

**Dissertation**

# **MERCOSUR, the common market of the South**

**The possibility of creating a common market for MERCOSUR**



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**December 17, 2013**

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## Preface

During my exchange in Buenos Aires I learned about MERCOSUR in the course 'International relations of Latin America' taught by Constanza Mazzina. It was my favourite course and when I learned about MERCOSUR not being able to reach its initial goal, it got me interested. I wanted a topic for my dissertation on which I could apply the knowledge learned during the semesters at The Hague University and the semester in Buenos Aires at la Universidad Argentina de la Empresa. Furthermore, I wanted to be able to use the languages which I learned during my studies. The languages which I learned with 'European Studies' and used for this dissertation are English, Spanish and Portuguese.

For this dissertation I would like to thank C. Mazzina for her interesting classes and my supervisor M. van Munster for his helpful feedback. Furthermore, I would like to thank Anja Mudde for her support and motivation.

## Executive Summary

This paper analyses the regional integration possibilities for MERCOSUR, which is a regional integration scheme in South America. The initial goal of MERCOSUR was the creation of a common market. However, MERCOSUR was not able to reach this goal and it created a customs union instead. This paper analyses the possibility for MERCOSUR to create a common market.

Regional integration is the processes by which states provide common rules, regulations and policies for a region. The main reasons why states choose for regional integration are economic benefits, protection of their own interests, attracting new trade and investment flows and promoting democracy and peace. Two important conditions for regional integration to develop are demand and supply conditions. Demand conditions refer to the level of regional interdependence between the states. The regional integration should lead to economic benefits in order to create a demand for integration. Interdependence leads to functional spill-over for further integration. The supply conditions refer to the presence of a regional leader who will provide demand for regional institutions during the integration process and to the establishment of commitment institutions. A regional leader could be a country who is willing to serve as paymaster and pay a larger share of the regional integration costs. The creation of commitment institutions are institutions who will ensure the compliance with treaty obligations.

Regional integration in Latin America came in different waves and protectionism has always been an important stance for the different countries. Presidential diplomacy has dominated in the regional integration schemes. MERCOSUR is an intergovernmental organisation where the control rests on presidential diplomacy. MERCOSUR did not create any supranational body. It has several internal problems which hold back further integration. The asymmetries between the Member States are huge. Some differences are size, power, economy, wealth and integration ideas. The larger states prefer more protectionism, while the smaller states would like more trade and create supranational institutions. A significant problem in MERCOSUR is the implementation problem. Many laws are not implemented by the Member States. The reasons for this problem are the lack on supranational control institutions and the fact that the presidents of the Member States are in charge. A region cannot integrate any further if its own laws are not being implemented. A common market cannot function properly without common rules and common policies.

The explained needed demand and supply conditions are not met in MERCOSUR. Its market size is too small and export base too narrow to generate demand conditions for regional integration. The region also lacks a leader which could take the paymaster role. Brazil is the only possible candidate for this role but is not willing nor able to do so. Furthermore, MERCOSUR has no commitment institutions which can ensure the compliance of treaty obligations. Malamud stresses the importance of a third condition, which is the inertial condition. This condition refers to

the creation of supranational or autonomous institutions. MERCOSUR did not meet this criteria either.

To conclude, the creation of a common market is not a feasible and realistic objective for MERCOSUR. This because MERCOSUR is not able to meet the demand, supply and inertial conditions. Furthermore, the internal problems of MERCOSUR make further integration very complicated.

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## Introduction

This paper aims to discuss and analyse regional integration in South America. It focuses on the Common Market of the South (MERCOSUR), which is a regional integration scheme in South America between Argentina, Brazil, Uruguay, Venezuela and Paraguay.

There are different reasons why states choose for regional integration. The main reasons are economic benefits, protection of their own interests, attracting new trade and investment flows and promoting democracy and peace.

The initial goal of MERCOSUR was the creation of a common market. However, MERCOSUR was not able to reach this goal and it created a customs union instead. This dissertation aims to investigate the reason why MERCOSUR has not been able to create a common market (Dijck van & Wiesebron, 2002, P 1).

The central question of this dissertation is: *‘Is the creation of a common market a feasible and realistic objective for MERCOSUR?’* The central question is answered with the help of five sub-questions: ‘What is regional integration?’, ‘What is needed to develop regional integration?’, ‘How has regional integration developed in Latin America?’, ‘What is MERCOSUR and what are their internal problems?’ and ‘Does MERCOSUR has the needed factors to develop regional integration?’

Chapter one defines the concept of regional integration, discusses different types of it and explains the needed factors to develop regional integration. Chapter two focusses on regional integration in Latin America and the impact of the European Community on integration in Latin America. Chapter three explains MERCOSUR and analyses its internal problems. Chapter four analyses if MERCOSUR has the needed factors for regional integration to develop. Chapter five gives a conclusion and answers the central question.

## Methodology

For this dissertation desk research is conducted and secondary literature is analysed. Many books from the Institute of Social Studies library and Rotterdam library have been used. The articles have been acquired through EBSCO and JSTOR. The decision to use desk research as methodology is made because of the existence of many information on the development of regional integration. Analysing these resources has helped answering the central question.

## Chapter 1 Regional integration

Regional integration is the processes by which states provide common rules, regulations and policies for a region (Baylis, Smith, & Owens, 2008, P 436). Many regional integration schemes have been created, such as NAFTA, the European Union and MERCOSUR. This chapter will answer the sub question ‘What is regional integration?’. It will explain the reasons for states to choose for regional integration and discuss the different types of it.

### 1.1 Reasons for regional integration

Regional integration can be used by states as a protective way to secure their own interests. This is especially for states who cannot do this on their own (Malamud & Gardini, 2012, P 4). One of the main reasons for regional integration is the economic benefits. Most integration agreements include the lowering of tariff and non-tariff barriers. This leads to new trade and investment flows. Long-term effects are the augmentation of capital, such as foreign direct investment, which produces higher growth rates. Regional integration agreements (RIA) can also contribute to the efficiency, production and technology (Ocampo & Ros, 2011. P 342). Eventually RIA can improve policy-making because the involved states can learn from each other. RIA can lead to further cooperation on other areas including investment in regional public goods (Ocampo & Ros, 2011. P 343). Another reason for regional integration is the promoting of democracy and peace and end rivalry (Baylis, Smith & Owens, 2008, P 440).

### 1.2 Types of regional integration

There are different types of integration such as economic integration and political integration (Laursen, 2010, P 5). Economic integration is an agreement between different states on the removal of trade barriers. Such barriers can be tariffs, quotas and border restriction. Economic integration can lead to the creation of free trade areas, customs unions, economic communities and monetary unions. Political integration refers to the common policies and common political institutions. Most organisations start with economic integration, which later can expand to political integration or cooperation (What is regional integration, n.d.).

#### 1.2.1 Economic integration

The first form of regional integration, economic integration, consists of various stages which lead to trade improvements and economic benefits. The first step usually is the abolishing of import and export tariffs between the states, thereby creating a free trade agreement. The second step is the creation of a customs union. This is a free trade area which is also composed of a common external tariff for imports and export from and to third countries. The third step generally is the creation of



a common market. A common market adds to the zero import tariff and common external tariff of the previous steps, the free movement of persons, capital, goods and services. The fourth step is creating an Economic and Monetary Union. This step adds to the above the harmonization of the monetary and economic policy (Vleuten, van der, 2012, P 21).

### **1.2.2 Integration theories**

There are different political theories for understanding integration. Such as functionalism, neofunctionalism and intergovernmentalism. Each theory has a different effect on the regional integration development. Functionalism arose between the First and Second World Wars. It focusses on supranational institutions. Its objective is creating peace through prosperity (Mattli, 1999, P 21). Neofunctionalism stresses that supranationality should be used if states want maximum welfare. Ernst Haas description of the process of neofunctionalism: “a process whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations, and political activities towards a new larger centre, whose institutions possess or demand jurisdiction over the pre-existing states” (Mattli, 1999, P 24). An alternative approach to integration is intergovernmentalism. It leaves the control with the states, where the head of states have a central role. The states do not want to lose their sovereignty. The functionalism and neofunctionalism theories have more chance to develop regional integration, since it focusses on the creation of supranational institutions. The creation of these institutions is important for regional integration.

## **1.3 Needed conditions for developing regional integration**

According to Mattli two conditions are needed for regional integration to develop. These two conditions are demand and supply. Malamud stresses that next to the demand and supply conditions the third condition inertia is needed.

### **1.3.1 Demand condition**

Demand for regional integration through market pressure is needed in order to develop regional integration (Mattli, 1999, P 43). Demand conditions are generated through higher levels of regional interdependence, where countries want to lower the costs of cross border activities by cooperation and coordination. These demand conditions lead to integration (Malamud, 2008, P117). The regional integration of the markets needs to have a potential for economic gains. Member States are more willing to give some of their sovereignty to the regional organisation if there is potential economic gain. If the potential gain is inadequate, the integration process will decrease (Mattli, 1999, P 42). States who could gain from wider markets will try to realize these gains (Mattli, 1999, P 46). Potential gains from regional integration could be the achievement of economies of scale in production (Mattli, 1999, P 46). Economies of scale means that the increase

of production leads to the reduction of production costs (Economies of scale, n.d.). Another gain could be the exploiting of the comparative advantage of the states in the region. A comparative advantage is an advantage a country has over another country because it can produce a particular product more efficiently (Comparative advantage, n.d.). A country would gain from specializing in the product if it can produce more efficiently and export these products at a relatively low cost. These trade gains could attract investment (Mattli, 1999, P 47). Thus, the potential gain would be inadequate if the regional market is too small, which has no important economies of scale and lack complementarity advantage.

Another important driving force for regional integration to develop is the demand for regional rules, regulations, and policies by market players (Mattli, 1999, P 42). Market players are the companies involved in the particular market. Companies can have a critical role in integration (Mattli, 1999, P 49).

An important factor for further regional integration is functional spill-over. Functional spill-over takes place when cooperation in one sector of the economy creates technocratic pressure for cooperation in neighbouring sectors. (Moravcsik, 2005, P 352). Functional spill-over is not possible without interdependence because it is interdependence which leads to functional pressure for further integration (Krapohl, n.d, P 5).

### 1.3.2 Supply condition

The other needed condition for further regional integration is the supply condition. There are two supply conditions which are important for regional integration to develop. These are the presence of a undisputed leader state and the establishment of commitment institutions.

#### Leader

A significant supply condition is the presence of a regional leader who is willing and able to provide demands for regional institutions during the integration process. This leader could either serve as paymaster and pay a larger share of the costs brought by regional integration or provide the region with monitoring, enforcement and eventually regional integration (Malamud, 2008, P 117). This leader will supply regional institutions and will be responsible for the coordination of rules, regulations, and policies. Furthermore, the leader could ease distributional tension.

Differences in distribution may lead to tension. One Member State might think the other Member State is receiving more benefits. A leader could ease these tensions (Mattli, 1999, P56).

If the political leaders are willing to lead the region depends on the benefits which deeper integration will bring. Political leaders with prosperous economies are less willing to integrate deeper. This is because their expected marginal benefit from deeper integration in terms of retaining political power is minimal. They want to keep their autonomy and political power. When the political leader has economic difficulties, it could benefit more from regional integration and

thus is more willing to take this role (Mattli, 1999, p 51). Economic difficulties have in the past led to deeper integration. For example the creation of the Single European Act was a reaction to the slow growth in Europe.

Even if a political leaders want to take this role, some are unable to do this due to collective action problems. Collective action problems refer to coordination and cooperation problems in the region. Coordination is important for integration to develop. The leader must also keep in mind how the inhabitants of the country might react to the paymaster role. A leader might lose votes, which could lead to losing the power (Mattli, 1999, p 51).

Thus, a significant supply condition is presence of a leading country within the region who is willing to seek integration. Without this leadership, coordination is difficult to achieve. Coordination is needed when a region want to integrate deeper.

#### Other types of leadership

Malamud argues that there are four subtypes of leadership: broker, paymaster, intergovernmental diplomacy and regional funds. As described before, a paymaster is a Member States which pays a larger share of the integration costs. Regional funds is a way to redistribute wealth among the Member States through a budget. A Broker refers to the capacity of some actors to strike deals among governments. They provide communications, agreements and monitoring at a regional level. Finally the fourth type of leadership is intergovernmental diplomacy. This refers to direct negotiations between national officials (Malamud, 2008, P 122).

#### Commitment institutions

Another supply condition is the establishment of commitment institutions, such as centralized monitoring institutions. These institutions will have to ensure the compliance with treaty obligations and provide procedures against the Member States who violate the obligations.

This condition is less important since the absence of it not necessarily makes integration impossible. However, the creation of commitment institutions improves the process of integration through the compliance of rules and sustained cooperation (Mattli, 1999, P 54).

### **1.3.3 Importance of the conditions**

If the demand and supply conditions are not met, the chance for regional integration to succeed is small. All the successful integration schemes have met this conditions. All the integration schemes who have met this conditions succeeded. On the other hand, integration schemes not meeting the conditions have never succeeded (Mattli, 1999, P 65).

#### 1.3.4 Inertial condition

Malamud adds to the demand and supply conditions a third condition: the inertial condition.

According to Malamud ‘inertial conditions take the form of demand or supply conditions that become institutionalized, locking in previous agreements and creating path dependent effects’ (Malamud, 2008, P 115). The goal of this condition is protection the regional integration process when the demand and supply conditions are declining. It refers to the creation of autonomous institutions (Malamud, 2008, P 116).

## Chapter 2 Regional integration in Latin America

Region integration in Latin America dates back to the postcolonial era. Many integration schemes have been created and different strategies have been used. This chapter will give an insight on regional integration in Latin America. It will answer the sub question 'How has regional integration developed in Latin America?' It will describe its history, development strategies, integration waves and the effect of the European Economic Community on Latin America. This insight will contribute to understanding the development of MERCOSUR.

### 2.1 History of regional integration in Latin America

The vigour for regional integration in Latin America dates back to the postcolonial era. During colonial times Latin America was ruled by Spain and Portugal. After the independency Brazil remained united forming a federal republic. The former Spanish colonies were formed as the Federal Republic of Greater Colombia from 1819 until 1831 and the Federal Republic of Central America from 1828 until 1839 (Baylis, Smith & Owens, 2008, P 438). The leaders of the wars of independence had as an objective the restoring of the in their opinion natural unity of Latin America. Simón Bolívar, the Venezuelan liberator believed in the establishment of a United Latin America with a supranational parliamentary assembly, common military and mutual defence pact. He organised two Pan-American congresses in 1819 and 1826. He failed to achieve regional unity and soon the region was marked by civil wars (Malamud & Schmitter, 2012, P 140). Eventually after a long period of civil wars, caudillos and conflicts the current states were consolidated. There have been many conflicts between the states in Latin America and sovereignty has always been very important to the states (Baylis, Smith & Owens, 2008, P 438).

#### 2.1.1 Industrialization strategies and regional integration

In the 1930s Import-Substituting Industrialization emerged as a development strategy in Latin America as a reaction to the Great Depression. Import-Substitution Industrialization is policy of industrial development based on manufacturing goods domestically that were previously imported. Due to the Great Depression there was a huge decline of exports from Latin America to the industrialized nations of North America and Europe. Therefore, Latin American states did not earn enough to import the needed products. Initially, this strategy was a reaction to the depression and it was made into a strategy for the long-term. The Latin American states used a protectionist policy with quotas and tariffs for foreign goods (Handelman, 2011, P 296 ). In the 1950s the Latin American growth weakened. The deepening of import substitution was suppressed because of an inadequate market size. The solution for growth was regional integration, which could bring domestic protection, induce competition and expand market size (Ocampo & Ros, 2011. P 345). It was mostly a response to the creation of the European Economic Community, who created a

common external tariff and a protectionist agricultural policy and preferential arrangements of individual colonial powers, making exports from member colonies duty free (Mattli, 1999, P 140).

## 2.2 Integration waves

In the postwar era regional integration came in three waves. The “old” regionalism wave, the “new” regionalism wave and the current wave. The first “old” regionalism wave was between the 1950s and 1960s. The main goal was deepening import substitution (Ocampo & Ros, 2011, P 341).

### 2.2.1 European Economic Community (EEC) impact on integration in Latin America

When the EEC was created it had a negative effect on the Latin American market. Therefore, the Latin American countries formed integration schemes themselves. The damage caused by the EEC on Latin American exports changed quickly. Latin American exports experienced a boom. This was due to the EEC members growing prosperity, the EEC’s grant of preferential market access including some Latin American countries. There was a major increase of exports to the EEC. The Latin American economic prosperity declined the need of integration. The Latin American trade agreements established in the sixties and seventies were formed by the model of state-led, import-substituting industrialization. Their intention was to reduce the dependence on world markets, reduce the costs of protection and persuade foreign investment (Buve, & Wiesebron, 1999, P 35).

### 2.2.2 New regionalism

In the 80s a wave of ‘new regionalism’ in Latin America began which was focussed on strengthening the foundations of outward-oriented policies with more open economies and internationally competitive. The policy framework supports structural reforms and democratic regimes (Ocampo & Ros, 2011, P 341) It was mostly created as a response to the EU enlargement and deepening together with the fall of communism in Europe. Latin American countries were afraid of negative effects on trade, investment and aid. New regionalism was an attempt to reverse the economic decline. The states tried to attract foreign investment with market reforms and adopting market-oriented policies. Although they reformed, they did not attract that many foreign investors (Mattli, 1999, P 155). The institutions set up during the ‘new regionalism’ wave had a light structure mostly based on intergovernmentalism.

MERCOSUR was created in 1991, which will be further explained in the third chapter (Baylis, Smith & Owens, 2008, P 440). There has not been an integration organisation yet that includes whole Latin America. All organisations are territorially segmented and some regions overlap (Malamud & Gardini, 2012, P 3).

### 2.2.3 Current wave

The third regional integration wave, is the current wave in which increased North-South

agreements predominate and the drive for merging overlapping initiatives. In 1994 the first Summit of the Americas was held in Miami with as goal the achieving of a Free Trade Area of the Americas (FTAA) and deeper cooperation on several areas such as drugs, terrorism and environment (Baylis, Smith & Owens, 2008, P 440). This agreement was for the whole American continent, excluding Cuba. MERCOSUR and Venezuela rejected the agreement in 2005 because they believe that the FTAA would increase inequality in America.

## Chapter 3 MERCOSUR

After understanding regional integration and the regional integration process in Latin America in the previous chapters, this chapter will explain the organisation MERCOSUR. It answers the sub question ‘What is MERCOSUR and what are its internal problems?’ It will give background information, such as its objectives, members, decision-making and laws. Next to the lack of demand and supply conditions in MERCOSUR, which will be explained in the next chapter, there are several other problems which have a negative effect on the regional integration development. This chapter analyses the internal problems of MERCOSUR. Furthermore, its current plans and future are explained.

### 3.1 Objectives

The objectives of MERCOSUR are described in article 1 of the Treaty of Asunción. The first objective is the free movement of goods, services and factors of production between countries. MERCOSUR wants to reach this objective through the elimination of customs duties and non-tariff restrictions on the movement of goods. Its second objective is the establishment of a common external tariff and the adoption of a common trade policy and the coordination of regional economic forums and international trade. The third objective is the coordination of macroeconomic and sectorial policies between the Member States in order to ensure competition. The fourth objective is the commitment of the Member States to harmonize their legislation in the relevant areas, in order to strengthen the integration process (Quienes somos, n.d.). The initial goal of MERCOSUR to create a common market could not be reached. Therefore, it amended the objective to the creation of an imperfect customs union by January 1995 (Malamud & Schmitter, 2012, P 16).

### 3.2 Members

The founding countries are Argentina, Brazil, Uruguay and Paraguay. Paraguay is currently suspended. On July 31, 2012 Venezuela joined MERCOSUR. Negotiations for the accession of Bolivia started in December 2012. Associated members of MERCOSUR are Chili, Colombia, Ecuador, Peru, Surinam and Guyana. Surinam and Guyana entered MERCOSUR as associate members July 2013, connecting all South American Countries to MERCOSUR. The associate members can enter free-trade agreements and receive tariff reductions. However, they do not receive all the benefits of the customs union. They have no voting power nor have they complete access to the MERCOSUR markets (Mercosur: Introduction, n.d.).

MERCOSUR has a population of more as 276.805.000. The country with the highest population is Brazil with 196.655.000 people. Uruguay has the lowest population and has only 3.380.000 inhabitants. The total surface of MERCOSUR is 13.771.174 km<sup>2</sup>.



The surface of the biggest country Brazil is 8.514.880km<sup>2</sup>. The surface of the smallest country Uruguay is 176.220 km<sup>2</sup>. These numbers show that the difference in population and surface between the Member States is huge. Brazil accounts for about 75% of the total population of MERCOSUR. (MERCOSUR Escolar, n.d.). The total GDP of MERCOSUR is about \$2.9 trillion. MERCOSUR is the fourth-largest trading bloc after the EU, NAFTA and the Association of South East Asian Nations (ASEAN) (Klonsky, Hanson & Lee, 2012).

### 3.2.1 Accession of Venezuela

The Protocol for the accession of Venezuela in 2006, accepted Venezuela as a member, but Paraguay did not recognise this. MERCOSUR has enlargement problems and the Member States have different opinions on enlargement. Paraguay did not accept the accession of Venezuela, because it believes Venezuela is undemocratic. In 2012 when Paraguay was suspended, Venezuela was officially accepted as a member (Mercosur: Introduction, n.d.).

### 3.2.2 Suspension of Paraguay

Paraguay is suspended from MERCOSUR and the Union of South American Nations (UNASUR) since the 28<sup>th</sup> of June 2012. UNASUR is an organisation created by MERCOSUR and the Andean Community of Nations (CAN). MERCOSUR and UNASUR decided to suspend Paraguay because of the removal of President Fernando Lugo on June 22, 2012 who was impeached for poor administration and incompetence. MERCOSUR finds this removal undemocratic and violates the rules of the bloc. This suspension means that Paraguay cannot participate in MERCOSUR's bodies and discussions (Peña, 2013).

In December 2012 the two unions stated that Paraguay would be suspended at least until the end of April 2013, when the presidential election is being held (MERCOSUR suspends Paraguay over Lugo impeachment, 2012). The election has been held and the new president is Horacio Cartes, who is elected democratically (Santos, 2013).

MERCOSUR decided to lift Paraguay suspension on 15 August 2013. However, because Venezuela took the Pro Tempore chair (The presidency of the CMC) of MERCOSUR it did not want to return to the bloc yet (Mercosur will lift Paraguay's suspension next August 15, announced Uruguay, 2013). Paraguay expects to return to MERCOSUR in 2014 (Chile offers closer links and access to the Pacific, 2013).

### 3.2.3 Bolivia in process of accession

In 2012 the Protocol for the accession of Bolivia was signed. Bolivia is not a member yet. They are in the process of accession to MERCOSUR (Quienes somos, n.d.). If Bolivia will join MERCOSUR is unclear. The MERCOSUR Member States are not allowed to have free trade agreements with non-members. Bolivia is a member of CAN and thus Bolivia would have to resign from CAN in

order to join MERCOSUR. Venezuela already has resigned from CAN in order to join MERCOSUR. Furthermore, the external tariffs of Bolivia are lower than the tariffs of MERCOSUR. So, Bolivia would have to increase their tariffs if they want to join, which can have a major impact on prices in Bolivia (Klonsky, Hanson & Lee, 2012).

### **3.3 Treaties**

On March 26, 1991 the Treaty of Asunción was signed, hereby creating MERCOSUR. The basis of the institutional structure of MERCOSUR is formed by the Treaty of Asunción and the Protocol of Ouro Preto. Initially, the objective of MERCOSUR was to create a common market in goods, capital, services and people by January 1995. This objective could not be reached due to the inability of MERCOSUR to coordinate and agree on economic, common trade and industrial policies.

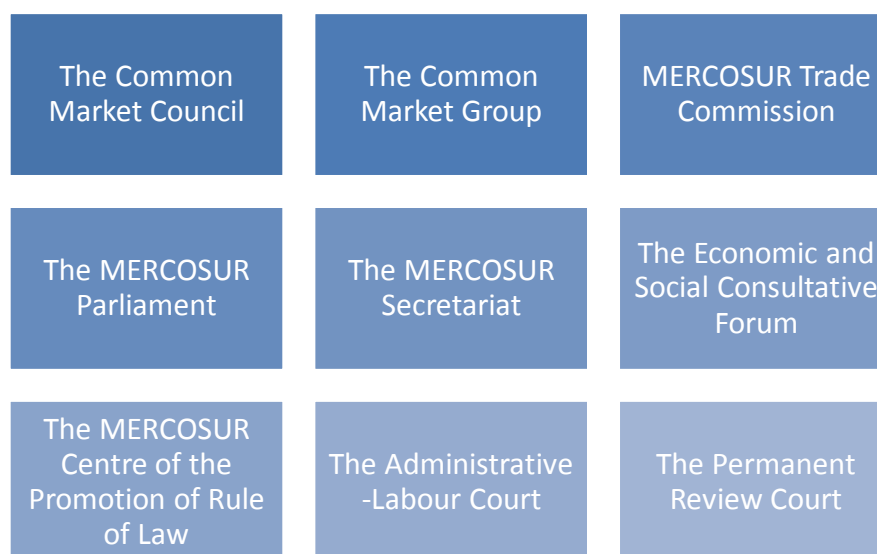
#### **3.3.1 Protocol of Ouro Preto**

Because the initial objective of MERCOSUR could not be reached, the Treaty of Asunción was amended by the Protocol of Ouro Preto in 1994. The Member States amended the objective to the creation of an imperfect customs union by January 1995. The protocol gave MERCOSUR a formal institutional structure, an international legal personality and defined its juridical basis. The Protocol explains the institutional structure of MERCOSUR naming all its bodies and their functions (Malamud & Schmitter, 2012, P 16).

### **3.4 Institutional framework**

MERCOSUR is an intergovernmental organisation where most decisions are taken by consensus. The Member States do not give sovereignty to the organisation and hold a veto power. MERCOSUR is formed by different institutional bodies which functions are explained in the Protocol of Ouro Preto.

The MERCOSUR institutional framework is composed of the following institutions:



**Figure 1**(Estructura Institucional, n.d.).

The intergovernmental decision-making organs are the Common Market Council (CMC), the Common Market Group (CMG) and the MERCOSUR Trade Commission (MTC). CMC is the highest body of MERCOSUR and is responsible for the processes and policy execution of MERCOSUR. The CMG is the executive body (Caetano, Carrau, & Sanz, 2011, P 182). The CMG is responsible of the implementation and regulation of the decisions of the CMC and directs the functioning of the integration process. The MTC assists the CMG and is responsible for the implementation of the common trade policy instruments agreed to by the Member States for the functioning of the customs union. (Aspectos institucionales del MERCOSUR, 2011, P5 article 16).

### 3.5 Law and decision-making in MERCOSUR

MERCOSUR is an intergovernmental organisation where the control rests on presidential diplomacy. This means that the national presidents of the Member States have the power and take the crucial decisions in the organisation. Not only do they have this power, they take this power with presidential intervention. The presidents of the Member States want to hold the power when decisions have to be made, for example crisis or dispute settlements. Even problems which could be solved by the MERCOSUR institutions. The presidents are also in charge of the law enforcement and dispute resolutions. MERCOSUR has no supranational or autonomous bodies (Malamud, 2010, P 113).

Law made by MERCOSUR consists CMC decisions, GMC resolutions and MTC directives which are binding. However, they have no direct effect, no direct applicability and no supremacy over the internal legal system (Pont, 2011, P 45). The Member States are obligated to

incorporate binding law, but there is no supranational institution that supervises the compliance of MERCOSUR law. Only the Member States hold the right of legislative initiative (Vervaele, 2005). The decision-making is done by consensus and in the presence of all Member States. Only PARLASUR uses QMV (Caetano, Carrau, & Sanz, 2011, P 181).

It does not have a body like the European Court of Justice where citizens may file an appeal (Malamud, 2010, P 114). MERCOSUR did create The Permanent Review Court (PRC), which is the highest body regarding dispute settlement between Member States (Azevedo Cunha de, n.d, P 4). However, the PRC is not used often. The Member States prefer to solve disputes between the presidents of the Member States. As stated before, the control in MERCOSUR rests on presidential diplomacy. The presidents take the decisions. If the presidents cannot solve the dispute, they prefer to send it the International Court of Justice (Oelsner, 2013, P 125). MERCOSUR control mechanisms are minimal and there are transparency problems in the decision-making process such as no access to all documents. The level of commitment to MERCOSUR decisions is low (Pont, 2011, P 32).

### **3.6 Integration stage of MERCOSUR**

MERCOSUR now is an incomplete customs union. As explained in chapter one: a customs union is a free trade area which is also composed of a common external tariff (CET) for imports and export from and to third countries. There currently is free movement of goods and services between MERCOSUR countries. However, the Member States can request exemptions on certain products to protect local industries. The CET is the tariff that non-members have to pay when trading with MERCOSUR members. The CET is set by consensus and can be changed. Argentina and Brazil favour high CET, while Paraguay and Uruguay prefer lower tariffs. In 2012 the CET was between 10 and 12 per cent (Keller, 2012). In 2012 MERCOSUR decided on a maximum of 35 per cent CET on imports (Klonsky, Hanson & Lee, 2012).

MERCOSUR's goal initially was to create a common market, which adds to the customs union the free movement of persons, capital, goods and services

### **3.7 Internal problems which have a negative effect on regional integration**

MERCOSUR has several internal problems such as asymmetries between Member States, implementation problems, incomplete trade-zone, CET exemptions and lack of policy coordination. Furthermore, the Member States have been through several crisis and have had internal disputes.

#### **3.7.1 Asymmetries Member States**

The Member States differ in size, power, economy, GNP, GDP and wealth. Moreover, the states

are divided on which way MERCOSUR should go. If the organisation should focus on regional trade or also on political affairs and the Member States are divided on enlargement to other South American countries. . MERCOSUR only enlarged to Venezuela and it took six year before the accession was ratified (Dias Varella, 2013, P 32). Since the global crisis, protectionism has increased in South America (Klonsky, Hanson & Lee, 2012). Argentina and Brazil want more protectionism, while Uruguay and Paraguay want more trade (Mercosur RIP, 2012). The smaller Member States would like to move more towards supranationalism, however, Brazil and Argentina are not interested. Uruguay wants to reform the institutional framework of MERCOSUR and create a Court of Justice (Pont, 2011, P 42).

### **3.7.2 Implementation problems**

The application of MERCOSUR law is a problem. Until 2005 only 40 per cent of the decisions were incorporated by the Member States. A reason for this implementation problem is the lack of a supranational institution which is in control of the incorporation of MERCOSUR law (Vervaele, 2005). Implementation problems in the northern region such as the EU, would solve implementation problems with the help of its institutions (Krapohl, n.d, P 16). However, MERCOSUR does not have supranational institutions which control the implementation. The presidents of the Member States are in charge of the implementation and since they do not want to implement all the laws, there is nothing that could force them. Other reasons are the coordination problems of MERCOSUR and the protectionist regimes of the Member States. If there are economic difficulties, the Member States, especially Brazil and Argentina, take a protectionist stance. If regional integration threatens the competitive advantage of a Member State it will prevent new integration steps or stop implementing the rules (Krapohl, n.d, P 4.).

### **3.7.3 Incomplete trade-zone**

The liberalisation of intra-zone trade is still incomplete. Examples of product sectors which are excluded from the zero tariff rates are the sugar and automotive sectors. Moreover, there are many exemptions to the CET. The Member States have the power to decide which products are excluded from the CET (Pont, 2011, P 64).

### **3.7.4 Lack of coordination on trade policies**

There is no harmonisation of trade policies. The coordination of trade policies will benefit the integration process (Pont, 2011, P 64).

### **3.7.5 Crisis which influenced the integration process**

Some Member States had crisis of their own which also affected the bloc, such as the devaluation of the Brazilian currency in 1999 and the Argentinian crisis of 2001-2002 (Arestis & Paula de, 2003, P 1). The devaluation of the currency led to a decrease in Brazilian export prices and

increased Argentinean export prices. This led to a decline in Argentinean exports and Argentina became in crisis (Krapohl, n.d, P 22). Brazil recovered quickly and Argentina recovered in 2002 after the floating of the Argentinean currency. However, the confidence in the Argentinean economy was damaged and foreign direct investment (FDI) declined. In Uruguay FDI increased during this crisis (Krapohl, n.d, P 23).

### **3.7.6 Internal disputes**

One of the disputes between Member States was between Uruguay and Argentina over pulp mills which are placed on a shared river. This pump mill was built with the largest received FDI in the history of Uruguay. Argentina had environmental concerns and blocked the bridge between Fray Bentos (Uruguay) and Gualeguatchú (Argentina). This dispute had a negative effect on regional integration which came to an halt. The Permanent Review Court of MERCOSUR has not been able to solve this dispute (Krapohl, n.d, P 24). The dispute was ended by the ruling of the International Court of Justice (Oelsner, 2013, P 125).

### **3.8 Success**

The initial goal of MERCOSUR was to create a common market. It did not reach this goal yet and only created an incomplete customs union. Their free trade zone does not work effective as unilateral tariff restrictions are being constructed at will and there are many non-tariff barriers (Malamud, 2013, P 6). MERCOSUR has only managed to create free trade deals with Israel and the Palestinian Authority (Klonsky, Hanson & Lee, 2012). They are negotiating about a possible free trade agreement with China, but first need to further investigate the benefits and disadvantages of this FTA. There have also been on-going negotiations between the EU and MERCOSUR on a FTA (Peña, 2013).

However, MERCOSUR has been successful. It has tripled intraregional trade flows, attracted much foreign investment and became an recognized actor in the world trade (Malamud, 2010, P 114). The Member States now are less dependent economically on the United States (Dias Varella, 2013, P 32).

### **3.9 MERCOSUR now**

In the latest summits the discussed themes were the suspension of Paraguay, the espionage of the United States, Bolivia's incorporation as a full member and the reception of the associated members Surinam and Guyana (President Cristina attends the Mercosur Summit in Montevideo, 2013). The creation of the common market has not been on the agenda lately. It seems like MERCOSUR is concentrating on different topics at the moment. It is not clear if it still want to create a common market and how and when it will plan to do this.

Another topic on the agenda is a trade agreement between MERCOSUR and the EU. The two blocs will exchange proposals with a list of the goods and services that they want to be a part

of the agreement and which not. Uruguay and Brazil have already finished their proposals. Argentina and Paraguay did not make a proposal yet. They both have to make a proposal. MERCOSUR will discuss this during the next summit. (Uruguay and Brazil agree Mercosur will make a joint trade proposal to EU next December, 2013). The next summit was supposed to be in December, but has been moved to the end of January due to the health conditions of the president of Argentina.

### 3.10 Future

Although MERCOSUR has no major regional institutions it has made a lot of progress (Malamud, 2010, P 113). However, lately MERCOSUR is becoming paralyzed. There is some division between the Member States on if the organisation should stay focussed on regional trade or if it should also focus on political affairs. Some analysts believe that the accession of Venezuela would further politicize the bloc (Klonsky, Hanson & Lee, 2012). MERCOSUR has turned a bit towards protectionism agreeing on a 35% maximum CET on imports in 2012. It is not clear if it will ever create a common market or common currency. The next step is to improve the customs union. The opinions on whether or not MERCOSUR should create a common currency are divers. Some authors believe that MERCOSUR should not become more as a customs union, others believe a common currency would be very beneficial for MERCOSUR and others think it is too early for a common currency. A common currency could be beneficial for MERCOSUR. It could provide a new framework for economic management, it could prevent new currency crisis in MERCOSUR countries and it would stimulate economic integration in MERCOSUR (Arestis & Paula de, 2003, P 1). Felix Peña believes that MERCOSUR could eventually stop to exist (Peña, 2013). As written above some analyst believe MERCOSUR might be replaced by UNASUR (Klonsky, Hanson & Lee, 2012).

## **Chapter 5 Needed conditions for developing regional integration in MERCOSUR**

This chapter analyses if MERCOSUR has the demand and supply conditions which are needed for developing regional integration. It answers the sub-question ‘Does MERCOSUR has the needed factors develop regional integration?’ There are economic and institutional factors which are important for regional integration to develop. They are explained as the needed demand and supply conditions.

### **5.1 Demand MERCOSUR**

The region South and Central America is a big region. However, it only accounts for 4 per cent of the world exports (World exports, 2013). This region exports mostly agricultural, fuel and mining products.

Brazil has the most prosperous economy within MERCOSUR. Its economic export value in millions of US dollars is 242,580.0. Venezuela follows with 97,340.0, Argentina with 80,927.0, Uruguay with 8,743.3 and Paraguay with 7,271.3 million. The total export value of MERCOSUR export in 2012 was \$ 339,521.6 million and the total import value was \$ 325,049.4 million (World Trade Organization, 2010). These numbers exclude Venezuela.

MERCOSUR has a relatively small market size and narrow export base. There is no high level of regional interdependence. This limits the possibilities for further integration. During the first ten years of MERCOSUR interdependence was higher. The trade of the Member States grew 7 per cent to more than 11 per cent of GDP. After the economic crisis in Brazil, Argentina and Uruguay interdependence dropped (Malamud, 2008, P 118).

### **5.2 Supply MERCOSUR**

Brazil has the largest economy and largest population of MERCOSUR. It is the only possible leader for the bloc. However, it would be difficult for Brazil to serve as paymaster. The situation is quite different as in Europe. Brazil may have the largest economy, its poverty and inequality rates are higher than other MERCOSUR members. Furthermore, its Gross National Product (GNP) per capita is lower than in Uruguay and Argentina. If Brazil would pay a higher share of the costs, the inhabitants of Brazil would not accept this. It will seem as helping richer countries. Thus, Brazil would not be able to take this role. Furthermore, Brazil is not willing to take this role. They already have a prosperous economy and the expected marginal benefit from deeper integration in terms of retaining political power is minimal. They do not want to lose power. Moreover, the other Member States need Brazil more as the other way around. Brazils main trading partners are the European Union and China. The main trading partner of Argentina, Uruguay and Paraguay is Brazil (World Trade Organization, 2010). Besides Brazil there seems to be no other actor who could take the leading role. There are no potential brokers who could promote regional integration.



Intergovernmental diplomacy is used daily by MERCOSUR. Interpresidentialism is an important feature of the integration process. The presidents are the decision-makers, dispute solvers and commitments guarantors. During the first years of MERCOSUR interpresidentialism worked well. However, after the Brazilian and Argentinian crisis its success decreased (Malamud, 2008, P 127).

### **5.3 Commitment institutions MERCOSUR**

MERCOSUR has no commitment institutions who can ensure the compliance of treaty obligations. Due to the lack of a supranational institution which could supervise the compliance of MERCOSUR law, there are problems with the application of MERCOSUR law. There are laws being made by MERCOSUR, but the level of commitment to these laws is low.

### **5.4 Inertial condition MERCOSUR**

MERCOSUR did not create supranational or autonomous institutions. It created intergovernmental institutions, where the power lies with the Member States. The Member States have the task of enforcement and compliance of the MERCOSUR rules (Malamud, 2008, P 128). MERCOSUR law has no direct effect, no direct applicability and no supremacy over the internal legal system. It has implementation problems. Its decision-making is done by consensus or unanimity and political direction is set by presidential summits (Malamud, 2008, P 125). The MERCOSUR institutions have not been able to meet the inertial condition. MERCOSUR did raise the intraregional trade. However, it could not solve the coordination and redistribution problems (Mattli, 1999, P 65).

### **5.5 European Union**

The EU is the most successful integration scheme. It has met the needed demand and supply conditions. The potential economic gain of integration further was enough to create a demand for regional integration by the Member States and other actors. The EU also has a regional leader and commitment institutions.

Germany is the Member State who has the leader role within the EU. This country has the strongest economy and pays more contribution to the EU budget. Examples of commitment institutions in the EU are the European Commission and the European Court of Justice. Germany as leader has contributed to the shaping of the commitment institutions. As noted above leadership does not only refer to countries. A type of leadership is a broker. An important broker for the EU was Jacques Delors. He became chairman of the Commission in 1985 and gave momentum to the European integration process (Vleuten van der 2012, P 145).

In the EU there was a demand for institutions and rules by the governments and other actors. These rules and institutions were supplied by the national governments and the EU

institutions such as the European Commission and the European Court of Justice (Malamud, 2008, P 127). The EU had the needed conditions to develop deeper regional integration.

## H6 Conclusion

After analysing regional integration, the EU and MERCOSUR, this chapter will answer the central question ‘Is the creation of a common market a feasible and realistic objective for MERCOSUR?’ MERCOSUR has been successful in some areas. It tripled intraregional trade flows, attracted foreign investment and created a customs union. However, the initial goal of MERCOSUR was to create a common market, it did not reach this goal and created an incomplete customs union.

### **Creating a common market is not a feasible objective**

The creation of a common market is not a feasible and realistic objective for MERCOSUR. There are several reasons why this is not feasible and realistic. First of all, the creation of a common market has no priority at the moment for MERCOSUR. It has not been on the agenda recently. More importantly, MERCOSUR does not have the needed conditions for deeper regional integration. As discussed in chapter 1, for regional integration to develop the demand and supply conditions need to be met. The reason why the creation of the common market has no priority is due to the lacking of the demand condition. There is no market pressure for further regional integration. The potential economic gain from further integration is inadequate due to the relatively small market size and export base of MERCOSUR. The MERCOSUR members are not willing to lose their sovereignty to MERCOSUR in order to integrate deeper.

The supply condition is not met either. MERCOSUR lacks a regional leader. Brazil seems to be the only candidate for this role, however it has no interest in doing so. It already has a prosperous economy and is not willing to lose power. Moreover, the wealth in Brazil is not equally divided. The economy is larger than the other Member States, however, there is a lot of poverty in Brazil. If Brazil would take the leading role and serve as paymaster, it would have to pay more contribution to MERCOSUR while many of their own inhabitants are living in poverty. It will be seen as subsidy to richer countries. The region has no broker either, which could promote further regional integration, as Jacques Delors has done for the EU.

Furthermore, MERCOSUR has not created the needed commitment institutions. It has created many bodies which seem similar to those created by the EU. However, the difference lies in the power that those bodies hold. The EU has supranational bodies, where MERCOSUR only has intergovernmental bodies.

MERCOSUR also has several internal problems which effect regional integration negatively. The huge asymmetries between the Member States also make further integration difficult. There are asymmetries in population, power, GDP, GNP and wealth. The leaders of the Member States cannot decide in which direction they want to lead MERCOSUR. Their opinions and ideas differ too much to find a compromise. This holds back further integration. Moreover, MERCOSUR has implementation problem of its rules. MERCOSUR law has no direct effect, no direct applicability and no supremacy over the internal legal system. Due to the lack of an

institution which monitors the compliance of MERCOSUR law, many laws are not implemented by the Member States. A common market needs to have common rules and policies in order to work properly. MERCOSUR has not been able to solve the coordination and redistribution problems. Especially trade policies should be coordinated. The intra-zone trade is incomplete and there are many CET exemptions. Moreover, the decision-making process in MERCOSUR is slow, since it votes by consensus.

In short, MERCOSUR will not be able to create a common market, because of the lack of the right economic conditions, lack of regional leadership, lack of commitment institutions and lack of political will.

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