.1
<b>e. Population</b>				
<b>Distributed revenues</b>				
• simple rule	17.2	79.0	2.3	1.5
• with adjustment for per capita income	14.1	81.8	2.7	1.4
<b>Estimated transfer</b>				
• simple rule	-8.2	9.5	0.1	-1.4
• with adjustment for per capita income	-11.2	12.3	0.4	-1.6

Brazil would prefer a distribution rule based on population and extraregional imports. By contrast, Argentina would benefit from a distribution rule based on consumption (approximated by output). The smaller economies (including Argentina), however, would prefer to have intraregional imports considered as the weighting factor. The poorer economies (Paraguay and Brazil) are always better off when the incorporated term takes account of deviations in per capita income; the converse is true for the richer economies (Argentina and Uruguay).

If minimal transfers among the member states in relation to the current situation were deemed desirable overall, distributing by consumption would be the most satisfactory alternative. In fact, the formula that makes the smallest transfer would be the one based on consumption. But this formula would be unsatisfactory to the extent that the poorest, landlocked economy, which is also dependent on fiscal revenues from duties, would find itself making a net transfer.

Table 6.13 was prepared by combining various asymmetries considered when analyzing distribution rules. Two values were defined for each asymmetry, a very schematic approximation that simply highlights certain facts. Strictly speaking, for most of the factors considered, the variation is continuous, and such differences should also be considered.

As regards size, population was considered. The large countries are those whose populations are larger than the group average, and the small countries have populations below the

Table 6.13 Comparative Distribution of Asymmetries in SACU and MERCOSUR

SACU					
	Size	Large		Small	
Wealth	Fiscal dependency /geography	Without fiscal dependency	With fiscal dependency	Without fiscal dependency	With fiscal dependency
Rich	Not landlocked	South Africa		Botswana	
	Landlocked				
Poor	Not landlocked				
	Landlocked			Namibia Lesotho Swaziland	
MERCOSUR					
	Size	Large		Small	
Wealth	Fiscal dependency /geography	Without fiscal dependency	With fiscal dependency	Without fiscal dependency	With fiscal dependency
Rich	Not landlocked			Argentina Uruguay	
	Landlocked				
Poor	Not landlocked	Brazil			
	Landlocked			Paraguay	

average. As to wealth, per capita income was considered. The rich countries have incomes above the group's average, and the poor countries have incomes below the average. For fiscal dependency, a threshold was established to define whether the country was fiscally dependent on extraregional import taxes (more than 10 percent of current revenues). For geography, the categories were *landlocked* or *not landlocked* (having a sea outlet). The ordering of the variables placed the more advantaged countries in the upper-left-hand corner and the poorest countries in the lower-right-hand corner.

SACU is almost an archetype; transfers must take place while countries are at extremes. In MERCOSUR, the main obstacle is that the largest economy is not the richest, although one country is clearly situated in the lower-right-hand corner of the table. The richer countries are small (even Argentina, when population is considered) and there is very limited capacity to generate transfers to the other countries.

## Conclusions

In 2005 MERCOSUR's integration process began moving toward a customs union, beyond convergence on the CET. A CMC decision established the concept of free movement, modifying the rules of intraregional trade, and the choice was to apply the rule gradually, which would initially cover only goods whose inclusion had no fiscal effect (list of 0 percent CET and 100 percent common preference). In a second stage, once three basic requirements were met (a customs code, customs interconnection, and distribution of revenues), a schedule would be established to apply the rule to all goods. This is significant because the asymmetries in market size mean that smaller economies are harmed by the status quo.

Progress has been slower in defining how to allocate common customs revenues. A three-year period was given to find a solution. Three alternatives for allocating the common revenues were identified: (i) an exact fiscal offset in which a charge would be made in accordance with destinations of extraregional imports, (ii) distribution in accordance with some general rule that approximates the scale of the countries and/or any other objective, and (iii) capitalizing a common fund to finance joint policies and integration institutions.

The choice depends on the goal of the integration process. One aim might be that changes in the rules of movement governing customs union operations should be neutral from a fiscal viewpoint and not affect the member states' public finances. Another would be to use the distribution mechanism to create some kind of system for transfers between one type of country and another (rich–poor, large–small). Finally, a third objective might be to create a fund to finance common policies that favor the integration process.

As mentioned earlier, MERCOSUR implicitly adopted a strategy that separates discussions about creating a fund for financing common policies from discussions about what to do with customs revenues. A fund of approximately \$100 million was created, with contributions from the countries and with guidelines for distributing allocations. The problem now is what to do with the resources.

The many asymmetries among the MERCOSUR countries mean that any changes in the movement rule would have to be fiscally neutral, and the distinct effects (widening or narrowing of economic disparities) of any measure would have to be considered.

One MERCOSUR country, Paraguay, has a high fiscal dependence on duty revenues from imports from the rest of the world. It is also landlocked, small, and has the lowest per capita income. Any distribution mechanism must pay special attention to Paraguay. Another factor to be kept in mind is that the biggest country with the biggest market, Brazil, is not among the richest countries in terms of per capita income. Consequently the SACU formula does not yield entirely satisfactory results when considering the general rule of distribution for MERCOSUR, and the situation requires careful analysis.

In one sense, discussion of the allocation of common funds is analogous to that of the distribution of customs revenues. The fundamental difference is that once common funds are generated, community issues affecting several countries can be addressed simultaneously without any particular country necessarily appropriating the common funds. The options entail various institutional densities in terms of the quantity and quality of community institutions, but every option would increase the size and improve the quality of the common bodies.

## APPENDIX

### **A Case of Interest: Distribution of Customs Revenues in the SACU**

SACU is an interesting case because it includes several Southern African countries and is marked by asymmetries similar to MERCOSUR's in terms of geography, fiscal dependence on customs revenues, and differences in relative development levels.<sup>37</sup> SACU dates from the start of the twentieth century, but was made formal in 1969 through an agreement between Botswana, Lesotho, South Africa, and Swaziland. Namibia joined in 1990, and a new agreement in 2002 sought to improve on the 1969 accord. A basic aspect of the agreement is that it involves the distribution formula for common revenues.

Lesotho and Swaziland are landlocked and the public finances of three of the five countries depend on transfers from SACU. In fact, Swaziland, Lesotho, and Namibia receive a large part of their fiscal revenues from this source (54.1 percent, 51.0 percent, and 30.4 percent, respectively). According to 2000 data, Botswana and South Africa have the highest per capita income (\$3,424 and \$2,864, respectively). At the other extreme, Swaziland's per capita income is \$1,308 and Lesotho's is \$407, making it one of the poorest countries in the world. Namibia is in an intermediate position, with a per capita income of \$2,006.

There are some analogies in methods for distributing revenues in SACU and MERCOSUR, which is why a more detailed study of the customs revenues distribution formula used by these African countries is helpful. The complex distribution equation combines several criteria:

$$RA^e = RA_{..}^R \left( \frac{M_{..R}^e}{M_{..}^R} \right) + \alpha ID^R \frac{Y^e}{Y^R} + (1 - \alpha) ID^R \frac{((k+1) - (\sum_e y^e n))}{nk} \quad (A.1)$$

where superscript  $e$  indicates the country (member state) of reference;  $RA$  = customs revenues; the superscript  $R$  is the aggregate for the region;  $M_{..R}^e$  = imports of member state  $e$  as a proportion of the imports of all products (.) that are regional in origin ( $R$ );  $ID$  = special domestic taxes that also enter in the distribution;  $\alpha$  = the proportion of domestic taxes distributed by the production rule;  $e$  = production per capita;  $n$  = number of countries in the trade agreement; and  $k$  is a parameter determining the degree of distribution of the rule's relative development component.<sup>38</sup>

The procedure starts by calculating the aggregated revenues to be distributed, which have two different sources: the totality of the customs revenues of the SACU ( $RA_{..}^R$ ), and a

<sup>37</sup> This appendix draws on Kirk and Stern (2003) and WTO (2003).

<sup>38</sup> A minimum value of parameter  $k$  needs to be defined, such that the numerator of the fraction of the third term of equation (A.1) will be positive. The minimum value for  $k$  depends on the degree of asymmetries in the relative levels of development of the member countries.

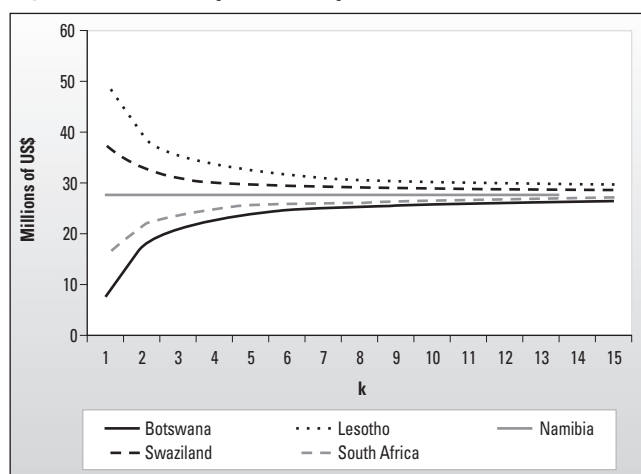
series of special domestic taxes ( $ID^R$ ) that also feed the pool of revenues to be distributed. This SACU tax revenue is divided among the member countries in line with three criteria [see equation (A.1)]:

- (i) In the first term, the customs revenues are distributed on the basis of the countries' share in MERCOSUR's intraregional trade ( $M_{.R}^e/M_{.R}^i$ ).
- (ii) The second criterion is to distribute a fraction of the special domestic taxes ( $\alpha ID^R$ ) in accordance with share of output ( $Y^e/Y^R$ ).
- (iii) Finally, the other fraction of the special domestic taxes are distributed ( $(1 - \alpha)ID^R$ ) on the basis of a criterion set in accordance with the deviation in the development level of each country relative to the region's average level.

The smaller economies with a lower relative level of development are considered in three different ways in the distribution formula. In the first term, the criterion of distributing customs revenues on the basis of intraregional trade gives greater weight to smaller economies that participate relatively more in intraregional trade than the larger economy (South Africa). In the second term, for parameter  $\alpha$ , the smaller the parameter, the greater the proportion of revenues from special domestic taxes that will be distributed in line with a formula responding to asymmetries in per capita income levels. Finally, parameter  $k$  modulates distributive intensity in accordance with the chosen response to relative levels of development. If this parameter is very large, then this term tends toward equidistribution, reducing the importance of the deviation's magnitude. At the other extreme, as parameter  $k$  tends to 1, the distribution is greater for the poorer economies (see Figure 6A.1).

Taking into account that there are no domestic tax revenues to be distributed, only common customs revenues could be distributed. In the long term, with a universal rule of movement, customs revenues will be based on the customs union's CTP. In the short term, with a more restricted rule of movement, a precise definition of the revenues to be distributed is needed.

**Figure 6A.1. Development Component in SACU's Rule**



Source: Prepared by the author on the basis of Kirk and Stern (2003).

**Table 6.A1 Production, Population, and Per Capita Income  
in SACU Countries**

(\$ millions and millions of persons)

	Production	Population	Per Capita Output (\$)
Botswana	5.65	1.70	3,424.0
Lesotho	0.88	2.20	407.0
Namibia	3.47	1.70	2,006.0
Swaziland	1.28	1.00	1,308.0
South Africa	125.60	43.90	2,864.0
Total	136.88	50.42	2,001.8

Source: Prepared by the author on the basis of Kirk and Stern (2003).

**Table 6.A2 Distribution of the Pool of Revenues in SACU Countries by Component for 2002**  
(\$ millions)

Component/Country	Botswana	Lesotho	Namibia	Swaziland	South Africa	Total
Customs revenues	225	113	210	123	173	844
Production	28	5	17	7	730	787
Development	26	30	28	29	26	139
Total	279	148	255	159	929	1770
Share of distribution (percent)	15.7	8.4	14.4	9.0	52.5	
Share of output (percent)	4.1	0.6	2.5	0.9	91.8	

Source: Prepared by the author on the basis of Kirk and Stern (2003).

Note: A 2002 average exchange rate of 10.23 rands = \$1 was used.

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PART III:

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**Coordination of Microeconomic Policies**

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## **National Policies and the Deepening of MERCOSUR: The Impact of Competition Policies**

*Gustavo Baruj, Bernardo Kosacoff, and Fernando Porta\**

### **Introduction**

The official agenda for deepening the Southern Common Market (MERCOSUR) is wide and varied. It emerges from the heritage of the Ouro Preto agreements of 1994 (completing and putting into effect the institutions of the customs union) and the commitments on agreements successively negotiated in the decade that followed (including harmonizing macroeconomic policies, liberalizing services trade, and setting up a common competition policy). Throughout this period, and in contrast to the goodwill behind that agenda, there has been only modest transposition of the agreed-upon regulations, and an increasing number of infringements of the rules previously adopted by the member countries (Bouzas, Motta Veiga, and Torrent, 2002; Chudnovsky and Fanelli, 2001; Kosacoff, 2004; Secretaría del Mercosur, 2004). The consequence of this institutional pattern is somewhat perverse: the list of pending obligations grows on par with that of frustrations. Of course, there is an intense debate on the causes of this dilemma and its possible resolution. Essentially, one group believes the goals are overly ambitious and the other believes resources have been insufficient.

Perhaps with the exception of Paraguay, the MERCOSUR countries have a long track record of promoting productivity and have generally sought to stimulate productivity and exports of manufactured goods. In the 1990s, the approach shifted and traditional market reserve policies began losing ground to other, more horizontal practices geared toward promoting firms' competitiveness in a context of more open economies. The debate over the functionality of regional integration in general, and of MERCOSUR in particular, has acknowledged this problem from two perspectives. First, what can each member country do to motivate its productive sector without infringing regional regulations? Second, what is the best way to exploit the potential of an enlarged market in order to stimulate production in

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\* Preliminary versions of this chapter appeared in workshops organized by the IDB entitled "Deepening Integration in MERCOSUR: Dealing with Disparities," held in Washington, D.C., and Rio de Janeiro in February and July 2005, respectively. The authors would like to thank workshop participants and the following for their comments: Mariano Laplane, Fernando Masi, Ernesto Miranda Álvarez, Fernando Lorenzo, Carlos Paulino, and Nicole Perelmuter.

member states? Behind these questions lies an old discussion about the theoretical benefits of cooperation in times of uncertainty (Ghymers, 2001; Mattli, 1999).

This chapter addresses the question of deepening integration in MERCOSUR, as it relates to the effectiveness of particular policies that promote national competitiveness. It should be noted that, among deficits and infringements that have marked MERCOSUR's history, "incentive wars" (promotional competition) have been recognized as highly detrimental. There are also clear differences in the capacities of each member to sustain such competition and benefit from it (Porta, 2004). It is assumed here that deeper integration in MERCOSUR should guarantee the effectiveness of the enlarged regional market, and that the competition rules are the same for all producers resident in the member states. This entails a possible clash between some of the domestic promotional measures and the stated goals, as well as between those measures and the integration scheme's institutional structure—especially if implementation of the measures distorts the conditions of competition by introducing discriminatory elements.

Beginning with a broad survey of the instruments used in the MERCOSUR countries to promote the competitiveness of productive activities,<sup>1</sup> this chapter aims to examine whether their effects are conducive to or undermine the regional goal. To that end, the next subsection explains what is meant by "competitiveness policies" (concerning the instruments used) and "deepening integration in MERCOSUR" (concerning the terms of this assessment). The section "A Review of the European Experience" briefly reviews European experience in this field as a valid reference for MERCOSUR's stated objectives. The section following that offers a general comparative analysis of the approach and main features of competitiveness policies in the bloc's member countries. "The Impact of the Promotion Instruments on Competition Conditions in MERCOSUR" examines the potential impact of the main promotional instruments—instituted at the national level—on MERCOSUR's goal of deepening integration. Then the following section considers current regulatory asymmetries and their harmful effects on MERCOSUR's institutional dynamics. Finally, the concluding section provides general recommendations on the harmonization of national policies and the formulation of common strategies in this area. The appendix presents a list of the instruments in each country and summarizes their main characteristics.

## General Definitions

The competitiveness policies examined in this chapter are confined to the instruments used in the MERCOSUR countries to promote, sustain, or improve the performance of businesses and productive activities in the member countries (and involve the transfer of public funds for those purposes).<sup>2</sup> This selection is justified by the fact that these national instruments may

<sup>1</sup> This study examines and summarizes information and conclusions contained in reports by Baruj and Porta (2005); Laplane (2005), Masi and Miranda Álvarez (2005), and Lorenzo, Paulino, and Perelmutter (2005).

<sup>2</sup> In this context, the concept is similar to thoughts on "state aid" in European regulations (see the section "A Review of the European Experience"). For that reason, the analysis expressly excludes those instruments and mechanisms used to regulate the conditions of access of imports to the domestic market (tariffs and other similar restrictions), except when they were applied to imports from other MERCOSUR countries.

intervene in (and modify) the conditions of competition established in the enlarged market through regional regulations. Hence attention has been paid to the various mechanisms that: (i) promote investment (by installing increased capacity, and expanding or updating existing capacity by reducing start-up or operating costs); (ii) promote exports (by improving “price and nonprice competitiveness”); (iii) strengthen the productive capacity of businesses by incorporating technological advances and educating the workforce; and (iv) promote performance (by facilitating activities and supporting firms).

### ***Competitiveness Policies***

In the regulations and normal policy making of the MERCOSUR countries, instruments to promote competitiveness fall under the scope of industrial policies (broadly defined to cover all production activities), trade policies (limited to exports, in this case), and technology and innovation policies. They were also regarded as part of special labor regimes (distinct from the general regulations governing labor markets at the national level). Because this chapter seeks to assess the impact of these instruments on competition conditions in the enlarged market, the study is specifically geared toward those instruments that could impact tradable productive activities.

In the MERCOSUR countries, especially Argentina and Brazil, various jurisdictions are responsible for formulating and implementing such policies. There is a distinction between instruments defined at the national level—where the budgetary authority is national and the resources come from the central budget—and others established at the regional or provincial level by the corresponding authorities, which solely involve those authorities’ responsibilities and funds. Moreover, an assessment of the promotional reach of these different instruments requires that they be distinguished by use, whether mainly (i) horizontal (available to all productive activities), (ii) sectoral (for a specific activity), or (iii) regional (only for a specific political jurisdiction). A significant number of the instruments examined are explicitly geared toward micro, small, and medium-sized enterprises. In this case, the instruments have been regarded as horizontal, since they are meant to tackle widespread market failures.<sup>3</sup>

### ***On the Deepening of MERCOSUR***

MERCOSUR is officially defined as a customs union (Ouro Preto Protocol, December 1994), which assumes intrazone free trade and a common external trade policy. This official ideal has not yet been fully realized, for three reasons. First, there are several exceptions to the zero intrazone tariff and the common external tariff (CET), and the originally scheduled deadlines

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<sup>3</sup> The national documents include a description of the basic objectives of each instrument, the type of funding (subsidy, credit, tax deduction, technical assistance, or financial aid), the planned, committed and expended resources (if information is available), financing methods, temporary scope, potential beneficiaries (and real beneficiaries, if information is available), the mechanisms for selection and allocation, the institutions and associated agencies, and the allocation authority. These elements have been taken into account when assessing the type and possible magnitude of the potential impact of each of these instruments on the goal of deepening integration in MERCOSUR.

for the expiration of those exceptions have not yet been met or have been extended. Second, there has been slow progress in the area of customs and technology harmonization. Third, and especially since the end of the 1990s, agreed-upon or unilateral forms of exceptional treatment have threatened the original goals. In sum, today MERCOSUR functions as a very imperfect free trade area (Bouzas, 2004). Hence, deepening integration in MERCOSUR requires reestablishing the original objective of setting up an enlarged market on the regulatory bases of a customs union.

Theoretically, the purpose of a customs union is to ensure the free movement of goods within an area and the leveling-out of the conditions of competition for all resident producers—which should maximize expected benefits. The European integration experience has shown that, in order to meet this goal, it is not enough to establish a CET and remove tariff and nontariff barriers to regional trade (that is, the formal attributes of a customs union). The goal also calls for decisive progress on the elimination of other barriers with similar effects, macroeconomic policy coordination, and production incentives. The European Union (EU) has designated this process as a transition toward an “internal market,” a notion denoting the area in which the two conditions that opened this paragraph are met (see the section “A Review of the European Experience”).

Accordingly, deeper integration should go beyond ensuring that the goals established in Ouro Preto more than a decade ago are still valid, and should seek to create a true MERCOSUR internal market. This is the definition adopted herein as a general guide to assessing the potential effects of the competition policies that member states have applied in order to attain regional objectives. This study does not review all the regulatory and policy coordination requirements needed for a full and effective internal market. Essentially, it analyzes the impact of promotion policies and assesses their contribution to the harmonization of competition conditions, the consolidation of intrabloc free trade, and the establishment of closer regional linkages among productive sectors. In this sense, the study seeks to determine if the policy instruments under consideration hamper the deepening of integration and cooperation within MERCOSUR, are neutral in their effects, or facilitate further integration.

Once the main instruments have been identified, and their scope and application analyzed, the prime goal is to assess their potential impact on the conditions of competition and the structural links within the enlarged regional market. To determine the direction of the various policy instruments selected, four dimensions or specific goals of deep integration have been identified: (i) assurance of the free movement of goods within the MERCOSUR internal market and respect for the preferential access conditions offered to producers in the member states; (ii) elimination of cost-price distortions (subsidies to the sales price in the MERCOSUR internal market); (iii) elimination of the negative cross-border spillovers associated with investment promotion (incentives to encourage companies or activities to base themselves in particular locations in order to supply the MERCOSUR market); and (iv) exploitation of economies of scale and specialization to develop productive complementarity in the MERCOSUR internal market.

The first three are conditions for deeper integration; the fourth should be the result, albeit not necessarily spontaneous. The geographic distribution of the welfare gains in an integration scheme will mainly depend on the trends of productive specialization induced by the new conditions of competition in each member state. The long-term sustainability and the political and social cohesion of a regional integration project require that potential problems in distribution be considered and resolved effectively. The costs of structural adjustments are relatively low and easily managed when the partner countries follow a pattern of intrasectoral specialization (and thus of trade), which tends to facilitate real convergence among their economies (Fontagné et al., 1997; Ocampo, 1991). For this process to take place, especially when there are significant structural asymmetries (see the section “The Impact of Regulatory Asymmetries”), it seems necessary to implement well-considered policies that tend to correct the concentrated effects of economies of scale and agglomeration.

### The Substance of the Assessment

For each of the instruments identified, its potential impact has been determined, taking into account its nature and purpose, and whether each: (i) facilitates, restricts, or has no effect on free intraregional trade; (ii) eliminates/reduces, introduces/expands, or has no effect on cost-price distortions at borders; (iii) eliminates/reduces, introduces/expands, or has no effect on cross-border spillovers; and (iv) stimulates, restricts, or has no effect on intraregional productive complementarity. Use of these criteria allows for an assessment of whether the instrument in question is positive, corrosive, or neutral for deep integration in MERCOSUR. To approximate an assessment of the scale of the instruments’ potential impact on the four dimensions of the process of deepening MERCOSUR, some indicators that suggest the quantitative effects of each of them have been analyzed.<sup>4</sup>

Moreover, using the analysis of the main areas of conflict or convergence among the national policies and a possible deep integration scheme in MERCOSUR, an effort has been made to identify the existing disparities in the areas of competitiveness-promotion institutions and instruments among the four countries—that is, what are usually termed “policy asymmetries.” Note that, for the purposes of deepening integration, policy asymmetries are potentially harmful even in the absence of specific distortionary impacts, since they can cause problems of distribution among the member states.

### A Review of the European Experience

The European integration process provides an indispensable reference for an evaluation of the limitations and possibilities of policy coordination in MERCOSUR, given the formal aims of

<sup>4</sup> These indicators refer basically to the resources available or used to finance the programs, to the relative impact on operating or investment costs for the activities and firms, or to the number of beneficiaries affected (see the discussion in the section “The Impact of the Promotion Instruments on Competition Conditions in MERCOSUR” and the national studies).

deep integration that drive it. It has been rightly said that in reviewing the European experience, its method is more important than its model (Ghymers, 2001)—that is, it is more important to consider the design and implementation of the criteria and basic policies than the institutional set-up that contains them. There are two reasons for this: first, because institutional arrangements tend to be idiosyncratic and unsusceptible to extrapolation; and second, because the substance and forms of national and community policy coordination evolve and change without necessarily altering the formal appearance of institutions.<sup>5</sup> This section reviews a set of European laws that, with greater or lesser interrelation over time, have provided the substance of a regional approach to promoting productive activities since the customs union was established. The section also makes reference to the debate that has framed this process.

## ***Regulations***

### **The Internal Market**

The Single European Act (1987) formally enshrined the concept of the internal market as an integral part of European Community (EC) legislation. The term had been put forward two years earlier in connection with a diagnosis of the difficulties hampering European integration's attainment of the economic effects expected of the customs union and the region's efforts to deal with protectionist (equivalent) nontariff measures among member countries.<sup>6</sup> The main goal of the new legislation was to guarantee the free movement of goods, but it also sought to establish the other three freedoms considered fundamental for the establishment of the common market: the movement of people, capital, and services. Indeed, in European legislation, the concept of an internal market grants a particular legal standing to the economic notion of a common market, and establishes the conditions whereby the EC market should function in a manner similar to the internal market of any member country—that is, as a “borderless space.”

The White Book (Comisión de las Comunidades Europeas, 1985) had mentioned four remaining types of barriers to the free movement of goods once tariffs and nontariff barriers to intra-EC trade were eliminated: physical, technical, tax, and public barriers. At the time, it was estimated that the costs of these restrictions amounted to 5 percent of EC gross domestic product (GDP) (Cecchini, 1988). This is why the main effort in European integration, before the transition that led to a monetary union, focused on the harmonization of customs legislation and border controls, technical and phytosanitary standards, indirect taxation, and public procurement. These measures had the dual objective of reducing transaction costs and ensuring the principles of free movement and equality of treatment. Although relatively dissimilar progress was made in these four areas, toward the end of the 1990s, parallel progress

<sup>5</sup> It should be stressed that this virtue does not form part of the European policy of cooperation, which is generally and fundamentally concerned with transplanting its institutional model (supranationality, and so on).

<sup>6</sup> Comisión de las Comunidades Europeas (1985).

on the free movement of capital and services, as well as freedom of migration, gave rise to the sense that the internal market had become a reality.

In the European experience, then, the establishment of the internal market entailed, on the one hand, eliminating obstacles in each member state so as to bring them into compliance with the required conditions for freedom and equality (the process of “negative” integration, whereby national laws that might affect those four freedoms were removed). It also entailed the coordination of policies—sectoral, commercial, and social—that might impede the smooth functioning of that internal market (the process of “positive” integration, whereby the distributive effects of market liberalization are managed). It should be noted that this greater scope, which goes beyond the level of harmonization required to establish the internal market, was not expressly instituted in the legislation deriving from the Single Europe Act. But it has been progressively incorporated into the interpretation and practice of the European institutions, in such a way as to make the internal market more cohesive (Arnaiz and Fonseca Morillo, 1998; Bianchi, 1997).

### State Aid

In the post-World War II period and during much of the subsequent integration process, the countries of Europe based their industrial policy on fostering the establishment, expansion, protection, and internationalization of their own productive sectors, and, most importantly, of their businesses. Many of the instruments designed for this purpose were based on the transfer of public funds through fiscal or financial mechanisms. The actual establishment of the internal market set up an arena for contention between EC objectives and this national-policy approach, since the latter could impinge on the conditions of competition, discriminating among enterprises and violating the principle of equality in the marketplace. EC legislation therefore established the inconsistency of “aid granted by the member states” with the common market when such aid involved “the attribution of any material advantage in favor of particular enterprises, whether individually or generally, directly or indirectly, as long as they result from the use of public funds and in conditions other than those normally prevailing in the market.”<sup>7</sup>

The criterion includes measures that may affect trade between associated countries, distort competition, or favor particular companies or kinds of production. This restriction extends to acts emanating from any level of national public authority—central or decentralized, administrative or business related—and includes both positive actions (explicit transfers), and exemptions or discounts of equivalent effect (implicit transfers). At the same time, aid originating in EC funds, and that which was provided by member states in fulfillment of express directives and EC regulations, remains outside the scope of this restriction. This distinction is key, since it indicates the prospect of a common policy, either through supranational mechanisms or intergovernmental coordination, and it entails a transfer of responsibility for

<sup>7</sup> Article 92, Chapter I of Title V of the Founding Treaty of the European Community.

policies of promotion or compensation to the EC domain. On the other hand, the member states can still take exceptional actions (such as to foster the development of disadvantaged regions), but always under the direct authorization of EC institutions.

## Competition Policy

The principles of freedom of movement and equal treatment in the internal market may be similarly undermined by abusive, anticompetitive practices on the part of enterprises participating in the various national (sub-)markets. These are defined as: (i) collusive practices between enterprises that tend to restrict the entry of or competition from other producers; (ii) abuse of a dominant position by means of discriminatory practices on the part of users or suppliers in a given market; and (iii) concentrations of enterprises, if these bring about the real or potential control of a particular market. In many of these cases, the ends sought through the integration process—the suppression of policy barriers to intra-EC trade—can be altered by private strategies with equivalent effects, and thus an EC competition policy is needed to prevent or regulate such practices. It should be made clear that, in principle, the existence of such a policy neither nullifies nor supersedes provisions with the same intent at the national level.

What is specific to EC competition policy is that it is concerned with anticompetitive practices that affect the internal market, including those that affect intra-EC trade (in violation of freedom of trade among member countries), and those with an impact on competition in the common market (in violation of the principle of equality of access and treatment). Collusive practices or potential abuses include: fixing transaction prices or conditions; limiting production, distribution, technical development, or investment; cornering markets or sources of supplies; discriminatory treatment; and tied bidding. But the ban on collusive practices is not absolute, and EC bodies can expedite matters if it is believed that the agreements in question entail improvements in production or technological development, or that the resulting benefit is shared with users or consumers.<sup>8</sup> In such cases, the EC prerogative of promoting certain specific competitive strategies of European firms reappears.

## Structural Funds

The European integration process gave early recognition to the importance of matters of distribution—whether among countries, regions, or sectors; whether static and stemming from initial conditions, or dynamic and emerging from the liberalization and expansion of the EC market. Although it was not the only aim, one of the important goals of the common agricultural policy (CAP) was to tackle the gap between rural and urban income. More specifically, the European Social Fund (created in the 1960s) and the European Regional Development Fund (created in the 1970s) were established to address particularly unfavorable social

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<sup>8</sup> Article 85, Chapter I of Title V of the Founding Treaty of the European Community.

or regional conditions. A regional or territorial EC policy was more decisively worked out in the 1980s with the consolidation of the structural funds, designed to correct regional imbalances in access to the benefits of integration. In the early 1990s, they were complemented by the establishment of the Cohesion Fund, basically geared toward fostering infrastructure in countries with lower per capita income.

The specific aim of the undertakings financed with the structural funds has been to establish productive investments, develop infrastructure, and build human resource capacity. In this field, European policy has combined approaches that are basically compensatory (to reduce existing disparities) with approaches geared toward fostering skills and capacities (to improve factors of attraction and absorption)—increasingly favoring the latter over the former. Similarly, it has been improving aspects of coordination among the different instruments and activities, and among EC transfers and policies at the national or local level. Apart from the changes made over the course of time to the institutional framework for these policies, to the approaches and mechanisms used for intervention, and to the actual scale of the resources, the principle of intra-EC solidarity (the financial basis of the redistributive mechanisms) also emerges as one of the fundamental attributes of the internal market.

## Industrial Policy

Unlike the agricultural sector, industrial production was neither the object of a specific EC policy nor explicitly recognized as such until the end of the 1980s, when the new institutional setting of the internal market raised the need to reorder the practices and prerogatives of member states. Throughout the entire preceding period, fostering productive activities and promoting specific objectives for their performance were exclusively matters of national policy (and were used liberally). EC legislation sought the development and consolidation of the enlarged market (free internal trade, common trade policy, and some redistributive policies), and each country managed the structural adjustment to new competition conditions in line with its own resources and preferences.

The relative preeminence and independence of the national sphere in this period was supplemented in some instances by assistance and initiatives coordinated and financed at the EC level. These were geared toward reconverting sectors in crisis, such as the iron and steel or shipbuilding industries, or gaining scale in sectors deemed strategic, such as the aeronautics industry. The dysfunctional nature of state aid, together with the deepening of the internal market and a progressive tilt toward a “competitiveness” approach, led to the redefinition of national policies and the emergence of a new and more explicit EC strategy.

This new approach was endorsed in a series of documents published in the first half of the 1990s (Comisión de las Comunidades Europeas, 1990, 1993, 1994, 1995; Bangemann, 1992) and was embodied in law through the Maastricht Treaty. Its stated aims were to create a favorable setting for the growth of firms and the promotion of their innovative activities. To those ends, the essential catalysts were the creation of the internal market and greater openness toward third parties (competitive pressure). At the same time, the

promotion of research and development (R&D) activities, the building of human resource capacity (intangible investment), and the formation of networks of firms—chiefly small and medium enterprises (SMEs)—both within and outside Europe (industrial cooperation) were seen as providing the main impetus and, at the same time, as market failures that required intervention. Coordination between member states and EC institutions was redefined and reinforced in two ways. On the one hand, deregulation at the national level was strengthened, shifting part of the responsibility for competition and international cooperation to EC policies, and partially steering the structural funds toward new goals. On the other hand, explicit R&D policies were devised and strengthened (prioritizing activities in “vanguard” sectors and fostering private participation), and the development of SMEs was promoted by improving their financial environment and encouraging them to cluster and internationalize.

In the 1990s, this new approach to industrial policy was consolidated by certain developments in Europe—the expansion of the borderless space through monetary union and the liberalization of services, and, in the international arena, the shrinking of the scope for public intervention, as established in the multilateral framework following the Uruguay Round and the creation of the World Trade Organization (WTO). In any event, heterogeneity (the weakness of real convergence), unemployment, and a lack of competitiveness remain significant (Blanchard, 2004; Debonneuil and Fontagné, 2003; Sapir et al., 2004). These conditions were aggravated by the recent enlargement of the EU, which saw the accession of the first group of Eastern European countries. In general, these countries are characterized by specialization in low-technology sectors, low levels of average productivity, and a deficit of entrepreneurship. Thus far the enlargement has provoked two quite different responses: on the part of European firms, the outsourcing of low-cost production to the new members; on the part of EC policy, a ratification of the 1990s approach of providing an overall framework of conditions while setting more ambitious quantitative goals for R&D (the Lisbon strategy) and promising greater coordination among the various areas involved (Comisión de las Comunidades Europeas, 2003, 2004a, 2004b).<sup>9</sup>

### *The Debate*

In the last 25 years, Europe’s industrial policy—taken in its broad sense as promoting activities and skills, managing diversity, and regulating intra- and extra-EC competition—has gone from merely supplementing and serving the initiatives undertaken by member states to being an undertaking with its own momentum in the process of resource allocation, and a framework that helps harmonize national activities. In the course of this transition, it has strengthened its components for horizontally promoting skills and intensifying competition. This change reflects a wide range of factors—from the institutional demands of deepening integration to the emergence of new technocratic agreements, and from the

<sup>9</sup> See Tabellini and Wiplosz (2004) for a critique of the Lisbon strategy.

dynamic of structural changes in the European domain to the restrictions in effect in the multilateral architecture. Obviously, this transition has been beset by tensions among the three primary traditions of industrial policy that have coexisted in Europe: the Latin tradition (involving strong central interventionism), the Anglo-Saxon tradition (involving strong local autonomy), and the Eastern European tradition (involving a strong emphasis on planning).

The debate covers not only the substance of policy but also the distribution of authority among national and EC mechanisms. Alesina, Angeloni, and Schuknecht (2001), and Alesina and Perotti (2004), discuss the trade-off between an efficient supply of regional public goods and the degree of divergence within an integration scheme (Siroen, 2000). They propose a general framework for assessing such functional competencies on the basis of theories of federalism. The policy areas in which diverse national preferences predominate over economies of scale and the externalities of having a common framework should be confined to the national levels. When the situation is the opposite, EC authorities should take responsibility. Applying this approach to European regulations, the authors find that there is consistency in some areas (international trade, the common market, monetary policy) and inconsistency in others (environmental policy, international relations, social security). The assessment of industrial policy (termed a sectoral or competitiveness policy, depending on the context) on the other hand, has proven to be ambiguous, to a large extent because it combines instruments and norms from different policy areas.

An assessment must take account of this multifaceted character, and of how different policy dimensions interact—which in Europe include competition, promotion, and trade policies. Coriat (1996) calls this set of activities meant to improve competitiveness “structural policies,” and points out the imbalance among them in terms of how they are devised in Europe: the first exerts strong pressure and the others lack strategic considerations (and intervention). Similarly, it has been argued that in the underlying tripod of the contemporary European undertaking, “<competition + cooperation + solidarity>” (according to the Delors Report, Comisión de las Comunidades Europeas, 1993), the preeminence of the first dimension is thought to have led to a weakening of national social systems, without there having been a strengthening in the provision of supplementary public goods at the EC level (Herzog, 1998).

## Competitiveness Policies in the MERCOSUR Countries

There is a popular Latin American saying, “*hay de todo, como en botica*”—meaning, in effect, that everything under the sun can be had.<sup>10</sup> This sums up, in the common view, both the perplexity and wonder provoked by the abundance of means available to meet a particular aim. A brief glance at the tables in the appendix to this chapter might prompt readers to

<sup>10</sup> This section is essentially based on national documents prepared for the project of which this book is the fruit: Baruj and Porta (2005), Laplane (2005), Masi and Miranda Álvarez (2005), and Lorenzo, Paolino, and Perelmuter (2005). See also Laplane et al. (2001).

reach a similar verdict. The range of promotional policies and incentives implemented in the MERCOSUR countries is vast. They include instruments of all kinds (tax related, financial, technical assistance) devised at the level of the central government or by various local agencies: those of horizontal access or those geared toward specific firms, regions, or sectors; general support of overall performance or of specific activities; and both permanent and temporary mechanisms. At the same time, the prevailing sense conveyed by the available assessments, or by simple observation, is that they are relatively ineffective and their impact is weaker than originally anticipated.

To be sure, the chief concerns animating the approaches and instruments applied have changed over recent decades, and thus the criteria used to gauge their effectiveness have also altered. Especially in Argentina and Brazil, the main goal of promotional policy, until the start of the 1980s, was to fill in the empty boxes in the input-output matrix; this policy's effectiveness was measured in terms of the coefficient of self-sufficiency. Supplanting this notion, from the mid-1970s onward, promotion started to tilt toward generating and diversifying exports with the aim of tackling increasing external constraints on the growth of the economies. Beginning in the 1990s, fiscal considerations and, especially, deregulation and market opening called into question the suitability and viability of that approach to promotion, and raised doubts about the efficiency of the productive apparatus thereby established. The resulting reforms tended to reduce and change public aid, favoring horizontal instruments and those promoting endogenous competencies. At the end of this winding road, however, there remain the same uncertainties about the sustainability of these instruments' development, and specifically their actual effectiveness.

There seems to be more than one reason for this contradiction between the number of instruments and the quality of their effects. In an effort to aid understanding, several issues that in one way or another arise in the four MERCOSUR countries may be mapped out:

- (i) There are several different overlapping "generations" of instruments. On the one hand, these were designed in the context of different and even divergent approaches to economic policy making and government intervention. And, on the other hand, they were devised to be applied in different macroeconomic conditions.
- (ii) The instruments are not necessarily derived from or integrated with a clearly defined competitiveness strategy. Their proliferation and overlapping (a kind of "inflation of instruments") stem from the susceptibility of public action to various sectoral lobbies, as well as to competition among different public agencies to occupy certain issue areas.
- (iii) Macroeconomic volatility affects promotional policy decisions in two ways. First, many instruments are designed reactively to mitigate emergencies caused by successive shocks. Second, the transfers implicit in macroeconomic changes (whether variable or due to policy) tend to be substantially stronger than the incentives provided.
- (iv) In this context of inconsistent strategies, bureaucratic rivalries, patronage practices, and macroeconomic overdetermination, the operability and efficacy of promotional policies are negatively affected in varying degrees by serious coordination failures, a lack of effective commitment, and a relative paucity of funding.

## *Argentina*

Until the early 1990s, Argentina had a long tradition of promotional policies geared toward setting up and diversifying productive activities, especially in manufacturing. Generally speaking, the instruments tended to reduce the cost of initial investment and of operating costs over a lengthy transition, while strengthening expected profitability with “market-reserve” policies. In line with these criteria, a sectoral approach prevailed, combined with incentives to locate activities in particular provinces, often involving negotiations with large local or international firms. The instruments were based mainly on fiscal incentives and sought to initiate and foster the growth of the activities in question rather than competitive performance.

In the mid-1980s, an effort was made to compensate for the antiexport bias implicit in this approach, or in recurrent episodes of real exchange-rate appreciation, with various export subsidies—in this case with a horizontal approach, although in practice with marked sectoral biases. Nevertheless, increasing fiscal constraints and mounting disputes at the multilateral level, caused by the use of these measures, led to their being dismantled. The debt-capitalization programs implemented toward the end of the 1980s (in relation to private companies) and the beginning of the 1990s (the privatization of state enterprises) are the latest examples of this older generation of promotional policies, which emphasized discrimination by sectors and firms. With the exception of public utilities, trade reforms and competition regimes (introduced as of 1987) sharply diminished promotion based on market reserves.

Thenceforth, the stated aims of promotion focused on modernizing products and strengthening firms’ competitive capacities. This gave rise to a new generation of instruments with a predominantly horizontal approach, geared toward promoting firms’ technological and managerial competencies, and with a greater export component chiefly for SMEs. The dismantling of closed-economy instruments was followed by a reactive promotion policy in the mid-1990s. Certain instruments were devised to offset the exchange-rate appreciation that accompanied the Convertibility Plan (the so-called “fiscal devaluations”). Subsequently, during the crisis and collapse of the fixed exchange-rate scheme, other instruments aimed to enhance productive performance under the emergency conditions.

The wide range of instruments in force in Argentina reflects these successive “geological strata” of promotional policy. Although most of those still in place today were created in this latter phase, there are still some instruments (or the rights derived therefrom by their beneficiaries) that date from the earlier period. Some sectoral regimes that were implemented in the 1990s were meant to promote “new” natural advantages and sustain the automotive industry. Horizontal instruments are predominant among activities to promote exports and enhance technological competence; these also comprise the bulk of the measures more recently adopted to strengthen internal market performance. The range of policies is more balanced in investment promotion: although a number of horizontal instruments are geared toward the incorporation of capital goods, there are various sectoral regimes whose promotional impact appears to be comparatively high.

These vertical regimes, which seek to promote the growth and modernization of the activities in question, sprang from different motivations: the “new” segments of large-scale

natural advantages, such as the promotion of metals mining or forestry; and industrial segments considered strategic, such as the vehicle industry (since 1991) or, more recently, the software industry. In parallel, other instruments are geared more toward dealing with crises, such as those in the production of tobacco, capital goods, and agricultural machinery.

The predominance of horizontal instruments goes hand in hand with SME-related measures that, although numerous, are of debatable effectiveness. The large majority of instruments to promote capacity building and competition target this sector of the business community as formal beneficiaries; the same is true of most of the emergency measures taken in the most recent crisis. This configuration, which is largely a feature of SMEs, is less evident in the promotion of investment and exports. There are only modest linkages among the programs for SMEs, and between those instruments and a more comprehensive development strategy. Rather, there seems to be an accumulation of instruments arising from pressures exerted by political and business groups or from “competition” among government bodies that claim responsibilities in this domain. The search for a means of coordination among these entities has not been fruitful, and the supply of public support services is fragmented, which means that opportunities to exploit economies of scale and advance institutional learning are being squandered.

The propensity to support SMEs has also been predominant in provincial instruments. In this case, it is commonly accompanied by an effort to promote specific activities and to make the most of the available resource endowment. With few exceptions, the financing for these provincial programs—based on tax cuts in corresponding jurisdictions—is very modest, and hence their promotional impact appears to be poor. The relevant promotional scheme in Argentina is based on national instruments. At the provincial level, apart from a few technical assistance programs that may be useful for resident firms, activities basically seek to manage job crises, and their contribution to localization decisions is entirely marginal.

## ***Brazil***

Analysis of the main instruments of industrial, technological, and trade policy in Brazil reveals a contradictory picture. On the one hand, there is a relative abundance of resources, chiefly in the form of tax breaks and various funds for the financing of exports and investment. On the other hand, there is a clear lack of focus and coordination among the available instruments. This situation stems from a combination of factors, notably the persistence of some traditional instruments from the period of swift industrialization, the strength of regional and state interests in Brazil’s federal system, and the ideological/political standoffs that until very recently paralyzed the reformulation of policies for promotion and competitiveness.

In 2003, the government began to devise a new industrial, technological, and foreign trade policy (PITCE). To date, this process has resulted in a wide range of initiatives and in diverse ways of designing and implementing them. Horizontal programs predominate. Some of these are truly new and others are adaptations of preexisting programs, such as support programs for SMEs. Nevertheless, the federal government now faces numerous obstacles to

planning, implementing, and monitoring promotion programs. In this sense, the PITCE remains a work in progress, and the measures announced to date are far from a coordinated and finished whole.

It is to be expected that the competitiveness policies in the PITCE will gradually become more coordinated and effective to the extent that Brazil's federal government makes progress in two severe constraints: the difficulty of coordinating government programs; and rigidity in the criteria for resource allocation and in the cost of resources available to implement high-impact projects. In late 2004, a federal law was passed that created the Brazilian Industrial Development Agency (ABDI) and the National Council for Industrial Development (CNDI), both of which are responsible for coordinating government programs. Regarding resource allocation, much is devoted to financing exports, and the costs of financing investment have proven to be relatively high for potential investors. Thus far, efforts to introduce mechanisms to equalize interest on investment credits, similar to those used for financing exports, have faced insuperable resistance from the Treasury.

In principle, the export-promotion instruments seem to be the most implemented. The combination of tax breaks for export production and for actual foreign sales, with financing amounts and costs compatible with international standards, has allowed for a sustained increase in Brazilian exports, even when there have been constraints on access to external financing sources. In particular, the availability of financing instruments has been critical to the performance of Brazil's exports of manufactured and semimanufactured goods, and, in this regard, the direct and indirect conduct of federal public banks in the supply of export credits has become very important.

Instruments to promote national investment have also been relatively important, although they exhibit a number of limitations. Tax breaks on the assembly of capital goods were delayed on fiscal grounds. The volume of long-term credit offered by federal public banks, chiefly the National Economic and Social Development Bank (BNDES), is substantial, but the financing conditions are not as good as in the international market, in part because the borrower must assume the exchange-rate risks for the funds acquired by BNDES abroad. The resources of the Constitutional Investment Funds are also subject to a comparatively high interest rate, which is added to the commissions of the brokers involved in the operation. Financing costs are therefore high for potential investors on average, and private-sector demand for investment credit has been modest, despite the relative availability of resources; commonly, up to 80 percent of private investment is self-financed.

Various regional incentives meant to induce the localization of activities, which involve substantial resources, merit special consideration. Although the reduction of regional inequalities is a legitimate aim, granting such benefits exacerbates fiscal wars among Brazil's federal states and spurs disputes within MERCOSUR. Clearly these incentives may tilt the playing field in favor of one of the states in question, but their effectiveness may also diminish as they come into more general use, as has indeed occurred. In any case, although their impact on some major investment projects in recent years should not be disregarded, the states involved should not be overestimated with regard to their effect on traditional factors of attraction such as proximity to consumer markets, transport infrastructure, and labor

costs. At present, state-level incentives seem to be redundant and constitute a significant loss to the states granting them.

Instruments geared toward promoting capacity building in companies appear to have had a more limited effectiveness, partly owing to the shortage and high cost of resources available for financing innovation programs. Apparently, both constraints might be eased with the passing of the Innovation Law, which regulates the financing of innovation and cooperation among companies and institutions with resources from the Sectoral Funds for Technological Development. In any event, the limited willingness of national and foreign companies in Brazil to make significant efforts in technological development on their own account should be noted. Progress does not depend solely on the availability of resources for promotional activities, but also on coordination between the companies' strategies and the country's technological development strategy.

Instruments to support performance are generally developed for SMEs and microenterprises. These are traditional instruments, with the exception of those that support clusters of enterprises (the so-called local productive arrangements), which involve relatively modest resources but have a large number of beneficiaries. The available assessments indicate that the instruments that focus on and promote specific activities separate from the enterprises themselves—innovation and exports, for example—are of relatively limited effectiveness. On the other hand, promotional programs that include a more comprehensive approach to the problems involved in the development, performance, and management of this set of business measures—such as activities designed and executed by the Serviço Brasileiro de Apoio às Micro e Pequenas Empresas (SEBRAE) in selected clusters—tend to be more effective.

## *Paraguay*

Paraguay did not follow the post-World War II import-substitution model adopted by most Latin American countries, and thus did not develop highly protectionist policies. Up until the 1990s, therefore, it was more exposed to international competition than were other countries in the region. In addition, its institutional weakness in containing flows of contraband made it MERCOSUR's most open economy. This did not help make its industrial production internationally competitive. Indeed, Paraguay has stagnated in a state of very low industrial development in an economic set-up that has favored the export of agricultural raw materials, and has not overcome the structural constraint imposed by its small internal market. Similarly, an absence of genuine support policies has aggravated the difficulties of nascent industries seeking to develop in an environment characterized by a high degree of smuggling.

In the context of outward-oriented growth, export promotion has not been a central component of Paraguay's public policies, probably because the concentration of exports with high comparative advantages—such as soya and cotton—do not require explicit public support. Toward the end of the 1980s, the export of manufactures was not part of the prevailing public policy agenda. Only with the onset of MERCOSUR, coinciding with the country's democratic opening and the implementation of structural reforms, did the low levels of competitiveness

in local production begin to be seen as a problem requiring government attention. Practically all the instruments for the promotion of competitiveness now in effect in Paraguay date from that transition period, and were devised to respond to competition conditions induced by the regional integration process.

In any case, such concerns did not translate into effective regulations: most instruments to promote technological modernization, foreign direct investment, and the growth of nontraditional exports did not, in practice, go beyond an initial stage and did not hold the attention of the authorities. Such instruments played roles that were merely marginal or secondary. The presentation of the Study on the Economic Development of Paraguay (EDEP), drafted by the Japan International Cooperation Agency (JICA) in 2000, may be seen as a pivotal point in Paraguay's recent development, and as the first rigorous and consistent initiative to devise a competitiveness strategy. Its recommendations focus on the challenges arising from integration in MERCOSUR and market deregulation.

The central recommendation of the EDEP is the formation of clusters in agroindustry, since: (i) the industry for processing agricultural products is not fully exploiting the potential of the primary sector; (ii) agroindustry has had some successful experiences and has productive bases in several regions of the country; and (iii) the comparative advantages of the agricultural sector suggest that it would be helpful to prioritize its development over other industrial or service sectors, on condition that progress be made in the respective value chains. Specifically, the EDEP recommends the promotion of clusters around balanced foodstuffs, other intensive livestock products, vegetables, fruit, cotton, and timber, since these products have great potential for processing and for competitive export. In tandem, it suggests promoting production of specialized agricultural machinery and transport.

These guidelines were taken up by the administration, which proposed replacing the primary export model with an agroindustrial export scheme. Following an effort to resolve the fiscal and financial crises toward the end of 2004, the government presented an "Economic Growth with Equity Plan," which includes programs in the areas of "business environment and competitiveness," and "economic diversification, value added, and exports." This set of competitiveness policies is little more than a series of unorganized and unsystematized pronouncements.

The programs listed in the first of these areas entail a comprehensive reform of the public sector, including: opening up public monopolies to competition and private capital; licensing public works projects and their subsequent operation; reforming the pension system; and reorganizing public banking (specializing in a "first-floor" bank that focuses on the rural sector and a separate "second-floor" bank that channels foreign resources for long-term loans). Similarly, a simplification of the procedure for establishing SMEs has been proposed with a view to making it easier for them to become formal—as has an "Exporters' One-Stop Window" for the management of information and incentives.

The National Export Plan, in turn, must address the viability of prioritized sectors in terms of competitiveness parameters; promote the integrated participation of private and public sectors in generating business possibilities, and in identifying institutional needs and opportunities for cofinancing; organize a system of market intelligence; develop a program

for strengthening productive chains and clusters; and identify and attract potential investors to prioritized sectors and activities.

## *Uruguay*

In the mid-1970s, Uruguay embarked on a slow and gradual process of trade liberalization. In the 1990s, the process was deepened through tariff reduction, the elimination of nontariff barriers, the signing of trade agreements with neighboring countries, participation in the negotiations of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), and accession to the WTO. The creation of MERCOSUR increased Uruguay's foreign commitments in the area of trade policy, while exposing the economy to more foreign competition and reducing the government's room to use trade policy instruments in a discretionary manner.

Trade reform was slower in certain sectors deemed sensitive, for which a relatively protected internal market was maintained. In practice, this delay responded more to the ability of various sectors to exert pressure on the government than to technical criteria that revealed those sectors' viability, or to the existence of reconversion plans to make them viable. Consequently, the pace with which liberalization was implemented was not necessarily adapted to the scale of the adjustment costs or the burdens that each sector or segment of society had to bear. Moreover, often the instruments used to protect certain sectors against the mounting competition attendant on economic opening were not geared toward ensuring successful reconversion, but rather were confined to postponing the moment when those sectors would have to adjust to reduced production.

Uruguayan public policy to promote competitiveness was relatively stable during the 1990s and has been so in recent years. In general terms, the main aims of the policy instruments have been to create new productive activities and foster traditionally competitive activities in sectors such as agriculture and tourism. The resulting benefits have mainly consisted of tax and fiscal exemptions and financing facilities.

Most of the current instruments basically seek to lower initial investment costs and operating costs, or, to a lesser degree, to promote capacity and performance. As a supplement to this, in the context of regional and national crises in 2001 and 2002, the Uruguayan government devised various emergency instruments to resolve some of the main problems arising from the crises—chiefly indebtedness and access to financing in various agricultural and agroindustrial categories, such as the Fund for Financing Dairy Activities, and the Fund for Financing and Reconstruction of Rice Cultivation.

Assessment of the policies to promote competitiveness reveals certain sectors that have received particular attention: tourism services, forestry, some agricultural categories, and agroindustrial chains with clear competitiveness deficits (such as horticulture and fruit cultivation). It also reveals others that have clear comparative advantages, such as the livestock sector, the agroindustrial beef chain, citrus production, and certain segments of viticulture. In contrast to policies implemented in the other countries of the region, Uruguayan policies do not include specifically regional incentives. A notable exception in this regard is the tem-

porary admission regime. This is probably the most influential of all the instruments geared toward export promotion, and one of the main attractions for foreign investors.

Investment promotion instruments are particularly prominent, and are used intensively. Among these, tax breaks are the most common. Considering the country's high tax burden, the prospect of access to tax and fiscal incentives is a significant benefit. These instruments, like those geared to promoting exports and capacity building, are balanced in terms of their scope (horizontal and sectoral), whereas programs to promote performance are generally sectoral.

Regarding instruments to promote capacity building, at the aggregate national level these have not yet raised investment in R&D to adequate amounts, and have been insufficient to bring about a proper link between the supply of and demand for investment in R&D. In agriculture, by contrast, the amounts available for R&D relative to the sector's GDP are significantly higher, although the innovation system still faces significant coordination problems that compromise the results achieved. Among the activities geared toward promoting performance, sectoral instruments are most common, especially those aimed at promoting the agricultural sector. This same bias is evident among instruments to promote capacity building. The benefits available to promote performance mainly involve granting financial facilities.

Analysis of the policies currently in effect reveals significant implementation difficulties that seem to surpass problems of instrument design. Such difficulties chiefly stem from tensions between the sectoral promotion agencies and the units responsible for oversight, which seek to institute the greatest number of safeguards before granting benefits. There are also significant weaknesses in the *ex post* evaluation of instruments to promote competitiveness. In summarizing a general assessment of public policy to promote competitiveness, it can be said that it is marked by the coexistence of a number of instruments with little coordination and scant strategic orientation. The analysis indicates that the institutional framework is weak and insufficiently coordinated to support the productive sector, there being no real national policy to promote competitiveness.

## **The Impact of the Promotion Instruments on Competition Conditions in MERCOSUR**

This section makes some brief comments on the approach and general nature of the instruments in effect in MERCOSUR countries. It also identifies and analyzes those that have particularly distorting effects on deep integration. The section includes tables for each country, summarizing the characteristics of the main instruments deemed corrosive, in line with the criteria set out at the beginning of the chapter.<sup>11</sup>

The four MERCOSUR countries apply a substantial number of promotion instruments.<sup>12</sup> In general, horizontal incentives predominate and most of them—especially the most impor-

<sup>11</sup> These summary tables provide information that underpins the evaluation put forward in this section, for which reason it is suggested that they be scrutinized in the light of the assertions in question.

<sup>12</sup> See the appendix to this chapter for the complete list.

tant ones—consist of tax or tariff exemptions and loans at subsidized rates. Less use is made of instruments that provide financial facilities (chiefly in Brazil) or technical assistance. There are several vertical instruments (such as the regimes for forestry, mining, and the automotive industry), and Uruguay, in particular, is notable for its large share of mainly sectoral policies, such as the Dairy Law, the Sugar Fund, and the Special Drawback for Textiles.

In Argentina and Brazil—countries with pronounced federal systems and, importantly, marked regional inequalities—the central governments finance strong policies that have a specific regional scope (in Argentina, for example, reimbursements for exports through Patagonian ports, and the special fiscal and customs regime in the province of Tierra del Fuego; in Brazil, the promotion scheme in the Manaus Free Zone). Local governments have great formal scope to set up tax incentives or provide infrastructure, although there are substantial differences in the significance of such instruments between the two countries because of differing degrees of fiscal decentralization. Since this is greater in Brazil, the tax authority of local governments and their contribution to total tax collection are considerably greater; thus, state governments have significantly more scope to design and implement active policies.

Most of the promotion instruments are neutral as regards the free movement of goods, the introduction of intrazone cost-price distortions, investment diversion (cross-border spillovers), and product complementarity. In these cases, the competitiveness policies implemented have no specific impacts on the goals of deep integration in MERCOSUR. This characteristic is common to all the instruments to promote capacity building and technological competencies, and to many of those geared toward promoting exports and general performance.

The four countries also have a far from negligible number of instruments that have a potentially corrosive impact on the attainment of the goals of deep integration. Some of these, moreover, are among the most powerful, because of the nature and scope of the implicit incentives. All the countries implement investment-promotion regimes that may introduce or magnify negative cross-border spillovers; temporary admission regimes for imports and drawback systems that tend to place significant constraints on productive complementarity; and free-zone regimes that affect the four dimensions of deep integration under consideration. Paradoxically, recourse to the two latter types of regimes has been explicitly adopted as a general practice in MERCOSUR through the use of permanent exceptions.

In Argentina (Table 7.1), in addition to instruments that could potentially have a corrosive impact on the conditions for intra-MERCOSUR competition, there are those that tend to introduce cost-price distortions: the reimbursements for exports through Patagonian ports;<sup>13</sup> the incentives regime for the production of capital goods;<sup>14</sup> the program for the reconversion

<sup>13</sup> This regime stipulates that exports through ports and customs offices located south of the Río Colorado are entitled to an additional reimbursement, as long as the merchandise is going out of the country. In 2003, fees varied between 3 percent and 8 percent, with a prediction of their termination between 2007 and 2012 (they fall by one point per year, per port). It cost approximately \$71 million to finance this regime in 2004.

<sup>14</sup> Consists of payment of a tax rebate to be applied to the payment of national taxes, for an amount equivalent to 14 percent of the difference resulting from subtracting the sale price, the value of the inputs, parts or components of foreign origin incorporated into the product that have been nationalized with an import fee of 0 percent. In the July 2001–October 2004 period, benefits of some \$230 million were granted in rebates.

**Table 7.1 Trade Instruments That Impede Deep Integration: Argentina**

Instrument	Scope			Importance	Type of Impact				Observations	
	H	S	R		Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity	Execution / Budget	Use / Acceptance / Duration
Temporary admission regime	X			High	N	N	N	R	Some \$5 billion in goods exported use this regime (about 1/6 of total exports).	Used quite a lot by exporters.
Drawback system	X			High	N	N	N	R	NA	Very much used by big firms.
Reimbursements for exports through Patagonian ports	X		X	High	N	I/E (Low)	N	N	Fiscal expenditure amounted to approximately \$74 million in 2003 and some \$71 million in 2004.	Used by a small group of firms, since the rebate applies to products from Patagonia, as long as there is a transformation that triggers a change of tariff classification and that does not involve mere assembly or mounting.
Promotion of investment in capital goods and infrastructure projects	X			High	N	N	R (Low)	N	The fiscal amount is roughly \$400 million a year.	In October 2004, the first call for bids was made.
Special Fiscal and Customs Regime in the Province of Tierra del Fuego—Law 19.640	X		X	High	R	N	I/E	N	Estimated tax cost for 2004 was \$225 million.	Duration until December 31, 2013.

(continued on next page)

Table 7.1 Trade Instruments That Impede Deep Integration: Argentina (continued)

Instrument	Scope			Type of Impact				Execution / Budget	Use / Acceptance / Duration	Observations
	H	S	R	Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity			
Program for Reconversion of Tobacco Growing Areas (PRAT)		X		N	I/E	N	N	In 2003, some \$75 million was transferred to production. Currently, PRAT disburses some \$60/65 million a year, which comes from the levy on sales of cigarettes (varies according to amount collected).  In 2000–03, \$326.8 million in goods were imported.	Very common among specific producers.	
	X			R	N	(Low)	N			
Import regime for goods used in “large investment projects”								The difference between what automakers would have paid in tariffs without this regime and what they actually paid was some \$600 million a year (1995–2000).	Very common among specific producers.	
		X		F/R	N	N	St			
MERCOSUR automotive regime				N	I/E	N	N	From July to October 2004, benefits granted for some \$230 million in promotional bonuses. From January October 2004, benefits of some \$105 million in bonuses were granted.	Very common among specific producers. To date, some 1,250 firms have benefited.	

(continued on next page)

**Table 7.1 Trade Instruments That Impede Deep Integration: Argentina** (*continued*)

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Execution / Budget	Observations	Use / Acceptance / Duration
			H	S	R		Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity			
Promotion regimes for Patagonia and Historical Reparations Act (La Rioja, San Luis, Catamarca and San Juan)	PP	E			X	High	N	I/E	N	N	Estimated fiscal cost in 2004 was \$213 million.		Both closed to entry. The Patagonian regime expires in 2004 and the Historic Reparation Act in 2011.
Free zones	EP	E	X		X	Medium	N	N	N	R	NA		Moderate use by firms. Furthermore, at present there are only 9 free trade zones in operation.
Regime for exports from turnkey plants	EP	E	X			Low	N	I/E (Low)	N	N	NA		Used by a very limited number of firms.
Buy national—hire national	PP	MS	X			Low	R	N	N	N	NA		Its use by companies is very marginal; the benefit is not very significant.
Provincial regimes for industrial promotion	IP/PP	E	X		X	Low	N	N	I/E (Low)	N	The benefits granted by legislation are not very relevant for firms in general. They consist primarily of exemption, rebates, or reduction of provincial taxes (gross income and real estate, in some instances extending to stamp taxes and automobile tax).		Use is marginal.
Industrial parks	IP/PP	E	X		X	Low	N	N	I/E (Low)	N	These benefits are of little relevance to firms in general.		Its use is very marginal.

EP: export promotion; IP: investment promotion; CP: capacity promotion; PP: performance promotion; C: credits at subsidized rates; MS: monetary subsidies; E: fiscal and/or tax exemptions; TA: technical assistance; FF: financial facilities; H: horizontal; S: sectoral; R: regional; N: no impact/nondistorting (neutral); I/E: introduces/expands (negative); I/E: restrictive (negative); St: stimulates (positive); F: facilitates (positive).

of tobacco-growing areas (PRAT);<sup>15</sup> the promotion regimes for Patagonia and the Historic Reparations Act<sup>16</sup> (for the provinces of La Rioja, San Luis, Catamarca, and San Juan); and, to a lesser extent, the export regime for turn-key plants.<sup>17</sup> Similarly, the Special Fiscal and Customs Regime in the Province of Tierra del Fuego<sup>18</sup> and the Import Regime for Goods Used in “Large Investment Projects”<sup>19</sup> tend to restrict free movement within the MERCOSUR internal market, since they infringe on the principle of preferential access. These two regimes, and the regime for the Promotion of Investment in Capital Goods and Infrastructure Projects<sup>20</sup> can cause negative cross-border spillovers, as can the Industrial Promotion Regime<sup>21</sup> and the Provincial Industrial Parks Regime.<sup>22</sup> The potential impact of these latter two provincial schemes is frankly weak because of the shortage of the resources involved.

<sup>15</sup> It is financed with resources from the Special Tobacco Fund, depending on revenues from the sale of cigarettes (variable based on earnings). The main benefits it confers are: payment to the tobacco grower of an increment to the price per type and class of tobacco sold; financial assistance for technical upgrading, reconversion, and diversification of production; technical assistance and training; and assistance for the development of services that are ancillary to production. The PRAT has financed more than 250 projects since 1994 and has transferred more than \$23 million in credits and \$25 million in nonreimbursable financing each year.

<sup>16</sup> These regimes stimulated the placement of plants in provinces with high structural unemployment and low income, according different benefits to the firms that opened operations there. Notable among the most important incentives are exemption from value added tax (VAT) and capital gains tax (both for a period of up to 15 years), and from import tariffs on capital goods. These regimes have been terminated, although the benefits for the provinces of La Rioja, San Luis, San Juan, and Catamarca expire in 2011. In 2004, the estimated fiscal expenditure was of the order of some \$213 million.

<sup>17</sup> Consists of a specific rebate that covers exports from industrial plants in general or else engineering works intended to provide services that appear on the list attached to Decree 525/85.

<sup>18</sup> The incentives consist of a wide range of tariff and tax exemptions for activities conducted on Isla Grande (defined as a special customs area). In 1989, promotion benefits were suspended and consequently so was the approval of new projects. In 2003, the establishment of new companies was allowed and those already established were authorized to submit projects for new products not previously contemplated. The regime was established through December 31, 2005, and the rights and obligations assumed would be valid until December 31, 2013. The estimated tax costs stood at some \$225 million in 2004.

<sup>19</sup> Establishes a benefit of 0 percent of import fees for goods used in a project and imported from outside the region. It also allows for the import of spare parts up to an FOB value not greater than 5 percent of the total value of the goods being imported. The goods to be imported must be new, must form part of a complete and independent new line of production, must be present within the property where the company operates, and must be indispensable to the performance of the productive process that is the subject of the application. In turn, new industrial plants or expansions and/or modernization of existing plants must be involved.

<sup>20</sup> Establishes a temporary regime of accelerated amortization on capital gains tax and anticipated rebate of VAT, for the purpose of stimulating investment in new capital goods intended for industrial activities (except automobiles) and the execution of infrastructure projects (excluding public works). The fiscal share is of some \$400 million a year. This program issued its first call for applications in October 2004.

<sup>21</sup> At present, 17 provinces have these kinds of regimes. But the use of these instruments is infrequent because of the requirements to be met. The benefits granted by industrial promotion legislation generally consist of exemptions, rebates, or reduction of provincial taxes (gross income and real estate, in some cases extending to the stamp tax and automotive tax).

<sup>22</sup> At present, a little fewer than 140 areas are promoted (industrial parks, industrial areas, and reserves) in 22 provinces. In general, this offers companies the benefits of industrial promotion regimes, for those that bring together availability of infrastructure, equipment, and common public services necessary for the installation of companies, and for them to interact to create a space conducive to the formation and consolidation of development poles, as well as additional benefits such as preferential conditions for the purchase of land. The number of firms located in them is very small.

In Brazil (Table 7.2), as well as the corrosive instruments mentioned above, there are the Regional Fiscal Incentives Regimes (north and northeast),<sup>23</sup> the Fiscal Investment Funds (north and northeast),<sup>24</sup> the State Programs for Investment Attraction,<sup>25</sup> the Federal Fiscal Incentives for Manaus and Free Trade Areas,<sup>26</sup> and the State Fiscal Incentives for Manaus.<sup>27</sup> Combined promotional force is a characteristic of these instruments, inasmuch as they involve plentiful resources, and, therefore, very significant transfers to the beneficiaries. In these cases, there tend to be negative effects on possible processes of productive complementarity, aggravated by the introduction or expansion of negative cross-border spillovers and, simultaneously, of cost-price distortions. Furthermore, the Special Customs Regime (RECOF)<sup>28</sup> tends to impose substantial restrictions on intra-MERCOSUR productive complementarity.

These three dimensions of deep integration in MERCOSUR also seem to be affected by certain Paraguayan regimes (Table 7.3), such as the tourism regime<sup>29</sup> (or reexport regime) and the *maquila* regime.<sup>30</sup> Uruguay (Table 7.4) has sectoral policies that tend to introduce a major cost-price distortion into the enlarged regional market because of its impact on export prices. This is the case for the Special Textiles Drawback<sup>31</sup> (for exports of products containing

<sup>23</sup> Their purpose is to promote investment and production in the north and northeast, reducing the amount of income tax (IT). Projects receiving benefits may enjoy a reduction of up to 75 percent of IT for a period of up to 10 years. Companies that benefit can use up to 30 percent of IT on reinvestment projects, adding up to 50 percent of their own resources. In 2004, the estimated value of revenue foregone was some \$1.15 billion. The benefits are projected to last to December 31, 2013.

<sup>24</sup> Their purpose is to promote private savings and investment in the north and northeast regions of Brazil by offering financing facilities.

<sup>25</sup> State governments offer various kinds of fiscal incentives, including combinations that provide financing at subsidized rates, exemption from the tax on the movement of goods and services (ICMS), and even monetary subsidies.

<sup>26</sup> Their purpose is to promote investment and production in Manaus and in the three free trade areas (two in Western Amazonia, and the other in Macapá/Santana). The benefits have an effect on Import Tax (II) and the Tax on Industrialized Products (IPI). The estimated value of the revenue foregone in 2004 was some \$1.3 billion.

<sup>27</sup> Their purpose is to promote investment and production in the Manaus free zone (ZFM) through a wide range of tax incentives.

<sup>28</sup> Promotes exports through the reduction of production costs for selected products. The regime benefits companies in four sectors: aeronautics, automobiles, IT and semiconductors, and high technology components for software and telecommunications. The value of imports through this regime was \$921 million in 2002 and \$1.03 billion in 2003.

<sup>29</sup> Promotes reexport of imported goods. It is a regime of reduced taxation and single payment of taxes for a wide range of products—intended for tourism purchases or reexport to neighboring countries—imported from non-neighboring countries, chiefly in Asia and Europe, and from the United States. It has allowed for intense trade triangulation through Ciudad del Este (which operates as a large duty-free facility) on the Brazilian border, estimated at more than \$4 billion per year.

<sup>30</sup> *Maquila* operations are exempt from all taxes or fees affecting the process—from the import of raw materials and inputs, through product manufacture, to the export of the same products. Firms pay a single income tax of 1 percent on the added value in the national territory.

<sup>31</sup> The Pineda Law (from the 1940s) determined a drawback of 9 percent for exports containing wool. Since this sort of stimulus was not authorized by the World Trade Organization (WTO), it was replaced by Decree 243/003, which enabled the Ministry of Economy and Finance to increase the legal level through an administrative ruling. Immediately, it was increased to that level. As a result of the special drawback, it is an instrument with a high impact that affects price formation in the export of the products.

Table 7.2 Trade Instruments That Impede Deep Integration: Brazil

Instrument	Scope			Type of Impact				Observations	
	H	S	R	Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity	Execution / Budget	Use / Acceptance / Duration
Drawback system	X			N	N	N	R	In 2001, some \$4.64 billion was imported under this regime (8.34% of total imports) and the amount of foregone revenue involved was about \$650 million. In 2002 and 2003, the volume of imports under this regime was \$4.20 billion and \$5.00 billion, respectively (about 8.9% and 10.4% of total imports for those years).	Its use is widely accepted.
RECOF		X		N	N	N	R	In 2001, some \$1.072 billion was imported under this regime (1.9% of total imports) and the amount of foregone revenue involved was about \$170 million. In 2002 and 2003, the value of imports through RECOF was \$921 million and \$1.028 billion.	Use accepted in specific sectors promoted (aeronautics; automotive; computer hardware and telecommunications; and semiconductors and high-tech components for IT and telecommunications).
Regional fiscal incentives (north and northeast)	X	X	X	N	I/E	R	R	Foregone revenue in 2004 was estimated at \$1.148 billion.	Very important for firms with investment in priority sectors for development in the north, northeast, and central-west regions. Projected duration is until December 31, 2013.
Federal fiscal incentives for Manaus and free zones	X		X	N	I/E	R	R	Foregone revenue in 2004 was estimated at \$1.295 billion.	Very important for projects located in the Manaus free trade zone, in other free trade zones, and western Amazonas. Projected duration is until December 31, 2013.

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**Table 7.2 Trade Instruments That Impede Deep Integration: Brazil** (*continued*)

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations	
			H	S	R		Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity	Execution / Budget	Use / Acceptance / Duration
State fiscal incentives for Manaus	PI	E	X			High	N	I/E	R	R	NA	Very important for projects located in the Manaus free trade zone (mainly electronics and in certain appliances such as micro-waves, air conditioners, fans, and so on). No termination date has been set.
MERCOSUR automotive policy	IP/ EP/ CP	E		X		High	F	N	N	St	Foregone revenue in 2005 was some \$370 million.	Applies to all firms comprising the automotive productive chain. Establishes the free trade intrazone in 2006.
Incentives for R&D in information technology (IT Act)	CP	E		X		High	N	N	N	N	Foregone revenue in 2004 was estimated at \$720 million.	In effect until 2009.
Programs for growth of sectoral funds for scientific and technological development	CP TA/ C/ MS		X			High	N	N	N	N	NA	They support all activities involving innovation, with reimbursable and nonreimbursable funds.
Fiscal Investment Funds (north and northeast)	IP C	C	X		X	Medium	N	I/E (Low)	R (Low)	R (Low)	Foregone revenue in 2004 was estimated at \$270 million.	To date these funds have not seen much use, with exceptions in the services sector (tourism) and agricultural projects. In effect until December 31, 2013.
State programs to attract investment	IP C/ E/ MS		X	X	X	Medium	N	I/E (medium)	R (medium)	R (medium)	Involves permanent or temporary foregoing of revenues. No data available on execution.	Duration varies from state to state.

EP: export promotion; IP: investment promotion; CP: capacity promotion; PP: performance promotion; C: credits at subsidized rates; MS: monetary subsidies; E: fiscal and/or tax exemptions; TA: technical assistance; FF: financial facilities; H: horizontal; S: sectoral; R: regional; N: no impact/nondistorting (neutral); R: restrictive (negative); I/E: introduces/expands (negative); St: stimulates (positive); F: facilitates (positive).

Table 7.3 Trade Instruments That Impede Deep Integration: Paraguay

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations	
			H	S	R		Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity	Execution / Budget	Use / Acceptance / Duration
Tourism Regime (reexport)	EP	E		X	R	High	R	I/E	I/E	R	This regime gave rise to an intense movement toward trade triangulation through Ciudad del Este, estimated at more than \$4.00 billion a year.	Widely accepted for reexporting to Brazil and Argentina.
Import Regime for Raw Materials	CP	E	X			High	R	R	N	R	NA	Allows imports with zero tariff from outside MERCOSUR, from raw materials and inputs for agricultural and industrial production. Widely used by firms.
Regime of Fiscal Incentives for Investment under Law 60/90	IP	E	X			High	N	N	I/E (Low)	N	From 1996 to 2001, some 1,800 investment projects were approved for a total of \$2.173 billion (40.4% is foreign investment). Information on revenue foregone is not available.	Used with great frequency by national and foreign enterprises for new investments and expansion of existing ones.
Industrial rates for electricity	CP	MS		X		High	N	R	I/E	N	NA	Industrial consumption of electricity receives preferential treatment that translates into prices up to 39% lower than standard rates for commercial consumption.

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Table 7.3 Trade Instruments That Impede Deep Integration: Paraguay (continued)

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Execution / Budget	Observations
			H	S	R		Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity		
Maquila regime	EP+ IP	E		X		Medium	R	I/E	I/E	R	NA	Maquila industry has provoked growing interest among entrepreneurs because it makes it possible to use idle capacity of existing industrial facilities, but it is not an activity that has been undertaken very much. Established in 2003. Not yet very developed.
Free zone regime	EP	E	X			Medium	R	I/E	I/E	R	NA	As a result of this regime, there have been no major new investments in the automotive sector.
National Automotive Regime	EP+ IP	E		X		Low	F + R	N	I/E	St	NA	Of limited use by firms. The new customs code of 2004 limits the TA regime to imports of goods that must be reexported without undergoing modifications, but creates the figure of TA for active improvement that makes the entry of foreign merchandise into the customs territory possible, with total or partial suspension of customs duties, subject to completion and subsequent reexportation.
Temporary Admission and Drawback	EP	E	X			Low	N	N	N	R	NA	

EP: export promotion; IP: investment promotion; CP: capacity promotion; PP: performance promotion; C: credits at subsidized rates; MS: monetary subsidies; E: fiscal and/or tax exemptions; TA: technical assistance; FF: financial facilities; H: horizontal; S: sectoral; R: regional; N: no impact/nondistorting (neutral); I/E: introduces/expands (negative); I/E: introduces/expands (negative); St: stimulates (positive); F: facilitates (positive).

Table 7.4 Trade Instruments That Impede Deep Integration: Uruguay

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations	
			H	S	R		Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity	Execution / Budget	Use / Acceptance / Duration
Temporary Admission Regime (TA) and Drawback	EP	E	X		R	High	N	N	N	R	NA	The TA now accounts for a 20% share of total imports. While TA is heavily used by firms, drawback receives less use. Both regimes can be used for intrazone trade until 2010.
Special Textiles Drawback	EP	E		X		High	N	I/E	N	N	NA	Specified a 9% drawback for exports containing wool. When this sort of stimulus was not authorized by the WTO, it was replaced by Decree 243/003, which enabled the MEF to increase the valid threshold via administrative rulings. They were raised to that level forthwith. As a result of special drawback, it is a high-impact instrument that affects the formation of export prices.
Automotive Regime	EP/ IP/ CP	E		X		High	F + R	N	N	St	The amounts allowed for exporting to Argentina could go from 18,000 units in 2001 up to 20,000 in 2006. Auto parts went up from \$45 million to \$60 million in 2006. In the case of Brazil, the threshold amount of 18,000 went up to 20,000 units and the amount for auto parts will increase from \$40 million in 2001 to \$65 million in 2006.	Widely accepted among specific firms.

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Table 7.4 Trade Instruments That Impede Deep Integration: Uruguay (continued)

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations	
			H	S	R		Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity	Execution / Budget	Use / Acceptance / Duration
Dairy Fund/Dairy Policy	PP	FF/ MS		X		High	R	I/E	R	R	The managed prices imply an average transfer from consumers to producers in the period from 1994 to 2004 of some \$20 million per year.	Has an impact on this entire industry.
Fund for Financing and Reconstruction of Rice Cultivation Activities	PP	FF		X		High	N	I/E	N	N	NA	Has an impact on this entire industry. Enables capture of institutional resources for direct investment or transfer to consumers, based on securitization of future flows of goods that are sold on markets. Makes it possible to reduce liabilities and creates a certain amount of operating capital.
Sugar Fund/Sugar Growers Policy	PP	FF/ MS		X		High	R	I/E	R	R	NA	Very important for this particular sector. In 2004, a 10-year extension was approved.
Fund for Reconstruction and Growth of Farming	PP	FF/ MS		X		High	R	I/E	R	R	Between June 2002 and November 2004, the fund disbursed as nonreimbursable financial assistance a total of \$ 7.8 million, transferring resources to some 2,010 producers.	Originally, the fund was to have expired on June 30, 2005. In the course of 2004, a new law extended the fund and its source of financing for another 10 years.
Viticulture Policy	PP	FF		X		High	R	I/E	N	N	NA	Very important for this particular sector

(continued on next page)

Table 7.4 Trade Instruments That Impede Deep Integration: Uruguay (continued)

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations	
			H	S	R		Free intrazone circulation	Cost-price distortion	Trans-border spillover	Intrazone production complementarity	Execution / Budget	Use / Acceptance / Duration
Transfer and management of the property of the silos to the private sector	PP	FF/ MS		X		High	N	I/E	N	N	NA	Law 17 556 authorized the PE to transfer the plants from the National Silos Plan to their current legitimate owners with authorized deeds. By the conditions negotiated for the transfer of the assets from the public to the private sector (periods of time and assessment of the assets), it is a subsidized mechanism that affects the costs of storage services.
Free zones regime	EP/ IP	E	X			Medium	R	I/E	R	R	There is no data on revenue foregone. There are 8 free trade zones in the country.	Provides benefits greater than those elsewhere in the world. These include customs and tax benefits and exclusion from the area of government monopolies. In the free zones, any kind of commercial, industrial, or service activity, including financial services, may be undertaken. This can be considered a comparative advantage in relation to other regional regimes.

EP: export promotion; IP: investment promotion; CP: capacity promotion; PP: performance promotion; C: credits at subsidized rates; MS: monetary subsidies; E: fiscal and/or tax exemptions; FF: financial facilities; H: horizontal; S: sectoral; R: regional; N: no impact/nondistorting (neutral); R: restrictive (negative); I/E: introduces/expands (negative); St: stimulates (positive); F: facilitates (positive).

wool), the Fund for Financing and Reconstruction of Rice Cultivation, the dairy policy,<sup>32</sup> the Fund for the Reconstruction and Development of Farming,<sup>33</sup> and the sugar policy.<sup>34</sup> These last three instruments also tend to have negative effects on productive complementarity, heighten the prospect of negative cross-border spillovers, and constrain free intra-MERCOSUR movement, since they impose barriers to entry in the Uruguayan market that impair preferential conditions for MERCOSUR members.

In this context, there is a notable absence of instruments to promote deep integration in MERCOSUR among national competitiveness policies. It could rightly be argued that any instrument that does not restrict free movement in the enlarged market, or that does not involve spurious subsidies or grant an artificial price competitiveness to particular activities or producers, does not impair the principle of equalization of competition conditions, and in that sense is perfectly compatible with (and even promotes) that goal. Indeed, this is true of many of the instruments surveyed here, albeit the relatively weaker ones, as noted above. But concern for the goal of strengthening productive complementarity, and hence for promoting regional productive networks and intraindustry trade as a necessary part of deeper integration, requires a broadening of this perspective. The assessment that market incentives are not sufficient to advance this process necessarily prompts consideration of policies designed for such a purpose.

In this regard, the MERCOSUR Automotive Policy<sup>35</sup> is the only instrument that has tended explicitly to generate some productive synergy in regional integration. Strictly speaking,

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<sup>32</sup> The government determines the average production costs per liter of milk at the level of the producer and in all industrial and sales outlets, until reaching the price for the end consumer for pasteurized milk distributed for consumption. The price of this “milk fee” is historically higher than the price of the “dairy industry,” which is essentially determined by export prices in the international market. The mechanism also allows for the distribution of “quotas” among pasteurizing firms, and establishes limits on the entry of new companies into the sector. In 2002, a Financing Fund (\$26 million) was created, 60 percent of which was to amortize debts contracted with the Banco de la República, and 40 percent freely available. It is estimated that this law involved a transfer to the producers of some \$20 million per year for the 1994–2004 period.

<sup>33</sup> This was established by Law 17.503 in 2002 and originated in a climate of corruption. The fund was established through the levying of a tax on fruit, flowers, and vegetables imported and sold in supermarkets. It was to expire on June 30, 2005, but it was extended in 2004 for another 10 years with slight modifications of its primary purposes, allocating a certain portion of the amount assessed to defray the indebtedness of the producers with the Banco de la República. Similarly, an attempt was made to promote agricultural insurance for farms. Between June 2002 and November 2004, the fund disbursed some \$7.8 million in nonreimbursable resources to about 2,010 producers.

<sup>34</sup> Uruguay has historically maintained very high levels of protection in this industry. Accession to MERCOSUR entailed a review of this situation, but a level of protection was maintained that allowed the crop not to disappear entirely. With the intention of reconverting the zone for the production of sugar cane, a Reconversion Fund was created in June 2001. Through this fund, support has been granted to various productive activities in the Bella Unión region, especially existing enterprises. The fund is supplied from an internal consumption tax on sugar. Its benefits were to expire in 2005, but it was extended for another 10 years.

<sup>35</sup> This policy, instituted at the Florianópolis Summit in December 2000, stipulates a compensated exchange regime among the member countries until 2006, and establishes an external tariff of 35 percent for cars imported from outside the region. To ensure the benefits of tariff-free trade within MERCOSUR, the agreement establishes that all cars produced in the region should have 40 percent of their parts imported and 60 percent of local origin. It construes a car, assembly, or subassembly, put together in the country, when the imported parts from all origins do not exceed 50 percent, as national. The percentage of local content required will diminish progressively in subsequent years.

it is not a regional policy, since it receives no centralized financing at the MERCOSUR level. Nonetheless, on the basis of the definition of regional norms such as the CET and a program of managed (and variable-geometry) intra-MERCOSUR trade, some national instruments have been established and approved that seek to make the MERCOSUR area a center of automotive production, with international production standards. A number of deficiencies have been reported in this regulatory arrangement, notably the scant attention paid to the auto parts sector (disregarding the potential for complementarity) and the “incentives war” to attract new facilities (Porta and Sierra, forthcoming). Both issues have spurred disputes among the member states and have dampened the prospect of fully free trade.

In sum, of the ample arsenal of promotion instruments surveyed in the MERCOSUR countries, only a relatively small number are deployed without potentially adverse effects on the deepening of regional integration. Progress in that direction will require that they be eliminated, or at least that they be redefined in such a way as to make them compatible. In some cases the adverse effect is minimized, either because the resources allocated are modest, because the instrument is focused on particular sectors (which also leads to recurring conflicts), or because the benefits expire soon. In the latter case, attention should be paid to the cumulative effects of promotion and to the possibility of extending the periods for which the instruments are in force—something that already happens. Indeed, some measures originally conceived as transitory or exceptional instruments to offset structural asymmetries among the member states—such as special customs regimes—have not only been extended but are generally applied. In this regard, the regional space is used as a source of extraordinary revenue and the effects of links are minimized. At the same time, few or no elements of current strategy can be considered part of an effective MERCOSUR competitiveness policy.

To provide a comprehensive illustration of the foregoing ideas, the following tables summarize the main promotion instruments—in each of the MERCOSUR member states—that could undermine the conditions of competition and the prospects of stronger structural links in the enlarged regional market. They are grouped by country and classified according to three variables:

- Their basic and priority objective in export promotion, investment promotion, capacity promotion, and performance promotion
- The sums and beneficiaries involved (described in the “observations” column—the importance of each instrument was assessed as high, medium, or low)
- The nature of their impact (positive, neutral, or negative) on deep integration, taking the following dimensions into account:
  - Free movement of goods within the MERCOSUR internal market and respect for preferential access conditions for producers from the member states
  - Elimination of cost-price distortions (subsidies to the sale price in the MERCOSUR internal market)
  - Elimination of negative cross-border spillovers associated with investment promotion (incentives to establish companies or activities in order to supply the MERCOSUR internal market)

- Exploitation of economies of scale and specialization to develop productive complementarity in the MERCOSUR internal market

## The Impact of Regulatory Asymmetries

In the context of regional integration agreements, two different kinds of asymmetry should be distinguished: those arising from structural factors, and those created by explicit policies or regulatory interventions on the part of the member countries (Bouzas, 2005). The first are present from the very start of the agreements and may require some measures to offset them. The second tend to distort the conditions for competition, may magnify existing structural gaps or give rise to new ones, and must be managed.

The main structural asymmetries derive from substantial differences in economic size, development levels, income, geographic position, access to regional infrastructure, and the quality of institutions or the extent of their development. These factors condition the capacity of the different economies to capture the benefits of greater market integration. Policy asymmetries may spread in the integrated economic area through macroeconomic cross-border spillovers. At the same time, the insufficiency or poor quality of collective rules may have adverse effects on resource allocation. That is, policy asymmetries may give rise to negative regional externalities and may cause efficiency losses and distribution problems, thereby impairing the member states' political cohesion regarding the integration process. It should be noted that regulatory asymmetries (and their harmful effects) are present, irrespective of whether the policies that give rise to them are compatible with the goals of deep integration.

Structural asymmetries in MERCOSUR have been and remain significant: there are enormous differences in the four countries' economic size and populations, as well as a wide divergence in their levels of per capita income and the diversification of their productive structures. They display very different degrees of openness to international trade and levels of interdependence in the regional market. None of these issues was accounted for in the original design and regulations, beyond relatively minor and temporary exceptions in the process of freeing intra-MERCOSUR trade. Nor were common or agreed-upon policies subsequently adopted in MERCOSUR to tackle the effects of these sorts of asymmetries.<sup>36</sup>

The foregoing sections' review of the promotion instruments now in force in MERCOSUR countries makes it possible to consider policy asymmetries. It is evident that, although the member countries' competitiveness policies are generally based on similar approaches and instruments, and also suffer from relatively similar failures of coordination and implementation, the scale of the available resources favors Brazil. To some extent, and without minimizing differences in the effectiveness of and commitment to the implementation of the instruments, it could be said that some of the structural asymmetries (basically in terms of economic size

<sup>36</sup> See Bustillo and Ocampo (2005) for a discussion of the influence of disparities in the development level of the associated countries on the standard of distribution of potential benefits of market expansion.

and financial capacity) are at the heart of the evident regulatory asymmetries. Hence what might seem to be a game in which all take an equal part (either following or breaking the same rules) is in fact a permanent reflection of completely different powers of intervention and action. In this sense, MERCOSUR follows a path in which policy asymmetries reproduce and deepen structural differences.

It was said earlier that Brazil applies strong measures to promote investment and exports that amplify the capacity of the local private sector to take advantage of conditions in the enlarged regional market. This is true of the export financing programs, the regional promotion scheme in the Manaus free zone, and certain sectoral regimes considered herein. For their part, the growing tax subsidies granted by various state governments toward the end of the 1990s, in the context of the decentralization of promotion policy, have been one of the main sources of state aid-generated asymmetries. The incentives war waged by the Brazilian states, which has undermined promotion and made the eventual benefits redundant, has also exacerbated negative cross-border spillovers.

The distributive effects of structural and regulatory asymmetries have played an important role in the process of forming MERCOSUR and the negotiations within it, and undoubtedly they comprise one of the main reasons for the tortuous progress of creating norms. To deal with the consequences, the member countries have been adopting protective measures, generally unilaterally, by applying nontariff barriers, which have given rise to significant market fragmentation and to reversals in the process of regional economic integration.

The lack of thought given to these asymmetries and to the need to manage the undesirable effects of such swift trade liberalization was an original defect in MERCOSUR, one later perpetuated by differences in interests and aims, particularly between Argentina and Brazil. This pattern created a substantial gap in the area of implementation, since MERCOSUR was making significant progress in negotiations and in trade policy coordination without any corresponding advances in the coordination of macroeconomic and structural policies. This deficiency became devastating for the region's institutional arrangements because in these two policy areas, the member states should have joined efforts to correct the perverse effects of trade liberalization, to support the process of resource allocation and productive reconversion, and to plot a strategic course for MERCOSUR.

Consequently, MERCOSUR developed a highly contentious approach to negotiations, whereby what had been agreed upon in the area of trade policy was undermined by the absence of coordination in other fields. Barriers were reimposed and the prospect of devising and implementing common policies deteriorated. The reactive and unilateral introduction of restrictions on access to national markets, the systematic violation of earlier agreements, and delays in the transposition of legislation had two grave consequences for the integration process: (i) there was no clear signal regarding the real size of the regional market; and (ii) distributive problems among the member countries worsened.

Conditions for intra- and extra-MERCOSUR access have changed according to various specific circumstances, weakening any long-term signals, and thus distorting or undermining incentives that might have spurred investment decisions that sought to exploit the potential of an enlarged regional market. The successive breaches of the CET and the persistence of

exceptional import regimes distorted the structure of protection toward third parties, while the chaotic process of imposing barriers to internal trade aggravated uncertainty about the true scale of the enlarged market.

Hence the main and most powerful economic incentive that the regional agreement should have offered—that is, to increase the potential scale of output—tended to be weakened. Since MERCOSUR is characterized by the coexistence of economies of very different size, it is most likely that this pattern discriminates against investment and capacity building in the smaller countries, when in theory they should have benefited most from the prospect of exploiting economies of scale.

At the same time, as is evident from the impact assessment in the previous section, the adoption of specialization and complementarity strategies in MERCOSUR is hampered by some of the regulations agreed upon, such as temporary admission regimes for extraregional imports for their reexport to the enlarged market, following some form of processing. This legislation was originally justified as a compensatory measure to favor the two smaller countries, and was to be relatively brief. But it was subsequently adopted for use by all members and its timeframe was recently extended to 2010. In other words, while the positive incentives to increase the scale of production are undermined, adverse signals are sent regarding the establishment or strengthening of intra-MERCOSUR production chains.

This context of policy (un)coordination strengthened the distortionary impact of structural asymmetries on the integration process. In the recessive phase of their internal economic cycles, the larger economies, notably Brazil, tend to dump exportable surpluses on the rest of the regional market. This tendency is even more problematic in view of the significance of specific incentives and when, as happened between 1999 and 2001, there are substantial exchange-rate misalignments among the member countries. Given the pronounced differences in installed capacity, this occasional competitive oversupply may have serious consequences for the productive structure of importing partners.

Paradoxically, in a setting of uncertain rules concerning the functioning and regulation of the regional market, instead of the scale of potential demand becoming an incentive and opportunity to expand production in the smaller economies, the scale of the available supply comes to pose a threat to the sustainability of their own productive capacity. From a more long-term perspective, moreover, given the absence of adequate compensation or administration mechanisms, the mere action of economies of agglomeration exacerbates the existing structural asymmetries, replicates their effects on a broader scale, and aggravates the problems involved in distributing the potential benefits of integration among the member states.

The lack of cooperation and real coordination among the members, and the prevalence of reactive and unilateral measures that tend to cause market fragmentation (defensive) and unfair competition (aggressive), bring about general acceptance of a strategy of “harming one’s neighbor.” Clearly, not all the members are well equipped for this, and in a world without rules, the “heavyweights” tend to win. Hence structural asymmetries have a correlate in policy asymmetries, reflecting each member’s different commitment or revealed capacity to implement and finance promotional measures that impinge on their own competitive capacity in the regional market.

It is clear that Brazil, apart from being the largest and most diversified economy in MERCOSUR, has also concentrated policy asymmetries in its own favor, maintaining investment and export incentives that are more powerful and effective than those of the other member states. Following the Brazilian devaluation in January 1999, the abrupt modification of exchange rate parities that had characterized the biggest boom in intraregional trade (1994–98) pushed in the same direction, widening the competitiveness-price gap in favor of Brazil. Given the rigidity of Argentina's exchange rate policy at the time—and, to a lesser extent, Uruguay's—this realignment of parities seemed to be a more permanent signal of the structure of relative costs within MERCOSUR. It should come as no surprise, then, in view of this complex picture of noncoordination and various asymmetries, that Brazil's own scale should have acted as a general incentive for the establishment of more reliable and attractive activities than the uncertain and diffuse scale of the enlarged market.

Weaknesses in conception, process, and implementation have affected MERCOSUR's progress, since there has been a failure to take advantage of the potential for growth by means of intraregional specialization and complementarity, thereby causing a decline in joint gains. In this context, the costs of structural adjustment have been heightened, driven by the new competition conditions in each of the members, and at the same time no provision was made for regional instruments or agreements to mitigate such costs and facilitate reconversion of the affected resources. These coordination failures exacerbated the problem of distribution within the bloc while widening the competitiveness gap and reproducing the structural asymmetries on a larger scale.

Apart from any inclination on the part of the member states to act as free riders, the failures to comply with the regulations derive from the actual logic of the integration program as it was originally conceived and subsequently implemented. Indeed, the accelerated liberalization of intra-MERCOSUR trade—in a context marked by macroeconomic volatility, an absence of common instruments for productive reconversion, and asymmetrical incentives—has had a number of destabilizing effects on the member countries, either on their external accounts or on output and employment in certain sectors. Without agreed mechanisms to manage emergencies, a plethora of restrictions come into being. Hence, in MERCOSUR, the institutions of the customs union cannot be made fully operational simply by exercising their formal attributes. Rather, there should be a radical change in the logic of policy (non)coordination that has characterized the process thus far.

## Conclusions

In principle, MERCOSUR is an ambitious customs union project that needs a high degree of policy coordination. In practice, it is a free trade area with multiple exceptions and poor institutional credibility. The gap between the ideal and the reality is the result of objective difficulties in consolidating the customs union among economies that are basically volatile and very dissimilar. It also stems from the absence of a strong internal consensus on the suitability of the stated goal. Deepening MERCOSUR requires narrowing this gap by adopting and complying with three definitions concerning the nature of the regional market, the

treatment of structural disparities, and the will to act cooperatively—that is, to coordinate policy. Paradoxically, the MERCOSUR countries are facing relatively similar problems of competitiveness and are trying to resolve them in relatively similar ways. To the extent that such actions are not coordinated, they tend to degrade the quality of negotiations and distort the conditions for intra-MERCOSUR competition.

For this reason, nearly two decades after the establishment of MERCOSUR's customs union, there is a general sense of dissatisfaction in the four member countries that stands in stark contrast to the euphoria of the early years—a euphoria that was wiped out by the crisis of the late 1990s. A number of assessments emphasize the lack of norms and management, or the strategic divergences among the partners, or the asymmetrical nature of intrabloc trade and investment flows, and conclude that there is a need to redesign the agreement if MERCOSUR is to be deepened. But these different emphases indicate that there is no broad consensus on the causes of the current stagnation and contentiousness, much less on how to overcome those circumstances.

In some official spheres (Secretaría del Mercosur, 2004), emphasis has been placed on the increasing noncompliance with norms and goals. Proposals have been made to reestablish and, this time, fully respect the customs union format and the commitments agreed upon at Ouro Preto. This stance assumes that the repeated failures to comply and the unilateral decisions taken must stem from a sort of apathy, or a tendency to fecklessness on the part of the member states. It does not take into account that, in fact, this pattern arises from having liberalized intra-MERCOSUR trade without simultaneously instituting mechanisms to manage structural and regulatory asymmetries or to coordinate macroeconomic and promotion policies. In these circumstances, the destructive effects of liberalization tended to prevail over the creation of export opportunities, and the countries began early to resort to purely defensive measures that breached the agreements.

A second set of opinions, characterized by a “preference for flexibility,” shares the idea of redefining MERCOSUR as a free trade area—so as to reduce the fields in which coordination is required and recover maneuvering room for trade policy and external negotiations. The basic alternatives range from choosing other avenues of liberalization—such as the Free Trade Area of the Americas (FTAA)—to options that are not particularly reliable or suitable for the MERCOSUR countries. To some extent this posture is based on two questionable premises: that the MERCOSUR countries, on their own, would have sufficient capacity in international negotiations to maximize their access to any market without making burdensome concessions; and that multilateral disciplines would be enough to avert the harmful effects of opportunistic or predatory strategies on the part of neighbors.

Finally, another perspective is based on an assessment that emphasizes the imbalance between the rigor of trade liberalization and the weakness of macroeconomic and microeconomic coordination in practice. This approach maintains that deepening MERCOSUR would require that liberalization and competition policies in the customs union be accompanied by policies for productive development and management of the distribution problems (see, for example, Kosacoff, 2004). In general, this stance assumes that it is necessary to develop a new rationale for MERCOSUR—associated with a sustainable strategy of productive diversification—

and holds that, to this end, it is not enough either to return to Ouro Preto or opt for a free trade area. The goal, in this case, consists of establishing a better managed customs union by means of more comprehensive and balanced policy coordination. It is plain that this chapter subscribes to that view. In any event, it is understood that there will be many difficulties in building an institutional structure of this kind.

All MERCOSUR countries have developed (or rather, accumulated) competitiveness policies. In all of them, too, there is some consensus that these policies should be strengthened. Much has been said about competitiveness in the past 20 years—in parallel to discussions of reducing barriers to international trade—and there has been widespread acceptance of the idea that competitiveness is the result of a complex and systemic process involving interactions among various domains of public policy, private actions and strategies, and institutional and social environments. But beyond this general definition, a variety of causes and structures have been advanced to explain this process of macro-meso-microeconomic interaction, as well as the market and coordination failures at play. Hence there is no (nor could there be any) single way of devising competitiveness policies. In practice, the MERCOSUR countries have been combining—with more inconsistency than virtue, and more discretionary conduct than strategy—competitive pressures, promotion instruments, and rescue mechanisms.

To some extent, MERCOSUR's "free trade" dimension and regulations have formed part of the member countries' competitiveness policies in recent years. The members have opened up further (that is, competitive pressure has increased) and have put forward a potential scale incentive. Efficiency gains (due to improved resource allocation and productivity) and thus greater competitiveness would be the expected result of regional integration. But it is unclear how these gains would be distributed among the partners,<sup>37</sup> because each one's initial capacity to take advantage of them may be different and because, once the process is under way, the dynamic of relative specialization may generate new asymmetries.<sup>38</sup> Because of this, and beyond the general incentives, the countries have tended, either preventively or reactively, to apply their own "competitiveness" policies aimed at the regional market, with a view to maximizing their share of the bloc's gains—even at the cost of violating the principle of equality of conditions for competition. Europe faced this dilemma by regulating national government aid and transferring part of promotion policy and redistributive policies to the EC domain; MERCOSUR is still far from this.

Two additional problems have emerged in MERCOSUR. First, macroeconomic instability not only has provoked various abrupt shifts in conditions for intrazone competition, but has also undone the promotional impact of the instruments in place and caused significant major intersectoral transfers. Moreover, it has been the source of various regulatory inconsistencies, causing some policies to run short of funds, or warranting isolated countervailing measures. Second, one of the most pronounced structural asymmetries is the different capacity (and

<sup>37</sup> This problem is not exclusive to MERCOSUR; it is found in every scheme.

<sup>38</sup> See Hinojosa-Ojeda (2005) for a discussion of the standard of specialization within NAFTA and the need for specific policies to promote genuine convergence.

sometimes willingness) of each member country to finance promotion policies that improve the performance of its businesses in the enlarged market. The regulatory asymmetries thus tend to exacerbate the structural asymmetries.

Several of the investment incentives surveyed in the different countries, some of which have a significant impact, violate the principle of preferential access for producers from member states, or are a potential source of negative cross-border spillovers. The deepening of MERCOSUR requires that they be eliminated or made compatible. Similarly, some of the members' export promotion mechanisms distort competition conditions in the regional market and reveal a bias against strategies for greater productive integration, placing constraints on deeper integration. An agreed-upon schedule for the phasing out of such mechanisms is required.

MERCOSUR needs to deepen its norms, which involves three interrelated courses of action: to remove the exceptions introduced unilaterally, to transpose agreed norms that have not yet entered into force, and to make headway on commitments to policy coordination that have been successively assumed and then postponed. The harmonization of national competitiveness policies, especially promotion policies, is part of this process, and is an essential requirement for the juridical construction of the internal market. The few supposedly compensatory policies at the regional level sustain trade triangulation and do not promote intrazone linkages.

Nevertheless, the scope of this new phase of greater commitment to policy coordination calls for a prior agreement that the prevailing practices that most distort competition should be subject to some sort of common discipline. This requires a transition period in which available emergency mechanisms could take over whenever policy asymmetries caused negative cross-border spillovers. It should be pointed out that, since Ouro Preto, the MERCOSUR countries cannot apply safeguards to intrabloc trade and that the use of antidumping measures has not only been subject to acute controversy, but in practice has become a marginal part of trade among the partners. Additionally, the lack of other commercial compensation mechanisms has not been effectively offset by the implementation of temporary agreements on voluntary export restraints. In general, this has not been in effect for long, and for even less than was originally proposed.

In the North American Free Trade Agreement (NAFTA), for example, trade defense instruments remain in effect for intrazone trade, subject to the signatories' national legislation, although susceptible to bilateral judicial review. In the EU or the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), these instruments were dismantled and replaced by a common competition policy. In both, a transition period of not less than 10 years was established for this replacement to happen, and national legislation was modified to enable enterprises in the member countries to denounce distorting behavior in the exporting country (Delgado, 2004). The rapid dismantling of intrazone trade defense measures and the delay in establishing a common competition policy have proven wholly at odds with the major policy asymmetries in MERCOSUR.

Clearly, the long-term solution is to remove those asymmetries and implement regional policies. It is also clear that, given MERCOSUR's current institutional and political circum-

stances, the establishment of common regulations in these matters and the disappearance of the distorting effects of the promotion policies in force will take a fairly long time. This transition should be administered by instruments that regulate intrazone trade and that allow the bloc to: (i) manage the undesirable effects of divergent economic cycles when, as is the case, there are significant size asymmetries; and (ii) prevent possible harm to the productive capacity of one member as a result of another's use of incentives that distort the conditions for intrazone competition. In the first instance, it would be a matter of applying restrictive emergency measures for a set period. In the second, it would be a question of reestablishing trade defense measures so as to compensate for the effect of such subsidies.

Nevertheless, an indispensable part of any thorough solution is to foster greater integration and complementarity among the productive systems. To date, business strategies based on productive specialization and intrazone complementarity programs seem to have been used systematically only by a group of international companies with affiliates in some of the MERCOSUR countries, and in a limited number of sectors. A few large Brazilian (and, to a lesser extent, Argentine) groups have invested using a similar strategy. In any event, in the prevailing macroeconomic and regulatory circumstances, market incentives appear to have been inadequate to allow movements of this kind to occur more frequently. Consequently, they have tended to constrain the expected dynamic effects. Moreover, attainment of the economic effects expected of a virtuous integration process—sustainable growth and distributive equity—requires that specific structural policies be developed at the regional level.

For MERCOSUR to be part of a competitiveness strategy that supports an equitable growth process for its members, several other things are needed: (i) reestablishment of the enlarged market (a genuine internal market) as an effective long-term signal, so that the scale incentives make it possible to maximize the bloc's joint gains; (ii) coordination of strategies of specialization and productive complementarity that are attentive to a proper distribution of dynamic effects, in order to make potential opportunities effective for all the members; and (iii) correction of policy asymmetries and of cumulative distributive distortions in such a way as to avert the creation of new and greater structural asymmetries, while attending to the reconversion of "losers."

This requires redefining the CET and effectively implementing it; harmonizing technical standards (key to fostering complementarity among distinct products); and, crucially, effectively coordinating sectoral and microeconomic policies. It would involve thinking of the regional space as a setting for the strengthening of value chains that make it possible to expand the opportunities and development horizon of SMEs, and to negotiate with transnational firms (already established or new) with a view to maximizing the effects of linkage and thus restoring the density of the industrial fabric. It is important to generate a supply of regional public goods—such as a framework to foster cooperation among enterprises, the provision of infrastructure, or a coordinated system of research, development, and innovation—to guide strategic planning for a more appropriate international insertion on the part of MERCOSUR. This entails coordinating programs that promote intraregional specialization, the exchange of best practices, the provision of sources of financing, the transfer of technology, and complementarity in R&D efforts.

The European experience shows that the coordination of structural policies should combine both vertical and horizontal approaches. In some cases, it will be necessary to take sectoral approaches, either to guide the reconversion of procedures already set up on the basis of intrazone specializations, or to shape the joint development of new sectors. In other cases, especially as regards SMEs, there is a need to maximize regional synergies between policies to promote competitiveness and foster innovation, and those geared to business development and training. In any case, such measures will involve programs for specialization and complementarity in finished products, for the joint development of new products and adaptations, the joint construction of particular niches, setting up export alliances, and maximizing relationships with suppliers in international production systems. As an integral and crucial part of these programs, attention should be paid to the financing of these policies, so as to anchor specific instruments in the regional domain.

APPENDIX

Competitiveness Policy Instruments and Impact Matrices  
for the MERCOSUR Countries

This appendix presents a comprehensive list of the main elements of the competitiveness policies now in force in the MERCOSUR countries, and indicates their potential impact on the goals of deep integration. The instruments were basically categorized in line with three variables: (i) their basic and priority aim in export promotion, investment promotion, capacity promotion, and/or performance promotion; (ii) the amounts involved, their beneficiaries and timeframes; the importance of each instrument was judged to be high, medium, or low; and (iii) their effect (positive, neutral, or negative) on deep integration, taking the following into account:

- The free movement of goods in MERCOSUR’s internal market and respect for the preferential access conditions offered to producers from the other member countries
- Elimination of cost-price distortions (subsidies to the sale price in the MERCOSUR internal market)
- Elimination of negative cross-border spillovers related to investment promotion (incentives for the location of businesses and activities to supply the MERCOSUR internal market)
- Exploitation of economies of scale and specialization to develop productive complementarity in the MERCOSUR internal market

Nomenclature Used in the Instrument Matrices

Item	Abbreviation	Meaning
Objective	EP	Export promotion
	IP	Investment promotion
	CP	Capacity promotion
	PP	Performance promotion
Type of benefit	C	Subsidized rate credits
	MS	Monetary subsidies
	E	Tax and/or fiscal exemptions
	TA	Technical assistance
	FF	Financial facilities
Type of impact	N	No impact/nondistortionary (neutral)
	R	Restrictive (negative)
	I/E	Introduces/expands (negative)
	S	Stimulus (positive)
	F	Facilitates (positive)

**Argentina: National Promotional Instruments in Force**  
**Matrix 7A.1 Export Promotion**

National Instruments	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Export drawbacks	EP	D	X			High	N	N	N	N	* = observation pertains to (particular column)
Temporary admittance regime	EP	D	X			High	N	N	N	R	
Drawback system	EP	D	X			High	N	N	N	R	
Reimbursements for exports through Patagonian ports	EP	D	X		X	High	N	I/E (low)	N	N	
Reimbursement of value added tax (VAT)	EP	D	X			High	N	N	N	N	
Export financing	EP	C	X			High	N	N	N	N	
Export prefinancing	EP	C	X			High	N	N	N	N	
Credits for regional exportable production	EP	C	X(*)		X	High	N	N	N	N	
Free zones	EP	D	X		X	Medium	N	N	N	R	
Turnkey plant export regime	EP	D	X			Low	N	I/E (low)	N	N	
Regime for financing of VAT on purchase or import of capital goods	EP	C	X			Low	N	N	N	N	
Program for the promotion of export groups	EP	TA	X(*)			Low	N	N			
Export-Ar Foundation	EP+CP	TA	X	X(*)		Low	N	N	N	N	
La Pampa Exporta Trusteeship	EP+CP	C	X		X	Low	N	N	N	N	

In effect until December 31, 2005.

\* Only for SMEs.

\* In 2004, the "Sectoral Promotion Plan" was instituted. This facilitates the design of long-term plans for various sectors.

Matrix 7A.2 Investment Promotion

National Instruments	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Promotion of investment in capital goods and infrastructure projects	IP <sup>a</sup>	E	X			High	N	N	I/E (low)	N	* = observation pertains to (particular column)  Very recent. First call made on Oct. 29, 2004.
Special Fiscal and Customs Regime in Tierra del Fuego, Antarctica, and the South Atlantic islands—Law 19640	IP	E	X		X	High	R (*)	N	I/E	N	* Restricts preferential access. Benefits in force until Dec. 31, 2013.
Law on Investment for Cultivated Forests 25.080	IP	E		X		High	N	N	N	N	
Financing for acquisition of capital goods	IP	C	X			High	N	N	N	N	
Credit line for purchase of agricultural machinery	IP	C		X		High	N	N	N	N	
Incentives for the mining sector	IP	E		X		High	N	N	N	N	
Import regime for “large investment project” goods	IP+CP <sup>b</sup>	E	X			High	R (*)	N	I/E (low)	N	* Restricts preferential access.
National Development Fund for Micro, Small, and Medium Enterprises	IP+CP	C	X (*)			High	N	N	N	N	* Only for SMEs.
Reconversion Program for Tobacco Areas	IP+CP	MS+C+TA		X		High	N	I/E	N	N	

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**Matrix 7A.2 Investment Promotion** *(continued)*

National Instruments	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Financing for investment projects in goods and services MERCOSUR automotive regime	IP+CP	C	X			High	N	N	N	N	* = observation pertains to (particular column)
	IP+EP+CP	E		X		High	F+R (*)	N	N	S	
Bonus rate regime	IP+EP	C	X (*)			High	N	N	N	N	* Promotes intra-zone trade and regulates the direction of the flows. * Only for SMEs. * Only for SMEs.
Credits for business reactivation	IP+CP	C	X (*)		X	High	N	N	N	N	
Import regime for "used production lines"	IP+CP	E	X			Low	N	N	N	N	In effect until Dec. 31, 2005.
Software industry promotion regime	IP+EP+CP	E		X		Low	N	N	N	N	

a. Could have less of an impact on exports because the investment projects presented, whose output is solely for the export market, have a double incentive; they can simultaneously access accelerated amortization and early reimbursement of VAT.

b. Also promotes capacity, though that is not the main aim, since the firm is required to have a contractual link with an accredited certifying agency for certification of norms IRAM-ICC-ISO 9001 for products, or HACCP and BPM for food, or ISO 14000 for projects concerned with the treatment of polluting substances.

Matrix 7A.3 Capacity Promotion

National Instruments	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Nonreimbursable contributions (ANR-FONTAR)	CP	MS	X (*)		X (*)	High	N	N	N	N	* Geared toward SMEs.
	CP	C	X			High	N	N	N	N	
Credits to Firms to Finance Technology Development Projects (CAEFIPP)	CP	E	X			High	N	N	N	N	
	CP	MS	X (*)			Medium	N	N	N	N	* Only for SMEs.
Fiscal Credit Program (ANPCyT) Business Restructuring Program (PRE)	CP	C	X (*)			Medium	N	N	N	N	
	CP	E	X (*)			Low	N	N	N	N	* Geared toward SMEs. * Only for SMEs.
Credits granted by articles 2 and 3 of Law 23.877	CP	MS	X (*)			Low	N	N	N	N	
	CP	C	X			Low	N	N	N	N	* Geared toward SMEs.
Fiscal Credit for Training (SSPyMEyDR)	CP	C	X			Low	N	N	N	N	
	CP	C	X			Low	N	N	N	N	* Geared toward SMEs.
Subsidies granted by articles 5, 6, and 7 of Law 23.877	CP	C	X			Low	N	N	N	N	
	CP	C	X			Low	N	N	N	N	
Credits to companies	CP	C	X			Low	N	N	N	N	
	CP	C	X			Low	N	N	N	N	
Quality certification	CP	C	X			Low	N	N	N	N	
	CP	C	X			Low	N	N	N	N	
Environmental impact studies	CP	C	X			Low	N	N	N	N	
	CP	C	X			Low	N	N	N	N	

**Matrix 7A.4 Performance Promotion**

National Instruments	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Regime of incentives for the production of capital goods	PP	E		X		High	N	I/E	N	N	
Mutual guarantee company program	PP	FF	X (*)			High	N	N	N	N	* Only for SMEs.
Guarantee Fund for Micro, Small, and Medium Enterprises (FOGAPyME)	PP	FF	X (*)			High	N	N	N	N	* Only for SMEs.
Promotion regimes for Patagonia and Historical Refurbishment Act (La Rioja, San Luis, Catamarca, and San Juan)	PP (*)	E			X	High (*)	N	I/E (*)	N	N	* Both closed. The Patagonia regime in 2004 and the Historical Refurb. Act in 2011.
Italian credit to nurture SMEs	PP+CP	C	X (*)			High	N	N	N	N	* Only for SMEs.
Global Credit Program for Micro and Small Enterprises (MyPEs II)	PP	C	X (*)			High	N	N	N	N	* Only for SMEs.
Tax policies to reduce production costs by lessening payroll pressure (reduction of employers' contribution)	PP	E	X		X	High	N	N	N	N	
National Fund for the Creation and Consolidation of Microenterprises (FoMicro)	PP	C	X (*)			Medium	N	N	N	N	* Only for SMEs.
Buy National-Hire National	PP	MS	X			Low	R	N	N	N	
VAT technical balance (capital, information technology, and telecommunications goods)	PP	E		X		Low	N	N	N	N	
Policies to reduce production costs through employment subsidies	PP	MS	X			Low	N	N	N	N	

Argentina: Major Provincial Promotional Instruments

Matrix 7A.5 Provincial Instruments

Provincial Instruments	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
<b>Buenos Aires Province</b> Buenos Aires Guarantee Fund (FOGABA) Banca Provincia credit program  Fuerza PyME Fund for the Promotion of Buenos Aires Exports (FOPREXBA) Rescue for businesses in crisis Financing for Viable Small Projects (PPV) Baexporta Private employment programs	PP	FF	X (*)		X	High	N	N	N	N	* Only for SMEs.
	IP+EP	C	X (*)		X	High	N	N	N	N	* Only for microenterprises and SMEs.
	PP+IP	C	X (*)		X	Medium	N	N	N	N	* Only for SMEs.
	EP	TA	X (*)		X	Low	N	N	N	N	* Geared toward SMEs.
	PP	C	X		X	Low	N	N	N	N	* For microenterprises.
	PP	C	X (*)		X	Low	N	N	N	N	
	EP	TA	X		X	Low	N	N	N	N	* Only for microenterprises and SMEs.
	PP	MS	X		X	Low	N	N	N	N	
	PP+IP	C	X (*)		X	Low	N	N	N	N	
		MS	X (*)		X	Low	N	N	N	N	* Only for microenterprises and SMEs.
<b>City of Buenos Aires</b> PROMPyme  Support Program for Technology Modernization  Subsidies for the city's leather and footwear firms	PP+IP	C	X (*)		X	Low	N	N	N	N	* Only for microenterprises and SMEs.
	CP	MS	X (*)		X	Low	N	N	N	N	* Only for microenterprises and SMEs.
	CP	MS		X (*)	X	Low	N	N	N	N	* Only for SMEs.

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**Matrix 7A.5 Provincial Instruments** *(continued)*

Provincial Instruments	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Subsidies for tourism firms	CP	MS		X (*)	X	Low	N	N	N	N	* Only for microenterprises and SMEs.
Subsidies for software firms	CP	MS		X (*)	X	Low	N	N	N	N	* Only for SMEs.
Foreign trade promotion	EP	TA	X (*)		X	Low	N	N	N	N	* Only for SMEs.
Metropolitan Design Center	CP	TA	X (*)		X	Low	N	N	N	N	* Firms, designers, and entrepreneurs.
Córdoba Province											
Subsidies for job creation	PP	S	X		X	High	N	N	N	N	* Only for microenterprises and SMEs.
Law 9.121—Program for the Promotion and Industrial Development of Córdoba	PP	E/C/MS	X (*)		X	Low	N	N	N	N	
Córdoba SME Quality	CP	MS	X (*)		X	Low	N	N	N	N	* Only for SMEs.
Law 7.232—Provincial Incentive Regime for Tourism Investment	IP	E		X	X	Low	N	N	N	N	
Mendoza Province											
Provincial Fund for the Transformation and Growth of Mendoza	IP+EP	C	X		X	High	N	N	N	N	* TA. Only for SMEs.
Pro Mendoza	EP		X (*)		X	Low	N	N	N	N	
Santa Fe Province											
Law 12.307—Financial assistance for milk producers, Nuevo Banco de Santa Fe	PP	C		X	X	High	N	N	N	N	
(continued on next page)											



## Brazil: Principal Promotional Instruments

## Matrix 7A.6 Export Promotion

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Fiscal incentives for exports	EP	E	X			High	N	N	N	N	
Drawback	EP	E	X			High	N	N	N	R	
RECOF	EP	E		X		High	N	N	N	R	
Support to exports—BNDES	EP	FF	X			High	N	N	N	N	
PROEX	EP	FF	X			High	N	N	N	N	
Exportação (FNO)	IP/EP	FF	X		X	Medium	N	N	N	N	
Export Promotion Program (FCO)	IP/EP	FF	X		X	Medium	N	N	N	N	
Special Program of Financing Production for Exports	EP	FF	X		X	Medium	N	N	N	N	
Support/guarantee funds	EP/IP/CP	FF	X			Low	N	N	N	N	Micro, small, and medium enterprises.
Trade promotion (APEX)	EP+CP	TA	X			Low	N	N	N	N	Micro and small enterprises.
Industrial export extension project	EP+CP	TA	X			Low	N	N	N	N	Micro and small enterprises.
PROGEX	EP+CP	TA	X			Low	N	N	N	N	Micro and small enterprises.

Matrix 7A.7 Investment Promotion

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Regional fiscal incentives (north and northeast)	IP	E	X		X	High	N	I/E	R	R	Until Dec. 31, 2013.
Federal fiscal incentives for Manaus and free trade areas	IP	E	X		X	High	N	I/E	R	R	Until Dec. 31, 2013.
State fiscal incentives for Manaus	IP	E	X			High	N	I/E	R	R	
MERCOSUR automotive policy	IP/EP/CP	E		X		High	F/R	N	N	S	Promotes intrazone trade but establishes conditions.
Reduction of II on capital goods, and information technology and telecommunications products, without national production ("extra-tariff")	IP	E	X			High	N	N	N	N	
Reduction of IPI for capital goods	IP	E	X			High	N	N	N	N	Implemented as of January 2004.

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**Matrix 7A.7 Investment Promotion** *(continued)*

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Financing for investment of federal public banks (BNDES, BB, CEF, BASA, and BNB)	IP	FF	X	X	X	High	N	N	N	N	BNDES financial support lines are permanent. The programs were of limited duration (some until 2005 and others until 2007). Until Dec. 31, 2013.
	Fiscal investment funds (north and northeast regions)	C	X		X	Medium	N	I/E (low)	R (low)	R (low)	
	State programs to attract investment	C/E/MS	X	X	X	Medium	N	I/E (medium)	R (medium)	R (medium)	
Support/guarantee funds	IP/EP/PP	FF	X			Low	N	N	N	N	Micro, small, and medium enterprises.

Matrix 7A.8 Capacity Promotion											
Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Incentives for R&D in information technology (information technology law)	CP	D		X		High	N	N	N	N	
Programs to foster sectoral development funds in science and technology	CP	TA/C/MS	X			High	N	N	N	N	
Brazilian Design Program	CP	TA/FF	X			Low	N	N	N	N	
Industrial Technology Development Program (PDTI) and Agropecuária (PDTA)	CP	E	X			Low	N	N	N	N	
Programs of the Financing Agency for Studies and Projects	CP	FF	X			Low	N	N	N	N	
Innovation for Competitiveness Program	CP	TA	X			Low	N	N	N	N	
Support for Technological Development Program—PRODETEC (BNB)	CP	FF			X	Low	N	N	N	N	

**Matrix 7A.9 Performance Promotion**

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Support/guarantee funds	PP/EP/IP	FF	X			Low	N	N	N	N	Micro, small, and medium enterprises.
Trade promotion (APEX)	PP/EP	TA	X			Low	N	N	N	N	Micro and small enterprises.
Industrial export extension project	PP/EP	TA	X			Low	N	N	N	N	Micro and small enterprises.
PROGEX	PP/EP	TA	X			Low	N	N	N	N	Micro and small enterprises.
Support Program for Micro and Small Enterprises (PMPE)	PP	FF			X	Low	N	N	N	N	Micro and small enterprises.
Technological Support Program for Micro and Small Enterprises (PATME)	PP	TA	X			Low	N	N	N	N	Micro and small enterprises.

Paraguay: Principal Promotional Instruments  
Matrix 7A.10 Investment Promotion

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Law 60/90 fiscal incentives regime for investment	IP	E	X			High	N	N	I/E (low)	N	The benefits were sharply cut by tax reform Law 2.421/04.  * No benefits granted. Only guarantees equality of national and foreign investment.
Law 117.92 investment regime	IP	(*)	X			Low	N	N	N	N	
Regime to foster forestation and reforestation	IP	S/E/C		X		Low	N	N	N	N	
Regime for administration of equity investment funds	IP	E	X			Low	N	N	N	N	

**Matrix 7A.11 Export Promotion**

Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact				Observations
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Tourism regime	EP	E		X		High	R	I/E	I/E	R	Fosters the reexport of imported products.
Free zones regime	EP	E	X			Medium	R	I/E	I/E	R	
<i>Maquila</i> regime	EP/IP	E		X		Medium	R	I/E	I/E	R	
National automotive regime	EP/IP	E		X		Low	F + R	N	I/E	S	
Temporary admission drawback and temporary export	EP	E	X			Low	N	N	N	R	Modified by the new customs code of Law 2.422/04.
Regime to promote exports of nontraditional and manufactured products	EP	E	X			Low	N	N	N	N	
General Directorate for the Promotion of Exports and Investment—ProParaguay	EP	TA	X			Low	N	N	N	N	
One-stop counter window for exporters	EP	—	X			Low	N	N	N	N	Helps deal with red tape.

Matrix 7A.12 Capacity Promotion										
Instrument	Objective	Type of benefit	Scope			Importance	Type of Impact			
			Horiz.	Sect.	Reg.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity
National Development Bank	CP	C		X		High	N	N	N	Observations  In the short term, these credit windows will undergo public banking reform.
Industrial Tariff on Electricity	CP	MS		X		High	N	R	N	Benefits agriculture and industrial businesses.
Raw material import regime	CP	E	X			High	R	R	N	
Guarantee fund for micro, small, and medium enterprises	CP	FF	X			Medium	N	N	N	
Rural Development Fund	CP	C		X		Medium	N	N	N	
General Law on Science and Technology	CP	TA	X			Low	N	N	N	
Industrial Development Fund	CP	FF		X		Low	N	N	N	
National Institute of Technology and Standardization	CP	TA	X			Low	N	N	N	
Labor training system	CP	—	X			Low	N	N	N	

## Uruguay: Principal Promotional Instruments

## Matrix 7A.13 Export Promotion

Instrument	Objective	Type of benefit	Scope		Importance	Type of Impact				Observations
			Horiz.	Sect.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Temporary admittance and drawback regime	EP	E	X		High	R	R	R	R	For intraregional exports until December 31, 2010.
Special textiles drawback	EP	E		X	High	N	I/E	N	N	The benefit is more a drawback than a subsidy.
Automotive regime	EP/IP/CP	MS		X	High	F and RN	N	N	S	
Reimbursement of indirect and export taxes	EP	E	X		High	N	N	N	N	
Free zones regime	IP	E	X		Medium	R	R	R	R	
Promoción Uruguay XXI	EP	TA	X		Low	N	N	N	N	

Matrix 7A.14 Investment Promotion

Instrument	Objective	Type of benefit	Scope		Importance	Type of Impact			
			Horiz.	Sectoral		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity
Investment promotion regime	IP	E	X		High	N	N	N	N
Declaration of national interest	IP	E	X		High	N	N	N	N
Promotion of tourism services	IP	E/C/MS		X	High	N	N	N	N
Forestry promotion regime	IP	E/MS		X	High	N	N	N	N

**Matrix 7A.15 Capacity Promotion**

Instrument	Objective	Type of benefit	Scope		Importance	Type of Impact				Observations
			Horiz.	Sect.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
National Institute for Agricultural Research (INIA)	CP	TA		X	High	N	N	N	N	Nonstate public institution run by representatives of the public and private sectors with mixed financing.
	CP	TA		X	High	N	N	N	N	Nonstate public entity with a mixed public-private legal status, financing, and management.
National System of Cattle Raising Research (SNIG)	CP	TA/MS		X	High	N	N	N	N	Seeks to boost information on Uruguayan cattle raising, coordinating the various official agencies that gather and manage data.
	CP	TA		X	High	N	N	N	N	Nonstate public entity with a mixed public-private legal status, financing, and management.
INAVI Uruguayan Technological Laboratory (LATU)	CP	TA		X	High	N	N	N	N	Nonstate public entity with a mixed public-private legal status, financing, and management.
	CP	TA	X		High	N	N	N	N	Fosters the creation of groups of producers to receive technical assistance, and especially to promote the reconversion of genetic materials used by producers with a view to export.
Program for the reconversion and development of farming	CP	TA/MS		X	Medium	N	N	N	N	

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Matrix 7A.15 Capacity Promotion (continued)

Instrument	Objective	Type of benefit	Scope		Importance	Type of Impact				Observations
			Horiz.	Sect.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Agriculture Services Program (PSA)	CP	TA	X		Medium	N	N	N	N	Geared to strengthening the adoption and creation of agricultural technologies and to support activities that improve animal health.
	CP	TA/MS	X		Medium	N	N	N	N	
Decentralization Funds (OPP)	CP	TA/MS		X	Low	N	N	N		Focused on infrastructure projects and, in some cases, on promoting production in specific projects.
Livestock project	CP	TA/MS			Low	N	N	N	N	Promotes innovations by cattle-raising groups or business plans in the livestock or export chain.
Technological development program	PP	MS/TA	X		Low	N	N	N	N	Promotes the call for technological development proposals by the private sector in association with research groups. The scope of the project is limited and thus far the impact has been modest because of a lack of continuity in execution—the result of restrictions in counterpart financing.
Agricultural Plan Institute (IPA)	CP			X	Low	N	N	N	N	
	CP	E	X		Low	N	N	N	N	

**Matrix 7A.16 Performance Promotion**

Instrument	Objective	Type of benefit	Scope		Importance	Type of Impact				Observations
			Horiz.	Sect.		Free intrazone movement	Cost-price distortion	Cross-border spillover	Intrazone production complementarity	
Financing fund for dairy activities and policy	PP	FF		X	High	R	I/E	R	R	This intervention mechanism affects competition conditions by restricting free competition and altering cost-price ratios.
Sugar fund	PP	FF/MS		X	High	R	I/E	R	R	Reduces protection in the sector and improves the competitiveness of the foods-making sector.
Fund to finance and reconstruct rice cultivation	DP+IP	FF		X	High	N	I/E	N	N	
Fund for the reconversion and development of farming	PP	FF/MS		X	High	R	I/E	R	R	Originally the fund was to expire on June 30, 2003. In 2004, efforts were made to design a new law to extend the fund and its financing for 10 years.
Transfer and management of silos	PP	FF/MS		X	High	N	I/E	N	N	The benefit resides in the transfer of an asset.
Vinicultural policy	PP	FF		X	High	R	I/E	N	N	This regulatory framework is geared toward promoting quality viticulture.
Trusteeship Law	PP	FF	X		High	N	N	N	N	Trusteeship Law 17.703 was approved in October 2003.
Financing bodies for micro and small enterprises	DP+IP	FF		X	Low	N	N	N	N	

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## **Tax Harmonization and Economic Integration\***

*Fernando Rezende*

### **Introduction**

Nearly two decades since the presidents of Argentina, Brazil, Paraguay, and Uruguay met in Asunción to agree on forming an economic union, the status of the Southern Common Market (MERCOSUR) is far from the original vision. On the one hand, the region's economies have been deeply affected by international financial crises that provoked macroeconomic imbalances and created an unfavorable climate for economic integration. On the other, political enthusiasm for the project faded as the domestic agenda of economic stabilization gave way to conflicts of interest over more immediate goals.

It is therefore unsurprising that, apart from some efforts to keep the project alive by sustaining a far from perfect common external tariff (CET), further steps to deepen economic integration have thus far been postponed. Although the Asunción Treaty mentioned the need to avoid a discriminatory tax treatment of MERCOSUR products in the domestic markets of the group's members, tax harmonization remained outside the regional agenda. The Ouro Preto Protocol contemplates some institutional advances,<sup>1</sup> and various meetings have mentioned the need for coordination of macroeconomic policies, but the conditions required to effect these recommendations are still absent.

Chosen as the cornerstone of macroeconomic stabilization policies, fiscal adjustment has entailed additional difficulties for tax-system harmonization. With differences in emphasis and timing, every country in the region has been forced to increase tax revenue in order to help reverse fiscal deficits and check the growth of the public debt-to-GDP ratio. In the process, the quality of their tax systems deteriorated, since overall preference was accorded to taxes that faced less political opposition and were easier to collect.<sup>2</sup>

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\* This chapter is a slightly revised version of a study written in 2005; it is based on the information then available and circumstances at the time.

<sup>1</sup> Reig (1996) mentions the Trade Commission (Comisión de Comercio del MERCOSUR, CCM), the Joint Parliamentary Commission (Comisión Parlamentaria Conjunta, CPC), and the Economic and Social Consultative Forum (Foro Consultivo Económico-Social, FCES).

<sup>2</sup> The chapter does not discuss alternatives for fiscal adjustment. What is emphasized is the fact that by relying on tax increases to tackle fiscal imbalances and using "bad" taxes (those that are easily collected and face less political

The deteriorating quality of member states' tax systems caused additional problems for the business sector. Tax differentials did not favor the consolidation of the private sector's interest in economic integration, since the prospects of developing cross-border activities within the region were constrained by tax costs. Furthermore, the lack of basic infrastructure integration raised barriers to the integration of business activities inside MERCOSUR's borders.

Despite recent disputes over the dominance of Brazilian products in the Argentine market, there is some prospect that the MERCOSUR project will gain greater importance in the regional agenda. Economically, recent progress on macroeconomic stabilization has opened up new possibilities for lessening past tensions and increasing regional cooperation. Politically, new leaders in the region have reiterated their commitment to economic integration and to making it effective by acting as a bloc in the main negotiating arenas—the Free Trade Area of the Americas (FTAA), World Trade Organization (WTO), and the European Union (EU). In this more favorable context, the issue of tax harmonization may come to the fore as one of the newer proposals to deepen economic integration.

This chapter appraises alternative scenarios for tax harmonization in MERCOSUR and proposes a specific route to be followed. The next section discusses the most important differences in the tax systems of the member countries. This is followed by “Main Reasons for Tax Differentials.” The fourth section considers the main challenges members face in harmonizing taxation in the region. The fifth section looks at the EU experience of tax harmonization, an important reference for MERCOSUR. The section “Tax Asymmetries and Deepening Integration” assesses the implications of tax asymmetries for the prospects of further integration in MERCOSUR. The seventh section analyzes alternative scenarios for tax harmonization, and the concluding section presents a route to tax harmonization in the region.

## Comparing Tax Structures in the MERCOSUR Countries

A comparative analysis of the tax systems that prevail in the MERCOSUR countries has been the subject of a recent study by Barreix and Villela (2003). Reviewing an extensive array of information, the authors show that wide differences in total tax collections do not preclude a remarkably similarity in the structure of taxation.

The data in this study make clear that the aggregate tax burden in Brazil is more than three times that in Paraguay, about one and a half times that in Argentina, and 20 percent greater than that in Uruguay. But the share of the most important taxes in total tax collection does not vary significantly among these countries.<sup>3</sup> A closer look at the characteristics of the taxes applied in each case, however, shows that similar structures mask important differ-

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opposition) to that end, the MERCOSUR countries increased tax asymmetries and made it more difficult to attain harmonization.

<sup>3</sup> The latest figures for the aggregate tax burden ratio (2003) and the respective sources are: Brazil: 35.5 percent (Rezende, 2004); Argentina: 23.75 percent (González Cano, 2004); Paraguay: 9.9 percent (Alarcón, 2005); Uruguay: 30.5 percent (Barreix and Roca, 2003). Data for Paraguay do not include social security contributions.

ences in the economic impact of taxation. An understanding of the differences requires an examination of the details involved.<sup>4</sup>

To offer an impression of tax differences in MERCOSUR that is relevant for tax harmonization goals, this section focuses on the different approaches to consumption, capital, and labor taxes adopted in the region. Each of these main kinds of taxes is dealt with in sequence, following the priorities usually attached to a process of tax harmonization. An appraisal of the main reasons for differences in the regional tax systems, and the difficulties facing harmonization, closes this section.

To assess these differences, it is important to bear in mind that the harmonization of indirect taxes is not synonymous with the equalization of taxes and tax rates. With harmonization, consumers' tax costs are the same regardless of where goods and services are produced. That is, taxation is harmonized when a good produced in Brazil and consumed in Argentina is taxed at the same rate as a similar Argentine good and *vice versa*. This happens when exports are fully exempted from every tax imposed along the production chain, and when imports are taxed at the rate applied in the domestic market. In the case of direct income taxes, however, harmonization implies uniform rules and rates.

### ***Consumption Taxes***

Take the broad category of indirect taxes on the production and consumption of goods and services. Argentina, Uruguay, and Paraguay apply a more usual version of a broad-basis value added tax (VAT), whereas Brazil has three imperfect varieties of this kind of tax: two collected by the federal government (the manufactured goods tax and social security contributions, Contribuição para o Financiamento da Seguridade Social, COFINS) and another applied at the state level to all kinds of goods and to interstate transport and communication services. Apart from the latter, services under the tax authority of the municipalities are not subject to value added taxes.

Turnover and selective taxes, as well as a tax on financial transactions, are also widely used and have risen significantly. Brazil is by far the leader in collecting taxes that generate substantial revenues without requiring much administrative effort or causing political turmoil. Turnover taxes were reintroduced in Brazil in 1970 and gained impetus after the promulgation of the 1988 constitution.<sup>5</sup> Moreover, in 1993 a tax on financial transactions was adopted on a provisional basis and has been renewed ever since at higher rates. In Argentina, turnover taxes have long been applied by the provincial governments, but recent changes have sought

<sup>4</sup> These details have been expounded in the comparative analysis of the MERCOSUR tax systems carried out by Barreix and Villela (2003) and González Cano (2003b). Additional information can be found in the individual studies for each country referred to in footnote 3.

<sup>5</sup> A 0.15 percent tax on sales of goods and services was introduced in 1970 to support a special Social Integration Program (PIS) as an indirect way of accomplishing a constitutional provision for workers' participation in businesses' profits. Since then, turnover taxes in Brazil have not stopped growing, having received a strong impulse with the extension of social rights in the 1988 constitution. For a chronology of the deterioration in the quality of Brazil's tax system, see Rezende (2001).

to mitigate their economic inefficiencies, albeit with dissimilar results across the country.<sup>6</sup> The federal government also reintroduced a tax on financial transactions and applied export duties to adjust the fiscal accounts.<sup>7</sup> Uruguay did the same, although in a less distorted manner. In 2001, Uruguay introduced a value-added-type contribution earmarked for social security (COFINS), which applies to goods and public utilities. Paraguay relied on increases in selective taxes, mainly fuel, to offset the deterioration of its tax base in the second half of the 1990s. Even then, the tax-burden ratio in Paraguay remained in the vicinity of 10 percent of gross domestic product (GDP).<sup>8</sup>

Recent changes in Brazil's tax legislation seek to reverse the growing importance of cumulative turnover taxes in total tax revenues. Bending to pressures from the productive sector and aware of the need to reduce the burden imposed on exports and investments, the government enacted new rules for collecting the Social Integration Program (PIS) and COFINS contributions. These rules used a value-added approach to collect these contributions from big business, but allowed for some sectors, small enterprises, and important service activities to be taxed under the old regime. The duality of rules and the innumerable provisions for dealing with those who can and cannot deduct the tax paid in previous rounds of the production chain make the operation of the new PIS/COFINS very complex. From the viewpoint of tax harmonization in MERCOSUR, the results are mixed.<sup>9</sup>

Excise taxes present a different picture. Federal excises on fuel, electricity, and telecommunications were abolished in Brazil in 1988. The power to tax these goods and services was transferred to the states, subjecting them to the states' value added tax. A new, federal tax on fuel was reintroduced by a constitutional amendment in 2001.<sup>10</sup> Excises on fuel, tobacco, and beverages (alcoholic and nonalcoholic) are the rule in MERCOSUR countries (see Table 8.1). Nominal rates vary: Brazil and Paraguay hold opposite positions on tax rates. The low rates applied in Paraguay to tobacco and beverages may induce cross-border trade and could explain a similar policy adopted by Argentina with respect to alcoholic and nonalcoholic beverages. Low rates for diesel in the region might reflect the importance of road transport for moving

<sup>6</sup> González Cano (2004) points out that collection of the provincial tax in Argentina is highly concentrated. The city of Buenos Aires, together with the provinces of Buenos Aires, Santa Fé, Córdoba, and Mendoza, account for four-fifths of revenues. Moreover, successive modifications reduced the rates applied at the lower and middle stages of the production process (primary and manufacturing) at the same time as they increased the burden on sales of final goods in order to attenuate the cascade effect.

<sup>7</sup> The tax on financial transactions and export duties now account for 20 percent of total federal government revenues in Argentina.

<sup>8</sup> It should be noted that half the revenues from Paraguayan VAT are collected at customs. The corresponding figure is 50 percent in Uruguay and 25 percent in Argentina.

<sup>9</sup> Sectors that remained under the old regime include those for which COFINS was already collected as a one-stage tax (*regime monofásico*), the main examples being the automotive, pharmaceutical, food, and beverage sectors, services that opted for a presumptive system for appraising their income tax liabilities, and small businesses that adhered to a simplified regime for paying all federal taxes. Sales from these sectors or firms do not generate tax credit for those that are covered by the general regime.

<sup>10</sup> Imports and domestic sales of fuel, as well as natural gas and ethanol, pay a fixed amount per unit (present rates are 280 reais per cubic meter of gasoline and 70 reais per cubic meter of diesel). The proceeds of this tax are shared with the states and earmarked for roads and environmental protection programs.

goods and people within each country and across MERCOSUR borders. It should not be assumed that fuel in Brazil is taxed at preferred rates, since the data do not consider the effect on fuel prices of the states' tax on the circulation of goods, interstate and intercity transport, and communication services (Imposto sobre Operações Relativas à Circulação de Mercadorias e sobre Serviços de Transporte Interestadual e Intermunicipal e de Comunicação, ICMS).

Despite policies to mitigate the impact of fuel taxes on transport, a recent study measuring tax costs as a percentage of the value added in land transport activities in Argentina (Rezk, 2004) gives interesting results. Taking into account all federal, provincial, and local taxes, as well as fiscal benefits, the tax burden of a typical Argentine transportation firm is equivalent to 26 percent of its value added. This finding underlines the need for further microeconomic analysis of effective tax rates in the region.

Taxes on external trade also vary greatly. The case in point here is Paraguay, whose fiscal dependence on revenues from export and import taxes is remarkable. A recent reform in tax legislation aims to improve domestic taxation in order to make it possible to reduce the importance of foreign trade taxes in the government budget. But it is unlikely that significant changes can be made in the short run.<sup>11</sup> Export and import taxes are of residual significance in Brazil, but that does not mean that foreign trade is exempt. Exporters still face difficulties in recovering states' taxes on inputs, the impossibility of deducting local taxes on services, and the duality of the rules applied to the new PIS/COFINS. The latter's incidence on imports raised the tax burden on foreign goods and services, although it helped bring about fair treatment of foreign and domestic goods in the Brazilian market.

In Argentina, the reintroduction of export duties—which apply mainly to agricultural goods—serves a double purpose: to reinforce the federal budget and to induce the aggregation of value to their exports.

Under the federal VAT, exports are exempted and imports are taxed at the local rate (destination principle). Exports are indirectly taxed by the provincial governments and by levies on fuel and electricity, but this burden is partially offset by a federal arrangement to give back money to exporters.<sup>12</sup> The situation in Uruguay is almost the same as in Argen-

**Table 8.1 MERCOSUR: Excise Rates**  
(percent of the sales price)

	Argentina	Brazil	Paraguay	Uruguay
Tobacco	60	75	4–7	n.a.
Whisky	12	130	5–10	n.a.
Beer	4	80	5–10	n.a.
Wine	0	30	5–10	n.a.
Mineral water	4	0–30	5–10	n.a.
Gasoline	62	27	38	48
Diesel	19	16	21	8

Source: Alarcón (2005).

<sup>11</sup> A description of the main provisions of this reform can be found in Alarcón (2005). One important aspect of this reform is the introduction of a personal income tax in Paraguay.

<sup>12</sup> The “export drawbacks” are a percentage of the exports' FOB price set by the Finance Ministry, using information provided by business organizations. They cover part of the export tax costs and benefit higher value added products.

tina, except that there are no provincial governments.

A study (Rezk and Rezende, 2003) on the tax burden borne by three important products of Brazilian and Argentine agribusiness—soya (beans and oil), chicken, and beef—provides empirical evidence of the surprises encountered in a detailed microeconomic study of tax

differentials. Contrary to what an examination of the tax legislation in the two countries might suggest, taxes on the domestic consumption of beef and chicken are lower in Brazil, while exports of chicken and soya are more heavily taxed in Argentina (Table 8.2). The main explanations for these results are as follows:

- (i) Differences in VAT rates explain most of the divergence in the tax burden on domestic sales. While Argentina has a general VAT with few exceptions, the federal states' VAT in Brazil does not cover the service sector and the federal VAT does not apply to the goods concerned. Moreover, the Brazilian states' VAT varies according to where primary production and final consumption occur, because of differences in the rates applied to interstate sales and because of incentives to producers.
- (ii) With respect to exports, the higher effective rates for Argentine products reflects the export duties applied and the provincial turnover tax.

### *Capital Taxes*

Every comparative analysis of the use of income taxes in MERCOSUR calls attention, at the outset, to an important divergence: whereas Brazil and Argentina tax income at both the corporate and the individual level, Uruguay, and (until recently) Paraguay,<sup>13</sup> do not have a comprehensive system of personal income taxation. This alone is a significant problem in dealing with proposals for harmonizing income taxes in MERCOSUR.

To Barreix and Villela (2003), these circumstances demonstrate distinct preferences among big and smaller economies in the region. A greater domestic market may have induced Brazil and Argentina to coordinate capital taxes and development policies in order to attract investment. Uruguay and Paraguay, on the other hand, opted to attract foreign savings through favorable treatment of capital income and the maintenance of a regime that protects investors' identities.

**Table 8.2 Effective Tax Burden on Agribusiness Products**  
(total tax cost as a ratio of sales price)

	Soya beans	Soya oil	Beef	Chicken
<b>Domestic sales</b>				
Argentina	0.4350	0.2273	0.2130	0.2336
Brazil	0.1532	0.1790	0.1093	0.1517
<b>Exports</b>				
Argentina	0.2569	0.2032	n.a.	0.1171
Brazil	0.0828	0.0649	n.a.	0.0364

Source: Rezk and Rezende (2003).

<sup>13</sup> A tax reform in 2004 left Uruguay as the only MERCOSUR country with no personal income tax.

This tells only part of the story. Differences in approaches to the corporate income tax, and in provisions for assessing tax liabilities, are important for investors. Brazil and Argentina tax global income (that is, all local businesses are taxed on income they generate inside and outside the country), whereas Uruguay and Paraguay tax only income from local sources. Subsidiaries of multinationals are taxed on the same basis in all countries (in Brazil and Argentina, they are liable only for the income they generate within their territories). At first glance, and assuming all else equal, this could give incentives to footloose manufacturing producers and high-tech services to move their headquarters to Uruguay or Paraguay, in order to benefit from a more favorable income tax environment.

Rates do not differ by much,<sup>14</sup> but some provisions that affect the after-tax rate of return on investments are worth noting. In particular, it is important to consider:

- (i) The method adopted to avoid double taxation through corporate and personal income taxes
- (ii) The rules applied to capital gains and shares
- (iii) The joint corporate and personal income taxes on profit distribution
- (iv) Provisions for dealing with transfer prices
- (v) Investment incentives through tax holidays, accelerating capital depreciation, or other forms of fiscal benefits

Apart from the global-source approach divide, there are no significant differences in provisions for assessing taxable profits. Of some importance are the distinct rules applied to interest, dividends, royalties, and technical assistance. Brazil and Argentina adopt similar criteria on payments to foreigners (dividends, interest, and technical assistance) while the other countries apply rates that vary from 10 percent to 17 percent (Paraguay) and from 0 percent to 30 percent (Uruguay). Uruguay does not tax interest paid to foreigners.

More important, however, are the rules applied to avoid double taxation of capital income. While interest is exempted from the personal income tax in Argentina, it is subject to a 15 percent tax in Brazil. Both countries exempt dividends at the personal level so as to avoid double taxation. Capital income received by residents is wholly exempted at the personal level in Uruguay (which does not apply a personal income tax), but dividends paid to foreigners are taxed. Paraguay also taxes dividends paid to foreigners and will tax capital income received by residents through a new personal income tax.

Differences in the rules applied to dividends, interest, and retained profits are important from the viewpoint of both firms and individuals. The way interest and dividends are taxed at the corporate and individual levels affects savings options and the prospect of inducing market capitalization to finance private investment. By not taxing capital income at the individual level, or interest paid to foreigners, Uruguay gives a remarkable incentive to financial institutions and savings. Paraguay has similar rules to those applied in Uruguay,

<sup>14</sup> Rates are 35 percent in Argentina, 34 percent in Brazil, and 30 percent in Paraguay and Uruguay.

but a more fragile institutional setting does not have similar effects on its financial system. Taxing interest and dividends at source, as in Brazil and Argentina, lessens the impact on savings entailed by the Henry-Simons approach to income taxation: add all income sources regardless of their nature before applying the progressive scale for assessing the tax due at the individual level.

A reform of Brazilian income tax laws implemented in the second half of the 1990s introduced changes that sought to redress the balance in the treatment given to interest and dividends. The reform allowed businesses to deduct interest on their own capital, as well as dividends, in assessing the taxing of profits. Hence the incentive that previous rules provided to finance new investment through debt disappeared, as capitalization and debt financing began to be treated equally for income tax purposes. The Brazilian legislation attempted to reduce the burden on investment and savings, along with the exemption granted to dividends and the sole taxation of interest at source.<sup>15</sup>

Despite provisions to avoid the double taxation of capital income, underdeveloped regional capital markets offer firms little alternative to finance investment, apart from resorting to debt. Big businesses could also rely on reinvesting their own profits, but this option may conflict with shareholders' interest in receiving dividends. The issuance of new shares is constrained by the size of capital markets. Besides narrow options for investment financing, the income taxes applied in the region give an additional impulse to borrowing, since interest on debt is fully deductible in assessing the taxing of profits. Brazil's income tax reform sought to obviate this incentive to indebtedness at the business level, but without adequate conditions to enable reliance on other sources of financing, capital enlargement did not noticeably change the situation.

Incentives to investment have been used widely, notably in Brazil and Argentina, but have waned in importance as tax rates fell, simplified procedures were adopted to assess and collect income tax, and industrial policies went out of fashion. All the MERCOSUR countries have a simplified tax regime for small businesses. It has evolved to a flat rate on total sales, and replaced both consumption and income taxes. But this is not the only case. Brazil expanded the number of firms entitled to a simplified income tax system by raising the ceiling for opting to use a presumptive regime to assess corporation income tax liabilities.<sup>16</sup>

The room for incentives was narrowed by reducing the number of firms that are required to submit tax returns showing how profits are measured and how the amount of tax due is set, and by expanding simplified rules at a time when the MERCOSUR economies had lost dynamism. Tax holidays for investment in low-income domestic regions persisted, but this had little effect on the government purse because of a lack of investment. Coupled with changes in the conditions that have a crucial influence on location decisions concerning big

<sup>15</sup> Critics of this reform point to the possibility of shifting the tax basis of multinational corporations to their countries of origin.

<sup>16</sup> Under this regime, firms whose annual sales do not exceed 24 million reais (about \$8 million) can opt to pay a fixed percentage of their total sales as a substitute for the regular business tax regime.

investment projects, income-tax-based incentives for investment have not had much influence in the last two decades.<sup>17</sup>

Transfer prices are a case in point. Recently, Brazil and Argentina adopted legislation to deal with problems created by the increased activities of multinational firms in the region. Thus far, Uruguay and Paraguay have not implemented any rule on this matter. Critics of the Brazilian legislation point to the arbitrary nature of the country's rules, which deviate from the norms adopted in the United States and from those enforced in the EU. Argentina's legislation resembles that of the EU. But, as in Brazil, its implementation suffers from tax administrators' lack of experience in dealing with a very complex and novel situation.<sup>18</sup>

Overall, property taxes are not particularly important in the region. A general wealth tax is imposed on businesses and individuals only in Argentina and Uruguay. Argentina also taxes assets held in foreign countries (shares, bank deposits, real estate, and so forth), while Uruguay only taxes assets held in the country. Rates vary from 0.5 percent to 0.75 percent (Argentina) and from 0.7 percent to 3 percent (Uruguay). The tax on businesses' assets in Argentina can be deducted from the corporate income tax and can be seen as an effort to curb tax evasion. Argentina applies a tax on rural and urban properties at the provincial level. Urban real estate is taxed at the local level in all countries except Argentina, and is particularly important in Brazil because of Brazilian municipalities' high degree of political and fiscal autonomy. Apart from the burden on big rural landowners in Argentina,<sup>19</sup> which may adversely affect rural production, property taxes are not a significant problem for tax harmonization in MERCOSUR.

### ***Labor Taxes***

Labor is taxed in two main ways: through social security contributions and personal income tax. With regard to the former, Argentina and Uruguay reformed their social security systems to cut present and future deficits by limiting the responsibility of the public budget in social security financing. Payroll taxes fell in Uruguay as a result, but they remained very high in Argentina, as is evident from Table 8.3.<sup>20</sup>

Combining the figures for the social security wage tax and the rates for personal income tax, it is apparent that taxation of labor incomes in Brazil, Argentina, and Uruguay is as great as might be expected for low-income brackets. In Brazil and Argentina, wages are taxed at

<sup>17</sup> It is important to make clear that the "fiscal war" among Brazilian states to attract investments did not rely on income taxes (which are not under the states' fiscal jurisdiction) but on the possibilities offered by the mixed origin-destination principle applied to the states' VAT. See Rezende and Afonso (2001).

<sup>18</sup> For a brief account of the differences between Brazilian and Argentine legislation see Amaral (2000).

<sup>19</sup> Rezk and Rezende (2003) show that the tax on rural property accounts for 2.4 percent of the domestic sale price for beef and 5 percent of the soya price in Argentina.

<sup>20</sup> González Cano (2003b) draws attention to the fact that the actual rate can be much lower in some Argentine provinces, since the federal government gave incentives to employment in backward regions through lower payroll taxes (the reduction could be as high as 40 percent). The extent of the Uruguayan reform can be seen in the high rates for the social security wage tax.

26 percent. It is interesting to note that even though Uruguay does not impose a broad-based personal income tax, labor is taxed at a rate that is not very different. In fact, the top rate for the social security wage tax in Uruguay is similar to that imposed on Brazilian and Argentine workers.

**Table 8.3 Payroll and Labor Taxes**

	Payroll Tax (percent)	Wage Tax (percent)	Personal Income Tax (percent)
Argentina	32.0	7	9–35
Brazil	31.5	8–11	15–27.5
Paraguay	16.5	9.5	—
Uruguay	18.5	19.25–24.25	—

Source: Based on data from González Cano (2003b).

**Concluding Remarks**

As shown above, indirect taxation in MERCOSUR includes a set of taxes that are similar in appearance but distinct in nature. Differences in approaches to VAT and the overlapping of other taxes make it impossible to appraise the actual burden on goods and services in the region without a detailed microeconomic study. That being so, tax costs cannot be properly adjusted at the borders, and thus distortions in intraregional trade will not be easy to correct. Recent changes in Brazil with regard to the federal social security contribution, as well as the prospect of a uniform state VAT in the future, give hope for some progress, but a rapid advance toward a more harmonized system of indirect taxes cannot be expected.

As regards direct income taxes, a *de facto* distinction between the treatment of capital and labor incomes in the region, albeit for distinct purposes and reasons, suggests it might be possible to reduce the impact of present asymmetries on decisions related to the allocation of savings and investment.<sup>21</sup> That will be the case if gradual moves toward a dual-income tax approach, along the lines of the proposals being discussed in the EU, yield results in the foreseeable future.

Because of lower mobility, asymmetries in the taxation of labor income are not so important for the deepening of integration. But more attention might have to be paid to the issue of eliminating social security barriers to the mobility of skilled workers within the bloc.

<sup>21</sup> Note that the growing importance of multinational corporations calls attention to the need for common rules to deal with transfer pricing. Genschel (2001) points out that even though econometric studies on the effect of high tax rates on FDI show that this effect is weak in terms of size and statistical significance, “this does not mean that companies do not avoid taxes. They just take another route to avoidance. Instead of relocating real activities to low-tax jurisdictions, multinational companies manipulate commercial and financial exchanges within the company to shift paper profits out of high-tax environments and into low-tax jurisdictions. For example, to reduce the taxable profits of a subsidiary in a high-tax country, affiliates in less tax-heavy locations will charge inflated prices for deliveries to this subsidiary and pay deflated prices for deliveries they receive from it (transfer pricing).”

## Main Reasons for Tax Differentials

The foregoing description of the main characteristics of the MERCOSUR countries' tax systems includes some facts that aid understanding of the differences pointed out earlier. This is not enough, however, to provide a greater appreciation of the challenges that will have to be faced in overcoming the barriers to tax harmonization. It is worth considering the main reasons for the tax differentials.

Macroeconomic fiscal policy plays an important role in explaining recent changes in MERCOSUR tax systems. As mentioned earlier, the fiscal adjustment of recent years relied heavily on turnover, export, and other inefficient taxes. That circumstance makes it difficult to appraise the actual tax burden on distinct products and services. It also makes it impossible to adjust taxation at the borders, so that—regardless of origin—goods and services can be taxed at the same rates in regional and domestic markets.

It is far from clear, at this point, how the requirements for maintaining fiscal responsibility will be met in the near future. So far, efforts to restore fiscal discipline in MERCOSUR have varied within the region. Recently, Argentina has adhered to orthodox means of generating fiscal surpluses in order to avert further public indebtedness. In Uruguay, interest on the public debt has tripled since 2000, reaching 6.2 percent of GDP in 2003 and adding stress to an already tight budget. Public indebtedness also grew in Paraguay, to 45 percent of GDP—up from 32 percent at the beginning of the past decade. In tandem with a deterioration in the tax base, this helped transform an 8 percent primary surplus in Paraguay's public accounts in 1990 into a 1.8 percent deficit in 2002 (Alarcón, 2005). Brazil, which has been following a very conservative fiscal policy since 1999, still has not managed to put the public debt-to-GDP ratio on a downward trend, despite achieving even higher primary surpluses in the past five years.

High ratios of public indebtedness and uncertainties about domestic reactions to changes in the world economy (the twin deficits and trade protectionism in the United States, fears of a hard landing in China, oil prices, and terrorism)<sup>22</sup> may not leave much room to relax fiscal policy in the foreseeable future. The prospects that the tax burden ratio can be reduced in Brazil or that further increases elsewhere can be avoided are slight. Of course, some maneuvering room could arise from a firm approach to cuts in public spending, but legal entitlements and political opposition make this alternative unlikely. Changes, therefore, may come more from efforts to replace inefficient turnover, export, and financial transaction taxes for value-added models of taxation. Higher rates of domestic economic growth may help improve the quality of MERCOSUR tax systems and enhance the prospects for tax harmonization in the region.

Fiscal macroeconomics explains MERCOSUR's recent retreat from tax modernization, but there are other important reasons for the member states' different approaches to taxation. Paramount among these is the peculiar circumstance that MERCOSUR is an economic bloc

<sup>22</sup> In a recent analysis of international economic conditions, the director of the Institute for International Economics, Fred Bergsten, advanced some reasons to worry about the likely effects of international crises on emerging economies. See *The Economist*, September 11, 2004.

formed by two large federal countries and two small unitary countries. The usual difficulties faced in uniting economies that differ greatly in size are matched by the MERCOSUR states' distinct political natures and the specific problems which that creates for tax harmonization.<sup>23</sup>

Because of the constitutional division of tax powers and differences in the degree of subnational autonomy to tax, decisions on the harmonization of MERCOSUR tax systems do not depend on the will of federal authorities in Argentina and Brazil. Every change in legislation is subject to negotiation in parliament, where state or provincial governors and mayors have a strong influence. Matters are complicated in Brazil, given the states' control over the most important VAT, the municipalities' power to tax services, and the greater fiscal autonomy of state and local government relative to Argentina's provinces and, especially, its municipalities.

Note, moreover, that in both cases it is not enough to look at the constitutional division of tax powers. Because of the complex nature of fiscal federalism in Argentina and Brazil, any change in tax legislation must also be examined from the viewpoint of its consequences to the vertical and horizontal distribution of tax revenues, as they affect the transfer of resources within the federation. For example, although income taxes are solely the responsibility of the federal government in Brazil and Argentina, any proposal that leads to a fall in income tax revenues will reduce the resources flowing into the budgets of state and local governments, thus prompting reactions from them.

Fiscal federalism is behind structural differences in MERCOSUR taxation. One important difference is evident from a comparison of the bloc's two biggest economies. In Argentina, a turnover-type tax provides support to provincial budgets, while the federal government relies more on a broad VAT. In Brazil, the most important VAT is in the hands of the states, while the federal government relies on two distinct kinds of VAT to cover its budgetary needs. The unique position of Brazilian municipalities explains the division of the tax base: goods are taxed at the federal and state levels, while services are taxed at the federal and local levels. This poses a formidable obstacle to the adoption of a uniform, broad-based VAT in Brazil.

In Uruguay and Paraguay, historical developments and different approaches to the role of the state have contributed to differences both between the two countries and between them and the other member states. Paraguay, as a less developed economy and a weak state, kept the tax ratio at low levels in a period when many Latin American countries embarked on government-sponsored industrialization and copied generous European welfare policies. Hence foreign trade taxes—the usual source of budget revenue in less developed economies—retained their dominant position in Paraguayan public finances, despite efforts to diversify

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<sup>23</sup> It is interesting to note that the German federal regime did not pose great difficulties for tax harmonization in the EU, given the uniform tax rules applied throughout the German federation and the federal government's control of tax legislation. Moreover, economic disparities among the six original members were not as great as those in MERCOSUR. Whereas difference in per capita income among EU countries was not more than twofold in 1962 (Dosser, 1967), recent data for MERCOSUR from the Economic Commission for Latin America and the Caribbean (ECLAC) show that per capita income in the region differs by sixfold.

revenue sources. In Uruguay, a developed, rural-based economy in the first half of the past century allowed the implementation of a very generous welfare state that still impinges on efforts to cut public spending.

More recently, all MERCOSUR tax systems have been infected by the “easiness” virus. Fiscal authorities were pressed to restore fiscal discipline and avoid an uncontrolled expansion of public debt in a context of inefficiencies in the tax administration. They turned to old-fashioned kinds of tax whose main features are ease of collection and less susceptibility to political opposition. The options were similar but the consequences were not. Since it is impossible to assess with even minimum confidence the real burden of these taxes on each good and service in each country, there is no way of attaining a harmonization in which cross-border trade allows resident consumers to pay the same tax, regardless of where the goods are produced.

### **Tax Harmonization Goals and MERCOSUR’s Challenges**

Tax harmonization processes pursue four important goals:

- (i) To set the stage for the free movement of goods and services within the region
- (ii) To avoid interference in decisions on the location of economic activities in MERCOSUR
- (iii) To eliminate barriers to labor mobility
- (iv) To be neutral to the mobility of financial capital

Not by chance, the harmonization of indirect taxes on goods and services is seen as the second important step—after a reduction in import duties—toward an economic union. If domestic taxes impinge on free trade within the region, they block the process of economic integration. That is why the EU drew up a timetable on the harmonization of indirect taxes from the outset, and took vigorous steps to ensure its implementation.

As has been pointed out repeatedly, the harmonization of indirect taxes does not call for a uniform set of taxes or uniform rates. It does require that any good or service be taxed at the same rate in the jurisdiction where it is consumed, regardless of its origin. To this end, all exports must be wholly exempted from indirect taxes, and all imports have to be taxed at the corresponding domestic rate. This proposal can be expressed simply, but its implementation is difficult.

Some of the challenges that MERCOSUR countries face in harmonizing their taxes were mentioned in the previous section, but, at this point, it is important to highlight the main difficulties.

### ***Macroeconomic Fiscal Targets***

The first challenge is the subordination of tax measures to macroeconomic stabilization policies. The hard budgetary constraints imposed by macroeconomic goals, together with mounting

pressures to raise public spending on infrastructure and social programs after years of tight expenditures, do not inspire confidence about the outcome of any suggestion to reduce tax collections—quite the opposite. Brazil began to apply conservative fiscal policies early and managed to increase the aggregate tax burden by ten percentage points in the 1998–2003 period, but the other MERCOSUR countries have moved slowly or not at all in that direction. Between 2000 and 2003, the ratio of tax revenues to GDP increased by two percentage points in Argentina, while the tax burden ratio remained stable in Uruguay and Paraguay.<sup>24</sup>

Keeping tax revenues at the levels required to sustain macroeconomic targets raises a dilemma. Taxes that are efficient from the viewpoint of tax administration (those that generate substantial revenue with low administrative and political costs) are very inefficient from an economic perspective and are not conducive to harmonization.

### Greater Reliance on Income Taxes

One possible means of reducing the dependence on low-quality consumption taxes without compromising macroeconomic fiscal targets is to make better use of income taxes. In MERCOSUR, income taxes are not particularly important for the public budget (except in Brazil) but their impact on corporations and on investment decisions cannot be disregarded. Argentina recently adopted measures to improve personal income taxation, although those measures have not yet had a significant impact. Suggestions for a general income tax on individuals have been made in Uruguay, but there is no official proposal in that regard (Barreix and Roca, 2003). Recent legislation in Paraguay introduced a personal income tax at modest rates. According to Alarcón (2005), an important goal of this tax is to curb evasion by inducing taxpayers to collect receipts on all families' purchases, since these expenses can be fully deducted.

From the viewpoint of tax harmonization, circumstances in the area of income taxes differ from those in the area of the indirect taxation of goods and services. First, full harmonization of income taxes requires the harmonization of tax bases and rates. Second, the technical conditions needed for progress on this front are more easily achieved than those required for the harmonization of indirect taxes. Third, political opposition is easier to overcome, because subnational claims are not strong and equity considerations provide support. Fourth, new proposals to move away from the Henry-Simons model for personal income tax and return to a scheduled regime are gaining support.<sup>25</sup>

New approaches to income tax stem from the impact of the globalization of capital markets. For some time, Norway and Finland have had a dual income tax regime whereby capital income is taxed at a preferential rate and is not subject to the progressive scale applied to personal income taxes. High marginal rates for personal income taxes in the Nordic countries were the main reason for this measure, since a higher burden on capital income

<sup>24</sup> It is not unlikely that those that stayed behind will join the tendency for an increase in the tax burden ratio in the region to fulfill fiscal adjustment targets.

<sup>25</sup> This proposition has been made by Vito Tanzi and has gained new supporters recently. See Tanzi (1995).

would lead to capital flight. Proposals have been made for the adoption of a dual income tax in the EU, with a view to facilitating the harmonization of European income taxes (Cnossen, 2003).

The arguments used to sustain the Norwegian position are similar to those in Uruguay and Paraguay: small, open economies cannot tax capital income under a progressive personal income tax, since that would lead to capital flight. Hence the rate of the income tax at the individual level cannot exceed the rate applied to corporate income. This new approach to capital income taxes opens up new possibilities for income tax harmonization in MERCOSUR.

In practice, if not in legal terms, the regime adopted in Uruguay resembles a dual income tax approach. Corporate income is taxed at a rate not far from the MERCOSUR average, and personal capital income is untaxed. Brazil and Argentina, for their part, tax dividends at source only. Interest is exempted from the personal income tax in Argentina. In Brazil, it is taxed at source only.

A dual approach to income tax also reduces the burden on tax administrators. Taxing both labor and capital income at source lowers the cost of administering income taxes and offers more room for harmonizing income tax regimes in economic unions.

### Tax Harmonization and Fiscal Discipline

Since the harmonization of indirect taxes does not imply unification, the impact of harmonization on fiscal discipline is limited—although it may increase as the economies become more integrated. Having a broad-based VAT as the main revenue source throughout MERCOSUR does not impinge on the autonomy of member states in altering their tax rates. Thus, governments can raise revenues by increasing VAT rates to avoid fiscal deficits, provided that the tax costs are fully adjusted at the borders. But they can also do the opposite—cut rates to boost political support in preelection years.

Of course, the freedom to change rates has its own limits. If deficits continue to grow, tax rates cannot rise forever. Moreover, if tax costs differ too much, producers can move plants to less profligate neighbors, provided that transportation costs do not surpass tax gains.<sup>26</sup> In addition, it can be said that the harmonization of indirect taxes contributes to sound fiscal policies in the medium term, since it precludes the option of financing a spending spree in order to win elections through turnover or financial transactions taxes. The only space open, apart from VAT, is that which is held by a few excises, which will also have to face the discipline imposed by cross-border trade if differences in rates are large.

With respect to income taxes, two distinct situations should be noted. Full harmonization of corporate income taxes requires equal bases and rates, thereby making individual actions impossible. Higher discretion may be applied in the case of personal income taxes, because of

<sup>26</sup> González Cano (2003a) mentions the sixth directive of the European Commission, which imposed restrictions on EU members regarding VAT rates. The basic rate cannot be lower than 15 percent and the floor for reduced rates applied to basic goods was set at 5 percent. The average rate is now 19.4 percent; Luxembourg (15 percent) has the lowest rate and the Nordic countries (25 percent) the highest.

low labor mobility. Despite constraining the member states' autonomy, the harmonization of income taxes is related more to competitiveness and fairness than to fiscal discipline.

### ***Improve Tax Administration and Exchange Information***

It should be stressed that the path toward tax harmonization intersects, from the outset, with immediate actions to increase efficiency in tax administration. Despite programs that have been implemented in MERCOSUR to enhance the use of information technology for tax administration purposes, the overall picture is unsatisfactory. This suggests that a calendar for harmonizing indirect taxes will have to take the need for administrative improvements into account.

In theory, a broad-based VAT could generate the same revenue as that collected through other, less economically efficient taxes on goods and services, provided good information is available to assess the proper rates. In practice, the problem is different. First, the information needed is unavailable, which makes it difficult to substitute turnover taxes for VAT without creating distortions. This was borne out by Brazil's recent experience with the implementation of noncumulative rules for COFINS. Second, even if proper information to assess the rates could be collected, tax substitution entails a significant change in the distribution of the tax burden; sectors with short production cycles face a significant increase in taxation to allow for a reduction in the tax-burden ratio of those with long production cycles (in general, services are severely hit). Hence the likelihood of political reactions to these changes cannot be disregarded, and ad hoc adjustments may be made to calm the reactions.<sup>27</sup> Third, even if these reactions could be overcome, the quality of the tax administration is paramount to ensure that rates are not set too high in order to guarantee revenues against possible miscalculations. Good administration is even more critical in light of the importance of small businesses in the MERCOSUR economies, and the attendant difficulties involved in administering a VAT.

Wide differences in administrative capacity are also a source of tax asymmetries. As mentioned earlier, the harmonization of indirect taxes would seek to move away from the recent trend in MERCOSUR to rely on more easily collected taxes, in order to meet the macroeconomic goals of fiscal responsibility. Substituting a broad-based consumption VAT for the economically inefficient turnover, foreign trade, and financial transactions taxes requires less uneven conditions for enforcing a truly neutral VAT. It is not enough to attain harmonization in purely legal terms. Distortions will arise if taxpayers are not treated on a more or less equal basis.

Two situations can be envisioned. In one, there is unfair competition in the markets for goods and services between organized firms, as well as informal activities that are usually found in an environment that is more conducive to firms' expansion through their evasion of

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<sup>27</sup> Strong reactions from nontradable service sectors to the first version of the legislation adopting a value-added mechanism for collecting Brazil's COFINS extended the list of activities that remained outside the new regime so as to avert substantial increases in their tax burdens. The ad hoc adjustment process meant further economic distortions.

tax obligations. In the other, big business can thrive in a context where the sophistication of organizational structures and financial markets face administrations that lack the resources and skills to audit accounts properly.

Informal activities may expand in less developed administrative settings, but at the cost of leaving governments with a small budget to foster economic development. Moreover, poor administration may spur differences in effective tax rates because of improper functioning of the credit mechanism for collecting VAT. As a result, goods produced in a less efficient environment may lose competitiveness in both domestic and regional markets, since tax costs will not be fully adjusted at regional borders. Different administrative capacities in a context of harmonized tax legislation may thus lead to wider regional disparities.

Conversely, geographic limits do not constrain big businesses from benefiting from differences in administrative capacities. Multinational groups may look for ways of improving after-tax profits by moving their headquarters to places where legal practices geared to reducing the tax base (transfer prices, for instance) are less subject to controls. But this does not help diminish economic disparities, because production-location decisions are more concerned with market size, quality of the labor force, good infrastructure, and better institutions.

Because divergences in tax administration capacities will put even greater pressure on huge regional disparities in the wake of tax harmonization, priority should be given to implementing a regional project that brings about the convergence of the MERCOSUR countries' administrative capacities in fiscal matters. To that end, the experience of the Inter-American Center of Tax Administrations (CIAT) might be helpful.

In a recent appraisal of Latin American countries' inefficiencies in tax administration, a former CIAT director, Claudino Pita, stressed the importance of good tax administration in a context of technological changes that create new patterns of production and consumption, and that give further momentum to economic globalization.

Pita (2004) pointed out that improvements in tax administration are complex. They have to be tackled as part of a broad plan to address distinct dimensions of the problem, such as organization, management, human resources, tax procedures, technology, and information systems. All of the problems have to be tackled in a balanced and integrated manner that considers the legal framework. In Latin American countries, he said, some progress is evident in the use of information technology for operational purposes, but little has happened in the areas of human resources and management.

As regards the role of administration in tax harmonization, information exchange and the integration of registers should be addressed. Whatever procedure is used to adjust the fiscal burden at the borders (a full destination principle or an origin principle, coupled with a clearing mechanism to redistribute the tax collected at the border), important conditions for proper tax harmonization are joint information systems and member states' access to them.<sup>28</sup>

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<sup>28</sup> It is worth noting that in moving toward deeper integration, the Andean countries took concrete steps to harmonize VATs and excises in the region (Gaceta Oficial del Acuerdo de Cartagena, July 2004). They are also paying special attention to the role of the exchange of information in this process. Uruguay will have to change its tax code to allow for the exchange of information within MERCOSUR.

The call for tax administrators to exchange information has become louder as globalization has advanced and multinational enterprises have expanded their activities worldwide. Several attempts have been made to design models that include rules for information exchange, through either bilateral or multilateral agreements. Four of these models have been analyzed: those of the Organisation for Economic Co-operation and Development (OECD), the United Nations, the Andean Pact, and CIAT (Pita, 2003). Over time, these models evolved from being mainly concerned with the old issue of avoiding double income taxation toward greater awareness of the need to obviate tax avoidance and evasion. Despite this progress, information exchange was confined to taxes that are the specific object of the agreements.

New economic conditions and deeper economic integration suggest a need for another step forward. Agreements are required that are mainly concerned with the exchange of information on all taxes, and on means of dealing with the challenges that globalization poses to tax administrators, as methods of tax evasion become more sophisticated. Moreover, as Pita pointed out, international agreements on the avoidance of double taxation include clauses on the exchange of information related to income and property taxes; they do not address the indirect taxes that are of such importance for economic integration.<sup>29</sup>

In moving towards deeper economic integration, the MERCOSUR countries should take immediate steps to reach a multilateral agreement on the exchange of information. To that end, they can benefit from the work of CIAT. For two decades, CIAT has brought together experts in this field to devise a general framework for a broad agreement on information exchange, one that could be used throughout Latin America and the Caribbean. This framework is monitored by a permanent working group that could advise MERCOSUR on the matter.

An important contribution to any project on information exchange is the establishment of a joint data system based on compatible technological platforms. In this regard, MERCOSUR will have to tackle problems that stem from the federal structure of its two biggest member states. Brazil's situation is unique; taxpayers face several tax jurisdictions, each of which has its own rules on the identification and ancillary obligations of taxpayers, as well as on auditing tax returns. Efforts to integrate federal and state tax administrations have thus far failed. Lack of integration and cooperation among federal and provincial tax authorities is also the case in Argentina, but this is less harmful for tax harmonization because of the lesser importance of provincial taxes in Argentine public finances.

All the challenges that MERCOSUR faces in undertaking smooth tax harmonization arise from tax administration. Without initial steps to disclose and share information, improve the training of tax administrators, expand the use of information technology, and create better conditions for the enforcement of tax laws, the process might move forward—but only slowly and with uncertain results.

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<sup>29</sup> Pita (2003) notes some recent advances in this direction: the 1988 OECD multilateral agreement, the 1991 Nordic agreement, the 1990 Mexico-Canada-United States agreement, and some bilateral agreements between Central American and Caribbean countries with the United States.

## *Federalism and Regional Disparities*

Fiscal federalism, together with regional domestic inequalities in the main MERCOSUR economies, poses a significant challenge to tax harmonization. The difficulties involved in moving toward a uniform VAT on the consumption of goods and services in Brazil have to be considered against the background of sharp antagonisms in the federation. There are two main divergences: the different preferences of developed and less developed states and municipalities as regards the balance of tax powers and transfers in subnational finances; and competition among states and local governments to attract economic activities through tax benefits. A shared, uniform VAT might resolve these conflicts, but it is not feasible without a profound reform of Brazil's fiscal federalism and a new approach to regional development policies.<sup>30</sup> Regional disparities are almost as great in Argentina, but its provinces have less autonomy to tax, and its municipalities play a very small role, leaving the federal government freer to push for harmonization. Nevertheless, the federal government's difficulties in negotiating changes to the coparticipation law make it clear that fiscal federalism in Argentina also poses a significant challenge to tax harmonization in the region.

Centrifugal forces springing from economic openness and financial globalization will push the issue of regional inequalities further up the agenda for deeper integration. Two studies on the prospects for wider regional disparities in Brazil and Argentina in this new international context merit careful attention. Haddad, Domingues, and Perobelli (2002) analyze the Brazilian case and call attention to the prospect of Brazil's regions moving away from the convergence in per capita income evident up to the mid-1980s. From a different standpoint, Kacef (2002) shows that the impact of the FTAA and trade integration with the EU will not change the already high concentration of economic activity in Argentina, which could even rise because of the regional concentration of imports. Simply put, fiscal federalism and regional policies should be treated as intertwined issues.

Federalist grievances are reinforced by asymmetrical economies. Both circumstances make it hard to harmonize taxes, but at the same time they are negatively affected by the lack of harmonization. The present tax differentials foster the concentration of production units in large markets, where they can benefit from economies of scale that may allow them to compete outside domestic borders. If goods and services were allowed to move freely inside the region, the relevant market for investment decisions would be the region as a whole, rendering the size of domestic markets irrelevant.

To date, the smaller economies have sought to counteract the advantages that the larger economies have in attracting investment by using special tax regimes for capital income that benefit financial activities but have little effect on the economy as a whole. The real ques-

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<sup>30</sup> The successive failure of proposals to apply uniform rules for the states' ICMS can be ascribed to fears of opening a sensitive debate on the pitfalls of Brazil's system of fiscal federalism. The present system is rooted in the 1967 tax reform but partial changes over the last four decades have brought about vertical imbalance and erratic horizontal fiscal disparities. To achieve better and faster results in further tax reform rounds, a full revision of the fiscal federalism model will have to be considered.

tion is what they should do while the region moves toward deeper integration. Should they maintain this policy until MERCOSUR becomes a fairly free regional market? In the past, the answer would have been yes. Now, the answer is less certain. Development policies that generate enclaves and that do not bring long-run benefits may be rendered ineffective by the liberalization of capital markets and competition to attract foreign capital.

To deal with the challenges MERCOSUR faces in achieving deeper integration, tax harmonization will have to tackle indirect and direct taxes simultaneously. Indeed, a similar treatment for capital income, under the dual approach to income taxes mentioned above, may enhance the prospect of faster progress on the removal of indirect tax barriers to the free movement of goods and services in the region. Additionally, a supranational regional development policy should be implemented in tandem with tax harmonization, so as to help the smaller economies—as well as lagging regions in the bigger countries—draw level with the most dynamic areas of the bloc.

## Lessons from the EU

The model for appraising the prospects and shortcomings of tax harmonization is the EU. The EU is the most important example of a union of countries with a long history of military conflict and substantial differences in size and culture. It exemplifies a unique experience of overcoming pride and prejudice in the name of a common political project to build a union of nations with the economic power to rival the leading players in the international arena.

In retrospect, the EU's achievements are remarkable. In little more than half a century, the EU has incorporated more members, harmonized general consumption taxes, reinforced the supranational institutions, and adopted a common currency. Tax harmonization is still far from complete, but the process is under close scrutiny and is now focused on options for harmonizing excises and income taxes.

At the outset, the studies conducted to underpin the design of tax harmonization strategies navigated uncharted waters. In a pioneering study, Dosser (1967) argued that:

Theoretical studies of tax harmonization involve the theory of two fields of economics which have, in practice, proceeded quite separately, namely, public finance and international trade. The theory of public finance is commonly confined to a closed economy, as can be seen from Musgrave. International trade theory often disregards the public sector ... The possibilities for cross-fertilization of public finance theory and international trade theory are great and, indeed, are necessary for the study of tax harmonization. To a slight extent, customs union theory involves both areas, but is highly circumscribed on the public finance side since only one tax is considered, and the tariff in any case is a tax which is not usually looked at as a weapon for the multifarious functions and objectives of the modern budget, such as growth, stabilization and redistribution. Hence tax harmonization studies can be viewed as developing out of customs union theory, but with a much greater variety of budget policies allowed for, besides just tariff changes. Alternatively, it

can be seen as a development of public finance theory given a set of economies in open relationships with one another. Which path one takes or rather which point of departure in standard theory one chooses tends to color one's views on the basic meaning of tax harmonization, as we shall see later.

The tax systems of the first six countries that formed the European Economic Community (EEC)—now the EU<sup>31</sup>—were significantly different in several respects. The contribution of general sales taxes to total revenues varied from 16 percent in Luxembourg to 35 percent in France. The differences were also great as regards the importance of excises and income taxes in each country, as the data in Table 8.4 show. The figures reveal the importance of income and excise taxes and the modest contribution of customs income for the public revenues of the European pioneers.

The harmonization of indirect taxes was seen as the main priority, given the need to remove the barriers to the trade in goods and services within the bloc. Nonetheless, progress was slow at the beginning but gained speed later. By the late 1970s, a fairly harmonized general value-added consumption tax was in place. Following technical recommendations, the European VAT adopted the destination principle as a solution for the perfect adjustment of tax burdens in cross-border transactions. This solved the fiscal problem but required the preservation of physical controls at the borders.

Border controls, however, were incompatible with full implementation of the principle that goods, services, and people should be allowed to move freely in the EU. Hence the search for a means of removing border controls without harming the adjustment of taxes in commercial transactions among EU members.

After the abolition of border controls in 1992, a transitional regime was put in place whereby controls were shifted to the first purchaser in the importing country and became dependent on a reliable exchange of information. Since this was vulnerable to fraud, the search for alternatives has been on the European agenda ever since. After appraising these alternatives, Cnossen (2003) concludes that they either violate the principle of subsidiarity or lack proper enforcement. Moreover, he argues that insofar as none of them gives evidence that the transitional regime involves unmanageable frauds, it should be installed with improvements in the exchange of information.

**Table 8.4 Aggregate Tax Revenues in EEC Countries, 1959 (percent)**

	Sales	Excises	Customs	Income and Wealth	Total
Belgium	29	19	5	34	100
France	35	23	2	23	100
Germany	25	18	4	33	100
Italy	20	40	6	23	100
Luxembourg	16	15	4	49	100
Netherlands	19	13	8	54	100

Source: Prepared on the basis of data from Sullivan (1967).

<sup>31</sup> France, Germany, Italy, the Netherlands, Belgium, and Luxembourg.

Some progress was made on excises. In 2002, 90 percent of total excise revenues came from three products: tobacco, alcoholic beverages, and fuel. Further harmonization of excises raises questions of tax autonomy and environmental policies, although the current differences entail cross-border shopping. In view of these matters, it is unlikely that excise harmonization will be accorded priority on the EU tax harmonization agenda.

That position is now held by income taxes. If the harmonization of income taxes was not a significant matter when the countries of the EU embarked on unification, differences in the tax treatment of capital are a crucial issue today. The globalization of financial markets allows for the instantaneous arbitrage of financial gains, in which taxes play an important role. As mentioned earlier, this new circumstance is prompting reconsideration of old proposals for an overall progressive income tax, and has already provoked some changes.

It will be interesting to see how the EU deals with the impact of enlargement on tax harmonization. The recent spread of VAT in Eastern Europe makes matters easier in the field of indirect taxes, but income tax is an area more prone to conflict. Already, older members are complaining that low corporate tax rates in the newly acceding countries cause unfair competition for new investment. A 2004 account of corporate tax rates in the EU<sup>32</sup> notes that Poland and Slovakia reduced their basic rate to 19 percent, down from 27 percent in the former and from 25 percent in the latter. Hungary has a 16 percent rate and Estonia does not even levy corporate tax on reinvested profits. These rates are about half those applied in Germany and France.

Besides differences in rates, corporate income taxes in the EU have different tax bases. Dividends and interest received by residents are increasingly taxed at scheduled personal income tax rates, in the form of final withholding taxes (the joint taxation of capital and labor income at the personal level is losing ground). Cnossen (2003) lists some conditions that affect the effective tax rate on investment returns: the choice of financing (debt or equity); the corporate dividend policy; the form of investment (corporate or noncorporate); and the tax status of the recipient of the return (liable to personal income tax and/or the corporation income tax, or exempt). He concludes that in the EU, debt financing appears to be favored and individual investors are discriminated against.

An alternative means of addressing this issue—the adoption of a common tax base for corporation incomes across the EU, a matter discussed in the Bolkestein Report<sup>33</sup>—has been dismissed by Cnossen on several grounds. He argues that a dual income tax would be a much better option (Cnossen, 2003).

The new international economic context makes things a little more difficult for MERCOSUR. Whereas the EU could pursue tax harmonization slowly and in stages, MERCOSUR faces pressures to move fast and to tackle simultaneous issues on different fronts. The process of harmonizing indirect taxes in Europe took two decades to yield beneficial results and is incomplete. To date, no progress has been made on direct taxes.

<sup>32</sup> *The Economist*, July 24–30, 2004.

<sup>33</sup> The Bolkestein Report was an attempt by the European Commission to examine a number of remedies to obstacles to EU cross-border investment and suggest comprehensive alternative taxation methods.

Appraising the MERCOSUR case against the EU experience reveals the importance, for emerging economies, of access to foreign direct investment (FDI) and external capital to finance current account deficits in their balance of payments. Moreover, vulnerability to international financial crises makes the MERCOSUR countries more sensitive to short-term capital flows that may be needed to sustain confidence in their currencies. In a context of global free movement of capital, emerging economies face strong pressure to avoid actions that may jeopardize their access to foreign capital.

Another important difference arises from technological changes that interfere with traditional tax bases. In a recent presentation, Tanzi (2004) called attention to the erosion of these traditional bases caused by the silent work of “fiscal termites.” These changes are related to the progress of information technology in various economic fields, such as domestic and foreign trade—e-commerce, electronic financial transactions, off-shore financial centers, tax havens, and asset holdings.

Because of such phenomena, wrote Tanzi, a country’s fiscal base is no longer restricted to the local economy, since it may include parts of the global economic environment. Examples include the possibility of a country taxing foreign consumers and capital income, as well as the foreign capital gains of their own citizens. Hence a country can export part of its fiscal burden. A small country, in particular, can explore the fiscal bases of others.

When tax harmonization in Europe is used as a reference for MERCOSUR, one neglected matter is how the harmonization timetable has been related to a strong policy of promoting the convergence of regional incomes within the EU. The EU’s regional policies helped reconcile the immediate goals of free access to the single market with the desire of low-income countries and regions to gain from economic union. The more developed countries were prepared to extract immediate benefits from trade. At the same time, the less developed ones would improve their economic prospects by gaining access to capital, in order to improve their economic and social infrastructure and thereby modernize their economies under very favorable conditions. It can be argued that in the absence of a regional policy to add economic substance and attract business support to a political project, there would have been many more obstacles to economic union and to the timetable for tax harmonization.

## **Tax Asymmetries and Deepening Integration**

Tax asymmetries distort trade, affect investment decisions, aggravate regional disparities, and generate conflicts that may block progress towards deeper integration. Previous analysis of the MERCOSUR countries’ tax systems reveals the main asymmetries affecting trade and investment in the region. Before making specific proposals for removing these asymmetries, it is important to briefly analyze the most important ones.

### ***Trade Distortions***

Trade distortions arise because it is impossible to secure a perfect adjustment of the tax burden on cross-border transactions. A perfect adjustment requires that all exports from one country

to another be completely exempted from any taxes that impinge on export costs, and that all imports bear the same tax burden as that applied to local production.

Exports can be taxed directly, by means of the traditional export tax (or duties), or indirectly, through turnover and financial transactions taxes, and through the imperfect operation of the tax credit mechanisms used in VAT. The direct taxation of exports has been abolished in most cases, apart from the reintroduction of export duties in Argentina. The indirect burden on exports, however, is a matter of great concern.

There is no way of assessing the actual tax costs each MERCOSUR country imposes on its exports, given the erratic impact of turnover and financial transaction taxes on different goods and services. Taking into account the nature of the taxes and the distinct economic structure of each MERCOSUR country, it can be said that differences at the microeconomic level can be great. Rezk and Rezende (2003) show that the hidden tax costs differ according to tax legislation and production conditions. Brazilian exports of soybeans and beef bear a tax cost lower than the corresponding Argentine products; for chicken, the opposite is the case. The main explanation for these differences is that primary goods are exempted from the state tax in Brazil, while Argentina applies a surcharge on exports of them. As for chicken, Brazilian exports compare unfairly with those from Argentina because of the cumulative effect of federal turnover taxes.<sup>34</sup>

The difficulties of appraising the actual impact of taxes on MERCOSUR exports, however, do not preclude an evaluation of the distortions they create. Taxing exports distorts both intraregional and extraregional trade. When the levies are applied to commodities, which is generally the case of direct export taxes in MERCOSUR, the costs of taxes on exports are less evident in high international price cycles.

One argument for retaining taxes on commodities exports, besides the importance they may have for public revenue, is the likelihood that the benefit of erasing these taxes will be shifted to international buyers and will not be appropriated by local producers. Nonetheless, taxing exports impinges on the goals of an economic union.

The effect of export taxes on intraregional trade is the same as an import duty. While an import duty generates inefficiency in the importing country, export taxes do the same for the exporting country. Intraregional trade is affected twice, a circumstance that does not favor economic integration. Comparing the alternatives of buying or selling goods and services among partners, or seeking short-term gains elsewhere, producers may prefer the latter option and thereby weaken the prospects of further integration.

Like exports, imports can be taxed directly through tariffs<sup>35</sup> and import taxes, or indirectly through domestic taxes. Tariff harmonization is the first measure adopted in economic integration processes. This is accomplished by applying a zero tariff for intraregional trade and a CET for extraregional trade. Provisional exceptions to the common tariff are negotiated to account for regional economic differences in size and structure. There

<sup>34</sup> Note that this study was made before the changes in the Brazilian COFINS.

<sup>35</sup> Nontariff barriers are a case in point.

have been exceptions to MERCOSUR's common tariff since it was established, and these are adjusted often.

Indirect domestic taxes affect imports into MERCOSUR in two ways: through the collection of value added taxes at the borders, and through the further impact of turnover taxes on the production and distribution chain for goods and services. Because of defects in the operation of the tax credit mechanism applied to VAT collections (that is, when credits cannot be fully deducted from tax due at the next production stage) and the incidence of cumulative taxes, intermediate and capital goods are disadvantaged in intraregional trade, relative to final consumption goods. Intermediate and capital goods will incur additional tax costs as they proceed along the production and distribution chain within the importing country (because of imperfect value added taxes and cumulative taxes), but final consumption goods go directly to the wholesale or retail stages. The longer the production and distribution chain, the higher the disincentive to move intermediate goods within the bloc.

The peculiar situation arising from the dual imposition of the CET poses additional obstacles to the integration of economic activities in the region. Extraregional imports are taxed twice when moving within MERCOSUR: the CET applies when goods cross any MERCOSUR border and again when they move to a second country in the region.<sup>36</sup> Hence the intraregional flow of intermediate and capital goods is hampered by tax costs. Needless to say, this circumstance makes it very difficult to form regional manufacturing chains that would benefit from the member states' comparative advantages.

The joint effect of tax costs on imports and exports hampers realization of the goals of integration. Taking for granted that economic integration deepens when the political project is reinforced by the business sector's common interest in economic union, the disincentive to the movement of intermediate and capital goods is a significant obstacle to overcome.

Tax costs on intraregional trade may induce individual policies on extraregional trade. Not coincidentally, exceptions to the CET have remained in place and have changed over time.<sup>37</sup> If higher taxes raise the cost of regionally produced capital goods above that of equivalent goods from abroad, producers will not buy them. At the same time, imports of extraregional intermediate goods will favor the implementation of national industrial policies if those goods remain outside the common tariff because of the double incidence of the CET and the higher tax costs on imports of these goods from the region.

Apart from the impact of general consumption taxes, the consolidation of business sector interests in MERCOSUR may also be affected by selective taxes on basic inputs. As mentioned earlier, inefficiencies in tax administration drove the MERCOSUR countries away from modern taxes and closer to those that are more easily collected. Thus highly concentrated industries such as tobacco, beverages, oil, telecommunications, and electricity are obvious targets for tax administrators.

<sup>36</sup> For an interesting analysis of the double incidence of the CET in the region, together with proposals to change this situation, see SAT-SM-CE (2004).

<sup>37</sup> Exceptions granted to capital goods in 1995 should last for five years. For telecommunications and information technology, exceptions from the CET were intended to remain in place for 10 years.

Fuel tax differentials are not on the priority list for harmonization, since cross-border shopping is hampered by the natural barrier of distance, as well as by regulations. Telecommunications and electricity, however, should be a matter of concern, since they are crucial for high-tech industries and modern services. Nonetheless, the actual burden the MERCOSUR countries impose on these inputs cannot be properly assessed without a microeconomic study.<sup>38</sup>

It will be very difficult to progress toward the free movement of goods and services in MERCOSUR without policies designed to foster complementary economies in the region. It is important to keep in mind how tax-induced distortions that interfere with intra-MERCOSUR trade hinder the consolidation of business interest in deeper integration. In designing strategies to remove tax barriers to deeper integration, therefore, priority should be given to changes that help eliminate this disincentive.

### ***Investment Decisions***

In general, decisions about the location of new investments are influenced by policies on the taxation of capital income. Tax benefits that reduce production costs, however, can also influence business investors. That is the case, for instance, with preferential rates for the production of manufacturing goods in specific regions, an approach quite often used to foster development in areas that are lagging. Coupled with income tax incentives to invest, special advantages for production magnify the impact on investment decisions.

Special benefits for regional development purposes have been used in Brazil and Argentina for a long time, but waned somewhat after economic opening and the submission of domestic industrial policies to international rules. The main exception is the Manaus free zone and the special industrial zone in Tierra del Fuego. Under MERCOSUR regulations, goods produced in these zones should be treated in the same way as extrazone goods, but a temporary agreement between Brazil and Argentina has suspended the enforcement of this rule in bilateral trade.

Of production tax breaks that affect decisions on the location of new investments, the example that has attracted most comment is the array of benefits granted by Brazilian states to attract manufacturing industries, mainly automotive assembly plants. Surfing on a wave of FDI that flowed into Brazil in the second half of the 1990s, the states of Paraná, Goiás, Bahia, Rio de Janeiro, and Ceará offered special advantages with regard to the ICMS (the state VAT) and have made some gains from that strategy. To that end, those states could benefit from the peculiar situation created by the mixed origin-destination principle applied to interstate trade. Essentially, these benefits were conceded at the expense of São Paulo state, the main consumer market for manufacturing goods. Since São Paulo is required to grant credits to

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<sup>38</sup> Harmonization of fuel taxes may be important, since they affect production costs, especially in the agribusiness sector. It should not be put on the priority list, however, for other reasons—among them differences in environmental policies and budgetary importance.

goods imported from other states, the “fiscal war” in the Brazilian federation accentuated interstate antagonisms and a constitutional reform was required to end it.

The events of the second half of the 1990s are unlikely to be reproduced. Competition for investment among Brazilian states has lost impetus in recent years because of a fall in FDI and the paralysis of domestic investment. But antagonisms within the federation reached such a point that everybody agreed on the need for change.<sup>39</sup> For the first time in many years, the states embarked on a serious debate over a proposal for constitutional change, so as to harmonize the rules applied to the ICMS throughout the country, and to move gradually towards the implementation of a full destination principle in interstate transactions. Although this proposal has not yet secured final legislative approval, the debate is a positive sign. Furthermore, recent changes in federal tax legislation, which led to the application of value-added rules to COFINS, will increase the pressure on the states to agree on a unified legislation for the ICMS, in order to be able to jointly defend a more favorable division of a common tax base.<sup>40</sup>

In addition, under new requirements for attracting modern industries, it is unlikely that traditional tax incentives to production will decisively affect business decisions on the location of new investments. Modern infrastructure, the quality of the labor force, easy access to raw materials and major consumer markets, good governance, and environmental considerations may be more important. The Brazilian states that managed to induce foreign investors to install new plants in their territories had all or some of these characteristics.

In this new scenario, competition for investment in MERCOSUR may focus attention on income and excise taxes. As regards income taxes, differences in assessing the tax basis and in the rates applied to corporate income are the first things to be considered. Information in the section “Comparing Tax Structures in the MERCOSUR Countries” shows that rates of corporate tax for big business do not differ significantly, but that some rules applied to assess bases for taxation do.

The main point of concern is differences in rules that interfere in investors’ decisions by affecting the after-tax rate of return on investments. Taxation of interest, dividends, and capital gains, as well as the rules applied to payments to nonresidents, deserves special attention. A focus on foreign investors is justified given the importance of FDI for MERCOSUR’s development prospects.

Another matter that merits scrutiny is the distinct situation of transfer prices. Different criteria for avoiding the use of transfer prices to reduce the taxable profit of multinational enterprises will be very important in the future, and thus the mixed situation in MERCOSUR will have to change. Argentina, which adopted legislation in line with OECD rules, is in a better

<sup>39</sup> A recent measure adopted by the state of São Paulo (which unilaterally decided to disregard tax credits when goods sold in that state benefited from fiscal incentives in the place of origin) may mean that the tax war can no longer be sustained. The outcry over that decision led the states to reactivate the debate on the proposal for a uniform ICMS across the country.

<sup>40</sup> An informal agreement in the senate pointed to a calendar for future tax reform rounds in which further steps, following a unified ICMS, should include the merger of COFINS and IPI (Imposto sobre Produtos Industrializados) to form a broad-based federal VAT.

position than Brazil, which chose to enact its own rules. Both, however, are in an unfavorable position in view of the absence of any rule on transfer prices in Uruguay and Paraguay.

Investment decisions are also influenced by the tax policies applied to major institutional investors, such as pension funds and insurance companies. Foreign investors may not favor countries that tax interest and dividends at source when they are exempted at home. The Brazilian government's decision to tax pension fund incomes shows that domestic institutional investors also react against such measures.

Capital gains taxes on shares also differ in the region. The global income approach to the personal income tax adopted in Brazil and Argentina—which leads to treating capital gains like any other income source—contrasts with the position of Uruguay and Paraguay, which have different rules.<sup>41</sup>

The influence of capital tax benefits on investment decisions concerning the location of manufacturing plants and modern services is conditioned by facilities for the movement of inputs and final goods within a common market. That is, infrastructure matters and is an important barrier to deeper integration. Differences in communication costs due to higher taxes may induce the dislocation of footloose activities such as modern services. Energy-intensive activities are affected by higher energy taxes, while fuel taxes hinge on the movement of goods, with adverse effects on the regional integration of production chains. Hence the need, already noted, to appraise the effective rates of taxes on fuel, energy, and telecommunications in MERCOSUR.

## Alternative Scenarios for Tax Harmonization in MERCOSUR

The usual sequence of tax policies used to proceed toward full economic integration gives priority to the harmonization of indirect taxes so as to abolish tax barriers to the free movement of goods and services in a region. Once a free market is established, capital tax harmonization becomes most important, in order to avoid production inefficiencies that are artificially sustained by the preferential treatment of capital income in some member countries of the union. Then come labor taxes: these are not regarded as very important—apart from special cases (renowned individuals in sports and the arts, liberal professionals)—since language, culture, and family ties pose a significant barrier to the migration of ordinary people.

The European experience is paradigmatic. Economic logic, political reasons, and a different global economic context determined the path followed by the EU. Economic logic teaches that if goods do not move freely across members' borders, investment decisions will not distinguish the regional market from the international market as a whole, and thus differences in capital income taxes would not be important until that condition were met. Direct income taxes are more sensitive to political and ethical reasoning. Moreover, before economic

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<sup>41</sup> The impact of capital taxes on investment has centered on decisions concerning the creation or expansion of economic activities. Emerging economies also need to pay attention to the tax implications for short-run capital movements.

globalization reached its present levels, capital flows were subject to restrictions that lessened the importance of capital tax harmonization.

The first question to be asked, therefore, is whether MERCOSUR should adhere to the above sequence in designing strategies to harmonize its members' tax policies. Some considerations already raised (see the section "Main Reasons for Tax Differentials") suggest that it should not. Further reflections are needed.

Consider the tax problems that affect businesses' interest in the MERCOSUR project. If all efforts are geared to erasing every barrier to trade, economic disparities will increase in the region, conflicts of interest will emerge, and the political will to proceed will be negatively affected. Asymmetric initial conditions related to size of the economies, their growth potential and institutional development aggravate the prospect of a lack of support for deepening integration in the absence of countervailing measures.

The joint implementation of a powerful regional policy would help reduce tensions that tend to mount if disparities increase as integration proceeds. In this respect, the EU experience is worth copying, but with an important difference. The European project featured strong political will, a handful of powerful economies, and a firm belief in the long-term benefits of integration. These conditions made the Big Four (France, Germany, Italy and the UK) willing to finance a common investment fund to bring economic laggards close to the regional average.

Although MERCOSUR does not fulfill these conditions, the need for a regional development fund should not be disregarded. The Initiative for the Integration of Regional Infrastructure in South America (IIRSA), a project designed by the Inter-American Development Bank (IDB), is an important undertaking, but it is far from what is needed. Besides basic infrastructure (which in many cases will also demand nonreimbursable funds), human capital and institutional development—as well as infrastructure for science and technology—require financing that cannot be provided through traditional financial institutions.

To reinforce political will in MERCOSUR by means of a common business sector interest in further integration, it is necessary to give priority to the formation of regional productive chains. Public authorities in Brazil and Argentina have already recognized the importance of moving in this direction. If this is so, the creation of a better tax environment to facilitate this outcome gains preeminence in tax harmonization policies. In considering alternatives for tax harmonization in MERCOSUR, therefore, the main trade-off is not the preference for tackling direct or indirect taxes first. It is the trade-off among choices that may facilitate further integration and those that may leave the project as it is.

Paramount among measures to induce the consolidation of regional productive chains is eliminating the double imposition of the CET. As mentioned, this procedure curbs greater efficiency in regional production by imposing a high cost on the manufacture of goods in places other than the country of the first port of entry. Although the removal of this abnormality hits its public finances in the short run, Paraguay is the most affected in the long run because, as a landlocked nation, it is dependent on the others for cheaper access to imports. Proposals to solve this problem have been advanced in the above-mentioned study sponsored by MERCOSUR's Technical Secretariat.

On the tax side, priorities for harmonization should simultaneously consider proposals to facilitate the adjustment of tax costs at the region's borders, as well as to remove tax-induced distortions in the location of new investments. The technical recommendation for fair tax treatment of goods and services in regional economies that embark on an integration process is to substitute a broad-based value added consumption tax for other, less economically efficient taxes. Nevertheless, for the reasons explained in the section "Main Reasons for Tax Differentials," this alternative is not feasible in the short term. In the meantime, other options should be appraised. Measures to attenuate the cumulative effects of turnover taxes—such as those adopted in Argentina's most important provinces—help, as does the recent change in Brazilian legislation for collecting social security contributions (PIS/COFINS).

The exchange of information and the harmonization of administrative procedures could bring very significant benefits. If confidence in tax audits and in the operations of tax administrators could be built quickly, administrative controls could help remove barriers to the formation of regional productive chains in more sensitive sectors.

Consolidation of regional production chains depends not only on indirect tax barriers but also on differences in income tax that affect investments.

For big multinational investors, present conditions in the area of transfer price policies are very important. Difference in the norms applied to the taxation of interest and dividends also have a significant influence on the attraction of institutional investors. Since foreign capital plays a key role in meeting targets for raising investment ratios in the region, the MERCOSUR countries' income tax differentials may hamper the inflow of foreign capital and simultaneously generate distortions in its allocation.

Taxing retained corporate earnings at different rates, and asymmetric provisions for capital depreciation and past losses, also impinge on the efficiency of capital allocation. Thus, the harmonization of rules that interfere with the post-tax rate of return on investments should proceed, as should measures to advance in equalizing tax costs at MERCOSUR's external borders.

The general adoption of a dual income tax (DIT) approach, along the lines of the recommendations that have been made recently for the EU, can make it much easier to harmonize capital taxes. The main problem pointed out by the authors of pioneering studies on tax harmonization in MERCOSUR, Jorge Macón and Hugo González Cano—that capital income is not taxed at the personal level in Uruguay and Paraguay—becomes less significant. In addition, some features of the DIT model are already present in Brazilian and Argentine tax legislation, and to some extent in Uruguayan and Paraguayan legislation, which may facilitate the transition.

The harmonization of excises on basic inputs is more difficult to accomplish in the short run—even though they are particularly important for the consolidation of regional production chains—because of two important factors: first, their importance for the MERCOSUR countries' budgets;<sup>42</sup> and second, in Brazil they are mostly under the jurisdiction of the states.

<sup>42</sup> Although the contribution of selective taxes to the public purse has fallen recently, they still account for about 10 percent of total tax revenue in MERCOSUR.

The goal of moving toward substituting a broad-based VAT on goods and services for current indirect taxes in the region should be kept in mind, but due account must be taken of the above-noted obstacles to this goal. For the first time in two decades, the debate in the Brazilian parliament has raised the need to submit the states' ICMS tax to a uniform national legislation, and has contemplated advancing further in merging federal, state, and municipal indirect taxes into a single national VAT. But a significant amount of time will be required to meet this goal. Attainment of such an ambitious objective depends first on the full implementation of uniform rules for the ICMS, contemplated in the last version of the constitutional amendment, and still pending final approval in the Brazilian parliament. One sensitive point is the negotiation of who will cover for the benefits already granted to private investors. In the same proposal for a constitutional amendment, these benefits should last for another 11 years.

### **A Calendar for Tax Harmonization**

In light of the above arguments, some recommendations on the preparation of an official calendar for tax harmonization in MERCOSUR may be advanced. Needless to say, this is a very risky endeavor. What follows is a mixture of technical reasoning, political evaluation, and personal prejudices, and thus is open to a variety of criticisms. The sole purpose of ending this chapter with such a proposal is to contribute to a debate that may help build consensus in designing a strategy for tax harmonization in MERCOSUR.

This calendar comprises three stages to be tackled in sequence. Suggested dates for the completion of each stage are made with an understanding that the pace of tax harmonization in MERCOSUR cannot follow that of the EU. While immediate gains in consolidating a common economic interest in the MERCOSUR project may not occur, new and strong international pressures give rise to centrifugal forces that may lead to looser regional economic ties. Instead of the two decades that the EU took to achieve a reasonable harmonization of indirect taxation, MERCOSUR should aim to obtain similar results in one decade. Similarly, MERCOSUR does not have the option of awaiting progress on the harmonization of indirect taxes in order to begin harmonizing direct income taxes. For both reasons, tax harmonization in MERCOSUR requires a firm political commitment, highly skilled technical support, and a great deal of energy devoted to complex negotiations.

#### ***First Stage: 2005–06***

This stage may lay the groundwork for swift progress in the second half of the decade. Hence it should give priority to making tax harmonization an official undertaking and to creating facilities for its implementation. These include resources to conduct in-depth studies, to support a technical advisory board, to maintain a forum for negotiations, to propose a formal strategy, and to set up a common, negotiated calendar. In addition, some specific measures could be adopted, with special consideration being given to:

- (i) Elimination of the double imposition of the CET
- (ii) Agreement on the exchange of information, coupled with a joint project on common information technology for tax administration purposes
- (iii) Adoption of uniform rules for dealing with transfer prices
- (iv) Consolidation of efforts to suppress or mitigate the negative impact of cumulative taxes on the regional trade of intermediate and capital goods, such as those imposed by the Brazilian federal government and some Argentine provinces
- (v) Design of a uniform regional agreement to avoid the double imposition of income taxes in MERCOSUR<sup>43</sup>
- (vi) Design and appraisal of the feasibility of a regional development project along the lines of the EU experience<sup>44</sup>

### ***Second Stage: 2007–10***

By this time, it is hoped that the economies of the MERCOSUR countries will have overcome their present difficulties and can relax macroeconomic restrictions on deeper changes in taxation. It is also hoped that the unification of the ICMS and improvements in federal social security contributions (PIS/COFINS) in Brazil, as well as further modernization of the provincial Argentine taxes (emerging from negotiations on the coparticipation law), will make it easier to embark on a reasonable adjustment of indirect tax costs for goods crossing MERCOSUR borders. In the area of income tax, it is expected that a better understanding of the advantages of a dual income tax will allow present asymmetries to be reduced. Under these assumptions, countries might be expected to:

- (i) Erase the most important hidden tax costs that impinge on the formation of regional production chains, such as the accumulation of tax credits, the incidence of export taxes, and the increase in the cost of regionally produced capital goods because of high taxes
- (ii) Adopt a common technological platform for tax administration purposes in all MERCOSUR countries, so as to facilitate the exchange of information and allow for the joint auditing of regional transactions
- (iii) Put into place a regional development policy to bring about the convergence of regional incomes and to favor the deepening of economic integration<sup>45</sup>

<sup>43</sup> The agreement between Brazil and Argentina on the double imposition of income taxes dates from 1982, when both countries still applied corporate income taxes on a source basis.

<sup>44</sup> Since the bigger MERCOSUR economies cannot play the role that powerful nations had in supporting a regional development policy to bring convergence in per capita incomes in the EU, multilateral organizations should consider taking the initiative in this respect.

<sup>45</sup> The recent creation of the MERCOSUR Structural Convergence Fund (FOCEM) is a good start. According to the rules, an annual sum of \$100 million will be allocated to this fund. Brazil (70 percent) and Argentina (27 percent) are the main contributors. Paraguay (48 percent) and Uruguay (32 percent) will receive the bulk of the financing. It is still a small sum but the Fund may receive support from multilateral institutions in the future.

- (iv) Apply common rules to corporate income taxes, so as avert distortions to investment decisions on the location of new investments
- (v) Establish common rules on tax breaks for production taxes until the region reaches full harmonization<sup>46</sup>
- (vi) Reduce differences in the taxation of basic inputs (telecommunications and electricity), focusing on priorities for the integration of regional production chains

### ***Third Stage: 2011–14***

If partial success is achieved in the previous stages, there will be a greater prospect of reaching an acceptable degree of tax harmonization by the beginning of the next decade. Pending a favorable regional economic and political environment, the following could be expected:

- (i) Prevalence of a national consumption VAT in all member countries as the major contributor to the public finances
- (ii) Implementation of a dual approach to income tax, along the lines of the proposals being made for the EU

The proposed calendar looks ambitious and perhaps unrealistic under the present conditions. But the challenges that MERCOSUR faces in consolidating the economic integration project do not give much time to delay initiatives that are of great importance if the goal established in the Asunción Treaty is to be met.

## **Conclusions**

If the political project to transform MERCOSUR into a *de facto* economic union is to become reality, the adoption of a negotiated calendar for harmonizing taxation in the region is a prime necessity. Private sector cooperation with political leaders is needed as a means of restoring public confidence in the project, and under present conditions, tax asymmetries within the bloc present a strong impediment to this cooperation.

Public confidence is necessary to support deeper integration. Because of old rivalries and more than a decade of economic crisis and social frustrations, the citizens of the MERCOSUR countries did not develop any sense of a common identity. Thus the lack of public support adds to the economic difficulties of consolidating the MERCOSUR project.

The presentation of an official calendar for tax harmonization could provide an opportunity to launch a campaign aimed at building business and public confidence in the medium- and long-run benefits of economic integration.

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<sup>46</sup> Suggestions for limiting fiscal incentives have been floated in the press, but they are barely politically feasible. In this respect, it is worth noting the rules approved by the European Commission in 1998 to avert harmful tax competition.

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## **Regional Competitiveness Policies for Deeper Integration in MERCOSUR\***

*Renato G. Flôres, Jr.*\*\*

### **Introduction**

The Southern Common Market (MERCOSUR) is a young and highly asymmetrical integration initiative. A brief comparison with European economic integration in 1969 offers some perspective on the progress made in MERCOSUR—where the mechanisms for integration, including a convergence of preferences at the microlevel and common initiatives, are yet to be fully established.

The main problem for MERCOSUR is asymmetry among its member countries, often expressed in a wearisome dialogue between Argentina and Brazil, with relatively little involvement by the other countries in the group. Of the initial six members of what is now the European Union (EU), four had an approximately equivalent status: West Germany, France, Italy, and the Benelux countries. They debated integration at some length. Despite the crucial French-German relationship, different combinations of allies arose with respect to different issues, and most tensions among members were usually eased and dispersed. Where disparities were strong, the broader debate usually helped resolve the issue. In MERCOSUR, by contrast, the disparities lie either in one of the smaller members or in one of the bigger two. The smaller members' disparities usually have a lower priority, and are translated into a demand for exceptions or for funds. For the larger members, the disparities are one more item on the agenda of disputes in a generally unproductive and solely bilateral dialogue.

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\* This chapter is a slightly revised version of a document written in 2005. Though based on information then available and circumstances at the time (many since superseded by various events), the main messages and the structure of the proposal remain valid. In a few cases, though not all, a new footnote says something about later developments.

\*\* The author is indebted to many people for their help in the writing of this chapter, including participants at the February and July 2005 seminars in Washington, D.C., and Rio de Janeiro, respectively. Eduardo Fernández-Arias and Mauricio Mesquita Moreira were instrumental as critics. Paolo Giordano and Robert Devlin were very helpful and creative in their suggestions. Stephan Krier, the distinguished German consul in Rio de Janeiro, provided interesting insights and enthusiasm about the EU and MERCOSUR. The author is solely responsible for all that follows.

As long as MERCOSUR maintains this four-way geometry, the solutions that have worked for other small communities of countries may not work here. The only way to minimize the standoff in this case is to enhance the integration instruments by progressively consolidating the basic devices. Hence, the regional competitiveness policies presented in this chapter are policies to deepen integration.

Given the pattern of income distribution among the MERCOSUR countries, no policy can eliminate disparities. Some policies could, however, create a context for tackling disparities more fairly from a regional perspective. Moreover, a healthier, deeper, and more transparent move toward integration could help somewhat in transforming the disparities into a positive force. Indeed, the smaller members may have an incentive to become “model members,” obliging the bigger partners to discharge their duties and to act more fairly. In this respect, Uruguay should be guaranteed that it will host all of the bloc’s new or enlarged institutions, while Paraguay should be placed in a better position to claim the rewards warranted by its active adherence to the process.

### ***Methodology***

Deepening MERCOSUR’s integration, in the context of enhancing regional competitiveness, requires that important additional measures be implemented by the four partners—beyond just strictly observing rules—as well as a final liberalization schedule leading to a full customs union. After the key step represented by the Olivos Protocol and the even more important formal establishment of the MERCOSUR Permanent Review Tribunal in Asunción in 2004, progress in the legal area is fundamental. Though this matter is not the focus of this chapter, it will be evoked here frequently since it is a necessary background strategy to ensure that any proposal is sustainable and enforceable.

National policies need to be coordinated and common regional policies created in three areas:

- (i) Policies to ensure that the customs union is completed and that there is an environment for sustainable, unencumbered free trade within MERCOSUR’s borders.
- (ii) Industrial and competitiveness policies for each member state, and their relationship to a common regional competitiveness policy, including more specific national policies and fiscal incentives for investment issues—both foreign direct investment (FDI) and intrabloc flows (Kosacoff, 2005). The investment question is particularly important in the region.
- (iii) In conjunction with the two previous points, regional funds would help less developed areas that have been damaged by integration, and would strengthen the group’s cohesion as a socioeconomic unit.

When dealing with these issues—especially the first and second—the two major concerns are the coordination of current national policies and the design of genuinely common policies such as those in the EU. To lessen the likelihood of conflict and of obstacles to deeper inte-

gration, national policies that should be in place, reformed, or eliminated must be identified so that regional proposals can be successfully implemented.<sup>1</sup> It is also essential to identify the existing or potential instruments that could be used to attain the goals of the common policies.

The main purpose of this chapter is to propose ideas and suggestions geared toward advancing the MERCOSUR process. The regional policies outlined here should be considered suggestions, although they could also act as a provocative starting point for debate. To that end, the section “Implementation” specifies the core policies, though a more detailed description of the choices will be required in a subsequent phase.

It is worth recalling that some of the main issues in this chapter have been discussed since 1994, when the establishment of the free trade area looked like a promising start, and in pioneering earlier studies such as that of Ferrer and Lavagna (1992). This chapter seeks to synthesize various positions and provide some new arguments.

### ***Assumptions***

The principal working assumptions in this chapter are that MERCOSUR is a reality and that there is no going back, and that the group’s prime goal is to establish a common market among its members as stated in Article 1 of the Asunción Treaty. Another assumption is that current sector-specific initiatives have a tremendous impact on integration, and will continue their course. The best example of this is the joint (and South America-wide) effort to build or enhance infrastructure.<sup>2</sup> There are several other projects of regional scope. The proposals that follow all build on such efforts, which should be maintained and completed.

This chapter also addresses the issue of supranationality, a concept underlying any sound measure to advance regional integration. Supranationality is usually addressed in legal or juridical contexts. But since it is involved in all the economic and institutional suggestions made here, one of the first questions about their implementation concerns the extent to which the supranationality required by any given measure is palatable to MERCOSUR members.

Until recently, the members’ attitudes toward supranationality have varied. Argentina was the most receptive from the perspective of international public law. Brazil was by far the least receptive: recall such famous episodes as the *Carta Rogatória 7618 da República Argentina* case, when the Supreme Court was unwilling to back the resolutions in the Las Leñas and Buenos Aires protocols, to the disappointment of the other members (de Magalhães, 2000). Hence there are doubts about the extent to which the members will waive their sovereignty in favor of deeper integration.

<sup>1</sup> This task exceeds the scope of this chapter and should be accompanied by a political economy analysis relating the supply of policies with actual demand in the four member countries.

<sup>2</sup> The Inter-American Development Bank (IDB), the Andean Development Corporation (CAF), the Financial Fund for the Development of the River Plate Basin (Fonplata), and Brazil’s Banco Nacional de Desenvolvimento Econômico e Social (BNDES) are involved in the successful Initiative for the Integration of Regional Infrastructure in South America (IIRSA), launched by the South American presidents in 2000.

Supranationality, however, is not an insurmountable obstacle. Much progress can be made while more mature views on the matter take shape. The subsidiarity principle—through which national policies serve regional objectives—could allay concerns about supranationality if used intelligently.

## Theory

Nearly all the issues covered in this chapter can be modeled. Rodrik (2004, 2005), inspired by insights from the theoretical model in Hausmann and Rodrik (2003), recently presented a set of ideas suitable for addressing the crucial questions of priority and timing for the different policies proposed herein.<sup>3</sup>

A consideration of two other theoretical areas might also shed light on the problems addressed in this chapter, albeit with some reservations. First, economic geography models in general, while intelligent and perceptive, are usually based on overly restrictive assumptions. In addition, they have only recently been submitted to rigorous empirical testing. The deep asymmetries in MERCOSUR, moreover, invalidate most of their usual findings.<sup>4</sup> Nonetheless, the fundamental principles of spatial agglomeration and dispersion forces must be taken into consideration when designing and monitoring policies to enhance competitiveness and regional aid.

The other area comprises trade models for South-South integration. These initiatives are doomed, as a couple of modeling exercises suggest. While elegant and creative, they rely on a rather schematic Ricardian framework and cannot be transformed into an argument that opposes South-South to North-South integration. A lucid comment that raises some of the issues can be found in Devlin, Estevadeordal, and Rodríguez-Clare (2006). Neary (2001) also makes a comprehensive, authoritative, and constructive critique of economic geography models.

The foregoing points should be regarded as further incentive to contribute to these fields of research. This most compelling task is, however, beyond the scope of this chapter, which takes a minimalist and *realpolitik* view of the regional policy issues to be tackled, and aims first to construct a meaningful, useful, and feasible agenda. Given the relevance of the theoretical background, the chapter occasionally makes the links between it and the proposal more explicit.

## Structure

This chapter is organized as follows. The measures related to each of the three issues outlined above are described in the following three sections (“Dimension 1: Trade-Related Regional Policies,” “Dimension 2: Creating a Truly United Area for Investment and Common Com-

<sup>3</sup> Based on a two-period general equilibrium framework for a small economy.

<sup>4</sup> In the broader project of which this chapter was part, attempts were made to deal formally with this question. See, for instance, Chapter 4 by Gianmarco Ottaviano.

petitiveness Policies,” and “Dimension 3: Regional Cohesion Funds.”). The subsequent section presents two background policies. The section “Implementation” considers the manner of implementation and the timing of the various initiatives. The instruments are broadly reviewed—with particular reference to the secretariat—and the crucial “supranationality versus subsidiarity” issue, often neglected by economists, is also discussed. The final section presents conclusions.

The main message of the proposals is that deeper integration requires efforts to combat powerful trends and groups pushing in the opposite direction. It also calls for absolute belief in the need for such integration, expressed as a steadfast political will to realize the necessary outcomes.

### **Dimension 1: Trade-Related Regional Policies**

A true common market requires that intra-MERCOSUR trade move in an unconstrained and sustainable flow—very close to the ideal of free trade. A set of regional policies are needed to improve the present situation and, above all, to create the desired trade environment.

Regional competitiveness policies, like any similar policies, will run up against an obstacle in the unfinished tasks of the customs union. To use Cecchini’s (1988) image, “the cost of the non-customs union” is the constraint it places on further integration. Most of the four initiatives below have been started or tried before, and then been forgotten or abandoned; some are being pursued and should be expanded, and one may be new.

#### ***A Revised Common External Tariff (CET)—Policy D1.1***

The Ouro Preto Protocol is more than 10 years old. The CET it produced reflected, for better or worse, the political economy at the time.<sup>5</sup> Since then, perforations have occurred, delays have been requested and experienced (even if not actually granted), and statistical taxes have been raised. As a result, skeptics have spilled much ink proclaiming the death of the Ouro Preto CET.<sup>6</sup>

The members should revise the CET downwards in order to secure a more consistent customs union. Two important points concerning this revision must be made. The first is the capital goods issue. Brazilian pressures have kept tariffs for these goods high relative to their value in the other member countries. Brazil must be bold here and agree to lowering the existing levels, since the evidence indicates that such tariffs caused serious injury to its partners. The second point concerns the Doha Round, which will produce a new list of tariff concessions for members of the World Trade Organization (WTO).

<sup>5</sup> See Calfat, Flôres, and Ganame (2003). Some authors go further and hold the present CET responsible for deepening asymmetries within the group, and for placing the costs of trade diversion on the smaller members while conferring the benefits on the larger members.

<sup>6</sup> Sometimes with barely disguised pleasure.

These points raise the issue of the right time to discuss and revise the CET. Some argue that this should happen soon, without awaiting progress in ongoing regional agreements or the results of the Doha Round. At the WTO, moreover, there is flexibility about the difference between bound and actual tariff values. But there are several reasons to disagree with this view. First, there seems to be no scope for addressing the WTO and CET negotiations simultaneously. In particular, demands in the WTO nonagricultural (goods) market access (NAMA) group are expected to escalate. Also MERCOSUR negotiators will be involved, at least until the Hong Kong ministerial meeting in December 2005, in the delicate *quid pro quo* that (it is to be hoped) will deliver minimum progress on agricultural liberalization. On the one hand, the naive device of distinguishing between bound and actual values will not satisfy developed-country *demandeurs*. On the other hand, Argentina and Brazil are, encouragingly, trying to devise a united negotiating front. Further review of the CET will be facilitated by as concerted a stance as possible on the agricultural and NAMA negotiations in Geneva by MERCOSUR members, and thus their present (joint) efforts may be transformed into an exercise for CET revision. Moreover, there should be serious studies and debate before the revision starts, in order to attenuate the protective forces that will inevitably emerge. The revision should not be scheduled before 2006 or, more realistically, before the first six months of that year, when the outcome of the Doha Round might be known and when the general public and informed opinion will be ready for a decision.<sup>7</sup>

### ***Finalizing CET Revenue Collection and Distribution Mechanisms—Policy D.1.2***

While it may seem obvious that the CET should be collected only once, for many goods this is not the case. There are several reasons for this disparity, including red tape, lack of fully harmonized customs procedures, and additional complications arising from differing rules of origin. Foreign investors in MERCOSUR have complained about this matter.

The MERCOSUR Secretariat in Montevideo has made efforts in this regard. In its December 2004 meeting, the Common Market Council (CMC) approved Decision 54/04, which called for studies of the matter. These are underway and should receive strong support. The redistribution issue must be settled, and a serious timetable must be drawn up so that the issue can be resolved once and for all.

### ***Finalizing a Safeguards and Antidumping Protocol—Policy D.1.3***

Whatever happened to the safeguards and antidumping protocol? Opposition by Brazil and then by Argentina stalled the discussions, and the proposed texts seem to have been filed away somewhere. A recent dispute between Brazil and Argentina over Argentine imports of

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<sup>7</sup> This consideration is largely outdated. Given the June 2007 events at Potsdam, revision should not await the outcome of the Doha Round.

Brazilian-manufactured electrical appliances made it necessary to adopt an ill-considered safeguards compromise in the December 2004 meeting of the Council. Discussions, however, continued during 2005 and also covered distorting subsidies and investment incentives.<sup>8</sup> This piecemeal approach is far from desirable.

Argentina subsequently tabled a proposal on the adoption of import quotas to offset the disequilibria triggered by divergences in economic cycles or exchange rates. The quotas would not be lower than the simple average of the market share of the exporting country in the apparent consumption of the injured party during the preceding three years. They would be allowed for six-month renewable periods while the disequilibria persist. Discussions continue. Paraguay—which held the presidency of MERCOSUR at the time of this writing—has tried to secure an intermediate but conclusive text.<sup>9</sup>

Integration cannot be deepened without a clear and reasonably comprehensive protocol on basic contingent protection mechanisms that would safeguard countries against damaging exports from their partners, and avert or eliminate recourse to the WTO in such cases. The two bigger members must display sufficient good will to make such circumstances reality.

The Argentine proposal has the merit of being concrete and new, but it has serious shortcomings. The threshold values that would trigger the automatic enforcement of safeguards—whether in countercyclical periods or in the event of exchange-rate misalignments—are not defined. This kind of small-print clause can lead to endless and fruitless discussions. Moreover, the proposal pays scant regard to mechanisms or to the serious work required of the complainant in order to correct the imbalance using the safeguards. Unfortunately, Brazil has been playing a dubious game by avoiding until recently a frank discussion of the ideal content and format of a definitive text.

Rather than devising new formulas, it would be useful to adapt article XIX of the 1994 General Agreement on Tariffs and Trade (GATT), along with the clarifications in the Uruguay Round's Agreement on Safeguards. The final text could also combine ideas contained in articles XI and XII. Indeed, some parts of the Argentine idea—such as allowing quotas rather than suspending all imports, and the shorter initial period of six months—could be retained. The definition of “serious injury” and of renewal conditions should follow the WTO framework.<sup>10</sup>

The final document must have the legal status of a protocol. If not, internal trade flows will remain subject to the vagaries of harder macroeconomic conditions and ever-present demands from less competitive groups of producers.<sup>11</sup>

<sup>8</sup> See policy 2.3, subsection “A MERCOSUR Competition Directorate—Policy D.2.3.”

<sup>9</sup> Unfortunately, all this led to the conclusion, on January 31, 2006, of a bilateral adjustment mechanism for safeguards between Brazil and Argentina. Despite this inadequate and distorting measure, the remaining considerations in the subsection remain valid.

<sup>10</sup> The reference is to an internal MERCOSUR measure. WTO safeguards are not allowed even within an imperfect customs union such as MERCOSUR. Another question that should perhaps be deferred for now is the design of external, now common, WTO safeguards applied by MERCOSUR to extraregional exporters.

<sup>11</sup> See the sections “Links between National Industrial Competitiveness Policies and a Common MERCOSUR Initiative,” “Outlining the Policies,” and “Compatible Supranationality and Subsidiarity.”

### ***Implementation and Enlargement of the MERCOSUR Clearinghouse— Policy D.1.4***

Brazil and Argentina are currently engaged in a pioneering experience that seeks to establish a clearing mechanism for bilateral trade payments.<sup>12</sup> A kind of compensation regime already exists among members of the Latin American Integration Association (LAIA) in the form of a reciprocal payments system to finance trade among them, coordinated by LAIA, and backed by the members' central banks. Now, however, a full-fledged clearinghouse operated by independent institutions in each country is being created.

The clearinghouse would drastically reduce the amount of U.S. dollars needed to settle the flows. In 1997–98, for example, when bilateral trade peaked, it would have reduced a total of around \$15 billion annually that flowed both ways to a unilateral flow of around \$1 billion from Brazil to Argentina. The Brazilian Mercantile and Futures Exchange and a similar institution in Rosario, Argentina—with the support of both countries' central banks and funds from the IDB—will bring the first bilateral (trade) clearinghouse into operation in 2005. Beyond the drastic reductions in exchange-rate operations, there would also be substantial savings in banking commissions and fees. Of course, the two big economies have trade volumes that justify this undertaking. But once the two institutions are operating, at least one other could be established in Uruguay to deal with its two flows with the bigger members, and in the near future the system could be extended to Paraguay and at least to Chile, an associate member. Such measures are very important for consolidating links that will gradually bring the partners closer in an enduring and profitable way.

### **Dimension 2: Creating a Truly United Area for Investment and Common Competitiveness Policies**

In this second dimension, the focus is on investment, because industrial policy considerations are meaningless unless they are tied to investment policies.

#### ***Investment: General Issues***

MERCOSUR's record on FDI has ranged from impressive to less impressive, though the region can still be considered an attractive area in global terms. The remarkable asymmetry between Brazil and its other partners has usually led foreign companies—pursuing either a MERCOSUR or a South American marketing strategy—to choose the biggest economy. Roughly the same pattern prevails in intragroup flows: the other countries' firms (mostly Argentine) more often relocate to Brazil, and especially to the São Paulo area. Fiscal wars have either enhanced or altered this overall picture, creating further tensions not only between Brazil and Argentina, but also within each country.

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<sup>12</sup> The author is indebted to Isney Manoel Rodrigues, foreign exchange director of BM&F, Brazil.

How can the disparities be attenuated and the national policies be better coordinated? One approach—recently favored by Argentina—is to form cross-border production chains that would spur a more cooperative environment and obviate many of the problems mentioned above. Investment opportunities would then be clearly identified in detailed geographic terms, and channeled to specific areas under the terms of a common agreement among all those involved in the chain.

A more comprehensive view would require starting from the Colonia Protocol on the Reciprocal Promotion and Protection of Investments in MERCOSUR (agreed in Colonia, Uruguay, on January 17, 1994); and the Buenos Aires Protocol for the Promotion and Protection of Investment from Third Parties (Buenos Aires, August 5, 1994), which was intended to regulate foreign investment flows, including fiscal wars. Neither protocol was adopted. Only Argentina ratified them despite Common Market Group Resolution 92, which created a committee on the reciprocal protection of investments. Both texts are now fairly outdated and new items should be added to them.

Beyond the purely legal measures mentioned above, the different investment mechanisms should be more fully integrated. Initially, Brazil's Banco Nacional de Desenvolvimento Econômico e Social (BNDES) and its Argentine counterpart, the Agencia de Desarrollo de Inversiones, could be the leading actors. They could develop joint programs to implicitly channel or promote geographically targeted investments.

Any constraint on investment opportunities that might create an artificial environment is unwise, because it would discourage innovative ventures and block new opportunities. An attempt to resolve investment disparities either through a bold and detailed directive or by enforcing an explicit regional policy would be an error. This is particularly true with regard to fiscal wars, as evidenced by the emergence of the problem in the EU's May 2004 enlargement.<sup>13</sup>

Fiscal wars in Argentina and Brazil are first and foremost a matter of national policies. Then, from the perspective of distortionary subsidies, they require regional competition legislation. Very complex distortions are the subject of ad hoc negotiations. These problems will eventually be attenuated by overall fiscal harmonization—which is more closely related to and dependent on the macroeconomic harmonization package—and by the consolidation of a more diversified production structure within the integrated area.<sup>14</sup> Investors, however, cannot be forced to put their money where bureaucrats or regional associations want them to. But there are some more or less indirect ways to help alleviate the distortions caused by fiscal wars and by the excessive concentration of FDI in a few locations.

<sup>13</sup> Though not exactly equivalent to MERCOSUR, where taxes related to FDI are generally lower among the new members.

<sup>14</sup> See Chapter 8 by Fernando Rezende.

### ***Links between National Industrial Competitiveness Policies and a Common MERCOSUR Initiative***

Analysis of this matter must begin by establishing the limits of top-down policies in creating ideal agglomeration and development processes. The EU experience reveals mixed evidence of the combined effect of state aid and community funds in creating welfare-improving agglomerations, and occasionally counteracting the destructive effects of scale due to deeper integration. Basically, the combination of these policies has secured some equality between members but has not been able to slow down or avert greater inequality and income concentration within (rather than among) the members. Moreover, there is an unfortunate trend toward the creation of “black holes”—agglomerations with one or only a few different sectors that do not improve welfare (see, for example, Midelfart-Knarvik and Overman, 2001).

Ireland has emerged as a clear champion, although its success certainly stems from other factors as well.<sup>15</sup> In other lagging countries that received substantial funds (such as Greece and, especially, Portugal), performance has been far from encouraging.

Leaving aside the cohesion or structural aspects of the question, any MERCOSUR policy must address these issues. Some hypotheses are also needed. The first is “desertification” in the Southern Cone, due largely to Brazilian asymmetry and the presence of a few powerful centripetal agglomerations. These include São Paulo (above all), Porto Alegre (in relative terms for Uruguay and Argentina), Rio de Janeiro, and Buenos Aires—the latter being the only sizeable agglomeration outside Brazil.

The second hypothesis is that—in contrast to what happens in Europe—apart from agribusiness (basically in Argentina and Brazil), MERCOSUR lacks internationally competitive regional production networks and has not been inserted into any global production network. In addition, given its relatively modest competitiveness in services (with the possible exception of financial services), it is a little more difficult for official policies to create an environment of positive externalities.

Natural associations have been emerging in the integration area. The bulk of the chemicals sector is a prime example. Paper and pulp producers are getting closer to each other, and even the steel industry—the source of unfortunate antidumping cases in MERCOSUR—is moving toward a common view. It could be argued that all these sectors or subsectors are oligopolies that are jointly redefining their position in the enlarged market. This is not a bad thing; on the contrary, it is normal and unavoidable in any integration process.

Are MERCOSUR production chains an answer? This idea has been recently revived by Argentina. For the food sector in general and many agribusiness-related activities, the answer is a qualified yes. But it will take some time for successful chains to match the powerful export-ing oligopolies in Argentina and Brazil. One interesting point is that, where a MERCOSUR

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<sup>15</sup> Having English as the national language has been key in the capacity to provide many outsourced services such as call centers. Good domestic education policies were also a plus.

chain seems feasible and self-sufficient (as in sectors such as grapes and wine, and in other sectors such as shoes) a South American chain—one that could even include Mexico—could jointly target large markets such as the United States and the EU. Indeed, production chains should be pursued in the more fragmented sectors that are closer to perfect competition. In these sectors, coordination failures are more likely within the group: islands of small producers may suffer the impact of more competitive rivals, for instance, while there is a significant possibility of production combinations or product specialization and, consequently, creative price discrimination.

In the heavier and more technically intensive industrial sectors, the situation is more complicated. Success stories such as Embraer, the mid-sized aircraft producer, are mostly a Brazilian phenomenon with no or negligible MERCOSUR spillovers, at least to date. In other areas, such as electrical and electronic appliances/machines, there has been substantial relocation to Brazil, raising protectionist sentiments among the other members. Parts of the chemical sector remain segmented. Despite such diversity, specific oligopolies will eventually find a common *modus vivendi*. Others may be too small for this or may be suffering from extra- and intra-MERCOSUR competition, which may be an argument in favor of a regional competition authority to act when conditions are unfair. Finally, the car and automotive industries worryingly tend to pool together in one or two black holes whose sustainability (given the footloose nature of these sectors) is debatable.

The single-minded pursuit of internal production chains would eventually be disappointing. MERCOSUR must consider how its competitive chains can insert themselves into modern patterns of global production, where added value is segmented along an international chain that usually increases northwards. With this proviso, three main situations are possible regarding the chain:

- (i) The idea might be worth trying—perhaps with regional help—in selected sectors of the food and agribusiness-related groups, and in the traditional and competitive manufacturing sectors typical of most members, such as shoes or leather and textiles.
- (ii) The idea will depend on the natural forces of integration in many oligopolistic manufacturing sectors and need no official, regional intervention.
- (iii) The dilemma in the automotive sector must be tackled and the sector must be streamlined. Certain high-tech or heavy-industry production chains may also make sense.

Additionally, account must be taken of the logic of international production by expanding the members' territorial scope. Associations that seem unfeasible or unsustainable in the purely MERCOSUR context may be practical in a South American context or, more boldly, in a MERCOSUR alliance with the United States, the EU, or emerging Asian economies. Brazil's industrial relations with Colombia might have as much scope as those with Argentina, and the latter could become a much closer partner of Chile. Both Argentina and Brazil could and should tighten their production links with the United States. Some aspects of "regional policies" must extend beyond MERCOSUR's external borders. These initiatives would be distinct from a national effort because their design and related proj-

ects would consider MERCOSUR as a unit. Country-centered considerations would have only second or no priority. This will inevitably prompt a new perspective on the external negotiating agenda—one that should give serious consideration to the integrated production structure.

To complicate matters, however, there are still annoying discrepancies in competition law and enforcement. Despite the progress prompted by the Fortaleza Protocol on competition,<sup>16</sup> the recent crisis has delayed further integration of MERCOSUR's competition authorities. Such efforts must be resumed—with a clear schedule and at a faster pace—and should be related to the establishment of a safeguards and antidumping protocol. The time is ripe to send a clear signal that internal and international competitiveness is being taken seriously: the creation in the near future of a MERCOSUR Competition Authority.

### *Outlining the Policies*

#### **Readdressing and Implementing an Investment Protocol—Policy D.2.1**

The Colonia and Buenos Aires Protocols must be reconsidered and deepened. They could be unified into a single protocol that addresses the following delicate matters:

- (i) The dispute settlement mechanism should refer to the MERCOSUR system—which has been greatly improved by the creation of the permanent tribunal in Asunción—rather than resort (as both of these unadopted protocols did) to the World Bank's International Centre for Settlement of Investment Disputes.<sup>17</sup>
- (ii) As regards fiscal wars, something similar to the Code of Conduct for Multinational Enterprises of the Organisation for Economic Co-operation and Development (OECD) should be implemented—as Brazil has argued with respect to Argentina's complaints about fiscal competition.
- (iii) The definition of investment and of the scope of the most-favored nation and national treatment concepts for FDI within the group should be updated. The protocol should pay attention to restrictions imposed by the WTO's Trade-Related Investment Measures (TRIMS) agreement and include qualifications, if necessary.
- (iv) Uruguay signed an investment agreement with the United States, without consulting its MERCOSUR partners. Though not yet ratified, the agreement should be examined to accommodate legitimate queries, if they are feasible and reasonable.

Were all four members to fully adopt an instrument along these lines, foreign investors would be more confident, improving coordination on investment issues.

<sup>16</sup> For earlier views on the protocol and competition in MERCOSUR, see Flóres (2001) and da Silveira (1998).

<sup>17</sup> A point that elicited concern in more than one country, but did not transpose the two protocols.

### Enhancing MERCOSUR's Competitiveness: Internationally Competitive World Links—Policy D.2.2

This policy seeks to ensure the creation of production networks either within MERCOSUR or including the bloc, so as to boost competitiveness and bring about the diversification and upgrading of international value chains. This entails defining a strategic approach to competition that also helps improve or connect production chains, in order to expand MERCOSUR's export capacity in a few selected industrial sectors.

The question of how to identify or select the sectors has no clear answer. Given the broad purpose of providing effective incentives to potentially competitive and innovative sectors willing to take risks, technical indicators can help guide the choice. The indicators would consider MERCOSUR's potential in international trade flows and the possibility of closer links with extra-MERCOSUR partners to create vertical linkages on both sides.<sup>18</sup> The potential of the sector to supply the MERCOSUR market would also be considered (see the Appendix to this chapter).

Candidate sectors and related national policies need to be identified and assessed with the goal of implementing a social process, pooling technical insights with collective preferences. A nonexclusive portfolio of priority sectors could thus be produced, opening up opportunities for individual undertakings.<sup>19</sup> Since the BNDES budget is bigger than that of the World Bank, it could be one of the agents to open special credit lines to help concrete developments.

The MERCOSUR Secretariat could connect the project with national governments, with a view to eliminating cumbersome bureaucratic requirements. These measures would not necessarily require new funds. Grants or credits to exploit new investment or market opportunities, to improve logistics and distribution in current or new export operations, and to start new ventures would be channeled to the potential (chosen or approved ad hoc) sectors in the budget of the national agencies and development banks. Dismantling or streamlining the regulations that thwart these operations, and increasing the efficiency of the sectors, would receive immediate attention. The gist of the proposal lies in coordinating national institutions and government agents with the regional/international targets. Last but not least, a mechanism of checks and balances must be part of the policy design.

### A MERCOSUR Competition Directorate—Policy D.2.3

Of the policies proposed here, a competition directorate is the long-term strategy. This would be a new supranational institution with a major role in the progressive deepening of integration. Clearly this idea is inspired by the EU experience, but the MERCOSUR institution would not be as powerful as the one in Brussels for the foreseeable future.

<sup>18</sup> Ideally, upstream and downstream.

<sup>19</sup> The priority sectors are suggested, not exclusive.

The directorate should be housed in the MERCOSUR Secretariat and initially should have a modest structure. Its first responsibilities would be administration of the safeguards and antidumping protocol (see policy D.1.3 in the subsection “Finalizing a Safeguards and Antidumping Protocol—Policy D.1.3”), and the activities related to the Fortaleza Protocol and its developments. Subsidiarity should be strongly applied and encouraged: as far as possible, national legislation should deal with straightforward competition cases so as to reinforce practices in Paraguay and Uruguay and to aid the integration of the fairly advanced systems in Brazil and Argentina. There are still probably few MERCOSUR competition cases.

The directorate should also deal with state subsidies and their distorting effects on competition and investment. It could work as an alternative arbiter in, for instance, serious cases of fiscal competition. Deeper reflection is needed to arrive at a precise determination of the circumstances that would trigger the directorate’s intervention and the legal requirements for complaints. The idea is to move all competition-related matters, up to a certain level, from the other dispute settlement options to the directorate.

### **Dimension 3: Regional Cohesion Funds**

Since the Asunción Treaty was signed, Paraguay has been drawing up vigorous pledges to create a regional cohesion fund in MERCOSUR. Now that the integration project has its secretariat, the context seems ripe for this kind of measure.

It is hard to imagine direct income transfers within MERCOSUR for social purposes. The scale of the member countries’ poverty, social inequality, dire housing, health conditions, security, and educational deficiencies is such that any transfers between them are likely to spur fierce opposition in the donor country. The giant, moreover, has feet of clay. Brazil has the most pronounced regional disparities in the bloc: how could a structural fund channel money to Paraguay and not to most of Maranhão and Piauí, where poverty is even starker? Ironically, these two Brazilian states are in the north and have virtually no link with the Southern Cone.

A second problem is that the richer members are not really rich. Beyond having little cash available to contribute to a structural fund, as exists in the EU, the kind of convergence that this could promote is debatable. In the EU, donors are wealthy economies with fewer internal disparities. It made sense to bring countries such as Ireland, Spain, Portugal, and Greece to levels closer to those prevailing in the richer members. It is difficult to achieve the same awareness in MERCOSUR.

At the national level, both Brazil and Argentina have their own instruments to reduce internal social inequality—Brazil’s Fome Zero initiative or projects conducted by BNDES or the Argentine government, in addition to development resources from international organizations or certain countries and agencies.

None of this necessarily means that it would be impossible to create a cohesion fund targeting specific development-enabling objectives, tied to the dynamics of integration. In basic terms, the fund could have a dual purpose. First, projects that complement or further an integration initiative in a lagging region could be purely local or could involve one or more

members, and the chief characteristic of such projects would be that their outcome clearly benefits the integration process. Second, general, regionally concentrated aid would not be excluded, but rather would be targeted on a specific problem, either caused by or hindering integration. So, if an area in Paraguay or Argentina suffered severe negative effects from the cessation of certain activities due to their relocation within MERCOSUR, the fund could provide support for structural adjustment.

Both goals would require a prior, unified ranking of MERCOSUR regions and a defined threshold in order to exclude wealthier areas from support. This would create some pressure to make the still fairly fragmented and poorly disseminated statistical system more adequate to overall integration needs. Even in that event, the whole of Paraguay or Uruguay might qualify as a structural adjustment area.

The institutional design of the cohesion fund cannot be very similar to that of the EU.<sup>20</sup> It would be something closer to the Andean Finance Corporation (CAF). The capital would consist of initial endowments from all four or the two largest countries and from national financial and development institutions. Extra-MERCOSUR partners would be accepted. Chile or Chilean institutions, Colombia, the CAF itself, and European institutions could be admitted. Not all projects would be funded at zero cost. Moreover, the annual budget could be increased by revenue from integration—CET receipts are the most obvious candidate in this regard.

The cohesion fund would dynamically interact with the other two dimensions. It could be used to offset or weaken negative effects that occur in the other cases. Moreover, it overlaps somewhat with the policy to enhance MERCOSUR competitiveness (see the section “Enhancing MERCOSUR’s Competitiveness: Internationally Competitive World Links—Policy D.2.2”)—though the latter would apply to a specific firm or entrepreneur while the former would consist of (usually horizontal) aid to a specific geographical area. This raises two questions. Should a new body be created to administer the fund? Could it be a separate financing line within the same institutions involved in competitiveness enhancement? A simpler solution would consist of merging the two ideas and, within competitiveness enhancement, opening a financing line that gives special priority to initiatives originating in specific areas. An even more straightforward form of implementation would be to bluntly give priority to projects originating in Paraguay (and perhaps Uruguay). This policy is here termed *D.3.1*.

## Background Policies

In addition to the policies related to the chosen dimensions, two background activities can be viewed as having a key role in weaving a truly integrated fabric among the different MERCOSUR agents. The first is complex. The second poses few problems of implementation.

<sup>20</sup> The December 2003 meeting of the Common Market Council (CMC) approved CMC Decision 27/03 to promote studies on the creation of structural funds to help poorer areas and the smaller MERCOSUR economies. The analysis by Masi and Hoste (2002) is among the half-dozen papers on this subject.

### ***Support to the Permanent Tribunal and Proactive Dissemination, Management and Control of MERCOSUR's Juridical Acquis—Policy BP.1***

Very few people know the Olivos Protocol, and even fewer are aware of the existence of the tribunal in Asunción or have any idea of how it could help them or how to use it. The few who do know are unable to say whether the “old” dispute settlement procedure through arbitration is finished.

Many of the policies discussed in this chapter are anchored in current or future protocols and legal texts. It is hard for an interested layperson to find a MERCOSUR protocol. It is difficult to track which protocols have been signed and which have not, and even lawyers seldom know whether some have come into force.

Transparency, dissemination, and marketing are urgently needed to manage the juridical *acquis*. Better administrative control of deadlines and the flow of documents in general would be very welcome. This policy requires only a few very concrete initiatives. A “Know MERCOSUR” campaign could inform specific sectors of the population of their basic rights, obligations, and facilities within the common market, while management systems should be streamlined and upgraded. Transparency would be given top priority. The Montevideo Secretariat should be responsible for pursuing and coordinating these and similar initiatives.

### ***A MERCOSUR Human Capital Mobility (HCM) Project—Policy BP.2***

MERCOSUR's main cities have good universities and research centers that could host their own or other members' young graduate students. MERCOSUR needs skilled technical specialists to develop and technologically upgrade many of its productive activities.

The HCM project is one of a few possible educational policies that in the long run would help to strengthen integration links, by creating closer ties within the technical, scientific, and university communities. Initially, two kinds of exchanges could be envisaged: (i) doctorate students and recent graduates would receive support for one to two years in an institution in a country other than their home country; and (ii) specialized technicians could receive support for training in a factory or production unit in another member country.

Project funding could be minimal if there were proper coordination with the national research councils and sectoral associations. Mobility would be supported for researchers/technical specialists in predetermined areas that match key export sectors (also included in the “competitiveness enhancement” outlined in the section “Enhancing MERCOSUR's Competitiveness: Internationally Competitive World Links—Policy D.2.2”), as well as a few areas of the social sciences and humanities. The focus would probably be on biotechnology, the food industries, engineering, education sciences, sociology, and history.

## Implementation

### *The MERCOSUR Secretariat*

Were a portfolio of policies to be adopted and pursued, most initiatives should be coordinated by, or at least located in, the secretariat in Montevideo. The secretariat's current size and its number of staff are clearly insufficient for these responsibilities. The secretariat would be endowed with such responsibilities in any case, if the members want to pursue combined regional efforts to deepen integration and alleviate the impact of asymmetries.

The secretariat needs additional human and capital resources, although this should not be a specific policy since the institution is (or should be) the key instrument for policy implementation. It can acquire its extra responsibilities gradually as policies are implemented. The funds would come mostly from the budgets of the member countries.

Simple measures can be taken quickly. One is related to what might be an overly large LAIA staff in Montevideo. The four member countries could unify their representation at LAIA and transfer some of their nationals to the secretariat in order to bolster its scant resources easily and cost effectively.

Another measure is inspired by the EU's rotating presidencies. Each MERCOSUR presidency should establish a small task force at the respective foreign ministry to help during the six months of the mandate. As in the EU, the MERCOSUR task force should include a national (probably a diplomat) of the previous and next presidencies. Moreover, during each period, a designated member of the secretariat's technical staff should participate in as many task force meetings and activities as possible, and should ensure close connections with Montevideo. This would smooth transitions, improve the control and continuity of decisions, measures, and projects, and foster greater understanding among the four ministries and the secretariat.<sup>21</sup>

The secretariat should also host the competition director (and the competition directorate), who will answer to the secretary. The latter's position will thus become much more powerful as integration progresses, and responsibility for such important jobs as the competition director will fall under the aegis of the secretary. In this respect, political maturity is urgently required of the four members.

Unless the secretariat becomes the locus of all policy-related activities, the MERCOSUR project will gain neither credibility nor efficiency. At the same time, greater pressure to discharge management duties will be placed on Montevideo and the secretariat budget will need to be increased, even if the costs of "housing" each policy come mainly from the policies' own funds. Here, international organizations or the EU could provide cooperation.

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<sup>21</sup> The author is indebted to Ambassador Hans Ulrich Spohn for explaining EU procedures and for his interesting suggestions.

### ***Compatible Supranationality and Subsidiarity***

To what criticisms is this proposal likely to be subject? The chief obstacle will be the cession of national sovereignty, which has consistently blocked many needed developments in MERCOSUR. Will MERCOSUR's architecture become more supranational? Consider those policies in which the demands of supranationality will be more dramatic: the establishment of the safeguards and antidumping protocol (policy 1.3), the creation of a competition directorate (2.3), and the cohesion fund (3.1).

The safeguards and antidumping protocol (1.3) has already stalled because of serious opposition in Argentina and Brazil. Nonetheless, it is crucial if the proposal's core policies are to function smoothly and be credible. An additional implication may explain part of the heightened reactions: it signals the start of a common MERCOSUR trade policy, which will eventually lead to a single negotiating voice in Geneva (at least as regards market access in goods). This triggers fear and insecurity across the region, not only in the bigger members—in Uruguay, for instance, former President Jorge Batlle tried to pursue an independent foreign trade policy. This area is a litmus test of members' concern with this common goal. No half measures will work. Significant effort and skills are needed if the protocol is to be signed and adopted.

The competition directorate (2.3), though broader and more ambitious than the former policy, poses fewer problems. Competition authorities in Argentina and Brazil are well aware that this is needed, and the EU experience is very well regarded worldwide. Implementation should progress as described in the subsection, "A MERCOSUR Competition Directorate—Policy D.2.3." Once anchored in the policy on safeguards and antidumping, the directorate should lean heavily toward subsidiarity and give as much weight as possible to national legislation and national courts. This would greatly help to minimize disputes and to counteract opposing forces.

The cohesion fund (3.1) may raise delicate questions of supranationality, apart from other forms of opposition, but these will depend on the final institutional arrangement. Will it have "shareholders" or a group of sponsors, or be a full administrative unit under the secretariat? Will it be an arm of the policy on enhancing MERCOSUR competitiveness (policy 2.2)? In the former case, a structure giving a reasonably prominent place to the main national development or funding agencies would be more palatable. At present, given the many reactions it might trigger, this policy should begin in the more limited manner mentioned at the end of the section "Dimension 3: Regional Cohesion Funds"—as a special priority for projects involving Paraguay. This will set the fund reasonably apart from the EU concept and cohesion will boil down to explicit support for Paraguay.

Concerns about supranationality arise not only in discussions of the implementation of the above measures, but also in debates about deepening integration. Persuading national governments to cede some of their sovereignty will require more than a nicely designed integration project. Support to the MERCOSUR tribunal and management of the MERCOSUR *acquis* must cover this matter through marketing activities. Argentina and Paraguay have

either officially<sup>22</sup> or informally taken a position that favors giving international treaties precedence over national law. More comprehensive work will be required in Uruguay and, especially, Brazil.

A related matter is the extent to which national policies would conflict with an envisaged regional initiative. Kosacoff (2005) analyzed this issue by classifying policies into four categories: export promotion, investment promotion, capacity, and performance enhancement. For each national policy identified in each category, the impact on integration was qualitatively assessed from positive to negative. The resulting matrices reveal that Brazil, Uruguay, and Paraguay may be the source of more incompatibilities.<sup>23</sup> The picture, however, is less serious than expected.

Brazil's more negative measures are in the investment promotion category, while Uruguay's and Paraguay's relate to export promotion. Uruguay is the champion of sectorally targeted initiatives involving wine, sugar, rice, chocolate, and dairy products, among others—ironically confirming the insights of Calfat, Flôres, and Ganame (2003) and similar studies. Dismantling these structures is a step-by-step task that is only feasible if the basic legal instruments and institutions at the group level are clearly established.

### *Timetable*

The policies presented in this chapter are related either through mutual interactions or by causality. The core of the proposal lies in policies 1.3, 2.2, 2.3, and 3.1; the latter three interact strongly and should be jointly pursued. The remaining policies should be considered as enabling measures, be they direct preconditions for the core or not. The main causal relations among the eight undertakings and BP.1 are:

$$\{1.1, 1.2, 1.3, 2.1, \text{BP.1}\} \Rightarrow \{2.2 \Leftrightarrow 2.3\}$$

$$\{1.1, 1.2, 2.1, 2.3\} \Rightarrow \{3.1\}$$

The key interaction is

$$2.2 \Leftrightarrow 2.3 \Leftrightarrow 3.1.$$

Given this, a first tentative schedule can be drawn up. Table 9.1 shows the evolution and duration of all proposed activities. Time is measured in quarters, starting with Q1 or the first quarter when action begins. Implementation is supposed to take one and a half years.

<sup>22</sup> Explicitly, in the Argentine constitution.

<sup>23</sup> Distorting policies in Argentina are usually geographical, related as they are to Tierra del Fuego, Patagonia, and La Rioja.

Some policies may be only well advanced and not necessarily fully complete before another begins—as, for example, with 1.3 (safeguards and antidumping protocol) and 2.3 (competition directorate). This is what is meant by causality. Hence the directorate could be officially launched at the beginning of the fourth quarter, when the protocol should be close to full adoption. Similarly, 3.1, even in its simpler form, would only start three months after 2.2's entry into effect.

Policy 1.4 (the clearinghouse) has its own timing and is already under way. The proposal here, however, is that the system between Argentina and Brazil be fully operational by the end of the fifth quarter, with the incorporation of Uruguay also well advanced.

### Conclusions

Most of the 10 policies described here need to be explored further, in greater detail, before they can become operational. Doubtless their implementation would face difficulties, but they are not far from a set of Pareto improvement measures. This, along with the provisos outlined in the section "Dimension 3: Regional Cohesion Funds" may facilitate their acceptance.

At present, attention should focus on the four core measures plus the two background measures. The interaction between the sectoral competitiveness policy 2.2 and the other two closely linked policies requires further examination.

**Table 9.1 Timetable**

Policies	Quarters					
	Q1	Q2	Q3	Q4	Q5	Q6
1.1 <sup>a</sup>				x	x	
1.2	x	X	x	x		
1.3		X	x	x		
1.4	x	X	x	x	x	x
2.1			x	x	x	
2.2 <sup>b</sup>				x	x	x--->
2.3				x	x	x--->
3.1					x	x--->
b.1 <sup>c</sup>	x	X	x	x	x	x
b.2			x	x	x	x--->

- a. Unless otherwise signed, the policy/activity will be completed by the end of the last quarter indicated by an x.  
b. The arrow at the last quarter means that the policy will continue beyond that time.  
c. This policy can be maintained continuously, although less intensely.

## APPENDIX

### On Selecting Sectors

Identifying the sectors to be included in policy 2.2 could benefit, on the technical side, from the use of selected trade intensity indices defined for each product/good  $k$ , exported from MERCOSUR to country/group  $j$ . Letting

$X_i^k$  = MERCOSUR or member country  $i$ 's exports of good  $k$

$X_i$  = total exports of MERCOSUR or member country  $i$

$M_j^k$  = country/bloc  $j$ 's imports of good  $k$

$M_j$  = total imports from country/bloc  $j$

$M_w^k$  = world imports of good  $k$

$M_w$  = total world imports

two of the most best known indices (Balassa, 1965) are the Revealed Comparative Advantage or Export Specialization Index (RCA) of exporting country  $i$  and the Revealed Comparative Disadvantage or Import Specialization Index (RCD) of importing country  $j$ , expressed as:

$$RCA_i^k = \frac{X_i^k / X_i}{M_w^k / M_w}$$

$$RCD_j^k = \frac{M_j^k / M_j}{M_w^k / M_w}$$

The RCA equals the ratio between the share of a product in a country's total exports and the share of the same product in world trade. This roughly shows a country's export specialization. It is common practice to consider that when the RCA is greater than 1, the country is more export-oriented for that particular good than for the "world average" and, therefore, it displays a revealed comparative advantage in that particular good (Flôres, 2005).

Analogously, the RCD equals the ratio between the share of the product in a country's total imports and the corresponding share in world trade. Again, when the import specialization index is greater than 1, the country reveals a comparative disadvantage in that good.

Combining the two indices, four situations can arise:

1. The case  $RCA < 1$  and  $RCD < 1$  is of no interest in terms of possibilities, unlike the following.
2. *Sustained gains.*  $RCA > 1$  and  $RCD > 1$  describes a perfect match between the comparative advantages of MERCOSUR and other group needs.
3. *Intermediate case.*  $RCA > 1$  and  $RCD < 1$  when MERCOSUR is competitive, although the other group is not a great consumer of the product in average world terms, and may reap further gains.
4. *Short-lived or future gains.*  $RCA < 1$  and  $RCD > 1$ , meaning that whether a preferential agreement lowers the trade barriers facing MERCOSUR or a technological improvement occurs, a temporary or permanent advantage might offset lower competitiveness.

In addition to other criteria, firms/sectors for which  $RCA < 1$  would receive attention, as they need more a competitiveness boost. The analysis would be refined by computing the corresponding RCD values for different key MERCOSUR export markets. The products with higher RCDs would be given preference.

This would be nothing more than a complementary device for guiding the allocation of resources. It would concur with Hausmann and Rodrik (2003), in the sense that nonexistent or unexploited areas (translated into low RCA) would be favored. Of course, this must be accompanied by good reasoning and common sense.

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## PART IV

### **Coordination of Macroeconomic Policies**

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## **MERCOSUR in Transition: Macroeconomic Perspectives\***

*Daniel Heymann and Adrián Ramos*

### **Introduction**

The Southern Common Market (MERCOSUR) has witnessed wide macroeconomic swings in recent years. Argentina's economic crisis of 1999–2002 and subsequent recovery exemplify drastic fluctuations in regional economic behavior over relatively short periods. During such swings, macroeconomic policies have been managed with little regard for their spillover effects on other economies of the region. Trade flows have oscillated widely in scale and composition, causing visible frictions among partners. Amid this turmoil, it has been difficult to identify a sense of direction for MERCOSUR as an economic project. Nonetheless, the belief that countries stand to gain from trying to “grow together” (and would incur losses if the regional arrangement were to break down) still seems to be widespread, if diffused.

The political decision that MERCOSUR is a permanent undertaking appears to be established, having outlived governments of various political stripes. Since the region has entered a recovery phase, apparently leaving behind episodes of extreme turbulence, and since decision-making timelines have been somewhat extended, it seems appropriate to reconsider MERCOSUR's medium-term prospects, including the possibility of a move toward deeper integration. This chapter seeks to contribute to the debate by briefly analyzing macroeconomic interactions in MERCOSUR, and by discussing the incentives for and constraints on macroeconomic cooperation in the region's current circumstances.

Themes that recur in the discussion include the facts that (i) the lack of a shared, concrete perspective on MERCOSUR's role in the growth of its members' national economies has curbed the perception of the integration project as a valuable and permanent economic undertaking, one that would place individual policies in the context of repeated interactions within a partnership; (ii) macroeconomic spillovers in the region have mainly originated in wide fluctuations in national economies, associated with crises that have cast doubt on the sustainability of past observed trends; (iii) on several occasions, the MERCOSUR countries (and specifically their authorities) have evinced substantial differences in their approach to

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\* This chapter is a slightly revised version of a study written in 2005; it is based on the information then available and circumstances at the time.

economic policies, prominently including the management of key macroeconomic instruments; (iv) uncertainties about how (and why) the integration scheme would evolve, and doubts about incentives and the reliability of the partners' macroeconomic management, have induced centrifugal forces, especially in times of economic turbulence; (v) in order to become a progressive project, MERCOSUR members should develop shared views about the growth strategies of their economies and the role of the regional agreement in those strategies, which would proceed *pari passu* with advances in macroeconomic cooperation; and (vi) the latter would include a search for some convergence of analytical and policy-making "models" (which is not the same as uniformity of policies) and a routine of consultations to facilitate the implementation of joint actions when circumstances require it.

## Regional Macroeconomic Performance

Throughout the region, albeit to varying degrees depending on the country, both resident and nonresident agents have faced difficulties in identifying permanent levels of income and sustainable spending. Those difficulties reflected wide fluctuations in real output and relative prices, and probably helped generate them (Heymann, Kaufman, and Sanguinetti, 2001). Additionally, perceptions of the relative size of the economies, and of their prospects and growth potential, have varied substantially over time.

An indication of the magnitude and pattern of these movements is offered by the evolution of the dollar values of countries' gross domestic product (GDP). Since they embody changes in prices and quantities, those variables do not serve to inform comparisons of production volumes or living standards, as would be the case with purchasing power parity (PPP) data. They do, however, have an analytical meaning of their own. The dollar values of GDP are related to the concrete measure of the purchasing power of a country's total output over traded goods, given actual market prices. In this sense, those dollar values and agents' expectations of how they will move are related to the magnitude of aggregate demand in terms of tradables, and therefore to the demand for imports and the trade balance. In addition, it seems clear that when a large volume of financial contracts are denominated in foreign currencies (as is the case for the MERCOSUR countries concerning foreign debts and, in Argentina and Uruguay in the 1990s, also for contracts between residents), debt sustainability is closely linked to the performance of the dollar value of incomes.

Clearly (see the time charts and histograms in Figures 10.1 and 10.2), the fluctuations of the series have been particularly intense for Argentina.<sup>1</sup> As can be observed, the range of variation over the last three decades has been very wide, between values as high (and obviously unsustainable) as \$15,000 in 1980 and as low as below \$3,000 in moments of crisis such as 1975, 1989, and 2002. Moreover, the changes were noticeably nonmonotonic—thus, in the recent crisis, the dollar GDP per capita fell to its lowest level since 1970.

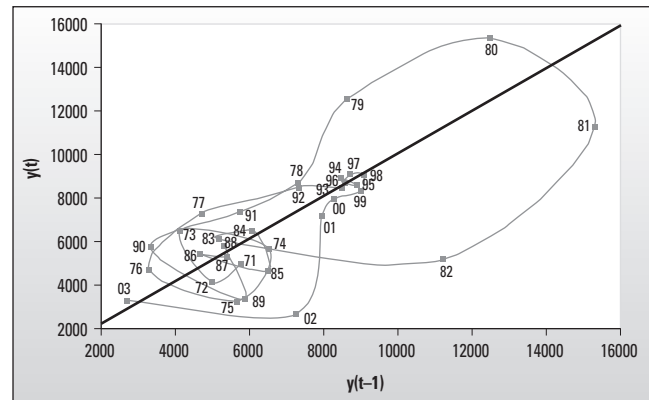
<sup>1</sup> The data refer simply to the ratio between per capita GDP at constant prices and the actual exchange rate, adjusted for the consumer price index (CPI) inflation of the United States. The phase diagram indicates in the vertical axis the value of the variable in year  $t - 1$ , and in the horizontal axis the value in year  $t - 1$ . Points above the diagonal represent increases in year  $t$ .

From this perspective, the period of convertibility seems to have been a time when, for the most part, the behavior of public and private agents was consistent with the expectation that the economy was “fundamentally” productive enough to sustain a level of spending in dollar terms much higher than in the past (although less than in the extraordinary peaks of the early 1980s). Those beliefs were expressed in particular in the large number of commitments denominated in dollars. The thwarting of those expectations and the widespread breaking of economic promises in the chaos of the crisis left the economy, as a starting point, with a historically very low level of dollar income (Galiani, Heymann, and Tommasi, 2003). The subsequent recovery of real output (and the partial reversal of the jump in the real exchange rate) indicated that those levels were transitory and characteristic

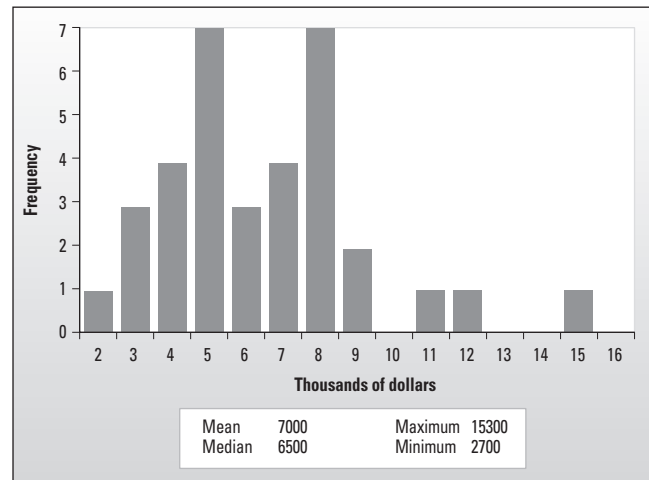
of extreme circumstances. As the histogram shows, however, the distribution of the values in the dollar GDP series is clearly not unimodal. Hence, in addition to the real uncertainties implicit in any projection of real output and exchange rates in an economy with disruptions in performance, there is no easily identifiable reference point to mark the likelihood of “regression to the mean” after a large shock.

While the movements of Uruguay’s dollar GDP are somewhat analogous with Argentina’s (although with less variation), those of the Brazilian series are different, with a lower volatility and more observations concentrated around central values. This suggests, in a very simple fashion, that the pattern of macroeconomic fluctuations has been heterogeneous in the region and that uncertainty about permanent incomes was less intense in Brazil (Figures 10.3 to 10.6).

**Figure 10.1. Argentina: Phase Diagram of Per Capita GDP in Constant 2000 Dollars, 1970–2003**



**Figure 10.2. Argentina: Histogram of Per Capita GDP in Constant 2000 Dollars**

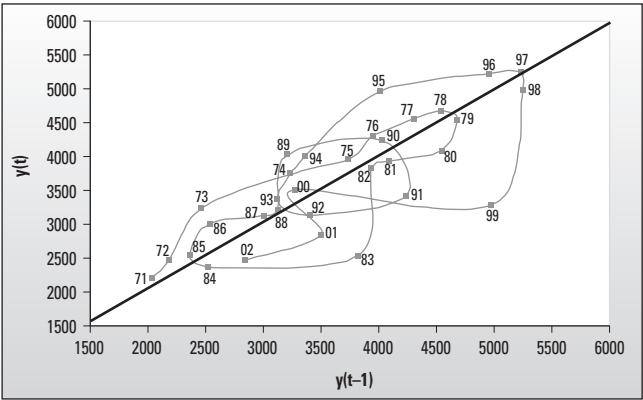


A similar picture emerges from the evolution of real GDP (see Figures 10.7 to 10.9). In Argentina, the macroeconomic fluctuations appear not only as oscillations around a more or less steady trend, but also as ups and downs of the measured trend lines; those trend lines vary visibly as new observations are added.<sup>2</sup> By contrast, the Brazilian trend is more neatly defined, and has been relatively steady despite the short-run fluctuations in aggregate output.

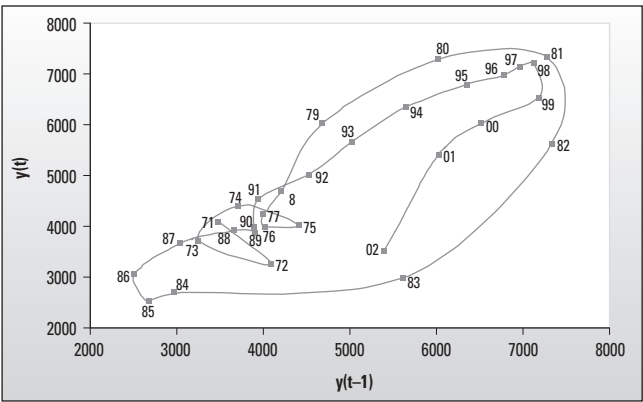
In any case, when measured in current (dollar) magnitudes, the relative sizes of the region's economies have varied considerably. That is, beyond the fact that the economies of MERCOSUR have large and well-defined "structural" size asymmetries, the magnitude of

<sup>2</sup> The exercise, consisting of calculating "recursive" trends, tries to capture in a simple fashion the notion that measures of "normal" levels of a variable such as GDP at a certain moment typically rely on data that are unobtainable at that moment (and some that, referring to later periods, will remain unavailable for long intervals). In this sense, it is merely a descriptive device and lacks statistical accuracy. However, it seems to be the case that, in an economy where those calculated trends reveal greater variability, it may be expected that agents are more uncertain about their future levels of income (since simple extrapolations may not serve as good approximations) and, on occasions, macroeconomic forecasts in market decisions can feature large errors.

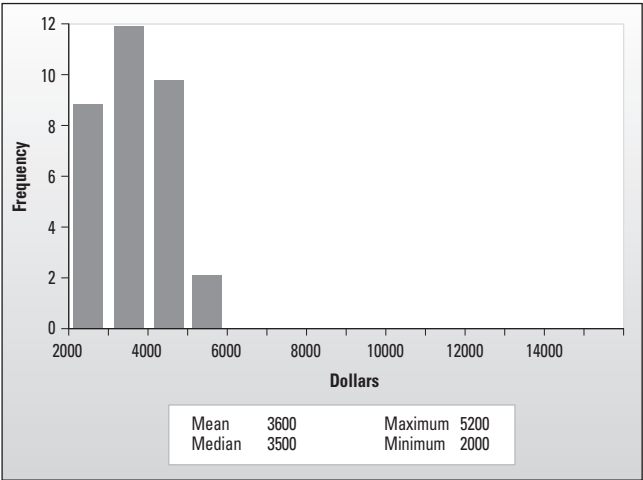
**Figure 10.3. Brazil: Phase Diagram of Per Capita GDP in Constant 2000 Dollars, 1970–2002**



**Figure 10.4. Uruguay: Phase Diagram of Per Capita GDP in Constant 2000 Dollars, 1970–2002**



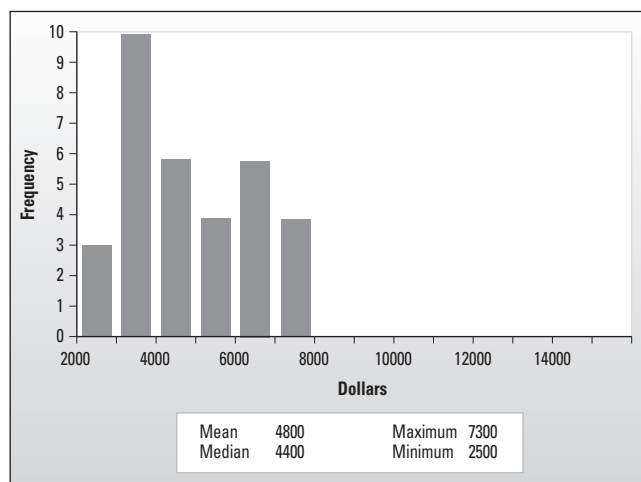
**Figure 10.5. Brazil: Histogram of Per Capita GDP in Constant 2000 Dollars**



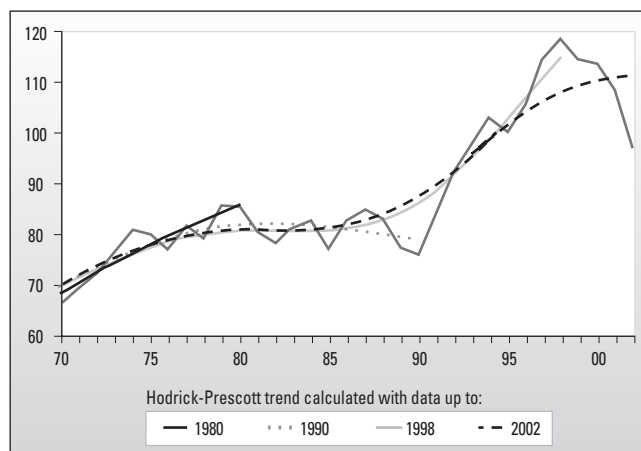
those asymmetries has shifted from period to period. For instance, at several times in the 1990s, Argentina's economy appeared to be about half the size of Brazil's (with a peak of almost 60 percent in 1992); the ratio fell to 22 percent in 2002. Uruguay's GDP was equivalent to about 7 percent of Argentina's in 1994 and 1999, and 12 percent in 2002. These fluctuations seem to have influenced perceptions about the size of the economies and their respective markets.<sup>3</sup>

The differences in macroeconomic behavior were probably related to patterns of movement in the international terms of trade and capital flows observed for each country (see Figures 10.10 and 10.11).<sup>4</sup> As is

**Figure 10.6. Uruguay: Histogram of Per Capita GDP in Constant 2000 Dollars**



**Figure 10.7. Argentina: GDP at Constant Prices and Recursive Trends**



<sup>3</sup> Although some statistical analyses suggest that the bilateral real exchange rate between Argentina and Brazil is a stationary series (Fanelli and González-Rozada, 2003), this was not necessarily reflected in the agents' interpretation of the data: casual observation suggests that part of the large changes were taken to be permanent.

<sup>4</sup> The argument is based on a comparison between terms of trade effects and capital movements "scaled" by the magnitude of imports. That is, the variables that are measured are the averages of absolute values of:

$$\hat{p}_X \frac{X}{M} - \hat{p}_M$$

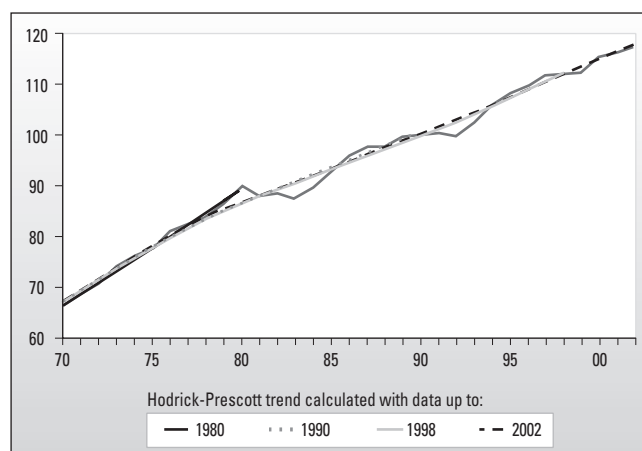
(where  $\hat{p}_X, \hat{p}_M$  are, respectively, the proportional changes in export and import prices and  $X, M$  are the values of exports and imports), and  $\Delta F / M$  (where  $\Delta F$  is the annual change in the magnitude of capital flows, and  $M$  are imports). The use of this metric derives from an assumption that the macroeconomic significance of movements in balance of payments variables (in terms of the adjustments in domestic spending and output with which they would be associated) is better measured by indicators that use as a reference the value of imports/exports, or that of the output of tradable goods, rather than the standard proportions of GDP (Heymann, 1996; Calvo, Izquierdo, and Talvi, 2003). Regarding this exercise, it should be stressed that capital movements are not interpreted as purely exogenous variables (as if they were some kind of "rain from above"): residents must be willing to sell assets if foreigners are to buy assets from them, and it is likely that expectations about the prospects of the economy have a strong influence on the decisions of both groups. From this perspective, a large variability in capital flows is related to wide swings in those expectations.

evident, Argentina has experienced a sharp variability in the scale of foreign financing compared with its neighbors, especially Brazil.<sup>5</sup>

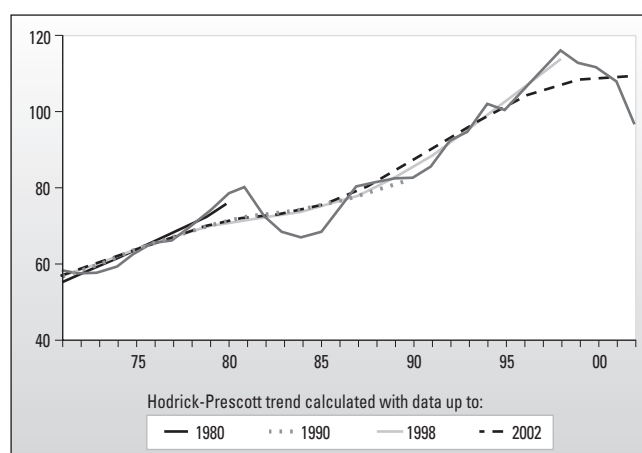
These contrasts correspond with the different features and intensities of the crises that the countries have experienced. In particular, the Brazilian episode of 1999 was much more a “devaluation crisis” than the epochal crisis that marked the end of convertibility in Argentina. The latter not only involved a breakdown of the exchange rate regime but was also associated with default on the public debt, and put into question the whole system of contracts. Despite such noticeable differences, however, there is a common element in that the macroeconomic fluctuations in real output and relative prices in the region do not match the image of fluctuations generated by recurrent, transitory shocks drawn (as it were) from given and well-known distributions.

Rather, the wide swings—which in one way or another have had regional repercussions, even though they may have originated and had their main effects in one country—seem more like individual events. Apart from the general logic that applies to any macroeconomic dynamics, performance in these events has been strongly influenced by behaviors and decisions specific to time and place—such as large-scale policy reforms and the responses that they induced. Additionally, in these instances the sustainability of macroeconomic trends was typically an

**Figure 10.8. Brazil: GDP at Constant Prices and Recursive Trends**



**Figure 10.9. Uruguay: GDP at Constant Prices and Recursive Trends**



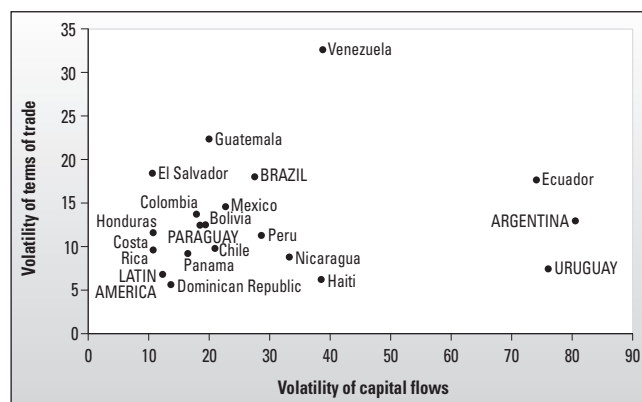
<sup>5</sup> To illustrate the magnitude of the volatility of private capital flows the Inter-American Development Bank (IDB, 2002) identified cases in which annual variations in net private capital flows exceeded 20 percent of exports in the period 1972–99. The report found that MERCOSUR, which accounts for almost 40 percent of the observations with these characteristics, had a higher level of volatility than other regions.

issue. It follows that there was an interaction between macroeconomic fluctuations and changing views about the countries' (and the region's) longer-term economic prospects. This applies in particular to the recent period, when moods appear to have varied widely and when, in fact, the behavior of the economies kept sending signals that might have belied expectations formed not much earlier. From another perspective, the possibility that shocks and fluctuations have had a nonrecurrent component implies that care should be taken when interpreting and using prospectively "stylized facts" that try to summarize performance features throughout potentially heterogeneous episodes.

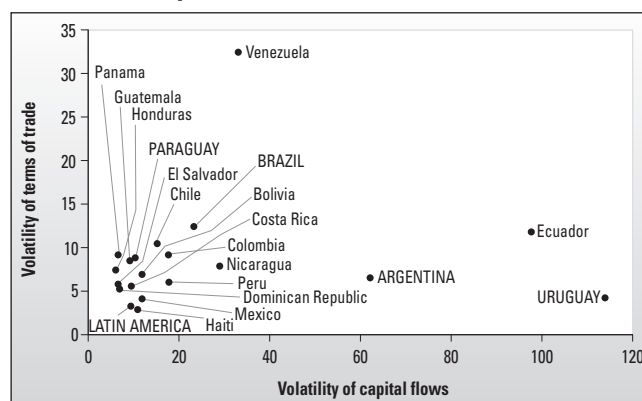
In addition, the macroeconomic crises have left a residue of high government debts. The experience has been quite varied in this respect. Argentina declared a default and engaged in a long negotiation in order to redefine debt services and make them sustainable. Uruguay looked for a rapid agreement with its creditors, while Brazil has avoided restructuring. Despite these clear differences, there have been large fiscal adjustments throughout the region. However, the magnitude of public debt is likely to remain a major macroeconomic constraint and a potential source of shocks.

Degrees of openness and shares of international trade are very different for the various countries of the region. Clearly, the creation of macroeconomic spillovers through the exchange of goods is strongly asymmetrical.<sup>6</sup> Nonetheless, even Brazil seems to have been

**Figure 10.10. Latin America: Volatility of International Terms of Trade and Capital Flows, 1981/2003**



**Figure 10.11. Latin America: Volatility of International Terms of Trade and Capital Flows, 1990/2003**



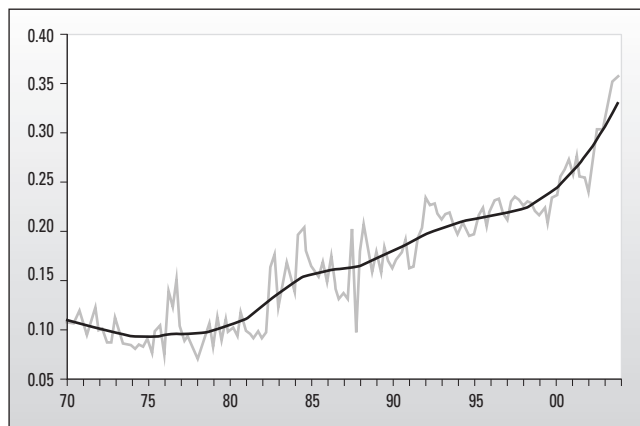
<sup>6</sup> Lacunza et al. (2004a, 2004b). As Bevilaqua, Catena, and Talvi (2001) have suggested, the vulnerability of the smaller partners in MERCOSUR (especially to sharp changes in Brazil's real exchange rate) increases in line with the share of "regional goods" (i.e., those tradable within the region but largely nontradable with the rest of the world) in their total output and consumption.

affected as its neighbors experienced very wide fluctuations. Between 1990 and 1994, for instance, Argentina's total imports increased by more than fivefold, and its purchases from Brazil by sixfold; the scale of the increase in bilateral imports amounted to about 11 percent of Brazil's exports in 1990 (and 0.8 percent of its GDP of that year)—a nonnegligible proportion, even if not extremely large. Similarly in the 1998–2002 depression, Argentina's bilateral imports declined by about two-thirds; the fall represented 9 percent of total Brazilian exports in the starting year.<sup>7</sup> In the other direction, rapidly increasing demand from Brazil between 1993 and 1998 was macroeconomically significant for its neighbors: in that period, the rise in Argentina's bilateral exports represented nearly 40 percent of the initial value of total exports. The confidence in MERCOSUR's prospects during the boom period of the 1990s (and the implicit belief that the regional agreement was on course, without much need for action) contrasted strongly with attitudes in the subsequent period of declining trade.

Movements in intraregional trade followed the fluctuations in the aggregate performance of the economies, as expressed particularly in their total demand for imports, but they have also displayed features of their own. The shares of intra-MERCOSUR imports in the countries' total imports has fluctuated markedly in both directions (see Figures 10.12 and 10.13).

Since MERCOSUR's inception as a regional agreement, trade has evolved in several phases. In the early 1990s, both Argentina and Brazil increased their share of their neighbor's imports (in the case of Brazilian imports from Argentina, starting from very low levels of less than 5 percent of the total). In the second half of the decade, Brazil's bilateral imports kept growing as a proportion of its total purchases (reaching peaks of about 15 percent in 1998), while Argentine bilateral imports remained at about 20–22 percent of the total. Since these shares remained constant or increased, while each country's total imports were also rising, the considerable growth in the volume of trade in both directions suggested that MERCOSUR might be on a sustained path of expansion, with stronger interdependencies. Performance in the

**Figure 10.12. Argentina: Imports from Brazil as a Share of Total Imports and Trend**  
(%)



<sup>7</sup> These are undoubtedly very approximate indicators of macroeconomic impacts transmitted from one country to another. They serve simply to give a first impression of orders of magnitude. In any case, it should be noted that, although the scale of intraregional trade as a proportion of total trade is relatively small for Brazil, the wide shifts in its movements have meant that changes in sales to the region represented fractions of total exports that are comparable to those observed, say, in trade between large partners in the European Union (EU).

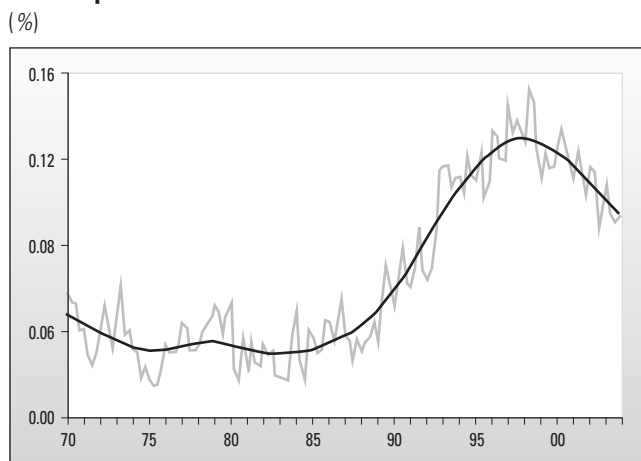
following years, marked by the Brazilian devaluation of 1999 and the Argentine crisis, clearly differed from that image. While total bilateral trade between Argentina and Brazil declined sharply between 1998 and 2002 (by no less than 50 percent, against a 600 percent increase between 1990 and 1998), the share of Argentine goods in Brazilian imports fell substantially, while Brazil took a much larger share of Argentine imports, reaching over 33 percent in 2003.

These very marked changes in the pattern of trade are also evident in sectoral data (see, for example, Heymann, 2004, and Ribeiro, 2004). Considering the 1990–2002 period as a whole, a wide range of Argentine and Brazilian economic activities simultaneously increased their share of the neighboring country's imports. This happened across a range of sectors, including agriculture, mining, food products, paper and chemicals, basic metals, and motor vehicles. Overall, this performance suggests that the expansion of trade was associated in part with complementarities in production. Nevertheless, there has been a noticeable break since the late 1990s. A large number of Argentine activities (which in the manufacturing sector account for about two-thirds of value added) suffered a decline in their presence in the Brazilian market as a proportion of Brazil's imports. At the same time, the share of Brazilian goods in Argentine imports increased in sectors as varied as textiles and apparel, leather and footwear, chemicals, rubber and plastic, metal products, and machinery.

Such changes indicate a structural break in recent years, particularly regarding Argentine imports, although it is still difficult to draw definitive conclusions about their micro- and macro-origins or the likelihood that they will persist. Possible contributing factors include such heterogeneous effects as productivity increases in Brazil due to maturing investments, fiscal incentives for the installation of industries (particularly in connection with multinationals' choice of production sites), and the comparative willingness of Brazilian exporters to sell to Argentina in the midst of its crisis. In any case, these shifts in the configuration of trade have caused frictions—especially by inducing various sectoral demands in Argentina for protection against imports from Brazil, which spurred Brazilian reactions—and have created uncertainty about the nature of “exchange opportunities” in the future.

One simple way of analyzing the changes in trade flows is to estimate “reciprocal aggregate import functions” (see the Appendix to this chapter). The evidence suggests that the parameters of the equation for Brazilian imports from Argentina have not changed substantially in recent years. Overall, therefore, the large movements in these flows can be represented approximately

**Figure 10.13. Brazil: Imports from Argentina as a Share of Total Imports and Trend**



as responses to Brazil's changing macroeconomic outlook, in roughly similar terms as in the past (in particular, an acceleration of Brazilian growth would have a sizeable impact on Argentina's bilateral exports).<sup>8</sup> By contrast, in the Argentine import function, a significant structural break can be identified, one that has increased the demand for goods from Brazil. Since this break seems to have occurred recently (around 2002, in a period when the Argentine currency underwent a large depreciation), it is difficult to establish whether this has been a jump in levels or a drop in the exchange rate elasticity of imports from Brazil. It remains the case that the value of Argentine imports from Brazil in 2003 was similar to that in 1997, when (for a roughly similar level of real GDP) the real exchange rate was considerably lower.

To summarize, the region's macroeconomic performance (and especially Argentina's) has been quite varied and has been marked by episodes of crisis. Macroeconomic spillovers were particularly strong during those episodes. In recent years, there have been visible changes in the configuration of intraregional trade: a sharp increase in the share of Brazilian goods in the Argentine import market and smaller flows in the opposite direction. These swings have created tensions, which have diverted attention from the search for longer-run opportunities through integration. In any case, the observed behavior has made it difficult to identify trends and patterns of macroeconomic interaction that could be projected into the future.

## Macroeconomic Cooperation in Conditions of Transition

The management of macroeconomic spillovers is only one aspect of the challenges facing MERCOSUR. After a period of strong turbulence, the features and direction of the integration project still remain to be defined in such a way that the countries perceive it as being conducive to the growth of their economies. The motives and conditions for some type of joint undertaking in the macroeconomic field cannot be separated from the "real" elements of integration. Although the mere existence of macroeconomic interdependencies may induce agents in one economy to watch the other economies and react to how they behave, this does not automatically trigger (as MERCOSUR's own experience suggests) a concrete demand and a concrete supply of coordinated or cooperative (that is, jointly decided by mutual agreement) policy activities.<sup>9</sup> Additionally, it does not seem to be the case that formal pronouncements themselves generate cooperation with actual consequences. A necessary condition appears to be the common perception that "neighborhood effects" are and will be important for each economy—perhaps through different channels and with different intensities according to the country—and that policy interactions will recur over time and can generate significant individual benefits.

In a region marked by size differences as large as those between the members of MERCOSUR, macroeconomic interdependencies will be clearly asymmetrical—and so too, there-

<sup>8</sup> There were incipient signals in that regard in the latter part of 2004. Brazil's bilateral imports reveal a large elasticity with respect to its aggregate output, indicating that the cyclical response of Brazil's regional imports is strong, also in comparison with that of total imports.

<sup>9</sup> See Meyer et al. (2002), Mooslechner and Schuerz (1999), and Canzoneri, Cumby, and Diba (2002) for surveys of economic models and experiences with international macroeconomic policy coordination.

fore, will be the incentives to engage in concrete policy interactions. The asymmetry of the incentives, however, does not seem to be very different from that involved in participating in the construction of an integration project. The question, again, centers on the existence of real perceived gains from integration for all parties. Clearly, these gains will be of a different magnitude (and possibly a different nature) for the large, medium and small partners. Nonetheless, if the cost-benefit assessment of progressive economic integration is positive, and the regional project starts providing a long-run perspective for private and public decisions, it may seem valuable to invest in mechanisms to deal with regional macroeconomic spillovers and, especially, to help avert crises or absorb their effects.

To those ends, it is important that the members develop common views on macroeconomic issues. In principle, it is conceivable that countries may engage in some type of coordinated actions, even though their governments have pessimistic expectations of each other's economies and doubts about how those economies are managed—just as heterogeneous beliefs might induce trade. But this argument does not seem to be relevant, inasmuch as coordination is largely an intertemporal exchange (wherein, in general, *quid pro quo* need not be immediate) and where reputation plays an important role. The development of practices and routines of macroeconomic cooperation seems to demand a long-term perspective, such that the participants envisage a persistent and useful interaction with the others. That in turn requires a progressive view of integration as an important part of each country's growth strategy. Otherwise, the incentives for either inaction or differentiation are likely to dominate. This has been apparent in MERCOSUR recently. During both the Brazilian devaluation and the Argentine crisis, the authorities in the other countries made visible and sometimes vocal efforts to separate their economy from the one in trouble, while the government of the troubled economy was absorbed with its own problems. Clearly, the "supply of cooperation" was quite limited in those instances.<sup>10</sup>

MERCOSUR is in a state of flux. In order for the integration project to move forward, it is important to define a direction that allows the countries to perceive the regional agreement as a means of expanding productive opportunities in a concrete way (and to reduce the pressures associated with the notion that the economies are involved in a zero-sum game of competing for parts of the regional market). This does not necessarily require a detailed "sectoral" approach, but it may involve outlining, at least implicitly, elements of a common development strategy that identifies areas of complementarities between the economies—particularly those that may strengthen each economy's export potential relative to third markets.<sup>11</sup> In that context, the incentives to move toward deeper integration would emerge from the anticipated gains to be reaped from exploiting those complementarities.

<sup>10</sup> Note that the centrifugal forces not only were internal to the region but also came from influential international actors. The effort to divide countries into those whose behavior was "good" or "bad" was evident, for example, in the attitudes of the International Monetary Fund (IMF). While this was probably part of a policy to avoid "contagion," it also tended to drive policies in the region away from one another in a way that further reduced the incentives for cooperation.

<sup>11</sup> In the 1990s, Lavagna (1996) argued that the MERCOSUR countries would gain by coordinating strategic goals in technological and productive areas, on the basis of a common evaluation of the prospects of international markets.

A concrete, long-term view of integration as a tool for growth may induce specific demands for coordination that would not otherwise emerge. For example, if countries deem it in their best interests to promote (rather than restrict) the mobility of goods and services inside the region, tending toward a “single market,” they would also find incentives to start harmonizing the relevant taxes and, in general, to move together toward reducing transaction costs. At the same time, the perception that substantial gains may be obtained from exploiting productive complementarities can dilute competition for the localization of investments, and help make the national (and perhaps also local) authorities more willing to discuss their investment-promotion policies with their regional partners, as well as to agree on common criteria.<sup>12</sup>

Deeper integration intensifies the spillovers between the economies. Hence each country would have a greater stake in the performance of the region as a whole. The anticipated payoffs from participating in the integration project would depend (with due regard for asymmetries) on the expected growth and volatility of the partners’ economies. It is hard to credit that countries may seriously engage in progressive integration if they are skeptical about the future performance of their partners, and if they do not perceive clearly how they would benefit from the growth of the region as a whole. Once under way, a deep integration project has large exit costs, in fact and by design. According to the standard arguments, the willingness to make such an “irreversible investment” would depend on the expectation of gains large enough to offset the preference for flexibility. Conversely, governments would be reluctant to formally undo an existing regional arrangement even if they have doubts about the future gains to be derived from it. This bias toward the status quo may lead to stalemates, whereby integration remains stagnant (or perhaps limited to wide political issues or to its role as an instrument in negotiations with third parties) and, in practice, is not viewed as a concrete joint project. Breaking this stalemate requires a long-term perspective on the expected evolution of individual economies in the regional context. Such a perspective would also set the stage for macroeconomic cooperation.

The search for a reasonably predictable and sustainable trend seems to be a task of great macroeconomic significance for the economies of the region: if intertemporal budget constraints can be satisfied without major adjustments or oscillations in real spending, a major source of turbulence would be removed. The large macroeconomic fluctuations have been mainly induced by crises that, in one way or another, put into question the sustainability of the course that the economies (and central elements of macro policies) had been following. From this standpoint, a crucial element for the prevention of crises and deep recessions would be to establish a path on which permanent levels of income and spending are reasonably well defined, so that public and private agents within and outside the country in question can make informed decisions, with due regard for the unavoidable real uncertainties about future growth. In this respect, views of the region’s macroeconomic sustainability would influence rational assessments of the creditworthiness of individual economies.

<sup>12</sup> There may be reasons not to have strict uniformity in those policies (Fernández-Arias, Hausmann, and Stein, 2001), but it seems clear that outright policy competition for investments, in addition to its direct fiscal costs, places the economies in a noncooperative setting and can cause frictions that may contaminate an integration process.

At the same time, how the region's governments and populace perceive the partners' macroeconomic sustainability is likely to have a significant influence on attitudes toward integration. Such perceptions, in turn, depend on how those agents assess the prospects for and management of each economy—that is, figuratively, on what their working “macro model” is and how it corresponds, or not, with the model they see as implicit in the policies of the countries. The willingness to make international commitments, and to develop integration in a way that would increase the strength of spillovers, seems to require some degree of confidence in the macroeconomic management of the partners' economies and a certain commonality of views about macroeconomic strategies. This does not necessarily imply identical policies, but rather a mutual understanding of why each party acts as it does, given the circumstances and conditions of each economy. This seems to be an initial step toward the conclusion of regional agreements on the management of specific policy tools. “Strategic coordination” would then have to run in parallel with, or some steps before, “instrumental coordination.”

The development of a set of common views on the growth process and on the broad outlook of macroeconomic policies is not a trivial matter, and should not be regarded as mere small talk. It is a question of practical relevance. In the 1990s, the macroeconomic approaches and criteria (not only the actions) of the Argentine and Brazilian authorities were quite different, especially when one of the economies experienced difficulties (at which time, the value of cooperation is obviously particularly high). Broadly speaking, at certain times it seemed that many Brazilians regarded Argentina's reluctance to contemplate alternatives to convertibility as a mere ideological whim, and they paid scant regard to the costs of abandoning that system. Similarly, influential opinion in Argentina viewed Brazil's search for monetary flexibility as a refusal to establish clear institutional constraints on discretion, and gave little consideration to the importance of having instruments to respond to shocks. More recently, the criteria used for debt management have varied from country to country—and considering any type of coordination on the issue seemed far-fetched, not to say heretical. In this context, when one of the neighbors experienced a macroeconomic disturbance, the attitude evident in the others that “it had only itself to blame” did not induce a cooperative mood.

In any case, there has been some spontaneous convergence of views (for example, on monetary systems). In their own ways and with their own timing, policies have been moving toward what Bernanke and Mishkin (1997) term “constrained discretion” in regulating inflation without explicitly anchoring variables, particularly the exchange rate. Clearly, however, the general definition of macroeconomic policies, and, of course, their design and implementation, have remained strictly domestic concerns.<sup>13</sup>

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<sup>13</sup> This has also applied to trade policies, as indicated in the November 2004 episode when Brazil unilaterally recognized China as a “market economy” and Argentina did the same some days later, also on its own but apparently influenced by the earlier Brazilian move. Interestingly, when those decisions spurred fears among industrialists in the two countries, entrepreneurs joined forces to coordinate demands for safeguards and assurances of protection from the governments. Such quick reactions, designed to trigger joint actions for protection against third parties, contrasted with the conflicts over bilateral trade and, especially, with the apparent scarcity of ventures geared to exploiting “productive complementarities” so as to compete internationally.

The importance in regional contexts of repeated interactions, reputation effects, and “tacit agreements” developed over time has been stressed for the case of Europe. In particular, the useful review and interpretation of the European macroeconomic experience presented in Ghymers (2003) suggests that: (i) international cooperation on macroeconomic management, which must be seen by the parties as a means of achieving self-interested national objectives, cannot be conceived as the result of a predetermined “grand design”; (ii) rather, the evidence indicates that it evolves through processes of trial and error or a “natural selection” of instruments and procedures; (iii) additionally, cooperation does not arise from a diffuse perception of occasional interdependencies, but requires that the countries see themselves as being involved in a repeated game that generates incentives to accumulate reputation and to gain knowledge of one another; and (iv) in the process of building that collective “capital,” and apart from the existence of formal commitments on the management of instruments, it is important to develop the interactions and contacts of those who make and implement policy, so as to develop a common language at the political and technical levels. This common language can lead to a joint understanding of the policies that the partners are following (and help them to handle the unavoidable disagreements), and allow agreed-upon reactions to disturbances that may internalize spillovers in mutually acceptable ways.

That way of thinking can explain why some joint activities in the macroeconomic field that do not require strong institutional commitments (but that do presuppose an accumulation of reputation) can generate shared benefits over time, merely by reducing the scope for uncoordinated policies—in the sense of policies based on erroneous assumptions about the behavior of the other interdependent economies.

From the viewpoint of the major macroeconomic channels of interdependence, large movements in real exchange rates have indeed been a source of significant spillovers, which sometimes have caused trade and investment frictions. While it would be hard to characterize events such as the Brazilian depreciation of 1999 or Argentina’s traumatic departure from convertibility as policy actions “directed against the neighbors,” the effects on those neighbors were clearly felt. Defensive sectoral reactions to higher imports from the region have often resulted in demands for trade restrictions of one type or another. An integration project in which intraregional flows are subject to restrictions that vary uncertainly according to macroeconomic conditions does not provide good incentives for productive undertakings with a regional perspective. At the same time, the lack of a long-term view of integration makes policy makers concentrate on the immediate claims of sectors demanding protection, and less on the opportunities for growth through trade. But in any case, those claims are likely to be stronger (and based on an actual perception of problems, it would be naive for policy makers to simply disregard) when macroeconomic shocks cause large sectoral disturbances. On the basis of observed experience, progressive integration may not easily resist recurrent macroeconomic crises that have a regional impact, and would probably prompt only lukewarm responses if decision makers anticipate that shocks will be large and difficult for policies to handle. Some sort of “coordinated flexibility” is thus in order, so as to lessen the chance of shocks and moderate their effects.

This demand for shock absorbers clearly points toward the need for exchange rate policies. But the possible shocks may be of quite different natures, intensities, and degrees of permanence, and a forward-looking identification of sustainable, intraregional real exchange rates for policy purposes seems a very hard task. Hence it would be quite difficult to define numerical target zones in advance. Moreover, monetary policies institutionally driven by domestic objectives (such as inflation targeting) do not have much scope to coordinate formally. However, the observable move in the region toward monetary systems that try to combine a commitment to low and predictable inflation with exchange-rate flexibility seems to provide a potential framework for monetary policy interaction—provided, to repeat, that such interaction is motivated and supported by a belief that the economies will be persistently and progressively interconnected.

Monetary stability, especially in the larger partner(s), has an element of regional public good (Wyplosz, 2004). Monetary shocks can cause excessive exchange-rate volatility, with repercussions for the other countries. The denomination of financial instruments also seems to be a crucial issue. In a region where currency substitution and dollarization of contracts have traditionally been private-sector responses to the perception that future domestic monetary conditions are uncertain, the capacity to adjust through exchange rate movements can be limited. If the transmission of regional instability disturbs the use of the local currency as an asset and a denominator of contracts, the ensuing “fear of floating” (Calvo and Reinhart, 2000) would restrict the economy’s ability to adapt to real shocks. From a long-term perspective, too, the prospect of regional monetary arrangements (Machinea, 2004; Carrera and Sturzenegger, 2000; Giambiagi, 1998) seems to depend—apart from the necessary “real conditions” of strong interdependencies—on building up a reputation for consistent monetary management throughout the region. In this regard, apart from optimum currency area considerations, the possibilities for monetary cooperation would seem to be quite limited if the agents in the region use nonregional denominations in their contracts.

While the convenience of operating monetary policies with a single inflationary objective or with multiple targets in some “loss function” may be subject to discussion, it seems that, in the region, a sustained performance with low and steady inflation precludes large shifts in the real exchange rate: although the pass-through coefficients in recent episodes have been small, large real devaluations (of the order of magnitude, say, of those experienced by central currencies) could hardly have been expected to take place without some significant inflationary effects. From this point of view, avoiding real-exchange-rate misalignments, with due regard for the difficulties in specifying when one exists, would be a legitimate concern of central banks worried about determining a steady trend for inflation (Inter-American Development Bank, 2002). Moreover, inflation-targeting schemes normally include a margin of flexibility that allows policies to respond to a set of macroeconomic variables. In practice, central banks do not seem to disregard sizeable movements in exchange rates or to treat them with indifference.

In any case, national monetary policies indirectly influence trade flows. It is conceivable to have a dialogue between central banks on the transmission of monetary policies to exchange rates and the associated international spillovers. The fact that the practices of

inflation-targeting systems involve the estimation and use of explicit macroeconomic models may allow interaction at the technical level for discussion of those models and their cross-border implications—and perhaps, at some point, for development of some linkage between the models that may provide a commonly understood basis for estimating the regional impacts of policies. To the extent that these discussions create common analytical ground or clarify disagreements, they could help focus and orient actual policy interactions, especially in the event of shocks. In practice, those interactions are certainly not going to be *inter pares*. In a transitional period, however, the establishment of formal schemes—whether explicitly asymmetrical or would-be symmetrical—would ignore the deep uncertainty about the medium-term evolution of national economies and their policies, and about the performance of the regional arrangement as a whole. “Playing the game” of policy dialogues over time can help identify if and how a *de facto* “monetary (or, more generally, policy) leadership” emerges and whether the evolution leads to a demand for forms of closer cooperation, with reputations reasonably established through the experience of actual behavior in a regional framework.

Reference to the European experience often prompts the argument that formal commitments among regional partners can serve as commitment devices for national policies, so as to deal with domestic pressures and solve credibility problems. Clearly, this can be the case in some circumstances. The conditions prevailing in MERCOSUR, however, do not suggest that the argument will be applicable in the immediate future. At the regional level, the enforcement of agreements to meet certain numerical targets would mainly be effected by the reactions of the partners in the case of a certain country’s noncompliance—by, for example, refusing to allow that country to participate in some common project (such as the introduction of the euro). The strictness of the enforcement, and the consequent disincentive to ignore a regional agreement on a certain variable, would depend on the value assigned by the country to the joint projects to be foregone or delayed, either formally or through reputational effects. It would also depend, ultimately, on the importance that the country ascribes to being part of the integration process. That value would be subject to the asymmetries implied by differences in size. In any case, the perception that integration is important for each country would have to be more or less established in order to sustain the credibility of the targets or the commitments. Hence it seems that while common monitoring of macroeconomic variables, particularly fiscal results, may have a useful role in the search for a sustainable regional trend, it may be premature to seek to establish formal targets.

At this point, moreover, “purchasing credibility” through institutionalized promises does not seem the most urgent matter for the region’s fiscal and monetary policies. In their own way, and with differences in policy approaches, the MERCOSUR countries have been normalizing their macroeconomic behavior after a period of great turbulence. The strengthening of public finances (with due regard for the heavy debt burdens still to be dealt with), and the low inflation rates obtained under systems that offered some flexibility, have helped arouse a certain confidence in macroeconomic policies over short horizons. The accumulation of reputation through observed performance seems to be a possible means of gradually extending those horizons. Given the experience of the concerned economies, a crucial element

in macroeconomic stabilization and in that accumulation of reputation would be avoidance of major crises.

If the countries perceive that progressive economic integration can allow geographic proximity to be translated into joint growth, the increasing interdependencies and the interest in promoting steady macroeconomic conditions for the region as a whole would provide incentives for cooperation. As mentioned earlier, a nontrivial matter is to jointly monitor trends in the economies, in order to keep track of signals about their sustainability and, if necessary, to deal with shocks. Additionally, it has been suggested (Ocampo, 1999; Agosin, 2001) that regional funds can provide first lines of defense against disturbances. In a project to increase integration, and apart from the practical issues involved in designing and managing such institutions, placing some resources under regional administration may establish a specific context for these activities (because the potential use of funds would naturally require an agreement among the partners about the nature of the problems they face and about how to handle them). It would also signal a willingness to deal with the macroeconomic aspects of integration.

## Conclusions

MERCOSUR is transitioning in several ways. The region has just emerged from a period of macroeconomic crises. The economic recoveries and the reinforcement of macroeconomic policies have been notable, but it is still hard to identify the new trends. Sustainability remains an issue. Intraregional trade patterns have changed noticeably, and this has been a source of friction. The growth strategies of the individual economies, and specifically the role assigned to economic integration, do not yet seem to be well specified. Hence the nature and intensity of macroeconomic interdependencies cannot be anticipated with any precision.

The regional agreement appears to be near a junction. The path to be taken will not necessarily be established by one dramatic event but may be defined over time. The crucial condition is likely to be whether governments and public opinion in the different countries come to perceive integration as a practical instrument for growth, so that the members can exploit the opportunities arising from proximity and specific productive complementarities. Additionally, progressive integration seems to require the view that (apart from fits and starts that historically have meant that some economies progressed faster or faced more difficulties) a process of continued development for a single country may be limited if the region as a whole does not advance. Otherwise, centrifugal forces and a sense that MERCOSUR has no clear economic purpose will eventually prevail.

Macroeconomic policies and macroeconomic behavior cannot be isolated from the general choices ahead. Macroeconomic imbalances certainly contributed much to the instabilities of and frustrations with the integration process that have marked MERCOSUR's recent history. Nonetheless, the main question is not what the macroeconomic components of an ongoing integration project might be, but whether there will be a common approach to growth, of which macroeconomics would be an important part.

The general logic for coordination is simple. If the countries are interested in integrating their markets, they will benefit from harmonizing the conditions (especially on taxes and regulations) to carry out economic activities and invest in the region. The existence of macroeconomic spillovers and interdependencies opens up “exchange opportunities” in policy making that may lead to concerted policy actions. But these coordination activities will not happen automatically: there has to be investment in mutual knowledge and confidence building, so that the potential agreements can be based on reasonable information about their likely results, and be determined in a context where reputational arguments limit opportunistic behavior. Such investment requires sustained efforts over time, and seems to have an element of irreversibility. In that case, coordination may face large “transaction costs” in the initial stages of integration and become much easier (and more natural for decision makers) later on. The development of conditions for meaningful and practical coordination coincides to a large extent with the search for a more or less common vision of a medium-term path of sustainable growth in the region. This is not a trivial undertaking.

## APPENDIX

### **Bilateral Import Demand Functions for Argentina and Brazil**

Bilateral trade flows between Argentina and Brazil have been examined in previous studies (Heymann and Navajas, 1992, 1998). It has been found that, overall, those flows could be represented by “import functions,” so that their magnitude depends mainly on the macroeconomic conditions of the importing country. That is, the principal determinants of Argentine exports to Brazil, say, were the levels of real activity and the real exchange rate in Brazil. Diagnostic tests did not indicate the presence of significant “cross effects” of macroeconomic variables of the exporting country. But there was evidence of “jumps” in the trade flows, measured by dummy variables, which perhaps could represent unidentified supply effects.

The main question addressed here is whether those models can still account for the movements in bilateral trade in recent years, or rather offer evidence of structural breaks. The bilateral import demand functions were estimated over the extended sample period 1970:Q1–2004:Q1. Results are shown in Table 10A.1. The function representing Argentine imports from Brazil shows some important changes with respect to that of the earlier period. If the same specification is used, Argentina’s real exchange rate would now appear as nonsignificant (this derives from the relatively small drop in Argentine bilateral imports following the large depreciation of 2002). In any case, the recursive residuals and *p*-values for a one-step forecast test suggest that structural breaks or parameter instability may be present in the data. Likewise, Chow tests for forecasts in the interval 2002:Q2–2004:Q1 point in the direction of a structural break, as the null hypothesis can be rejected. Furthermore, recursively estimated coefficients, both for the autoregressive and the real exchange rate variables, show noticeable changes around 2002 (by contrast, the GDP coefficient has remained reasonably stable). This evidence strongly suggests the inclusion of a shift dummy or an interaction term (or both) for that period.

Accordingly, the model was re-estimated with a “level” dummy variable for the period 2002:Q2–2004:Q1 (see Table 10A.1). The results show a satisfactory fit. All expected signs of the parameters are significantly confirmed in the estimation results. Argentina’s GDP and real exchange rate (contemporaneous and lagged one year) were found to be significant variables. The value of the short-run GDP elasticity of demand for imports is significantly higher than unity. The estimated coefficient of the long-run elasticity of GDP (3.47) is very high; this indicates a very intense response of bilateral imports to changes in real activity (although such an elastic behavior clearly cannot represent the evolution over indefinitely long time periods). The measured elasticity with respect to the Argentine real exchange rate is  $-0.46$  in the short run, while the long-run exchange rate elasticities are close to one ( $-0.94$ ). All these key estimated coefficients are statistically significant at the 5 percent level.

The dummy variable is not only significant, but also quite large. Its size implies that Argentine imports from Brazil after 2002 were 40 percent larger than the estimate generated

by the model ignoring the shift variable. Since this shift took place after a large devaluation, it is also possible that the change in the behavior of bilateral imports in fact reflected a break affecting the exchange rate elasticity. When this alternative is tried, the estimation admits a structural break, with a noticeable fall in that elasticity. With the data available so far, the type of structural break cannot be precisely identified. The fact remains that either the response of imports to the exchange rate has declined, or there has been an upward jump in levels.

With regard to supply effects from Brazil, measured through that country's macroeconomic indicators, the omitted-variables tests for the contemporaneous and lagged GDP and real exchange rate, in levels and growth rates, have indicated that the quality of the estimation is not substantially affected by leaving aside those macroeconomic variables.

For their part, the bilateral imports of Brazil (or exports from Argentina) can be represented with a model that is similar to that obtained for past periods. Among the changes observed, the autoregressive term now shows a two-period lagged effect. The short-run reaction of bilateral imports to Brazilian GDP is somewhat higher (1.53, in comparison with the 1.46 previously estimated). Additionally, earlier evidence of an "acceleration effect," such that the level of imports responds to the change in GDP, is not present now. Although the long-run GDP elasticity has a high value, it is not as large as the response estimated for the period up to 1997. The short-run elasticity of bilateral Brazilian imports with respect to the real exchange rate is lower than the previous estimation ( $-0.41$  for the one-year effect, compared with 0.48 in the previous equation). In the long run, that elasticity is also lower. In conclusion, the extension of the sample for a longer period indicates that Brazil's imports from Argentina still show a considerable response to both the domestic product and the real exchange rate, but perhaps not as strong as it seemed some years ago. Argentine "supply effects" have been studied through an omitted-variables test, and were not found to be significant. Moreover, recursive residuals suggest the lack of structural breaks. This is confirmed by Chow tests, indicating that the null hypothesis that two subsamples were generated by the same structure cannot be rejected over the periods 1999:Q1–2004:Q1 (after the Brazilian currency depreciation) and 2002:Q2–2004:Q1 (after the Argentine currency devaluation).

Hence the available evidence about the determinants of trade flows between Argentina and Brazil again indicates that there is an asymmetry in the effect of the macroeconomic variables (real output and exchange rate) of the buyer and seller. Roughly speaking, the influences on the demand side have been more important, both for Argentine sales to Brazil and for flows in the opposite direction. Another salient characteristic of the trade between the two countries is that, although exchange-rate effects are sizeable, there is a particularly large response to the level of activity in the economy of the importing country. The fact seems important when studying the causes of the volatility of trade flows: this appears to be generated, in part, by shifts in real exchange rates, but particularly by fluctuations in real output.

In brief, Brazilian imports from Argentina can be represented in approximately similar terms as in the estimates made some years ago. Those flows respond to the macroeconomic conditions of the buyer country, with a particularly elastic response to real output. In the case of the Argentine import-demand function, there is significant evidence of a structural break, with a sizeable increase in imports from Brazil relative to what would have been predicted us-

ing the equation estimated in the 1990s. Since the parameter change appears to have occurred recently, it is hard to ascertain whether this was a jump in the level of imports or a fall in the elasticity of bilateral imports with respect to the Argentine real exchange rate.

**Table 10A.1 Determinants of Bilateral Import Demand, 1970:Q1–2004:Q1**  
(standard errors in parentheses)

Argentine imports from Brazil in dollars	1970–1997	1970–2004a	1970–2004b	1970–2004c
Constant	–0.987 (1.86)	–5.370 (1.35)	–3.570 (1.38)	–3.624 (1.38)
AR imports from BR in dollars (lagged)	0.502 (0.08)	0.529 (0.06)	0.515 (0.06)	0.517 (0.06)
AR real exchange rate with U.S. dollar (contemporaneous)	–0.368 (0.09)	–0.138 (0.07)	–0.341 (0.08)	–0.338 (0.08)
AR real exchange rate with U.S. dollar (lagged 1 year)	–0.215 (0.10)	–0.029 (0.07)	–0.115 (0.07)	–0.107 (0.07)
AR GDP at constant prices	1.244 (0.44)	1.804 (0.34)	1.685 (0.32)	1.685 (0.32)
APER80 (dummy)	0.232 (0.09)	0.277 (0.08)	0.196 (0.08)	0.197 (0.08)
Dummy 1982:Q3	0.566 (0.09)	0.322 (0.07)	0.460 (0.07)	0.454 (0.07)
Dummy 1991:Q2	0.208 (0.10)	0.281 (0.07)	0.139 (0.08)	0.142 (0.08)
SEAS(1)	–0.183 (0.05)	–0.036 (0.05)	–0.043 (0.05)	–0.043 (0.05)
SEAS(2)	0.135 (0.05)	0.030 (0.04)	0.037 (0.04)	0.037 (0.04)
SEAS(3)	0.068 (0.05)	0.063 (0.04)	0.063 (0.04)	0.063 (0.04)
Dummy 2002:Q2			0.351 (0.10)	
Dummy02*AR real exchange rate				0.072 (0.02)
<i>N</i>	112.00	133.00	133.00	133.00
<i>R</i> <sup>2</sup>	0.97	0.98	0.98	0.98
<i>F</i>	345.4	618.6	618.2	615.3

(continued on next page)

**Table 10A.1 Determinants of Bilateral Import Demand, 1970:Q1–2004:Q1** (*continued*)  
(standard errors in parentheses)

Brazilian imports from Argentina in dollars	1970–1997	1970–2004
Constant	–1.367 (0.54)	–1.898 (0.52)
BR imports from AR in dollars (lagged)	0.424 (0.09)	0.529 (0.09)
BR real exchange rate with U.S. dollar	–0.484 (0.13)	–0.412 (0.09)
BR GDP at constant prices	1.464 (0.26)	1.527 (0.23)
“Acceleration effect” $GDP - GDP(-1)$	1.208 (0.53)	
Dummy 1989:Q3	0.209 (0.09)	0.204 (0.09)
Dummy 1992:Q4	0.375 (0.11)	0.497 (0.10)
SEAS(1)	–0.203 (0.07)	–0.173 (0.06)
SEAS(2)	–0.431 (0.10)	–0.190 (0.06)
SEAS(3)	0.265 (0.07)	–0.197 (0.06)
BR imports in dollars (lagged 2 periods)		–0.132 (0.08)
<i>N</i>	112.00	135.00
<i>R</i> <sup>2</sup>	0.96	0.97
<i>F</i>	248.60	436.80

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## **Macroeconomic Coordination Policies: From Europe to MERCOSUR**

*Diego Moccero and Carlos Winograd\**

### **Introduction**

Macroeconomic coordination in the Southern Common Market (MERCOSUR) has been very limited to date, even though the bloc's founding goals include the coordination of monetary, fiscal, and exchange-rate policies. As is widely discussed in the literature, macroeconomic policy coordination may have costs and benefits that should be carefully analyzed before progressing with cooperation. To that end, two types of literature are usually considered. The first addresses optimal currency areas (OCAs) and stresses the conditions under which it would be beneficial for a country to abandon (or lose some freedom in) its exchange-rate policy (monetary policy) as an instrument of economic adjustment. The second examines credibility gains, and holds that it could be beneficial for one country to peg its currency to that of a low-inflation country in order to "absorb" its credibility.

Other relevant arguments, ranging from interdependence to contagion, and unaccounted for in the aforementioned theories, should be considered in the decision-making process leading to macroeconomic cooperation among nations. One argument concerns the costs that interdependent countries have to face in light of possible macroeconomic disturbances in a partner country (the "costs-of-interdependence" approach). It would then be in the interest of these countries to coordinate their policies in order to avoid "contagion" effects and perhaps obviate such turmoil. Integration in trade and assets raises the level of interdependence between economies, thus reinforcing the transmission of shocks between countries. The need to coordinate macroeconomic policies in order to prevent or diminish the negative impact of shocks will then emerge.<sup>1</sup> In turn, if greater integration in trade and financial markets

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\* The authors are grateful for the support of the Inter-American Development Bank (IDB) and participants at the Washington and Rio de Janeiro seminars in February and July 2005, respectively, on "Deepening Integration in MERCOSUR: Dealing with Disparities." Robert Devlin, Eduardo Fernández-Arias, Daniel Heymann, Hernán Lacunza, Gianmarco Ottaviano, Tony Venables, Bernardo Kosacoff, Pablo Sanguinetti, and seminar participants in various conferences contributed with comments. All errors are those of the authors.

<sup>1</sup> Coordination may lessen the possibility of a crisis by imposing limits on fiscal deficits and debt, favoring cross-country economic monitoring and so on. The issue is addressed in a later section.

improves welfare, a more stable macroeconomic environment between partners in the international economy will in turn reinforce the incentives for deeper integration.<sup>2</sup> In the case of MERCOSUR, international shocks, as well as national economic disturbances and the effects of contagion, have been significant in the last 20 years. In the course of the trade integration process that began in the 1980s, these countries have become increasingly interdependent, and the transmission of economic shocks in the region has played an ever greater role in their macroeconomic performance.<sup>3</sup>

Real-exchange-rate volatility is another key element for the region—one that is unaccounted for in the theories mentioned above. When the volatility becomes excessive, it can have a negative impact on macroeconomic variables such as trade, investment, and growth. Abrupt changes in bilateral real exchange rates may have a strong negative effect on certain sectors of the economy and society, leading to pressures for protectionist measures or distortionary policies. In MERCOSUR's current circumstances, which are marked by confusion and paralysis, the pursuit of relatively stable real exchange rates based on consistent fundamentals may help contain the political gains of protectionist rhetoric and lead to deeper integration.

On the other hand, political economy considerations may also drive the process, as happened in Europe. For centuries, Europe was the arena of frequent wars. From 1870 to 1945, France and Germany engaged in three major military conflicts, with ever-rising human casualties and material destruction. At the end of World War II, Western leaders developed the conviction that the only way to secure a lasting peace and economic progress was to increase interdependence between these longtime rivals. This background explains the outcomes of several periods of economic and political tension in the last 40 years.<sup>4</sup> Military considerations in MERCOSUR are of minor importance compared to those in Europe, but it should be noted that the MERCOSUR countries were rivals from independence onwards<sup>5</sup> and that, as recently as 1978, Argentina and Chile (an associate member), then ruled by dictatorships, were a few hours away from open war. Consequently, MERCOSUR's founding treaty has clauses on the common goal of sustaining democratic regimes in the region.<sup>6</sup> Given that the political incentives for interdependence in MERCOSUR are smaller than in Europe, economic disturbances

<sup>2</sup> This argument goes back to the controversies about the preferred international monetary regime in the days of the gold standard, and to the views of J. M. Keynes leading to the Bretton Woods agreements that followed the collapse of international trade and finance in the 1930s. A virtuous cycle of cooperation, growing interdependence, and welfare benefits may thus result.

<sup>3</sup> For an analysis of trade specialization and the relationship between Argentina and Brazil, see Miotti, Quenan, and Winograd (1995, 1998, 2004). Carrera, Panigo, and Feliz (1998) show that a shock to one country had a greater impact on the other in the 1990s than in the 1980s—that is, as the integration process proceeded.

<sup>4</sup> In 1950 and as a first step in the integration process, French Foreign Minister Robert Schuman proposed integrating the coal and steel industries of Western Europe. As a result, in 1951, the European Coal and Steel Community (ECSC) was set up with six members: Belgium, Luxembourg, Netherlands, France, Italy, and West Germany.

<sup>5</sup> See Potash (1969), Rouquié (1978), and Rock (1985).

<sup>6</sup> These clauses operated effectively when Paraguay faced a political crisis in the 1990s and MERCOSUR's actions lessened the risks of a military coup.

and economic lobbies may prevail in times of crisis, thereby increasing the risk that the integration process will be derailed.

But the will to foster integration through cooperation cannot neglect the fundamental characteristics of the member countries. The disparities among the economies of the region are significant—in terms of size, per capita income (among countries and as regards domestic inequality), trade openness, economic structures, institutional development, and social indicators. These disparities may have a strong negative impact on the potential for regional macroeconomic coordination. Excessive differences among the countries may impinge on coordination by requiring the unequal treatment of countries and groups in the face of adverse conditions, such as asymmetrical shocks. In turn, these disparities in various dimensions, and the resulting responses, will produce unequal benefits of policy coordination. Thus one of the main challenges for regional economic policy lies in designing coordination strategy with due regard for the fundamental disparities that are identified. In turn, it may be expected that macroeconomic coordination will endogenously contribute to convergence in the dimensions mentioned above.

This chapter is divided into six sections. The section, “Why and How Did Europe Coordinate?” briefly discusses the coordination experience of the European Union (EU), and the section “European Disparities and Lessons for MERCOSUR” draws the main lessons of that experience for MERCOSUR. Attention is paid to the European experience since the early days of the European Economic Community (EEC). The exchange-rate system being a key characteristic of coordination in Europe, the section analyzes the “monetary snake” and the European Monetary System (EMS), and assesses the critiques of those schemes. The lessons drawn for MERCOSUR take the presence of disparities that affected the functioning of the European coordination process into account. The next section, “Why Coordinate Macroeconomic Policies in MERCOSUR?” addresses the arguments for macroeconomic coordination in MERCOSUR, from OCA theory and potential credibility gains to the role of interdependence. It also examines the impact of frequent financial crises and contagion problems in MERCOSUR, and the significance of real-exchange-rate volatility. The section “What Should Be Coordinated in MERCOSUR?” discusses macroeconomic coordination strategies in MERCOSUR, stressing the current conditions of public finances, public debt, inflation, and exchange-rate regimes, as well as political economy arguments relevant to a cost-benefit analysis of policy coordination. The final section presents the conclusions.

## Why and How Did Europe Coordinate?

The European case is the one that most merits analysis in a search for insights into the theory and practice of macroeconomic coordination policies for other regions of the world. The process proceeded in steps, from a low to a high level of coordination. Moreover, the coordination effort has been long and difficult, involving countries of varying economic status and institutional arrangements, and it developed in changing international environments. Economic and monetary crises were not absent, and there were frequent ups and downs in the process that eventually led to monetary union. During the long period that culminated in

the successful launch of the common currency, the strategy and policy choices adopted were often subject to severe criticism, especially in the most recent phases preceding the introduction of the euro—the EMS and the Maastricht Treaty. As the following sections show, the main controversies concerned the possibility of maintaining long-standing pegged exchange rates, the conception of system-wide monetary policy and the convergence criteria for interest rates, inflation, and fiscal targets. It should be noted that most of the arguments against the chosen course of action were coherent and robust from an economic perspective, yet the road to monetary union proved to be quite smooth.

Analysis of the European experience prompts many important questions. What policies have been coordinated? What were the most important disparities among countries when coordination began? Did those disparities impinge on macroeconomic policy coordination? If so, how did policy makers deal with them? No less important, the discussion below addresses the institutional arrangements that were developed to bring about coordination.

### ***The Bretton Woods System as a Coordination Mechanism***

By the beginning of the 1960s, coordination of exchange-rate policy in Europe was conducted through the International Monetary Fund (IMF) under the Bretton Woods System (BWS). This was a quasi-fixed exchange-rate system that linked all currencies to the U.S. dollar, the latter being anchored on a fixed parity to gold. Changes in the parities were allowed only in the case of a “fundamental disequilibrium” of the balance of payments, while temporary disequilibria could be financed through credits from the IMF.<sup>7</sup> In practice, bilateral exchange rates were stable and the BWS led the European countries to attain almost completely fixed exchange rates during most of the 1960s.

From the viewpoint of the overall integration process, the decisive event by that time was the signing of the Treaty of Rome (in the late 1950s), which included two chapters on economic policy coordination and the balance of payments. In particular, it was maintained that the state of each country’s macroeconomy and its exchange-rate policy were a matter of common concern. But these provisions of the treaty were never applied in practice, since policy on exchange rates and the balance of payments assistance were considered part of the IMF’s role. The treaty’s only important practical consideration regarding macroeconomic policy coordination was the creation of the Monetary Committee. This was composed mainly of representatives of the central banks and finance ministries of the member countries, and it was considered a fruitful environment in which to exchange information (Gros and Thygesen, 1998).<sup>8</sup>

<sup>7</sup> A one percent fluctuation around the central parities against the U.S. dollar was allowed. As this was considered excessive by the European countries, they jointly agreed to limit the band of fluctuation for their currencies against the dollar to 0.75 percent, so as to lessen intra-European exchange rate volatility.

<sup>8</sup> Later, other committees dealing with economic policy coordination were established. In 1960, the Short-Term Economic Policy Committee was set up, and in 1964, the Committee for Medium-Term Economic Policy, the Committee on Budgetary Policy, and the Committee of Governors of the Central Banks were created.

Because the 1960s were a relatively favorable period marked by low levels of unemployment and inflation, there was little need for strong government intervention to stabilize the economy. Hence disparities in macroeconomic behavior among countries were reduced. From this perspective, the stabilization of exchange rates did not entail the sacrifice of any important domestic policy target. On the other hand, trade integration among EEC members was not strong, thus lessening the role and benefits of macroeconomic coordination.<sup>9</sup>

### ***The Beginning of Monetary Cooperation***

Toward the end of the 1960s, two important goals in the European integration process were met: the customs union, and the establishment of the common agricultural policy. Therefore, it seemed time for a step forward. At the end of 1969, the German chancellor, Willy Brandt, suggested that member states should, in a first phase, jointly set medium-term objectives and aim to harmonize short-term policies. In a second phase, the EEC economies could move to a monetary union with permanently fixed exchange rates. The countries then agreed to conduct a major study of these issues.

In October 1970, a detailed report was issued (the Werner Report), describing how Europe could establish a monetary union in three stages by 1980. This was the first time that a common currency was mentioned as an official goal of the EEC—30 years before the launch of the euro. In the first stage, the goal was to reduce fluctuation margins between the currencies of the member states.<sup>10</sup> Then, in the second stage, the European economies were to fully liberalize capital movements with the integration of financial markets and, in particular, banking systems. Finally, exchange rates between the different currencies were to be irrevocably fixed. Monetary union implied “the total and irreversible convertibility of currencies, the elimination of fluctuation in exchange rates, the irrevocable fixing of parity rates, and the complete liberalization of capital movements” (Werner Report, 1970).

The Werner Report did not make specific references to the procedures, institutional set-up, and macroeconomic policy coordination needed to achieve monetary union. It was suggested that a community system of central banks, based on the U.S. Federal Reserve System, should conduct monetary and exchange-rate policy toward third currencies. As regards fiscal policies, the report highlighted the need for a “center of decision for economic policy” that would have a decisive influence over every country’s economic policy, including national budgetary policies. In particular, changes in public budgets, the size of balances, and financial policies were to be agreed at the community level. The lack of interest in such matters can be explained by the remarkable economic performances of the EEC member states in the 1960s, when these countries diverged little in terms of inflation and other macroeconomic indicators.

<sup>9</sup> Nonetheless, note that in the 1960s, gradual pressures for the appreciation of the mark were building up and Britain, not yet a member of the EEC, underwent a series of balance of payments crises and corrective devaluations with the assistance of the IMF. Simultaneously, the Triffin problem of confidence in the dollar was developing, eventually leading to the crisis of the Bretton Woods rules in the early 1970s.

<sup>10</sup> In particular, the report suggested that the bilateral fluctuation margins be reduced from the 0.75 percent agreed under the BWS to 0.6 percent.

The Werner Report was never implemented, although the goal of monetary union was politically endorsed by the member states. The reasons were twofold (Gros and Thygesen, 1998). On the one hand, members would not accept the creation of new institutions outside the existing framework. On the other, international conditions deteriorated sharply in the 1970s with the collapse of the Bretton Woods rules and the first oil shock in 1973. Inflation and unemployment emerged as new economic policy challenges, generating tensions in the EEC because of different policy preferences. The plans for monetary union were then shelved.

### *The Monetary Snake*

Though the Werner Report was never implemented as such, many of its goals and ideas were pursued later. In particular, note the report's emphasis on macroeconomic policy coordination. As regards monetary policy, for instance, the Committee of Central Bank Governors was to establish general guidelines for member states on issues such as bank liquidity, the terms for supply of credit, and the level of interest rates. In practice, however, policy coordination concerned only the day-to-day management of the foreign exchange market.

On the other hand, the member countries followed the report's basic views on preserving stability in European exchange movements. To that end, the monetary snake was created in 1972. Under the new system, the currencies of the six members (Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany) were allowed to fluctuate up to  $\pm 2.25$  percent against the dollar (4.5 percent against each other).

Shortly after the launch of the monetary snake, Denmark, Ireland, Norway, and the United Kingdom joined the EEC. To ensure the proper operation of the snake mechanism, in 1973 the member states created the European Monetary Cooperation Fund (EMCF), which was authorized to receive part of the national monetary reserves. The Fund settled intervention balances and provided short-run balance of payments support by providing short-term facilities to the countries. Initially, the fund existed more on paper than in reality, since all operations were performed by the Bank for International Settlements, acting as agent.

In the context of growing uncertainty following the collapse of the Bretton Woods rules in 1972, the system was put under severe pressure with the oil shock crisis of the early 1970s. Member states' currencies fluctuated sharply. Some countries (Denmark and France) left and rejoined the system, and others left it altogether (the United Kingdom and Italy). For the countries that stayed in the system, individual realignments in exchange rates were frequent; others let their exchange rate fluctuate temporarily. The case of France is paradigmatic in this respect, since it revealed the extent of the disparity in policy preferences with Germany. While the latter never left the system and managed to control inflation, France abandoned the snake exchange-rate regime twice (in 1973 and 1976) in order to engage in more expansionary policies. The failure of Germany and France to agree on policy coordination was then apparent.

A general realignment in October 1976 (the "Frankfurt realignment") launched a phase of frequent exchange-rate changes. Overall, there were five realignments between the Frankfurt realignment and the end of the snake before the negotiations to introduce the EMS in the last quarter of 1978. In the second half of the 1970s, inflation increased sharply in Europe,

notably so in countries such as Italy and the United Kingdom, where it approached 20 percent a year (Figure 11.1). In retrospect, the mid-1970s appear to have been a low point in European monetary integration, marked by tensions in policy objectives (and preferences) among countries and disparities in monetary policies.

In sum, the positive performance expected by the supporters of the monetary snake did not materialize.

The disruptions provoked by the collapse of the Bretton Woods rules and the sharp rise in oil prices had asymmetrical effects on the European economies and prompted divergent economic policy responses by the member states in the 1970s. In turn, increasing volatility induced frequent and sharp exchange-rate fluctuations. Entry and exit from the exchange stability mechanism became regular economics in the European arena, and the market expectations reinforced destabilizing fundamentals. The snake mechanism, originally designed as a community-wide agreement, was finally (by 1977) reduced to a zone of monetary stability around the German mark, with only five of nine member states taking part (Belgium, Denmark, Germany, Luxembourg, and the Netherlands).

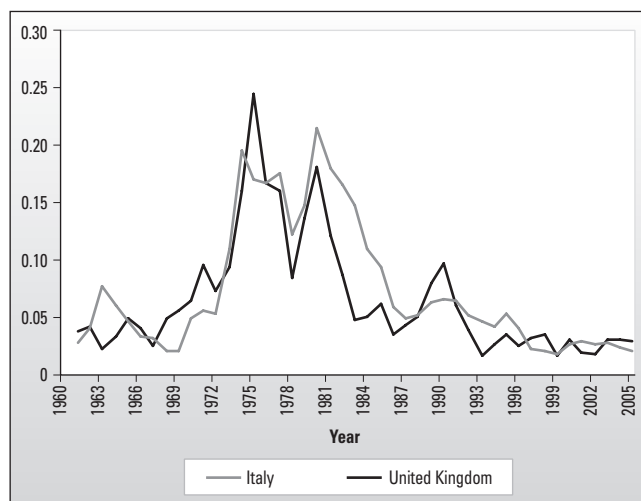
### *The European Monetary System (EMS)*

German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing decided in 1978 to establish a fixed exchange-rate system for the member countries. Academic and public criticism was then widespread. The new scheme started in March 1979 and operated in its original format, with minor changes, until the beginning of the EMS on January 1, 1999.<sup>11</sup>

In March 1979, all 10 member countries were part of the EMS, but the United Kingdom and Greece did not participate in the exchange-rate mechanism (ERM). Their membership was purely formal, except that their currencies were included in the new currency basket of the European Currency Unit (ECU).

When the ERM began, the eight members were relatively heterogeneous. Their populations varied from 360,000 (Luxembourg) to 61.3 million (Federal Republic of Germany).

**Figure 11.1. Inflation in Italy and the United Kingdom, 1960–2005**



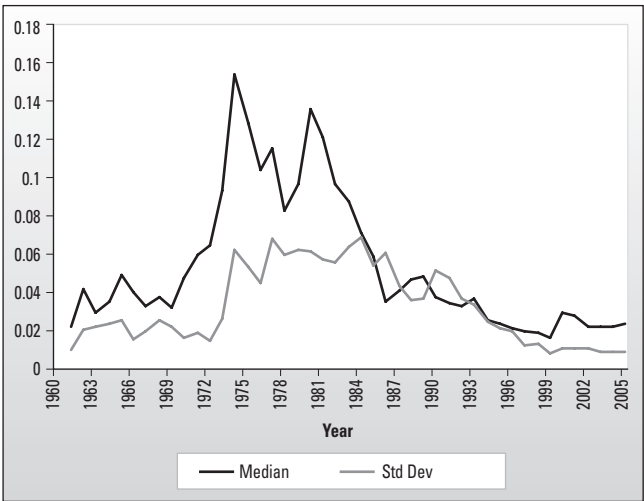
<sup>11</sup> Negotiations had started well before 1978 and were held during much of that decade.

The per capita income of the poorest country (Ireland) was only 58 percent of the wealthiest (the Netherlands). The inflation rate in Italy (14.7 percent) was more than three times higher than the rate in Germany (4.1 percent). And while Germany then had full employment (the unemployment rate was 3.2 percent), Italy was already confronted with a serious unemployment problem (7.8 percent). There were also significant differences in terms of the eight countries' trade openness: each of the three Benelux countries (Belgium, Luxembourg, and the Netherlands) had a degree of openness (exports plus imports as a percentage of gross domestic product [GDP] of 50 percent and more), while France was a relatively closed economy (18.3 percent).

Despite these disparities, the European countries had common objectives on exchange-rate and monetary policy arrangements (Bofinger and Flassbeck, 2000). In the 1970s, inflation was a serious problem for many of them (Figures 11.2 and 11.3) and disinflation was an important common objective. Given the high credibility of the Bundesbank's monetary policy and Germany's relatively low inflation rate in 1978, there was an incentive for the high-inflation ERM members to target a stable nominal exchange rate with Germany, which was the best anchor for European monetary stability.<sup>12</sup> Furthermore, the relatively unsettled European monetary policy was an important motivation for a common search for exchange-rate stability. The frustrating experience of the monetary snake was at the heart of the new initiative for monetary cooperation.

The EMS was a response to this dissatisfaction with monetary affairs, although it should be noted that there was initial resistance to the initiative and it had limited credibility. The basic feature of the new monetary scheme was the establishment of the ERM, by far the most important characteristic of the system. The core of this mechanism was provided by a parity grid, a matrix of bilateral exchange rates that determined a par-

**Figure 11.2. Inflation in the EU-15, 1960–2005**



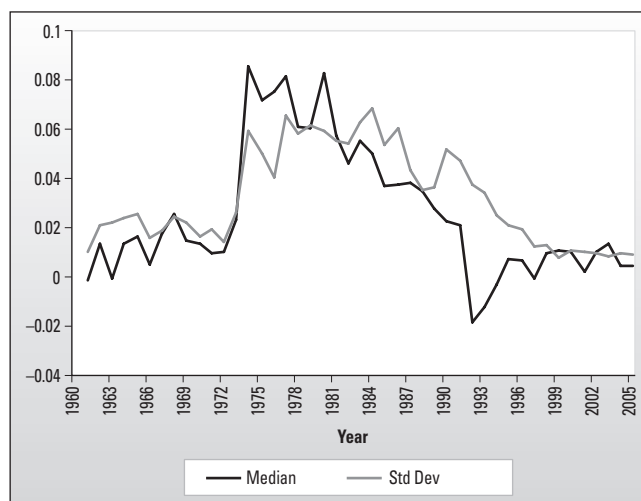
<sup>12</sup> The common agricultural policy (CAP) was also an incentive for stable bilateral exchange rates. For the agricultural sector, the treaty envisaged a scheme of strongly regulated common prices (in a common currency) for all member countries. Under CAP rules, short-term exchange rate instability had very unpleasant consequences. In an economic area without trade restrictions and low transport costs, deviations from the “law of one price” will be very limited. Thus, strongly fluctuating exchange rates provide opportunities for arbitrage that impair or benefit local producers arbitrarily. To deal with this problem, a highly complicated system of “green parities” and compensating payments was created. Hence the CAP rules in a context of highly integrated markets were an additional incentive for exchange-rate stability.

ity relative to all other ERM currencies for each member currency. Around this parity, a band of  $\pm 2.25$  percent for most member countries was established (Belgium, Denmark, France, Germany, Ireland, and the Netherlands). Italy was allowed to use a wider band of  $\pm 6$  percent until 1990, when it decided to adhere to the narrow band. Newcomers to the system, Spain (1989), the United Kingdom (1990), and Portugal (1992), initially adopted the wider band. The width of the band seemed

then to reflect disparities in reputation and macroeconomic performance among the member countries. After the 1992–93 ERM crisis, the band was widened to  $\pm 15$  percent.<sup>13</sup> For each currency, the bands constituted an upper and a lower intervention point relative to all other currencies.<sup>14</sup>

The system had a turbulent start, since the second oil shock in 1979–80 again underscored significant disparities in policy preferences in Europe. The shock led not only to an increase in inflation in the European economies, but also to a deterioration in the current accounts, a contraction of output, and a sharp rise in unemployment (Figures 11.4 and 11.5). The French authorities' response to the oil shock again revealed that they had a greater preference than their peers in Germany for overcoming recession through an expansionary fiscal policy (and a lesser preference for tight public finance and price stability). This fundamental divergence in preferences, which extended to other EEC countries, explains the region's exchange-rate volatility in the first half of the 1980s, as evidenced by frequent currency realignments—that is, changes in the central parities between countries.<sup>15</sup> They became less frequent after the mid-

**Figure 11.3. EU-15: Inflation Differential with Germany, 1960–2005**



<sup>13</sup> The symmetry of the bilateral parities meant that whenever currency A reached its upper intervention point relative to currency B (that is, it depreciated against that currency), currency B simultaneously reached its lower intervention point relative to currency A. Hence if a currency pair drifts to the extremes of its bands, there were supposed to be two central banks with an obligation to intervene.

<sup>14</sup> A second important feature of the system was the creation of the ECU, a new monetary unit defined as a basket of currencies of the member countries of the EMS. The ECU was composed of fixed absolute amounts of the currencies of all nine member countries, which reflected the economic size of each participant in the system. It was supposed to serve four main functions: (i) as a denominator for the exchange-rate mechanism; (ii) as the basis for a divergence indicator; (iii) as the denominator for operations in both the intervention and credit mechanisms; and (iv) as a means of settlement between EEC monetary authorities. In practice, however, the ECU's role in the ERM remained very limited. For a more detailed analysis, see Bofinger and Flassbeck (2000).

<sup>15</sup> More than 10 realignments had taken place by then.

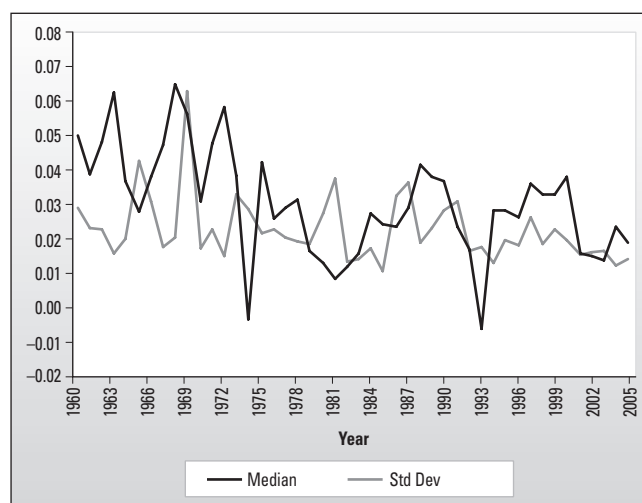
1980s, and from 1987 to 1992, there was no realignment.<sup>16</sup>

The EMS allowed for some progress in the conduct of community monetary policy. First, realignments started to be seen as a joint responsibility, in contrast to the experience of the monetary snake, when individual realignments were the rule. In particular, realignments had to be endorsed by the Council of Ministers of Economics and Finance (ECOFIN), or at least to have the informal agreement of the other countries. Second, they were considered useful in preventing serious misalignments and in reinforcing sustainable equilibrium. Although there was no visible rule on the scale of realignments, inflation differentials were broadly accommodated to contain changes in competitiveness.

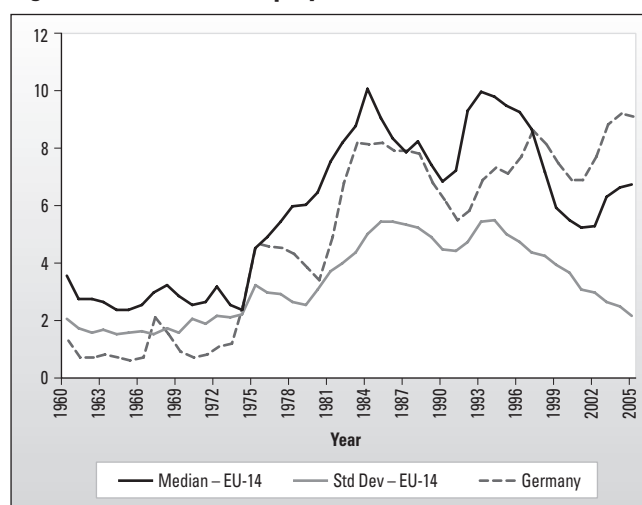
The operational and institutional set-up changed little between its creation and the Maastricht Treaty in 1992. By then, a series of developments had shocked the system:

the apparent overvaluation of some participating currencies, German unification and the associated distortions in the German policy mix, doubts about the feasibility of economic and monetary union (EMU) in light of the difficulties of ratifying the Maastricht Treaty in several member countries, and the weakness of the U.S. dollar.

**Figure 11.4. GDP Growth in the EU-15, 1960–2005**



**Figure 11.5. EU-15: Unemployment, 1960–2005**



<sup>16</sup> It is worth mentioning that realignments were generally coupled with local policy measures that tended to offset inflationary pressures, such as de-indexation of the economy, temporary freezing of prices and wages, control of fiscal deficits, and so on. In general, these measures were discussed with the other EMS members or at least they were informed if the situation was urgent. The other countries evaluated the country's economic situation in terms of external sustainability, inflation, competitiveness, and so on, and assented or not.

## *The Maastricht Treaty*

The Maastricht Treaty of 1992 introduced new forms of cooperation among the member states in matters such as defense, justice, and so on. By adding this intergovernmental cooperation to the existing community system, the treaty created the EU. The members agreed to engage in the EMU process, leading in time to the introduction of a single European currency managed by a European Central Bank (ECB).

The strategy established by the Maastricht Treaty to reach monetary union was based on two principles. The first was that the transition was gradual, extending over many years. The second principle required the members to meet a number of convergence criteria before joining the monetary union.<sup>17</sup>

The gradual transition was to proceed in several stages. In the first step, which had already begun in July 1990, the EMS members abolished all remaining capital controls and embarked on a process of greater cooperation among their central banks. During this phase, realignments were still possible. The second stage started on January 1, 1994. In that year the European Monetary Institute (EMI) was created as a transitional step toward the establishment of the ECB and the introduction of a common currency.<sup>18</sup> In the third and final step (January 1, 1999), exchange rates between countries were irrevocably fixed and the ECB started operating.<sup>19</sup>

The transition to the final stage, however, was conditional on compliance with the convergence criteria. These had to be met by each member before it could take part in the last stage of EMU, before the creation of the common currency. A country could only join this third stage if:

- (i) There was a sustainable degree of price stability and an average inflation rate, observed over a one-year period before the examination, which did not exceed—by more than 1.5 percentage points—that of the three best (inflation) performing member states
- (ii) There was a long-term nominal interest rate that did not exceed by more than 2 percentage points that of the three best performing member states in terms of price stability (Figure 11.6)
- (iii) There had been no devaluation during the two years preceding entry into the union
- (iv) The ratio of government debt to GDP did not exceed 3 percent, or, if higher, was declining continuously and substantially, and approaching the 3 percent norm—or, alternatively, the deviation was exceptional and temporary, remaining close to the reference value (Figure 11.7)

<sup>17</sup> See De Grauwe (1994).

<sup>18</sup> The EMI operated only during this phase and was the precursor of the ECB, with the goal of strengthening cooperation between the national monetary authorities.

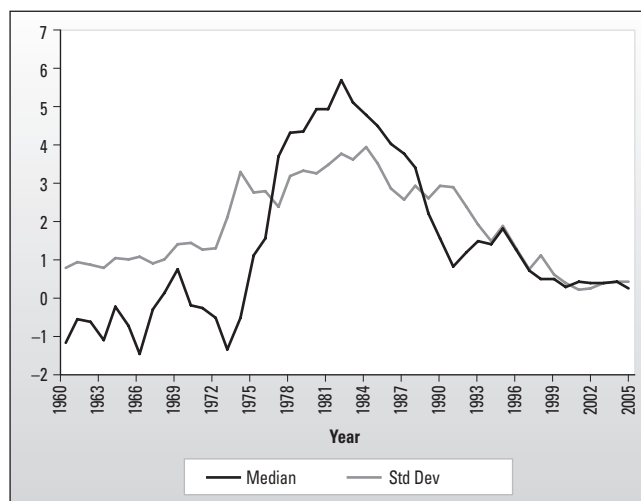
<sup>19</sup> The ECB, established in 1998, is in charge of setting the single monetary policy and interest rate for the nations concerned.

- (v) The ratio of government debt to GDP did not exceed 60 percent or was diminishing sufficiently to be approaching the reference value at a satisfactory pace

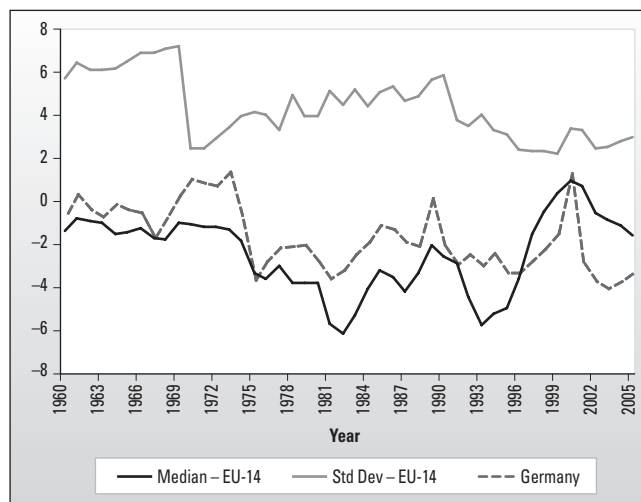
What was the rationale for these rules? The convergence criteria were meant to ensure that the macroeconomics within EMU were balanced and did not give rise to destabilizing tensions between member states. In particular, the commitment to stable exchange rates (no devaluation) aimed to prevent opportunistic behavior by governments seeking to gain in competitiveness before the launch of the euro. Such behavior could threaten the path to the common currency, leading to a contagion of competitive devaluations. In other words, Germany aimed to lessen preference disparities in the monetary area, giving incentives and discipline devices to induce convergence toward the German benchmark.

As regards the criteria on inflation and budget deficits, the main argument advanced by the advocates of Maastricht was that Germany would have been disadvantaged if it were to form a monetary union with “less responsible” countries. If German preferences were strongly biased in favor of price stability as opposed to employment, and given that the euro-area inflation rate is a weighted average of member countries, Germany could have suffered a welfare loss if the other euro partners were more inflation-prone (Barro-Gordon model). In turn, Germany may have had strong disincentives to participate in monetary union unless it could impose some entry conditions (restrictive criteria) that led to a euro outcome closer to its own preferences.

**Figure 11.6. Interest Rates: EU-15: Government Bond Differential with Germany, 1960–2005**



**Figure 11.7. EU-15: Fiscal Deficit of the Central Government as Percentage of GDP, 1960–2005**



The same reasoning provides the arguments for tight budget rules. Countries with high levels of public debt as a percentage of GDP could have strong incentives to inflate and thus melt the debt burden before entering the monetary union, and then ride on the coattails of German credibility (apart from the preferences of the monetary authority). The idea is that if part of the debt was issued at a constant rate (based on previous inflation expectations), an inflationary surprise would reduce its real value. The low-inflation country would thus have a strong interest in obtaining debt reductions from the high-debt partners through noninflationary adjustments. Indeed, sound public finance was the tool, and the hard constraint on budget deficits, coupled with public debt target levels, was the preferred instrument of the low-inflation players. On the other hand, the budget deficits of the high-debt or inflation-prone countries are endogenous to the currency regime. The jump from a low-credibility currency such as the Italian lira to a quasi-German euro leads to a reduction in interest rates on public bonds, thus giving rise to an automatic improvement in the budget deficit of the high-debt country. The common currency entry conditions can then be interpreted in the following way: before the union starts, the candidate countries should provide evidence that they somehow accept German preferences on price stability—that is, buying the mark's well-established credibility in exchange for forced discipline.

The convergence criteria were the focus of an intense controversy in the 1990s. As mentioned earlier, it is interesting to note that despite the robust and well-grounded economics of the criticisms of the Maastricht strategy, the anticipated inconsistencies and problems did not materialize. Those debates are the subject of the next subsection.

### ***Criticisms of the EMS and the Maastricht Treaty***

The controversies that developed on the path to the euro illustrate important issues in the economics, in theory and practice, of macroeconomic coordination and common currency strategies. The European debates yield important lessons for MERCOSUR. The most important problem of the EMS concerned the credibility of the regime of pegged exchange rates used for the transition to the common currency system. Another source of concern was the conduct of monetary policy—that is, the liquidity problem. These issues led many economists to question the system's long-run sustainability.<sup>20</sup>

The credibility problem arises for two different reasons. The first is related to the fact that the exchange rate may often be the less costly instrument for adjustment in the face of an adverse shock. In such circumstances, rational speculators will conclude that the government has an incentive to change the parity and will thus discount a positive probability of devaluation in the future. As a result, the central bank exchange-rate commitment will not be credible and speculative attacks may thus arise. Grounded on the wrong fundamentals or self-fulfilling peg regimes, implosions are legion. To overcome the problem, the government in question will have to commit to the agreed fixed exchange rate, bearing the costs in terms of employment and output.

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<sup>20</sup> See De Grauwe (1994).

The second source of concern stems from the disparity in the reputations of the monetary authorities involved in the exchange-rate peg system. Indeed, reputational differentials and the resulting credibility problems may undermine the stability of the peg exchange regime. When a monetary authority viewed as having a poor reputation fixes its exchange-rate parity, speculators may anticipate a surprise devaluation, leading to higher inflation, and thus ensuring a more favorable output-inflation outcome. With such expectations, inflation in the country will be permanently higher, forcing the authorities to change the parity regularly—that is, chronic realignment. As such, the low-credibility country will find it very difficult to fix its exchange rate in a credible manner.

The liquidity problem of pegged exchange rate regimes can be stated as follows: in an  $n$ -country system, only one country can independently fix its monetary policy, while the other countries in the peg regime have to adjust in order to maintain the fixed exchange rates. The actions based on this degree of freedom may produce conflicts of interest among member countries. One possible scenario is that only one country, the leader, follows a monetary policy fully independent of the others. In such a case, an adverse shock on the followers will be completely absorbed by them, making their monetary stock and output very volatile. Another scenario may be considered: all the countries concerned jointly decide on the level of the monetary stocks and interest rates (cooperative solution). Here, a shock to one country is absorbed by all of them (all the countries intervene in order to keep the exchange rates aligned), minimizing monetary and output volatility. In brief, asymmetrical systems are not satisfactory regimes to deal with asymmetrical shocks. They tend to increase the probability of conflicts among member countries over the pace of the collective system's monetary policy. Enhanced cooperative arrangements will eventually be needed.

As regards the Maastricht Treaty, its basic rationale was that of a transitory arrangement leading in time to monetary union. The dominant Maastricht view was that a successful launch of the common currency required a prior convergence of inflation rates, interest rates, budget deficits, and public debt indicators in the region, as stated above. Simultaneously, it was argued that a gradual increase in the rigidity of the exchange system was desirable: the proposition finally adopted was to establish fixed exchange rates between member countries two years before the introduction of the EMU. This strategy gave the upper hand to discipline devices consistent with German preferences, thus somehow repressing the preferences of other countries.

This Maastricht strategy for the transition to monetary union gave rise to intense debates among economists. Some academics, such as Giovannini (1990), Begg et al. (1991), and De Grauwe (1994), argued that the Maastricht road to EMU would jeopardize the goals of monetary union. These authors maintained that fixed exchange rates would not be sustainable for a long period before the introduction of the common currency. Pressures on the fixed parities would emerge not only from the different trends observed for the macro fundamentals of the member countries, but also from the conflicts of interest related to the preferred monetary policy for the region. It was thus argued that these tensions would jeopardize the credibility of the fixed exchange regime for the transition to EMU, eventually producing a negative contagion effect on the common currency project.

In turn, the lack of credibility of the fixed parities regime would have hampered the convergence of interest rates—one of the Maastricht criteria for entry into the common currency. Interest rates could only converge in the context of growing confidence that the exchange rates would remain fixed. Thus the lack of credibility in the peg system would be evident in the interest rate differentials among member countries.

The convergence of inflation rates during the transition phase was also problematic, since the national governments would continue to issue their own currencies. Since reputations may vary across monetary authorities, expected and actual inflation might be affected, jeopardizing the desired convergence established by the treaty.

The public finance rules for entry into the EMU (fiscal deficit-to-GDP ratio of 3 percent, and government debt-to-GDP ratio of 60 percent) were also criticized. These criteria were considered fundamentally ad hoc and based on a weak economic rationale. Again, recall the monetary conservatism of the German view. There is no fundamental reason to prohibit a country or region from having higher levels of public debt. The market parities should reflect the perception of intertemporal solvency, depending on that country's expected future performance. Higher debt levels may contribute to positive economic yields for the country in question, thus improving solvency in the future (oil production in country A or better education and increased human capital). But a political economy argument lies behind the Maastricht view. The countries with soft monetary postures may try to free-ride on the German reputation, engaging in excessive indebtedness and eventually jeopardizing the solvency conditions of their public finances. In the negative scenario, the probability of financial collapse may arise, and in the name of European stability and regional solidarity, pressures for a German (collective) rescue package may be difficult to contain. Region-wide monetary policy, as well as inflation rates, may thus become endogenous, and the well-behaved countries penalized. Furthermore, a self-fulfilling game can be feared. This scenario was resisted by the German opposition to the common monetary venture. Hence the "discipline device" view was embodied in the Maastricht strategy.

Those opposed to the Maastricht strategy but favorable to monetary union believed that the convergence of exchange rates, interest rates, and inflation would only occur easily after a monetary union was in place. Before that, it was seen as hardly feasible to meet all of these criteria simultaneously. Moreover, the conditions stressed by OCA theory emphasized conditions very different from those of the Maastricht Treaty (flexible prices and wages, integrated labor markets, automatic fiscal redistribution mechanisms, and so on). Critics of the Maastricht convergence criteria argued that the strategy was an obstacle to monetary union. But given that the standard OCA conditions for a common currency did not prevail, the decision to embark on the process was based on economic optimism, coupled with political will, as discussed earlier. The strength and fragility of the European currency in the future may lie in these arguments.

## European Disparities and Lessons for MERCOSUR

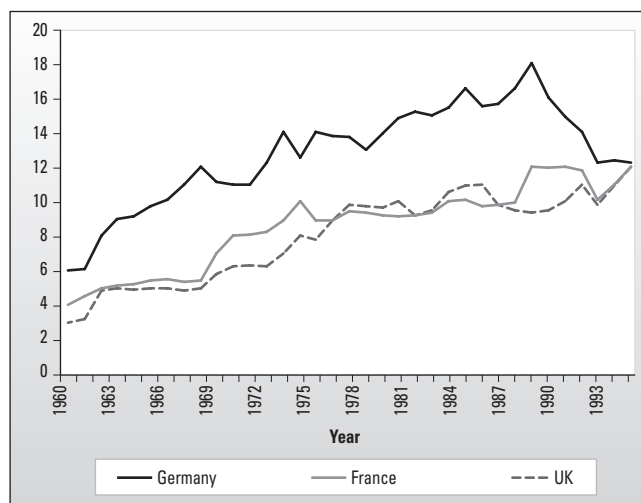
Four important questions were posed at the beginning of the section "Why and How Did Europe Coordinate?" What policies have been coordinated? What were the most important

disparities between countries when coordination began? Did these disparities impinge on macroeconomic policy coordination? And, if the answer to the previous question is yes, how were these disparities dealt with? This section aims to answer these questions.

Exchange-rate policies have been a key feature of European macroeconomic coordination initiatives and were implemented before other coordination policies, such as fiscal policies. An important reason for this was the significant increase in intraregional trade.<sup>21</sup> The demand for monetary coordination then grew in line with intra-Community commerce. Figure 11.8 shows that exports to member countries (15 members), as a percentage of GDP, has grown steadily since 1960. For Germany, the share tripled between 1960 and 1989, the period before unification, from 5 percent to more than 15 percent. There are substantial differences between Germany and France; the latter is consistently behind Germany.

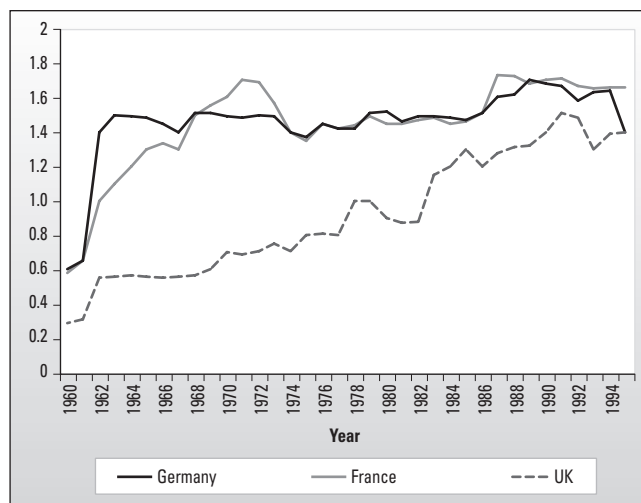
Only toward the end of the period is there a convergence between these two countries. Intra-regional trade is even more important considering the ratio of intra-Community exports to extra-Community exports (Figure 11.9). Since the beginning of the 1960s, exports from

**Figure 11.8. Intra-EU Exports as a Share of GDP, 1960–93**



Source: Gros and Thygesen (1998).

**Figure 11.9. Ratio of Intra-European to Extra-European Exports, 1960–95**



Source: Gros and Thygesen (1998).

<sup>21</sup> Efforts at macroeconomic cooperation always complemented progress on trade integration. Thus interdependence incited coordination but macroeconomic coordination (in exchange rates) facilitated greater interdependence (Machinea, 2004).

France and Germany to the member countries have been greater than those to extraregional economies.

Exchange-rate coordination and macroeconomic cooperation have not been smooth ventures in Europe. The regional exchange-rate agreements have suffered frequent credibility crises and speculative attacks. If Europe (and the German anchor) found it hard to establish a regional reputation, the credibility challenge for MERCOSUR is certainly greater. MERCOSUR can expect a more difficult process, with more frequent and more intense currency attacks. The MERCOSUR countries should also envisage the development of appropriate institutional mechanisms (regional budget policies and an intervention fund) for cooperative responses if coordinated exchange-rate policies are introduced. In any case, in the face of the wide credibility gap in the region, acquiring a reputation will require very rigorous and sustained policy positions, unless a South American “Germany” can be found or constructed.

It can also be inferred from the European experience that disparities in the preferences of the member states (voters and policy makers) were very important during the whole coordination process. This was the case with the snake system in the 1970s and the EMS in the 1980s and 1990s. France and Germany provide a good example of this problem: the former has focused mainly on output and employment stability, while the latter has given greater primacy to inflation rates. The EMS crisis in 1993 was closely related to the fact that the recession revealed nontrivial economic policy conflicts among the countries. It then seemed that marked differences in policy makers’ preferences in terms of inflation, output, and unemployment might jeopardize coordination. How then did the countries deal with these disparities?

First, recall that the European integration process was above all a political agreement in response to the collective trauma of war and mass destruction in the region. This is an important reason why it could progress over time, even when countries seemed to diverge significantly and faced frequent crises (notably in the 1970s, the 1980s, and the speculative attacks of 1992–93). In view of the significant disparities, this implies that the member countries should have a strong commitment to integration.<sup>22</sup> As mentioned, MERCOSUR’s lack of strong political will potentially jeopardizes the integration process.

Second, the Europeans explicitly tried to reduce these disparities by disciplining and/or repressing them. The Maastricht Treaty (which is the expression of the winner) acted as a device that convinced the leader (Germany) to participate in monetary coordination, to assume the role of leader, and to relinquish monetary autonomy. This is a crucial issue when decisions about monetary policy in a monetary union are made by member countries through their representation in the union’s central bank. The country with the best reputation and the lowest inflation rate would resist taking part in a monetary union with less credible countries and higher inflation rates, since to do so may reduce its welfare. In the EU, Germany solved this problem by demanding that its partners give more weight to price stability. This prefer-

<sup>22</sup> As suggested by Machinea and Monteagudo (2002), the process was gradual and involved the mutual trust of the member countries.

ence shift emerged in the Maastricht Treaty, which subjected the members to quite restrictive macroeconomic rules on inflation, budget deficits, and public debt.

It should be stressed that the convergence criteria established by the Maastricht Treaty are neither necessary nor sufficient conditions for the introduction of a single currency. As mentioned above, the Maastricht rules are unrelated to the conditions proposed by OCA theory as necessary to obtaining an outcome of net benefits from a common monetary strategy. The criteria give incentives for the high-credibility country to take part in the union, thus gaining a low-inflation bias for the monetary area. Hence a minimum degree of homogeneity in country preferences is a necessary condition if the system is to successfully survive destabilizing economic events.

In MERCOSUR, the “Germany-like” country is not immediately evident. What then would be the advantage of a Maastricht-type treaty in MERCOSUR? This issue is addressed in more detail below, but mention should be made of the reduction in potential disparities among countries, as well as a lower probability of balance of payments and financial crises in the region (by means of a set of constraints for the fundamentals). And a potential benefit of a set of restrictive macroeconomic rules is the decline in real-exchange-rate volatility that leads to severe political economy problems—the greater lobbying activities of disfavored interest groups and frictions that may block or derail the integration process.

Finally, note that the international environment plays an important role in the dynamics of integration, and may favor a reduction in preference disparities. A favorable international economic context eases the integration and coordination process. For instance, the high growth rates of the world economy in the 1990s certainly had a positive impact on compliance with the Maastricht convergence criteria of 1992. Such criteria would have been hard to meet, and political approval of the agreement would have been hard to secure, if the world economy had displayed low growth or been in recession.<sup>23</sup> The favorable international environment of the 1960s, with low inflation and low unemployment, also had a positive effect on the European integration process, smoothing the path to greater interdependence. By contrast, when the international economic context is marked by significant turbulence, the responses of voters and policy makers in the different countries may diverge, to the detriment of coordination. This was the case in the 1970s and 1980s, when the collapse of the Bretton Woods system and the severe oil shocks destabilized the macroeconomic environment and forced frequent realignments of exchange rates, as well as many departures from and re-entries to the EMS by the member countries.

In MERCOSUR, the impact of the international environment on the region’s economies seems to be even more complex than in Europe. The “international economy” has a wider set of relevant variables in MERCOSUR: international capital markets, volatile commodities prices, international interest rates (when there is access to international capital markets), and growth rates in the developed countries (which are important export markets). Though the

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<sup>23</sup> Note that the current slow growth rates have prevented France and Germany from improving their fiscal situation.

economies of the MERCOSUR countries are only modestly open, and thus less vulnerable to external conditions, macroeconomic volatility has been very high. This should certainly be acknowledged in the design of coordination policies.<sup>24</sup>

## Why Coordinate Macroeconomic Policies in MERCOSUR?

The previous section showed that preference disparities were determinant in the evolution of Europe's cooperation process. This section discusses the fundamentals for macroeconomic coordination in MERCOSUR, applying the theories presented in the introduction in order to identify what type of disparities may be relevant for MERCOSUR. In particular, the following two subsections analyze the costs and benefits highlighted by OCA and credibility theories for MERCOSUR. The subsection "Interdependence, Financial Crisis, and Contagion" then examines the "costs of interdependence" approach, while the subsection "Exchange-Rate Volatility and Intraregional Trade" looks at regional exchange-rate volatility, which may also call for closer macroeconomic cooperation.

### *Is MERCOSUR an Optimal Currency Area?*

It may be useful to evaluate the costs and benefits of macroeconomic cooperation (or monetary union)—that is, OCA theory—in view of the economic circumstances in MERCOSUR. Are the fundamental conditions of an OCA satisfied in that part of the world? The main benefit of coordination or a common currency is the fall in transaction costs that are associated with the need to change currencies in order to conduct foreign trade operations among the countries of the region.

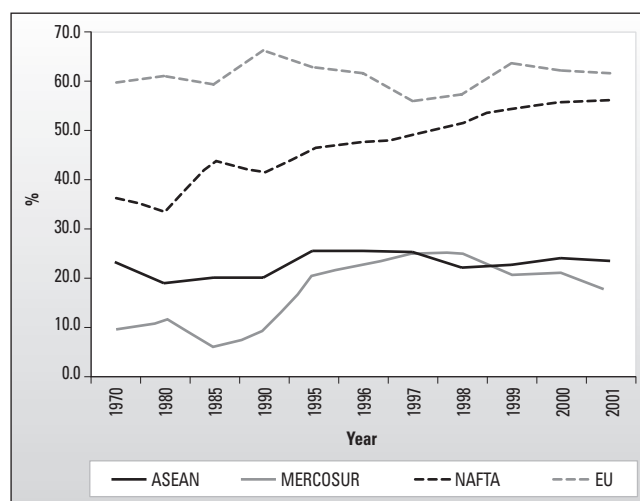
A direct measure of the benefits of unification is provided by the member countries' degree of openness. If there is much intraregional trade, the reduction in transaction costs and the incentives to form a monetary union may be significant. Figure 11.10 shows that the degree of intraregional trade (measured by share of exports to regional trade partners in total exports) is low compared to the EU, and also compared to other economic regions—the North American Free Trade Agreement (NAFTA) and the Association of Southeast Asian Nations (ASEAN). The evidence seems to show that the gain from reducing transaction costs is lower than in other economic regions. Moreover, Tables 11.1 and 11.2 show that these benefits are heterogeneously distributed: the smaller countries would benefit the most. Nonetheless, note recent trends in Uruguay's trade flows, which exhibit a consistent increase in extraregional trade. Uruguay's intraregional sales accounted for about 40–50 percent of total exports in the 1990s and reached 55 percent in 1998, but the figure had fallen to 23 percent by 2005.<sup>25</sup> If this

<sup>24</sup> The countries of the region may thus have an incentive to develop joint response mechanisms against external shocks and design policies to make it less likely that such shocks will occur (rules on robust public finance, coordination of banking system surveillance, and so on). These issues are addressed in later sections.

<sup>25</sup> These recent specialization changes are related to the boom in the commodity markets (prices and quantities) with a strong extraregional bias and the sharp increase in meat exports to the United States.

trend persists, a small member such as Uruguay will derive smaller benefits from the decline in transaction costs associated with macroeconomic coordination or a common currency. The political incentives favoring the MERCOSUR strategy may then be altered. This may even be truer in view of the recent volatility of the bigger partners, contagion effects, and the regular exclusion of the smaller members in MERCOSUR's decision-making process.

**Figure 11.10. Exports to Partners as Share of Total Exports, 1970–2001**



Source: CEI.

**Table 11.1 Intraregional Exports as a Percentage of GDP**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina	1.6	1.9	2.6	2.9	3.3	3.1	2.5	3.0	2.8	5.6	4.3	4.3	4.1
Brazil	1.2	1.1	0.9	0.9	1.1	1.1	1.3	1.3	1.2	0.7	1.1	1.5	1.5
Paraguay	4.6	5.4	6.5	7.5	6.6	6.6	4.2	7.8	8.0	10.9	13.7	12.5	12.2
Uruguay	4.7	5.1	5.1	5.6	6.2	6.9	4.8	5.1	4.5	5.0	6.0	5.8	4.6
Average	3.0	3.4	3.8	4.2	4.3	4.4	3.2	4.3	4.2	5.5	6.3	6.0	5.6
GDP weighted average	1.4	1.4	1.5	1.6	1.8	1.8	1.8	1.9	1.9	1.8	1.9	2.2	2.1

Source: Authors' calculations based on Centre for International Economics, Argentina.

**Table 11.2 Intraregional Exports as a Share of Total Exports (percent)**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina	28.1	30.3	32.3	33.2	36.3	35.6	31.2	31.9	28.2	22.2	18.8	19.2	18.8
Brazil	14.0	13.6	13.2	15.3	17.1	17.4	14.1	14.0	10.9	5.5	7.8	9.2	9.9
Paraguay	39.6	46.2	57.4	62.8	53.7	51.7	41.5	63.6	52.4	58.1	59.1	53.2	54.0
Uruguay	42.5	47.0	47.1	48.1	49.7	55.4	44.9	44.4	40.8	32.6	30.5	26.1	22.9
Average	31.0	34.3	37.5	39.9	39.2	40.0	32.9	38.5	33.1	29.6	29.1	27.0	26.4
GDP weighted average	19.6	19.8	19.2	20.8	23.0	23.2	20.8	20.6	17.7	9.4	10.8	11.9	12.1

Source: Authors' calculations based on Centre for International Economics, Argentina.

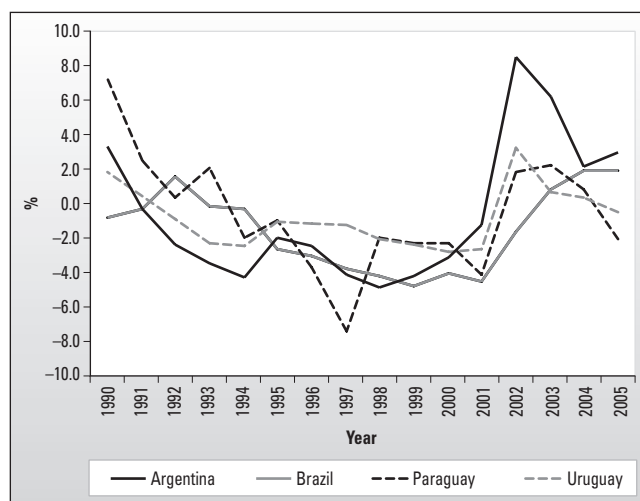
OCA theory also highlights the costs of a common currency. In particular, a cardinal lesson of the theory is that an important determinant of these costs lies in the asymmetry of shocks among member countries: if shocks are symmetrical, countries will tend to react in similar ways if their preference disparities are not wide (credibility argument). In the case of symmetrical shocks and identical preferences, the incentives to resort to the exchange rate as a means of adjusting will be weak.

Licandro Ferrando (2000) has compared the symmetry of shocks in MERCOSUR with those in NAFTA and Europe, and finds that shocks are less symmetrical in MERCOSUR than in the other regions. Machinea and Monteagudo (2002) also show that cycles are less synchronous in MERCOSUR than in Europe. Bayoumi and Eichengreen (1994) and Kenen (1995) find that the shocks are bigger in MERCOSUR than in Europe. As of today, therefore, shocks are more significant and less symmetrical in the MERCOSUR countries. But many authors (Carrera, Panigo, and Feliz, 1998; Giambiagi, 1999; Lacunza and Redrado, 2003; Machinea, 2004) have found that shocks have become more symmetrical in recent years as the integration process has evolved.

An alternative, if less formal, evaluation of the degree of symmetry of external shocks to an economic region may be based on the evolution of a set of indicators such as current accounts, country (interest rate) risk, and export performance. The analysis of the current accounts gives an indicator of access to international financial markets. In MERCOSUR during the 1980s (starting in 1982, when Mexico defaulted on its public debt), in the face of generalized speculative attacks and a sudden stop in capital inflows, the Latin American countries were forced to operate severe and often chaotic balance of payments adjustments. In the early 1990s, a sharp turnaround in international capital markets led to massive inflows into emerging markets. In that decade, the current accounts of the MERCOSUR countries showed persistent deficits (Figure 11.11).

Turbulent conditions for emerging economies began to develop in the mid-1990s with the tequila crisis in Mexico, followed by speculative attacks in Southeast Asia, Russia, and Brazil in 1999. Indeed, a new sudden stop in capital flows to MERCOSUR, coupled with the severe crisis at the beginning of the present decade in Argentina, led to a sharp turnaround in the current account balances of the region in 2003. Sizeable surpluses in MERCOSUR are the evidence of that period.

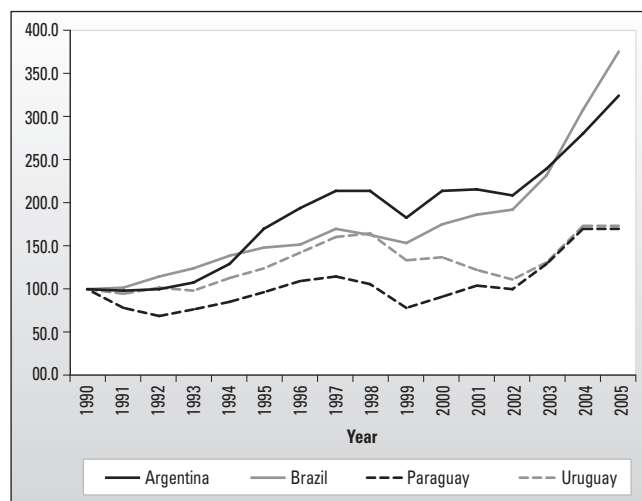
**Figure 11.11. Trends in the Current Account as Percentage of GDP, 1990–2005**



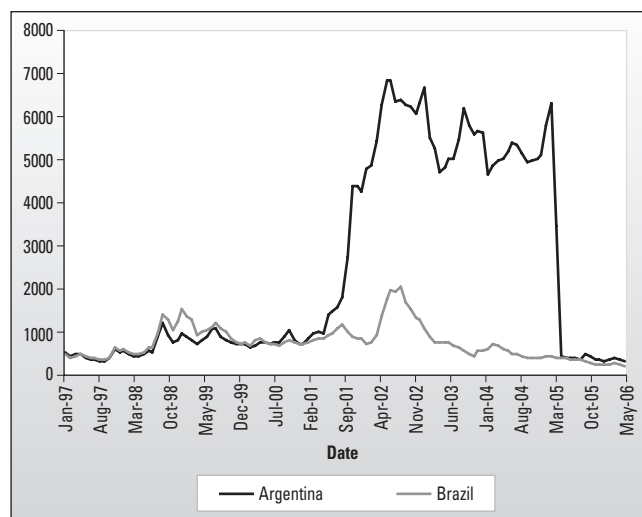
There is also a strong positive correlation for exports (Figure 11.12) and for the behavior of country risk—the latter with a break when Argentina entered into default (Figure 11.13), converging to a common regional pattern more recently. It thus appears that the MERCOSUR economies suffer common shocks from the international environment: trends in export performance, capital markets, and country risk, including the effect of contagion.

The increase in shock correlation and the common impact of the international environment may indicate that the costs of exchange coordination have diminished over time. If the region continues on its current path, the resulting correlation of the economic cycles may eventually imply that the OCA conditions for a beneficial common currency option may be satisfied.<sup>26</sup> But there may be limits to the increase in synchrony. A study by Calderón, Chong, and Stein (2003) finds that the impact of trade integration on the degree of business cycle synchronization is lower in developing economies. Thus the (dynamic) effect of monetary integration on synchronicity (via a higher trade channel) may be weak.<sup>27</sup> In such

**Figure 11.12. Exports from MERCOSUR Countries, 1990–2005**  
(1990 = 100)



**Figure 11.13. Country Risk Ratings (EMBI) of Argentina and Brazil, 1997–2006**



<sup>26</sup> Rose and Frankel (1996) have discussed the dynamics of monetary integration and the synchronization of economic cycles in developed economies. They show that, *ex ante*, the OCA criteria for a successful monetary union may not be satisfied, but once the common currency is launched these conditions might be met *ex post*.

<sup>27</sup> The impact (synchronicity) is higher in developing countries that are members of a regional integration agreement. The authors argue that the growing interdependence of developing countries may have an ambiguous or a

a case, even including the positive intertemporal impact of a currency union, the common currency strategy may not be a favorable outcome. Nonetheless, if intraindustry trade has a major role in the process of specialization (as seems to be the case in MERCOSUR, especially for the bigger countries), the latter proposition should be qualified. In such a case, MERCOSUR may show growing synchronicity.

Of course, as established by OCA theory, asynchronous shocks would not be a severe problem (leaving aside disparities in preferences) if wages and prices were flexible, if there were factor mobility, and if the authorities were able to engineer redistributive fiscal transfers among countries. These are the economic substitutes for adjustment in the absence of the exchange rate. In the first case, the adjustment is made via the prices of goods and wages. In the second case, factors of production could migrate to the country in which they are better paid, and hence there is no requirement to adjust relative prices in order to recover employment. Finally, with intercountry transfers, the economies facing an adverse shock may receive compensating flows, making alternative countercyclical policies viable and thus weakening the incentives to resort to an independent national monetary policy and exchange-rate adjustments.

Stein and Panizza (2002) discuss the state and performance of Latin American labor markets, and conclude that the degree of wage flexibility is not high compared to that of developed economies. The assessment is based on comparative dismissal costs and the persistence of unemployment.<sup>28</sup> The imperfect adjustment of nominal wages to sharp devaluations and inflation in these countries in recent years may call these propositions into question. The role of sizeable informal labor markets in the region should also be noted. The effective functioning of labor markets, considering the potential deviations of practice from legal (administrative) rules, cannot be disregarded.

In a region with significant wage disparities among countries, if a relatively well-off country suffers a negative shock, its workers will not have incentives to migrate to a low-income country. This will be true in any regional or national economic environment. But more importantly, a serious political economy problem may arise if intercountry labor mobility is to be reinforced. It could be a source of national and regional political conflict if high-income countries are expected to open their labor markets to workers from low-income countries.<sup>29</sup> This may be particularly true in view of tremendous size disparities. The high-income countries are Argentina and Uruguay, while low-income workers abound in Brazil and Paraguay. In the face of strong income differentials, a small labor market with more favorable social protection, such as Uruguay's, could face serious difficulties in coping with substantial labor flows from its northern neighbor—the population of Brazil is 60 times that of Uruguay. In

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negative impact on the correlation of economic cycles: this result may be linked to gradual product specialization in differentiated goods (interindustry trade). The asymmetry of shocks may thus rise and the degree of shock correlation may decline.

<sup>28</sup> Sturzenegger and Levy Yeyati (1999) find that the degree of correlation between nominal wages and prices is very high in Argentina and Brazil, and also conclude that labor markets may not be very flexible.

<sup>29</sup> Sturzenegger and Levy Yeyati (1999).

Europe, the high-income countries are the most populous and the low-income countries tend to be the smaller economies. Indeed, the typology of income disparity tends to be inverted in terms of size.

Economic geography may qualify the previous political economy considerations on labor mobility in MERCOSUR. Intercountry income disparity in South America is significant, but intracountry income differentials are also very high. In Brazil, by far the most populous labor market, income inequality is very substantial: lower-income groups are concentrated in the north of the country while the south has income levels equivalent to the richer parts of Brazil's more affluent southern neighbors, Argentina and Uruguay. Migrants will thus tend to go to the southern areas of Brazil, because of advantages of language, distance, and habits (that is, lower barriers to migration), thus containing large potential population flows to Uruguay and Argentina. In brief, if regional labor markets were open as of today, the political economy risks mentioned above would be weaker than expected.

In terms of fiscal redistribution, establishing a regional budget in MERCOSUR would be highly controversial these days. First, if there is an increasing correlation of shocks in the region, the demand for compensatory funds will tend to come simultaneously from various member countries, making redistribution problematic. Extreme size disparities would also make this difficult: if Brazil suffers an adverse shock, it is hard to conceive of manageable regional fiscal redistribution coming from the smaller partners. On the other hand, national income inequality would jeopardize the political legitimacy of compensatory fiscal flows to higher-income countries (or regions) based partly on contributions from low-income regions—it is hard to think of northeast Brazil financing part of the adjustment to an adverse shock in Argentina.

Summarizing the above views on MERCOSUR based on the OCA theory yields some interesting insights. On the one hand, the amount of intraregional trade is not high compared to current (and early) European levels, as well as to levels in other regional trade agreements. But note that intraregional trade has been increasing, even though some recent trends are toward a decline in Uruguay. The temporary and permanent components of this new pattern are hard to disentangle given the short time span. From a direct regional-trade perspective, the welfare gains from lower transaction costs would be weak. The coordination costs could be significant in the face of asymmetrical and sizeable shocks, relative to other regions. Though the regional shock correlation seems to be on the rise, the disparities in economic structure suggest that the potential upper limit (for correlation of shocks) may not be too high. Furthermore, as of today, the economic substitutes for the exchange-rate tool in the face of asymmetrical shocks are not easily available: fiscal redistribution and price-wage flexibility. This may be a static view; a dynamic perspective may offer qualified results. The language barrier is less significant in MERCOSUR than in Europe, but there are weaker incentives for sustained common initiatives in MERCOSUR. From the OCA viewpoint, the case for monetary union does not emerge strongly, at least in the short run. There follows an assessment of other (non-OCA) sources of potential gains from macro-economic coordination.

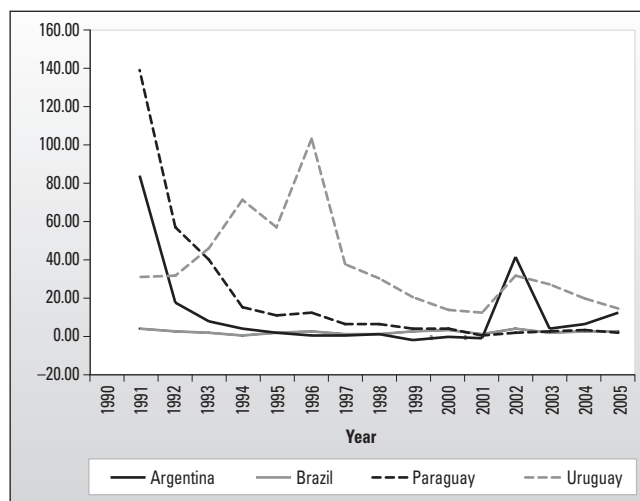
### *Are There Credibility Gains in MERCOSUR Countries?*

As mentioned earlier, the potential credibility gain and the reduction of inflation were decisive factors for some European countries (Greece, Italy, and Spain) when deciding to join EMU. In South America, one country that could act as a leader and spread credibility throughout the region is far less evident. Analysis of the macroeconomic indicators and of the current and past performance of the MERCOSUR countries is an important step in the search for this potential “Germany” in the region. Furthermore, it would help in identifying disparities in the different countries’ policy preferences—that is, varieties of revealed preferences. Even in the face of symmetrical regional shocks, a weak difference in country preferences (or convergence) would be a critical issue. Indeed, wide disparity in policy preferences may lead to different policy responses to a common shock.

After decades of regional monetary disorder, with the extreme experiences of hyperinflation in Argentina, the 1990s was a period of remarkable success on the inflation front (Figure 11.14). Furthermore, MERCOSUR inflation rates have converged markedly: through the sharp devaluations of the late 1990s and the early years of this decade, the natural acceleration of inflation proved to be transitory.<sup>30</sup> Today, regional inflation rates are below 12–15 percent a year; Argentina has the highest, and in the other members, the rate is less than 7 percent. How permanent is this? While opinion polls show that the MERCOSUR population’s main concern these days is unemployment and social exclusion (Figure 11.15), low inflation remains an important issue. As those who experienced past monetary disorder grow older and new majorities with different preferences emerge, might there be a return to inflation populism in the future? In a discussion of the costs and benefits of macroeconomic coordination or monetary union in MERCOSUR, the question may not be merely speculative.

As regards the fundamentals, there has been an impressive turnaround: massive budget deficits in the 1980s and the second half of

**Figure 11.14. Convergence in Inflation (CPI) in MERCOSUR Countries, 1990–2005**

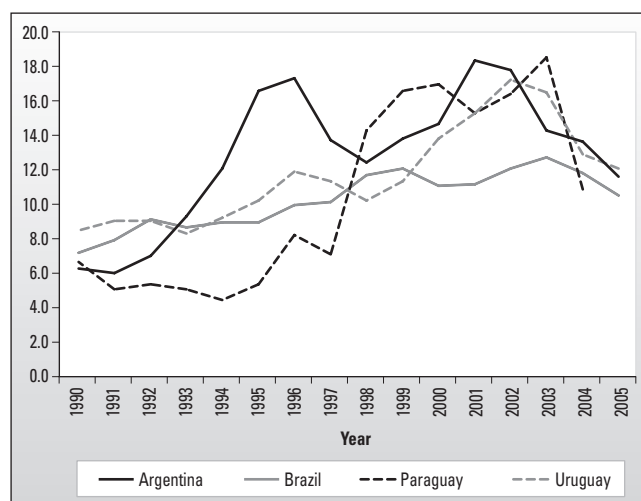


<sup>30</sup> The transitory character of the significant increase in inflation was not discounted at the time. Many respected analysts, on the basis of the historical record and the expected reemergence of indexation mechanisms, had anticipated price explosions and the return to past sins. Nevertheless, if a return to the chronic high inflation or hyperinflation of past decades seems highly unlikely, prudence on public finance and monetary management should be called for.

the 1990s led to speculative attacks and financial crises (Figure 11.16). In recent years, budget and current account surpluses have been the norm in the region. There is a budget surplus in Argentina and Brazil, and balance in Paraguay and Uruguay, and recent results have been better than the Maastricht rule of 3 percent. Nonetheless, given the historical records of disorder in public finances, monetary turmoil, and low financial intermediation, the MERCOSUR countries should aim for more conservative positions than Europe in order to gain credibility. Growing budget deficits in the mid-1990s, coupled with easy access to international capital markets, led to rising levels of public debt (Figure 11.17). When the share of dollarized or dollar-indexed public bonds is high, devaluations cause sharp disequilibria in the state balance sheet. This was particularly so in Argentina and Uruguay in 2002, when public debt-to-GDP ratios soared, reaching levels higher than 100 percent. Debt default and massive contractual disruptions (“pesification”) followed in Argentina, while voluntary debt restructuring was managed in Uruguay.

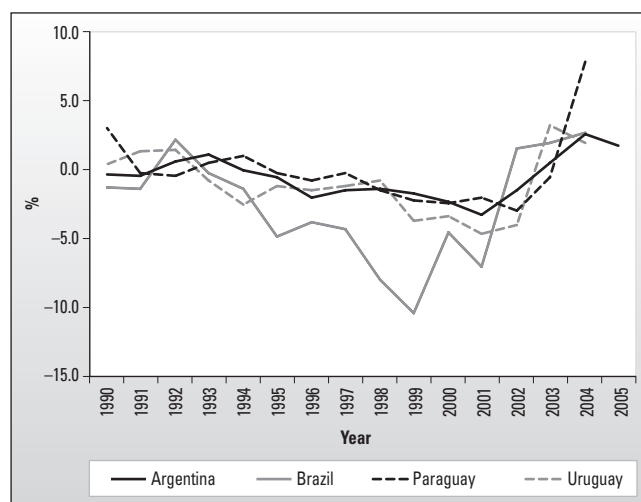
These two economies have rebounded strongly and their public finances are more robust than in the past, but long-term trends remain uncertain. The international context certainly raises a question. Will the currently favorable commodity markets and low interest rates persist? In any case, after years of severe turmoil, there is a quasi-magic phenomenon of convergence in economic indicators, as well as in exchange-rate regimes, with generalized floating in the

**Figure 11.15. Unemployment in MERCOSUR Countries, 1990–2005**



**Figure 11.16. Deteriorated Fiscal Balances in MERCOSUR Countries, 1990–2005**

(% of GDP)



region. Inflation targeting is in fashion, even if some countries follow the rules of the game more than others. The MERCOSUR countries also share common challenges: persistent unemployment and social exclusion, sustained growth trends, high levels of public debt, and balance of payments vulnerability. But again, are these transitory or permanent features of the region's economics and policy preferences?

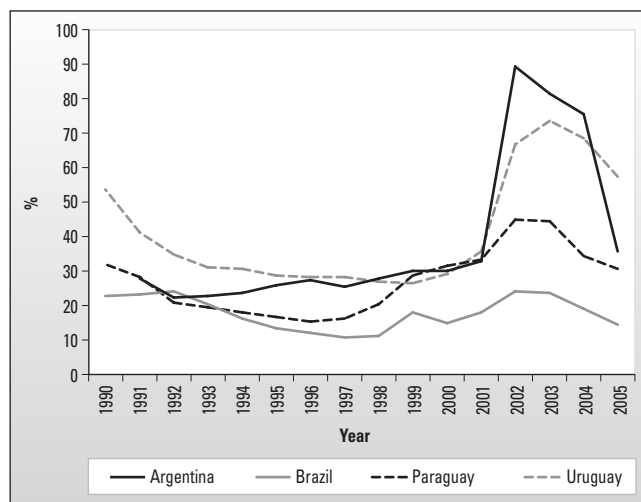
The role of regional monetary leader is not in excess supply. The largest country in the region, Brazil,

had an average inflation rate of 394.5 percent between 1991 and 2003, strongly influenced by extreme episodes of inflation in the 1990s (1991–94), when inflation reached four digits. The countries with the lowest rates in the same period are Argentina and Paraguay (12 percent on average). Argentina has had a decade of price stability, but suffered extreme monetary mismanagement in previous decades and again faced severe macroeconomic crisis from 2001 to 2002. Uruguay has had an intermediate level of inflation, at 28.4 percent in the period. Despite the recent convergence in macroeconomic indicators, markets do not forget that excessive budget deficits, monetary disorder, high inflation, balance of payments crises, and speculative attacks have been chronic events in recent decades. No country of the region has a long (or even short) history of stable and credible monetary behavior, as was the case of Germany in Europe. True, memory can be partly erased, as the German experience itself has shown: Germany's monetary history includes the hyperinflation of the 1920s under the Weimar Republic. Economic, political, and social disorder—and World War II—were fundamental events in the German markets until the late 1940s. The monetary credibility of Germany today has been hard won.

Analysis of the disparities in the preferences of voters and policy makers seems to indicate that the country with the strongest bias toward price stability was Argentina in the 1990s. Argentina sacrificed the nominal exchange rate as an adjustment mechanism and consequently was forced to suffer large and protracted output and employment contractions in response to adverse external shocks. The other countries of the region, even under stabilization programs, have given more flexibility to exchange-rate policy. Nevertheless, Argentina's credibility ranking was seriously jeopardized after the 2001 to 2002 debt default. A longer-term perspective of 25 years reveals Paraguay to be the relative best monetary performer. But size,

**Figure 11.17. Public External Debt in MERCOSUR Countries, 1990–2005**

(% of GDP)



Note: Data for Uruguay represent total public debt.

institutional weakness, and current political instability prevent the country from serving as a potential anchor in the region.

The risk of severe macroeconomic divergence in MERCOSUR seems to have diminished in the 1990s, when the countries of the region experienced a high degree of macroeconomic convergence. On the basis of past economic behavior, however, the risk of renewed divergence in the future cannot be disregarded. More positively, the MERCOSUR countries now have flexible exchange-rate regimes in common (different versions of floating systems). These recent trends might indicate a growing convergence in preferences in the region, thus lowering the costs of coordination in terms of the utility of the policy maker. On the negative side of flexibility, there is greater implicit discretion in monetary policy, which could lead to destabilizing monetary policies and potential negative contagion effects among the economies. The fact that the MERCOSUR economies may have a bias toward divergence in the future may also be an incentive to institute coordination mechanisms so as to obviate the return of the panics of the past. In such a case, coordination could act as a peer control that allows countries to implement policies and reforms that they would not be able to apply by themselves.<sup>31</sup>

### ***Interdependence, Financial Crisis, and Contagion***

Interdependent economies will be affected by other countries' policies and shocks. The greater the interdependence, the more vulnerable the national economy to events in other economies. In an interdependent world, national authorities' decisions about trade or financial issues should take account of the potential spillovers on, and from, other countries. Collective welfare gains from coordination may thus arise, as compared to purely autonomous policy decisions.<sup>32</sup> In other words, a process of "agreed decisions" among countries (policy cooperation) may increase the intertemporal well-being of all the players. Hence the greater the commercial and financial interdependence among countries, the stronger the incentives to coordinate macroeconomic policies.

As regards commercial interdependence, the same indicators considered before to assess the benefits of a monetary union are used here to measure the level of trade interdependence. Through intraregional trade, cycles in one country may be transmitted or "exported" to others. Figure 11.10 shows that the degree of aggregate interdependence in MERCOSUR (as measured by the share of intraregional exports in total exports) is low compared to the EU, NAFTA, and ASEAN.<sup>33</sup> Regional trade interdependence in MERCOSUR differs among the four member countries: Brazil has the lowest level of intraregional trade, at 9 percent in 2004, followed by Argentina (close to 20 percent), Uruguay (26 percent), and Paraguay (50 percent)

<sup>31</sup> See Carrera, Levy Yeyati, and Sturzenegger (2000).

<sup>32</sup> On sudden stops and domestic optimal monetary policy, see Calvo (2006). An analysis of the role that international and domestic policies can play in making emerging economies less vulnerable to shocks can be found in Calvo (2005).

<sup>33</sup> As suggested by Miotti, Quenan, and Winograd (1998, 1995), Lacunza and Redrado (2003) and Lavagna and Giambiagi (2000), the degree of interdependence is higher if exports with higher value added are taken into account.

(Table 11.2). There are also substantial differences in exports as a percentage of GDP, from 1.5 percent for Brazil to 4 percent for Argentina, 6 percent for Uruguay, and 12 percent for Paraguay (Table 11.1). Hence there is a potential disparity in the incentives to coordinate: the country with the lowest incentive is Brazil, followed by Argentina, and the greatest demand for coordination would be in Paraguay and Uruguay.<sup>34</sup>

The gains from coordination may extend to areas other than pure economic decision making. Indeed, political economy arguments may again affect the incentives for cooperation: Brazil's geopolitical strategy and its will to win the regional leadership from its MERCOSUR partners may increase its interest in economic coordination, despite its relatively lower level of intraregional trade. Lobbying from strongly (regionally) dependent sectors may also affect the incentives to coordinate: in Brazil's manufacturing sector, the level of intraregional trade is high. The pressures for cooperation from the firms and regions affected may be more important.

But apart from this "real" interdependence, speculative attacks and financial crises were regular occurrences in emerging markets in the second half of the 1990s.<sup>35</sup> Financial crisis became a distinctive feature of the decade, highlighting the fact that financial interdependence could be as deep as trade interdependence. Indeed, financial contagion emerged as a fundamental feature of these economies, leading to increased interest in the study of this issue.

In MERCOSUR, financial turbulence in one member country may become a serious problem for the others, and macroeconomic coordination may help mitigate the contamination effects of financial instability. In particular, from a trade interdependence perspective, the smaller countries with higher levels of regional trade will tend to have stronger incentives for macroeconomic coordination. As regards the role of financial interdependence, however, the bigger economies may have significant incentives to cooperate if collective policies contribute to regional stability. Argentina and Brazil were both sources of financial turmoil in the region. In view of the lessons learned from financial instability and contagion effects, the costs and benefits of macroeconomic coordination are once again examined here.

The literature on the sources of financial and balance of payments crises discusses a series of common and idiosyncratic factors in the different regions. Of the latter factors, the literature highlights the fixed exchange-rate regimes that contributed to macroeconomic disequilibria, current account deficits, and speculative bubbles in asset markets (Takatoshi, 2003). Weak financial institutions are another common factor of fragility that have been shown to be important in twin financial and balance of payments crises. In some cases the turmoil starts in the balance of payments and then contaminates the exchange markets, while in other cases the opposite is true. Banking fragility is also relevant and points to two important factors: poor portfolio diversification with high exposure in sectors or firms that

<sup>34</sup> Note a decline in interdependence since 1998 with the slowdown of the regional economy, on the basis of share of regional exports in total exports. This is less so with the exports to GDP indicator. The rebound in economic growth since 2003 may be evident in a trend toward greater interdependence.

<sup>35</sup> Starting with Mexico's tequila crisis in December 1994, turbulence affected several countries of Southeast Asia in 1997, Russia in 1998, and Latin America again (this time Brazil) in 1999. Turkey followed in 2001, and then the megacrisis of Argentina which occurred in 2002.

have high risk levels; and the maturity and currency mismatch in the banks' balance sheets (short-run capital flows), with the destabilizing effects of sudden stops and capital flight.<sup>36</sup> A difference between recent financial crises in Asia and Latin America is the role of public finance—unsustainable budget deficits—and private indebtedness. The former is a distinctive feature in Latin America, whereas the latter plays a major role in Southeast Asia.<sup>37</sup>

Fratzscher (2004) discusses the sources of contagion, focusing on the Mexican (1994) and Thai crises (1997). The main issue is to disentangle the role of weak fundamentals in the contaminated country from herd behavior, and the study shows that unsustainable fundamentals are an important channel of contagion.<sup>38</sup> In Asia, the fragility of the financial system, coupled with sharp reversals of capital flows, played an important role in the crisis, whereas in Latin America the main factor was unsustainable public policies leveraged by weak banking systems. In both cases, close financial and trade relations provided a significant channel of contagion. Indeed, the growing level of interdependence in MERCOSUR reinforces the region's financial fragility, leading to a higher probability of imported turmoil from neighbors. This is truer now than in the early days of regional integration. In turn, this evidence should increase the incentives to seek regional stability and tools for macroeconomic coordination.

In short, greater financial interdependence has led to a higher probability of contagion in emerging economies. The existing evidence tends to show that close trade relations reinforce financial contamination from the international environment at large, as well as from regional partners.<sup>39</sup> The incentives for cooperation in MERCOSUR may thus increase, relative to the arguments highlighted in previous sections. The bigger members, Argentina and Brazil, frequent sources of financial volatility and both good candidates for financial epidemics, may find a new interest in reinforcing regional stability.

### ***Exchange-Rate Volatility and Intraregional Trade***

The coordination of exchange-rate policies has been a key feature of the European experience, the goal being not to damage a sizable and increasing intra-European trade. It is expected that the potential gains of reduced exchange-rate risk will grow with intraregional trade and with the level of exchange-rate volatility. Evaluating the economic costs of regional real-exchange-rate volatility thus requires an absolute measure of volatility, as well as the degree of intraregional interdependence.<sup>40</sup>

<sup>36</sup> Agosin (2001) shows that short-run capital flows may be excessive relative to the size of the domestic banking systems.

<sup>37</sup> See Hamada (2004).

<sup>38</sup> An econometric analysis is carried out using as economic indicators exchange-rate arrangements, budget deficits, current account balances, and the size and composition of debt, among others.

<sup>39</sup> See Machinea and Monteagudo (2002). The evidence seems to show that real-exchange-rate misalignments between member countries are more significant in explaining currency crises than misalignments with the rest of the world.

<sup>40</sup> For a discussion of the impact of real-exchange-rate volatility on trade, see Moccero and Winograd (2006), which develops an econometric application for Argentina.

As mentioned earlier, intraregional trade in MERCOSUR has increased but is still much lower than in the EEC in the 1980s, when the EMS was launched. On the one hand, given the lower degrees of trade interdependence, the expected (intraregional) gains from exchange-rate coordination may be lower in MERCOSUR than in Europe. On the other hand, bilateral real-exchange-rate volatility is much higher in MERCOSUR, presumably leading to positive expected effects of macroeconomic coordination.<sup>41</sup>

Analysis of the sources of excessive volatility should not be bypassed without discussion. If the main contribution to such volatility stems from certain well-identified macroeconomic variables, economic policy design could be called upon to repair these inefficiencies, thus leading to reduced real-exchange-rate volatility. It may be the case that these economies have stronger fluctuations in fiscal or monetary policies, or are subjected to frequent external shocks and so on. On the other hand, it might be that controlling for these observable sources of real-exchange-rate volatility, the latter remains very high. If so, there could be grounds for considering policies geared to reducing volatility, such as exchange bands or a common currency.<sup>42</sup>

Eichengreen (1998) studies the sources of volatility for a large set of countries, including developed and less developed economies. The author conducts econometric tests to analyze the impact on real-exchange-rate volatility of variables such as differences in country size,<sup>43</sup> disparities in production and trade structures (agriculture, manufactures, minerals, and so on),<sup>44</sup> and the degree of shock asymmetry and trade interdependence among countries.<sup>45</sup> The findings show that MERCOSUR has 60 percent more volatility than other comparable economies.

The comparison of MERCOSUR and the EU yields two kinds of evidence. MERCOSUR has less average intraregional trade, even when the EU started to set the basis for the common currency. However, MERCOSUR has significantly higher intraregional real-exchange-rate volatility, even controlling for its observable sources. It seems that the comparison with Europe does not provide straightforward results on this matter.<sup>46</sup> But if long-term stationary interdependence is significantly higher than the observed current values, a dynamic view of interdependence may provide a more positive perspective on the potential gains of coopera-

<sup>41</sup> Licandro Ferrando (2000) stresses that absolute bilateral real-exchange-rate volatility is significantly higher in MERCOSUR than in Europe.

<sup>42</sup> Of course, exchange rate bands and common currency refer to the control of nominal rather than real exchange rates. In any case, nominal and real exchange rates may be strongly correlated.

<sup>43</sup> The smaller the economy, the higher the demand for stability, and thus the higher the incentives for cooperation.

<sup>44</sup> Sizeable production and trade-structure disparities may lead to substantial differences in the impact of sectoral shocks. More flexibility may thus be needed to accommodate such shocks, leading to more exchange-rate volatility.

<sup>45</sup> The higher the level of trade interdependence, the stronger the incentives for cooperation and exchange-rate stability.

<sup>46</sup> In view of the disparities among the MERCOSUR countries, the gains from lowering exchange-rate risk would be asymmetrical. The smaller economies would benefit most by increasing cooperation and stability, followed by Argentina and then Brazil. Recall that intraregional trade is greater for Paraguay and Uruguay than for Argentina and Brazil.

tion. This would be the case if the decline in real-exchange-rate volatility were associated with an increase in trade among partners.

Empirical studies are inconclusive on the impact of exchange-rate volatility on international trade, but tend to show a negative effect. It is argued that in developing economies where financial markets and hedging instruments (to insure against exchange variations) are less developed, the trade effect of exchange-rate volatility should be more significant (negative) than in richer economies (Devlin et al., 2001).<sup>47</sup> It was said earlier that MERCOSUR has a much higher degree of real-exchange-rate volatility than Europe. Indeed, excessive volatility could repress the development of intraregional (and extraregional) trade.

The analysis of macroeconomic coordination and exchange-rate arrangements should not neglect the impact on trade of intraregional and extraregional volatility. If intraregional volatility alone matters, there will be a strong incentive to coordinate intraregional policies and exchange rates, and some form of peg in the region may be a good option.<sup>48</sup> Machinea and Monteagudo (2002) show that intraregional exports tend to respond more strongly to exchange-rate volatility than do extraregional exports. This finding supports the idea of coordination among the MERCOSUR countries. Thought could also be given to a regional cooperative policy arrangement that reduces extraregional volatility, such as a common currency pegged to a basket of world currencies, or other variations of exchange arrangements. In turn, given that it would be a regionally coordinated rule, regional volatility would also be managed.<sup>49</sup>

High exchange-rate volatility may also encourage protectionist lobbies, helping to jeopardize integration and eventually derailing a coherent strategy to deepen interdependence. Theory and experience have both shown that highly unstable exchange rates may lead to destabilizing political economy mechanisms. Devaluation of the currency of a member of the regional trade agreement, often the result of an unsustainable appreciation, is perceived as opportunistic behavior, triggering protectionist reactions, and potentially negative political dynamics for the integration process. A devaluation may lead to a temporary overshooting of the exchange rate, which would be followed by a gradual appreciation. In time, a stationary state will prevail, with a diminished price differential in favor of the devaluing country. But overshooting maximizes the temporary handicap of the partners, thus providing strong incentives for protectionist lobbies (employers, workers, and politicians). Transitory price advantages may provoke permanent (persistence of protectionist measures) trade barriers that are politically costly to remove. The politics of silent winners versus superactive losers tends to be in motion, and may severely affect the integration process. This is a fundamen-

<sup>47</sup> On the Latin American case see also Machinea and Monteagudo (2002) and Stein and Panizza (2002).

<sup>48</sup> In such an event, central banks should maintain foreign reserves in the other countries' currencies.

<sup>49</sup> These options may raise questions about the potential anchors for the region. Dollarization has been intensively discussed in the past (today, thought could also be given to euro-ization or a basket), but often from the national perspective. Stand-alone autonomous dollarization would only partly reduce regional real-exchange-rate volatility. A coordinated peg (and variations on this theme) would not suffer this monetary handicap. It may certainly suffer other handicaps worth considering.

tal reason to favor macroeconomic coordination or the adoption of a common currency in MERCOSUR.

In Argentina and Brazil, there are many examples of sharp changes in the real exchange rate triggering protectionist activity. In the 1990s, the real appreciation of the peso led to a 10 percent statistical import tax in Argentina. In the face of rising current account imbalances, Brazil imposed restrictions on MERCOSUR imports in 1997. And again in 1999, when Brazil suffered a speculative attack and a sharp devaluation, protectionist responses emerged among the other members. The smaller countries, Paraguay and Uruguay, had regularly confronted sectoral protectionist barriers from the bigger partners, a circumstance aggravated by their weak bargaining power. Note also that the relative importance of the protectionist activity of a given country tends to depend on the size of the devaluing economy. The same reaction should not be expected in NAFTA when Mexico (4 percent of regional GDP) devalues as in MERCOSUR if Brazil (65 percent of regional GDP) does so.<sup>50</sup> In MERCOSUR, exchange-rate volatility has originated mainly in the bigger partners, thus increasing the incentives for protectionist behavior. Indeed, consideration should be given to developing buffer measures for these episodes of sharp discontinuities. In particular, temporary and predetermined compensatory measures for transitory real-exchange-rate overshooting by the devaluing economy should be discussed. The aim would be to contain persistent protectionist barriers triggered by temporary price changes, thus increasing the robustness of the integration process.

### What Should Be Coordinated in MERCOSUR?

Macroeconomic coordination has not ranked high on the MERCOSUR agenda, and less so for the bigger countries. Despite the natural and slow learning-by-doing process in any cooperative venture, matters of national urgency in an unstable region have led to delays and distortions in regional policy initiatives. Lavagna and Giambiagi (2000) argue that the cause of the paralysis of regional coordination is twofold. The first is the strongly divergent macroeconomic trends of the bigger MERCOSUR countries. In fact, after severe monetary turmoil in the 1980s, Argentina achieved price stability in 1991 (the Convertibility Law), while Brazil suffered high inflation until the end of 1994 when the Real Plan was launched. These authors also highlight discordant macroeconomic objectives between these countries: the exchange rate was used to anchor price stability in Argentina, while the main target of Brazilian policy was the current account balance. The second source of delay in coordination is the priority assigned in the early stages of integration to dismantling regional trade repression (severe commercial distortions), leaving macroeconomic coordination initiatives for the future.

The Brazilian currency crisis of January 1999, and the sharp devaluation that followed, placed intense pressures on the MERCOSUR trade agreement. Argentina, anchored to the dollar under the convertibility regime, had been facing an economic contraction since mid-

<sup>50</sup> This general argument should in turn be qualified by considering sectoral impact—that is, a small country with a strong competitive advantage in a given sector that affects sensitive (or active) players (regions) in a bigger country.

1998, a circumstance aggravated by the abrupt change in the bilateral real exchange rate. As expected, the Brazilian currency initially overshot, triggering protectionist demands in Argentina. Hence there were stronger incentives to develop cooperative policies. The political consensus in Argentina was still strongly behind convertibility, thus requiring a regional strategy based on the coexistence of a fixed exchange-rate regime and appreciated currency in Argentina, and a newly adopted flexible regime and overly depreciated currency in Brazil. A transitory compensation mechanism could have been designed to partly compensate for the natural overshooting of the Brazilian real, geared toward containing the protectionist reaction (which may lead to permanent distortions) prompted by the sharp devaluation.

More recently, all the countries of the region converged on common, flexible exchange-rate regimes based rhetorically on inflation-targeting rules. But it could be argued that there are still regional disparities in objectives. Monetary policy anchors inflation in Brazil while, beyond rhetoric, Argentina seems to have a strong preference for some form of exchange targeting. Policies again seem to reveal diverse preferences, albeit the opposite of those of the 1990s.

In 2000, the Argentine<sup>51</sup> and Brazilian governments decided to launch a series of cooperative initiatives, particularly in the macroeconomic arena. The MERCOSUR countries agreed to: (i) devise common macroeconomic objectives; (ii) construct comparable and consistent macroeconomic indicators—the existing ones were based on different methodologies; (iii) publish fiscal indicators regularly, enhancing transparency, and common knowledge of the state of national public finances; (iv) establish a set of common targets for budget deficits, public debt, and inflation; (v) study the national capital markets with a view to future regional integration; and (vi) create a flexible institution responsible for macroeconomic initiatives—the Macroeconomic Monitoring Group.<sup>52</sup>

In line with these objectives, there was significant progress on the harmonization of statistics on budget deficits, public debt, and prices—a necessary step toward discussion of common macroeconomic rules. The MERCOSUR countries had also agreed on a set of macroeconomic targets in the style of the Maastricht criteria, such as a maximum 5 percent inflation rate by 2005 and 4 percent thereafter; a consolidated budget deficit of 3 percent of GDP; and a downward trend for public debt, to reach 40 percent of GDP in 2010. A European approach to managing deviations from the agreed targets was proposed: the country in question was expected to present a convergence plan to the Macroeconomic Monitoring Group and show concrete actions with a view to the application of the proposed plan within a year. Enforcing the collectively agreed targets remains a serious problem in Europe, and was even more so in MERCOSUR at the beginning of the coordination process. Furthermore, Argentina's macroeconomic collapse in late 2001 and 2002, with the regional financial epidemics and contagion, led to severe disturbances that jeopardized the continuity of the coordination initiatives. The current regional challenge is to relaunch negotiations on macroeconomic issues.

<sup>51</sup> The strategic international focus of the newly elected government in Argentina was biased toward MERCOSUR, as opposed to the more ambiguous policy of the previous administration.

<sup>52</sup> See Machinea (2004).

## Exchange-Rate Policy

Exchange-rate policy has been central to the European experience from the outset. It was said earlier that bilateral real-exchange-rate fluctuations may have a negative impact on regional trade, jeopardizing integration. This section examines the role of exchange policies in reducing regional volatility.

## Monetary Union

A first alternative is the creation of a monetary union in MERCOSUR. A Maastricht-type treaty in the region would be subject to theoretical critiques similar to those applied to the European version. The main problem to be considered in MERCOSUR is contagion. A common currency would eliminate regional exchange-rate volatility, contributing to trade integration.<sup>53</sup> But, as mentioned earlier, the current consensus on the issue highlights the absence of the *ex ante* conditions set by the OCA theory for a beneficial currency union.<sup>54</sup>

The favorable view of monetary integration would also consider the endogeneity of the OCA criteria—that is, a dynamic approach as opposed to the static approach. Indeed, the countries would engage in a process of monetary union in the expectation that future *ex post* benefits will be greater than costs. The member countries of the currency union, however, may still be subject to asymmetrical shocks even after monetary integration, and thus the issue of managing this disparity in shocks and responses may persist.

A related but not fully explored monetary framework would consist of pegging the region's currencies to the Brazilian real. If the MERCOSUR countries anchor their currencies to the major regional economy, they would entirely “buy” Brazilian monetary policy, its preferences, and objectives. Brazil is now following a fully-fledged inflation-targeting regime which is bearing fruit in keeping inflationary expectations low. In the unstable MERCOSUR, the benefit of containing the intraregional real-exchange-rate volatility should not be disregarded. A reduction in such volatility would help diminish the lobbying activities that distort the integration process. The region could thus experience a political economy bonus and lower the costs of deepening trade integration. But acquiring reputation by anchoring to the real and reducing regional volatility is not cost-free. In the presence of asymmetrical regional shocks, output and employment in the pegging countries would fluctuate more than with independent monetary policies.

If Brazil's central bank pursues a responsible monetary policy, the main cost for the partner countries would come in the event of asymmetrical shocks. On the other hand, if Brazil follows an irresponsible monetary policy, the partners would import Brazil's higher inflation.

<sup>53</sup> As mentioned earlier, these alternatives will reduce the volatility of the nominal exchange rate. It is widely known that nominal and real exchange rates are strongly connected.

<sup>54</sup> See Licandro Ferrando (2000), Stein and Panizza (2002), and Machinea (2004).

Acquiring reputation by anchoring to the real cannot be compared to the European case and the dilemmas facing the German mark as the monetary leader on the path to the euro. The potential volatility of relative inflation dynamics in the MERCOSUR countries persists, and could still induce significant exchange-rate misalignments, thus endangering the sustainability of a common currency venture.

### Exchange-Rate Bands

Exchange-rate coordination agreements in MERCOSUR based on exchange-rate bands have been less explored. Currencies may fluctuate within predetermined bands, as in Europe with the snake and the EMS. A regime of exchange bands combines the need for flexibility to respond to asymmetrical shocks with the benefit of limited volatility to foster the process of trade integration. In the flexibility–volatility trade-off, a bands system is an intermediate solution for coordination, between an irrevocable currency union and autonomous, uncoordinated monetary policies. In 1993, the Brazilian authorities proposed a system of bands centered on bilateral real-exchange-rate parities. The expectation then was to implement such a regional exchange-rate regime in 1995, simultaneous with the launching of the common external tariff for extraregional imports. Two types of bands were proposed: a narrow one for the bigger economies (Argentina and Brazil) and a wider band for the smaller countries. The stated goal of the band regime was to contain competitive devaluations. An intervention fund was to be designed (the Regional Intervention Fund), inspired by the European experience, to contain excessive exchange-rate fluctuations.<sup>55</sup> In view of the fund's limited resources, it was expected to concentrate its interventions in the smaller economies. To reduce the incentives for competitive devaluations, there was also a proposal to institute a system of penalties based on extraordinary regional import tariffs for countries devaluing their currency.

But some matters should be underscored. The bigger MERCOSUR economies are more often the sources of financial disorder and extreme volatility, and thus a system of stabilization funds focused on the smaller countries would leave the initial problem unresolved. The credibility of the band regime would be weakened. Similarly, if the fundamentals (fiscal, debt, terms of trade, and so on) are misaligned, a devaluation may be a necessary adjustment or the result of a speculative attack in the face of a credibility crisis, not necessarily a voluntary and competitive devaluation. Such was the case in Brazil in January 1999 and Argentina in 2002. The role of disequilibrium in the fundamentals, exchange-rate volatility, and the means of securing stability should be carefully discussed. But in the mid-1990s, the proposal to implement a system of bands was not on the common agenda. Argentina was under the currency board and convertibility, while Brazil had a flexible exchange-rate regime and was dealing with high inflation. The differences in monetary regimes and macroeconomic postures prevented progress toward a regime of regional exchange bands.

<sup>55</sup> See Lavagna and Giambiagi (2000).

The current convergence in economic trends and exchange-rate regimes is conducive to a positive dialogue on a common agenda for macroeconomic coordination. A system of bands (not necessarily centered on the real exchange rate, but on nominal exchange rates) could be a subject for regional discussion if the natural caveats stemming from experience are not neglected. Consideration could then be given to establishing adjustable central parities, with lower and upper limits of the band allowing for an interval of exchange fluctuation. The regular revision of the central parities averts the growing pressures on the system that may arise from persistent disequilibria, eventually leading to speculative attacks. In view of the European experience, the adjustment of parities would require a collective agreement, as well as complementary policy measures (budgetary and so forth) to reinforce sustainability. Excessive flexibility may nourish vicious circles, contributing to greater volatility rather than diminishing it—the latter being the prime goal of coordination.

In general terms, the width of the band is what diminishes speculative attacks, obviating sharp jumps in the nominal exchange rate. This argument explains why free-floating regimes are less prone to speculative attacks than rigid arrangements.<sup>56</sup> The bands in MERCOSUR should be wider than in Europe, given the higher degree of shock asymmetry and the potential frequency of attacks on the MERCOSUR currencies.

Nonetheless, exchange-rate bands in MERCOSUR may face many problems. First there is the scale and volatility of capital movements. It has been argued that unstable capital flows are a significant source of instability and may jeopardize the proper functioning of a regime of restricted exchange-rate bands.<sup>57</sup> The MERCOSUR countries' level of international reserves is low compared to the scale of capital flows, thus weakening the central banks' defensive line in the face of sharp turnarounds in private portfolios. In the event of speculative pressure on the currency, relatively low levels of international currency reserves may force a sharp devaluation. This argument holds true in the case of the parity of a weak currency in terms of (strong) international currencies, but less so in the case of the bilateral parity of two weak currencies such as the peso and the real. In theory, if the central banks of Argentina and Brazil allow the currencies to float freely against the dollar, nothing prevents the fixing of peso–real parity. But the stability of the latter currencies relative to the dollar cannot be disregarded, and hence the relevance of the volatility argument linked to unstable capital flows returns.

The long history of monetary turmoil and recurrent balance of payments crises in the region may be evident in a marked lack of credibility of exchange-rate coordination ventures—even more so than the EU has suffered in the past. Furthermore, the bands system is easier to reverse than a monetary union. Indeed, the member countries of a band arrangement may opt out at a lower cost. In that event, speculative attacks would be the rule rather than the exception.<sup>58</sup> Credibility in MERCOSUR may also be undermined by the absence of a leader to anchor the system.

<sup>56</sup> See De Grauwe (1994).

<sup>57</sup> See Eichengreen (1998) and Machinea (2004).

<sup>58</sup> In Europe, as mentioned, the bands regime had set a wider fluctuation interval for the Italian lira in view of the credibility handicap affecting the country's monetary institutions.

A high probability of asymmetrical shocks may require frequent adjustments of nominal exchange rates in the future, and in time the countries may leave the system (as many European countries did). The credibility cost would thus be high. In a world of rational expectations, these events will tend to be anticipated and the credibility handicap may lead to a self-fulfilling prophecy. The band regime could be seriously impaired from day one.

### General Considerations

Whatever form exchange-rate coordination takes (exchange-rate bands, varieties of cooperative arrangements, or monetary union), a basic issue is the role of extraregional currencies. Dollarization is an important feature of economics in MERCOSUR, through its role in private portfolios and in the public debt in foreign currency (or bonds indexed to the dollar), as well as through the price of commodity exports.<sup>59</sup> Sharp changes in the domestic currency's parity with the dollar (euro) will thus have a sizable impact on the public sector's balance sheet and on private firms, and may cause extraordinary financial fragility.<sup>60</sup> The greater the dollar obligation of the banks (dollarized deposits), the more complicated the situation. In such a case, responses based on rescheduling operations may entail a credibility loss, triggering bank runs. If contract restructuring and defaults are anticipated in cases of financial turmoil, destabilizing expectations may reinforce financial fragility. The economic and social costs of such an environment may be significant. In the face of devaluations, the contractionary effects on output and employment may be reinforced and have a greater impact than the standard expansionary effects that tended to dominate in the European experience. With a high degree of dollarization, any strategy of exchange-rate coordination may contribute to financial stability if it successfully restrains the volatility of the parity with the dollar (euro).

Dollarization entails a sort of credibility paradox. In a context of widespread dollarization (as well as dollar-indexed financial instruments or contracts), there may be less need for a monetary leader to anchor a coordination process. The incentive to peg the domestic currency to the dollar (contractual unit), rigidly or partially, may be a substitute for the absence of a credible monetary incumbent. Consideration could be given to a common currency peg to a hard currency or a basket (trade-weighted rule), thus importing credibility from the extraregional central banks. The rationale of such a strategy will depend on the degree of dollarization, as well as on the relative intraregional/extraregional exchange-rate volatility.

Disparities in the objective function of monetary-exchange rate policy may also have an impact on coordination strategies. Inflation-targeting may be the rhetoric of the monetary rule, but economic policy may reveal other objectives, in some cases weighted with the former. Brazil has often resorted to the exchange rate as an instrument for external balance (output) targeting, while Argentine monetary policy focused on price stability in the 1990s.

<sup>59</sup> The "original sin" problem limits the possibilities of agents in peripheral countries issuing international debt in domestic currency.

<sup>60</sup> On the risk of domestic dollarization and sudden stops, see Calvo, Izquierdo, and Mejía (2004).

Today, the relative preferences seem to have been reversed: Brazil has a high commitment to inflation-targeting and Argentina is pursuing a somewhat ambiguous objective with a bias toward nominal exchange stability. If the disparities in the preferences regarding monetary instruments and objectives persist, some countries will be less prone to peg than others, leading to a dilemma in the conduct of cooperation and the setting of common targets. Sizeable disparities in country (economy) size may also have a negative impact on the incentives for macroeconomic coordination. The bigger partner will have to suffer a loss in economic autonomy in exchange for relatively minor economic gains from its smaller partners. If the objective function (economic or geopolitical) of the major player is enlarged, resistance to cooperation may diminish.

Given the high levels of real-exchange-rate volatility in MERCOSUR and its negative effect on trade, varieties of bilateral exchange-rate pegs could be beneficial. But the difficulties involved in finding a workable mechanism may not be minor. In particular, the region may need a regime of flexible exchange-rate coordination: if exchange bands are the preferred option, the latter should be quite wide, so as to accommodate large and frequent disturbances. But such a policy choice may be self-defeating, signaling a weak commitment, and thus inducing a credibility handicap. Excessive flexibility may jeopardize the very first objective of coordination—to curb volatility. Furthermore, whatever peg system is implemented in the region, it should be kept in mind that high levels of dollarization demand a reasonable degree of extraregional currency stability. The following section discusses other arguments, beyond real-exchange-rate volatility, that call for macroeconomic cooperation.

### ***Financial Instability and Contagion***

As mentioned earlier, the two bigger MERCOSUR economies are regular sources of financial turmoil that contaminates the other economies. Cooperative strategies are needed to lessen the probability of speculative attacks. The current trend toward more flexible exchange-rate regimes should help reduce the probability of currency crises, but in time it could also be conducive to a lesser commitment to discipline in the fundamentals. A balance between flexibility and sound macroeconomics is crucial to attaining stability. The coordination of macroeconomic fundamentals to foster regional stability should focus on three matters: fiscal deficits, the level of public debt, and inflation.

Empirical evidence tends to show that public debt and budget deficits have a strong impact on domestic interest rates, particularly in emerging economies with low levels of financial intermediation and short maturity profiles in their financial instruments.<sup>61</sup> There are also high degrees of correlation in financial-asset returns across these economies, indicating strong incentives to engage in economic cooperation and establish discipline devices to avert national infection and international contagion. MERCOSUR has been a regional testing ground for such financial epidemics.

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<sup>61</sup> Gavin and Hausmann (1999) and Grandes (2001).

The European experience is an interesting benchmark for the design of discipline devices. The MERCOSUR countries have a long history of monetary disorder, chronic inflation in the last 50 years, and hyperinflation in the 1980s and early 1990s. Public finance mismanagement has long been the rule rather than the exception. The bias toward excessive budget deficits has been a recurrent feature of the economics of the region, coupled with low levels of financial intermediation. Though the MERCOSUR economies currently have relatively robust postures on public finance, renewed misbehavior is not impossible in view of the history and the weakness of the institutional environment. Future financial vulnerability cannot be discounted, and market expectations might preclude the probability of a return to economic instability. MERCOSUR should embark on a credible, low-debt path, with public finance targets that are more stringent than the European (Maastricht) benchmark. This is true both in a cooperative strategy and in an autonomous, noncooperative policy. In the latter case, moreover, there may be arguments for overshooting fiscal prudence as an insurance against contagion.

Prudence in public finance by means of rigid fiscal targets entails the loss of countercyclical policies, particularly when external shocks are frequent. A target for the structural budget deficit—adjusted by the economic cycle—may be an interesting policy instrument to reconcile prudence and flexibility: the fiscal targets (ceilings) should be lower in economic recessions than in expansionary phases. If there is limited rationale for rigid collective fiscal rules in the framework of monetary integration or macroeconomic coordination, beyond risk aversion and pure credibility arguments, the application of structural budget-deficit ceilings may also be questionable. The definition of cycles is an *ex post* exercise, while the targets for the structural deficit are set *ex ante*. The development of the leading indicators literature helps forecast economic activity, but important prediction errors cannot be excluded. Furthermore, severe political economy problems may emerge in countries with extensive institutional failings, opening the door to opportunistic behavior on the part of governments. Good intentions may easily be jeopardized in practice.

The sequence of shocks may also be a problem: the countercyclical mechanism should be launched in a boom, when the political authorities might be tempted to profit from the bonanza. Incumbent politicians may thus resist saving for the bad days. In a world of weak institutions, appropriate electoral cycles may worsen the dynamics. The idea of structural deficits is very appealing in theory, but complex in practice.

As to public debt coordination, potential liquidity problems suggest the need for low target levels. In many cases, the short maturity of the debt instruments, coupled with volatile commodity prices, leads to frequent demands for funds (refinance), involving sizeable placements. Budget adjustments are not a short-run solution in the event of a liquidity shortage, because of the severe political and social costs they may involve. But the capital markets confronted by emerging economies show particularly high volatility, drying in times of uncertainty, when the marginal benefit of liquidity is higher. But under credit rationing, these countries are forced to engage in sharp adjustments of their public finances, thus bringing about procyclical fiscal policies when the opposite may be needed. Such turbulent market dynamics only boost volatility in employment and output. Indeed, when there are such levels

of volatility in access to credit markets, a reasonable degree of risk aversion implies rather low levels of public indebtedness.

As regards domestic financial systems and the status of the current account, another consideration should be kept in mind. As the Asian crisis showed, the financial system may be a direct source of instability or a channel that transmits shocks from other parts of the economy. Strengthening MERCOSUR's financial systems through the coordination of robust prudential regulations and supervisory practices can only contribute to stability. Though not a sufficient condition for sustainable financial policies and growing credibility, it may certainly be a necessary condition. The recurrent experience of emerging economies shows that high current-account deficits may become unsustainable and develop into a source of instability. The succession of speculative attacks and devaluations in Europe in 1992 indicate that financial disequilibria from the dynamics of external assets may be destabilizing in other economies too. The situation may be aggravated when these deficits are financed by short-term external debt, as evidenced by a variety of financial crises. A close follow-up on the temporal structure of public debt should be considered, as well as regulations on the levels of short-term indebtedness. A credible concern for the state of the current account (levels of debt) may also help to lower the vulnerability of these economies.<sup>62</sup>

On the fiscal front, the sustainability of public finance may also be signaled by coordinated targets. The setting of fiscal rules,<sup>63</sup> increased transparency in the budgetary process and the establishment of independent budget monitoring committees may help reinforce the credibility of public finances. A long-lasting and credible regional agreement on public finance may help trigger intertemporal confidence in the financial markets. A monetary history of chronic high inflation and hyperinflation up to the 1990s demands that policy makers explore the potential stabilizing role of greater interdependence in monetary policies. The lack of credibility in public finance and monetary matters stems not only from the persistence of unreasonable levels of inflation in past decades, but also from the many failed disinflation promises of successive administrations. Since economic agents have deep memories of inflation, the commitment to price stability should be very strong, and a regional goal of prudent financial and monetary policies could help lower the costs of credibility. National and regional commitment to price stability may signal a prudent type of administration, thereby reinforcing expectations of low inflation.

Adoption of a common currency could curb abnormal monetary behavior, but it may not work as desired. In the negative scenario, it could lead the region to monetary disorder. Credible constraints on public finance and monetary policy may avert the temptation to excessively exploit the short-run inflation-unemployment trade-off, which might erode credibility

<sup>62</sup> If the macroeconomic coordination considered here proves successful, bilateral real exchange rates could be expected to be less volatile. This may happen independent of the particular exchange rate arrangement chosen by each country. In the 1990s, the greater macroeconomic stability in the region itself contributed to lower volatility in bilateral real exchange rates in the MERCOSUR countries (Machinea, 2004).

<sup>63</sup> Varieties of the Responsibility Law in Brazil, or other initiatives such as the Fiscal Convertibility Law in Argentina, may be considered.

and bring back inflationary expectations.<sup>64</sup> Currently, the prospect of a common currency in MERCOSUR is remote. Hence the need to explore more flexible coordination arrangements that may signal a path of low inflation for the region.

### *Coordination Rules and Enforcement Design*

This section addresses the enforceability of the rules in a macroeconomic coordination initiative for MERCOSUR. In Europe (the Maastricht Treaty), supranational institutions were empowered to impose sanctions on countries that did not comply with the rules. The problem of designing appropriate incentives to keep countries committed naturally arises.<sup>65</sup> The case of multiple economic contingencies and potentially conflictive interests lies in the background of the incentive design exercise. The relevance of this issue is magnified in MERCOSUR because of the lack of established and credible regional institutions. The evidence of asymmetrical shocks in the region only increases the incentives problem. In Europe, there were three aspects to the enforcement rules: losing face if the member countries did not participate in the process (France in 1983);<sup>66</sup> strong trade interrelationships, which shed a very negative light on any partner's instability (particularly on exchange rates); and economic and political sanctions for failing to meet agreed targets.

In MERCOSUR, such enforcement mechanisms are present to a far lesser extent. When coordination gains are visible and shared among countries, coordination mechanisms are easier to implement. The threat of being excluded from the integration process may be enough for countries to keep their policies aligned with the common objectives. But if the benefits are unclear or unequally distributed, there is a significant prospect that some of the countries may leave the integration project. This may be the case for the smaller MERCOSUR members, who benefit substantially from intraregional trade but are hurt by financial turmoil imported from the bigger countries. As regards trade interrelationships, although intraregional trade has grown significantly since the beginning of the 1990s, the level of interdependence is still low, lessening the incentives for compliance. Furthermore, Uruguay's intraregional trade has declined considerably. The state of regional political relations also provides a significant impetus to the consolidation of the integration process. The smaller MERCOSUR countries often felt excluded from hard decision making; this may be destabilizing in times of crisis.

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<sup>64</sup> Prudent public finances and a credible central bank (fully independent or not), coupled with a strong commitment, may also lead to a lower debt cost.

<sup>65</sup> In Europe, the penalty for deviation from agreed targets is a non-interest-bearing deposit converted into a fine after two years unless the excessive deficit has been corrected

<sup>66</sup> By 1983, in the context of a balance of payments crisis and speculative attacks on the currency, a significant sector of the French government viewed the EMS as an excessive constraint on economic policy. The rationale and the benefits of the common market were also under severe scrutiny. Hence the emergence of proposals to leave the European monetary regime and the regional trade integration process. In the end, this line of reasoning was defeated by the pro-European fraction of the government. Withdrawing from European integration was considered too risky an option in the search for regained macroeconomic stability. The government preferred a strong commitment to stabilization in accordance with Germany, in return for an assurance that the franc would be defended decisively by the EMS central banks.

One possible means of strengthening “enforcement” is to create regional groups and appoint nonregional experts to assess compliance, and to make public assessments and recommendations, as a form of peer pressure (Machinea, 2004). The threat of exclusion does not seem to be an option in MERCOSUR, given the small number of members.<sup>67</sup> It may thus be concluded that it will be hard to establish credible enforcement rules. The difference with Europe in this case is substantial.

### **Conclusion: Reversing the European Sequence**

Preference disparities were significant in Europe and threatened the integration process. The Europeans addressed the issue in various ways. The disparities were explicitly taken into account in the design of regional policies, such as the wider exchange-rate bands for Spain and Italy. The political and economic environment was also conducive to helping countries comply with the rules. Circumstances will be less favorable in MERCOSUR, and will thus require a particular political commitment to construct shared interests. Moreover, the Europeans also tried explicitly to reduce disparities through regional policies.

In light of the foregoing analysis, MERCOSUR currently does not satisfy the standard conditions for an OCA. The question that arises is why member countries should embark on a process leading to monetary integration or exchange-rate coordination. One answer springs from the evidence of extreme regional real-exchange-rate volatility leading to a decline in regional trade, thus endangering integration and diminishing collective welfare. A band regime may be an intermediate solution to the trade-off between the flexibility needed to absorb asymmetrical shocks, on the one hand, and the goal of lowering exchange-rate volatility to foster intraregional trade, on the other. Countering this argument is the modest credibility of the region’s central banks, which poses the risk of frequent and strong speculative attacks. The history does not help.

On a more positive note for successful monetary and fiscal policy coordination, regional macroeconomic indicators are gradually converging. The historical economic record, however, suggests that the risk of renewed divergence in the future cannot be discounted. It is also positive that the MERCOSUR countries now have flexible exchange-rate regimes (different versions of floating systems) in common. These recent trends could signal a growing convergence in preferences, which would lower the costs of coordination.

As to the negative aspects of flexibility, the implicit discretion in monetary policy is higher under flexible exchange regimes and may lead to destabilizing policies and negative contagion effects. In a context of greater commercial interdependence, dysfunctional behavior in one country is immediately evident in the others. The fact that the MERCOSUR economies may have a bias toward divergence in the future may also be an incentive for them to implement coordination mechanisms, so as to obviate the costly panics of the past. In that event, coordination could act as a peer control that allows countries

<sup>67</sup> It would be impossible to consider MERCOSUR without Argentina or Brazil in case of noncompliance.

to implement policies and reforms that might be resisted if pursued under autonomous national initiatives.<sup>68</sup>

On the basis of the above arguments, the conclusion is that the preferred strategy for MERCOSUR should be to reverse the sequence of European coordination: start with a focus on the coordination of macroeconomic fundamentals, such as budget deficits, debt and inflation targets, and then build up reputation and credibility. This coordination sequence would help narrow preference disparities, thereby lessening the likelihood of financial crises. Only in a second phase would coordination involve exchange-rate coordination and consider its various alternatives. A system of currency bands might then be an interesting option to start the second stage.

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<sup>68</sup> See Carrera, Levy Yeyati, and Sturzenegger (2000).

# APPENDIX

## MERCOSUR and Europe in Perspective

	Europe	MERCOSUR
<b>OCA**</b>	<i>Benefits:</i>  RER* volatility (+) Trade levels (+)	High trade and low RER volatility.  Low trade and high RER volatility (even when controlling for other factors).
	<i>Costs:</i>  Symmetry of shocks (–)	Shocks are more asymmetrical in MERCOSUR. Cycles are also less synchronous in MERCOSUR. Endogeneity of OCA criteria (shock asymmetry) seems to be less important in MERCOSUR. Shocks are bigger in MERCOSUR.
	<i>Substitutes for monetary/exchange rate policies:</i>  Flexibility of prices and wages. Labor mobility. Fiscal redistribution.	Low flexibility in prices and wages.  Higher flexibility (sizeable informal sector).
		Low labor mobility.  High disparities in income and country size. Language transaction cost (low) and distance (high). Rich countries are the small countries. Political resistance may emerge and undermine labor mobility. The buffer of economic geography.
		Existence of federal budget (redistribution) Imbalanced, PAC dominance.
		Nonexistence of federal budget. Brazil rescue may be too expensive. High intracountry income inequality. Political resistance: poor regions (population) may resist redistribution to richer countries.
<b>Contagion</b> Interdependence and Coordination	High trade interdependence. High financial interdependence (crisis and contagion in the 1990s).	Lower trade interdependence. High financial interdependence (contagion).
<b>Credibility</b>	Monetary leader (Germany). Sizeable reputation gains for many countries (Italy, Spain, Greece, and so on).	No evident leader. The distribution of credibility gains is unclear. Significant potential disparities between member countries.
<b>Political economy</b>	Strong political will. The system tends to overcome crises. Resistance to lobbies is high.	Weaker political will. Lobbies have substantial impact.

\* RER = real exchange rate.

\*\* OCA = optimal currency area.

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## PART V

### **Institutions for a Deeper Integration**

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## **Regional Governance Institutions, Asymmetries, and Deeper Integration in MERCOSUR**

*Roberto Bouzas*

### **Introduction**

The objectives set forth in the Asunción Treaty (1991) make plain that the Southern Common Market (MERCOSUR) was conceived as a process of deeper integration. After an initial phase of intraregional trade liberalization, member states would adopt a common trade policy and establish a customs union. In the longer term, they would broaden the scope and depth of common rules and policies, and establish a common market with free movement of goods, services, and factors of production. Regional governance mechanisms would develop on the basis of a “framework treaty” (the Asunción Treaty), which set out basic objectives, as well as a number of intergovernmental institutions empowered with the task of steering the regional integration process toward its objective.

The Asunción Treaty established detailed mechanisms to eliminate tariffs (the trade liberalization program) as well as a timetable to adopt the common external tariff (CET). It was not, however, equally precise in other policy areas. In particular, no procedure was agreed upon to identify and harmonize (when necessary) nontariff measures or to coordinate macroeconomic, sectoral, and industrial policies. Nor were any permanent procedures established to deal with asymmetries among member states, whether structural or regulatory. In an approach to the development of regional governance mechanisms that was implicitly incremental, these policy areas were to be addressed as the member states deemed it necessary.<sup>1</sup>

Over fifteen years since the Asunción Treaty, MERCOSUR has advanced very unevenly toward its original goals. Import tariffs have been removed for all goods except sugar and

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<sup>1</sup> On this point, an inevitable comparison arises with other regional integration processes, particularly the European Economic Community (EEC) and the North American Free Trade Agreement (NAFTA). The Treaty of Rome, which created the EEC, adopted regional governance mechanisms based on a framework treaty (“primary legislation”), which established general objectives and obligations, and which created institutions, procedures, and mechanisms for rule making (“secondary legislation”). Periodically, the framework treaty would be expanded or renegotiated to adapt it to new circumstances. NAFTA established detailed commitments and an arbitration mechanism for settling differences of interpretation or application. Consequently, the regional governance mechanisms established in this agreement had a very limited scope. Despite numerous differences, the logic implicit in the Asunción Treaty (to the extent that it had any) is more similar to that of the EEC than to that of NAFTA.

automobiles, but the elimination of nontariff barriers, the implementation of a common trade policy, the harmonization of other policies typically associated with deeper integration, and the treatment of structural and policy (regulatory) asymmetries have progressed very slowly. In particular, the absence of mechanisms to address asymmetries in a context of rapid tariff elimination has affected trade flows and investment location across the region, leading to political tensions and pressures for the reestablishment of protection through nontariff restrictions. In practice, the forms adopted by MERCOSUR's regional governance structures not only failed to facilitate progress toward deeper integration as stated in the founding agreements, but also called into question the viability of a model of "shallow" integration—as evidenced by the sharp increase in trade restrictions that has taken place in recent years.

International institutions are state creations whose objective is to solve cooperation or coordination problems. The kind of institutions adopted, however, usually affects outcomes, since it influences interactions and determines the range of possible choices, the timing of actors' movements, and the information that is available to them (Martin, 1999). Tsebelis (2004) has pointed out that "different institutional structures will result in different strategies for the actors and in different consequences as a result of their interaction." Because of this double-edged nature of institutions, they can be studied using two complementary approaches. One views institutions as "independent variables" and considers their impact on the result of interactions. In the other approach, institutions are conceived as "dependent variables," and emphasis is placed on factors that influence the adoption of a certain institutional design and not another.

This chapter analyzes MERCOSUR's mechanisms for regional governance from the viewpoint of their contribution to a process of deeper integration. The next section examines the main elements of MERCOSUR's legal and institutional structure, taking institutions as "independent variables." The section "MERCOSUR Institutions as 'Dependent Variables,'" takes an eclectic approach to explaining the adoption of MERCOSUR's regional governance structures, viewing them as "dependent variables." The sections "Regional Governance and Structural Asymmetries" and "Regional Governance and Regulatory Asymmetries" analyze how these institutions have addressed the issue of structural and policy asymmetries. The chapter ends with a final section of conclusions and recommendations on regional governance reforms, based on the assumption that member states still share the goal of deeper integration.<sup>2</sup>

## MERCOSUR Institutions as "Independent Variables"

MERCOSUR was created in 1991 by the Asunción Treaty, a short text that defines the bloc's aims, principles, and instruments, including an interim institutional structure. One conventional interpretation of the Asunción Treaty is that it is a framework agreement that should be

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<sup>2</sup> Strictly speaking, in recent years there has been plenty of evidence that this premise may be incorrect. Admission of this fact would be a step toward shaping a realistic agenda with some prospect of having a real impact on the regional integration process.

further developed through rules and decisions to be taken by governing institutions created for that end. In practice, however, the process has worked differently. First, some of the most important pieces of legislation produced by MERCOSUR institutions (such as the protocols on the protection of competition, services, and investment) are not items of “secondary legislation” but conventional international treaties. Hence they must follow the procedures for parliamentary ratification set out in the constitutional arrangements of each member state. In this sense, they are pieces of “primary legislation,” although many of them have not been ratified by national parliaments and thus comprise “primary legislation” with no real effect. The accumulation of unratified “primary legislation” has significantly undermined the credibility of the decision-making process.<sup>3</sup>

Second, much of the “secondary legislation” produced by MERCOSUR institutions has not been enforced or has had only limited effect. This failure is largely explained by the characteristics of the decision- and rule-making mechanism, which reflect member states’ strong preference for discretion and autonomy in policy making (see subsection “The Rule-Making Process”).

This section analyzes MERCOSUR’s structure for regional governance by examining how its institutions work, how rules are made, and how the dispute settlement mechanism operates.<sup>4</sup>

### ***Regional Governance Institutions***

The Asunción Treaty created two bodies with decision-making authority: the Common Market Council (CMC) and the Common Market Group (CMG). The Ouro Preto Protocol (OPP) of 1994 added the MERCOSUR Trade Commission (MTC). The CMC is the highest political authority and comprises ministerial representatives. It creates rules by issuing decisions. The duties of the CMG are: (i) to prepare CMC meetings and decisions, (ii) to implement these, (iii) to make rules on certain issues through resolutions, and (iv) to develop and coordinate the technical work needed to advance the integration process through the activities of Working Subgroups (WSGs). The MTC is entrusted with managing intrabloc trade relations and implementing the common trade policy. The MTC also issues rules known as *directives* and oversees its own support structure in the form of a network of issue-specific Technical Committees.

From a legal and political perspective, these three bodies are equivalent: they are all composed of national government officials (who divide their time between community institu-

<sup>3</sup> Normally, the passage of “primary legislation” by regional governance institutions should be followed by rapid public debate and national parliamentary ratification. Otherwise, the momentum needed to adopt such legislation (which is assumed to enjoy the status of “primary legislation” because of its importance) would be difficult to guarantee. The delay in the ratification of items of “primary legislation” adopted by MERCOSUR, which in some cases has taken more than a decade, suggests that this process has not worked properly.

<sup>4</sup> Most of the conclusions of this section are well known. If the passing of time has confirmed anything, it is the strong resistance to institutional change among MERCOSUR’s regional governance mechanisms. This suggests either a low capacity for institutional learning or preferences strongly opposed to a reduction of autonomy and discretion. This subject is addressed in the section “MERCOSUR Institutions as ‘Dependent Variables’.”

tions and national governments) and have some rule-making authority. In all cases, decisions are made by consensus and in the presence of all members, and formal veto power is held by each member state. Strictly speaking, lower-ranking institutions are not preparatory bodies for the activity of upper-level institutions, although issues unresolved at lower levels can be submitted for consideration to upper levels. The overlapping of decision-making bodies and the presence of broad areas in which authority is ambiguous has led to inconsistencies, conflicting norms, and a selection of priorities that is deficient or absent. This has been exacerbated because the two lower-level bodies have their own technical and auxiliary structures with poor interconnections.

MERCOSUR's three decision-making bodies were created as "permanent," but it is questionable whether the adjective can be applied to all of them. The involvement of the CMC, at least, can best be defined as remote and sporadic. The CMC normally meets once every six months, a frequency that has proven insufficient to deal with a regulatory agenda of the complexity and sensitivity of a deep integration process that is expected to advance through the production of "secondary legislation." In practice, the paucity of CMC meetings and the slow pace of its work have granted a great deal of influence and responsibility to the CMG, a body comprising lower ranking officials that lack the political authority and legitimacy to take decisions on sensitive issues. The result has been the concentration of a high degree of decision-making authority in a body that has strong inclinations to behave "conservatively," lacks political initiative, and is governed by weak accountability mechanisms.<sup>5</sup>

The purely intergovernmental nature of regional governance bodies was justified by the decision to maintain national administrations' control of the integration process. This was originally defended as an attempt to prevent the "isolation" of officials entrusted with making decisions from the national bureaucracies responsible for converting those decisions into national policies. But the experience of nearly two decades suggests that the regulatory ineffectiveness of MERCOSUR lies not so much in the intergovernmental nature of the mechanisms for rule making, but in the type of norms created and their legal standing in each member state (see the section "The Rule-Making Process"). In particular, the fact that the procedures provide national authorities with a second—and very nontransparent—veto opportunity undermines the commitment and political accountability of regional decision-making bodies.

This structure of governance differs significantly from others, such as those of the European Union (EU). The EU has an institution (the European Commission) that is independent of governments and has exclusive jurisdiction in certain policy areas, as well as the power to take initiatives. There is also an intergovernmental body (the Council of the EU) whose structure comprises three levels of governance and which is composed of: (i) the council (or rather councils), in which the competent ministers of each policy area participate, (ii) the Committee of Permanent Representatives (COREPER) and other high-level groups, and (iii) the working

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<sup>5</sup> The description of the CMG as a "conservative" body is based on the dynamics created by the relatively low level of political authority and accountability of its members, which makes them favor the status quo over innovation.

groups. Despite the presence of these three levels, all council decisions require ministerial participation (in cases where there are no disagreements, the ministerial body approves them without debate—the so-called “A-points” of the council agenda). Another important difference between MERCOSUR regional governance bodies and those of the EU is that the former include several national representatives (two in the CMC, and four in the CMG and the MTC). This may have helped to undermine the effectiveness of the decision-making process, since the proliferation of “seats at the table” is likely to be inversely correlated with the ability to take responsibility for difficult decisions.

In addition to the MTC, the OPP created a representative parliamentary body, the Joint Parliamentary Commission (JPC), and a consultative body, the Economic and Social Consultative Forum (ESCF). It also assigned new and expanded duties to the support body (the MERCOSUR Secretariat) created by the Asunción Treaty. The JPC was established as a regional body representing national parliaments, with the essentially consultative role of advising and facilitating the legislative approval of norms requiring action by national legislatures. In practice, the JPC has made little contribution in all these areas: it has not been a significant consultative or advisory body, and it has not made a noticeable contribution to speeding up parliamentary procedures in cases requiring the intervention of national legislatures.

The JPC's scant contribution has prompted a proposal—currently being implemented—to create an embryonic MERCOSUR Parliament. The drafts submitted to the JPC by the Argentine and Brazilian delegations, as well as the approved text, only changed the nature of representation (through the provision on direct election) and failed to address other substantive issues, including rule-making authority. Though it seems unrealistic to grant legislative powers to a regional parliamentary body in MERCOSUR's present circumstances, the political, material, and institutional resources invested in developing this initiative provide a good example of a poor allocation of effort. Presumably, if the goal was to strengthen institutional capacities to promote deeper integration, that effort could have been more efficiently made in other areas where the contribution to improving the quality and effectiveness of regional governance would be more apparent. Although the “political” motivation for the initiative is understandable (coming as it does from parliamentary representatives), it is unclear how it will help improve regional governance. Nor is it apparent how such reform might increase the commitment of national parliaments to the regional integration process, especially as regards the transposition of norms requiring legislative approval. Indeed, the proposed reform could actually make the existing mechanisms even more redundant and less effective, by creating an institution that has no structural link to national parliaments.

The OPP also created a body for consultation with the private sector, the ESCF, comprising representatives of member states' social and economic sectors. In practice, the ESCF has been a vehicle for *ex post facto* communication and exchange rather than an active agent in the construction of the regional agenda. In effect, the main channels for business participation in the regional integration process have remained national, at which level there are already formal and informal mechanisms for public-private sector interaction.

MERCOSUR also has an Administrative Secretariat (AS), created by Article 15 of the Asunción Treaty, as a subordinate body of the CMG. The original tasks of the AS were limited

to filing documents, but were gradually expanded to include other activities such as oversight of the targets set at Las Leñas in 1992.<sup>6</sup> At the end of 1994, the OPP made the AS a full-fledged MERCOSUR institution, broadening its role and powers to activities such as the publication and dissemination of rules (including publication of the *Official Bulletin* of MERCOSUR), logistical aspects of meetings, the provision of information about progress on transposition by member states, and the registration of national lists of arbitrators and experts. The most significant change, however, took place in 2002, when Decision 30/02 called for the gradual transformation of the Administrative Secretariat into a technical body with “full operational capacity.” The process that followed has made clear the reluctance of national officials to share responsibilities with bodies not composed of government representatives. It has also made clear the resistance of intergovernmental institutions to letting technical bodies improve transparency, upgrade the quality of decisions, and provide a “common vision” of the regional integration process.

Examples of this reluctance include Resolution 16/04, which established that demands for technical work submitted to the MERCOSUR Secretariat should first be approved by consensus among decision-making bodies and should not involve “issues that have been the object of disputes among member states.” Another revealing episode was the withdrawal of the first semiannual report of the MERCOSUR Secretariat from the official website and its reclassification as confidential, a decision taken by the CMG after the document had been publicly available for about a week. The second semiannual report, which should have been published in December 2004, was not even considered in full by decision-making bodies.

This complex governance structure was supplemented in 2003 by the creation of the Commission of Permanent Representatives (CPRM) through Decision 11/03. The CPRM brings together member states’ diplomatic representatives to the Latin American Integration Association (LAIA) and to the MERCOSUR headquarters in Montevideo. It includes a presidency entrusted with the authority of international representation. The CPRM has no decision-making authority, but can make proposals. In practice, the CPRM has just become a new intergovernmental body with no clear link to the decision-making process. Despite its name, the CPRM is not like the EU’s COREPER (which also comprises member states’ permanent representatives in Brussels). COREPER is a crucial preparatory body for decision making by intergovernmental institutions. The composition and powers of the CPRM, by contrast, suggest that its creation was an ad hoc response rather than an attempt to rationalize and strengthen MERCOSUR’s weak institutions for regional governance.

In sum, the regional governing bodies have a dysfunctional structure in which levels of responsibility are blurred, and mandates and prerogatives frequently overlap. The marginal participation of the supreme decision-making body (the CMC) in steering and managing the integration process has resulted in a lack of strategic guidelines and priority areas for negotiation. This vacuum has not been filled adequately by the CMG, a body composed of

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<sup>6</sup> The Las Leñas Schedule, approved at the presidential summit in mid-1992, consisted of a set of measures to harmonize economic and sectoral policies before the end of the “transition period,” December 31, 1994. The schedule established specific goals and deadlines for each of the working subgroups of the CMG.

mid-level national officials with an essentially conservative stance. The CMG has played no role in promoting initiatives to improve regional governance mechanisms, and often its activities have been geared to limiting the contribution that other bodies could make (such as the technical secretariat). The latest institutional innovations (such as the creation of the CPRM or the reform of the secretariat) either have done nothing to improve regional governance or have given rise to a vast field of conflict with existing intergovernmental bodies.

### *The Rule-Making Process*

As pointed out in the subsection “Regional Governance Institutions,” the rule- and decision-making procedure adopted by MERCOSUR is based on the principle of consensus, which amounts to granting veto power to each member state. Nonetheless, the rule-making process seems to have been designed to provide a second (and less transparent) opportunity for national vetoes of decisions already taken by national officials on the basis of the consensus rule. This second veto opportunity arises from the ambiguity of the legal status of the “secondary legislation” drafted by MERCOSUR’s governing bodies. According to Article 40 of the OPP, to ensure the simultaneous entry into force of “MERCOSUR legislation” in all member states, decisions taken by the governing bodies become applicable only 30 days after the administrative secretariat has notified member states that the norm has been transposed in all of them.<sup>7</sup> The wording of Article 40 appears to confuse the entry into force of “MERCOSUR legislation” as an obligation binding upon member states with the application of that legislation to individuals. This ambiguity opens the door to different interpretations of the meaning of a single legal act (which in practice has happened with rulings made by the dispute settlement mechanism), and creates a legal asymmetry that can run counter to the principle of reciprocity of rights and obligations among the member states. It also gives national governments a second veto opportunity.<sup>8</sup>

One of the main problems of the regional governance structure has been the lack of national transposition of the norms produced by regional bodies. According to the MERCOSUR Secretariat, between January 2000 and May 2004 only 40 percent of CMC Decisions were transposed (Secretaría del MERCOSUR, 2004). The ratios for CMG Resolutions and MTC Directives (requiring transposition) were 26 and 43 percent, respectively. This huge “implementation gap” is compounded by a substantial stock of untransposed norms inherited from the 1990s, which clearly casts doubt on MERCOSUR’s regulatory effectiveness.<sup>9</sup>

<sup>7</sup> For a more detailed discussion of the legal foundations, see Chapter 13 of this volume by Deisy Ventura.

<sup>8</sup> Ramón Torrent has called my attention to many of the institutional fragilities addressed in this paper. For a more detailed discussion, see Bouzas, Motta Veiga, and Torrent (2002). The resolutions issued by the CMG show an overall percentage of transposition of 49 percent, although the individual average ranges between 71 percent and 79 percent.

<sup>9</sup> According to calculations by the government of Argentina, between 1991 and 2004 the MERCOSUR bodies adopted a total of 1,152 norms requiring transposition. Of this total, only 52 percent were transposed by the four member states.

The problems in the process for creating and implementing legislation adopted by MERCOSUR have been addressed through piecemeal measures that have failed to deal with underlying obstacles. During the second half of the 1990s, the CMG issued a number of Resolutions, mostly of an exhortative nature, intended to improve transposition procedures. In 2002, Decision 20/02 made it mandatory to hold consultations with competent national agencies before drawing up a norm, as a way of preventing incompatibility with domestic legal arrangements and of involving appropriate bodies in designing the norms they would subsequently have to implement. This process of prior consultation (which seeks to reduce the number of norms likely to face problems of transposition) may reduce the “implementation gap,” but it may not help improve the effectiveness of rule making in the interests of advancing toward deeper integration.

Similarly, in July 2004, Decision 22/04 (on the entry into force and application of MERCOSUR norms that do not require legislative approval) established new principles, but its real impact remains to be seen.<sup>10</sup> This decision does not resolve doubts about the procedure through which MERCOSUR norms, once they take effect, will supersede national legislation of equal or lesser standing with which they may conflict.<sup>11</sup>

In this respect, MERCOSUR’s rule-making process differs substantially from that of the EU, especially as regards the “direct effect” and “immediate application” principles. In the EU, regulations have “immediate application” but directives and primary legislation (such as treaties) do not. Regulations are the legislative mechanism in areas such as trade policy, fisheries, agriculture, and monetary matters. In other areas, such as the harmonization of other national policies, rules are created through directives that have to be transposed (and do not have “immediate application”). The obligation to transpose, however, exists from the moment the norm is created and approved, whether it be through a procedure requiring unanimity or qualified majority voting. Some aspects of directives (which do not have “immediate application”), on the other hand, may have “direct effects” on individuals. Indeed, when their substance is clear, precise, and unconditional, a particular provision may be invoked in a particular jurisdiction to challenge a norm that is at variance with the directive.<sup>12</sup>

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<sup>10</sup> This decision, which should have been implemented within a period of 90 days, established that all MERCOSUR norms must include the date on which they enter into force. Once drafted and adopted in keeping with the terms of CMC Decision 20/02, MERCOSUR norms must be published in the national official bulletins 40 days before the date set for their entry into force. The publication of the norm in the official bulletin will materialize the transposition of the norm into the national legal systems, rendering without effect such provisions of equal or lesser standing with which they may be at variance.

<sup>11</sup> All reforms that have been attempted, whether through Resolutions of the CMG or Decisions of the CMC, encounter the same problem: no legal provision deriving from them can supersede the scheme set forth by article 40 of the OPP. Hence it is difficult to foresee any significant improvement in the transposition procedure without a revision of the founding treaties or an amendment to the OPP.

<sup>12</sup> The European Court of Justice has ruled that directives have “direct effect,” such that individuals may invoke them in actions against governments. Governments can also be sued for damages resulting from the nontransposition of a directive (Craig and de Búrca, 2003).

By the end of 2002, the CMC had taken a total of 46 decisions that expanded the coverage of the Asunción Treaty and that could strictly be considered items of “primary legislation” (since they required parliamentary ratification). By the beginning of 2005, many of these texts were still unratified. These include the Buenos Aires Protocol for the Promotion and Protection of Intraregional Investment (1994), the Colonia Protocol for the Promotion and Protection of Investment by Third Parties (1994), the Fortaleza Protocol on Competition Defense (1996), and the Montevideo Protocol on Trade in Services (1997). In fact, the effectiveness of the rule-making process when rules require legislative approval has been no better than in the case of norms that do not require such action. On the contrary, the “horizontal” expansion of the MERCOSUR agenda has simply multiplied the number of rules that remain unadopted at the national level.<sup>13</sup>

These circumstances corroborate the view that the JPC has had little impact on the process of ratifying “primary legislation” and transposing norms that require congressional action. In line with MERCOSUR’s exhortative approach, in 2003 the CMC and the JPC signed an Inter-Institutional Agreement whereby the former undertook to hold consultations with the JPC on matters requiring legislative action. The JPC, in turn, undertook to push forward the transposition of MERCOSUR norms adopted with the consensus of the JPC. At the time of writing, this agreement has had no visible effect. As indicated earlier, it is unclear to what extent the reform of the mechanisms for parliamentary representation currently under consideration can help resolve these problems.

### ***Dispute Settlement***

The dispute-settlement mechanism has leaned toward diplomatic or negotiated solutions rather than the application of rules and legal principles. The provisional procedures for dispute settlement were established by the Brasilia Protocol on Dispute Settlement (BPDS) in 1991 and superseded by the Olivos Protocol, which entered into force in 2004 (also as a provisional mechanism). The Brasilia Protocol included three alternative means of settling differences, two of them based on negotiations (consultations and claims) and the third involving arbitration. In the early years, member states made intensive use of the consultation mechanism, especially as a means of exchanging information and promoting adaptation on issues that were not of fundamental importance. The use of this mechanism declined noticeably thereafter, especially during the period of acute trade conflicts that followed the devaluation of the real in 1999. Prominent among the weaknesses of the consultation procedure are its slowness, the lack of transparency (there are no public reports on the substance of the consultations), and the constraints on the private sector’s direct participation.

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<sup>13</sup> This can be inferred from the fact that the decisions of the CMC that need to be transposed are those that have made least progress (61 percent of them have not been transposed). In some cases, for instance, mechanisms for cooperation and consultation are established that incorrectly assume the existence of prior harmonization among national agencies.

The procedure for making legal claims was used much less often than consultations. Its main weakness was that solving a dispute at the “claim” stage required consensus at the MTC or the CMG. Since it is unlikely that disputes can be settled on the basis of consensus, a relatively high number of claims have ended up in arbitration. The operation of the latter mechanism has also run into problems. The first has been the possibility of indefinitely extending the negotiation phase before arbitration. The second has been the ad hoc nature of panels, which has militated against the creation of a common body of interpretation. The third has been that ad hoc tribunals have been confined to dealing exclusively with the dispute for which they were convened, limiting the scope for legal oversight.<sup>14</sup> Finally, there was the problem of enforcing panel findings in the context of the different meaning ascribed in each national legal system to the concept of “final and binding decision.”

To deal with some of these problems, in 2002 the member states signed the Olivos Protocol (OP) to supersede the BPDS. The OP entered into force in 2004, its main innovations being the establishment of an obligation to choose jurisdiction (thus restraining the possibility of “forum shopping”), the creation of more expeditious mechanisms for addressing technical matters, a reduction in the time needed to resort to arbitration when agreement is not reached through negotiation, the establishment of a permanent court of appeal, and the possibility of this court’s issuing opinions in response to national court requests. These changes introduced significant innovations in the working of the dispute settlement mechanism, although their effectiveness will only become evident over time. Nonetheless, the mechanisms established by the OP have neither fully resolved the problem of the lack of a jurisdictional instrument that endows the regional integration process with greater legal certainty, nor made it possible for claims be raised by actors other than member states.

In sum, dispute settlement is probably the area in which the greatest progress has been made toward more effective regional governance structures. Even so, major weaknesses persist, notably: the survival of ad hoc arbitration tribunals (with the risk of overlapping applicable rights whose precedence is unclear, a circumstance that makes it hard for national law to admit the rulings of the tribunals); the choice of forum (which makes it possible for other bodies to review MERCOSUR legislation); and the optional and nonbinding character of the consultations drawn up by national courts. One outstanding matter that has not been addressed by either the BPDS or the OP is the possibility of initiating legal proceedings in response to a member state’s failure to meet its obligations. The European record indicates that the vast majority of nonfulfillment procedures are initiated either by private parties or community agencies. Neither of these two options is available in MERCOSUR, and thus nonfulfillment actions are limited to those launched by one government against another. The establishment of a procedure whereby a community agent has the standing to initiate nonfulfillment procedures would strengthen regional governance while leaving the consensus decision-making process untouched.

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<sup>14</sup> All rule-making systems must include a mechanism to ascertain the legality of the procedure and the substance of the norms produced. In the European integration process, this oversight has been exercised primarily by the European Court of Justice. MERCOSUR ad hoc tribunals do not have this authority.

## MERCOSUR Institutions as “Dependent Variables”

As argued in the preceding section, in MERCOSUR's governing bodies, rule-making mechanisms and dispute settlement procedures enable national governments—especially the executive branches—to retain strict control over the integration process and cede only a minimal degree of autonomy and discretion in policy making. While national governments pursued consistent objectives and confined themselves to implementing the initial, automatic commitments on tariff elimination, this model of regional governance proved quite efficient. Whenever conflicts emerged, the direct involvement of the presidents made it possible to resolve impasses and find pragmatic compromises. In line with this interpretation, Malamud (2003) argues that, “between 1985 and 2000, interpresidentialism stimulated integration rather than impeded it, despite the upheavals of the final years of this period.” The alleged effectiveness of this mechanism of governance was based on the predominant role of executive branch leaders in domestic political systems.

This model for regional governance, however, yielded diminishing returns over time, and its effectiveness in furthering deeper integration was subject to growing challenges. In fact, increasingly frequent episodes of market fragmentation, regulatory ineffectiveness, and the legitimacy crises of regional governance mechanisms have raised the question of whether the prevailing institutional model is even consistent with a shallow integration process. While it is true that “presidentialism” in the domestic political systems and national incentives for cooperation favor the kind of regional governance institutions that have prevailed in MERCOSUR, there also seems to be no doubt that ambitions and targets have been out of step with reality.

International relations theorists and political scientists hold two contrasting views about the forces that lead to the creation of international institutions. For realists, neorealists, and intergovernmentalists, concepts such as power, hegemony, leadership, and relative gains are the keys to understanding the forces behind the creation of international institutions. By contrast, functionalists and neofunctionalists stress the role of specific functional demands. According to this view, the incentives to cooperate, reduce transaction costs, and develop common regulatory regimes are in direct proportion to the depth of economic interdependence.

However, to view these two perspectives as alternatives is to lose sight of many nuances of a process as complex as regional integration. Mattli (1999) proposed merging the two approaches in an eclectic view that conceives them as complementary means of explaining the supply and demand factors that influence the creation of regional institutions. In his view, functionalist and neofunctionalist theories shed light on the factors that affect the demand for regional institutions. Governments are neither the only relevant actors nor the most important ones for regional integration. The process springs from a core area, from where it influences other domains (spillovers), thereby expanding the number of actors involved and leading to a process of institutional change that acquires autonomy (Haas, 1958).

For the functional perspective to work in practice, however, domestic political actors must have the will and capacity to accommodate and respond to pressures that push toward integration and that are nourished by the deepening of the process itself. From this standpoint,

realist, neorealist, and intergovernmentalist perspectives aid understanding of the strengths and weaknesses of supply-side conditions that underlie the establishment of successful regional institutions. For authors such as Moravcsik (1998), integration is the result of interstate negotiations based on the identification of concrete national interests. In this process, domestic policy becomes a fundamental factor in understanding regional policy. Since state action is basically designed to avoid compromising key powers, realists, neorealists, and intergovernmentalists emphasize the development of decision-making institutions and mechanisms that are essentially intergovernmental.

Bouzas and Soltz (2001) apply this eclectic approach to regional governance institutions in MERCOSUR.<sup>15</sup> Given the strong reactive stimulus underlying the creation of MERCOSUR, supply and demand prerequisites for the creation of substantive regional institutions could not be expected to be particularly strong.<sup>16</sup> In MERCOSUR, the functional demands to reduce market fragmentation or foster policy harmonization are weak. This weakness is the result of the modest and asymmetrical nature of interdependence relations binding the countries of the region together. Demand considerations that lay the ground for a light institutional design are reinforced when supply conditions are also taken into account. Given the size asymmetries prevalent among member states, there are no obvious incentives to develop institutional mechanisms that would entail a reduction in policy autonomy, especially for Brazil. Institutions that are more centralized, independent, and able to generate more effective rules would reduce the discretion of national officials in a context of asymmetrical and modest interdependence, economic volatility, and national preferences that are not entirely convergent (Bouzas, 2001). Thus the weakness of demand-side conditions are reinforced by weak supply-side considerations, which helps account for the prevalence of light institutional arrangements in which negotiation and discretion take primacy over rules.

In 1991–98, interdependence among the MERCOSUR economies increased quite rapidly, albeit starting from low levels relative to other preferential agreements, such as the EU and the North American Free Trade Agreement (NAFTA). While this process may have increased the incentives for deeper integration and subsequent institutional reform, the crisis that followed the devaluation of the real in 1999 led to a sharp drop in intraregional trade

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<sup>15</sup> Mattli (1999) also maintains that to have a comprehensive vision of the incentives and dynamics of regional integration, it is necessary to bear in mind that discrimination is also a reactive process stimulated by defensive considerations and domino effects. To the extent that reactive agreements are characterized by weak internal conditions of supply and demand, their prospects for success are limited. According to Mattli, reactive responses are of two types: (i) the “first integrationist response” occurs when the reactive stimuli induce an outsider to become part of the integration process under way; (ii) the “second integrationist response” takes place when two or more outsiders decide to set up their own regional grouping.

<sup>16</sup> In the 1980s, the governments of Argentina and Brazil fostered a process of bilateral integration based on the conviction that they shared common challenges to integrating into the world economy, and that both countries ran the risk of remaining outside of major integration trends worldwide. New defensive incentives were nurtured in the early 1990s with the negotiation of NAFTA and the gradual expansion of cooperation between the EU and the countries of Eastern Europe.

flows and opened the door to a period of tension, aggravated by severe national differences in macroeconomic and microeconomic policy preferences.<sup>17</sup> While Argentina stuck to its currency board and to a fixed nominal exchange rate, Brazil faced a sharp devaluation and thereafter adopted a managed floating exchange rate regime. Major differences in industrial policy were also evident in each government's degree of activism and intervention, as well as in the size of internal transfers.

An increase in the importance of reciprocal effects as a consequence of growing interdependence could have stimulated demand for institutional change and a deepening of the integration process. In practice, this did not happen. Although interdependence did increase considerably until 1998, it was still relatively low and very asymmetrical. Moreover, this asymmetry deepened markedly in the postcrisis period: by 2004, exports to MERCOSUR as a share of total Brazilian exports had returned to 1991 levels, when the Asunción Treaty was signed.<sup>18</sup> From 2002 onwards, a narrowing of divergences in the area of exchange rate policy created a more favorable environment, but at a time when other kinds of asymmetries, both structural and policy related, had grown even bigger.

Precisely at the height of the crisis, the role of regional institutions became more irrelevant. Deepening conflicts were addressed through "presidential diplomacy," but with declining effectiveness because of differences in perspective and the absence of a common focus and shared goals for the integration process. Successive attempts to "relaunch" MERCOSUR never got beyond an inventory of problems awaiting a solution. Similarly, the setting of timetables could not substitute for the absence of effective mechanisms for consensus building, decision making, and implementation of rules. Since then, MERCOSUR has lacked a strategic focus and its priorities have become diluted in a context of mounting vagueness about common goals.

## Regional Governance and Structural Asymmetries

Robson (1998) points out three main reasons for establishing mechanisms to address structural asymmetries: (i) since asymmetries may favor an unequal distribution of costs and benefits, not all areas within an integrated region may gain as a result of a larger market; (ii) for many reasons, regional disparities may persist or deepen for a long period; and (iii) regions exhibiting pronounced structural asymmetries will not necessarily converge over time. At the national level, the traditional case for implementing specific policies to tackle structural asymmetries is based on the presence of market failures that give rise to

<sup>17</sup> For an analysis of trends in the demand for coordination in the period of growing regional interdependence, see Lavagna (1996).

<sup>18</sup> In 2004, the share of exports to MERCOSUR in Brazil's total exports amounted to only 9.2 percent, in comparison to an average of 17.2 percent in the 1987–1988 period. In 1991–1992, the share was an average of 9.3 percent. At the regional level, the ratio of intraregional exports to total exports increased from 11.1 percent in 1991 to 13.8 percent in 2004, after having reached 25 percent in 1998.

a suboptimal allocation of resources (for example, unemployment may rise if labor is not perfectly mobile).<sup>19</sup>

Apart from economic reasons, social and political considerations may support the implementation of regional policies, such as the avoidance of political tensions, mass migration, and other potentially traumatic developments. These same considerations also operate in the context of regional integration processes. In this case, however, the question also arises as to why responsibility for these policies should fall on a regional body and not national authorities. The consensus is that there will be a specific role for a regional community policy when it is a matter of: (i) preventing regional aid from distorting competition, (ii) ensuring that community sectoral policies do not exacerbate regional problems, or (iii) enabling regional policies to contribute more effectively to reducing disparities throughout the whole community.<sup>20</sup>

Despite the arguments in favor, the empirical evidence on the impact of regional policies on structural asymmetries is inconclusive. There is evidence that transfers may improve conditions in the most disadvantaged regions and sectors as long as such transfers exist, but there is no guarantee that the beneficiaries will be able to maintain their position and pace of growth once transfers cease. The identification of effective policies that can increase the pace of growth in an autonomous and sustained manner for the most backward regions is a matter still open to investigation and requires more conclusive evidence. The EU approach has been to develop regional instruments, probably spurred by political as much as economic considerations (the active promotion of cohesion has unquestionably had a legitimizing effect). In other regional integration processes, such as NAFTA, the emphasis was placed on market mechanisms and national policies as instruments to stimulate convergence.

The MERCOSUR experience has been, in practice, very similar to that of NAFTA. Despite the significant structural asymmetries that characterize the MERCOSUR economies, until very recently the member states have avoided adopting explicit policies that seek to reduce inequalities among regions and/or countries (Bouzas, 2005). The Asunción Treaty contained nothing like a regional policy, nor was it suggested that one should be established. In fact, the Asunción Treaty did not even recognize the formal principle of special and differential treatment that had been part of the normative tradition of the Latin American Free Trade Association (LAFTA) and LAIA, and that had been a developing-country demand in the General Agreement on Tariffs and Trade (GATT). On the contrary, article 2 explicitly stated that “the common market will be founded on the reciprocity of rights and obligations among member states.”

The fact that MERCOSUR did not formally adopt the principle of special and differential treatment sprang partly from the fact that the architecture of the agreement was the by-product of a bilateral understanding between Argentina and Brazil. That circumstance vastly limited the leverage of Paraguay and Uruguay to demand preferential treatment or

<sup>19</sup> Regional policies cannot only be justified by the need to “internalize” negative externalities. Positive externalities can also justify the implementation of regional policies that increase the supply of a particular good or service above what the market would suboptimally provide. This chapter does not address regional policies in general, but those geared to dealing with the effects of asymmetries.

<sup>20</sup> The relationship between regional aid and competition is dealt with exhaustively in Wishlade (2003).

permanent policies of negotiated discrimination. In their place, the smaller countries obtained more flexible conditions for reaching total liberalization of intraregional trade, such as longer deadlines for tariff phase-outs, a higher number of exceptions, more lax rules of origin, and other temporary exceptions. A form of sectoral special treatment was also granted to the sugar and automotive industries, since both were temporarily exempted from intraregional trade liberalization and, from 1994 onwards, from common trade disciplines.

Some differences in treatment were also recognized at the end of the trade liberalization program, when member states adopted the Final Adaptation Regime to the Customs Union and began to implement the CET.<sup>21</sup> Once again, the instruments used were a greater number of temporary exceptions to free intraregional trade, one additional year for Paraguay and Uruguay to implement the regime, a greater number of temporary exceptions to the CET, and longer periods for Paraguay to eliminate all national exceptions. Similarly, longer periods were allowed for convergence with the CET in capital goods (900 products) for Paraguay (2006 instead of 2001), and in the information technology and telecommunications sectors (220 products) for Paraguay and Uruguay (2006 instead of 2001).

All these mechanisms, however, were exceptional and were to be in force only temporarily. This approach was openly challenged in later years, when the subject of structural asymmetries was put on the negotiating table more forcefully by the smaller partners. In 2003, the government of Paraguay formally made a proposal for addressing the asymmetries in MERCOSUR. This led to several Decisions, notably Decision 27/03 (mandating a study on the establishment of structural funds), Decision 28/03 (on special treatment for Paraguay in MERCOSUR's external negotiations), Decision 29/03 (establishing more flexible rules of origin for Paraguay), and Decisions 31/03 to 34/03 (establishing special tariff treatment and special import regimes for Paraguay and Uruguay) (Secretaría del Mercosur, 2004). As a by-product of Decision 27/03, at the December 2004 presidential summit the member states agreed to set up a Structural Convergence Fund. The creation of the fund was more a matter of political symbolism than economic significance, since it was endowed with only a very modest budget allocation.

It is important to point out that in MERCOSUR, the implementation of special policies and the creation of redistributive schemes to offset structural asymmetries face more serious obstacles than in regional integration processes such as the EU.<sup>22</sup> First, the four Mercosur members are developing countries with middle or low per capita income and very limited resources for transfers. Second, distributional matters are especially conflict prone because the member states have serious problems of internal inequality. Measured by per capita income, MERCOSUR's poorest area is in the territory of the largest member (Brazil), while per capita income in one of the smaller countries (Uruguay) is higher than the regional average. This configuration makes it politically difficult to choose countries/regions that may be candidates

<sup>21</sup> The extension to 2006 (later deferred to 2010) of national temporary admission programs can also be considered a concession to the small economies, especially Uruguay. However, all member states have taken advantage of the benefits, thus blurring its discriminatory nature.

<sup>22</sup> For some basic indicators of asymmetries in MERCOSUR, see Bouzas (2005).

to be net contributors and/or beneficiaries. Third, thus far the case for interregional cohesion has played a secondary role in the regional discourse, relative to that played in the process of European integration. This should come as no surprise, since all member states are characterized by deep internal inequalities. Finally, the member states (especially Brazil) have shown strong resistance to centralizing powers in a community authority, even for issues less conflict prone and with less distributional impact than regional funds.

The sectoral agreements instrument is the only one with a regional focus that has been present in MERCOSUR from the outset; it is an instrument that has remained more ideal than real. The sectoral agreements were inherited from the selective approach adopted by the Argentina-Brazil Program for Integration and Cooperation (normally referred to by its Spanish acronym, PICAB) in the mid-1980s, which favored managed trade and productive complementarity on the basis of such sectoral agreements. When PICAB's gradualist and sectoral approach was replaced by across-the-board liberalization (without the parallel harmonization or coordination of other policies),<sup>23</sup> the sectoral agreements remained in effect but were practically unused, with the exception of the automotive agreement.<sup>24</sup>

An approach similar to that of the sectoral agreements partially resurfaced with the creation of the Sectoral Competitiveness Fora, first at the national level (Brazil was a pioneer here) and later at the regional level. Although the number of initiatives has been small to date and resources are very limited, the fora could help foster business networks and regional value chains. Nonetheless, their relevance has still to be shown in practice.

## Regional Governance and Regulatory Asymmetries

The challenges of regional governance that face MERCOSUR are neither solely nor mainly related to the impact and treatment of structural asymmetries. There are also significant regulatory and policy asymmetries that create negative cross-border spillovers, and that may require some degree of coordination or harmonization. When they are substantial, these spillovers can trigger protectionist pressures through nontariff measures that lead to market fragmentation. As the MERCOSUR experience has shown, the outcome will be not only a slowdown in the process to deepen integration, but an actual reversal.

Cross-border spillovers that affect resource allocation occur when the provision of public goods through national budget or regulatory actions has effects beyond the borders of the implementing states. These spillovers cause efficiency losses that can clash with regional policies intended to internalize the externality that lies at the root of the problem. Prominent among policy areas with the potential to generate negative cross-border spillovers are pollution and other environmental concerns, as well as state aid policies (including fiscal competition). The

<sup>23</sup> This was first done between Argentina and Brazil through the Buenos Aires Act in 1990. The procedures of the Buenos Aires Act were adopted with few changes by the Asunción Treaty in 1991.

<sup>24</sup> Strictly speaking, until 2002 the automotive agreement was a bilateral agreement between Argentina and Brazil, based on the application of national sectoral policies.

freer movement of goods, services, and factors of production may also create macroeconomic spillovers stemming from the closer interdependence of national economies. Such spillovers can endogenously stimulate macroeconomic policy coordination.

Although concerns about cross-border spillovers with resource-allocation effects have been present since the early days of MERCOSUR, the issue has been addressed very ineffectively. Article 1 of the Asunción Treaty explicitly recognized the potentially problematic role of policy asymmetries, but it established a programmatic principle rather than a specific mechanism to deal with them. Further attention was paid to the issue in the Las Leñas Agenda of 1992, when the member states reaffirmed that the harmonization of national, macroeconomic, and microeconomic policy was a key objective and set a calendar for implementation. In 1993, the document “Consolidation of the Customs Union and Transition to the Common Market” officially acknowledged that the member states would not meet the ambitious goals established in the Las Leñas Agenda, and instead opted to foster trade policy convergence and other measures necessary for the implementation of the customs union. This approach set aside proposals for simultaneous harmonization of all trade policy instruments (such as tariffs, export incentives, rules of origin for products excluded from the CET, duty-free zones, nontariff restrictions, and so on) and government subsidies. Instead, emphasis was placed on the negotiation and application of a CET. Member states also did not adopt the proposals advanced at the time for the implementation of structural adjustment programs or the extension of the “safeguards clause” beyond the end of the transition period (December 1994).<sup>25</sup>

Progress in policy harmonization (except for customs duties) was negligible after 1995, even in relatively innocuous areas, such as identifying practices that could be subject to some kind of coordination. Only in 2001 was a preliminary inventory of national and subnational public incentives concluded. The inventory included a list of all measures in effect, their legal bases, implementing authority, and eligibility criteria. Even though the inventory assessed neither the effects of incentives nor their relative importance, its results were not made public.<sup>26</sup> Lack of progress on these matters led to increasing market fragmentation, largely as a result of unilateral measures. Nontariff barriers were used more often after 1999, when the margin of preference over most favored nation (MFN) tariffs reached 100 percent for all goods except automobiles and sugar. During the course of 2004 in particular, Argentina applied a wide array of measures (including “voluntary export restraint agreements”) to imports of Brazilian electrical appliances, televisions, textiles, and footwear.

The negative impact of macroeconomic spillovers also became increasingly apparent by the end of the 1990s, when the intensity of regional economic interdependence had increased from the low levels earlier in the decade. Although the level of interdependence remained low compared to that of other successful integration schemes and the incentives to coordinate were still asymmetrically distributed, negative macroeconomic spillovers spurred tensions, and cast doubts on the prospects not only for a customs union but also for a free trade area.

<sup>25</sup> The Final Adaptation Regime implemented as of 1995 proved to be an imperfect and transient substitute.

<sup>26</sup> For a more detailed analysis, see Bouzas (2005).

There are two options for dealing with regulatory asymmetries, and they are not mutually exclusive. One is harmonization. Harmonization is relatively demanding because it entails a certain degree of preference convergence (as well as equivalent institutional and financial capacities). The second approach, applicable in certain cases, is centralized oversight of national policies.<sup>27</sup> In the EU, state aids were considered from the outset to be subject to community disciplines if they were shown to distort competition. A community body (the European Commission) was given the task of overseeing the application of competition defense policy so as to discourage the use of national policies to distort markets. Harmonization (convergence in certain highly distorting policies, such as export subsidies) can coexist with mechanisms that foster centralized oversight (such as tax exemptions or investment incentives). To date, MERCOSUR has made no progress in either of these two areas,<sup>28</sup> although the subject has become more prominent on the public agenda in recent years—albeit from a “defensive” perspective (Delgado, 2004).

In 2004, the Argentine government again insisted on the adoption of mechanisms to address macroeconomic and/or microeconomic disparities.<sup>29</sup> It proposed measures such as a competitive adjustment clause, a temporary safeguard mechanism, and a code for dealing with multinational companies. The first two mechanisms would provide for temporary and exceptional measures (such as quotas or nonautomatic import licenses) in the face of a sudden rise in imports of a particular product, or macroeconomic shocks such as a devaluation, or wide divergences in growth rates. These measures essentially sought to institute procedures to enable a country to resort to emergency protection under specified conditions. In turn, the code of conduct on foreign investment, modeled on the Organisation for Economic Co-operation and Development (OECD) investment codes, sought to discourage the use of tax incentives to attract investment. OECD codes cover issues such as fiscal compliance, environmental protection, geographic decentralization and locational balance, employment, anticorruption practices, consumer protection, technology transfer, and promotion of competition.

Formally, there had been no safeguard mechanisms in MERCOSUR since 1994. Resistance to implementing such procedures has rested on the argument—made chiefly by the Brazilian government—that it would be inconsistent with a customs union. Nevertheless, the reluctance to apply such a mechanism has not helped preserve the integration of the market. On the contrary, it has stimulated the application of nontariff and ad hoc measures on a discretionary and very nontransparent basis.<sup>30</sup>

<sup>27</sup> In some matters, the “principle of mutual recognition” (rather than centralized supervision of national policy) can be used as a complement to harmonization.

<sup>28</sup> In fact, subsidies for intrazone exports were prohibited by Decision 10/94. Implementation of this Decision, however, has been problematic.

<sup>29</sup> As of October 2005, none of these mechanisms had been set in motion. As argued below, the result has been a proliferation of ad hoc trade management measures.

<sup>30</sup> In 2004, for example, Argentina established nonautomatic import licenses for a number of Brazilian electrical appliances, proposed “voluntary” import restraint agreements (such as for footwear and textiles), and applied the CET to imports of television sets from the Manaus Free Zone.

## Conclusions and Recommendations

This chapter has analyzed MERCOSUR's mechanisms for regional governance and has discussed their weaknesses in promoting deeper integration. These conclusions underscore some key points raised in the chapter and offer specific recommendations that take into account the constraints revealed in recent years. Rather than making recommendations that ignore those constraints (or the author's perception of them), a conservative approach has been adopted in the expectation that the recommendations may be of practical use. As will be seen below, even with a conservative approach, the challenges facing MERCOSUR will demand a significant investment of political and material resources. Part of the efforts should be devoted to improving the management capacity of regional governance institutions to an extent unprecedented in MERCOSUR's history. The rest should be geared to making substantive progress on addressing structural and policy asymmetries. Without such progress it will be impossible for MERCOSUR to move toward deeper economic integration. In the best case, it will continue to adapt to the swings in the economic cycle, alternating between periods of rising interdependence and market fragmentation.

The first two preconditions for effectively meeting these demands are: (i) for the member states to revive a shared vision of the aims of the regional integration process (including reaffirming the goal of deeper integration), and (ii) for the member states to restate an internal commitment to that shared vision. The strength and effectiveness of an integration process (as of any other public policy) depend on its internal consistency and the perception by public and private actors that it works in a way conducive to meeting its goals. Since the mid-1990s, the MERCOSUR member states and leading regional actors seem to have lost sight of this consistency requirement. Without an effective response at both the regional and national levels, it will be impossible to introduce effective measures to deal with MERCOSUR's management problems as set out in this chapter.

At certain "founding" moments, such as the signing of the Integration and Economic Cooperation Program in 1986, the Buenos Aires Act in 1990, and the Ouro Preto Protocol in 1994, the member states and other regional actors identified a set of complementary interests that they wished to promote, and which were allegedly served by MERCOSUR. Leaving aside the hypothesis of a frivolous agreement, these founding moments were backed by a matrix of complementary interests that gave meaning to the integration process and made it possible to assess the trade-offs faced by each member state. By definition, such a matrix is a dynamic political construct whose updating and adaptation are ongoing processes. The record of MERCOSUR since the mid-1990s, however, makes plain that such updating has not taken place. The more the member states' policy preferences have diverged, the harder it has been to identify a matrix of complementary, or at least compatible, interests. This issue demands the utmost attention from MERCOSUR's political and economic elites—otherwise it will be impossible to improve the mechanisms for regional governance and the development of the integration process itself.

Reviving the commitment to a shared vision of the integration process is necessary to overcome the period of paralysis, reversal, and regulatory crisis that has prevailed in recent

years. But this is by no means a sufficient condition. As has been argued in this chapter, it is also necessary to strengthen regional governance mechanisms and address the most distorting and conflict-prone asymmetries. A number of practical recommendations follow.

### ***Reform of Governance Institutions***

Although “presidential diplomacy” may continue to play an important role in times of crisis, it cannot be the main mechanism in normal circumstances. MERCOSUR’s problems of governance, however, go well beyond the role of presidential diplomacy. It is necessary to restore political responsibility for decision making at the ministerial level (the CMC) and leave behind the present situation in which political responsibility for steering the process is diluted and falls, in practice, on a midlevel body with a pronounced conservative bias. To this end, the CMC should adapt its commitment and pace of work to the scale of the regulatory agenda faced by MERCOSUR, including a frequency of meetings that is compatible with the goals of deeper integration. This reform should help to establish a more transparent and legitimate mechanism for decision making, lessen the scope for discretionary action, and curb the amount of unfocused and nonprioritized work carried out by subordinate bodies. The frequently made argument that ministers are overloaded and lack the time to be more closely involved with MERCOSUR affairs is an explicit admission that national governments do not accord priority to the integration process and lack political commitment to it.

In order for the CMC to discharge its duties effectively, other bodies—such as the CMG, the MTC, and the CPRM—should engage in genuine preparatory activities, ending the current overlapping of responsibilities. This entails reviewing the structure of auxiliary bodies to make them consistent with selected priorities. The technical and political work will thus revolve around those priorities, and the work of the auxiliary bodies will be guided by a consistent program.

In tandem with a clearer demarcation of political and decision-making responsibilities, the concentration of management and decision-making power in the CMC, and the reform of the current structure of working subgroups and technical committees, there is a need to strengthen permanent and independent regional institutions. These should be endowed with procedures and resources that let them contribute to the process by providing technical, independent, and regionally-focused analysis. This will require an increase in resources, responsibilities, and autonomy for the Technical Secretariat. The latter should be given the capacity to make proposals, which need not be binding on decision-making bodies. It would also be helpful to increase the resources devoted to improving the quality of MERCOSUR norms, by making norms subject to the technical evaluation of the Secretariat and other community agencies.

### ***Reform of the Rule-Making Process***

The weaknesses of the process for creating and implementing norms cannot be overcome if reform of that process is not matched by conviction and consistent domestic practices on the part of each member state.

The best mechanism would be to transfer authority in specific fields to an intergovernmental body whose decisions would not have to be transposed by each member state in order for them to have legal effect. The constitutional obstacles to such mechanisms in Brazil and Uruguay should not pose an insurmountable barrier, as the European experience shows.<sup>31</sup> Brazil and Uruguay's participation in other international institutions, such as the World Trade Organization (WTO), where they assume new commitments without the need for parliamentary ratification, indicates that any possible conflict would not be insoluble. Alternatively, other mechanisms, such as a fast-track, could be adopted, as noted below.

The relationship between "primary" and "secondary" legislation must be clarified, since many things deemed "secondary legislation" in MERCOSUR are really international treaties. The disadvantage of international treaties as mechanisms for integration is their rigidity, since each amendment requires a new parliamentary ratification. Given that deeper integration processes require legislative flexibility, legislating by international treaty is not efficient.

Some of the difficulties of transposition could be resolved through a fast-track mechanism for those decisions that require parliamentary action. If this is feasible for measures that need the intervention of the legislatures, it should also be so for those that only require executive decisions. By the same token, article 40 of the OPP should be revoked, since it provides the national governments with a second (and nontransparent) opportunity to thwart decisions taken by community bodies, thereby preventing MERCOSUR legislation from developing into community law. The current procedures also deprive national officials who take part in the decision-making process of responsibility, since they always have a second line of defense before their decisions have any legal effect. It seems reasonable that there be a gradual movement toward the principle of direct application.

A legal framework should be established to allow member states to be exempted temporarily from the application of a particular measure. To that end, it would be useful to distinguish between two situations: (i) adoption of common regimes, and (ii) authorization for a member state to be exempted temporarily from the application of such regimes. In the former case, consensus could continue to be used for decision making. In the latter, majority voting mechanisms could be used.

### ***Dealing with Asymmetries in MERCOSUR***

Dealing with structural and policy-based asymmetries demands the adoption of mechanisms that operate more effectively than the institutional arrangements in force to date. As argued

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<sup>31</sup> In the cases of France, Germany, Italy, and the United Kingdom, admission of the primacy of community legislation was neither unconditional nor automatic (Craig and de Búrca, 2003). The most interesting case is perhaps that of the United Kingdom, where the principle of parliamentary sovereignty does not allow for commitments that annul the possibility of subsequent repeal (as a result, all Community legislation in force in the United Kingdom could be repealed by subsequent domestic law). Even so, the European Communities Law of 1972 and subsequent legal interpretations enabled the two systems to become compatible, confirming that constitutional obstacles are essentially political and that a practical way can be found to surmount them without the need for constitutional reform. I am very grateful to Ramón Torrent for drawing my attention to this issue.

in this chapter, addressing structural asymmetries poses distributional problems inherent in this policy. In MERCOSUR, they are exacerbated by the characteristics of the member states. It is difficult, however, to discern how the regional integration process can deepen unless these disparities are addressed effectively.

The EU's structural and cohesion policies can serve as a model for similar initiatives in MERCOSUR, duly keeping in mind that all member states are developing countries with severe problems of poverty and internal inequality. Partly for that reason, the extraregional provision of funding should be given a greater role. The financing of regional projects is still very modest, and credits from multilateral lending institutions go largely to individual countries. Multilateral institutions such as the Inter-American Development Bank (IDB) or the World Bank could allocate greater resources—such as investment in infrastructure, the development of regional innovation systems, or macroeconomic coordination (Porta, 2004)<sup>32</sup>—to financing the provision of regional public goods in areas where there are indivisibilities or externalities. Because of their characteristics, these public goods should be provided by means of a centralized mechanism that favors technical and regional considerations over the classical concerns of intergovernmental management. It remains to be seen whether the Initiative for the Integration of Regional Infrastructure in South America (IIRSA) will contribute to this objective.

Another means of attenuating the effect of structural asymmetries is to upgrade cooperation and coordination in the field of sectoral and microeconomic policies, taking the regional arena as a sphere for strengthening value chains and the industrial fabric. The Sectoral Competitiveness Fora are already operational. Although their effectiveness has been questioned, part of the difficulty seems to be related to a shortage of resources and limited national commitment. In this case too, external support to establish these spheres of information exchange and coordination could make a contribution.

Despite the importance and impact of structural asymmetries, this is not the main policy problem. The most urgent task is to deal with regulatory asymmetries. As long as there is no spontaneous convergence of member states' policy preferences, it is imperative to implement common disciplines to address practices that are likely to distort competition. Such disciplines would be even more necessary if all members were to move toward more aggressive state aid policies, so as to limit the risk of subsidy competition. To that end it is essential to broaden the sphere of application of competition defense (which is still in the making) to state aid. While some of the more distorting measures should be identified and eliminated through harmonization, those about which there is greater ambiguity should be subject to collective (and probably independent) mechanisms for centralized oversight.

While these instruments are being developed, it is crucial to implement emergency mechanisms that make it possible to offset the effects of structural and policy-based asymmetries in a way that is consistent with progress toward deeper integration. This should also

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<sup>32</sup> Machinea (2004) suggests that the development of regional funds financed with resources "external" to the region could become a powerful mechanism to increase incentives for macroeconomic coordination.

make it possible to move forward in a more transparent manner than is currently the case. The lack of emergency mechanisms is not proof of MERCOSUR's "virtuosity" as an integrated market, but rather a justification for even more discretionary and opaque practices of market fragmentation, income protection, and resource transfers. Such emergency measures should be associated with structural adjustment programs for sectors in difficulty.

It is clear that the agenda outlined here is quite ambitious, even without "maximalist" recommendations. These recommendations spring from an awareness of the constraints imposed by the relatively low and asymmetrical degree of regional interdependence. But if minimum levels of cooperation and centralized oversight cannot be assured, it is hard to imagine that progress could be made toward deeper forms of cooperation, such as those involved in regional redistribution policies or macroeconomic coordination. Alternatively, maintaining the status quo will inevitably lead to greater market fragmentation, more widespread use of nontransparent policy instruments, and mounting tensions due to asymmetries and tariff-free trade.

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## **Overlapping Asymmetries or Normative Cubism? The Transposition of Norms in MERCOSUR**

*Deisy Ventura*

### **Introduction**

It is natural that the development of a system to control the enforcement and judicial application of norms should be considered as part of an economic integration process. Why produce a set of norms that are not intended to take effect (that is, to be translated into concrete activities or forms of behavior)? A juridical norm, irrespective of the sphere in which it arises, is one whose implementation is guaranteed by an external and institutionalized sanction. This entails acknowledging that the existence of law supposes the existence of an organization that imposes a normative system. The most advanced juridical-institutional integration system in the modern world is that of the European Union (EU), which was developed more than a half-century ago. This is not a diplomatic alliance but a structural overlapping of states in which all government portfolios and the full range of national political institutions participate.

The Southern Common Market (MERCOSUR) did not expressly create an autonomous juridical order for the Asunción Treaty (March 26, 1991) to play a role equivalent to that of a national constitution. It is undeniable, however, that the normative measures of MERCOSUR's institutions derive from the Asunción Treaty and must conform to it. That is, they must conform once they have been transposed, or transferred, into the domestic order of the member states. Because it grows out of the political and juridical decisions taken during the integration process, this set of norms proceeds from an evolutionary process. The obligatory nature of the decisions, resolutions, and directives adopted by the common institutions was reaffirmed several times in the Ouro Preto Protocol (OPP) of December 17, 1994. The articles establishing the classification of MERCOSUR norms endow them with a coercive nature.<sup>1</sup> The member states are therefore obliged to transpose those rules into their national legal frameworks. But the conditions under which that transposition occurs limit the scope of the

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<sup>1</sup> See articles 9, 15, and 20 of the OPP. With regard to the hierarchy of derived-law norms, in MERCOSUR law there is no rule on dispute settlement. It is possible to presume that the hierarchy among the deliberative bodies extends to the norms they sanction. Council Decisions, therefore, take primacy over Resolutions by the Group, which in turn are higher in the hierarchy than the directives of the Trade Commission.

member states' obligations and cause serious problems of systemic coherence in the norms' entry into force.

Although it might be regarded as a separate matter, the application of norms is closely related to the problem of their entry into force.<sup>2</sup> Because of the limited possibility (or, in some cases, the impossibility) of undertaking legal proceedings against foreign states and international institutions in national jurisdictions, as well as the limitations of the few international jurisdictions now extant, an autonomous system for applying the law is the only one capable of ensuring that states comply with their commitments, and of enabling citizens to invoke community laws in legal cases. This is one of the prime elements of the principle of juridical security, which is crucial to increasing trade and attracting foreign investment.

Rather than create a true community jurisprudence, the MERCOSUR member states preferred a dispute-settlement system inspired by the classical conception of international conflict resolution, one that proceeds through diplomatic negotiations and arbitration. The system introduced by the Olivos Protocol (February 18, 2002), which replaces that outlined in the Brasilia Protocol (December 17, 1991), has three main features. First, it rests more on diplomatic activities and arbitration than on juridical principles—the Permanent Review Tribunal established in Montevideo is simply a venue for appealing to arbitration. Second, the Brasilia Protocol's field of application is confined to the interpretation and application of common norms, or to sanctioning breaches of the rules by the member states. The protocol does not cover the acts of the MERCOSUR institutions or physical and legal persons. Finally, individuals have no direct access to the system, although an individual can invoke the Olivos Protocol in a member state. In the event the member state decides to endorse the individual's claim, it becomes the plaintiff. Thereafter, continuation of the process is wholly in the hands of the plaintiff state.

The present juridical framework for dispute settlement in MERCOSUR has three levels. First, a dispute *among the member states* can be resolved by the autonomous MERCOSUR system on the basis of the Olivos Protocol, the OPP, and the Olivos Protocol's implementing regulation; or it can be resolved by other dispute settlement systems in a sphere in which the litigants participate, such as the World Trade Organization (WTO). Second, a dispute *between a citizen and a member state* can be resolved only within the autonomous MERCOSUR system, by means of a state's endorsement of the individual's case.<sup>3</sup> Finally, a dispute over MERCOSUR law *between citizens of the member states* can be resolved through the several international agreements on commercial arbitration between individuals (with the limits entailed by arbitration) or by national jurisdictions, it being clear that (i) the national judge is limited to applying the *domestic law* that originated in MERCOSUR (since only common rules that have been transposed into domestic legislation may be applied); and (ii) there is no guarantee that the application of that law will be uniform in the different member states.

Hence, a system that cannot ensure (or inadequately ensures) entry into force bears directly on the deficient application of norms. This chapter seeks to identify how the model

<sup>2</sup> On the judicial application of MERCOSUR law, see Secretaría del Mercosur (2003).

<sup>3</sup> In no case can a citizen pursue a legal claim against his or her own member state.

for transposing norms impinges on the effectiveness of MERCOSUR law and shows how the different asymmetries overlap within the bloc. The first part of the chapter addresses the systemic elements and shows that the main problem of transposition is *not* constitutional asymmetry among the member states. Although the Argentine and Paraguayan constitutions have a mechanism that could exempt them from transposition, neither has used it. The second part of the chapter examines issues of the immediate context, with a view to demonstrating that the community system for transposition gives rise to a sharply asymmetrical normative framework because it gives different national considerations primacy over a regional-level perspective of juridical security.

### **Structural Issues: National Systems and the Complex Common System for the Transposition of Norms**

Chapter IV of the OPP is entitled “Internal Application of Norms Issued by the MERCOSUR Bodies.” In line with article 38, the member states pledge to take all necessary measures to guarantee application of the Decisions, Resolutions, and Directives within their territory. The single paragraph of that article adds that the member states shall inform the MERCOSUR Administrative Secretariat (SAM) of the measures taken to that end.<sup>4</sup> Article 38, therefore, establishes the general principle that the national governments shall each control the application of MERCOSUR-derived law within their own jurisdictions. The member states are thus the guardians of their own commitments. Effective community norms depend on the diligence of member states in taking the measures that allow such application.

The protocol removes any prospect that MERCOSUR-derived law will be immediately applied in national juridical arrangements. It sets out the procedure for the domestic transposition of such law by member states so as to guarantee “simultaneous entry into force” in each of them (article 40, first paragraph). First, according to article 40 *i*, “once the norm is adopted, the member states shall take the necessary measures to transpose it into the national juridical order.” This provision reiterates, at the end, that the member states must inform the SAM of the measures taken. Then, “when all the member states have given notice of the transposition into their respective juridical orders, the MERCOSUR Administrative Secretariat shall communicate the fact to each member state” (article 40 *ii*). Finally, “the norms shall enter into force simultaneously in the member states 30 days after the communication on the part of the MERCOSUR Administrative Secretariat” (article 40 *iii*).

Article 39 makes provision for the publication of the bloc’s norms in the MERCOSUR *Official Bulletin*. Article 40 adds, however, that “the member states, within the period mentioned, will give notice of the start of the application of the norms mentioned by means of their

<sup>4</sup> The reference to the Secretariat in article 38 should not be seen as an additional oversight function at the community level. In reality, it amounts to the natural extension of the records and information function assigned by the OPP to the SAM. The SAM’s transformation into a technical body through CMC Decision 30/02 does not change that circumstance. For public purposes the Secretariat became known as the MERCOSUR Secretariat (SM), although legally it retains its original name.

own official bulletins” (*iii, in fine*). This second, internal publication is imposed as a condition for the norms to take effect. In reality, only the first publication of the text is important. The second (of the date of entry into force) has never been undertaken by any member state. The MERCOSUR *Official Bulletin*, in turn, is uncompiled, is issued irregularly and has a format that is incompatible with national regulations governing the official press. This is not and never has been an indispensable condition for a norm to enter into force.

So the entry into force of MERCOSUR norms follows a procedure more complex than that applicable to any other agreement signed individually by a member state. Such agreements’ entry into force depends solely on domestic transposition in line with the applicable constitutional procedure. From the viewpoint of each member state, the entry into force of MERCOSUR norms is a three-stage odyssey.

First, the member state must undertake the transposition. According to article 42, MERCOSUR-derived law must be transposed into each national legal order “by means of the procedures for which each country’s legislation makes provision.” No member state, however, currently uses a specific procedure for the transposition of MERCOSUR norms. The four countries assiduously comply with the procedure applicable to any source of international law. Parliamentary approval is required for agreements that create new obligations. For norms stemming from framework accords, such as executive agreements, this is transposition by executive action. The mechanisms included in the Argentine and Paraguayan constitutions have never been applied in MERCOSUR and it is not hard to understand why.

According to article 75 of Argentina’s constitution (amended in 1994), Congress has the authority to approve “integration treaties that delegate authority and jurisdiction to state organizations, on condition of reciprocity and equality, and so long as they respect the democratic order and human rights. The norms passed as a result of those supersede the laws” (paragraph 24). Note two consequences of this approach. First, the constitution expressly authorizes the approval of a supranational organization’s constitutive treaty because the Argentine state can delegate authority to that organization and submit itself to its jurisdiction. Second, the norms devised within that supranational organization take primacy over the laws. So, to law derived from supranational bodies, the constitution would extend the general rule of primacy over treaties established in article 22. According to the latter, treaties take primacy over law as long as they meet three conditions: reciprocity, equality, and respect for the democratic order and human rights. Nonetheless, it is worth outlining the scope of these conditions.

Above all, reciprocity seems to be a safeguard, inasmuch as Argentina will use this constitutional mechanism only if its partners prove equally willing to delegate authority and accord favored status to MERCOSUR norms in their domestic legal arrangements. Equality among states—the classical Westphalian principle—bars activities that entail subordination to other states or the conclusion of leonine agreements that give the other partners an undue advantage that would be harmful to Argentina. Finally, respect for democracy and human rights reflects the modern tendency toward the proliferation of democratic clauses in international agreements.

Amended in 1992, the Paraguayan constitution expressly authorizes the state's participation in supranational juridical arrangements. Article 145 states that "the Republic of Paraguay, in conditions of equality with the other states, admits a supranational juridical order that guarantees the prevalence of human rights, peace, justice, cooperation, and development in the political, economic, social and cultural spheres." Decisions on this juridical order "may only be adopted by an absolute majority of each chamber of Congress." Argentina's text is similar in spirit inasmuch as it seeks to enable these countries to adapt to a community order in the future. Unlike Argentina, however, Paraguay does not mention derived law in its hierarchy of law sources, confining itself instead to affirming that the constitution takes primacy over ratified and approved international agreements, which in turn take primacy over national laws. Argentina has the most explicit constitution but cannot apply it in the absence of a supranational MERCOSUR institution.

Brazil's 1988 constitution, which with Uruguay's is seen to hinder a new regional juridical system, refers to economic integration only in the single paragraph of article 4, which establishes the principles that should guide Brazil in its international relations: "the Federative Republic of Brazil shall seek the economic, political, social and cultural integration of the peoples of Latin America, with a view to creating a Latin American community of nations." Ever more outdated is the doctrine whereby this rule has any programmatic character and thus never enters fully into force.

The reference to integration in Uruguay's Basic Law of 1967 is pioneering but enigmatic—probably because it is obsolete. According to article 6 (final subsection), "the Republic will seek the social and economic integration of the Latin American states, especially as regards the common protection of their products and raw materials. Moreover, it will seek true complementarity among their public services." The Uruguayan doctrine is not unanimous in specifying the scope of article 6 or article 4, and apparently is quite restrictive as regards the sources of law that it admits: "full sovereignty is rooted wholly in the nation, which has the sole right to enact laws as set out below."

The rigidity of the Brazilian and Uruguayan constitutions is relative, and the prospect of their being amended is not remote. Moreover, examination of European constitutions reveals various means of dealing with EU member states, ranging from detailed regulations to complete silence. This does not hamper the convergence of the community's stock of norms nor impede the prospect of invoking community law in legal proceedings. In reality, the strict application of those provisions of the member states' constitutions that concern the rules originating in classical international sources are inappropriate for the integration process. It is plain that international law corresponds to the structural aspects of interstate society, while community law is adapted to the needs of an integration process—which, in the final analysis, justifies its detachment from its internationalist roots and underpins its specificity.

Second, once transposition has taken place—just as happens for any other norm of international law—the state must draw up a communication to report on the transposition and send it to the SAM. Third, the state must await the communication from the SAM containing the announcement of the transposition of the norm into the legislation of the four member states. Finally, after that communication has been received, the member state must

take the necessary internal measures, especially publication in the official bulletin, so that the norm can enter into force 30 days after the SAM's notification. The members reaffirmed this system in Council Decision 23/00 ("Transposition of MERCOSUR Norms into the Domestic Legislation of the Member States"), which confines itself to adding some details. Such a peculiar system leaves to the SAM's modest structure the heavy burden of collecting and then disseminating the information on the transposition of community norms. Nonetheless, that task was elevated by the text of the protocol to a *sine qua non* condition for the entry into force of MERCOSUR-derived law.

These articles suggest that law originating in MERCOSUR recognizes the existence of parallel juridical orders and hence clearly admits *dualism*, a term with roots in the old dispute among internationalists on the nature of relations between international and domestic law: were these relations *monist* or *dualist*? As Virally (1964) writes: "Either there are two separate orders, rigorously closed in on themselves and between which no relationship is conceivable at the level of law. This is the dualism thesis. Or there is a single juridical order that encompasses all others.<sup>5</sup> This is what underpins monism." The constitutions of the four member states enshrine the dualist system.<sup>6</sup>

Although the international roots comprise the genetic heritage of integration law, is this notion of dualism compatible with the goals of the MERCOSUR treaties? At the same time, the complex procedure for transposing MERCOSUR norms created by the OPP generates several problems regarding the application of derived law, mainly with respect to uniform interpretation. The MERCOSUR member states, like the god Janus, can present different faces according to circumstances. After the meetings of the MERCOSUR institutions, when government representatives return to their own capital cities, they embark individually on a lengthy endeavor to apply the norms that they have just drawn up together. Their faces may take on a threatening aspect to community commitments: they have real power to stop the norms from truly entering into force, and can transpose norms as they see fit.

The text of the OPP gives the member states real veto power over community norms, as has been evident in several ways and at various stages of MERCOSUR's legislative process. Initially, a member state's mere absence from or abstention in the institutions' deliberative meetings allow any deliberation to be blocked, since decision-making is by consensus with the presence of all member states (article 37).<sup>7</sup> As in Europe in the 1960s,

<sup>5</sup> According to Kelsen, founder of the monist thesis with primacy in international law, "there is a universal legal order, independent of any recognition and superior to states, a *civitas maxima*." "Les rapports de système entre le droit interne et le droit international public," *RCADI* 1926, 4: 325. Postulating the unity of the science of law, he sees barely a difference of degree between international law and domestic law. See Tournaye (1995, 98).

<sup>6</sup> On national constitutions, see Perotti (2004).

<sup>7</sup> The observation of a former Secretary General of the European Commission, Emile Noël, in 1984, should be added: "it is broadly acknowledged that the systematic search for unanimity is at the root of the paralysis of the Council ... There should be no hesitation in moving to a vote when there is doubt. Just as the systematic search for unanimity instituted paralyzing and even destructive habits over the years, so too the more frequent resort to votes on important matters could gradually establish a new, more flexible and politically more demanding code of conduct." "Réflexions sur le processus de décision dans le Conseil des Communautés européennes." *Mélanges Teitgen*, 346–47.

“empty chair”<sup>8</sup> crises should be feared not only when a member state deliberately seeks to block decision-making by its absence, but also when a member, because of immediate political difficulties, believes that slow integration generally favors it.

Second, if all states are present and agree to the adoption of a norm by a community body, it is enough (according to article 41) for a member state to fail to inform the SAM that it has taken the necessary steps for transposition in order to block the norm’s entry into force. According to the OPP system, application of a common rule depends on a communication from the SAM on that norm’s transposition in “all the member states.”<sup>9</sup> It is as unfortunate as it is true, however, that when a norm is not transposed this does not lead to sanction of the member state in question.<sup>10</sup> A MERCOSUR member can therefore refrain from taking systematic steps on transposition with complete impunity. It can also manipulate the date on which those norms that are hardest to justify domestically enter into force, either by delaying the adoption of the transposing measure or by not notifying the SAM of the adoption.

Apart from a member’s slowness or possible abstention, three arguments suggest that the OPP system cannot be allowed as a general rule for transposing derived law, and hence that it is not a *sine qua non* condition for the entry into force of MERCOSUR norms. First, there is a specific provision on the conditions for a norm’s entry into force in the text of each norm of derived law. Then there are numerous practical difficulties in adapting that procedure to the national transposition systems. Finally, the system is incompatible with the nature of integration.

As regards the dispositions on entry into force, for which provision is made by each norm of derived law, there are several examples of its being inimical to the OPP system. For instance, the “agreements” arising from the Ministerial and Specialized Meetings have their own clauses on entry into force, similar to those available in classical international law. Among many examples, Common Market Council (CMC) Decision 2/96 approved a protocol on jurisdictional cooperation in penal matters. According to article 28, this protocol “shall enter into force for the first two member states that ratify it thirty (30) days after the second country deposits the instrument of ratification. For the other ratifying countries, it shall enter

<sup>8</sup> In 1965 France opposed applications of the EC Treaty that, after a transition period, allowed majority voting (in agricultural matters). This stance prompted the “empty chair” crisis as France’s representatives failed to participate in the meetings of intergovernmental community bodies. This crisis led to the adoption of the Luxembourg Declaration in January 1966. According to this, if a majority vote were possible but one or more member states indicated that “very important interests” were at stake, discussion would continue to seek solutions acceptable to all members of the Council. The Council refrained from resorting to qualified majority voting even when such a course was permitted by the treaties. The result was a significant slowdown in the Council’s work and a virtual paralysis of the Community in many areas. See Manin (1999, 204–05).

<sup>9</sup> Moreover, after that notification, the member states must wait 30 days more to acknowledge its obligatory force.

<sup>10</sup> The term *failure* would also apply to the abstention of a state legally obliged to apply a norm. But the term *lack* was deemed preferable in order to avoid any confusion with the European Community procedure, whereby an *application for failure to act* seeks “acknowledgement by the judge of the illegality of the abstention of a [community] institution that is legally obliged to take a decision” (Boulois and Darmon, 1997, 227). The *action for failure* allows the European Commission or each member state to resort to the European Court of Justice if they believe that a member state failed to comply with one of its obligations under the treaties, according to articles 226 and 227 of the EC Treaty. Moreover, “it is now wholly established in the jurisprudence that an abstention, being active behavior, can constitute a failure” (Boulois and Darmon, 1997, 267).

into force on the thirtieth day after the deposit of the corresponding instrument of ratification.” Thus, this specific provision of the protocol wholly rules out the “simultaneous entry into force” of MERCOSUR law mentioned in the OPP.

Is it possible to conclude from this conflict that the system foreseen by each protocol individually should prevail (it being a special provision) over the general system established by the OPP? In that event, the OPP system would be applied only exceptionally because most of the norms of MERCOSUR-derived law make provision for much more flexible conditions for application. Moreover, oversight of the norm’s entry into force would become highly complicated, if not hazardous: some norms would be controlled by the SAM in Montevideo, on the basis of information provided by the member states; others would depend entirely on the information available to the government in Asunción, since all the instruments of ratification must be deposited together with the Paraguayan state. It would therefore be likely that some norms might be applied in one member state and not in the others.

Second, if there were only the OPP system, that too would arouse some application difficulties. The member states must inform the SAM that they have taken measures on application, and they can only do that when such measures are truly adopted. Depositing the instrument of ratification does not endow the norm with the capacity to take effect, which is the immediate consequence of publication, not of ratification. Hence the norm must be promulgated and published so that the member states may inform the SAM of its transposition.

In practice, a MERCOSUR norm takes effect in each country after it has been transposed domestically in line with the country’s own constitutional procedure for transposition, at which point it may be invoked in a legal case as a national norm.<sup>11</sup> No country waits for the SAM communication to apply a MERCOSUR norm, precisely because that would amount to a new round of transposition, including the waiting period and a new publication that would set the date after which the norm would be obligatory.

Finally, even if the foregoing objections were irrelevant, it is worth asking if this system is consistent with the juridical nature of international relations. “All doctrines of ‘transposition’ (however the procedure is termed in the various states) are essentially inappropriate for the demands arising from international law” (Pescatore, 1984, 400). Thus, by transposing a norm originating in international law into a domestic law, the state alters the nature of the norm: from being an international *commitment* it is reduced to a juridical norm and is subject to the authority of the *lex posterior derogat priori* principle (more recent law prevails over previous law). Consequently, “the legislator may, if he or she so desires, modify its terms and put an

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<sup>11</sup> This is precisely the argument used by Argentina in the case of textile products, the object of MERCOSUR’s third arbitration ruling, and accepted by the Tribunal. According to Buenos Aires, “in MERCOSUR’s experience and practice it has not proven possible to strictly apply the mechanism of article 40.” What has been possible is a decision, resolution or directive that has been transposed into domestic law and that has effect in each country from the date of the respective transposition. On the basis of the information provided by the plaintiff, the “act of transposition” is still under way. See “Aclaración del Laudo del Tribunal Arbitral Ad Hoc del MERCOSUR constituido para decidir sobre la Reclamación hecha por la República Federativa del Brasil a la República Argentina, sobre la Aplicación de Medidas de Salvaguardia sobre Productos Textiles (Res. 861/99) del Ministerio de Economía, Obras y Servicios Públicos.” Available at [www.mercosur.org.uy](http://www.mercosur.org.uy).

end to its effects.” (Pescatore, 1984, 401)<sup>12</sup> This is precisely the kind of problem evident in MERCOSUR, since the transposition of norms can be undertaken according to the interests of each member state.

Examination of article 40 of the OPP reveals that MERCOSUR-derived law, as a whole, *must be transposed*, and the states must meet this obligation by applying the procedure established by that protocol. A few lines later, however, the OPP includes a provision that is at least enigmatic: “the norms issued by the MERCOSUR bodies for which provision is made in article 2 of this Protocol<sup>13</sup> are obligatory and, *when necessary*, must be transposed into national legal orders by means of the procedures for which each country’s legislation makes provision” (article 42).<sup>14</sup>

The result is that a state can believe that the substance of a rule is already present in its domestic juridical arrangements and thus decide not to transpose the norm, or to do so only partially.<sup>15</sup> The text of this article of the OPP, as it was conceived, authorizes the member state to hold that the nature of an act exempts the state from the need to transpose it, in contrast to what seems to be established in article 40 of the same text. It may be deduced from article 42 that transposition is not the rule and that the transposition procedure to be followed is not that fixed by article 40, but the one for which provision is made by each member state’s own regulations. The national governments therefore enjoy discretionary power over the timing of transposition and the form in which community norms are transposed.

At first glance, article 42 recalls the logic of the directive in European law. According to article 249 of the founding treaty of the European Community, a directive “shall be binding as to the result to be achieved, upon each member state to which it is addressed, but shall leave to the national authorities the choice of form and methods.” Thus, directives offer the members the choice of how to undertake transposition. Moreover, the member state can invoke “spontaneous conformity” with the directive in order to relieve itself of the obligation to transpose the norm formally. This happens if a member state has legislation or a national regulation that is compatible with the provisions of the directive. Nonetheless, two differences should be noted in drawing this parallel with directives in the transposition of MERCOSUR-derived law.

First, directives are scarcely a category of norm from community-derived law, simply the only one that allows the transposition mechanism for domestic law. Community law in

<sup>12</sup> Similarly, according to Simon (1999): “if the hierarchical position of international law depends on a provision of domestic law, the primacy of international law is essentially based on a provision that is inferior to the superior norms whose prevalence it is called upon to bring about, which is a logical apory; on the other hand, the basis of the primacy of international law is by nature vulnerable, in the sense that the constituent power could at any time put in question the position of international law in the hierarchy of norms.”

<sup>13</sup> The Council, the Group and the Commission—that is, the decisionmaking bodies, a reference identical to that of article 40.

<sup>14</sup> Emphasis added.

<sup>15</sup> This interpretation is corroborated by CMC Decision 23/00, according to which MERCOSUR law shall not be transposed into domestic law when the member states as a whole regard the substance of the rule as referring to the bloc’s internal operations or when the state individually holds that the substance already prevails in the domestic order (article 5).

general undeniably benefits from immediate applicability. In MERCOSUR there is no means of adopting directly applicable norms and rules that must be transposed, since all norms, in principle, must be transposed. Thus a possible “exemption from obligation to transpose” in MERCOSUR does not mean that the community law has immediate applicability. On the contrary, the fact that some norms are not transposed in some countries confirms the power conferred on each government to assess the need to transpose MERCOSUR-derived law and promote it as it chooses. Hence the principle of a community directive—the obligation of ends and not means—applies to all MERCOSUR norms.

A state might hold, for example, that a norm related to the functioning of a MERCOSUR institution does not need to be transposed into domestic law. It might also be maintained that, because of the nature of the norm, the transposition may be summary, rather than in line with the procedure foreseen in article 40. Hence the importance of the second distinction: in European law, the national authorities do not have full freedom to determine how transposition will be ensured. The imperatives of uniformity in the application of community norms lead to a progressive delimitation of the member states’ maneuvering room.

In MERCOSUR, such maneuvering room is total, since the four partners have presidential systems. The governments can send the community norm to the legislature with a view to its being transposed into law. They can also adopt a simple administrative act for norms and thereby escape parliamentary oversight. In general, the administrative law of the MERCOSUR countries enshrines the principle whereby the executive branch may modify or derogate a normative act at any time, as long as the public interest is respected. In the event that such an act is adopted, it is very likely that it will be inconsistent with the transposition procedure foreseen in article 40, since it will be necessary to await the communication from the SAM and to re-publish before the norm can take effect. There is no guarantee that this law will be applied, much less that it will be applied uniformly.

Finally, even if the state really allows a transposition measure, the possibility of *defective transposition* can alter and even distort the spirit of the community text. This risk is even greater when the national governments can choose how to transpose a norm, for example, by attenuating its coerciveness. If a transposition is poorly done, however, there is no sanction for the state in question.

Once transposed, therefore, community rules have the same obligatory force as national rules, be they laws or normative acts of the executive branch, since they form part of domestic law. Nonetheless, there is no absolute obligation to undertake transposition and no oversight of how MERCOSUR-derived law is applied. The foregoing assertion is not refuted by recent jurisprudence.<sup>16</sup> This undeniable fact has led the member states to adopt a significant pal-

<sup>16</sup> In Brazil, for example, the transposition of a MERCOSUR-derived norm was the object of an emblematic decision of the Federal Supreme Court. The *Belem Port* case (Carta Rogatória 8.279 República Argentina, May 4, 1998) concerns the application of a protocol signed by the MERCOSUR member states in the Meeting of Ministers and Justice, and approved by Council Decision 27/94 of December 17, 1994. This was a protocol of jurisdictional cooperation on the implementation of preventative measures.

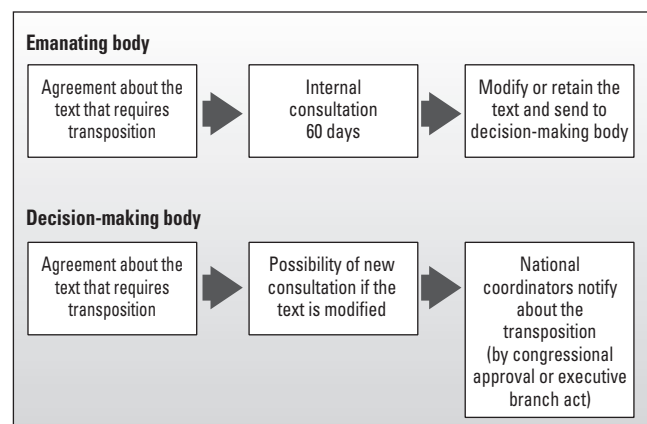
liative measure. In parallel, for two years the member states sought unsuccessfully to reach agreement on the immediate applicability of MERCOSUR norms.

In line with Decision 20/02, a complex system of prior consultation with the member states was set up. The aim is to consult, during the process of drawing up a norm in the MERCOSUR institutions, those who have domestic authority in the subject matter of the future community norm. The aim of the norm is to create a procedure that can produce a normative text that is compatible with national juridical arrangements, and hence that can be transposed by the member states. It might also facilitate oversight of the transposition of MERCOSUR norms into domestic law, as soon as there is a provision on the timeframe and conditions for transposing norms, one provided by the member states during the process of drawing up the norm. Figure 13.1 illustrates the domestic consultation procedure.

As of the second half of 2003, there was substantial compliance with CMC Decision 20/02. As a result, several draft norms were returned to the bodies in which they originated because they had not been submitted to the decision-making institutions in a manner consistent with the aforementioned legal provision. The matter is one of choice between the quantity and the quality of norms. There is certainly less of a workload at the end of each summit, but in the long term what will diminish is the vast limbo of norms that have been approved but are breached, thereby enhancing MERCOSUR's credibility and juridical security. The consultation procedure, however, is not enough to resolve the complex problem of transposing norms. There is no automatic connection between a favorable response to a consultation and immediate transposition, although it is likely that transposition will happen in less time and with fewer problems. By contrast, the national transposition procedures are wholly necessary.

Aware of the scale of the problem of the scant and asymmetrical application of MERCOSUR norms, in the MERCOSUR Work Program 2004–2006 (CMC Decision 26/03, annex item 3.2), the decision-making institutions acknowledged the need to analyze the transposition issue. They decided “to sign, in July 2004, an instrument establishing the procedure for the immediate entry into force of MERCOSUR norms that do not require parliamentary approval, mindful of the specific nature of certain matters, such as tariff issues.” In this regard, in Iguazú the CMC adopted Decision 22/04 on the “application of norms issued by MERCOSUR’s decision-making bodies” after long and difficult negotiations that involved the personal and direct intervention of the foreign ministers. The aim of the decision is the future adoption by each member state of a procedure for the

**Figure 13.1 Flow Chart of the Legislative Procedure**  
(according to CMC Decision 20/02)



entry into force and application of MERCOSUR norms that *do not need legislative approval*. In a memorable juridical formula, the Council decided that each member state's implementation of this procedure must be *completed or started* before October 5, 2004. The member states continue to negotiate a uniform means of implementing this procedure within their national juridical orders, in conformity with the guidelines set out in the annex.

The main text of the decision stipulates that MERCOSUR norms must indicate the date of their entry into force. According to the annex, the adoption of norms will be preceded by internal consultations (CMC Decision 20/02) and analysis of their juridical consistency. These consultations may modify or complement the norms, and will seek to specify the national rules that will lose effect once the MERCOSUR norm has been adopted. Moreover, starting from the day on which the approved text is received, the member states shall publish the norm within 40 days of the date on which the norm itself specifies that it will enter into force. Finally, once the MERCOSUR norm takes effect, contrary national norms of equal or lower status will cease to be applicable. The status of a MERCOSUR norm remains to be defined. The procedure will not apply to norms governing MERCOSUR's organization or operations. These will enter into force on the date of their approval or on another specified date.

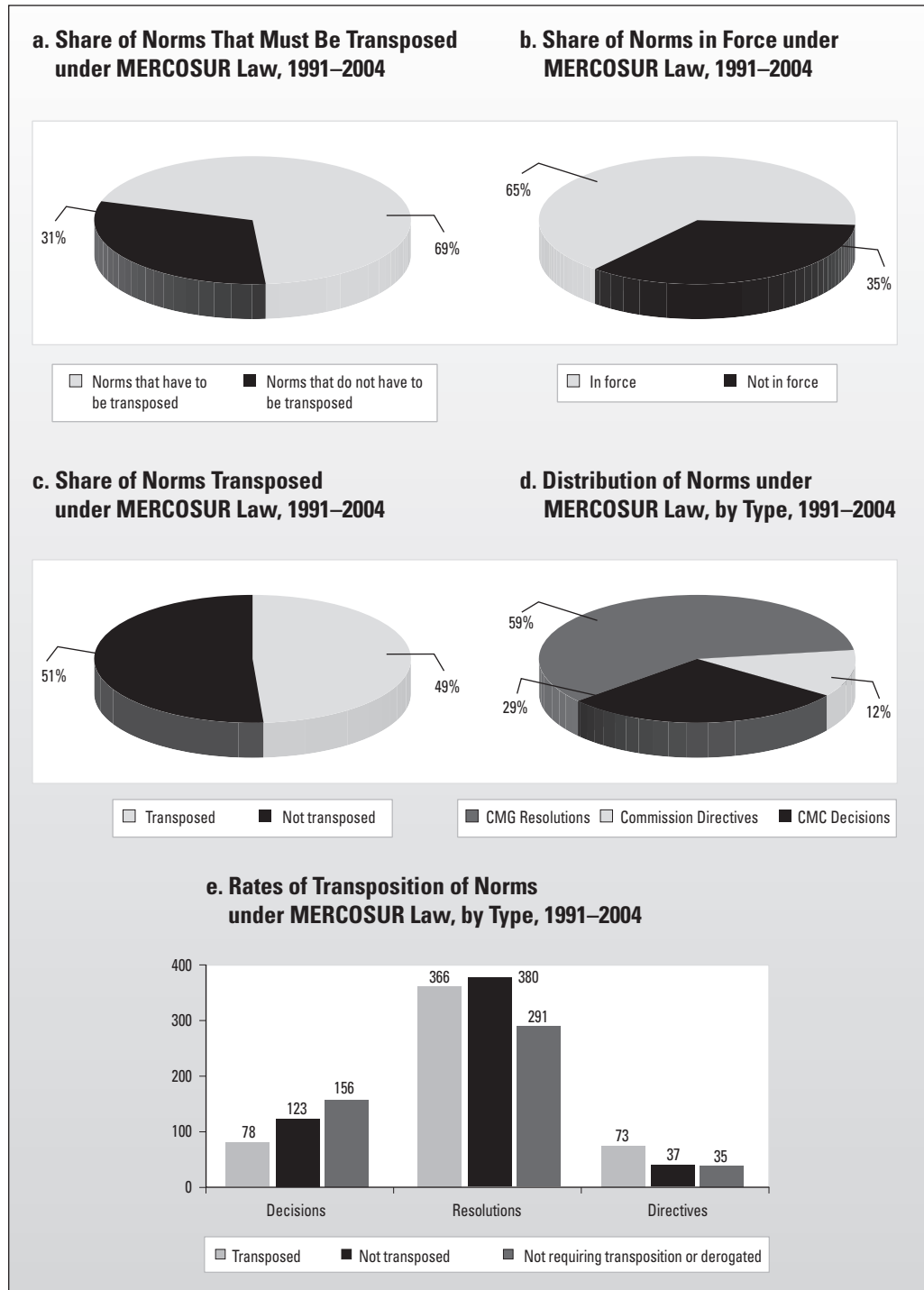
Once implemented, this decision will create a new means of transposition, aside from that outlined in article 40 of the OPP. According to article 42, there is a general rule (obligatory, without the need for legislative transposition) and an exception (obligatory, with the need for legislative transposition). Article 40 addresses the procedure for entry into force under the exception—that is, after legislative transposition. The decision addresses the procedure under the general rule. So the decision excludes norms that do not have to be approved by the national parliaments.

Another important innovation is the creation of special sections or headings in the official bulletins, giving unprecedented exposure to MERCOSUR norms from the viewpoint of the governments and citizens. It is possible, however, that some member states might not publish only the MERCOSUR norm but rather draw up a national norm that transposes the MERCOSUR norm, and then publish the national version containing that of MERCOSUR—once more invoking the question of the status of a MERCOSUR norm. The fate of this decision depends on whether each member state defines and delimits its domestic implementation procedure in such a way as to ensure proper compliance—a concern warranted by the modest technical quality of the norm's drafting.

### **Immediate Context: The Current Status of the Transposition of Norms and Their Impact on Disparities among the Member States**

Of the 1,542 MERCOSUR norms drawn up since the bloc's creation, the member states have to transpose 1,060; some 517 have already been transposed. The norms that do not have to be transposed are those whose effects are strictly *interna corporis*—that is, those that concern the bloc's functioning and that include an express clause on exemption from transposition. The scope of the norms that have to be transposed is illustrated in Figure 13.2a.

Figure 13.2



An understanding of this matter reveals why the member states adopted a new method for drawing up the transposition information. Consider the extent to which MERCOSUR law is in effect according to the criterion of whether a norm is *in force* or *not in force*, rather than whether it has been transposed or not. To the number of transposed norms should be added those that do not have to be transposed and those that have been derogated. As shown in Figures 13.2b and 13.2c, the new total (using the same numbers as above) gives a more favorable impression of the share of norms in force.

From the juridical standpoint, however, it is questionable whether an *interna corporis* norm is *in effect*, since its status is more closely related to its practical application than to its capacity to have effects (true entry into force). It is better to make no comment on the number of derogated norms among those in effect.

As to the distribution of norms by category, it is clear that Common Market Group (CMG) Resolutions are most numerous (see Figure 13.2d). This reflects the concentration of the decision-making process in that institution, which has to negotiate with most of the 260 “dependent bodies”<sup>17</sup> and which the constitutive treaties refer to as MERCOSUR’s executive body.

Looking at the overall data by category of norm, however, decisions display a lower degree of transposition (see Figure 13.2e).

It is worth asking if the foregoing comprise norms in the real sense of the word. A significant number of norms are simply declarations of intentions, diverse lists, or various goals that cannot be classified. There are many examples of texts that, in internal administrative law, would be categorized as ordinary administrative acts, especially since they use formulas through which an authority (a decision-making body) issues a final decision (it could equally be an interlocutory matter) on a situation submitted for its consideration. Many of the norms considered here have no general and abstract mandate or juridical effects. It is highly advisable that a classification of the bloc’s ordinary administrative acts be drawn up to avoid transforming a simple decision into a norm.

Like other international organizations, MERCOSUR has a number of different bodies with distinct powers and competences. These institutions’ activities may be preparatory, taking the form of proposals. Or they might be of general and abstract substance geared to the production of norms or, alternatively, of concrete and specific substance—a norm of specific effect or deliberation. Institutional activity might lead to declarations on a factual situation or rules; or it might extend an invitation or offer express instruction. Their effects may be internal to the organization, directed at the member states (obligatory or nonobligatory) or at third parties (other international organizations, nonmember states, individuals). The language and other formal matters are important inasmuch as they clarify, in each case, intentions throughout the stages of the procedure for drawing up the rule (powers, negotiation, adoption and authentication of the text, willingness to continue the procedure, willingness to express

<sup>17</sup> Institutional spheres of negotiation lacking in decision-making power, such as the ministerial meetings and specialized meetings, the technical committees, the working subgroups, the specialized fora, ad hoc groups and committees, and so forth.

consent), as well as the effects of such acts and norms. In this sense, it is highly desirable to adopt a clear and precise normative terminology in order to guide those MERCOSUR bodies that have the power to make proposals.

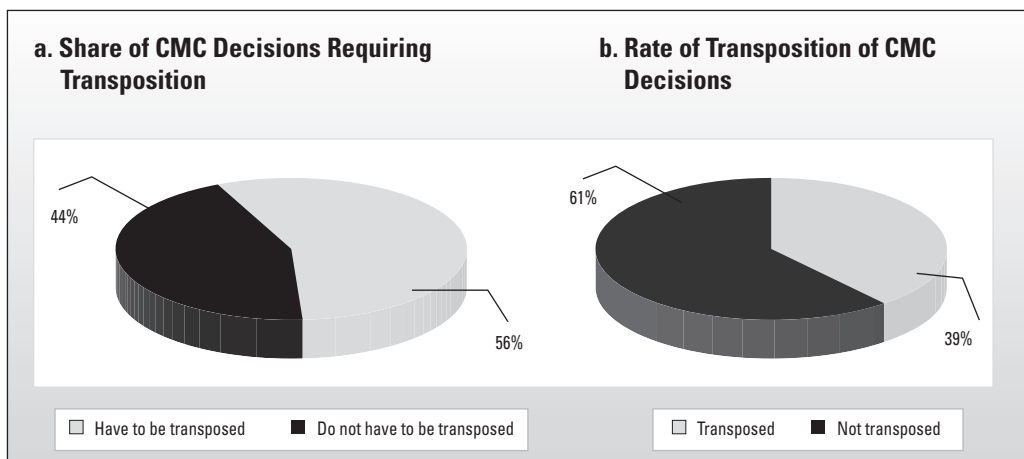
The Common Market Council (CMC), MERCOSUR's highest body, is responsible for the political oversight of the bloc and produces a number of norms that are exempt from transposition (see Figure 13.3a).

The CMC also has the greatest difficulty in arranging for the transposition of those norms that have to be transposed (see Figure 13.3b).

Most of the untransposed norms originate in the ministerial meetings and the specialized meetings, especially in the areas of justice and home affairs. The deficit in transposing Council norms is attributable, among other things, to administrative and bureaucratic problems related to the absence of interministerial coordination within the governments, which have not created a centralized body to oversee integration issues in the various ministries. With their modest structures and highly political approach, the foreign ministries retain most of the responsibility for coordinating implementation of the commitments assumed at the sub-regional level. Not infrequently, one sector of a ministry is unaware that it should transpose a certain norm. Or the various sectors and portfolios do not agree on the substance of a norm, or on who should transpose it and using which procedure.

Unfortunately, there are other, deeper reasons for the deficit in legislative harmonization. Many of these norms do not harmonize, but instead establish cooperation and consultation mechanisms that depend on a prior harmonization of norms or the prior adoption of a set of practical initiatives before they can be implemented. When the matter involves the public safety system and the judicial branch, it is not easy to bring about structural changes. Efforts in that regard depend on a greater political integration. Legislative harmonization—a long-term endeavor involving the vigorous participation of the national parliaments—is moving slowly in MERCOSUR.

**Figure 13.3**

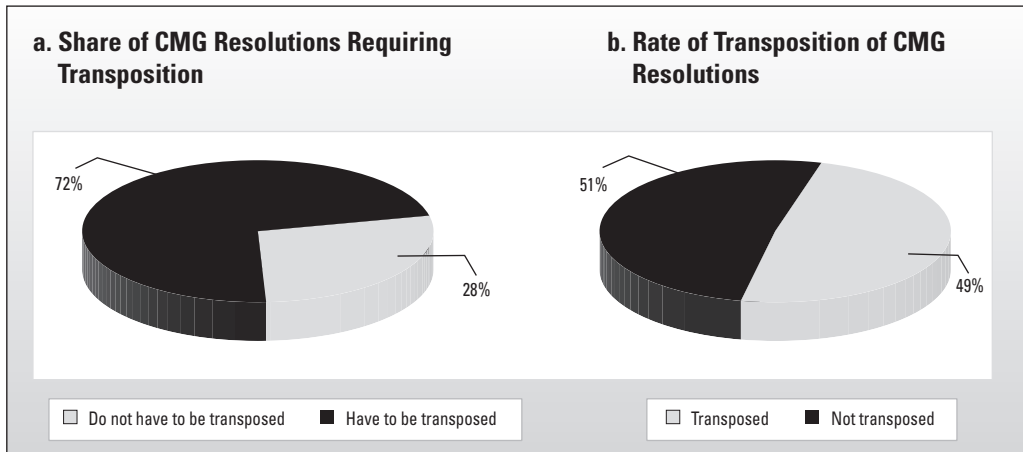


As regards norms arising from meetings of the interior ministers—those still to be transposed—include, for example, norms on firearms (for example, on common registration, CMC Decision 7/98; and information exchange, CMC Decision 15/04); crossborder traffic (CMC Decisions 18–19/99 and 14–15/00); the border security control system, SISME (CMC Decisions 20/99 to 26/99 and 18–19/00); trafficking in minors (CMC Decisions 6–7/00); combating economic and financial crimes (CMC Decisions 8–9/00); environmental crimes (CMC Decisions 10–11/00); the illicit trade in radioactive material (CMC Decisions 12–13/00); the exemption from translation of administrative immigration documents (CMC Decisions 44–45/00); the creation of preferential channels for entry in airports (CMC Decisions 46–47/00); and visa exemptions (CMC Decisions 48–49/00).

Although interjurisdictional cooperation has made great strides in MERCOSUR, since 1996 a striking number of norms arising from the meetings of justice ministers are still awaiting transposition, such as the agreements on jurisdiction in consumer relations (Protocol of Santa Maria, CMC Decisions 5–6/97 and 10/96); commercial arbitration (CMC Decision 3/98); extradition (CMC Decisions 15/98); vehicle restitution (CMC Decision 16/99); free legal assistance (CMC Decisions 49–50/00); and jurisdiction in the area of international cargo transport (CMC Decisions 11–12/02).

The norms arising from the ministerial meetings raise two other problems in the area of transposition. The first is that each agreement has its own clause on entry into force, as in ordinary public international law. There are agreements that enter into force solely for those that have deposited the instrument of ratification after the second or third member state has done so. So almost all the norms not considered in force for MERCOSUR are regarded officially in force in two or three member states. The second problem is that the associate members, especially Bolivia and Chile, play an active role in these bodies, but there is no oversight of transposition in these countries. Moreover, each item of normative substance takes two forms: an intra-MERCOSUR agreement and a *MERCOSUR + associate member* accord. Hence, as with the protocol on mutual legal assistance on penal matters (CMC Decision 12/01), a MERCOSUR norm can take effect but the same text is not in force for MERCOSUR, Bolivia and Chile.

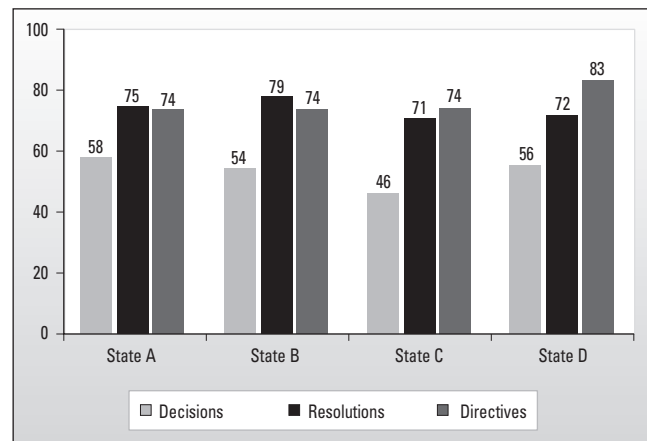
Of course, nontransposition is not a privilege, either for norms that originate in the ministerial meetings or for those concerned with judicial and security issues. Among others, norms still to be transposed include those on important matters such as protection of competition (CMC Decisions 3/98, 18/96, 02/97, 64/00, 04/04); dumping (CMC Decision 11/97); nonmember safeguards (CMC Decisions 19/98 and 07/04); subsidies (CMC Decision 29/00); intra-MERCOSUR trade defense (CMC Decision 22/02); intellectual property (CMC Decision 8/95); services trade (CMC Decisions 13/97, 9/98, 12/98, 56/00, 10/01, 23/03); automotive policy (CMC Decisions 70/00 and 04/01); public tenders (CMC Decision 40/03); social security (CMC Decision 19/97); electrical integration (CMC Decision 10/98); industrial designs (CMC Decision 16/98); education (CMC Decision 5/99); insurance companies (CMC Decisions 8–9/99); gas integration (CMC Decision 10/99); creation of the MERCOSUR visa (CMC Decision 16/03); and emergency mechanisms in the dispute settlement system (CMC Decision 23/04). There are also untransposed norms on apparently less controversial issues, such as the MERCOSUR symbols (CMC Decision 17/02).

**Figure 13.4**

*Interna corporis* norms are less numerous among CMG resolutions and thus represent a near balance between transposed and untransposed norms (see Figures 13.4a and 13.4b).

It is beyond the scope of this chapter to determine precisely why 380 norms—the vast majority of which are strictly technical—have not been transposed (see Figure 13.5). What is striking in the case of the CMG Resolutions is the wide gap between the overall percentage of transposition (49 percent) and the member states' individual average of transposition (between 71 and 79 percent).<sup>18</sup>

In other words, it is not easy to identify the reasons why there are few norms that have not been transposed in at least one of the member states, and a large majority that are easily transposable in two or three members but problematic to transpose in the third or fourth member. On this point, the issue of the

**Figure 13.5 Percentage of Transposition, by Member State**

<sup>18</sup> In the case of the Council, this same comparison would be direct because many of the norms are “agreements” arising from the Ministerial Meetings that have their own clauses on entry into force. Normally these are more favorable to the MERCOSUR system but almost invariably they require later approval by the national parliaments. In the case of the CMG Resolutions, almost all of the norms depend exclusively on transposition by the executive branches.

intragovernmental distribution of authority to transpose recurs. Equally true, however, is that domestic determinants condition the attitude of each government toward certain norms on sensitive matters; these can be studied only on a case-by-case basis, using an approach that is more sociological than juridical.

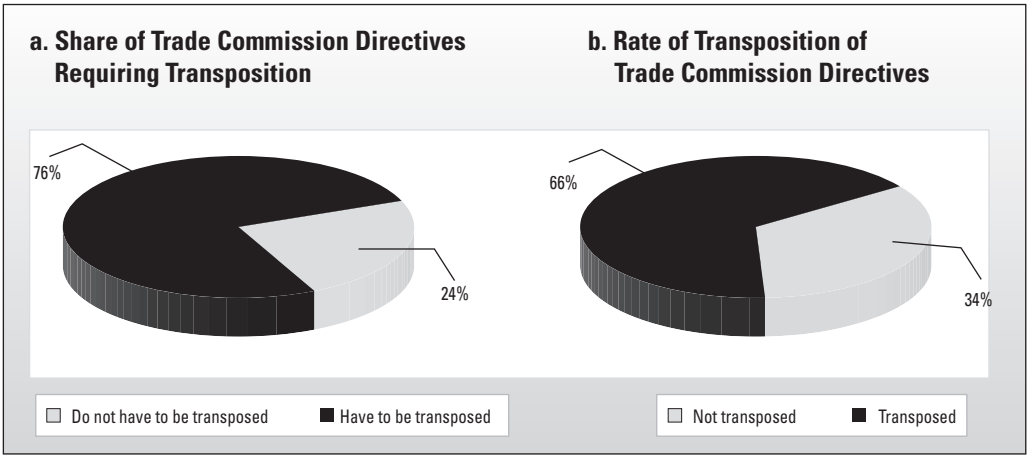
Which countries find it most difficult to transpose MERCOSUR norms? For some answers, see Figure 13.5, which shows that the individual member states have similar levels of transposed norms: the slight variation in rates is not seriously asymmetrical. There is, then, not so much quantitative asymmetry as qualitative asymmetry. While all the members transpose norms to a similar degree, they transpose different norms. In light of our remarks at the outset of this chapter—especially the fact that the simultaneous entry into force foreseen by the OPP is a juridical fiction (and thus a normative act by the executive branch is promptly and fully in effect once it is published)—the outcome is a true cubist mosaic of norms in effect. At the same time, it is important to note that Brazil and Uruguay have slightly higher rates of transposition, a circumstance that belies a possible automatic link between economic asymmetry and difficulties in transposing norms.

Still to be addressed is the work of the Trade Commission, the institution responsible for managing MERCOSUR’s trade policy and one with some authority in dispute settlement. This is seen as the most efficient body, a view supported by its figures on transposition (see Figure 13.6).

Most of the untransposed directives are rulings on tariffs and regulations on integrated border control.

Among the MERCOSUR member states, there is no doubt that immediate applicability (in other words, exemption from the transposition to domestic law) for norms that do not require legislative approval is the only way of avoiding this cubist mosaic of norms’ effectiveness. Any citizen or business may directly invoke into law a norm that does not require intermediate mechanisms to enter into force. That benefit would cover the vast majority of MERCOSUR norms, as is evident from Figure 13.7.

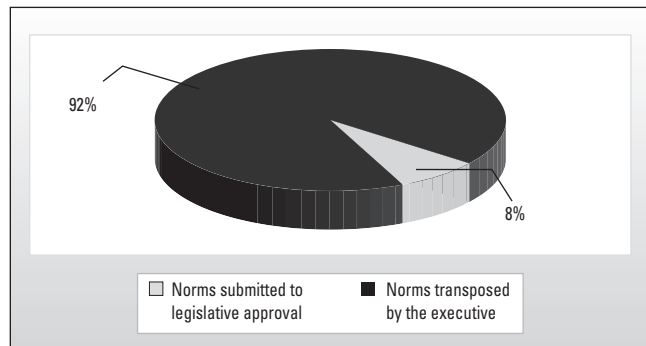
**Figure 13.6**



A MERCOSUR Parliament—which should take place in 2006 as foreseen in CMC Decision 49/04—will eventually solve the problem of transposing norms that need parliamentary approval, thanks to legislative harmonization and faster national bureaucratic procedures for transposing norms.

The transposition of norms allows individuals or economic actors to invoke MERCOSUR law in their own jurisdiction. The transposition problem is therefore related on the one hand to citizenship but on the other hand to juridical security—an economic factor of great importance. The limitations of MERCOSUR's dispute settlement system are linked to the transposition deficit. There can be no doubt that arbitration rulings contributed to MERCOSUR's institutional development, because they recognized the existence of MERCOSUR law, placed limits on the flexibility of trade liberalization, and dared to make provision for sanctions against the strongest member states. But these rulings emerge from a system to which individuals cannot easily gain access. In the event that a member state endorses an individual's legal claim, moreover, the matter becomes a semidiplomatic, semijudicial arrangement in which only governments can move with relative ease. The perspective on the transposition of norms thus remains markedly national.

**Figure 13.7 Norms Submitted to Legislative Approval**



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## INTEGRATION AND TRADE

Regional integration among asymmetric countries is a hot and burning policy topic worldwide. *Deepening Integration in MERCOSUR* analyzes the most important issues of economic integration and policy coordination that countries face as they advance towards deeper integration and are urged to address development disparities among partner countries. To provide a concrete angle to the investigation, the chapters herein focus on the experience of the Southern Common Market (MERCOSUR). However, the lessons learned are valuable to other integration agreements—particularly of the South-South type—such as the Andean Community or the Central American Common Market. The contributors to the volume are highly regarded economists from Europe and Latin America, selected for their international experience, expertise in the field and innovative work.



978-1-59782-072-1

ISBN 1-59782-072-5



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