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# Regional Integration and Incomplete Club Goods: A Trade Perspective

Chris Brummer\*

## I. INTRODUCTION

In the last ten years, regional organizations have emerged as the fora of choice for tackling many of the world's most intransigent political and economic challenges. By providing smaller and more accessible venues for negotiations, regional organizations often make possible a more efficient means of consensus building than that usually available under multilateral frameworks like the World Trade Organization. And because many governments are more familiar with their neighbors than with far-flung multilateral interlocutors, regional organizations—frequently referred to in the literature as regional integration agreements (“RIAs”)<sup>1</sup>—are also well-suited to achieving results in non-economic issue areas such as the environment, peace-building, and immigration.

Yet despite their popularity, regional organizations are decidedly controversial, particularly among economists, for the very fact that they depart from multilateral (global) free trade and thereby the field's normative preference for efficiency.<sup>2</sup> As integrative agreements *only* between neighboring countries, RIAs do not always create new trading opportunities. Instead, by lowering tariffs on goods flowing between member states, while at the same time retaining high tariffs against goods from third-party countries, they substitute intra-bloc

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<sup>1</sup> Due to the underlying commitments on which regional organizations are based, regional organizations are often referred to by economists and many legal scholars as regional integration arrangements, a terminology reflecting both the political and economic underpinnings of the organizations. This Article will use both terms interchangeably.

<sup>2</sup> See, for example, Jagdish Bhagwati, a leading critic of regionalism, in his influential article, *Regionalism versus Multilateralism*, 15 *World Econ* 535, 550–54 (1992) (expressing skepticism about whether regionalism serves the “widely-shared objective of multilateral free trade for all”).

imports for what would otherwise be imports from outside the group.<sup>3</sup> Because of such trade diversion, many academics and policymakers have relied on longstanding economic theory to characterize regional free trade as a “club good”—that is, as a special private benefit deriving value, in part, from the fact that nonparticipants are excluded.<sup>4</sup>

This characterization not only highlights the fact that regional trade agreements are distinguishable from other kinds of accords in which cooperation creates benefits for both signatories and nonsignatories. It also implies two core descriptive claims regarding the underlying dynamics of regional integration. First, it suggests that regional organizations have strong internal dynamics that create overwhelming incentives for countries to form or to join them and for outsiders, in response, to create their own organizations in order to enjoy similar benefits. Second, it implies that the size of any regional organization will be, in part, a function of the number of other countries that consume the club good. Where too many countries create a preferential market, a certain “congestion point” will be reached; beyond that juncture, adding additional members will diminish the value of membership in the organization for all participants.

This Article undertakes the first systematic examination of RIAs as clubs in the legal literature and argues that although regional organizations exhibit some club-like dynamics they are at best incomplete forms of such cooperation. Two shortcomings are specifically identified. First, the Article shows that the legal architecture of trade agreements limits the degree to which regional organizations are truly exclusive. As a result, regional organizations provide fewer benefits to members than classic economic clubs. Second, regional organizations are heterogeneous in ways other than those envisioned in the classic economic club literature. Specifically, members differ not in terms of the

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<sup>3</sup> For a comprehensive discussion of this phenomenon in the legal literature see Sungjoon Cho, *Breaking the Barrier between Regionalism and Multilateralism: A New Perspective on Trade Regionalism*, 42 Harv Intl L J 419 (2001) (outlining political and economic perspectives of trade regionalism). See also Chris Brummer, *Ties that Bind?: Regionalism, Commercial Treaties and the Future of Economic Integration*, 60 Vand L Rev 1349, 1354–62 (2007).

<sup>4</sup> See, for example, Todd Sandler, *Regional Public Goods: Demand and Institutions*, 1 Rev Intl Org 5 (2006). See also Michele Fratianni and John Pattison, *International Organisations in a World of Regional Trade Agreements: Lessons from Club Theory*, 24 World Econ 333, 333–358 (2001) (asserting that club theory reveals that regional trade agreements are not flukes, but have proliferated because cooperation is feasible and attractive in smaller groups with a few larger players); Michael Wohlgemuth and Clara Brandi, *Strategies of Flexible Integration and Enlargement of the European Union: A Club-Theoretical and Constitutional Economics Perspective*, 06/7 Freiburger Discussion Papers on Constitutional Economics (2006), available online at <[http://walter-eucken-institut.de/publikationen/06\\_7bw.pdf](http://walter-eucken-institut.de/publikationen/06_7bw.pdf)> (visited Nov 17, 2007) (analyzing the EU as a club and the “club-of-clubs” approach as an ideal-type model for a European Union of the future).

degree to which they prefer the club good—as is the theoretical conception of heterogeneity in the club goods literature—but instead in terms of their qualitative characteristics and competitiveness. Each member will thus not only incur different costs in joining a regional organization, but will also have a different point at which the preferential trading market will be congested with too many competitors. This heterogeneity further suggests that, all other political factors being equal,<sup>5</sup> expansion of an RIA's membership will be based not so much on the economic competitiveness of new members, but instead on the inefficiency of a prospective member state's domestic industries relative to those of each of the RIA's members.

Before proceeding, however, a brief note as to this Article's methodology is in order. I consciously employ a series of hypothetical scenarios to demonstrate the welfare implications of certain RIA structural characteristics. Though virtually all of the examples are drawn from actual events identified in the Article's footnotes, I use abstract labels (such as "Country A" as opposed to "Germany") to underscore the generalizability and broad applicability of the incentives many, if not most, members of RIAs face. By emphasizing the commonality of structural dynamics driving economic integration, I hope to spur a broader theoretical re-examination of regional trading blocs untethered from geographic or institutional qualifications.

## II. A PRIMER ON THE THEORY OF CLUB GOODS

To understand just how the theory of clubs relates to regional organizations, some introductory remarks regarding the economic theory of clubs are required. As an academic undertaking, the study of clubs provides a theoretical foundation for the study of cooperation. In particular, it is used to assess why groups arise and to what extent members in groups should exclude nonmembers from cooperation or joining the group in order to maximize utility.

Economists generally define clubs as voluntary groups in which two or more individuals cooperate in order to create a common shared good.<sup>6</sup> These common goods share two characteristics. First, they are at least partly

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<sup>5</sup> Indeed, it is critical to emphasize that many countries join regional organizations for not only economic reasons but for political purposes as well. See Sungjoon Cho, *Defragmenting World Trade*, 27 *Nw J Intl L & Bus* 39, 43 (2006) (noting that RIAs "are often suffused with political considerations that may prevail over . . . concerns of economic policy").

<sup>6</sup> Richard Cornes and Todd Sandler, *The Theory of Externalities, Public Goods, and Club Goods* 347 (Cambridge 2d ed 1996) (differentiating "club" goods and "public" goods).

“rivalrous.”<sup>7</sup> In other words, when one unit of the good is consumed by one individual, it detracts from the consumption opportunities of others.<sup>8</sup> Second, club goods are “excludable,” that is, the common good and its benefits can be kept within the group and away from others.<sup>9</sup> Together, rivalrousness and excludability denote utility derived from the creation of an exhaustible good that is at the same time protected from consumption by outsiders to the group who did not contribute to its creation.

The optimal size of a club is largely a function of what economists call congestion, or the size at which the costs of adding additional members outweighs the benefits.<sup>10</sup> Club theory holds that where membership is small, members can consume a good without any one member’s consumption detracting greatly from the ability of others to consume the good. However, once the membership in a club becomes so large that, due to the rivalrous nature of the benefit, members are less able to enjoy the benefit due to the presence of others, club theory implies that membership should be closed and no new members added.

The classic example used to describe the dynamics of a club is the construction and maintenance of a swimming pool.<sup>11</sup> On her own, one person typically will not have the resources to build a swimming pool, and even if she did, she might not have enough incentive to build it by herself. There are, however, economies of scale that arise with the provision of a pool. In particular, two people, acting in a club, are much better suited to buy and to operate a pool than one, and four are even better than two, and so on. So long as the number of pool club members remains modest, the enjoyment by one will not greatly undermine the enjoyment of the other group members, and thus it is attractive to have multiple members of the club.

Nevertheless, the economies of scale made possible by cooperation are not infinite. As membership in the club increases, the marginal costs to existing members will increase as crowding of the pool takes place. Furthermore, as membership grows, the marginal benefit of any additional member will be ever smaller as users may have to account for longer waits, less room to swim, and

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<sup>7</sup> See *id.* at 8 (defining rivalrous goods as arising “when a unit of the good can be consumed by one individual without detracting, in the slightest, from the consumption opportunities still available to others from that unit”).

<sup>8</sup> *Id.*

<sup>9</sup> See *id.* at 349 (describing excludability as arising where nonmembers can be monitored or barred).

<sup>10</sup> *Id.* at 348 (defining congestion).

<sup>11</sup> This example was first introduced by James M. Buchanan in his seminal piece *An Economic Theory of Clubs*, 32 *Economica* 1 (1965) (asserting that “there exists some most preferred or optimal membership for almost any activity and this membership varies in some relation to economic factors”).

higher bacteria counts in the swimming pool.<sup>12</sup> Thus eventually, the addition of new members in the swimming club will overwhelm the utility for existing members. At this point, the optimal size of the consumption group will be smaller than the size of the population.

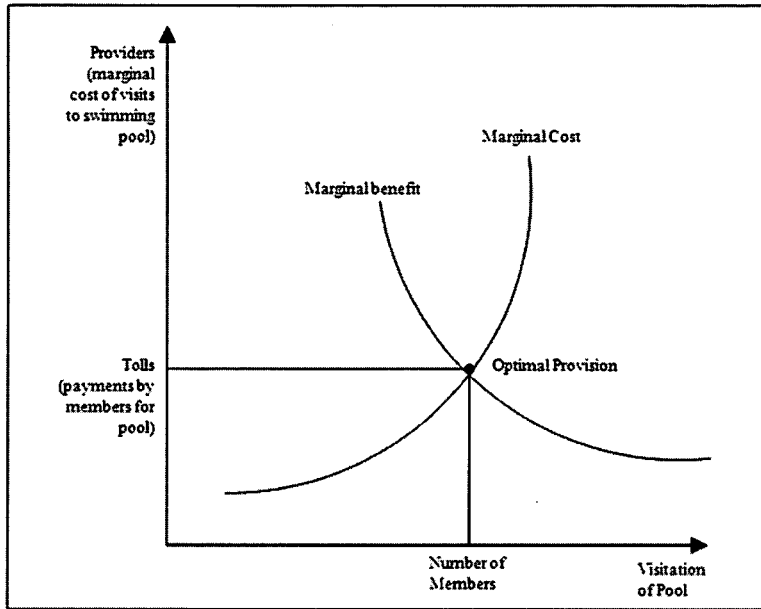


Figure 1: Optimal Provision of a Swimming Pool

Economic clubs, economists explain, work in the same way. By allowing members to draw from one another's characteristics, clubs create private benefits for members. Because, however, the utility of each individual's consumption of the benefit is a function of the number of others who consume the good, congestion can arise. As a result, there are natural limits to the size of membership in a club, limits that are themselves tied to the kinds of obligations members undertake, the degree of preferences among members, and the kind of good to be provided.<sup>13</sup> These factors inform the point at which congestion is reached.<sup>14</sup>

<sup>12</sup> See Cornes and Sandler, *The Theory of Externalities* at 348 (cited in note 6) (describing the "sundry" forms that congestion may take).

<sup>13</sup> Todd Sandler and John Tschirhart, *Club Theory: Thirty Years Later*, 93 *Pub Choice* 335, 338 (1997) (providing a survey of club theory with an emphasis on the last fifteen years).

<sup>14</sup> *Id.*

### III. REGIONAL ORGANIZATIONS AND THE PRODUCTION OF CLUB GOODS

Regional organizations are analogous to clubs in a variety of ways. In regional organizations, geographically proximate countries pledge to adopt common legal rules or principles regarding, at a minimum, the preferential treatment of goods from other members of the organization.<sup>15</sup> Usually, such commitments include most-favored nation (“MFN”) treatment, whereby a state accords to a counterparty the same favorable terms it offers in agreements with other nations,<sup>16</sup> and national treatment, in which countries afford one another’s nationals the same benefits and treatment they afford their own.<sup>17</sup> Some RIAs, like the European Union, are also empowered to address policies concerning investment and services.<sup>18</sup> Meanwhile, others, like the North American Free Trade Agreement (“NAFTA”) and the Central American Free Trade Agreement (“CAFTA”), grant investors from signatory countries the right to sue member governments whenever a state fails to live up to its treaty commitments concerning foreign direct investment.<sup>19</sup> Thus, if a member state decides to discriminate against a foreign investor, that investor, as a citizen of a member state, would be able to compel arbitration with the host state government in order to obtain compensation.

The logic of regional integration is derived largely from the perceived advantages of collective action. Cooperation in the form of regional integration makes possible the creation of a larger market, as well as access to that market on terms better than those available to outsiders to the regional group. Suppose, for example, Country X and Country Y are members of the same regional organization, and the rules under which a regional organization operates require that participants impose no more than a \$1 duty on goods. Otherwise, each imposes a \$2 duty on goods imported from nonmembers. Suppose further that Country Z is not a signatory to the regional treaty. In such circumstances,

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<sup>15</sup> For a comprehensive account of RIAs, see Maurice Schiff and L. Alan Winters, *Regional Integration and Development* (Oxford 2003).

<sup>16</sup> World Trade Organization, *Principles of the Trading System*, (2005), available online at <[http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact2\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm)> (visited Nov 17, 2007).

<sup>17</sup> Id.

<sup>18</sup> See Treaty Establishing the European Community, 1997 OJ (C 340) 3, art 57 (Nov 10, 1997) (indicating that the EU’s Council of Ministers may, with certain restrictions, adopt measures on the movement of direct investment). Investment policies are also addressed indirectly through other programs such as the WTO’s General Agreement on Trade and Services. See also Brummer, 60 Vand L Rev at 1372–73 (cited in note 3).

<sup>19</sup> See North American Free Trade Agreement (1993), ch 10, 32 ILM 289 and Central American Free Trade Agreement (2004), ch 11, 43 ILM 514.

Country Y will enjoy a competitive advantage over Country Z when exporting its goods to fellow members of the regional organization, including Country X. All things being equal, trade will be diverted to Country Y from Country Z.

Cooperation among countries also allows members to leverage their collective voice in international negotiations.<sup>20</sup> Suppose that Countries X, Y, and Z are members of an RIA and are looking to negotiate trade terms with Country A, which is twice as large as each of the members alone. Individually, each country would have less leverage in negotiating the terms of a treaty. However, by pooling sovereignties and resources, they will be much better positioned to speak with one voice and to advance their collective strategic interests. Importantly, such coordination allows regional organizations to improve their members' leverage not only in economic affairs, but in the political and military fields as well.

These advantages have led to the description of regional organizations as institutions that create club goods.<sup>21</sup> Though RIAs may erode global welfare insofar as domestic consumers may have to pay more for goods than if no such RIA existed, they also create what can be considered to be important excludable benefits for domestic firms of member countries. By creating a common market to which members enjoy special preferential access, regional organizations functionally exclude outsiders from the group's collective resources. That is, by excluding outsiders, members are able to draw on each other's markets to the advantage of their home state exporters.<sup>22</sup> In addition, by coordinating political power, members may more effectively extract rents from outsiders in the form of economic, political, and, possibly, even military concessions.<sup>23</sup>

The literature further suggests that RIAs experience congestion as new members join.<sup>24</sup> Some economists have, for example, modeled regional

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<sup>20</sup> This fact is often raised by countries in the European Union, such as Germany and France, as justification for their membership. Of particular emphasis in such explanations have been the benefits of European cooperation when negotiating trade agreements with powerful countries outside the region, such as the United States and China.

<sup>21</sup> Among the most prominent voices forwarding this argument has been Todd Sandler. See generally Sandler, 1 *Rev Intl Org* (cited in note 4).

<sup>22</sup> Schiff and Winters, *Regional Integration* at 65 (cited in note 15) (noting that RIAs not only affect imports, but also promise the benefits of duty-free access for exports to partner markets).

<sup>23</sup> Id at 6 (describing governments' desire to maintain influence and sovereignty by "pooling [sovereignty] with others in areas of economic management where most nation-states are too small to act alone").

<sup>24</sup> Soamiely Andriamananjara, *On the Size and Number of Regional Integration Agreements: A Political Economy Model*, Policy Research Working Paper 2117 (World Bank 1999), available online at <[http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/1999/09/14/000094946\\_99060411032930/Rendered/PDF/multi\\_page.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/1999/09/14/000094946_99060411032930/Rendered/PDF/multi_page.pdf)> (visited Nov 17, 2007) (finding that where trading blocs do not have open membership, their creation will inevitably lead



integration as an event in which RIA members compare the gains from getting preferential access to the new member's market with the losses for having to share its original preferential market with the new member.<sup>25</sup> Meanwhile, political choice theory suggests that although liberalization may create certain benefits for governments in terms of economic prosperity, after a certain point, integration will generate fewer political gains for governments.<sup>26</sup> This is because even though countries as a whole may benefit from liberalization, not all individuals and industries will prosper since some foreign firms will be more competitive than domestic industries.<sup>27</sup> Moreover, those firms that suffer a loss of market share due to globalization will penalize governments that open or plan to open their markets to more efficient competitors. These costs will likely outweigh political gains because those benefitting in the aggregate most from liberalization—namely individual domestic consumers—will often not be as effective as producers at promoting their interests.<sup>28</sup> Furthermore, the domestic political process often assigns disproportionate weight to the interests of domestic producers as compared to those of individual domestic consumers, though of course consuming industries may still wield significant political influence.<sup>29</sup>

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to the creation of competing blocs). See also Monika Tothova and James F. Oehmke, *Harmonizing Standards as Institutions*, 1, 7, 20, Paper presented at the 7th International Conference on "Institutions in Transitions," Kranjska Gora, Slovenia (June 19–20, 2003), available online at <<http://www.umar.gov.si/conference/2003/papers/Tothova-Oehmke.pdf>> (visited Nov 17, 2007) (finding that where club goods are characterized by congestion and excludable benefits, standards are likely to develop at each level of organization, for example, global, less-than-global, and national).

<sup>25</sup> See Andriamananjara, *On the Size and Number of Regional Integration Agreements* at 2 (cited in note 24).

<sup>26</sup> Schiff and Winters, *Regional Integration* at 89 (cited in note 15) ("Trade creation can be a mixed blessing for a negotiating government: it generates surpluses for consumers at home and for exporters in the partner country but reduces them for one of the [government's] main [domestic] lobbying groups—domestic import-competing producers.").

<sup>27</sup> *Id.*

<sup>28</sup> Warren F. Schwartz and Alan O. Sykes, *Toward a Positive Theory of the Most Favored Nation Obligation and Its Exceptions in the WTO/GATT System*, 16 *Intl Rev Law & Econ* 27, 28 (1996).

<sup>29</sup> *Id.*

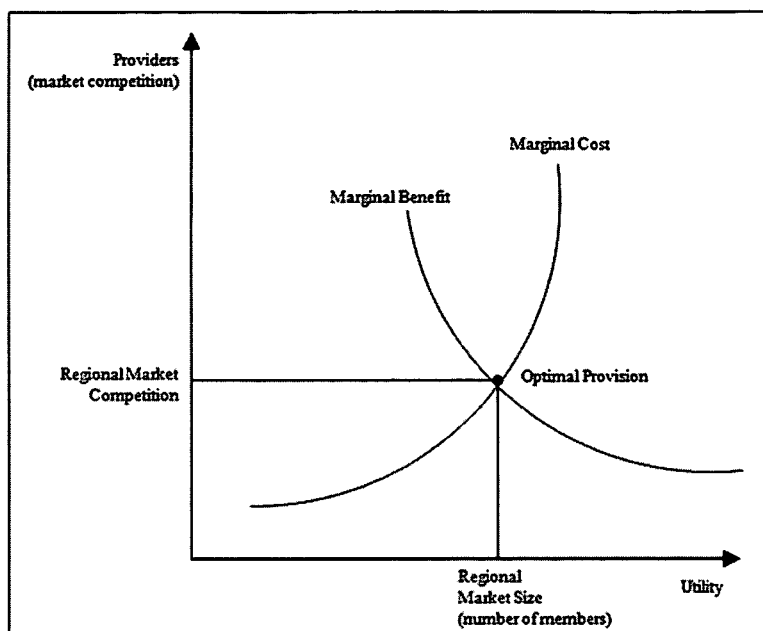


Figure 2: Optimal Provision of Regional Trade

The existence of tradeoffs accompanying RIA membership implies that the gains of adding an additional member will be large where the bloc is small and that these gains will likely offset the costs of opening home markets. As the bloc expands, however, the marginal benefit of an additional new market will decrease. An increase from two to three members will provide, in other words, a greater benefit to members than an increase in membership from ten to eleven members. On the other hand, as the size of a regional organization increases, the existing market will be shared by more and more competitors. Club theory consequently predicts that members' incentives for expanding will decrease, particularly in light of domestic producers' concerns. Ultimately, regional organizations will reach a tipping point where crowding occurs, and current members will reject new members. Meanwhile, remaining outsiders likely will seek to form a bloc of their own.<sup>30</sup>

<sup>30</sup> Richard Baldwin, *A Domino Theory of Regionalism*, Nat Bur Econ Res Working Paper 4465 (1993), available online at <<http://www.nber.org/papers/w4465.v5.pdf>> (visited Nov 17, 2007) (hypothesizing that the enlargement of regional organizations shifts the political equilibrium of nonmember countries and causes some of them to seek membership in the group or other groups).

#### IV. REGIONAL TRADE AS AN INCOMPLETE CLUB GOOD

For all of the usefulness that club theory provides in illustrating the incentives driving regional integration, it overlooks two qualitative aspects of regional organization that make the club goods analogy problematic. First, the above model envisions largely homogeneous or similarly situated countries when assessing the growth of the formation of regional organizations. Second, it assumes that regional organizations exercise fully effective exclusion mechanisms. These assumptions, however, are often inaccurate, suggesting RIAs are at best incomplete club goods.

##### A. THE PROBLEM OF HETEROGENEOUS CONGESTION

Many quantitative economic assessments of regional organizations as clubs are at least implicitly premised on homogenous country membership. In other words, regional member states are largely assumed to be similar to one another in size and market power. Club theory, as a general matter, has considerable difficulty modeling member heterogeneity beyond accounting for depth of participant preference. To return to the swimming pool analogy, club theory can only account for how many times a member wants to use the pool, and not, say, for the different sizes of individuals using the club. Thus, even though a child may take up less space than a six foot man, and will thus interfere less with the enjoyment of others, club theory rarely deals with such qualitative differences. Instead, by focusing on the depth of preferences, it seeks to determine what kind of fees or tolls to administer to swimmers such that they contribute to the extent that they use the pool.

Nevertheless, regional organizations do not always consist of homogeneous (or similarly situated) member states. Instead, many, if not most, regional organizations, like NAFTA and the Southern African Customs Union, are either organized around one large country, or, as in the case of the EU and MERCOSUR, a group of powerful countries. In such arrangements, countries with large economies are often the “hub” of economic activity in the region around which smaller markets, or “spokes,” interact.<sup>31</sup>

This heterogeneity is important because it suggests multiple equilibria for congestion for RIA member states. Because countries and their respective markets are unique, members will not all experience the same costs (or benefits)

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<sup>31</sup> This phenomenon also characterizes a rise in bilateral treaty making. See Tiziana Bonapace, *Regionalism, Multilateralism and Development: An Ongoing Debate*, 8–9, available online at <[http://www.unescap.org/tid/projects/tradev04\\_s2.pdf](http://www.unescap.org/tid/projects/tradev04_s2.pdf)> (visited Nov 17, 2007) (noting how larger countries despite being members of RIAs conclude bilateral agreements as part of an “offensive trade strategy” to find smaller “spoke” countries for their exports).

when regional organizations grow. Consider, for example, a situation where Countries X, Y, and Z are already members of a regional organization. Assume further that Country A wishes to join the organization, and its economy and industries are more competitive than those of Countries Y and Z, though less competitive than that of Country X. Where each country assesses accession based on the consequences for domestic industries and special interests, Countries Y and Z will be more likely than Country X to reject Country A's accession. Even though Country A may provide new markets, market penetration will likely be difficult because of the inferior nature of the domestic industries in Countries Y and Z. Furthermore, Countries Y and Z will have to share their preferential market with Country A, which would likely result in a decline in their share of economic activities. On the other hand, in contrast to Countries Y and Z, Country X would find Country A's accession attractive. Not only would it gain an additional market for its exports, but it would also be able to continue to dominate the preferential market it has enjoyed, assuming accession does not in some way bolster Country A's competitiveness.

Thus, as this example illustrates, members will have their own preferences as to the extent and size of regional integration where congestion arises at different points for each country. Moreover, congestion will depend on—and indeed be defined by—something other than the mere number of members in a regional organization, as classical club theory postulates. Instead, congestion will reflect the qualitative make up of the group and comprise a function of the comparative advantages (or disadvantages) of the markets new members represent.

This congestion underscores the nature of preferential regional trade—the “club good” provided by virtually all regional organizations—as distinctly rivalrous. Although regional organizations as a theoretical matter create an economic commons accessible to every member country, one country's consumption of the preferential market diminishes the opportunity for other members to consume it. Regional organizations are thus inherently animated by a kind of internal tension that classical clubs escape unless and until congestion occurs.

## B. THE WEAK EXCLUSION PROBLEM

Another problem relating to any description of regional organizations as providers of club goods is the exclusion mechanism such institutions employ. Club theorists generally envision effective, and at times even costless, exclusion mechanisms by which outsiders are barred from the quasi-public goods members provide. Under such circumstances, the exclusion mechanism serves as the basis upon which club members derive value from club goods and, more fundamentally, are incentivized to cooperate. Where, however, exclusion

mechanisms fail to create or to realize the complete exclusion of outsiders, clubs are said to produce “impure” public goods.<sup>32</sup> Goods are consumed not only by members, but potentially by nonmembers as well.

This is an important distinction because as a practical matter, regional organizations are not always exclusive. Instead, regional organizations generally arise in two basic formats: free trade treaties and customs unions.<sup>33</sup> On the one hand, free trade treaties like NAFTA and CAFTA impose no legal restrictions on member states as to their relationships with third party countries. Signatories to free trade treaties can (and do) offer access to third-party countries on terms equal to those available to members. As a result, these “open” RIAs create nonexcludable “impure” public goods.

Customs unions, in contrast, provide for a range of different restrictions on the economic sovereignty of members. Some, for example, have outright prohibitions against bilateral treaty-making, whereas others are based on consensus procedures whereby members must first secure the permission of other members before independently negotiating with third parties.<sup>34</sup> In such instances, customs unions create what are understood as “closed” regional arrangements that, at least structurally, approach the exclusion dynamics envisioned in the club literature.

Yet even customs unions fall well short of the hermetic exclusion upon which club theory is based. This is because although customs unions may restrict countries from making new treaties once they join, many countries have pre-existing commitments that are grandfathered into a custom union’s legal architecture. From the standpoint of exclusion, this is an important flaw given the reciprocal nature of trade commitments. As noted above, many treaties entail MFN commitments that require a state to accord to a counterparty the same favorable terms it offers to other countries. Such commitments are dynamic and attach not only to past agreements, but to subsequent agreements of the parties, unless specific exceptions to the treaty are enumerated.

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<sup>32</sup> Georgia State University Experimental Economics Center, *Introduction to Public Goods*, (2006), available online at <[http://www.econport.org/econport/request?page=man\\_pg\\_introduction](http://www.econport.org/econport/request?page=man_pg_introduction)> (visited Nov 17, 2007).

<sup>33</sup> See Schwartz and Sykes, 16 *Intl Rev Law & Econ* at 45 (describing preferential trade agreements as arising as customs unions or free trade areas) (cited in note 28).

<sup>34</sup> The European Union, for example, prohibits, under its common commercial policy, members from signing bilateral investment and trade treaties, whereas members of the Andean Community, South America’s second-largest RIA, are ultimately permitted to engage outsiders unilaterally, although such conduct by members is frowned upon. See Brummer, 60 *Vand L Rev* at 1372–76, 1378 (describing aspects of EC trade and investment law) and 1383–84 (describing the Andean Community’s rules as enshrined by Decision 598) (cited in note 3).

To demonstrate just what kind of implications this may have for the policy of RIAs, imagine a situation where Countries A, B, and C are all members of a regional organization. Assume further that Country D wishes to join the organization, though it already has in place a bilateral treaty with Country E with MFN obligations. In such a scenario, once Country D enters the regional association, and the group decides to extend the existing preferences offered among group members, Country D will be required under the MFN clause of its bilateral treaty with Country E to provide the same benefits and preferences to Country E. This is the case even though Country E will not be required to itself undertake any form of subsequent liberalization.<sup>35</sup> The same holds for all third parties that may have bilateral treaties with not only Country D, but Countries A, B, and C as well.

Importantly, some customs unions do have in place rules for the prevention of such incorporation by reference—and concomitantly, the costless liberalization enjoyed by third-party states where RIAs encourage liberalization among members. The European Union, in particular, additionally requires uniformity among members as to their economic foreign policy.<sup>36</sup> Nevertheless, even where regional organizations require uniformity, achieving such policy objectives may be challenging. For one, as regional organizations grow, it may be difficult for members or regional executives to collect and to examine all the myriad economic commitments to which member states may be subject. Treaties are not always registered in one central location, and states must generally voluntarily divulge the information for such recordkeeping to be effective.<sup>37</sup> Furthermore, states themselves may not be aware of all of the commitments to which previous governments have agreed.<sup>38</sup>

Uniformity may also incur heavy costs on members, thereby making compliance at times undesirable. This is because to achieve uniformity, some

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<sup>35</sup> This dilemma confronts MERCOSUR, South America's largest regional organization, insofar as Venezuela, Brazil, and Argentina are all concerned with the bilateral free trade agreements associate members have in place with outsiders. See *id.* at 1388–89.

<sup>36</sup> Specifically, the European Union has had as an underlying obligation for membership the commitment of members to the basic constitutional structure, laws, and policies of the European Union, collectively termed the *acquis communautaire*. This means that where either a member or candidate exercises authority in an area in which the Community has concluded a treaty in pursuance of a common policy, it will be overridden to the extent that it conflicts with EC law.

<sup>37</sup> This is also a challenge for multilateral institutions. See Palitha T.B. Kohona, *The United Nations Treaty Collection on the Internet—Developments and Challenges*, 30 *Intl J Legal Info* 397, 399–400 (2002) (describing the UN's efforts to keep records of international treaties).

<sup>38</sup> This is especially the case with bilateral investment treaties where, as officials from developing countries often complain off the record, signatories from states with few administrative resources may be unaware of the full extent of MFN commitments that may be activated due to prior commitments made to other countries.

members might have to denounce or modify their existing bilateral treaties—a process that can impose heavy reputational and economic costs.<sup>39</sup> Although treaty denunciation is legal, former counterparties to bilateral agreements will reset their expectations as to the denouncing member's future policy and economic (and political) allegiances.<sup>40</sup> Furthermore, treaty denunciation may make a country a less attractive destination for trade and investment. For example, if a state denounced a bilateral investment treaty, treaty termination would effectively remove promises by the host country not to interfere with foreign investment. As a result, more political risk would accompany foreign investment, driving up the cost of capital and making investment less attractive. Meanwhile, in the case of trade treaties, denunciation of an agreement could incentivize (former) trade partners to raise duties on exports from the exiting counterparty. Because of these costs, members will be hesitant to denounce treaties even where regional rules impose restrictions.

Finally, even if a violation of regional policy is detected, some RIAs may not have effective enforcement mechanisms. RIAs vary widely in terms of the degree of enforcement mechanisms they incorporate. Some RIAs, like the European Union, may have very formal dispute resolution mechanisms such as courts and arbitration arrangements, while others like the Association of Southeast Asian Nations (“ASEAN”) may rely more on diplomatic consultations whenever there are disputes.<sup>41</sup> In such less formal contexts, discipline among members may be difficult to achieve, and uniformity only partially realized.

## V. THE IMPLICATIONS OF INCOMPLETE REGIONAL CLUBS

### A. INDISTINGUISHABLE CLUBS AND UNDEFINED MEMBERSHIP

The fact that regional organizations do not fully exhibit the characteristics of classic economic clubs has important implications for our understanding of the dynamics driving such cooperation. Perhaps most fundamentally, the imperfections of regional integration suggest a need to rethink the basic concept of club membership as well as the very contours of the regional “club” itself. At least formally, RIAs are comprised of identifiable participants that sign a regional

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<sup>39</sup> For a comprehensive account of these costs, see Laurence Helfer, *Exiting Treaties*, 91 Va L Rev 1579 (2005) (describing the factors and consequences of unilateral exit from treaties).

<sup>40</sup> George W. Downs and Michael A. Jones, *Reputation, Compliance, and International Law*, 31 J Legal Studies 95, 98 (2002) (describing the reputational costs of defecting as “the negative consequences that follow from states readjusting their estimates of the defecting state’s expected reliability”).

<sup>41</sup> See Axel Berkofsky, *Comparing EU and Asian Integration Processes—The EU a Role Model for Asia?*, Euro Poly Ctr Paper 8, available online at <[http://wwwsoc.nii.ac.jp/eusa-japan/download/eusa\\_ap/paper\\_AxelBerkofsky\\_s12.pdf](http://wwwsoc.nii.ac.jp/eusa-japan/download/eusa_ap/paper_AxelBerkofsky_s12.pdf)> (visited Nov 17, 2007) (contrasting ASEAN to the EU by noting the absence of “institutionalisation and institution-building”).

treaty that sets the basis for ongoing cooperation. Yet, as discussed above, many nonsignatories can potentially enjoy some of the benefits provided through collective action without themselves undertaking the commitments involved in full membership.

This suggests that any analysis of RIAs and their optimal size must explore and take account of the actual size of a regional organization as encompassing third-party freeriders as well as its formal members. The theoretical challenge of such an approach is, of course, that freeriders are not contributing to the regional trade commons. Returning to the swimming pool analogy, regional integration is akin to a situation where children can jump over a fence (the exclusion mechanism) surrounding the pool and go swimming in the shallow end without paying membership fees for the upkeep of the pool. The children are not “members” in a classic sense since they are not paying for the upkeep in the pool and only swim in the shallow area. Nevertheless, as freeriders they are participants in the commons and consumers of at least part of it. As such, their activities lend inefficiency to the club insofar as nonmembers can consume part of the club good while avoiding the costs of membership and cooperation.

## B. “UNDERSUPPLIED” CLUB GOODS

By extension, the freerider problem has important implications for the very dynamics driving regional integration. Club theory is predicated on groups creating utility through exclusive collective action. The weak exclusion mechanism of many regional organizations suggests, however, that there are likely fewer incentives to join a regional organization than a participant would have in joining a classical economic club. This is particularly important in light of the fact that accession to regional organizations is often costly, at least in the short run, because membership opens domestic firms to competition and may require members to undertake costly changes in their legal, social, or economic policy. In this context, the existence of a weak exclusion mechanism further incentivizes members not to join due to the possibility of freeriding on bilateral agreements. Instead of acceding to costly regional agreements, a country may instead seek to continue or build upon existing treaties and relationships.

The imperfect excludability characterizing regional integration should consequently result in fewer preferential markets for trade being supplied than would be the case if excludability was perfect. Because regional organizations enjoy weak exclusion mechanisms and are potentially subject to freeriding, members may enjoy—because of less trade distortion—fewer exports than they would if regional organizations were truly exclusive economic clubs. Furthermore, congestion is more likely to occur at an earlier point since RIA members will face heightened competition in the markets of regional partners where such countries have entered into bilateral treaties with third-party states.



As a result, the imperfect club dynamics informing trade and investment considerations complicate theories as to why states have flocked to regional organizations. Club theory posits that RIAs create important economic incentives for states to align with one another. The potentially limited nature of such benefits suggests, however, that countries may derive additional (and likely more important) political benefits—especially where RIAs exhibit weak exclusion. The fact that RIAs often provide a political function and help to establish peace, military security, and leverage with third party outsiders, may outweigh any internal inefficiencies or economic costs.

## VI. OBSERVATIONS FROM GLOBAL EFFICIENCY

Imperfect organizational structures also, necessarily, complicate dominant presumptions of regionalism's broader implications for the global economy. As mentioned above, commentators generally examine regional organizations based on whether they create new trade or merely divert trade from outside the bloc to members inside the club. Where they divert trade from outside the bloc to members, economists criticize regional integration as not so much furthering integration, but obstructing global efficiency and liberalization.

Though this Article does not put forward an empirical answer to this long-debated question, the incomplete club features of regional integration provide important theoretical insights unexplored in the academic literature. First, the imperfect excludability of most regional organizations indicates that although regional organizations divert trade substantially from third parties, the precise impact of such diversion will require closer empirical inspection than that implied in the literature. As shown above, even in closed regional organizations, some states will not only continue to access markets, but participate in subsequent liberalization efforts from RIA member states that are counterparties to prior bilateral agreements. This ability to freeride is an organizational inefficiency insofar as RIA members are not able to recoup the full value of their liberalization efforts. However, from the standpoint of global efficiency, such freeriding creates welfare gains. In other words, insofar as it involves a wider consumption of the preferential market (the club good), it enhances free trade. Consequently, imperfect excludability should result in a more efficient allocation of resources.

The existence of multiple equilibria for congestion furthermore suggests that enlargement-based liberalization may not necessarily arise even where the accession of new members and the extension of free trade would create for the group a positive welfare gain. The club-like dynamics of regional integration, along with the individual member state objectives of trade diversion, imply that states will have strong market incentives to promote regional expansion only where such enlargement would bring in *less* economically competitive members

to the club. As stated above, it is the accession of countries that are comparatively less competitive that allows existing members to enjoy welfare gains insofar as their home industries can expand into new markets without losing their preferential markets to new competition.

As a result, it is plausible that growth will likely depend to a substantial degree on the governance and decision-rules of the group. Where, for example, RIAs have strict membership rules requiring unanimity, admission will be most likely where the candidate is less competitive than the least efficient or competitive member of the existing bloc. On the other hand, where majority voting is in effect, the decision-rule will be based on the relative competitiveness of those countries that can together form voting blocs sufficient to admit a new member. Notably, in either instance, politics could inform the decisionmaking of a state. Where a small country has a low congestion point and does not want to let another small country into the bloc because it fears a trade diversion, a large country with a higher congestion point may be able to use its political muscle to coerce (or to bribe) the smaller regional member into accepting the outsider as a new member.

## VII. CONCLUSION

This Article has shown that although regional organizations exhibit some club-like dynamics, they are at best incomplete forms of such cooperation. Not only does the legal architecture of trade agreements limit the degree to which regional organizations are truly exclusive, and therefore welfare enhancing for members, but each member will also, as a result of its own special characteristics, differ as to the point at which a preferential trading market will be congested with too many competitors. This heterogeneity suggests that, all other political factors being equal, expansion of an RIA's membership will be based not so much on the economic competitiveness of new members, but instead on the relative inefficiency or competitiveness of a prospective member state's domestic economy.

