

Csongor István Nagy *Editor*

World Trade and Local Public Interest

Trade Liberalization and National
Regulatory Sovereignty

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Csongor István Nagy
Editor

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Chapter 1

World Trade, Regional Economic Integrations and Local Public Interest: Comparative Perspectives



Csongor István Nagy

Trade liberalization has featured international economic relations since the conclusion of the GATT in 1947. The club it established served as a platform for a series of trade rounds, which have been remarkably successful in diminishing tariffs, and became a truly universal system with the creation of the World Trade Organization in 1994 and the extension of its membership (currently WTO members account for 97% of world GDP).¹

The last couple of decades have seen a significant shift in the focus of this process.

First, multilateralism seems to have reached its limits, giving room to bilateralism and plurilateralism (or regionalism). While the Doha Trade Round has fallen into a stalemate, new generation free trade agreements have been gaining ground. By today, it became clear that the about-face of US foreign trade policy did not block the internationalization of free trade. Although the US put the EU-US free trade agreement (TTIP) aside,² backed down from the trans-pacific free trade agreement (TPP) and renegotiated NAFTA, the last decade of international trade has featured numerous success stories. The TPP, renamed as Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), was signed in March 2018, without the US. The Canada-EU free trade agreement (Comprehensive Economic and Trade Agreement, CETA) entered into force in September 2017, followed by the Economic Partnership Agreement between the EU and Japan in February 2019 and the EU-Singapore Free Trade Agreement in November 2019.

Second, it is generally accepted that although customs duties are still an issue, especially in industries hit by tariff peaks, they are no longer the major hurdle faced by cross-border trade. As a corollary of this recognition, the focus of trade

¹Nagy (2019), p. 88.

²For an analysis on the TTIP's controversial issues, see Martonyi (2018).

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liberalization shifted to non-tariff barriers. States, in the name of the public interest, may introduce standards, develop regulations, shape taxation, impose regulatory burdens or maintain monopolies in a way that restricts trade. As a general experience, at times, these measures are influenced by disguised protectionism. In response to this, a new generation of free trade agreements emerged that are comprehensive, cover the whole spectrum of trade items (goods, services, technology, capital etc.) and extensively target non-tariff barriers. These agreements adumbrate a new governance for international economic relations and, not surprisingly, have incited a good deal of criticism for encroaching, with renewed enthusiasm, on national regulatory autonomy.

While these developments have incited a good deal of attention in the scholarship, the subject's comparative perspectives have been largely neglected. Notably, trading systems—the WTO, regional economic integrations and federal systems—center around the dichotomy of free trade and local public interest: they prohibit the constituent parts (states) from restricting trade and release them from this duty if the restriction is warranted by a local legitimate end. These free trade laws concentrate in four layers: the global framework (WTO), regional economic integrations, as well as the EU as a one-of-a-kind system, and federal markets, that is, federal states with strong local regulatory powers (e.g. Australia, India and the United States). Although the scholarship has not completely neglected the comparative perspectives of the subject, still, a lot of work needs to be done to grasp the pervasive issues and cross-cutting questions of these systems. The limited number of works having a comparative perspective has been confined to comparing two federal systems³ or to making comparisons as to special points.⁴ With this, free trade law lags considerably behind other (more traditional) fields of law, like contracts,⁵ constitutional law⁶ and antitrust/competition law,⁷ where the global systems have already been elaborated.

The purpose of this volume is to contribute to the filling of the above gap, through putting the central issues of regional economic integrations into a comparative perspective. It provides a general economic analysis of the measurement of the costs and benefits of trade liberalization and the role and function of normative values in commercial policy. This is followed by a comparative analysis of the approaches of different regional economic integrations (in North America, Europe and Latin-America) and federal markets (United States, Australia and India) as to the tension between free trade and local public interest. The key issues of investment

³For a comparison between the EU and US, *see* Barnard (2009). For Australia-EU comparisons, *see* McNaughton (2011); Kiefel (2010); Staker (1990); Puig (2008), pp. 99, 100–101 and 127–128. For an EU-WTO comparison, *see* Sørensen (2011).

⁴For a comparison of treaty provisions, *see* Bourgeois et al. (2007).

⁵To mention two notable examples from the wealth of literature: Reimann and Zimmermann (2006) and Graziano (2019).

⁶Rosenfeld and Sajó (2012) and Dorsen et al. (2010).

⁷*See e.g.* Duns et al. (2015).

law, as one of the most contentious elements of new generation free trade agreements, are also addressed.

Part I of the book deals with the general issues of international trade liberalization: the measurement of economic benefits and drawbacks and the status of normative considerations. While it is generally accepted by economists that free trade generates wealth, the empirical measurement of this still calls for further analysis. The wealth-generating effects of international economic intercourse are asymmetric and play out in a complex way. While, on the macro-level, undistorted international trade makes societies better off, on the micro-level, it leaves both winners and losers behind. Furthermore, at times, it seems that the development of trade calls for a normative structure based both on economic and non-economic considerations. International economic relations concern not only genuine economic issues but also non-economic ones that are relevant for trade.

The chapter of Zombor Berezvai (“Benefits and Costs of International Trade”) gives an economic analysis of the benefits and costs of international trade. It provides an overview of the effects on consumers, enterprises and the national economy as a whole, with the use of theoretical models and empirical analyses. The chapter points out that the gains and losses of international trade liberalization emerge unequally in different segments of the society and the net positive effects are non-linear. The latter may explain why policy makers are decreasingly interested in furthering international trade liberalization. The chapter presents a set of issues that need to be addressed to grasp the likely effects of new generation free trade agreements.

The chapter of Jessica C. Lawrence, titled “The EU in the Mirror of NPE: Normative Power Europe in the EU’s New Generation Trade and Investment Agreements”, gives an analysis of EU trade and investment policy through the prism of “normative power Europe” (NPE), specifically the EU’s use of trade and sustainable development (TSD) to incorporate social and environmental values into its bilateral trade and investment agreements. It argues that TSD chapters, instead of attempts to engage in the diffusion of EU values abroad, are better understood as performing an internal function: they allow the EU to believe simultaneously that it is a cosmopolitan, progressive power, and that it is a savvy, effective market builder.

Péter Mezei’s chapter (“Acquis Communautaire+ The Copyright Aspects of the EU’s Free Trade Agreements”) gives an overview of how the EU has constantly modified and broadened the scope of its free trade agreements’ (FTAs) copyright chapters. It argues that here the EU’s chief objective was to build a TRIPS+ or *acquis communautaire*+ copyright system.

Parts II and III analyze the same issue in regional economic integrations and in federal markets. All free trade systems, same as WTO law, allow states to restrict trade if justified by a local legitimate end. States may introduce standards, shape taxation, impose public service duties on enterprises or maintain monopolies in a way that restricts trade. Since the regulatory frameworks contain vague and fluid concepts and notions, states are normally afforded a wide margin of appreciation and the application of the law becomes a social and mental process, blending economic, societal and legal considerations and aspects. Free trade systems differ as to how

local legitimate ends are defined, the standard on the basis of which the existence and weight of public interest are judged and the way states' margin of appreciation is conceived when comparing free trade with public interest values. Balancing free trade and local public interest lies at the heart of the social discourse on internal trade. On the one hand, facially non-discriminatory regulation and references to local public interest are frequently used (more precisely: abused) to cut out foreign trade and protect the local industry. Furthermore, experiences show that even neutral, non-protectionist and evenhanded local standards may stifle cross-border trade. On the other hand, states are afforded a certain margin of appreciation to preserve their regulatory autonomy and the system's legitimacy. The promotion of free trade may sometimes be perceived as suppressing local legitimate regulatory policy considerations and may display free trade as "unregulated trade" in the eyes of the local electorate.

Part II translates the above questions to regional economic integrations and addresses some of their key issues in North America, the EU and Latin America.

The chapter of David A. Gantz, titled "Addressing Environmental Protection in the United States-Mexico-Canada Agreement (USMCA)", analyses the environmental protection aspects of the recently renegotiated North-American free trade agreement, signed on 30 November 2018.

The chapter authored by Márton Varju and Mónika Papp ("Member State Capitalism(s) and EU Law: Protecting Local Varieties in the Single Market") analyses the EU Single Market as a multi-layered marketplace characterised by a considerable diversity among the institutional models of local capitalisms in Europe.

The chapter of Valentina Delich, titled "South American Trade Policies Reconsidered: the 'Convergence While Diversity' Mantra", discusses the discourse on trade liberalization in Latin America and addresses the current initiatives of regional economic integration.

Part III gives a structured analysis of three federal markets: the United States, Australia and India. These federal systems have developed in relative isolation from each other and have rarely been grasped from a comparative perspective.⁸ Although in these federal markets courts face the very same conceptual issues, have to deal with similar (or sometimes the same) cases and suffer from the same headache-producing dilemmas, the scholarship has failed to grasp and conceptualize federal markets from a comparative perspective.

Lee J. Strang ("The Supreme Court's Attempts Via Its Dormant Commerce Clause Jurisprudence to Navigate State Police Power and National Free Trade: Potential Lessons for International Trade") gives a concise overview of the circuitous path of the United States Supreme Court's Dormant Commerce Clause case law and, from this, suggests three potential lessons for international free trade

⁸For a counterexample, see e.g. *Castlemaine Tooheys Ltd v South Australia* (1990) 169 CLR 436 (7 February 1990), para 37. As a further example, the treaty rules on the EU internal market, in particular the provisions on the free movement of goods, were modeled after GATT. For instance, both the chapeau of Article XX GATT and the last sentence of Article 36 TFEU refer to arbitrary discrimination and disguised restriction on trade.

arrangements. It demonstrates how intractable the line between legitimate and illegitimate state regulation of interstate commerce is, argues that there is a relationship between institutional competence and the efficacy of different modes of analysis to ascertain whether a state regulation is legitimate or illegitimate, and shows how different conceptions of sovereignty influenced the Supreme Court's analysis.

Gonzalo Villalta Puig's chapter, titled "The Judicial History of the Federal Market of Australia: Free Trade Versus Free Enterprise", gives an in-depth analysis of Australian constitutional law's shift from an interpretive theory of free trade as a right to an interpretive theory of free trade as a principle.

Wasiq Abass Dar's chapter ("India's Tryst with Free Trade: Overcoming the Inherent Challenges of Federalism") presents how India has coped with the challenges that a federal system encounters when engaging in trade and commerce at a multilateral level.

Part IV addresses the central issues of investment law in the context of new generation free trade agreements' investment chapters. Arguably, the purpose of the first investment protection treaties (starting with the Germany-Pakistan Treaty of 1959),⁹ was to elevate certain core standards of economic constitutionalism (e.g. compensation for expropriation, protection of legitimate expectations) to the level of international obligations. With this, investment treaties overcame the shortcomings of customary international law as to the treatment of foreign property and projected certain constitutional requirements to the level of international disciplines. The most important added value of these treaties was that these requirements became internationally binding (that is, they could not be rescinded unilaterally)¹⁰ and were backed by a dispute settlement mechanism.¹¹ At the outset, these treaties were concluded between developed and developing countries. Although they contained mutual (reciprocal) obligations, they were clearly led by concerns generated by the latter's legal system. Nonetheless, after a while, international investment protection law took a life of its own. Developed democracies commenced to conclude investment treaties with each other and, at times, the arbitral practice appears to have exceeded the protection afforded by developed constitutional systems.¹² This gave rise to the criticism that investor-state arbitration subjects genuine public-law disputes to a procedural pattern tailored to the needs of purely commercial disputes (arbitration) and devoid of democratic legitimacy due to its secrecy, intransparency and ad-hoc nature.¹³ The above developments were topped by new-generation free

⁹Treaty for the Promotion and Protection of Investments (with Protocol and exchange of notes), Germany and Pakistan, 25 November 1959, 457 U.N.T.S. 24 (entered into force 28 November 1962), available at <https://treaties.un.org/Pages/showDetails.aspx?objid=0800000280132bef>.

¹⁰Nagy (2018), p. 206.

¹¹It was not until the mid-1970s that BITs started making provision for investor-state dispute settlement. Lim et al. (2018), pp. 59 and 61.

¹²Cf. Islam (2018), p. 188.

¹³Cf. Weiler (2014) ("[T]he Bar that adjudicates them [investment disputes] is of a limited range (...), and dominated by arbitrators from private practice rather than public interest backgrounds (...); and most damning of all, the substantive provisions of the investment treaties, when it comes

trade agreements, which are blamed for reinforcing these loose standards and the attached dispute settlement mechanisms lacking democratic legitimacy into relations between developed democracies.

Rebecca E. Khan, in her chapter titled “Foreign Investors and Greater Transparency in Investor-State Dispute Settlement: Re-Evaluating Confidentiality Expectations in International Investment Arbitration”, addresses a major point of criticism against investor-state dispute settlement (ISDS). It examines the tension between the two opposing requirements faced by ISDS: transparency and confidentiality.

Begaiym Esenkulova’s chapter, titled “Investment Protection and Sustainable Development in International Investment Agreements: Building Bridges Instead of Walls”, addresses another internal tension of investment law: the relationship between investment protection and sustainable development.

Zoltán Víg and Gábor Hajdu, in their chapter titled “New Model of Investment Protection Under CETA”, provide an analysis of the EU’s emerging new dispute settlement pattern (Investment Court System) proposed to address the major points of criticism against ISDS and introduced by the Comprehensive Economic and Trade Agreement (CETA) concluded between Canada and the EU.

The chapter authored by Marcin J. Menkes (“Screening of Foreign Investments: Promises and Perils of Technological Sovereignty”) addresses the emerging regulatory trend of screening foreign investments and the risks involved in blurring distinctions between economic and political issues for international peace and stability.

All in all, it seems that new-generation free trade agreements are opening a new age in international economic relations and necessitate the re-thinking of our fundamental notions on global governance, state sovereignty and regulatory autonomy. The share of free trade in the global economy is becoming paramount and the emerging new-generation free trade agreements are generating a major shift from national sovereign towards international governance. Nonetheless, while these emerging international disciplines enhance wealth and development and it would be a grand mistake not to make use of them, the internationalization of national competences also raises serious questions of democratic legitimacy. The discourse on the subject calls for a conceptual lingua franca and a transsystemic understanding of the core issues and dilemmas. It is hoped that the volume’s comparative approach will contribute to this process.

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to protecting societal interests, are woefully defective and inferior when compared with similar public interest provisions in trade agreements such as the WTO itself.”).

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Part I

Chapter 2

Benefits and Costs of International Trade



Zombor Berezvai

2.1 Introduction

There is a wide consensus among economists that freer international trade is on average favorable for a society. The University of Chicago Booth School of Business surveyed its Initiative on Global Markets (IGM) Economic Expert Panel in 2012 about the overall positive effects of freer trade.¹ Ninety-five percent of the respondents agreed or strongly agreed that the benefits of freer trade significantly surpass the costs in the long run. Only two economists were uncertain, and no one disagreed with the statement. Despite this consensus, international trade is one of the most disputed part of economic theory (Krugman et al. 2018) and political voices emerge from time to time to stop or at least control international trade.

Why international trade is creating so many discussions and debates among economists and policy makers? There are three potential reasons. First, the gains and losses of freer international trade are distributed unequally in the society. The modified income distribution unfavorably impacts some citizens and/or companies. Second, the net positive effects arise in the long run, but short run problems have to be managed. Since politicians are more concerned about short run impacts (e.g., due to the next election), they might oppose a new free trade agreement. Third, the positive effects of freer international trade are not linear. After World War II, tariffs and other restrictions were much higher than today. Current tariff rates are rather small, especially in the developed part of the world (Fig. 2.1). Only in some developing countries were average tariff rates higher than 10% in 2016. Removing

I would like to thank the precious comments of Klára Major on the previous versions of this chapter.

¹<http://www.igmchicago.org/surveys/free-trade>. Accessed 30 September 2018.

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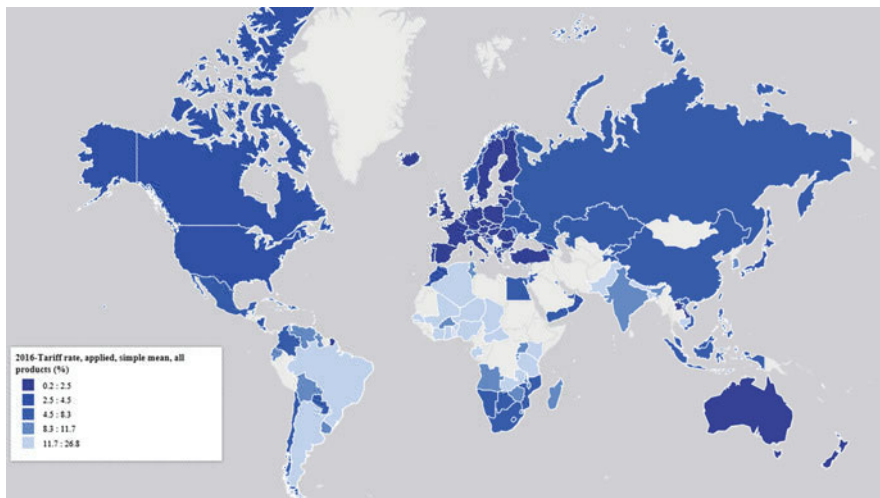


Fig. 2.1 Average tariff rates in 2016. Source: World Development Indicators (The World Bank Data Bank)

high barriers (e.g., reducing the tariff rate from 40% to 5%) provided much higher benefits and less costs than removing the remaining smaller barriers (e.g., further reducing the tariff rate from 5% to 0%) would provide. Lower potential benefits, higher costs and larger income distribution effect are less tempting, therefore, there are less motivation to freer international trade. This is one reason why newer free trade agreements are more about investment rules, intellectual property rights, environmental regulation, anti-competitive business practices than older ones were (Rodrik 2018).

There are several models to analyze the effects of international trade. Different models focus on different aspects and might provide different implications. However, the basic concept is that international trade provides access to different and more efficient production processes. This is beneficial for some consumers and firms as they can get access to these products that can mean lower prices, increased product variety, etc.

On the other hand, costs are arising from two sources. First, the effects on income distribution are hurting some specific groups. Even worse, these groups can consist of unskilled low-wage workers, therefore, it might cause severe social problems. However, industrial tycoons can also be negatively impacted that is less of a concern from a societal point of view. Second, the given country has to adjust its economy to the new circumstances. This adjustment can also be costly and requires time to get executed. Furthermore, a general observation is that losers of international trade are more organized and have better lobbying power (Viscusi et al. 1998) than the beneficiaries. This can be one reason behind national regulations, quotas, tariffs and other restrictions.

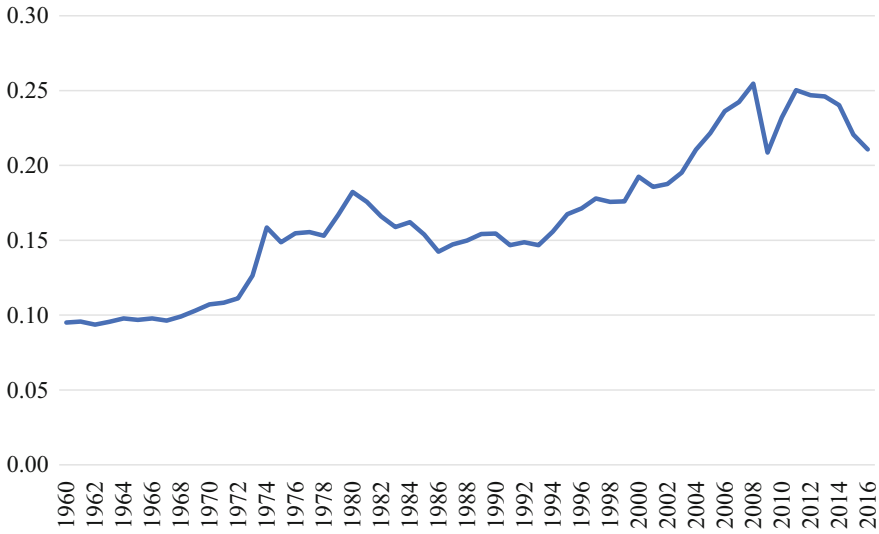


Fig. 2.2 Global export-to-GDP ratio. Source: Calculation based on WTO and World Bank data

Despite the concerns against freer trade, in the past several decades, but especially after 1972, the expansion of international trade was enormous (Fig. 2.2). Compound annual growth rate of global export and GDP in current prices between 1960 and 2016 was 9% and 7%, respectively. International trade was growing faster than GDP, and the export-to-GDP ratio more than doubled globally in 50 years.

The aim of this study is twofold. First, to provide a comprehensive picture about the advantages and disadvantages of international trade and to show empirical studies that verified these impacts. Second, to create a list of questions that should be considered to evaluate the potential effects of a new free trade agreement. The latter one is getting more and more important as the barriers against international trade are rather low today, therefore, further reduction is causing potentially lower benefits, but higher costs (Rodrik 2004). The study is organized across three main topics: effects on consumers, effects on firms and effects on economic growth.

2.2 Effects of International Trade on Consumers

As it was outlined in the previous section, international trade can provide access to different production processes. Consumers can benefit from this by paying lower prices for the same or very similar products. Lower prices mean a direct increase in consumer surplus as consumers will have the same products but have to pay less. This means that the budget constraint of the consumers is allowing more products to buy. Consumers are, therefore, always better off due to lower prices (keeping all other factors constant).

International trade is feasible in this setting if the relative price of the product in the local market is higher than adding up production cost in the exporting country and trade costs (transportation cost and tariffs). It means that the relative cost advantage of the foreign country has to be high enough to exceed trade costs.

The effect of international trade on consumer surplus was estimated by Buongiorno et al. (2017). The authors analyzed the global forest sector to identify the winners and losers of international trade. They calibrated a model to the current situation and estimated the impact of full autarky. Their analysis clearly shows that consumers are gaining due to lower prices and higher consumption compared to autarky. The increase of consumer surplus due to international trade was estimated to be around \$140 billion that was distributed across consumers located both in developed and developing countries. Kersten (1995) showed that the more restrictive EU regulation on bananas caused a loss of \$1.14 billion to the European consumers. The source of this loss is again price increase and consumption reduction.

Following this logic, countries should trade with different products and commodities. However, international trading data indicate a high level of intra-industry trade. Intra-industry trade refers to the case when a country is exporting and importing very similar goods. Several researchers (e.g., Krugman 1979; Brander 1981) concluded that increasing returns to scale and imperfect competition is present in reality and these are causing the observable international trading patterns.

The basic models of international trade assumed perfect competition both on the import and export sides. This is rarely the case. Taking market power of the companies into consideration, freer international trade provides another advantage, it can be a way to limit market power as more companies can enter the local market. Since the reduction of market power often lowers prices, this is also favorable for the consumers.

In this case, no technological or other differences were assumed among the trading partners, this is the reason why intra-industry trade can happen. International trade will decrease prices, but trade costs will occur. It means that it would be theoretically better to avoid trade costs by forcing local companies to act like being in a perfectly competitive market. If a regulator could force local companies to decrease prices, import could be eliminated, and trade costs could be saved (Brander 1981). This would be a better solution, however, not feasible as governments cannot force companies to sell their products on fixed prices (in market economies).

The basic model of Brander (1981) was extended by several researchers. Markusen (1981) showed that trade between identical countries is welfare improving even if companies are competing imperfectly. Nevertheless, if small and large countries are trading with each other, the large country may sustain a welfare loss.

Marjit and Mukherjee (2015) extended the analysis to the long run and showed that unilateral trade cost (transportation cost and/or tariff) reduction is often neutral or negative for the consumers located in the importing country. If domestic and foreign firms are producing exactly the same products, trade cost reduction has no effect on consumer welfare. If the products are not perfect substitutes, production costs matter. If foreign firms are producing more expensively (adding up production and trade costs) than the local ones, then trade cost reduction is welfare decreasing.

On the contrary, trade cost reduction is favorable if foreign companies can produce cheaper than the domestic ones. However, the model of Kosiec (2016) illustrated that consumers are always better off due to international trade, but this is not the case with companies. The latter can cause a decrease in welfare.

Trade cost reduction can mean both transportation cost and tariff reduction. The major difference between transportation costs and tariffs is that tariffs generate income for the importing country. Therefore, tariff cuts reduce government income. As Marjit and Mukherjee (2015) showed, further decreasing an already low tariff can cause a reduction in government expenses that can make the welfare effects even worse.

Until this point, only price changes were assessed. Imported products are, however, often not exactly the same as local ones. Higher product variety is another benefit of international trade. Imported products enlarge the consumption opportunities by making a wider portfolio of goods available. Theoretically, increasing variety cannot impact consumers negatively as they always have the opportunity to choose those products that were also available before.

Two cases need to be distinguished: new products and wider product selection. New products are mainly connected to specific resources (e.g., special climate characteristics or patents) that are not present in the country of importation. These products would not be available in the market without international trade. For example, in the Middle Ages, spices and luxury products made up the majority of long distance international trade. Trade routes originated from Africa and Asia provided products for Europe that could not be grown locally. This is still present today, and the availability of special fruits, vegetables and spices are increasing the well-being of several consumers.

Wider product selection covers products that could also be grown or manufactured domestically. The presence of imported goods adds new brands, new tastes, new packaging, new sizes, new product variants, new quality level or better price-to-value ratio to the existing product portfolio. By making these products also available in the market, consumers' selection set will increase, and this may also rise consumer surplus.

Krugman (1979) developed a general equilibrium model to verify the impacts of wider product selection. He employed the monopolistic competition model à la Dixit and Stiglitz (1977) in which consumers prefer variety: consumers' utility is increasing with the number of product varieties available in the market. Krugman (1979) showed that international trade can be a result of consumers seeking high product variety and hence, it is increasing consumer surplus.

Broda and Weinstein (2004, 2006) empirically verified the welfare consequences of increased product variety. Based on a very disaggregated database, they showed that import product variety in the United States increased by three times between 1972 and 2001. The authors estimated that this expansion in product variety caused a welfare increase equivalent to 2.6% of GDP to the US consumers.

On the other hand, increasing product variety can have potentially negative effects after the saturation point of the consumers is reached. These negative effects can come from more difficulty on choosing the right products, more frustration

during selection, dissatisfaction with the final choice, etc. Some studies indicate that these are due to limited attention and bounded rationality. The meta-analysis of Scheibehenne et al. (2010) indicated that increasing the available selection of products has an average zero effect on consumers, but the results of the different studies show significant differences. The meta-analysis also showed some factors that can affect the so-called “choice overload”. If the consumers are having more expertise and stronger prior preferences, they benefit more from increasing product variety. Furthermore, newer publications show that the choice overload effect is less severe compared to earlier results. This suggests that people might get used to the enlarged product selection.

Not only choice overload can cause unfavorable outcomes. Egger and Falkinger (2016) presented a different model with limited consumer attention. Companies aimed to catch as much attention from the consumers as possible and this is causing an overbidding in advertisement and diverts consumption of imported goods at an overall inefficient level.

To summarize the theoretical and empirical findings, freer international trade is welfare improving for the consumers in two channels: lower prices and higher product variety. The first benefit is always present if the exporting country can produce same or similar products cheaper than the importing country. The additional gain of further widening product selection is more likely getting lower and lower with the number of already available products on the market. The effect might be negative after the saturation point is reached. However, the saturation point varies by consumers and product categories and there is no evidence to define where it lies.

2.3 Effect of International Trade on Firms

In the previous section, only consumers were considered. In this section, we focus on companies. A company consists of both capital owners and employees. In this case, the effect of freer international trade can be either positive and negative depending on several factors. From a corporate point of view, international trade is providing access to larger markets and to cheaper (or sometimes unique) resources as well as enables global supply chains. On the other hand, competition will increase as foreign companies are granted access to the domestic market.

The main idea behind international trade is connected to the fact that countries are having different natural, human and capital resources and their production technologies are also different. These indicate that different countries can produce the same products for different prices. In case of autarky, a country has to supply all the products on its own. Even if a country is able to do it (it has all the necessary resources and technologies), it might be inefficient due to several factors:

- producing small quantities can mean that economies of scale are not exploited;
- maintaining several production technologies might be very costly;

- the country might not have the best available technology, the production system might be not efficient and productive enough;
- there is a scarcity of available natural and other resources.

The above specified problems can be grouped into two main categories: resources and technology. The Heckscher–Ohlin model focuses on the resource difference across countries and assumes similar technologies (Acemoglu 2009). The model indicates that countries are specializing based on their resource availability. As Deardorff (1982) proved, the Heckscher–Ohlin theorem suggests that there is a negative correlation between resource price in autarky and net export of the given resource. This means that countries are exporting goods that require abundant resources and importing goods that require scarce resources.

The Heckscher–Ohlin model has important consequences for companies. The model indicates a type of specialization based on the input need of the production. Companies using the abundant resources will gain from international trade as they can also sell these products abroad. Companies that are using tradable, but domestically scarce resources will also gain to get access to the global supply of these resources (Lee 1995). These companies can lower input prices, hence, increase the competitiveness and profitability of their products.

On the other hand, the scarce resources of a country are more expensive domestically than internationally. International trade can provide access to the cheaper resources; therefore, domestic producers of these resources will be adversely impacted. If the scarce resource is produced in the country (e.g., mining), then the producers will lose when the country is getting involved in international trade. If the scarce resource is not produced, but it is not tradable either (e.g., land), then the owners of these resources will be adversely impacted by freer international trade.

Bernhofen and Brown (2016) used the case of Japan to verify the predictions of the Heckscher–Ohlin model. Japan was closed from the outside world until 1859. The authors used input price, production technology and commodity trading data from the early free trade period (1865–1876) and verified that on average Japan was a net exporter of its abundant resources and a net importer of its scarce resources. This provides strong evidence supporting the Heckscher–Ohlin model at the end of the nineteenth century. Since there were significant technological differences between Japan and its trading partners,² the authors did not specify the abundant and the scarce resources.

Ito et al. (2016) analyzed the World Input-Output Database to verify the predictions of the Heckscher–Ohlin model in the recent years (between 1995 and 2009). According to their results, the model is valid if we analyze the added value in international trade (and not gross production value). Labor abundant countries (e.g., China) are mainly contributing to the global production with cheap (and often unskilled) workforce, while skill abundant countries (e.g., the USA or the EU) are exporting skill-intensive products.

²The industrial revolution did not reach Japan at that time, therefore production technologies in Japan were less efficient compared to its trading partners.

A special case of this theory is provided when some inputs are domestically not available at all. In this case, producers have no choice but to import them. It is similar to the case of new product availability for consumers. However, in case of producers, the lack of a critical resource can completely disrupt production (Ossa 2015). In some cases (e.g., for countries importing crude oil), the lack of import can hinder the functioning of the whole economy. In this case, the gain from international trade can be enormous (Ossa 2015).

The second type of models is focusing on technology and productivity differences among countries. International trade can increase global production by allowing specialization based on efficiency differences. A country can specialize on the products it can produce comparatively cheaply and trade it to other products in the international marketplace. In this way, total production cost can be decreased. The theory of comparative advantages was developed by Ricardo in the nineteenth century (Krugman et al. 2018).

The key point in this theory is that only relative production costs matter (and not nominal ones). This is rooting back to the assumption that countries are on their production frontier, i.e., increasing the production of a given good has to trigger a reduction of another good. Theoretically it is conceivable that a country can produce almost every good cheaper than other countries do. However, there is a constraint of capital and labor. For a country to produce all the products would require so many resources that no country can supply. On the other hand, the resources of other countries would not be utilized at all. This is not efficient and specializing based on comparative advantages is superior compared to this solution.

This theory presumes that there are efficiency differences among countries that can create different comparative advantages to different countries. The source of these efficiency differences can root back to several factors. First, different countries are on different levels of development and there are also differences in the complexity of the production process they can handle. Second, Belloc (2006) argued that institutional architectures are important determinants of the comparative advantages, however, the relationship is complex, not unidirectional and difficult to interpret. Costinot (2009) showed that countries with higher institutional quality and larger human capital are having comparative advantage in more complex industries. Finally, specialization can happen on purpose due to different public policies. Chatterjee (2017) proposed that there is an incentive even for similar countries to choose different policies and specializations as gains from international trade can be obtained this way.

Specialization is favorable for companies active in industries characterized by comparative advantages. However, firms operating in industries having comparative disadvantage will be the losers of international trade. In theory, these companies should leave the market and transfer their resources to a competitive industry. However, this is possible only if resources (like labor or capital) can be fully and easily allocated across industries. Resource allocation between different industries often cannot be implemented or can be done only in the long run. Industry-specific capital investments and labor skills are not easily transferable to completely different industries. Therefore, despite the favorable net effects of international specialization,

some specific industries will be adversely affected and can potentially die. This is the reason behind the adjustment and income distribution effects mentioned in the introduction.

Specialization can be observed in several countries. Cadot et al. (2011) showed that there is a U-shaped relationship between export specialization and national income, i.e., low- and high-income countries are more specialized in trade than middle-income countries. This can be connected to a slow adjustment process when the country is getting more technology oriented and “old” comparative advantages are getting lost. However, “old” industries die slower than “new” industries appear. This view is also supported by Pelli and Tschopp (2017). The authors showed that after a hurricane destroyed the manufacturing sites, export decreased from industries with comparative disadvantage and increased from industries with high level of comparative advantage. The hurricane destroyed existing investments, hence, accelerated the penetration of the “new” comparative advantages.

However, international trade changed significantly in the recent period, especially after 1985. This process was enhanced by freer capital flows across nation-states that enabled companies to globalize their production processes. Baldwin and Lopez-Gonzalez (2015) called it as “denationalizing comparative advantage”. This means that comparative advantages are getting more and more knowledge related, therefore, these are connected to companies rather than to countries. Large companies are building their own supply chains and are locating different activities (production, services, R&D, etc.) to locations they find the most attractive for the particular activity. The abundant resources of a given territory can be utilized by the international companies.

The presence of company-related comparative advantages caused the globalization of the production processes and supply chains. The concept of global factory indicates that large multinational companies are allocating small parts of their value chains to different countries to achieve lowest possible cost and maximum efficiency (Celo et al. 2018). In this regard, international trade is the way how a country can be part of the global factory.

The global factory phenomenon is of crucial importance today. Baldwin and Lopez-Gonzalez (2015) pointed out that in 2009 final goods accounted only for 34% of total world export, the rest consisted of intermediaries. Free trade can have two consequences on domestic firms in this setting.

First, local companies will have the opportunity to participate in the global factory. They can also dismantle the value chain and find the best locations for all their activities. Furthermore, large multinational companies are outsourcing more and more activities to other firms. Local companies can supply foreign production sites and companies if trade barriers are not preventing this. This is favorable for those companies that can connect to the global factory as suppliers. Participating in the global factory can result in higher profits, but the question is how the additional profit is distributed among the parties. Sexton et al. (2007) analyzed the agricultural product segment and found that if the market is not perfectly competitive (which is almost always the case), profits from trade liberalization (zero tariffs) flow to trading firms rather than to producers. This is lowering the benefits a developing country can

obtain from international trade. However, Hoque and Schroeter (2010) showed that if ad valorem tariffs are removed, results are completely different, and producers of developing countries can get even better off compared to the perfect competition case. The perceived gain a company can obtain from trade liberalization depends therefore heavily on the market structure and the type of restriction that was eliminated.

Second, free trade implies that multinational companies can also sell their products in the domestic market without any restrictions. This is increasing competition on the domestic marketplace. Less efficient local companies will lose this competition and their sales revenue and market share will most likely decline.

Furthermore, the model of Egger and Kreickemeier (2012) indicated that companies with higher productivity tend to get involved in exporting. These companies are paying higher wages to their employees to reward the efforts they undertake. A survey of empirical literature on international trade by Wagner (2012) similarly suggests that international trade relates to higher firm productivity, however, it is mainly the result of self-selection. Namely, more competitive companies tend to present in more export markets and in more developed export markets. Similarly, there is a positive relationship between firm productivity and import activities. Wagner (2012) indicated that not international trade is making the companies more efficient, but already more efficient companies are starting to export and import products.

This means that international trade is favoring the well performing companies in two ways: they make the international market available for them and they increase competition in the domestic market that might necessitates less efficient companies to exit from the market. Both are contributing to better resource allocation. This can enhance the economic performance of a country, too. The next section deals with this question.

2.4 Effect of International Trade on Economic Growth

In the first section, we reviewed the direct effects of international trade on consumers, while in the second section we focused separately on firms. Firms and consumers are, however, connected to each other. Consumers are also gaining if domestic firms are performing well. This will create new jobs, increase salaries and foster economic growth. In this section, the focus is set on economic development and how international trade can contribute to higher economic growth and better value creation on the national level.

The link between micro-level analyses (that are focusing on particular industries and consumers) and assessing aggregated gain on a national level is not straightforward at all. Arkolakis (2012) surveyed the micro-level literature on international trade and concluded that they are not helping much in measuring the overall welfare gains of international trade. Arkolakis (2012) argued that the welfare gain of a country depends on two measures: expenditure share of domestic products (i.e.,

one minus import penetration) and cost elasticity of import (also known as trade elasticity).

The macro level theories, namely, the comparative advantage theory of Ricardo and the Heckscher–Ohlin theorem can be the starting points for analyzing the impact of international trade on a particular economy. Both theories conclude that international trade is favorable for the economy. However, there are two main concerns with them.

First, these theories assume that all the countries are on the border of their production possibilities and increasing the production of one good has to trigger a decrease of production of another one. In the reality, companies are often not producing on their production frontiers and are not fully utilizing their capacities. Therefore, countries can better utilize economies of scale via international trade. This is the so called “vent-for-surplus” theory. This is different from the theory of comparative advantages as it assumes that due to capacity underutilization, export can be increased without any sacrifices, i.e., simply utilizing the previously unused capacities (Myint 1958).

The main point of the “vent-for-surplus” theory is that absolute advantages matter, not comparative ones. Since developed countries often have absolute advantages for a large number of products, these countries can dominate international trade by utilizing previously unused capacities. Hence, less productive countries might be expelled from the market. This is obviously favorable for those countries having absolute advantages and underutilized capacities in several industries and bad for the rest. Freer international trade is, therefore, not mutually favorable for all the contracting parties.

A stream of empirical papers tested the “vent-for-surplus” theory by analyzing special agricultural products of Africa, like palm oil, cotton and cocoa. The idea is that Africa has underutilized land and labor that can be used to produce more agricultural products without any sacrifices (Tosh 1980). However, the “vent-for-surplus” theory not only assumes that there are available land and human resources, but also that these can be combined to produce increased export quantity. Austin (2014) examined the Ghanaian cocoa production take off between 1890 and 1936. He concluded that labor is shifted from other activities to cocoa farming, hence, the “vent-for-surplus” theory did not prove to be true.

Empirical evidences did not support the “vent-for-surplus” theory and it did not become mainstream. A further point against this theory is that there are barriers in every country and production cannot be increased only up to a certain point. Additionally, shipping and transaction costs also constitute a barrier against international trade (Pomfret 2014).

The second and more important concern regarding the macro theories is that these are static theories and the dynamic effects are not incorporated. Namely, the existing specialization can be conserved. Developing countries are often having comparative advantages in raw material production and cheap labor force (Ito et al. 2016). Exploiting these comparative advantages might not help these countries to fuel economic growth (Rodríguez and Rodrik 2000) and reach a higher stage of development. This can be one reason why developing countries are applying government

policies to diversify their export portfolio (Cadot et al. 2011). This seems to be a potential way to avoid the drawbacks of specialization.

However, some examples clearly show that developing countries can also benefit from international trade. The best example is the High Performing Asian Economies³ (HPAEs). These countries were focusing on creating internationally competitive products and incentivizing export. Furthermore, the increasing export revenues were allocated to education, research and development, capital formation and/or improving macroeconomic stability. HPAE countries were continuously developing their export goods to compete in more and more capital and skill intensive product categories. International trade was helpful for these economies to achieve exceptionally high growth rates and increase the revenue of the local companies and citizens (Krugman et al. 2018; Darku and Yeboah 2018). This example supports that international trade provides opportunities, but countries can utilize them differently. HPAEs were able to exploit the opportunities at a high extent. Empirical results of Darku and Yeboah (2018) indicated that HPEA countries were able to utilize trade liberalization the most among developing countries. The effect of trade openness on economic growth was the highest for this group compared to the rest of the developing countries.

At first glance, the survey of Wagner (2012) can be contradictory to the case of the HPAEs. The examples are, however, supporting each other. HPAEs did not start their exporting activities with state-of-the-art skill intensive products, but rather with clothes and labor-intensive mass products. They were able to identify the product categories where their companies had comparative advantage in the international marketplace. Export revenues generated by these industries were used to develop other industries; hence, they increased their productivity in more and more business segments. This productivity increase created the basis to expand the export of more and more industries and increase GDP growth through international trade.

An important element of their success was that HPAE countries exposed high tariffs on those industries that they were developing in order to avoid international competition when the industries were still in their infancies. Trade barriers were eliminated once the industries became competitive.

This overview suggests that it might be optimal for a country to restrict international free trade (Samuelson 1962). However, free trade is able to maximize world production and income. Most importantly, the heart of this problem is income allocation. Some countries gain from international trade, while others lose. This is also true within a country: consumers and exporters will have higher income, while a specific group of industry-specific resource owners will be worse off. Both can be compensated as free trade is increasing aggregate welfare (Samuelson 1962). Unfortunately, it is often not so straightforward and hardly manageable, especially among countries.

Trade liberalization has positive effects on average, but theories are mixed regarding the impact of trade openness on economic growth for particular economies

³Hong Kong, Taiwan, South Korea, Singapore, Malaysia, Thailand, Indonesia and partially China.