10.1 The Gains from 1992

In 1987, the nations of the European Community (now known as the European Union) agreed on what formally was called the Single European Act, with the intention to create a truly unified European market. Because the act was supposed to go into effect within five years, the measures it embodied came to be known generally as “1992.”

The unusual thing about 1992 was that the European Community was already a customs union, that is, there were no tariffs or import quotas on intra-European trade. So, what was left to liberalize? The advocates of 1992 argued that there were still substantial barriers to international trade within Europe. Some of these barriers involved the costs of crossing borders; for example, the mere fact that trucks carrying goods between France and Germany had to stop for legal formalities often resulted in long waits that were costly in time and fuel. Similar costs were imposed on business travelers, who might fly from London to Paris in an hour, then spend another hour waiting to clear immigration and customs. Differences in regulations also had the effect of limiting the integration of markets. For example, because health regulations on food differed among the European nations, one could not simply fill a truck with British goods and take them to France, or vice versa.

Eliminating these subtle obstacles to trade was a very difficult political process. Suppose France decided to allow goods from Germany to enter the country without any checks. What would prevent the French people from being supplied with manufactured goods that did not meet French safety standards, foods that did not meet French health standards, or medicines that had not been approved by French doctors? Thus, the only way that countries can have truly open borders is if they are able to agree on common standards so that a good that meets French requirements is acceptable in Germany and vice versa. The main task of the 1992 negotiations was therefore one of harmonizing regulations in hundreds of areas, negotiations that were often acrimonious because of differences in national cultures.

The most emotional examples involved food. All advanced countries regulate things such as artificial coloring to ensure that consumers are not unknowingly fed chemicals that are carcinogens or otherwise harmful. The initially proposed regulations on artificial coloring would, however, have destroyed the appearance of several traditional British foods: Pink bangers (breakfast sausages) would have become white, golden kippers gray, and mushy peas a drab rather than a brilliant green. Continental consumers did not mind; indeed, they could not understand how the British could eat such things in the first place. But in Britain, the issue became tied up with fear over the loss of national identity, and loosening the proposed regulations became a top priority for the British government, which succeeded in getting the necessary exemptions. On the other hand, Germany was forced to accept imports of beer that do not meet its centuries-old purity laws and Italy to accept pasta made from—horrors!—the wrong kind of wheat.

But why engage in all this difficult negotiating? What were the potential gains from 1992? Attempts to estimate the direct gains have always suggested that they are fairly modest. Costs associated with crossing borders amount to no more than a few percent of the value of the goods shipped; removing these costs adds at best a fraction of a percent to the real income of Europe as a whole. Yet economists at the European Commission (the administrative arm of the European Union) argued that the true gains would be much larger.

Their reasoning relied to a large extent on the view that the unification of the European market would lead to greater competition among firms and to a more efficient scale of production. Much was made of the comparison with the United States, a country whose purchasing power and population are similar to those of the European Union, but that is a borderless, fully integrated market. Commission economists pointed out that in a number of industries, Europe seemed to have markets that were segmented: Instead of treating the whole continent as a single market, firms seemed to have carved it into local zones served by relatively small-scale national producers. The economists argued that with all barriers to trade removed, there would be a consolidation of these producers, with substantial gains in productivity. These putative gains raised the overall estimated benefits from 1992 to several percent of the initial income of European nations. The Commission economists argued further that there would be indirect benefits because the improved efficiency of the European economy would improve the trade-off between inflation unemployment. At the end of a series of calculations, the Commission estimated a gain from 1992 of 7 percent of European income.[[1]](#footnote-1)

While nobody involved in this discussion regarded 7 percent as a particularly reliable number, many economists shared the conviction of the Commission that the gains would be large. There were, however, skeptics who suggested that the segmentation of markets had more to do with culture than with trade policy. For example, Italian consumers wanted washing machines that were quite different from those preferred in Germany. Italians tend to buy relatively few clothes, but those they buy are stylish and expensive, so they prefer slow, gentle washing machines that conserve their clothing investment.

Now that a number of years have passed since 1992, it is clear that both the supporters and the skeptics had valid points. In some cases, there have been notable consolidations of industry; for example, Hoover closed its vacuum cleaner plant in France and concentrated all its production in a more efficient plant in Britain. In other cases, old market segmentations have clearly broken down, and sometimes in surprising ways, like the emergence of British sliced bread as a popular item in France. But in still other cases, markets have shown little sign of merging: Germans have shown little taste for imported beer and Italians none for pasta made with soft wheat.

How large were the economic gains from 1992? By 2003, when the European Commission decided to review the effects of the Single European Act, it came up with more modest estimates than it had before 1992: It put the gains at about 1.8 percent of GDP. If this number is correct, it represents a mild disappointment but hardly a failure.

10.2 Politicians for Sale: Evidence from the 1990s

As we explain in the text, it’s hard to make sense of actual trade policy if you assume governments are genuinely trying to maximize national welfare. On the other hand, actual trade policy does make sense if you assume special-interest groups can buy influence. But is there any direct evidence that politicians really are for sale?

Votes by the U.S. Congress on some crucial trade issues in the 1990s offer useful test cases. The reason is that U.S. campaign finance laws require politicians to reveal the amounts and sources of campaign contributions; this disclosure allows economists and political scientists to look for any relationship between those contributions and actual votes.

A 1998 study by Robert Baldwin and Christopher Magee[[2]](#footnote-2) focuses on two crucial votes: the 1993 vote on the North American Free Trade Agreement (generally known as NAFTA, and described at greater length below), and the 1994 vote ratifying the latest agreement under the General Agreement on Tariffs and Trade (generally known as the GATT, also described below). Both votes were bitterly fought, largely along business-versus-labor lines—that is, business groups were strongly in favor; labor unions were strongly against. In both cases, the free trade position backed by business won; in the NAFTA vote, the outcome was in doubt until the last minute, and the margin of victory—34 votes in the House of Representatives—was not very large.

Baldwin and Magee estimate an econometric model of congressional votes that controls for such factors as the economic characteristics of members’ districts as well as business and labor contributions to the congressional representative. They find a strong impact of money on the voting pattern. One way to assess this impact is to run a series of “counterfactuals”: How different would the overall vote had been if there had been no business contributions, no labor contributions, or no contributions of any type at all?

The following table summarizes the results. The first row shows how many representatives voted in favor of each bill; bear in mind that passage required at least 214 votes. The second row shows the number of votes predicted by Baldwin and Magee’s equations: Their model gets it right in the case of NAFTA but overpredicts by a few votes in the case of the GATT. The third row shows how many votes each bill would have received, according to the model, in the absence of labor contributions; the next row shows how many representatives would have voted in favor in the absence of business contributions. The last row shows how many would have voted in favor if both business and labor contributions had been absent.

|  | Vote for NAFTA | Vote for GATT |
| --- | --- | --- |
| Actual | 229 | 229 |
| Predicted by model | 229 | 290 |
| Without labor contributions | 291 | 346 |
| Without business contributions | 195 | 257 |
| Without any contributions | 256 | 323 |

If these estimates are correct, contributions had big impacts on the vote totals. In the case of NAFTA, labor contributions induced 62 representatives who would otherwise have supported the bill to vote against; business contributions moved 34 representatives the other way. If there had been no business contributions, according to this estimate, NAFTA would have received only 195 votes—not enough for passage. On the other hand, given that both sides were making contributions, their effects tended to cancel out. Baldwin and Magee’s estimates suggest that in the absence of contributions from either labor or business, both NAFTA and the GATT would have passed anyway. It’s probably wrong to emphasize the fact that in these particular cases, contributions from the two sides did not change the final outcome. The really important result is that politicians are, indeed, for sale—which means that theories of trade policy that emphasize special interests are on the right track.

10.3 Settling a Dispute—and Creating One

The very first application of the WTO’s new dispute settlement procedure has also been one of the most controversial. To WTO supporters, it illustrates the new system’s effectiveness. To opponents, it shows that the organization stands in the way of important social goals such as protecting the environment.

The case arose out of new U.S. air pollution standards. These standards set rules for the chemical composition of gasoline sold in the United States. A uniform standard would clearly have been legal under WTO rules. However, the new standards included some loopholes: Refineries in the United States, or those selling 75 percent or more of their output in the United States, were given “baselines” that depended on their 1990 pollutant levels. This provision generally set a less strict standard than was set for imported gasoline, and thus in effect introduced a preference for gasoline from domestic refineries.

Venezuela, which ships considerable quantities of gasoline to the United States, brought a complaint against the new pollution rules early in 1995. Venezuela argued that the rules violated the principle of “national treatment,” which says that imported goods should be subject to the same regulations as domestic goods (so that regulations are not used as an indirect form of protectionism). A year later, the panel appointed by the WTO ruled in Venezuela’s favor; the United States appealed, but the appeal was rejected. The United States and Venezuela then negotiated a revised set of rules.

At one level, this outcome was a demonstration of the WTO doing exactly what it was supposed to do. The United States had introduced measures that pretty clearly violated the letter of its trade agreements; when a smaller, less influential country appealed against those measures, it got fairly quick results.

On the other hand, environmentalists were understandably upset: The WTO ruling, in effect, blocked a measure that would have made the air cleaner. Furthermore, there was little question that the clean-air rules were promulgated in good faith—that is, they were really intended to reduce air pollution, not to exclude exports.

Defenders of the WTO point out that the United States clearly could have written a rule that did not discriminate against imports; the fact that it had not done so was a political concession to the refining industry, which did in effect constitute a sort of protectionism. The most you can say is that the WTO’s rules made it more difficult for U.S. environmentalists to strike a political deal with the industry.

In the mythology of the anti-globalization movement, which we discuss in Chapter 12, the WTO’s intervention against clean-air standards has taken on iconic status: The case is seen as a prime example of how the organization deprives nations of their sovereignty, preventing them from following socially and environmentally responsible policies. The reality of the case, however, is nowhere near that clearcut: If the United States had imposed a “clean” clean-air rule that had not discriminated among sources, the WTO would have had no complaints.

10.4 Testing the WTO’s Metal

In March 2002, the U.S. government imposed 30 percent tariffs on a range of imported steel products. The official reason for this action was that the U.S. industry faced a surge in imports and needed time to restructure. But the real reason, almost everyone agreed, was politics: West Virginia, Ohio, and Pennsylvania, where the steel industry is concentrated, were widely expected to be crucial “swing states” in the 2004 election.

Europe, Japan, China, and South Korea filed suit against the U.S. steel tariff with the WTO, asserting that the U.S. action was illegal. In July 2003, a WTO panel agreed, ruling that the U.S. action was unjustified. Many observers regarded the U.S. response to this ruling as a crucial test of the WTO’s credibility: Would the government of the world’s most powerful nation really allow an international organization to tell it to remove a politically important tariff? There was even talk of a looming trade war.

In fact, the United States complied with the ruling, lifting the steel tariffs in December 2003. The official explanation for the decision was that the tariffs had served their purpose. Most observers believed, however, that the key motivation was a threat by the European Union, which by now had received WTO clearance to take retaliatory action, and was getting ready to impose tariffs on more than $2 billion in U.S. exports. (The Europeans, who understand politics as well as we do, targeted their tariffs on goods produced in—you guessed it—political swing states.)

So the WTO passed a big test. Still, it’s one thing for the United States to defer to a complaint from the European Union, which is an economic superpower with an economy roughly the same size as that of the United States. The next question is what will happen when the WTO rules in favor of smaller economies against major economic powers like the United States or the EU.

In March 2005, in a landmark decision, the WTO agreed with Brazil’s claim that U.S. subsidies to cotton producers were illegal. The United States said it would comply and eliminate the subsidies, but by 2009 had made only partial moves toward compliance; at that point, the WTO authorized Brazil to retaliate with substantial sanctions on U.S. exports. In 2010, the United States reached a provisional deal with Brazil, offering a number of concessions, which staved off immediate action. However, as of 2013, unsatisfied with the results to date, Brazil was still threatening to go ahead with sanctions.

10.5 Free Trade Area versus Customs Union

**The difference between a free trade area and a customs union is, in brief, that the first is politically straightforward but an administrative headache, while the second is just the opposite.**

**Consider first the case of a customs union. Once such a union is established, tariff administration is relatively easy: Goods must pay tariffs when they cross the border of the union, but from then on can be shipped freely between countries. A cargo that is unloaded at Marseilles or Rotterdam must pay duties there, but will not face any additional charges if it then goes by truck to Munich. To make this simple system work, however, the countries must agree on tariff rates: The duty must be the same whether the cargo is unloaded at Marseilles, Rotterdam, or, for that matter, Hamburg, because otherwise, importers would choose the point of entry that minimizes their fees. So a customs union requires that Germany, France, the Netherlands, and all the other countries agree to charge the same tariffs. This is not easily done: Countries are, in effect, ceding part of their sovereignty to a supranational entity, the European Union.**

**This has been possible in Europe for a variety of reasons, including the belief that economic unity would help cement the postwar political alliance between European democracies. (One of the founders of the European Union once joked that it should erect a statue of Joseph Stalin, without whose menace the Union might never have been created.) But elsewhere these conditions are lacking. The three nations that formed NAFTA would find it very difficult to cede control over tariffs to any supranational body; if nothing else, it would be hard to devise any arrangement that would give due weight to U.S. interests without effectively allowing the United States to dictate trade policy to Canada and Mexico. NAFTA, therefore, while it permits Mexican goods to enter the United States without tariffs and vice versa, does not require that Mexico and the United States adopt a common external tariff on goods they import from other countries.**

**This, however, raises a different problem. Under NAFTA, a shirt made by Mexican workers can be brought into the United States freely. But suppose the United States wants to maintain high tariffs on shirts imported from other countries, while Mexico does not impose similar tariffs. What is to prevent someone from shipping a shirt from, say, Bangladesh to Mexico, then putting it on a truck bound for Chicago?**

**The answer is that even though the United States and Mexico may have free trade, goods shipped from Mexico to the United States must still pass through a customs inspection. And they can enter the United States without duty only if they have documents proving that they are in fact Mexican goods, not transshipped imports from third countries.**

**But what is a Mexican shirt? If a shirt comes from Bangladesh, but Mexicans sew on the buttons, does that make it Mexican? Probably not. But if everything except the buttons were made in Mexico, it probably should be considered Mexican. The point is that administering a free trade area that is not a customs union requires not only that the countries continue to check goods at the border, but that they specify an elaborate set of “rules of origin” that determine whether a good is eligible to cross the border without paying a tariff.**

**As a result, free trade agreements like NAFTA impose a large burden of paperwork, which may be a significant obstacle to trade even when such trade is in principle free.**

10.6 Do Trade Preferences Have Appeal?

**The European Union has slipped repeatedly into bunches of trouble over the question of trade preferences for bananas.**

**Most of the world’s banana exports come from several small Central American nations—the original “banana republics.” Several European nations, however, have traditionally bought their bananas instead from their past or present West Indian colonies in the Caribbean. To protect the island producers, France and the United Kingdom have historically imposed import quotas against the “dollar bananas” of Central America, which are typically about 40 percent cheaper than the West Indian product. Germany, however, which has never had West Indian colonies, allowed free entry to dollar bananas.**

**With the integration of European markets after 1992, the existing banana regime became impossible to maintain because it was easy to import the cheaper dollar bananas into Germany and then ship them elsewhere in Europe. To prevent this outcome, the European Commission announced plans in 1993 to impose a new common European import quota against dollar bananas. Germany angrily protested the move and even denied its legality: The Germans pointed out that the Treaty of Rome, which established the European Community, contains an explicit guarantee (the “banana protocol”) that Germany would be able to import bananas freely.**

**Why did the Germans go ape about bananas? During the years of communist rule in East Germany, bananas were a rare luxury. The sudden availability of inexpensive bananas after the fall of the Berlin Wall made them a symbol of freedom. So the German government was very unwilling to introduce a policy that would sharply increase banana prices.**

**In the end, the Germans grudgingly went along with a new, unified system of European trade preferences on bananas. But that did not end the controversy: In 1995, the United States entered the fray, claiming that by monkeying around with the existing system of preferences, the Europeans were hurting the interests not only of Central American nations but also those of a powerful U.S. corporation, the Chiquita Banana Company, whose CEO had donated large sums to both Democratic and Republican politicians.**

**In 1997, the World Trade Organization found that Europe’s banana import regime violated international trade rules. Europe then imposed a somewhat revised regime, but this halfhearted attempt to resolve the banana split proved fruitless. The dispute with the United States escalated, with the United States eventually retaliating by imposing high tariffs on a variety of European goods, including designer handbags and pecorino cheese.**

**In 2001, Europe and the United States agreed on a plan to phase out the banana import quotas over time. The plan created much distress and alarm in Caribbean nations, which feared dire consequences from their loss of privileged access to the European market. But even then the story wasn’t over. In January 2005, the European Union announced it would eliminate import quotas on bananas, but that it would triple the tariff on bananas that did not come from the so-called ACP countries (African, Caribbean, and Pacific— essentially, former European colonies). Latin American countries immediately moved to challenge the new tariff, and in December 2007 the WTO ruled that Europe’s latest banana regime, like its predecessor, was illegal. (Chiquita’s stock price jumped with the news.)**

**Finally, in December 2009, the European Union reached an agreement with Latin American banana producers. It wouldn’t completely eliminate trade preferences, but it would cut tariffs on bananas by a third over a seven-year period.**

10.7 Trade Diversion in South America

**In 1991, four South American nations, Argentina, Brazil, Paraguay, and Uruguay, formed a free trade area known as Mercosur. The pact had an immediate and dramatic effect on trade: Within four years, the value of trade among the nations tripled. Leaders in the region proudly claimed Mercosur as a major success, part of a broader package of economic reform.**

**But while Mercosur clearly was successful in increasing intraregional trade, the theory of preferential trading areas tells us that this need not be a good thing: If the new trade came at the expense of trade that would otherwise have taken place with the rest of the world—that is, if the pact diverted trade instead of created it—it might actually have reduced welfare. And sure enough, in 1996 a study prepared by the World Bank’s chief trade economist concluded that despite Mercosur’s success in increasing regional trade—or rather, because that success came at the expense of other trade—the net effects on the economies involved were probably negative.**

**In essence, the report argued that as a result of Mercosur, consumers in the member countries were being induced to buy expensively produced manufactured goods from their neighbors rather than cheaper but heavily tariffed goods from other countries. In particular, because of Mercosur, Brazil’s highly protected and somewhat inefficient auto industry had in effect acquired a captive market in Argentina, thus displacing imports from elsewhere, just like our text example in which French wheat displaces American wheat in the British market. “These findings,” concluded the initial draft of the report, “appear to constitute the most convincing, and disturbing, evidence produced thus far concerning the potential adverse effects of regional trade arrangements.”**

**But that is not what the final, published report said. The initial draft was leaked to the press and generated a firestorm of protest from Mercosur governments, Brazil in particular. Under pressure, the World Bank first delayed publication, then eventually released a version that included a number of caveats. Still, even in its published version, the report made a fairly strong case that Mercosur, if not entirely counterproductive, nonetheless has produced a considerable amount of trade diversion.**

1. See Michael Emerson, Michel Aujean, Michel Catinat, Philippe Goubet, and Alexis Jacquemin, “The Economics of 1992,” European Economy 35 (March 1988). [↑](#footnote-ref-1)
2. Robert E. Baldwin and Christopher S. Magee, “Is Trade Policy for Sale? Congressional Voting on Recent Trade Bills,” Working Paper 6376, National Bureau of Economic Research, January 1998. [↑](#footnote-ref-2)