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Advanced Introduction to INTERNATIONAL TRADE LAW

Michael J. Trebilcock

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International Trade Law

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Preface

This revised edition of *Understanding Trade Law* (2011) is an introductory book on international trade law (principally GATT/WTO law) and builds on a 25-year-long involvement in the field. Over this period I have taught an introductory trade law course at the University of Toronto Faculty of Law and as a visitor at New York University Law School, Yale Law School, the University of Virginia Law School, and Tsinghua Law School (Beijing) – sometimes with co-teachers including my former student, former colleague and co-author Robert Howse (now at NYU Law School), Donald Macdonald, former Minister of Finance for Canada and Dr. Sylvia Ostry, former Senior Trade Negotiator for Canada. I have also authored or co-authored numerous scholarly articles on issues in international trade law and a major treatise, with Robert Howse and Antonia Eliason, *The Regulation of International Trade* (London: Routledge, 4th edition, 2013). My experience as a teacher, author, occasional policy advisor or expert witness, and media commentator in the international trade field has underscored to me the need for a short, straightforward account of the basic structure and principles of international trade law that is widely accessible to beginning students and non-specialist scholars and policy advisors. Our treatise (which now runs to 900 pages) presupposes a need or desire to invest in acquiring a sophisticated understanding of the field that is beyond what this broader readership requires. My hope in writing this book is that this broader readership, with a limited investment of time and intellectual effort, can acquire a basic understanding of the field, while recognizing that acquiring a more sophisticated understanding of the complexities of the field will require much larger investments of time and effort. In my view, the basic elements of international trade law are no more arcane or inaccessible than any other area of law.

Throughout the book, I have kept citations to relevant case law and scholarly literature to a minimum, while nevertheless providing references to basic sources that readers can pursue if they wish.

In writing this book, I have had the benefit of helpful comments on earlier drafts from anonymous reviewers and my colleague, Andrew Green, who specializes in the field, which have substantially improved the final version and for which I am greatly indebted. I am also indebted to legions of students who have challenged me constantly to render the field of international trade law both accessible and interesting to them. I am extremely grateful to my research assistant, Kristen Pue, for her help in preparing this new edition and to my assistant, Nadia Gulezko, for her endless patience and meticulousness in correcting numerous drafts of the manuscript.

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Contents

1 Setting the context

1.1 Classical free trade theory

Members of different societies have traded with each other since the beginning of recorded history.[1] However, one of the first efforts to articulate a rigorous intellectual basis for the economic benefits of facilitating trade between members of different societies was made by Adam Smith. In *The Wealth of Nations*, published in 1776, Adam Smith argued that the gains that could be realized from specialization in domestic economic activity could readily be extended to international economic activity.[2]

> The tailor does not attempt to make his own shoes, but buys them off the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a tailor... 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 ourselves can make it, better buy it off them with some part of the produce of our own industry, employed in a way in which we have some advantage.[3]

Smith's Theory of Absolute Advantage essentially stated that countries should export those products which they can produce more efficiently than other countries and import those products which they cannot. For example, if countries with tropical climates can produce bananas or pineapples more cheaply than countries with temperate climates,

1 See William J. Bernstein, *A Splendid Exchange: How Trade Shaped the World* (New York: Atlantic Monthly Press, 2008); Nayan Chanda, *Bound Together: How Traders, Preachers, Adventurers and Warriors Shaped Globalization* (Yale University Press, 2007).

2 For a comprehensive account of the intellectual history of free trade theory, see Douglas A. Irwin, *Against the Tide: An Intellectual History of Free Trade* (Princeton, NJ: Princeton University Press, 1996); Elhanan Helpman, *Understanding Global Trade* (Cambridge, MA: Belknap Press of Harvard University Press, 2011).

3 Adam Smith, *The Wealth of Nations* (1776) (reprinted New York: Modern Library Edition, 1937) at 424.

the latter should purchase these products from the former. Conversely, if countries with industrialized economies can produce hydro-electric plants or communications systems more efficiently than countries that enjoy a cost advantage in producing tropical fruit, the latter should buy these products from the former. In Smith's view, international trade is merely a means by which to broaden the division of labour by expanding the size of the market. It is important to note that, according to Smith's theory, unilateral trade liberalization would be an advantageous policy for a country to pursue. Even if other countries did not liberalize their trade policy, a country which did liberalize its trade policy could realize economic gains by importing products made more efficiently by foreigners.

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 USA, Michigan specializes in producing automobiles (*inter alia*), Florida citrus fruits and tourism, Texas oil and beef, and California wine and high-technology products. If each state of the USA were to have attempted to become self-sufficient in these and all its other needs, the USA would today be immeasurably poorer.

A key question raised by Smith's Theory of Absolute Advantage is what relevance international trade has to a country that has no absolute advantage, that is, a country which cannot produce any product more efficiently than its trading partners. This question was addressed by David Ricardo's Theory of Comparative Advantage, set out in his book *The Principles of Political Economy*, published in 1817. Ricardo famously postulated the following scenario: Portugal can produce a given quantity of wine with 80 units of labour, and a given quantity of cloth with 90 units of labour. England can produce the same quantity of wine with 120 units of labour, and the same quantity of cloth with 100 units of labour. Thus, Portugal enjoys an absolute advantage over England in both wine and cloth. Ricardo argued that trade between the two countries was still mutually advantageous. England is able to export cloth which took 100 units of labour to produce in exchange for wine which it would have required 120 units of labour to produce. Similarly, Portugal, by exporting wine which it took 80 units of labour to produce, gains cloth which would have taken 90 units of labour to produce. Both countries are rendered better off through trade. Another way of understanding the same intuition is to imagine the following simple domestic example.[4] Suppose

4 Adapted from P. Samuelson and A. Scott, *Economics* (Toronto: McGraw-Hill, 1980) at 807.

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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 it would if the lawyer typed 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 would 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.

Ricardo's insight was that the crucial question is the relative or comparative advantage of one country vis-à-vis another in producing a product. In other words, the issue is not whether Portugal can produce both wine and cloth more efficiently than Britain, but rather Portugal's relative efficiency in producing cloth versus producing wine compared to Britain's relative efficiency in producing the same goods. In an international trade context, this generalizes 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.

Although Ricardo's theory still constitutes the basis of conventional international trade theory, it has been refined by subsequent analysis. One deficiency in Ricardo's theory is that it assumes that countries will specialize completely in those products in which they have a comparative advantage, without taking into account the possibility of decreasing returns to scale. Hecksher and Ohlin's Factor Proportions Hypothesis recognized that most products were a function of multiple factors of production (in the case of wine, land and labour), and that combining factors of production at ever-increasing levels of output did not necessarily lead to increasing production in constant proportions. For example, bringing more land into the production of wine may result in utilizing less productive land, which requires more intensive use of labour. In recognition of these considerations, the Factor Proportions Hypothesis states that countries will tend to specialize in producing goods that use their abundant factors of production more intensively, and will import goods that use their scarce factors more intensively.

The Factor Proportions Hypothesis does not, however, provide an adequate explanation of manufacturing activities in advanced industrialized economies. Casual observation suggests that firms in different countries often specialize in different segments of the same or closely related product markets, simultaneously importing and exporting products in these sectors. The Product Cycle Theory, developed by Raymond Vernon, incorporates the idea that products undergo a variety of stages in their life cycle, and firms in different countries will specialize in their manufacture depending upon the particular stage the product is in.[5] Highly developed economies will tend to specialize in the manufacture of products in the early stages of development, where financial capital, specialized human capital and innovation are at a premium. In the later stages of the product cycle, as production technology becomes standardized, it is adopted by producers in other countries, typically countries with lower labour costs. At this point in the product cycle, comparative advantage shifts to these countries. Moreover, as is evident in the increasingly globalized production chains for many products (for example, automobiles, computers), different countries may have a comparative advantage in different stages of the production process for given products. More generally, classical theories of international trade are relatively static in nature, and did not centrally focus on dynamic factors that might shift a country's comparative advantage through time (for example, England moving beyond cloth manufacturing; Portugal moving beyond wine production) or the role that government policy may play in promoting new sources of comparative advantage – through, for example, investments in infrastructure, education, research and development, selective subsidies or trade protection – which, in turn, may intensify tensions with the countries who perceive some of these policies as a source of unfair trade.[6]

5 See Raymond Vernon, "International Investment and International Trade in the Product Cycle", (1966) 80:2 *Quarterly Journal of Economics* 190.

6 For a masterful review of the evolution of modern trade theory, see Elhanan Helpman, *Understanding Global Trade* (Harvard University Press, 2011). See also Justin Lin, *The Quest for Prosperity* (Princeton: Princeton University Press, 2012) and Dani Rodrik, *One Economics, Many Recipes: Globalization, Institutions, and Economic Growth* (Princeton: Princeton University Press, 2007) on dynamic conceptions of comparative advantage.

1.2 Qualifications to the case for free trade

1.2.1 Reciprocity

The development of the current international trade regime has been animated by the classical theory set out above. However, a great deal of the debate in international trade law today centers around the extent to which international trade law should permit deviations from classical theory.

A major qualification to the case for free trade is the concept of reciprocity. Recall that classical trade theory views unilateral trade liberalization as advantageous for the liberalizing country. From this perspective, the emphasis placed on reciprocity in trade liberalization commitments in the General Agreement on Tariffs and Trade (GATT) may seem anomalous.[7] However, it is clearly better for the liberalizing country if its trading partners also liberalize, since the first country will realize benefits on the export side in addition to the benefits on the import side. One strategy might be for the first country to refuse to remove any of its existing trade restrictions on imports unless its trading partners agree to do the same. This may result in a classic Prisoner's Dilemma game, whereby trading partners who recognize that it is in the first country's interests to liberalize no matter what the trading partners do will withhold concessions in the hopes of gaining the benefits of the first country's liberalization for free. The dominant strategy becomes protectionism, and such individually rational action leads to an inefficient collective outcome of restrictive trade policies.[8] Trade agreements incorporating reciprocal tariff reductions thus offer governments a means of escape from a Prisoner's Dilemma.[9]

Reciprocity is also important from a political economy stand-point. Certain domestic producer interests may oppose any governmental effort to liberalize trade policy on the import side if they are likely to be uncompetitive with foreign producers in the absence of tariffs. If it is to be politically tenable for a government to engage in such liberalization, it will likely need concessions from its trading partners on the export

7 Kyle Bagwell and Robert W. Staiger, *The Economics of the World Trading System* (Cambridge, MA: MIT Press, 2002) at 7.

8 Bernard M. Hoekman and Michel M. Kostecki, *The Political Economy of the World Trading System: The WTO and Beyond* (New York: Oxford University Press, 2001, 2nd edn) at 109.

9 Bagwell and Staiger, supra note 7 at 3.

side in order to enlist the countervailing political support of export-oriented producer interests. According to Bagwell and Staiger, one of the main functions of trade agreements is that they represent credible commitments by governments that they will not protect certain industries.[10] In summary, while the concept of reciprocity plays a marginal role in classical trade theory, it is nonetheless crucial to an understanding of the institutional arrangements that govern international trade.

1.2.2 The Optimal Tariff

A second qualification to the case for free trade is the concept of the so-called Optimal Tariff. On this theory, countries that account for a large proportion of international demand for a particular good may exercise monopsony power by imposing a tariff which effectively forces exporters from other countries to reduce the price of their products and absorb the tariff. Consumers pay the same price for the good as before, and the government gains revenue from the tariff. While arguably maximizing national welfare, these policies are likely to reduce global welfare and, if replicated by foreign countries, are also likely to reduce national welfare. Bagwell and Staiger argue that the centrality of principles of reciprocity and non-discrimination in the GATT can in part be explained as an attempt by countries (particularly larger countries) to escape from a terms-of-trade driven (non-cooperative) Prisoner's Dilemma where each country, acting unilaterally, has incentives to adopt trade policies (for example, tariffs on imports, taxes on exports) that externalize a high proportion of the costs of its trade policies onto foreigners. "Beggar-thy-neighbour" trade policies adopted by many countries during the Great Depression are often viewed as exemplifying this danger.

1.2.3 Infant industries

A third qualification relates to infant industries.[11] In the early stages of a country's economic development, a case may be made that import restrictions are justified in order to permit domestic industry to develop by selling to a protected domestic market. Ideally, such protection is temporary and the infant industry eventually develops the scale and

10 Bagwell and Staiger, supra note 7 at 4; see also Douglas A. Irwin, Petros C. Mavroidis, and Alan O. Sykes, *The Genesis of the GATT* (New York: Cambridge University Press, 2008), chapter 3, for a discussion of economic and political rationales for trade agreements.

11 See Irwin, supra note 2, chapter 8.

sophistication required to compete not only in a liberalized domestic market but also in international export markets. A major case in point is the "special and differential status" accorded to less-developed countries (LDCs) under the GATT, which permits them to protect domestic industries and engage in import substitution trade policies to some extent. A variant of the infant industry argument is Strategic Trade Theory, which argues that governments can assist domestic firms in establishing strategically dominant pre-emptive positions in industries where economies of scale imply that there is room for only a limited number of firms in international markets (for example, large jet airplane manufacturers), in part by maintaining entry barriers to potential foreign competitors or subsidizing domestic firms.[12]

However, the case for government-led protection and/or promotion of domestic industries may be critiqued on a number of grounds, chiefly: (i) private capital markets may be better equipped than governments to identify the long-term growth potential, if any, for an infant industry, and should thus be relied on rather than government to "pick winners"; and (ii) the vulnerability of governments to capture by rent-seeking special interests with regard to the decision to promote and sustain an infant industry through trade-restrictive policies.[13] Nevertheless, according to some commentators, a number of the high-performing East Asian economies have deployed infant-industry protection policies or strategic trade theory successfully; other developing countries much less successfully. It is also true that many currently developed countries early in their development adopted extensive infant-industry protection policies (for example, the USA, Canada, Germany).

1.2.4 Revenue raising

A fourth qualification to the case for free trade relates to the revenue-raising potential of customs duties. In industrialized countries, income, consumption, and business taxes constitute the vast majority of government revenue. However, in less developed countries with weak internal taxation systems, import and export duties are often an important source of government revenue and may be difficult to replace in the short term.

12 See Paul R. Krugman (ed.), *Strategic Trade Policy and the New International Economics* (Cambridge, MA: MIT Press, 1986).

13 See Robert E. Baldwin, "The Case Against Infant Industry Protection", (1969) 77:3 *Journal of Political Economy*, 295–305.

1.2.5 National security

A fifth qualification to the case for free trade relates to national security considerations. These may arise on both the import and the export sides. With respect to imports, it is often argued that there may sometimes be a case for trade restrictions in order to protect domestic industries which, even though not internationally competitive, may be required in the event of war or other international disruptions (for example, domestic steel or coastal shipping industries). On the export side, national security considerations have sometimes been invoked to restrict exports of strategically sensitive products or military material to "unfriendly" foreign countries. More generally, trade agreements are often designed to serve broader foreign policy objectives, for example greater economic integration may enhance global or regional peace and reduce the potential for military conflicts by raising the costs of such conflicts. This was clearly a major rationale for the emergence of the European Community and also seems to have been part of the motivation for the GATT.

1.2.6 Adjustment costs

A further qualification to the case for free trade relates to the adjustment costs that firms, workers, and communities may face with abrupt forms of trade liberalization and argues for gradual implementation of such policies.[14]

1.2.7 Health, safety and environmental concerns

Finally, where imports threaten the health, safety and environmental conditions of citizens in importing countries, trade restrictions may be justified to minimize these risks.

1.3 Objections to free trade

In the last decade or so, public perturbations leading up to and surrounding meetings of the World Trade Organization and other international financial institutions, in particular the World Bank and the IMF, in Seattle, Washington, Quebec City and Genoa, supported by

14 See Michael Trebilcock, *Dealing with Losers: The Political Economy of Policy Transitions* (Oxford: Oxford University Press, 2015), chapter 5.

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