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National Policies and the Limits of International Integration

James Gerber
Economics Department, San Diego State University

In spite of the rapid growth of merchandise trade since the end of World War II, the world economy is far from integrated. Services trade, capital flows, population migration, and price differences demonstrate far more scope for international economic integration. Even among nations with preferential trade agreements, networks of merchandise trade relations are far denser intra-nationally than internationally. The absence of goods trade predicted by trade models when nations have few policy barriers implies that crossing national boundaries is a significant indicator of increased transaction costs. These patterns have caused the world trade agenda to examine some unintended trade restrictions which make up a part of national domestic policies. This focus is apparent in current negotiations such as the Free Trade of the Americas Agreement. New items for negotiation include product standards, competition policies, services, and investment policies. Most contentious are labor and environmental standards, where the potential for protectionist capture is greater and the mutual recognition versus harmonization debate is obscured.

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Introduction: The World Economy and National Policies

Traditionally, international economic policy has been limited to two themes. The first is microeconomic issues "at the border," including tariffs, quantitative restrictions, and customs procedures. The second theme focuses on macroeconomic links to the international economy through variables such as the exchange rate and the balance of payments. More recently, however, several new themes have emerged, from labour and environmental standards, to competition and foreign investment policy, to product standards and other

fields traditionally reserved for national or sub-national policy.

A variety of forces have pushed international economic policy across the line that has traditionally separated international and domestic issues. None of these forces is greater than the growth of world trade during the second half of the 20th century. Between 1963 and 1996, world output growth averaged about 3 percent per year, while world trade grew more than 10 percent per year, expanding from US $30.5 thousand million to US $826.6 thousand million (World Trade Organization, vol. II, 1997). The leading reasons cited for this growth in trade include falling transportation costs, rising incomes, and declining tariff and non-tariff barriers; there is less agreement over the role of preferential trade agreements between subsets of the world's nations (Rose, 1991; Krugman, 1995; Frankel, 1997). Trade growth, however, is but one of the many forces pushing nations to negotiate their domestic policies. Private international capital flows, advances in telecommunications and other technological changes, and global climate change, to name a few, are all working in the same direction.

Elements of International Integration

In spite of the growth of trade, empirical analysis of international economic integration shows that the world is a long way from a single global market (Frankel, 1997; Helliwell, 1998). For example, the United States and Canada share the largest single bilateral trade relationship in the world. Helliwell (1998) and McCallum (1995) have shown that Canadian provinces are 10 to 12 times more likely to trade with other provinces than with the United States, even after adjusting for differences in market size and distance. In general, most measurements of integration have focused on merchandise goods or capital flows, where there is a relative abundance of data. Flows of goods and capital are not the only spheres where integration occurs, however; indicators of integration should also consider trade in services, population movements, and the international linkages of prices.

Services

Trade in services is far more restricted than trade in goods, yet the share of services in the economies of industrial nations is 70 percent of GDP or more, and although the share of services is usually smaller in industrializing nations, it is still often over 50 percent. The value of services exported by the United States was 37 percent of the value of goods exported in 1997, while in developing countries the value of services exported can often reach 20 percent of the value of goods exported (Bureau of Economic Analysis, 1998; International Monetary Fund, 1998).

Multilateral commitments to trade liberalization under the WTO have only recently begun to include services. The Uruguay Round of the GATT (1986-1993) led to the adop-

tion of the first ever multilateral agreement on services (General Agreement on Trade in Services, GATS) and began a slow movement towards increased liberalization. In addition to addressing services trade, the Uruguay Round extended the scope of negotiations to include investment measures and intellectual property rights, both of which have important impacts on service products. Since then, WTO-sponsored plurilateral agreements have been signed in two important service industries, telecommunications and financial services.

Most of the bilateral and plurilateral agreements in the Western Hemisphere and elsewhere omit large parts of the service economy. For example, all of Chile's bilateral trade agreements omit services. The Southern Cone's common market (MERCOSUR), comprising Argentina, Brazil, Paraguay, and Uruguay, proposes to include the free circulation of services, but there are many exceptions, particularly in the area of investments that limit the provision of services by foreign firms. The Andean Community also intends to permit the free circulation of services, without exception, but few details have been specified (Organization of American States, 1999a).

Capital Flows

The increased variety of international financial instruments and the reduction of transaction costs brought on by advances in telecommunications have drastically increased the dollar value of international capital flows. While volatile speculative flows have become the bane of many economies, more permanent flows of foreign direct investment (FDI) have also risen significantly, from around 0.4 percent of global GDP in 1985 to over 1 percent in 1997 (Preeg, 1998).

Globally, integrated financial markets imply that the correlation between national savings and national investment should be small, since savers would not have preferences for their national markets but would invest wherever they earn the highest returns. Feldstein and Horioka (1980), however, show that domestic savings and investment levels are highly correlated, although the correlation has been falling in the second half of the 20th century, presumably as capital markets have become more integrated. Nevertheless, Taylor (1996) shows that increased capital market integration since approximately 1950 is a recovery of some, but not all, of the integration lost between 1929 and 1950.

Prices

In a highly integrated international economy, purchasing power parity (PPP) would hold. PPP is the simple idea that national price levels should be equal once they are converted to a common currency. Rogoff (1996) argues that the literature on PPP has achieved a "surprising degree of consensus" around the following two points. First, PPP does seem to hold in the long run, but price convergence is extremely slow, perhaps in the order of 15 percent

per year. Second, in the short run, deviations from PPP are "large and volatile." In sum, it is impossible to find credible evidence in the price data for the existence of a unified international goods market.

Two Puzzles about International Economic Integration

Economic integration is desirable because it increases allocative efficiency, it produces dynamic spillover benefits that enhance growth, and it lowers prices and thereby improves consumer welfare. In addition, open markets reduce the hold of domestic monopolists and improve competition, while international capital flows partially compensate for the scarcity of domestic capital and are a primary source of technology transfer. Empirical studies using global data sets tend to confirm that economic growth is faster in more open economies (Edwards, 1993; OECD, 1998).

It is curious, then, that in the cases where free trade has existed long enough for structural adjustments to occur, for example, the Canada-U.S. Trade Agreement (CUSTA) or the European Union, the network of economic relationships remains far denser within nations than between nations. Among OECD countries, the effects of national borders make the average level of intra-national trade about ten times greater than international trade, after controlling for distance, the size of national markets, and language differences. CUSTA increased the density of international trade relative to the networks of intra-national trade, but after several years of increasing relative importance, international networks no longer seem to be deepening relative to intra-national ones. With respect to forms of integration other than merchandise trade, empirical analysis shows that firms remain biased towards transacting within the nation. Border effects on services and migration are even greater than those affecting merchandise trade, while the international integration of prices and capital flows appears to be broadly consistent with the results for trade (Helliwell, 1998). In other words, economic policy permits a far greater degree of integration than actually occurs.

Furthermore, there is a lot of "missing" trade, relative to the predictions of the standard Heckscher-Ohlin (HO) model of endowments-based-trade theory (Trefler, 1995). Some of the failure of theory to accurately predict trade volumes may stem from the unrealistic assumptions of the HO model, yet it is also the case that the HO model seems to fairly accurately predict intra-national trade patterns (Davis et al., 1997).

One implication of these two points—(1) far denser intra-national networks than can be explained by policy barriers to international trade, by distance, or by market size, and (2) the absence of trade that is predicted by theory, given international differences in endowments—is that the nation state and national boundaries reduce transaction costs for firms operating within their borders. This hypothesis implies that either we have reached

the limits to international economic integration, or, what is more likely, further integration awaits the reduction of barriers that are less transparent than tariffs and quantitative restrictions. Given the economic and political pressures on governments to negotiate a wide array of new issues, a case can be made for the second interpretation.

Recurrent Themes in the Global Trade Agenda

The fact that national borders are still important probably ranks as one of the least surprising findings of the 1990s. Nevertheless, there are at least two reasons why it is worth stressing. First, it is a useful counterbalance to the unrealistic hopes and fears that have been generated by popular perceptions of a new, global economy. Second, it raises important questions about the future direction of the world trade agenda.

The direction of trade liberalization as embodied in, say, the WTO or the Free Trade Agreement of the Americas (FTAA) contains a number of themes that go far beyond the traditional topics of tariffs and quotas, and beyond the traditional sector of manufactured goods. For example, between the Miami Summit in December of 1994 and the Santiago Summit in April of 1998, FTAA negotiators created 12 working groups to prepare the agenda. The topics included market access, customs procedures, rules of origin, standards and technical barriers, intellectual property rights, subsidies and antidumping and countervailing duties, sanitary and phyto-sanitary standards, services trade, investment measures, government procurement, competition policy, dispute settlement, and the role of small economies. Since the Santiago Summit, some issues have been combined, but by any measure, the negotiating agenda comprises much more than tariffs and quantitative restrictions (Hufbauer and Schott, 1999).

Robert Z. Lawrence (1995) differentiates new issues from traditional issues of tariffs and quantitative restrictions by distinguishing between trade barriers that are at the border and barriers (often unintended) that result from a nation's non-trade, domestic policies. Lawrence labelled integration caused by the removal of tariffs and other border barriers as shallow integration; he labelled integration caused by the removal of domestic policy barriers as deep integration. Deep integration was not entirely new to the 1990s, since the Tokyo Round (1973-1979) of the GATT negotiations covered domestic subsidies; however the Uruguay Round (1986-1993) and the 1990s wave of preferential trade agreements have made a number of new issues negotiable. Important elements of this agenda include foreign investment and competition policies, along with the related issues of antidumping and countervailing duties, and labour, environmental, and product standards, including sanitary and phyto-sanitary standards.

Investment Agreements

Investment is a necessary complement to trade, particularly in the cases of service industries, which must provide their products at the source of consumption, and a variety of high-tech goods industries that require consumer education, special credit arrangements, and after-sales service. The number of bilateral and plurilateral investment agreements has increased significantly in the 1990s, particularly in the Western Hemisphere (Organization of American States, 1999b). These investment arrangements are often part of broad-based trade agreements such as NAFTA and MERCOSUR, but also are stand-alone bilateral investment treaties. For example, Chile's trade agreements with Canada, Colombia, Ecuador, MERCOSUR, Mexico, and Venezuela contain investment provisions, and Chile has also signed separate bilateral investment treaties with Costa Rica, El Salvador, Honduras, Panama, and Nicaragua, among others.

Developing countries are interested in ensuring that they receive private capital flows, while high-income economies seek to take advantage of new systems of global production. In general, investment agreements seek to provide foreign investors with national treatment, to create an investment form of Most Favoured Nation (MFN) status, to remove performance requirements, and to eliminate restrictions on capital and profit remittances. From the standpoint of host countries, the goals are to raise national investment levels, increase the rate of technology transfer, and increase economic growth.

Competition Policies

Large-scale commercial enterprises with significant market (and political) power emerged during the latter part of the 19th century. In response, many nations developed competition (antitrust) policies aimed at preserving their economies of scale while ensuring that consumers reaped some of the benefits. Competition policies generally limit horizontal restraints such as price-fixing agreements or the formation of domestic cartels. There is less consensus over prohibitions of territorial divisions and over vertical constraints such as exclusive agreements between producers and distributors. Most nations permit export cartels and offer a wide variety of individual exceptions to their own rules.

The overlap between competition policy and trade policy occurs because the benefits created by the removal of tariffs can be offset by the absence of domestic competition. Price fixing, output restriction, allocation of market shares, or exclusive dealing, all may mean that technically open markets are effectively closed to foreign firms.

International variation in competition policies partly stems from differences in national views towards competition (Scherer, 1995). As a result, there are significant variations in remedies for addressing the breakdown in competition, the willingness to grant exceptions to national rules, the perceived costs of allowing uncompetitive practices, and the

willingness to include competition policy in trade negotiations. For example, in the Western Hemisphere, NAFTA, the Canada-Chile FTA, and the G-3 (Colombia, Mexico, and Venezuela) have committees to review competition policy developments affecting the agreements, and the G-3 countries have begun to harmonize practices. Both the Andean Community and MERCOSUR have competition policy provisions. Twelve countries in the Western Hemisphere have legal provisions designed to protect competition, but there are a wide number of exceptions to these rules, particularly in the areas of territorial restraints, exclusive agreements between manufacturers, wholesalers, and retailers, and agreements to share research, technology, production, and marketing (Organization of American States, 1999c). In addition, state monopolies are usually exempted, as are a variety of specific sectors, and many countries have no rules regarding mergers.

A second intersection between competition policy and trade policy takes place in the area of antidumping duties (ADD). In theory, it is possible to eliminate antidumping duties if there are international agreements on competition policies; in practice, the Canada-Chile FTA has already done this. The elimination of antidumping duties is desirable for a variety of reasons. First, ADDs assume that exporters have market power at home that enables them to finance below cost sales abroad, but the imposed remedy is to raise foreign prices rather than lower home prices. Second, in the short run, competitive firms will sell below average costs, yet ADDs use an average cost criterion to judge whether dumping has occurred. Third, ADDs have increased the extraterritorial application of national competition policies.

Agreements on competition policies are likely to have costs as well as benefits. One of the costs would be added constraints on national industrial development policies. Many nations allow various forms of horizontal and vertical collusion as an element of these policies, particularly in cases where imperfect capital markets or high information costs lead to less than a socially optimal level of investment. For example, investment in a particular export industry may require simultaneous investments in port facilities in order to be profitable. Various forms of firm collusion, including information sharing and exclusive contracts, may help to overcome the market failure but may also run afoul of competition policy. Similarly, other forms of market failure, such as under-investment in new technologies or in technology transfer, are frequently addressed with exceptions to competition policy that permit a certain degree of collusion between firms.

Labour and Environmental Standards

Labour and environmental standards are part of the trade agenda because developed countries demand it. These demands will persist in spite of the fact that it is unlikely that labour or environmental agreements will have the same effect of increasing trade flows that

investment or competition policy agreements might have. Many developing countries view these demands as a new form of protectionism, a view supported by the fact that the sources of many of the initiatives for labour and environmental standards are groups interested in reducing trade flows. Nevertheless, the full range of motives behind the call for standards is diverse and includes humanitarian and ecological concerns, as well as the fear of competitive advantage which is conferred by exploitation of the environment or labour, and the fear that trade with less developed countries has increased wage inequality (United States) or the rate of unemployment (Europe).

Space limitations prevent a full discussion of these issues, but a couple of observations are warranted. First, with respect to environmental issues, economic analysis is absolutely clear that trade interventions are rarely an optimal approach to pollution reduction and that full cost pricing (i.e., internalization of the environmental costs of production within the firm) is far superior to any form of trade intervention (Corden, 1997). Second, trade sanctions by themselves have a miserable track record at achieving their goals, so even if they were not sub-optimal policy, they are relatively ineffective (Hufbauer, Schott and Elliot, 1990). Third, with respect to the argument that trade has caused income inequality and unemployment, there is a developing consensus that technological change is far more powerful at generating inequality and that macroeconomic and labour market policies (not trade policies) are the reasons behind the high rates of unemployment in some industrial countries over the last 20 years (Cline, 1999). Fourth, much of the rhetoric in industrial countries has conflated the issue of low wages and low productivity as legitimate sources of comparative advantage with lax enforcement or exploitation as a source of advantage.

In spite of the last point, the moral outrage of many middle-class residents of industrial nations over the low wages and poor working conditions prevalent in developing countries makes it unlikely that the proposal to link trade sanctions to enforcement of labour standards will disappear soon. A partial sense of legitimacy for this linkage is conferred by the fact that all nations impose a variety of restrictions on new technologies and new products when they offend moral or ethical standards. One has only to think of the bans on slavery or experimentation on humans. Similarly, animal experimentation is widely regulated, as are technologies and products associated with birth control and human sexuality. The point is that these are considered legitimate restrictions on trade, technology, and production, because they offend the citizens (and/or authorities) in one country. Similarly, many residents of industrial nations view the labour standards of some developing countries as illegitimate, and as a result, arguments about efficiency, consumer welfare, comparative advantage, the history of industrial economies, or the essential contribution of children to household income, often fall on deaf ears.

Proposals for moving the trade agenda forward while simultaneously addressing

labour and environmental concerns usually involve some form of labelling in which consumers are provided information about conditions in the exporting country. This could happen through a combination of independent agencies such as the International Labour Office (ILO), private non-governmental organizations, a new international environmental review organization, or some other organization(s). The advantages inherent in a labelling system are that it educates consumers and lets them decide what to purchase, product by product, thereby avoiding the blunt hammer of government-imposed sanctions.

Two Considerations

This is not an exhaustive list of items on the new trade agenda, and additional topics are currently under negotiation (e.g., product standards) or are potential topics for negotiation (e.g., capital flows and migration). Two generally applicable considerations are the potential for capture of the negotiations by protectionists and the distinction between harmonization and mutual recognition of standards.

The potential for protectionist capture of the new trade agenda is a very real danger. For example, recent odd alliances between labour and environmentalists, and between extreme right-wing nationalists and left-wing progressives, usually center around a protectionist consensus. Given that the industrial organization literature is full of examples of government regulations that have been captured by the interests they were designed to regulate, there is no reason why trade agreements should be any different.

A second consideration is the distinction between harmonization of standards and mutual recognition. In the former, standards are made more or less the same, while in the latter, countries keep their own standards but agree to recognize those of their trading partners, perhaps after some adjustment falling short of harmonization. It is often assumed that closer integration requires harmonized standards, but the degree of harmonization depends on the specific issue involved. For example, harmonization of collective bargaining rules is probably less essential than harmonization of child labour rules, and some harmonizations are absolutely undesirable (e.g., overtime rules). Rules and preferences for standards are a source of comparative advantage, and as long as they represent a non-coercive social consensus, world welfare is greater when harmonization is avoided. Accordingly, many economists argue that mutual recognition is usually superior to harmonization (Krugman, 1997). Given existing differences in national cultures and tastes, income levels, and geography, there is no reason to believe that one set of standards will maximize every country's welfare. As long as standards reflect a social consensus, a competition of rules serves the collective interest best and avoids the problem of harmonizing around a set of standards that are less efficient and/or less equitable.

Conclusion: More Integration?

The goal of most, but not all, of the new items on the trade negotiating agenda is to increase consumer choice and producer efficiency through increased specialization in production. Labour and environmental standards are different, however, in that they relate to the public's perception of fairness. In both industrial and industrializing economies, support for further integration is likely to fail if trade liberalization is perceived to increase inequality. It does not matter that trade cannot do much, either positively or negatively, to change the level of inequality. If it is believed that trade has increased inequality, then it is hard to see how democratic societies will sustain the momentum towards deeper integration.

In the long run, the deeper-integration agenda seeks to create institutional changes that are critical to the further deepening of international economic integration. Although each theme is relatively limited in its application, they all serve the much broader purposes of increasing transparency in rules and rulemaking, developing greater commitments to the rule of law, and increasing the security of property rights. It is unlikely that these institutional changes will completely overcome the greater transaction costs of trading abroad rather than at home, but they hold the promise of further significant increases in cross-border trade.

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