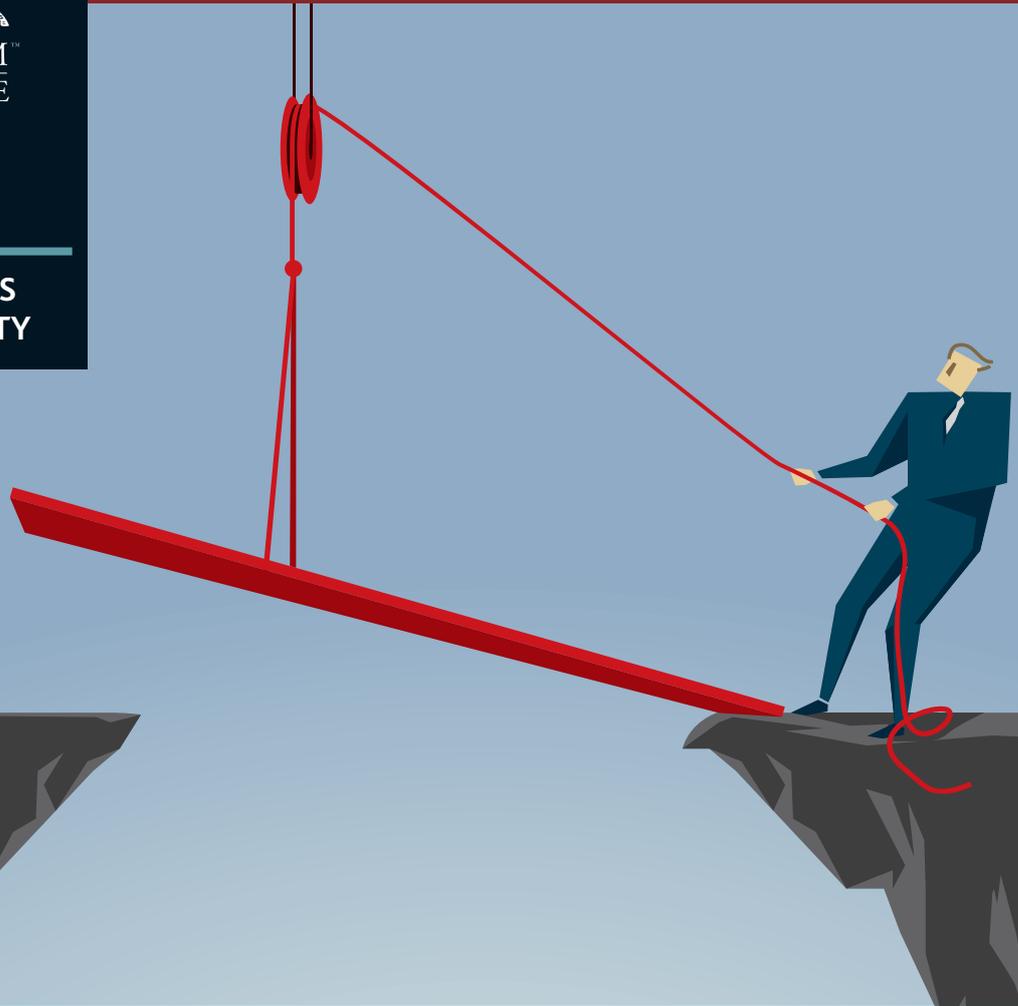




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Trade Tools for the 21st Century

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EXECUTIVE SUMMARY

Previously high levels of public support for free trade are eroding at an ever-increasing rate. This study outlines the difficulties that are faced by modern trade agreements, which include powerful political forces opposing globalisation and the rising tide of protectionism, populism, and nationalism. We argue that the public backlash against free trade emanates from the failure of policy-makers to deal properly with behind-the-border trade barriers, including a host of economic distortions that we have termed “anti-competitive market distortions” (ACMDs). Failure to develop offensive and defensive trade-policy tools will result in continued fracturing of free markets and increased public opposition to job—and wealth-creating—free-trade agreements.

We lay out these offensive and defensive tools, identify best practices around the world, and explain how they can best be deployed to deliver both open trade and competition on the merits. Finally, we present a case study of Britain after the Brexit referendum vote. Brexit has opened up new opportunities for Britain to stand at the centre of a vast global network of trade relationships, cemented by its importance in global supply chains. We argue that the British government should prioritise negotiations with like-minded countries and its historic trading partners, notably the Commonwealth. Bold action by the UK in breaking down foreign and domestic trade barriers could serve to reinvigorate the stalled global trade agenda and the sluggish global economy. We believe that this “Brexit moment” is an inflection point in history which requires creative thinking and courageous leadership. We conclude this paper by giving a rough estimate of the economic value that could be liberated as a result of the trade policy proposals we outline, and contend that, with so much at stake, British policy-makers must cast off their partisan blinkers and take full advantage of the opportunity that has been presented to them.

INTRODUCTION

Throughout history, most international trade consisted of products being produced in country A and then sold in country B. The tariff barriers that increased the cost of these sales were the major impediments to the international trading system. The General Agreement on Tariffs and Trade (GATT) dramatically reduced these tariffs and ushered in a new era of prosperity in which innovative supply chains and transnational companies thrived. The reduction of many tariff lines to almost zero for a range of industrial goods meant that behind-the-border barriers such as domestic distortions and regulatory protectionism became the chief impediment to the global trading system. Thus, trade in the 21st century presents a very different set of problems from trade at other times.

We have termed these behind-the-border barriers that distort markets and impede competition “ACMDs”. Removal of these ACMDs would render supply chains more efficient and foster greater generation of wealth. ACMDs typically have three effects: to limit the number and range of competitors; to restrict the ability of individual companies to compete by artificially increasing their costs or artificially lowering competitors’ costs; and to favour state-owned enterprises. The various means by which ACMDs are proliferated include the granting of exclusive distribution rights, licencing regimes, corrupt public procurement practices, geographical/labour limitations, scientifically unsound standard-setting, limitations on direct-to-consumer advertising, forced production shifting, exemptions from onerous regulations for “favoured” corporations, and outright subsidies.

Trade policy must deliver the global economy from these ACMDs, and the purpose of this paper is to develop ideas on how this might be accomplished. We will set out the current state of trade and explain where bottlenecks exist. We will then describe an ideal set of solutions and present the case for picking and choosing from well-functioning existing regulation. Finally, we will examine the topical case of Great Britain, which, as a result of Brexit, finds itself with a unique opportunity to overhaul both its trading relationships and its domestic regulatory structure.

TRADE IN THE 21ST CENTURY

Although trade deals are designed to promote commercial interests, they are often motivated by political considerations and can be concluded or thwarted by political considerations. The GATT system, which emerged in 1947 from the 1944 Bretton Woods Conference as an agreement, was a direct response to World War II and the Depression-era tariffs which had helped to escalate existing tensions. The most recent World Trade Organization (WTO) multilateral round, the Doha Development Agenda, was opened in the month following the terrorist attacks of September 11, 2001. Historically, a general understanding existed that free trade was one of the best-known remedies for conflict. The unprecedented period of peace which Europe and the US have enjoyed in the past 70 years has bred complacency concerning the causes of that peace, and specifically has given rise to a belief that free trade is not now as important as it once was.

Around the globe, a disturbing brand of nationalist populism is on the rise, the result of anti-establishment sentiment stemming from a perception that existing institutions are rigged against the common people. A succession of elections across Europe—in Poland, Hungary, Slovakia, Austria, Germany, and Italy—has seen nationalist, populist, protectionist candidates take the fore. PiS in Poland and Jobbik in Hungary have embraced rhetoric which openly discriminates against foreign persons and companies and aims to push back the free movement of people and trade. For example, PiS has instituted a programme of re-polonisation which includes “polonising” the banks, supermarkets and other economic sectors.¹ In Britain, hostility to free markets, trade, and the antipathy towards the 1% fuelled the rise of Jeremy Corbyn to lead the Labour Party in the UK. In the US, both major parties’ presidential nominees, despite appearing to come from opposite ends of the political spectrum, decry foreign imports, trade agreements, and liberalisation itself. Donald Trump advocates prohibitive tariffs on Mexican and Chinese goods as part of his bid to “make America great again”. This economically unsound rhetoric is matched by Bernie Sanders, who took advantage of anti-establishment sentiment to push Hillary Clinton towards the same protectionist policies. No matter the outcome of the election in November 2016, America is guaranteed a president who will not be supportive of trade liberalisation.

In the developing world, China began scaling back its reform efforts before the 2008 fiscal crisis, embracing “indigenous innovation”, which amounts to further restrictions on foreign access to its markets. For all the hope and optimism from economists surrounding the 2014 victory of Prime Minister Narendra Modi in India, his brand of economic thought seems to be pro-business (Indian business) and not necessarily pro-market. While the jury is still out on whether Modi can deliver economic growth and opportunity to the hundreds of millions of Indians in abject poverty, policies such as “Make in India” suggest that he is in fact no less protectionist than his predecessors.

This global push for protectionism has come in three waves. First-generation protectionism was the norm for most of human history, lasting until the first attempts to liberalise during and after the Industrial Revolution (for example, the repeal of the Corn Laws) in the 19th century. In this status quo, trade was often on mercantilist terms and was accompanied as frequently as not by open warfare (for example, the Treaty of Nanking which opened up trade with China and ended the First Opium War in 1842). Second-generation protectionism began with the advent of the Great Depression in 1929. While

the US had, against the advice of the League of Nations, proceeded with the Fordney–McCumber Tariff Act in 1922, it was the Smoot–Hawley Tariff Act of 1930 which most significantly drove up the dutiable rate of goods to a height of 59.06 percent in 1932.² Trade remained at depressed levels until World War II, after which it was generally recognised that a freer global trading system and significant capital investments in rebuilding would be more likely to engender peace than the regime of reparations and protectionism which characterised the post-World War I period and gave rise to fascism in Germany and Italy. At an extraordinary moment in history, global leaders chose to reduce tariffs to their lowest-ever rates. It was in this period of unprecedented openness that the world experienced unprecedented growth. The stagnant global GDP rates of history gave way to a tenfold increase between 1947 and 2000, which lifted billions of people out of poverty around the world. According to data compiled by Bourguignon and Morrison, the percentage of the world’s population living on less than \$1 per day has gone from 55% in 1950 to 24% by 1992.³ World Bank data shows a decline in the percentage of people living on less than \$1.90 per day has gone from 44% in 1981 to less than ten percent (projected) for 2015. Looked at another way, the number of people living in extreme poverty has moved from 1.8bn in 1950 to 705m in 2015.⁴

The development of the GATT was significantly marred, however, by the failure to implement the International Trade Organization (ITO). Effectively blocked by the US Congress in 1950, the Havana Charter, under the terms of which the ITO was to be established, was the first international treaty to call for pro-competitive rules among its signatories. Article 46 of the Havana Charter calls for the following:

1. Each Member shall take appropriate measures and shall co-operate with the Organization to prevent, on the part of private or public commercial enterprises, business practices affecting international trade which restrain competition, limit access to markets, or foster monopolistic control, whenever such practices have harmful effects on the expansion of production or trade and interfere with the achievement of any of the other objectives set forth in Article 1.
2. In order that the Organization may decide in a particular instance whether a practice has or is about to have the effect indicated in paragraph 1, the Members agree, without limiting paragraph 1, that complaints regarding any of the practices listed in paragraph 3 shall be subject to investigation in accordance with the procedure regarding complaints provided for in Articles 48 and 50, whenever
 - a. Such a complaint is presented to the Organization, and
 - b. The practice is engaged in, or made effective, by one or more private or public commercial enterprises or by any combination, agreement or other arrangement between any such enterprises, and
 - c. Such commercial enterprises, individually or collectively, possess effective control of trade among a number of countries in one or more products.
3. The practices referred to in paragraph 2 are the following:
 - a. Fixing prices, terms or conditions to be observed in dealing with others in the purchase, sale or lease of any product;

- b. Excluding enterprises from, or allocating or dividing, any territorial market or field of business activity, or allocating customers, or fixing sales quotas or purchase quotas;
- c. Discriminating against particular enterprises;
- d. Limiting production or fixing production quotas;
- e. Preventing by agreement the development or application of technology or invention whether patented or unpatented;
- f. Extending the use of rights under patents, trademarks or copyrights granted by any Member to matters which, according to its laws and regulations, are not within the scope of such grants, or to products or conditions of production, use or sale which are likewise not the subject of such grants;
- g. Any similar practices which the Organization may declare, by a majority of two-thirds of the Members present and voting, to be restrictive business practices.⁵

While tariff reductions were successfully accomplished after the launch of the GATT, the record on reduction of ACMDs was much poorer. Although the ITO Charter contained many other provisions on labour that might have distorted trade, ratification of Article 46 of the Havana Charter and creation of the ITO would probably have stymied many of the anti-competitive practices which flourished in the second half of the 20th century among (now) WTO members.

The third, current generation of protectionism has its roots in the financial crisis of 2008. Unlike previous crises in which one particular sector (technology, housing, even tulips, etc.) went “bust”, the entire financial system crashed virtually overnight, revealing systemic weaknesses that stretched across sectors and borders.⁶ The resultant bailouts of failing banks and automobile companies, and the failure to bail out pension and retirement funds, created deep-seated populist resentment. The privatising of profits and socialising of losses which occurred in the financial sector left many with the impression, first, that government would happily trade individual for corporate welfare, and second, that the global financial system, including the global trading regime, was in need of immediate overhaul. Instead of attacking partial reform, politicians on the left and right chose to rail against free trade, unable to differentiate between job—and wealth-generating—competition and unfair competition resulting from distortions. This represents a dangerous misunderstanding of the causes and effects of trade.

Public policies that rely on free market forces and avoid government interventions that distort terms of international trade benefit producers, consumers, and national economies alike. The Heritage Foundation’s *Index of Economic Freedom* reports that “countries with low trade barriers are more prosperous than those that restrict trade”.⁷ Indeed, free-trade policies both promote a strong economy and vindicate the rights of individuals to pursue their own interests, as summarised by Heritage Foundation scholars Bryan Riley and Anthony B. Kim:

Freedom to trade—the freedom to exchange goods and services openly with others—is as fundamental to human well-being as any right guaranteed in the US Constitution. Indeed, the freedom to trade is the foundation of America’s modern economic system that provides historically unprecedented opportunities for individuals to achieve greater economic freedom and prosperity.

The process of economic specialization and trade, in which individuals focus on doing the things they do best, and then exchange the product of their labour with others who are likewise concentrating on their own areas of excellence, leads to much higher levels of production of goods and services as well as the most efficient use of labour and resources. It is this process that creates and sustains the markets of the “free market” system. The development of this system upended feudalism and brought about the dramatic and revolutionary improvements in living standards that characterize the modern age.

In other words, free and open trade has fuelled vibrant competition, innovation, and economies of scale, allowing individuals and businesses to take advantage of lower prices and increased choice. As a result, billions of people around the world have escaped the constraints of subsistence farming and extreme poverty that characterized the lives of most of humanity throughout history.⁸

The full benefits of international trade will not be realised, however, if buying and selling mechanisms are distorted by anti-competitive behaviour or other illegitimate commercial conduct (such as theft, fraud, or deceit) that undermines market forces. Transactions affected by such types of illicit business behaviour do not reflect the efficient working of a free market. Thus, it is appropriate for governments to enact laws that seek to correct for such international trade distortions.

Despite the empirical support for the benefits that free trade provides, free trade itself is under attack. A growing consensus seems to be emerging that free trade leads to rising inequality as it benefits the rich while harming the poor. The reality is that it is free trade that stimulates the competition that allows people to rise out of poverty and to become more socially mobile. Without free trade, and without competition, the beneficiaries of the current system can monopolise markets, and keep out competitors. The consequent higher prices hurt the poor more than the rich, as the necessities of life (food, clothing and energy) become prohibitively expensive. Part of the problem associated with this debate is that those who think free trade harms the poor are looking at the world through a zero sum lens. However, economic interactions between people are non-zero sum in nature, and the economic pie can get bigger or smaller. Free trade makes the pie substantially bigger.

It is also important to note that trade is blamed for many things that it has little to do with. The increase in automation, brought about as a result of efficiency enhancing innovations has had a very big impact on the labour market. Free trade and competition can set up the preconditions for wealth creation, but other policies will surely be needed to deal with the economic impact of automation, artificial intelligence and other innovations that, while empowering for many people do impact the labour market.

Now that we have explained the benefits of free trade, we will describe the dangers lurking in protectionism.

THE PROBLEM WITH PROTECTIONISM

Despite its seemingly benign prevalence in the global economy, protectionism carries a high cost. Across OECD countries, as Felbermayr, Prat, and Schmerer explain,

the overall picture is fairly robust and surprisingly clear-cut: regardless of the precise econometric model used, independent from the exact source of data or the definition of the employed openness measure or the nature of controls, we find that higher openness does not increase unemployment. Quite to the contrary, openness strictly lowers the equilibrium rate of unemployment in most regressions.⁹

Specifically, the authors find that a 10 percent increase in openness to trade correlates with a 0.76 percent decrease in unemployment. A 2000 study on the textiles and garments industry in Europe echoes these findings. Francois, Glismann, and Spinanger show that, in 1997, European Union consumers paid ECU 12.7 billion more than the equilibrium price on both imported and domestic textiles and garments goods. The total cost to a family of four, when considering this ECU 12.7 billion loss and the ECU 12.3 billion loss from inefficiency, was roughly ECU 270 in 1997.¹⁰

However, a recent study of the effects of Chinese imports on the US labour market found that exposure to Chinese imports has adversely affected labour employment. Autor, Dorn, and Hanson write that “local labor markets that are exposed to rising low-income-country imports due to China’s rising competitiveness experience increased unemployment, decreased labor-force participation, and increased use of disability and other transfer benefits, as well as lower wages”.¹¹ They also find that areas affected by Chinese import competition experience a thirty-fold increase in social security claims per capita—as people who begin collecting social security benefits are likely to do so until death, this represents a massive cost to the US government.¹² Specifically, they find that the most exposed areas see a \$63 increase in transfer payments per capita. These transfer payments are made primarily through federal disability, unemployment, and in-kind medical payments. Secondary sources of payments are unemployment insurance and income assistance, while Trade Adjustment Assistance accounts for a negative portion of the increase in transfer payments.

The study looks only at the overall level of Chinese imports into the US. It does not differentiate between state-owned or state-privileged importers and those operating without government support or favour. These two types of importers act in very different ways and produce dramatically different results. Imports that emanate from efficient and independent Chinese firms should be welcomed, as they settle at the market clearing price and improve consumer choice and welfare. Imports that emanate from privileged Chinese firms lead to artificially lowered costs (and therefore lower prices) and distort the ordinary market mechanism price discovery process. These distortions destroy wealth in the economy, raise consumer prices, and result in job loss with no job replacement. It is entirely correct for citizens and their politicians to seek to eliminate this sort of distortive trade. The danger lies in the lack of a robust policy toolbox to distinguish between these two types of trade, which has too often resulted in throwing the proverbial baby out with the bathwater. We endeavour to provide a robust toolbox which succeeds in providing nations with both the offensive and the defensive tools necessary to harness the full power of trade.

* The ECU (European Currency Unit) was a currency basket used as the forerunner of the euro from 1979 to 1999.

SOLUTIONS

The major barrier to trade in the 20th century was at the border, in the form of tariffs. In the 21st century, the major barrier to trade is behind the border, in the form of regulation. Any proposed solutions must recognise this new reality and move from relatively easy tariff reduction to much more difficult regulatory changes, while arming nations with the ability to protect themselves from distortive trade.

Distortions behind the border have two primary effects. First, they keep products and services out of markets or simply make insurgent domestic firms less competitive, even if they have market access. Second, they block market access for foreign firms. The policy toolbox must deal with this reality and insist that the end goal of government is to create a level playing field, not to pick winners and losers. The policy toolbox must also be narrowly directed at the distortions themselves. It must not involve blanket anti-dumping or countervailing duties policies with no sunset provision—instead, it should be narrowly tailored, time-limited and linked to the level of distortion. It must give the distorting country an incentive to limit its own distortions.

The major barrier to trade in the 20th century was at the border, in the form of tariffs. In the 21st century, the major barrier to trade is behind the border, in the form of regulation.

The offensive element of trade policy must also seek to eliminate not only tariffs, but also non-tariff barriers and ACMDs.¹³ Given the current political climate, this will only be achieved via a combination of bilateral, regional, and multilateral trade agreements in different negotiating venues. There is a rich history of domestic reform emanating from trade deals. Mexican president Carlos Salinas sought to join the NAFTA negotiations shortly after his election in 1988 so that he would be provided with political cover to make necessary reforms to the Mexican economy. Despite politically motivated criticism in the US, NAFTA has been the most successful regional trade deal of all time and should serve as a model for future deals, especially in nations where powerful vested interests would otherwise make reform difficult, if not impossible.

By simultaneously moving forward with an offensive and defensive trade strategy, governments will be able to short-circuit the most common complaint against globalisation: that trade policy is written by and for the wealthy with no regard for the effects on “ordinary people”. Nipping this argument in the bud will allow the cost-benefit analysis of trade agreements to be made on the basis of economic considerations, rather than becoming obscured by political motivations.

IMPLEMENTATION: EXISTING TOOLS AND THEIR POTENTIAL FOR ADAPTATION

Best practices regulations have already been drafted across many policy areas, including those we outline below. Unilateral free trade and the unilateral embrace by all countries of legal, economic and regulatory systems that promote competition would be the first best solution to the problems outlined at the beginning of this paper. However, it is simply not realistic to expect all countries (including the world's major distorters) to adopt such a position. History (for example the former Soviet Union privatisations, or the Latin American apertura) has shown that where free trade is not accompanied by competition inside the border, cronyism and oligarchy are the result.

DEFENSIVE TRADE REMEDIES

The core defensive trade remedy is to apply a tariff that is linked to the impact of the ACMD ("ACMD Tariffication"), and thus penalise the producer who benefits from unfair advantage in its export markets. With respect to services, the trade remedy must provide the equivalent of an ACMD Tariffication, understanding that services cross borders in a very different way from goods.

Any proposed tool must pass muster under prevailing WTO rules. Many countries already have trade laws that with some adaptation could be used to combat distortions. The next section reviews the rules that are used by major trading partners. However, any defensive measure must comply with the WTO Anti-Dumping Agreement, the WTO Subsidies and Countervailing Measures Agreement, and general principles on non-discrimination.

Under WTO rules, any law or regulation that discriminates against goods produced in a particular member country is a violation of national treatment.

The anti-distortion trade remedy measure should operate in the following way:

1. An injured party would bring a complaint to the trade remedy agency;
2. The injured party would have to prove that there was an ACMD in the offending market; this would include proving the following elements:
 - a. A distortion;
 - b. An anti-competitive effect with respect to consumer welfare;
 - c. Harm to the injured party caused by the distortion.
3. The defendant would be allowed to adduce exculpatory evidence;
4. A decision would be made on ACMDs and tariffication (or equivalent for services) of distortion;
5. An appellate process would follow;
6. Finally, there would be a sunset review process in which the defendant could prove that the distortion had been eliminated at any time.

In order for the ACMD trade remedy to deal with these issues, it is necessary to understand how other trade remedies function, and how they could be improved.

Anti-dumping

The WTO defines dumping as “a situation of international price discrimination, where the price of a product when sold in the importing country is less than the price of that product in the market of the exporting country”.¹⁴

Anti-dumping (AD) law is aimed at “unfairly low” pricing of imports by companies. AD laws, by focusing on price rather than cost, have fallen into the trap of disincentivising efficiency, much like laws against price discrimination in the antitrust context. There is significant scholarship on the economic harm done to consumers in countries where AD laws are frequently applied. Too often, such laws are simply used by industries to protect themselves from the ordinary forces of competition. The original justification for AD law was to prevent anti-competitive predation by foreign producers, but many such laws—as currently designed and applied—instead diminish competition in industries affected by AD tariffs and reduce economic welfare. Modification of AD laws to incorporate more of an economics based standard that disciplines predatory conduct, but does not stop genuine competition would strengthen the national economy and benefit consumers, and it would also preclude any truly predatory dumping designed to destroy domestic industries and monopolise industrial sectors.

A recent economic study supported by the World Bank and released by the European University Institute confirms that the global proliferation of AD laws in recent decades raises serious competitive concerns.¹⁵ The study concludes:

Over a century, antidumping has gradually evolved from an obscure and rarely used policy tool to one that now constitutes an important form of protection not subject to the same WTO controls as members’ bound tariff rates. Rather, antidumping is one of several instruments that allow members to exceed their bound tariffs, albeit subject to very detailed WTO procedural disciplines. Moreover, while the application of antidumping was until the WTO era mainly the province of a few traditional users, emerging markets have become some of the most active users of antidumping and related policies as well as important targets of their application. And though these policies are known collectively as temporary trade barriers, WTO rules governing the duration of antidumping measures are much weaker than for safeguards.

As antidumping use has evolved and proliferated (about 50 countries now have antidumping statutes although some are not active users), both its economic justification and the concerns raised by its possible abuse have also evolved. While the original justification of antidumping was to protect importing countries from predation by foreign suppliers, by the 1980s antidumping had come to be regarded as just another tool in the protectionist arsenal. Even more worrying, evidence began to mount that antidumping was being used in ways that actually enforced collusion and cartel arrangements rather than attacking anticompetitive behaviour.

Today's world economy and international trading system are much different even from those of the early 1990s, when this concern reached its peak. Some changes, in particular the significant growth in the number of countries and firms actively engaged in international trade, tend to limit the possibility of predation by exporters. Moreover, antidumping has developed a political-economic justification as a tool that can help countries manage the internal stresses associated with openness. But other changes, especially the important role of multinational firms and intra-firm trade and the increased use by many countries of policies to limit exports, suggest that concerns about anticompetitive behaviour by exporters cannot be entirely dismissed. Vigilance to ensure that antidumping is not abused by complainants to achieve and exploit market power thus remains appropriate today.

This standard reduces economic welfare and undermines market forces, and ideally should be replaced with a true predation standard based on market principles.¹⁶ Given the widespread adoption of AD laws in recent decades, multilateral consideration of a more efficient predatory pricing test as a trade-expanding initiative could have considerable merit.

A predation standard is economically robust and would be consistent with the goals of international trade and competition on the merits. Such a standard would recognise that some countries do distort their markets in anti-competitive ways and that this practice artificially lowers the costs of their goods and services. In principle, market forces are distorted when a firm (1) engages in a systematic programme of loss-inducing pricing below cost which is (2) designed to drive competitors out of business (3) in an industry where recoupment of short-term losses is possible through future monopoly pricing (4) without attracting competitive entry.

The original justification for anti-dumping law was to prevent anti-competitive predation by foreign producers, but many such laws as currently designed and applied instead diminish competition in affected industries and reduce economic welfare.

When such unfair pricing occurs in import trade, the imposition of an anti-dumping tariff that eliminates this predatory component is appropriate. Adoption of such a test in AD law by trading countries would promote efficient international trade relations. Regrettably, however, US law as currently formulated (as well as the laws of other major trading countries) ignores this market-oriented standard, and instead penalises pro-competitive pricing that is found to fall below "fair" market prices overseas. Two US statutes are targeted specifically at "unfair" pricing in import trade: the anti-dumping law and the countervailing duty law, both of which are designed to meet the standard of international trade agreements (the GATT Anti-dumping Agreement and the GATT Subsidies and Countervailing Measures Agreement), to which the US and other major trading countries are parties.^{17,18}

A recent Heritage Foundation paper highlighted the anti-competitive effects of the AD laws in the US.¹⁹ The concerns expressed regarding American AD law apply equally well to the UK, and a reform of AD

law along the lines suggested would yield substantial benefits for the British economy. UK anti-dumping reform along these lines would represent a rejection of crony capitalism and an endorsement of a consumer welfare-based approach to international trade law—an approach that would strengthen the economy and ultimately benefit British consumers and producers alike. It would also reinforce the role of the UK as a leader in international trade liberalisation. Moreover, to the extent that foreign nations adopted the proposed AD reform, UK exporters would directly benefit from the opportunity to compete in foreign markets.

Countervailing Duties

Countervailing duty (CVD) law aims to offset foreign subsidies on imported goods. Ideally calibrated countervailing duties would eliminate government-imposed distortions and thereby promote economic welfare. Nevertheless, according to some scholars, imperfections in application suggest that current CVD laws may actually lower welfare—they “are simply one more arrow in the quiver of import-competing industries that seek protection, and likely have no systematic value in discouraging wasteful subsidy practices.”²⁰ Despite such complaints, CVD laws are well entrenched around the world and widely accepted by the GATT as a “second best” means of discouraging nations from adopting subsidy schemes that distort trade.

There are examples around the world of mechanisms to deal with unfair trade practices, many of which have themselves been quite distortive of international trade. However, some of the measures which have been used in the US and Europe are a starting point for the development of new tools. The US’s trade remedy law in this area is perhaps the most developed, and the one most useful to build on.

Section 337 of the Tariff Act of 1930 (“Section 337”) is the US trade law provision most specifically targeted at anti-competitive business conduct affecting American imports.²¹ Section 337 condemns as illegal imports (1) that violate US intellectual property (IP) rights related to a US industry (including patents, copyrights, trademarks, and certain designs), or (2) that involve “unfair methods of competition and unfair acts” that cause harm to a US industry. The US International Trade Commission (USITC), an independent federal agency, is required to investigate allegations of Section 337 violations and to direct the exclusion of the articles concerned when a violation is found, unless it deems that specified public policy conditions counsel against exclusion. The USITC may also issue “cease and desist” orders in lieu of exclusion orders. The US president may disapprove (“for policy reasons”) a USITC Section 337 exclusion or cease and desist order within 60 days of receiving it from the USITC, but in practice, this right has very seldom been exercised.

In recent decades, almost all Section 337 cases have involved violations of US IP rights, especially patents, rather than non-IP-related conduct.²² Overall, Section 337 does a good job of vindicating the rights of American IP holders, and discourages products that “free ride” on US technology and thereby distort the terms of competition in the affected American product markets. Applied in this manner, Section 337 is consistent with free-trade principles. Nevertheless, the statute could be improved upon at the margins. Targeted statutory changes that addressed current possible limitations on its application to IP infringement schemes could, for instance, make it an even more valuable tool to protect the holders of US IP rights (who may be either American or non-American parties), in a manner consistent with general free-trade principles.²³

Another US relief statute, Section 201 of the Trade Act of 1974 (the US “safeguard law” or the “escape clause”), deserves a brief mention. Section 201 does not require the finding of competition-distorting import practices. Rather, under Section 201,

The USITC determines whether an article is being imported in such increased quantities that it is a substantial cause of serious injury, or threat thereof, to the US industry producing an article like or directly competitive with the imported article. If the Commission makes an affirmative determination, it recommends to the President relief that would prevent or remedy the injury and facilitate industry adjustment to import competition. The President makes the final decision whether to provide relief and the amount of relief.²⁴

In principle, Section 201 is at odds with free-trade principles—as long as competition proceeds on the merits, the fact that imports are preferred by American consumers and thereby injure individual US producers represents the workings of market forces and should not give rise to import limitations. Nevertheless, Section 201 is authorised under the GATT Safeguards Agreement to which the US is a party, which allows nations to establish temporary import limitations to address domestic injury concerns, subject to certain constraints.²⁵ In short, Section 201, like other nations’ analogous import-limiting “safeguard” statutes, represents an internationally recognised concession to mercantilist and protectionist interests. Although repeal of Section 201 and other countries’ safeguard laws would undoubtedly promote global economic welfare, such a broad reform does not appear to be politically feasible in the near term.

Ensuring Proposed Trade Remedy Passes Muster under WTO Rules

WTO rules on anti-dumping and countervailing duties provide certain minimum standards for any countries’ laws that allow for a duty increase over the bound rate. Since part of the remedy proposed would lead to an increase in tariffs over the bound rate, we must evaluate whether this remedy passes muster under WTO rules.

WTO AD rules provide that any AD law must satisfy the following minimum criteria:

1. There must be material injury to the domestic industry;
2. Governments must have processes in place whereby they can show that dumping is taking place, calculate the extent of it, and show the specific material injury to a domestic industry;
3. Specific mechanisms must be in place to calculate the exporter’s home market price, and—if that is not available—the price charged by the exporter in other markets, or a constructed price based on the exporter’s normal production costs, other expenses, and normal profit margins;
4. The AD provisions also lay down basic procedural requirements that any proposed ACMD remedy would have to follow;
5. Cases must end immediately if the margin of dumping is insignificant (less than 2 percent of the export price).²⁶

WTO CVD rules provide that CVD procedures must satisfy the following requirements:

1. Subsidies must be specific to an enterprise, industry, or group of industries in order to be countervailable. There are two kinds of subsidies, prohibited and actionable: prohibited subsidies are always illegal (for example, export subsidies); actionable subsidies are actionable in certain cases where they harm the importing country's interests; and
2. CVD measures in countries must conform with the basic procedural requirements as set out in the WTO AD agreement and must provide that there is a mechanism whereby injury to a domestic industry can be shown.²⁷

The ACMD remedy should comply with these two WTO agreements. In order to do this, one would have to argue that prices below home country market prices or constructed cost will always be found if there is below-cost pricing due to the ACMD. Such below-cost pricing would only be an antitrust violation in cases where the predator had market power. This may not be the case for other distortions, but from a compliance standpoint, the ACMD remedy is less likely to be a violation of either the AD or the CVD agreements than is the case for most countries' trade remedy laws, because the ACMD remedy is cost-rather than price-based. For example, suppose there are two manufacturers in the US who both produce product X, and both sell into the UK at price, P. If one manufacturer benefits from distortions so that its costs are artificially reduced and it can reach price point P because of this, then the remedy would discipline whatever measure caused the cost reduction. If the other manufacturer reached price point P solely because of its own efficiency, the ACMD Tariffication would not apply to it.

The defensive trade remedy tools we have proposed deal with distortions in markets that have an impact on the home country market. These effects are felt most particularly among domestic producers, consumers in the distorting market, and potentially consumers in the home country market as well if the result of the distortions is to cause domestic firms to exit and thus lead to potential price increases in the future.

Domestic producers are also damaged as they seek to access other markets by distortions in those markets. In order to solve this problem, there needs to be a set of offensive tools which can be used to lower the level of distortions in those markets.

The next section examines what these tools may be, in particular with reference to the tools that already exist to deal with similar issues. Our goal is to develop offensive measures which could be included in an international trade remedy agreement.

OFFENSIVE TRADE REMEDIES

State Aid

The European Union has very good prima facie state aid rules which could serve as a model for other nations, but the EU also maintains a broad range of exemptions. The exemptions tend to diminish the benefits of the tool itself. Notably, EU state aid laws deal with government distortions which favour specific undertakings. According to the European Commission, "to be State aid, a measure needs to have these features:

- » There has been an intervention by the State or through State resources which can take a variety of forms (e.g. grants, interest and tax reliefs, guarantees, government holdings of all or part of a company, or providing goods and services on preferential terms, etc.);
- » The intervention gives the recipient an advantage on a selective basis, for example to specific companies or industry sectors, or to companies located in specific regions;
- » Competition has been or may be distorted;
- » The intervention is likely to affect trade between Member States.²⁸

There are exemptions to the state aid rules, including fisheries and agriculture (where state aid controls are governed by the relevant directorates). There are also exemptions for the exercise of public powers (police, army, air and sea navigation, prisons, education, etc.). These are not deemed to be economic activities.

Services in the General Economic Interest (SGEIs) are also subject to exemptions. While the relevant communication from the Commission recognises that SGEIs can be provided by private or public firms or undertakings, it allows member states to determine whether they should be financed by member states.²⁹ One problem is that a state aid can be determined to be illegal only if it is applied to an undertaking. Cross-sectoral aids that are less specific and thus are equally distortive (e.g. aid in support of a particular technology) are outside the scope of the State Aids laws. This is a drawback in the system because there are many cross-sectoral aids that are broadly distortive and wealth destroying. While there are provisions for connected undertakings with common shareholding, the rules should be extended to include sectoral aids that are distortive and apply across a number of firms. The definition of SGEI should also be more tightly drawn so as not to confer a general exemption. Currently, merely stating that a service is in the general economic interest allows the member state to provide financing. The leading case in the matter of public service obligations (PSOs) is the Altmark case, in which the European Court of Justice said that:

for such compensation to escape qualification as State Aid in a particular case, a number of conditions must be satisfied.

— ... First, the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined. ...

— ... Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner, to avoid it conferring an economic advantage which may favour the recipient undertaking over competing undertakings. ... Payment by a Member State of compensation for the loss incurred by an undertaking without the parameters of such compensation having been established beforehand, where it turns out after the event that the operation of certain services in connection with the discharge of public service obligations was not economically viable, therefore constitutes a financial measure which falls within the concept of State aid within the meaning of Article (107(1) of the Treaty).

— ... Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit ...

— ... Fourth, where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant to a public procurement procedure which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.³⁰

While the Altmark conditions play a significant part in clarifying and defining what a PSO is and how it can be funded, it is important to ensure that countries do not use the notion of public service obligation as a way of giving certain privileged companies an edge. The goal is to have a set of disciplines on state aids that automatically generate a level playing field for competition.

The requirement that there must be an effect on inter-member trade for an action to qualify as state aid allows for domestic distortions in which one domestic company is favoured over another. But we submit that even in such a case, where no international trade is involved, a company damaged by such unfair aid should have redress under state aid rules.

Such a set of rules, without the broad exemptions for SGEIs, could be drafted by countries wishing to limit distortions that affect their markets on the basis of EU state aid rules to serve as a disciplinary tool for distortions in foreign markets.

Public Procurement

As public procurement represents 15 to 20 percent of global GDP and is especially prone to cronyism and favouritism, ensuring competition is vital. Public procurement rules can ensure transparency in government purchasing and a level playing field for bidders. The EU's rules on public procurement are a model for this goal and effective in making the European public procurement field more competitive. These rules broadly map the government procurement rules in the WTO. Competition in government procurement can be more easily secured by the application of these rules, which prevent bid rigging and other anti-competitive practices.

Securities

US securities rules are quite specific on disclosures for companies that seek to raise money on US markets. There is an opportunity here for greater transparency over the disclosure of government benefits and privileges. Securities laws could be amended in all countries to reflect the need to disclose the following issues:

1. The amounts of funds received through government grants, low-interest loans, or other privileges either to the company directly or where the company benefits from a government grant or privilege because of industry-wide measures;

2. Any exemptions from laws or regulations granted to a particular company that are not available to others producing goods or services in the same market;
3. Any other reductions in the costs of a firm as a result of government benefits or privileges.

Standards and Technical Barriers to Trade

Standards, sanitary and phytosanitary standards (SPSs)—measures that are put in place to protect animal, plant or human health—and technical barriers to trade (TBTs) represent some of the most dangerous and prolific behind-the-border barriers. Standards restrictions are particularly pernicious for trade in services, while SPSs damage trade in agricultural and fisheries products. We will focus on a region where there are many barriers in this area, the European Union. They are particularly pernicious because laws to protect health are so publicly sensitive, and provide such easy cover for protectionist interests.

Foreign standard-setting bodies and private companies are rarely allowed input into the standard-setting process, and when they are allowed input, they are not allowed to vote.

The process by which standards are set is as important as the standards themselves. The EU's standard-setting process is especially damaging to foreign companies and should be avoided. European Harmonised Standards are regulated by the Committee for Standardisation, the European Committee for Electrotechnical Standardisation, and the European Telecommunications Standards Institute. Foreign standard-setting bodies and private companies are rarely allowed input into the standard-setting process, and when they are allowed input, they are not allowed to vote. This often leaves companies with the choice of either making their products comply with EU standards (even when those standards are not the most up-to-date or internationally recognised practices) or enduring an arduous and expensive exemption application process. The EU also mandates that each member state should have its own accreditation body and that these bodies are not allowed to compete with each other.

An ideal situation would provide for public as well as private input into standard-setting, and would not be limited by nationality or regional affiliation. International standard-setting and accreditation organisations have already produced a large body of work on best practices across all sectors, and it would be reasonable to adopt some, if not all, of their recommendations so as to avoid duplicating the efforts of individual governments. These voluntary standard-setting organisations would generally involve the private companies that produce given products meeting to determine what the standards should be.

It would take hundreds of pages to detail every example of distortive standards within the European Union. Instead, taking a sample of major EU economies, we will provide examples in a number of different sectors, to demonstrate the breadth and depth of these restrictions:

COUNTRY	SECTOR	SPECIFIC RESTRICTION
France	Foodstuffs	Ban on food packaging containing Bisphenol A (BPA), which was deemed safe by the European Food Safety Authority on 21 January, 2015.
Denmark	Education	Condition of nationality for university professors.
Poland	Broadcasting	33 percent of TV broadcasting time each quarter must be reserved for programming originally produced in Polish; more than 50 percent of programming must originate in the EU.
Austria	Professional services	Condition of nationality for admittance to the bar (lawyers) and tax advisers must hold Austrian or EU citizenship to represent clients before the tax authority.
Romania	Pharmaceuticals	The process for approving new (and especially innovative) drugs is arcane, often rendering reimbursement for life-saving medication impossible.

Antitrust

It is worth noting that the US antitrust laws (the Sherman and Clayton Acts) and the US Federal Trade Commission Act apply to imports into the United States, as is made clear by the US Foreign Trade Antitrust Improvements Act. Thus, foreign agreements that involve harm to competition or unfair and deceptive conduct which has an impact on US markets are subject to American legal sanction. Because the US antitrust laws and the Federal Trade Commission Act only condemn conduct that harms consumer welfare and economic efficiency, US enforcement application of these statutes to import trade may be expected to promote free-market trade principles.³²

The range of defensive remedies we have described therefore falls into two categories: those that promote competitive markets by disciplining anti-competitive practices (private, public, or a combination of both); and those that damage the ordinary process of competition by protecting domestic industries from imports at efficient pricing levels.

The remedy that needs to be fashioned to deal with ACMDs should fall into the latter category. We believe that if it does so, it is likely to pass muster under the WTO provisions on anti-dumping and countervailing duties.

CASE STUDY OF GREAT BRITAIN

“Great Britain has lost an empire and not yet found a role.”

Dean Acheson (1962)

Britain’s vote to leave the European Union in June 2016 created the opportunity to shape a new global trading system. In this, Great Britain has perhaps found or re-found its role as a pioneer and beacon of free trade and competition, sitting at the centre of a vast global network of trading relationships and agreements. This new system would tackle many of the behind-the-border issues that we have outlined in this paper and chart a course of expanded global growth. The Brexit vote has created an inflection moment in history in which the stalled global trade agenda could finally be revived through plurilateral and unilateral reform, drawing on global best practices. The reform agenda laid out here could be adopted by any WTO member.

Once the exit negotiating process with the EU has been concluded, the UK will have the opportunity to contemplate a different regulatory system in which it is able to reduce internal ACMDs. In this section, we will examine what both a new UK trade policy and domestic UK regulatory reform might look like across several sectors. This is not an exhaustive list but represents those areas where a different pathway from that currently followed by the EU could bring immediate dividends.

COMPETITION

The new UK government should focus on simpler, clearer rules in competition policy enforcement, particularly as regards single-firm conduct. It should seek to avoid second-guessing innovative and novel contractual arrangements by high-tech firms, that may be key to innovation which leapfrogs existing technologies and economic growth. In an increasingly globalised economy, the risk of single-firm monopoly exploitation, in the absence of government-imposed entry barriers and trade protections, is increasingly small. The US approach (which may be in flux) of allowing substantial leeway for powerful single firms—for example, Google, Amazon, and Facebook—has allowed entrepreneurship to flourish and established the US as the undisputed leader in the global information economy. Attempts to micro-manage single-firm practices, as witnessed in the European Commission (as well as in Korea, Japan, China, and India) have not promoted strong global information economy/Internet-enabled firms. On the contrary, government micro-management by the EC’s Competition Directorate and by continental European countries (such as Germany and France) has encouraged weaker competitors to run to the government to obtain restraints on more successful/efficient competitors—in effect, a sort of innovation tax. The results have been disappointing for consumer welfare, economic growth, and innovation in Europe. More generally, a competition law policy that focuses on “decision theory” and clear rules that minimise error costs is likely to yield the best results for the domestic economy.



PROMULGATION OF NEW LAWS AND REGULATIONS

Following exit from the EU, the UK can embrace a regulatory promulgation process in which competition on the merits is the organising principle for regulatory reform. The test of such a regulatory promulgation process should be the impact of a proposal on (1) the individual product market, (2) the British market as a whole, and (3) consumer welfare. Regulation should only be undertaken in ways that minimise the market impact, consistent with the regulatory goal. This would be a better regulatory promulgation process than any other country currently has (most countries, if they do this at all, focus on business compliance cost).

Outside the EU, the UK could eliminate the precautionary principle as a basis for regulation. Currently the EU regulates on the basis of the precautionary principle, which provides that where there is any risk for a new product, it must be regulated. This principle forms one of the pillars of European regulation and, on the surface, seems to be a good measure for protecting consumers. However, the precautionary

Above: Brexit results on BBC news site. 24 June 2016.

principle is very counter-innovative and stymies economic activity. It conflicts with WTO rules in the TBT (technical barriers to trade) agreement which require laws and regulations to be based on sound science.

Instead, many countries have adopted cost-benefit analysis in the promulgation of regulation. Usually, “costs” mean the business compliance cost with respect to the new regulation. In the US, Circular A-4, published in 2003, was designed “to assist analysts in the regulatory agencies by defining good regulatory analysis—called either ‘regulatory analysis’ or ‘analysis’ for brevity—and standardising the way benefits and costs of Federal regulatory actions are measured and reported”.³³ It clearly and helpfully lays out the basis of any regulatory analysis:

To evaluate properly the benefits and costs of regulations and their alternatives, you will need to do the following:

- » Explain how the actions required by the rule are linked to the expected benefits. For example, indicate how additional safety equipment will reduce safety risks. A similar analysis should be done for each of the alternatives;
- » Identify a baseline. Benefits and costs are defined in comparison with a clearly stated alternative. This normally will be a “no action” baseline: what the world will be like if the proposed rule is not adopted. Comparisons to a “next best” alternative are also especially useful;
- » Identify the expected undesirable side-effects and ancillary benefits of the proposed regulatory action and the alternatives. These should be added to the direct benefits and costs as appropriate.

This circular can be taken as a model of how to design a sound regulatory promulgation process for a nation or region of any size. A recent Obama administration regulation provides that the impact of regulation on international markets should be taken into consideration in the regulatory promulgation process.³⁴ Much of this, however, is the impact of regulation on international trade and not necessarily on markets. The UK has an opportunity to shift thinking from producer to consumer welfare by focusing on the actual impact of these issues on markets and individuals.

In addition, specific sectors can be addressed, some of which we discuss below.

Energy

The high cost of energy in the UK can be attributed to a number of different factors including a lack of competition in the energy sector. The Competition and Markets Authority (CMA) in the UK is currently looking into potential anti-competitive practices in this sector. UK energy regulation, especially with respect to fossil fuels, is cumbersome and renders UK firms less competitive in the global market.

Carbon Price Floor

Schedule 6 to the Finance Act of 2000 and the various Climate Change Levy regulations (of 2001 and 2013) set a carbon price floor in Britain. The carbon price floor is an excise tax designed to reduce the usage of fossil fuels and to provide additional revenue to the British government. It works by levying a tax or applying a duty on energy generators who use fossil fuels and certain fuel oils (specifically, coal, solid fossil fuels, “gas of a kind supplied by a gas utility”, and liquefied petroleum gas). The levy depends on the product and increases over time. Levies available through to the end of March 2019 are as follows:

CPS RATE COMMODITY	GAS	LPG	COAL AND OTHER SOLID FOSSIL FUELS
Unit	£ per kilowatt hour (kWh)	£ per kilogram (kg)	£ per gigajoule (GJ) on gross calorific value (GCV)
1 April, 2015 to 31 March, 2016	0.00334	0.05307	1.56860
1 April, 2016 to 31 March, 2019	0.00331	0.05280	1.54790

In addition to the market disequilibrium price which the levy creates, exemptions built into the relevant regulation have a distortive effect on the energy market as a whole. Small generators, Northern Irish generators, and generators fitted with carbon capture and storage technology are granted exemptions or abatements from the levy.

As a result of these regulations, the UK carbon price floor rate is roughly £18 per tonne. In the US, fossil fuels and carbon emissions are taxed on a state-by-state basis and generally limited. Even in California, where fossil fuels are heavily taxed, the carbon price varies between \$10 and \$15, well above the national average of \$2–3. The UK price floor therefore operates like a carbon tax, and one that makes electricity generated from fossil fuels much more expensive than in other comparable countries. Given that it is unrealistic to try and produce all energy from non-fossil fuels in a reasonable timeframe, this increase in overall energy costs damages UK business competitiveness and harms the poor.

Lowering energy costs should be a priority for any economy, as the poor are disproportionately affected by high energy prices. Energy costs also feed into all other industries (notably manufacturing, but also services), and energy prices as disproportionately high as Britain's make it much more difficult for firms to compete, even in Europe. We will examine this and other lifeblood industries (including aviation and logistics) in greater depth in subsequent publications.

Financial Services Regulation

The UK will maintain financial services regulation equivalent to that of the EU (through MiFiD II) through to the end of its exit negotiations. At that point, Britain will have to choose between easy access to European financial markets or a more pro-competitive regulatory system. This will largely depend on where the savings and capital pools are located. If European savings and capital pools are shrinking and Asian capital pools are increasing in size, then the City of London's future will depend on its ability to attract these Asian pools. In this case, it may well be that restrictive EU and US regulation creates a window of opportunity for the City of London. Lower capital adequacy requirements and less onerous compliance rules would lower the barriers to entry in the financial services sector, thereby increasing consumer choice and welfare.

UK Negotiation with the WTO

The UK will have an unprecedented opportunity to renegotiate its WTO schedule. Given that its current schedule was negotiated by the EU in common with other member states, there are a number of areas where the UK could be in a position to strike a better deal with the WTO.

Outside the EU's common external tariff, the UK could offer a better tariff deal in agriculture than the EU currently does, as we will outline in the "Revitalisation of the Commonwealth" section below.

The EU services offer, which has not been amended since 1994, contains a limited amount of services liberalisation. It contains a number of exemptions to the fundamental WTO principles of most favoured nation and national treatment. These include exemptions for the audio-visual sectors. There are exemptions for road transport (passenger and freight), road transport services, sales and marketing of air transport services, internal waterways transport, rental and leasing services, publishing, news agency services, press agency services, direct non-life insurance, certain financial services, Nordic co-operation activities, and others. The UK's services offer to WTO members could be much more liberalising.

UK Negotiation with the EU

We recommend that the UK negotiate as a sovereign nation with the UE and the European Free Trade Association (EFTA). There should be a withdrawal agreement, and then a free-trade agreement (FTA) with the EU. This will be different from the so-called EFTA option because the UK will be negotiating a modern FTA with the EU, which will include not only the tariff deal but also specific measures that prevent the EU from allowing access but not contestability. In terms of the elimination of ACMDs, such an agreement would go beyond the Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU, and the Transatlantic Trade and Investment Partnership (TTIP) between the US and the EU.

We discuss and rule out other options as follows.

EEA Option

The UK could seek to be part of the European Economic Area (EEA). Such an arrangement would preclude it from negotiating trade agreements with third countries as it would not be negotiating as a sovereign state. An attempt to remain in the EEA in some form would likely come with an immovable demand for free movement of persons and a large budgetary contribution. It would be similar to the current situation, except that the UK would become a taker, not a maker, of EEA rules. This option has a lot of downside and not much upside.

EFTA Option

The UK could join EFTA in order to ensure access to the EFTA countries themselves. While the UK could negotiate separate trade deals as an EFTA member (along the lines of the FTAs between Switzerland and China, and Iceland and China, for instance), the downside would be that it would be a taker, not a maker, of EEA regulation because of EFTA's unique relationship with the EEA. It should be noted that many EFTA agreements with third countries are quite basic (Canada–EFTA is goods only, and the Swiss–China deal is very one-sided, as China gets immediate tariff access on 99.7 percent of goods, while the Swiss have to wait 15 years for access). EFTA agreements tend not to deal with real regulatory barriers and behind-the-border trade issues such as standards, which particularly affect the UK. There are two EFTA models: Norway, Liechtenstein, and Iceland are EFTA members which have taken on all EEA internal rules and regulations—they cannot therefore vary their domestic regulation from EEA law; Switzerland, on the other hand, takes on EEA rules as part of a series of bilateral agreements.

FTA Plus with the EU

Finally, the UK could negotiate an agreement with the EU just as any sovereign state does (for example, EU–Mexico, EU–Korea, and so forth). Ironically, Britain may be able to get a better deal with the EU than the EFTA countries do through the EEA. This is because EFTA countries have limited services access, and services access would be front and centre of any UK–EU agreement. This agreement would have to include much more than just tariffs on goods—it would have to include comprehensive schedules in services, domestic regulation, and financial services access for the City of London. Under GATS Article V, no services sector can be excluded from coverage for an FTA to pass muster under Article XXIV of GATT 1947. Given that there will be a financial services deal, it should simply allow maximum coverage—all four modes under GATS with no exemptions to most favoured nation (MFN) and national treatment. In the event that MiFID II is no longer the common financial services regulation, a deal will also have to be struck on financial services passporting for UK-based firms.

Given the UK's preponderance of services trade—roughly 80 percent of all exports—the UK is particularly interested in the trade barriers that prevent services access and contestability. Services are disproportionately affected by regulatory barriers, which are pernicious because they often deal with issues that appear at first blush not to be germane to the commercial interest of the complaining country. All four modes under GATS should be extended to trade in services as well.

CETA has been proposed as a basis for such a negotiation, and we would only note that this and the framework of TTIP represent the base floor of what is needed. Because of the UK's unique position, it should be able to get an even more comprehensive agreement with the EU than CETA and TTIP (both of which, at the time of writing, look to be in difficulty).

Revitalisation of the Commonwealth

There is a possibility that the Brexit vote gives an opportunity for the UK to lead the Commonwealth into a more vibrant era. This could start with a revision of the EU Economic Partnership Agreements (EPAs), allowing agricultural access on more favourable terms for developing country producers and putting an end to tariff escalation (the practice whereby raw materials from predominantly farmers from poor countries have a lower entry tariff than more processed products). One example of tariff escalation relates to Ghanaian cocoa beans and chocolate production. The current EU tariff rate for cocoa beans is 0 percent, but chocolate slabs from Ghana have an entry tariff at the Generalized System of Preferences (GSP) rate of 4.8 percent. This rate could go up to the normal rate of roughly 40 percent if Ghana lost its GSP preferences, which can happen quite rapidly as a consequence of changed political or economic circumstances. Ending or substantially reducing the UK's domestic agricultural subsidies programme would also serve to bolster Commonwealth ties while reducing food prices for UK consumers.

All of this is contingent on the UK moving from the production-subsidy or land based payment system to a more focused and tightly drawn transfer payment system for UK farmers that gives them the benefit of direct payments to solve particular problems such as environmental remediation and the like.

TOWARDS A PROSPERITY-ENHANCING PARTNERSHIP

The measures put forward below can together be described as a Prosperity-Enhancing Partnership (PEP). Such a PEP would consist of a number of measures all designed to ultimately improve global prosperity. It recognises that not all countries fully embrace open trade, competition on the merits, and property rights protection. For those that do, a more deeply integrative agreement is possible. Others may accede to their arrangements over time, but for large markets bilateral agreements with this smaller core of countries is possible and may lead to greater reform for those other countries (in the same way that NAFTA acted as a powerful reform document for Mexico). The diagram on page 27 shows these different arrangements in concentric circles, with those with the greater potential for wealth creation nearer the centre. Countries could be moved from the outer circles to the inner ones as they are able to make more of the internal structural changes that constitute the preconditions for joining more advanced agreements.

A PROPOSAL FOR AN ANTI-DISTORTIONS AGREEMENT

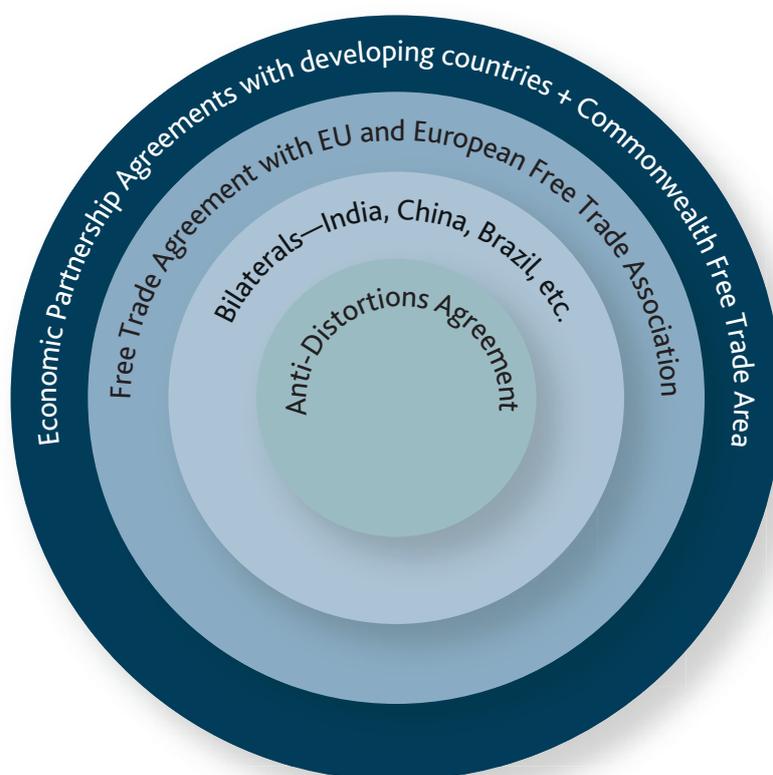
An anti-distortions agreement (ADA) would be an agreement among countries that are disposed to accept the foundational pillars of classical liberalism—property rights protection, open trade at the border, and competition on the merits inside the border. These countries could agree among themselves a set of rules that optimised their respective environments and broke down barriers to trade. The ADA would also incorporate rules that dealt with third-country issues, including distortions in other markets that have a negative impact on firm activity inside the zone. Some of these rules could be drawn from the defensive measures referred to above.

Once its Article 50 treaty negotiations are concluded, Britain will be able to commence negotiations with other countries. This could include a number of elements:

1. Initiating negotiations with the US, Australia, Canada, Singapore, New Zealand, and possibly Switzerland, as part of the ADA;
2. Negotiating bilateral agreements with large markets which would be prepared to accept more traditional trade agreements but not the reduction of distortions that underpins the ADA;
3. Moving gradually towards a Commonwealth Free Trade Zone (on the assumption that the UK is not subject to the Common Agricultural Policy/Common Fisheries Policy), starting with an upgrading of the EPAs into more equal agreements. Currently EU EPAs allow limited access for developing-country agricultural producers.

The key elements of the ADA will include optimisation across the dimensions of open trade, competition on the merits, and property rights protection. Key provisions will include:

- » Reduction of tariffs to zero within the ADA area;
- » Provisions to reduce ACMDs;
- » Provisions to tariffy identified ACMDs within the zone with a mechanism to ensure their reduction (as discussed above);



- » Provisions to determine how laws and regulations are promulgated in ADA countries such that any new law/regulation is subjected to a cost-benefit analysis, where the cost is the impact on the market of the law/regulation (the goal being to ensure that any new laws or regulations are the least distortive possible consistent with the regulatory goal);
- » Upgrading of securities laws in ADA members requiring any companies raising money from investors to declare any privileges or benefits they receive from their government;
- » Strong investor-protection provisions that cover not only expropriations, but also actions tantamount to expropriation, and critically regulatory takings with investor-state dispute-settlement mechanisms in international arbitration;
- » The empowerment of domestic competition agencies to engage with other government departments on regulations and laws that are ACMDs, giving them the authority to advise governments to remove the offending laws and

Above: Prosperity-Enhancing Partnership

regulations (this could be set up under a modified version of the UK's Deregulation and Contracting Out Act, 1994);

- » Elimination of geographical indication protections;
- » Elimination of genetically modified organism (GMO) and beef hormone bans—all technical barriers and measures to protect health and safety to be based on sound science;
- » Provision of higher level of agricultural access across ADA region.

Potential Economic Impact of ADA

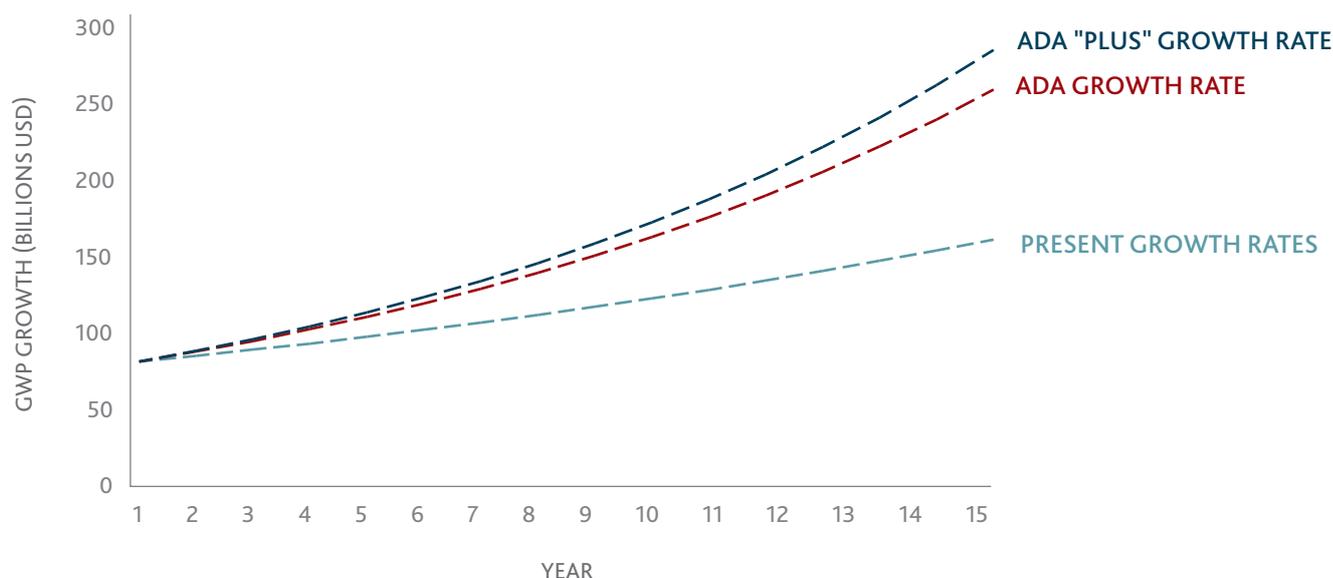
Within the ADA region, the potential GDP gains stand at 626 percent if all trade barriers and market distortions are eliminated. Naturally, this is an aspirational goal that is well beyond what is realisable in real life. However, it does show the magnitude of what is at stake and what the ceiling is for wealth creation potential. Even if a small fraction of this potential gain is actually realised as a result of the ADA, the benefit to the global economy is massive. It is nothing short of creating a growth engine for the world.

These gains were found using our Productivity Simulator, which models the gains to productivity at the country level when ACMDs are eliminated. The simulator leverages our Distortions Index (DI)—a tool which measures the level of ACMDs in property rights protection, domestic competition, and international competition in a country. The DI provides a score for each country which represents how close that country is to having an idealised pro-competitive environment in each category.³⁵

Each country receives a score for property rights protection, domestic competition, and international competition. Each score is equal to a weighted average value of a set of subcategories, and these subcategories are themselves equal to the weighted average value of a set of variables representing various economic policies.

The results from applying the simulator to an initial group of potential ADA countries are as follows:

COUNTRY	Distortions Index Scores (out of 6)			Current GDP (bn)	Fully Undistorted (bn)	GDP Growth (%)
	Current Property Rights	Current Domestic	Current International			
Australia	4.67	4.17	4.66	1,585	8,926	463
Canada	4.74	4.45	4.63	1,872	10,379	454
Hong Kong SAR ³⁶	4.9	4.7	5.51	271	819	202
New Zealand	5.19	4.66	5.24	177	502	184
Singapore	5.12	4.83	5.47	285	754	164
Switzerland	4.49	4.52	4.58	673	4,636	589
United Kingdom	4.84	4.47	5.15	2,683	10,356	286
United States	4.37	4.29	4.73	16,741	112,482	572
TOTAL				24.287	148,854	513



The countries listed above currently account for around 30 percent of the total Gross World Product (GWP). The Productivity Simulator suggests that 30 percent of GWP could increase by around 600 percent if all distortions were eliminated. This change would take time, during which overall GWP would itself increase. Assuming a 15-year horizon, during which, according to most forecasts, there would be a 100 percent increase in GWP, GWP becomes \$160 trillion. Meanwhile, under our scenario, 70 percent of GWP increases at a 100 percent rate (\$110 trillion), while the remaining 30 percent grows to \$149 trillion, delivering a total GWP of \$259 trillion, i.e., a 62 percent increase over what the world would look like without the ADA. Assuming compound interest, this means that a fully undistorted scenario delivers a year-on-year difference in GWP growth of 3.4 percent for each of the 15 years. Thus, putting the countries on a track to reduce distortions through the ADA equates to a 3 percent difference in GWP growth year on year for 15 years. Even if we assume the ADA delivers only one third of the reduction in distortions noted, this will still translate into a 1 percent difference in GWP growth rate per year. This is akin to injecting \$2.7 trillion into the global economy in year 1, and then following the chart above.

Above: Year-on-year GWP growth rate under different scenarios (in billions USD)

The chart shows what might be accomplished in the global economy with a reduction of distortions to zero in a 15-year period. Our contention is that the ADA countries are uniquely placed to achieve this reduction of distortions because they are all committed to the concept of open trade, competition on the merits as an organising principle for the economy, and property rights protection.

But the ADA is not intended to be a closed agreement. It is intended to welcome other trading partners if they share the commitment to open trade, competitive markets, and property rights protection. So, if we start adding other potential partners who happen to be closer to the ideals expressed above (Chile and Mexico), we see even greater impacts in an ADA "Plus" scenario:

COUNTRY	Distortions Index Scores (out of 6)			Current GDP (bn)	Fully Undistorted (bn)	GDP Growth (%)
	Current Property Rights	Current Domestic	Current International			
Australia	4.67	4.17	4.66	1,585	8,926	463
Canada	4.74	4.45	4.63	1,872	10,379	454
Chile	3.39	4.13	4.9	269	3,210	1,093
Hong Kong SAR	4.9	4.7	5.51	271	819	202
Mexico	3.08	4.32	4.42	114	22,200	1,843
New Zealand	5.19	4.66	5.24	177	502	184
Singapore	5.12	4.83	5.47	285	754	164
Switzerland	4.49	4.52	4.58	673	4,636	589
United Kingdom	4.84	4.47	5.15	2,683	10,356	286
United States	4.37	4.29	4.73	16,741	112,482	572
TOTAL				24,670	174,264	606

The potential gains from applying this framework are substantial. If governments fail to remove these ACMDs, they stand in the way of the economic transformation that would otherwise occur, and they harm their own people.

To the extent that these tools actually lead to a reduction in trade barriers and market distortions, the increased productivity that can be generated is significant. On a global basis, reduction of distortions, or optimisation around open trade, competition, and property rights protection, could lead to a 1,100 percent GDP increase. Set against many economists' projections for the global economy of 150 percent or so GDP growth out to 2030, we can see the tremendous amount that is at stake, and the potential gains that are achievable. Given this potential, it is imperative that policy-makers around the world capitalise on this unique moment to deliver the staggering wealth creation possible for mankind.

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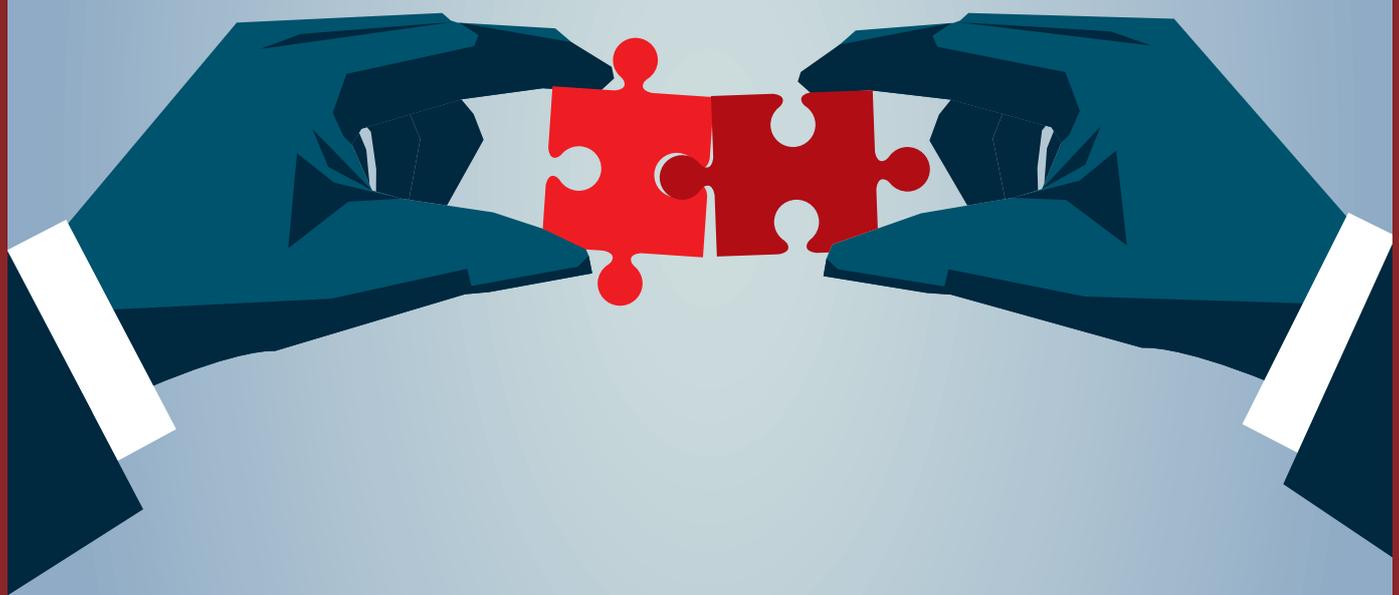
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