International Trade Agreements

By Douglas A. Irwin

Ever since ADAM SMITH published *The Wealth of Nations* in 1776, the vast majority of economists have accepted the proposition that FREE TRADE among nations improves overall economic welfare. Free trade, usually defined as the absence of tariffs, quotas, or other governmental impediments to INTERNATIONAL TRADE, allows each country to specialize in the goods it can produce cheaply and efficiently relative to other countries. Such specialization enables all countries to achieve higher real incomes.

Although free trade provides overall benefits, removing a trade barrier on a particular good hurts the shareholders and employees of the domestic industry that produces that good. Some of the groups that are hurt by foreign COMPETITION wield enough political power to obtain protection against imports. Consequently, barriers to trade continue to exist despite their sizable economic costs. According to the U.S. International Trade Commission, for example, the U.S. gain from removing trade restrictions on textiles and apparel would have been almost twelve billion dollars in 2002 alone. This is a net economic gain after deducting the losses to firms and workers in the domestic industry. Yet, domestic textile producers have been able to persuade Congress to maintain tight restrictions on imports.

While virtually all economists think free trade is desirable, they differ on how best to make the transition from tariffs and quotas to free trade. The three basic approaches to trade reform are unilateral, multilateral, and bilateral.

Some countries, such as Britain in the nineteenth century and Chile and China in recent decades, have undertaken unilateral tariff reductions—reductions made independently and without reciprocal action by other countries. The advantage of unilateral free trade is that a country can reap the benefits of free trade immediately. Countries that lower trade barriers by themselves do not have to postpone reform while they try to persuade other nations to follow suit. The gains from such trade liberalization are substantial: several studies have shown that income grows more rapidly in countries open to international trade than in those more closed to trade. Dramatic illustrations of this phenomenon include China's rapid growth after 1978 and India's after 1991, those dates indicating when major trade reforms took place.

For many countries, unilateral reforms are the only effective way to reduce domestic trade barriers. However, multilateral and bilateral approaches—dismantling trade barriers in concert with other countries—have two advantages over unilateral approaches. First, the economic gains from international trade are reinforced and enhanced when many countries or regions agree to a mutual reduction in trade barriers. By broadening markets, concerted liberalization of trade increases competition and specialization among countries, thus giving a bigger boost to EFFICIENCY and consumer incomes.

Second, multilateral reductions in trade barriers may reduce political opposition to free trade in each of the countries involved. That is because groups that otherwise would oppose or be indifferent to trade reform might join the campaign for free trade if they see opportunities for exporting to the other countries in the trade agreement. Consequently, free trade agreements between countries or regions are a useful strategy for liberalizing world trade.

The best possible outcome of trade negotiations is a multilateral agreement that includes all major trading countries. Then, free trade is widened to allow many participants to achieve the greatest possible gains from trade. After World War II, the United States helped found the General Agreement on Tariffs and Trade (GATT), which quickly became the world's most important multilateral trade arrangement.

The major countries of the world set up the GATT in reaction to the waves of PROTECTIONISM that crippled world trade during—and helped extend—the GREAT DEPRESSION of the 1930s. In successive negotiating "rounds," the GATT substantially reduced the tariff barriers on manufactured goods in the industrial countries. Since the GATT began in 1947, average tariffs set by industrial countries have fallen from about 40 percent to about 5 percent today. These tariff reductions helped promote the tremendous expansion of world trade after World War II and the concomitant rise in real per capita incomes among developed and developing nations alike. The annual gain from removal of tariff and nontariff barriers to trade as a result of the Uruguay Round Agreement (negotiated under the auspices of the GATT between 1986 and 1993) has been put at about $96 billion, or 0.4 percent of world GDP.

In 1995, the GATT became the World Trade Organization (WTO), which now has more than 140 member countries. The WTO oversees four international trade agreements: the GATT, the General Agreement on Trade in Services (GATS), and agreements on trade-related INTELLECTUAL PROPERTY rights and trade-related INVESTMENT (TRIPS and TRIMS, respectively). The WTO is now the forum for members to negotiate reductions in trade barriers; the most recent forum is the Doha Development Round, launched in 2001.

The WTO also mediates disputes between member countries over trade matters. If one country's government accuses another country's government of violating world trade rules, a WTO panel rules on the dispute. (The panel's ruling can be appealed to an appellate body.) If the WTO finds that a member country's government has not complied with the agreements it signed, the member is obligated to change its policy and bring it into conformity with the rules. If the member finds it politically impossible to change its policy, it can offer compensation to other countries in the form of lower trade barriers on other goods. If it chooses not to do this, then other countries can receive authorization from the WTO to impose higher duties (i.e., to "retaliate") on goods coming from the offending member country for its failure to comply.

As a multilateral trade agreement, the GATT requires its signatories to extend most-favored-nation (MFN) status to other trading partners participating in the WTO. MFN status means that each WTO member receives the same tariff treatment for its goods in foreign markets as that extended to the "most-favored" country competing in the same market, thereby ruling out preferences for, or discrimination against, any member country.

Although the WTO embodies the principle of nondiscrimination in international trade, article 24 of the GATT permits the formation of free-trade areas and "customs unions" among WTO members. A free-trade area is a group of countries that eliminate all tariffs on trade with each other but retain autonomy in determining their tariffs with nonmembers. A customs union is a group of countries that eliminate all tariffs on trade among themselves but maintain a common external tariff on trade with countries outside the union (thus technically violating MFN).

The customs union exception was designed, in part, to accommodate the formation of the European Economic Community (EC) in 1958. The EC, originally formed by six European countries, is now known as the EUROPEAN UNION (EU) and includes twenty-seven European countries. The EU has gone beyond simply reducing barriers to trade among member states and forming a customs union. It has moved toward even greater economic integration by becoming a common market—an arrangement that eliminates impediments to the mobility of factors of production, such as capital and labor, between participating countries. As a common market, the EU also coordinates and harmonizes each country's tax, industrial, and agricultural policies. In addition, many members of the EU have formed a single currency area by replacing their domestic currencies with the euro.

The GATT also permits free-trade areas (FTAs), such as the European Free Trade Area, which is composed primarily of Scandinavian countries. Members of FTAs eliminate tariffs on trade with each other but retain autonomy in determining their tariffs with nonmembers.

One difficulty with the WTO system has been the problem of maintaining and extending the liberal world trading system in recent years. Multilateral negotiations over trade liberalization move very slowly, and the requirement for consensus among the WTO's many members limits how far agreements on trade reform can go. As Mike Moore, a recent director-general of the WTO, put it, the organization is like a car with one accelerator and 140 hand brakes. While multilateral efforts have successfully reduced tariffs on industrial goods, it has had much less success in liberalizing trade in agriculture, textiles, and apparel, and in other areas of international commerce. Recent negotiations, such as the Doha Development Round, have run into problems, and their ultimate success is uncertain.

As a result, many countries have turned away from the multilateral process toward bilateral or regional trade agreements. One such agreement is the North American Free Trade Agreement (NAFTA), which went into effect in January 1994. Under the terms of NAFTA, the United States, Canada, and Mexico agreed to phase out all tariffs on merchandise trade and to reduce restrictions on trade in services and foreign investment over a decade. The United States also has bilateral agreements with Israel, Jordan, Singapore, and Australia and is negotiating bilateral or regional trade agreements with countries in Latin America, Asia, and the Pacific. The European Union also has free-trade agreements with other countries around the world.

The advantage of such bilateral or regional arrangements is that they promote greater trade among the parties to the agreement. They may also hasten global trade liberalization if multilateral negotiations run into difficulties. Recalcitrant countries excluded from bilateral agreements, and hence not sharing in the increased trade these bring, may then be induced to join and reduce their own barriers to trade. Proponents of these agreements have called this process "competitive liberalization," wherein countries are challenged to reduce trade barriers to keep up with other countries. For example, shortly after NAFTA was implemented, the EU sought and eventually signed a free-trade agreement with Mexico to ensure that European goods would not be at a competitive disadvantage in the Mexican market as a result of NAFTA.

But these advantages must be offset against a disadvantage: by excluding certain countries, these agreements may shift the composition of trade from low-cost countries that are not party to the agreement to high-cost countries that are.

Suppose, for example, that JAPAN sells bicycles for fifty dollars, Mexico sells them for sixty dollars, and both face a twenty-dollar U.S. tariff. If tariffs are eliminated on Mexican goods, U.S. consumers will shift their purchases from Japanese to Mexican bicycles. The result is that Americans will purchase from a higher-cost source, and the U.S. government receives no tariff revenue. Consumers save ten dollars per bicycle, but the government loses twenty dollars. Economists have shown that if a country enters such a "trade-diverting" customs union, the cost of this trade diversion may exceed the benefits of increased trade with the other members of the customs union. The net result is that the customs union could make the country worse off.

Critics of bilateral and regional approaches to trade liberalization have many additional arguments. They suggest that these approaches may undermine and supplant, instead of support and complement, the multilateral WTO approach, which is to be preferred for operating globally on a nondiscriminatory basis. Hence, the long-term result of bilateralism could be a deterioration of the world trading system into competing, discriminatory regional trading blocs, resulting in added complexity that complicates the smooth flow of goods between countries. Furthermore, the reform of such issues as agricultural export subsidies cannot be dealt with effectively at the bilateral or regional level.

Despite possible tensions between the two approaches, it appears that both multilateral and bilateral/regional trade agreements will remain features of the world economy. Both the WTO and agreements such as NAFTA, however, have become controversial among groups such as antiglobalization protesters, who argue that such agreements serve the interests of multinational CORPORATIONS and not workers, even though freer trade has been a time-proven method of improving economic performance and raising overall incomes. To accommodate this opposition, there has been pressure to include labor and environmental standards in these trade agreements. Labor standards include provisions for MINIMUM WAGES and working conditions, while environmental standards would prevent trade if environmental damage was feared.

One motivation for such standards is the fear that unrestricted trade will lead to a "race to the bottom" in labor and environmental standards as multinationals search the globe for low wages and lax environmental regulations in order to cut costs. Yet there is no empirical evidence of any such race. Indeed, trade usually involves the transfer of technology to developing countries, which allows wage rates to rise, as Korea's economy—among many others—has demonstrated since the 1960s. In addition, rising incomes allow cleaner production technologies to become affordable. The replacement of pollution-belching domestically produced scooters in India with imported scooters from Japan, for example, would improve air quality in India.

LABOR UNIONS
and environmentalists in rich countries have most actively sought labor and environmental standards. The danger is that enforcing such standards may simply become an excuse for rich-country protectionism, which would harm workers in poor countries. Indeed, people in poor countries, whether capitalists or laborers, have been extremely hostile to the imposition of such standards. For example, the 1999 WTO meeting in Seattle collapsed in part because developing countries objected to the Clinton administration's attempt to include labor standards in multilateral agreements.

A safe prediction is that international trade agreements will continue to generate controversy.

About the Author

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Further Reading

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