# LL.M. in International Legal Studies

# WTO LAW

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Part I – Trade Theory

# Why trade?

- Autarky: a country has only one choice, turning domestic factors of production (labour, technology) into goods and services
- Trade: a nation gains two ways of raising national income: production and exchange

- Key questions for economic analysis:
  - Where do the gains from trade come from?
  - How can we analyse patterns of specialisation?
  - Does everyone gain from trade?

- The practice of **market opening** suggests that overall gains from greater openness/competition tend to exceed adjustment losses
- But – effects of political economy :

- Gains from openness may be diffuse, not easily detectable
- Losses are concentrated in time and space
- Adjustment is not always quick, nor always temporary; losses can be permanent
- Producers are typically more vocal and better organized than consumers
- It is difficult in practice to compensate losers through redistributive policies

# The gains from trade

- Understanding of why nations trade with one another and the gains they mutually derive from it is barely 200 years old
- 1776: **Adam Smith's** *Wealth of Nations*:
- First to sketch out the gains from trade via specialization
  - Virtues of unilateral liberalisation: specialize and use the profits to import what you are not good at producing, whatever your partners do

- Smith’s analysis was based on the notion of ***absolute advantage***, which he measured by comparing levels of labour productivity across countries:
- The country that requires the smallest amount of productive factor inputs to produce a given quantity of goods was deemed to possess an absolute advantage

# The theory of comparative advantage

- But what if a country has no absolute advantage over its trading partners in the production of any good or service? Should it refrain from trading?

- **David Ricardo** solved that puzzle four decades later in his *Principles of Political Economy and Taxation* (1817) by enouncing the theory of ***comparative advantage***

# Ricardian analysis

- Two countries –Portugal and England, and two products –wine and cloth
- Labour productivity and technology = the key influences in determining patterns of specialization and gains from trade
- Assumptions:
  - Labour is the only factor of production, immobile between countries
  - Complete specialization in the good in which a country has a comparative advantage
  - Markets are fully competitive
  - Transport costs are zero

- Differences in prices under of system of autarky generate differences in opportunity costs (the quantity of resources that must be given up to obtain an item)
- Countries will specialize in the production of goods and services in which they have the lowest opportunity costs
- Portugal enjoys an absolute advantage over England in the production of both wine and cloth, but its comparative advantage is greater (its opportunity costs lower) in wine production -> it should specialize in wine and import cloth

| Wine | Cloth | |
| --- | --- | --- |
| 120 | 100 | England |
| 80 | 90 | Portugal |

- By trading cloth produced by 100 British men for wine produced by 80 Portuguese, England obtains a good - wine - that would have required 120 British men to produce. Portugal gains by her 80 men's worth of labour in wine cloth that would have taken 90 Portuguese workers to produce
- The gains are not the same for England and Portugal, yet both can consume more of each good than would have been possible in autarky

# Arguments in favour of protection

- Protection is needed to reduce domestic unemployment or to cure a deficit in the BoP
- Protection is necessary on national defence grounds
- Protection as a bargaining chip – a card for big countries
- Optimal tariff protection – market power needed
- Revenue raising protection
- Cultural or social values as arguments for protection
- Infant industry protection
- Strategic trade policy

# Key instruments of trade protection

- Tariffs: price based, transparent, government gets the revenue; WTO legal and subject to periodic negotiations to lower tariffs

- Quotas: quantity based, domestic producers get the rent - consumers lose, GATT-illegal

- Voluntary Export Restraints: quantity-based, foreign producers get the rent - domestic consumers lose, GATT-illegal

- Non-tariff measures: as tariffs are lowered, governments resort to them as a means to provide protection to domestic producers (e.g. standards, licensing regimes, safety regulations, environmental regulations, procurement preferences, discriminatory rules of origin in PTAs)
  - the need for a necessity/proportionality test, esp. when regulatory measures are non-discriminatory

- WTO Agreements are based on the “multilateralisation” of Ricardo‘s theory of comparative advantage
- Initially, the US had strictly opposed the inclusion of an exception for regional trade agreements into the GATT (Art. XXIV)
- Developing countries convinced the US that preferential trade liberalisation would be better than no liberalisation at all
- However: according to trade policy analysis, regional trade agreements are always only “second best”

# Preferential liberalisation

- Free Trade Areas (retention of individual members' barriers against third countries)
- Customs Unions (FTA + common external tariff)
- Common Markets (CU + full factor mobility + deeper regulatory convergence)
- Economic Union (CM + monetary union + policy harmonization)

# The theory and practice of preferential trade liberalisation

- Is a smaller, partial, measure of market opening better than none at all, or much worse than global free trade?
- Economic theory offers no *ex ante*-support to the proposition that preferential trade liberalization will necessarily be welfare-enhancing.
- But it does, based on Jacob Viner’s analysis in 1950, provide some useful tools to assess the likely welfare effects of PTAs, both static and dynamic

# Two forces at play

- Trade creation: shift towards more efficient producers within the preferential area
- Trade diversion: substitution of efficient non-member suppliers by inefficient regional suppliers as a result of the tariff preference
- -> There has to be more trade creation than trade diversion

# PTAs: Pros

- Increased competition/economies of scale
- Stimulus to investment - domestic and foreign
- Better overall allocative efficiency
- Strong evidence that North-South PTAs exert stronger dynamic benefits, including by tackling new issues not on the WTO agenda

# Cons

- Promoting inter-block rivalry
- Making multilateral liberalisation harder for fear of preference erosion
- Deflection of scarce negotiating resources, especially in developing countries
- Risk of unequal bargains (agriculture, labour mobility)
- Risk of compliance costs – notably rules of origin