INTERNATION OF
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2ND EDITION

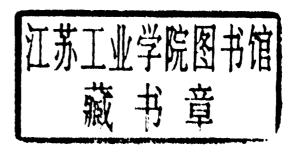
MICHAEL J.TREBILCOCK AND

ROBERT HOWSE

The Regulation of International Trade

Second Edition

Michael J. Trebilcock and Robert Howse





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Preface and acknowledgements

The first edition of this book went to press between the December 1993 finish to the Uruguay Round negotiations and the Marrakesh Meeting, at which those results were formalized. The second edition has given us an opportunity to refine and deepen our understanding of the WTO Agreements negotiated in the Uruguay Round, as well, of course as to reflect subsequent developments. These developments include the (now stalled) negotiations on a Multilateral Agreement on Investment, the finalization of negotiations on basic telecommunications and financial services under the GATS, and three years of dispute settlement at the WTO, including a number of important rulings by the new Appellate Body. We have also added separate chapters on areas of emerging importance such as trade and labour rights, trade and competition, and health and safety and other technical standards. The dispute settlement policy chapter has been substantially rewritten in light of three years of WTO practice; funding provided by a Canadian Social Science and Humanities Research Council grant to Robert Howse permitted more extensive reflection on the place of dispute settlement and its jurisprudence in the multilateral trading order than would otherwise have been possible, and those familiar with the first edition of the book will notice in this chapter a considerable evolution in our thinking.

We are grateful for the very constructive comments and criticisms of a number of colleagues who have used various parts of the first edition in their work, including in a number of cases classroom teaching. These include: Petros Mavroidis, Henrik Horn, Joseph Weiler, Armand de Mestral, Larry Herman, Benedict Kingsbury, Pierre Sauve, Ernst-Ulrich Petersmann, Kalypso Nikolaides and Dan Trefler. Several of our colleagues at the Faculty of Law have been of great assistance on specific chapters, especially Brian Langille (trade and labour rights), Rosemary Coombe (trade-related intellectual property rights) and Craig Scott (trade and environment, dispute settlement). Superb research assistance and advice was provided by Dan Markel, a JD student at Harvard Law School, and two graduate students at the Faculty of Law University of Toronto, Jason Levine and Julie Soloway. May Seto coordinated the production process for the manuscript with great skill. All errors and shortcoming are our own.

Preface, first edition

This book is intended to introduce serious students of law, economics, politics, and public policy to the institutions and rules that govern trade between sovereign states. Although we are legal academics, we have not written a traditional legal treatise. Instead, we have sought to bring to bear on our analysis of rules and institutions a wide range of disciplinary perspectives. This includes not only perspectives from the various branches of economics (whether trade theory itself or the theory of finance and industrial organization), but also from contemporary political and ethical philosophy and the international relations and political economy literatures.

Although we do discuss extensively the domestic legal regimes of some of the major trading states, most of the law dealt with in this book is international law. There is, of course, an age-old debate as to whether international law is really law in the true sense of the word, as it is not subject to authoritative enforcement by a sovereign. The GATT/WTO, the main legal and institutional framework for multilateral free trade, has frequently been judged against a domestic law benchmark and found wanting. Some theorists of international relations question whether rules and institutions matter at all, except as reflections of much more fundamental power relationships.

Our own perspective is that rules, norms and institutions matter a great deal. We see their function as the provision of a framework or structure that permits long-term mutually beneficial cooperation between states. Hence, we tend to take a neo-liberal or new liberal institutionalist view of international relations. This book is not, however, intended as an application or vindication of this particular theory of international relations, which would require a sustained discussion of the theory of international economic cooperation not well suited to an introductory text. Still, in examining the function and evolution of particular rules and norms, we have not hesitated to take stances based on a neo-liberal view nor to be critical of alternative policy stances premised on power-based realist or positivist views of international economic relations.

In general, we see the evolution and maintenance of an open, liberal trading order as to the mutual benefit of states. This view is not premised upon a naïve or unquestioning adherence to the economic theory of the gains from trade. On the contrary, throughout our analysis we are highly sensitive to the qualifications to and limits on the case for free trade, as well as the complexities involved in determining the domestic interest in these matters — including concerns about unemployment, worker adjustment, the quality of life and values of human rights and environmental protection. We examine, in a wide range of areas, the multiple challenges that increased economic integration and interdependence pose for domestic and international policymaking. While we frequently see the need to evolve new rules and institutions, or to clarify existing rules and strengthen existing institutions, we also conclude that the basic building blocks of the liberal trading order are not fundamentally defective, and that a protectionist retreat from an open system is likely to reduce both domestic and global welfare.

Compared to the immediacy and directness of the concerns that often result in demands for protectionism – whether job loss within a community or outrage at another state's environmental policies - the basic rules and norms of the global trading order that constrain protectionist responses often appear arcane or obscure. This applies as well to the jurisprudence that has evolved, especially in the GATT, to interpret those rules and norms. We believe that this impression is inaccurate and that in fact there is considerable clarity and coherence to the rules, with interpretation and application to diverse and rapidly changing circumstances being no more difficult and no easier than with respect to other areas of law. But this impression has partly been created because of the often unnecessarily inaccessible and complex presentation of the rules and jurisprudence by trade law experts and officials, and their frequent lack of interest in reaching a broader intellectual and policy community. Ernst-Ulrich Petersmann notes comments by non-experts that 'anyone who reads the GATT is likely to have his sanity impaired' and that there are 'only ten people in the world who understand the GATT and they are not telling'. This book is a modest attempt to show that, to the contrary, international trade law is no more impenetrable or obscure than any other sophisticated body of contemporary law, when it is clearly explained in terms of fundamental concepts, principles and rules.

The topics covered and general organization of this book reflect a number of years' experience in co-teaching an introductory course in international trade regulation at the University of Toronto. The course has typically attracted senior undergraduates both in law and in economics, and we have also been fortunate to have the participation of graduate students in both disciplines, many of whom bring perspectives from undergraduate studies and work experience in a wide variety of countries, both developed and developing. Without this sustained and on-going dialogue with a very diverse and demanding group of students, this book would not have been possible.

We wish to acknowledge excellent research assistance from a number of students or former students at the Faculty of Law, University of Toronto, including Evan Atwood, Ari Blicker, Richard Braudo, John Loukidelis, Karen Powys-Lybbe, Presley Warner, Dan Markel, Julie Soloway, and Jason Levine. In addition, on particular chapters, several colleagues and students read earlier drafts or otherwise assisted us with their reflections and advice. In particular, we wish to thank Isis Calder, Kevin Davis, Gary Horlick, Brian Langille, James Odek, Elie Perkins,

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1 The evolution of international trade theory and policy

AN INTELLECTUAL HISTORY OF INTERNATIONAL TRADE THEORY AND POLICY¹

The central question that must be confronted at the outset of any study of international trade is: why do we need a theory of international trade at all? Why is the analysis of the economic, political and social implications of exchange between traders in two national markets different from the analysis of the implications of exchange between traders within a single national market?

Early thinking on foreign trade

In a marvellously accessible and illuminating intellectual history of free trade, Against The Tide,² Douglas Irwin traces views on the virtues and vices of foreign trade back to early Greek and Roman writers. Their views generally reflected a high degree of ambivalence about trading with foreigners, mainly for non-economic reasons. First, merchants or traders of whatever origins were often regarded as of an inferior social class. This general hostility to merchants and commercial activity was accentuated in the case of foreign traders where contact with strangers could disrupt domestic life by exposing citizens to the bad manners and corrupt morals of barbarians. On the other hand, some early writers (such as Plato) acknowledged the gains from specialization or division of labour, although they were reluctant to extend the implications of this acknowledgement explicitly to foreign trade.

Other writers (such as Plutarch) took the view that God created the sea, geographic separation and diversity in endowments in order to promote interactions through trade between the various peoples of the earth. This doctrine of universal economy was developed by philosophers and theologians in the first several centuries AD, although dominant strands in medieval scholastic thought (reflected, for example, in the writings of St Thomas of Aquinas) continued to be suspicious about commercial activity and to worry that contact with foreigners would disrupt civil life. Natural law philosophers of the seventeenth and eighteenth centuries (such as Grotius) sought to resurrect the doctrine of universal economy, justifying a largely unconstrained freedom to trade on the law of nations (jus gentium).³

Mercantilism

However, none of these early views on international trade were primarily based on economic arguments, although (as we will see) they have continued to recur in one form or another even in contemporary debates over free trade. In the seventeenth and eighteenth centuries a school of thought often referred to as mercantilism emerged in Britain and the Continent that was explicitly economic in its foundations. While not hostile to commercial activity generally or to international trade in principle, mercantilists argued for close government regulation of international trade for two principal reasons: (1) to maintain a favourable balance of trade, which argued for aggressive export but restrictive import policies (although how foreigners were to pay for imports without the ability to export was never adequately explained); and (2) to promote the manufacturing of raw materials at home, rather than importing manufactured goods, which would displace domestic production and employment; hence arguments for export taxes on exported raw materials and import duties on imported manufactured or luxury goods.

The origins of the economic case for free trade

These two central tenets of mercantilist theories of international trade were fundamentally attacked and undermined, at least as a matter of theory, if not as a matter of policy, in the second half of the eighteenth century. The first argument for restricting foreign trade reflected a concern that international trade may give rise to an inadequate supply of circulating monetary gold as a result of balance of payment deficits. Silver and gold were mainstays of national wealth and essential to vigorous commerce. Hence the appropriate policy goal was perceived to be the maintenance of a continuing surplus in the balance of payments, i.e. sell more to foreigners than one buys from them. Imperial rivalries also led to political concerns about the transfer of specie into foreign hands and in part explains colonization efforts in the eighteenth and nineteenth centuries where colonies were seen as a source of raw materials and an outlet for manufactured goods. However, David Hume, in 1752, demonstrated that through the price-specie-flow mechanism, international trade was likely to maintain an equilibrium in the balance of payments. If a country found itself with surplus currency, domestic prices would tend to rise relative to prices of foreign commodities, and money would flow out of the country. If a country found itself with a shortage of currency, domestic prices would become depressed and would attract foreign currency until the shortage had disappeared.4

Adam Smith, in the *Wealth of Nations* (1776), mounted a broader assault on mercantilist theories, in particular the commodity composition argument for restricting trade, and argued that the case for gains from specialization in domestic economic activities applied equally to specialization in international trade:

What is prudence in the conduct of every private family can scarcely be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we can make, better buy it of them with some part of the produce of our own industry.⁵

Thus, to take some simple examples, if countries with tropical climates can produce bananas or pineapples more cheaply than countries with temperate climates, the latter should purchase these products from the former. Conversely, if countries with industrialized economies can produce hydro-electric generators or telephone systems more cheaply and of better quality than those that could be produced by countries that enjoy a cost advantage in producing tropical produce, the latter should buy these products from the former. In domestic economic activities, most of us accept that it makes no sense for an individual to try and produce all his or her own food, clothing, medical services, dental services, home construction services, etc., but rather to specialize in producing some goods or services for others and perhaps for some limited subset of his or her own needs, while purchasing requirements to meet remaining needs from others who specialize in their production. It is equally easy to appreciate the force of this argument for free trade within nation states. For example, in a large federal state like the US, Michigan specializes in producing automobiles (inter alia), Florida citrus fruit and tourism, Texas oil and beef, and California wine and high technology products. If each state of the US were to have attempted to become self-sufficient in these and all its own needs, the US would today be immeasurably poorer. It equally follows, on Smith's theory, that similar specialization is likely to generate mutual gains from trade in international exchanges - the division of labour is limited only by the extent of the market. It is important to note that on Smith's theory, unilateral trade liberalization would be an advantageous policy for a country to pursue, irrespective of the trade policies pursued by other countries.

The theory of comparative advantage

A central question left open by Smith's Theory of Absolute Advantage (as it came to be called) was: what if a country has no absolute advantage over any of its potential trading partners with respect to any products or services? Is international trade of no relevance or value to it? David Ricardo, in his book The Principles of Political Economy published in 1817, answered this question with a shattering insight that continues to form the basis of conventional international trade theory today. His insight has come to be called the Theory of Comparative Advantage. He advanced this theory by means of a simple arithmetic example. In his example, England could produce a given quantity of cloth with the labour of 100 men. It could also produce a given quantity of wine with the labour of 120 men. Portugal, in turn, could produce the same quantity of cloth with the labour of 90 men and the same quantity of wine with the labour of 80 men. Thus, Portugal enjoyed an absolute advantage over England with respect to the production of both cloth and wine, i.e. it could produce a given quantity of cloth or wine with fewer labour inputs than England. However, Ricardo argued that trade was still mutually advantageous, assuming full employment in both countries: when England exported to

4 The regulation of international trade

Portugal the cloth produced by the labour of 100 men in exchange for wine produced by 80 Portuguese, she imported wine that would have required the labour of 120 Englishmen to produce. As for Portugal, she gained by her 80 men's labour cloth that it would have taken 90 of her labourers to produce. Both countries would be rendered better off through trade.

Another way of understanding the same intuition is to imagine the following simple domestic example. Suppose a lawyer is not only more efficient in the provision of legal services than her secretary, but is also a more efficient secretary. It takes her secretary twice as long to type a document as the lawyer could type it herself. Suppose, more specifically, that it takes the lawyer's secretary two hours to type a document that the lawyer could type in one hour, and that the secretary's hourly wage is \$20, and that the lawyer's hourly rate to clients is \$200. It will pay the lawyer to hire the secretary and pay her \$40 to type the document in two hours while the lawyer is able to sell for \$200 the hour of her time that would otherwise have been committed to typing the document. In other words, both the lawyer and the secretary gain from this exchange. These examples, in an international trade context, generalize to the proposition that a country should specialize in producing and exporting goods in which its comparative advantage is greatest, or comparative disadvantage is smallest, and should import goods in which its comparative disadvantage is greatest.

An unfortunate semantic legacy of Ricardo's demonstration of the gains from international trade that has been perpetuated in the terminology of much subsequent trade literature and debate is that in international trade *countries* are trading with each other. This, of course, is rarely the case. As in purely domestic exchanges, *private economic actors* (albeit located in different countries) are trading with each other. In its most rudimentary form, all that international trade theory seeks to demonstrate is that free international trade dramatically broadens the contract opportunity set available to private economic actors and hence the mutual gains realizable from exchange as parties with different endowments of specialized resources or skills are able to reap the gains from their differential advantages and disadvantages through trade.

It may be argued that in international exchanges, in contrast to domestic exchanges, part of the gains from exchange are realized by foreigners, and that a country would be advantaged by capturing all the gains from exchange for itself. However, this raises the question of whether the domestic gains foregone by foreign trade are greater or less than the additional gains from purely domestic exchange. As a matter of simple economic theory, the gains to domestic consumers from foreign trade will almost always be greater than the additional gains to domestic producers from purely domestic trade. This is so because higher domestic than foreign prices will entail a transfer of resources from domestic consumers to domestic producers (arguably creating matching decreases and increases in welfare), but *in addition* some domestic consumers will be priced out of the market by the higher domestic prices and will be forced to allocate their resources to less preferred consumption choices, entailing a dead-weight social loss. An alternative way in which to conceive of the net domestic loss from foregone foreign exchange opportunities