Chapter 1

Introduction and Overview

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I. Introduction

This book brings together a collection of papers that Robert M. Stern and his coauthors have written and that have been published over the years in academic journals, books, and reports. The collection addresses a variety of issues pertinent to the global trading system. One group of papers deals with globalization in terms of what the public needs to know about this phenomenon and the role of the World Trade Organization (WTO), whether some countries may be hurt by globalization, how global market integration relates to national sovereignty, and how and whether considerations of fairness are and should be dealt with in the global trading system and WTO negotiations. A second group of papers consists of analytical and computational modeling studies of multilateral, regional, and bilateral trading arrangements and negotiations from a global and national perspective for the United States and other major trading countries. The remaining papers include an empirical analysis of barriers to international services trade and the consequences of liberalization, and issues of international trade and labor standards.

The book can serve the interests of upper-level undergraduates, postgraduates, academics, researchers, and policy-makers in international trade and trade policy. Each paper in the chapters that follow has been edited to some extent but still contains all of the essential details as originally published. At the end of each chapter, there is a series of study questions that may be used for teaching purposes by faculty members and students.

Brief summaries of the chapters that comprise the volume are provided below. Given the length and complexities of the chapters, these summaries should be helpful in guiding the reader in focusing attention on the particular topics and issues that are of greatest interest and concern. Also, at the end of each chapter, there are suggested further readings listed that provide up-to-date treatment of the relevant subject matter in the chapter that the reader will find helpful.

II. Overview

Part I. *Globalization*

Chapter 2 — "What the Public Should Know about Globalization and the World Trade Organization," with Alan V. Deardorff, *Review of International Economics*, 2002.

This chapter reviews the essentials of economic globalization, as well as the major institution that has recently gotten much of the credit and blame for it, the World Trade Organization (WTO). It first defines globalization, which is just the increasing economic integration of the world economy. It then asks who gains and loses from globalization, drawing primarily upon economic theory to identify its benefits and costs, and who within and among the world's economies get them. The discussion concludes by asking briefly what can and should be done about globalization.

The second half of the chapter turns to the WTO, which was the focus of so much negative attention at its Seattle meeting in December 1999. For it too, it is first asked what the WTO is, trying to clarify several misperceptions about what it does and why. It is then asked what groups gain and lose from the WTO, some simply as a byproduct of its role in facilitating globalization, but others from particular WTO rules and procedures. This leads to the controversies that raged in Seattle in November 1999. The Seattle events are described as they have been described to us by those who were there at the time. The chapter concludes with what might be done to change both the WTO itself and the public's perceptions of it.

Chapter 3 — "Globalization's Bystanders: Does Trade Liberalization Hurt Countries That Do Not Participate?" with Alan V. Deardorff, *World Development*, August 2006, 34(8).

This chapter uses trade theory to examine the effects of trade liberalization on countries that do not participate in it. These include both countries that fail to participate in multilateral trade negotiations, and also countries that lie outside of preferential trading arrangements such as free trade areas. The analysis suggests that, while it is theoretically possible for excluded countries to gain, through improved terms of trade, from trade liberalization, several reasons suggest that they are more likely to lose.

Chapter 4 — "Global Market Integration and National Sovereignty," with Andrew G. Brown, *The World Economy*, March 2006, 29(3).

This chapter first traces the evolution of the global trading system from the 19th century to the present-day GATT/WTO arrangements, calling attention to the key roles of reciprocity and non-discrimination. It is noted how the system is now challenged by the new paradigm of global market integration. Then considered is the recent plethora of free trade agreements (FTAs), including those between industrial and developing countries, and their uneasy relationship with a multilateral system based on non-discrimination. Thereafter, the boundaries of the WTO are defined, and there is an examination of how the potential expansion of these boundaries may result in the over-extension and weakening of the effectiveness and influence of the WTO.

Chapter 5 — "Concepts of Fairness in the Global Trading System," with Andrew G. Brown, *Pacific Economic Review*, August 2007, 12(3).

This chapter first establishes why some conception of fairness is inherent in a system of trade rules and procedures that is voluntary. The different criteria implicitly used in assessments of fairness are then explored. First considered is the operational idea of reciprocal gains in market access — long embodied in GATT/WTO negotiations. It is observed that reciprocity is less important in the actual outcomes than in the rhetoric of bargaining. Considered next are the economists' criteria of efficiency as defined in welfare terms or in terms of productivity growth, and note their limited bearing on the idea of fairness. Focusing first on relations among the developed economies, the broader idea of fairness as equality of opportunity is addressed. This idea embraces not only reciprocity in market access but also equality in the supporting rules affecting market access. Disparate national conceptions of fairness can be bridged only when differences in national forms of business organization or in preferences for public goods do not intervene. The question of fairness in relations among countries at very different levels of development is next addressed. The meaning of distributive justice in trade relations is first explored, and then how far it is realized in present arrangements for market access. Thereafter considered is the question of fairness for developing countries in the rules affecting market access. The analysis of criteria is completed with some comments on procedural justice affecting both developed and developing countries in such matters as dispute settlement and trade defense measures. The findings are summarized in a final section together with suggested implications pertinent to the Doha Development Round negotiations.

Part II. *Analysis of Multilateral, Regional, and Bilateral Trading Arrangements*

Chapter 6 — "Multilateral Trade Negotiations and Preferential Trading Arrangements," with Alan V. Deardorff, in Alan V. Deardorff and Robert M. Stern (eds.), *Analytical and Negotiating Issues in the Global Trading System*, University of Michigan Press, 1994.

This chapter begins with a discussion of the principles of the General Agreement on Tariffs and Trade (GATT), followed by a brief history of the main characteristics of the GATT negotiating rounds and an assessment of their accomplishments. The chapter then addresses how preferential trading arrangements are accommodated within Article XXIV of the GATT Articles of Agreement and proceeds to a discussion of the characteristics and consequences of existing preferential arrangements and a comparison of the advantages and limitations of multilateralism and preferential arrangements. Thereafter, a comparative advantage framework is introduced for the purpose of undertaking a theoretical analysis of the welfare effects of the expansion of preferential trading blocs. Finally, there is a discussion of some implications for the design of trading blocs with the objective of enhancing world economic welfare.

Chapter 7 — "An Overview of the Modeling of the Choices and Consequences of U.S. Trade Policies," with Alan V. Deardorff, in Alan V. Deardorff and Robert M. Stern (eds.), *Constituent Interests and U.S. Trade Policies*, University of Michigan Press, 1998.

This chapter provides the context for the theme of a conference, "The Representation of Constituent Interests in the Design and Implementation of U.S. Trade Policies," which was held at the University of Michigan in 1996. It first reviews the normative and political economy approaches to the modeling of trade policies. The normative approach is the basis for the traditional analysis of the welfare effects of trade and the choice of policies designed to correct distortions in the economy and to achieve first-best optima. The political economy approach provides an analytical framework for understanding of the choices made by policy-makers in a political setting in response to the lobbying and related activities of producing interests. The major limitations of these approaches are identified and then discussed in what Dixit (1996) has referred to as the "transaction-cost approach," which may provide a middle-ground between the other approaches and permit the analysis of some hitherto imperfectly understood issues of trade policy. There is also a brief discussion of the empirical literature pertinent to the normative and political economy approaches.

Thereafter, a sketch of the main features of the U.S. trade-policy process is provided, focusing in particular on the roles played by the agencies of government together with the important constituent interest groups in the U.S. economy. Each of the modeling approaches are then considered and how they can be interpreted in the representation of the behavior and interactions of the different constituencies. Setting the modeling issues aside, it is also asked what can be learned from the past half-century of U.S. trade policy experiences. It is observed that there has been a distinctive movement towards more liberal and open trade in the United States and elsewhere in the period being considered. There is a final discussion of the implications of the interplay of the different modeling approaches for research and policy in light of the observations about the ways in which trade liberalization and increased openness have evolved.

Chapter 8 — "Issues of Manufactures Liberalization and Administered Protection in the Doha Round," with Alan V. Deardorff, *Global Economy Journal*, December 2005, 5(4).

This chapter focuses especially on the positions that the developing countries should take in their own interests on the issues of manufactures liberalization and administered protection in the Doha Development Agenda negotiations. A series of recommendations are set forth with supporting arguments:

- For market access, both developed and developing countries should commit to reducing their most restrictive trade barriers, using a formula approach with limited exceptions.
- Negotiated tariff reductions should be phased in over a period of ten years in equal incremental installments.

- Adjustment assistance should be provided by a system of wage insurance and subsidized by transfers from developed countries.
- The rules for safeguards, countervailing duties, and anti-dumping should be redrafted to focus their use on cases of legitimate economic justification and to discourage their use as protectionist devices.
- The U.S. and EU should devise and implement a program of comprehensive but declining import restrictions on imports from China consistent with China's terms of WTO accession and eliminated by 2008.
- WTO rules governing Preferential Trading Arrangements should be revised to ensure that they contribute to the liberalization and simplification of the multilateral trading system.
- Preference-granting countries should provide assistance to countries experiencing the erosion of preferences due to multilateral liberalization.
- The WTO system of dispute resolution should remain in place.
- Special and differential assistance, if granted, should not exempt countries from the provisions for their own market liberalization.

Developing countries should participate actively and constructively in the negotiations to further their own interests. Developing countries may be at a disadvantage in the negotiating process, due to their resource limitations and inexperience in negotiations. Offsetting such disadvantages, however, are their large numbers and the compelling case for meeting their needs. What is needed is leadership and cooperation as, for example, with the Group of 20 and other coalitions, together with willingness to listen and be flexible on the part of their developed country counterparts.

Chapter 9 — "An Assessment of the Economic Effects of the Menu of U.S. Trade Policies," with Kozo Kiyota, *Global Economy Journal*, December 2005, 5(4).

In this chapter, the Michigan Model of World Production and Trade is used to calculate the aggregate welfare and sectoral employment effects of the menu of U.S. trade policies. The menu of policies encompasses the various preferential U.S. bilateral and regional FTAs negotiated and in process, unilateral removal of existing trade barriers by the United States, its FTA partner countries, and global (multilateral) free trade. The welfare impacts of the FTAs on the United States are shown to be rather small in absolute and relative terms. The sectoral employment effects are also generally small, but vary across the individual sectors depending on the patterns of bilateral liberalization.

The welfare effects on the FTA partner countries are shown to be mostly positive though generally small, but there are some indications of potentially disruptive employment shifts in some partner countries. The results further suggest that there would be trade diversion and detrimental welfare effects in some non-member countries/regions. It also appears that, while FTA partners may gain from the bilateral FTAs, they may be adversely affected because of overlapping "hub-and-spoke" arrangements due to other discriminatory FTAs that have been negotiated.

The welfare gains from both unilateral trade liberalization by the United States and from global (multilateral) trade liberalization are shown to be rather substantial and more uniformly positive for all countries/regions in the global trading system as compared to the welfare gains from the bilateral FTAs analyzed.

The issue then is whether the WTO member countries will be able to overcome their divisiveness and indecisions and bring the Doha Round multilateral negotiations to a successful conclusion. The computational results suggest that the menu choice appears to be clear.

Chapter 10 — "Trade Diversion under NAFTA," with Kyoji Fukao and Toshihiro Okubo, in Robert M. Stern (ed.), *Japan's Economic Recovery: Commercial Policy, Monetary Policy, and Corporate Governance*, Edward Elgar Publishing, 2003.

In this chapter, a theoretical framework is developed for analyzing how tariff preferences in the NAFTA may affect U.S. imports from Canada and Mexico. Using trade and tariff information at the 2-digit and 4-digit levels of the Harmonized System, our econometric analysis has suggested that there may be trade diversion especially in U.S. imports of textiles and apparel products from Mexico. Evidence based on other studies suggests that these imports have come at the expense especially of Asian suppliers.

The research and some of the other studies noted demonstrate the importance of commodity disaggregation in analyzing the effects of preferential trading arrangements. There is also a strong case to be made for analyzing how foreign direct investment and outsourcing interact with tariff preferences in influencing patterns of trade and specialization in member and non-member countries in preferential trading arrangements.

Chapter 11 — "Some Economic Effects of the Free Trade Agreement between Tunisia and the European Union," with Drusilla K. Brown and Alan V. Deardorff, in Ahmed Galal and Bernard Hoekman (eds.), *Regional Partners in Global Markets: Limits and Possibilities of the Euro-Med Agreements*, London and Cairo: Centre for Economic Policy Research and Egyptian Center for Economic Studies, 1997.

This chapter uses a specially constructed version of the Michigan Brown–Deardorff–Stern Computational General Equilibrium (CGE) Model of World Production and Trade to estimate the potential economic effects on the Tunisian economy that may result from the free trade agreement (FTA) between Tunisia and the European Union (EU) that was concluded in July 1995. The static welfare benefits for Tunisia of the FTA are found to range from slightly negative to somewhat positive, depending on what is assumed about inter-sectoral capital mobility in Tunisia. Further, depending on the length of time allowed for the phasing in of the FTA, Tunisia could experience significant adjustment problems in connection with the inter-sectoral movements of labor and capital that the FTA would induce. Finally, while the computational scenarios are subject to the difficulties of integrating foreign direct investment (FDI) into a CGE trade modeling framework, it is concluded that the FDI inflows into Tunisia that might result from the

FTA would not materially increase Tunisian economic welfare. These results suggest therefore that Tunisia may not have much to gain economically from the FTA. Reducing its trade barriers multilaterally and reinforcing these actions with further liberalization of its foreign investment policies and maintenance of macroeconomic and political stability might in the end be the best path for Tunisia to follow.

Chapter 12 — "A North American Free Trade Agreement: Analytical Issues and a Computational Assessment," with Drusilla K. Brown and Alan V. Deardorff, *The World Economy*, January 1992.

This chapter seeks to identify some important issues arising in the analysis of a NAFTA and to provide a computational assessment of some of the economic effects involved. While the various experiments conducted are not exhaustive of all the possible changes that might be negotiated in connection with a NAFTA, they are nonetheless indicative of the order of magnitude on trade, output, number of firms, factor returns, and employment that could result from trilateral trade liberalization and increased investment.

Overall, the computational results suggest that the formation of a NAFTA will have positive benefits for all countries involved on several accounts, as follows:

- The participating countries all enjoy an increase in aggregate welfare.
- Although the inclusion of Mexico erodes some of Canada's benefits under the US-Canada FTA, the effect is minuscule.
- The wage gap between the United States and Mexico will narrow, thereby reducing the incentive for illegal immigration. However, the real wage in the United States still rises as a result of trade liberalization.
- A NAFTA will have beneficial scale effects in all three countries.
- A reduction in barriers against foreign direct investment in Mexico will stimulate new capital formation, which has the beneficial effects of alleviating poverty in Mexico by raising the

marginal product of labor and raising the average product of both capital and labor by increasing the scale of production in Mexico.

- The inflow of capital into Mexico may come primarily from outside the NAFTA, not from the United States, suggesting the fear that US firms will relocate production in Mexico may be largely unfounded.
- There appears to be relatively little inter-sectoral factor reallocation in the United States especially, so that the associated relocation costs are likely to be small.
- While there are negative effects on the rest of the world, they appear to be relatively small.

Chapter 13 — "Computable General Equilibrium Estimates of the Gains from U.S.–Canadian Trade Liberalization," with Drusilla K. Brown, in David Greenaway, Thomas Hyclak, and Robert J. Thornton (eds.), *Economic Aspects of Regional Trading Arrangements*, London: Harvester Wheatsheaf, 1989.

This chapter provides some estimates of the economic effects of the U.S.-Canada Free Trade Agreement that was negotiated in 1986–87 and implemented beginning in 1989. The focus is primarily on bilateral tariff elimination, although some attention is given to the removal of non-tariff barriers. The many qualitative aspects of the FTA are not included in the computational analysis. The computational model used has a variety of features of imperfect competition that distinguish it from the more commonly used model that assumes perfect competition, constant returns to scale, and national product differentiation.

The computational results suggest that the FTA will be beneficial to both Canada and the United States. National income may be increased in Canada by 1%–2% and by less than 1% for the United States. The far-reaching changes in the rules and procedures governing bilateral trade and investment relations would be likely to reduce the uncertainty of policies and lower costs of transactions. The rest of the world is also likely to benefit from the FTA.

Chapter 14 — "The Effects of the Tokyo Round on the Structure of Protection," with Alan V. Deardorff, in Robert E. Baldwin and Anne O. Krueger (eds.), *The Structure and Evolution of Recent U.S. Trade Policy*, Chicago: University of Chicago Press for the National Bureau of Economic Research, 1984.

This chapter presents a computational analysis of the protective effects of the changes in tariffs and NTBs that were negotiated in the Tokyo Round of multilateral trade negotiations that were completed in 1979–1980. The analysis is based on the Michigan Model of World Production and Trade. The focus is on the changes in value added by sector for the major industrialized and developing countries that participated in the Tokyo Round negotiations. The chief findings were as follows:

- The change in per unit value added (CPVA) as calculated by the model provided substantially different information about the structure of protection as compared to using nominal tariffs or effective rates of protection. The CPVA calculation was more closely related to the flows of changes in protection than the other measures.
- The Tokyo Round reduced protection most in those sectors that were previously most protected, although the pattern of protection remained substantially unaltered from what it was previously.
- The greatest benefits of the Tokyo Round would be felt in the sectors with the greatest export interests, reflecting the fact that the pattern of tariff reductions was quite similar across countries.
- There was no evidence that levels of protection were more uniform as a result of the Tokyo Round, protection was not becoming any more or less cascaded against imports of final goods, or that the Tokyo Round was biased against the interests of the major developing countries.

Part III. ***Services Trade***

Chapter 15 — "Empirical Analysis of Barriers to International Services Transactions and the Consequences of Liberalization," with Alan V. Deardorff, in Aaditya Mattoo, Robert M. Stern, and Gianni Zanini (eds.), *Handbook of International Trade in Services*, New York and Oxford: Oxford University Press and the World Bank, 2008.

This chapter begins with a conceptual framework for understanding international services transactions and the barriers that may affect them. There follows a discussion of the characteristics of services barriers, and we provide some examples of barriers for the banking sector and for foreign direct investment in services sectors. Next, there is a discussion of methods of measurement of services barriers, including frequency measures and indexes of restrictiveness, price-effect and quantity-effect measurements, gravity-model estimates, and financial-based measurements. In each case, information and examples are provided of how the measurements are constructed and an evaluation of their merits and limitations. The appendix contains brief summaries of studies that have used these methods. Thereafter, there is a discussion of how the various measurements can be used in assessing the economic consequences of the liberalization of services barriers. Since this chapter is designed for instructional purposes, it concludes with a presentation of guideline principles and recommended procedures for measuring services barriers and assessing the consequences of their liberalization.

Part IV. ***International Trade and Labor Standards***

Chapter 16 — "Pros and Cons of Linking Trade and Labor Standards," with Drusilla K. Brown and Alan V. Deardorff, in Douglas Nelson (ed.), *The Political Economy of Policy Reform: Essays in Honor of J. Michael Finger*, Elsevier, 2004.

Some advocates of labor and environmental rights have asked that these issues also be taken over by the WTO and that they be enforced by the same mechanism that it uses for policing trade policies. This chapter reviews the arguments for and against such integration in the case of labor standards. The debate is first put into context by reviewing the issues and the events that have led to the current situation. Next considered are the arguments in favor of putting labor standards into the WTO and then the arguments against doing so. Finally, advice is offered to developing countries as to the position that they should take in this debate, and how more broadly they should deal with this and other issues in the forthcoming WTO multilateral trade negotiations.

Chapter 17 — "The Effects of Multinational Production on Wages and Working Conditions in Developing Countries," with Drusilla K. Brown and Alan V. Deardorff, in Robert E. Baldwin and L. Alan Winters (eds.), *Challenges to Globalization*, University of Chicago Press, 2004.

This chapter assesses the evidence regarding the effects of multinational production on wages and working conditions in developing countries. It is motivated by recent controversies concerning whether multinational firms in developing countries exploit workers by paying low wages and subjecting them to substandard conditions. First addressed are the efforts of activist groups, universities, and colleges in the "Anti-Sweatshop" Campaign in the United States, the social accountability of multinational firms, and the role of such international institutions as the International Labor Organization and World Trade Organization in dealing with labor standards and trade. It is then considered conceptually how foreign direct investment might affect host-country wages. Available theories yield ambiguous predictions, leaving the effects to be examined empirically. It is therefore important to review empirical evidence on multinational firm wages in developing countries, and the relationship between foreign direct investment and labor rights. This evidence indicates that multinational firms routinely provide higher wages and better working conditions than their local counterparts, and they are typically not attracted preferentially to countries with weak labor standards.

Chapter 18 — "U.S. Trade and Other Policy Options and Programs to Deter Foreign Exploitation of Child Labor," with Drusilla K. Brown and Alan V. Deardorff, in Magnus Blomström and Linda Goldberg (eds.), *Topics in Empirical International Economics: A Festschrift in Honor of Robert Lipsey*, University of Chicago Press, 2001.

There is a growing theoretical and empirical literature concerning the causes and consequences of child labor. The objective of this chapter is to evaluate the policy initiatives targeted at child labor in light of the newly emerging theoretical argumentation and empirical evidence. The focus in particular is on programs to address child-labor practices, and an attempt is made to evaluate these programs, given the empirical evidence concerning the primary determinants of when and why children work. Throughout, it is found to be instructive to evaluate the policies that have been adopted with the intent of reducing overall child labor in terms of the impact they are likely to have on the welfare of children.

Chapter 19 — "Labor Standards and International Trade," INTAL, *Integration and Trade*, May/June 1999.

This chapter explores the wide disparity of views on issues of international labor standards and the available options for addressing the issues involved. Labor standards are multi-faceted and may vary from country to country depending on the stage of development, per capita income, and political, social, and cultural conditions and institutions. It may be difficult therefore to distinguish unambiguously so-called core labor standards from other labor standards that will depend on given national circumstances. A review of the theoretical and empirical analysis of labor standards suggests that there are no compelling grounds on which to support the international enforcement and harmonization of labor standards. It is argued accordingly that the World Trade Organization is not the appropriate international institution to deal with issues of international labor standards. Rather, the International Labor Organization is the preferred multilateral forum to monitor and help developing countries to improve their labor standards. In the final analysis, the policies of the United States and other industrialized countries should be directed to maintaining open markets and encouraging the economic growth of their developing country trading partners. This is the surest way to achieve higher labor standards since there is pervasive historical evidence that standards are improved as per capita incomes increase.