

**“Assessing the Efficiency Gains from Further Liberalization”**

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## **“Assessing the Efficiency Gain from Further Liberalization”**

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In engineering, efficiency means getting the most output out of a given input -- for example, getting the most energy out of a given quantity of fuel -- subject to the laws of physics. In economics, efficiency means getting the most of whatever the objective is -- it can be GDP, but need not include only that -- out of given inputs, subject to the laws of human behavior.

The idea that it is more efficient for countries to engage in international trade than to produce everything they want domestically, is virtually as old as the field of economics itself. The current vantage point in history, the year 2000, is a time when the gains from trade should be abundantly tangible. During the first half of the 20<sup>th</sup> century, governments turned back the hands on the historical clock of international integration. The resulting decline in trade was implicated in world depression, political upheaval, and war. During the second half of the 20<sup>th</sup> century, the leadership of the western alliance, in general, and the United States, in particular, turned forward the hands of international integration. The resulting increase in trade has been accompanied by overall world prosperity and the spread of western economic and political values to virtually all parts of the globe.

Nonetheless, the turn of the millennium is a time when critics are questioning the gains from further efforts to liberalize trade. Many are not convinced that historical correlation implies causation. Others might agree that the increase in trade has been a source of economic growth, but argue that concerns other than GDP -- such as equality or the environment -- point to a different judgment regarding the desirability of trade. Still others might agree with the characterization of the last half-century, but say that little more now remains to be done. After all, most tariffs are now close to zero, and globalization seems to be complete.

### **How Far Has Globalization Gone?**

It is easy to get the impression that globalization is almost complete, that most trade barriers have already been dismantled, borders are irrelevant, nation states are inconsequential. It is easy to imagine that American citizens already trade with buyers or sellers on the other side of the globe as easily as the other side of town. But this is not the reality.

#### *How Much Further Do We Have to Go?*

Globalization of trade still has a lot further to go. Although trade as a share of the US economy, for example, has tripled over the last half-century, the increase is less impressive viewed by the hypothetical standard of complete global integration. The trade share is now about 12 per cent (exports or imports of goods and services as a fraction of GDP). But this is less than one-sixth of the way toward complete global integration,

defined as the hypothetical condition that would hold if Americans were truly no more likely to buy from, and sell to, each other than to trade with residents of other economies.<sup>1</sup> Similar statistics hold for other countries, even those that are smaller and naturally more open. [See *Chart.*] We are still far from the day when we buy from across the globe as easily as across the country.

At any point in history there are many powerful forces working to drive countries apart, at the same time as there are other powerful forces working to shrink the world. It is true that the shrinking forces have dominated over the last 50 years, but there is nothing inevitable about that. From 1914 to 1944 the fragmenting forces dominated, and it could happen again.

#### *What Are the Barriers?*

It is not difficult to identify some of the impediments to international economic integration that remain. Geographical, social, and policy factors all play a role. Their effect can be quantified in many ways. The following discussion of effects on bilateral trade draws on statistical estimates from the so-called gravity model.<sup>2</sup> Other approaches, such as inspection of the ability of cross-border arbitrage to narrow differentials in prices, give similar results.

Statistically, when two firms are located on opposite sides of a national border, operating for example under different legal systems, trade between them falls by an

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<sup>1</sup> That is, the US trade/output ratio would have to rise from 12 per cent to 75 per cent, before it fully reflected the share of non-US producers and consumers in the world economy. Even this statistic of a six-fold gap is an understatement, because exports and imports are gross transactions, not net value added; Singapore and Hong Kong, for example, export and import well over 100 per cent of their GDPs.

<sup>2</sup> These estimates of the gravity model of bilateral trade are from Frankel (1997), Rose (2000) and Frankel and Rose (2000).

estimated  $2/3$ , that is, to  $1/3$  of what it would be if they were located in the same country. This estimate even allows that the two countries in question officially have free trade between them, speak the same language, and use the same currency. If the two countries use different currencies, trade again falls by a further  $2/3$ , even if they fix the exchange rate between them. That is, the two border effects together reduce trade to  $1/9$  of what it would be within the same country. In addition, when the exchange rate is as variable as it is for the average pair of currencies, currency risk and transactions costs reduce trade by a further 13 percent. Such factors together explain why Canadians are twelve times more likely to trade with other Canadians than with Americans, despite the physical and cultural proximity of the two countries.<sup>3</sup> National borders still matter.

For most pairs of countries, the impediments to trade are much higher. If the two countries do not belong to a free trade area, but have tariffs and other trade barriers between them that are average in level, trade again falls by roughly  $2/3$ . (It falls by even more if the trade barriers are at levels typically found in poor countries.) If the two share no common historical or cultural links, the impediments are greater still. If they speak different languages, for example, trade falls by half.

Finally, notwithstanding the long-term historical decline in physical shipping costs, geography still matters. If two countries are not adjacent to each other, trade falls by half. In addition, for every one percent increase in the distance between them, trade falls by another one percent. [Small wonder, then, that US purchases from and sales to the EU, for example, are less than 3% the level of US purchases from and sales to the United States, even though the EU economy is as large as the US economy.]

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<sup>3</sup> E.g., Helliwell (1998, p.115).

The three-fold increase in the last 50 years that the US has experienced in trade as a share of the economy can be attributed in large part to declining trade barriers and declining transport costs. But neither of these sources of friction is yet close to zero. Differences in currencies and languages and the other factors mentioned above have diminished little. Globalization, though not in its infancy, has not yet reached full maturity. Unless we do something to screw it up, trade barriers and transport costs are likely to continue to fall during the 21<sup>st</sup> century. It follows that there are still large gains to be reaped from further reductions in trade barriers. That is, it follows provided integration is viewed as beneficial -- the question to which we now turn.

### **The Economic Benefits from Globalization**

Why do economists consider free trade so important? What exactly are the benefits?

#### *The theoretical case for trade*

Classical economic theory tells us that there are national gains from trade, associated with the concept of comparative advantage. Over the last two decades, scholars have developed an alternative New Trade Theory. Though often misinterpreted, it suggests the existence of possible additional benefits from trade, which are termed dynamic. Let us consider each theory in turn.

The classical theory goes back to Adam Smith and David Ricardo. Adam Smith argued that specialization--the division of labor--enhances productivity. David Ricardo

extended this concept to trade between countries. The notion is that trade allows each country to specialize in what it does best, thus maximizing the value of its output. If a government restricts trade, resources are wasted in the production of goods that could be imported more cheaply than they can be produced domestically.

What if one country is better than others at producing *every* good? The argument in favor of free trade still works. All that is required is for a country to be *relatively* less skilled than another in the production of some good in order for it to benefit from trade. This is the doctrine of comparative advantage--the fundamental (if perhaps counterintuitive) principle that underlies the theory of international trade. It makes sense for Tiger Woods to pay someone else to mow his lawn, even if Woods could do it better himself, because he has a comparative advantage at golf over lawn-mowing. Similarly, it makes sense for the United States to pay to import certain goods that can be produced with relatively greater efficiency abroad (apparel, shoes, tropical agriculture, and consumer electronics), because we have a comparative advantage in other goods (aircraft, financial services, wheat and computer software).

This is the classical view of the benefits of free trade in a nutshell. Two key attributes of the classical theory are worth highlighting. First, it assumes perfect competition, constant returns to scale, and fixed technology, assumptions that are not very realistic. Second, the gains from trade are primarily static in nature--that is, they affect the *level* of real income. The elimination of trade barriers raises income, but this is essentially a one-time increase, rather than a permanent rise in the rate of growth.

The "New Trade Theory" is more realistic than the classical theory, in that it takes into account imperfect competition, increasing returns to scale, and changing

technology. It ultimately provides equally strong, or stronger, support for the sort of free-trade policies that the United States has followed throughout the post-war period, that is, multilateral and bilateral negotiations to reduce trade barriers, than did the classical theory.

Much has been made of the result from these theories that, under certain very special conditions, one country can get ahead by interventions (e.g., public subsidies to strategic sectors), provided the government gets it exactly right, and provided other countries don't retaliate or emulate. But these theories also suggest that a world in which everyone is subsidizing at once is a world in which everyone is worse off -- a classic "prisoner's dilemma" -- and that we are all better off if we can agree to limit subsidies or other interventions. An example would be the agreement between the United States and Europe to limit subsidies to our respective aircraft manufacturers. Assume for the sake of argument that the US government is knowledgeable enough to use aircraft subsidies in such a way as to reap extra profits for the American producer (Boeing) at the expense of the EU producer (Airbus) if the Europeans do not retaliate. But how does that help? The Europeans would in fact retaliate.

Bilateral or multilateral agreements where other sides grant concessions in favor of US products, in return for whatever concessions we make, are almost the only sorts of trade agreements we have made. Indeed, most recent trade agreements (like NAFTA or the agreement to give China permanent Normalized Trade Relations) have featured much larger reductions in import barriers on the part of our trading partners than we are required to make ourselves. The explanation for this is that their barriers were higher than ours to start with. But the implication is that such agreements raise foreign demand



for our products by more than they raise our demand for imports. Hence we are likely to benefit from a positive “terms of trade effect.” This just adds a bonus on top of the usual benefits of increased efficiency of production and gains to consumers from international trade.

Furthermore, even when a government does not fear retaliation from abroad for trade barriers, intervention in practice is usually based on inadequate knowledge and is corrupted by interest groups. Special interests waste money lobbying to get the government to raise the price of whatever they are selling or lower the price of whatever they are buying. Ruling out all sector-specific intervention is the most effective way of discouraging such “rent-seeking” behavior. Globalization also increases the number of competitors operating in the economy. Not only does this work to reduce distortionary monopoly power in the marketplace (which corporations exercise by raising prices); it can also reduce distortionary corporate power in the political arena (which they exercise by lobbying).

Most importantly, new trade theory offers a possible reason to believe that trade can have a permanent effect on a country’s rate of growth, not just on the level of real GDP. Openness allows firms to keep in touch with global markets. A high rate of economic interaction with the rest of the world speeds the absorption of frontier technologies and global management best practices, spurs innovation and cost cutting, and competes away monopoly.

*The empirical case for trade*

Citing theory is not a complete answer to the question, "How do we know that trade is good?" We need empirical evidence.

There are a number of studies of the static microeconomic costs of protection by tariffs, quotas, and other trade barriers. It has been estimated, for example that the EU's distortions impose costs on it as high as 7 per cent of European GDP. These studies do not attempt to include possible dynamic effects on growth rates.<sup>4</sup>

Economists have undertaken macroeconomic statistical tests of the determinants of countries' growth rates. Investment in physical capital and education are the two factors that emerge the most strongly in these studies. But other determinants matter as well. There is a correlation of growth with openness, measured for example as the sum of exports and imports as a share of GDP. David Romer and I looked at a cross-section of 100 countries during the period since 1960.<sup>5</sup> We sought to address a major concern regarding simultaneous causality between growth and trade: Does openness lead to growth, or does growth lead to openness? We removed the complication of simultaneous causality by isolating variation in trade patterns that could be clearly attributed to geographical influences such as distance, borders, language, and so forth. We found that the effect of openness on growth is even stronger when we correct for the simultaneity, as compared to standard estimates.

The estimate of the effect of openness on income per capita varies, depending on the particular data set and equation, but is in on the order of 0.3 over the span of 25 years, and perhaps four times that in the truly long run. That estimate means that when trade

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<sup>4</sup> Messerlin (1999). Hufbauer and Elliott (1994) perform the analogous exercise for the United States.

<sup>5</sup> Frankel and Romer (1999). Frankel and Rose (2000) contains updated estimates.

increases by one percentage point of GDP, income increases by about one-third of a percent over 25 years. By way of illustration, the increase in U.S. openness since the 1950s has been 12 percentage points. The numbers imply that increased integration has had an effect of about 4 percent on U.S. income over this period, or about 15 per cent in the very long run. More dramatically, compare a stylized Burma, with a trade ratio close to zero, versus a stylized Singapore, with a ratio close to 200 percent. Our ballpark estimate, the coefficient of 0.3, implies that as a result of its openness Singapore's income is about 60 percent higher than Burma's over a 30-year period, or about 250 per cent higher in the very long run.

One possible response to these claims is that this approach demonstrates only the growth benefits from geographically induced trade, and need not necessarily extend to the effects of policy-induced trade. But it is not obvious why the benefits of one impetus to trade should be so different from those of another. In any case, popular critics of globalization seem to think that increased international trade is the problem, regardless of whether it comes from technological progress or market-opening negotiations. If the question is the broad-brush phenomenon of globalization, the answer seems to be that the effect on incomes is clearly positive.

The case for free trade has more support in most countries now than it did thirty years ago. Trade has been a major component of the growth that has visibly lifted East Asia out of poverty over the last 40 years. The rest of the world now wants the same. Poor countries don't want to be protected from "exploitation" – the exploitation of having the opportunity to sell their products abroad to willing buyers and thereby to raise their incomes.

## **The Non-Economic Benefits or Costs of Trade**

Many critics of globalization today do not dispute the claim that international trade has positive effects on GDP. Rather, they have other concerns in mind -- non-economic goals such as the promotion of labor rights and protection of the environment. The most important lesson from the Seattle demonstrations of November 1999 is that these issues will increasingly dominate public debate regarding globalization and multilateral institutions. They cannot simply be shunted off to the side, with pure trade issues occupying alone the center stage of international negotiations.<sup>6</sup>

International trade and investment have implications, in such areas as income distribution or environmental quality, that are sometimes favorable and are in some cases unfavorable. Facile generalizations are likely to be wrong. In particular, it is misleading to talk as if the partners in US trade or investment are generally countries that have lower wages, labor standards, and environmental standards, than does the United States, and that will thus inevitably pull down American standards. In more than half of US trade and direct investment, the partners are high-wage countries, who sometimes have "higher standards" than the United States does.

From the viewpoint of Europe, *the United States* is the low-wage country, with less-regulated labor markets. Environmental standards are sometimes lower in Europe than in the United States, but are as often higher. A case in point is European resistance to genetically modified organisms crossing the Atlantic. In fact there is as yet no scientific evidence that GMOs are harmful. But if European consumers want to avoid buying

foods that have had the benefit of such technology, under the “precautionary principle,” that should be their right, so long as their governments avoid discriminatory trade policies.<sup>7</sup>

Even when the partner country is at income levels below the US level, the feared undercutting of US standards is less in evidence than one might think. When American multinationals locate in developing countries, for example, they tend to raise labor and environmental standards relative to local employers. Once a technology or a management practice has become well established in the United States, the world’s biggest market, trade and investment spread the same techniques to partner countries. The major effect, in practice, is often upward pressure on the poor-country standards, rather than downward pressure on rich-country standards.

### *The Case of the Environment*

There is no question that the early stages of industrialization bring environmental damage. On the other hand, a clean environment is a “superior good” – something that societies wish to purchase more of, even though at some cost to aggregate income, as they grow rich enough to be able to afford to do so. If this effect is strong enough, then trade might be expected eventually to improve the environment, once the country gets past a certain level of per capita income. There is some empirical support for this pattern. Grossman and Krueger (1995) popularized what is called the environmental Kuznets curve: growth is bad for air and water pollution at the initial stages of industrialization,

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<sup>6</sup> Two key references in this rapidly growing field are: Bhagwati and Hudec (1996) and Rodrik (1997).

<sup>7</sup> The precautionary principle, “better safe than sorry”, cannot always answer the question however, even for the risk-averse. In the case of GMOs designed for agriculture in poor countries, doing without them may be the riskier strategy.

but later on reduces some forms of pollution, as countries become rich enough to pay to clean up their environments.<sup>8</sup> A substantial literature has followed.

The idea that trade can be good for environment is surprising to many. The pollution-haven hypothesis instead holds that trade and investment encourage firms to locate production of highly polluting sectors in low-regulation countries, in order to stay competitive. But research suggests that environmental regulation is not a major determinant of firms' ability to compete internationally.<sup>9</sup> In a model that combines various effects of trade, including via the scale and composition of output, Antweiler, Copeland and Taylor (1998) estimate that if openness raises GDP by 1 percent, then it reduces sulphur dioxide concentrations by 1 per cent. The implication is that, because trade is good for growth, it is also generally good for the environment.

It is important to note that government intervention is the most evident channel whereby people enact their desire for a cleaner environment as they grow richer. There is no reason to think that the market can take care of it by itself.

Most of the econometric studies of effects of trade and growth on the environment are limited, in that they examine only a few specific measures of pollution. There is a need to look at other environmental criteria as well. It is difficult to imagine, for example, that trade is anything but bad for the survival of tropical hardwood forests, absent substantial international efforts by governments to protect them.

The argument that richer countries will take steps to clean up their environments is likely to hold only for issues where the primary effects are felt domestically -- where the primary "bads," such as smog or water pollution, are external to the firm or

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<sup>8</sup> An earlier reference is IBRD (1992).

<sup>9</sup> Jaffe, Peterson, Portney and Stavins (1995).

household, but internal to the country. Two important environmental externalities are global, however: greenhouse gas emissions and depletion of stratospheric ozone. A ton of carbon dioxide has the same global warming effect regardless where in the world it is emitted. In these cases, individual nations can do little to improve the environment on their own, no matter how concerned are their populations or how effective their governments. International cooperation is required, which inherently means a trade-off at the margin against national sovereignty. The same is true about those environmental concerns over so-called non-use values that are increasingly cross-border, such as the value placed on endangered species. Governments have negotiated international treaties in an attempt to deal with each of the three problems mentioned -- ozone depletion, greenhouse gases, and biodiversity. Of the three, however, only the attempt to save the ozone layer, the Montreal Protocol, can be said as yet to have met with much success. The Kyoto Protocol on Global Climate Change faces political hurdles that approach the insurmountable. Desire by countries to protect their national sovereignty is one of the most important hurdles.

Is the popular impression then correct, that international trade exacerbates global environmental externalities? Yes, but only in the sense that trade promotes economic growth. Clearly if mankind were still a population of a few million people living in pre-industrial poverty, greenhouse gas emissions would not be a big issue. Industrialization initially leads to environmental degradation, and trade is part of industrialization. But virtually everyone wants industrialization, at least for themselves. Deliberate self-

impoverishment is not a promising option.<sup>10</sup> Once this point is recognized, there is nothing special about trade, as compared to the other sources of economic growth, such as capital accumulation, rural-urban migration, and technological progress.

The popular impression is that trade is somehow different. US congressional opponents of the Kyoto Protocol fear that if the industrialized countries agreed to limit emissions of carbon dioxide and other greenhouse gases, there would be an adverse effect on American trade competitiveness vis-à-vis the developing countries, who are not yet covered by the treaty. This is partially true: those US sectors that are highly carbon-intensive, such as aluminum smelting, would indeed suffer adversely. But other US sectors would be *favorably* affected by trade with non-participating countries.

The real issue -- the true reason why we need the developing countries to participate in a global climate change agreement -- has little to do with competitiveness. It is that the industrialized countries would otherwise have very little effect on aggregate global emissions over the coming decades, even if they were willing to cooperate to achieve the emission targets of the Kyoto Protocol and to bear the moderately high costs (but no higher) involved in gradually restructuring their domestic energy economies. But this point has nothing to do with trade. It would be the same in a world where industrialization took place without globalization. International trade, whether in goods or in emission permits, actually offers a way of bringing down the economic cost of attaining any given reduction in global emissions, or a way of obtaining deeper cuts in emissions for any given economic cost. Indeed, elimination of such distortions as

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<sup>10</sup> In any case, indoor air pollution (particulate matter from cooking and heating fires) and lack of cleaning drinking water are larger environmental threats in poor countries, each claiming millions of premature deaths per year. Economic development is the best way to address them.



subsidies to agriculture, logging, and coal, can be pro-environment and pro-free-trade at the same time.

*“Efficiency” as the achievement of objectives*

As noted at the outset, efficiency means maximizing one’s objective, whatever it may be, subject to the constraints of nature and man. The objective is not limited to GDP, but includes such non-economic goals as the equality of income distribution and the quality of the environment. The principle remains that countries can better achieve their goals through free international exchange -- subject to rules mutually agreed in international fora such as the WTO, IMF, ILO and UNFCCC -- then they could if they hid behind barriers to trade and investment.

**What Areas Should Be Priorities for Negotiation?**

Now that most tariffs have been reduced substantially, the remaining non-tariff barriers are more important, and merit more attention, even though they are inherently more complicated to negotiate over. This has been said at the time of each of the GATT rounds of the last 40 years. But it has been true each time.

The challenge in proposing multilateral negotiations is not to identify sectors that remain to be liberalized. There are lots of those. Rather, it is to identify a set of liberalizations that is perceived by each major participant as a package that on net offers it major benefits. Furthermore, under a well-known principle of political economy, which might be called reciprocal mercantilism, the benefits had better accrue to important

producer interests in each country. The economist's argument that liberalization is beneficial to *consumers* in the importing country does not carry much weight in the political sphere.

There have been some exceptions to this rule of political economy in recent years. One type of exception is unilateral liberalizations in some countries that had become disenchanted with old import-substitution policies. Another is recent post-Uruguay Round multilateral liberalizations in single sectors such as information technology, financial services, or telecommunications. These single-sector negotiations succeeded despite the absence of scope for trading concessions across producers, because they involve sectors that firms in many countries see as *inputs* important to industrial development.<sup>11</sup> But it is unlikely that those single-sector negotiations can be repeated for many other industries.

### ***The Form of Negotiations: Where and Who?***

Should attempts at further liberalization be negotiated regionally or multilaterally? Who are the key players who must agree to the agenda?

#### *Regional vs. multilateral*

Given the difficulty of reaching agreements at the multilateral level, the question arises whether more progress might be made at the regional level, where fewer players are involved, political goals might help, and the countries might in any case be natural

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<sup>11</sup> Council of Economic Advisers (1998, pp. 224-226); Hufbauer and Wada (1997).

trading partners.<sup>12</sup> From 1982 to 1994, regionalism had a lot of momentum, in part because progress at the multilateral level was so slow [blocked largely by failure of the EU to agree to US demands to liberalize agriculture]. But regional arrangements no longer look like such a promising alternative, outside of Europe. On the one hand, the Uruguay Round was successfully concluded, while on the other hand regional clubs in the Western Hemisphere have made no further progress, and in Asia have come to nothing. The major 1982 shift in US policy, the decision to accept regional FTAs as an alternative to multilateral negotiations, has become less relevant during a period when Congress refuses to give the President fast-track authority for trade negotiations of any sort, in part due to a perceived popular backlash against NAFTA. This is not to say that the next occupant of the White House might not do better using a modest objective like Chilean accession to NAFTA for selling fast-track to Congress than a big WTO objective. Nevertheless, the current obstacles to liberalization exist as fully at the regional level as at the multilateral level. We might as well have the debate at the global level, where it really counts.

The general rule stands, that packages must offer perceived benefits to producer interests in each major country. This means a package of market-opening measures in a variety of well-chosen areas. It probably should come in the form of another WTO round, even if it does not turn out to be called the Millennium Round, and even if it is decided to lock in a first set of concessions after a few years of negotiations (a “round up”), rather than waiting until the end.

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<sup>12</sup> See Frankel (1997) for an analytical framework that evaluates whether regional trading arrangements are natural -- more likely to be trade-creating than trade-diverting -- and an extensive review of the literature,

*The developing countries*

Even though decisions in the GATT and WTO are technically made by consensus, with each country having an equal vote, it is inevitable that some players in practice count far more than others. The pattern in past GATT rounds has been that cut-and-thrust exchange between the United States and Europe has dominated the negotiations, and when those two powers had come to some agreement, the rest of the world generally fell into line. Other countries had little influence over the agenda.<sup>13</sup> Little vote was given to the developing countries, largely because they had little in the way of lucrative concessions to offer the rich countries.

Increasingly, however, the developing countries are important players, at least collectively. Asia and Latin America now constitute major markets. Under the new rules agreed in the Uruguay Round, they like other WTO members are generally no longer able to opt out of aspects of an agreement,<sup>14</sup> or to block decisions by panels under the dispute settlement mechanism. Furthermore, in the Uruguay Round developing countries were asked in the area of Intellectual Property Rights to put energy into enforcement of a set of rules that, whatever their economic justification, benefit rich-country corporations and not them. This time their interests will have to be taken into account. This means liberalization of textiles trade, for one thing. It would also mean protection against arbitrary anti-dumping measures, if the United States would agree, and liberalization in

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including the political economy of regional arrangements.

<sup>13</sup> In the case of Japan, anything that maintained the momentum of a rule-based multilateral trading system was beneficial, as it constitutes insurance against unilateral demands against Japan.

<sup>14</sup> Bhagwati (1998). The requirement that WTO members must adhere to all negotiated obligations as a “single undertaking” still has exceptions for the poorest developing countries. Also, two areas, government procurement and civil aviation, remain under “plurilateral accords” of the WTO. Schott (1998, p.3).

agriculture, if Europe would agree. If a new round has nothing to offer the developing countries, they might this time try to block it.

*Environment, food safety and labor standards*

The other relevant set of players, who have gained a new seat at the table de facto if not de jure, are the NGOs in areas such as environmental and social policy. They are often confused and inconsistent about what they want. It was surprising at the time of the Seattle Ministerial to see demonstrators from the environmentalist and labor movements claim to share some beliefs about the proper role for multilateral institutions. (The former's complaint about the WTO is, for example, that they see it as an obstacle to enforcing regulations like the Kyoto Protocol on Global Climate Change. The latter are the strongest opponents to the Kyoto Protocol.) It was even more surprising to see them claim to share some interest with the populations of poor countries. (The labor and environmental groups want western countries to import less from poor countries, the latter want them to import more.)

Nevertheless, the day has passed when those working to advance free trade can respond to environmental and labor concerns from the NGOs by simply explaining that the WTO deals only with trade. It is possible that discussion of these issues will have to take place under the auspices of the WTO,<sup>15</sup> going beyond the step taken at the Singapore ministerial of 1997 of mentioning the words "labor and environment" in the agreement.

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<sup>15</sup> In the past, the immediate legal obstacle to including most environmental and labor issues, beyond the more fundamental political obstacles, has been the key distinction between internationally traded goods, which are the proper subject of internationally-agreed rules, and the processes by which the goods are produced within each country, which have not been considered an appropriate subject for the WTO. It might be argued that the inclusion of Intellectual Property Rights in the Uruguay Round has now shattered the distinction regarding processes. [Maskus (2000) argues that labor issues lack the international externalities of competition policy or cross-border environmental problems.]

Even if the discussion remains outside the WTO, some acceleration of effort toward international agreements on environmental and labor standards is necessary. It is necessary if only to convince an important bloc of public opinion that the world's governments are not just paying lip service to these concerns. Otherwise, again, trade negotiations are likely to be blocked.

The ultimate goal should be international agreements voluntarily entered into. There is no alternative, in a world of sovereign countries. An agreement on genetically modified food concluded in Montreal in January 2000, under the 1992 UN Convention on Biological Diversity, might be a model. (US grain exporters, for example, will have to identify shipments that "may contain living modified organisms," in effect allowing those farmers eschewing GMOs to appeal to consumers who prefer "natural" foods and are prepared to pay the cost premium.) This global Biosafety Protocol, if it works out, will show that it is in fact possible to marry international progress on health/environmental issues with trade rules that protect producers from arbitrary or discriminatory actions by importing countries. Furthermore, in a move to transparency, environmental NGOs were included in the negotiations, and supported the outcome.

The logical locus for most international agreements is designated multilateral institutions, such as the ILO in the case of labor standards, the UN Framework Convention on Climate Change (UNFCCC) in the case of greenhouse gases, etc. In the meantime, one must recognize, as the NGOs point out, that the WTO is a more credible institution than the ILO or the UNFCCC, and that this is in part because withholding trade is one of the few powerful weapons that countries have, short of military action.

The ILO and UNFCCC have no teeth. The United Nations Environment Program (UNEP) is so weak an institution that it should be replaced from scratch.

But the reason these institutions lack teeth is because the member countries, so far, want it that way. The failure to agree on binding international standards enforced by sanctions is attributable to the desire for retaining national sovereignty, to disagreements among countries, and *to internal disagreements within each country* on what priority to assign labor rights and the environment. It is the fault neither of globalization nor the international institutions themselves. Agreements should include sanctions if and only if members, acting through their chosen national governments, can agree that they want them to.

Multilateral institutions can play a major constructive role in the areas of:

- certification -- monitoring multi-national corporations that commit to particular codes of conduct, along the lines of the U.N. Global Compact;
- labeling -- so that consumers can if they choose exercise their right not to consume products that they view as environmentally or socially harmful or objectionable -- for example, dolphin-unfriendly tuna or turtle-unfriendly shrimp; and
- scientific fact-finding and risk-assessment -- to offer an unbiased expert judgment on, for example, the state of scientific knowledge regarding the effects of hormone-treated beef and GMOs, thus refereeing where countries hold vastly different perceptions.

The aim is to facilitate the desired ability of individuals to use their purchasing power as a signal to express their values and beliefs, and as a weapon to pressure corporations and countries to behave in particular ways. [It has worked successfully to persuade

Mexican tuna fishermen to protect the dolphins, a process that was not impeded by the WTO panel ruling.] Such signals and weapons should help pressure the system to move in the direction of international agreements of the sort noted above.

But we should establish from the outset that countries must not make up their own rules for international trade, imposing trade penalties on other democratic countries in an attempt to bully them into changing their environmental or social policies, in violation of WTO rules. Without this assurance, developing countries will refuse altogether to discuss the whole subject of environmental and labor standards in the context of the WTO.

### ***Priority Sectors for Negotiation***

In what sectors are the prospects of efficiency gains from liberalization promising?

#### *Textiles and other manufactures*

The WTO has not finished lowering tariffs and quotas on manufactured products. This is especially true of manufactured imports into developing countries.

We have already mentioned textiles and apparel, the first rung of manufacturing exports for poor countries seeking to climb the ladder of development. Rich countries agreed in 1995, under the Uruguay Round, to phase out over the next ten years the quotas that under the Multi Fiber Agreement (MFA) have long kept the textile sector highly protected. An acceleration of the schedule is the simplest concession to offer the poor countries in exchange for the many demands being placed on them. But little



liberalization has occurred to date. The difficult time the Administration had convincing the US Congress to support the elimination of barriers to apparel exports even from Africa and the Caribbean is revealing. China's accession to the WTO alarms some with the prospect of a huge increase in the global supply of inexpensive textiles and apparel. There are grounds for skepticism, given domestic politics in the United States and other rich countries, regarding whether the MFA phase-out that was promised in 1995 will actually happen. If rich countries fail fully to deliver on this promise, it is hard to see what incentive developing countries have to go along with a new Round, or even to carry out their Uruguay Round commitments in the area of Intellectual Property Rights.<sup>16</sup>

*Built-in agenda: agriculture and services*

Agriculture and services were both exempted from the original GATT rules. Both were formally brought under the WTO in the Uruguay Round that was completed in 1994. But in both cases, serious liberalization was postponed. Agriculture and services constitute the "built-in agenda" of negotiations that was scheduled to resume by the year 2000, and are the most likely core of a new Round. Distortions in agriculture remain as high as ever -- import barriers, export subsidies, and producer subsidies -- especially in industrialized countries.<sup>17</sup> The Uruguay Round only got as far as expressing these distortions in terms of tariffs, with an eye toward facilitating future negotiated reductions. Anderson et al (1999) estimate that one third of the total worldwide gain from rich countries eliminating distortions in their goods markets is to be had in agriculture.

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<sup>16</sup> Wang and Winters (2000), Subramanian (1999).

<sup>17</sup> Less developed countries tend to tax agriculture rather than subsidizing it. In OECD countries, agricultural protection, measured as the rate of assistance, has risen to about 60 percent in 1998, from about

Services constitute a diverse category of sectors, most of which have historically been less affected by trade than goods sectors, but many of which (e.g., business services) engage increasingly in trade, in part due to the internet and other advances in telecommunications and computer technology.

Within the large and diverse category of services, perhaps the greatest efficiency gains are to be had by liberalizing transportation services. Protection levels tend to be higher for transport services than for construction and business services.<sup>18</sup> The airline industry is heavily regulated internationally -- passengers, air cargo and express -- with an overabundance of national champions and a lack of competition. The shipping industry is even more highly regulated and cartelized, and unevenly so around the globe. "Liner conferences" operate as cartels. Thus the airline, shipping and trucking sectors are prime candidates for liberalization. Their role as inputs into international trade makes them doubly important candidates: not only would liberalization reduce costs in the transport sector, but the enhanced ease of international trade would confer additional gains throughout the global economy. [The United States has been a leader in negotiating bilateral open skies agreements, but the maritime industry firmly blocks multilateral efforts at liberalization in shipping.]

### ***Other Issues for Negotiation***

An increasing number of issues cut across sectors of the economy.

#### *Antidumping*

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30 percent thirty years earlier, a period during which tariffs on industrial goods have fallen sharply. (Hertel, 1999, and Roberts, Podbury, Andreas and Fisher, 1999).

While trade distortions have been reduced in many areas, and are roughly unchanged in others, there is one kind of distortion that is on the upswing. That is antidumping (AD) measures. In 1999, 328 AD cases were launched, up 41 percent from 1998, and more than double the rate in 1995.<sup>19</sup> The name “antidumping” sounds like it has something to do with antitrust enforcement against predatory pricing; thus it gives the press and public the impression that these measures are a tool to combat trade distortions and increase competition. But they have nothing to do with predatory pricing, they suppress competition rather than defend it, and they are among the costliest of trade barriers.<sup>20</sup>

The use of AD measures increased rapidly in the United States in the 1980s and 1990s, because firms hit by increased imports have found it much easier to gain protection under the antidumping laws than under the safeguard laws. Their use has subsequently increased rapidly in other countries as they emulate and retaliate against the United States. An attempt to rein in the indiscriminate use of antidumping would rank near the top of the economist’s wish-list of priorities for the next round of multilateral negotiations. (It could be coupled with some steps toward a multilateral competition policy, to reassure those who are under the illusion that the AD laws have some pro-competition value.) Unfortunately, the United States is unlikely to agree to the inclusion of this issue.

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<sup>18</sup> Hoekman (1995).

<sup>19</sup> The Economist, April 22, 2000.

<sup>20</sup> The enactment of antidumping duties means import quantities on average fall by almost 70 percent and import prices rise by more than 30 percent -- Prusa (2000).

*Competition policy and investment*

The Uruguay Round already included an agreement on Trade Related Investment Measures, but its effects were minimal. Some hoped to generalize provisions in the NAFTA to the multilateral level. But opposition from suspicious developing countries led to an attempt to begin by using the OECD as a venue for negotiating a Multilateral Agreement on Investment among industrial countries alone. Notwithstanding the inadequacy of the MAI, NGOs rallied opposition in a surprising first display of successful electronic populism that presaged Seattle. Some combination of that opposition and French intransigence killed the MAI in 1998. Investment may not now be the most promising issue with which to make progress in multilateral negotiations. If it is to be pursued, which would require more thought regarding environmental and labor standards, it should probably be moved back to the WTO.<sup>21</sup>

The world is probably even less ready for a comprehensive multilateral agreement in the related area of competition policy.<sup>22</sup> Countries vary widely in their conception of what sort of competition policy is desirable, even at the domestic level. History suggests that formation of a consensus world-view on an issue, even before horse-trading begins, is a prerequisite for international cooperation.<sup>23</sup>

*Government procurement*

Potential gains to an agreement for enhanced market access in public procurement would be substantial, particularly covering such services as construction,

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<sup>21</sup> Bhagwati (1998), Graham (1998).

<sup>22</sup> Richardson (1998).

<sup>23</sup> Cooper (1986).

maintenance and repair services.<sup>24</sup> But this is yet another area where developing countries are in effect being asked to make larger concessions than industrialized countries.

### *Enforcement of DSM rulings*

The Uruguay Round created in the WTO a dispute settlement mechanism (DSM) purged of the crippling limitation that the losing country could block a panel ruling. On the whole, it has worked well. But a mechanism to compel enforcement is still lacking. Nothing has forced the EU to comply with adverse panel rulings in the cases of bananas and hormone-treated beef.<sup>25</sup> The EU has retaliated with a complaint, now upheld by a WTO panel, that US Foreign Sales Corporations constitute a subsidy to exports, in violation of WTO rules. One hopes that the EU and United States can work out their differences before they undermine the legitimacy of the DSM.

An immediate need for the dispute settlement panels is an expansion of personnel, as in the WTO more generally. A more ambitious need for the longer term is agreement among the members over enforcement.

### *Estimates of Efficiency Gains from Further Multilateral Liberalization*

Statistical estimates of the association between trade and growth, of the sort discussed earlier, cannot be used by themselves to put a number on the benefits of specific negotiations to liberalize trade. Too many other factors have contributed to the observed increase in trade in addition to past liberalization, such as technological

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<sup>24</sup> Francois, Nelson and Palmeter (1996).

<sup>25</sup> Jackson (2000, p.13).

reductions in the costs of transportation and communication. To assess the gains from multilateral negotiations aimed at further liberalization, we must turn to microeconomic models. Of the various possible econometric approaches to modeling trade, the computable general equilibrium (CGE) models are the most popular for evaluating multilateral negotiations, because they attempt to take into account interactions across sectors. An evaluation of the effects of lifting steel quotas, for example, would include not just the savings to firms that buy steel, but also the impact via the prices and sales of products made from steel, the impact on industries that produce other materials that might compete with steel, the diversion of resources out of the steel industry in steel-importing countries and into other industries, the reverse movement within steel-exporting countries, and so forth.

A number of researchers have recently used versions of a global CGE model called the Global Trade Analysis Project to evaluate the possible effects from a new WTO round. Hertel (1999, p.17, 30) estimates that the gains from reducing trade barriers in manufacturing, services and agriculture, to take effect in 2005, would be a global welfare gain of nearly \$350 billion. [Of which, agricultural liberalization contributes the most, followed by manufacturing and services. The services experiment is knowingly limited, excluding, for example, transportation services.] Nagarajan (1999) includes in his experiment a modest reduction in trade costs from a WTO agreement on trade facilitation, coupled together with a 50 per cent across-the-board cut in worldwide protection in all agricultural, industrial and services sectors, and estimates resulting annual welfare gains of around \$400 billion for the world economy, or about 1.4 percent of global income. In addition, a WTO agreement on competition is said to generate an

annual welfare gain of approximately \$85 billion. Dee and Hanslow (2000, p.17-18) use a version of the model that has been modified to include the effects of Foreign Direct Investment, so as to be able better to get at liberalization in services. They project an increase in world real income of more than \$260 billion in current dollars as a result of eliminating all post-Uruguay trade barriers.<sup>26</sup> About \$50 billion of this would come from agricultural liberalization, \$80 billion from liberalization of manufactures and \$130 billion from liberalizing services trade. Overall, then, the static gains are estimated on the order of 1 per cent of world income.<sup>27</sup>

The estimates of the CGE models are not designed to take into account the possible long-term effects on the growth rate, as opposed to a one-shot effect on the level of real income -- the dynamic benefits mentioned earlier in this chapter as opposed to static effects. As already noted, these potential dynamic gains include the benefits of technological improvements through increased contact with foreigners and their alternative production styles. Such interactions can come, for example, from direct investment by foreign firms with proprietary knowledge, or by the exposure to imported goods that embody technologies developed abroad. For a back-of-the-envelope calculation that includes all growth effects, we must return to something like the Frankel-Romer estimate of the coefficient on openness. The results in Hertel (1999, p. 15-16) estimate that a new Round entails a 20 per cent increase in global trade volumes [3/4 of it

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<sup>26</sup> The most obvious reason why these estimated effects are less than Hertel's is that they are in current dollars, whereas his are in terms of 2005.

<sup>27</sup> Welfare gains on this order are often described as disappointingly low. But an annual gain of \$300 billion is in fact a huge number, especially when one takes the (present discounted) sum over time. Perhaps it would sound more impressive as the numerator of a benefit/cost ratio, where the denominator is the budget of the WTO (a mere \$76 million per year) and of national trade negotiators.

coming from cuts in manufacturing tariffs, and most of the rest from agricultural liberalization]. This would raise the global levels of merchandise exports plus imports as a share of income from a ratio of about 37 per cent<sup>28</sup> to 45 per cent, so the .3 Frankel-Romer coefficient implies that the Round might raise global income per capita by 2 per cent over a 25-year period, and four times that in the truly long run. Needless to say, such a calculation merits many qualifications. Nevertheless, if trade can have long-term effects of this nature, it makes the case for further liberalization negotiations even more compelling.

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<sup>28</sup>  $(\$11 \text{ trillion})/(\$29 \text{ trillion})=.37$ , in 1998.



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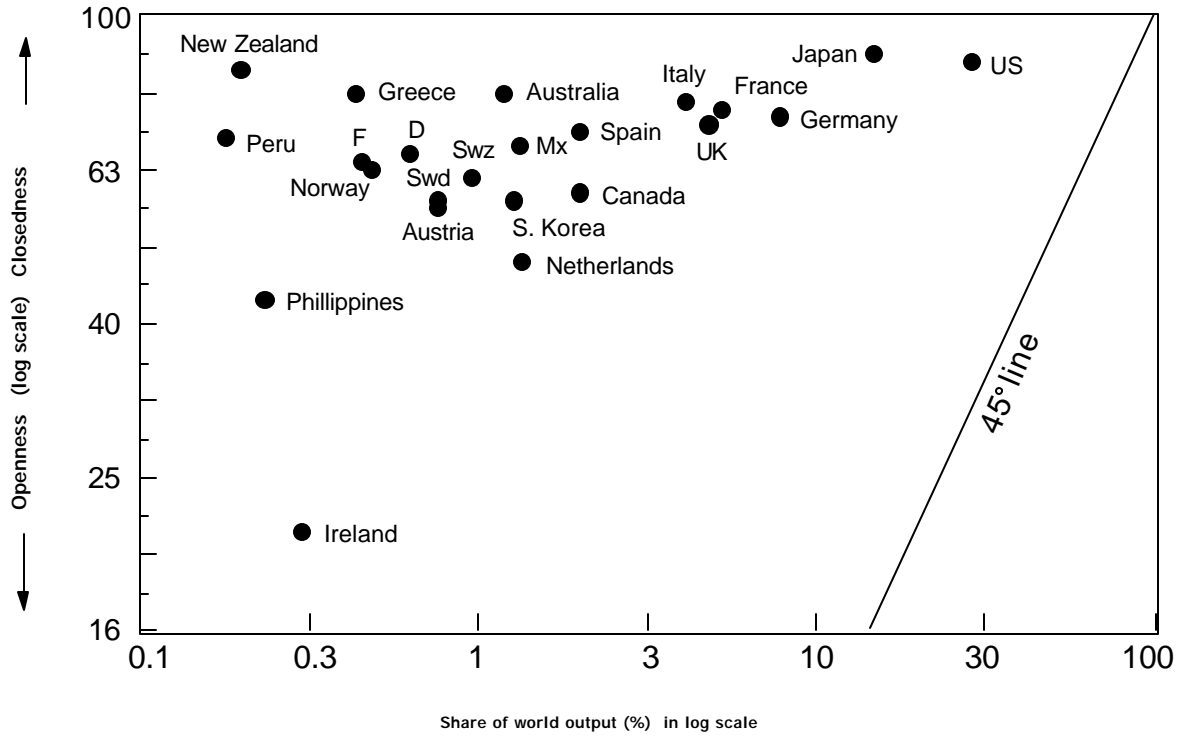
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# Openness and Size



Note: closedness =  $\{1 - [(X+M)/(GDP*2)]\} * 100$

Data source: IMF's IFS National Accounts

Number of countries: 23