Chapter 11

Appendix A: Global Trade: Doctrines and Regulation

11.1 Doctrines

Free Trade. Throughout history, *free trade* has been an important factor behind the prosperity of different civilizations. Adam Smith pointed to increased trade as the primary reason for the flourishing of the Mediterranean cultures, such as Egypt, Greece, and Rome, but also of Bengal (East India) and China. The great prosperity of the Netherlands, after it threw off Spanish imperial rule and came out in favor of free trade and freedom of thought, made the free trade versus mercantilist dispute the most important question in economics for centuries.Mercantilism is an economic theory that holds that the prosperity of a nation is dependent upon its supply of capital, and that the global volume of trade is "unchangeable." Economic assets or capital are represented by bullion (gold, silver, and trade value) held by the state, which is best increased through a positive balance of trade with other nations (exports minus imports). Mercantilism suggests that the ruling government should advance these goals by playing a protectionist role in the economy through encouraging exports and discouraging imports, especially through the use of tariffs. Mercantilism was the dominant school of thought from the 16th to the 18th centuries. Domestically, this led to some of the first instances of significant government intervention and control over the economy, and it was during this period that much of the modern capitalist system was established. Internationally, mercantilism encouraged the many European wars of the period and fueled European imperialism. Belief in mercantilism began to fade in the late 18th century, as the arguments of Adam Smith and the other classical economists won out. Today, mercantilism (as a whole) is rejected by economists, though some elements are looked upon favorably by noneconomists. Ever since then, the "free-trade doctrine" has battled with mercantilist, protectionist, isolationist, and other trade doctrines and policies.

One of the strongest arguments for free trade was made by classical economist David Ricardo in his analysis of *comparative advantage*. Comparative advantage occurs when different parties (countries, regions, or individuals) have different opportunity costs of production. The theory is that free trade will induce countries to specialize in making the products that they are best at and that this will maximize the total wealth produced.

Adopting the free-trade doctrine means supporting and protecting (a) the trade of goods without taxes (including tariffs) or other trade barriers (e.g., quotas on imports or subsidies for producers); (b) trade in services without taxes or other trade barriers; (c) the absence of "trade-distorting" policies (such as taxes, subsidies, regulations, or laws) that give some firms, households, or factors of production an advantage over others; (d) free access to markets; (e) free access to market information; (f) efforts against firms trying to distort markets through monopoly or oligopoly power; (g) the free movement of labor between and within countries; and (h) the free movement of capital between and within nations.

Protectionism. Opposition to free trade, generally known as *protectionism*, is based on the notion that free trade is unrealistic or that the advantages are outweighed by considerations of national security, the importance of nurturing infant industries, preventing the exploitation of economically weak countries by stronger ones or of furthering various social goals.

Free trade is sometimes also opposed by domestic industries threatened by lower-priced imported goods. If U.S. tariffs on imported sugar were reduced, for example, U.S. sugar producers would have to lower their prices (and sacrifice profits). Of course, U.S. consumers would benefit from those lower prices. In fact, economics tells us that, collectively, consumers would gain more than the (domestic) producers would lose. However, since there are only a few domestic sugar producers, each one could lose a significant amount. This explains why domestic producers may be inclined to mobilize against the lifting of tariffs or, more generally, why they often favor domestic subsidies and tariffs on imports in their home countries, while objecting to subsidies and tariffs in their export markets.

Antiglobalization groups that maintain that, in reality, "free-trade agreements" often do not increase the economic freedom of the poor but rather make them poorer. These groups are another source of opposition to free trade. An example is the argument that letting subsidized corn from the United States into Mexico freely under NAFTA at prices well below production cost is ruinous to Mexican farmers. The real issue here, of course, is that such subsidies violate the principles of free trade and that this therefore exemplifies a flawed agreement rather than a valid argument against free trade.

As economic policy, protectionism is about restraining trade between nations, through methods such as tariffs on imported goods, restrictive quotas, and a variety of other restrictive government regulations designed to discourage imports and prevent foreign takeover of local markets and companies. This policy is closely aligned with antiglobalization and contrasts with free trade, where government barriers to trade are kept to a minimum. The term is mostly used in the context of economics, where protectionism refers to policies or doctrines that "protect" businesses and workers within a country by restricting or regulating trade between foreign nations.

Historically, protectionism was associated with economic theories such as mercantilism and import substitution. During that time, Adam Smith famously warned against the “interested sophistry” of industry, seeking to gain advantage at the cost of the consumers.Friedman and Friedman (1980). Virtually all modern-day economists agree that protectionism is harmful in that its costs outweigh the benefits and that it impedes economic growth. Economics Nobel Prize winner and trade theorist Paul Krugman once stated, “If there were an Economist’s Creed, it would surely contain the affirmations ‘I believe in the Principle of Comparative Advantage’ and ‘I believe in Free Trade.’”Krugman (1987).

A variety of policies can be used to achieve protectionist goals, including the enactment of the following items:

1. *Tariffs*. Typically, tariffs (or taxes) are imposed on imported goods. Tariff rates vary according to the type of goods imported. Import tariffs will increase the cost to importers and increase the price of imported goods in the local markets, thus lowering the quantity of goods imported. Tariffs may also be imposed on exports, and in an economy with floating exchange rates, export tariffs have similar effects as import tariffs. However, for political reasons, such a policy is seldom implemented.
2. *Import quotas*. Import quotas reduce the quantity, and therefore increase the market price, of imported goods. Their economic effect is therefore similar to that of tariffs, except that the tax revenue gain from a tariff will instead be distributed to those who receive import licenses. This explains why economists often suggest that import licenses be auctioned to the highest bidder or that import quotas be replaced by an equivalent tariff.
3. *Administrative barriers*. Countries are sometimes accused of using their various administrative rules (e.g., regarding food safety, environmental standards, electrical safety) as a way to introduce barriers to imports.
4. *Antidumping legislation*. Dumping is the act of charging a lower price for a good in a foreign market than is charged for the same good in the domestic market (i.e., selling at less than “fair value”). Under the World Trade Organization (WTO) agreement, dumping is condemned (but not prohibited) if it causes or threatens to cause material injury to a domestic industry in the importing country. Supporters of antidumping laws argue that they prevent “dumping” of cheaper foreign goods that would cause local firms to close down. In practice, however, antidumping laws are often used to impose trade tariffs on foreign exporters.
5. *Direct subsidies*. Government subsidies (in the form of lump-sum payments or cheap loans) are sometimes given to local firms that cannot compete well against foreign imports. These subsidies are

purported to "protect" local jobs and to help local firms adjust to the world markets.

6. *Export subsidies*. Under export subsidies, exporters are paid a percentage of the value of their exports. Export subsidies increase the amount of trade, and, in a country with floating exchange rates, have effects similar to import subsidies.
7. *Exchange rate manipulation*. A government may intervene in the foreign exchange market to lower the value of its currency by selling its currency in the foreign exchange market. Doing so will raise the cost of imports and lower the cost of exports, leading to an improvement in its trade balance. However, such a policy is only effective in the short run, as it will lead to higher price inflation in the country, which will in turn raise the cost of exports and reduce the relative price of imports.

In the modern trade arena, many other initiatives besides tariffs, quotas, and subsidies have been called protectionist. For example, some scholars, such as Jagdish Bhagwati, see developed countries' efforts in imposing their own labor or environmental standards as forms of protectionism.Bhagwati (2004). The imposition of restrictive certification procedures on imports can also be seen in this light. Others point out that free-trade agreements often have protectionist provisions such as intellectual property, copyright, and patent restrictions that benefit large corporations. These provisions restrict trade in music, movies, drugs, software, and other manufactured items to high-cost producers with quotas from low-cost producers set to zero.

Arguments for protectionism. Opponents of free trade include those who argue that the comparative advantage argument for free trade has lost its legitimacy in a globally integrated world in which capital is free to move internationally. Herman Daly, a leading voice in the discipline of ecological economics, has stated that although Ricardo's theory of comparative advantage is one of the most elegant theories in economics, its application to the present day is illogical: "Free capital mobility totally undercuts Ricardo's comparative advantage argument for free trade in goods, because that argument is explicitly and essentially premised on capital (and other factors) being immobile between nations. Under the new globalization regime, capital tends simply to flow to wherever costs are lowest—that is, to pursue absolute advantage."Daly (2007).

Others criticize free trade as being "reverse protectionism in disguise," that is, of using tax policy to protect foreign manufacturers from domestic competition. By ruling out revenue tariffs on foreign products, government must fully rely on domestic taxation to provide its revenue, which falls disproportionately on domestic manufacturing. Or, in the words of Paul Craig Roberts, "[Foreign discrimination of U.S. products] is reinforced by the U.S. tax system, which imposes no appreciable tax burden on foreign goods and services sold in the U.S. but imposes a heavy tax burden on U.S. producers of goods and services regardless of whether they are sold within the U.S. or exported to other countries."Roberts (2005, July 26).

Other defenses of protectionism include the idea that protecting newly founded, strategically important infant industries by imposing tariffs allows those domestic industries to grow and become self-sufficient within the international economy once they reach a reasonable size.

Arguments against protectionism. Most economists fundamentally believe in free trade and agree that protectionism reduces welfare. Nobel laureates Milton Friedman and Paul Krugman, for example, have argued that free trade helps third-world workers even though they may not be subject to the stringent health and labor standards of developed countries. This is because the growth of the manufacturing sector and the other jobs that a new export sector creates competition among producers, thereby lifting wages and living conditions.

Protectionism has also been accused of being one of the major causes of war. Proponents of this theory point to the constant warfare in the 17th and 18th centuries among European countries whose governments were predominantly mercantilist and protectionist; the American Revolution, which came about primarily due to British tariffs and taxes; as well as the protective policies preceding World War I and World War II.

11.2 Regulation of International Trade

Traditionally, trade was regulated through bilateral treaties between two nations. After World War II, as free trade emerged as the dominant doctrine, multilateral treaties like the GATT and *World Trade Organization* (WTO) became the principal regime for regulating global trade.

The WTO, created in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT), is an international organization charged with overseeing and adjudicating international trade. The WTO deals with the rules of trade between nations at a near-global level; is responsible for negotiating and implementing new trade agreements; and is in charge of policing member countries' adherence to all the WTO agreements, signed by the majority of the world's trading nations and ratified in their parliaments. Additionally, it is the WTO's duty to review the national trade policies and to ensure the coherence and transparency of trade policies through surveillance in global economic policy making.

Headquartered in Geneva, Switzerland, the WTO has more than 150 members, which represent more than 95% of total world trade. It is governed by a ministerial conference, which meets every 2 years; a general council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the ministerial conference.

Five basic principles guide the WTO's role in overseeing the global trading system:

1. *Nondiscrimination*. This principle inspired two major policies—the most favored nation (MFN) rule and the national treatment policy—embedded in the main WTO rules on goods, services, and intellectual property. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members, that is, a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members. The national treatment policy, adopted to address nontariff barriers to trade (e.g., technical standards, security standards) dictates that imported and locally produced goods should be treated equally (at least after the foreign goods have entered the market).
2. *Reciprocity*. This principle reflects both a desire to limit the scope of free riding that that may arise because of the MFN rule and a desire to obtain better access to foreign markets.

3. *Binding and enforceable commitments*. The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a list of concessions. A country can change its commitments but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.
4. *Transparency*. WTO members are required to publish their trade regulations, to maintain institutions charged with review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO.
5. *Safety valves*. Under specific circumstances, governments can (within limits) restrict trade to attain noneconomic objectives, to ensure "fair competition," and under special economic circumstances.

The WTO operates on a "*one country, one vote*" system, but actual votes have never been taken. Ostensibly, decisions are made by consensus, with relative market size as the primary source of bargaining power. In reality, most WTO decisions are made through a process of informal negotiations between small groups of countries, often referred to as the "green room" negotiations (after the color of the WTO director-general's office in Geneva) or "miniministerials" when they occur in other countries. These processes have been regularly criticized by many of the WTO's developing-country members who are often excluded from these negotiations.

The WTO oversees about 60 different agreements that have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession. Some of the most important agreements concern agriculture, services, and intellectual-property rights.

Regional arrangements such as Mercosur in South America; the North American Free Trade Agreement (NAFTA) between the United States, Canada, and Mexico; ASEAN in Southeast Asia; and the European Union (EU) between 27 independent states constitute a second dimension of the international trade regulatory framework.

The *EU* is an economic and political union of 27 member states. Committed to regional integration, the EU was established by the Treaty of Maastricht on November 1, 1993, upon the foundations of the preexisting European Economic Community. With almost 500 million citizens, the EU combined generates an estimated 30% share of the nominal gross world-product.

The EU has developed a single market through a standardized system of laws that apply in all member states, ensuring the freedom of movement of people, goods, services, and capital. It maintains common policies on trade, agriculture, fisheries, and regional development. A common currency, the euro, has been adopted by 16 member states known as the Eurozone. The EU has developed a limited role in foreign policy, having representation at the WTO, G8 summits, and at the UN. It enacts legislation in justice and home affairs, including the abolition of passport controls between many member states. Twenty-one EU countries are also members of NATO, those member states outside NATO being Austria, Cyprus, Finland, Ireland, Malta, and Sweden.

Mercosur is a regional trade agreement among Argentina, Brazil, Paraguay, and Uruguay, founded in 1991 by the Treaty of Asunción, which was later amended and updated by the 1994 Treaty of Ouro Preto. Its purpose is to promote free trade and the fluid movement of goods, people, and currency.

Bolivia, Chile, Colombia, Ecuador, and Peru currently have associate-member status. Venezuela signed a membership agreement on June 17, 2006, but before becoming a full member, its entry has to be ratified by the Paraguayan and the Brazilian parliaments.

The *NAFTA* is an agreement signed by the governments of the United States, Canada, and Mexico, creating a trilateral trade bloc in North America. The agreement came into force on January 1, 1994. It superseded the Canada–United States Free Trade Agreement. In terms of combined purchasing power, parity GDP of its members, as of 2007 the trade block, is the largest in the world and second largest by nominal GDP comparison. NAFTA has two supplements: the North American Agreement on Environmental Cooperation (NAAEC) and the North American Agreement on Labor Cooperation (NAALC).

The *Association of Southeast Asian Nations*, commonly abbreviated *ASEAN*, is a geopolitical and economic organization of 10 countries located in Southeast Asia, which was formed on August 8, 1967, by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Since then, membership has expanded to include Brunei, Burma (Myanmar), Cambodia, Laos, and Vietnam. Its aims include the acceleration of economic growth, social progress, cultural development among its members, and the protection of the peace and stability of the region.