

BOOK REVIEW

TERMITES IN THE TRADING SYSTEMS: HOW PREFERENTIAL TRADE AGREEMENTS UNDERMINE FREE TRADE(2008) by Dr. Jagdish Bhagwati, Oxford University Press, New Delhi, pp. xviii+ 139, Price INR 295.

Jagdish Bhagwati has been a lifelong critique of the preferential trade system prevalent in the international trade regime globally. In this book, the Professor for Economics at Colombia University has attempted to make a robust case against the preferential trade agreement (PTAs, hereinafter used interchangeably for free trade agreements) culture and severely criticizes it. Bhagwati has made a compelling argument against PTAs and calls it a short sighted idea wherein the political leaderships are negligent towards the legal and economic implications of such agreements. His primary reasons against the preferential trading system are that PTAs allow for a more preferential treatment towards partner countries thereby creating a barrier for non-partner countries by discriminating against them. He argues that the premise of a multilateral trading system is non-discriminatory and by succumbing to the idea of providing preferential treatment to each other, the discrimination against the non-partner countries eventually leads to the contradiction of the basic premise.

ORIGINS OF PREFERENTIAL TRADE AGREEMENTS

In the first chapter, Bhagwati has traced the history of the PTAs and has divided the same into three subsections. He initiates the discussion by explaining PTAs, FTAs and the Custom Unions (CUs) and then shifts focus to the United States of America (US)'s view point, in 1800s, towards open market which should be free from all the discriminations and the market forces would determine the fate of the economy. He explains how the US's view point was different from that of the United Kingdom (UK), which believed for a preferential trade regime and then proceeds to the shifting paradigm in the UK, where economists like John Keynes had a change of heart and came out in full support for a trade system with no barriers or discriminations.

The chapter identifies the flow which led to the establishment of GATT regime. It begins with discussing the gradual shift, where economies were adopting the Most Favored Nations (MFN) principle to a sudden change into a "protectionist

regime” in the 1930s. The chapter also discusses the failure of International Trade Organization (ITO) to exist and its subsequent ramifications as to origin of General Agreement on Tariffs and Trade (GATT). Bhagwati argues that the GATT’s system of emphasizing on MFN for reduction in trade barriers worked wonders and resulted in reduction of tariff barriers to negligible. He criticizes the misuse of Article XXIV of the GATT, which is an exception to the general principle of MFN. The chapter emphasizes on increase in the preferential treatment as a result of uncoordinated pursuit of protectionism and the misconception that such protectionism will further the nation’s interests in the race for free trade. To back his contention, he resorts to statistics displaying rapid rise of PTAs across all dominions of civilizations till 2006.

REASONS FOR SURGE IN PTAs AND FAILURE OF GATT

In the second chapter, Bhagwati explores the whys and wherefores for such surge in the number of PTAs and holds that the proponents of trade barriers “piggybacked” the proponents of multilateral nondiscriminatory free trade. He holds that FTAs are in fact not free since by the virtue of abolishing tariffs and other barriers for the member states, the PTAs subject the non-members by not providing such preferential treatment and therefore increase protection against the non members. Due to the aforesaid, trade can actually divert from efficient, low cost non-members to inefficient participants. Citing the above he comes down heavily on the NAFTA which was helmed by the United States.

Bhagwati then proceeds to analyze the effects of the GATT on the PTAs and how, if at all, does GATT tends to curtail the rising number of the PTAs. The chapter holds that GATT was initially largely successful in restoring the multilateralism however, it soon faded due to the misuse of the exception clause i.e. Article XXIV, which regulates formation of PTAs and CUs on fulfillment of certain criteria. Bhagwati chalks out a few reasons for such inability and holds the shifting views of the US towards the PTAs as the first reason. US was a vocal critique of countries resorting to such agreements and during the formation of the ITO, negotiated towards applicability of the exception clause only in the case of CUs. However, later US sought to form a PTA with Canada and therefore changed its stance to include the PTAs under the ambit of the exception clause as well. This caused the exception clause to lose a little of its mettle since the PTAs are far easier to agree upon than the Custom Unions without requiring difficult negotiations over common external tariffs.

The second reason for GATT's incapacity to discipline the formation of PTAs is the ignorant attitude of Members towards restrictive qualifications under Article 24. Bhagwati states that the WTO created Committee on Regional Trade Agreements and tasked it with the responsibility to examine the complicity of the referred PTAs with Article 24. However, since there is practically no member state left which has not entered into a PTA of its own, there is no neutral members to enforce the mechanism under Article 24 and thus, he argues that the existence of the Committee has turned into a mere formality.

Bhagwati holds the special exception carved out for the Developing nations under the Special and Differential Treatment (S&DT) as the third reason for GATT's inability, wherein the developing countries are exempted from the obligations imposed by the GATT membership, while being eligible to enjoy the rights enshrined under it. According to this exception, the developing countries are not subjected to any of the mechanisms imposed by Article 24 as long as the PTA is amongst the less developed or developing states.

Upon assessing the aforesaid reasons, Bhagwati divides the post Tokyo Rounds timeline into two groups, first period of regionalism and second period of regionalism. He highlights that that many developing and underdeveloped countries in East Africa and Latin America, entered into their own PTAs where they would produce the commodities for their consumption without relying on the Western powers. However, the idea could not succeed because these states relied on bureaucratic decisions, instead of market forces, to allocate the different import substituting activities among themselves.

However, he says that the second Regionalism was a huge success which can be attributed to the change in opinion of the United States towards bilateralism. He traced its origin from the Cold war era, where the United States was desperate to have a foot hold in the Europe in form of the first NAFTA. This, coupled with the fact that even the UK was struggling to become a part of the European Community's proposed CU due to opposition from the French, motivated the North Americans to abandon their policy of multilateralism and inspire the British to look out for a "policy space" of its own. Bhagwati also blames the European Union (EU) to enter into multiple PTAs with non EU members thereby motivating the United States to look "South". United States being a major player in the international trade scenario found potential partners in the South American countries, which were struggling from heavy debts and were in

desperate need of debt relief. Bhagwati argues that the aforesaid coupled with the furtherance of the personal ambitions of the bureaucrats and misunderstanding as to PTAs paving way for Multilateral Trade Negotiations (MTNs) resulted in the much-needed boom to the second period of regionalism.

Towards the conclusion of the chapter, Bhagwati jots down the reasons of how and why the developing countries joined the impending race of forming one's own PTAs. He associates the fear of competition, sense of security among one's peer and "monkey see monkey do" as the key reasons for the developing states to form PTAs among each other. Whereas, he associates sense of stability with presence of hegemony, fear of being left out in the "big table" and retaliation against other's PTAs as the reasons for developing countries to enter into PTAs with a developed country.

THE ILLS OF PTAS

The third chapter discusses the detail of how PTAs are ticking time bombs. As discussed earlier, PTAs are shifting trade from cost effective non-partners, thereby affecting allocation among the countries and thus undermining, what he calls as "cosmopolitan advantage". He further blames PTAs to cause "terms of trade loss" wherein a member shifts to import from a higher costing member, therefore buys imports more expensively. However, he humbly accepts that it's not necessary, theoretically, that PTAs might not result in aforementioned "trade diversion" but rather might result in some welfare enhancing deals for the host nation or "trade creation" but still he firmly believes that the preferential trade system is largely a double edged sword.

Bhagwati then proceeds to analyze the recent trend in defense of the PTAs - only countries which are "natural trading partner" should enter into PTAs and the determining factors between them will be the volume of existing trade between them and their geographic proximity. Using simple statistics mechanisms and secondary data he rejects the aforesaid citing that whether two countries share 'high' volume of trade is a relative question with no fixed answers. He objects to the thinking that high volumes of trade make two countries 'natural trading partners'. At times powerful states are in fact biased towards a developing state for their own 'non trade' motives and it's not unusual for one state to coerce other to trade more volumes than the latter actually intend to. He further states that it is not advisable to build models believing that the

PTAs are beneficial up to a certain range because in such situation a country would need to shift the comparative advantage in order to still derive benefits from that PTA.

In the later half of the chapter, Bhagwati discusses that the PTAs arrangement has become a general norm where one country is now signatory to multiple PTAs and thus creating a “Spaghetti Bowl” in the world trade. In such a situation, tariff reduction varies from the PTA to PTA and tariff on specific goods would depend on the country of its origin. Under this ‘rules of origin’, “substantial transformation tests” and “value content tests” are applied to see if the product is eligible for the preferential tariff rate and if the product uses the prescribed amount of raw materials originating in the country enjoying preferential treatment. These rules of origin vary between members and non members across different FTAs and across different products within each FTA. Chapters on rules on origin across different FTAs aren’t just a one or two paged document but rather are hefty bound books which usually run to thousands of pages! Bhagwati also resorts to the plight of the private sector in explaining how this “Spaghetti Bowl” is a problematic affair for them as well. Apart from producing goods and their marketing, the companies are now worried about trade barriers, rules of origin, rise in prices and also the reduction in flexibility. He also discusses the reasons sun related to trade, for instance, powerful countries like the United States enter into PTAs with developing nations to force upon them certain non trade stipulations pertaining to intellectual property, environment, labor welfare etc. in garb of conditions necessary for that arrangement or in interest of other party. Bhagwati also refers to multiple specific incidents where representatives from the United States have tried to sell off the preferential trade system to the small countries by luring them into believing that it’s in “their interest” to get into PTAs with the United States and secondly it helps them to ‘embrace’ multilateralism and negotiations at WTO, both of which he rejects by labeling as “waste assets” and “problematic”.

BEST CASE SCENARIO

The fourth and final chapter serves as the conclusion to the book where Bhagwati tends to give his opinion on how the multilateral trade system suffering from the pandemic, chaotic and problematic PTAs can be restored. He advocates for three viable alternatives to resolve the aforementioned- 1) No more preferences and reduction in the existing ones by build in reduction of

difference between MFN tariff of non members and preferential tariff of the members. However, he agrees that this will not be the correct choice since, a lot of members enjoying benefits of PTAs will not be fine with their preferences being eroded. 2) Reduce the chaos of the aforementioned “Spaghetti Bowl” through harmonization and convert it into “Pasta” and then “Pizza”. What he argues here is that now countries must untangle the proverbial spaghetti by aggregating PTAs to plurilateral regional groups, instead of bilateral agreements. Such plurilateral regional groups should be further aggregated to substantially freed multilateral trade. However, despite it being the most lucrative alternative, Bhagwati is aware that such resolutions will be filled with insuperable technical problems for e.g. resolving different rates for similar products across PTAs, different rules of origin for different products, plethora of trade un-related measures etc. 3) Bringing the MFN tariff down to negligible level, which according to him is the most appropriate solution given that the “hegemony” have already exploited a lot of developing countries through different means in garb of the PTAs negotiation and now this “indirect” solution to control damage done by PTAs to trading system through tariff system is probably the most viable alternative.

In the conclusion Bhagwati emphasizes that the journey to bring MFN tariff down will be an uphill task as a lot of countries are deprived of the sources to negotiate meticulously and meritoriously over its demands and on the other hand the lobbyist and developed countries in favour of the prevalent PTAs are supported with insurmountable riches to go against such countries not in support of *status quo*. Therefore, Bhagwati rests his case by putting up a lot of faith in the need of political will to surmount the challenges posed by the existing crisis.

The book is an interesting read for anyone interested in the field of international trade law. Bhagwati elaborates upon his beliefs and theories with reasons, illustrations, his insider tidbits and humor. A few observations stand out after the reading of the book. First being that he has focused heavily on the behavior of the United States in global trade, its shifting paradigm and lobbying practices. Therefore, the book proves as an interesting case study of the American practice towards PTAs. Secondly, it seems like he has focused extensively on manufacturing goods and has undermined the contribution of agrarian commodities and economies in the world trade. In the present day, it is also to be considered that PTAs are a method of diplomacy. Most of the MFN

tariff is zero now and PTAs tend to exclude the high MFN tariff items.¹Therefore the relevance of adopting the reduction of MFN rate methodology as suggested by Bhagwati might become futile with increase in further liberalization. With that being said, the relevance of the book in contemporary times cannot be minimized. Considering the increasing number of PTAs negotiations underway, emergence of new economies and the existing crisis in WTO, Bhagwati's book serves as a basic reading for everyone trying to figure out the jargons of contemporary trade law.

*PraharshGour*²

¹Yose Rizal Damuri, 'How preferential are preferential trade agreements? Analysis of product exclusions in PTAs', (2009) Working Paper No. 2009/30 available at: <https://repository.graduateinstitute.ch › record › files › CTEI-2012-02> (last visited on April 10, 2019).

²LLM Candidate, Faculty of Legal Studies, South Asian University, New Delhi