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Deepening Integration of MERCOSUR: Dealing with Disparities

Regional Competitiveness Policies for Deeper Integration in Mercosul

Renato G. Flôres, Jr

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REGIONAL COMPETITIVENESS POLICIES FOR DEEPER INTEGRATION IN MERCOSUL

Renato G. Flôres, Jr.*

I INTRODUCTION: DEEPENING MERCOSUL'S INTEGRATION AND DEALING WITH ITS DISPARITIES.

A. A few qualifications

Mercosul is a young and highly asymmetric integration effort. The first characteristic means that it needs time to solve or at least accommodate, within the integration framework, most of its numerous problems. With all the imperfections that lie in comparisons - and aware that "times have changed", even in terms of the speed and comprehensiveness of economic events -, a look at the state of the European project in 1969 wouldn't leave Mercosul in a very bad situation. A short history also means that convergence of preferences at the micro level hasn't been achieved in many instances yet, and that a variety of common initiatives are still in search of a solid ground where to be founded.

"Mercosul bashing" or engaging in often vapid, philosophical debates on the integration, are two faces of an anxiety that, if well-intentioned, merely reveals a lack of historical perspective, an ignorance of the mechanisms that, day by day, slowly forge the integration links. As any premature will of fulfilment, beyond a waste of time, it can only lead to frustration. Part of nowadays problems, provided a minimum of "environmental conditions" are created or sustained, in order to let the integration forces do their job, will eventually find if not a positive, very likely a second best solution. Though this, by any means, is supposed to make a pledge for a passive attitude towards the process, it serves however to remind that, nearly all questions under the heading of this project won't be solely equated by the *fiat* of a governmental or institutional initiative, how carefully crafted it might be.

The asymmetry is a big problem. In overall terms, it boils down many times to a tiring dialog between Argentina and Brazil, in which, not infrequently, one turns a deaf ear to the other's arguments. No third party exists to divert tensions or introduce the possibility of a combinatorics of alliances that would change the monotone conflict between the two main partners. This gives a very special character to the question of the disparities. In the early EU of six, four powers of approximately equivalent status – Western Germany, France, Italy and the Benelux – were the actors of the integration quarrels and disagreements. In

* I'm indebted to many people in writing this report, the contribution of some being directly acknowledged in the text. The participants at the February and July seminars, in Washington, D.C. and Rio, respectively, played a major role in obliging me to sharpen the arguments and proposals, expanding my perception of the different issues at stake. Eduardo Fernandez-Arias and Mauricio Mesquita Moreira were most instrumental in this; Mauricio, in a role that is becoming traditional, acted as a constructive counter-point to my optimism and an always precise critic of the weaker points in the text. I entertained long and open-minded conversations on the spirit and form of the project with Paolo Giordano and Robert Devlin, which were very helpful and creative. Robert also suggested some fine points and specific references to minimise both my ignorance and preaching. Stephan Krier, the distinguished German consul at Rio de Janeiro, passed me interesting insights out of his knowledge and enthusiasm for both the EU and Mercosul. Of course, I remain the plain, blunt author, solely responsible for everything that follows.

spite of the crucial French-German relationship, different combinations occurred for different problems; tensions among members were usually eased and dispersed. In the event of a disparity, ideas and contributions from more than one source would help in finding a solution. In Mercosul, disparities either lie in one of the smaller members or in one of the two big ones. In the former case, they have a lower priority, and are usually translated into a demand for either exceptions or funds. In the latter, they are an additional item in the agenda of conflicts, being confined to a bilateral dialog often unproductive, for lack of alternative voices.

As long as Mercosul remains at the present quadrilateral geometry, this is an unavoidable, perhaps unfortunate, reality. Such reality gives a different nuance to well-tested ideas, in other contexts, to deal with disparities. Solutions that worked for a small community of countries may not work for Mercosul; here, the disparity becomes a liability in the bilateral agenda of the big country that suffers from it and, often, a negotiating asset in the one of the opposite member, nothing else.

There is no policy space in such a tit-for-tat game, no room for encompassing solutions. The only way to minimise these outcomes, if the geometry remains unchanged, is to enhance the integration instruments. The progressive establishment and consolidation of the basic integration devices shall counteract this tendency that many Mercosul questions have: to become another subject for the Argentina-Brazil recurrent exchange of shocks, complaints and, even sometimes, ungentlemanly behaviour. That is why part of the regional competitiveness policies in this paper are still simply policies for deepening the integration.

Actually, given the income distribution of Mercosul countries, no policy will efface the disparities, though some may make room for their being treated in a fairer way, from a regional viewpoint. Moreover, a healthier, deeper and more transparent integration drive may help in partially turning the disparities into a positive force. Indeed, the smaller members may have an incentive to become 'model members', constraining the bigger partners to the line of duty and to a fairer conduct. In this vein, Uruguay should be given the certainty of concentrating all new or enlarged institutions of the bloc, while Paraguay should be given a better position to claim the equalising rewards deserved by its active adherence to the process.

B. Two or three points on methodology

Deepening Mercosul's integration, in a context of enhancing regional competitiveness, requires important additional moves from the four partners, beyond the strict observance of rules and a final liberalisation schedule leading to a full customs union. Progress in the juridical area, after the key step represented by the *Protocolo de Olivos*, and the even more important one by the formal establishment of the Asunción Court in 2004, is a fundamental dimension to be pursued. Though we shall not concentrate in this dimension, it will be brought forth quite a few times, as an unavoidable background strategy to secure the sustainability and due enforcement of any proposal.

We identify three important axes where co-ordination of national policies and the creation of common, *regional* ones are an urgent task:

i) policies for ensuring the definitive establishment of the customs union and creating a sustainable and unencumbered free trade environment within Mercosul national borders;

ii) individual members' industrial and competitiveness policies and their relation to a common, regional competitiveness policy, including more specific national policies and fiscal incentives, as related to investment issues (both FDI and intra-bloc). An analysis of part of this question has been conducted by Kosacoff (2005), to whose results we shall later refer. In this item, a special emphasis is given to the investment question, due to its relevance in the region;

iii) regional funds that – in conjunction with the two previous points – would help less-developed areas *hurt by the integration* and strengthen the cohesion of the bloc, as a social economic unit.

When dealing with the three points above, particularly i) and ii), two different aspects must be taken into account. One is how to co-ordinate the existing national policies, in order to minimise the probability of conflicts and impairments to deeper integration. This implies identifying the national policies that should be in place or reformed, even eliminated, in order to allow for the successful implementation of the regional proposals[1]. The other is how to design really *common* policies, as in the European Union (EU) experiment, that would effectively further integration. Moreover, identification of the available – or to be created – instruments to achieve the goals of the common policies is also a must.

We have tried to exploit these issues in a creative way. Though we shall take into account the present situation, our main purpose is to produce ideas and suggestions for the common pursuits. The Regional Policies here outlined should be considered as such. They could also act as a provocative, starting point for a debate on which are going to be really feasible and effective. To help in this, we have singled out, in section 6, the "core policies", as opposed to less important ones. Anyhow, a more detailed description of those actually chosen will be required in a subsequent phase.

It may seem to some that we have put forward an ambitious and utopian proposal. Though the latter was not our purpose, we acknowledge having chosen to push the limits of the possible to force agents, decision-makers and all those involved in Mercosul to take bold steps forward. Without this, the common market project may muddle through a perverse mix of internal and external pressures, and we would not like to imagine what its future would be.

It is also worth reminding that part of the main issues in this report have drawn attention since at least 1994 - when the establishment of the free trade area looked as a promising start -, not to mention pioneering reflexions like Ferrer e Lavagna (1992). Actually, perhaps

[1] Such a task can be a huge one, and though we try to tackle it here, it goes beyond the scope of this report. Moreover, it should be complemented with a political economy analysis relating the *supply* of policies here outlined with the *actual demand* – constrained by the main lobbies – in the four members.

most in the following lines is not really new, as many of the ideas here have surfaced, in various guises and contexts, during the past ten years. The way they are tied together and advocated is maybe the major contribution of this paper.

C. Assumptions

We adopt throughout an apparently evident but key working assumption, namely that Mercosul is a reality and that there will be no round turn, its main goal being to achieve a common market among its members, as stated in Art. 1 of the Asunción Treaty. This neither denies the difficulties inherent to such undertaking, nor the different views on how to achieve and configure it nor, lastly, the right to contradict the assumption itself. But we do not put in check the common market goal.

The second assumption encompasses the certainty that sector-specific initiatives in progress, which have a tremendous impact on integration, will continue their due course. Perhaps the best example is the joint (even South American) efforts for infrastructure building or enhancing. Several projects exist[2], that clearly make for *regional* measures, related to the issues in this report. The proposals below are, to a certain extent, an addition to such ventures; all consider fundamental their maintenance and, eventually, completion, and many will interact with them.

Finally, our ideas touch, sometimes lightly, sometimes not, on the issue of supranationality, a concept behind any sound measure to advance a regional integration. Supranationality *per se* is usually addressed in legal or juridical contexts; however, as all suggestions presented here, either economic or institutional, involve it, a first main concern regarding their implementation is: *to what extent is the amount of supranationality required (by this measure) palatable to Mercosul members* ?

Until the recent past, the members' attitudes towards supranationality have not been homogenous, with Argentina being perhaps the one most open to accept it, under an international public law perspective. Brazil has been by far the most reactive one, with episodes like the famous "Carta Rogatória n° 7618, da República Argentina" case, when the Brazilian Supreme Court[3] revealed itself fairly unwilling to back the resolutions in the Las Leñas and Buenos Aires protocols, spreading disappointment among the other members (see, for instance, Magalhães (2000)). All this raises concrete doubts on the extent to which the members will waive their sovereignty rights in favour of deeper integration.

However, we *do believe that,* though an issue, the supranationality question is not a stumbling block, and much can advance while a more mature view on it takes shape in Mercosul. Intelligent use of the subsidiarity principle, through which national policies become functional for regional objectives, is a way to appease supranationality concerns. We shall exemplify this in a later section.

[2] IADB itself being involved, together with CAF, Fonplata and the Brazilian BNDES, in the successful IIRSA initiative, launched by the South-American Presidents in 2000.
[3] The *Supremo Tribunal Federal* – STF.

D. Theory

Nearly all issues covered in this report can be modelled in a way or other. In particular, Rodrik (2004a, b), inspired on insights from the theoretical model in Hausmann and Rodrik (2003)[4], has recently presented a set of ideas that we find suitable to address the crucial questions of priority and timing of the different policies we propose.

As for two other theoretical areas that might shed light on the problems treated here we have a few reservations. The first is economic geography models in general. Though bright and perceptive, these models are usually based on somehow too restrictive assumptions, beyond having only in the recent past started to be submitted to rigorous empirical testing. Moreover, the deep fundamental asymmetries in Mercosul, previously treated in 1.1, invalidate most of their usual findings[5]. Even so, fundamental principles on the spatial agglomeration and dispersion forces must be taken into consideration when designing and monitoring policies related to competitiveness enhancing and regional aid.

The other area is trade models for South-South integration. There is an inkling, backed by a couple of modelling exercises, that such initiatives are doomed to failure and frustration. Though again elegant and creative, such exercises dwell on a rather schematic Ricardian framework and, if contributing to the debate, cannot be transformed into an argument opposing South-South to North-South integration. A lucid comment, raising some of the various issues at stake in judging this question, can be found in IDB (2005)[6], while an encompassing, authoritative and constructive critique of economic geography models in general is Neary (2001).

The above points should be regarded as an extra incentive to contribute to these fields of research; a most compelling task that, in our view, is beyond the scope of this work. We have adopted here a minimalist and *realpolitik* view of the regional policy themes to be tackled, aiming first and foremost at constructing a meaningful, useful and feasible agenda. Aware of the relevance and interest of the theoretical background, in a few instances, we try to make more explicit the linkages between it and the proposal. This makes only for a starting point to a challenging and very appealing job to which, in due time, we hope to rank among the pursuers.

E. Structure of the text

The text is organised as follows. We first describe the measures related to each of the three items, in separate sections. In section 5 we add two background policies to complement the proposal, while section 6 deals with implementation in a broad way. By this we mean not only a little more detailed schedule for the different policies, taking into account their interrelations, but rather a more careful consideration of the sequential logic of the various initiatives. Instruments also receive attention, in a broad perspective. As a foremost item in

[4] Based on a two-periods general equilibrium framework for a small economy.
[5] In the encompassing initiative, of which this project is part, attempts will be made to formally deal with this key Mercosul characteristic.
[6] Precisely in the last chapter of the study, at footnote 21.

this, we strongly make an institutional point involving the Secretariat. The key and usually forgotten (by economists) duality - and integration tool – *supranationality versus subsidiarity* is also brought to the discussion. Section 7 concludes.

The main message behind the proposals is that the road to a common market is not dispensed as a gift; it neither appears by chance nor as the consequence of a smooth, continuous process. Paving the way to deeper integration means fighting against contrary, powerful trends and groups, and requires the absolute conviction of its need, expressed in a steadfast political will to make, bit by bit, the needed results come true.

II DIMENSION 1: REGIONAL POLICIES RELATED TO THE TRADE FLOWS

It is simply impossible to have a true common market if internal trade doesn't take place in an unconstrained and sustainable flow, very close to the ideal of free trade. Though, in our view, progress continues to occur in this dimension, even if recently at a slow, if not despairingly pace, we identify a set of *regional* policies that, beyond improving on the present situation, are actually a must for creating the desirable trade environment.

Without completing the measures outlined below, it will be senseless to talk about regional competitiveness policies, as any such policy will find either a barrier or a slippery field in one of the unfinished tasks of the customs union. In this way, using the image coined by the Cecchini report, Cecchini (1988), the 'cost of the non-customs union' is that it mars the adoption of further integration pursuits.

Most of the four initiatives below have been started or tried somehow, being then "forgotten" or "left aside"; some are being pursued and should be enlarged, and one is perhaps new:

p1.1 *A revision of the CET.*

The Ouro Preto Protocol is a full ten years old, and the CET it produced reflected, for the good or evil, the political economy at the time[7]. Since then, perforations have occurred, delays have been asked and taken place – even if not exactly allowed -, increases and statistical taxes raised; all in such an amount that sceptics spent a few tons of ink proclaiming[8] the death of the Ouro Preto CET.

It is high time that members face a courageous revision of the CET – of course with a downward bias – to secure a more consistent customs union. We highlight two important points concerning this revision. The first is the *capital goods issue*; being well known that Brazilian pressures kept tariffs for these goods high, relative to their value in the other

[7] See, among others, Calfat et al. (2003). Some authors go even beyond and consider the present CET as responsible for not only deepening the asymmetries inside the bloc, as concentrating the costs of trade diversion on the smaller and the benefits on the larger members.
[8] Sometimes with a faintly disguised joy.

members. Brazil must be bold here and agree to lower the existing levels, as there are evidences that this was a serious source of impairments for its partners. The other is the Doha Round, which will have as one of its outcomes a new list of tariff concessions agreed among WTO members.

The above facts raise the issue of the right time to discuss and implement the revision. Some are favourable to its starting soon, without waiting for any advances in ongoing regional agreements and, more specifically, the results of the Doha Round. Moreover, at the WTO, one can always count with the flexibility allowed for the difference between bound and actual tariff values. We don't share this view. First, there seems to be no scope for simultaneously addressing the WTO and CET negotiations. In particular, demands in the WTO NAMA[9] group are due to escalate and, at least till the December 2005 Hong Kong Ministerial, Mercosul negotiators will be involved in the delicate *quid pro quo* that will (hopefully) deliver a minimum progress in the agricultural liberalisation. On one hand, the (quite naïve) device of slicing the fat between bound and actual values clearly won't satisfy developed countries *demandeurs,* on the other hand Argentina and Brazil are, in a very encouraging way, sitting down together in order to try to design, if not a common, a rather close negotiating front. An as-concerted-as-possible stance, in the agricultural and NAMA negotiations in Geneva by Mercosul members, will certainly ease the further review of the CET. This turns this year's efforts into a main exercise for the CET revision. Moreover, serious studies and debates should be made and promoted *before the revision starts*, in order to lessen the sheer protection forces that will unavoidably come up.

These points make for the revision to be scheduled not before the first semester of 2006 or, more realistically, the second one, when the outcome of the Round might be foreseeable, and the public and learned opinion will be ripe for a decision.

p1.2 *Definitive establishment of the mechanisms of collection and (re)distribution of the CET revenues*

Though apparently obvious that the CET should be collected only once, this is not the case yet for many goods. Red tape, lack of (supposedly already completed) full harmonisation of customs procedures, additional complications due to differing rules of origin, indeed a variety of motives account for this disparity, which is a constant source of complaint by foreign investors in the integration space.

The Montevideo Secretariat, aware of this, has been pursuing studies and efforts in this direction; the Common Market Council, in its December, 2004 meeting, approved Decision CMC 54/04, regarding the conduct of studies on this subject. These are in progress and must be strongly supported. The redistribution issue must be settled and the required streamlining put in a serious timetable, to clear this file for good.

p1.3 *Definitive establishment of a Safeguards and Antidumping Protocol*

[9] Non-Agricultural (goods) Market Access.

Whatever happened to the Safeguards and Antidumping Protocol ? Opposition, first by Brazil and then by Argentina, stalled the discussions and the formerly proposed texts must be lying in a drawer somewhere. Recent attrition between Brazil and Argentina – concerning Argentinean imports of Brazilian manufactured electric appliances – obliged the adoption of a half-baked safeguards *entente,* in the December meeting of the Council, with discussions supposed to continue until February, this year, encompassing also distorting subsidies and incentives for investment attraction[10]. This had a flavour of a piecemeal, far from desirable approach, as it later proved to be.

Argentina then tabled a proposal in which import quotas would be adopted, to compensate for disequilibria triggered by divergences in the economic cycles or in the exchange-rate evolution. The quotas wouldn't be inferior to the simple average of the market share of the exporting member in the apparent consumption of the impaired partner in the past three years. They would be allowed for renewable periods of six months, whenever the disequilibria would last. Discussions continue to evolve, with Paraguay – holding now the Presidency of Mercosul – having tried to find an intermediate but conclusive text.

It is of course inconceivable to try to deepen the integration without a clear and reasonably encompassing protocol on basic contingent protection mechanisms, that would reassure partners against damaging exports from others and *avoid, or rather, abolish the use of recourse to the WTO in these cases.* The two bigger members must display maturity and goodwill and come to terms in a way to make it come true.

The Argentine proposal has the merit of putting forward a concrete, new (?) proposal, but it has serious shortcomings. The threshold values that would trigger the automatic enforcement of safeguards – be they in the counter-cyclical or in the exchange rates instances – are not defined, and this is a kind of small print clause that can lead to unending and fruitless discussions. Secondly, it pays lip service to describe the mechanisms, or the serious undertakings that the complainant should put in action in order to, with the aid of the safeguards, try to correct the imbalance. Unfortunately, if right in airing criticisms of this sort, Brazil has been playing a dubious game, having avoided, till of late, a frontal discussion of the ideal content and format of a definitive text.

Rather than devising new formulas, we think that an adaptation of GATT 1994's Article XIX, with the further clarifications contained in the Agreement on Safeguards of the Uruguay Round, WTO (1994), would do a good job. The final text could also combine ideas in Arts. XI and XII. Indeed, some points of the Argentine idea, like the allowance of quotas instead of total suspension of imports and the shorter initial period of six months could be kept, but definition of "serious injury" and of renewal conditions should follow the WTO framework[11].

The final document must have the legal status of a protocol. In the absence of such document, internal trade flows will ever be subject to the vagaries of harder

[10] See policy **p2.3**, in section 3, below.

[11] It should perhaps be emphasised that we are talking about a Mercosul internal measure; strictly speaking, WTO safeguards are not allowed within even an imperfect customs union like Mercosul. Another question, which should perhaps be postponed at this moment, is the design of *external,* now common, WTO-safeguards, applied by Mercosul against outside exporters.

macroeconomic conditions and the always present demands from less competitive groups of producers[12].

***p1.4** : Implementation and enlargement of the Mercosul Foreign Exchange Clearing House*[13]

A pioneering experience is taking place at present, between Brazil and Argentina, aimed at establishing a clearing mechanism for the bilateral trade payments. Though a sort of compensating system already exists among ALADI[14] members – actually a reciprocal payments system to finance trade among them, co-ordinated by ALADI itself and backed by the respective Central Banks -, what is being created is a full-fledged Clearing House, operated by independent institutions in each country.

The Clearing House would drastically reduce the amount of US dollars needed for settling the flows; taking, for instance, the 1997-1998 years, when bilateral trade peaked, it would reduce, in each year, a total of around 15 bn US$ that flowed both ways to a unilateral flow of around 1 bn US$ from Brazil to Argentina. Conducted by BM&F – *Bolsa Mercantil & de Futuros* in Brazil, and a similar institution in Rosario, Argentina, with the support of the Central Banks of both countries and funds from the very IADB, the first bilateral (trade) clearing house is supposed to be in operation still in 2005. Beyond the drastic reductions in exchange rate operations, this would also mean considerable savings in banking commissions and fees. Of course, the two big members have a volume of trade that justifies the enterprise; however, once the two houses are in operation, at least another one can be established in Uruguay – to deal now with the two flows -, and, in a near future, the system could be extended to Paraguay and, at least, to an associate member, Chile. Measures of this sort are clearly very important to consolidate links that will progressively make partners closer, in a durable (and profitable) way.

III DIMENSION 2: CREATING A TRULY UNITED AREA FOR INVESTMENT AND COMMON COMPETITIVENESS POLICIES

As said, in the second dimension, we decided to single out investment, though this may perhaps be somewhat arbitrary. In any case, industrial policy considerations are indeed meaningless if not tied to investment ones, and so we start with this subject.

A. The investment issue – global points.

Mercosul's record in FDI has ranged from impressive to less impressive periods, though it still can be qualified as an attractive area in world terms. The remarkable size asymmetry

[12] See more on this in sections 3.2, 3.3 and 6.2.
[13] I am indebted to Isney Manoel Rodrigues, Foreign Exchange Director, BM&F, Brazil, for explanations on this project; see also Rodrigues (2005).
[14] ALADI – *Associação/Associación Latino-Americana de Integração/Integración*, also known in English as LAIA – Latin American Integration Association.

between Brazil and its other partners has usually led foreign companies – when either in a Mercosul or South American marketing strategy – to choose the biggest economy. As regards intra-bloc movements, roughly the same pattern has been taking place, with other partners' firms (mostly Argentinean ones) more often delocating to Brazil, especially the São Paulo conurbation. Fiscal wars have either enhanced or altered this global picture, creating further tensions not only between Brazil and Argentina, but in the interior of each country as well.

How to smooth out disparities and better co-ordinate national policies in this area ? One answer, which has been of late greatly favoured by the Argentinean partner, is the establishment of cross-border *production chains* that would build up a closer co-operation environment, able to avoid many of the above mentioned problems. Investment opportunities would then be clearly identified, in detailed geographical terms, and channelled to specific areas, with the common agreement of all those involved in the chain. This option will be discussed in the next sub-section.

Under a more encompassing view, it is our contention that the starting point must be another set of protocols which has been left aside: the '*Protocolo de Colonia para a Promoção e a Proteção Recíproca de Investimentos no Mercosul*', on inter-members investment, signed on January 17, 1994, in Colonia, Uruguay, and the '*Protocolo do Mercosul para a Promoção e Proteção dos Investimentos de Terceiros Estados (Protocolo de Buenos Aires)*', of August 5 of the same year, on the regulation of foreign (i.e., from outside Mercosul) investment flows, including fiscal wars. Both were never adopted, as only Argentina ratified them, in spite of the existence of a GMC – *Grupo do Mercado Comum* Resolution 92, creating a commission for the reciprocal protection of investments. In both cases, the original text has become fairly outdated and new items need to be included.

Beyond the above purely juridical measure, a better integration of the different investment mechanisms must be pursued. In a first approach to this process, main actors should be the Brazilian BNDES (Banco Nacional de Desenvolvimento Econômico e Social) and its Argentinean counterpart, the Agencia de Desarrollo de Inversiones: they could develop joint programmes that would implicitly direct, or encourage, specific investments also geographically determined.

Apart from developments based on these two suggestions, we think unwise to constrain investment opportunities, at the risk of creating an artificial environment that would in fact discourage innovative ventures and the appearance of new opportunities or dynamics. It would indeed be unfortunate to try to solve the investment disparities with either a bold and detailed directive or by enforcing an explicit policy of a *regional* character. This is particularly true in the fiscal wars issue; a problem that even nowadays re-emerged in the EU with the May, 2004 enlargement[15].

Fiscal wars, in Argentina and Brazil, are first a matter of national policies, next, from a distorting subsidies viewpoint, must be tackled by *regional* competition legislation and

[15] Though, of course, in a way not exactly equal as it presents itself in Mercosul. Broadly, what happens there is that taxes in general, in most aspects related to FDI, are lower in the new members.

finally, in the event of a very complex distortion, be the subject of *ad hoc* negotiation. These problems will eventually be attenuated, in the medium to long run, by global fiscal harmonisation measures[16] – something more related to, and dependent of, the macroeconomic harmonisation package – and the consolidation of a more diversified production structure in the integration space. It is silly to 'force' investors to put their money where bureaucrats or regional associations want, and not according to the vagaries of their will or feelings, irrespective of the technical support they might have had.

Notwithstanding, the above considerations don't mean that other, more or less indirect ways do not exist to help alleviate distortions caused either by fiscal wars or excessive concentration of DI in a few spots. They are discussed next.

B. Linkages among the national industrial and competitiveness policies and a common Mercosul initiative.

A realistic analysis of this theme must begin by clearly establishing the limits of top-down policies in creating ideal agglomeration and development processes. The EU experience shows mixed evidences on the combined effect of state aid and community funds in creating welfare improving agglomerations and, sometimes, counter-acting destructive effects of scale, due to deeper integration. Basically, the combination of these policies has secured some equality at the inter-members level, while being unable to slow down, or even avoid, greater intra-members, i.e. at the *regional, internal* rather than at the *national, inter-members* level, inequality and income concentration. Moreover, a trend towards the creation of "black holes" (roughly, agglomerations with just one or a few different sectors, not welfare improving) seems unfortunately evident (see, for instance, Midelfart-Knarvik and Overman (2001)).

A clear champion has nonetheless emerged, Ireland, though its success is certainly also due to other factors[17], while the remaining backwards countries like Greece or, specially, Portugal, which were generously endowed with all kinds of funds, have been showing a far from encouraging performance.

Leaving aside the cohesion or structural aspects of the question – to be discussed in the next section -, consideration of the above elements seems fundamental for designing any Mercosul policy on the subject. Some hypotheses are also needed.

The first is that, more than the possibility of black holes, "desertification" must be feared in the Southern Cone; a phenomenon largely due to the Brazilian asymmetry and the existence of a few powerful centripetal agglomerations. These are São Paulo (first and foremost), Porto Alegre – in relative terms, for the Uruguayan and Argentinean neighbours –, Rio de Janeiro (deserving also, perhaps, to be included) and Buenos Aires, the only sizeable agglomeration outside Brazil.

[16] See the paper by Fernando Rezende in this set of studies.
[17] Including the fact that the national language is English, a key factor, useful for providing, in a contracting-out basis, many services (as call centres, for instance). The (good) domestic education policies were also a plus.

The second is that, contrary to what happens in the European space, with the exception of the agribusiness[18], Mercosul doesn't show yet many internationally competitive regional production networks, having not been positively inserted in any global one either. Adding to this its relatively low competitiveness in services – with the exception perhaps of financial services -, it becomes a little more difficult to set in motion positive-externalities environments through official policies.

Natural associations have been emerging in the integration space. The bulk of the chemical sector is a major example, paper & pulp producers are starting to get closer to each other and even the steel industry, responsible for unfortunate antidumping cases in the interior of the bloc, is beginning to move towards a common view. It could be argued that, all these sectors or sub-sectors are oligopolies which are redefining *together* their position in the enlarged market. Is this bad ? We say it is normal and unavoidable in any integration.

Are, in this context, Mercosul 'production chains' - an old idea brought back by Argentina in the recent years – an answer to this ? In the case of the food sector in general and many agribusiness related activities we say a qualified yes, though it will certainly take sometime till successful chains will eventually 'climb up' to reach the powerful exporting oligopolies in Argentina and Brazil. One interesting point is that, if in sectors like grapes & wine a Mercosul chain seems feasible and self-sufficient, in others, like shoes, a South American chain, even including Mexico, is possible, joining forces to target big markets as the US and the EU. Indeed, our first point regarding 'production chains' is that *they should be pursued in the more pulverised sectors*, those closer to perfect competition. In these "fragmented" sectors, co-ordination failures are more likely within the bloc - islands of small producers may suffer a harsh impact from more competitive rivals, for instance - while at the same time the possibility of production combinations or product specialisation – and, consequently, creative price discrimination – is high.

When we move to the heavier and more technically intensive industrial sectors, the situation gets more complex. Success stories, like EMBRAER, the middle-size aircraft producer, are mostly a typical Brazilian phenomenon, with no or negligible Mercosul spillovers, at least till now. In other areas, like electric and electronic household goods/machines, we witness strong delocations to Brazil, raising protectionist feelings in the other members. Parts of the chemical sector remain fragmented. In spite of such diversity, specific oligopolies will eventually find a common *modus vivendi*. Others may be too small for this or, in a given member, may be suffering from both extra and intra-Mercosul competition. Rather than of help, the latter may be a case for a regional competition authority, if conditions are unfair. Finally, there is the car and automotive industries, that show an upsetting trend of pooling together in one or two black holes whose sustainability – given the footloose character of these sectors – is at least debatable.

A single-minded pursuit for *internal* production chains would be eventually deceptive. The bloc must give equal consideration to how its competitive chains insert themselves in the modern global production logic, in which value-added is segmented along an *international*

[18] And this, basically, in Argentina and Brazil.

chain, usually increasing northwards. With this proviso, we identify three main situations as regards the chain's idea:

i) worth trying, with *perhaps* regional help, in selected sectors of the food and agribusiness related groups, as well as in the traditional (and competitive) manufacturing sectors, typical of most members, like shoes & leather or textiles;

ii) will be established or not, depending on how "the natural forces of integration" will act, in many oligopolistic manufacturing sectors, needing no official, regional intervention;

iii) the automotive sector dilemma must be faced and streamlined. Out of it, certain 'high-tech' or 'heavy industry' production chains may also make sense.

Additionally, the international production logic must be incorporated by enlarging the partners' space. Associations which seem unfeasible or unsustainable in a Mercosul perspective, may become sensible in a South American one or, in a broader and bolder perspective, in a US, EU or even Asian emerging economies-Mercosul alliance. Brazil's industrial relations with Colombia might have as much scope as those with Argentina, the latter may surely become a much closer partner to Chile, and both, for instance, may, could and should tighten production links with the US. As said, at least part of the "regional policies" must have a wider character, going beyond Mercosul's external boundaries. But what would make such initiatives distinct from an individual country's one ? Basically, that their design and related projects would be developed taking Mercosul as a unit, country-based considerations receiving second or no priority. This will inevitably induce a new outlook on the external negotiating agenda, that should seriously take into consideration the integrated production structure.

To make things more complicated, competition law and enforcement still present annoying discrepancies. In spite of advancements triggered by the '*Protocolo de Fortaleza*', on competition[19], the recent crisis has delayed further integration of the Mercosul competition authorities. These efforts must be resumed, in a clear schedule and faster pace, and not only due to the previous discussion, but also in association to policy **p1.3**. Time is ripe for sending a clear sign that competitiveness, be it internally or internationally, is being taken seriously: the creation, in a near future, of a Mercosul Competition Authority.

C. Outlining the policies.

We are now able to present a first draft of the policies related to this dimension:

***p2.1** : Re-discussion and definitive implementation of an investment protocol.*

[19] For earlier views on the protocol and competition in Mercosul, see Flôres (2001) and the encompassing, basic treatment in Silveira (1998).

The Colonia and Buenos Aires Protocols must be re-opened and deepened. One idea would be to unify them in a single protocol, where, among others, the following delicate points should be addressed:

a) the associated dispute settlement mechanism, instead of resorting to the World Bank's International Centre for Settlement of Investment Disputes (ICSID)[20], as both non-adopted protocols did, should refer to the nowadays Mercosul system, greatly improved by the creation of the permanent tribunal in Assunción;

b) regarding fiscal wars, something close and not very beyond the OECD's Code of Conduct for Multinational Enterprises should be implemented, as has been argued by Brazil, regarding the past Argentine complaints on fiscal competition;

c) care and a modern approach should be given to a definition of investment and of the actual scope of the most-favoured-nation and national-treatment concepts for DI within the bloc. Attention must also be paid to the restrictions imposed by WTO's Trade Related Investment Measures (TRIMS) agreement, with due qualifications, if needed, being included in the protocol;

d) finally, Uruguay, under the last Administration, without consulting its Mercosul partners, signed an investment agreement with the US. Though not ratified yet – and being not certain that under President Vazques' it will be -, it is important to examine this agreement to, if feasible and reasonable, accommodate legitimate queries contained in it.

Full adoption by the four members of an instrument in these lines would add confidence to foreign investors and contribute to create an environment for a more co-ordinate and common thinking on investment issues.

***p2.2** : Enhancing Mercosul competitiveness: internationally competitive world linkages.*

This policy aims at securing the establishment of production networks within or comprising Mercosul, that would boost its competitiveness, leading to diversification and upgrading in international value chains. This involves the creation of a strategic approach to competition, that should also help in improving or connecting production chains that would expand Mercosul's export capacity in a few selected industrial sectors.

The last sentence above raises the ticklish issue of how to identify or select the sectors, a point to which there is no clear and indisputable answer. However, under the broad purpose of providing effective incentives to potentially competitive sectors, engaged in innovation and willing to take risks, technical indicators can be used in helping guiding the choice. These would take into account Mercosul potentialities in the international trade flows and also consider the possibility of closing links with partners outside Mercosul, so that vertical

[20] A point that raised concern in more than one of the members that did not internalise the two protocols.

linkages[21] would be created between both sides. Weight would also be given to the potentialities of the sector in supplying the Mercosul market. A brief elaboration of these ideas is presented in the Annex.

As a mandatory requirement, the completion of a few steps, where analysis and identification of candidate sectors, as well as of the national policies concerned, should be conducted. The final, desired outcome would be the implementation of a social process, pooling the technical insights with collective preferences. A *non-exclusive* portfolio of priority sectors could be thus produced, opening opportunities for individual undertakings[22].

Reminding, for instance, that BNDES's budget is bigger than that of the World Bank, it could become one of the agents to open special lines to help concrete developments.

The Mercosul Secretariat would make the connection of the project with national governments, to produce specific directives to reduce red tape and untie bureaucratic requirements that might hinder the operations. The helping measures wouldn't necessarily imply the need of new funds. Grants or credits to exploit new investment or market opportunities, to improve logistics and distribution in general in export operations – existing or new -, and to start new ventures would be channelled to the potential (chosen or approved *ad hoc*) sectors, in the budget of the national agencies and development banks. Dismantling or streamlining of regulations impairing these operations, or a more efficient performance of the same sectors, would be given special and immediate attention. The gist of the proposal lies in co-ordinating the national institutions and government agents with the regional/international targets. Last but not least, a checks and balances mechanism must of course be part of the policy design itself.

***p2.3** : Creation of a Mercosul Directorate of Competition.*

The Directorate of Competition is the longer term policy among those proposed here. It creates a new supranational institution supposed to progressively have a major role in deepening the integration. It is undeniable that, in this instance, we are mimicking the EU experience in this field. Nonetheless, not in the foreseeable future will it be as powerful as the one in Brussels.

The Directorate should be housed in the Secretariat, in Montevideo, and start with a modest structure. Its first responsibilities would be administration of the Safeguards and Antidumping Protocol (see policy **p1.3**) and of the activities related to the Fortaleza Protocol and its developments. Subsidiarity should be strongly used and even encouraged, sheer competition cases being as far as possible dealt with the national legislations. This would reinforce such practices in the smaller countries – Paraguay and Uruguay – and help the integration of the fairly advanced systems in operation in Brazil and Argentina. Moreover, truly Mercosul competition cases are probably still few.

[21] Ideally, upstream and downstream; vertical meaning not necessarily intra-industry trade, though this would also be welcome, either vertical or horizontal.
[22] The priority sectors should be regarded as suggested sectors, they should not have an exclusive character.

Linking to what was said in 3.1 above, the Directorate should also deal with state subsidies and their competition *and* investment distorting effects. It could work as an alternative arbiter in really serious cases of fiscal competition, for instance. The precise characterisation of the situations that would allow its intervention, and the legal requirements for such complaints, must be better thought. The idea is to move, up to a certain level, everything related to competition from the other dispute settlement options to the Directorate.

IV DIMENSION 3: REGIONAL COHESION FUNDS FOR MERCOSUL.

Since the Asunción Treaty, Paraguay has been formulating vehement pledges for the creation of a regional cohesion fund in Mercosul. In an integration project which hadn't properly established its secretariat yet, this couldn't be taken as an urgent demand (even if theoretically so). Nowadays, the situation seems ripe for this kind of measures.

It is hard to imagine the possibility of direct income transfers, within Mercosul, for social purposes. The magnitude of poverty, social inequality, dire housing and health conditions, security and education deficiencies within the member countries is so big that, very likely, any such transfer inter-members would raise fierce opposition in the donating country. Moreover, the giant, in this tale, has clay feet: Brazil is the champion of regional disparities in the region: how could a structural fund channel money to Paraguay and not do the same to most of Maranhão and Piauí, for instance, where poverty is starker than there ? Ironically also, these two Brazilian states are up north, having almost no links with the Southern Cone.

A second problem is that the "richer" members aren't really rich, in world terms. Beyond having not much cash available for contributing to a structural fund in the EU terms, the kind of convergence this could promote is debatable. In the EU, donors were wealthy economies, with much less internal disparities, like Germany, the UK and France, and it made sense to bring countries like Ireland and Spain – that made it -, or Portugal and Greece, to levels closer to theirs. It seems difficult to achieve this conscience in Mercosul.

Additionally, at the national level, to remain in the Brazilian and Argentinean examples, both members have their own instruments to reduce (internal) social inequality, be they the *Fome Zero* Brazilian initiative, or projects conducted by BNDES (Brazil) or the Argentinean government. To this, it must be added development funds received from either international organisations or select countries and agencies.

All previous arguments do not necessarily imply that a cohesion fund, targeted to specific, development enabling objectives, *tied to the integration dynamics,* may not be conceived.

In basic terms, it could accommodate a dual purpose. First, projects or initiatives that complement or further an integration measure *in a backward region*; such projects could range from purely local ones to efforts involving one or more members, *their key* *identifying characteristic being that their output would bring clear benefits to the integration process*. Second, general regionally concentrated aid wouldn't be excluded, but, again, targeted at a specific problem either *caused by* or which is impairing integration. So, if an area in Paraguay or Argentina suffered severe negative impacts due to the closing of activities, as an outcome of a Mercosul re-allocation, structural adjustment help could be provided by the fund.

Both objectives would require a unified ranking of Mercosul regions to be conducted beforehand, and a threshold defined, so that wealthier areas would be excluded from help through the fund. This would put a positive pressure for improving the nowadays still fairly fragmented statistical system[23], making it more adequate to global integration needs. Even in this event, it might be that the whole of Paraguay, or of Uruguay, would sometimes qualify as a structural adjustment area.

The institutional design of the "cohesion fund" cannot be very similar to that of the EU ones[24]. One possibility is to envisage something closer to the CAF, whose capital would be composed by initial endowments from (the four, or the two biggest economies) governments and national financial & development institutions. Other partners, outside the strict Mercosul realm, would be accepted. Chile – or Chilean institutions -, Colombia, CAF itself, European institutions could be admitted. Not all projects would be funded at zero cost; moreover, its annual budget could be increased by a specific integration revenue - the most evident candidate being the CET receipts.

Of course, the cohesion fund will dynamically interact with both previous dimensions, being possibly used to offset or weaken negative effects that may happen in the other cases. Moreover, it bears a certain superposition with **p2.2**, though the latter would be given to a specific firm or entrepreneur, and the former would be translated into a (usually horizontal) aid to a specific geographical area. This raises two questions: whether a new entity should be created to administer the fund or if, again, couldn't it be a separate line of resources, within the same institutions involved in policy **p2.2** ? Moreover, a simpler solution would consist in merging the two ideas and, within policy **p2.2**, open a line giving special priority to projects or initiatives originating from a specific area(s). An even more straightforward implementation, would be bluntly assign this priority to projects originating in Paraguay (and perhaps Uruguay).

Within these still open questions, this policy will be denoted as **p3.1**.

V BACKGROUND POLICIES.

Beyond those policies related to our three chosen dimensions, we envisage two background activities considered to play a key role in weaving a truly integrated tissue among the

[23] As well as poorly disseminated.

[24] It is worth pointing out that in the December 2003 meeting of the Common Market Council, decision CMC 27/03, to promote studies on the establishment of structural funds to help poorer areas and the smaller Mercosul economies, was approved. Masi and Hoste (1992) are one among a half dozen of papers to also treat this subject.

different Mercosul agents. If the first is perhaps more complex, the second doesn't present many implementation problems:

pb.1 *Support to the Asunción Court and pro-active dissemination, management and control of the Mercosul juridical acquis.*

Very few people know the Olivos Protocol, less even are aware of the existence of the Asunción Court and don't have the least idea on how it could help them, or how to use it. The few who know it are unable to say whether the 'old' Dispute Settlement procedure through arbitrage is over or not.
Many of the policies in this paper are anchored on protocols or other legal documents, either existing or to be completed or created; finding the text of a Mercosul protocol is not very easy for an interested layman, the follow-up of signed/not-signed protocols is obscure, and quite often even lawyers don't know whether they have already come into force or not.

Transparency, dissemination and *marketing* are urgently needed in the management of the juridical *acquis*, and better administrative control of deadlines and documents' flow in general would be most welcome. This policy should materialise in a few very concrete initiatives: a "Know the Mercosul" campaign, which would bring to chosen segments of society a basic knowledge of the rights, obligations and facilities within the common market, and a streamlining and upgrading of the management systems, where transparency would be given top priority. Both initiatives, among others alike, should be pursued under the responsibility and co-ordination of the Montevideo Secretariat.

pb.2 *Establishing a Human Capital Mobility (HCM) Project in Mercosul.*

Mercosul counts, in its main cities, with good universities and research centres that could be used to host young PhD's or offer this degree to students from other members' units. It also has a need of qualified technicians, for the development and technological upgrade of many of its productive activities.

The HCM Project is one among a few possible educational policies that would contribute, in the long run, to strengthening the integration links, by creating closer ties within its technical, scientific and university community. In the beginning, two kinds of interchanges could be envisaged: PhD students and young PhD's, who would receive support for a one to two years stay in a centre in a country different from the one of their origin, and specialised technicians able to receive support for training periods in a factory or productive unit in another member country.

Funding from the project itself could be minimum, if co-ordination with the national research councils and sectoral associations is properly done. The mobility would be supported for researchers/technicians in pre-determined areas, which, preferably, should match key export sectors (comprised also in **p2.2**) as well as a few social sciences and humanities specialities. Focus would probably be on biotechnology, food industries, engineering, as well as education sciences, sociology and history.

VI IMPLEMENTATION.

A. A basic instrument - the relevance of the Montevideo Secretariat.

One thing becomes evident if a portfolio like the one previously outlined is adopted and set in motion: most initiatives should be co-ordinated by, or at least located at the *Secretaria*, in Montevideo, but its present size and staff are clearly insufficient for absorbing these responsibilities. This is a fact that will occur anyhow, *irrespective of the specific policies chosen,* if members really want to pursue combined *regional* efforts to deepen integration and alleviate the impact of asymmetries.

Considerable power must thus be given to the Secretariat, that will need extra human and capital resources. We don't think this should be singled out as an extra policy, as the Secretariat actually is – or should be - *the key instrument for policy implementation*. It can progressively acquire its extra responsibilities, while the policies themselves are being implemented (as scheduled below), funds coming mostly from their respective budgets.

Moreover, simple measures can be quickly taken. One relates to the perhaps oversized ALADI staff now existing in Montevideo. The four members could unify their representation at ALADI and merely transfer part of their nationals there to the Secretariat, adding in an easy and cost-effective way to its scarce human resources.

Another undertaking of this kind is inspired by an EU procedure regarding its rotating presidencies. Each Mercosul country during its turn at the Presidency should establish, at the respective Ministry for Foreign Affairs, a small task force to assist it along the six months period. The task force, in a way similar to what happens in the EU, should include a national (probably a diplomat) of the past one and another of the next one; moreover, each period, a member of the technical staff of the Secretariat should be designated as go-between, participating in as many as possible meetings and activities of the task force and caring for its close connections with Montevideo. This would smooth transitions, improve control and continuity of decisions, measures and projects, and develop a greater understanding and sympathy bonds among the four Ministries and the Secretariat[25].

The Secretariat will also house the Competition Director – and its Directorate – who should answer to the Secretary. This implies that choosing the Secretary will become a much more serious issue; the position will gain considerable power as integration progresses and will have *under* its responsibility equally important jobs, as the Competition Director himself. Political maturity is being here urgently required from the four members.

Without systematically focusing on the Secretariat, and making it, *par default et excellence,* the locus of all activities related to the policies, the Mercosul project won't gain either credibility or efficiency. On the other hand, greater managerial stress will be put on Montevideo and, even if the costs of 'housing' each policy will mostly come from the

[25] I am indebted to Ambassador Hans Ulrich Spohn for explaining me the procedures of the EU presidencies and making interesting suggestions on the theme of this subsection.

policies' own funds, the Secretariat budget will need a reinforcement. Here international organisations or the EC could co-operate.

B. Using supranationality and subsidiarity wisely – the question of compatibility.

What are the likely criticisms that the proposal here outlined could face ? A single one stands out as the main barrier: the cession of national sovereignty that has consistently blocked many needed developments in Mercosul. In other words, will the supranational enter more deeply in the Mercosul architecture ? To answer this question we start by focusing on the policies where *supranationality demands* will be more dramatic. They seem to be **p1.3**, **p2.3** and (**p2.2** +) **p3.1**. We shall analyse these requirements in a little more depth, trying to indicate the path to be followed:

* the 'Safeguards and Antidumping Protocol' (**p1.3**) got stalled already due to serious oppositions in Argentina and Brazil; it is, however, fundamental for the smooth (and credible) operation of the core policies in this proposal. It has also an additional implication that may explain part of the heightened reactions it continues to arouse: it signals the definitive start of a common Mercosul trade policy, that will eventually lead to a common negotiating voice in Geneva (at least as regards market access in goods). This triggers fears and insecurity not only in the bigger members, Uruguay, for instance, under former President Jorge Battle, having tried to display an independent foreign trade policy. It is our view that this policy is a litmus test of the concern members will give to this common goal, and so, there should be no half measures here: significant effort and skills should be applied to succeed in (signing and) adopting the Protocol;

* the Competition Directorate (**p2.3**), though broader and more ambitious than the former policy, poses less problems in our view. Competition authorities in Argentina and Brazil are well aware that this will be needed someday, and the EU experience is very well regarded world-wide. Implementation here should progress as said in 3.2: once anchored in **p1.3**, the Directorate should begin its activities leaning heavily *to the subsidiarity side*, giving as much as possible weight to the national legislations and courts; this would greatly help in minimising conflicts and contrary forces;

* finally, the 'Cohesion Fund' (**p3.1**) may certainly raise delicate supranationality questions – beyond other oppositions -, but they will be highly dependent on its final institutional arrangement. Will it have 'shareholders' or be a fully institutional unit under the Secretariat ? Will it be an arm of **p2.2** ? In the former case, a structure which would give a reasonably prominent place to the main national development (or funding) agencies would be more palatable in all sovereignty issues involved in its creation. At present, given the manifold reactions it might raise, we favour starting this policy in the more restricted way mentioned at the end of section 4: as a special priority to projects involving Paraguay. This will set "the fund" reasonably apart from the EU concept; *cohesion* boiling down to the restrict meaning of an explicit support to Paraguay.

Supranationality concerns are not only present in the specific doubts (or reactions) raised by the implementation of measures as the three above; it is always on the table when deepening an integration. Bending national governments to concede to Mercosul authorities a little portion of their sovereignty needs more than a nicely designed integration project. Background policy **pb.1** must incorporate this theme in its 'marketing activities' and, while Argentina and Paraguay have - either officially[26] or informally - a position favourable to give precedence to (adopted) international treaties over national law, a more encompassing work will have to be done in Uruguay and, specially, Brazil.

A related dimension is to which extent national policies would conflict with an envisaged regional initiative. The Kosacoff (2005) study analysed this issue by classifying policies along four categories: export promotion, investment promotion, capacity and performance enhancement. For each identified national policy, in each category, its impact on the integration – from positive to negative – was *qualitatively* evaluated. Inspection of the eight resulting matrices (four for each member) reveals that Brazil, Uruguay and Paraguay may be the sources of more incompatibilities[27]; even so, a less-serious-than-expected picture appears.

Brazil's more negative measures are in the investment promotion category, while Uruguay's and Paraguay's relate to export promotion. Uruguay – ironically confirming insights from the econometric findings in Calfat et al. (2003) and similar studies – is the champion of sector targeted initiatives, involving wine, sugar, rice, chocolates and dairy products, among others. Dismantling these structures is a stepwise task, only feasible if the basic legal instruments and organisms – at the level of the bloc, are clearly established.

C. Timing and interrelationships: a first schedule for the ten activities.

The different policies are naturally related either through mutual interactions or causality links. The core of the proposal lies in **p1.3, p2.2**, **p2.3** and **p3.1**; the last three bear a strong interaction and should be pursued under full mutual communication. All the remaining ones should be considered as enabling measures, be they direct pre-conditions for the core ones or not.

The main causal relations among the eight undertakings and **pb.1** are:

$\{$ **p1.1**, **p1.2**, **p1.3**, **p2.1**, **pb.1** $\} \Rightarrow \{$ **p2.2** $\Leftrightarrow$ **p2.3** $\}$
$\{$ **p1.1**, **p1.2**, **p2.1**, **p2.3** $\} \Rightarrow \{$ **p3.1** ;

the key interaction being, as said,

$$\mathbf{p2.2} \Leftrightarrow \mathbf{p2.3} \Leftrightarrow \mathbf{p3.1.}$$

[26] In this case, explicitly in the Constitution, as happens in Argentina.
[27] Distorting policies in Argentina usually have a geographical character, being related to the Tierra del Fuego, Patagonia and La Rioja regions.

Given this, a first, tentative schedule can be produced. Exhibit 1 shows the evolution and duration of all proposed activities. We used as starting date October, 1, 2005, and time, in the table, is counted in quarters (at the top of each column, the first month of the respective quarter is indicated).

The causality relations above mean that, sometimes, the policy in the left must not necessarily be fully completed, but rather well-advanced, before the other in the right begins. This is the case, for instance, with **p1.3** (the 'Safeguards and Antidumping Protocol') and **p2.3** (the 'Competition Directorate'). As shown in the Exhibit, we plan nine months for resuming discussions, closing them, signing and (fully) adopting the protocol, with June 30, 2006 as deadline. Thus, the Directorate could be officially launched in July 2006 when, in principle, full adoption of the Protocol would be near. In a similar way, **p3.1** – even in its simpler form - would only start after a three-months operation of **p2.2.**

Policy **p1.4** (the 'Clearing House'), as said, has its own timing and is already in progress. We are however proposing that, by December 2006, the system between Argentina and Brazil will be fully in operation and, at least, incorporation of Uruguay will be well-advanced.

Exhibit 1: Scheduling the proposal.

Policies	Quarters					
	Oct05	Jan06	Apr06	Jul06	Oct06	Jan07
p1.1[1]				xxxxxx	xxxxxx	
p1.2	xxxxxx	xxxxxx	xxxxxx	xxxxxx		
p1.3		xxxxxx	xxxxxx	xxxxxx		
p1.4	xxxxxx	xxxxxx	xxxxxx	xxxxxx	xxxxxx	xxxxxx
p2.1[2]			xxxxxx	xxxxxx	xxxxxx	
p2.2				xxxxxx	xxxxxx	xxxxx--->
p2.3				xxxxxx	xxxxxx	xxxxx--->
p3.1					xxxxxx	xxxxx--->
pb.1[3]	xxxxxx	xxxxxx	xxxxxx	xxxxxx	xxx	xxx
pb.2			xxxxxx	xxxxxx	xxxxxx	xxxxx--->

Notes: [1] unless otherwise signed, the policy/activity will be completed by the end of the last quarter where the sequence of x's appears (see also the next notes); [2] the arrow at the last quarter means that the policy will continue beyond the time limit in the table (March, 2007); [3] this policy can be maintained, in a continuous base, though with less intensity.

VII FINAL CONSIDERATIONS.

Out of the ten policies here described, most need additional detailing, in order to become operational. Without denying the difficulties in their implementation, they are however not far from a set of *Pareto improving* measures, what, with the due provisos in section 6, may ease their acceptance.

At present, we would stick around the four core measures, plus the two background ones, as regards their importance and individuality. Even so, the interaction between the sectoral competitiveness policy **p2.2** and the two other closely linked ones must be further examined.

Annex. On selecting sectors.

Identification of the sectors to be included in policy **p2.2** could be helped, from the technical side, by the use of select trade intensity indices. These indexes are defined for each product/good *k,* exported from Mercosul to country/bloc *j*. Letting,

X_i^k = Mercosul or member country *i*'s exports of good *k*,

X_i = total exports of Mercosul 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 well-known indexes, Balassa (1965), are the *Revealed Comparative Advantage or Export Specialisation Index (RCA)* of the exporting country *i* and *the Revealed Comparative Disadvantage or Import Specialisation Index (RCD)* of the importing country *j*, which can be 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 that of the same product in world trade; it roughly shows the export specialisation of a country. It is common practice to consider that, when the RCA is greater than 1, the country is more export oriented in that particular good than the "world average" and, therefore, it displays a *revealed* comparative advantage in that particular good (see, for instance, 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 specialisation index is greater than 1, the country *reveals* a comparative disadvantage in that good.

Combining the two indexes, four situations may occur; of course, the case RCA<1 and RCD<1 has no interest in terms of possibilities, contrary to the following ones:

i) *sustained gains* : RCA > 1 and RCD > 1, which describes a perfect match between the comparative advantages of Mercosul and the other bloc "needs";

ii) *intermediate case* : RCA > 1 and RCD < 1, when, though the other bloc is not a great consumer of the product (in average world terms), Mercosul, being competitive in it, may reap further gains in its market;

iii) *short lived or future gains* : RCA < 1 and RCD > 1, meaning that, either in the event of a preferential agreement, lowering the trade barriers faced by Mercosul, or of a technological improvement, a temporary or permanent advantage might overcome the present lower competitiveness.

In addition to other criteria, attention could be given to those firms/sectors for which RCA < 1, as they need more a competitiveness boost. The analysis would be refined by computing the corresponding RCD values for different, key Mercosul export markets. The products for which the higher RCD's are found would be given preference.

Reminding that this would be nothing more than a complementary device for guiding the allocation of funds, we point out that it would be in agreement to Hausmann and Rodrik (2003)'s idea, in the sense that non-existing or non-exploited areas (translated into the low RCA) would be favoured. Of course, this must be accompanied by good reasoning and common sense.

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