

ARE PREFERENTIAL TRADE AGREEMENTS  
STRENGTHENING OR UNDERMINING A RULES-  
BASED SYSTEM?

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I. INTRODUCTION

The current multilateral trading system is at an impasse. The World Trade Organization (WTO)'s Appellate Body has been dormant since the United States blocked appointments of new judges in 2019, preventing the Appellate Body from adjudicating any disputes with only one judge remaining on the bench.<sup>1</sup> At a more general level, the Doha Development round of trade negotiations, launched in 2001 and lasting a decade, failed to reach a comprehensive deal.<sup>2</sup> In addition, the distrust developing states have brewed towards developed states has only further bifurcated the trading system into developed United States and European Union on one side, and emerging China, Brazil, and India on the other.<sup>3</sup> Despite the brief

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1. Tom Miles, *U.S. Blocks WTO Judge Reappointment As Dispute Settlement Crisis Looms*, REUTERS (Aug. 27, 2018), <https://www.reuters.com/article/us-usa-trade-wto/u-s-blocks-wto-judge-reappointment-as-dispute-settlement-crisis-looms-idUSKCN1LC19O>. Since the Appellate Body's dormancy, 17 cases have been in limbo, enabling states to continue their trade practices rejected by the lower panel. Yuka Hayashi, *Countries Seek New Fix for Dormant International Trade Court*, WALL ST. J. (Feb. 24, 2021), <https://www.wsj.com/articles/countries-seek-new-fix-for-dormant-international-trade-court-11614189115>.

2. Ben Otto, *Trade Ministers Try Again to Revive Doha Deal*, WALL ST. J. (Dec. 2, 2013), <https://www.wsj.com/articles/SB10001424052702303670804579233950315253692>.

3. Bernard Hoekman, *Multilateral Cooperation in a World of Preferential Trade Agreements*, 21 BROWN J. WORLD AFFS. (2015); see, e.g. Yuka Hayashi, *India Official's Opposition to Agreements Unsettles WTO Meeting*, WALL ST. J. (June 15, 2022), <https://www.wsj.com/articles/india-officials-opposition-to-agreements-unsettles-wto-meeting-11655329432> (describing India's commerce and industry minister Mr. Goyal's frustration with the developed states' inability to help developing states during the pandemic and the actions developed states like United States and European Union took at the expense of developing states' development).

success the WTO achieved in June 2022 when states convened to agree on a measure aimed to boost the supply of COVID-19 vaccines in developing states,<sup>4</sup> the organization has not produced any broad, substantive trade agreements since 2013.<sup>5</sup> The standstill can be traced to the fundamental structure of the WTO, which comprises of 164 members all at various stages of development and with distinct objectives.<sup>6</sup>

In response to the stalemate in the WTO, many states have resorted to preferential trade agreements (PTAs) to improve market access by reaching specific agreements with selected partners. PTAs allow states to reach negotiations with greater speed and flexibility, while affording the opportunity to reach agreements on areas that have been excluded from the Doha Development Agenda, such as investment, government procurement, and competition.<sup>7</sup> Agreements containing provisions that go beyond the current WTO mandate agreed upon the multilateral level are referred as “WTO plus.”<sup>8</sup> An example of a WTO plus provision is greater reduction in tariff level as required by existing WTO agreements. By contrast, agreements that contain provisions attending to areas outside the WTO mandate, such as commitments on labor standards, are referred as “WTO-X.”<sup>9</sup>

Given the rise of PTAs with WTO plus or WTO-X provisions, a question that comes to bear is whether these agreements strengthen or undermine the rules-based trading system under the WTO framework. On a trade level, PTAs allow preferred partner states to enjoy greater market access by negotiating amongst themselves outside the WTO framework. However, this same attribute also creates room for discrimination against states that are left out of the agreement. On a systemic level, PTAs allow hegemonic states to attain their trade agenda through series of bilateral or regional trade

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4. World Trade Organization, Ministerial Decision on the TRIPS Agreement, WTO Doc. WT/MIN(22)/30 (adopted June 17, 2022); World Trade Organization, Ministerial Decision on the WTO Response to the COVID-19 Pandemic and Preparedness For Future Pandemics, WTO Doc. WT/MIN(22)/31 (adopted June 17, 2022).

5. Yuka Hayashi, *WTO Nations Agree to Ease Patent Rights to Boost Covid-19 Vaccine Suppliers in Poorer Nations*, WALL ST. J. (June 17, 2022), <https://www.wsj.com/articles/wto-nations-agree-to-ease-patent-rights-to-boost-covid-19-vaccine-supplies-in-poorer-nations-11655441416>; see Editorial, *The WTO Is On Life Support – But The World Still Needs It*, FIN. TIMES (June 19, 2022), <https://www.ft.com/content/85ac7098-4d6d-4f93-9f5f-f12e373dd753> (describing how the agreements reached during the ministerial meeting “lacked much real substance”).

6. *Understanding the WTO: The Organization*, WTO, [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org6\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm) (last visited Oct. 16, 2022).

7. KENNETH HEYDON AND STEPHEN WOOLCOCK, *THE RISE OF BILATERALISM: COMPARING AMERICAN, EUROPEAN AND ASIAN APPROACHES TO PREFERENTIAL TRADE AGREEMENTS* 6 (2009).

8. Henrik Horn et al., *Beyond the WTO? An Anatomy of EU and US Preferential Trade Agreements*, 7 BRUEGEL BLUEPRINT 4 (2009).

9. *Id.*

negotiations, with developing states using their political and economic powers. Yet, the use of power is directly against the consensus decision-making at the multilateral trading level and may turn the rules-based system into a power-based one.

This Annotation proceeds as follows. Part I provides an overview of the founding principles of the rules-based system, from the General Agreement of Tariff and Trade (GATT) in 1947,<sup>10</sup> to the succeeding WTO established in 1995. Part II investigates the effect PTAs pose on a trade level by examining empirical evidence of trade creation and diversion caused by PTAs. Part III focuses on the systemic level by analyzing the impact from hemogenic states' power play on their counter PTA partners. Finally, Part IV concludes that, despite the positive trade effects conferred by PTAs, hegemonic states' abuse of PTAs has undermined principles of trade without discrimination and fair competition in our rules-based, multilateral trading system.

## II. FOUNDING PRINCIPLES OF THE RULES-BASED SYSTEM

After a period of world-wide recession, followed by protectionist and discriminatory trade policies during the interwar period,<sup>11</sup> twenty-three states convened in Geneva to create the General Agreement on Tariff and Trade (GATT) in 1947, a rules-based trading system through which states negotiated trade barriers and tariff reductions.<sup>12</sup> The framework was founded upon the vision of an open world trading system, where states could “[enter] into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce.”<sup>13</sup>

GATT's successor, the WTO, upholds similar principles. The WTO's five core principles are (1) trade without discrimination, (2) freer trade through negotiation, (3) predictability through binding and transparency, (4) promotion of fair competition, and (5) encouragement of development and economic reform.<sup>14</sup> The first principle has two elements: (a) most-favored-nation (MFN) treatment, which requires states to treat each WTO member equally without special favors granted to selected states, and (b) national treatment, which requires states to treat foreign importers the same

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10. General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT].

11. DOUGLASS A. IRWIN ET AL., *THE GENESIS OF THE GATT* 5–7 (2008).

12. IRWIN ET AL., *supra* note 11, at 1.

13. GATT, *supra* note 10, Preface.

14. *Principles of the Trading System*, WTO, [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact2\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm) (last visited Oct. 16, 2022).

as domestic producers.<sup>15</sup> The second principle speaks to the idea of “progressive liberalization” where states should gradually lower their trade barriers and open up their markets.<sup>16</sup> The third aims to provide stability and predictability in the multilateral trading system by having states “bind” their commitments in tariff reduction.<sup>17</sup> The fourth directs at a “system of rules dedicated to open, fair and undistorted competition.”<sup>18</sup> Lastly, the fifth principle reiterates the organization’s founding vision to facilitate economic prosperity and reform through international trade.<sup>19</sup>

The WTO is a member-driven organization. As such, decision-making is taken by consensus among all member states.<sup>20</sup> This structure allows each member’s interests to be properly considered and creates an opportunity for any single member state to hold up and block a negotiation from going forward. The following sections will examine whether PTAs strengthen or undermine the WTO’s rules-based trading system through the lens of trade effects and systemic effects.

### III. TRADE EFFECTS OF PTAs

PTAs can create synergistic opportunities for preferred partner states. If a PTA succeeds in reducing trade barriers, members of the agreement can reduce their trade costs and enjoy an increase in trade volume. The North Atlantic Free Trade Agreement (NAFTA),<sup>21</sup> signed by Canada, Mexico, and the United States in 1992, serves as an illustration. From 1993 (a year before NAFTA went into effect) to 2005, sectoral tariff rates between Mexico, Canada, and the United States dropped from an average of 12.5%, 4.2%, and 2.7%, respectively, to almost zero.<sup>22</sup> In correlation with the tariff reduction, intra-bloc trade increased by 118%, 11%, and 41% for Mexico, Canada, and the United States, respectively.<sup>23</sup>

The corollary of trade creation is the inevitable effect of trade diversion that occurs when a trade agreement diverts trade from a lower-cost,

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15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Whose WTO Is It Anyway?*, WTO, [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org1\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/org1_e.htm) (last visited Oct 16, 2022).

21. North Atlantic Free Trade Agreement, Can.-Mex.-U.S., Dec. 17, 1992, 48 CFR 25.405 [hereinafter NAFTA]. NAFTA was renegotiated and substituted with United States-Mexico-Canada Agreement in 2020. United States-Mexico-Canada Agreement, Can.-Mex.-U.S., Nov. 30, 2018, 19 U.S.C. Ch. 29.

22. Lorenzo Caliendo & Fernando Parro, *Estimates of the Trade and Welfare Effects of NAFTA*, 82 REV. OF ECON. STUDIES 3 (2015).

23. *Id.*

more-efficient state to a partner state within the PTA bloc.<sup>24</sup> Provisions like “rules of origins, regulatory convergence, and mutual recognition” contained in a PTA makes sourcing in a PTA state cheaper than in a non-PTA one. This differential creates a strong incentive for companies to relocate into a PTA bloc just to reap the economic benefits of trade.<sup>25</sup> Trade diversion can be very significant in scale. A study in 2001 estimated that if an East Asia Free Trade Area were to be created without U.S. membership, U.S. exports would fall by \$25 billion annually.<sup>26</sup> Nonetheless, trade diversion is only harmful to the extent that the loss in trade is greater than the creation of trade. Overall findings from economic literature suggest that, though there is evidence of weak trade diversion, trade creation on a net basis is still greater and PTA is generally welfare-improving for the partner states.<sup>27</sup> The NAFTA study cited above supports this general finding. The study concludes that trade creation between NAFTA members is larger than trade diversion from other economies.<sup>28</sup> Mexico and the United States enjoyed a respective 1.31% and 0.08% increase in wealth respectively, while Canada suffered a welfare loss of 0.06%.<sup>29</sup> Therefore, although PTAs lead to trade diversion, on a net basis, the multilateral system still benefits from a deeper trade integration and a modest welfare improvement.

#### IV. SYSTEMIC EFFECTS OF PTAS

PTAs stand in a unique position to spur open market liberalization. They create a domino effect that propels states not in an existing agreement to participate in a similar one or to lower their trade barriers.<sup>30</sup> This effect is achieved in two stages. In the first stage, there is an “idiosyncratic deepening of integration” amongst states in the PTA.<sup>31</sup> In the second stage, states left out of the agreement experience a “knock-on impact” of trade discrimination, spurring them to either join the agreement or lower their trade barrier to gain the same market access.<sup>32</sup> In effect, the rise of PTAs

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24. HEYDON & WOOLCOCK, *supra* note 7, at 18; JADISH N. BHAGWATI, TERMITES IN THE TRADING SYSTEM: HOW PREFERENTIAL AGREEMENTS UNDERMINE FREE TRADE 49 (2008).

25. Hoekman, *supra* note 3, at 139.

26. C. FRED BERGSTEN, THE UNITED STATES AND THE WORLD ECONOMY: FOREIGN ECONOMIC POLICY FOR THE NEXT DECADE 35 (2005).

27. HEYDON & WOOLCOCK, *supra* note 7, at 221–22.

28. Caliendo & Parro, *supra* note 22, at 3.

29. *Id.*

30. Richard E. Baldwin, *Multilateralising Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade*, 29 WORLD ECON. 1451, 1467 (2006).

31. *Id.*

32. *Id.*

expediates trade liberalization by creating a fear of being left behind among states not willing to liberalize their trade to the same extent.

However, it is unclear whether this systemic effect is a positive one for the rules-based order established under the WTO. If states can negotiate their desired trade agenda with selected partners through PTAs and propel states not in the agreements to follow suit and liberalize to similar extent in the face of the fear of being left behind, PTAs may effectively turn the rules-based multilateral trading system into a power-based one.

PTAs are especially vulnerable to interest capture, as described above, if negotiated between powerful, hegemonic states like the United States and European Union members, and states with less political and economic leverage, like many in Southeast Asia and Africa. In these negotiations, the hegemons derive strong bargaining power from the sheer size of their economies.<sup>33</sup> The power imbalance allows them to press forward WTO-X provisions that may otherwise have been rejected at the WTO forum through consensus decision-making.<sup>34</sup> However, on a bilateral level, these provisions become difficult to resist if the counterpart state does not have equal economic might as a bargaining chip. These powerful states implement a strategy of “divide and conquer,” that first divides the developing mass’s collective bargaining power by signing PTAs containing WTO-X provisions with individual developing states, and eventually conquers the WTO forum with agendas the developing states were forced to accept on the bilateral level.<sup>35</sup> This strategy is problematic because the obligations imposed by PTAs through asymmetrical bargaining may establish regulatory structures that are advantageous to the states which bargained for them, but incompatible with the developing states given their stage of development.<sup>36</sup> In effect, PTAs turn the trading system into a power-based one, enabling powerful states to shape the rules in the multilateral trading system by taking coercive advantage of the power imbalances that exist at the bilateral level.

## V. CONCLUSION

To address the question of whether PTAs strengthen or undermine the multilateral rules-based system under the WTO framework, on a trade level, PTAs seem to have positive effect on trade volume and overall wealth improvement despite weak trade diversion. However, the question becomes more complicated on a systemic level. PTAs provide a more flexible and efficient avenue for states to liberalize their markets on a scale not

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33. BHAGWATI, *supra* note 24, at 71.

34. *Id.* at 71–73.

35. *Id.* at 81.

36. *Id.* at 95–81.

achievable on the multilateral level. Instead of trying to reach consensus with every member in the WTO, states can choose their own partners and craft their own provisions to open up their markets. However, the flexibility of PTAs is a double-edge sword: PTAs allow powerful states to bypass the rules established in the multilateral trading system and capitalize on their political and economic forces to achieve their desired agendas. Such exercises of power directly contravene the principles of trade without discrimination and promoting fair competition that lie at the core of the WTO framework. Thus, despite the benefits conferred by PTAs, their proliferation poses a threat to the rules-based multilateral trading system.