1 Introduction to trade policy

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The study of international trade by economists can be roughly divided into three general areas of inquiry: (a) trade theory; (b) empirical studies of trade; and (c) trade policy. The former seeks fundamental insights through the rigorous application of structural formalism and tightly specified assumptions. Empirical studies test the propositions of trade theory (Perdikis and Kerr, 1998) or attempt to garner insights from the statistical evidence pertaining to trade flows and related economic indicators. Trade policy deals with the economic effects of direct or indirect government intervention that alters the environment under which international transactions take place. Work in trade theory is most often undertaken within a *general equilibrium* context while trade policy, for the most part, is accomplished using *partial equilibrium* analysis. Trade policy deals with the winners and losers that arise from government intervention in markets. Vested interests are at the heart of trade policy, with government actions viewed as redistributive and open to influence. It has been the subject of many of the great economic debates of the last two and a half centuries and still provides topics that are hotly contested in the academic, political and civil society arenas.

Trade policy has been around since the dawning of economic science. While Adam Smith (1776)[1] may have had a number of motivations for writing *The Wealth of Nations*, there can be little doubt that a central task was to debunk the intellectual respectability of mercantilism – a trade policy prescription that favoured exports and eschewed imports. It can be argued that the development of trade policy since Smith's time has consisted of the gradual stripping away of the intellectual legitimacy of various protectionist theories that have attempted to identify narrow vested interests with the general good. Trade theory evolved from this process as economists sought ever greater intellectual rigour in trying to understand the underlying welfare implications of an economy choosing (or not) to engage in international trade. As trade theory fundamentally came down on the side of trade liberalization it was enlisted in the service of trade policy. The result of these endeavours has been to raise the cost of obtaining protection from those involved in the political process. Protectionists, however, have proved to be both formidable and tenacious – as one would expect as there is often much at stake.

The analysis undertaken in trade policy has, over time, had to deal with increasingly complex issues. In part this is a result of the expanding set of constraints that have been imposed on trade policy makers as trade liberalization has become a generally accepted goal of governments. This has often meant that governments have agreed to constraints on the use of direct trade policy instruments such as border taxes. Faced with these constraints, less straightforward and transparent trade policy measures may have to be devised when the politicians need to respond to protectionists' requests that arise.

In addition, the Great Depression of the 1930s which induced an era of high trade barriers – particularly tariffs – overlapped, to a considerable degree, with the Keynesian revolution that brought a general expansion in the role of government in the economy.

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A myriad of subsidies, redistributive policies and regulations were put in place behind high tariff walls and without any regard for their potential effects on international commerce.

Over the long process of liberalization, particularly in developed countries, that began with the coming into force of the General Agreement on Tariffs and Trade (GATT) in 1947, tariffs were progressively removed and firms engaging in international trade increasingly found domestic policies in importing countries acting to inhibit the opportunities they could identify. As a result, trade policy analysis has had to examine questions that were long considered in the purview of domestic policy. Determining the trade effects of domestic policies is often much more complex than that associated with border measures. Further, as most domestic policies that inhibit trade have a domestic policy objective, questions of legitimacy often arise. This is particularly important given the temptation to respond to protectionist requests by imposing nefarious policies or regulations justified on the basis of some supposed domestic imperative. Trade policy interfaces increasingly with science (for example food safety, the environment), with analysis of consumer preferences (for example animal welfare, child labour) and social policy (for example sustainable development, labour standards). As a result, trade policy analysis has been broadened to include questions such as: What is the appropriate degree of caution in the face of scientific uncertainty?; Can the regulation of imports be enlisted to foster dolphin-friendly fishing methods?; or Is the regulation of the trade in rhinoceros horns likely to aid in the preservation of the species? These are competencies that have not been typically expected from trade economists.

Trade policy also deals with institutions and questions relating to the efficacy of those institutions. Governments have concluded a host of multilateral, regional and bilateral agreements and arrangements to manage trade. These agreements cover a host of topics from rules for trade in goods, to rules for trade in services, the international protection of intellectual property, what constitutes unfair trade, the regulation of international investment, when sanctions can be applied and what forms of subsidies are allowed, to name only a few. In some cases these rules have a sound economic underpinning such as the official preference for tariffs relative to other border measures while others, such as those pertaining to dumping, have only the most tenuous grounding in economic theory. Their application, however, will have economic consequences that can be illuminated through economic analysis.

The relative merit of various institutional arrangements, whether they are multilateral, plurilateral, regional, bilateral, unilateral or autarkic are also active topics of research interest in the trade policy area. There are literally thousands of agreements among countries that regulate trade in some fashion from the 140 member plus World Trade Organization to bilateral arrangements on the appropriate forms veterinarians can use to certify meat fit for export. There are agreements dealing with the classification of goods for tariff purposes, on how to value goods for the collection of tariffs and on how new products will be incorporated into the trade nomenclature. Even such apparently innocuous topics as tariff classification can have considerable economic ramifications and become contentious trade policy questions.

The development of trade policy is almost always contentious. At its most basic, this is because any change to trading arrangements among countries will lead to winners and losers. Of course, winners and losers will arise from a change in any government policy. The interesting question is why trade policy changes are consistently the subject of

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acrimonious debate. Part of the reason is that there is an expectation that governments should have as their primary concern the welfare of their own citizens. In many cases, changes in trade policy may be to the detriment of domestic vested interests and to the benefit of foreign competitors. For example, the removal of a tariff will be to the detriment of domestic firms whose markets have been protected and to the benefit of foreign competitors. From the perspective of the firms that lose from this trade policy change, their government is acting contrary to their expectations. Of course, this perspective fails to acknowledge the larger benefit domestic consumers reap from lower prices. Further, the losers are often confined to a few firms, which suffer commensurately larger losses. The consumers who benefit from the change in trade policy, on the other hand, each receive only a small benefit, and hence may not have a strong incentive to actively engage in activities that influence trade policy makers. The result is that public disagreements over trade policy are seldom undertaken in the context of dispassionate academic debate. They are full of rhetoric against 'cheap foreign goods ruining the market' and 'low paid foreigners stealing our jobs'. If protectionists win their arguments and liberalization does not take place there is no way to establish if their claims are true while if they lose the argument and liberalization takes place, the winners have no incentive to investigate the protectionists claims (Kerr and Foregrave 2002). As a result, there is an incentive to exaggerate claims regarding the expected losses from trade liberalization. Further, those who expect to lose from a change in trade policy have an incentive to attempt to associate their cause with the 'general good' so that their rent seeking activities have a cloak of legitimacy. Latterly, traditional commercial protectionist interests have been joined by civil society activists who are often characterized as being 'anti-globalization' and see the loss of 'local control' that arises from trade liberalization commitments as a major and visible manifestation of globalization. Their concerns have attracted a considerable constituency and resources and have brought new issues that have had to be accommodated in trade policy analysis. As a result, public debates pertaining to trade policy are often joined by well financed advocates. Their arguments are sophisticated and well targeted to sway policy makers and garner valuable support from the broad civil society. Given the degree of protection manifest in the trade policies of all but a handful of countries, these advocates and the interests they represent have enjoyed considerable success. The existence and ongoing development of trade policies that fly in the face of social welfare maximization suggests that trade policy analysis must extend beyond neoclassical-based welfare analysis and incorporate political economy elements such as rent seeking behaviour, political decision making and game theory.

Game theory also has a role in explaining the actions of states both in their trade strategies and the strategies employed during negotiations pertaining to the institutional rules under which trade can be conducted. Game theory and other aspects of modern industrial organization theory including transaction costs and New Institutional Economics have been adapted for, and harnessed to, the analysis of trade policy.

The workhorse of trade policy analysis, however, remains partial equilibrium, comparative static analysis. With all its shortcomings – inability to encompass general equilibrium interactions or to provide dynamic paths of adjustment – it provides the flexibility needed to handle complex markets and a wide variety of institutional arrangements that act to inhibit or enhance international trade. It also has the advantage of generally being accessible to a broad audience without advanced training in economics and its usefulness

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in undertaking analysis is not restricted to a relatively narrow group of academics. Further, its data requirements tend to be relatively modest thus allowing analysts to investigate topical questions. Of course, many trade policy practitioners use the most up-to-date empirical techniques and data intensive methods.

Trade policy is often undertaken at the interface of economics and law. International trade law is largely the outgrowth of international treaties although it has aspects that are rooted in the domestic trade laws of individual nation states and the conventions of international commerce that preceded more formal international institutions. The causality runs both ways. Economic (and commercial) considerations often drive the interest in codifying the ways in which government policy is allowed to interfere with the flow of goods and services across national boundaries. Firms that invest in international commercial activities generally want strong restrictions on the ability of governments to alter the commercial environment after their investments are made. Weak rules increase the risks associated with investing in international commerce and lead to opportunities forgone. Politicians, on the other hand, while generally understanding the benefits of liberal trade, want to be able to respond to requests for protection (or other trade distorting requests such as for the subsidization of exports) from their domestic constituents. Their political survival may well depend on being able to acquiesce to these requests. The constitution of international trade law at any point in time tends to reflect a compromise between these two forces. Thus, business people and other members of civil society often find international trade law frustrating because it does not provide the predictability that one generally expects from domestic legal systems, at least those in modern market economies. The compromise between the two forces tends to ebb and flow depending on the general state of the world economy. When the international economy is performing robustly, and hence it is easier to find new opportunities or otherwise accommodate through social policy those who would be losers from changes in trade policy, trade liberalization through greater restrictions on the trade inhibiting activities of governments tends to strengthen. Conversely, when global economic activity slows, politicians are faced with rising unemployment and fewer new opportunities for trade displaced workers and less tax resources with which to fund social policies. Requests for protection tend to rise and become more strident. As a result, trade liberalization tends to be officially put on hold and trade more restricted in fact.

Given the interplay of these two forces, it is probably not surprising that the codification of the economics of trade policy into international trade law requires long and difficult negotiations and precise but not necessarily predictable language. Trade policy analysis is required to understand the effects of governments' intervention in markets and to assist in the construction of the formal legal texts that constitute trade agreements.

Once the formal legal texts come into force, however, the causality begins to run the other way. As governments put in place policies within the constraints imposed by their formal international obligations, their effect on individual markets and trade patterns becomes the subject of economic analysis. In some international trade agreements there is an obligation to use the policy to achieve the domestic goal that distorts trade the least. Thus, a range of trade policy measures may have to be evaluated either by the imposing country to ensure that it is living up to its international obligations or by trading partners to ensure that the imposing country is not violating its obligations to their detriment.

If the application and legal interpretation of currently agreed international law proves too lax or too strict to achieve economic goals, then economic analysis is applied

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to formulating new negotiating positions and the causality is again reversed. Of course, proposals by individual countries or groups of countries need to be evaluated as to their economic effect by trade partners that will also be engaged in the negotiations and other interested groups in civil society. Thus, international trade policy is developed through the interaction of economic analysis and law formulation. Of course, trade law and economic analysis do not always develop in lock-step and trade law can, at times, be at odds with sound economic analysis (for example as is currently the case with anti-dumping (Kerr 2006)). Large divergences between international law and economically justified trade policy tend to become points of international tension where the confrontation between liberalization and protectionism become highly visible and politicized. One example is the treatment of agricultural trade in the General Agreement on Tariffs and Trade (GATT) where waivers from general GATT disciplines had long been granted. The waivers allowed the international markets for agricultural products to become heavily distorted over time. The economic consequences of the absence of disciplines on the policy making activities of governments began to spill over into other aspects of international commercial relations and, indeed, broader aspects of states' international relations. The result was, after admittedly acrimonious and prolonged negotiations in the GATT's Uruguay Round (1986–1994), an agreement to move the rules of trade for agricultural commodities towards conformity with general GATT disciplines, albeit without a pre-specified timetable. Thus, it is important to understand the economic forces that underpin the transboundary movement of goods and services and their interaction with government policies because simply interpreting existing international trade law does not provide insights into the stresses that can arise from interference in international markets. As trade policy is highly interdependent with international trade law, it is also concerned with the evaluation of the institutions that are put in place to administer international trade law and to handle other facets of trade relations such as negotiations and trade capacity building in developing countries. In some cases formal dispute settlement mechanisms have been built into international trade law institutions so that trade law, and its economic analysis, evolve through quasi-judicial interpretation.

Although formal trade facilitation/regulation institutions have probably existed as long as firms in different countries have engaged in international trade and came into prominence during the nineteenth century (for example the Zollverein and Steuerverein among various German states), it was not until the formal restructuring and structuring of international institutions by the victors of the Second World War that the modern era of international trade institutions came into being. The late nineteenth and first half of the twentieth century was characterized by technological innovations that allowed for international commerce to be conducted on a grand scale for the first time. These innovations related primarily to cost reductions and reliability improvements in transportation but also included time reducing revolutions in communications and new forms of organization for the management and financing of commercial activities. International institutions, however, were largely absent and those that did exist were limited in scope and in the constraints their commitments imposed on sovereignty. The experience of the Great Depression of the 1930s and the subsequent hostilities, along with the increased acceptance of the role of government that arose in the wake of the application of Keynesian economics (broadly defined) suggested to the peacemakers that international co-ordinating institutions were required to reduce the tensions that arise in international

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relations. In particular, there was a perception that the risks associated with the ability of countries to restrict trading access to resources was responsible, in part, for the military-based expansionism of the defeated Axis powers. Absence of co-ordinating mechanisms and institutional avenues to air and settle grievances were seen as a major institutional failure that contributed to the outbreak of the two world wars that defined the first half of the twentieth century. New institutions were required.

Four major areas where international tensions could arise were identified: (a) political disputes between states; (b) the strategic use of currency devaluation to gain a trade advantage; (c) the use of trade distorting measures; and (d) differences in levels of average national income. Prior to the Second World War there had only been an attempt at institutional co-ordination in the area of political disputes between states – the ill-fated League of Nations. Learning from the League's deficiencies, a new institution to deal with political disputes between states was created, the United Nations. To deal with the problems created by the strategic use of currency devaluation, the International Monetary Fund was created at negotiations which took place in Bretton Woods, New Hampshire in the United States. At the same venue, the International Bank for Reconstruction and Development (IBRD) – which is more commonly referred to as the World Bank – with the objective of fostering first post-war economic recovery and, in the longer term, economic development was also put in place.

To provide rules for international commercial relations and a mechanism for dealing with trade disputes, a fourth institution, the International Trade Organization (ITO) was also negotiated. These four organizations were to be the basis of a new and peaceful ordering of international relations. The ITO, however, was stillborn. While it had been negotiated by the administrative arm of the US government, there was not sufficient support in the US Congress for its ratification and it was, in the end, never submitted for a Congressional vote. Given US hegemony in global economic affairs in the early years after the Second World War, the ITO made little sense without the participation of the US and it was abandoned.

The ITO was conceived as a comprehensive international trade organization. One of its agreements dealt with rules of trade for goods and provided a mechanism for the reduction of tariffs. This agreement – The General Agreement on Tariffs and Trade – was salvaged from the ashes of the ITO and became the *de facto* multilateral institution dealing with international trade issues. One of its primary purposes was to provide a venue for the negotiation of the reduction of the very high tariffs that had been put in place during the Great Depression and remained in place in the late 1940s. Given there had been no effective restrictions on a country's ability to unilaterally impose trade barriers prior to the GATT, tariffs were the primary trade restricting mechanism in use. Thus, the relatively narrow mandate of the GATT was sufficient to foster a considerable degree of trade liberalization in its early years. This was accomplished through a number of negotiating 'Rounds' that took place periodically. In all, between 1947 when the GATT came into being and 1994 there were six Rounds. All made significant cuts to industrial tariffs. The negotiating Rounds each took longer to accomplish and became increasingly complex. In part this was because the number of member states increased, particularly in the wake of the process of de-colonization, and as the organization gained in prestige and impact. Negotiations also increased in complexity as other trade distorting policies of governments were encountered once border measures were reduced or removed. Further, as the

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GATT prohibited new tariffs and did not allow existing tariffs to be raised above agreed levels (their 'bound' rate) governments faced with the political need to placate protectionists had to find alternative means to deliver protection (for example technical requirements). The result was that new topics were added to the GATT negotiating agendas, particularly in the later Rounds. Over time, however, the GATT's narrow mandate and institutional limitations became increasingly out of step with the requirements of modern international commercial relations.

At the last GATT Round of negotiations, the Uruguay Round, a reconstitution of the organization took place with a new organization, the World Trade Organization (WTO) coming into being in 1995. The GATT as an organization ceased to exist and the WTO took over the administration of a revised GATT agreement. The old GATT had not dealt with trade in services, which had become the fastest growing sector in modern market economies. During the Uruguay Round a new General Agreement on Trade in Services (GATS) was negotiated to be administered by the new WTO. More contentious, the WTO was also given responsibility for administering the new Agreement on Trade Related Aspects of Intellectual Property (TRIPS). Thus, the trade policy envelope was increased significantly with the establishment of the WTO.

The GATT, and subsequently the WTO, allows for the creation of regional trade agreements as long as they do not contradict commitments agreed at the multilateral organization. As a result, there is a plethora of regional and bilateral trade agreements, all with their own sets of rules and whose rulemaking covers areas of trade policy where the WTO is silent. Hence, the analysis undertaken in trade policy extends to topics that are beyond the institutional reach of the WTO.

The operation of trade institutions themselves can have trade effects. For example, the dispute settlement process has lags that can be used as a strategic advantage; if countries refuse to comply with dispute panel rulings, the aggrieved country is allowed to choose the products it selects for retaliation; and the process of acceding to the WTO allows existing members to extract concessions from applicants. The opportunities for engaging in strategic behaviour that are created by the rules of the institutions are also analysed by trade policy practitioners. The negotiation process has tended to be opaque. This lack of transparency has been the source of considerable criticism from activist civil society groups in recent years. As a result, the WTO and other trade institutions have been trying to become more transparent but there is a trade off between transparency and negotiating efficiency that is a contentious issue and a subject for trade policy analysis.

The questions encompassed by trade policy are clearly wide ranging and multi-faceted. Its study draws upon a wide range of economic theories, approaches and analytical tools. The mechanisms used by trade policy makers are only constrained by the inventiveness of the bureaucrats and others who devise them. The set of measures is not static and is ever expanding. The focus of the study of trade policy changes as new issues and problems arise. Those who work in the area need to update their human capital on an ongoing basis.

While there are few constants in this dynamic area of economic inquiry, one stands out in its persistence. The desire for protection from deteriorating economic circumstances whether or not the source of declining competitiveness is of foreign origin. As long as declining economic fortunes can be altered by imposing costs on foreigners, one can expect requests for protectionist trade policies. Foreign firms are always softer targets than

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domestic competitors, it is the 'real politik' of trade. Without this constant, however, there would be little need for the study of trade policy.

Note

1. There are many versions of Adam Smith's classic. One accessible version is Smith (1994).

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