Mechanisms for Compensating the Asymmetrical Effects of Regional Integration And Globalization: Lessons From Latin America And The Caribbean

The Case of Mercosur

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1. INTRODUCTION

This paper provides a summary account of how the Common Market of the South (Mercosur) has dealt with the effects of asymmetries on regional integration agreements (RIAs). The paper is organized in six sections. Section 1 raises some analytical issues, making a distinction between structural and policy asymmetries. Sections 2 and 3 examine the extent of structural asymmetries prevalent in Mercosur and the measures of agreed discrimination that were implemented to cope with their consequences. Sections 4 and 5 review the extent of policy (allocation and macroeconomic) asymmetries in Mercosur, also focusing on how they have been dealt with. Based on the preceding discussion, Section 6 concludes that the inadequate treatment given to structural and policy asymmetries in Mercosur has helped to place regional integration in reverse.

2. ASYMMETRIES AND REGIONAL ECONOMIC INTEGRATION

Several empirical and theoretical reasons provide a case for designing and implementing policies aimed at dealing with asymmetries and distributive issues in RIAs. The most straightforward is that it is not necessary that all regions and countries will benefit from increased market integration.[1] As a general rule, even if a regional integration agreement raises aggregate members' welfare, the distribution of costs and benefits is most likely to be uneven across countries and regions. This well-known proposition of the theory of trade discrimination is true either in a partial or general equilibrium framework, and it is confirmed by the more recent insights offered by the "new economic geography" school.[2] One major conclusion from these analyses is that unless some sort of redistributive policies are put in place, RIAs are unlikely to be sustainable on a voluntary basis.

Similar conclusions can be reached using a dynamic framework. When a group of countries integrate their markets, there are specific dynamic reasons why regional disparities may persist or even increase during long periods of time. Similarly, by those very same reasons there is no compelling cause why convergence may take place in either output growth rates or per-capita income levels. In fact, models of cumulative causation and endogenous growth theories provide stylized accounts on the persistence of disparate economic performances over long periods of time.[3] The consequence is that "polarization effects" may deepen pre-existing regional disparities and make RIAs politically and/or economically unsustainable, thus strengthening the case for public policy intervention.

Naturally, the fact that the existence of asymmetries provides a case for public policy interventions must be subject to the usual public choice qualifications, including a decision on the assignment of policy responsibilities.[4] Regional policies can be decided and enforced either at the national or the community level. If regional policy is left in member states´ hands it is more likely to reflect member states' different preferences. Moreover, national governments are closer to the source of the problems and may have more information and knowledge than "distant" community

[1] The classic analysis are those of Viner (1950), Johnson (1962), Vanek (1965) and Kemp (1969)
[2] See Krugman and Venables (1990) and Krugman (1996).
[3] The original contributions on cumulative causation models are those of Myrdal (1957), Hirschman (1958) and Kaldor (1970). For the classical works on endogenous growth theory see Romer (1986) and Lucas (1988)
[4] For an overall discussion of policies to promote convergence and equity in RIAs, see Robson (1998), chapter 12.

authorities. These reasons may contribute to make national authorities more efficient in deciding and implementing corrective measures.

However, if regional policies are left exclusively in the hands of national authorities, other problems may emerge. First, national policies may distort competition and thus be inconsistent with increased market integration. Second, since funding resources and institutional capabilities are likely to be unevenly distributed across nations, the poorer members will be at a disadvantage compared to the richer ones. Third, when there is regional cross-border spillovers there may exist gains from co-ordination and centralization. Consequently, community policies can help to prevent regional aids and domestic policies from causing distortions in competition and contribute to reduce community-wide disparities.[5]

There are different kinds of asymmetries relevant for RIAs. One possible distinction is between those based on structural factors and those created by public sector policies or regulatory interventions. While structural asymmetries will usually demand the implementation of policies of agreed discrimination (ie, the enforcement of some kind of preferential treatment), policy asymmetries are likely to create pressures for deeper policy coordination or, even, harmonization. Structural asymmetries are determined by factors that shape the economies' ability to benefit from increased market integration. Among others, they include economic size, factor endowments, per-capita income levels, the degree of flexibility of goods and factors markets and the level of economic development. These attributes change only slowly over time. If they constrain the ability of a RIA member to benefit from increased market integration, the community may choose to adopt policies of agreed discrimination.

Policy asymmetries, by contrast, are rooted in preferences, choices and institutional characteristics. Policy asymmetries may produce allocation and macroeconomic cross-border spillovers. This may lead to efficiency losses and undermine market integration. The harmonization of policy asymmetries may seem to be an easier task than dealing with structural asymmetries. However, the experience of Mercosur and other RIAs shows that this is not the case. The harmonization of policy asymmetries demands an intrinsically unstable compromise between legitimate differences in national preferences and the need of a "level playing field".

[5] In addition, the precise assignment of policy responsibilities will depend on the characteristics of the member states as well as on the degree of economic integration that they aim at or have already achieved.

Policy harmonization may also demand institutional capacities and a level of resignation of national policy autonomy that may be beyond the scope of the countries involved.

3. STRUCTURAL ASYMMETRIES IN MERCOSUR: AN OVERVIEW

The spatial dimensions, the effects of structural asymmetries and the regional impacts of Mercosur have been poorly researched issues. This gap has not been filled up despite the preliminary evidence that Mercosur has contributed to deepen economic concentration (Calfat e Flores, 2001).[6] Most of the studies available emphasize the relevance of the issue but do not go beyond general statements based on a limited empirical base. For example, using a general equilibrium model Terra y Vaillant (1998) have shown that the path and content of integration policies can soften or deepen regional disparities. Their simulations, based on an economic geography "center-periphery" model, show that Mercosur´s regional disparities can be strengthened by incomplete liberalization. By contrast, deeper liberalization (including the free movement of factors of production) and the implementation of infrastructure policies can reduce regional disparities and contribute to a more even distribution of output and population across regions.

Other studies have equally emphasized the potential for agglomeration effects and an uneven distribution of benefits across Mercosur. Studying the case of Brazil, Sa Porto y Canuto (2002) and Haddad, Domíngues y Petrobelli (2002) conclude that the South and Southeast are the regions best placed to gain from regional integration due to their proximity to the larger markets, their diversified productive structures and the reasonable availability of transport infrastructure. Concerning the smaller economies, Masi y Bittencourt (2001) argue that they have had a limited ability to benefit from increased regional economic integration. In the same vein, Quijano (2002) argues that the gains from specialization obtained by Uruguay in Mercosur have been very small or non-existent, thus limiting one of the major potential dynamic gains that a small economy can reap from increased market integration. This conclusion is reinforced by other findings, such as that the number of exporting firms have remained stable, that exports continue to be concentrated in a small number of large firms and that there is little evidence of an export-learning process. Borda y Masi (2002) reached similar conclusions concerning the effects of Mercosur on Paraguay.

[6] The main reasons are the obstacles posed by the lack of adequate statistical information and the relatively short lifespan of Mercosur.

Indeed, cross-country structural asymmetries in Mercosur are significant. In 2001 Brazil accounted for nearly three quarters of regional GDP (at purchasing power parity exchange rates, PPP), Argentina for less than a quarter and the smaller economies (Paraguay and Uruguay) for about 3% (see Table 1). Population asymmetries are even more notable: nearly 80% of Mercosur's total population lives in Brazil and an additional 17% in Argentina. Paraguay and Uruguay contribute with only 4%. The gap between the countries with the highest (Argentina) and lowest (Paraguay) per capita output (in PPP terms) in 2001 was 3.4 times. This compares unfavorably with the European Union (EU), where the gap between the countries with the highest (Luxemburg) and lowest (Greece) per capita output in the mid-nineties was only 2.5.[7]

Mercosur member states also show significant asymmetries in the sector composition of output: in year 2001 agriculture accounted for 6% of GDP in Argentina, 9.6% in Brazil, 10.2% in Uruguay and 29% in Paraguay. Industry, in turn, contributed with over a third of total GDP in Brazil, 28% in Argentina and about a quarter in Uruguay and Paraguay. These differences in production structures were partly reflected in the sector composition of exports: while in 2001 primary products accounted for 60% of Paraguay exports and over a third of Argentine sales abroad, they represented only 18.4% and 14.9% of Brazilian and Uruguaian exports, respectively. The share of industrial products in exports was the highest in Uruguay (84.6%) and Brazil (79.5%). In the former, however, traditional industries (many of which process natural resources) account for over two-thirds. These differences also show in the commodity composition of intra-regional trade, which depicts a clear North-South pattern (Brazil exports manufactured goods and imports foodstuffs and unprocessed raw materials from its partners in the region).[8]

The implications of these asymmetries are heightened by the disparate levels of regional interdependence that prevail among Mercosur member states. In effect, during year 2001 Paraguay and Uruguay discharged in their regional neighbors more than a half of their total exports, while Argentina and Brazil placed only 28% and 10.9%, respectively.[9] Since the Mercosur economies also display different degrees of openness to international trade (partly as a

[7] In the mid-eighties the ratio was 2.4 (between Luxemburg and Portugal).
[8] Intra-regional commerce, particularly between Argentina and Brazil, also displays a much higher index of intra-industry trade than foreign trade with the rest of the world.
[9] Trade interdependence fell remarkably after 1998, dragged by the macroeconomic crisis. In 2001 intra-regional trade as a share of total trade fell to 18.2, from a 25% peak recorded in 1998.

result of size), the intra-regional exports/GDP ratio ranged between a minimum of 1.3% in the case of Brazil to a maximum of 7.2% in that of Paraguay.[10]

Cross-regional asymmetries are equally marked. The Pampean region in Argentina and the Brazilian South and Southeast concentrate more than 65% of Mercosur's total population and nearly three-quarters of the regional output (see Table 2). These three regions (plus Argentina's Cuyo and Uruguay) are the highest per capita output districts, all of them above the Mercosur average.[11] Cross-regional asymmetries are clearly shown by the large gap that exists between Mercosur's best-off and worst-off regions. Measured by per capita output, the best-off region (Patagonia) has an index that is nearly five times that of the worst-off region (Brazil´s Northeast) (see Table 3). This ratio is higher than the equivalent in the EU, where important redistributive policies have been put in place (in the mid-nineties the output per capita of the best-off region in the EU was 4.5 times that of the worst-off).[12] The best-off region in Mercosur, Patagonia, accounts for only 0.8% of the total population. When the Pampean region is also counted (with a per capita output slightly lower than that of Patagonia), the two regions account for 12% of total Mercosur population. By contrast, the worst-off region (the Northeast of Brazil) is the home for nearly a quarter of Mercosur's inhabitants.

Cross-regional data also shows that a small number of regions account for the bulk of intra-regional foreign trade. In effect, the Pampean region and the South and Southeast of Brazil are responsible for more than 70% of total intra-Mercosur exports (see Table 4). These three regions (plus Cuyo in Argentina) are also the regions with the highest relative export concentration ratios in Mercosur. The relative export concentration ratio measures the share of exports to Mercosur in total regional exports as compared to the national average.[13] However, intra-Mercosur export coefficients (as measured by exports to Mercosur as a share of GDP) show a different picture. According to this indicator Patagonia is the region most closely linked to Mercosur: in year 2000 exports to Mercosur accounted for 7.5% of regional output, a ratio even higher than those of

[10] On average, during the last decade Argentina´s and Brazil´s the foreign trade/GDP ratio was below 10%. By contrast, in the case of Paraguay and Uruguay it was more than a third.
[11] Paraguay and Uruguay are taken each as a single region.
[12] The gap is similar (4.5 times) when measured in terms of unemployment rates. However, in making a comparison between cross-national and cross-regional unemployment rates one should keep in mind that the estimates are subject to significant methodological differences.
[13] When measured in absolute terms, the share of intra-regional exports in total exports is obviously higher in the smaller economies Paraguay and Uruguay, which here are taken as individual regions.

Paraguay and Uruguay. In Brazil, the highest intra-Mercosur export coefficient was that of the South (1.9%).

Despite the high concentration of foreign trade in a small number of regions and the heterogeneous importance of Mercosur as an export outlet for each one, some of the regions that experienced the fastest growth rate of exports and intra-Mercosur export coefficients were also the least engaged in intra-regional trade. In effect, intra-regional exports increased the fastest for Argentina's Northwest and Patagonia and for Brazil's North, Northeast and Center-west (see Table 5). Intra-Mercosur export coefficients also increased the fastest in Argentina's Northwestern and Patagonian regions and in Brazil's North. Except for Patagonia, all these regions are only marginally engaged in Mercosur.

4. TRUCTURAL ASYMMETRIES AND AGREED DISCRIMINATION IN MERCOSUR

Despite these significant asymmetries, since its creation Mercosur failed to adopt policies aimed at reducing cross-regional or cross-national disparities. Mercosur had nothing equivalent to regional policies. Moreover, the Treaty of Asunción did not acknowledge any formal role to the principle of special and differentiated treatment. That principle was a cornerstone both of the Latin American Free Trade Association (LAFTA) and the Latin American Integration Association (LAIA). It had also become an integral part of multilateral trading rules after the GATT contracting parties adopted Part IV.[14] However, Article 2 of the Treaty of Asunción stated explicitly that "the common market will be founded on reciprocal rights and obligations on the part of all member states".

That Mercosur did not formally adopt the principle of special and differential treatment was partly a result of the fact that the architecture of the agreement was a by-product of a bilateral deal between Argentina and Brazil.[15] Conscious of this political fact, but eager to participate, neither the government of Paraguay nor that of Uruguay formally requested preferential treatment.[16] Instead, they emphasized more flexible conditions (particularly more lengthy terms) to reach full intra-regional trade liberalization. Thus Article 6 of the Asunción Treaty read that "member states acknowledge designated differences in the pace (of trade liberalization) in the case of Paraguay and Uruguay". In particular, the *Trade Liberalization Program* included the following differential treatments:[17]

[14] The principle of special and differential treatment became increasingly challenged during the eighties and was sharply circumscribed during the Uruguay Round of multilateral trade negotiations (MTNs).

[15] In 1988 the Argentine and Brazilian governments signed a bilateral *Tratado de Integración, Cooperación y Desarrollo* (which was ratified by the two countries´ Legislatures in 1989). In Article 2 the *Tratado* committed member states to implement all agreements "according to the principles of gradualism, flexibility, equilibrium and symmetry…". In July 1990 the two governments signed the *Acta de Buenos Aires*, enforcing a *Trade Liberalization Program* based on linear, automatic and across the board tariff cuts.

[16] In the case of Uruguay the incentives to join Mercosur were heightened by the expected erosion of existing bilateral preferences (PEC with Brazil and CAUCE with Argentina). See: Abreu (2000).

[17] The existing bilateral preferential agreements between the larger economies and the smaller ones (enshrining the special and differential treatment principle of LAIA) also remained in force until being overtaken by Mercosur commitments.

a) one additional year to complete the *Trade Liberalization Program* (for Paraguay and Uruguay);[18]
b) a larger number of tariff items in the smaller countries´ lists of exceptions to intra-regional trade liberalization (Brazil, 324 tariff items; Argentina, 394; Paraguay, 439; Uruguay, 960);[19] and
c) more flexible rules of origin for Paraguay (50 instead of 60 percent of regional value added).

A sort of special treatment was also granted at the sector level, as the sugar and motor vehicles industries were temporarily exempted from intra-regional liberalization and, after 1994, from common trade disciplines. The exclusion of sugar from Mercosur´s general disciplines was a result of the asymmetric structure of public sector aids prevalent in that sector (particularly the implicit subsidies granted by Brazil´s Pro-Alcohol program) and the strong influence of sugarcane growers and sugar refineries in Argentina and Uruguay.

Motor vehicles trade was also exempted from Mercosur´s general disciplines and governed by bilateral deals. Argentina and Brazil adopted a trade-administered program based on tariff-free quotas and balanced trade requirements. Uruguay, in turn, maintained its bilateral preferential agreements with Argentina and Brazil. These agreements granted Uruguay tariff-free export quotas and were decisive to maintain Uruguay´s tiny assembly capacity, focused in supplying neighbor markets. The Argentine-Brazilian agreement (combined with the Argentine motor vehicles´ sector program) offered a stimulus for the location of assemblers and component makers in Argentina, particularly prior to the devaluation of the Real in January 1999.[20] The exceptions of sugar and motor vehicles were temporary, abut they were regularly extended for more than a decade.

Designated differences in treatment were also acknowledged at the end of the *Trade Liberalization Program*, when member states enforced the *Régimen de Adecuación Final a la*

[18] Paraguay and Uruguay were given one additional year (31/12/95) to eliminate all exemptions to intra-regional free trade.
[19] The number of tariff items in national exemption lists was to be cut back by 20% each year. Argentina and Brazil cut the first 20% in December 1990, while Paraguay and Uruguay did so one year later.
[20] For a detailed analysis of the automotive sector in Mercosur see Bastos Tigre et al (1999).

Unión Aduanera and started the implementation of the Common External Tariff (CET).[21] As far as the *Régimen de Adecuación Final* and the CET were concerned, the differential treatments acknowledged were the following:

a) a larger number of temporary exceptions to intra-regional free trade in the *Régimen de Adecuación Final,* especially for Paraguay and Uruguay (Brazil, 29 tariff items; Argentina, 212; Paraguay, 432 and Uruguay, 958);
b) one additional year for Paraguay and Uruguay to conclude the *Régimen de Adecuación Final* and enforce 100% preferences over MFN tariff rates (December 1999, as opposed to December 1998 for Argentina and Brazil);
c) a larger number of temporary exceptions to the CET (399 tariff items instead of 300) and more lengthier terms to eliminate all national exceptions (2006 instead of 2001) for Paraguay;
d) more lengthier terms to converge to the CET in capital goods (900 tariff items) for Paraguay (2006 instead of 2001), and in computer and telecommunication products (220 tariff items) for Paraguay and Uruguay (2006 instead of 2001).

[21] The extension of national temporary admission programs until 2006 can also be regarded as a concession made to the smaller economies, particularly to Uruguay, which had vocally demanded a continuation of the program. However, its benefits were exploited by all member states.

5. POLICY ASYMMETRIES IN MERCOSUR: THE BACKGROUND

As mentioned in section 1, policy asymmetries –especially when they have negative cross-border spillovers- usually demand some degree of policy coordination or harmonization. In the case of Mercosur, negative allocation and macroeconomic spillovers have led to significant pressures for increased protection through non-tariff barriers and other *ad hoc* measures, thus increasing market fragmentation. This has placed in reverse the process of regional economic integration.

Allocation cross-border spillovers occur when the provision of public goods through national budgetary or regulatory actions has effects that go beyond member states' borders. When they are negative, cross-border spillovers will produce efficiency losses. These efficiency losses may be counteracted by regional policies aimed at internalizing the prevailing externality. Examples of policy areas in which negative allocation cross-border spillovers exist include: pollution and environmental issues and state aids and tax competition.[22] Macroeconomic spillovers also arise from the increased interdependence of national economies produced by the freer movement of goods, services and factors of production. These spillovers can provide a rationale for the co-ordination of macroeconomic policies. As interdependence deepens this rationale may become more compelling, eventually leading to closer policy harmonization.

5.1. Allocation cross-border spillovers

The issue of allocation spillovers was present since Mercosur´s inception. However, it has been dealt with very ineffectively. There was very slow progress even in the task of identifying the practices that should potentially be subject to some kind of coordination or harmonization. After a long delay, only in 2001 a preliminary inventory of existing public sector incentives at national and sub-national levels was drafted. The inventory was expected to list all the incentives in force and to briefly describe their content, legal base, authority of application and eligibility criteria. Although the inventory made no assessment of the effects of existing incentives or measured their relative size, its results have not been made public.

[22] Positive cross-border spillovers also exist in areas such as transport infrastructure. Regional policies may also help to fully exploit their benefits. Mercosur has taken some initiatives aimed at coordinating infrastructure development in areas such as transportation and energy transmission. Similarly, in policy areas in which there are large indivisibilities (such as research and development), regional policies can have

Throughout the 1990s Mercosur member countries showed significant asymmetries in the extent and type of state aids used. In Brazil, the main instruments currently in use are geared at stimulating exports and providing investment finance.[23] Brazil also enforces a regional promotion scheme in the *Zona Franca de Manaus* and two sector regimes (computer and motor vehicles) granting various tax benefits. One problem with public sector aids in Brazil is the significant increase in local government tax subsidies in the late 1990s. These aids have partly compensated the reduction in federal funds produced by the central government´s fiscal adjustment. Since the contribution of local governments to total tax collection is significantly higher in Brazil than in other Mercosur countries, the room for activist policies on the part of sub-national administrations is wider.[24] The incentives offered by sub-national governments have given rise to tax competition among local jurisdictions, which have had negative cross-border spillovers.[25]

In the case of Argentina, during most of the 1990s public sector aids targeted exports and activities focused in foreign markets. In contrast to Brazil, production and investment incentives generally played a minor role. The exceptions were the special regimes for the mining, forestry and motor vehicles industries.[26] Argentina also enforces two national regimes with regional impact: the *Tierra del Fuego* special customs area and the tax rebate program on exports shipped from Patagonian ports. Since Argentina is also a federal state, sub-national governments have considerable formal leeway to provide tax incentives to the private sector. This leeway has been used in major industrial districts such as Buenos Aires, Córdoba and Mendoza, which have offered tax exemptions and dedicated infrastructure. However, the acute fiscal constraint of local governments has severely limited their ability to grant significant direct aids.

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positive effects. Mercosur has made almost no progress in these areas (see Laplane, Sarti, Sabbatini e Britto, 2001).

[23] Excluding BNDES/Exim finance, in the late 1990s export incentives accounted for nearly a fifth of total public sector incentives. The most important export incentives were the exemption from PIS/PASEP and COFINS, the "presumed" credit against IPI, Proex-interest rate equalization and BNDES/Exim financing. Investment financial aids were granted by the BNDES and Constitutional and Regional Investment Funds. Including export finance granted by the BNDES-Exim, investment financial aids account for nearly 9% of public sector total subsidies.

[24] Argentina and Brazil are both federal states. But while in the late 1990s local governments collected taxes for nearly 10% of GDP in Brazil, they did so for only 4% of GDP in the case of Argentina. The Brazilian *Impuesto a la Circulación de las Mercaderías* (ICMS), for example, is a type of value-added tax, but levied by state governments. Much of Brazil´s inter-state tax competition has used differential ICMS tax rates.

[25] Although sub-national government aids are only one factor and "regional fundamentals" play a central role in explaining investment patterns in Brazil, there is some evidence that their effect was not negligible. See: Volpe Martincus (2002).

Uruguay and Paraguay also enforce several incentive regimes. In Uruguay the two main ones are the *Ley de Promoción de la Inversión* and the *Ley de Promoción Forestal.* The former is a horizontal program that authorizes the Executive to grant fiscal incentives to targeted investments. These investments may also benefit from exemptions from local real estate taxes. The latter grants fiscal benefits to investments in forestry. In the realm of export incentives the Central Bank offers credit and a 9% tax rebate on wool textiles. In the case of Paraguay the two main instruments used are tax exemptions on new investments, including tariffs on extra-zone imports of capital goods, inputs and raw materials, and the *Ley de Maquila y Zonas Francas,* consisting of special tax regimes for highly export-oriented investment and production facilities. Paraguay also enforces a special scheme of tax reimbursements for forestry.

The reimbursement of "indirect taxes" on exports has been a source of disputes in Mercosur. All "cascading" indirect taxes make difficult to ensure that indirect tax incidence is neutral, i.e.: that indirect taxes are paid in the consuming and not in the producing country.[27] When governments try to compensate the effects of "cascading" indirect taxes through tax rebates on exports, the calculation of the exact incidence of the tax (a virtually impossible task) becomes a source of attrition. The method most frequently used has been to set fixed tax rebates that may bear little relationship with real tax incidence. The Argentine government enforces several categories of indirect tax rebates depending on the kind of export product. In Brazil, although exports are exempted from the COFINS and PIS/PASEP, they are affected by the tax accumulated in earlier stages of production. To compensate for that the Brazilian government offers a "presumed" tax credit on IPI tax liabilities.

[26] This picture changed in early 2001, when the government enforced sector competitiveness plans granting a wide array of discretionary and non-transparent tax benefits. Sector competitiveness plans are scheduled to be phased out in 2003.

[27] In Argentina, the *Impuesto a los Ingresos Brutos* (IIB) is a general consumption tax with "cascading" effects levied by state and local governments. In Brazil, the *Imposto sobre Servicos* (ISS) is levied on all services (except transportation and communications, taxed with the ICMS) and administered by municipal governments. Since the ISS is applied separately from the ICMS, there are also "cascading" effects between the two. Brazil also applies two social security contributions (COFINS and PIS/PASEP) with effects equivalent to those of a general consumption tax (the tax base is business´ total sales). "Cascading" effects arise from the fact that taxes charged at one stage of production becomes part of the base upon which taxes are levied in the next stage.

5.2. Macroeconomic cross-border spillovers

Although regional economic interdependence in Mercosur is still low, it rose significantly during the 1990s. Aggregate demand interdependence (as measured by the contribution of exports to the region to regional GDP) is nearly 2%, significantly below the level reached by the European Union in the early 1970s (9%). This is the result of a relatively low share of intra-regional trade in total foreign trade and economies relatively more closed to foreign trade (as measured by the foreign trade coefficient). In addition, aggregate demand interdependence in Mercosur is very asymmetric: there are significant disparities between the largest economy (Brazil) and the rest (including Argentina).

Foreign direct investment (FDI) interdependence is also modest. In fact, during the FDI boom of the 1990s all member states were net recipients of funds from the rest of the world. According to official estimates, only 2% of total FDI inflows were originated in the region (with a much higher share in the cases of Paraguay and Uruguay). Financial markets are also poorly integrated region-wide, as all member states are capital-importing countries. One partial exception is Uruguay, which has played the role of an off-shore banking center for Argentina. The strong correlation in the performance of Argentine and Brazilian EMBI spreads until 1998 suggests that shocks are external to both countries and correlated. Labor market integration is even more limited, as the free circulation of labor remains only a programmatic statement.

The empirical evidence about the depth of economic interdependence in Mercosur and its recent changes confirms what may be expected from these structural features. Carrera, Levy Yeyati and Sturzenegger (2000) found that prior to the stabilization of the early 1990s business cycles in Argentina and Brazil were not synchronized. However, after the macroeconomic stabilization of the early 1990s their synchrony increased markedly. Although aggregate trade interdependence has been low, regional trade flows have been sensitive to domestic macroeconomic conditions and have made cross-border spillovers relevant. Macroeconomic impulses transmitted through trade flows have been significant in the case of the smaller economies, and not negligible in the case of Brazil. One consistent feature in most econometric studies is the asymmetry in the effects on trade flows of conditions prevalent in the exporting and importing country: regularly, the latter have been shown to be far more significant than the former.[28] This finding was confirmed by the

[28] Heymann and Navajas (1998) estimated that the aggregate effect (considering the lags) of a 1% increase in Brazil´s real GDP was a 2.5% expansion in Argentine exports to that country. The ("long term")

behavior of Argentine-Brazilian trade flows after the devaluation of the Real in January 1999: although exports from Argentina to Brazil decreased, exports from Brazil to Argentina decreased even more. Consequently, by the end of 2002 Argentina still enjoyed a trade surplus with Brazil (although the value of trade was much lower than before the crisis).

The first significant spillover episode occurred at the beginning of the 1990s, when Argentina´s aggregate demand recovered fast and the peso experienced a real appreciation. The result was larger Argentine trade deficits, both bilateral and global, which stimulated *ad hoc* trade measures and managed trade initiatives.[29] The second episode took place in the mid-1990s, when the strong economic recovery that followed the *Plano Real* in Brazil (together with the real appreciation of its currency) made Argentine exports surge and helped that country to leave the effects of the "tequila crisis" behind faster.[30] Although size asymmetries mean that the effect of regional exports on the Brazilian economy were relatively more modest, Brazil´s worsening trade balance led its government to enforce protectionist measures, which frequently did not exempt its Mercosur partners.

The third and politically most troublesome example of stabilization spillover was the exchange rate crisis of the late 1990s. Although Argentina had entered into a depression prior to the Brazilian crisis due to a combination of negative external shocks (the East Asian crisis, the nominal appreciation of the US dollar, falling terms of trade and international credit rationing), the devaluation of the Real in January 1999 severely worsened the external environment. Once again, the outcome was a proliferation of *ad hoc* trade measures, such as the application of antidumping duties and the imposition of new non-tariff barriers or voluntary export restraint agreements. The tensions that followed placed under question even the feasibility and desirability of implementing a common external tariff and a customs union. The increase in economic interdependence in Mercosur has considerably raised the relevance of macroeconomic spillovers (including "contagion effects"). Although interdependence is still low and the incentives to coordinate asymmetrically distributed, there is enough evidence that negative stabilization

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elasticity of exports from Argentina to changes in the real exchange rate of the Brazilian currency was estimated to be about 0.9%. This confirms an elastic response of exports to changes in activity levels in the importing country.

[29] The Argentine government increased export tax rebates and applied new import levies. The Brazilian government decided to import wheat and oil from Argentina to restore balance in bilateral trade. The management of these spillovers was made easier by the abundance of external finance.

spillovers have created strong tensions in the process of regional economic integration. These tensions not only hinder its development, but have placed the process of market integration into reverse.

[30] In 1995 and 1996 Argentine exports to Brazil increased by 49% and 21%, respectively (doubling the rates of growth of exports to the rest of the world). Uruguay also benefited from faster growth in Brazil and the real appreciation of the Real.

6. POLICY ASYMMETRIES AND POLICY COORDINATION/HARMONIZATION IN MERCOSUR

The potentially troubling role of policy asymmetries was explicitly recognized in Article 1 of the Asunción Treaty. However, the Treaty laid a programmatic principle rather than specific mechanisms or policies to cope with asymmetries. The issue was taken up again in the *Agenda de Las Leñas in* 1992, when member states´ reiterated that harmonization of national macro and microeconomic policies was a key target and set a schedule to do so, revealing a concern to reduce asymmetries in national policies and instruments. In 1993 the document *"Consolidación de una Unión Aduanera y Transición para el Mercado Común"* formally recognized that the ambitious targets set in the *Agenda de las Leñas* would not to be met, opting instead to promote convergence on trade and other policy instruments required to implement the customs union. But proposals to simultaneously harmonize all trade policy instruments (such as tariffs, export incentives, rules of origin for products excluded from the CET, free-trade zones, non-tariff restrictions) and even some government subsidies were dismissed, placing the emphasis on the negotiation and enforcement of a CET.[31]

After 1995, the lack of progress in dealing with allocation and macroeconomic spillovers led to increased market fragmentation. As preferences over MFN tariff rates reached 100%, the use of NTBs became more and more frequent. The enforcement of common trade policies has been made only partial progress. This became more evident as the transition periods to fully implement the CET came to an end.

6.1 Administering allocation spillovers

Mercosur member states have made very limited progress in implementing disciplines to deal with state aids and incentives that distort intra-regional competition. They have also failed to designed collective instruments that may level the playing field (see Laplane, Sarti, Sabbatini e Britto, 2001). Wide differences in tax and incentives structures can distort trade flows and investment location, leading to significant pressures for increased protection and market fragmentation. In Mercosur, the first priority was given to discipline incentives on intra-regional

[31] Proposals to implement structural adjustment programs or to extend the "safeguards regime" after the end of the "transition period" were equally discarded. The adoption of the *Régimen de Adecuación Final* in 1995 proved to be an imperfect substitute.

exports. Dec 10/94 determined that tax incentives should not be used for intra-regional exports (except in certain circumstances), that export incentives should be GATT-compatible, that the concession or creation of a new incentive (or the maintenance of existing ones) should be subject to consultations and that member states should refrain from using multiple exchange rate regimes.[32] In order to appropriately enforce these commitments, Dec 10/94 asked member states to implement adequate verification and auditing mechanisms, particularly concerning indirect tax rebates. However, no precise instructions were given as to the content of these procedures. The lack of practical mechanisms was one of the major drawbacks of Dec 10/94.

Dec 10/94 did not address domestic production and investment subsidies explicitly, as these were supposed to be dealt with by a special group aimed at disciplining competition-distorting public sector policies. The issue was explicitly addressed by Dec 20/94, which created a technical committee to examine competition-distorting public sector policies. The committee should classify measures according to their compatibility or incompatibility with the customs union, taking into account economic efficiency criteria and GATT obligations.[33] The committee`s report should include guidelines to harmonize compatible measures and to progressively eliminate those incompatible with the custom union.

Although the list of measures was supposed to be submitted in mid-1995, the technical committee remained inactive during 1995 and 1996. In mid-1996 (Dec 15/96) an *Ad Hoc* group in charge of drafting recommendations on how to deal with competition-distorting public sector policies was created. One year later the *Ad Hoc* group asked member states to submit a list of competition-distorting public sector policies in order to prepare a consolidated list of national distorting practices. However, it set no date for submission. Eventually, in 2001 an inventory was drafted but not made public.

[32] These special circumstances were: a) long-term finance for capital good exports granted in conditions, terms and costs compatible with international practices; b) indirect tax rebates on exports, up to an amount equivalent to the tax paid along the process of production (or, alternatively, to exempt exports from indirect taxes until production taxes are harmonized); and c) those established by special customs regimes (temporary admission and drawback) for intermediate products, parts or components used to produce goods in process of convergence towards the CET, or for products charged with the CET but in which inputs, parts or components in process of convergence to the CET account for more than 40% of the product´s fob value. The reimbursement, suspension or exemption of import tariffs should never be higher than the amounts effectively paid, suspended or exempted.

[33] Measures should be classified in: a) measures involving an exemption from common trade policies; b) tax measures; c) credit measures; d) government procurement measures; and e) rules governing public sector firms or monopolies.

The issue of competition defense and the need to harmonize existing legislation also entered Mercosur´s negotiating agenda in the mid-1990s. Dec 21/94 defined a number of basic principles to guide competition defense and established that before March 31, 1995 member states should submit detailed information on existing national legislations.[34] Based on this information, the Common Market Group was asked to draft a Competition Defense Statute before mid-1995. In 1996, Dec 18/96 passed Mercosur´s Competition Defense Protocol (not yet in force). The Protocol would apply to all acts which may affect competition in the region. The Protocol listed the practices that limit or restrain competition or market access and those that constitute an abuse of dominant position. Member states were asked to adopt common rules to control practices and contracts that may affect competition or lead to a dominant market position. The Trade Commission and the Competition Defense Committee (formed by the competent national agencies) were designated as the agencies responsible for enforcing the Protocol.

The Protocol established that within a period of two years member states "should draft common rules and mechanisms to discipline state aids that may limit, restrict, falsify or distort competition and may affect intra-regional trade". This commitment led to the creation of the *Ad Hoc* group on distorting public sector policies mentioned before. Lack of progress led to the continuous enforcement of national antidumping regimes. In particular, the Argentine authorities refused to stop applying its domestic antidumping and countervailing legislation to intra-regional trade until there was an agreement on state aids and competition defense extends its reach into state aids.

Mercosur member have signed two protocols on extra and intra-regional investment, but none of them makes explicit provisions concerning minimum standards of treatment. Moreover, none of them has been yet implemented, since Congressional approval is still pending. The Buenos Aires Protocol (1994) defined general treatment principles for extra-zone investors, while the Colonia Protocol (1993) addressed disciplines on intra-regional investment. None of the protocols make progress in disciplining investment incentives. The Buenos Aires Protocol establishes that member countries should not "grant third parties a treatment more favorable than that established by the present Protocol". However, since the Buenos Aires Protocol makes no reference to

[34] The basic competition defense principles agreed included: the definition and prohibition of a set of agreements and concerted practices aimed at impeding, restricting or distorting competition; b) the definition and prohibition of what constitutes an abuse of a dominant position; c) the examination of concentration initiatives that would lead to a market share equal or higher than 20%; and d) the definition of cooperation and coordination criteria between national authorities in charge of enforcing competition defense law.

incentives or instruments to attract investment, the statement is applicable only to the legal treatment. The Protocol left the door open for divergent national incentives regimes, since it established that "each member state will promote in its own territory the investment of third parties and will admit those investments according to its own legislation and regulations".

The Colonia Protocol was even more explicit in authorizing divergent national treatments for intra-regional investors. Art. 2 established that investors from other member states should be treated "not less favorably" than local investors or third party investors, although transitory and limited exemptions could be maintained. However, this opened the possibility of more favorable treatment, as explicitly stated in Art 7 ("if the legislation of one member state (…) or an agreement between an investor from a member state and the member state where the investment was made have agreed more favorable treatment than (…) that of the present Protocol, it will prevail over the present Protocol". The Protocol also established that there will be no "performance requirements as a condition for establishment, expansion or maintenance of investments demanding a certain level of exports, the acquisition of domestic inputs or services or any similar conditions". Argentina and Brazil reserved their rights to temporarily maintain performance requirements in the motor vehicles industry.

6.2 Dealing with macroeconomic spillovers

Apart from the general statements made in the Treaty of Asunción and the *Acta de las Leñas*, the issue of macroeconomic coordination was not taken up until the *Acta de Ushuaia* (1998). The *Acta de Ushuaia* established that member countries should work towards macroeconomic harmonization and address issues relevant to monetary unification. However, the *Acta de Ushuaia* was an initiative of the Argentine government geared more to promote a region-wide extension of the currency board system prevalent by that time (and eventually dollarization), than a proposal aimed to foster intra-regional coordination. Partly because of this reason the Brazilian authorities received the proposal unenthusiastically.

Following the commitments undertaken in the *Acta de Ushuaia*, in 1999 the governments agreed the standardization of macroeconomic statistics as a first step towards enhanced macroeconomic cooperation. In 2001, member countries set medium-term indicative targets for selected macroeconomic indicators, such as the inflation rate, the public sector debt/GDP ratio and the public sector deficit/GDP ratio. A system was also established to correct deviations from the

agreed targets, but including no enforcement mechanism.[35] The assumption behind this approach was that given the divergent national revealed preferences concerning the exchange rate regime (an inflation targeting regime with managed floating in the case of Brazil and a currency board in the case of Argentina), the best option would be to promote convergence in a set of nominal variables, in the expectation that this would prevent major disruptions in real variables. The indicative targets agreed were eventually not met. The foreign exchange and financial crisis of Argentina in 2002 radically changed the environment of macroeconomic policy coordination: one of the major obstacles for enhanced coordination was removed (the currency board), but the Argentine crisis opened a period of significant macroeconomic volatility.

During 2002 talks about the creation of a Mercosur Monetary Institute to promote macroeconomic convergence have re-surfaced. However, macroeconomic cooperation will make headways only in a gradual manner. At a first stage partners may exchange views and information, thus reducing uncertainty and raising mutual knowledge and understanding. At a second stage, they may engage in mutual consultation and discussions. At that stage they may be ready to coordinate a response to perceived common threats ("dilemmas of common aversion"). Eventually, common policy instruments or explicit targets may be agreed. One worrying sign of Mercosur is that member states have failed to maintain even a regular, systematic and structured exchange of information and analysis among economic authorities, a necessary process to eventually engage in deeper macroeconomic cooperation.

[35] The targets agreed included a maximum 5% inflation rate for the transition period 2002/2005 and then a convergence towards 3%: a maximum 3.5% of GDP public sector deficit for the transition period until 2003 and 3% thereafter; and a declining trend for the public sector debt/GDP ratio after 2005 and a convergence towards a 40% ratio thereafter.

7. CONCLUDING REMARKS

This paper has briefly reviewed the extent of structural and policy asymmetries in Mercosur. Its major conclusions have been that: a) structural and policy asymmetries are significant, and b) they have not been addressed satisfactorily. Consequently, after a period of rapid market integration led by the removal of tariffs, market fragmentation has re-surfaced through less transparent and more discretionary measures. In this context, common trade policies have been increasingly difficult to enforce, making the customs union (and even the free trade area) more formal than substantive.

The enforcement of policies of agreed discrimination and the creation of regional funds to compensate structural asymmetries face a number of obstacles. One of them is the need to solve sensitive distributional issues: which countries/regions will be net contributors and which will be net recipients? In terms of output per capita, for example, the poorest region is in Brazil (the Northeast), while a small country such as Uruguay has an output per capita higher than the Mercosur average. Another obstacle is political and institutional: regional aids usually require pooling national competences in a community authority, which has so far proved difficult even is less demanding areas such as the enforcement of a CET. For the time being, the most promising areas for deeper cooperation are infrastructure investment and, hopefully, other regional initiatives aimed at fostering firms´ competitiveness and technological development. In these areas extra-regional resources may act as catalysts and stimulate a learning process that may eventually be extended into other policy areas.

Dealing adequately with policy asymmetries is probably more urgent. But coping adequately with this challenge will require that Mercosur member states gradually move toward shared preferences and develop equivalent institutional and financial capabilities. This is also an area in which external support can make a decisive contribution by helping to develop common policy frameworks and institutional resources. Whether the recently created Competitiveness Fora will play such a role is still to be seen. Initiatives such as BNDES proposed scheme to extend investment financial aids to Brazilian firms investing in other Mercosur countries was a first step, but a clearly insufficient one.[36]

[36] In 2002 the Banco Nacional de Desenvolvimento Económico-Social opened the door to facilitating investment finance for Brazilian firms making investments in Mercosur. However, the decision is not operational yet.

In summary, unless some progress is made in coping with structural and policy asymmetries, it is unlikely that Mercosur will make sustained progress towards increased economic integration. At best, it will follow the ebbs and flows of the economic cycle, alternating periods of growing interdependence with others of increased market fragmentation. One urgent task is to bring under some sort of common discipline the most distorting public sector policies currently in place. If such a modest degree of policy harmonization or centralized oversight cannot be secured, it is hard to imagine that there will be progress toward deeper forms of policy coordination, such as regional policies for compensating structural asymmetries, regional competitiveness programs or enhanced macroeconomic coordination.

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TABLE 1
Cross-country structural asymmetries in Mercosur: selected indicators

Indicator	Argentina	Brazil	Paraguay	Uruguay	Mercosur
Share in regional GDP (PPP) (percentage) 2001	24.8	72.5	1.1	1.6	100.0
Share of regional population (percentage) 2001	16.9	79.0	2.6	1.5	100.0
GDP per head (PPP) (Mercosur=100) 2001	152.8	95.7	45.3	106.2	100.0
GDP-Distribution by sector (percentage) 2001					
Agriculture	6.0	9.6	29.0	10.2	8.6
Industry	28.1	35.2	25.6	25.1	32.5
Exports-Sector distribution (percentage) 2001					
Primary products	35.4	18.4	60.0	14.9	23.9
Industrial products	62.8	79.5	40.0	84.6	74.1
of which:					
traditional industries	24.7	29.4	31.9	66.2	28.9
Unemployment rate (percentage), 2002	21.4	7.1	18.3	15.9	9.9*
Urban population (percentage of total), 2000	88.0	81.0	56.0	92.0	81.8*
Infant mortality rate (per 1000 live births) 2000	17.0	32.0	23.0	14.0	28.9*
Illiteracy rate, adult males (percentage), 2000	3.0	15.0	6.0	3.0	12.6*
Life expectancy at birth (years) 2000	74.0	68.0	70.0	74.0	69.2*
Foreign trade coefficient (X+M/2)/GDP (percentage) 2001	9.8	8.4	35.1	37.3	9.5
Exports to Mercosur as a share of total exports (percentage), 2001	28.0	10.9	52.4	54.8	18.2
Exports to Mercosur as a share of GDP (percentage) 2000	2.9	1.3	7.2	5.1	2.0

* Population weighted regional average.
Sources: Author's calculations based on EIU, ECLAC, IBGE, CEI, The World Bank, INDEC, IPEA.

TABLE 2
Cross-regional structural asymmetries in Mercosur: selected indicators

Region	Share in regional population (percentage) 2000	Share in regional GDP (PPP) (percentage) 2000	GDP per head (PPP) Mercosur=100 2000	Unemployment rate (percentage) 2002
Cuyo	1.2	1.5	128.5	14.2
Northeast	1.5	1.1	71.5	17.1
Northwest	2.1	1.6	79.0	21.3
Pampean	11.1	20.0	180.4	23.4
Patagonia	0.8	1.6	205.8	17.1
Argentina	**16.7**	**25.9**	**155.4**	**21.4**
North	6.0	3.3	54.4	n/a
Northeast	22.3	9.3	42.0	7.2
Southeast	33.7	41.3	122.2	7.1
South	11.7	12.5	107.1	5.2
Central-west	5.4	5.0	91.4	n/a
Brazil	**79.2**	**71.4**	**90.2**	**7.1**
Paraguay	**2.6**	**1.1**	**42.2**	**18.6**
Uruguay	**1.6**	**1.6**	**101.1**	**15.6**
Mercosur	**100.0**	**100.0**	**100.0**	**9.9***

* Population weighted regional average.
Sources: Author's calculations based on INDEC, EIU, IBGE, DGEEyC and INE

TABLE 3
Gaps between best-off and worst-off regions in Mercosur

Region	GDP per head (PPP) Mercosur=100 2000	Unemployment rate (percentage) 2002
Best-off region	205.5	5.2
Worst-off region	42.0	23.4
Best-off/Worst-off*	4.9	4.5
Three best-off regions	171.6	6.5
Three worst-off regions	46.2	21.1
Three best-off/Three worst-off*	3.7	3.2
Standard deviation	49.2	5.9

* In the case of the unemployment rate these ratios are inverted.
Source: Author's calcularions based on INDEC, EIU, IBGE, DGEEyC and INE

TABLE 4
Regions and foreign trade in Mercosur

Region	Share in total intra-Mercosur exports (percentage) 2000	Relative concentration of exports in Mercosur* Index=100 2000	Share of Mercosur in total exports of the region (percentage) 2000	Intra-Mercosur export coefficients (percentage of regional GDP) 2000
Pampean	33.7	105.0	33.9	2.8
Patagonia	7.5	95.1	30.7	7.5
Northwest	2.4	83.3	27.0	2.5
Northeast	0.8	94.7	30.0	1.3
Cuyo	2.6	110.4	35.3	2.8
Unclassified	1.3	na	19.3	na
Argentina	**48.3**	**na**	**32.3**	**3.1**
North	2.1	80.0	11.1	1.3
Northeast	2.7	84.9	12.0	0.6
Southeast	25.9	106.9	15.0	1.3
South	11.3	112.9	15.8	1.9
Central-west	0.4	27.3	4.0	0.2
Unclassified	0.5	na	5.3	na
Brazil	**42.9**	**na**	**14.0**	**1.3**
Paraguay	**3.1**	**na**	**63.6**	**7.2**
Uruguay	**5.7**	**na**	**44.6**	**5.1**
Mercosur	**100.0**	**na**	**20.9**	**2.0**

na, not applicable

* The index was calculated as the ratio between the share of exports to Mercosur in the region's total exports and the share of exports to Mercosur in each country's total exports.

Source: Author's calculations based on INDEC, CEPAL, Ministerio de Economía, AliceWeb-MDIC, IBGE y Base SAM

TABLE 5
Regions and foreign trade growth in Mercosur

Region	Growth of intra-Mercosur exports (percentage) 1993-2000	Growth of intra-Mercosur export coefficients* (percentage) 1993-2000
Pampean	133.3	100.0
Patagonia	210.2	150.0
Northwest	228.9	177.8
Northeast	69.5	62.5
Cuyo	91.1	64.7
Unclassified	30.1	na
Argentina	**136.4**	**93.7**
North	392.5	333.3
Northeast	105.3	50.0
Southeast	24.2	-13.3
South	61.6	18.7
Central-west	92.3	0.0
Unclassified	300.6	na
Brazil	**43.2**	**0.0**
Paraguay	**46.2**	**71.4**
Uruguay	**92.6**	**0.0**
Mercosur	**79.2**	**33.3**

na, not applicable

* Calculated as a percentage of regional GDP.

Source: Author's calculations based on INDEC, CEPAL, Ministerio de Economía, AliceWeb-MDIC, IBGE y Base SAM.