

Why trade is good for you

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A short tour of economic theory

ECONOMISTS are usually accused of three sins: an inability to agree among themselves; stating the obvious; and giving bad advice. In the field of international trade, they would be right to plead not guilty to all three. If there is one proposition with which virtually all economists agree, it is that free trade is almost always better than protection. Yet the underlying theory is not readily understood by non-economists. And the advice that follows from it—protection does not pay—is seldom wrong.

The argument for free trade is based on the theory of comparative advantage. This is one of the oldest theories in economics, usually ascribed to David Ricardo, an Englishman who wrote in the early 19th century. To see how it works, imagine two countries, East and West, which both produce two kinds of goods, bicycles and wheat. In a year, an Eastern worker can make two bikes or grow four bushels of wheat. A Westerner, however, can manage only one bushel or one bike. Each country has 100 workers, and initially both of their workforces are split evenly between the two industries. So East produces 200 bushels of wheat and 100 bicycles, whereas West produces 50 bushels and 50 bikes (see table 3).

Since East can produce both wheat and bicycles more cheaply than West, it has an absolute advantage in both industries. Even so, Easterners will benefit from trading with Westerners. This is because East is relatively more efficient at growing wheat, where it is four times as productive as West, than it is at making bikes, where it is only twice as productive. In other words, it has a comparative advantage in wheat. At the same time, West has a comparative advantage in making bikes, even though it has no absolute advantage in anything.

According to Ricardo's theory, both countries will be better off if each specialises in the industry where it has a comparative advantage, and if the two trade with one another. Specialisation increases world output. Suppose that East specialises in wheat growing, shifting ten workers from its bicycle factories to its fields, and producing 240 bushels and 80 bikes. West moves 25 workers from wheat farming into bike making, where its comparative advantage lies, and produces 75 bikes and 25 bushels. Global production rises (see second panel).

The point of economic activity, however, is not to produce but to consume. Both countries can enjoy more bikes and more wheat if they trade on terms at which both will gain. If East is going to import bikes, it will pay no more than two bushels in return (faced with a higher price, it would be better off moving workers back to the bike factory). Similarly, West will pay no more than one bike per bushel. Suppose that the "terms of trade", as economists call the ratio of export to import prices, are set at one-and-a-half bushels per bicycle, and that 33 bushels are traded for 22 bikes. The result (third panel) is that both countries are better off.

In essence, the theory of comparative advantage says that it pays countries to trade because they are different. West's relative deficiency in bike manufacture is less than in wheat farming. It is impossible for a country to have no comparative advantage in anything. It may be the least efficient at everything, but it will still have a comparative advantage in the industry in which it is relatively least bad. And even if a country were the most efficient in every industry, giving it an absolute advantage in everything, it could not have a comparative advantage in everything. In some industries, its margin would be more impressive than in others.

Economists' next argument for free trade is that opening up markets to foreign suppliers increases competition. Without free trade, domestic companies may have enjoyed monopolies or oligopolies that enabled them to keep prices well above marginal costs. Trade liberalisation will undermine that market power. Competition should also spur domestic companies to greater efficiency because they will not be able to pass on the costs of slackness in higher prices.

Comparative arithmetic **3**

Autarky	Wheat	Bicycles
East	200	100
West	50	50
Total	250	150
Specialisation	Wheat	Bicycles
East	240	80
West	25	75
Total	265	155
Trade	Wheat	Bicycles
East	207	102
West	58	53
Total	265	155

In addition, free trade means that firms are no longer limited by the size of their home country, but can sell into bigger markets. In industries where average production costs fall as output increases, producing economies of scale, this means lower costs and prices. In such industries, trade also increases the variety of products on offer. If a car manufacturer, say, were limited to its home market, it would have a choice between producing small quantities of a number of models and large quantities of just a few, which could be produced more cheaply thanks to economies of scale. But given free trade, it would be able to produce more models because they could all be produced in large enough numbers.

All these arguments revolve around re-allocating resources to produce one-off improvements—what economists call the “static” gains from trade. But they think there are also “dynamic” gains to be had: freer trade can mean faster economic growth.

In recent years, theories of economic growth have become much more sophisticated. Although economists have long realised that productivity growth is a prime determinant of general economic growth, models of growth in the past made no attempt to explain productivity growth, but assumed that it was “exogenous” (caused by outside factors). Modern “endogenous” growth theories, however, do try to explain productivity growth.

Freer trade can play a part in this in a number of ways. For one, by making markets bigger it creates more scope for “learning by doing”—ie, for firms to become more efficient with repetition. Larger markets also offer bigger incentives for firms to invest in research and development. Moreover, trade disseminates knowledge and technology. Simply by participating in international markets, countries are exposed to other countries’ techniques, and have an incentive to copy and improve on them.

All this can make the relationship between trade, technology and growth quite complicated. For example, freer trade does not necessarily mean faster growth all the time. If a country’s comparative advantage lies in slow-growing, traditional industries, it may cut back its production in other, faster-growing industries, so its growth rate may fall. But later on it will benefit from the technical advances of countries with a comparative advantage in faster-growing industries, which will give it better computers, more advanced drugs and so forth than if every country had tried to make everything for itself. Slower growth in the short run might therefore be balanced by faster growth in the long term.

Pinning down the link between freer trade and growth is not easy. One problem is how to measure the openness of a country’s trade policy: trade barriers can take many different forms. Even so, there is good reason to believe that freer trade and faster growth generally go together.

Exceptions that prove the rule

So is free trade always the best policy? Not quite. One well-known exception is the “optimal tariff” imposed by countries that are big enough to exert an influence on the world prices of the goods they trade. By raising tariffs, they can significantly reduce world demand, cutting the world price of the good and tilting the terms of trade in their favour.

A second example, which came to prominence in the 1980s, is “strategic trade policy”. In an industry with economies of scale, the imposition of a tariff, by reserving the home market for a domestic firm, allows the firm to cut its costs and, with luck, to undercut foreign rivals in overseas markets. Economists and politicians reckon that this might work in civil aircraft, semiconductors and cars.

However, it is rare for governments to be powerful enough to set optimal tariffs—and even rarer for them to have enough information to do so with pinpoint accuracy. They would need to be able to recognise a likely business proposition, and get their maths absolutely right. Even then, rival countries could follow suit, leaving them all worse off.

Border battles

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Conventional trade barriers are coming down, but not quickly enough

THROUGHOUT eight rounds of GATT talks, tariffs were trade negotiators’ staple fare (see table 4). Only in the sixth, the Kennedy round, did the diplomats even begin to add other trade barriers to their diet. After half a century

at the table, you would think, they must have made plenty of progress. And so they have; but it is surprisingly hard to say how much, and disappointingly easy to conclude that they still have a lot on their plates.

What GATT did		
GATT rounds		
Date	Venue/name	Subject
1947	Geneva	Tariffs
1949	Annecy	Tariffs
1951	Torquay	Tariffs
1956	Geneva	Tariffs
1960-61	Geneva (Dillon round)	Tariffs
1964-67	Geneva (Kennedy round)	Tariffs and anti-dumping measures
1973-79	Geneva (Tokyo round)	Tariffs, non-tariff measures, "framework" agreements
1986-94	Geneva (Uruguay round)	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc.

Source: WTO

A commonly quoted statistic is that when the GATT was founded, developed countries' tariffs on manufactured goods averaged around 40%. According to the WTO, by 2000 that average will have tumbled to less than 4%. Most developing countries have further to go, but these figures convey the right message: trade has become freer over the past 50 years. At the same time the figures' precision is misleading.

In particular, it is hard to pin down a meaningful average tariff rate for the late 1940s. Outside the United States, tariffs at that time were not even the main barriers to international commerce. After the first GATT talks in 1947, *The Economist* sniffed that: "For many of the countries involved customs tariffs are at present without any influence on the volume of trade." Currencies were not freely convertible, and imports were subject to licences and quotas. The trouble with quotas is that, once filled, they completely insulate domestic producers against foreign competition, and bestow monopolies on the importers that hold them. One of GATT's achievements was to establish tariffs as the least bad method of protection, and to negotiate maximum tariff rates (so-called "bound" levels). By now nearly all OECD countries have bound all, or almost all, of their tariffs.

Another reason for treating historical data with caution is that in GATT's early days most tariffs were "specific", ie, based on the volume of imports rather than their value. This, according to a paper by Douglas Irwin of Dartmouth College*, explains why America's average tariff rate looked far lower in the early 1950s (12%) than in the 1930s (50%). Four-fifths of that fall was due to inflation.

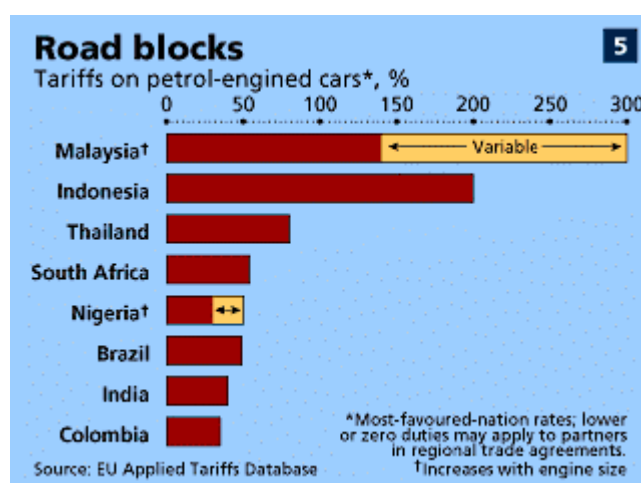
However, even today, measuring protection remains difficult. Quotas, licences and specific tariffs are still around. Although WTO members are committed to imposing tariffs on a "most-favoured-nation" (MFN) basis, which is meant to be non-discriminatory, in practice most of them do discriminate. Imports from partners in regional trade agreements are tariff-free. Developed countries levy special low tariffs on some goods from poor countries.

Even the MFN tariffs actually imposed may be far below the "bound" levels. Applied tariffs are therefore a better guide to protection than formal WTO commitments, but there is a risk that they may be increased abruptly. For example, Nigeria's bound tariff on most agricultural goods is 150%, and few industrial tariffs are bound at all; its applied tariffs now average 23%, but they have changed frequently in the past few years.

In addition, "average" tariffs can hide as much as they reveal. The measure used by the WTO is to weight tariffs by the share of goods in a country's imports. But if a tariff is pitched so high that it chokes trade altogether, its weight becomes zero, which is clearly nonsense.

The OECD's annual survey of trade barriers† uses several different weighting systems, none of them perfect. Under one, tariffs are weighted by the shares of goods in the domestic production of the importing country, but this gives too much weight to highly protected products. In another, the simple average of all tariffs is used unweighted, which means it takes no account of the relative importance of different goods. In a third, the import weights used are OECD averages rather than the country's own. Yet OECD countries often protect the same industries, depressing their weights across the board. Even among developed countries, which tend to have lower tariffs than developing ones, the use of different weights can yield markedly different results. In 1996, estimates the OECD, Canada's import-weighted average tariff was 5.7%, its simple average was 9.2% and its production-weighted average was 12.1%.

No matter which weighting system is used, averages tell you nothing about extremes. In manufacturing trade high tariff rates, or spikes, are less common than they used to be, but even in developed countries they still persist. For example, trucks attract a tariff of 25% in America and 22% in the European Union. High tariffs in the food industry often reflect heavy protection for agriculture. America's tariff on peanut butter is 132%; the EU slaps anything between 46% and 215% on fruit juices.



Developing countries can be spikier still. Malaysia's average import-weighted applied tariff fell from 15.2% in 1993 to 8.1% last year; well done. But tariffs in agricultural goods and car manufacture can go up to 145%, on top of licensing restrictions. Many developing countries make heavy use of high tariffs to protect their car makers (see chart 5).

And so to work

All of this suggests that the WTO still has plenty of tariff-cutting to do. The best place to start would be manufactured goods. In developed countries, the tariffs on some of them are so low that they are barely worth collecting. They should be scrapped. In developing countries, average levels still have a long way to go—Mercosur's common external tariffs, for example, range up to around 20%. And there are plenty of spikes that need blunting.

The WTO also has to sort out textiles and agriculture, two of the world's most protected industries. The Uruguay round brought both of these under the same trade rules as other goods. That this counts as an achievement is a measure of how bad things were, and are. Although the agreements created the basis for further negotiation, they did little to reduce protection.

Until the Uruguay round, much of the world's trade in textiles and clothing was governed by the Multifibre Arrangement (MFA), a cat's cradle of bilateral import quotas. Under the new textiles agreement, these quotas are being increased and items covered by the MFA are gradually being brought under GATT rules. "Gradually" is the operative word. At the start of 1995, WTO members shifted items accounting for 16% of their 1990 imports into the new system. Another 17% followed at the beginning of this year. A further 18% is due to move over in 2002, and the rest follows in 2005.

To slow things down further, importing countries (mostly developed ones) chose to start the transition from the MFA to the GATT with items on which quotas were not fully used. In the early years, therefore, it makes very little difference. And even when all the quotas have gone, trade will be no more liberal than at the outset, because high tariffs will remain. The United States, for instance, levies tariffs of between 14% and 32% on most synthetic, woollen and cotton clothing. A \$25 pair of leather shoes imported into Japan attracts a tariff of 160%. No wonder that developing countries, which tend to be textile exporters, feel short-changed—even though their own markets are rarely monuments to open trade.

In much the same way as the textiles agreement, the Uruguay round's agreement on agriculture brought farm trade under GATT disciplines for the first time. In a useful recent study[‡], Timothy Josling, an economist at Stanford University, lucidly explains the fiendishly complicated results. The agreement did three things. First, with a few temporary exceptions, it converted all non-tariff barriers and unbound tariffs into bound tariffs. These tariffs have to be cut by an unweighted average of 36% between 1995 and 2000. Second, it prohibited new export subsidies and cut existing ones. And third, it began to tackle the domestic subsidies which, in effect, protect farmers against foreign competition in much the same way as tariffs.

This provides the starting point for new negotiations, due to begin next year. There is plenty to talk about. Some of the tariffs that have taken over from quotas are clearly set at a level designed to stop trade altogether: 300% on butter in Canada, 550% on rice in Japan, 215% on frozen beef in the EU, 179% on sweet powdered milk in America.

Further liberalisation, argues Mr Josling, is urgently needed, not only because tariffs and subsidies remain high but because the countries trying to join the WTO include big agricultural producers with large state-owned enterprises, such as China and Russia. There are some promising signs. In its recent Farm Act, America took another step towards uncoupling support for farmers from production subsidies. American farmers, keen to export, have been lobbying for a renewal of fast-track negotiating authority. In the EU, meanwhile, the prospect of enlargement to the east is increasing the pressure for reform of the common agricultural policy.

Then again, the difficulties should not be underestimated. If farm prices were to tumble, both America and Europe might be loth to relinquish export subsidies, which in recent years have been kept down by firm markets. America's sugar, dairy and peanut farmers have so far held on tenaciously to protection, and will try to go on doing so. Europe, too, can still muster plenty of opposition to free farm trade. Agriculture nearly scuppered the Uruguay round altogether. It seems more than capable of disrupting the next one.

Alphabetti spaghetti

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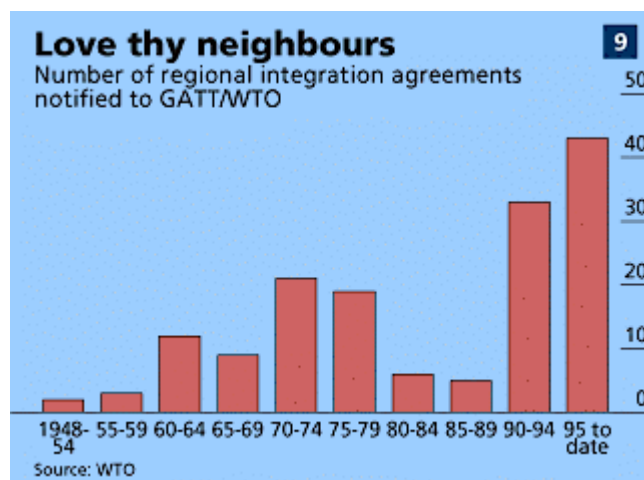
Are regional trade agreements a good idea?

DRIVING around the ever-spreading factories of Tijuana, Enrique Mier y Teran points to one foreign-owned plant after another: JVC, Sony, Messer Griesheim, all making goods for the American market. Then he stops between two factories. The one on the right, he explains, can export TVs duty-free to the United States because it uses tubes made in the one on the left. The one on the left is a product of the North American Free-Trade Agreement's "rules of origin": for a TV to enter America duty-free, some critical components—in this case, the tubes—must be made in NAFTA countries.

Mr Mier y Teran's tour neatly captures economists' ambivalence over regional trade agreements. Thanks to free trade between Mexico and the United States, Americans now import from their southern neighbours things that they used to make for themselves at greater cost. Economists call this "trade creation", and it is all to the good. Yet were it not for the rules of origin, the tube factory would have been somewhere else, probably in Asia. America imports those TVs, or at least the tubes inside them, from Mexico only because NAFTA discriminates against non-NAFTA goods. This is called "trade diversion", and it is not a good thing at all.

In the past few years, economists have had a great many regional agreements to scratch their heads over. Besides NAFTA, the Americas have seen the creation of Mercosur in the south, and one day a Free-Trade Area of the Americas may be born. The European Union, the grandmother of them all, has formed the European Economic Area with the remaining members of the European Free-Trade Association. It also has Europe Agreements with Central Europeans as well as deals with North African countries and Mercosur. In Asia there is APEC, the Asia-Pacific Economic Co-operation forum, which has a grand goal of "free trade in the Pacific by 2020" (but no formal trade

deal at present), as well as the ASEAN free-trade area and ANZCERTA, a pact between Australia and New Zealand. All told, in the past 50 years 153 regional trade agreements have been notified to the GATT or the WTO, of which most are still in force. Almost half of these—some, admittedly, revisions of previous deals—have been set up since 1990 (see chart 9).



This deluge of alphabet soup has deeply divided economists. Even language has become an issue. Jagdish Bhagwati of Columbia University, perhaps their most vocal critic, insists on calling them “preferential” rather than “regional” or (heaven forbid) “free” trade agreements, lest anyone forget their trade-diverting effects.

As international commerce has become more intricate, so have the arguments. For a start, regional deals do not take place in a vacuum; they affect the climate of global trade negotiations. But are they, in Mr Bhagwati’s phrase, “building blocks” or “stumbling blocks”? The first, says Fred Bergsten of the Institute for International Economics. In the early 1980s, he recalls, the thought that America might embrace regionalism, previously anathema in Washington, shocked the EU into GATT talks. The same thing, he believes, happened in the 1990s: the rise of APEC persuaded the EU to bring the Uruguay round to a close.

Mr Bhagwati agrees with Mr Bergsten’s reading of the 1980s, but considers his view of the 1990s “fanciful”. Politically, he thinks, NAFTA has made the liberalisation of trade between America and poorer countries more difficult. Contrast that with the Uruguay round, in which there was only mild political resistance to freeing America’s trade with much poorer India.

A second complication is that manufacturers increasingly carry out different stages of production in different countries. It is this which gives rise to rules of origin. Regional agreements need to spell out whether, for example, a TV assembled in Mexico, which might contain components from all over the world, is Mexican enough to be allowed duty-free into the United States. This is a nonsense, says Mr Bhagwati. Preferential trade agreements create a “spaghetti bowl” of overlapping rules of origin that are sure to distort some investment decisions.

Third, as Bernard Hoekman of the World Bank describes in a recent paper*, regional agreements are pushing the definition of free trade beyond the “national treatment” principle. Under national treatment, all goods and services, once inside the country, are subject to the same rules, regulations and taxes, regardless of their origin. Thus all companies are subject to the same antitrust and merger rules. Imported pharmaceuticals, food and electrical equipment, say, have to pass the same safety tests as those produced at home. Doctors and accountants must hold the country’s professional qualifications to be able to practise.

Secret weapon

However, such rules can act as barriers to trade. Sometimes they are deliberately used in that way: for example, Mexico used to insist that imported American pigs be vaccinated against hog cholera, a disease that disappeared from the United States in the 1970s. But even if national rules are applied in all innocence, they can still gum up trade. Having been tested for safety at home, goods must be tested again before being sold abroad. Professionals have to take more exams before they can practise abroad. Some countries are now trying to get round these problems by harmonisation or mutual recognition of standards.

The prime examples of such agreements are to be found within the EU. In 1979, the European Court struck down a German ban on Cassis de Dijon, a French liqueur, imposed because of its low alcohol level. This established the principle of mutual recognition: that goods sold in one member state could be sold in all. As well as mutual recognition, in some fields the EU is pursuing harmonisation. For instance, products are subject to common minimum safety standards. National competition laws are supplemented by pan-European legislation. And a dramatic act of harmonisation is due to begin next year, when 11 countries will adopt the same currency.

Within other regional trade agreements, governments have also sought mutual recognition and harmonisation agreements, if not to the same extent as within the EU. Nevertheless, Mr Hoekman points out, a trade agreement is not a prerequisite for a deal on standards. The EU and America have recently struck such a deal even though there is no prospect of a transatlantic trade agreement. In several sectors, ranging from medical and electrical equipment to pharmaceuticals, the two sides have agreed that European organisations can test goods to American standards on behalf of American testing organisations, and vice versa. This falls short of mutual recognition, but is a step in that direction.

This kind of integration is often as much about politics as about commerce. Even so, harmonisation and recognition agreements can both create and divert trade. The new agreement between America and Europe should boost transatlantic trade in electrical goods, but the deal also gives American and European products an edge in each other's markets over goods from other countries. It is worth noting, says Mr Hoekman, that the EU is loth to negotiate mutual-recognition agreements with developing countries.

The WTO does have rules on regional agreements, but they are vague and out of date. Article XXIV of the GATT says that a regional deal must cover "substantially all trade" among its members. Define that if you can. It adds that barriers to non-members must not be raised. This is a weak test of trade diversion.

In 1996 the WTO set up a committee to examine regional trade agreements. It replaced a bunch of working parties on the compatibility of individual deals with Article XXIV. They rarely reached conclusions. Whether the new committee will be more incisive remains to be seen, but it seems unlikely to offer strong criticism of any regional group—if only because of the WTO's 132 members, all but three (Japan, Hong Kong and South Korea) are members of some regional trade club.

The trouble with regional deals is that they discriminate between their members and the rest of the world. The best thing the WTO can do to minimise the damage is not to try to unpick them, but to press on with multilateral trade liberalisation. The more progress it can make on that front, the less room there will be for discrimination.

Turtle wars

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Greenery and globalisation do not mix

CESAR LUNA leafs through photographs of a "border reality trip" to Tijuana. Corroding drums of chemicals litter an industrial site open to the elements. There is nothing to keep children out, says Mr Luna, a campaigner with the Environmental Health Coalition in San Diego. Water runs down an escarpment towards people's homes below. He talks about heavy metals and acids contaminating the environment and damaging people's health: "We're not talking about skin rashes and cold sores, but serious long-term health problems."

Mr Luna explains that he is not against a "just" free-trade agreement between America and Mexico, but that in Tijuana some companies are getting away with far too much. The side accords to the North American Free-Trade Agreement, which oblige NAFTA countries to uphold their own labour and environmental laws, have no teeth.

Environmental campaigners such as Mr Luna are becoming more vocal in arguing that world trade is already too free for the planet's good. And if they are cross about NAFTA, they are hopping mad about the WTO.

They have two main complaints. First, a string of national laws aimed at protecting the environment or human health have fallen foul of the WTO's dispute-settlement panels, beginning in 1995 with the very first case to be heard by one of these tribunals. The way in which America administered its clean-petrol laws was held to discriminate against imports from Venezuela.

Since then, say the greens, things have got worse, citing two cases decided earlier this year. In the first, the WTO upheld a complaint by India, Malaysia, Pakistan and Thailand against an American law banning the sale in the

United States of shrimps caught in nets that do not allow sea turtles to escape. Shrimp nets are the biggest killers of sea turtles, says Peter Fugazzotto of Earth Island Institute, a marine-conservation group in San Francisco. It was Earth Island that prodded the American government into taking up the turtle case. The second decision was that a long-standing EU ban on beef treated with growth hormones—ie, most American meat—was incompatible with WTO rules.

The environmentalists also fret that WTO rules may undermine some international agreements to protect the global environment (known as multilateral environmental agreements, or MEAs). Of the total of around 200 such MEAs, about 20 either ban trade in certain pollutants or in goods made using them, or permit the use of trade sanctions as tools of enforcement. For example, the Montreal Protocol bans trade in chlorofluorocarbons (CFCs), which deplete the ozone layer. This trade ban, says Duncan Brack of the Royal Institute of International Affairs in London, played a big part in persuading countries to sign the protocol and end CFC production.

Luckily, so far no government has challenged the trade provisions of any MEA, but that luck may run out. For instance, a country that has not signed the Basle Convention on hazardous wastes (which bans trade in some waste chemicals and metals) might want to import blacklisted goods in order to recycle them or use them in some manufacturing process. Its goods might be barred by a signatory to the convention. The non-signatory could take the reluctant importer to the WTO, and stand a good chance of winning.

All this might worry environmentalists less if the WTO's dispute-settlement system were as limp as the old GATT's, but in fact it is remarkably effective. If one government believes that another is blocking its imports in breach of WTO rules, it can ask for talks. If these fail to resolve the dispute, the complaining government can ask for a panel of trade officials to adjudicate. If the panel finds the rules have been broken, the "guilty" party is supposed to amend its laws or practice to conform with WTO rules. Appeals are possible, but once a final decision is reached, it can be blocked only by a consensus of WTO members. This is a big change from the old GATT system, under which every member (including guilty parties) had the right of veto. So far, no one has ignored a panel decision, because no one wants to jeopardise the credibility of the system of rule-based trade. But if someone did, the offended party could eventually retaliate with trade sanctions of its own.

The WTO's rules do in fact allow countries to impose trade restrictions for environmental and health reasons. Article XX of the GATT permits trade measures "necessary to protect human, animal or plant life or health relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption."

However, some supposedly "green" rules are not necessary to protect health or the environment at all, but are protectionist in either intent or effect. America's ban on Venezuelan petrol is one example. The EU's refusal to accept beef treated with hormones is another. There is little scientific evidence to suggest that such meat is any more dangerous than hormone-free beef.

Some greens insist that the WTO has no business sitting in judgment on laws passed by sovereign governments. Yet judging the compatibility of national laws with trade accords is precisely what the WTO's dispute-settlement process—set up with the agreement of all its member states—is there for. Both the disputed cases are examples of governments doing more than they should. Americans can surely make up their own minds on which shrimp to eat, helped if necessary by clear labelling. And if Europeans are happy to eat hormone-treated beef, and science judges it safe, why shouldn't they? John Jackson of Georgetown University Law School, an authority on WTO law, says the hormone case is particularly interesting because: "It's the first to grapple heavily with the question of what scientific evidence a government has to present and the degree of risk it is obliged to negotiate." WTO rules suggest that governments can decide how much risk they will accept in imported food. In effect, says Mr Jackson, the EU decided to run no risk at all. But if governments have so much leeway, they could get away with any import ban, however flimsy its scientific foundations.

A shrimp's a shrimp for a' that

A more important reason why the WTO and the greens are at loggerheads is another GATT rule requiring "like products" to be treated identically. This means that with very few exceptions—eg, goods made by prisoners—countries cannot ban imports because they do not like the way they have been produced: if they could, it would give rise to all sorts of protectionist jiggery-pokery. So WTO panels, like GATT panels before them, have regarded production methods as irrelevant: a shrimp is a shrimp, whether or not the net in which it was caught has a turtle-excluder.

Many environmentalists object. If the WTO rules out all trade sanctions that discriminate between more and less conservationist methods of production, then what chance is there of cleaning up? There should be exceptions to allow countries to favour goods made in less polluting ways.

According to Mr Brack, in some circumstances they may be right. Where pollution spans or crosses borders, the threat of trade sanctions can be an efficient way of achieving an environmental goal. The Montreal Protocol is a case in point. Other MEAS might be more effective if their trade clauses were immune from challenge by non-signatories at the WTO.

But this is far from straightforward. Suppose that the signatories to an MEA—to reduce emissions of certain gases, say—were mainly rich countries and the non-signatories were mainly developing ones. The developing countries might be less concerned about reducing pollution, or they might think they were being asked to bear too much of the burden. Would the rich be justified in banning imports from the poor? Clearly any exceptions to Article XX for MEAS would have to be chosen with care.

In any event, where pollution is confined to a single country, the argument for using trade sanctions against it is hard to stand up. Different parts of the world, Mr Brack points out, can tolerate different levels of pollution, depending on climate, the preferences of local people and governments, and existing pollution levels. Imposing the same environmental rules on every country, backed by trade sanctions, would destroy the comparative advantage of many countries, especially developing ones. It would be easy for protectionists to use greenery as an excuse for import restrictions.

Coming out of the shell

The WTO is looking around for ways of accommodating the greens' complaints. For example, it plans to open up its procedures by allowing non-governmental organisations to provide briefs to dispute-settlement panels and to attend hearings. It is already taking more advice from experts: in the shrimp-turtle case, for example, it assembled a clutch of marine biologists. That should help to deflect the environmentalists' charge that the WTO is secretive and lacks know-how.

Changing the WTO's rules, however, is a taller order. In theory, says Mr Jackson, it would be easy to add a paragraph to Article XX to the effect that nothing in the WTO's rules prevents the application of certain MEAS. But he adds: "Politically, I can't see it going through." Such an amendment would have to be approved by three-quarters of all WTO members, and opposition from non-signatories to those MEAS would be robust.

But there are things governments can do that would make trade freer and the planet cleaner at the same time. According to a recent OECD study*, governments continue to support agriculture, energy and transport in ways that damage the environment (see chart 10). Minimum farm prices, for example, encourage farmers to produce too much, using more energy and more chemicals than they should. Coal subsidies encourage power companies to use dirty methods of electricity generation. Such subsidies are already in decline. Speeding their demise would please both free-traders and environmentalists.

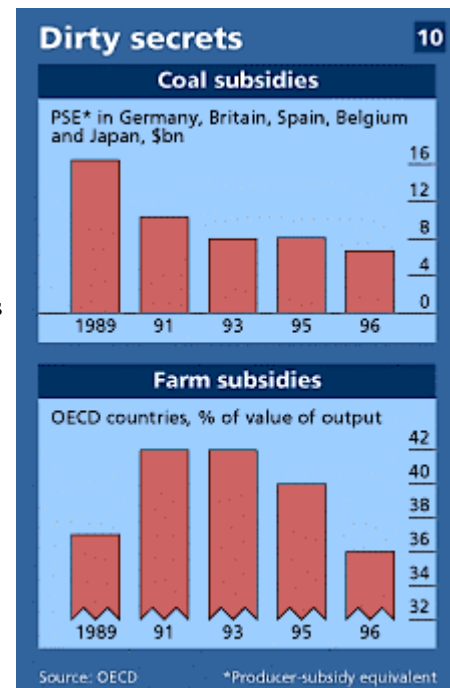
* "Improving the Environment through Reducing Subsidies". 1998

Brothers up in arms

Oct 1st 1998 From The Economist print edition

How not to enforce labour standards

A FORMER World Bank economist recounts a field trip to Morocco. Her guide led her through the medina to watch people working in miserable conditions, buffing up pots for the tourist trade. Next, they ducked into a workshop lit by a single weak lamp where two men were making moulds from dirt. They went on, and down, into more heat and



darkness, until they came to the last circle of this little hell: in a near-lightless room, a dull-eyed boy was shovelling coal into a kiln.

‘How long do you work?’ asked the economist.

‘Ten hours a day, six days a week,’ he replied.

‘How old are you?’

‘Sixteen.’

‘And how long have you been working here?’

‘Nine years.’

The boy was uneducated. His family, back in his home village, needed money. Sadly, his plight is far from the worst in the developing world, and it is anything but new. Indeed, a century or so ago, that economist’s European forebears may well have faced the same choice: work or starve.

Trade unions, backed by some politicians, think they can use international trade as a lever to make things better. Use trade sanctions as a punishment for countries that ignore minimum standards of decency, the argument goes, and they will come to their senses. But the WTO disagrees: its rules do not ban imports made by either slave labour or child labour—only those produced by prison labour.

Some WTO members, notably America, have long wanted to link trade liberalisation and labour standards. Others, especially developing countries, smell protection, and not without reason. American unions have long argued that low wages and labour standards in the third world create “unfair” competition for American workers (see [article](#)). But the WTO points out that labour standards are the domain of the International Labour Office (ILO), another organisation based in Geneva.

The ILO, a tripartite body made up of governments, trade unionists and employers from 173 countries, has been going since 1919. It is quite happy to look after its own patch without help from the WTO. In June it produced a Declaration on Fundamental Principles and Rights at Work which obliges its members “to respect, to promote and to realise” the principles of seven ILO conventions defining core labour standards, even if they have not ratified them (see table 11).

Labouring			
ILO conventions on “core” labour standards			
No.	Date	Subject	No. of signatories
29	1930	Forced labour	149
105	1957	Forced labour	132
87	1948	Freedom of association	122
98	1948	Right to organise and collective bargaining	138
100	1951	Equal remuneration	137
111	1958	Discrimination	128
138	1973	Minimum working age	61
Number that have ratified all seven			35

Source: ILO

The ILO makes no link between labour standards and trade; indeed its declaration stresses that labour standards should not be used for protectionist purposes. So how will they be enforced? Through shame, hopes the ILO. “In the future,” says Michel Hansenne, its director-general, “public opinion will be more important for pushing governments to comply with their commitments.” Not good enough, say trade unionists. “The ILO declaration is a great step forward,” acknowledges Thea Lee of the American Federation of Labour and Congress of Industrial

Organisations (AFL-CIO). “But we’ll never see that as a substitute for action in the trade arena. We’re not going to give up at the WTO.”

The WTO’s rules and its dispute-settlement system, trade unionists say, have the bite they are looking for. Bill Jordan, general secretary of the International Confederation of Free Trade Unions (ICFTU), a Brussels-based club of 206 union federations from 141 countries, puts it this way: “We aim to get the world committed to core standards. But we know there’s no world government, so we’re at a disadvantage. The WTO is the nearest thing we have.” The ICFTU wants to see WTO membership made conditional on the observance of core labour standards, certified by the ILO: “If you want to belong to this club,” says Mr Jordan, “you have to believe in these standards.”

Teeth or gums?

What little information is available suggests that there is no strong link between observance of core labour standards and trade flows, so exporters in developing countries would not suffer much if they adopted the ILO’s conventions. By the same token, it seems that workers in rich countries have little to fear from competition with the downtrodden of the developing world.

That is reassuring, but it does not mean that the use of trade measures to enforce core labour standards is a good idea. There is nothing wrong with the intentions behind the standards: civilised people would agree that bonded labour or imprisonment of trade unionists is wicked. But enforcing the standards may not always have the desired effect. If trade unions are recognised, wages in unionised sectors might rise but employment might fall. Displaced workers might be pushed into worse-paid jobs than they had before.

In a paper published last year*, Keith Maskus, an economist at the University of Colorado at Boulder, explains why using trade sanctions to try to improve people’s lives may not work. Suppose, he says, that a developing country exports goods made with adult labour, but relies on an input made in an unregulated industry using child workers. Other countries, wishing to discourage the use of child labour, put a tariff on the developing country’s goods. Demand for those exports will fall, reducing demand for the adult workers in the industry and cutting their wages. There is also a knock-on decline in demand for its inputs, and therefore the labour of the children making them. So fewer of them work, and their wages fall. Both adult and child employees are worse off.

This could be offset, says Mr Maskus, if the rest of the world recycled its tariff revenue to the target country (or made a contribution from other taxes) in return for a higher minimum working age. The best solution, though, would be not to use trade restrictions at all, but to find other policies that avoid their adverse effects. For instance, children are often put to work because their parents’ incomes are too low to make ends meet. So it would help to create more and better-paid jobs for adults—which sounds like a case for freer trade, not more restrictions. Equally, children would be less likely to work if education were more affordable. Subsidising education in developing countries would not only stop some children working; in the long run a more educated workforce would also boost the country’s productive potential.

Aware of these pitfalls, some advocates of linking trade and labour are shy of calling for tariffs and import bans. “We don’t want to go down the sanctions route,” says Stephen Pursey, the ICFTU’s chief economist. His tentative suggestion for making the link is that if a country persistently failed to meet the ILO’s standards, it could be denied the right to bring cases to the WTO’s dispute-settlement system. But without the risk of a dispute-settlement case, other countries would feel free to maintain whatever trade barriers they liked against imports from the recalcitrant country, or even to put up some new ones.

The losers would be exporters from the punished country, be they good or bad employers, along with their workers. Better by far to stick with the ILO. If trade unions and their allies in government try to borrow the WTO’s teeth, they may find that they bite in the wrong place—if at all.

* “Should Core Labour Standards be Imposed Through International Trade Policy?” World Bank Development Research Group, Policy Research Working Paper 1817, August 1997

The wages of fear

Oct 1st 1998 From The Economist print edition

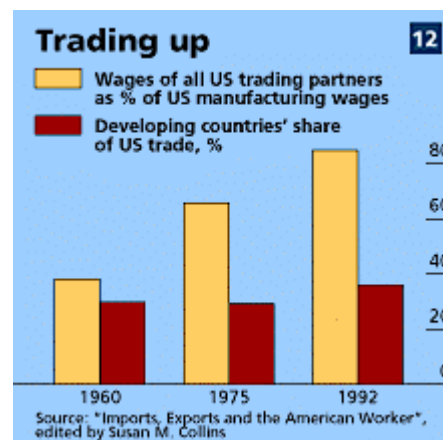
Are poor countries pinching the rich ones' jobs?

UNTIL the recent jitters, the 1990s seemed to be a golden age for America's economy. Growth was high, inflation and unemployment low. All the same, though, plenty of Americans were wondering why the economy's health was not reflected in their pay packets. Indeed, many Americans have seen little improvement in their living standards in the past quarter-century. After allowing for inflation, average hourly earnings are now lower than they were in 1973—although thanks to increased fringe benefits, average annual earnings have actually risen, according to Susan Collins, an economist at Georgetown University*. At the same time, earnings inequality has increased strikingly. Between 1973 and 1993, the real pay of men 10% of the way up the earnings distribution fell by 21%; for men 10% from the top, it rose by 8%. Women did a little better at the bottom, where earnings went up by 3%, but much better at the top, where they rose by 29%.

In European countries, too, poorer workers are feeling the pinch. Like America, Britain has seen an increase in earnings inequality. In continental Europe, where wages are less flexible, pay differentials have not widened, but unemployment has risen steeply. Some politicians and union leaders, and a few economists, argue that freer trade with developing countries is to blame. This is being said on both sides of the Atlantic, but more loudly in America, especially since the passage of NAFTA. In 1973, only about one-sixth of America's manufacturing imports came from developing countries; now the proportion is one-third. To many people, it seems that American workers' pay is being cut by competition with cheap foreign labour.

But it is not as simple as that. Wages reflect productivity, which implies two things. First, Americans' wage growth has slowed down since 1973 because productivity growth has been lower. Second, the gap between wages in America and wages in developing countries, on average, reflects Americans' higher productivity. So although Americans generally have much fatter pay packets than workers in developing countries, they cost no more to employ per unit of output, and often less. Moreover, says Ms Collins, although America now buys a slightly larger share of its imports from developing countries than it did 25 years ago, average wages in its supplier countries have gone up relative to wages in America, because wages in developing countries have risen much faster than those in rich countries (see chart 12).

Those same trade unionists and politicians argue that, if some Americans are losing out from freer trade, America should put up barriers against imports from poorer countries. Trade with Mexico and China is a favourite target. Yet import barriers would make Americans as a whole worse off: American companies would be under less pressure to make goods as cheaply as they can, and resources would be wasted on making things that could be bought more cheaply from abroad. Everything would get more expensive—and poor Americans as well as rich ones would have to stump up.



A price to pay

Nevertheless, there are good reasons why freer trade might hurt some of America's poorer workers. The whole point of free trade is that it makes countries specialise in industries where they have a comparative advantage; so when trade barriers are removed, resources are shifted into those industries, and away from less productive uses. In America, although this change undoubtedly benefits the economy as a whole, it may work to the disadvantage of unskilled, and therefore low-paid, workers.

As any economist will tell you, this phenomenon can be explained by the Stolper-Samuelson theorem, which says that a fall in the price of a good—say, as a result of a tariff cut—reduces the pay of the type of labour most heavily used in making it. So a fall in American tariffs on imports from Mexico of goods that use low-skilled labour relatively intensively will cut the wages of low-skilled Americans.

Do the facts fit the theory? Economists have concentrated on explaining the increase in the “skill premium”, measured in most studies by the ratio of the pay of workers with college degrees to that of high-school graduates. In the 1970s this was around 1.3-1.4, but since 1980 it has risen fairly steadily, to about 1.7 now. Some studies have concluded that trade explains a lot of the skill premium, but most find the effect of trade is rather modest, accounting for perhaps one-fifth of the rise in the premium. This is partly because the evidence on prices does not quite fit the story: the relative prices of goods in low-skill industries did not fall in the 1980s, when the skill premium rose sharply, but they probably did in the 1970s, when it was constant.

Other factors seem to have been more important. Richard Freeman, of Harvard University, reckons that immigration has probably had a far bigger effect on the market for low-skilled labour than trade. Workers in many service industries, from barbers to taxi drivers, are fairly well insulated from international trade, but will meet hot competition from immigrants.

Most important of all seem to have been advances in technology, which have favoured the better-educated at the expense of the rest. Why only “seem”? Because the effects of technical change are hard to measure directly. Most models explain as much as they can of the change in the skill premium in terms of price changes, trade flows, immigration and whatnot, leaving a large chunk unexplained. That residual is then attributed mainly to changes in technology.

The effects of changes in technology and changes in trade are hard to unravel. Suppose that a foreign company discovers some new cost-cutting technique for making widgets, which brings down the price of widget imports into America. If the wages paid by its American competitors fall as a result, are the workers victims of trade or technology?

If trade has a smallish effect on the skill premium, it has an even smaller effect on wage inequality as a whole, says Ms Collins. Only about one-third of the increase in inequality can be put down to differences between workers—whether in education, race or sex. So at most only 7% of the increase in wage inequality can be blamed on trade.

Never mind the economics, count the votes

None of this, however, has stopped freer trade from becoming a political problem. Is it always possible to find anecdotes about jobs lost to foreign competition, or of workers swallowing pay cuts to stop their bosses from moving their factory to Mexico. Moreover, the benefits of trade tend to be more spread out than the losses. The local effects of a factory closure are only too obvious; the across-the-board effects of greater consumer spending power generated by cheaper imports, or of higher productivity brought about by increased competition, are far less evident.

One way of getting round these political problems is to compensate the losers from freer trade. In practice, that means those whose jobs disappear rather than those who merely suffer pay cuts. Since freer trade should benefit the economy as a whole, some of that benefit could be channelled to the losers through the tax and welfare systems.

This idea has, in fact, been put into practice in America since the Trade Expansion Act of 1962. Workers displaced by foreign trade can apply for Trade Adjustment Assistance (TAA). This extends unemployment insurance payments for up to a year beyond the usual six-month period, provided that claimants take part in a training programme. Since 1974, about 2m workers have been certified as eligible for TAA. The number taking it up has been much lower, because many of the workers have found other jobs.

In a recent book, “Globaphobia”†, four American economists—Gary Burtless, Robert Lawrence, Robert Litan and Robert Shapiro—say that TAA should be reformed. The payments go on for too long, removing the incentive to get a job quickly. Workers who find a new job at lower pay should also be compensated, to give them an incentive to work for less. And the training does little to fit workers for new jobs, so it should be scrapped.

All this would be an improvement on the current system, but two problems remain. First, how can the losers from trade be identified? Just think of the difficulties of unravelling the effects of technology and tariff cuts; then remember that trade is about a lot more than border measures. What about deregulation to allow foreign ownership of American airlines, shipping or television stations; or recognition of European drug-testing regimes, or of foreign medical qualifications?

Second, what is so special about trade? It is just one of many forces that send resources whizzing around the economy. It seems odd to pay a worker compensation because his firm has succumbed to competition from imports, but give him nothing if it has been put out of business by a company up the road, or failed to adapt to changes in

technology or in customers' tastes. Paying out in this way seems to support protectionists' contention that trade is a blight on employment like no other.

The four authors are aware of both these drawbacks. They suggest getting round the first problem by limiting compensation to victims of specific trade agreements, and by allowing Congress to specify the industries in which compensation will be paid. Yet as they note, the extremely complex Uruguay round triggered no special adjustment measures, even though it will have a far greater effect on the American economy than NAFTA, which did prompt such measures. The second point—that trade is just one of many economic forces, and should not be singled out—is unanswerable.

But perhaps such carping misses the point. Adjustment programmes are political devices, not economic ones. And for free-traders, the most bewildering fact about the American economy is that, despite all the stability and success in recent years, Americans have remained nervous about freer trade. So have plenty of their elected representatives. Why?

* This article draws on a book edited by Susan M. Collins, "Imports, Exports and the American Worker". The Brookings Institution Press, Washington, DC, 1998

† Published by the Brookings Institution Press, the Progressive Policy Institute and the Twentieth Century Fund