

Who's Better in International Trade and Development; the EU or NAFTA?

(Excerpted from Knowledge @Wharton.)

The similarities between Poland and Argentina were striking. By the time the Soviet Union collapsed, the two countries were beacons of reform in their regions. Each had a population of about 36 million. Both were introducing free-market reforms. And after decades of authoritarian rule, both were establishing democracies.

Argentina seemed the better bet. Its democracy was farther along and it had already begun a number of privatization programs. Poland started out with neither. Then, in 2001, Argentina was hit by a severe economic crisis which it has yet to recover from. Poland, meanwhile, has gone on to experience strong economic growth.

Wharton management professor Gerald McDermott, whose research focuses on international institutions, began to hear a joke circulating in Latin America several years ago: If you want your country to get rich, join the European Union. McDermott began to question whether there was more to that idea than a joke. He set out to examine international trade blocs and political clubs as institutional development programs by comparing the differences between the European Union's integration of former Eastern Bloc countries, the impact of the North American Free Trade Agreement (NAFTA) on Mexico, and the effect of Mercosur - the free-trade pact involving Argentina, Brazil, Uruguay and Paraguay - on Argentina and Brazil.

In a working paper titled, "International Integration Regimes as Development Programs: A Comparison of EU and NAFTA Accession Processes," McDermott and two co-authors suggest that economic integration schemes have a powerful impact on growth in developing nations.

The paper first examines a variety of economic development and governance indicators showing that Eastern European countries are pulling ahead of their counterparts in Latin America. Beyond that, the Eastern European nations, known as the Central and Eastern European Five (CEE-5) - Poland, Hungary, the Czech Republic, Slovakia and Slovenia - are experiencing a higher quality of economic development, including a concentration of high-tech firms and innovation-based businesses. "The Latin American countries were in the dumps while the Eastern European countries that are entering the European Union or have entered the European Union were doing much better," says McDermott.

The researchers then began to look at the characteristics of the international economic integration schemes that were in place in each region: The European Union and NAFTA.

According to McDermott, NAFTA is essentially a trade agreement aimed at liberalizing trade between member states. When it comes to economic development, he says, the theory underpinning NAFTA is that liberalized trade will eventually lead to an equal

distribution of wealth that will foster democracies. "With NAFTA, the theory is that if you give actors some strong economic incentives, then those private and public actors of the less developed countries will do everything possible to improve their situation."

80,000 Pages of Regulation

At first, Mexico's economy did respond to the new trade regime. Mexico had a one-time shift in productivity and made great strides in exports. "Then around the late 1990s, it flatlined." World Bank analysis of Mexico's economy suggests that the country has failed to develop the capacity to innovate and that its economy is based largely on producing cheap goods for export.

Meanwhile, in Europe, newly democratic states were petitioning for membership in the European Union which has elaborate standards for new members that, in addition to opening markets, require them to develop new social and political institutions. In addition, the European Union pledged financial aid to incoming members that were able to abide by its rules. Between 2007 and 2013 most of the countries will get from 2% to 4% of their GDP in aid, noting that this is more than countries received under the Marshall Plan after World War II. The European integration system is built on political institutions and mechanisms that decrease the probability that the gains and costs [of integration] will be distributed unevenly.

The study points to the regulatory machinery new members of the European Union must put in place that sets standards for everything from labor rules to safety to regulation of competition, banking and financial markets. In all, European Union members must comply with 80,000 pages of regulation.

"Trade agreements are paper thin," McDermott adds. "While free trade has important positive and negative impacts, it only gets you so far. To achieve sustainable gains for all parties involved, liberalized trade in goods, services and capital must be underpinned by greater institutional, political and social integration. Trade opens economies, but if you don't do the other work, you don't see the benefits of trade over time." For example, institutional integration includes common regulatory systems for markets like food, labor, capital markets, etc.; social integration includes labor flows and migration as well as greater development of education and cultural exchanges; and political integration includes the creation of supra-national entities that create laws and regulate various domains, but are governed by representatives from all member countries.

Another important difference in the two integration schemes is the ability for developing nations, referred to in the paper as "little brothers," to learn from their "big brothers" who have highly developed economies.

According to the paper, "The relative success of post-communist countries is the way the EU and its 'big brothers' have experimented with a variety of conditionality and compliance mechanisms to improve the institution building process of their 'little brothers.'" By "conditionality and compliance mechanisms," the authors mean the

monitoring and technical assistance systems that the EU uses to ensure that aspiring members meet the criteria for membership, use the financial aid properly, and develop superior institutions and infrastructure. In contrast, Mexico appears as a laggard because of the lack of institutionalization of learning and monitoring within the NAFTA framework. "NAFTA was just about free trade," says one author. "When new members join the EU, they become members of the political machinery."

As members of that machinery, little brothers face conditions for membership that are closely monitored by other members of the EU club. This deep engagement gives emerging economies an opportunity to see from the inside how successful economic systems operate. From there, they learn to build and manage their own institutions.

Capitalism: Two Views

The paper acknowledges that there are difficulties associated with enacting European-style integration. "The first challenge lies in the strain that such a development model places on big brothers' existing institutional capacity and financial resources. This makes the question of political commitment a central issue, not least of all because the provision of political and economic rewards is usually created by the big brother," the paper states. As McDermott notes, "It's one thing for advanced democracies to want stability and prosperity in their backyards; it's another thing to commit to the economic costs and power sharing after past failures in development and continued internal domestic social needs."

Second, the paper says, "issues about the nature of conditions and their determination could pose another potential obstacle. The strict demands of the EU could be considered to be undemocratic and paternalistic, and American counterparts may feel that EU conditions provide for the creation of institutions which are too interventionist for their liking." For instance, the EU requires aspiring members to harmonize their institutions and laws with those of the EU in 31 policy domains. Although the United States itself has large institutions and bureaucracies for regulating markets (e.g., capital markets, food safety, consumer safety, labor relations, environment, etc.), it still feels that such issues should not be linked in any substantial way with trade relations and that Mexico's regulations should come from its own efforts and market signals.

Why has there been such a big difference in the approach taken toward developing nations in the leading integration programs? The United States' more hands-off approach stems, perhaps, from a deep belief in unfettered capitalism. In Europe, there has long been a clash between two views of capitalism. One is the free-market, U.S.-style approach. The other is that capitalism must be moderated by a strong regulative state and social protections.

After the fall of Communism, many academics were predicting that the populations of Eastern Europe would eventually turn back toward a more socialist state if economic times got tough. Now, 17 years later, the pro-democracy, free-market zeal that prevailed in the streets of Prague and East Berlin has, for the most part, prevailed. The biggest fear

at the time, says McDermott, "was that democracy and capitalism might not be compatible, since large segments of society, at least in the short run, might experience significant social and economic hardships and use the politically liberalized environment to turn against reforms. Western European countries, living in close proximity to the populations of their developing neighbors, have security interests in keeping those closest to them happy in their own homeland.

Tourism flourishing between Western Europe and the newly emerging democracies also has played a positive role in Europe's approach to its "little brothers" compared to the Latin American countries in the U.S. economic sphere. "I think it was important in the process that they were right next door. Western Europe got to know these people gradually," says McDermott. There is more interaction."

Another geopolitical characteristic - the huge size of the United States - may have had a role in shaping the different approach to economic integration in Europe and the Americas, suggests McDermott. "The European Union is made up of a lot of countries, and even the largest ones are medium-sized. The U.S. is always going to have this asymmetrical relationship with the world, especially in the Americas. The U.S. is giant. Why would it want to share anything with anybody? It doesn't have to share."

Going forward, the paper suggests there may be ways around this imbalance.

"Behind the EU integration process is not simply a narrow economic interest or a pure philanthropic interest," says McDermott. "This is 'real-politic' in the multilateral world. The core EU countries want economic, social and political stability. By pro-actively strengthening the institutions of its Eastern neighbors in return for political voice and economic assistance, the core EU members gain a much more cohesive continent and much stronger club to compete in the world.

"The over-emphasis by the United States on economics and market expansion has greatly hamstrung its ability to shape geopolitics," McDermott adds. "For all practical purposes, NAFTA and the institutional development of Mexico are frozen. Further economic integration requires much deeper institutional integration, harmonization and upgrading, and these are fundamental political questions. Do the Mexicans, for instance, want greater U.S. and Canadian intervention into their lives in return for economic and technical assistance? Would the U.S. be willing to finance a large part of infrastructure and institutional development in Mexico and gradually share power with the Mexicans and Canadians over the governance of these programs?"