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DIFFERENTIATED INTEGRATION IN MERCOSUR: Risks and opportunities for the association with the European Union

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Asymmetries within MERCOSUR member states and vulnerability to financial crises forced the adoption of measures to facilitate flexibility. Differentiated integration was designed to handle centrifugal forces while preserving sovereignty and avoiding the paralysis that can result from a decision-making process that requires the consensus of all member states.

The asymmetries not only affect the internal dynamics, but should also be taken into account in external relations and were a key issue in the negotiation of the association agreement signed with the EU in 2019.

To prevent interregional asymmetries, in the EU–MERCOSUR agreement context, the EU should continue aiming to contribute to reducing the development gap in order to facilitate the opportunities for region-to-region interaction and give priority to regional cooperation over bilateral programmes to avoid increasing asymmetries between the members of MERCOSUR.

Like many other regional integration processes, since its creation in 1991 the Southern Common Market (MERCOSUR, for its Spanish initials) has faced tensions accommodating the interests of the different member states. The great differences in size, population, economic weight and even levels of development among the member states and within them made it difficult to establish common standards and homogeneous policies. Moreover, the economic crises that hit the region in successive phases due to its great vulnerability to external shocks, its dependence on raw material exports and the lack of internal financing prompted defensive policies and protectionist behaviour that eroded solidarity among members. All these elements hindered the deepening of the integration process and fuelled centrifugal tendencies that endanger the project's solidity. Nevertheless, it remains the organisation with the most potential in the region and its success or failure is an indicator of the health of Latin American regionalism.

This article addresses how MERCOSUR has overcome tensions within the integration process over more than three decades. It applies the theoretical framework of differentiated integration proposed by **Warleigh-Lack** (2015), which facilitates flexibility in order to accommodate diversity. According to Warleigh-Lack, differentiation includes three main types: multi-speed, where member states pursue the same collective objectives but in different periods of time; concentric

circles, also referred to as variable geometry, consisting of various tiers of member states organised around a “hard nucleus” and which derives from member states’ long-term inability to implement a policy; and *à la carte* differentiation, which offers member states the choice not to participate, regardless of capacity, and which results in policy regimes with different memberships.

This exercise is an extension and update of a **comparative regionalism policy paper** that applied these categories to three integration organisations – ASEAN, ECOWAS and MERCOSUR – as part of *EU Integration and Differentiation for Effectiveness and Accountability* (EU-Idea), financed by the European Union (EU) within the framework of the Horizon 2020 research programme. Despite the difficulties and limitations of adapting

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categories developed for the EU to very different contexts, comparing these three institutions led us to conclude that differentiated integration occurs in all the regions analysed as a key means of dealing with the disparities within the integration processes. By use of various legal and institutional instruments, «differentiation» facilitates flexibility and allows progress to be made in different areas of integration while preserving the specific interests of each member state. Nevertheless, differentiation can also deepen asymmetries that favour larger economies.

In integration processes like MERCOSUR, where there is resistance to ceding supranational powers to regional bodies and inter-governmentality predominates, differentiation becomes an essential element to avoid centrifugal forces while preserving sovereignty and avoiding the paralysis that can be caused by decision-making processes that require the consensus of all member states. In an integration process with as many asymmetries as MERCOSUR, in which Brazil–Argentina bilateral dynamics tend to prevail, differentiation also helps respond to the demands of smaller partners. The following sections will analyse: first, the evolution of MERCOSUR in the changing context of Latin American integration; secondly, the treatment of asymmetries as a key element of the differentiated integration of MERCOSUR; then – albeit not exhaustively – some categories of differentiated integration in various MERCOSUR policies will be

identified; finally, an assessment will be made of how differentiated integration is shown in the relationship with the EU, particularly the association agreement signed in 2019 after 20 years of negotiations.

MERCOSUR’s evolution in a changing regional context

MERCOSUR forms part of the complex regionalism developed in Latin America since the second half of the 20th century, which produced multiple initiatives in the region. Over 15 mechanisms created in different historical contexts coexist that derive from diverse economic, political and value-based visions and have different objectives. The literature distinguishes three different periods in Latin American regionalism (Altman, 2015): developmentalist regionalism (1950–1970s); open regionalism (1980s–1990s) and 21st century regionalism, which is currently undergoing revision.

The first wave of regionalism was the creation of a larger regional market as a defence against extra-regional industrialised markets. This model included the Central American Common Market (CACM), the Latin American Free Trade Association (LAFTA), and the Andean Pact. However, the huge differences between the national economies, the impossibility of some members complying with the LAFTA tariff reduction schedule and the worldwide crisis of the early 1970s led to a flexibilisation of the regional projects. In the aftermath of the 1980s debt crisis and under pressure from an economic structural adjustment process a more flexible regionalism was born, based mainly on bilateral and sub-regional agreements. The Latin American Integration Association (LAIA) replaced LAFTA, an umbrella organisation under which member states could sign commercial integration agreements that complied with World Trade Organisation (WTO) rules.

MERCOSUR was created in 1991 in a phase in which the so-called *new regionalism* or *open regionalism* was emerging. This wave of renewed regionalism in the 1990s promoted a liberalisation process that would make these economies more flexible and better-inserted into the interconnected world economy. Inspired by the Washington Consensus, this model prioritised trade openness, de-regulation and privatisation in Latin American and the Caribbean (LAC) economies. Regional integration was a way to improve international competitiveness and increase bargaining power in international negotiations, in search of export-led

growth. But the external vulnerability to financial crisis collapsed the model at the beginning of the 21st century.

The economic and social consequences of the economic crisis and the political changes in the region, with the rise of more socially oriented governments, propitiated the creation of new regional bodies with different features. This was defined as *post-liberal* regionalism, to emphasise a more political and less commercially driven approach, or *post-hegemonic* regionalism in order to underline LAC regional projects' search for greater autonomy from traditional US hegemony. But, apart from these general features, they were very heterogeneous initiatives with different objectives and scopes. In this third wave of Latin American regionalism, MERCOSUR tried to strengthen its institutional bodies and incorporate new policy issues, including social policies and human rights. In the same period, the creation of the Community of Latin American and Caribbean States (CELAC) in 2010 was an important step for promoting political cooperation within the LAC region. It impacted relations with the EU, providing a framework to work together with the entire region and helping to manage fragmentation. CELAC didn't seek economic integration, but rather policy coordination for intra- and interregional relations.

Two other initiatives were the creation of the Union of South American Nations (UNASUR) in 2008 to further unite South America in the areas of security, physical integration and social cooperation and to gain political autonomy in regional geopolitics; and the foundation of the Bolivarian Alliance for the Peoples of Our America (ALBA) in 2004 in order to strengthen cooperation between the governments representing so-called 21st Century Socialism, led by Venezuela. These two initiatives had a strongly political profile and did not create solid institutional frameworks or common regulatory bodies. With the change of the political cycle in several countries of the region and the political polarisation around the governance crisis in Venezuela, both went into decline. UNASUR was abandoned by most of its founder members, while today ALBA barely exists – it was highly dependent on the resources provided by Venezuela during the period of prosperity that ran from prior to the 2008 financial crisis to the fall in the price of raw materials. The turbulence only increased the tensions resulting from differing models of development.

MERCOSUR was not immune to these tensions. In common with them, it featured strong inter-

governmentalism and the rejection of any kind of sovereignty transfer from the states to the organisation. This made all these organisations highly dependent on consensus between the member states; when consensus doesn't exist, political tensions lead to institutional crisis. Nevertheless, MERCOSUR was created following a major crisis and has already withstood two other serious economic crises without collapse. This is probably due to the economic interdependence between its members, its robust institutional framework, and the fact that it benefits the bigger members, especially Brazil, while the smaller members have no other viable alternatives. Historically, the most resilient regional organizations in Latin America have been those with economic integration as a fundamental pillar. In addition to MERCOSUR,

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this includes the Central American Common Market, the Caribbean Community (CARICOM) and the Latin American Integration Association (ALADI). But that doesn't exempt them from great tensions deriving from internal asymmetries, which are especially relevant in the case of MERCOSUR.

MERCOSUR and its handling of asymmetries

The creation of MERCOSUR was the result of an initiative led bilaterally by Brazil and Argentina and joined by Uruguay and Paraguay. According to the parameters of "open regionalism", the aim was trade liberalisation and no further transfer of powers was contemplated than supervising member states' compliance with the treaties and the decisions made by the intergovernmental authorities. The disparities in size, potential and levels of development that exist between MERCOSUR member countries condition their capability of to take advantage of the potential benefits of trade liberalisation, but above all, they hinder the creation of a regional socioeconomic space that is moving towards convergence in terms of development. The debate on the treatment of asymmetries in MERCOSUR has a long history, but its development was very limited.

The Treaty of Asunción establishing MERCOSUR included differentiated treatment that was very partial and limited to tariff issues, due to the dominant export-

oriented open regionalism model. As a consequence, and due to the enormous disparities between MERCOSUR member states, tensions and conflicts arose. Due to the demands of the smaller MERCOSUR partners, some initiatives were applied to address financial, political and social considerations to favour a more multidimensional vision of the integration process. These initiatives, however, face multiple challenges. The first – a prior step – is the analysis of the asymmetries that constitute an obstacle to the equitable development of the integration process. Disparities in MERCOSUR occur not only between states, they are also reproduced within each country and between regions within a single country or several. Diagnosing the asymmetries started late, preventing the design of a comprehensive regional development strategy; while

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the instruments for managing the imbalances between countries had a very fragmented framework.

As MERCOSUR was initially established as a free trade area and future customs union project, the few instruments relating to differentiated integration included in the constitutive treaty focused on tariff issues. However, with the progressive expansion of the material agenda, other instruments linked to the social agenda were incorporated, although their level of development is uneven. These included mechanisms for the equitable use of trade liberalisation, with the initial trade liberalisation programme granting longer terms for tariff dismantling and a greater number of products with exceptions for Uruguay and Paraguay. Really, this was compensation, since in the adopted Common External Tariff (CET), the protectionist Brazilian tariffs on capital goods and the computer and telecommunications industries were used as a reference.

In the current CET, each member country applies tariff structures that have been harmonised, but the level of implementation is below 70%. Brazil and Argentina have also often used exceptions and safeguarding measures, particularly during periods of economic and financial crisis. Furthermore, any goods that originate outside MERCOSUR, enter a member state's territory and are exported to another without complying with the rules of origin are subject to "double taxation". This increases the costs of trade within the bloc and undermines the development of regional value chains.

In 2010 a Union Consolidation Program was approved to eliminate double taxation, but the agreed collection schedule was not accomplished.

Regarding the asymmetries in economic and territorial development, the Treaty of Asunción did not foresee policies to eliminate practices that distort the competitiveness of trade flows. Neither have measures been taken to avoid grievances around the different capacities for production incentives. In 2001, an inventory of national and sub-national incentives in the public sector was carried out but not made public. With all such regulations, the biggest problem is systematic non-compliance without penalties.

Another important instrument is the Structural Convergence Fund (FOCEM) created in 2005. It was an attempt to respond to one of the main demands made by smaller countries to establish mechanisms of interregional solidarity that would address development disparities between the member countries. The purpose of the FOCEM is to

finance development projects to reduce asymmetries between MERCOSUR member countries and increase the competitiveness of the economies as an instrument to promote integration and social cohesion. A problem with the distribution of these regional cohesion funds is that the largest impoverished areas are not in the smallest countries but in Brazil, the country with greatest fiscal pressure on its taxpayers, raising questions about the tax equity of contributions. Coordinating national policies for regional redistribution and greater tax harmonisation would be more equitable, but the financial imbalances that affect the region make it very difficult.

Other instruments of this sort were created in recent decades, as the material scope of MERCOSUR policies expanded, including the MERCOSUR Social Institute (ISM), which aims to develop an integrated vision for the design and application of social policies. Meanwhile, in 2010, the MERCOSUR Institute of Public Policy on Human Rights (IPPDH) approved measures on the rule of law and human rights protection for MERCOSUR members. In the social and labour spheres, a joint declaration by the presidents cited the need for an inventory of employment policies in order to develop common regional guidelines, with special emphasis on combating child labour through regional inspection programmes. In 2009 a MERCOSUR Family Agriculture Fund (FAF) was set up in order to finance incentive programmes and facilitate the participation of social actors. All these initiatives operate on a voluntary basis.

Another institutional problem is that in MERCOSUR important decisions can only be decided by consensus of the high representatives of the countries. That means that any single state has the right to veto any decision. There is no transfer of sovereignty to the institutions and all the important decisions must be approved by the competent internal bodies of each country, which often includes national parliaments and can take years. Furthermore, the absence of effective compliance control mechanisms adds further difficulties advancing on a deeper material agenda.

MERCOSUR and differentiated integration

However, a set of measures for pragmatic adaptation to problems arising in the negotiations within member states was implemented. They are mainly designed to address the demands of countries that fear being adversely affected by certain policies or norms. On the other hand, we find bilateral dynamics between Brazil and Argentina that are intended to produce a tracking effect among other members, but they risk generating fragmentation, hindering relations with third states.

Regarding the trade agenda, as mentioned, the initial trade liberalisation programme established *multi-speed* liberalisation and granted longer terms for tariff dismantling as well as a greater number of products that included exceptions for Uruguay and Paraguay. Initially conceived as a temporary mechanism until the playing field was levelled, it remained in place as a permanent feature due the asymmetric dynamics of the integration process. For example, recent progress in different intra-zone non-tariff instruments was only possible after the introduction of more flexible schemes in the application of the commitments taken on. This is the case for the agreement on public purchases, which came about following commitments by Argentina, Brazil and Uruguay, while Paraguay postponed the concessions.

In the case of mechanisms for the equitable use of trade liberalisation, other measures can be characterised as *à la carte differentiation*. In 2003 it was agreed that in the rules of origin for Paraguay a rate of 50% would be applied (in order for it to claim origin) instead of 60% as for other members. Paraguay and Uruguay were also authorised to import agricultural inputs from third states free of tariffs and special treatment was agreed for Paraguay in negotiations with third states.

To respond to one of the main demands of smaller countries, the FOCEM – created in 2005 to reduce

asymmetries between MERCOSUR member countries – established that its financing corresponds to 70% for Brazil, 27% for Argentina, 2% for Uruguay and 1% for Paraguay. On the other hand, the beneficiary rate was established as 48% for Paraguay, 32% for Uruguay, 10% for Argentina and 10% for Brazil. This is an example of a differentiated redistributive instrument. But we also find the practice in decision-making on regulatory norms. The new regulations for the adoption of common technical regulations allow a member to proceed unilaterally in the absence of consensus. This differentiated treatment can be seen as a compensation measure that attempts to satisfy the countries that have benefited least from the integration process. It is, therefore, a measure that seeks to consolidate the bloc.

MERCOSUR's strong emphasis on intergovernmentalism and rejection of any kind of sovereignty transfer to the organisation can be seen as a rebalancing mechanism for smaller countries to defend their interests against regional powers.

The formula of *concentric circles* can also be detected in the economic field. For example, Brazil and Argentina established a bilateral system of local currency payments in 2008. In 2014, a similar agreement was signed between Brazil and Uruguay and a year later between Argentina and Uruguay. Another example is the agreement on double taxation for trade in services signed between Argentina and Brazil that entered into force in 2019, followed by an agreement between Uruguay and Brazil adopted in the same year. This can be considered part of the pull factor of Brazil–Argentina bilateralism, which the minor partners end up joining.

Meanwhile, MERCOSUR's strong emphasis on intergovernmentalism and rejection of any kind of sovereignty transfer to the organisation can be seen as a rebalancing mechanism for smaller countries to defend their interests against regional powers that helps to accommodate differences and prevent impositions by stronger countries.

Beyond MERCOSUR, there is a logic of *concentric circles* between different organisations and Latin American countries under the Latin American Integration Association (ALADI) umbrella. This allows MERCOSUR member states to have agreements with other neighbouring countries, including Bolivia, with whom an accession treaty exists that has yet to be ratified. This is part of the Latin American spaghetti bowl that, while offering a legal framework for exchanges, is intricate and fragmented. Another example is the attempt to converge MERCOSUR and

the Pacific Alliance (formed of Chile, Colombia, Mexico and Peru), seeking a liberalisation process at various speeds. This, however, has been questioned due to political changes and instability in different countries. The tension between convergence and fragmentation not only affects the regional dynamics, but also impacts the negotiation with external actors like the EU.

Differentiation and the EU–MERCOSUR Association Agreement

During the *open regionalism* wave in Latin America, EU support for regional integration processes became one of the pillars of the bi-regional relationship. This included a preference for bargaining collectively with

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existing bodies and the development of sub-regional cooperation strategies with existing blocs. The newly created MERCOSUR became the priority. The EU has always assisted MERCOSUR as part of its support strategy for regional integration schemes around the world, and by 1992 the EU had made an agreement to supply the newly formed South American bloc with technical assistance. Political dialogue took shape in 1996 and included meetings between heads of state and government, ministers and diplomats. Traditionally EU funds were used to support the MERCOSUR secretariat as well as harmonisation measures in the customs, statistical, veterinary, and macroeconomic sectors. The EU is MERCOSUR's second-largest trade partner after China, accounting for nearly 20% of the bloc's commercial relations. It is also a major exporter of commercial services to MERCOSUR, as well as the biggest foreign investor in the region.

In 1999 the interregional strategic partnership between the EU and LAC was launched at the Summit of the Heads of State and Government in Rio de Janeiro. Europe tried to distance itself from a purely commercial approach and to promote a regulatory role incorporating three dimensions: political, through multilevel dialogues; economic, including trade and investment; and development cooperation, incorporating social policies in multiple levels. Thus, the EU–Mercosur relationship is structured in three different levels: political dialogue at the interregional level through CELAC; subregional, through the recently renewed EU–MERCOSUR agreement; and bilateral, engaging

each MERCOSUR member, and especially the EU–Brazil strategic partnership. This format reveals the asymmetry that exists between the two regions in terms of material competences and institutional capacities, as well as the asymmetries within MERCOSUR.

Given their political and economic links, it seems logical for the EU and MERCOSUR to strengthen their exchanges by concluding an association agreement and creating a free trade area. After two decades of negotiations, the talks, which began in 1999, saw no success until 2019, when political changes in MERCOSUR countries opened a window of opportunity to seal an association agreement. MERCOSUR and the EU trade negotiation teams achieved a basic understanding, but to become material it requires ratification and it is meeting resistance in some European countries and from some political parties in the European Parliament.

The main concerns are based on the notion that more imports to the EU could generate increased illegal deforestation in countries like Brazil. These critics demand

the incorporation of binding clauses, monitoring instruments with the participation of civil society, and the possibility of applying sanctions in case of non-compliance with the agreement. Certainly, the current terms of the EU–MERCOSUR agreement do not meet expectations and international commitments in terms of combatting deforestation. But with complementary measures that include stronger regional cooperation, the agreement could become an instrument to improve environmental governance, while taking into account the particularities of each country.

On the other hand, to prevent the agreement from being blocked by a single country, at the MERCOSUR summit of July 2019 the consensus was that the free trade agreement with the EU will enter into force on a provisionally bilateral basis before the respective ratifications by the individual countries. This represents a potential threat for internal cohesion. A bilateral and fragmented approach to the association agreement can deepen the asymmetries that favour larger economies.

Similarly, if MERCOSUR does not improve trade performance intra-zone, the agreement with the EU will tend to deepen the asymmetries that have traditionally favoured the larger economy. Differentiation can fuel progress in trade liberalisation, but in practice does little to reduce development gaps and can increase fragmentation. *À la carte* and opt-out formulas, in particular, allow subsets to surge ahead, but can at the same time exacerbate pre-existing development asymmetries and render agreements irrelevant.

To prevent interregional asymmetries, the EU–MERCOSUR agreement establishes multi-speed and differentiated liberalisation with exemptions concentrated on sensitive products. But to take advantage of the agreement requires MERCOSUR to overcome difficulties that have traditionally limited the performance of intra-zone trade and harmed integration. The agreement with the EU can help, as liberalisation with Europe would force some sectors still facing restrictions to internally liberalise. Through the agreement with the EU, MERCOSUR could improve the performance of its internal market to become a real customs union. Further developments of the agreement can contribute to consolidating convergent regulatory instruments that strengthen the multilateral system, including environmental measures, which also incorporate the differences between regions and countries in line with differentiated treatment.

The EU should also continue aiming to contribute to reducing the development gap in order to facilitate the opportunities for region-to-region interaction and give priority to regional cooperation over bilateral programmes to avoid increasing asymmetries between the members of MERCOSUR. Moreover, the EU can offer its own expertise to other regions in order to apply differentiation in other fields, including the security and political fields, in cases where flexible, non-homogeneous cooperation has contributed to stimulating and deepening regional integration. In this way, the logic of differentiated integration as an instrument to make integration processes more flexible not only has a regional dimension, it is also transnationalised and contributes to more balanced interregional relations.