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"IS FREE TRADE SUSTAINABLE IN A "GLOBAL AGE"?"

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IS FREE TRADE SUSTAINABLE IN A "GLOBAL AGE"

by

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I.

1. The new technological revolution which is widely acknowledged as a primary factor in promoting integration of economic markets on a global scale - globalization - has created a premise for international trade to become an engine of economic growth and prosperity worldwide on an unprecedented scale. Technical progress in the fields of computer science and communications and recent advances in information technologies have led to a steady decline in the costs of international transportation of goods and people, and of international communications and information flows. At the same time, technological progress in manufacturing, which makes it feasible to decompose production processes, has not only enlarged the scope of international investment flows, but also strengthened the trade creating effects of such investments. Consequently, the scope of international division of labour has been considerably widened.

2. Alongside the promises of opportunities for worldwide economic progress are the fears in advanced industrial countries that economic integration with developing countries in a globalizing world economy will drive down wages and standards of living of workers. There are fears that it will trigger a competitive race towards the bottom as "capital and jobs" move to countries with lower social and environmental standards. These fears have generated demands for "level playing fields" as precondition for free trade, the presumption being that unless domestic social policies are internationally harmonized, competition under free

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trade will be "unfair". Thus the interaction of social policy issues with trade presents major challenges to the cause of free trade, as well as to the multilateral trading system which promotes freer trade. This paper attempts to address some of the dimensions of these challenges.

II.

3. Free trade, as a desirable objective of trade policy, has been the main subject of analysis for international economists ever since David Ricardo formulated the famous doctrine of comparative advantage and provided the theoretical case for free trade. For most part the theoretical challenge to this doctrine has focussed until the 1980s on questioning the underlying assumptions of the doctrine. The analysis of imperfections of "factor" and "product" markets and the implications of economies of scale and "learning" has thus provided the basis for traditional explanation for infant industries protection, for optimum tariff to exploit monopoly power, and for providing protection and support to specific strategic sectors.

4. In the 1950s, however, a serious intellectual challenge to the free trade doctrine was advanced by the structuralist school which influenced a great deal the approaches to development policies and strategies of developing countries and their stance on international trade relations until the 1970s. Among the foremost of this school were Prebisch and Singer. They analysed trade between primary producing developing countries and the industrial countries and reached the conclusion that due to inelastic demand growth of primary products, there was a secular decline in the terms of trade of developing countries. From this they also deducted that most of the productivity gains in the export sector in developing countries were passed on to the consumers in developed countries, while the productivity gains in industrial countries were internally retained.

Similar conclusion was reached by the Nobel Laureat Arthus Lewis from a different route of the supply side. For him the main cause of "surplus transfer" (or productivity gains transfer) from the labour surplus economies of developing countries to developed countries was caused by the stagnation in wages due to the elastic supply of labour and the consequent gap between productivity growth and increases in wages in these economies².

5. Notwithstanding these intellectual challenges to free trade and the fact that most countries have always practised some form of trade-protection, except for the inter-war period, growth in world trade and the associated progress in the international division of labour has been sustained at a remarkable pace. In fact, world trade has continued to increase at a faster pace than the world output growth.

6. The inter-war period, however, was exception in that it experienced two World Wars and the Great Depression. Developments during this period also demonstrate how economic policy and even the thinking of great economists can so easily become prisoners of circumstances. It did not require much economic analysis to demonstrate that economic nationalism and building of tariff walls by the major industrial powers were not the tools to fight unemployment, even in the short run, during the Great Depression; it would only aggravate the problem of unemployment in these countries. However, all the major industrial countries followed this route to their own peril. Needless to say that many economists, including Keynes, endorsed this policy. In his evidence before the MacMillan Committee in February 1930 and in his follow-up writings during 1931, Keynes

² A similar line of argument as that of Lewis is to be found in the theory of "unequal exchange" developed in the early 1970s.

stressed the view that tariffs and protection, while unwise as a long-term policy, could immediately alleviate the slump and could be an effective tool for fighting unemployment³.

7. A point which needs to be emphasized here is that the lessons learnt from the trade policy experience of the 1930s have some relevance to meeting the new challenges to trade liberalization and the freer trade that have arisen from the globalization process, but have nothing to do with the conventional market failures. As the process of world economic integration has proceeded apace through the channels of trade, international investment and capital flows, there is growing demand in developed countries for linking social policy issues - at least two of them, environment protection and labour standards - with trade. These demands arise from the growing fears in these countries about the implications of globalization among others for jobs, wages of unskilled workers and environmental standards. I shall now examine the validity of these fears, as well as the approaches that are being proposed to deal with them.

III.

8. Those who seek linkage between trade liberalization and harmonization of domestic policies, such as labour standards and environment protection, argue that in a globalizing world economy differences in social standards can lead to "unfair" competition. The notions of "eco-dumping" and "social dumping" have thus gained ground in recent years. It is further argued that, as competitive advantages and international investments will move towards countries with lower labour and environment standards, this will eventually lead to competitive

³ Later Keynes did acknowledge that domestic reflation was a superior policy intervention to achieve full employment than trade-protection.

lowering of social standards in all countries - "race to the bottom" - and to lowering of social welfare world-wide. In particular, it is perceived that trade with developing countries would lead to empverishment of workers in developed countries.

9. There is no doubt that globalization of markets has vastly increased the exposure of manufacturing industries to international competition and at the same time considerably reduced the margin of comparative advantage of firms and industries across countries. This phenomenon has led to an increase in foot-loose industries, as well as in economic insecurity. But from this one cannot deduce the propositions made above related to "unfair competition" and "race to the bottom". In fact, as will be demonstrated below, the economic foundations of these propositions is at best very feable, both on empirical and analytical grounds. First let us consider the issue of labour standards.

Labour standards

10. The issue of labour standards has two dimensions : economic and moral. The economic aspects are related to the income-distribution effects of trade, and to the concerns about the loss of jobs. Here, as Professor Jagdish Bhagwati pointed out in his recent Prebish lecture, there is a reversal of roles between developing and developed countries. During the 1960s and 1970s developing countries feared the adverse income-distribution effects of their trade with the developed countries, as well as the neo-colonial exploitative role of the foreign direct investment. They seem to have overcome these fears and look positively towards trade and international investment.

11. There are now increasing fears in developed countries about the adverse income-distribution effect of, and immiserazation of unskilled workers from trade

with low-wage countries. Intellectual support of the plausibility of these fears can be sought in Samuelson-Stopler Factor Price Equalization Theorem. However, such support is based on a very feeble foundation, for two reasons. First, the convergence of wages through trade, as implied in the Factor Price Equalization Theorem, is to occur over a very long period. Moreover, the Theorem does not imply achieving this convergence through the immiserization of workers in the capital rich developed countries. Second, the Theorem was constructed on the basis of very restrictive assumptions and its conclusions have thus been questioned within the mainstream of economic thought.

12. Turning now to the real world, it is difficult to identify any specific development in the economic field since the 1960s that can be construed as lending support to these newly found fears in developed countries. The share of developing countries' exports in world exports, as well as the share of their exports to developed countries in their total exports, has not changed significantly over the last three decades or so. Similarly, there is no hard evidence of any significant change in skill and factor (capital and labour) composition of the exports of developing countries to developed countries. If anything, skill composition of developing countries' exports may have moved towards relatively higher skill-intensive products. Furthermore, most of the manufacturing imports in developed countries come from the relatively high wage developing countries.

13. The only new development of some significance since the 1980s is the acceleration of the growth of international investment and the closing of the productivity gap, at least in the tradeable sectors, between developed and relatively more advanced developing countries. However, most of the international investment flows (nearly 70 per cent) are intra-developed countries.

Over the last decade there has been some increase in the relative share of developing countries in foreign direct investment flows. But most of the foreign investment flows in the developing world are concentrated in relatively high wage developing countries, with the exception of China. Nevertheless, most foreign direct investment in China comes from the Chinese themselves living in Hong Kong and Taiwan (the Province of China).

14. It is hard to find econometric evidence which can lend support to the fears in the North of the immiserization of workers from freer trade with the South, or from freer international investment flows. Most studies suggest that the technological change in the North is the main factor responsible for the decline and stagnation of real wages, as well as for the large scale unemployment of unskilled workers in the United States and Western Europe.

15. As mentioned earlier, there is also a moral dimension to the issue of the labour standards. This relates to the enforcement of the core labour standards incorporated in ILO Conventions on workers' rights such as prohibition of forced labour, minimum age for the employment of children, conditions of work, including occupational health and safety, workers' right of association and to organize and bargain collectively. No one would question the need for establishing a mechanism at the international level for the enforcement of the relevant ILO Conventions on workers' rights. But whether one should link the enforcement of these rights to trade liberalization is open to debate. Needless to say, this can open a new door to protectionism.

Protection of environment

16. The need to protect environment, which is no longer "free good" poses yet another new challenge to the sustenance of trade liberalization or freer trade.

There is universal recognition of the need to protect environment. However, the degree and nature of domestic environment problems/pollution varies a great deal between countries and regions, especially between developed and developing countries. Consequently, even if countries follow the principle of internalising environmental costs in the pricing system through taxes or other means, one would expect diversity of environmental standards in the same industry in different countries. Policy makers in developed countries perceive this diversity as the source of "unfair trade" and therefore need to be eliminated by the harmonization of environmental standards or by convergence to higher environmental standards, or counterveiled by eco-dumping duties. There is also a fear that the diversity of environment standards among countries in the same industry may lead to a competitive race towards lower environmental standards.

17. There is a legitimate case for strong international cooperation to deal with global environmental issues and to assist developing countries to institute appropriate environmental standards. But the notion that the diversity of environmental standards in the same industry in different countries constitutes "unfair trade" and that such diversity can cause industries and jobs to move from locations (countries) with higher environmental standards to lower environmental standards thus triggering off a competitive "race towards the bottom" is hard to justify. Studies of environmental costs suggest that they constitute less than one per cent of the total costs in most industries. Only in a few industries the cost reaches 2 to 3 per cent⁴. Moreover, it is the "comparative" costs difference and not the "absolute" costs difference that is the basis of international specialization

⁴ See Fredrick W. Mayer, "The NAFTA, Multinationals and Social Policy, in *Multinationals in North America*" (Lorraine Eden, ed., University of Calgary Press, 1994); World Bank, "Trade Measures and Environmental Quality: Implications for Mexico's exports", *International Trade and the Environment*. World Bank Discussion Paper 107 (Patrick Low, ed., 1992).

and division of labour.

18. As regards running away of industries to locations that have lower environmental standards, the key question for policy - as Jagdish Bhagwati points out in his Prebisch lecture - is whether the empirical evidence shows that capital is in fact responsive to the differences in environmental standards and that different countries actually play the game, then of competitive lowering of environmental standards to attract capital. The same two propositions could be addressed to a situation where there are differences in social welfare schemes among countries and where differentials in wage rates exceed the difference in productivity. It seems in both cases the empirical evidence exists only on the first proposition and as Michael Hart points out in his paper "Coercion or Cooperation: Social Policy and Future Trade Negotiations"⁵, the effect of environment, labour and social policies on investment decisions is quite small.

IV.

19. Economic case for establishing a link between trade and social policy seems to be very weak. A question arises then as to why policy makers in major industrial countries consider harmonization of social policies - in particular labour and environmental standards - as a precondition for free trade, and insist that WTO begin to address the interaction of the social policy issues with trade. In fact, WTO have already begun to address the interaction of environment with trade. One answer to this question is that perhaps the policy makers in these countries are the prisoners of circumstances. As noted earlier, the globalization of markets has vastly increased the exposure of industries to international competition and at the same time considerably reduced the margin

⁵ See Canada - United States Law Journal (Vol. 203, 1994)

of comparative advantage of firms and industries across countries. As a result, firms are now watchful if differences in domestic policies give any advantage to their competitors in other countries. At the same time, and since the early 1980s, large scale unemployment has persisted in OECD countries (approximately 34 million in 1994). This period has also witnessed worsening of income distribution in many of these countries. This situation obviously breeds fears and insecurity. Political responses to these fears and insecurity are often short-sighted and can be guided by expediency.

20. Political prominence of the demands for addressing in WTO the interaction of social policy issues with trade remain thus a problem for developing countries. In this context it has been suggested by some that "The political case for negotiating international rules to govern the interrelationships between trade and social issues such as environmental and labour standards, is thus relatively straightforward. It rests on the larger risk posed by the willingness of large and powerful countries to act unilaterally in response to domestic political pressure arising from perceptions of fairness"⁶. The case is not so straightforward. It is hard to imagine how developing countries could concede demands for social clause and harmonization of environmental standards in contractual trade agreements. As regards the possibility of unilateral actions by developed countries, the situation is not so simple. The countervailing economic power of developing countries which would be the target of such unilateral actions should not be underestimated. Nor should it be ignored that the locomotive for world economic growth is no longer the OECD countries, but rather developing countries in South-East Asia.

⁶ See Michael Hart, "Coercion or Cooperation: Social Policies and Future Trade Negotiations", *Canada - United States Law Journal* (Volume 20, 1994).

21. Even if some compromise could be struck in WTO to address the interaction of social policy issues with trade, the threat to free trade would not be lessened. As long as the high level of unemployment and economic insecurity persists in industrial countries the question "Is free trade sustainable" will linger on. In this regards, it is encouraging to find employment issues on the agenda of the next meeting of the Group of Seven in Lyon.