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# Utility of Regional Trade Agreements: Experience from India's Regionalism

*by*

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# Executive summary

This paper formulated in the context of the Indian experience in regionalism. In the past decade, India's trade policy has seen a marked shift towards regionalism with the signing of many regional trade agreements (RTAs). As of May 2011, 13 RTAs were in force, with at least eight more under negotiations. This paper explores whether these RTAs were ultimately of use to Indian traders. To assess the usefulness of an RTA to traders, percentage ratios, like utilization, product-coverage and utility ratios, are generally calculated. Use of these ratios has been boosted by United Nations Conference on Trade and Development (UNCTAD) assessment of the use of Generalized Scheme of Preferences (GSP) tariff preferences by developing countries. However, the lack of data in official statistics on India's preferential trade limits the use of this methodology here. Thus, this paper explores an alternative route to find utility of RTAs to the traders.

First, using available official trade statistics, aggregate trade trends are compared with trends in trade of preferential items for each RTA; the gap between the two gives an idea of the extent of importance of preferences in trading with the RTA partners,. Next, a primary survey of certifying agencies, undertaken to find out the level of utilization of preferential schemes by Indian exporters, is reviewed. The results show that after the RTAs came into effect, both exports and imports from the RTA partners increased significantly. However, an interesting contrast was found amid preferential exports and imports; while preferential imports were the driving force behind the substantial increase in total imports from the RTA partners, preferential exports – despite increases in value – could not explain the level of increase in total exports to RTA partners. This indicates that non-preferential items accounted for much of the increase in post-RTA exports. Therefore, the RTAs per se cannot be said to have greatly benefited Indian exporters.

From the primary survey three main points emerge:

(a) GSP is a better utilized preference scheme than all of India's RTAs put together;

(b) Among the RTAs, most Certificates of Origin (CoO) are issued under the India-Sri Lanka Free Trade Agreement (ISFTA), implying that exporters are using ISFTA more than the other RTAs. Given the wide coverage under this Agreement, this is understandable; however, when compared with overall exports to Sri Lanka, only 11 per cent of total export transactions to Sri Lanka in 2008-2009 were issued with CoO. This tallies with the low utilization of preferential schemes seen in other RTAs among developing countries;

(c) Rules of origin (RoO) maybe a culprit with regard to the low level of utilization as it was found from the survey that when there is more than one RTA available for exporting to a particular country, exporters choose the RTA that has lower value added norms for satisfying RoO.

# Introduction

The world trading system has witnessed an increasing number of regional integration initiatives in recent times. The basic premise of such initiatives is to liberalize trade among the members by granting tariff concessions for, or eliminations of selected products. Regional integration initiatives can be of various types, depending on their degree of integration:

(a) Preferential trade agreements (PTAs) form the first tier arrangement, where trading partners grant partial tariff reductions to each other;
(b) The second tier is the free trade agreement/area (FTA), in which members eliminate all tariffs among themselves, but with each member retaining its own tariff rates on imports from non-members;
(c) Third, members of a customs union (CU) set a common level of tariffs vis-à-vis non-members;
(d) The fourth tier is a common market, which also allows free movement of factors of production;
(e) The last tier is the economic union, which involves integrating national economic policies and adopting a common currency.

The World Trade Organization (WTO) uses the umbrella term of RTA for all such initiatives. The welfare effects of RTAs are traditionally ascertained using trade creation/trade diversion analyses (Viner, 1950). However, theoretical and empirical research has not been able to provide a clear answer as to whether RTAs are necessarily welfare-augmenting (more trade-creating than trade-diverting). Meade (1955), Lipsey (1970) and Summers (1991) showed instances of trade-creating RTAs whereas Grossman and Helpman (1995) and Bhagwati and Panagariya (1996) provided examples of trade-diverting RTAs.

Opinions are also divided among economists as to whether RTAs are “building blocks” or “stumbling blocks” with respect to multilateral trade liberalization under WTO, the essential question that was posed first in Bhagwati (1991). As Baldwin (1997) noted, the debate on RTAs may be divided between the Larry Summers school (Summers, 1991) and the Jagadish Bhagwati school (Bhagwati and Krueger 1995); the former school looks at regional (i.e., discriminatory) liberalization and sees only liberalization, whereas the latter school sees only discrimination. Despite the debate, RTAs are the current reality of the global trading order with all but two members of WTO (Mauritania and Mongolia) being engaged in at least one regional integration initiative. Keeping this recent march of regionalism as its backdrop, this study attempts to deal with the essential question: “Are the RTAs of use to traders?”

The paper is made in the context of the Indian experience in regionalism. In the past decade, India’s trade policy has seen a marked shift towards regionalism with the signing of numerous RTAs. Thirteen RTAs are in force and at least eight more are under negotiation. This paper attempts to find the answer to whether such RTAs have ultimately been of use to Indian traders. In order to ascertain the usefulness of an RTA to traders, percentage ratios, (like utilization, product-coverage and utility ratios) are generally calculated (Inama 2003; and Candau, Fontagne and Jean, 2004). The use of these ratios has been boosted by UNCTAD assessment of the use of Generalized Scheme of Preferences (GSP)[1] tariff preferences by developing countries. However, the lack of data in official trade statistics on India’s preferential trade limited the use of this methodology in this study. Firm-level studies have been conducted by a few authors on the use of RTAs (Takahashi and Urata, 2010; and Kawai and Wignaraja 2010). However, since firm-specific surveys are outside the scope of this paper an alternate route has been used in finding the utility of RTAs to the traders. Using available official trade statistics, this paper first compares aggregate trade trends with trends in trade of preferential items for

[1] GSP schemes are trade preference provision schemes whereby developed countries unilaterally grant tariff preferences to developing and least developed countries.

each RTA; the gap between the two gives an idea of the extent of the importance of preferences in trading with the RTA partners.

Second, a primary survey of certifying agencies on the utilization of preferential schemes by Indian exporters is reviewed. With regard to the utilization of RTAs by importers, the required information from the Indian Customs was unavailable. However, some earlier studies that assessed the use of RTAs by exporters in India's RTA partners, especially Sri Lanka (de Mel, Jayaratne and Premaratne, 2011), reflect utilization from the perspective of Indian importers. Thus, this paper focuses on the utility of RTAs from the Indian exporters' perspective only. Section A gives a brief review of literature on RTAs. Section B details India's initiatives in regionalism. Section C gives the methodology and section D presents the results. In conclusion, taking into consideration the results, section E considers the utility of RTAs from an Indian perspective.

## A. RTAs and their effects: A brief review

A striking development in the recent history of the world trading system has been the unprecedented surge in RTAs. Figure 1 shows the significant increase in the number of RTAs entering into force from the mid-1990s. The continuity of such a trend in recent years is also clear from the figure. Prior to the mid-1990s, in some years only a few RTAs came into force, while in many years no new RTAs came into force. The WTO database on RTAs[2] states that between the inception of the General Agreement on Tariffs and Trade (GATT) up to the establishment of WTO (i.e., from 1948 to 1994), GATT received 123 notifications of RTAs, which covered mainly trade in goods. In contrast since the creation of WTO in 1995, more than 300 additional arrangements covering trade in goods and/or services have been notified.

The regionalism of the 1990s is referred to as the second wave of regional initiatives, or "new regionalism", to distinguish it from the first round of RTA formations that occurred as after-effects of the European Economic Community (EEC), that was established in 1957. The inception of the EEC led to signing of a few RTAs in Africa and Latin America from the 1960s to the 1980s, but the EEC remained the only successful regional integration initiative until the mid-1990s, when another wave of regionalism occurred, as shown in figure 1. In addition, most of the Agreements notified to WTO in 1970s and 1980s were those in the European Community[3] enlargement notifications. The "new regionalism" of the 1990s differed from the first wave of regionalism as it went beyond the tariff preference exchanges in goods, as it covered the entire globe rather than just Western Europe, and had a growing interregional dimension as many of the RTAs were no longer between countries of the same region (Busse and Koopmann, 2002).

There are, in general, three objectives for forging regional alliances:

(a) To promote economic cooperation among countries forging such alliances;

(b) To build a sense of security in order to facilitate political harmony within a region;

(c) To enable the countries concerned to achieve international competitiveness in the current era of globalization.

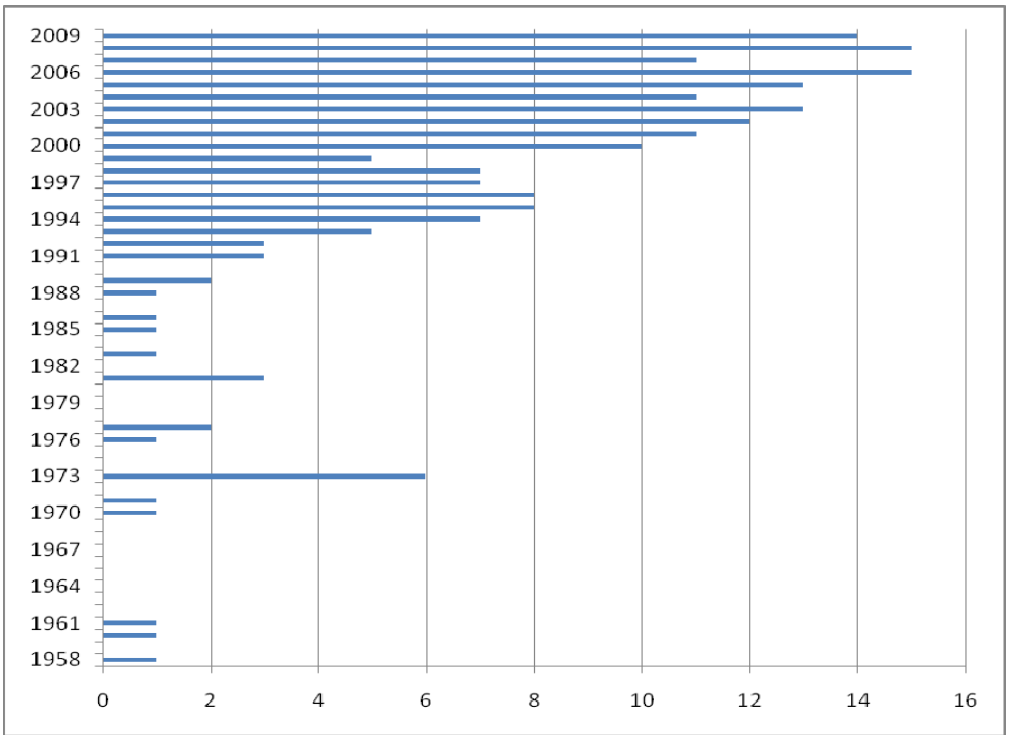
Although these objectives provide a politico-economic rationale for establishing RTAs, they cannot explain why there has been a sudden spurt in such agreements across the world as is evident from Figure 1. According to many economists, such as Bhagwati (1994), Krugman (1993) and Panagariya (1999), the proliferation of RTAs in recent years was due to the slow progress of GATT/WTO, as witnessed by the long-drawn out rounds as well as the bitterness in negotiating issues

[2] WTO Regional Trade Agreements Information System (RTA-IS), available at http://rtais.wto.org/UI/PublicMaintainRTAHome.aspx (accessed 30 April 2010).

[3] The European Economic Community was renamed as the European Community in 1993.

between the developed and developing nations, as seen in the Doha Development Round. This may have led to the forging of more regional partnerships to liberalize trade in recent times. Baldwin (1997) refuted this argument that the "new regionalism" has stemmed from frustrating WTO talks by stating that it was the regionalism in the European Community and the United States of America that actually had a "domino effect" in getting other countries to follow suit. Countries do not want to be left out of the RTA process as they fear that they will otherwise lose out on market access. So slow progress under GATT/WTO is not the catalyst for the "new regionalism", as GATT/WTO rounds have traditionally been long-drawn out; rather, a "domino effect" explains the new drive towards the growth in regional initiatives.

**Figure 1. Number of RTAs entering into force, 1958-2009**




*Source*: Author's calculation, based on the WTO RTA-IS database.
*Note:* 1958 – EEC comes into effect; 1973 – first EEC enlargement with the inclusion of the United Kingdom of Great Britain and Northern Ireland, and other countries; 1981 – second EEC enlargement with the inclusion of Greece; the third and fourth enlargements in 1986 and 1995; the fifth and last enlargement in 2004.

The traditional theory of gains from free trade suggests that the removal of trade barriers allows consumers and producers to purchase from the cheapest and most competitive sources of supply. This enhances efficiency and increases welfare. Following this logic, it was traditionally believed that regional trade blocs should generate gains from trade as and when member countries eliminated trade barriers among themselves. However, studies carried out in this area have found that RTAs do not necessarily result in welfare gains either for all the members or for the world as a whole. Viner (1950) introduced the concepts of trade creation and trade diversion, and showed that the net welfare effect of trade liberalization on a regional basis was not unambiguously positive. He pointed out that RTAs could lead to trade creation if, due to the formation of a regional agreement, the members switched from inefficient domestic producers and imported more from efficient producers of other RTA members. In this case, efficiency gains arise from both production efficiency and consumption efficiency. On the other hand, trade diversion takes place if, because of the RTA, members switch imports from low-cost producers in the rest of the world to higher-cost producers within the region. Trade diversion lowers welfare of not only the RTA countries but also that of the rest of the world.

There is a major ongoing debate among the trade theorists and empiricists about the relative dominance of these two effects. Some studies have shown that the balance between trade creation and trade diversion is more likely to favour trade creation (a) when MFN tariffs before the formation of RTAs are low (Meade, 1955); or (b) if member countries of an RTA are already large trading partners (Lipsey 1970); or (c) transportation costs are low (Summers, 1991). However, Grossman and Helpman (1995) claimed that the formation of trade-diverting RTAs was the most likely case as viability of a potential FTA increases only with enhanced protection for most domestic sectors. Also, according to Bhagwati and Panagariya (1996), if members of an RTA are small in relation to the outside world, very little trade creation will take place and trade diversion is likely to be the more dominant effect. Existing empirical studies do not provide any definite conclusion on the net welfare effect (Pomfret, 1988). The World Trade Report (2003) stated that the evidence drawn from econometric analysis produced different results for different RTAs in this regard and that a general conclusion could therefore not be drawn.

The effects of RTAs have also been analyzed using gravity models. The results have generally shown an increase in bilateral trade due to RTAs (Frankel, 1997; Soloaga and Winters, 2001; Martinez-Zarzoso and Nowak-Lehmann, 2003; Feenstra, 2004; and Bergstrand, Egger and Larch, 2007). The gravity model of trade predicts bilateral trade flows based on the economic sizes (GDP) of two countries and the distance between them. Policy variables such as RTAs are introduced as dummy variables in order to find their effects on bilateral trade. Gravity modeling of trade, though popular, has theoretical issues. With the advent of multi-country, multi-sector computable general equilibrium (CGE) models, techniques available for analyzing RTAs have improved substantially. These models can be used to predict the impact of an RTA on an economy-wide basis: they can evaluate the production, employment, consumption, trade, price and welfare effects of the formation or the expansion of an RTA. The general conclusion from studies using CGE models is that formation of an RTA leads to more trade creation than trade diversion and that welfare effects increase for all members of an RTA (Robinson and Thierfelder, 2002). Again, however, there is an ongoing debate on the use of CGE models for studying RTAs as such models have poor econometric foundations (Hertel, and others 2007).

Utilization of tariff preferences by firms is an area where some empirical work on regional integration has been presented recently in the literature. When preferential trade data are available, utilization by exporters can be easily found, using the percentage ratios mentioned above (product-coverage, utilization and utility ratios). For example, Cadot and others (2002) calculated the average utilization rate for NAFTA in 2000 and found it to be 64 per cent. Inama (2003) calculated utilization of GSP schemes by using the same percentage ratios and found that only 39 per cent of eligible products entered the Quad countries[4] from developing beneficiary nations under GSP.

Primary surveys have also been undertaken by some authors to ascertain use of RTAs by traders. Those studies found that utilization of most RTAs involving developing countries was much lower compared to developed country RTAs; for example, between 17 per cent and 25 per cent of the firms in South-East Asia use FTAs (Kawai and Wignaraja, 2010), while between 12 per cent and 33 per cent of Japanese companies use the various FTAs with the developing countries (Takahashi and Urata, 2010). Almost all the studies point to the restrictive role of Rules of Origin (RoO), which they say deters the use of RTAs. RoO are the requirements that a product must satisfy in order to be eligible for being declared as "originating" in a beneficiary country. If a traded product contains imported components, there are three general rules for determining "origin" – (a) change in tariff classification, (b) local value-added and/or (c) a technical rule. These rules are negotiated during the

[4] Quad countries is the term used by WTO to refer to the four major industrialized economies, i.e., the United States, European Union, Canada and Japan.

drawing up of an RTA, and different combinations of such rules can be found in RTAs around the world. They are designed to support a commercial policy; however, because of the way in which they have evolved, they have become commercial policy instruments in themselves (Vermulst and Waer, 1990). Krueger (1993), Palmeter (1993), Estevadeordal (2000), Brenton and Manchin (2003), and Krishna (2005), among others, described the role of RoO in RTAs.

Both at the theoretical and empirical level, economists are divided over the desirability of RTAs in a multilateral trade regime. Some envisage RTAs as "stumbling-blocks" to multilateral trade liberalization whereas others contend that they can act as "building-blocks", terminology introduced by Bhagwati (1991). Even after many years of debate, no consensus has been reached on this issue. As Herrmann (2008) noted "...it seems that even from a purely economic perspective – which is not necessarily best suited or conclusive for all problems of international political economy – no clear-cut case can be made for or against RTAs with regard to their impact on welfare and multilateral institutions". Herrmann also stated that each RTA would be different and hence should be assessed on its own. Thus, for this study, each of India's RTAs were analyzed to ascertain their effects on bilateral trade. Both secondary data sources and a primary survey were used to determine the use of RTAs by exporters, thereby contributing to the small, yet growing, literature that attempts to ascertain use of RTAs by traders.

## B. RTAs: India's initiatives

Seshadri (2009) traced the evolution of Indian RTAs, from limited scope and sometimes non-reciprocal PTAs with developing countries (such as the PTA with Nepal) to comprehensive and reciprocal arrangements with developing countries (e.g., the FTA with Sri Lanka) and then to the recent RTAs that India has negotiated with developed countries (e.g., European Union members).

The first RTA entered into by India was in 1975 when the Government signed the Bangkok Agreement. It started as a regional initiative between developing countries of the Asia-Pacific region but was very limited in its scope; in fact, it was only in 2005 that it was reincarnated as the Asia-Pacific Trade Agreement (APTA) and trade liberalization started in a meaningful way between its members (Bangladesh, China, India, Republic of Korea, Lao People's Democratic Republic and Sri Lanka). Members of the South Asian Association for Regional Cooperation (SAARC)[5] formed a PTA (SAPTA) in 1995, which was another regional initiative between the nations of South Asia under the ambit of SAARC. It was upgraded to an FTA (SAFTA) in 2006. India's first bilateral FTA was with Sri Lanka – the India-Sri Lanka Free Trade Agreement (ISFTA). It came into effect in March 2000. Subsequently, many other RTAs were signed and currently, as of May 2011, 13 are in operation. Annex I provides information on these RTAs. From the annex it is clear that in the past decade India has signed and implemented many RTAs. India is focusing on signing many more RTAs in the near future, particularly with its major trade partners such as the European Union and Japan. Table 1 lists the preferences exchanged under the bilateral RTAs covered by this study.