INTERNATIONAL TRADE

Objectives of the chapter
An understanding of international trade is critical to the study of international business. The primary objective of this chapter is to examine key economic theories that help to explain why nations trade. In addition, the role and importance of a country’s barriers to trade will be studied and discussed with a focus on why most nations use trade barriers despite vigorous international efforts to eliminate them.

The specific objectives of this chapter are to:
1. Define the term international trade and discuss the role of mercantilism in modern international trade.
2. Contrast the theories of absolute advantage and comparative advantage.
3. Relate the importance of international product life cycle theory to the study of international economics.
4. Explain some of the most common aid barriers to trade and other economic developments that affect international economics.
5. Discuss some of the reasons for the tensions between the theory of free trade and the widespread practice of national trade barriers.

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Trade of the triad and China

Over the last three decades, new entrants into the world export market have transformed the economies of industrialized countries and the types of products they export. At the beginning of this time period, the Japanese were a growing force in the international arena. They dominated the 1980s and were able to make substantial gains at the expense of such dominant exporters as the US and the United States. Indeed, between 1980 and 1998, both these countries lost worldwide market share to the Japanese in such industries as automotive products, office machines, telecommunications, machinery and transport equipment, chemicals, and textiles. In the late 1980s, however, the world economy began to see major changes. Asia, South Korea, Singapore, Taiwan, Thailand, and China were growing much more competitively on the world stage. South Korea, for example, started expanding its automotive industry, while China’s market share of office and telecom equipment rose from zero to about 1 percent of the market in 1990 to 4.5 percent by 2000. Meanwhile, thanks to NAFTA—which decreased barriers to trade within North America—Mexico and Canada were increasing their market share of automotive products, machinery, and transport equipment. Such competition spurred the United States to radically restructure many of its industries, invest billions in new technology, plant, equipment, and information technology, and introduce improvement programs, such as Six Sigma, that allowed it to match the quality offerings of worldwide competitors. As a result, the US share of the world’s export market in areas such as automotive products, machinery and transport equipment, chemicals, and textiles somewhat recovered. The big loser was Japan, which saw its export market share decline in most of these areas. Today the biggest challenge to the export markets of industrialized countries in China. Between 2000 and 2005, China’s share of the world’s auto industry merchandise trade doubled—from 4.7 percent to 9.8 percent (see Table 1). This increase comes at the expense of exports to triad countries over the same period. By 2005 the core triad’s share of world exports was 42.3 percent, with the EU accounting for 38.6 percent (see Table 2). The United States and Japan were the hardest hit. China’s expansion is particularly evident in the clothing and textile markets. Today the country holds 26.7 percent and 20.2 percent of each market, respectively (see the first table). More impressive, however, is China’s improvements in exports of office and telecom equipment and of machinery and transport equipment, both of which require significant technology know-how. As can be seen in the tables, China’s rise as a world exporter has decreased the share of the triad’s share of world exports in manufactures. In response to China’s increased competitiveness, triad countries are trying to balance the need to integrate this new player into the international business arena with the negative short-term effects to their economies.

Japan's attitude toward China took a turn from protectionism when it realized that this new trade partner could help it overcome some of the problems associated with its rigid economic system. Large amounts of inexpensive, low-skilled labor now allowed Japanese companies to outsource some of their manufacturing operations overseas within its own region, while more skilled Japanese workers took care of the more specialized areas of the production process. In addition, China eased Japan’s long dependence on the US economy for its industrial and consumer products. To US and EU companies, however, the new relationship with Japan has sparked several issues: First, the US and EU companies have also moved operations to Japan, the governments are reacting more aggressively to pressure from special interest groups that see China as a threat to US businesses and jobs. The United States, which has a large trade deficit with China, has argued that the yuan is undervalued, creating an unfair advantage for Chinese producers. The United States is threatening to impose tariffs on Chinese products. Japan has joined this view and is pressing China to move to a more flexible exchange rate. Yet, critics argue that Japan’s true and knows the market value of the yuan and that a fall in its price after devaluation could only worsen matters. For its part, the EU has reacted by asking China to curb exports of textiles into the union after exports of clothing increased by 354 percent in less than six months in 2005. In addition, China’s rapid increase in exports by any nation does not necessarily mean that other countries are losing out. In terms of trade alone, any new entrant to the world export market, other things being equal, will decrease the share of world exports of all other countries. This, however, does not mean that other countries are exporting less. They could be exporting, in value terms, a significantly higher amount because a new trade partner also means a new market to which they can export. More specifically, however, trade creates losses and winners. Triad economies are being forced to specialize. While those with most to lose pressure their governments to impose trade barriers, those with most to win—high-skilled industries—are expanding to serve the Chinese market. Further, consumers’ real incomes increase when they can purchase the same products at lower prices. The data on this case help to reinforce an important principle of international trade: specialize in those products in which you can achieve an advantage. Over time, of course, competitors may erode this advantage by developing even better offerings for the export market. In this case, it is important either to counterattack by improving your own offering to win back market share, or to find other markets where the country’s skills and resources will allow it to compete effectively. In light of the emergence of more and more industrial countries in Asia, the growing competitiveness of Latin America, and the emerging industries of Eastern Europe and the former Soviet Union, triad managers have their work cut out for them.

**Table 1. China's share of the world's market for exports of manufactures**

<table>
<thead>
<tr>
<th>Industry</th>
<th>2000</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>All manufactures</td>
<td>4.7</td>
<td>9.6</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>3.1</td>
<td>4.1</td>
</tr>
<tr>
<td>Chemicals</td>
<td>2.9</td>
<td>2.7</td>
</tr>
<tr>
<td>Machinery and transport equipment</td>
<td>3.1</td>
<td>7.6</td>
</tr>
<tr>
<td>Automotive products</td>
<td>0.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Office and telecom equipment</td>
<td>4.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Textiles</td>
<td>10.5</td>
<td>20.2</td>
</tr>
<tr>
<td>Clothing</td>
<td>18.3</td>
<td>24.9</td>
</tr>
</tbody>
</table>

Note: Manufactures are a subcategory within merchandise exports. These data include intra-regional EU exports. Source: Author's calculations based on data from World Trade Organization, International Trade Statistics Database.

**Table 2. The triad's share of merchandise world exports**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>15.3</td>
<td>16.1</td>
<td>11.7</td>
<td>3.6</td>
</tr>
<tr>
<td>EU</td>
<td>26.2</td>
<td>22.2</td>
<td>22.9</td>
<td>3.3</td>
</tr>
<tr>
<td>Japan</td>
<td>11.4</td>
<td>8.9</td>
<td>7.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Triad</td>
<td>53.1</td>
<td>67.2</td>
<td>62.1</td>
<td>18.0</td>
</tr>
<tr>
<td>Non-triad</td>
<td>44.9</td>
<td>52.8</td>
<td>57.7</td>
<td>16.8</td>
</tr>
</tbody>
</table>

Note: Data are calculated using world trade minus intra-regional trade. Source: Author's calculations based on data from World Trade Organization, International Trade Statistics, 2006 and 2007.

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**INTRODUCTION**

International trade is the branch of economics concerned with the exchange of goods and services with foreign countries. Although this is a complex subject, we will focus on two particular areas: international trade theory and barriers to trade.

Some international economic problems cannot be solved in the short run. Consider the US trade deficit. US trade with Japan and China heavily affects its overall imbalance. Moreover, this trade deficit will not be reduced by political measures alone; it will require long-run economic measures that reduce imports and increase exports. Other nations are also learning this lesson—and not just those that have negative balances. After all, most countries seem to want a continual favorable trade balance, although this is impossible, since a nation with a deficit must be matched by a nation with a surplus.
International trade has become an even more important topic now that so many countries have begun to move from state-run to market-driven economies. Inflation and, in many cases, unemployment are severe problems for these nations. Fortunately, enhanced international trade is one way to address a weak macroeconomy. International commerce is an aid for free market economies; the world's economic system. Since the time of Adam Smith in 1790, economists have shown that free trade is efficient and leads to maximum economic welfare. This chapter we will discuss the economic rationale for free trade and the political impediments to it.

INTERNATIONAL TRADE THEORY

To understand the topic of international trade, we must be able to answer the question why do nations trade? One of the earliest and simplest answers to this question was provided by mercantilism, a theory that was quite popular in the eighteenth century, when gold was the only world currency. Mercantilism holds that a government can improve the economic well-being of the country by encouraging exports and stifling imports. The result is a positive balance of trade that leads to wealth (gold) flowing into the country.

Neo-mercantilism, like mercantilism, seeks to produce a positive balance of trade but without the reliance on precious metals. Most international trade experts believe that mercantilism is a simplistic and erroneous theory, although it has had followers. For example, under President Mitterrand in the late 1970s and early 1980s, France sought to revitalize its industrial base by nationalizing key industries and banks and subsidizing exports over imports. By the mid-1980s the French government realized that the strategy was not working and began denationalizing many of its holdings. More recently, China has proven to be a strong adherent of mercantilism, as reflected by the fact that it tries to have a positive balance with all of its trading partners.

A more useful explanation of why nations trade is provided by trade theories that focus on specialization of effort. The theories of absolute and comparative advantage are good examples.

Theory of absolute advantage

The theory of absolute advantage holds that nations can increase their economic well-being by specializing in the production of goods they can produce more efficiently than anyone else. A simple example can illustrate this point. Assume that two nations, North and South, are both able to produce two goods, cloth and grain. Assume further that labor is the only scarce factor of production and thus the only cost.

<table>
<thead>
<tr>
<th></th>
<th>Cloth</th>
<th>Grain</th>
</tr>
</thead>
<tbody>
<tr>
<td>North</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>South</td>
<td>20</td>
<td>10</td>
</tr>
</tbody>
</table>

Thus lower labor-hours per unit of production means lower production costs and higher productivity per labor-hour. As seen by the data in the table, North has an absolute advantage in the production of cloth since the cost requires only 10 labor-hours, compared to 20 labor-hours in South. Similarly, South has an absolute advantage in the production of grain, which it produces at a cost of 10 labor-hours, compared to 20 labor-hours in North.

Both countries gain by trade. If they specialize and exchange cloth for grain at a relative price of 1:1, each country can employ its resources to produce a greater amount of goods. North can import one unit of grain in exchange for one unit of cloth, thereby paying only 10 labor-hours for one unit of grain. If North had produced the grain itself, it would have used 20 labor-hours per unit, so North gains 10 labor-hours from the trade. In the same way, South gains from trade when it imports one unit of cloth in exchange for one unit of grain. The effective cost to South for one unit of cloth is only the 10 labor-hours required to make its one unit of grain.

The theory of absolute advantage, as originally formulated, does not predict the exchange ratio between cloth and grain once trade is opened, nor does it reveal the division of the gains from trade between the two countries. Our example assumed an international price ratio of 1:1, but this ratio (Pcloth to Pgrain) could lie between 1:2 (the pretrade price ratio in South) and 1:2 (the pretrade price ratio in North). To determine the relative price ratio under trade, we would have to know the total resources of each country (total labor-hours available per year), and the demand of each for both cloth and grain. In this way we could determine their relative gains from trade for each country.

Even this simple model of absolute advantage has several important implications for international trade. First, if a country has an absolute advantage in producing a product, it has the potential to gain from trade. Second, the more a country is able to specialize in the good it produces most efficiently, the greater its potential gains in national well-being. Third, the competitive market does not evenly distribute the gains from trade within one country. This last implication is illustrated by the following example.

Prior to trade, the grain farmers in North work 20 hours to produce one unit of grain. If that country were to exchange for two units of cloth, after trade, those who remain can exchange one unit of grain for only one unit of cloth. Thus, the remaining grain producers are worse off under trade. Cloth producers in North, however, work 10 hours, produce one unit of cloth, and exchange it for one unit of grain, whereas previously they received only half a unit of grain. They are better off. If grain producers in North switch to cloth production, then 20 hours of labor results in the production of two units of cloth, which they can exchange for two units of grain. Thus, international trade helps them. As long as North does not specialize completely in cloth, there will be gainers (cloth producers and grain producers who switched to cloth) and losers (those who continue as grain producers).

Because the nation as a whole benefits from trade, the gainers can compensate the losers and there will still be a surplus to be distributed in some way. If such compensation does not take place, however, the losers (continuing grain producers) would have an incentive to try to prevent the country from opening itself up to trade. Historically, this problem has continued to fuel opposition to a free trade policy that reduces barriers to trade. A good example is Japanese farmers who stand to lose their livelihood if the government opens up Japan to lower-priced agricultural imports.

A more complicated picture of the determinants and effects of trade emerges when one of the trading partners has an absolute advantage in the production of both goods. However, trade under these conditions still brings gain, as David Ricardo first demonstrated in his theory of comparative advantage.

Theory of comparative advantage

The theory of comparative advantage holds that nations should produce those goods for which they have the greatest relative advantage. In terms of the previous example of two
countries, North and South, and two commodities, cloth and grain. Ricardo's model can be illustrated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Labor cost (hours) of production for one unit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cloth</td>
</tr>
<tr>
<td>North</td>
<td>50</td>
</tr>
<tr>
<td>South</td>
<td>200</td>
</tr>
</tbody>
</table>

In this example, North has an absolute advantage in the production of both cloth and grain, so it would appear at first sight that trade would be unprofitable, or at least that incentives for exchange no longer exist. Yet trade is still advantageous to both nations, provided their relative costs of production differ.

Before trade, one unit of cloth in North costs (50/100) hours of grain, so one unit of cloth can be exchanged for half a unit of grain. The price of cloth is half the price of grain. In South, one unit of cloth costs (200/200) hours of grain, or one unit of grain. The price of cloth equals the price of grain. If North can import more than half a unit of grain for one unit of cloth, it will gain from trade. Similarly, if South can import one unit of cloth for less than one unit of grain, it will also gain from trade. These relative price rates set the boundaries for trade. Trade is profitable between price ratios (price of cloth to price of grain) of 0.5 and 1. If, for example, at an international price ratio of two-thirds, North gains. It can import one unit of grain in return for exporting one and a half units of cloth. Because it costs only 50 hours of labor to produce the unit of cloth, its effective cost under trade for one unit of imported grain is 75 labor-hours. Under pretrade conditions it cost North 100 labor-hours to produce one unit of grain. Similarly, South gains from trade by importing one unit of cloth in exchange for two-thirds of a unit of grain. Prior to trade, South spent 200 labor-hours producing the one unit of cloth. Through trade, its effective cost for one unit of cloth is 133 labor-hours—cheaper than the domestic production cost of 200 labor-hours. Assuming free trade between the two nations, North will tend to specialize in the production of cloth, and South will tend to specialize in the production of grain.

This example illustrates a general principle. There are gains from trade whenever the relative price ratio of two goods differs under international exchange from what they would be under conditions of no trade. Such domestic conditions are often referred to as autarky, which is a government policy of being totally self-sufficient. Research shows that free trade is superior to autarky. In particular, free trade provides greater economic output and consumption to the trade partners jointly than they can achieve by working alone. By specializing in the production of certain goods, exporting those products for which they have a comparative advantage, and importing those for which they have a comparative disadvantage, the countries end up better off.

The general conclusions of the theory of comparative advantage are the same as those for the theory of absolute advantage. In addition, the theory of comparative advantage demonstrates that countries jointly benefit from free trade (under the assumptions of the model) even if one country has an absolute advantage in the production of both goods. Total world efficiency and consumption increase.

As with the theory of absolute advantage discussed previously, Ricardo's theory of comparative advantage does not answer the question of the distribution of gains between the two countries, nor the distribution of gains and losses between grain producers and cloth producers within each country. No country will lose under free trade, but in theory at least all the gains could accrue to one country and to only one group within that country.

**Factor endowment theory**

A trade theory which holds that nations produce and export products that use large amounts of production factors that they have in abundance and will import products requiring a large amount of production factors that they lack.

**Heckscher–Ohlin theory**

A trade theory that extends the concept of comparative advantage by taking into consideration the endowment and cost of factors of production and helps to explain why nations with relatively large labor forces concentrate on producing labor-intensive goods, whereas countries with relatively more capital will specialize is capital-intensive goods.

**Leontief paradox**

A finding by Paul R. Leontief, a Nobel Prize-winning economist, which states that the United States, surprisingly, exports relatively more labor-intensive goods and imports capital-intensive goods.

**International product life cycle (IPLC) theory**

A theory that addresses the stages of production of a product with the following stages: new, growth, maturity, and decline. It explains why a product that begins as a nation's export and ends up as an import.

**Active learning check**

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1. How does the process of the UK's finding market niches help illustrate the theory of comparative advantage?

The theory of comparative advantage holds that nations should produce those goods for which they have the greatest relative advantage. The finding of market niches helps illustrate this theory because it shows that the UK is picking those areas in which it has a relative advantage over competitors and exploiting its strengths in those markets. Given the rise of competition in many areas of the world, more nations have been able to maintain their market share for very long. So the UK will have to continue to use this approach in order to remain one of the world's major export nations.
theory, IPLC theory has two important tenets: (1) technology is a critical factor in creating and developing new products; and (2) market size and structure are important in determining trade patterns.

Product stages

The IPLC has three stages: new product, maturing product, and standardized product. A new product is one that is innovative or unique in some way (see Figure 6.1a). Initially, consumption is in the home country; price is inelastic, profits are high, and the company seeks to sell to those willing to pay a premium price. As production increases and meets local consumption, exporting begins.

As the product enters the mature phase of its life cycle (see Figure 6.1b), an increasing percentage of sales is achieved through exporting. At the same time, competitors in other advanced countries will be working to develop substitute products so they can replace the initial good with one of their own. The introduction of these substitutes and the softening of demand for the original product will eventually result in the firm that developed the product now switching its strategy from production to market protection. Attention will also be focused on tapping markets in less developed countries.

As the product enters the standardized product stage (see Figure 6.1c), the technology becomes widely diffused and available. Production tends to shift to low-cost locations, including less developed countries and offshore locations. In many cases the product will end up being viewed as a generic, and price will be the sole determinant of demand.

Personal computers and the IPLC

In recent years a number of products have moved through the IPLC and are now in the standardized product stage. Personal computers (PCs) are a good example, despite their wide variety and the fact that some versions are in the new product and maturing product phases. For example, the early versions of PCs that reached the market in the 1984 to 1991 period were in the standardized product stage by 1995 and sold primarily on the basis of price. Machines that entered the market in the 1996 to 1998 period were in the maturing stage by 1999. PCs with increased memory capability that were in the new product stage in 1999 quickly moved toward maturity, and by 2002 they were being replaced by even better machines with faster processors and more multimedia capabilities. Today, diskettes are standardized and rarely used while standard components include CD writers, DVD ROMs, DSL and wireless Internet connectors, USB ports, advanced graphics and sound, flat LCD monitors, digital photography capabilities, etc.

Desktop computers have been replaced by laptop models that are lighter, faster, more sophisticated, and less expensive than their predecessors. In turn, these machines are being replaced by notebooks with advanced Pentium chips, long-term battery capability, and storage capable of holding billions of bytes complete with wireless equipment and serve as a complete communications center from which the international executive can communicate anywhere in the world. These machines will first be manufactured locally and then in foreign markets. This is largely because IBM (the inventor of the PC) computers became a commodity, and IBM's PC division was sold to the Chinese firm Lenovo in 2005. Lenovo has the benefit of low labor costs and it is better able to manufacture the laptops of today. Thus, computers will continue to move through an IPLC.

The IPLC theory is useful in helping to explain how new technologically innovative products fit into the world trade picture. However, because new innovative products are sometimes rapidly improved, it is important to remember that one or two versions of them may be in the standardized product stage while other versions are in the maturing stage and still others are in the new product phase.

**Other important considerations**

Many factors beyond those we have considered greatly influence international trade theory. One is government regulation. Countries often limit or restrict trade with other countries for political reasons. For example, despite the benefits of international trade, the EU does not always see "eye to eye" with the United States on regulatory matters. As a result, there are different government regulations affecting business in Europe, than in North America. For example, EU competition policy differs from US antitrust policy, see the box International Business Strategy in Action: Microsoft shows the world is not flat. Other important factors include monetary currency valuation and consumer tastes.

**Monetary currency valuation**

When examining why one country trades with another, we need to consider the monetary exchange rate, which is the price of one currency stated in terms of another currency. For example, from 1999 to 2000 the value of the Japanese yen declined significantly over the value of the US dollar. As a result, many Japanese businesses found their products becoming much more competitive in the US market. Thereafter, the Japanese government announced that because the yen was again getting too strong, it wanted to weaken its value, thus ensuring that Japanese businesses could maintain their international competitiveness. Another reason why monetary currency valuation is important is because a foreign firm doing business will report its revenues and profits in home-country currency, So if a British firm sold $10 million of machinery in Canada and the value of the Canadian dollar declined against the British pound, the UK company would report less revenue (in terms of British pounds) than if the Canadian dollar had remained stable, or better yet, increased in value against the pound. In mid-2005, the euro became so strong compared to the dollar that Volkswagen reported a 63 percent decline in pre-tax profits. In the next chapter we will discuss exchange rates in more detail.

**Consumer tastes**

International trade is not based solely on price; some people will pay more for a product even though they can buy something similar for less money. This willingness to pay more may be based on prestige, perceived quality, or a host of other physical and psychological reasons. Personal tastes dictate consumer decisions.
International Business Strategy in Action

Microsoft shows the world is not flat

The dispute between Microsoft and the European Commission demonstrates that the world is not flat. Microsoft is a company that has reason to be wary of the wave of worldwide Internet access and software applications. Yet, it has run into a brick wall in Brussels. There the European Commission for Competition and State Aid ID0 Gendell has imposed large fines for breaking its competition rules.

In March 2004, the EC Gendell ruled that Microsoft is abusing its dominant market position with its Windows operating system. Since then the EC Gendell has been threatening to impose large daily fines because it says Microsoft is failing to comply with that ruling. On September 17, 2007, Microsoft lost an appeal to the European Court of First Instance ending a nine-year battle with the EU. In 2008, the EC issued a new antitrust investigation against Microsoft. This case illustrates that even the world’s most successful Internet-based software company does not have unrestricted global market access for its products. Instead, the world is divided into a “tripe” with strong barriers for entry into the key region markets of the EU, North America, and Asia-Pacific. Microsoft is simply the latest large MNE to misread the worldwide marketplace. Today, business activity is organized mainly within each region of the tripe, not globally. For US firms, going to a foreign trade market in Europe and Asia is fraught with peril.

The world’s 500 largest firms, on average, sell 72 percent of their goods and services in their home region. Very few firms are truly global, Defined as selling less than 50 percent of their products in each region. For example, the world’s largest firm, Wal-Mart, has 44 percent of its sales in North America. Unfortunately, Microsoft does not reveal the geographic dispersion of its sales, but it is likely that a majority of them are also in North America. Firms like Wal-Mart and Microsoft need to understand that a business model developed for North America will need to be adapted when going to Europe and Asia.

In the case of Microsoft, the key difference is in the way that the EU regulatory system operates. In Europe competition policy can be used as a barrier to entry. An individual firm may lose the case, but it has not been given an EU-wide investigation. In this process the deck is stacked against the foreign firm. In 2003 the US firm General Electric was also made a similar mistake in its planned acquisition of Honeywell which was disallowed by the EU.

While the United States has somewhat similar antitrust provisions, the application of these is more business-friendly than in Europe. US antitrust aims to help consumers, whereas EU law helps competitors. Microsoft was able to settle its antitrust case with the Bush administration, but it failed to do so with the EU. The regulatory climate in Europe is harsher than in North America. Multinational firms like Microsoft which assume the status of a large, worldwide market entry, and the other aspects of flat earth thinking are learning expensive lessons. In addition to differences in regulatory standards across the tripe, there are major cultural, social, and political differences that deny globalization.

In terms of regulatory differences antitrust is but one on an array of market entry barriers. Even worse are anti- dumping and countervailing duty laws which are used to keep out foreign rivals. The United States itself administers the anti-dumping and countervailing duty laws in favor of the home team. In 2006, on security grounds, the US Congress overturned the executive branch decision to allow Dubai Ports International to acquire the US ports owned by PDQ, a British firm. The Europeans perceive that the US commitment to free trade is weak, this is stifling their own growth.

For example, the US is the largest supplier of goods and services to the European Union. It accounts for 25 percent of all EU imports. Meanwhile, the US is the largest exporter of goods and services to the European Union. It accounts for 25 percent of all EU imports.

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BARRIERS TO TRADE

Why do many countries produce goods and services that could be purchased more cheaply from others? One reason is trade barriers, which effectively raise the cost of these goods and make them more expensive to local buyers.

Reasons for trade barriers

One of the most common reasons for the creation of trade barriers is to encourage local production by making it more difficult for foreign firms to compete there. Another reason is to help local firms export and thus build worldwide market share by doing such things as providing them with subsidies in the form of tax breaks and low-interest loans.

Other common reasons include:

- Protect local jobs by shielding home-country business from foreign competition.
- Encourage local production to reduce imports.
- Protect infant industries that are just getting started.
- Reduce reliance on foreign suppliers.
- Encourage local and foreign direct investment.
- Reduce balance of payments problems.
- Promote export activity.
- Protect foreign firms from dumping (selling goods below cost in order to achieve market share).
- Promote political objectives such as refusing to trade with countries that practice apartheid or deny civil liberties to their citizens.
Commonly used barriers

A variety of trade barriers deter the flow of international goods and services. The following presents six of the most commonly used barriers.

Price-based barriers

Imported goods and services sometimes have a tariff added to their price. Quite often this is based on the value of the goods. For example, some tobacco products coming into the United States carry an ad valorem tariff (see below) of over 100 percent, thus more than doubling their cost to US consumers. Tariffs raise revenues for the government, discourage imports, and make local goods more attractive.

Quantity limits

Quantity limits, often known as quotas, restrict the number of units that can be imported or the market share that is permitted. If the quota is set at zero, as in the case of Cuban cigars from Havana to the United States, it is called an embargo. If the annual quota is set at 1 million units, no more than this number can be imported during one year; once it is reached, all additional imports are turned back. In some cases a quota is established in terms of market share. For example, Canada allows foreign banks to hold no more than 16 percent of Canadian bank deposits, and the EU limits Japanese auto imports to 10 percent of the total market.

International price fixing

Sometimes a host of international firms will fix prices or quantities sold in an effort to control price. This is known as a cartel, a well-known example is OPEC (Organization of Petroleum Exporting Countries), which consists of Saudi Arabia, Kuwait, Iran, Iraq, and Venezuela, among others (see Table 6.1). By controlling the supply of oil it provides, OPEC seeks to control both price and profit. This practice is illegal in the United States and Europe, but the basic idea of allowing competitors to cooperate for the purpose of meeting international competition is being endorsed more frequently in countries such as the United States.

Non-tariff barriers

Non-tariff barriers are rules, regulations, and nontariff barriers that delay or preclude the purchase of foreign goods. Examples include (1) slow processing of import permits, (2) the establishment of quality standards that exclude foreign producers, and (3) a "buy local" policy. These barriers limit imports and protect domestic sales.

Table 6.1 Members of the Organization of Petroleum Exporting Countries (OPEC), 2007

<table>
<thead>
<tr>
<th>Member country</th>
<th>Quotas (barrels per day)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>610</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1,379</td>
</tr>
<tr>
<td>Iran</td>
<td>3,661</td>
</tr>
<tr>
<td>Iraq</td>
<td>215</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2,105</td>
</tr>
<tr>
<td>Libya</td>
<td>1,299</td>
</tr>
<tr>
<td>Nigeria</td>
<td>2,144</td>
</tr>
<tr>
<td>Qatar</td>
<td>474</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>8,561</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>2,301</td>
</tr>
<tr>
<td>Venezuela</td>
<td>3,029</td>
</tr>
<tr>
<td>Total</td>
<td>26,309</td>
</tr>
</tbody>
</table>

Source: Adapted from www.opec.org

Financial limits

There are a number of different financial limits. One of the most common is exchange controls, which restrict the flow of currency. For example, a common exchange control is to limit the currency that can be taken out of the country; for example, travelers may take up to only $5,000 per person out of the country. Another example is the use of fixed exchange rates that are quite favorable to the country. For example, dollars may be exchanged for local currency on a 1:1 basis without exchange controls, the rate would be 1:1. These cases are particularly evident where a black market exists for foreign currency that offers an exchange rate much different from the fixed rate.

Foreign investment controls

Foreign investment controls are limits on foreign direct investment or the transfer or remittance of funds. These controls can take a number of different forms, including (1) requiring foreign investors to take a minority ownership position (49 percent or less), (2) limiting profit remittance (such as to 15 percent of accumulated capital per year), and (3) requiring royalty payments to parent companies, thus stopping the latter from taking out capital.

Such barriers can greatly restrict international trade and investment. However, it must be realized that they are created for what governments believe are very important reasons. A close look at one of these, tariffs, helps to make this clearer.

Tariffs

A tariff is a tax on goods that are shipped internationally. The most common is the import tariff, which is levied on goods shipped into a country. Less common is the export tariff, for goods sent out of the country, or a transit tariff for goods passing through the country. These taxes are levied on a number of bases. A specific duty is a tariff based on the number of units, such as $1 for each item shipped into the country. So a manufacturer shipping in 1,000 pairs of shoes would pay a specific duty of $1,000. An ad valorem duty is a tariff based on a percentage of the value of the item, so a watch valued at $25 and carrying a 10 percent duty would have a tariff of $2.50. A compound duty is a tariff consisting of both a specific and an ad valorem duty, so a suit of clothes valued at $80 that carries a specific duty of $3 and an ad valorem duty of 5 percent would have a compound duty of $7.

Governments typically use tariffs to raise revenue and to protect local industry. At the same time, these taxes decrease demand for the respective product while raising the price to the buyer. This is illustrated in Figure 6.2, which shows how the quantity demanded decreases.
declines from Q_2 to Q_3 when a tariff drives the price of a good from P_1 to P_2 (the world price plus the tariff). This price increase allows local sellers to sell Q_3 at a lower market share away from foreign firms that were exporting Q_2. However, the figure shows this is done at the price of charging the consumer more money and reducing the number of buyers who purchase the product. At a new price P_2, there are no longer any imports.

There are numerous reasons for using tariffs, such as to protect domestic industries or firms. The US government has used them to prevent foreign companies from selling goods at lower prices in the United States than back home. US auto makers have often accused their overseas rivals of using this tactic. In the case of Japanese car manufacturers, this was a particularly troublesome area when the value of the yen rose sharply in the early 1990s. As a result, the US car companies, imported parts and cars had to reflect the increased value of the yen or be subjected to tariffs. Others have made similar arguments. Einhorn, Kodak, for example, asked the US Commerce Department to impose steep tariffs on the Fuji Photo Film Company. Kodak's argument was partially based on the raising yen. However, it also reflected a concern with dumping, which is the selling of imported goods at a price below cost or below that in the home country. In this case Kodak argued that Fuji sold color photographic paper for less than 20 cents a square foot in the United States, while charging almost 60 cents a square foot in Japan. For an example of a protectionist tactic see the box International Business Strategy in Action: The courier wars.

Another reason for using tariffs is to raise government revenue. Import tariffs, for example, are a major source of revenue for less developed countries. A third reason is to reduce citizens' foreign expenditures in order to improve the country's balance of payments.

Tariffs continue to be one of the most commonly used barriers to trade, despite the fact that they often hurt low-income consumers and have a limited impact, if any, on upper-income purchasers. In recent years most industrialized countries have tried to reduce or eliminate the use of these trade barriers and to promote more free trade policies. The United States is a good example. The trade policies of the EU are discussed in Chapter 16 and those of Japan in Chapter 17.

**US trade policy**

Despite being a highly protective nation in its early years, the United States has a policy today that generally strives to lower tariffs and trade barriers through the use of multilateral agreements. Since the protectionist disaster of the Depression years, the United States has sought to minimize the use of tariffs. It supported the General Agreement on Tariffs and Trade (GATT), and now it supports the 1994 World Trade Organization (WTO), which eliminates most trade restrictions (such as tariffs) among the United States, Canada, and Mexico and extends national treatment to foreign investment, and the Caribbean Basin Initiative, which eliminates tariffs on many imports from the Caribbean and Central American regions.

The move away from tariffs does not mean US trade policy is completely open. The US government employs a variety of approaches to promote or discourage international trade. For example, to encourage trade, there is the North American Free Trade Agreement (NAFTA), which eliminates most trade restrictions among the United States, Canada, and Mexico and extends national treatment to foreign investment, and the Caribbean Basin Initiative, which eliminates tariffs on many imports from the Caribbean and Central American regions. Yet the Trading-with-the-Enemy Act disallows trade with countries judged to be enemies of the United States, including North Korea and Cuba. The US administration has the authority to prevent sales of goods to foreign governments when they are believed to be in the best interests of the United States. These goods can range from computers to chemicals to materials used for making nuclear weapons.
The United States has also used negotiated agreements to limit the type or number of products entering the country. For example, a voluntary agreement with Japan restricts the number of cars imported to the United States. At the same time, exports are encouraged through legislation such as the Foreign Sales Corporation Act, which allows US exporters to establish affiliates in foreign countries and not pay taxes on the affiliates’ income until the earnings are remitted to the parent company. The government also offers trade adjustment assistance to US businesses and individuals who are harmed by competition from imports. This aid takes various forms, including loans for retooling and job counseling for those seeking alternative employment.

**Active learning check**

Review your answer to Active Learning Case question 3 and make any changes you believe. Then compare your answer to the one below.

1. In what way could the EU use trade barriers to protect its markets from foreign competitors? Who could be affected by these trade barriers?

   The EU could take a number of steps to protect its markets from foreign competitors. Examples include establishing or increasing ad valorem tariffs, placing quantity limits on imports, and limiting foreign direct investment. Of course, other countries could retaliate and take similar action against EU-produced goods, so the use of these trade barriers must be selective and should not be undertaken unless efforts at negotiated agreements prove fruitless.

**NON-TARIFF BARRIERS TO TRADE**

The economic effects of non-tariff barriers (NTBs) to trade are roughly similar to those of tariffs. They are inefficient distortions that reduce potential gains from trade. Table 6.2 lists a wide range of NTBs.

NTBs have gained prominence and importance in recent years as nations have begun resorting to them more frequently for protection. Sometimes they are not imposed by countries to interfere deliberately with trade. Rather, they arise out of domestic policy and economic management. Examples include tax breaks to reduce regional income disparities or regulations designed to increase local purchasing or employment. These, in turn, result in a type of indirect export subsidy. Other NTBs are more blatant devices that restrict imports or foster exports.

**Quotas**

The most important NTBs are quotas that restrict imports to a particular level. When a quota is imposed, domestic production generally increases and prices rise. As a result, the government usually ends up losing tariff revenues.

Historically, the GATT and WTO have prohibited import quotas except on agricultural products, as emergency measures, or when a country has short-run balance of payments problems. Countries have circumvented this regulation most notably for textiles, footwear, and automobiles by negotiating voluntary export restraint agreements that are useful in preventing retaliatory action by the importing country. In general, business would rather be protected by quotas than by tariffs. Under quotas, if future domestic demand is known, companies can determine their future production levels. Under tariffs, domestic producers must estimate the elasticity of the demand curve for imported products and the future movements in world prices, which is a more difficult challenge.

**"Buy national” restrictions**

"Buy national" regulations require governments to give preference to domestic producers, sometimes to the complete exclusion of foreign firms. In Europe, for example, many of the telephone, telegraph, electric utility, airline, and railroad industries are government owned and buy from national firms only, thus closing a large market to exporters. On the other hand, countries like the United States have a similarly wide range of inefficient "Buy American" regulations at the national and state levels that discriminate against foreign suppliers. During the 1970s Tokyo Round of the GATT negotiations, a mild code to open up government contracts to foreign suppliers was negotiated. Only 28 governments have agreed to the WTO’s Government Procurement Agreement and these must now publish large procurement contracts to make public the winner’s bid price or the basis for selecting the winning bid.

**Customs valuation**

Also during the GATT Tokyo Round, considerable progress was made in the area of customs valuation for the payment of duties. In the United States, there were nine valuation systems prior to the Tokyo Round. Value for duty is now generally based on the invoice cost, and the latitude of US customs to reclassify products has been reduced.

**Technical barriers**

Product and process standards for health, safety, quality, size, and safety can create trade barriers by excluding products that do not meet them. Testing and certification procedures, such as testing only in the importing country and conducting on-site inspections, are cumbersome, time consuming, and expensive. The costs must be
borne by the exporter prior to the foreign sale. National governments have the right and duty to protect their citizens by setting standards to prevent the sale of hazardous products. But such standards can also be used to impede trade. For example, at one point Japan excluded US-made baseball bats from the market because they did not meet the country’s standard. No product produced outside Japan (even products made by foreign subsidiary of Japanese MNEs) could bear the certification stamp of the Japanese Industrial Standard (JIS) or the Japanese Agricultural Standard (JAS), and selling in Japan without the US JAS logo was difficult. Similarly, at one time the new regulations for automobile safety in the United States required that bumpers be above the height practical for imported subcompact cars, thus creating a technical barrier for these car manufacturers. Today the new code on technical barriers to trade requires consultation between trading partners before a standard that impedes trade is put in place. The code also requires that testing and certification procedures treat imports and domestic goods equally and that the importing country accept certification testing conducted in the exporting country.

**Antidumping legislation, subsidies, and countervailing duties**

The GATT and WTO allow importing countries to protect their producers from unfair competition, such as “dumping” goods at extremely low prices in an effort to gain market share and to drive out local competition. Importing countries are allowed to impose additional duties on products that have received export subsidies or are “dumped.” Before the duties are imposed, however, the country must show that its domestic industry has suffered “material” injury from dumped or subsidized imports. Although products at these artificially low prices provide consumers in the importing country with a “good buy,” such competition is thought to be unfair to domestic producers who object to dumping (and also to subsidized imports that can be offset by “countervailing” duties) if the domestic market of the exporting country is closed to them. A good example is the US auto industry, which claims that some Japanese cars are cheaper in the US market than at home, while Japan continues to impede exports of US cars into Japan.

The GATT and the WTO have developed a code on countervailing duties and antidumping duties that now expedites the process of determining whether exports have been dumped or subsidized and whether the domestic industry has been injured. This subject is exceedingly complex. Here are some examples (and answers):

- **If the EU remits value-added taxes on exports by EU producers, is this a subsidy? (No)**
- **If Canada subsidizes production in a specific sector in one of its depressed regions for domestic purposes, are the exports of a subsidized firm subject to countervailing action? (Yes)**
- **If the British government subsidizes the British steel industry and its losses incurred by selling at home and abroad at prices below full cost, are its exports subject to antidumping or to countervailing duties? (Maybe, sometimes)**

The problem is complex because of the difficulty in determining what material injury is and how it should be measured. This area is likely to be a point of contention for years to come.

**Agricultural products**

Trade in agricultural products is highly regulated by both quotas and fixed and variable tariffs. Domestic producers in most industrialized countries are often highly subsidized both directly and by artificially high domestic prices. Agricultural exports are often subsidized as well. And the EU flatly refused to discuss its Common Agricultural Policy (CAP) at the Tokyo Round. The CAP sets variable tariffs on imports to maintain high domestic prices by excluding or impeding imports. Major reforms in the CAP are now underway that will see continuing support for farmers but independently of production volumes. This is expected to improve the EU’s negotiating position at the WTO. The United States is not without guilt in this area, however, since it also subsidizes the export of many agricultural products. The countries most affected by these subsidies are less developed countries with abundant and inexpensive labor and land and thus a competitive advantage in agricultural products. Agricultural subsidies have often stalled trade talks as these countries refused to further liberalize while developed countries continued to subsidize agriculture.

**Export restraints**

Over the vigorous objections of countries exporting natural resources, the GATT (and WTO) rounds have moved to tighten the conditions under which exports could be restrained. In goods, real tariffs increase with the level of processing; for example, import duties increase as copper is processed from concentrate to blister, to refined copper, to copper wire and bars, to copper pots and pans. This tariff structure makes upgrading of natural resources in the producing country easier. During the Tokyo Round, natural resource-producing countries were largely unsuccessful in their attempts to harmonize tariffs on a sectoral basis in order to increase their ability to upgrade prior to export. However, they did argue successfully for their right to restrict exports to induce further domestic processing.

**OTHER ECONOMIC DEVELOPMENTS**

In addition to the above, other economic developments warrant consideration. These include countertrade, trade in services, and free trade zones.

**Countertrade**

Countertrade is essentially barter trade in which the exporting firm receives payment in terms of products from the importing country. Countertrade is important to the airline industry (for example, the purchase of Boeing 747s by British Airways or Boeing uses Rolls Royce engines) and in defense (for example, the purchase of US jet fighters by Canada if some of the parts are locally sourced in Canada). Barter sometimes takes the form of a buy-back in which the exporter agrees to take products that are locally produced. Countertrade tends to decrease the efficiency of world trade because it substitutes barter for the exchange of goods or the price system. For example, a US exporter of machinery to Indonesia may have to take payment in an “equivalent value” of palm oil or rattan. The exporting firm will then either have to sell these products, in which it has no expertise itself, or sell them through a broker or other firm. Some party to the trade—exporter, importer, or consumer—must bear these additional costs. Despite such obvious inefficiencies, countertrade appears likely to continue as an increasingly important factor in the international trade environment of the twenty-first century.

In one type of situation, however, countertrade may be beneficial. For example, if a US producer of textile machinery export to China and agrees to take payment in the form of textile products, importers in the United States may perceive a lower risk of variability in product quality and delivery schedules (as a result of US technology and management), and the Chinese may perceive a lower risk of product failure in buying the machinery since the selling firm will not be "paid" unless the machinery performs to specifications.
Trade in services

International trade in services has received relatively little attention from governments and trade economists during trade negotiations. Reliable statistics are seldom collected, however, as high-income countries move toward a service economy, trade in services has grown and become a significant component of the current accounts of many countries.

In 2006, the United States exported goods worth $1.024 trillion and imported goods worth $1.868 trillion, which left a deficit of $846 billion on merchandise trade. In that same year, it exported $413 billion and imported $342 billion for a service surplus of $71 billion that partly offset its merchandise trade deficit. And, it had a deficit of $7.3 billion in the net income receipts from US FDI abroad. Thus, the net deficit on these three accounts for the United States in 2006 was $856.7 billion. Details of the US goods, services, and FDI accounts appear in Table 6.3. (The balance of payments account will be explained in the Appendix of this chapter.)

The flow of services across among countries is highly regulated. Internationally traded services such as banking, investment income, insurance, media, transportation, advertising, accounting, travel, and technology licensing are subject to a host of national and international regulations for economic, social, cultural, and political reasons. In 1995, the General Agreement on Trade in Services (GATS) came into effect. It covers all services except those provided by the government and those related to air traffic. Member countries are not forced to open all their service industries but can choose those areas for which they want to guarantee access to foreigners and, within a framework, how much access they want to provide. For example, a host nation might limit the scope of a foreign bank’s operation through the use of licenses or by setting a maximum number of allowable branches. As of January 2006, more than 140 WTO members started negotiating to further liberalize services.

Wherever reform is used, negotiating reductions in service trade barriers will be difficult, complex, and lengthy. The barriers are often difficult to list, much less quantify, and are not always subject to national analysis. For example, Canada imposes Canadian content requirements on television, radio, and print media to foster a “national cultural identity,” to protect its cultural heritage, and to preserve the domestic arts, theater, and movie industries. A government that reduced these trade barriers or even agreed to negotiate them would be in trouble with the (protected) Canadian media, as well as with the general public.

Table 6.3 Overview of the US balance of current account, 2006, preliminary

<table>
<thead>
<tr>
<th>Items</th>
<th>Credits ($ billions of US $)</th>
<th>Debits ($ billions of US $)</th>
<th>Balance ($ billions of US $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade of goods and services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goods, balance of payments basis</td>
<td>1,436.8</td>
<td>2,202.1</td>
<td>765.3</td>
</tr>
<tr>
<td>Services</td>
<td>1,023.9</td>
<td>1,859.7</td>
<td>836.0</td>
</tr>
<tr>
<td>Direct defense expenditures</td>
<td>42.1</td>
<td>232.6</td>
<td>70.7</td>
</tr>
<tr>
<td>Travel</td>
<td>65.7</td>
<td>312.1</td>
<td>70.7</td>
</tr>
<tr>
<td>Transporation</td>
<td>22.7</td>
<td>73.3</td>
<td>12.4</td>
</tr>
<tr>
<td>Other transportation</td>
<td>62.1</td>
<td>27.3</td>
<td>35.4</td>
</tr>
<tr>
<td>Royalties and license fees</td>
<td>68.2</td>
<td>66.6</td>
<td>11.7</td>
</tr>
<tr>
<td>Other private services</td>
<td>177.2</td>
<td>114.9</td>
<td>62.4</td>
</tr>
<tr>
<td>US government miscellaneous services</td>
<td>479.8</td>
<td>879.3</td>
<td>772.1</td>
</tr>
<tr>
<td>Income receipts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct investment receipts/payments</td>
<td>619.1</td>
<td>619.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Other private receipts</td>
<td>220.1</td>
<td>145.6</td>
<td>75.5</td>
</tr>
<tr>
<td>US government receipts</td>
<td>2.4</td>
<td>32.9</td>
<td>10.5</td>
</tr>
<tr>
<td>Compensation of employees</td>
<td>2.4</td>
<td>145.1</td>
<td>142.7</td>
</tr>
<tr>
<td>Unilateral transfers, net</td>
<td>2.4</td>
<td>46.4</td>
<td>44.1</td>
</tr>
<tr>
<td>Total</td>
<td>2,059.8</td>
<td>2,919.5</td>
<td>859.7</td>
</tr>
</tbody>
</table>

Source: Adapted from BLS, Survey of Current Business, June 2007. Take 3 International Trade.
No Mexican taxes are paid on goods processed within the maquiladora. Foreign companies doing such processing can benefit from lower wages and land costs than those of the United States as they increase the value added to their products. In return, Mexican plants create jobs and collects taxes on final products and more than 20 percent of worldwide trade. Free trade zones are advantageous to all because they provide benefits such as reduced trade and lower business costs.

### Key Terms
- International trade
- Mercantilism
- Neo-Mercantilism
- Theory of absolute advantage
- Theory of comparative advantage
- Factor endowment theory
- Heckscher-Ohlin theory
- Leontief paradox
- International product life cycle (IPLC) theory
- Monetary exchange rate
- Quotas
- Embargo
- Cartel
- Non-tariff barriers
- Exchange controls
- Foreign investment controls
- Specific duty
- Ad valorem duty
- Compound duty
- Dumping
- Caribbean Basin Initiative
- Foreign Sales Corporation Act
- Trade adjustment assistance
- Countertrade
- Free trade zone
- Maquiladora industry

### Review and Discussion Questions
1. Why is it difficult to solve international economic problems in the short run?
2. What is the supposed economic benefit of embracing mercantilism as an international trade theory? Are there many disadvantages to the use of this theory?
3. How is the theory of absolute advantage similar to that of comparative advantage? How is it different?
4. In what way does factor endowment theory help explain why nations trade? How does the Leontief paradox modify this theory?
5. If an innovating country develops a new technologically superior product, how long will it be before the country begins exporting the product? At what point will the country begin importing the product?
6. Of what value is the international product life cycle theory in helping to understand why nations trade?
7. How does each of the following trade barriers work: price barriers, quantity limits, international price fixing, non-tariff barriers, financial limits, and foreign investment controls?
8. What are some of the reasons for trade barriers? Identify and describe five.
9. How does the United States try to encourage exports? Identify and describe two ways.
10. Non-tariff barriers have become increasingly predominant in recent years. Describe a non-tariff barrier, and list four types, explaining how the United States does or could use such a device.
11. How does countertrade work? Is it an efficient economic concept?
12 What is a free trade zone? Is it an efficient economic concept?
13 What are two future problems and challenges that will have to be addressed by the international monetary system? Describe each.
14 What is meant by the term balance of payments?
15 What are the three major accounts in the balance of payments?
16 How would the following transactions be recorded in the IMF balance of payments?
   a. IBM in New York has sold an $8 million mainframe computer to an insurance company in Singapore and has been paid with a check drawn on a Singapore bank.
   b. A private investor in San Francisco has received dividends of $80,000 for stock he holds in a British firm.
   c. The US government has provided $60 million of food and medical supplies for
   Kurdish refugees in Turkey.
   d. The Walt Disney Company has invested $50 million in a theme park outside Paris, France.

Real Case

Job losses and offshoring to China

It was not a difficult choice to make. Over the last 10 years, US imports of manufactured goods from China shot up. Cheap labor—Chinese labor is six times cheaper than American labor—accounts for this. Continuing manufacturing operations in the United States and remaining price competitiveness is simply not feasible. When jobs are outsourced across national borders, often from the United States to China, this is called offshoring.

Competition on quality, which can soften domestic manufacturing from outsourcing to developing countries, was not an alternative because Chinese products for export are usually as good (although not in toys as Mattel found in 2007) when high labor intensity is tied to quality, the Chinese can supply Western industrialized countries. Another factor is that the Chinese have a combination of highly skilled management and low-skilled labor, ensuring that production is efficient and that quality standards are met. This ability to produce high-quality goods is also what allows China to move from expert manufacturing of Christmas decorations, toys, locomotives, and clothing to home- hold, consumer appliances, and, increasingly, the IT manufacturing sector.

National Presto, a US firm that makes high-quality pressure cookers and electric frying pans, had a difficult decision to make in the early 2000s. It could either offshore its production to China or see its market share continue to deteriorate. In 2002, the company closed plants in Mississippi and New Mexico, reducing its US workforce to less than half, and expanded its production in China. By 2003, all significant products marketed by the company were made in China.

Like many other US, European, and Japanese companies, National Presto uses an agent in Hong Kong to subcontract production to manufacturing plants in mainland China. Larger companies like Motorola, Philips, IBM, and GE have more control over their manufacturing plants in China. Rycroft of Japan, for example, invested $90 million in the early 2000s to construct a high- tech industrial park in Shanghai’s Zhonggong City.

Government Policy: Only 20 years ago, Guanzhong was dominated by paddy fields, today it is China’s largest manufacturing cluster.

Propontents of free trade argue that political rhetoric against trade with China is meant to appease US fears of job losses. Yet, as seen in the following table, under 2 percent of all job losses in the United States in the first quarter of 2007 were the result of overseas relocation. While some argue that this percentage is underestimated because industry does not take into consideration potential job gains that never materialized, others argue that given economic conditions there was no assurance that firms that created new jobs in China would have chosen to create these jobs in the United States if offshoring to China had not been a possibility.

Real Case

Dumping on trade complaints

One of the biggest problems in international trade is the ability of domestic producers to lobby their home governments to protect them from foreign imports. In the past, the textile, apparel, and shoe industries were able to obtain protection through quotas, tariffs, and special protective measures to restrict foreign trade. In the 1980s and 1990s, the US Department of Commerce was highly successful in restricting imports of products from other countries. This changed with the emergence of new trading partners like China and Mexico, which now produce goods in large quantities.

China has become the world’s largest manufacturer, first in the United States, Japan, and Germany. It has imposed a barrier to the country having the largest country barrier with the United States. US policymakers and lobbyists blame Chinese protectionist practices for the growing trade deficit between the two nations, which in 2008 was estimated at $124 billion. Among the barriers, US trade laws claim that the free flow of its goods to China are import barriers, unclear legal provisions applied in a discriminatory manner against US imports, and an undeclared duty. The last one has generated the most controversy in the last few years. The Chinese yuan has been fixed at 6.8 to the dollar since 1994, a rate that critics argue is too low, placing the Chinese economy at an unfair advantage.

A variety of studies have found that the bureaucrats who administer AD and CVD laws are subject to corruption. For example, the US Department of Commerce, especially antidumping (AD) and countervailing duty (CVD) sections. The economic logic of AD and CVD makes some sense. It is unfair for a foreign company to "dump" a product in your country below its price in the home country, or below the cost of producing it. Similarly, subsidized foreign products should be offset by a CVD of equivalent amount. The problem, however, lies with the administration of the trade laws, which is subject to political lobbying.
of the unresolved problems is how smaller countries can secure access to the protected markets of tried economies such as the United States and the EU. In Japan’s case, there are similar arguments excluding those from its triad rival as to whether it has entry barriers in place preventing market access.

Website: minnextra.org

ENDNOTES

5 For additional insights into trade theory, see, for example, Diehl, “New International Trade Theorists and Narvaez 1990: Some Results Relevant to EFTA Countries,” Journal of Common Market Studies, September 1989, pp. 33-74.

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Coads, Klaus Gauster and Speyer, Bernhard (eds.). The World Trade Organization (Cambridge: Cambridge University Press, 2010).

17 As an example, see Clyde H. Fitchett, “US Steel Computer for Brazil,” International Herald Tribune, April 13-14, 1991, p. 3.

CHAPTER 6: INTERNATIONAL TRADE

APPENDIX TO CHAPTER 6: BALANCE OF PAYMENTS

How well do we keep track of the millions of transactions that take place annually among exporters and importers, international banks, and multinational companies? The business who tabulate the foreign exchange dealings of their own banks are only a part of the picture. How well can we account for the proceeds that occur through overseas borrowings, yet affects the home country's international economic policies? Even more simply, how well can we measure "international" transactions that are simply transfers of funds from the account of one importer to the account of another foreign exporter in the same bank? The realistic answer to these questions is: not very well. National government accounts elaborate accounts for the transactions between their residents and foreign residents, but it is often very difficult to obtain full and accurate information. Putting that problem aside for the moment, let us consider the methods that governments use to record each country's international transactions.

The most widely used measure of international economic transactions for any country is the balance of payments (BOP). This record attempts to measure the full value of the transactions between residents of one country and residents of the rest of the world for some time period, typically a year. The balance of payments is a flow concept, in that it records flows of goods, services, and transfers between countries over a period of time, rather than a stock of accumulated funds or products. It is a value concept, in that all items recorded receive a monetary value, denominated in the given country's currency at the time of those transactions. The balance of payments thus is a record of the value of all the economic transactions between residents of one country and residents of all other countries during a given time period.

Why do we worry about measuring these transactions? We do so because a country records a substantial imbalance between inflows and outflows of goods and services for an extended period of time, some means of financing or adjusting away the imbalance must be found. For example, if the European countries record a persistent trade deficit for several years, there will be pressure either to devalue the currency relative to the Chinese currency, the yen, or for Chinese investors to place large and continuing investments into Euro-denominated securities. This pressure presents both a political outcome (pressure on the Chinese government to revalue the renminbi) and an economic outcome (pressure on the euro to devalue and on European producers to lower their costs, perhaps by producing in China).

So, the importance of the balance of payments is not only macroeconomic, in the domain of government accountants, but also managerial, since an imbalance provides guidance to managers about expected government policies as well as about opportunities to take advantage of currency opportunities. Since the relatively open foreign exchange markets of many countries today leave the exchange rate substantially to supply and demand, the balance of payments is an indicator of exactly that supply and demand for a country's currency that will lead to changes in the exchange rate.

The supply and demand for a currency come from both trade flows (exports and imports) and capital flows (investments and borrowing). So, the balance of payments implications for exchange rates must include both sides of the story: the "real" flows and the financial flows.

Balance of payments accounting

There is no such thing as the balance of payments, since the accounts are organized in a double-entry bookkeeping system, and for every debit entry there is a credit entry of equal

value. There are half a dozen BOP measures, which group some international transactions together and leave others in a second, "everything else" category. In each case the intent is to place the fundamental economic causes of transactions in the first group and leave the payments for them in the second group. In the actual accounts, the former transactions are listed above the line, and the payments are left below the line.

Current account

The current account consists of merchandise trade, services, and unilateral transfers. (See Table 6A, parts A and B.) Merchandise trade is typically the first part of the current account. It receives more attention than any of the other accounts because this is where the imports and exports of goods are reported, and these are often the largest single component of all international transactions. In this account, the balance of goods to foreign exporters is reported as credits

<table>
<thead>
<tr>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Goods, services, and income:</td>
<td>B Goods, services, and income:</td>
</tr>
<tr>
<td>1. Merchandise</td>
<td>1. Merchandise</td>
</tr>
<tr>
<td>2. Unilateral transfers:</td>
<td>2. Unilateral transfers:</td>
</tr>
<tr>
<td>3. Private</td>
<td>3. Private</td>
</tr>
</tbody>
</table>

Table 6A: Balance of payments: IMF presentation
Table 6A (Continued)

<table>
<thead>
<tr>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Increased investment in foreign enterprises controlled by residents, including reinvestment of earnings</td>
<td>(a) Decreased investment in foreign enterprises controlled by residents</td>
</tr>
<tr>
<td>(b) Decreases in investment by residents in domestic enterprises controlled by foreigners</td>
<td>(b) Increases in investment in domestic enterprises by foreigners</td>
</tr>
<tr>
<td>2 Portfolio investment</td>
<td></td>
</tr>
<tr>
<td>(a) Increases in investment by residents in foreign securities</td>
<td>(a) Decreases in investments by residents in foreign securities</td>
</tr>
<tr>
<td>(b) Decreases in investment by foreigners in domestic securities such as bonds and corporate equities</td>
<td>(b) Increases in investment by foreigners in domestic securities</td>
</tr>
<tr>
<td>(c) Long-term loans to foreigners by resident banks and private parties</td>
<td>(c) Foreign loan reductions</td>
</tr>
<tr>
<td>(d) Loan repayments by residents in foreign banks or private parties</td>
<td>(d) Sales to foreigners of government securities</td>
</tr>
<tr>
<td>5 Other short-term, official</td>
<td></td>
</tr>
<tr>
<td>(a) Short-term loans to foreigners by central government</td>
<td>(a) Short-term loans to resident central government by foreigners</td>
</tr>
<tr>
<td>(b) Purchase from foreigners of government securities; decrease in liabilities constituting reserves of foreign authorities</td>
<td>(b) Foreign sales of short-term resident government securities; increases in liabilities constituting reserves of foreign authorities</td>
</tr>
<tr>
<td>6 Other short-term, private</td>
<td></td>
</tr>
<tr>
<td>(a) Increases in short-term foreign assets held by residents</td>
<td>(a) Decreases in short-term foreign assets held by residents. Increase in foreign liabilities of residents. Increase in foreign liabilities of short-term domestic liabilities to foreigners</td>
</tr>
<tr>
<td>(b) Decreases in domestic assets held by foreigners, such as bank deposits, securities, debts to banks, and commercial claims</td>
<td>(b) Decreases in foreign liabilities of residents. Increase in foreign liabilities of short-term domestic liabilities to foreigners</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-1</td>
<td>Merchandise imports</td>
</tr>
<tr>
<td>C-4b</td>
<td>Increase in domestic short-term assets held by foreigners</td>
</tr>
</tbody>
</table>

The result of this purchase is that the United States has transferred currency to foreigners and thus reduced its ability to meet other claims.

**Services**

The services category includes many payments such as freight and insurance on international shipments (A-2); tourist travel (A-3); profits and income from overseas investment (A-4); personal expenditures by government, civilians, and military personnel overseas (A-5); and payments for management fees, royalties, film rental, and construction services (A-6). Purchases of these services are recorded as debits, while sales of these services are similar to exports and are recorded as credits. For example, extending the earlier example of Nissan and GM, assume that the US auto maker must pay $125,000 to Nissan to ship the engines to the United States. The transaction would be recorded this way:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-2</td>
<td>Shipment</td>
</tr>
<tr>
<td>C-4b</td>
<td>Other short-term, private capital</td>
</tr>
</tbody>
</table>

GM purchased a Japanese shipping service (a debit to the current account) and paid for this by increasing the domestic short-term assets held by foreigners (a credit to the capital account).

**Unilateral transfers**

Unilateral transfers are transactions that do not involve repayment or the performance of any service. Examples include the American Red Cross sending $10 million in food to refugees in Somalia; the United States paying military pensions to residents of the Philippines who served in the US Army during World War II; and British workers in Kuwait shipping money home to their families in London. Here is how the American Red Cross transaction would appear in the US BOP:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>D-1</td>
<td>Unilateral transfers, private</td>
</tr>
<tr>
<td>A-1</td>
<td>Merchandise exports</td>
</tr>
</tbody>
</table>
Capital account

Capital account items are transactions that involve claims in ownership. Direct investment (C-1) involves managerial participation in a foreign enterprise along with some assets that involve degree of control. The United States classifies direct investments as those investments that give the investor more than 10 percent ownership. Portfolio investment (C-2) is investment designed to obtain income or capital gains. For example, if Exxon shipped $20 million of equipment to an overseas subsidiary the entry would be:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>C-1</td>
<td></td>
</tr>
<tr>
<td>A-1</td>
<td>$40 million</td>
</tr>
</tbody>
</table>

“Other long-term” capital accounts are differentiated based on whether they are government (C-3) or private (C-4) transactions. These transactions have a maturity of over one year and involve either loans or securities. For example, Citibank may have loaned the government of Poland $50 million. “Other short-term” capital accounts are also differentiated based on whether they are governmental (C-5) or private (C-6). Typical short-term government transactions are short-term loans in the securities of other governments. Private transactions often include trade bill acceptances or other short-term claims arising from the financing of trade and movements of money by investors to take advantage of interest differentials among countries.

Official reserves

Official reserves used for bringing BOP accounts into balance. There are four major types of reserves available to monetary authorities in meeting BOP deficits (D1 through D4 in Table 6A). These reserves are analogous to the cash or near-cash assets of a private firm. Given that billions of dollars in transactions are reported in BOP statements, it should come as no surprise that the amount of recorded debts is never equal to the amount of credits. This is why there is an entry in the reserve account for net errors and omissions; if a country’s reporting system is weak or there are a large number of clandestine transactions, this discrepancy can be quite large.

US BOP

The official presentation of the US BOP is somewhat different from the IMF format presented in Table 6A. Because the United States plays such a dominant role in the world economy, it is important to examine the US system. Table 6B presents US international transactions for two recent years. A number of select entries in Table 6B help to highlight the US BOP. Lines 2 and 19 show that in 2006 exports of goods and services were $765.3 billion (line 71) less than imports. This trade deficit was greater than that in 2001 when it stood at $521.7 billion, and 2003 when it was $449.5 billion, showing that the United States continues to have trade deficit problems.

To assess the trade situation accurately, however, we need to examine the data in more depth. This information is provided in Table 6C. The table shows that although US exports are strong in areas such as capital goods and industrial supplies and materials, the country also imports a large amount of these products. In addition, the United States is a net importer of foods, feeds, and beverages, automotive vehicles and parts, consumer goods, and petroleum and products.

<table>
<thead>
<tr>
<th>Line</th>
<th>(Credits +, debits –)</th>
<th>2006 in millions of US $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Exports of goods and services and income receipts</td>
<td>$2,056.826</td>
</tr>
<tr>
<td>2</td>
<td>Exports of goods and services</td>
<td>$1,955.166</td>
</tr>
<tr>
<td>3</td>
<td>Goods, balance of payment basis</td>
<td>$1,022.629</td>
</tr>
<tr>
<td>4</td>
<td>Services</td>
<td>$413.127</td>
</tr>
<tr>
<td>5</td>
<td>Transfers under US military agency sales contracts</td>
<td>$16.462</td>
</tr>
<tr>
<td>6</td>
<td>Travel</td>
<td>$85.977</td>
</tr>
<tr>
<td>7</td>
<td>Passenger fares</td>
<td>$72.660</td>
</tr>
<tr>
<td>8</td>
<td>Other transportation</td>
<td>$48.708</td>
</tr>
<tr>
<td>9</td>
<td>Royalties and license fees</td>
<td>$62.051</td>
</tr>
<tr>
<td>10</td>
<td>Other private services</td>
<td>$177.384</td>
</tr>
<tr>
<td>11</td>
<td>US government miscellaneous services</td>
<td>$1,145</td>
</tr>
<tr>
<td>12</td>
<td>Income receipts</td>
<td>$622.076</td>
</tr>
<tr>
<td>13</td>
<td>Income receipts of US-owned assets abroad</td>
<td>$619.255</td>
</tr>
<tr>
<td>14</td>
<td>Direct investment receipts</td>
<td>$797.954</td>
</tr>
<tr>
<td>15</td>
<td>Other private receipts</td>
<td>$50.776</td>
</tr>
<tr>
<td>16</td>
<td>US government receipts</td>
<td>$2.469</td>
</tr>
<tr>
<td>17</td>
<td>Compensation of employees</td>
<td>$2.935</td>
</tr>
<tr>
<td>18</td>
<td>Imports of goods and services and income payments</td>
<td>$2,875.261</td>
</tr>
<tr>
<td>19</td>
<td>Goods, balance of payment basis</td>
<td>$2,202.083</td>
</tr>
<tr>
<td>20</td>
<td>Services</td>
<td>$1,869.655</td>
</tr>
<tr>
<td>21</td>
<td>Direct defense expenditures</td>
<td>$31.190</td>
</tr>
<tr>
<td>22</td>
<td>Travel</td>
<td>$73.299</td>
</tr>
<tr>
<td>23</td>
<td>Passenger fares</td>
<td>$57.306</td>
</tr>
<tr>
<td>24</td>
<td>Other transportation</td>
<td>$45.611</td>
</tr>
<tr>
<td>25</td>
<td>Royalties and license fees</td>
<td>$26.923</td>
</tr>
<tr>
<td>26</td>
<td>Other private services</td>
<td>$114.885</td>
</tr>
<tr>
<td>27</td>
<td>US government miscellaneous services</td>
<td>$4.274</td>
</tr>
<tr>
<td>28</td>
<td>Income payments</td>
<td>$629.386</td>
</tr>
<tr>
<td>29</td>
<td>Income payments on foreign-owned assets in the US</td>
<td>$619.867</td>
</tr>
<tr>
<td>30</td>
<td>Direct investment payments</td>
<td>$10.414</td>
</tr>
<tr>
<td>31</td>
<td>Other private payments</td>
<td>$329.231</td>
</tr>
<tr>
<td>32</td>
<td>US government payments</td>
<td>$145.070</td>
</tr>
<tr>
<td>33</td>
<td>Compensation of employees</td>
<td>$9.424</td>
</tr>
<tr>
<td>34</td>
<td>Unilateral current transfers, net</td>
<td>$16,922</td>
</tr>
<tr>
<td>35</td>
<td>US-owned assets abroad, net (increase)/financial inflow</td>
<td>$1,045.750</td>
</tr>
<tr>
<td>36</td>
<td>Foreign-owned assets in the US, net (increase)/financial inflow</td>
<td>$1,346.909</td>
</tr>
<tr>
<td>37</td>
<td>Balance on goods lines 3 and 21</td>
<td>$835.126</td>
</tr>
<tr>
<td>38</td>
<td>Balance on services lines 7, 71, and 72</td>
<td>$70.499</td>
</tr>
<tr>
<td>39</td>
<td>Balance on goods and services lines 2 and 19</td>
<td>$765.267</td>
</tr>
<tr>
<td>40</td>
<td>Balance on income lines 72 and 78</td>
<td>$7,266</td>
</tr>
<tr>
<td>41</td>
<td>Bilateral current transfers, net lines 25, 26, and 28</td>
<td>$84.122</td>
</tr>
<tr>
<td>42</td>
<td>Balance on current account lines 1, 18, and 25 or lines 73, 74, and 79</td>
<td>$665.635</td>
</tr>
</tbody>
</table>


In the early 1980s US trade deficits were offset by large amounts of income generated by direct investments abroad. Later in the decade massive international borrowing offset these deficits. More recently the situation has improved somewhat, and dollar devaluation has helped to generate stronger demand for US exports, thus partially reducing the growth rate of its annual trade deficit. However, more concerted action will be needed if the United States is to continue on this course. One way is to increase US competitiveness.
in the international market. Another way is to get other countries to reduce their trade barriers and to make international markets more open.

When a country suffers a persistent balance of trade deficit, the nation will also suffer from a depreciating currency and will find it difficult to borrow in the international capital market. In this case there are only two choices available. One is to borrow from the IMF and be willing to accept the restrictions that the IMF puts on the country, which are designed to introduce austerity and force the country back onto the right economic track. The other approach is for the country to change its fiscal policy (taxes and taxes), resort to exchange controls, or devalue its currency. To prevent having to undertake austerity steps, the United States will have to continue working very hard to control its trade deficit.

### Table 6C US merchandise trade, 2006

<table>
<thead>
<tr>
<th>Category</th>
<th>2006 billions of US $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports</td>
<td>1,023,109</td>
</tr>
<tr>
<td>Foods, feeds, and beverages</td>
<td>65,942</td>
</tr>
<tr>
<td>Industrial supplies and materials</td>
<td>276,965</td>
</tr>
<tr>
<td>Capital goods, except automotive</td>
<td>413,874</td>
</tr>
<tr>
<td>Automotive vehicles, engines, and parts</td>
<td>107,161</td>
</tr>
<tr>
<td>Consumer goods, except automotive</td>
<td>129,182</td>
</tr>
<tr>
<td>Other</td>
<td>43,589</td>
</tr>
<tr>
<td>Imports</td>
<td>1,061,580</td>
</tr>
<tr>
<td>Foods, feeds, and beverages</td>
<td>74,038</td>
</tr>
<tr>
<td>Industrial supplies and materials</td>
<td>671,988</td>
</tr>
<tr>
<td>Capital goods, except automotive</td>
<td>618,271</td>
</tr>
<tr>
<td>Automotive vehicles, engines, and parts</td>
<td>216,640</td>
</tr>
<tr>
<td>Consumer goods, except automotive</td>
<td>442,975</td>
</tr>
<tr>
<td>Other</td>
<td>59,487</td>
</tr>
</tbody>
</table>

America’s Mega-Regional Trade Diplomacy: Comparing TPP and TTIP

Daniel S. Hamilton

The United States is currently negotiating two massive regional economic agreements, one with 11 Asian and Pacific Rim countries and the other with the 28-member European Union. The Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) herald a substantial shift in US foreign economic policy as Washington turns its focus from the stalemated Doha Round of multilateral trade negotiations and scattered bilateral trade agreements to ‘mega-regional’ trade diplomacy. As the only party to both negotiations, Washington seeks to leverage issues in one to advance its interests in the other, while reinvigorating US global leadership.

Keywords: trade, investment, services, TPP, TTIP, United States, European Union, Japan, China, foreign policy

Since becoming US Secretary of State in 2013, John Kerry has become fond of saying that “foreign policy is economic policy”. The Obama administration is trying to translate that phrase into substantial advantage for the United States as it negotiates two massive regional economic agreements, one with 11 Asian and Pacific Rim countries and the other with the 28-member European Union. These two negotiations – the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) – herald a substantial shift in US foreign economic policy as Washington turns its focus from the stalemated Doha Development Round of multilateral trade negotiations and successful ratification of scattered bilateral trade agreements with Columbia, Panama and the Republic of Korea, to ‘mega-regional’ trade diplomacy.

If both deals are successful, the US and its partners will have opened trade and investment across both the Atlantic and the Pacific with countries accounting for two-thirds of global output. As the only party to both initiatives, the negotiations give the US a distinct advantage in leveraging issues in one forum to advance its
interests in the other, while potentially reinvigorating US global economic leadership and supporting a number of broader US goals.

Comparing TPP and TTIP

The Trans-Pacific Partnership, or TPP, includes 12 Pacific Rim countries (the United States, Australia, New Zealand, Canada, Mexico, Peru, Chile, Singapore, Brunei, Vietnam, Malaysia, and Japan). Together they account for about one-third of international trade and produce about USD 28 trillion annually, about 37 percent of global output. TPP negotiating partners accounted for 40 percent of US goods trade in 2012. A significant portion of this is a ‘North American’ story rather than a ‘Pacific’ story, since Canada and Mexico are by far the largest US trading partners among TPP countries in goods, and both are significant US services trade and investment partners. Japan is the third largest US–TPP goods trade partner, and second largest services trade and investment partner. The 12 TPP countries are all members of the 21-member Asia-Pacific Economic Cooperation (APEC) forum.¹ Leaders have stated explicitly that TPP could expand to include more APEC countries, which together account for 45 percent of the world’s people, over half of global production, over 60 percent of overall US trade and about one-quarter of the stock of foreign direct investment (FDI) into and out of the United States.²

The Transatlantic Trade and Investment Partnership, or TTIP, includes the US and the 28 member states of the European Union, represented in negotiations by the European Commission. Together the US and EU account for three-quarters of global financial markets, 50 percent of world GDP in terms of value and 41 percent in terms of purchasing power, 40 percent of world trade in services and one-third of global trade in goods. The dynamic interaction between investment and trade distinguishes the transatlantic economy from all others. Together the US and EU account for 57 percent of the inward stock of FDI worldwide and a whopping 71 percent of outward stock of FDI globally. In addition, they have investments of more than USD 3.7 trillion in each other’s economies, and each allots over half of its outward foreign investment to the other. Transatlantic investment flows of nearly USD 2.7 trillion dwarf those between any other continents. On a historic

¹APEC consists of Australia, Brunei, Canada, Chile, China, Hong Kong (officially Hong Kong, China), Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, South Korea, Taiwan (officially, Chinese Taipei), Thailand, the United States and Vietnam.
cost basis, the US investment position in Europe was nearly 4 times larger than in all of Asia at the end of 2011. In 2012, US affiliate income from Europe – USD 160 billion – was more than the combined US affiliate income from Latin America (USD 67 billion) and Asia (USD 57 billion). Foreign affiliate sales of services, or the delivery of transatlantic services by foreign affiliates, are far more important than cross-border trade in services, and have exploded on both sides of the Atlantic over the past few decades, topping more than USD 1 trillion. Under new WTO/OECD ‘value-added’ calculations, the US in 2009 was the major customer and supplier for Germany, the UK, France and Italy. Germany followed only Canada as the most important export market for the United States, ahead of Mexico, China and Japan.

Varying impact

While it is practically impossible to quantify the economic impact of successful TPP or TTIP negotiations, some attempts have been made. Petri and Plummer estimate that a successful TPP agreement could generate USD 295 billion in annual global income gains by 2025. They estimate that Japan would gain USD 119 billion annually and the United States would gain USD 78 billion annually. Benefits from a full APEC agreement would be even higher. Regarding TTIP, an independent study by the Centre for Economic Policy Research forecasts that an ambitious and comprehensive agreement could generate USD 159 billion in annual economic gains for the EU, USD 127 billion a year for the United States, and boost global income by almost USD 134 billion. Members of either TPP or TTIP would enjoy larger benefits than those expected from the World Trade Organisation’s (WTO) Doha Development Agenda.

These calculations may be underestimating the full impact of such agreements because of a relatively new, and potentially revolutionary development – America’s rise as an energy power. Surging domestic oil and gas production, driven in large part by hydraulic fracturing and horizontal drilling techniques that have unlocked previously inaccessible reserves of oil and gas, is transforming the North American – and potentially global – energy landscape and has positioned the United States

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5Petri and Plummer, *Trans-Pacific Partnership and Asia-Pacific Integration*, http://www.iie.com/publications/pb/pb12-16.pdf. Hufbauer, Schott and Foong (*Figuring Out the Doha Round*) estimated the benefits from a Doha Development Agenda agreement in the USD 63 billion to USD 283 billion range, although these estimates are not directly comparable to Petri and Plummer’s estimated results from TPP because they are not scaled to the economy of 2025.
6Francois et al., *Reducing Trans-Atlantic Barriers to Trade and Investment*.
to export natural gas abroad. Key partners in Europe as well as Pacific partners such as energy-dependent Japan are looking to the US as a new energy source. US law, however, currently limits natural gas exports to countries with which the United States has a free trade agreement. This gives some partners considerable motivation to move quickly to such an agreement with the United States. A surge in transatlantic and transpacific energy trade would generate even greater benefits than most calculations have shown.

**TPP, TTIP, and US economic statecraft**

As both an Atlantic and a Pacific power, the US is in a unique position to leverage one set of negotiations to support its interests in the other, while using each to advance a number of broader US goals.

First, the two mega-deals reflect US interest in continuing a strategy of ‘competitive liberalisation’ in which free trade agreements with some countries spur others to engage in trade liberalisation as well, thus leading to overall expansion of trade globally.\(^8\) The US conducts this strategy not only through the TPP and the TTIP but via other plurilateral negotiations as well, for instance ongoing talks on the International Services Agreement and negotiations to expand the WTO’s Information Technology Agreement.

Second, the TPP and TTIP reflect a frustration by Washington and its partners with the stalemated WTO Doha Development Round of multilateral trade negotiations. The WTO was created in 1995 as the primary forum for liberalising global trade, but it has foundered, and countries have rushed to conclude bilateral and regional trade deals – more than 250 since the WTO was created, and 319 now in force worldwide.\(^9\) In Washington’s view, successful TPP and TTIP negotiations might create momentum that could in fact push Doha forward. In addition, if TPP and TTIP partners went even further and codified and aligned their existing free trade agreements with all others with whom they have such free trade agreements, such a step would be a major boost to the global trading order. The feasibility of such a step, however, is subject to considerable debate.

Third, TPP and especially TTIP negotiations extend far beyond traditional free trade agreements. Each has a free trade component, but each also includes

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\(^8\)The United States now has FTAs in force with 19 countries, including Australia, Bahrain, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, Mexico, Morocco, Nicaragua, Oman, Panama, Peru, South Korea and Singapore. Cooper et al., *The Trans Pacific Partnership Negotiations*; Williams, *Comparative Trade and Economic Analysis*, http://fpc.state.gov/documents/organization/203883.pdf.

\(^9\)An agreement on trade facilitation was in fact reached by WTO members in Bali in December 2013, but the overall Doha Round has been underway for over 12 years with no agreement in sight. See http://www.wto.org; also Bergsten and Cline, *Trade Policy in the 1980s*. 
negotiations over additional disciplines, as well as standards, norms and regulatory coherence. The TPP and TTIP offer the US an opportunity to influence the formulation of standards and the establishment of norms among very diverse economies in the Asia-Pacific, while deepening shared US-EU norms as a core for global standards. In many cases, the standards being negotiated are intended to be more rigorous than comparable rules found in the WTO. Agreement on such issues as intellectual property, services, discriminatory industrial policies or state-owned enterprises could strengthen the normative underpinnings of the multilateral system by creating benchmarks for possible future multilateral liberalisation under the WTO.10 “Our goal,” US Vice President Joe Biden announced in April 2013, “is for high standards ... to enter the bloodstream of the global system and improve the rules and norms.”11

In Washington’s view, TPP and TTIP also create economic partnerships that can lock in commitments made by individual countries such as Vietnam to domestic reforms and open commerce, or to provide additional impetus to partners to implement commitments they have made yet not fulfilled, such as the EU’s intention to create a single market in services.

Greater trade and investment opportunities and alignment on high standards and norms are important not only in terms of how the US and its partners relate to each other, but how they together might best relate to rising powers, especially emerging growth markets, whose leaders are still debating their role in the international system. Whether those powers choose to challenge the current international economic order and its rules or promote themselves within it depends significantly on how the US and its partners engage, not only with them but also with each other. The stronger those bonds, the better the chances that rising partners will emerge as responsible stakeholders in the international trading system. The looser or weaker those bonds, the greater the likelihood that rising powers will challenge this order.

Each agreement is also important to Washington in its own regional context. The TPP provides a significant underpinning to the Obama administration’s ‘rebalance’ to Asia, including efforts to avoid being marginalised from a region in which China’s influence is growing and rival trade pacts are gathering momentum. Asia-Pacific countries have concluded more than 180 preferential trade agreements, most of which do not include the United States.12 The most significant perhaps is a parallel ‘Asian’ cluster of agreements centred on the Association of Southeast Asian Nations (ASEAN). Japan, South Korea and China have also initiated free trade talks, though current political issues among the three have slowed progress.

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10Cooper et al., The Trans Pacific Partnership Negotiations; Williams, Trans-Pacific Partnership Countries; Akhtar and Jones, Proposed Transatlantic Trade and Investment Partnership.
11Vice President Joseph P. Biden, 5 April 2013, cited in Cooper et al., ibid.
ASEAN’s Regional Comprehensive Economic Partnership, known as the RCEP, which is being negotiated by Australia, China, India, Japan, South Korea and New Zealand, is intended as a traditional free trade agreement focused on reducing trade tariffs. It excludes the US and it excludes provisions important to US interests, such as services, investment or intellectual property rights. The TPP, in contrast, is far more ambitious and offers the US a mechanism through which it can help shape the economic – and political – architecture of the Asia-Pacific region. Former US National Security Adviser Thomas Donilon called the TPP “the centerpiece of our economic rebalancing... . We always envisioned the TPP as a growing platform for regional economic integration.”

Although the TPP has been portrayed as an effort to contain China, it does not preclude Chinese entry since China, like any other APEC economy, has the right to request participation in the TPP. In this regard, the TPP is less about excluding China than defining the terms of its integration into the regional and global economy. Currently, China does not meet some basic criteria of TPP negotiating partners in terms of such issues as government controls, labour standards, intellectual property protection and currency conversion. The question is whether the TPP will be a strong enough inducement in terms of potential benefits to the Chinese economy to prompt Beijing to accelerate domestic reforms so that it can accede to the TPP and adhere to its negotiated disciplines. Deutsche Bank estimates that China’s TPP accession could increase the country’s real GDP by 2.0 percent due to trade liberalisation alone. Other TPP requirements, including liberalisation of investment regimes and capital accounts, freer competition and protection of intellectual property rights, would have significant additional effects on China. In the end, the degree to which TPP participants are prepared to include China, as well as China’s willingness or interest in participating in a comprehensive, high-standard agreement, will help determine if the TPP truly has the potential to become the basis of a far wider Asia-Pacific free trade agreement. Thus far, Beijing has reacted by promoting its own trade initiatives in Asia, although it is joining the plurilateral talks on the International Services Agreement and there are some indications that it may be considering joining the TPP.

The TTIP is similarly important in terms of US relations with Europe. The TTIP is about more than trade. At its core, it is about generating regulatory coherence and breaking down barriers to transatlantic commerce in ways that can generate growth and jobs without piling on debt. It is also about creating a more strategic, dynamic and holistic US–EU relationship that is better positioned with regard to third countries to open markets and strengthen the ground rules of the

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international order. There is also a reassurance element to the TTIP. Many view NATO as wobbly, and many Europeans are worried that the US rebalance to Asia will translate into less US attention and commitment to Europe. Creation of what would essentially be a Euro-American market of over 800 million people from Hawaii to the Baltic and Black Seas, together with a commitment to work together to advance core Western norms and standards, would offer reassurance that Europe is in fact America’s ‘partner of choice’. In this regard, TTIP has the potential to serve as a new binding element for the transatlantic partnership. It is not an ‘economic NATO’ – a term that can easily be misinterpreted – but it could be a second transatlantic anchor, rooted in deep and growing transatlantic economic integration. TTIP could be both a symbolic and a practical assertion of Western renewal, vigour and commitment, not only to each other but to high rules-based standards and core principles of international order. It is an initiative that can be assertive without being aggressive, and that challenges fashionable notions about a ‘weakened West’.

**Key differences**

While US goals for the TPP and TTIP are similar in some respects, there are also important distinctions. The first has to do with timing. The two negotiations are at different stages. There have been over 20 TPP negotiating rounds, whereas the United States and the European Union launched the TTIP only in early 2013 and conducted just three rounds of negotiations in 2013. TPP is thus further along, although Japan’s recent entry into the talks may slow them down. Since the TPP is likely to be concluded and considered for legislative approval ahead of the TTIP, it – more than the TTIP – is likely to be the lightening rod for US domestic debates about the value of additional trade agreements. US domestic stakeholders traditionally concerned about such agreements – including labour, consumer and environmental groups, each important to the Democratic Party – have been vocal in expressing concerns, and in some cases opposition, to the TPP. Such stakeholders have been relatively less vocal, however, with regard to the TTIP, largely because the EU upholds high protection for labour, as well as consumer and environmental standards.

The two arrangements also differ in that Washington is negotiating with only one party in TTIP (although in the end the European Commission will need support from 28 member states), with which it does not have a free trade agreement, whereas in TPP it is negotiating with 11 other parties, six of which already have free trade agreements with the US – Canada, Mexico, Australia, Chile, Peru and Singapore. But the negotiations also include five countries with which the US does not have a free trade agreement – Brunei, Malaysia, New Zealand, Vietnam and, most importantly, Japan, the world’s third largest economy, which accounted for 6
percent of all US goods trade in 2012 and 7 percent of all US services trade in 2011. This means that while the US and the EU share one overarching agenda for negotiations, TPP negotiations are divided in focus and content depending on the country, with the US negotiating market access for goods, services and agriculture with its ‘non-FTA’ countries.

The TPP’s diversity in trade partners is further enhanced by the fact that it includes a far more disparate set of countries than the TTIP, including advanced industrialised, middle income, and developing economies, which creates its own set of challenges in achieving a comprehensive and high standard agreement. This diversity has led the Asian Development Bank to express concern that the TPP could degenerate “into a series of loosely tied bilateral deals”. The US and the EU, in contrast, are far more homogenous; they account for two-thirds of the world’s high-income countries and each has generally strong protections for investors, intellectual property rights, labour and the environment – although those differences that do exist have proven tough to align in the past.

Another important distinction between the TPP and TTIP relates to the use of the term ‘living agreement’. The TPP has been envisaged as a living agreement with two components. First, TPP leaders have declared that a TPP agreement will not necessarily be concluded with a final document, but will “evolve in response to developments in trade, technology or other emerging issues”. This means that various mechanisms are likely to be set in place to address the regulatory impact of new innovative technologies for instance, or changing domestic rules among its members.

Second, leaders have used the term ‘living agreement’ to mean that the TPP is an open agreement, and can be expanded “to include other economies from across the Asia-Pacific region”. The TPP has in fact expanded already from an original group of four to the current membership of twelve. While leaders’ statements have charted the TPP’s future as an expansive trans-Pacific agreement, activities to date have focused on attracting other APEC countries. In December 2013 South Korea expressed interest in joining; other potential candidates include Taiwan, Thailand and the Philippines, and perhaps China and even Russia. Non-APEC countries such as Colombia and Costa Rica have also expressed interest, and it is conceivable that even non-Pacific countries could accede to the agreement, once negotiated, in the future. The TPP’s ‘open architecture’ could give it powerful leverage over other

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18TPP Leader’s Statement, Honolulu, Hawaii, 12 November 2011.
19Ibid.
countries seeking to share the benefits of expanded trade and investment and higher standards, and over leaders who would come to understand that if they wanted to reap the TPP’s benefits, they would have to create the domestic conditions that could make future accession possible.

US and EU officials, in contrast, have used the term ‘living agreement’ only in the context of creating a process to address new issues as they evolve; they have thus far been silent as to whether the TTIP, once negotiated, would be open to others willing and able to accede to its provisions. TTIP is unlikely to realise its strategic potential unless and until the US and the EU announce that it, like the TPP, can be expanded to encompass others. Framing the TTIP as an ‘open architecture’ accessible to others could give the West tremendous leverage in terms of ensuring ever broader commitment to the high standards and basic principles governing modern open economies, much as the ‘Open door’ principle guided NATO and EU enlargement and gave the West significant leverage over transitional democracies in central and eastern Europe. The US and the EU have stopped short of that, however, generating considerable uncertainty and concern among other countries – Turkey in particular – whether TTIP is about trade creation or trade diversion.

Once reason why many Turks are interested in TTIP is that it represents a ‘transatlantic form of governance’ as opposed to other models being debated in Turkey, and thus is important as a means to influence Turkey’s own modernisation. Yet the US and EU have not been clear whether Turkey could in fact accede at some point. Turkey has a customs union with the EU, but nothing similar with the US, which means that, under a TTIP, US goods could flow via the EU into the Turkish market without Turkish engagement on the terms. Switzerland and Norway face related issues. NAFTA member Mexico has a rudimentary free trade agreement with the EU, and the EU and Canada are in the process of ratifying their own Comprehensive Economic and Trade Agreement, or CETA, but questions remain whether and how to align such arrangements with the TTIP. The issue of open architecture could have even greater resonance for eastern European countries with whom the EU is negotiating deep free trade agreements, and even for Brazil and other rising economies.

The TPP and TTIP negotiations also differ in terms of the relative weight and focus given by the US on particular issues, reflecting the distinct nature of US commercial ties with each region. A comprehensive review of all issues in the negotiations exceeds the scope of this article, but a brief survey of a few important areas illuminates how Washington is approaching both negotiations, including how it seeks to use one set of negotiations to help advance US interests in the other.

Simply stated, US commercial ties with the Asia-Pacific region are driven primarily by trade in goods, whereas US commercial ties with Europe are driven primarily

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20 Kirisci, *Turkey and TTIP*.
by both investment and trade in services. That does not mean that transpacific
investment or services, or transatlantic goods trade are not important. But it does
indicate where the greatest benefits are to be had from each negotiation.

**Goods Trade**

The major immediate gains from a TPP agreement would come from dismantling
‘at-the-border’ trade tariffs across an ever-wider space in the Asia-Pacific region,
which is likely to make such trade even more of a driver of transpacific commerce.
Transatlantic tariffs on goods, in contrast, are relatively low, although there are
exceptions in some areas. Eliminating such tariffs can still be important, however,
given the size of the US and EU markets. According to the European Centre for
International Political Economy, a Transatlantic Zero Tariff Agreement would lead
to USD 120 billion in added growth in the US and the EU within five years of
signing the agreement. US exports to the EU would increase by USD 53 billion —
five times more than under the 2012 US–South Korea free trade agreement.

Tough market access issues remain, however, particularly in agriculture,\(^{21}\) which
is critical for both the TPP and the TTIP. Although such US industries as dairy
and sugar are wary of additional market concessions, in each negotiation the US is
pressing hard to open agricultural markets. In fact, unless the TPP and the TTIP
offer significant new market access to US agriculture, the US Congress is unlikely
to agree to either deal.

In 2012, two-way US agricultural trade with the other 11 TPP countries totalled
USD 108 billion, with the US recording a USD 10 billion surplus.\(^{22}\) This repre-
sented 44 percent of the combined total of US agricultural exports and imports
with the world. Within TPP, NAFTA countries Canada and Mexico once again
rank as the most important US partners, followed by Japan. Washington is seeking
to use the TPP to open agricultural markets in Malaysia, Vietnam and Japan, the
three commercially-significant countries with which the United States does not yet
have an FTA. Of the three, Japan is the clear prize. Though Japan currently is the
fourth largest US agricultural export market, it protects its producers with very
high tariffs and restrictive quotas. Japan has agreed to abolish tariffs on up to 89
percent of trade items with some TPP members, but that is still far below the
trade liberalisation rate of around 95 percent needed to conclude a successful
agreement.\(^{23}\)

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\(^{22}\)Cooper et al., *The Trans Pacific Partnership Negotiations*.

Historically, agriculture has been the big sticking point to a US-EU trade agreement. Studies generally show that the average EU tariff is two to four times the average US tariff for agricultural products. Most US free trade agreements have no product exclusions – “all tariffs go to zero” is the US mantra on tariff negotiations in free trade agreements. When exceptions have been negotiated, it is for just one or two products, and in many cases these products may avoid a tariff cut but still have to provide new access through expanded tariff-rate quotas. In contrast, in its trade negotiations the European Union has excluded a large number of agricultural products from tariff elimination, and in many cases from any tariff cut at all.24

**Services**

The United States is particularly competitive in services, which provide 83 percent of non-agricultural jobs and over 65 percent of US GDP. In fact, the US has a collective trade surplus both with its TPP partners and with the EU. Moreover, services are provided increasingly through US corporate affiliates based in these countries, rather than by trade, which underscores the importance the US attaches to open flows of foreign direct investment.

Services are the sleeping giant of the transatlantic economy. Most American and European jobs are in the services economy, which accounts for over 70 percent of US and EU GDP. The US and EU are each other’s largest and most profitable commercial partners when it comes to services trade and investment. Deep transatlantic connections in services industries, powered by mutual investment flows, are also the foundation for the global competitiveness of US and European services companies. Yet protected services sectors on both sides of the Atlantic, for example, account for about 20 percent of combined US-EU GDP – more than the protected agricultural and manufacturing sectors combined. Removing barriers in these sectors would be equivalent to 50 years’ worth of GATT and WTO liberalisation of trade in goods.25 Even modest progress could lead to substantial gains for both sides.

Cross-border trade in services, and provision of services through foreign affiliates, are much less developed across the Pacific Basin than trade in goods, and far less developed than transatlantic services trade and investment. Even within TPP, the majority of US services trade and investment is conducted not with partners across the Pacific but with North American partners Canada and Mexico. For instance, Canadian affiliates based in the United States account for up to three-fourths of all services supplied in the US from TPP countries.26 Opening protected services markets and reducing barriers to investment that would enable provision of services in

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26Williams, *Trans-Pacific Partnership Countries*. 
TPP markets by US foreign affiliates would offer significant opportunities to US companies and enhance considerably the overall impact of a deal. In addition, the TPP offers the US some potential leverage with the EU within TTIP. TPP countries have agreed to use the US approach of negotiating services on a ‘negative list’ basis, meaning that all types of services would be included in an agreement unless specifically excluded. Such provisions already are included in US free trade agreements with six of its TPP partners. This approach is generally considered to be more comprehensive than the ‘positive list approach’ used in the GATS and usually used by the EU in the vast majority of its trade agreements. The US is likely to use TPP ‘negative list’ commitments to leverage its negotiations on services-related issues with the EU in the TTIP.

**Investment**

Investment is a primary driver of transatlantic commerce. The United States and EU member states generally have open investment regimes, though certain restrictions remain. The United States has investment treaties with many of the EU’s 27 member states, but has no agreement with the EU itself. Yet in the 2009 Treaty of Lisbon, EU member states relinquished to the European Commission their authority to negotiate investment treaties, thus creating the potential for future legal uncertainty for US companies, absent a US–EU agreement on investment. Such an agreement on investment should be structured around the elimination of ownership restrictions and other investment barriers, alignment of bilateral investment competences, and common approaches to restrictions on investment in third countries. A US–EU investment agreement as part of the TTIP could also strengthen international investment law, and serve as a model for investment agreements worldwide.

Investment is less of a driver of commercial activity between the US and its Pacific TPP partners than between the US and the EU. As with services, over half of TPP FDI flows both into and out of the United States are actually with North American partners Canada and Mexico. US free trade agreements with six of the TPP countries include investment provisions and already cover the countries responsible for the majority of TPP–US FDI flows. However, no other bilateral investment treaties exist between the United States and the remaining TPP countries. Investment provisions in the US–South Korea free trade agreement are likely to serve as a template for US goals with other TPP partners. It requires the parties to treat foreign investors the same way they treat domestic investors (‘national

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27 Cooper et al., *The Trans Pacific Partnership Negotiations*.


29 Australia is the other significant FDI partner in the TPP.
treatment’); bans the expropriation or nationalisation of foreign investments unless they serve a ‘public purpose’; and establishes investor-state dispute settlement provisions designed to resolve disputes between foreign investors and governments. Except for the agreement with Australia, US free trade agreements have included an investor-state provision. The US has also sought to use TPP ‘negative list’ commitments to leverage its negotiation with the EU within the TTIP. The EU did in fact reverse its position and adopted a ‘negative list’ approach in the EU–Canada CETA, and EU negotiators pointed to this switch in their efforts to convince US officials to start the TTIP negotiations.

**Regulatory coherence**

Since ‘at-the-border’ tariff barriers between the US and the EU are generally so low, the biggest overall gain from a TTIP would be to tackle ‘behind-the-border’ regulatory differences. For instance, *The Economist* estimates although EU chemical exports to America face a modest 1.2 percent tariff rate, non-tariff barriers to chemicals result in a tariff equivalent of 19.1 percent.\(^\text{30}\) “Our main ambition,” EU Commissioner Karel de Gucht has stated, “beyond simply reducing tariffs across the board – is to make the EU and the US regulatory systems more compatible and to help shape global rules in trade since this is where the economic and political benefits of a deal lie.”\(^\text{31}\) Estimates indicate that 80 percent of the overall potential wealth gains resulting from TTIP will come from cutting costs imposed by bureaucracy and regulation, as well as from liberalising trade in services and public procurement.\(^\text{32}\) The goal is to build a more integrated transatlantic marketplace, while respecting each side’s right to regulate in a way that ensures the protection of health, safety and the environment at a level it considers appropriate. Regulatory coherence is likely to consist of a number of mechanisms, including mutual recognition agreements in which officials on each side agree to accept products or services from the other side based on a ‘tested once’ criterion for specific sectors and products. Where harmonisation or mutual recognition of existing regulations and standards cannot be achieved, then the TTIP seeks to create other forward-looking mechanisms to head off conflicts, including early consultations, impact assessments and regulatory reviews.

There are challenges, and a number of seemingly intractable issues remain. Some regulatory differences relate to divergent public preferences and values, for instance


\(^\text{31}\)Statement by EU Trade Commissioner Karel De Gucht on the Transatlantic Trade and Investment Partnership (TTIP) prior to the second round of negotiations, Brussels, 30 September 2013.

attitudes towards genetically-modified foods. In the face of high levels of concern in some EU countries that the TTIP may open the door to such US foods in Europe, EU officials have been adamant that the TTIP will not force the EU to change laws intended to protect human life and health, animal health and welfare, and that environment and consumer interests will not be part of the negotiations. This includes genetically-modified organisms. The intent, rather, is to improve US–EU exchange of information on policy, regulations and technical issues without affecting safety assessment and risk procedures carried out by the European Food Safety Authority.

Regulatory talks in the TPP are less ambitious than in the TTIP, although in some areas such as human health and animal/plant safety they are intended to secure commitments beyond those found in the WTO. In essence, the US is seeking to lift and align regulatory mechanisms among TPP countries, for instance through the creation of domestic regulatory structures similar to the US Office of Information and Regulatory Affairs in the Office of Management and Budget and similar approaches to regulatory impact assessments; use of cost-benefit analysis and procedures for assessing alternatives to regulation; and introduction of transparency in regulatory processes. The more compatible the regulatory systems of TPP countries, the more seamlessly US companies can operate in TPP markets.

Since the US and the EU already have high regulatory standards, the TTIP is not just about regulatory coherence across the Atlantic. Both sides hope that by aligning their domestic standards, they will be able to set the benchmark for developing global rules in ways that avoid lowest-common denominator outcomes when dealing with rising powers that may not necessarily share the same such standards with regard to health and safety or consumer, worker and environmental protection.

In this sense, a successful TTIP would actually be a TPP-plus agreement with regard to regulatory coherence. Its impact would stretch beyond transatlantic markets and would have considerable impact on countries in Asia and elsewhere. Since TTIP regulatory standards could be higher in many areas than TPP standards, Asian companies – and others – would have to orient to these higher standards if they wish to engage with the US and EU markets, which account for two-thirds of the world’s high-income economies.

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33Cooper et al., The Trans Pacific Partnership Negotiations.
Government procurement

On all the issues outlined so far, the United States is using one negotiation to help advance its interests in the other. In the case of government procurement, however, the EU and TPP partners are seeking to squeeze Washington.

The United States is a member of the plurilateral WTO Government Procurement Agreement (GPA), and US agreements with Canada and Mexico through NAFTA and US FTAs with Australia, Peru, Chile, and Singapore include chapters on government procurement, which provide opportunities for firms of each nation to bid on a reciprocal basis on certain government contracts over a set monetary threshold. Similar chapters have been proposed by US negotiators in the TPP and TTIP talks. This market potentially could be quite large. According to the WTO, government procurement accounts for 15-20 percent of a country’s GDP and the size of the government procurement market among GPA members was USD 1.6 trillion in 2008.\(^{36}\) Successful TTIP and TPP agreements would provide US companies access to the EU single market and open up some TPP markets, since among TPP partner countries only Japan and Singapore are members of the GPA, although New Zealand has announced that it will seek to join the agreement.

The US has a problem, however, due to resistance among some US states in providing access to their procurement markets. US states must voluntarily opt in to government procurement commitments in free trade agreements; the federal government cannot impose an agreement on them. The number of US states joining such agreements, however, is going down, not up. Whereas 37 of 50 US states signed up to the GPA, only 8 US states acceded to commitments under the most recent US bilateral free trade agreements with South Korea, Panama and Colombia. Because of this issue, the US approach has been to propose that negotiating partners agree on access commitments for central government procurement before addressing sub-federal or state level commitments.

The EU, in contrast, has a single public procurement framework for the single market, and thus has significant interest in using the TTIP to press the US to open up entirely. In fact, establishing a precedent for opening sub-national procurement to foreign bidders was arguably the EU’s main goal in its successful CETA talks with Canada, under which Canadian provincial procurement contracts will be open to EU companies. The EU hopes to use the CETA arrangement to push the US in the TTIP. Similarly, Canada is using the TPP to address US ‘buy American’ exclusions concerning state and municipal projects funded by the federal government, pressing for a TPP agreement that would obligate sub-federal entities to open procurement projects funded by a central government to competition from firms in TPP countries. In this case, TPP and TTIP partners are seeking to squeeze

\(^{36}\) Cited in Cooper et al., *The Trans Pacific Partnership Negotiations.*
the US, rather than the US leveraging each set of negotiations to its own advantage.

Conclusion
Beyond these illustrative areas, negotiators face a host of other issues, including the extent to which financial services should be included; whether new rules on geographical indications will be made; or how to engage on intellectual property rights and data protection. These tough issues are further reasons why there should be no illusions about the difficulties involved in achieving a TPP or TTIP agreement. Remaining tariff barriers, especially in agriculture, often reflect the most politically difficult cases. Regulatory differences can be extremely difficult to broker. Issues such as food safety or environmental standards can be extraordinarily sensitive. Investment barriers, especially in terms of infrastructure and transport sector ownership, will be very difficult to change.

In addition, the greatest challenge to US goals for the TPP and TTIP may actually be at home. Despite the Obama administration’s great ambitions for both the TPP and TTIP, each may suffer because, as of this writing, the administration does not yet have Trade Promotion Authority. In the United States the constitutional authority to “regulate commerce with foreign nations” lies with the Congress, not the executive branch. To preserve the constitutional role of Congress yet enable the executive branch to negotiate trade agreements without fear that their provisions would be picked apart by legislators, a mechanism known as Trade Promotion Authority (TPA) – previously called ‘fast track’ – was devised. TPA provides for expedited legislative procedures (limited debate, no amendments, up-or-down vote) for the consideration of the implementing bill for a trade agreement. TPA expired in 2007, however, and has not yet been renewed, which means that neither the TPP nor the TTIP negotiation is being conducted under TPA, although the administration is informally following its most recent procedures. TPA will need to be approved before TPP or TTIP is considered by the Congress, otherwise each will be subjected to potentially debilitating amendments.

In sum, both the TPP and the TTIP are highly ambitious but potentially risky endeavours. The potential payoff of such initiatives is high, however, and their geostrategic impact could be as profound as the direct economic benefits they may convey.

References

37 1 January 2014.
Comparing TPP and TTIP


that the E.U. already emphatically pleaded for eastern enlargement. See European Round Table, Reshaping Europe (Brussels: E.R.T., 1991). Several reports specifically on enlargement followed in 1999 and 2000. Most recently the E.U. has expressed its support for a continuing enlargement process to create a yet bigger single market.

Suggested Readings


Websites

Gateway to the European Union: http://europa.eu.int/index_en.htm
The European Roundtable of Industrialists: www.ert.be/

History of European Integration, Leiden University: www.en-history.leidenuniv.nl/


Chapter 22

The North American Free Trade Agreement

Tony Porter

In 1994, amid much controversy, Mexico, the US, and Canada joined together in the North American Free Trade Agreement (NAFTA), a dramatic change from their wary relationships in earlier periods. By 2004 NAFTA included 430 million people and US$11.4 trillion in economic activity, constituting a formidable economic bloc. This chapter will discuss, in turn, the reasons for NAFTA, its key features, its effects, and its significance. Although NAFTA is often seen primarily as an economic arrangement, this chapter stresses, consistent with one of this book's overall themes, that politics has played a key role in its negotiation and implementation. I argue that political initiatives are needed in response to the failure of NAFTA to improve the well-being of citizens in its three member countries in the way that its supporters claimed it would.

Why Was NAFTA Created?

For much of the post-World War II period few people would have imagined that Canada, Mexico, and the US would sign an agreement such as NAFTA. A growing Canadian nationalism, associated with fears about the negative consequences of Canada's increasing dependence on US investment and trade, reached a high point during the 1970s with new government initiatives, such as the Foreign Investment Review Agency, which sought to shape incoming investment in ways that were more beneficial to Canadians, and efforts to establish closer economic links with Europe and Japan. The Canada-US Free Trade Agreement (CUTA), which came into effect in 1989, and NAFTA, which went beyond that agreement by including Mexico and by adding new issues, marked a remarkable turn away from the earlier, more nationalist period.

In Mexico nationalism had even stronger roots than in Canada. Anger at foreign influence had helped fuel the Mexican Revolution of 1910 and had contributed to the strongly nationalist Constitution of 1917. In the post-World War II period Mexico had been a leading advocate of the right and duty of governments to build economic sovereignty through such measures as controls over cross-border capital and trade flows and the nationalization of important industries. Government spending as a share of GDP increased from 13.1 per cent in 1970 to 39.6 per cent in 1976. In 1973 Mexico enacted two major laws to regulate foreign investment and the transfer of technology. Even in 1982 the Mexican government's response to the debt crisis was to take over the privately owned banks, adding them to the more than a thousand other state-run enterprises. Yet by 1986 Mexico had signalling its commitment to free trade by joining the General Agreement on Tariffs and Trade, and then, in 1990 by initiating talks with the United States on NAFTA.

While the turn towards regional free trade could be traced through domestic political factors that were specific to each of the three countries, the simultaneous upsurge in enthusiasm for it in all three countries suggests that systemic factors were at work, and it is these that this chapter will stress.

One systemic factor, which is frequently cited, especially by supporters of NAFTA, is the worldwide expansion of markets and the opportunities and
constraints this expansion presents to policymakers. Opportunities reside in the capacity of market exchanges to generate growth through allowing people to specialize in the economic activities they can do best, in allowing capital to flow to the activity in which it is most productive as measured by the highest rate of return, and in forcing uncompetitive firms and individuals to modify their behavior if they wish to survive, a point that also highlights the constraints imposed by markets. These considerations might suggest that NAFTA is simply an expression of the recognition by governments and citizens of these opportunities and constraints, perhaps stimulated by technological advances that have increased the fluidity of international trade and capital flows.

There are three clues, however, that such an explanation is inadequate. First, these countries' earlier policies, for most of the post-World War II period, were associated not with stagnation but rather with unprecedented growth—indeed, with higher growth rates than those that have followed NAFTA. Second, the advantages of market exchange cannot alone explain the regional character of NAFTA. Third, the timing of NAFTA is difficult to explain on the basis of an ongoing expansion of market exchanges alone.

An explanation that accounts for these issues must highlight the impact of historically specific international political structures on the three countries, and most particularly the changing fortunes of the United States as the hegemonic leader of the West during the Cold War. In the aftermath of World War II, the United States was unsurpassed, in part due to the damage inflicted on its major competitors, including the division of Europe, as a result of the war and in part due to the superiority of its productive capacity. In constructing a post-war order with itself as the centre, the United States found it was willing and able to support the arrangements within which international markets flourished, including the trade and monetary regimes, as well as bilateral arrangements with key allies in which political and ideological allegiance was exchanged for relatively free access to US markets. These political arrangements were accompanied by a particular set of production arrangements: the rapidly expanding manufacturing industries upon which the United States had built its ascendancy were organized by US-based multinational corporations and spread to other countries through those corporations' branch plants and subsidiaries.

Canada's and Mexico's integration into these arrangements was, given their proximity to the United States, a particularly distinctive feature of their post-war political economies. US direct foreign investment poured into Canada in the 1950s and 1960s, dominating both the extraction of natural resources destined for the US market and manufacturing industries catering to the Canadian market. These economic ties were facilitated by close and informal political ties, symbolized by phrases such as 'special relationship' and 'quiet diplomacy' as a trusted ally Canada had privileged access for its diplomats in Washington, allowing it to manage tensions and promote integration in the economic relationship. Close economic ties also were associated with a strengthening of the Canadian state, allowing it to cushion its citizens from the negative effects of economic dependence through strategic reserves of foreign currencies and the creation of strong economic ties. Similarly, Mexico experienced huge inflows of US capital during the 1960s, and, by the end of the 1970s, 70 per cent of direct foreign investment and foreign debt originated from the United States and 70 per cent of Mexican exports were to the United States. Beginning in World War II, in which hundreds of thousands of Mexicans were recruited into the US army and brought into the country to replace mobilized US workers, migration from Mexico to the United States strengthened economic ties. Like Canada, Mexico tried to offset the negative effects of its close economic relationship to the United States by strengthening state intervention in the Mexican economy.

During the 1970s these arrangements began to change. In response to US fears about its diminishing economic lead over the rest of the world, US indulgence began to be replaced by a more aggressive unilateralism, evident for instance in the United States ending its support of the Bretton Woods monetary regime and its unexpected imposition of a new duty on imports in August 1971. There were direct negative effects for Canada and Mexico, such as increased trade frictions, but indirect effects as well. For instance, the United States took measures with regard to global finance that, due to the size and centrality of its financial markets, enhanced its own position but left smaller countries, including Canada and Mexico, vulnerable. This was evident in the early 1980s in the contribution to the Mexican crisis of high US interest rates, government deficits, and massive inflows of capital to the United States, and the related contribution of the overvalued US dollar to raising the Canadian dollar and making Canadian exports to the rest of the world less competitive.

Given the constraints facing Canada and Mexico during the 1980s the political balance in both countries began to shift towards support for free trade with the United States. Washington was in favour of negotiations on free trade as well, but this was far from a passive recognition of the mutual benefits that could be obtained by allowing markets freer play. The United States had key goals related to its competitive position in the world as well as to the need for income and employment generation. A new US goal was to preserve and enhance benefits and minimize costs for their own citizens. Intellectual property rights establish a temporary monopoly in knowledge, and it is far from clear that the resulting benefits of the increased incentives to produce new knowledge outweigh the costs from the barriers to the free flow of knowledge that this monopoly creates. The financial sector, because of its centrality to the economy as a whole and the intangible and interdependent nature of the transactions on which it is based, is filled with externalities—social costs and benefits not captured by the prices of particular transactions, which have traditionally been a reason for strong state regulation—and it is not clear that the efficiency gains from greater international competition in financial services outweigh the losses from a diminished capacity for regulation. These three areas were ones for which Washington had been campaigning in bilateral negotiations and at the
Uruguay Round of trade negotiations and their inclusion in NAFTA would enhance previous efforts more comprehensively and boldly in a major trade agreement, as well as providing the global negotiations with an implicit US threat to withdraw into a hemispheric alternative.

In short, NAFTA did not simply come about as a result of a sudden recognition by the three governments of the mutual benefits they would enjoy from a generalized expansion of market exchange. Each government came to the table influenced by constraints and power associated with their particular role in the evolving structure of the international political economy. For the United States, NAFTA was merely one element in a larger effort to promote, in a restricted form, the continuation of the leadership role it had played since World War II, and to promote the interests of powerful US firms. Canada and Mexico, by contrast, constrained by the restructuring of the international political economy, had to focus more narrowly on obtaining more secure access to the US market, and to substitute negotiated rules governing their relationship with the United States for previous informal understandings and independents deployment of their states’ capacity.

**Key Features of NAFTA**

While the final text of NAFTA runs to more than 2,000 pages and is impossible to review comprehensively here, it is useful to discuss its most significant provisions. The agreement is striking in its blending of an unprecedented level of legal detail on international trade obligations with very weak collaborative institutions, as compared, for instance, to the European Union. Politically this is consistent with the great disparities in power between the United States and the other two NAFTA partners. The United States wanted to preserve its traditional independence from international institutions, and Canada and Mexico were wary of creating a set of US-dominated continental political arrangements that would go too far in weakening their decision-making autonomy.

The NAFTA rules include greater market access in a variety of sectors, investment rules, intellectual property rights, dispute settlement, and side agreements on environmental and labor rights. These will be examined in turn, emphasizing especially the political significance of the Agreement’s provisions.

On energy, NAFTA restructured the controversial measures agreed between Canada and the United States in CUSFTA—a prohibition, except under specified conditions, on national security grounds, on restrictions on energy trade, forecasting export taxes and other measures that had been used in the past to support nationalism-based energy policies. The Mexican government did not go that far, but did agree to open up procurement by PEMEX, its oil company, to foreign participation, although it retained control of PEMEX in Mexican hands.

On automobiles, NAFTA included provisions for the elimination, over a 10-year period, of tariffs between the three countries for vehicles meeting requirements for substantial content. The regional content rules, which deviate from pure free trade principles, to a degree to which these provisions were designed to improve the prospects of firms engaged in North American-based auto manufacturing by allowing them to produce at a more efficient scale, shifting key manufacturing processes to low-wage locations in Mexico, while protecting these firms from competitors from other regions. Regions with more stringent rules on textiles and clothing, which also eliminated tariffs over 10 years for products that satisfied strict regional content rules, displayed a similar logic. Mexico agreed to phase out its rules that had been designed to get US auto firms to produce in Mexico rather than export to it, such as restrictions on imports of new vehicles or requirements for certain levels of local content in auto parts.

On agriculture, the provisions called for the immediate elimination of tariffs on 57 per cent of US-Mexican agricultural trade and the phasing out of other tariffs and quotas over 15 years. While NAFTA supporters have argued that this has benefited Mexico by providing Mexicans cheap US corn for tortillas and creating new export opportunities for Mexican growers of other vegetables, fruits, and fiber crops, it has also meant that the cheap US corn, which benefits from US government subsidies, has created severe dislocations for poor Mexican corn farmers, forcing many to abandon their land and move in search of work, threatening the unique genetic diversity and distinct ecologically appropriate practices of traditional Mexican corn-growing.

One of the main goals of US and Canadian negotiators was to get access to the Mexican market for their financial firms. Mexico made important concessions while seeking to retain control over the pace at which foreign financial services firms were allowed to expand their activities in Mexico. However, the near-catastrophic Mexican financial crisis that began soon after NAFTA was signed (discussed below) led Mexican authorities to desist from their efforts to deregulate their financial system, thus opening new opportunities for foreign financial services firms to enter the Mexican market, one of the largest in Latin America.

The intellectual property provisions are also striking. Governments are obligated to protect copyrights on computer programs, to prosecute sending of encrypted satellite transmissions (such as television programs), and to protect new sound recordings for 50 years, new trademarks for 10 years, and new patents for 20 years. Such levels of protection, as noted previously, are controversial because of their potential of increasing the monopoly power of firms in the pharmaceutical industry.

The NAFTA investment rules in Chapter 11 have been much more controversial aspect of the Agreement. For NAFTA supporters, they promote productive foreign investment, by assuring investors that they will be protected from discriminatory or arbitrary treatment. For critics the ability of investors to seek compensation against states in secret, binding arbitration processes provides excessive rights to investors and undermines democracy, especially since some firms have used the process to claim that environmental regulations are a form of expropriation for which they should be compensated by governments. Chapter 11 provisions apply to both long-term direct foreign investments and portfolio investments (where there is no direct control by the investor of the enterprise) and prohibit interference, except under certain restricted circumstances, with investors’ transfer of capital or profits across borders. Many governments have been reluctant to eliminate controls on portfolio investments because they are more likely to be short-term and speculative. Arguably these rules, by stimulating volatile inflows and outflows before adequate prudential financial regulations were established in Mexico, contributed to the 1994 peso crisis. Overall, the investment provisions of NAFTA went well beyond any other multilateral agreements, including those being negotiated through the GATT.

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llectual property was also seen by the United States as an important precedent for future negotiations with developing countries.

Canada and Mexico hoped that NAFTA would reduce what they saw as the frequent arbitrary use by Washington of two types of trade measures, anti-dumping and countervailing duties, which are supposed to be used only when an exporter engages in predatory flooding of a foreign market with products sold below their real cost. NAFTA had put in place a dispute resolution mechanism that, in its first five years, had led to two-thirds of Canadian appeals of US decisions being successful, twice the success rate of appeals by other countries using the non-CUSFTA procedures provided by the United States, perhaps creating a deterrent to the initiation of trade actions by the United States against its partners. While the reduced rate of US trade actions against its NAFTA partners relative to trade actions against other countries could be taken as evidence that this deterrent was at work with the NAFTA panel mechanism, it may also be due to other factors, such as the contrasts between robust North American economies and the East Asian crisis in the late 1990s. Indeed, a World Bank study found that the overall number of trade actions taken by the United States against its NAFTA partners does not appear to have been affected by NAFTA. Overall, the process ‘yielded leeway to the reality of the Parties’ power asymmetry’ by its reliance on self-help by the legal mechanisms without the use of sanctions. Opinion was sharply divided on the specific level of environmental and labour side agreements. Some felt they were precedent-setting in being the first significant attempt to integrate environmental and labour issues into a trade agreement. Others, especially the labour movement, dismissed them as unenforceable window-dressing. The provisions of NAFTA, in sum, were very significant, not just because three countries that might otherwise not have been expected to conclude a trade agreement did so, but also because the commitments went well beyond other trade agreements in the range of activities covered and in the strictness of the procedures for enforcement. The US goals concerning investment, intellectual property rights, and financial services were met or exceeded. Canada and Mexico received improved access to the US market for a variety of products. However, the letter of trade agreements, as with any law, is sometimes not as important as their implementation and broader significance. We turn to assess these in the next section.

The Effects and Significance of NAFTA

Anyone seeking to evaluate NAFTA faces serious challenges both in separating the economic effects of unrelated factors and in developing criteria for success that are not contested. Supporters and opponents of NAFTA often selectively use some facts and ignore others in making their arguments. Nevertheless, it is useful to review some of the major points of debate.

One obvious effect of NAFTA has been to increase trade and direct investment among the three partners. Between 1993 and 2000, trade in the NAFTA region grew annually at 12.5% per cent, higher than the 8% per annum growth rate of world trade, and foreign direct investment flows between the NAFTA partners tripled between the 1989–94 period and the 1995–2000 period. Some NAFTA supporters assume this must prove that NAFTA was beneficial, because they believe that free trade and investment always lead to economic growth. Most people, however, rather than assuming that growth in trade and investment is an end in itself or will automatically raise living standards, want some evidence that the well-being of citizens has improved.

For most people, a key factor in their well-being is the number and quality of jobs available. NAFTA supporters in all three countries argued that it would have a major positive impact on employment through the exports it would generate. However, it is misleading only to count jobs created from exports, as for instance the US President did in his 1997 report to Congress on NAFTA, without subtracting jobs lost from imports. The US Department of Labor's NAFTA-Transitional Assistance Program has recorded, by the end of 2001, 413,371 workers certified to receive adjustment benefits, a rough estimate of US job losses. The Economic Policy Institute has concluded the impact of both imports and exports on US employment and has estimated that NAFTA resulted in a loss of 879,280 US jobs between 1993 and 2002. Others have been sceptical of the ability of this method of separating the effect of NAFTA on US jobs from other factors, such as technological change, cycles of expansion and recession, or world trade. During the late 1990s, a vigorous expansion added millions of jobs to the US economy, suggesting at a minimum that NAFTA did not have the disastrous effect on jobs that US presidential candidate Ross Perot had ominously labelled the 'great sucking sound', even if more than two million jobs were subsequently lost between 2001 and 2004. A Carnegie Foundation study concludes that the effect of NAFTA on US unemployment was probably minimal relative to other factors shaping the huge US economy. Supporter of NAFTA claimed that it would lead to an expansion of higher-quality jobs as the United States specialized in the high-value-added industries in which it had an edge over its NAFTA partners. Critics suggested instead that there would be downward pressure on the quality of jobs as US workers were forced to compete with Mexican workers. A 2004 report from the World Markets found a dramatic decline in US job quality between 2001 and 2004 as high-pay jobs were replaced by lower pay, dead-end jobs by routine tasks, and the development that could be taken as lending support to the critics’ contentions. Critics point also to the toll taken on individuals of having their factory threaten to move to Mexico, as has been the case with a large number of unionized firms, or actually close down. A post-NAFTA study by Borden and Kelson found that half of US firms facing threats from Mexican plants were determined to fight relocation to Mexico, and when forced to negotiate with a union, 15 per cent actually did close all or part of a plant (three times the rate before NAFTA), confirming the fears of NAFTA critics. Combined with similar problems in Canada and the anti-union environment in the maquiladora region in Mexico, the NAFTA-related weakness of North American unions has contributed to the weakness of organized labour in the region.
American labour plays an important part in the widening gap between productivity and wages and in growing inequality in all three countries, as fewer workers produce more without benefiting from that improved effort.

For Canada, like the United States, separating non-trade factors, such as the decline in the value of the Canadian dollar over the 1990s, from NAFTA is difficult. One plausible assessment is that the US experienced significant employment difficulties in the first decade after CFTA and then modest improvements.11 A growing productivity gap with the US—from 17 per cent in 1993 to 33 per cent in 2001—and persistently higher unemployment rates in Canada as compared to the United States, however, might suggest that Canada's relative position in the continent had been weakened rather than strengthened by NAFTA, contrary to what liberal economic theory had predicted.12

Of the three countries, Mexico's experience in the post-NAFTA period was the most negative: the real minimum wage rose over 23 per cent of its value between 1993 and 1999 and labour income as a share of GDP fell from over 40 per cent in the 1980s to 18.7 per cent in 2000, while profits as a share of GDP jumped from 31 per cent to 68 per cent over the same period. Employment fell drastically after the peso crisis, grew strongly for several years, but then stagnated.13 In the decade after NAFTA, the economy grew by 4.1 per cent and per capita growth in the NAFTA period was 1.2 per cent, as compared to 3.2 per cent from 1948 to 1973, or to the South Korean growth over the same period of 4.3 per cent, despite the East Asian crisis.14 There is, however, sharp disagreement about the relationship of this performance to NAFTA. Some argue that Mexico's problems were due to the 1994 peso crisis and that NAFTA was important in helping Mexico recover from that crisis. Yet, as noted above, NAFTA should also share some blame for the peso crisis, since it encouraged volatile cross-border flows of capital without ensuring that the prudential regulations and other policies needed to avoid and manage financial crises were in place.15

A major problem in Mexico has been massive agricultural unemployment created by huge NAFTA-related inflows of low-skill workers and other US agricultural products, destroying an estimated 1.5 million livelihoods as prices paid to Mexican farmers dropped by 70 per cent.16 (Ironically, this has occurred in the land where corn was first domesticated several thousand years ago.) The connection of many Mexican NAFTA-related inflows of low-skill workers with the replacement of redistributive communal landholding policies dating back to the Mexican Revolution and private landownership as part of the neo-liberal economic restructuring in which NAFTA was associated.

Liberal economic theory might lead one to expect that these workers have been absorbed into expanding NAFTA-related export-oriented employment. Unfortunately, such increases in employment did not keep pace with job losses. Employment generated in the maquiladora region failed to lead to linkages or lasting transformations of the Mexican economy more generally. This failure was in part to the degree to which the foreign firms manufacturing in Mexico were treating their operations as merely one dispensable link in a processing chain starting and ending elsewhere, and in part due to the Mexican government not investing sufficiently in infrastructure, legal reform, or the upgrading of the skills of their population through education. As one economic noted, Mexico's old role as a low-skilled, low-wage producer is now played by other countries, and Mexico has been slow to move on to the next step in the production process.17 The inability of poorly represented Mexican workers to demand their share of the wealth generated by productivity increases further inhibited their ability to upgrade their own living standards. An estimated 2 million manufacturing jobs were lost from Mexico to lower-wage countries from 2000 to 2003, including, for instance, 1,200 jobs at a $250 million Mitsubishi computer monitor plant, created in 1998 and closed a few years later when it could not compete with flat-screen monitors produced in East Asia. China has been particularly worrisome for Mexico, after the former increased its connection with the US market by joining the World Trade Organization in 2001.

Despite the expected benefits of NAFTA, the number of Mexican-born residents in the United States increased by more than 80 per cent between 1990 and 2000, and the pace of illegal border crossings grew despite huge American investments in border controls, with the greater danger of the crossings reflected in the 1,600 deaths of migrants between 1999 and 2004. A decade after NAFTA's launch it was estimated that one in five Mexicans lived in the United States.18

In assessing NAFTA's performance it is also important not to rely only on aggregate figures that obscure important differences. In all three countries social inequality has increased significantly since NAFTA and the growth of a relatively small number of very high incomes at the upper levels can hide growing poverty and distress among the population more generally. The differences across industries are also an important part of the NAFTA story. One study found substantial variation across the 39 sectors it examined. For instance, the experience of electronics has been positive while the experience of apparel and textiles has been negative.19 A study of NAFTA lobbying patterns similarly found that its strongest supporters were in those industries for which economies of scale and high amounts of intra-firm trade would allow firms to reap considerable competitive advantages from being able to operate on a continental basis.20

NAFTA's effects on the environment have been a major concern. While some of these effects have been positive they appear to be outweighed by the negative effects. The positive environmental effects are primarily related to the North American Agreement on Environmental Co-operation (NAECE), the environmental side agreement, and the Montréal Convention on Environmental Co-operation (CEC), which it created. NAFTA itself is path-breaking in the way in which it went beyond previous trade agreements in acknowledging and seeking to address institutionally the links between trade and environment. The structure of the institutions, in which the Secretariat and the Joint Policy Advisory Committee have been able to operate with substantial autonomy from the member states and with a significant degree of participation from non-state actors, has contributed to the strengthening of a continent-wide environmental policy network. The NAECE can take credit for some important accomplishments, including its initial success in establishing the concept of cooperative environmental governance, the creation of pollution-related jurisdictions and firms in its Taking Stock reports; its contribution to Mexico's adoption of new procedures for tracking the emissions by firms of pollutants; agreements to restrict the use of persistent and toxic pollutants, including getting Mexico to agree to phase out the use of DDT, and actions taken to protect habitats of migratory birds.21 The North American Development Bank, which was supposed to play a large role in cleaning up severe environmental problems around the US-Mexican border, has played a disappointingly small role, with only $15 million in funding of its $3 billion total lending capacity dispersed by 2001.

Critics of NAFTA feared that it would lead Mexico to become a pollution haven for firms wishing to escape environmental regulation in the United States and Canada, and that the ability of these firms to export back into the United States and Canada would put downward pressure on those countries' regulatory standards. One study found no evidence that dirtier industries shifted to Mexico in higher proportions than clean industries, a shift one might expect if these fears were realized.22 However, this may be because some of the dirtier industries, including steel and chemicals, are highly capital-intensive, with massive fixed investments in plants and infrastructure, and are not easily moved, and it is possible that the cleaner industries may still produce serious pollution problems. The environmental degradation of the maquiladora area and the growth of infection and cancer have been horrifying.23 Studies have estimated that in 1997 only 12 per cent of 8 million tons of hazardous wastes generated in that area were treated and that the average annual costs in Mexico of environmental damage...
of US$36 billion exceeds the growth from trade and the economy as a whole. This suggests that many of the measurements of the benefits of economic growth from NAFTA are overstated because they do not take into account the associated environmental and social costs.

The CEC's citizen submission process by 2004 had involved 43 complaints, of which nine resulted in "actual records" (CEC reports), 10 remained active, two were dropped because they were being pursued elsewhere, and 22 were rejected or dropped because they did not, in the CEC's judgement, meet its criteria. The procedure is innovative in allowing citizens to engage in whistle-blowing and in providing a means of spotlighting violations, but the CEC has been careful to restrict the scope of the process, and its outcomes remain relatively to the severity of the environmental problems in the continent.

One of the most troubling environmental effects of NAFTA has been the use of the Chapter 11 investor dispute mechanism by firms seeking compensation from governments for restrictions imposed on them by environmental regulations. Critics have pointed to the similarity between this mechanism and an earlier failed proposal of the right wing of the Republican Party to have the US government provide such compensation to US firms. The Chapter 11 mechanism has raised concerns in general because its deliberations are secret, and it is not clear that its panels, many of whom have ties to the industry they are supposed to protect, are independent from industry as they should be. There are also no mechanisms for ensuring that environmental expertise will be brought to bear in the judgements made by the panel. Sometimes critics overstate the dangers. For instance, the panels have rejected some of the claims of the firms, and governments may be able to avoid future complaints by being more careful to devise regulations that are strong but not vulnerable to charges that they are overly designed to discriminate against foreign firms and support domestic firms, a problem associated with the Canadian government's effort to prohibit the export of toxic PCBs from Canada by a US-owned firm while allowing similar activities by a Canadian-owned firm. The NAFTA governments also agreed in 2001 to narrow somewhat the conditions under which investors can claim damages. Nevertheless, serious concerns remain. The award to Metalclad of $16 million when it was not allowed to open a toxic chemical processing operation in Mexico, for example, is portrayed in superficial accounts as a case in which a local authority acted arbitrarily to undermine a commitment made by the Mexican government to Metalclad, and thus a case of Chapter 11 wrongdoing it should not be treated as such. Careful and detailed examination reveals, however, that Metalclad must have been aware of a history of local opposition to the illegal burial at the dump site in question of 20,000 tons of toxic materials, which resulted in extensive contamination of the local environment and left a trail of broken windows in birth defects, that Metalclad made questionable payments to government officials in its efforts to get permission to operate, and that it would seem reasonable that those in the neighbourhood of the prospective toxic processing operation should have some say over whether it should be permitted to proceed. All this suggests that the critics are correct in saying that integration appears to be a process that is biased towards giving foreign firms the ability to pre-empt local democratic rights.

The North American Agreement on Labour Cooperation, the labour side agreement, has been less effective than the environmental side agreement. As of 2004, 28 submissions had been filed, 13 of which had been decided. The Pan American Surveillance Council had noted dramatically increased Mexican spending on the enforcement of labour standards since NAFTA. The Commission has had some modest positive impact in publicizing complaints about violations, promoting cross-border cooperation among labour rights advocates, and attracting the attention of some of the workers concerned. In a 2001 article on North American Free Trade Agreement, the issue of the Commission's effectiveness in addressing the concerns of workers was raised.

A development that clearly reveals the importance of politics for NAFTA is the backlash from the terrorist attacks on 11 September 2001. The immediate response of the US government was to sharply restrict entry at its land borders with its NAFTA partners, a clear reminder of the secondary importance to the United States of the economic and legal provisions of NAFTA when its national security interests were threatened. Trucks were lined up for miles at the Canada-US border, and auto firms that had retooled their production processes to be dependent on just-in-time cross-border parts delivery were losing CDN$1 million to $1.5 million per hour. While this problem was subsequently addressed, new technologies were developed for facilitating the fast but secure cross-border transit of goods (the "smart border"), it provoked discussions in both Mexico and Canada of how best to respond to US anxieties over the security of its own and North America's borders. Although the Mexican government and some prominent Canadian commentators and politicians called for using this as an occasion to further strengthen North American integration, the differences between the government of US President George W. Bush and the Mexican and Canadian governments over the conduct of the war on terrorism, especially evident in the latter two countries' lack of support for the invasion of Iraq, made NAFTA integration appear unlikely. Interestingly, despite NAFTA and many previous decades of heavy inflows of US cultural influences into Canada, survey research revealed that Canadian and American values in the new millennium were diverging rather than converging, suggesting that moves towards closer political integration are unlikely.

The stalling of the Free Trade Area of the Americas negotiations, which once had seemed like a logical and inexorable outgrowth of the successful negotiation of NAFTA, provides further indication of the political problems that have developed in the years since the launch of NAFTA. Initiated in 1994, the FTAA languished in the late 1990s when US Presidents Clinton and Bush were denied fast-track negotiating authority by a US Congress concerned about the political fallout from free trade dislocations. Fast track had restricted congressional involvement to acceptance or rejection of any trade deal negotiated by the executive branch and without it US trading partners were reluctant to negotiate because they feared Congress would make modifications in the legislation implementing the agreement. Bush was able to obtain fast-track authority, renamed 'Trade Promotion Authority', in 2002, but only a small number of aggressive actions to protect US economic interests, such as protection and financial support for steel and agriculture, were undertaken. With the Bush administration distracted from the FTAA by the war on terror and displaying aggressively unilateralist and protectionist economic policies, it is not surprising that by 2004 the FTAA negotiations had lost their momentum, with expectation reduced to, at most, an "FTA lite" in which the most important issues would be set aside and a series of bilateral agreements would be made between the United States and other countries, the kind of deal that was Chile. Indeed, it was not clear that the negotiators would be successful in concluding any FTAA agreement at all.

Conclusion

The political character of NAFTA is evident in both the process leading to its negotiation and in its effects and evolution since it was established. The provisions of most concern to important interests in the United States and to the long-range strategy of the US government—the investment, intellectual property rights, and financial services provisions—are the ones that were most innovatively and strongly developed. The dispute resolution mechanism for other matters, by contrast, remains subject to power politics and the mechanisms in the labour and environmental agreements are especially weak.

NAFTA helps consolidate a strongly market-oriented regime for North America, weakening pre-existing national political institutions that had been developed to offset the negative effects of markets, without developing alternative international institutions. In contrast to the European
Union, for instance, where a great deal of effort has been devoted to developing an institutional solution to regional inequality and exchange rate problems, such issues in North America are dealt with by individual government initiatives on an ad hoc basis. This market-oriented regime poses more challenges for Canada and Mexico than for the United States, in part because of the latter’s size and in part because it matches more closely the traditional relationship between state and market in the United States than it does in the other countries. Mexico’s failure to translate NAFTA-related rapid export growth of the mid-1990s into long-range development, its vulnerability to lower-wage juris-
dictions such as China, and the growing inequality across the continent all reinforce the importance of government initiatives in promoting the capacities of their citizens, in fostering innovation, in helping them harmed by trade-related dislocations, and in ensuring that the costs and benefits of trade are fairly distributed. Without such initiatives the negative effects of trade agreements can outweigh the benefits, and political opposition will prevent further trade agreements. In short, NAFTA, as with other issues in international political economy, reveals the intensely political nature of the evolving international economy.

Notes

1. Research assistance by Diana Cacuce is gratefully acknowledged.
5. The figures in this and the previous sentence are from George W. Grayson, The North American Free Trade Agreement: Regional Community and the New World Order (Lanham Md: University Press of America, 1999), 30.
7. See George W. Grayson, The United States and Mexico: Patterns of Influence (New York: Praeger, 1984), 27–31. Mexico’s criticisms of excessive US influence in Latin America were tolerated by the United States, which was grateful for its anti-communism, evident for instance in Mexico’s support of the US blockade during the Cuban Missile Crisis.
9. Bhagwati, a leading economist in favour of free trade, has commented with regard to intellectual property: ‘As it now widely conceded among economists ... there is no presumption of mutual gain, world welfare itself may be reduced by any or more IP protection, and there is little empirical support for the view that “adequate” IP protection impedes the creation of new technical knowledge significantly’. Jagdish Bhagwati, ‘Regionalism and Intellectual Property Rights’, World Economy 15, 5 (September 1992): 553.
11. Although many critics feel that NAFTA went too far and in effect created a new constitution for the rights of foreign corporations. See, for instance, Stephen Clarkson, Canada’s Secret Constitution: NAFTA, WTO and the End of Sovereignty? (Ottawa: Canadian Centre for Policy Alternatives, 2002). Available at: <www.policyalternatives.ca>.
19. For instance, a 10-year assessment by the partners’ three trade ministers has a full page of data about trade and investment but only a sentence on standards of living. Lower tariffs mean that families pay less for the products they buy and they have a greater selection of goods and services, which increases their standards of living. NAFTA: A Decade of Strengthening a Dynamic Relationship, at: <www.dfait-maeci.gc.ca/nafta-alegna/nafta10-en.asp>.
20. The number may underestimate local losses because of the antigovernmental criteria for receiving such assistance and because they are not accounted for in the official statistics, so they are not paid and the work is not certified or published. According to the Canadian government, the Mexican government, and the joint US-Mexico-Canadian body set up to monitor the NAFTA, the McGraw-Hill study at the time of writing was to assess the impact of NAFTA on the U.S. economy and the economies of Canada and Mexico.
26. Audley et al., NAFTA’s Promise and Reality.
27. Ibid.
28. Standing Committee on Foreign Affairs and International Trade, Partners in North America: Advancing Canada’s Relations with the United States and Mexico (Ottawa: House of Commons, 2002).
40. ‘Ten Year Track Record’.
43. ‘Ten Year Track Record’; Audley et al., NAFTA’s Promise and Reality, 6.
44. Calculated from list at <www.cec.org/citizen/smu/index.cfa>

Suggested Readings


Web Sites
Free Trade Area of the Americas: www.fita-ala.org
North American Free Trade Agreement: www.cec.org


North American Free Trade Agreement: www.naia.org

Stop the FTA! seoplusa.org


Open economy politics and trade policy

Thomas Oatley

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Open economy politics and trade policy*  

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ABSTRACT  

Has 25 years of accumulated empirical research informed by the open economy politics (OEP) perspective deepened our understanding of how politics influence trade policy? This paper offers an answer to this question based on a survey of empirical research on individual trade policy preferences, the impact of domestic political institutions on trade policy outcomes, and the relationship between international institutions and trade policy outcomes. I reach a rather disappointing conclusion: although every contribution to the OEP research program is rigorous and robust, the individual findings have not produced consensus on any of the major questions at the center of research. Consequently, we know no more about the politics of trade policy today than we knew three decades ago. This lack of progress in OEP’s variable-based approach creates opportunities for research that relies on a pattern-based approach informed by the logic of causal complexity.

KEYWORDS  

Trade; IPE; OEP; survey; political economy; complex causality.

In the mid-1990s, American IPE took a scientific turn. The field’s turn to science rested on three underlying assumptions. First, scholars assumed that trade politics are characterized by law-like empirical regularities that hold across time and space. Electoral institutions, for instance, should have the same effect on trade policy in contemporary European societies as they had in interwar Europe, and this effect should be the

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same in Sub-Saharan Africa as it is in Scandinavia. Second, scholars assumed that the primary (and for some, only) purpose of IPE research was to discover or identify these law-like empirical regularities. Research that demonstrated how a set of causal factors produced a particular outcome in a specific case was devalued and increasingly displaced from the discipline’s major journals. Instead research had to aspire to identify causal relationships that held across a large number of cases. Third, scholars assumed that an empirical framework based on linear regression and its many variants provides the most appropriate method for identifying these law-like empirical regularities. The case study method was demoted because single observations could not yield law-like regularities and large-n statistical studies became the model research design.

The turn to science progressed hand-in-hand with the growth of the open economy politics (OEP) paradigm. OEP was advanced as an alternative to the grand theories that shaped IPE research in its first generation. OEP would replace the impossible-to-falsify ‘isms’ of early IPE (mercantilism, liberalism, Marxism) with mid-range theories based largely on rational choice assumptions that could generate testable hypotheses. By embracing mid-range theory, the OEP paradigm encourages researchers to disaggregate trade politics into what is considered to be its three constituent modules: individual interests, domestic political institutions, and international interactions. It further encouraged researchers to research each module in relative isolation from the others, thereby encouraging research to evolve into narrowly focused hypothesis testing that was increasingly insulated from research in the two other modules. Eventually, researchers could begin to assemble the partial insights to account for the whole. For although ‘we are all touching different parts of the proverbial elephant...by pooling our knowledge of the different parts, we may be able to describe the whole animal more effectively’ (Lake, 2011, 472). Research on trade politics has largely adhered to this OEP logic of inquiry during the last 25 years. Indeed, the widespread embrace of OEP has transformed American research on trade politics into something of an intellectual monoculture (McNamara, 2009).

Has OEP delivered on its promise? In his recent review of research in the IPE of money, Cohen (2016) expressed disappointment in the insular and introspective nature of current scholarship, developments he attributes to the epistemological foundations of contemporary American IPE. Does OEP research on trade do a better job in meeting its own goals? Do we know more today about the source of individual trade policy preferences than we knew a quarter century ago? Does the field have a firmer grasp on how domestic institutions aggregate preferences? Have we a better understanding of the central processes of the international trade system such as international trade bargaining and dispute settlement mechanisms? That is, has a quarter century of research, taken as a whole,
validated the specific hypotheses generated by the mid-range theories at
the center of OEP, and thereby substantiated the more general OEP claim
that its reductionist strategy offers the surest path to a scientific under-
standing of trade politics?

My reading of the literature produces a rather disappointing conclu-
sion. In spite of the methodological sophistication on display in every
individual contribution to the OEP paradigm, empirical research taken
as a whole has yielded few if any definitive conclusions about empirical
relationships in any of the three modules. Researchers continue to offer
incompatible claims about the sources of individuals’ trade policy prefer-
ences. And if anything, the variety of claims on this issue is greater today
than it was 25 years ago. The situation is not much better in research on
domestic institutions, where a large body of empirical work has yet to
identify unambiguously robust empirical relationships. And empirical
work on system level phenomena has largely ignored bargaining in favor
of research on aspects of dispute settlement that is not readily amendable
to empirical research in a regression-oriented framework. Overall, then,
OEP has made little progress in its effort to reduce our uncertainty about
how the interplay between interests, institutions, and interactions influ-
ence trade policy. I argue in the conclusion that this lack of progress cre-
ates an opportunity to broaden the conception of causality as well as the
methodological tools at the center of OEP research.

INTERESTS

Individual interests constitute the base upon which OEP rests. As Lake
writes, ‘The fundamental building block of OEP is interest, or how an
individual or group is affected by a particular policy. Actors who benefit
from a policy are expected to expend resources in the political arena to
obtain that policy – as a shorthand, to lobby. Conversely, actors that lose
from a policy are expected to lobby against it’ (Lake, 2013, 574). Because
individual preferences are so foundational, OEP scholars have devoted
significant time and energy to identifying the source of individuals’ trade
policy preferences. Unfortunately, these efforts have yet to produce a
consensus understanding.

The earliest wave of research on interests assumed that individuals’
trade policy preferences were shaped by the impact of trade on individ-
ual incomes. Individuals who gained higher income as a consequence of
trade would support trade liberalization, while individuals who suffered
income losses from trade would support more protection. This core
assumption allowed researchers to derive individual trade policy prefer-
ences from the distributional effects of trade highlighted by standard the-
ories of international trade. As a first cut, researchers assumed that the
gains to each individual consumer were too small and the number of
consumers to large to enable people to organize for effective political action as consumers. Hence, rather than characterize trade politics as a battle between consumers and producers, the literature described the distributional consequences of trade through the lenses of the Hecksher–Ohlin (HO) model of comparative advantage, supplemented by the Stolper–Samuelson (SS) theorem, and the Ricardo–Viner (RV) model of trade. The HO–SS, or factor, model argued that the distributional consequences of international trade fall across the factors of production. Owners of society’s relatively abundant factor experience rising incomes as trade expands and thus prefer trade liberalization to protection. Owners of society’s relatively scarce factor see their incomes fall as trade expands and thus prefer protection (Rogowski, 1990).

OEP researchers developed the RV model as an alternative to the factor model by critiquing the strong assumptions the HO–SS model makes about inter-industry factor mobility (Alt et al., 1994; Hiscox, 2001). The HO–SS approach assumes that factors are perfectly mobile across industries: labor and capital released by contracting industries are readily absorbed by expanding industries. As a consequence, the national economy has fully integrated factor markets and a single factor price that either rises (for the abundant factor) or falls (for the scarce factor) as trade expands. The RV model claimed that factors are relatively immobile, that is, that they are often specific to their current use (Hiscox, 2002a; Hiscox, 2002b). As a result, factors released by contracting industries are not quickly absorbed by expanding industries but might instead sit idle for a period. And when factors are immobile, then the distributional consequences of trade fall across sectors rather than factors. That is, labor and capital in the declining industries that constitute the import competing sector suffer falling incomes while labor and capital employed in the expanding industries that make up the export-oriented sector realize higher incomes. Individuals employed in export-oriented industries thus prefer trade liberalization to protection, while those employed in import-competing industries prefer protection to liberalization.

To date, the body of empirical research that seeks to decide which of these two models better characterizes the sources of individual trade policy preferences has produced no strong conclusions. The bulk of this empirical work has taken the individual as the unit of analysis and analyzed survey data in search of correlations between individual answers to trade policy related questions and demographic and occupational attributes. Some empirical research in this tradition has found support for the HO–SS model (Mayda and Rodrik, 2005; Scheve and Slaughter, 2001). It has proven difficult to implement a clean test of the RV model. Existing survey data typically do not provide information about respondents’ occupations, and available proxies, such as educational attainment, are imperfect. Thus, even though the field has produced evidence to suggest that support for trade
liberalization rises as a function of education, the field lacks consensus on the causal mechanism that this correlation supports. In a very recent study, Rho and Tomz (2015) develop industry-specific measures of protectionism to conduct a fairly comprehensive test of the HO–SS and RV models. They find no support for either model. Overall, therefore, empirical research on the first generation models of individual preferences has been inconclusive.

As Mansfield and Mutz (2009, 429) summarize, ‘the explanatory value of these models has been quite limited to date, and even simple demographics often explain more about trade preferences that variables linked to either model.’

In the absence of robust empirical support for the first generation models, researchers have begun to search for alternatives. One line of research continues to hold that individual trade policy preferences are generated by economic interests, but uses ‘new new trade theory’ rather than standard trade theory to derive these interests (Madeira, 2014; 2016; Plouffe, 2015). New trade theory focuses on the heterogeneity of firms within industries. According to the new trade theory, firms within a given industry differ from one another in terms of their total factor productivity (TFP). Firms with high TFP export and thus have preferences for trade liberalization, while firms with low TFP are disadvantaged in the home and global markets and thus prefer protection. Empirical research to test the TFP hypothesis, though relatively immature, has generated ambivalent conclusions. Both Plouffe and Medeira report evidence consistent with the TFP model. Rho and Tomz (2015), in contrast, find no indication that individual trade policy preferences correlate with TFP.

The lack of robust empirical support for the trade-based models of preferences has led some researchers to argue that individual trade policy preferences reflect broader and often non-economic concerns. Some empirical research, for example, finds that sociotropic considerations—the impact of trade on broader economic conditions rather than on individual incomes—correlate more highly with individual attitudes about trade than measures of factor ownership and occupation or skill level (Mansfield and Mutz, 2009). In addition, an emerging literature reports that trade policy preferences may not be based on economic considerations at all. The analysis of survey data has found that individual attitudes toward trade and trade policy correlate with ideology, religion, national security and foreign policy beliefs, attitudes toward foreign cultures and immigrants. Other empirical work finds a robust relationship between gender and trade policy preferences, with women exhibiting more support for trade than men (Hainmueller & Hiscox, 2006; Mansfield et al., 2015; Kuo & Naoi, 2015). Education is also correlated with support for free trade, though whether this correlation reflects the causal impact of skill endowments as an economic model would hold or instead is a result of exposure to economic theory and its associated arguments in
favor of free trade remains in dispute. This line of research has been criticized for, among other things, drawing unwarranted causal inferences from correlational data (Fordham and Kleinberg, 2012).

At present, therefore, empirical research on individual trade policy preferences has yet to produce a consensus on the determinants of individual trade policy preferences. Researchers have yet to find robustly systematic evidence to support the claim that individual preferences reflect factor ownership, occupation, or firm characteristics. As a consequence, the field remains divided on so foundational an issue as whether individual trade policy preferences are rooted in narrow economic self-interest, reflect broader sociotropic concerns, or are driven by a variety of ideational factors. Indeed, many might find it difficult to disagree with Rho and Tomz (2015, 28) who conclude that the absence of positive findings ‘raises serious questions about the economic theories that have guided research about public opinion and trade for more than a decade.’

Yet, rather than throwing out the baby with the bathwater, one might suggest instead that the individual is simply the wrong unit of analysis. Societies almost never vote on trade policy, and individuals have no other means to directly influence trade policy. Hence, the interests of individuals are not especially relevant to the formation of trade policy (Guisinger, 2009). Instead, the relevant actors for trade politics are the organizations that attempt to influence its direction—unions, firms, and business associations. These highly sophisticated organizations, as representatives of the collective interests of a very specific membership, will develop trade policy positions that reflect the narrow economic interests of their membership. And thus, American labor unions (e.g. UNITE) are likely to be much more protectionist than business associations representing tech firms (such as the Software and Information Industry Association). A useful next step in the effort to understand interests, therefore, would be to collect and evaluate data for organizations rather than individuals.

**INSTITUTIONS**

OEP research on domestic political institutions, the middle link in its causal chain, strives to identify the variation in institutional characteristics that explains why some societies have much lower tariffs, on average, than others. The motivating question is pretty straightforward. Given that trade generates winners and losers in every society, the observed variation in national outcomes must reflect variation in the way domestic political institutions aggregate these interests. Some types of domestic political institutions must offer a systematic advantage to pro-trade preferences while other types must give the systematic advantage to protectionist interests. Although there are a myriad of pathways through which political institutions transform competing individual preferences into
trade policy outcomes, researchers have focused their attention most heavily on two major institutional differences: regime type (democracies vs. autocracies) and electoral systems (majoritarian vs. proportional).

The regime type hypothesis is derived from the interaction between the HO–SS model of individual trade policy preferences and the median voter theorem. As we have seen, the HO–SS model characterizes trade politics as competition between labor and capital. The median voter theorem tells us that in a simple majority rule system, when voting on a single dimension, the policy outcome will embody the preference of the median voter. Combining the two insights yields a fairly straightforward expectation about trade policy in democracies. First, a worker will be the median voter. And second, when labor is the abundant factor, the median voter will be pro-trade. Thus, democracies should have relatively low tariffs. In contrast, the equivalent ‘median voter’ in autocracies that restrict mass participation is most likely to be drawn from society’s capitalist class and will therefore prefer protection from imports. Autocracies should therefore have relatively high tariffs. Thus, labor abundant democracies are likely to be more open to trade than labor abundant autocracies. A considerable body of published empirical research corroborates the regime hypothesis. Tariffs are lower, on average, in developing country democracies than in developing country autocracies. Moreover, joint democratic dyads trade more and form preferential trade agreements at a higher rate than other dyads. Democracies do seem to be more liberal, and autocracies more protectionist.

The regime type hypothesis is not without problems, however. First, it is hard to reconcile the hypothesis with the research on individual trade policy preferences. As we saw above, researchers have not produced conclusive evidence that factor ownership determines individuals’ trade policy interests. And if labor doesn’t prefer free trade when it is the abundant factor, then the regime type hypothesis lacks an empirically valid causal mechanism that links the median voter to trade policy. That is, democracies might indeed have lower tariffs than autocracies, but the reason is not because the median voter votes her factor-based preference. Nor does this specific causal mechanism travel beyond the specific context of the contemporary developing world. Applied to the advanced industrialized democracies, the regime type model predicts relatively high protection. The median voter in the USA and EU is likely to be a worker. And because labor is the scarce factor the median voter should prefer protection, as the recent populist surge across the industrial democracies as is evident in the British EU referendum and American voter skepticism about the Trans-Pacific Partnership and other trade deals. Yet, the industrial democracies have the lowest tariffs in the world. According to World Bank data, for instance, the average tariff rate (weighted) for EU members and the United States in 2014 was
approximately 1.5 percent. Finally, some evidence suggests that the relationship between regime type and trade policy is conditional upon WTO membership and/or common geopolitical interests (C. Davis and Wilf, 2011; Gowa, 1995; Chaudoin, Milner, and Pang, 2015; Oatley, 2011).

The second principal line of research examines the impact of different electoral systems on trade policy outcomes. This scholarship focuses exclusively on democracies in order to evaluate whether trade policy varies across majoritarian and proportional representation electoral systems. Here too results remain somewhat maddeningly inconclusive. On the one hand, a substantial body of literature argues that majoritarian systems are more protectionist than PR systems. Contemporary variants of this argument rely upon the formal logic of Grossman and Helpman’s ‘A Protectionist Bias in Majoritarian Politics’ (Grossman and Helpman, 2005). The Grossman and Helpman model envisages a two party system with a three-person legislature. Each representative is elected from a single member district and each district hosts a unique industry. The majority party establishes government and sets policy to maximize the income of the districts it represents. Unless all legislators come from the same party, the majority government will tax the minority district and transfer the resulting income to the districts represented by the majority. Grossman and Helpman demonstrate that the legislators that constitute the government in majoritarian systems are substantially less likely to represent all districts than would the legislators that constitute the government in PR systems. As a result, taxes will be higher in majoritarian than in proportional representation systems.

On the other hand, another line of research suggests that PR systems are more protectionist than majoritarian systems. Both the selectorate model and Rogowski and Kayser’s seat-vote elasticity model imply that tariffs should be higher in PR system than in majoritarian systems (Bueno de Mesquita, Morrow, Siverson, & Smith, 2005; Rogowski & Kayser, 2002). The selectorate model argues that governments provide public goods at an increasing rate as the size of the winning coalition rises, and provide private goods to narrow groups as the winning coalition shrinks. By this logic, tariffs should be higher in PR systems than in majoritarian systems because the winning coalition is larger in the latter (Bueno De Mesquita et al 2005, 51). In the seat-vote elasticity model, the same loss of votes costs more seats in the legislature in a majoritarian system than in a PR system (Rogowski and Kayser 2002). As a result, politicians in PR systems can cater to the demands of narrow groups while legislators in majoritarian systems must hew closely to the interests of the median voter. Taxes should thus be higher in PR systems than in majoritarian systems.

Empirical research is unable to determine which perspective on the relationship between electoral systems and trade policy is correct.
The majoritarian bias has received substantial empirical support. Evans (2009) reports, based on a study covering 147 countries between 1981 and 2004, that countries with majoritarian electoral systems have higher tariffs than countries with PR systems. Rickard (Rickard, 2012) found that this bias applies to government subsidies as well. Based on a sample of 68 countries between 1990 and 2006, she reports that majoritarian systems are robustly associated with higher subsidies. ‘On average, governments in majoritarian systems spend 2.5 percentage points more on subsidies than governments in PR systems’ (Rickard 2012, 782). Other empirical work, however, indicates that governments are more protectionist in PR systems than in majoritarian systems. Mansfield and Busch (1995), in one of the first empirical studies of institutions and tariffs, find that tariffs are higher in PR systems than in majoritarian systems. Tests of the seat-vote elasticity model indicate that consumer prices are higher, on average, in PR systems than in majoritarian systems (see e.g. Chang, Kayser, & Rogowski, 2008; R Rogowski & Kayser, 2002). Though this work does not present a direct test of tariff rates or other trade policy instruments, these results are consistent with a world in which governments in PR systems use tariffs and other barriers to provide rents to important producers.4

It may be that research on electoral systems fails to reach a definitive conclusion because it pays little attention to individual preferences.5 Most of this literature characterizes trade politics as distributive conflict between protectionist producers and free trading consumers. Consequently, political institutions that empower narrow industry groups yield higher tariffs, while those that empower voters qua consumers produce open markets. Yet, as we have seen, such an approach is inconsistent with all of the economic models of trade politics, each of which characterizes trade politics as competition between special interests. Moreover, trade politics is rarely a single dimensional issue.6 Indeed, the postwar political commitment to liberal trade in (capital intensive) manufactured goods by the USA and Europe was made possible by the willingness to continue to protect and subsidize agricultural producers. The lack of progress might also reflect the omission of international interactions. Since 1950, the industrial democracies have been engaged in collective trade policy making through the General Agreement on Tariffs and Trade (GATT), the World Trade Organization (WTO) and, for the large majority of European democracies, the European Union (EU). Indeed, because EU membership obligates states to accept a common external tariff there cannot be meaningful variation in the level of protection across majoritarian and PR systems. And because the EU and the other industrial democracies have collectively reduced tariff barriers through the multilateral trade organizations, any variation in the level of protection
that might generated by differences of electoral systems will be over-rid-
den by the resulting cooperative agreements.
OEP research has yet to reach any consensus on how political institu-
tions aggregate trade policy preferences and transform them into trade policy outcomes. Research on regime type and trade policy seems to have produced a consensus that democracies trade more than autocracies—arguably this finding is the closest the field has come to identifying a law-like empirical relationship. Yet, and without diminishing this achievement, the correlation is not yet supported by an empirically validated causal mechanism. Moreover, one must worry that any regime effect will disappear as empirical research shifts from country as the unit of analysis to the network as the unit of analysis. For its part, the literature on electoral systems offers no clear answer about whether protectionism is higher in PR or in majoritarian systems. As Rickard (2015, 293) concludes from her recent review of this literature, empirical work has yet to produce a consensus that ‘a robust correlation exists between electoral systems and trade policy.’

INTERNATIONAL INTERACTIONS

System level trade politics constitute the final stage of the OEP causal chain. It is in international forums that competing national policy preferences generated by domestic institutions that have in turn aggregated individual preferences are (sometimes) transformed into trade agreements. These international agreements entail specific trade policy commitments—reduce tariffs, limit and prohibit subsidies, protect intellectual property and so on— and they entail broader constitutional rules that establish decision making and dispute settlement procedures. Classically, research on the system level focused on variation in bargaining outcomes, in institutional design, as well as on the stability of the system over time. Contemporary research has eschewed many of these questions to focus quite narrowly on elements of institutional design and impact.

A wave of research in the early 2000s explored the economic consequences of the WTO. One line of research explored whether the WTO helped expand trade. An article by Andrew Rose (2004) found that country pairs characterized by joint WTO membership traded no more intensively than country pairs not characterized by joint membership. WTO membership therefore appeared to have no systematic impact on trade volumes. Goldstein, Rivers, and Tomz (2007) challenged Rose’s conclusion. They showed empirically that once one takes into account the fact that the WTO/GATT grants MFN status to non-member states that were once colonies of member states, then joint WTO/GATT membership has had a large positive impact on the growth of trade. Subsequent research
has failed to resolve this debate as empirical findings are quite sensitive to measurement and model specification (C. Davis et al. 2015).

A second line of research examines the distribution of the gains from trade between countries. There appears to be a consensus that the largest industrialized countries have benefited most from the international trade system while developing countries have gained least (see e.g. Gowa and Kim, 2005). Less consensus exists about the conditions associated with large benefits from membership in the developing world. Some scholarship finds that in order to benefit from WTO membership, a developing country must have close ties to one or more large powers. More pointedly this implies that sharing geopolitical interests and establishing security and economic cooperation with the US yields economic benefits in the form of expanded trade opportunities. Other work draws more heavily on a legal tradition to argue that developing countries that lack close relationships with the large powers benefit from the ability of the WTO to protect their trade from arbitrary discrimination by the large trading states (Carnegie, 2014). As Carnegie summarizes, ‘the WTO allows states to solve political hold-up problems by enforcing long-term agreements, increasing trade and investment between states that differ in terms of capabilities, regime types, and alliances’ (Carnegie, 2014, 68).

The topic to attract the greatest attention, however, has been the design and function of dispute settlement mechanisms in the WTO and PTAs. Much of this work builds on Rosendorff’s (2005) seminal contribution. Rosendorff argues that when contemplating membership in a trade regime, politicians are uncertain about the future costs of compliance. If, for some reason, a government’s confronts a temporary import surge that threatens a politically important and previously liberalized domestic industry, then continuing to comply with the agreement to liberalize trade becomes very costly. Moreover, the deeper the economic cooperation, the greater the potential cost of future compliance. This uncertainty makes states reluctant to enter agreements that promote deep integration. States manage this uncertainty by building flexibility into trade agreements in the form of escape clauses (temporary opt outs). The GATT, for instance, allows states to enact safeguards to protect industry against temporary import surges. And in order to limit the incentive for opportunist behavior, states create DSMs to handle disputes that arise when states take advantage of these escape clauses. As a consequence, trade regime rules are essentially of three kinds: obligations, exceptions to obligations, and regulations about invoking the exceptions to obligations. Johns (2012, 2014) extends Rosendorff’s core argument by modeling the tradeoff between rigidity and regime stability in preferential trade agreements given the depth of integration.

In spite of the prominent position it occupies in the literature on the international trade system, neither the Rosendorff model nor Johns’
extension of this model have been validated empirically. Rosendorff sug-
gests that the lack of empirical testing of his model reflects problems aris-
ing from selection effects, simultaneity and model identification. In the
absence of direct tests, Rosendorff draws on empirical work published
by other scholars to argue for the empirical validity of his model. He
notes, for instance, that Kucik and Reinhart (2008) find that states with
antidumping procedures (which he notes impart flexibility to trade com-
mitments) are more likely to join PTAs. In addition, he suggests that the
empirical work that finds that democracies are more likely to join trade
agreements with strong DSMs supports his theoretical model (Rose-
ndorff, 2015, 142).

A second line of DSM-focused research is more empirically oriented
and somewhat more fragmented as a consequence. Some empirical work
explores which countries are most likely to initiate cases before DSMs,
though this research is problematic because of selection effects. Early
research in this tradition found that democracies and democratic dyads
are more likely to be involved in disputes than other regime pairs, thus
linking system-level processes to domestic institutions (see e.g. M. L.
Busch, 2000; Reinhardt, 2000; P. Rosendorff and Smith, 2013). More
recent work has argued that the timing of dispute initiation is strategic
and is most likely to occur during election years in the defendant when
public support for trade is high (Chaudoin 2014). Other research exam-
ine the attributes that influence success once a dispute is initiated, and
finds that the state’s legal capacity is among the most important factors
(Mark L. Busch, Reinhardt, and Shaffer, 2009; C. L. Davis and Bermeo,
2009). This implies that developing countries are at a substantial disad-
vantage in the DSM, a finding that speaks directly to the broader research
on who benefits from WTO membership. Other work investigates
whether the resolution of trade disputes increases trade flows between
the parties to the dispute. Some research finds that dispute resolution has
no impact on trade, while other work finds that it has a positive impact
(Bechtel and Sattler 2015; Chaudoin, 2016; Hofmann and Kim n.d.).

Finally, some scholarship explores the determinants of WTO/GATT
membership. One of the initial findings in this literature examined for-
er colonies who were eligible to enter the GATT without making con-
cessions. This design allowed the focus to be exclusively on country-level
demand factors. The analysis suggested that the most important factor
that differentiated early and late entrants was a high level of trade inter-
dependence with existing members. And in a paper that evokes an earlier
age of IPE scholarship, Davis and Wilf (2011) find that early decisions to
join the GATT were strongly influenced by geopolitical considerations.
Joanne Gowa (1995) has argued that concern about what she calls
‘security externalities’, or the economic gains realized as a result of trade
relationships, causes states to trade primarily with allies and limit their
trade with adversaries. Davis and Wilf (2011) find evidence consistent with this hypothesis. States that were allied to current members were more likely to join than states that were not allied to current members. And democracies were more likely to join than non-democracies. These findings highlight the need to embed the international trade sub-system into the broader international system.10

**IMPLICATIONS**

Overall, and in spite of the sophistication on display in OEP empirical research, one must conclude that 25 years of empirical research taken as a whole has done much less than one would hope to deepen our understanding of the politics of international trade. The theoretical insights and empirical questions that shape contemporary research are almost identical to those that shaped research 25 years ago. The entire body of empirical research that tests these theories has not reduced our uncertainty about relationships that may be present in trade politics. In some areas, intractable problems (selection, simultaneity) compromise even the most careful work, while in other areas robust empirical findings support two or more competing explanations of a given phenomenon.

I draw two conclusions from this survey. First, the OEP trinity of interests, institutions, and international interactions offers a compelling and useful theoretical framework. It is difficult to disagree with Lake’s assertion that a complete explanation for any phenomenon will combine elements of all three processes. None of the empirical work reviewed here suggests that any of the three pillars is unimportant; indeed, the issue isn’t a lack of empirical evidence, but too much evidence. Moreover, scholars can organize their research around the OEP trinity without needing to embrace a materialist approach. As we saw, researchers have generated considerable evidence about how non-material factors shape individual trade policy preferences and more work is needed to identify the source of these sociotropic considerations and to trace forward their causal significance for trade policy.

Second, the disappointing nature of the body of empirical research should encourage research that relies somewhat less heavily on a variable-based approach and somewhat more heavily on the pattern-based approach associated with causal complexity. Causal complexity can be defined as situations characterized by at least one of two characteristics: conditional relationships and multiple causal paths (or equifinality) (Braumoeller, 2003; Ragin, 1987; Rihoux and Ragin, 2009). Conditional relationships exist when the causal impact of one factor, say A, on an outcome of interest, Y, is influenced by another factor, such as B. Two types of conditional relationship are possible: interactions and configurations. Interactions involve situations in which A and B may each have an
independent impact on Y but in addition the impact of A on Y varies across values of B (or the converse). For example, the relationship between regime type and tariff rates is conditioned by WTO membership. Among WTO members, democracies have lower tariffs than autocracies. Among non-WTO members, regime type seems to have no significant independent effect on tariffs while WTO membership has a significant and negative independent effect on tariffs (Chaudoin, Milner, and Pang, 2015; Oatley 2011). Configurations are instances in which the joint presence of A and B cause Y, but neither A nor B have an independent effect on Y. Hypothetically, for instance, individual level characteristics such as nationalism and xenophobia might shape individual attitudes toward trade when they occur in the context of a large influx of foreigners and alarmist media coverage of trade and immigration. But none of these factors have an independent influence on individual attitudes.

Multiple causal paths exist when a given outcome can be caused by two or more configurations. Suppose, for instance, that we sought to explain the contemporary trade skepticism in the USA that has been so evident in the 2016 presidential election and was equally prominent in the UK’s referendum on EU membership. We might identify a configuration of factors that includes increased immigration, xenophobic and nationalist attitudes and low education among a segment of the population. This configuration in turn shaped policy through electoral processes – a referendum in the UK and a presidential election in the USA. But suppose instead that we sought to explain the widespread support for protectionism in the USA and the UK in the early 1930s. To explain widespread support for protectionism in this episode we would probably focus on a different configuration of factors. Here we might emphasize the dismal macroeconomic environment, falling commodity prices, and the collapse of international finance. This configuration produced protectionist outcomes via the legislative process. Protectionism is hardly unique in its capacity to arise through multiple paths. Individual attitudes are also likely to emerge from multiple causal paths – under some configurations attitudes reflect socio-tropic and non-material concerns, and in others attitudes reflect self-interest defined in factor or sectoral terms.

An approach based on causal complexity might help resolve the puzzle of individual attitudes about trade generated by OEP research. One might hypothesize, for instance, that individual attitudes toward trade are shaped by the joint presence of a set of factors that includes individual level characteristics such as education, union membership, occupation, nationalism, or ideological orientation, as well as some local and national environmental conditions, for instance how many friends are unemployed, is the dominant local industry expanding or contracting, is the national economy expanding or in recession, the rate of immigration, as well as a measure of how the major media outlets treat trade-related
issues. And rather than assume constant independence, we assume that all effects are conditional. Thus, ‘nativist’ beliefs shape trade policy only in conjunction with immigration, declining local industry and media coverage of the social and identity impacts of trade. In contrast, occupation or union membership, or skill level might shape trade attitudes in conjunction with declining local industry and an expanding national economy. Recently published research that examines individual attitudes about trade in the context of the Great Recession is highly suggestive in this regard (Mansfield, Mutz, and Brackbill, 2016). It seems useful to at least consider the hypothesis that individual attitudes are strongly influenced by social interactions and societal processes and likely to vary over time as the nature of these interactions and the environment in which they occur changes.

Although causal complexity underpins active research programs in comparative politics, the approach has attracted few adherents in international political economy. The lack of an active IPE research tradition may reflect the recognition that although causal complexity is first and foremost a set of assumptions about causal relationships, accepting these assumptions does imply reduced reliance on quantitative and greater reliance on qualitative empirical research, as well as a reduction of the scope over which empirical results hold (Mahoney and Goertz, 2006). Yet, given the somewhat disappointing results generated by 25 years of variable-based research, perhaps the embrace of causal complexity offers one useful path forward.

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NOTES

1. Moreover, almost all of this empirical work rests on surveys of the American public. We have very few studies that examine the relationship between education and trade policy preferences in the EU or the global south.

2. IPE once believed that organizations were the correct unit of analysis (see, e.g., Bauer et al. 1964; Magee, Brock, and Young, 1989. Three Simple Tests of Stolper-Samuelson). The field seems to have forgotten this or decided that organizations are merely the mouthpiece for the preference of their median member.
3. This section draws heavily from Rickard (2015, 283–5).
4. The electoral system literature ignores completely the simple fact that most democracies irrespective of electoral system have been active members of the WTO and as a consequence have been engaged in a common tariff reducing endeavor for the last 70 years.
5. Rickard (2015, 291) notes that the literature on individual trade preferences “have not yet been integrated into research on electoral institutions”.
6. And even if we accept the producer-consumer divide as the relevant cleavage, we still must wrestle with the absence of evidence to support the claim that the median voter is a free trade advocate. Moreover, as Guisinger (2009) points out, trade policy is a very low salience issue among the American electorate.
7. Research by Cranmer and Desmarais, for instance, demonstrates that shifting to a network approach undermines statistical support for the democratic peace hypothesis. One wonders if a similar result might characterize the relationship between regime type and trade.
8. “The simultaneity of international design and domestic politics makes the identification of causal arguments difficult. This is especially true when one of the causal processes is via ‘information’...that is difficult to measure and observe” (Rosendorff, 2015, 151).
9. It is not obvious that Rosendorff’s theoretical model implies that democracies will be more concerned than autocracies about the uncertainty of future costs. Kono (2015, 301–2) argues that many standard models (Grossman–Helpman PFS model, the median voter model) apply in democratic and autocratic settings.
10. One might also wonder if these findings weaken support for the regime type relationship where very few studies control for geopolitical and political institutional affinities.

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