Regional and Multilateral Trade Agreements: Complementary Means to Open Markets

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Free trade advocates face more than just the constant challenge of reminding the public and policymakers of the virtues of open global markets. They also confront theoretical and practical questions over how to secure them. In recent years the discussion has been over the respective merits of bilateral or regional free trade agreements such as the North American Free Trade Agreement (NAFTA) and the European Union (EU) on the one hand and the multilateral General Agreement on Tariffs and Trade (GATT), now manifest in the World Trade Organization (WTO), on the other.

With the establishment of GATT after World War II, the multilateral approach was the preferred method of trade liberalization. But the establishment of NAFTA has caused concerns about the rise of exclusionary trade blocks. In reaction, supporters of the multilateral approach have been reasserting their position. Yet unilateral, bilateral, regional, and multilateral trade liberalization are all valid means to open world markets. Each has its place, and no arrangement promising freer trade should be rejected without good cause.

Regional or Worldwide Trade?

Sidney Weintraub (1996), a supporter of the multilateral approach, proceeds from the following assumptions:

- Overall wealth for both individuals and countries tends to grow when barriers to trade are removed.

Cato Journal, Vol. 15, Nos. 2–3 (Fall/Winter 1995/96).

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- In general, a multilateral approach to trade liberalization is best.
- Bilateral and regional agreements are justified if they create more trade than they divert.
- Regional trade arrangements should not be adopted if they maintain high trade barriers to nonmembers.

From these premises Weintraub concludes that free trade areas or regional arrangements are justified under certain conditions:

- They should not merely be exchanges of trade preferences, with countries simply removing their tariffs and other traditional barriers such as quotas. They should go beyond what can be done on a multilateral basis in the WTO.
- Regional arrangements should "deepen" trade—that is, address entrenched internal barriers to trade.
- Regional arrangements should be "open"—that is, they should allow other countries in the region to join.
- Both regional and multilateral arrangements should continue to progress, lest they atrophy.

Four Evaluative Factors

It is useful to evaluate these proposed trade agreements in light of four factors: individual liberty, trade effects, the regulatory regime, and the political climate.

Individual Liberty

Trade liberalization is, first and foremost, the removal of restrictions on the freedom of a country's citizens to dispose of their property as they see fit and to engage in voluntary exchanges with others. Thus, market liberals should establish freer trade whenever possible. It is important to put free trade in this context, for the very language used to discuss this issue is misleading. Some speak of countries making trade concessions in negotiations with other countries. But in reality it is not a "concession" if the United States government restores to its citizens some of their freedom to purchase shirts from producers in Mexico or China.

From this perspective, a country should remove its trade barriers unilaterally, whether other countries do so or not. But since no other industrialized countries yet have approached the wisdom of the policies practiced by Hong Kong, the least countries could do is never miss an opportunity to expand trade on a bilateral basis. If one's standard for judging the merits of a trade policy is whether it increases or decreases the liberty of a country's citizens, then questions of trade creation or diversion would be secondary.

Thus, I offer the following criterion for judging the merits of a proposed regional or bilateral trade arrangement: *Does the trade arrangement increase economic freedom?* That criterion suggests that the burden of proof rests on those who would advise that an offer from another country to establish freer exchange should be turned down. There is no fundamental difference in the case for free exchange between individuals who live in different houses, on different streets, in different towns, in different states of the same country, or in different countries. Market liberals assume that such freedom should be the natural condition, with no special case or justification needed. Thus, the question we must ask is whether there are compelling reasons *not* to liberalize trade on a bilateral or regional basis if the opportunity presents itself.

Trade Effects

Even critics usually concede that, in general, freer trade, including bilateral and regional liberalization, improves the welfare of all countries by promoting wealth creation. But they also maintain that under certain circumstances, opening markets with only one or several trading partners could merely divert trade. Weintraub points out, for example, that in MERCOSUR, Paraguay and Uruguay could be forced to purchase higher-priced goods from Brazil rather than from less costly suppliers.

But let us consider the various types of bilateral and regional trade arrangements in light of the economic freedom rule. To judge the effects of trade arrangements other than the multilateral GATT/WTO approach, it is necessary then to distinguish between two types of regional arrangements: free trade areas (FTAs), such as NAFTA, and customs unions, such as the EU, which maintain common barriers to nonmember countries. The greatest danger for trade distortions and compromises of economic liberty seems to lie in the latter.

Customs Unions. Consider an example. The Czech Republic wishes to enter the EU. That might mean simply that it removes tariffs and traditional trade barriers to EU member countries while keeping intact barriers to nonmembers (e.g., to former Warsaw Pact countries). In such a case there is no net loss of freedom for the Czech people. Rather, there is a gain.

But such an arrangement could cause some trade distortions. For example, perhaps the Czechs maintain a 5 percent tariff on imported widgets. And under this tariff, Hungarian widgets are more competitive in the Czech Republic against rival German products. Thus, the Czechs purchase most of their widgets from Hungary. But with no tariff on German widgets, the Germans, although less competitive head-to-head with Hungarian suppliers, might dominate the Czech market.

That situation is not a problem for the Czechs, nor a reason to remain outside of the EU. The situation would be a windfall for the Germans. They would have no reason to block Czech membership. The competitive status of widget-makers in other EU countries would remain unchanged. Only Hungary would be at a disadvantage.

If Hungary has the option to enter the EU, it could eliminate this disadvantage. But Germany might block Hungarian membership to protect its advantage in widgets. So the Czechs, who do not sacrifice freedom with initial EU membership, might be cutting off opportunities for even freer trade in the future. And so might other EU countries that would like, in the future, to purchase less costly Hungarian widgets rather than expensive German ones.

But there is more to economies than widgets. No doubt some German manufacturers would wish to acquire access to Hungary as a means to overcome their competitive disadvantage in that market against Japanese high-tech products. Then the struggle would be between German interest groups for the support of the German government. The outcome might or might not be trade maximizing.

Thus, when a country enters a customs union, it does risk gaining a short-term increase in freedom while hampering opportunities for future gains. Yet that alone does not seem a sufficient reason for not entering a regional or bilateral trade arrangement. The battle for further trade liberalization among the members of a free trade area, as well as the trade battle within each country, is always a political one. In general, free-market advocates win one battle and then go on to the next one, understanding that they will always meet resistance. Unless the prospects of future trade problems within a regional trade area are very clear, freedom is worth the risk.

Deepening-of-Trade Problems. But EU membership would not simply mean that the Czechs would eliminate their tariffs and other traditional trade barriers. The Czechs might find that EU subsidies, agriculture policies, or new regulations from Brussels have the effect of raising trade barriers to its old, non-EU trading partners. After all, some of the so-called deepening of trade within the EU is, in fact, bad economic policy. That situation could have the effect of limiting economic liberty for Czechs in certain sectors. In such a case the Czechs would be sacrificing certain freedoms in hopes of gaining net freedom. But the problem here is not with regional *trade* liberalization. It is with customs unions that have bad internal economic policies.

Safer Free Trade Areas. In a NAFTA-type arrangement, the problem of sacrificing freedom might be reduced. Each member country retains it own trade barriers to nonmember countries. Thus, Mexicans and Canadians can continue to purchase Cuban cigars even though the United States bans the import of these products.

If Canadians decide to throw their market open completely to apparel imports from every country, they could do so. American consumers would envy their neighbors to the north. American apparel manufacturers, who hold those consumers hostage with the U.S. government as the armed enforcer, would curse the cold that woke up the Canadians to the advantages of open markets. Even Mexicans might grumble at competition in the Canadian market from Asian suppliers.

And there certainly would be more border activity as American customs officials block shipments of non-NAFTA apparel through Canada into the United States. Rules of origin would prevent Asians from going through Canada to get around American trade restrictions. This is an administrative cost that would reduce some of the advantages of the FTA. But there would be no loss of liberty or trade-offs of freedom.

Open FTAs? NAFTA also could face the problem of one of its members trying to block new entrants. For example, if Chile joins NAFTA, its wines will be more competitive in the United States in competition with Argentine vintages. Would Chile veto Argentine membership? Possibly, and for the same reasons Germany might resist Hungarian EU membership in the earlier example.

But as is the case with customs unions, the prospect—indeed, the inevitability—of future political battles over trade liberalization should not as such be cause to shy away from expanding a regional arrangement.

What Diverts Trade? Another problem with turning down freer trade for fear of trade diversion is that it is very difficult, before the fact, to determine whether thwarted wealth creation caused by trade diversion will offset new wealth creation that results from more open markets. That is because it is not possible to predict which enterprises will best serve the needs of consumers at any given time. Indeed, the whole point of having competition in a market is to separate successful from unsuccessful producers.

Furthermore, alleged trade diversion in the short term can be masked, indeed overwhelmed, by other factors. Exchange rates affect the international competitiveness of firms and the capacity of citizens and enterprises in a country to purchase imports. In the 1980s the U.S. economy was growing more rapidly than the economies of Western Europe and other countries. Thus, Americans imported more.

Recently, the erosion of America's trade surplus with Mexico has been blamed on NAFTA. But this erosion has had little to do with reduction of trade barriers or trade diversion. Rather, Mexico's irresponsible monetary policy and other policy failures led to the economic crisis that reduced Mexican purchasing power. It should be recalled that the United States bailed out Mexico in 1982 and, through the International Monetary Fund and World Bank, has continued to provide support for Mexico. Those policies, I would argue, were mistaken. But they took place at a time when America had no FTA with Mexico, when Mexico was not even a member of the GATT, and when Mexico's protectionist policies were particularly harsh.

If anything, it might be argued that closer economic ties with the United States have made it more difficult for Mexico to react to its self-inflicted crisis with the kind of self-destructive protectionist, nationalization, or confiscatory policies that often characterized its reactions to problems in the past.

Missed Opportunities. In the longer term, it is also difficult to determine where future opportunities to create more trade might lie. Fearing trade diversion, in the late 1950s some American policymakers might have turned down an offer by Japan to establish an FTA. Why divert trade from dynamic Europe or from the awaking economic giants of Latin America for not-so-promising Asian countries? We know now, of course, that had such an opportunity for a U.S.-Japan FTA arisen, and had America turned it down, it would have nothing to blame for decades of lost sales but the fatal conceit of putting political judgments ahead of market opportunities.

Another example offers proof of both the problems of predicting future markets, and of the role of a country's domestic policies as a major determinant of competitive international status. Weintraub observes that African countries benefited little from decades of GATT liberalization, whereas the four Asian tigers (Hong Kong, Singapore, South Korea, and Taiwan) benefited considerably. Quite true. Consider why.

Between 1965 and 1985 the combined GDP of Sub-Saharan African countries, minus South Africa, grew from about $100 billion to $200 billion in real purchasing power terms. Annual per capita income was stagnant over that period at about $500. If those countries had grown at the rate of the four Asian tigers during that 20-year period, in 1985 they would have had a total GDP of \$648 billion and a per capita income of \$1,800 (Hudgins and Johnson 1990). The repressive economic policies with which the African governments strangle their own people make it impossible for these people to breath the rich air of trade liberalization.

The Regulatory Regime

The foregoing discussion suggests that the role of regulation is more important to judging the wisdom of a regional trade arrangement than are strict trade effects. One of the greatest dangers to economic revitalization in the Western, industrialized countries, as well as to free trade, and certainly to economic liberty, comes from corporate statists of both the left and the right who wish to protect an increasingly untenable status quo.

The Western, industrialized democracies are currently experiencing a slow-motion version of the crisis that led to the collapse of the communist world. The contradictions of statist policies, including high taxes, heavy-handed government regulations, and government directions of economies, have produced economic, social, and political problems that cannot be mitigated by the same policies that caused these problems to begin with (see Hudgins 1994).

That situation is especially clear in Western Europe. Unemployment there is chronically twice as high as in the United States. Job creation, especially in the private sector, has been sluggish at best, in many cases nonexistent. Cutting-edge industries more and more are found in America and Japan. The latter countries also face systemic economic problems, though they might not be as obvious as they are in Europe. The federal regulatory burden on the American economy, for example, is estimated to be \$600 billion annually. That is more than America's annual exports of manufactured goods.

To avoid systemic reform, political and economic elites in the United States, Europe, and elsewhere have a strong incentive to foist their own failed economic policies on newly emerging competitors via trade agreements. Naturally, these poison policies will be pushed in the name of creating a "level economic playing field" or "avoiding a race to the bottom."

Often that strategy is found in proposals to "deepen" free trade arrangements or to harmonize standards. The current struggle within the EU is over just such issues. Often the same negotiators will promote both sound and unsound policies. A deepening of trade that results, for example, in the elimination of "buy national" provisions or trade-distorting subsidies certainly is preferable to the status quo. But it should not be forgotten that one of the world's most costly and trade-distorting policies, the Common Agricultural Policy, is integral to the EU, consuming some three-quarters of the EU budget.

Thus, a non-EU country seeking admission would probably not find as great a danger from trade diversion as from the regulatory regime under which it might be forced to live as a condition of membership, or from the prospects of future, unsound policies being forced upon it. Swiss voters recently rejected association with the EU. Fear of such regulations certainly figured in that decision.

The regulatory baggage that a regional FTA might carry can involve a real loss of economic liberty as the price for freer trade. In such a case, a potential member must make a pragmatic judgment about whether the benefits in the short and medium term outweigh the drawbacks and whether the prospects in the future are for freedom from regulations or a heavier regulatory burden.

The most blatant example of exporting bad regulations is found in the side agreements to NAFTA. With these agreements, the United States attempted to force Mexico to move closer to American environmental and labor standards. American labor unions, for example, feared that less costly Mexican labor would result in American firms moving jobs south of the border.

Those agreements so far have not had the bite that proponents had hoped for or that opponents had feared. But expansion of NAFTA might indeed destroy more liberty than it creates if the environmental and labor provisions in NAFTA are expanded. For example, so far the U.S. Congress has not given President Clinton fast-track authority to negotiate entry of Chile into NAFTA. That is so partly because Clinton wants authority to force unsound environmental and labor standards on that country. Free trade advocates in the U.S. Congress would not go along with those demands. And Chile would do better to wait for a more free-trade-friendly administration than to accept what in the future could be crippling regulations.

Lessons from American States. It is instructive to observe what is beginning to happen within the 50 American states. The states are keenly aware of the magnitude of the regulatory burden that Washington imposes on them. Furthermore, they are well aware of the loss of their freedom to control their own affairs. For example, when a state government is forced to spend millions of dollars on some pollution-prevention program aimed at a problem that is of little danger to citizens in that state, or when a far less costly alternative is available, the state must deny or reduce other services to its citizens (e.g., police protection).

Furthermore, regulatory regimes differ from state to state. California, for example, has one of the worst regulatory regimes in the

United States. In one case, Rohr Industries gave up its attempt to establish facilities in California, where the cost of license procedures would have been $750,000. It opted instead for Arkansas, where the license cost was $750 (Farah and Antonucci 1994: 24). Not unexpectedly, many California businesses have fled to neighboring Arizona and Nevada.

As federal regulations are reduced, the differences in regulations in the various states will become more economically significant. Countries considering membership in NAFTA or the EU can learn a lesson from the 50 American states. The ability of regulatory regimes to compete has several benefits. First, failed policies in one state or country will not necessarily harm its neighbors. Second, the competition from low-regulation states or countries will create incentives for others to change their policies.

Race to Prosperity. Some might call this a "race to the bottom" in which citizens will be exposed to debilitating pollution and dangerous working conditions. Even if there were some validity to this concern, balancing protection of public health and safety with other policy aims is best done within the various countries and states. Citizens do demand such protection. In countries such as Mexico, the need for jobs and economic growth mitigates some protective policies, as well it should. And as Mexicans and the citizens of other countries grow more prosperous, protection can be tightened without undue harm to the economy.

But such a model of tradeoffs between health and safety on the one hand and economic growth on the other is partly a result of government policies that purport to offer protection but that do so by harming the economy. There are, however, ways to protect health and safety through property rights, contract law, and reasonable tort law. The incentives in the 50 American states to consider such approaches are growing. FTAs can create incentives for countries to explore these approaches as well.

The Political Climate

Domestic political problems are also key factors to consider when judging the wisdom of a trade arrangement. In the first three post–World War II decades in the United States, a consensus was found both among economists and policymakers in favor of freer world trade. Of course, during those years it was easier for policymakers to maintain such a view, because American manufacturers had few competitors in domestic markets and exports were often an afterthought. Protectionists in those days, and even in the first decade after the oil shocks of the 1970s, tended to be traditional rent-seekers, principally textile and apparel manufacturers or large, integrated steel producers.

But since the late 1980s there has been a serious erosion of the political foundations for free trade. That does not suggest that any coherent or reputable theory, empirical study, or school of thought has arisen to actually challenge the case for open markets. The problem is that popular leaders, commanding significant followings, defend protectionist policies out of populist zeal or a deep confusion about economic reality. Pat Buchanan and Ross Perot are the most prominent American examples on the right.

Added to the problem is the managed approach to trade with the United States as the principal practitioner. Under Presidents Reagan, Bush, and Clinton, that practice has grown. It has included so-called "voluntary" restraint agreements, quota restrictions on imports of autos, and steel quotas. It included the semiconductor agreement in which Japan agreed to restrict sales in the United States and also, according to the interpretation of the Americans, to guarantee certain percentages of the Japanese market for foreign suppliers.

The late Commerce Secretary Ron Brown's much-publicized trade missions fall into the managed trade category. They suggest that rather than seek more comprehensive market openings through WTO or regional arrangements, the heavy-handed, one-on-one approach is to be preferred.

How does neoprotectionism affect decisions on whether or not to join a regional trade arrangement? It suggests that if a country can quickly enter a good regional trade liberalization agreement without harmful regulatory strings attached, it should do so rather than rely on the longer-term multilateral approach. That is because a regional agreement will give rise in one's country to businesses and other interest groups with a stake in keeping the system opened. Those interests can help counteract the political influence of neoprotectionists.

Conclusion

Bilateral or regional trade agreements that simply remove tariffs and traditional trade barriers are generally acceptable even if they divert some trade. First, such agreements increase economic freedom. Second, they actually hold less danger of being a vehicle for the export of failed regulatory policies. Third, it is difficult to determine before the fact what arrangements will be more trade diverting in the long term than the status quo.

Regional trade arrangements hold out better prospects for dealing with intractable trade problems than does the GATT/WTO mechanism, which usually must cater to the lowest common policy denominator. But the danger that deepening trade will simply deepen failed regulatory policies is also greater.

Bilateral and regional trade arrangements create incentives for nonmembers to join. This incentive effect is happening in the Western Hemisphere as traditionally protectionist countries come to understand the need to join NAFTA or remain poor or economically unstable.

But there is a similar relationship between regional and multilateral arrangements. NAFTA and the EU create an incentive for WTO countries to push ahead with further liberalization. If they do not, regional arrangements are likely to expand. It should be remembered that the American free trade areas with Israel and Canada resulted, in part, from the Reagan administration's frustration with multilateral trade problems. Another GATT round resulted in part because of the FTAs.

Unilateral, bilateral, regional, and multilateral trade liberalization are all valid means to achieve the goal that is the aim of market liberals: greater economic liberty.

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