# GATT and the Alternative of Unilateral Free Trade

by Pierre Lemieux

From December 5 to December 9 of last year, representatives of more than 100 national governments met in Montreal for the mid-term ministerial review of the Uruguay Round of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT).

## What Is GATT?

GATT is a commercial treaty, whose aim, as stated in its preamble, is "the substantial reduction of tariffs and other barriers to trade and . . . the elimination of discriminatory treatment in international commerce." Its main principles include: the most-favored-nation clause, according to which any advantage granted to one signatory nation has to be extended to all others (Article I); equal treatment of goods from signatory countries in terms of internal taxation and regulation (Article II); fair trade against dumping and export subsidization (Article VI); the elimination of quantitative restrictions and the exclusive use of tariffs for protection of domestic industry (Article XI); and negotiated settlement of commercial disputes (Articles XXII and XXIII).

The name "GATT" also refers to the somewhat informal association of signatory nations, called "Contracting Parties." All Western European countries, the United States, Canada, Australia, New Zealand, Japan, as well as some 70 underdeveloped countries, plus a few Communist-bloc nations (Czechoslovakia, Hungary, Poland, Rumania, and Yugoslavia) are members. The supreme governing body of GATT is the annual Session of the Contracting Parties but, in practice, the organization is ruled by the Council of Representatives of member states. The secretariat, employing some 400 persons and headed by a Director-General, is located in Geneva.

After World War II, protectionism was widespread. Prewar tariffs and import quotas had been supplemented by wartime measures such as foreign exchange controls. Tariffs on manufactured goods averaged 40 percent in the industrialized world; in the U.S. they averaged 18 percent with peaks of 50 percent or more.

In 1945, the U.S. government started two initiatives to liberalize international trade. First, an international trade treaty, to become known as the Havana Charter, was proposed. Second, trade talks were started among 15 nations—Australia, Belgium, Brazil, Canada, China, Cuba, Czechoslovakia, France, India, Luxembourg, the Netherlands, New Zealand, South Africa, the United Kingdom, and the United States—with the purpose of immediately reducing tariffs.

The Havana Charter was finally rejected as it aimed more at managed trade and economic planning than at free trade. The second initiative, the trade negotiations, was more successful. On October 30, 1947, 23 countries—the original 15 plus Burma, Ceylon, Chile, Lebanon, Norway, Pakistan, South Rhodesia, and Syria—agreed on tariff reductions covering a significant proportion of world trade. They also rescued the commercial section of the stillborn Havana Charter and signed it under the name of the General Agree-

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ment on Tariffs and Trade, to come into effect on January 1, 1948.

GATT has remained a provisional agreement without a formal organization to supersede it. As of June 1988, the Agreement has been officially signed by 96 nations, which represent more than four-fifths of international trade. It is also unofficially applied by some 30 other nations.

## Tariff Reductions Under GATT

Before the actual "round" of multilateral trade negotiations initiated in Uruguay in 1986, seven general negotiations had been held under GATT. These negotiations have presided over significant tariff reductions. At Torquay, England, in 1951, tariffs were reduced by one-fourth on average from 1948 levels. The 1964-1967 Kennedy Round and the 1973-1979 Tokyo Round, both held in Geneva, brought more general tariff reductions: in each of these rounds, tariffs on manufactured goods were reduced by an average of 35 percent.

Following the Tokyo Round, whose decisions came in full effect in 1986 and 1987, average (weighted) tariffs are 4.4 percent in the U.S., 4.7 percent in the European Community, and 2.8 percent in Japan. Average tariffs on industrial goods have thus decreased from 40 percent after World War II to around 5 percent today.

A voluntary dispute settlement mechanism was established under the Agreement. A trade complaint brought by one state against another is discussed between them. If it cannot be settled by consultation, it may be referred to the GATT Council of Representatives (or, more rarely, to the Session of the Contracting Parties) who will normally establish a special panel of three independent experts. After holding hearings and studying the contentious matter, the panel submits a report which typically includes a ruling and suggested remedies. Panel reports are generally adopted by the GATT Council.

In the 40 years of GATT, there have been about 100 complaints put before the GATT Council, only a small number of which were not finally settled one way or another. More than half of these issues could not be immediately resolved and were the object of a panel study and report. Complaints to the GATT have increased in the past few years: in the 22 months from the beginning of 1986 alone, 20 panels were established.

As with most GATT matters, decisions are reached unanimously. GATT decisions are generally obeyed, although they often require further negotiations and compromise. The only penalty provided in the Agreement against a member that does not abide by a Council ruling is authorization for other countries to suspend advantages to the offending party, but this has been done only once.

Indeed, in many instances, GATT has effectively, albeit slowly, enforced free trade. Results of its decisions over the years include: cancellation in 1961 of a British tariff increase on bananas; the 1985 liberalization by the Canadian government of a foreign investment regulation forcing foreign buyers of Canadian companies to engage in a buy-Canadian policy; abolition in 1986 of book printing protection through copyright restrictions in the U.S., following a European Community complaint.

## The New Protectionism

Yet, GATT's performance has been mixed. High tariff peaks remain: the International Monetary Fund reports that on textiles and clothing, "More than half the tariff lines in Austria, Canada, Finland, Norway and the United States carry duties in excess of 15 percent" (*Issues and Developments in International Trade Policy,* December 1988). More important, and despite some Tokyo Round efforts, GATT has been quite powerless in the face of a new protectionism based on non-tariff barriers, which not only have resisted the trend to generally decreasing tariffs, but have been on the rise since the 1970s. Also, the Agreement itself has been used to legalize new tariff and non-tariff barriers. Subsidies, countervailing duties, and anti-dumping duties have increased.

Non-tariff barriers are very diversified and include import licensing, foreign exchange authorizations, minimum import prices, and a number of bureaucratic obstacles at customs points. In industrialized countries, the major barriers are technical standards, government procurement policies, and quantitative restrictions.

**Technical standards and regulations.** These are health, environmental, or consumer protection regulations that are often used to close the domestic market to foreign products. Recent examples include a Canadian government agency's standards barring some American plywood from being used in Canadian construction, or the European Community forbidding imports of American meat treated with growth hormones.

**Government procurement policies.** Government purchases often involve preferences for national suppliers. The Tokyo Round has slightly opened up this market, but many contracts by state, provincial, and local governments remain closed to foreign bidders.

**Quantitative restrictions.** This category includes import quotas and export restraints, and is the most important and disruptive type of non-tariff barrier. Import quotas apply on many agricultural products (sugar in the United States is one example among many). In May 1988, 261 export restraints were in effect, most of the so-called "voluntary" variety. Many nations have skirted GATT regulations by blackmailing other countries into "voluntary" export restraint agreements in such industries as steel (more than 30 agreements), electronics, and automobiles. Including textiles and clothing, voluntary export restraint agreements cover some 10 percent of world trade.

In a December 6 statement to the Ministerial Meeting of the Trade Negotiations Committee in Montreal, World Bank President Barber Conable noted that trade affected by non-tariff barriers almost doubled in the last 20 years. For example: 56 percent of iron and steel imports are hit by non-tariff barriers, nearly 90 percent of food imports by industrialized countries face such barriers, as do 21 percent of undeveloped countries' exports of manufactures to developed countries.

In fact, many forms of the new protectionism have relied on exceptions duly recognized and thus legalized by GATT, such as anti-dumping or countervailing duties, safeguards, and the Multifibre Arrangements.

**Anti-dumping and countervailing duties.** These measures are meant to counter so-called unfair trade. Anti-dumping duties (such as the 6 to 47 percent duties just imposed by the European Community against Japanese dot matrix printers) are recognized by Article VI of GATT as a means of protecting domestic producers against products sold in their markets at lower prices than in the exporters' own markets. If the underselling is caused by a foreign government's subsidies, Article VI legalizes countervailing duties as a retaliatory measure. One recent example is the countervailing duties imposed by the U.S. government against Canadian soft-wood producers.

**Safeguards.** Even when no unfair trade practices are alleged, and notwithstanding other GATT articles, a country is empowered by Article XIX to enact emergency actions or "safeguards" against any imported products that "cause or threaten serious injury to domestic producers." Safeguards may be tariffs, quantitative restrictions, or any other measure. From 1950 to the end of 1988, 134 Article XIX actions had been taken; at mid-1987, 26 of these measures were still in force.

**Multifibre Arrangements.** Despite lip service about the desirability of opening up developed markets to producers from poorer nations, less developed countries have been badly hurt by the new protectionism, often with GATT's seal of approval. Protectionism in agricultural and especially tropical products is one example. But perhaps the worst case is the Multifibre Arrangements, renegotiated many times since 1974 under GATT. Under the Multifibre Arrangements and the 60 or so bilateral agreements signed under its authority, textile and clothing imports from underdeveloped countries into industrialized countries are severely restricted. This has led to a 20 to 50 percent increase in clothing prices for consumers in industrialized countries.

**Other exceptions.** Many other exceptions to free trade are legal under GATT, such as restrictions to safeguard the balance of payments (Article XIII), or to favor underdeveloped countries and their policies (Article XVIII and the new Part IV of the Agreement).

**Subsidies.** Government subsidies are often classified as non-tariff barriers but should be treated differently. On the rise mainly in agriculture but also important in other sectors (e.g., aeronautics and shipbuilding in Europe, automobiles in France), they have provided good excuses for a host of new tariff and non-tariff barriers.

Two periods may be distinguished in the post-war history of international trade. From GATT's formation until around 1970, tariff and, to a certain extent, non-tariff barriers were on the wane. Starting around 1970, a phenomenon began to parallel the decline of tariffs: the growth of non-tariff measures. According to some estimates, the percentage of U.S. imports covered by protection increased from 8 percent in 1975 to 21 percent ten years later (*The Wall Street Journal*, November 1, 1985). All over the world, this new protectionism has now cancelled much of the liberalization of the past decades.

The Tokyo Round had tried to deal with non-tariff barriers, subsidies, agriculture, services, safeguards, and so forth, but with little success. Many of the unresolved issues, which are also main contributors to the new protectionism, stood in the forefront of debates and disagreements in the recent negotiations in Montreal. Agricultural subsidies were the main contentious issue; the U.S. proposal to eliminate them by year 2000 was rejected by the European Community. Final adoption of frameworks of agreement on matters such as tariffs, services, tropical products, and better enforcement of GATT decisions were made conditional upon resolution of this issue. Moreover, no agreement could be reached on textiles and clothing, safeguards, and protection of intellectual property. The Uruguay Round negotiations are to last until 1990.

GATT's multilateral trade negotiations are based on the idea that trade liberalization requires a global approach by all sides. Bilateral agreements, as were used before (including in GATT's early history), were found to be too clumsy, slow, and inefficient. Multilateralism is now threatened again by the rise of bilateral trade actions, on the one hand, and by regional free trade areas, on the other hand. Bilateral agreements such as the Canada-U.S. Free Trade Agreement, the U.S.-Israel Free Trade Agreement, and the Australia-New Zealand Closer Economic Relations Trade Agreement were partly designed to counter the threat of the new protectionism, but they may have added fuel to it. Bilateral or regional free trade agreements do not necessarily lead to freer trade at the world level, and fears that protectionism may be actually strengthened by "Fortress Europe" and "Fortress America" are not without foundations.

But, as we shall see, multilateralism, bilateralism, and regional free trade areas are not the only alternatives.

The roots of the difficulties in achieving free trade lie in philosophical problems that are not unique to GATT, but which help to explain the recent underachievements of this organization.

In GATT's language and culture, individuals are identified with their countries which, in turn, are equated to their respective governments. This statist approach leads to a related problem. One often wonders whether what GATT tries to enforce is free trade or managed trade, i.e., its very opposite. In GATT, everything is done by or through national governments, everything is thought of in terms of state action. One GATT brochure (*Aider la croissance mondiale*) stresses that the General Agreement is "not a 'free trade charter' " but provides means for controlling protection of domestic industry. The necessity of some protection is unquestioned and, as we have seen, permitted or even encouraged under GATT. The requirements of domestic policies and planning have precedence over the principles of free trade. Has the Havana Charter made an anonymous comeback?

Another aspect of this fundamental misunderstanding is the philosophy of inter-governmental negotiations, on which the whole GATT system is based. It conveys the false idea that the less one government gives up and the more the other "contracting party" concedes, the better off people are. This approach is reminiscent of 17th-century mercantilism which viewed exports as wealth and imports as costs.

In a very real sense, freer trade does not need agreements between nations. Trade can be freed by declaring free trade unilaterally, which is basically what the British government did in the middle of the 19th century. British Prime Minister William Gladstone went so far as saying that "a commercial treaty would be an abandonment of the principles of Free Trade . . . if it were founded on what I may call haggling exchanges." The basic philosophical failure of GATT is that it may have distracted us from the advantages of unilateral, one-way free trade.

## Unilateral Free Trade

Although the idea of unilateral free trade has not yet passed into popular culture, it has been generally accepted by economists since the time of Adam Smith (1723-1790), John Stuart Mill

(1806-1873), and the Physiocrats in 17th- and 18th-century France. The desirability and feasibility of unilateral free trade can be demonstrated in three steps.

First, it must be realized that advantages from international trade stem more from imports than from exports.

Individuals, not countries, are the real trading partners and the ones who benefit from trade. Now, the advantages from trade come more from what one buys than from what one sells. Advantages from trade with your butcher lie more in the meat you buy from him than from the work you do to earn the money to pay him. We trade because we think that what we get is worth more than what we give up. Similarly, we work and produce in order to consume.

This applies also to international trade, which is only inter-individual trade over a political border. As individuals produce in order to consume, and sell in order to buy, so they export in order to import. From the point of view of individual traders, importation is the goal; exports are just a way to finance their consumption. Advantages of international trade come more from the freedom to import than from the capacity to export. GATT is plagued by the same problem as governments: it is more a producers' club than a consumers' association because, as shown by the Public Choice school, the interests of the latter are less concentrated and, thus, less vocal. Maximum prosperity requires that we let consumers (and firms as intermediaries) import freely as they wish.

Would not freedom to import lead to chronic balance of payment problems? No, for the simple reason that in order to import, residents of a country must export an equivalent value. Exports necessarily equal imports. This is the second step in demonstrating the advantages of unilateral free trade.

The basic reasoning is quite straightforward. As John Stuart Mill showed 200 years ago, "an imported commodity is always paid for directly or indirectly with the produce of our own industry." An American company pays for its imports in U.S. dollars, which are nothing but titles to American production. The foreign firm receiving the dollars can sell them in exchange for domestic funds. The final foreign acquirer of these U.S. dollars will use them to import from the U.S., or will save them to exercise later his claim to American production. Alternatively, imports into the United States can be financed by foreign loans, but these eventually will have to be repaid and thus represent titles against future U.S. production. If we look beyond the veil of money and financial transactions, then, products are exchanged only against products. Increasing imports will automatically promote exports.

This is just another way of saying that, since each trading company or individual takes care of his own balance of payments (i.e., revenues and expenditures), there can be no overall balance of payments disequilibrium. A current account balance deficit (higher imports than exports of goods and services) is financed and exactly compensated by a capital account surplus (net inflow of capital). Conversely, a capital account deficit (net capital outflow) serves to finance our partner's current account deficit, i.e., to compensate our own surplus. The correspondence need not be exact between any two countries, but the equality of all exports and imports must hold between any one country and the rest of the world.

The third step in our demonstration will be to show that domestic protectionism compounds problems.

It is true that foreign protectionism will reduce America's capacity to export. But as imports cannot exceed exports over time, foreign protectionism will also reduce American imports. Now, suppose the U.S. government retaliates with domestic protectionism. This will directly reduce the American consumers' liberty to import, adding further to the disadvantage of foreign protectionism. If Americans import less, they will not be able to export as much since their imports are somebody else's exports and revenues. It can thus be seen that domestic protectionism reduces both domestic imports and exports; it further limits two-way trade and compounds the problems of foreign protectionism.

It follows that if your neighbor is protectionist, you can limit damages to yourself by buying from him as much as it is in your interest and capacity to do. These purchases will automatically finance themselves since, by permitting foreign vendors to sell here, we also oblige them to buy from us, one day or another, a corresponding value. As a consequence, unilateral free trade represents the best strategy for the victim of protectionism.

The argument for unilateral free trade was well-known to French economists of the Physiocratic School. Pierre Mercier de la Rivière (1720-1793) wrote about free trade: "It is obvious that a nation can implement it by itself, independently of other nations; the right of property can become a sacred right for its subjects without becoming so in all foreign countries." Another Physiocat, Pierre Dupont de Nemours (1739-1817) added, talking about protectionism: "If some foreign power becomes guilty of one of the offenses we just talked about, let us never be led into retaliatory actions because these would be all against our nation's interest."

These theoretical considerations can be brought to bear on GATT. Let us suppose that the Uruguay Round turns out to be a failure in 1990. International markets could still be significantly opened up by any large country or any number of countries unilaterally freeing their citizens from their own import restrictions. Through unilateral elimination of trade barriers, we could obtain many of the advantages of GATT. Higher imports would result, but they would have to be paid for by increased exports, or by capital inflows which mean increased exports in the future.

Any absolute advantage poor countries have in labor costs would be counterbalanced by our advantages in capital-intensive production and/or by exchange rate adjustments. Trade would increase and flow according to comparative advantages. The economic distortions and moral disgrace of trade barriers against underdeveloped countries would be eliminated. Indeed, the best way of fostering development in these countries (besides a liberalization of their own internal policies) is to allow them to export in order to finance their imports from us.

As far as agricultural subsidies are concerned, the U.S. government is right in arguing that they must be abolished. But again, this problem could, and should, be solved unilaterally. Let's just announce (in Canada and/or in the United States) that we will abolish our own subsidies. Even if agricultural subsidies were not abolished elsewhere, unilateral liberalization would produce as high benefits for the economy as a whole as multilateral liberalization, as the International Monetary Fund correctly argues (*Issues and Developments in International Trade Policy*, December 1988).

It is quite probable that European taxpayers could not continue for long to subsidize agricultural production, at the rate of two-thirds the European Community budget. Liberalizing our agriculture would rapidly force them to follow. In the meantime, any disruptive effect of their temporarily higher subsidies would be compensated by the increase in other exports from us which would be necessary to finance our higher imports of agricultural products. Moreover, it is by no means certain that free and productive producers can never undersell subsidized and lazy ones. Boeing still sells airplanes and often wins sales against subsidized Airbus. The adjustment potential of a free-market economy has been shown in the petroleum markets for the last 15 years.

## The Real World, Today and Tomorrow

But the real world is what it is and, until understanding of the advantages of unilateral free trade has progressed, we may need institutions like GATT. For the collapse of multilateral trade negotiations under GATT probably would lead to all-around protectionism instead of declarations of unilateral free trade.

First best is multilateral free trade. Second best is unilateral free trade. Third best is institutions such as GATT. Worst is unchecked protectionism.

Provided it does not yield to managed trade, then, GATT serves a useful purpose for now. One advantage of such international organizations is to impose some discipline on national governments, to prevent them from complying too easily with demands of domestic pressure groups. Paradoxically, a club of producers' clubs can dampen local protectionist pressures.

But this short-run strategy shouldn't deter us from limiting more directly the powers and trade interventions of our own governments. No one would advocate that Western governments negotiate individual liberty with Communist countries: "If you do not free your subjects, we will enslave ours equally. . . ." But isn't this exactly what negotiating free trade amounts to in the economic realm? Let's consider the alternative of unilateral free trade. □

A REVIEWER'S NOTEBOOK

# The Other Path

by John Chamberlain

In two trips to post-Allende Chile I skipped over Peru without a decent sight of Lima. But I've seen the shacks of squatters on the hillsides in back of Caracas in Venezuela and in the land around Santiago in Chile, and it is easy to visualize the same ring of unfinished tin and cardboard huts around Lima.

The shacks are illegally situated, but nobody does much to disturb them. For where else can propertyless people go except back to the country, where life is all too hard for a mere peasant field hand? The shacks around Lima belong to what Hernando de Soto, a Peruvian who runs a fact-finding agency called the Institute for Liberty and Democracy (ILD) calls the informal, as opposed to the formal, economy. This economy, which de Soto disdains to call black, is the natural response to an impossible situation of people who, quite understandably, refuse to die. The story of "the invisible revolution in the Third World" is ably told in de Soto's *The Other Path* (New York: Harper and Row, 271 pp., $22.95).

The older inhabitants of Lima, with legal businesses staked out and their own housing needs taken care of, don't welcome newcomers from the country, but they bow to *faits accomplis* when these come with impressive planning and power. De Soto tells how the invaders from the country move in to seize empty stretches of land on the Lima periphery. One evening there may be nothing stirring on the land. But, come morning, a whole group of invaders will have marked out their plots and set up the first approximations of scores of houses. Normally the police look on. The police know that the invaders represent a potential political power that they may have to reckon with some day.

The invaders speak of something they call an "invasion contract" based on "an expectant property right." De Soto's ILD found in 1985 that out of every 100 houses built in Lima, 69 were governed by the extra-legal system.

After the first seizure comes the long wait. There are 159 bureaucratic steps which residents must complete in order to legalize, or formalize, their settlement. The process of formalization takes an average of 20 years.

To start a legal business is almost as forbidding. First, there must come an adjustment of land. This takes 83 months to complete. The cost of an adjustment is $590.36, which is 15 times the monthly minimum wage. Sewage and water functions must be arranged for, and there must be access to transport, which is largely illegal. It takes 12 months to obtain documents that allow building to start. Studying cases, the ILD found that "the cost of access to formal markets, in terms of time, was an average of seventeen years, from the formation of a minimarket until the market proper comes into operation." The difficulties of building their own markets explains why so many people decide to become street vendors. Even when one has a legal, or formal, business going, 40 percent of an administrator's working hours are used up by bureaucratic procedures.

It is small wonder, then, that newcomers to Lima are inclined to say to hell with formal