



# **Economics Session 2: Current Issues in International Trade**

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**Purpose: Review our understanding of FTA issues and concerns**

**Outline:**

- 1 Benefits and costs of Free(r) trade**
- 2 Background on Trade Agreements**
- 3 Provincial Activities to Promote International Trade**

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## What we know about Free(r) Trade:

### 1 Opening to trade generates Potential Pareto Improvements (PPI)

- a) Trade raises per capita incomes
  - but some people may be worse off
- b) Suggests capacity and need for internal compensation
- c) Political opposition to free trade can arise without compensation

### 2 Free trade not always optimal

- a) Countries may want to manipulate their *terms of trade*
  - Small countries have a weak incentive to do this
  - But all countries have a 'large sector'
  - For SK: Potash, Uranium, Lentils, Durum Wheat, Mustard, Canola, Flax (source: Economic Overview, Gov SK))
- b) Manipulating the ToT makes the other country worse off
- c) Can lead to a trade war in which every one is worse off

- 3 **Market failures can be made worse by opening to trade**
  - a) EG: Increased pollution due to increased production or consumption
  - b) Optimal response is to directly focus on the market failure
  - c) Tariffs can improve things. But this is a 'third-best policy'
  
- 4 **Countries have alternative ways to impact trade flows** so can hide their actions
  - a) Import Tariffs are equivalent to a domestic tax on Consumers and a domestic subsidy on production
  - b) Import Tariffs are equivalent to Import Quotas
  - c) Import Tariffs are equivalent to Export Tariffs (general equilibrium model)
  
- 5 **Small countries gain more from trade than big countries**
  - a) Terms of trade gains are bigger for the smaller country
  - b) Large countries gain more by pursuing trade with other large countries or collections of countries (US-UK versus US – EU)

## Why pursue FREER TRADE

- Political reasons
  - Creates local winners and losers so has election implications
    - Winners can identify the basis for wins but losers may find it hard to identify loses.
  - Trade can tie countries closer together:
    - eg basis for EU: Germany + France; Canada-Ukraine
- Economic reasons
  - Net economic gains for all countries (static gains from trade)
  - Knowledge is transferred with trade (dynamic gains from trade)
  - Immigration will tend to fall if we have FT
    - FT is a substitute for immigration
  - Can reduce market failure
    - More competition; less corruption; disciplines markets,....
- Efficiency
  - World production rises without additional resources
  - But depends on how externalities are handled

### **International agreements are a Global Public Good.**

- a) Having a set of rules that govern international transactions reduces risks and transactions costs and so benefits all countries even if they do not engage intensively in trade
- b) Know what the rules are before entering more fully into greater trade
- c) Increases the 'option value' of trade

### **Reduce national sovereignty**

- a) Other countries will punish those who break the rules
- b) Agreements force countries to change domestic law to meet international obligations
- c) But national discretion can lead to bad outcomes that would be constrained by agreements
- d) Eg: limit ability of governments to levy 'political' taxes

### **Facilitate FDI inflows to create more local high paying jobs**

- a) Investments raise GDP; more investment then more income

## Arguments against FREER TRADE

### 1. Trade creation versus trade diversion

- Partial movement to complete free-trade can lower welfare
- Consistent with Theory of the Second Best

### 2. Changes to Income Inequality

- Though trade is not a leading cause of inequality, it can contribute to it

### 3. Adjustment support for transition is missing

- Worsens income inequality

### 4. Can worsen power inequality

- FTA empower Business over workers ( eg union busting)

### 5. Harder to create domestic environmental policy.

- Carbon taxes will make domestic firms less competitive on world markets

## 6 Transition costs are high

- Not all workers can find new jobs
  - There is a large labor market response following trade liberalization but the transition may take several years;
  - Many social costs imposed with lost jobs
  - Potential aggregate welfare gains are significantly mitigated due to the delayed adjustment;
  - trade-induced welfare effects depend on initial sector of employment and on worker demographics
- Stranded capital assets
- Some effects are permanent

## DEPTH OF ECONOMIC INTEGRATION

### 1 Free trade Area: FTA

- Countries agree to reduce formal and informal barriers to trade in goods and services
  - a) Each maintains independent trade barriers with other countries
  - b) Example: NAFTA (MEX-US-CAN); EFTA (European free trade area: SCANDANAVIA-SWZ-EU)
  - c) ISSUE: non-member countries have an incentive to 'shop' for the lowest entry into the FTA-market and then transship to the other countries
  - d) SOLUTION: *Rules of Origin*: Domestic content rules stipulate that 'Made in Canada' means that a substantial portion of the value added is within Canada.

## 1 Types of trade integration

- a) FREE TRADE AGREEMENT FTA
- b) CUSTOMS UNION CU
- c) COMMON MARKET CM
- d) ECONOMIC UNION EU

## 2 Treaty Process

## 3 Process of Forming FTAs

## 4 Principles of FTAs

- a) National Treatment
  - issues
- b) Most Favoured Nation
  - exceptions

## 3 Dispute Mechanisms

## 4 Comprehensive Free trade agreements

## 2 CUSTOMS UNIONS: CU

- Countries agree to reduce formal and informal barriers to trade in goods and services but all agree on to a common external trade policy
  - a) Removes the ability for non-signatories to shop for access
  - b) Example: European Economic Community (precursor to the EU); Andean Pact (Bolivia, Columbia, Ecuador, Peru)
- ISSUES:
  - a) Small countries may find that big countries dictate the external trade policy.
  - b) External trade policy may not be optimal for any country – ‘Procrustean Bed’
- ADVANTAGES:
  - a) can offer bigger gains from trade to others and so can entice more involvement
  - b) Can bring more muscle to negotiations (eg US-EU)
  - c) Economies of scale in negotiations

### 3 COMMON MARKET: CM

- Free trade in goods and services and free mobility of capital and labour within the CM.
  - a) Deeper integration of economies. Example: EEC
  - b) Requires a deeper harmonization of local laws otherwise firms can shop for low cost jurisdictions (eg Ireland has low corporate taxes)
  - c) Does not require common currency

#### BENEFITS

- Strength in numbers for trade negotiations, influence
- Better ability to coordinate policy responses to crisis/recessions
- Higher labour and capital mobility raises efficiency and per capita income

#### Issues:

- Harmonization to a common standards is often to a common lowest standard
  - a) Eg Tax competition can lead each jurisdiction to lower taxes in a 'race to the bottom'
  - b) Can also have a raise to the top to push out dirty industries.
- Recognition of qualifications from other jurisdictions with different objectives

#### 4 ECONOMIC UNION:

- It is an FTA (no internal trade barriers), CU (same external barriers), and a CM (internal mobility of factors). Example: EU, Canada, US,
- Individual states merge under one federal government with all laws harmonized in one legislature
  - a) local 'state' governments will have jurisdiction over 'local issues'
  - b) Eg education, roads, health care,
- One currency (so no exchange risk but no independent state monetary policy)

Issues:

- No local control over immigration
- Inter-state transfer of income are required for stability (Canada – equalization; EU-common AG policy)
- Local rules must conform to the common rules which can lead to non-optimal local policies (eg local minimum wages may not make sense with high UE)

BREXIT is not a surprise. Issue is whether they can negotiate an FTA.

Once in an EU, getting out may be worse than staying. Eg Greece.

## TREATY Process

### Step 1: interested parties start negotiation

- a) Generally done in secret as state-to-state negotiations
  - Can lead to problems of legitimacy re democratic input
- b) Can seek input from 'stakeholders' – aka lobbying by provinces and companies
- c) Input from multiple Government departments
- d) Identify achievable goals and bargaining chips; what do you want and what are you willing to give up?
- e) Each country creates a negotiation team
- f) Negotiations reported back to the government but generally kept secret
- g) After negotiation ends, agreement is published for comment

## TREATY Process

### Step 2: Ratification by individual countries

- a) Each signatory then needs approval from home legislature: accept or reject
  - Lots of politics involved in forming coalitions of support
- b) Little opportunity to renegotiate (though CAN-EU did some negotiation for CETA)
- c) If too few ratify, then the deal is off (eg TPP required US ratification)
- d) Can then try to renegotiate or reset with fewer members

### Step 3: Implementation of treaty obligations into domestic laws

- a) Implementation period is part of the agreement
- b) Must change domestic laws to meet obligations
  - Tariffs are taxes and so need to be changed line by line
  - Labour laws need adjusting
  - Tax law needs to change
- c) Details matter. How one adjusts your laws can be a matter of dispute
  - If new laws are inconsistent with agreement obligations, then partners will challenge that you are not living up to your obligations

## Two Major Principles based on *Non-discrimination*:

### 1 Principle of National Treatment

- you should treat foreign products in the same way that you treat like domestic goods
- Must offer “no less favourably” treatment to imported goods and services
- How a good is produced is not relevant as long as the good is the same (or substantively similar)
  - a) EG; Cannot impose different tax rates based on whether a good is ‘union made’ or not.
- Domestic regulations are a legitimate restriction on commerce
- Domestic Rules are generally OK if there is no intention to distort trade
  - a) Eg: all fish sold in Canada must be tested for *E coli* contamination
  - b) Too bad it is harder for other countries to test for this.
  - c) Bias is unfortunate but OK if the policy achieves a legitimate safety concern

## Transparency and predictability

- Rules should be clear and predictable
- All firms should have equal access to markets and be treated the same
- Domestic regulations should also be ‘least trade distorting’ while achieving the same legitimate ends
  - a) One may have multiple ways to achieve a particular target, each will have a different impact on trading partners
  - b) Issue is how to judge this since instruments will also have different socio-economic impacts

## Main Principles:

### 2 Most Favoured Nation (MFN):

- An importing nation should not discriminate among competing importers
- We need to treat all signatories equally well
  
- EG If we lower tariffs to the US, we should also lower it to other countries.
  - a) We apply the same rules to US made goods as we do to Mexican made goods.
  - b) 'like goods' should be treated alike regardless of origin

**EXCEPTIONS:** Most FTA's do not eliminate discrimination. Rather, they allow mutually agreed upon discrimination.

### Example

- Government contracts can discriminate based on the location of the firm.
  - a) Can allow 'built in the US' as a basis for contracts
  - b) Typically allow local firms to bid above non-local firms eg but not more than 15% more
  - c) This is now in in CETA, TPP, but not in WTO
  
- Special and differential treatment:
  - a) Least developed countries are given leeway to 'break the rules'
  - b) Eg They need export and import revenues so lower tariffs a problem
  - c) Or get special treatment in local markets (EU tariffs were low for banana's from former colonies)
  
- Market disruptions
  - a) If imports surge, then the country can impose temporary restrictions
  - b) Allows for adjustment to take place gradually
  - c) Cannot have permanent-temporary restrictions

[https://ecampus.wto.org/admin/files/Course\\_382/Module\\_537/ModuleDocuments/eWTO-M8-R1-E.pdf](https://ecampus.wto.org/admin/files/Course_382/Module_537/ModuleDocuments/eWTO-M8-R1-E.pdf)

## General exceptions

Measures necessary to protect human, animal or plant life or health, which may restrict trade in goods (GATT 1994).

- May need to apply measures for purposes such as the protection of public morals; human animal or plant life or health; and, the conservation of exhaustible natural resources  
issue: I can choose to adopt your rules but can I force you to adopt my rules?
- Cannot constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade.

Eg:

- Dolphin-safe tuna; sulfur content in fuels;
- import bans on Canadian beef due to Mad-Cow disease
- import bans on Brazilian beef due to hoof-and-mouth disease
- Cartagena Protocol on LMOs would be consistent

## Security Exceptions

Right to take measures to protect essential national security interests

- in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security
- Eg: export bans on some IT technologies
  - a) Fissionable materials
  - b) Bans on exports of weapons to conflict zones

## Balance-of-payments (BOP) exceptions

Countries have the right to take measures to safeguard a their external financial position and BOPs

- If BOP is negative then there is downward pressure on exchange rates
- This increases inflation and price of imported goods.
- This makes imports more expensive (eg food and fuel) so will be a hardship on the poor
- Hence countries can limit imports to help support the exchange rate
- Must be least trade disruptive and just sufficient to meet goals

## **Regional Trade Agreements (RTAs) exceptions**

- Right to depart from the MFN principle in order to grant preferential treatment to goods (GATT 1994) or service suppliers (GATS) from trading partners within a customs union or a free trade area without extending such treatment to all WTO Members;
  - a) FTA's cannot increase barriers to others while decreasing it to partners
  - b) Try to ensure only trade creation and avoid trade diversion
  - c) Issue: want to ensure that Regional trade agreements are not a stumbling block to global free trade

## **Waivers**

- Temporary waivers granted with the authorization of the other Members, in exceptional circumstances
- Timelines set out

## **DISPUTE MECHANISM.** FTA's define the 'Rules of the Road'

- Countries agree to a set of rules and need to alter domestic rules to conform to obligations
- But suppose we want to break the rules. Then what?
  - a) The rules define how we determine whether damages have occurred, their extent, and whether and how others can retaliate
  - b) In general, retaliation has to be approved by a panel of independent trade experts.
    - Not a court of law so burden of proof will differ
    - Most FTAs based on WTO panel approach
- If found in contravention of the treaty, countries need to have an opportunity to change their behavior by repealing offending practice or offering compensation
  - a) Countries can choose not to change their practice.
  - b) But then they must offer compensation – eg better access to other markets
  - c) If no compensation, then 'aggrieved' country can retaliate with their own punishment.
    - But retaliation has to be proportionate to the 'damage' caused

## **COMPREHENSIVE FREE TRADE AGREEMENTS (like CETA and the TPP)**

### **Goals:**

- 1 Lower barriers to trade in goods**
- 2 Extent to services and government procurement**
- 3 Promote inward and outward Investments**
- 4 Protect Intellectual property**
- 5 Preserve Labour and Environmental quality**

## **Transpacific partnership:**

### **Tariff reductions and reductions in other barriers to trade:**

WTO rounds of negotiations left off a lot of Agricultural Trade and Services

1. TPP reduces manufactured goods tariffs even more
  - a) Sectors targeted (such as Textiles, telecom,...)
  - b) Typically phase in over 10-15 years
  - c) Easier licensing procedures
  - d) Surge clauses and countervailing duties
2. Improves access for trade in services
  - a) Eg Financial services, engineering, design, computing, storage
  - b) Countries cannot increase current restrictions
  - c) Encourages mobility of workers
3. Reduces barriers in Agricultural Trade
  - a) Banned export subsidies
  - b) Supply Managed Sectors (Dairy and 'feather industries') and protected sectors

## Government Procurement

Government often put out a contract for services to the private sector

Build a new school, Run Govt advertising; Provide highway maintenance

Does not mean that all services have to be contracted out.

- Eg: if garbage pickup is municipal, then it can stay municipal.
- But if you start to contract it out, then all firms have access to bids

Current and past practice is to give local firms a price advantage

- eg: if the lowest local bid is not more than 15% higher than the lowest 'foreign' bid, then the contract goes to the local firm even if it is not the low bid

FTA's will often exempt procurement from agreements (EG NAFTA)

## Investors' Rights

Comprehensive FTA's are also about promoting Foreign Direct Investment

- We want to protect Canadian firms that invest in other countries from government action, unfair courts, etc.
- We want to encourage foreign firms to build facilities here so we have more local employment (eg Toyota plants in Ontario)

### Provisions:

- Treaties prohibit governments from confiscating (nationalizing) foreign assets without adequate compensation
- Also, if a government chooses to change the rules (say for environmental reasons), then it will compensate firms for 'damages'

ISSUE: allows foreign firms to sue for domestic policy shifts. Access to compensation may be easier than a domestic firm which must use local courts to get compensation.

## INVESTORS RIGHTS dispute mechanism: Chap 11 in NAFTA

- Some comprehensive FTA's (eg NAFTA, CETA, TPP) include provisions for investors rights that generally require compensation for government appropriation of rights and property
- We already have provisions for expropriation of assets
- ISSUE: what is expropriation when only restriction is on market access
  - a) Even if legit, do you compensate for actual costs or lost profits as well?

## **Intellectual Property Rights:** Innovation: changes in techniques

- Improvements in product characteristics
  - a) pharmaceuticals; foods-golden rice; speed and features in phones
- New products
  - a) New drugs;
  - b) Music, movies, TV series
  - c) UBER; online buying (Ebay)
- Improvements in production processes
  - a) Eg: genetic improvements (GMO or traditional breeding) to plants;
  - b) energy saving technologies (eg steel production)

## **ISSUE: Positive spillovers**

- effects of innovation as others learn and improve their products
- Lowers costs and raises product quality
- Identifies/creates new market opportunities

But Innovation is risky so firms want protection to finance R&D

- Big initial costs with no assured sales
- Others can quickly erode markets with entry

## **Environmental and Labour side agreements**

Typically, no specific requirements but does try to ensure that the process within each country is 'fair' and robust.

**Labour rights** are protected through

- a) some acknowledgment of collective bargaining rights
- b) Bans of child and forced labour
- c) Countries cannot weaken existing laws to promote exports

## **Environment**

- a) Support for Multilateral Environmental Agreements (eg CITES, Montreal Protocol, MARPOL)
- b) EG: Environmental agreements will have some trade provisions and hence will violate trade agreements. So new FTA's will honour EA trade restrictions.
- c) Q: should trade agreements have environmental regulations? Not necessarily.

## **Wrap up:**

- 1. Free(r) trade offers aggregate benefits but not everyone will support it. Politics always matters.**
- 2. Free trade agreements (FTA) set out the type and degree of discrimination.**
  - **Not all sectors receive free access**
  - **Exclusions are identified and criteria agreed upon**
  - **Conflicts have a venue for resolution**
- 3. New FTAs are more than just about tariff reduction and market access**
- 4. Disputes will arise given the presence of winners and losers.**
- 5. Dispute mechanisms are required to resolve these in a dispassionate manner that avoids accelerated retaliation**