

# A Plea for Free Trade

Rational arguments for an  
emotionally conducted debate



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emotionally conducted debate

## Imprint

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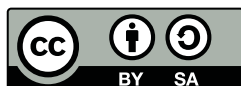
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## At a glance:

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The anthology *A Plea for Free Trade* offers solid facts and aims to add objectiveness to the emotional debate on globalisation.

The publication shows:

- › free trade strengthens the prosperity of all population groups in every participating country.
- › It increases labour protection and transparency, especially in poor nations.
- › In regard to climate protection, it is – in equal measure – part of the problem and the solution.

In the first chapter, “Freedom increases prosperity – all over the world”, Prof. Luca Rebeggiani shows the clear correlation between the liberalisation of economies and their prosperity. He demonstrates that this applies in particular to poor countries and low-income groups.

He states as his central arguments:

- › Globalisation and free trade precipitate an enormous increase in efficiency and hence greater welfare for the majority of people on Earth. The living conditions of broad swathes of society in many once desperately poor countries that have opened up to free trade since 1950 have experienced unprecedented improvement.
- › But not every section of society has benefited equally from the increase in prosperity induced by free trade. Free trade lacks the ability to compensate for regulatory deficiencies on the ground.
- › The way forward: to defend the principle of free trade against neo-mercantilist tendencies from the political left and right, while strengthening the regulatory competence of nation states and multilateral organisations.

Prof. Heribert Dieter uses the second chapter to illustrate that free trade needs rules. It demonstrates lucidly that strong rules vastly enhance the benefits of globalisation and that weaker actors benefit from these rules in particular.

- › Liberal trade policies can only help to foster peace if they do not result in excessive asymmetries. Clear rules on this exist within the EU, but more strenuous efforts are needed in this regard at global level.
- › International division of labour is beneficial in almost all cases, but requires political measures to correct unwanted trends. These include, first and foremost, opportunities for the unemployed to access the job market, incentives to improve vocational qualifications, redistribution of market incomes through taxes and social benefits and the elimination of encrusted economic structures.

In the third chapter, Prof. Galina Kolev investigates the question of whether free trade harms the environment. She comes to the conclusion that this clear correlation does not exist, although it is often axiomatically assumed in the public debate.

- › The data and a review of the relevant literature suggest that a link between the increase in international trade and global greenhouse gas emissions is far from clear.
- › Trade policy instruments, international trade flows and trade policies themselves can offset CO<sub>2</sub> emissions and contribute positively to a transformation of climate policy – but only as accompanying measures.
- › Nonetheless, the onus for resolving this global issue is on climate policy itself. It possesses effective instruments to quantify in monetary terms the negative implications of climate change and hence to deliver the most auspicious solution to the problem at hand.

In the fourth chapter, Dr Axel Berger shows that attempting to define rules for sustainability or social standards within the framework of trade partnerships does work.

- › Environmental and sustainability clauses have become integral elements in modern trade agreements. More recent empirical research demonstrates that interweaving trade and sustainability policies in this way has a positive effect on environmental and social standards in partner countries and also does not inhibit the positive effect of free trade agreements on trade flows.
- › Trade agreements with environmental and sustainability clauses can act as an important building block for international sustainability policies. It is important to note nevertheless that their direct effectiveness is by no means guaranteed and that changes towards greater sustainability require a broad-based strategy and support measures from other sectors.

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# Introduction

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*Jan Cernicky*

An astonishing trend has emerged over recent years: although prosperity and financial security are at an all-time high in Germany, many people are turning their backs on one of the principal causes: free trade.

There is no doubt that foreign trade has made an immense contribution to Germany's economic success story. Since 1960, German foreign trade has increased about fifty-fold from around €46 billion to €2.5 trillion. The standard of living for people in Germany has improved significantly during this time. Germany's greater integration within global trade is not the only reason for this development, although it is doubtless a key factor.

For instance, a quarter of German jobs and as many as half in the industrial sector depend directly or indirectly on foreign trade. As a result, Germany now has a record number of people in gainful employment that is subject to social insurance contributions. The global division of labour precipitated by trade has led to a specialisation in the German economy, which itself has increased general productivity and reduced working hours to a historically low level. At the same time, average net income is higher than ever before. A fact that is often overlooked: ultimately, the benefits acquired from free trade positively impact the economic opportunities of all citizens, including those who work in sectors that feel the pinch of globalisation. After all, tax revenues are also higher than ever. This places the state in a position to afford ambitious social policies and to initiate redistribution policies to mitigate income inequality. The quota of persons at risk of poverty has been around 15 per cent for a good decade. Only once before in history has it been lower: at the end of the 'Economic Miracle' in the mid-1970s.

Germans have never had it this good in regard to quality of life, health and security: average life expectancy is around 15 years higher than in 1960, and air and water have never been this clean since the advent of the industrial age. According to police crime statistics, the number of offences is also lower than at any time since 1980, whereby the comparability of earlier periods is questionable. Citizens are able to afford better and safer products. For instance, the number of traffic fatalities is at its lowest level since the introduction of records and is currently at around one third of the 1960 values.

Yet despite this correlation – which is rigorously proven in this publication – a broad coalition of lobby groups and sections of society continue to resist attempts to deepen free trade. For the time being, this has prevented the important free trade agreements with the USA (TTIP 2015) or the MERCOSUR trade bloc (2020). This vague hostility to globalisation has left even deeper marks in other countries of the western world. Their most visible manifestations were clear in certain developments related to Brexit and Donald Trump's election as US president in 2016.



The causes of this scepticism towards free trade in particular and globalisation in general are complex and not based entirely on rational arguments. Nevertheless, it feeds on a set of arguments that are repeatedly put forward and which certainly permit examination on a factual basis:

- › Free trade benefits only a few rich people and otherwise lowers prosperity among the vast majority of the population.
- › Free trade is particularly deleterious for poor countries and their impoverished citizens.
- › It contributes to an erosion of human rights and labour protection mechanisms around the world.
- › It leads to an exodus of industrial businesses and hence destroys jobs in industrialised nations.
- › It is bad for the climate.

This publication will demonstrate that not only are these arguments fallacious, the opposite is actually true in many cases:

- › Free trade strengthens the prosperity of all population groups in every participating country, albeit to different degrees and not always at the same time.
- › It increases labour protection and transparency, especially in developing countries.
- › In regard to climate protection, it is – in equal measure – part of the problem and the solution.

However, it is equally evident that the benefits of free trade are particularly noticeable when it is embedded in a stable framework comprising clear and robust rules.

In the first chapter, “Freedom increases prosperity – all over the world”, Prof. Luca Rebeggiani maps the clear correlation between the liberalisation of national economies and their growth. Ricardo’s old maxim still applies, whereby both partners benefit from trade, even if one of them is significantly more competitive. Trade is, after all, not a zero-sum game in which one party can only generate profits if they are taken away from the other. Quite the contrary, the cake actually becomes larger and both parties receive a bigger slice. Rebeggiani also demonstrates that the poorest members of society are benefiting from the increased prosperity, namely because they are not becoming poorer. The opposite is true: the number of destitute people living on our planet is at an all-time low, while working conditions have improved significantly at the same time, especially in developing countries! Among the reasons for this is that the free western media are interested in these issues and are therefore bringing a hitherto unseen transparency to developing countries with little media freedom. Even the counterargument that this trend has been fuelled by cutting jobs in traditionally industrialised countries is only true in some cases. Germany has performed well in absorbing the losses in “old” industrial sectors and has more than just compensated this by creating better-paid jobs. This is evidenced clearly by the trends in unemployment figures. Workers who have nevertheless been unable to find a new job are at least cushioned by a well-evolved social welfare system.

Anglo-Saxon countries with a less developed welfare state have not adapted to this transformation quite so well. It becomes clear that controlling free trade and its ramifications can certainly be advantageous: free trade needs rules. Prof. Heribert Dieter illuminates this aspect in the second chapter entitled “The economic and social benefits of a liberal trade order”. It demonstrates lucidly that strong rules vastly enhance the benefits of globalisation. This applies just as much at international level, where, for instance, rules-based free trade helps to keep peace and reduce poverty. At the same time, robust rules – in the WTO, for instance – are also needed to ensure that powerful countries do not take advantage of weaker nations. The WTO crisis is creating difficulties for the rules-based multilateral trade order, which is primarily to the detriment of less strong economies.

Prof. Galina Kolev uses the third chapter on “Free trade and climate protection” to investigate the issue of whether free trade harms the environment. She comes to the conclusion that this clear correlation does not exist, although it is often axiomatically assumed in the public debate. For example, she shows that although an expansion of transport and production is increasing the volume of greenhouse gas emissions, changes in production processes and supply chains and, above all, improved access to technology can increasingly compensate for this effect. The correlation between the degree of an economy’s liberalisation and falling CO<sub>2</sub> emissions in production, for instance, is surprisingly clear. Clear rules such as the efficient pricing of emissions enable the creation of free trade structures in which production relocates to where it causes the lowest greenhouse gas emissions. It follows, therefore, that clear rules would provide a tool kit to amplify the positive effect of free trade in this area as well.

The extension of trade benefits can also promote the introduction of an emission trading system or the enforcement of minimum labour protection standards. Trade powers such as the EU or the United States are attempting this by incorporating sustainability chapters in their free trade agreements. In the fourth chapter entitled “Sustainability chapters in EU free trade agreements; motivation, structure and impacts”, Dr Axel Berger shows that attempting to define set rules through trade partnerships does work. This has been particularly successful over the last decade in regard to regulations in the areas of labour protection and environmental protection. Berger proves that the much maligned sustainability chapters do not pay lip service. By no means do they ensure by themselves that, for example, a marginally democratic governments in developing countries adhere unconditionally to human rights and environmental standards, but they show significant influence in this respect.

The publication repeatedly reveals that clear and robust rules further increase the benefits of free trade substantially. This might also be perceived as a political duty: anyone seeking to safeguard prosperity, fight poverty and save the climate is called upon to participate in the debate on how to shape these rules. This is especially true now that a window for negotiations on global rules may open under the new US President Biden.

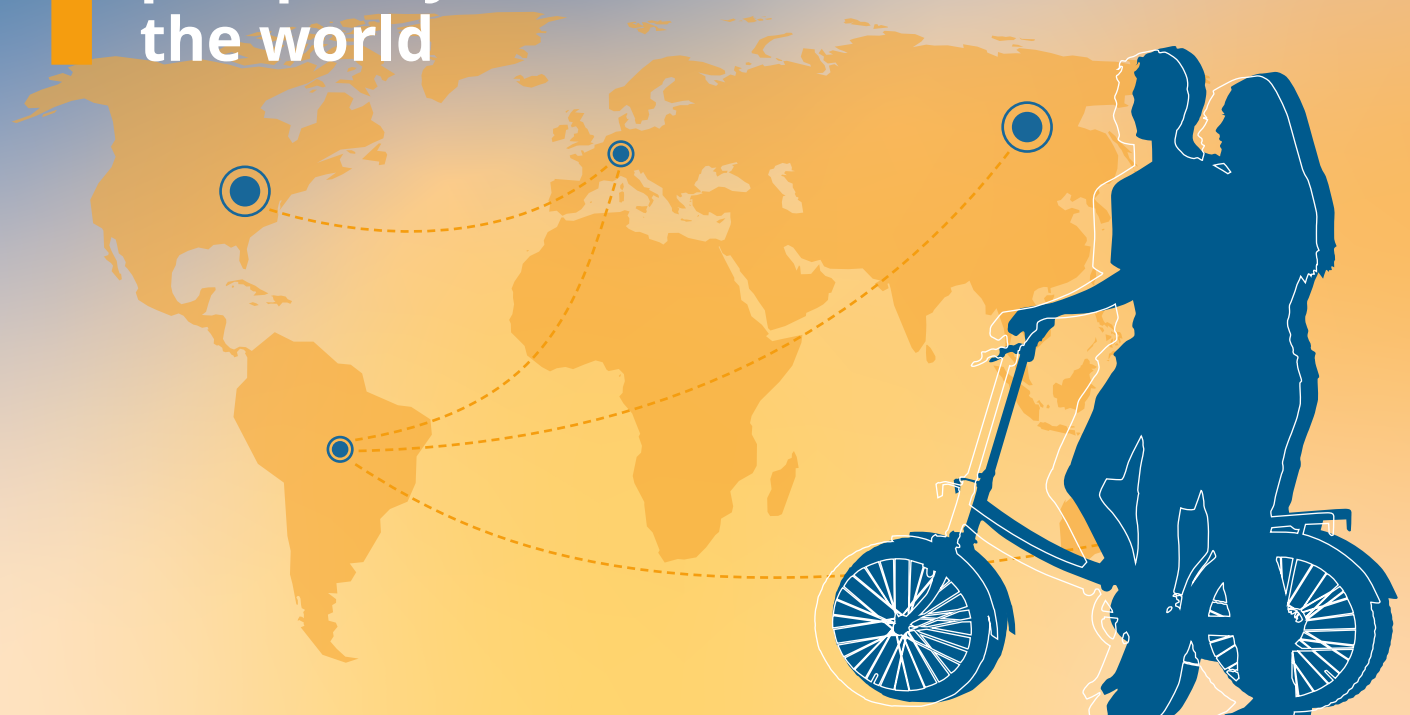
Finally, it becomes obvious that the benefits of free trade clearly outweigh its disadvantages in all of the examined dimensions. Trade is self-evidently unable to resolve existing problems alone: the modern world is complex and – as is the case everywhere – only a confluence of different approaches are able to deal with current issues.

It is important in this regard to use unequivocally proven facts in response to the blunt simplification of zero-sum game arguments that divide the world into winners and losers.

This publication is designed to be read in one go. The chapters build on each other in that the more general questions are addressed at the beginning, before proceeding to the more specific questions they provoke towards the end.

With its commitment to the social market economy, the Konrad-Adenauer-Stiftung perceives this publication as a means of injecting objectivity into the debate on “globalisation”. We cordially invite anyone interested to engage in the frank and controversial debate on this issue.

# 1 Free trade increases prosperity – all over the world



*Luca Rebeggiani*

## 1.1 Introduction

Public perception of the economic impact of international trade has undergone an astonishing evolution in most western countries: Around the turn of the millennium, the euphoria of the 1980s and 1990s about increasing convergence between the world's economies and the long-awaited inclusion of once communist states in this economic community (Antràs, 2020) has made way for a general scepticism and in many cases downright rejection of what is known as globalisation. This scepticism initially pervaded politically left-wing communities, which organised loud demonstrations against the G8 Summit in Seattle (1999) or Genoa (2001) and other actions. But it gradually spread to the centre of society, where an undertone of criticising free trade and globalisation has since become a generally accepted pattern of argumentation. In Germany, hundreds of thousands of people with a broad range of social backgrounds and political persuasions took part in the demonstrations against the free trade agreements TTIP and CETA in 2016. Remarkably, the loudest voice against free trade and globalisation in recent years has been raised by the political right, which has made headlines with sensational actions such as the United Kingdom's withdrawal from the European Union and the decidedly protectionist course of US President Donald Trump (in office 2017–2021). It appears almost as if the remaining proponents of free trade – heckled from left and right – have been almost sidelined in the public debate.

An exaggeration of risks associated with free trade and widespread ignorance of the benefits it entails are characteristic elements of this now familiar “critical undertone”. It is now accepted almost without question, although the majority of current entre-

preneurs would barely be able to think or act in anything other than a globalised world. And despite the preoccupation with detailed issues, barely any voices remain within economic research that favour protectionism and trade barriers (Poole, 2004). And finally, today's younger generations of "Millennials" and "Generation Z" enjoy the historically unprecedented benefits of a world without barriers to trade or travel and now take them for granted.

This paper investigates the astonishing discrepancy between the media and political debate and the preferences revealed within societal reality, which in most cases reveal a decidedly positive attitude towards free trade. The discussion will therefore be guided by some of the most important media stereotypes on the topic, e.g. that free trade exclusively benefits the rich Global North (chapter 3) or only favours the elites of a country (chapter 4). It then briefly touches on the labour markets and examines whether free trade is "to blame" for unemployment in advanced countries (chapter 5) or can be held responsible for the disregard of labour protection (chapter 6). These stereotypes are commented on and juxtaposed with the findings of research and simple statistical analyses. The paper's aim is to demonstrate that free trade belongs to the factors that have made our prosperity possible, although it requires regulation so that as many as possible can participate in welfare gains.

## 1.2 Free trade changes the world

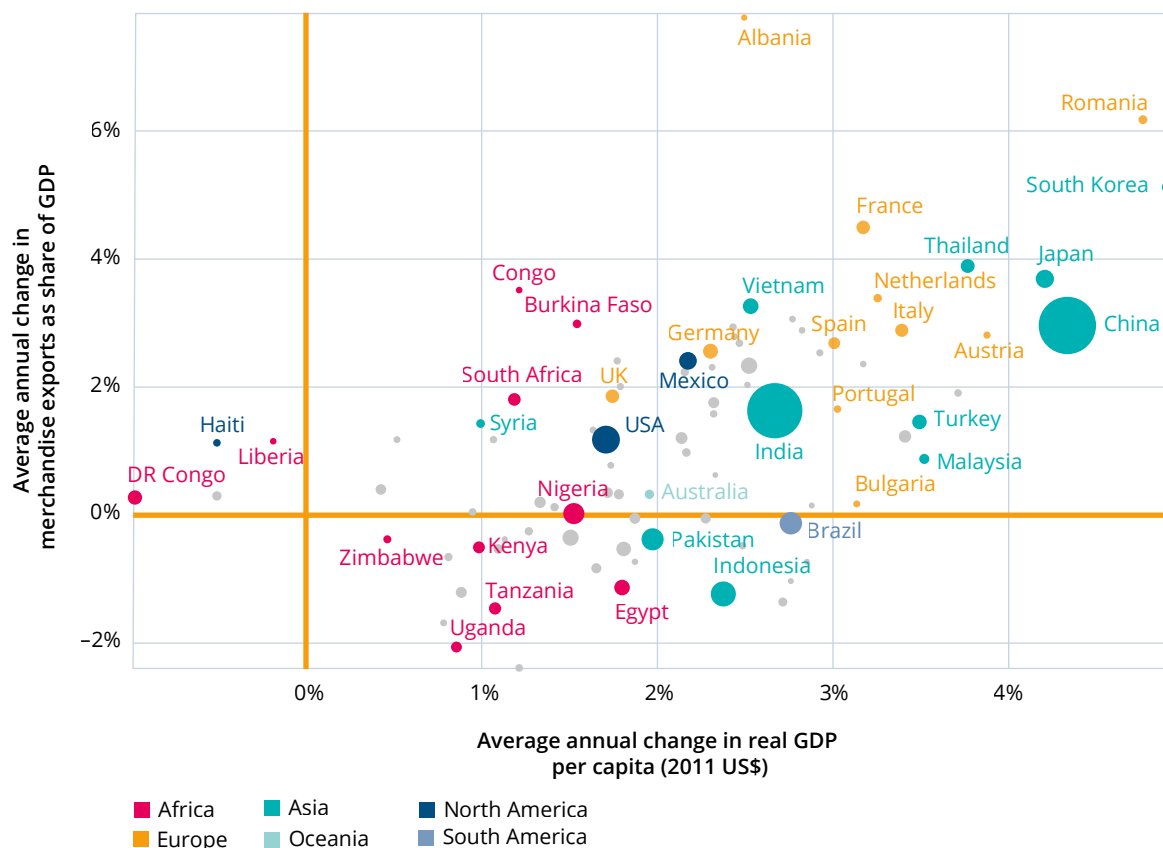
Long-distance trade can be traced back to the earliest stages of human history (Stearns, 2001) and reached considerable dimensions in certain highly developed phases, such as the golden age of the Roman Empire in the 1<sup>st</sup> century A. D. (Young, 2001) or during the European Renaissance of the 16<sup>th</sup> century. Nonetheless, traded goods never accounted for more than ten per cent of global production output. It was not until around 1820 when technological advancements significantly reduced transport costs, accompanied by the spread of political philosophies such as liberalism, caused cross-border trade to surge. This phase, which is often referred to as the first wave of globalisation, came to an end with the outbreak of the First World War at the latest. Between the wars, free trade was significantly impaired in a world marred by wartime destruction, economic crises and neo-mercantile ideas. But the situation changed dramatically in the aftermath of the Second World War, leading to what is today called the second wave of globalisation. Around 60 per cent of the goods and services produced worldwide are now traded across borders and almost all countries in the world participate in global trade. This second wave is gradually running out of steam, meaning that the share of exports and imports in global GDP has barely increased for a few years and the corona crisis of 2020 and 2021 with its manifold restrictions on movement and production will certainly have a dampening effect (Antràs, 2020; Wohlmann/Rebeggiani, 2020). As discussed earlier, ideological perceptions in many countries around the world have shifted to a more sceptical attitude towards globalisation. World trade remains nevertheless at a high level and this is unlikely to change, at least in the short term: International production (global value chains) is closely interwoven, as are research and development in most production sectors – research findings are published internationally and research-intensive industries in particular depend on large international sales markets to recoup their investments. In practice, therefore, international trade and globalisation will continue to have a defining influence in the lives of the world's citizens.

### 1.3 Free trade and prosperity

A thesis that often crops up in media and politics is that only the Global North, i.e. the countries that are already economically powerful, benefit from the era of free trade, while “weak” players would find themselves “exploited” in global trade. These accusations are frequently nourished by the perception of a global zero-sum game in which the gains achieved by one side are inevitably at the expense of the other.

By contrast, the majority of basic economic textbooks (e.g. Mankiw/Taylor, 2018, chapter 19) or those on international economics (e.g. Krugman et al., 2019) continue to advocate the classic Ricardian thesis that free trade leads to overall welfare gains (*gains from trade*) – for *all* participating states. The term “Ricardian” is used in this context in the sense that the British economist David Ricardo (1772–1823) was the first to outline systematically the economic benefits of a departure from autarky (Ricardo, 1821, chapter 7). Based on the principles underlying the classical model of international trade according to Ricardo (Krugman et al., 2019, chapter 3), free trade makes the cake bigger for all participating countries involved, ultimately yielding a net welfare gain for every stakeholder. International trade has a similar impact to the invention of new technology (Jung/Kohler, 2017): It reduces scarcities (e.g. of resources) and broadens the production opportunities (e.g. through the use of external know-how). Moreover, the expansion of sales markets allows companies to benefit from additional economies of scale, which are ultimately passed on to the consumers in the form of lower commodity prices (Atkin et al., 2018). International competition also ensures natural selection among more efficient firms; their productivity rises again as they participate to a greater extent in the global circulation of knowledge. Overall, therefore, free trade results not only in real income gains, but also in a broader variety of products and trends towards lower commodity prices (Feenstra/Weinstein, 2017).

Simple descriptive statistics (fig. 1) demonstrate very clearly how countries that have experienced a sharp rise in trade activities since the Second World War (with the share of exports in total GDP used as the benchmark) tend to have achieved greater growth than more reclusive nations. East Asian countries such as China and South Korea stand out, but large EU countries such as Germany and France also saw steady export growth accompanied by rising prosperity in the decades after 1945. In contrast, many African countries like Tanzania or Uganda remained characterised by below-par trade volumes and even negative economic performance during the same period.

**Fig. 1: Correlation between the development of trade and GDP per country since 2000**

Source: Our World in Data (<https://ourworldindata.org/trade-and-globalization>) and sources mentioned there.

It is an accepted fact that correlation does not imply causation. More sophisticated economic models must be used to investigate this issue econometrically, as they need to filter out the impact of other variables on growth especially and isolate the contribution attributable to free trade. Most of this work confirms the positive finding: a highly influential, methodologically elaborate paper by Fraenkel and Romer (Fraenkel/Romer, 1999) proved that international trade itself, adjusted for many other possible influences, positively affects the wealth of nations. In their search for possible impact channels, Alcalà and Ciccone, for example, demonstrated (Alcalà/Ciccone, 2004) that free trade significantly increases a country's labour productivity. Companies that are compelled to compete with imported products due to liberalised trade become more productive and the allocation of resources is more efficient nationwide, which means that it rises at micro- and at macro-level (Pavcnik, 2002). Review articles (e.g. Durlauf et al., 2005) clearly show that this positive effect also applies to many other impact channels, such as the influence of free trade on capital formation or product quality.

The impact of regional free trade agreements on the welfare of most countries involved – irrespective of their size – is also assessed positively: this is confirmed by econometric studies, for example, for the incremental reduction of tariffs under the multilateral Uruguay Round of the GATT (General Agreement of Tariffs and Trade) that

started in 1991 (Caliendo et al., 2015) and for the North American free trade agreement NAFTA (Anderson et al., 2015). In both cases, poor countries frequently gained more than their rich counterparts. An elaborate statistical simulation also predicted that the controversial Transatlantic Trade and Investment Partnership (TTIP) would bring welfare gains for most EU28 countries and the United States (Aichele et al., 2016).

### 1.4 Free trade, income distribution and poverty

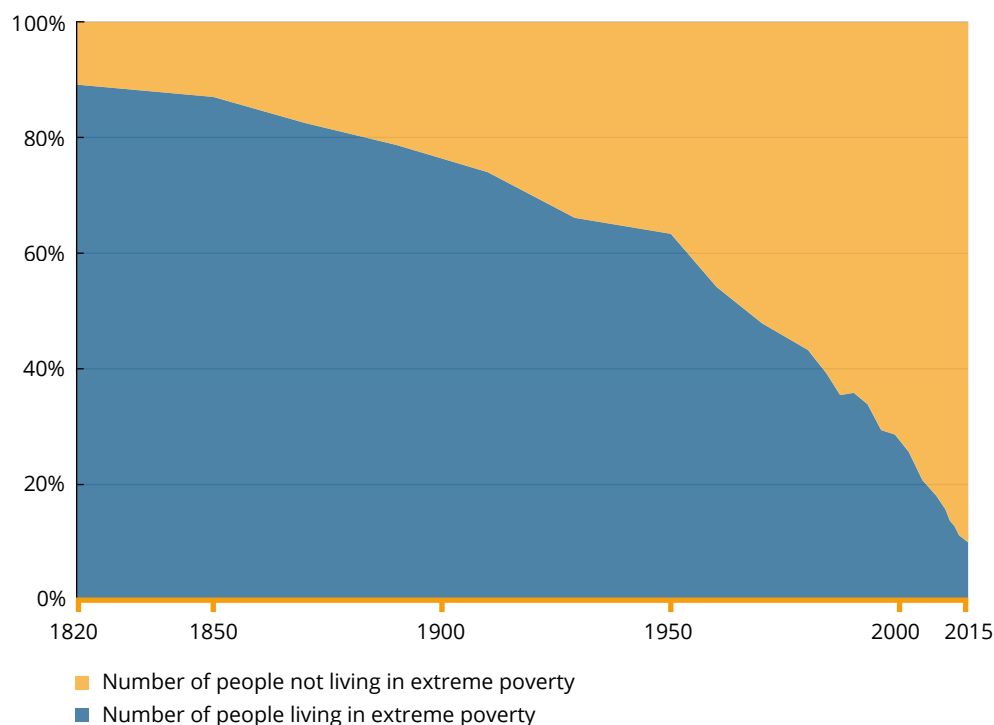
Another theory that features frequently in the media states that only “the elite” in industrialised nations and developing countries benefit from free trade. Indeed, the basic model for international trade mentioned above states that the welfare gains from free trade do not accrue equally across countries and that there are groups of winners and losers. Certain individuals may incur a loss in real income due to free trade, for instance if they possess production factors that are not particularly coveted (Stolper-Samuelson Theorem). So the question of whether free trade generally increases or decreases income inequality is indeed a controversial topic within economic research. In contrast, it is largely accepted that the effects of free trade increase efficiency and hence encourage growth. It is therefore reasonable to expect that average income within a country will rise in the long term. But the key words here are “average” and “long term”: so what can be said about the consequences of short- and medium-term distribution policy?

Many studies initially indicate that free trade tends to increase and not decrease income inequality in industrialised countries. Some authors argue that a suitable metric should be applied to deduct this elevated inequality from the welfare gains acquired due to free trade (Antràs et al., 2016). Overall, however, a common conclusion is that other factors such as technological advancements (especially automation) or the staggering inflation of asset values since the turn of the millennium have played a far more important role in the widening social disparity in western societies since the 1990s (Helpman, 2016; Pavcnik, 2017).

Aside from the relative scales of inequality, there is also an absolute dimension of poverty that affects developing countries in particular. Empirical studies indicate in this regard that in many places, the liberalisation of domestic markets has gone hand in hand with the emergence of a middle class with purchasing power and a significant improvement of life circumstances among poorer sections of the population (World Bank/WTO, 2018). So if the question is whether free trade has improved the material living conditions of broad swathes of society – and specifically the lower and middle strata in developing countries – then the empirical response is generally affirmative. A strong negative correlation exists between the growth in international trade after the Second World War and the number of people living in absolute poverty worldwide (fig. 2). Whereas most people lived in abject poverty on less than US\$ 1.90 per day (in today's terms) at the onset of the first wave of globalisation and a small societal elite of around ten per cent accounted for most of the wealth, this ratio has almost been reversed around two centuries later. The share of the global population that now lives in absolute, severe poverty is estimated at around one tenth – despite the dramatic rise in population levels that was also recorded during the same period (from a little over one billion people in 1820 to 7.4 billion in 2015).



**Fig. 2: Long-term trend describing the proportion of people worldwide living in extreme poverty**

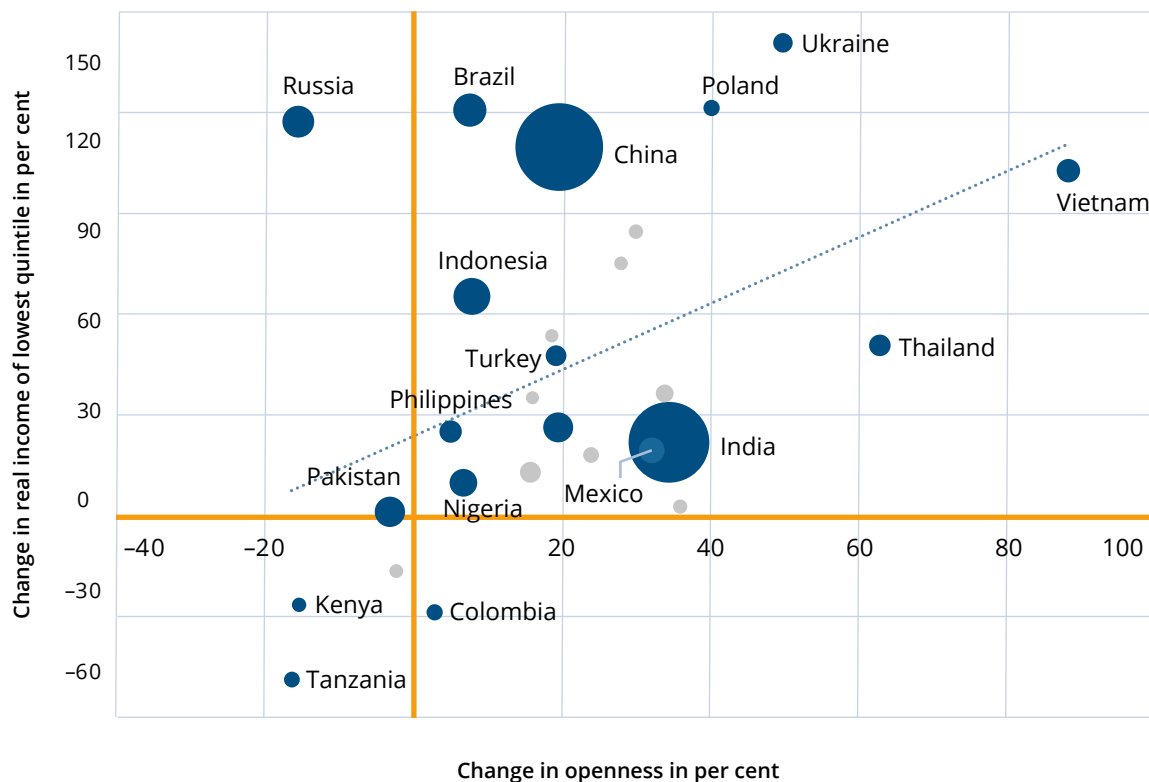


Source: Our World in Data (<https://ourworldindata.org/trade-and-globalization>) and sources mentioned there". Note: Extreme poverty is defined as income below 1.90 USD per day, using purchasing power parity.

Again, the specific effect of free trade on mitigating poverty reduction must also be isolated here, as other factors have undoubtedly made a considerable contribution to this factor as well, first and foremost technological advancement and the strengthening of state institutions, which have been able to implement effective social policy measures in many countries around the world. But it is nevertheless true of both factors that they have benefited simultaneously from globalisation and international trade: technological advancement would never have progressed so rapidly as it has over the last decade and a half without the global circulation of goods and ideas. Indeed, an important branch of empirical research into economic development focuses on investigating the correlation between free trade, growth and poverty reduction. An influential paper by World Bank economists Dollar and Kraay (Dollar/Kraay, 2002) concluded from an econometric analysis using a global dataset that the poorest quintile of a country's population benefits from economic growth as much as everyone else. Since empirical studies consistently identify free trade as an engine of growth, these findings (which have been replicated several times in follow-up studies, e.g. in Dollar et al., 2016) succinctly reflected the World Bank's "trickle down" approach of the 1990s, namely that economic growth is the decisive factor in the reduction of global poverty – and because free trade demonstrably fosters growth, the liberalisation of domestic markets should proceed as a matter of urgency in developing countries especially. Figure 3 illustrates that a positive correlation can indeed be established between openness to free trade and

the real income of the lowest wage-earning quintile (i.e. the bottom 20 per cent of a country's population according to income). Despite the complexity of inferring a causality (IMF et al., 2017), this is nonetheless a stark indication that the poorest members of society also profit from free trade.

**Fig. 3: Changes in the degree of liberalisation and income among the poor 1993–2008**



Source: IMF et al., 2017, p. 45.

Note: Dot size is proportional to population.

The prevalent approach during the 1990s was qualified in subsequent years as it had become unmistakably evident that this “automatic assumption” does not apply in each case and that some disparities between and within countries do not simply disappear. Empirical research made clear that while trade does promote growth, which in turn contributes to reducing poverty, this mechanism is not effective across the globe (World Bank, 2002). It was particularly problematic where the growth effects of trade were undermined by poor governance in the nation states or rendered impossible from the outset, as in some African countries. Overall, the state was assigned once again a more active role as a regulatory, structural and social policy actor in development policy. More recent research has therefore attempted to identify the channels through which free trade can contribute specifically to mitigating poverty, in order to then effectively promote this important aspect. A distinction can be made between the following areas in this regard (OECD, 2009):

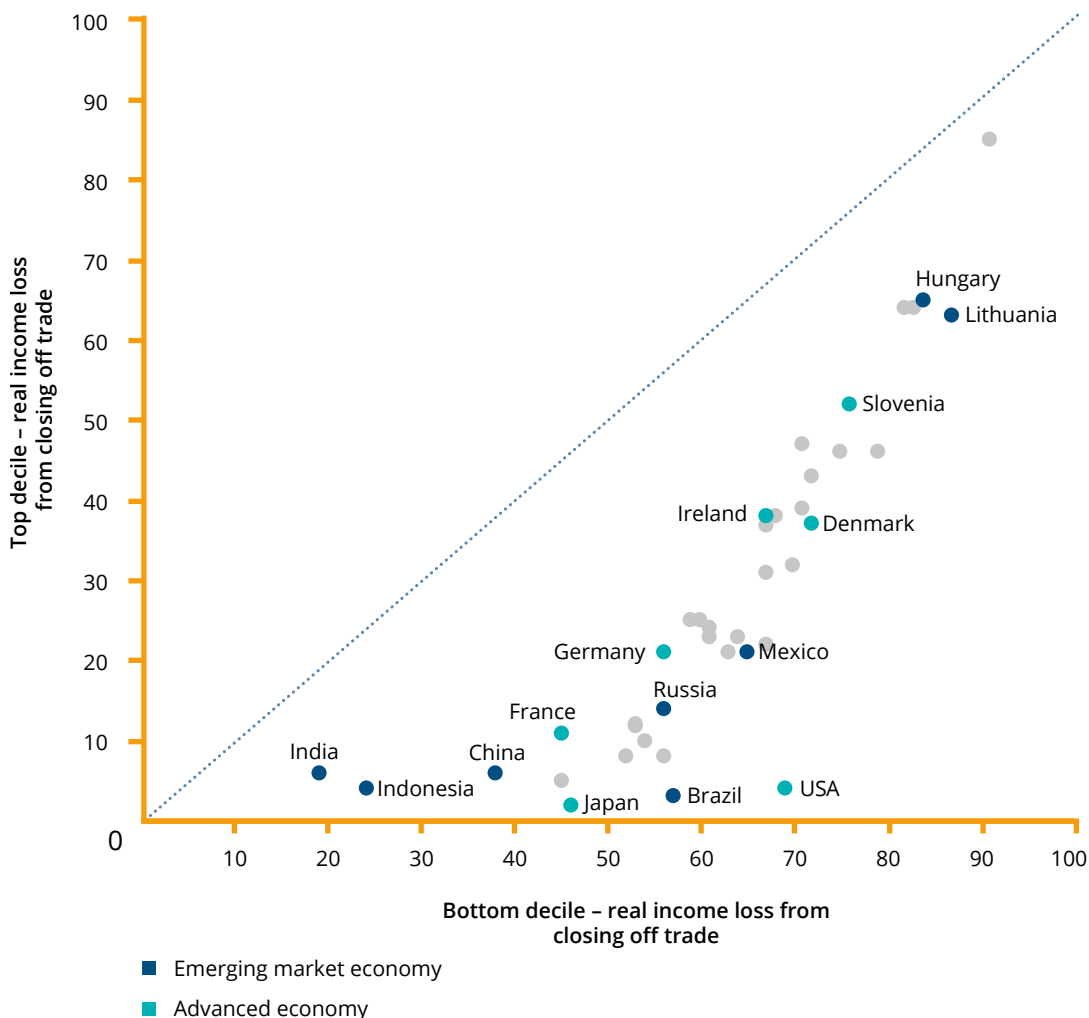
- › conventional supply-side measures (investments in infrastructure, reduction in trade barriers, establishment and expansion of financial markets);
- › specific support programmes to enable poorer individuals in developing countries to participate in global trade (liberalisation of international markets, micro-credits);
- › establishment of effective state redistribution policies to ensure that the gains from free trade reach the broadest possible strata and alleviate adjustment costs (Bannister/Thugge, 2001; Harrison, 2006); this includes education policies that promote vocational training and further education specifically;
- › macro-economic stability and the prevention of financial crises are immensely important, as it is usually the poorest who are disproportionately affected by these crises (World Bank/WTO, 2015).

More recent case studies about developing countries in Africa and Asia confirm these findings as well: free trade helps, but not all individuals and groups, especially if they are prevented from participating in global trade by their sectoral affiliation or geographical location or by trade barriers. This is also exacerbated if they have to bear adjustment costs during the transition phase (e.g. due to intensive import competition), which they are unable to shoulder due to scarce resources (World Bank/WTO, 2018). In this case, the state and supranational organisations must implement a suitable framework in order to ensure that even the weakest benefit from trade gains (e.g. through purposeful education policies) or that such gains are redistributed to them (through social policy measures).<sup>1</sup>

Finally, another aspect of distribution policy should be illuminated as well: the above-mentioned dampening effect of free trade on commodity prices enhances welfare also, as it increases the purchasing power of individuals on the domestic market (Atkin et al., 2018). On the one hand, this reduction is the direct result of dismantling customs tariffs and on the other a knock-on effect of increased competition that lowers the prices and helps to foster efficiency among local enterprises in the long term. Although it does not add directly to general prosperity, the broader product variety is another contributory factor as it provides greater potential for the substitution of overpriced commodities.

For a long time, there was a scarcity of micro-level consumption analyses due to the poor data situation in many countries and the extraordinarily complex modelling requirements. But recent studies have used econometric methods to demonstrate with comparative precision that the consumption-induced welfare effects of free trade are considerable and that poorer sections of society benefit disproportionately. In their influential study of forty countries, Fajgelbaum and Khandelwal (2016) conclude that the lowest income classes benefit disproportionately from free trade-induced price reductions as they tend to consume more internationally traded goods such as food. By contrast, more prosperous households consume an above-average number of goods that are not traded internationally such as private services, and therefore do not benefit to the same extent from price reductions precipitated by free trade. Were one to construct a model world without free trade, it would be mainly the poor who would lose out compared to the situation on the ground today: the losses in real income (meaning what people can actually afford to buy from their nominal income based on commodity prices) would be greater in the lowest decile of income distribution than in the highest (fig. 4).

**Fig. 4: Real income gains for the poorest and richest ten per cent**



*Reading example: Based on existing trade patterns, the real income of the poorest 10 per cent of the population in Germany would be 56 per cent lower if no trade would take place at all. The decline for the richest 10 per cent would be significantly smaller with 21 per cent. A classification below the blue line thus means that the poorest share of the population of a country would suffer more from a cessation of trade than the richest.*

Source: IMF et al., 2017, p. 22.

Interesting, all countries would have real income losses (Fajgelbaum/Khandelwal, 2016, p. 1152), which is further evidence that free trade has a welfare-enhancing effect. But due to its impact on the consumption side, this still serves to identify another channel through which free trade mitigates poverty overall.

The increase in purchasing power per hour of labour vividly illustrates this price reduction for Germany. It has grown exorbitantly for internationally traded commodities in particular: in 1960, for example, people still needed to work for 347 hours to afford a television set, whereas only a little over 24 hours were necessary in 2018 to acquire a technically far better device (Schröder, 2018). A premium men's shirt cost almost eight hours of work in 1960, but only around two in 2018. In contrast, goods such as personal services that are not traded internationally are barely cheaper at all; some services, including men's haircuts or newspaper subscriptions, have actually become more expensive.

Protectionist policies, on the other hand, hit low-income households first and foremost, as they have only tight budgets to absorb rising prices caused by tariffs and lack of competition. For once, broad sections of the media community recently agreed on this correlation, as it could be blamed on the protectionist China policies of US President Donald Trump (e.g. Meiritz, 2020).

A reasonable general summary is that globalisation and free trade precipitate an enormous increase in efficiency and hence greater welfare for the majority of people on Earth. The living conditions of broad swathes of society in many once desperately poor countries that have opened up to free trade since 1950 have experienced unprecedented improvement. But these welfare gains are not distributed equally, and there are differences between individuals and sectors that result from their inhomogeneous access to production factors. This is perfectly normal in a market economy, even a hermetic one. The broadest possible participation in these trade gains is not achieved by curtailing free trade, but through better governance – i.e. through education, structural and social policies as well as measures to combat corruption. Moreover, a stable regulatory framework (stable currency and financial markets in particular) is of crucial importance, especially for highly vulnerable regions and population groups (World Bank/WTO, 2015).

### 1.5 Free trade and labour markets in highly developed countries

A common argument, especially from the political right, is that international trade has caused a massive erosion of jobs in many Western countries. Many former industrial regions have been diagnosed with the "Rust Belt phenomenon" (so their rusting away), among them the North of England, the Ruhr region and some north-eastern parts of the United States. The Rust Belt finding is empirically undisputed, initially at least: A broad selection of academic literature exists on the decline of mining, heavy industry and manufacturing in western countries, especially since the 1970s (e.g. Hübl/Schepers, 1983; Klodt et al., 1989). Is this decline also connected to the concomitant spread of international trade in the decades following the Second World War? This ought to be considered indisputable, as the production conditions in the traditional western industrial regions were characterised a steady erosion of competitiveness compared to Australia, India or China, first in mining, then in heavy industry and finally in manufacturing.

But a closer examination nevertheless brings a number of questions to the fore. First the issue of causality: is globalisation primarily responsible for this development or would this transformation not have taken place over the decades anyway? Evaluation

of this trend is also controversial: should the structural change be perceived as a negative event, or would it not be more appropriate to welcome this faster transformation towards a “greener” and knowledge-based economy?

A number of experiences can be identified empirically: as we saw earlier, international competition elevates efficiency at both the micro- and macro-level. For instance, competition from Chinese companies compelled Europe to become far more innovative and quicker to adopt new technologies in the period between 1996 and 2007. From a macro-economic perspective, competition caused a shift in employment towards innovative companies (Bloom et al., 2016). But fiercer competition also led to problems in the sectors that were especially exposed to foreign competitors and were unable to increase their own competitiveness for structural or socio-political reasons. It can be demonstrated, for instance, that market liberalisation in the wake of NAFTA led to an at least temporary rise in unemployment in Canada, although highly positive efficiency effects were then observed in the long term (Trefler, 2004). In addition, globalisation was particularly hard on US regions in which the companies faced severe competition from Chinese imports. This led to a general loss of jobs and a reduction in wages (Autor et al., 2013).

More recent studies suggest in contrast that precisely the efficiency gains and technological advancements assumed above have gradually occurred. American companies that outsourced sections of their production to China diversified to a greater degree in the United States and created new jobs elsewhere. This rise in employment exceeded the total number of jobs lost in the analysed companies, and these new positions were even better paid on average (Magyari, 2017). Detailed analyses of the US Rust Belt at municipal level also show that while the de-industrialisation shock of the 1970s and 1980s left deep marks (around 850,000 jobs lost in the steel and automotive industries), the adjustments needed to balance the unemployment rates proceeded comparatively quickly: the affected communities again reflected the US average within just five years. This adjustment took place by migration in particular: people relocated from the former industrial regions to places where the structural transformation had created new jobs (Feyrer et al., 2007). Similar trends were also observed in the regions of North England, although their pace was somewhat slower. Overall, this led to permanent population erosion in the Rust Belt, which has lost over a quarter of its population since the early 1970s, cities like Detroit even more than half. But US American states belonging to the Sun Belt – where many of the flourishing services companies settled – registered a considerable rise in population over the same period.

After decades of subsidisation, the state promoted the transformation of Germany's old industrial regions in the Ruhr and Saarland into ecologically sustainable and knowledge-based economies (Federal Ministry of Education and Research – BMBF, 2019). Although the old coalfields remain unfinished business from the perspective of structural policies, considerable transformations have taken place already that have brought major ecological benefits to the particular regions (Kiese, 2019). At global level, the ILO estimates the net effect of transitioning to a “greener” economy would involve the creation of 18 million additional jobs compared to those lost in “old” economies that were heavily based on resource use (ILO, 2018).

It is therefore reasonable to conclude that while free trade can accelerate technologically necessary structural transformation, it is not the primary cause. Adopting preservative structural policies to maintain obsolete and inefficient sectors might be prompted at best by safety concerns, but it is not an efficient option in terms of economic policy. Therefore, the acceleration of structural change through international competition – although associated with adjustment costs in the short term – may eventually be revealed as a worthwhile investment in the future in the long term. Here also, the state is assigned the central task of using efficient governance in its structural policies to facilitate this transitional process and, on the other hand, to apply social policies that mitigate the adaptation costs for those affected by the negative consequences.

### 1.6 Free trade and labour protection

Finally, another controversy has emerged over the last 10–15 years and concerns labour protection: Fomented by fire disasters such as the one in a textile factory in Bangladesh in November 2012, politicians and the media have increasingly taken for granted that globalisation and free trade are mainly to blame for the decline in labour protection standards in developing countries (e.g. Schäuble, 2020). After all, in order to remain competitive on the global markets, these companies would have to exploit all opportunities to cut costs, often at the expense of the already quite vulnerable workforce.

But this perception is undermined by a fundamental flaw that is commonly argued from a western perspective and involves applying our standards to local markets (Pies, 2013). The first question to be asked in this regard is what might be the better alternative for the people in the affected countries: no jobs with internationally exporting companies? A national economy with largely closed markets or even a subsistence economy like those that existed in many Asian countries until a few decades ago?

The fact that the jobs mentioned are so coveted that they encourage rural exodus in many cases suggests that local conditions are perceived as comparatively acceptable and might even represent an indispensable macroeconomic stage in a development process. If, for instance, one compares the working conditions at subsidiaries of international companies with those of domestic companies, it becomes apparent that the working and pay conditions in the former tend to be better (Graham, 2000, chapter 4; Brown et al., 2004). The situation among supplier firms is more complex, as less data is available and they can only be controlled indirectly (Matthes, 2013).

This insight leads to a similar conclusion as the previous chapters: the market – not even the “global market” – is not automatically able to provide all solutions to working conditions either. What is needed instead is a regulatory framework that imposes minimum standards on the companies. This is not unproblematic in the case of labour protection, as the regulatory potential in many developing countries is considered rather weak, especially in regard to conflicts that might lead to the abandonment of production facilities.

Supranational organisations have the potential to exert greater influence: the International Labour Organisation (ILO) adopted core labour standards as early as 1998, which have since been ratified by almost all member countries and include various aspects of labour protection. Other voluntary commitments exist at UN and OECD level. But these standards occasionally suffer from a lack of enforceability (Scherrer, 2013). In contrast, bilateral free trade agreements have for quite some time included fairly effective trade sanctions against countries and companies that violate minimum labour standards. The WTO has debated the adoption of these sanctions regimes (or social clauses) since the organisation's inception, although there has been no majority support so far due to opposition from developing countries who fear the loss of their competitive advantages: efforts to this end broke down during the first Ministerial Conference of the WTO in 1996, which was one of the reasons why the 1999 meeting in Seattle failed so miserably. Since then, the fronts between the industrialised nations advocating change and the developing countries, which perceive social standards as protectionism in disguise, have hardened to such an extent that the issue of minimum labour standards is no longer negotiated so prominently at WTO ministerial level (Busse/Grossmann, 2003). Indeed, developing countries frequently have a completely different view of “cheap jobs”: the boom in the exporting textile industry gave Bangladesh, for example, one of the world's highest growth rates in the years after 2010 and, especially for women, the opportunity for financial independence and social advancement. “Extreme poverty and hunger [...] returned to Bangladesh” (Gerhardt, 2020) almost as soon as global demand collapsed due to the 2020 corona crisis.

The argument therefore turns full circle and brings us back to where we started: what is needed is a (by no means trivial) “ideal solution” (Matthes, 2013) to regulation that does not destroy the competitive advantages of new participants in the world market without leaving workers completely at the mercy of potential social dumping.

A final aspect relates to the general liberalisation of markets: effective pressure on manufacturers to improve labour protection emerged recently in the wake of serious accidents at work that were widely reported in the media or journalistic articles on conditions in factories in developing countries (in addition to the textile industry, for example, also about Apple supplier Foxconn). This pressure would be largely absent in a world of isolated markets: the local governments would find it considerably easier to control any domestic protest movements if they are not exposed to international media pressure that might gradually be reflected in tangible consequences for development aid or trade treaties with industrialised countries.<sup>2</sup> Although the western media frequently place international corporations in the cross hairs of their campaigns: it takes this global pressure to compel governments to ensure greater transparency and more effective control of labour protection standards. Raising public awareness and establishing consumer goods standards such as *Fair Trade* have proven an equally effective – or at least complementary – method of improving labour protection in developing countries.



## 1.7 Summary and outlook

Free trade has made a vital contribution to the tremendous growth in global prosperity over the last two centuries. Poorer members of the global community have also benefited from this sharp rise in affluence. Never before in the modern history of humankind have so few people had to fight for material survival as today. Although not the only reason, this development is certainly also linked to an increase in the circulation of goods, services, people and ideas.

Nonetheless, not every section of society has benefited equally from the increase in prosperity induced by free trade. In some cases – where there are too many or too few coveted production factors – certain groups or regions have even experienced an overall decline in prosperity. In the past, and in the 1980s and 1990s especially, the prevailing assumption that the rise in prosperity would trickle down more or less automatically like rising waters lifting boats has proven somewhat optimistic.

But this does not happen by itself, and free trade is not able to compensate regulatory deficiencies such as poor governance, corruption, the neglect of social policies for wealth distribution and the absence of thoughtful education and structural policies. The strategy for the future should therefore be to defend the principle of free trade against neo-mercantilist tendencies from the political left and right, while strengthening the regulatory competence of nation states and supranational organisations. There is sufficient evidence to suggest that this would work and that free trade will prove effective in driving prosperity for the entire global population.

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1 Refer to chapter 2 of this book on the role of rules in international trade.

2 Refer to chapter 4 of this book on sustainability in free trade agreements.

# 2 The economic and social benefits of a liberal trade order



*Heribert Dieter*

## 2.1 Introduction: Why trade?

International economic relations, their stability and reliability are of vital importance to economic, social and political development in Germany, Europe and worldwide. While the extremely strong ties to other economies in trade and capital movements – often referred to as globalisation – have enabled prosperity and employment on the one hand, they have also led repeatedly to crises on the other. Phases of euphoria – for instance the rise of the emerging countries just a few years ago – then make way for situations that give cause for concern. Cross-border trade in goods and services plays a key role in this process.

Mercantile concepts shaped economic policy in continental Europe, especially France, until the 19<sup>th</sup> century. International trade was viewed with a degree of scepticism: proponents of mercantilism believe that domestic production is more beneficial than the import of goods manufactured abroad. The alternative concept emerged in England especially, but also in the USA, which led to the development of a completely different understanding of international economic relations. The United Kingdom abolished the Corn Laws in 1846, liberalising the import of grain. The UK was the leading industrial power in the 19<sup>th</sup> century, and its companies were more competitive than those of its continental European and North American rivals. This goes some way to explaining British support for the liberalisation of trade: it is easy to propagate unrestricted trade if domestic firms are more productive than their foreign counterparts.

Loosening the shackles on trade became integral to the British national identity. The United Kingdom was a paragon of free trade and the only state that uncompromisingly embraced these policies during the second half of the 19<sup>th</sup> century (Trentmann, 1998, p. 219). Cross-border trade in goods was viewed primarily from a consumer perspective and only then through the eyes of producers (Trentmann, 2008, p. 2 and 10). When other states subsidised certain exports such as agricultural products, the British saw this as a good opportunity to acquire goods that had been partially financed by other governments. On the eve of the First World War, average tariffs in France were eighteen per cent, twelve per cent in Germany, but zero in the United Kingdom (Trentmann, 1998, p. 241).

The Great War brought this phase of liberal trade policies to an end. Several attempts were made to return to a liberal trade regime during the 1920s. Among the reasons for their failure was a resurgence of mercantile beliefs during the war years, which perceived imports as harmful and exports as beneficial. Buying local produce was considered a patriotic act. Although a correlation exists between the decline in trade during the 1930s and the growing political tensions leading up to the Second World War, elements of this mindset continue to exist in many countries around the world. For instance, heated debates on the effects of liberalised trade policies featured largely in the 2016 presidential election campaign in the United States. Having emerged victorious, Donald Trump promised his compatriots to ensure that they would incur fewer disadvantages from cross-border trade in future, criticising Germany's high export surpluses and other factors in this context.

It follows, therefore, that the history of trade policy is not one of linear evolution towards a liberalised global economy, in which borders and barriers between nations have been dismantled in favour of free trade. The debate on the benefits of free trade begins in this context with a seemingly trivial question: why do people exchange goods and services with people living in other national economies? It is frequently assumed that international trade is different from the domestic trade in goods, or even that international trade endangers the prosperity of national economies. The idea that international trade is a necessary evil, but does not increase prosperity within society, has its origins in phases of state protectionism. But neither of these ideas are correct: Individuals and companies engage in trade, which in turn – bottom line – increases prosperity. The motives of buyers and sellers do not differ, regardless of whether they trade with each other on a domestic or international market.

## 2.2 Peace and prosperity through trade?

The manufacturers of goods are by no means the sole beneficiaries of international trade. Consumers benefit equally from international trade, as imports enrich the range of available products. Imported and local goods compete in this context, which is reflected in more favourable prices.

A number of examples serve to illustrate these chains of effects. The economic benefit of today's liberal trade regime for the shareholders and employees of the German automotive industry is obvious: export production creates jobs in Ger-

many and gifts returns for the shareholders. It is equally clear that the South Korean electronics conglomerate Samsung and its workforce reap economic rewards from exports to Germany.

The benefits for domestic consumers are a little more complex. Importing low-priced goods from abroad does not increase people's income, but it does give them more purchasing power. For instance, the same wage enables them to buy a television set or other products that would be far more expensive if produced in Germany. Ultimately this means that people can consume more on the same income thanks to affordable imports.

It would be inappropriate, however, to view cross-border trade merely as a means of increasing prosperity. As far back as the mid-19<sup>th</sup> century, John Stuart Mill and Richard Cobden apportioned greater importance to the cosmopolitan and peace-making dimension of free trade than any increase in efficiency, which was the centrepiece of David Ricardo's theories. Mill viewed international trade as an important instrument to spread interdependency and "civilisation" (Helleiner, 2002, p. 313). Although John Stuart Mill was a vehement advocate of personal freedom, he nevertheless regarded the enforcement of free trade – even by military means – as a selfless blessing bestowed by the British on the recipient countries.

In view of the heightening tensions between the PR China on the one hand and the USA and other liberal-minded countries on the other, however, the question arises as to whether the peacekeeping dimension of trade is as convincing today as it was in the decades after the Second World War. The two superpowers are economically so closely intertwined that the US historian Niall Ferguson and the German economist Moritz Schularick coined the term "Chimerica" fifteen years ago to describe a symbiotic relationship between the two largest economies. Bilateral trade has become significant and far more vigorous than it was during the Cold War: annual trade between the USSR and the USA was never more than around US\$ 2 billion (Zakaria, 2020). In contrast, trade volume between the United States and China was US\$ 550 billion in 2019.

It is important to note nonetheless that bilateral trade between the two superpowers is not and has never been symmetrical. In 2019, US exports of US\$ 106 billion contrasted with Chinese exports of US\$ 451 billion.<sup>3</sup> Given this significant imbalance, political tensions are more likely to rise than they are to fall.

In view of this, it appears appropriate to add to the paradigm of the peacekeeping dimension of free trade: liberal trade policies can only help to foster peace if they do not result in excessive asymmetries.<sup>4</sup> The European Union has developed a set of rules for this purpose: current account deficits exceeding four per cent of an economy's output must be reduced. The same applies to current account surpluses, although their threshold value is set at six per cent of GDP.

## 2.3 The benefits for poor countries

The remarkable rise that some countries have charted from the clutches of poverty to relative prosperity is also due to the fact that they have gained access to other national markets where they can sell their products. China is probably the most obvious example. The communist country was a strictly planned economy with weak international economic relations from 1949 until the end of the 1970s. Industrial production and the export of industrially manufactured goods were barely developed at all. For instance, China manufactured a paltry 220,000 vehicles per year at the beginning of the economic opening in 1980.

By 2017, China had already become the world's leading automotive manufacturer, producing 24.8 million vehicles or 110 times the output in 1980. People in China have benefited enormously from this upswing. They are now more prosperous and enjoy greater life expectancy. Life expectancy around the world has increased by an average of 19 years since 1960, and in China by a staggering 30 years to 75 today (Sharma, 2016, p. 38 f.).

South Korea is another country that has become prosperous thanks to global trade. Despite a poor starting position – the country was a Japanese colony from 1910 to 1945 – Korean society has seized the opportunities that have presented themselves and has risen to become one of the world's leading industrial nations. The country's economic output in 2019 was US\$ 1,642 billion and therefore greater than Spain, Australia and Mexico.<sup>5</sup> South Korea's pro capita economic output in 2017 was US\$ 39,400, placing it ahead of Italy and Spain.<sup>6</sup>

Poorer countries can therefore benefit just as much as the established industrialised countries from increasing their trade in goods and services. Global trade rose by 930 per cent – from US\$ 2,310 billion to US\$ 21,447 billion – between 1985 and 2015.<sup>7</sup> This was accompanied by a decline in the global poverty rate from 42.5 per cent (1981) to 9.2 per cent (2018).<sup>8</sup> Not only did the share of the global population living in poverty fall, their absolute number decreased as well: from 1,926 million in 1990 to around 700 million in 2017. This is a huge success, which is often denied the appreciation it deserves. A 2016 survey interviewed 26,000 people in 24 countries about poverty reduction. Only very few were aware that poverty worldwide has been cut by more than half over the last twenty years. Merely one per cent of respondents knew the correct answer, while 87 per cent believed poverty had either increased (69 per cent) or remained the same (18 per cent). Another twelve per cent posited that global poverty has declined somewhat. However, around half of the respondents in China thought that extreme poverty had decreased in the last twenty years, while only eight per cent in Germany or the USA believed the same.<sup>9</sup> This survey proves that the successful global development of recent decades – which can also be attributed to the liberal trade regime – is perceived less clearly than the negative effects that can undoubtedly be observed as well.

## 2.4 The disadvantages of global division of labour in industrialised countries

Broadening the international division of labour creates benefits for many people, but also brings disadvantages for others. For instance, two groups profit from the relocation of a factory producing mobile phones from Germany to Romania: firstly, previously unemployed workers who are hired in Romania, and secondly the consumers who can buy cheaper mobile phones. In contrast, the people who lose their jobs because the factory in Germany is closed experience a disadvantage. And while international trade does not cause this structural transformation, it does accelerate the process.

This lays bare the problems facing politicians: relocating production is economically efficient and leads to a rise in prosperity, but not for everyone in the affected countries. The benefits for Romania are clearly identifiable in this case, but the one for Germany is only indirectly evident, namely the ability to import cheaper mobile phones.

By contrast, the social costs in Germany can be itemised unequivocally and clearly: those previously employed in the German factory have become unemployed and, if they do not find a new job, will receive unemployment benefits. In this case – beyond the purely financial implications – they also lose their stake in working life with potentially negative consequences for their self-esteem.

Critics of liberalised trade frequently argue that the prosperous are the main beneficiaries. But this assessment is inaccurate if one considers the imports. Restricting the trade in goods would mainly affect the poor and not the wealthy. This was confirmed in a study published in 2016 by the US economists Pablo D. Fajgelbaum and Amit Kumar Khandelwal. The study draws on twenty countries to illustrate that if international trade were to end, the richest ten per cent of consumers would lose 28 per cent of their purchasing power, while the poorest ten per cent of consumers would lose 63 per cent (Fajgelbaum/Khandelwal, 2016, p. 1116) or nearly two-thirds.

An important factor for international trade is the significant variance in labour costs between the individual countries, accompanied by a compulsion to raise productivity. After all, companies will only remain competitive if high value added is generated per hour of work. It follows, therefore that wages are not the only determinant of a company's price competitiveness, but also the so-called unit labour costs, which reflect how much is produced in one hour of work. Companies are able to pay relatively high salaries without losing their competitiveness, provided they remain sufficiently productive. Indeed, they can increase their competitiveness if they secure temporary monopoly profits, mainly through innovations, i.e. if they market highly specialised products for which competitive pricing plays a subordinate role: the products are purchased on the international markets because they are particularly good, not particularly cheap.

**Table 1: Labour costs in manufacturing in selected industrialised countries in 2019\***

Country	Labour costs in €
Switzerland	54.79
Denmark	47.04
Germany	42.02
France	38.75
USA	35.41
United Kingdom	26.88
Japan	26.64
Czech Republic	13.48
China	7.89
Philippines	1.99

*\* Hourly rates for employees (blue- and white-collar workers) in manufacturing; provisional figures in some cases.*

Source: German Economic Institute, Cologne, international labour costs: Germany in the top group, retrieved at [https://www.iwkoeln.de/fileadmin/user\\_upload/Studien/Kurzberichte/PDF/2020/IW-Kurzbericht\\_2020\\_Arbeitskosten\\_international.pdf](https://www.iwkoeln.de/fileadmin/user_upload/Studien/Kurzberichte/PDF/2020/IW-Kurzbericht_2020_Arbeitskosten_international.pdf).

Labour costs in Germany are high in an international comparison. Even in the United States and Japan, the wages are significantly lower than in Germany. And despite China's huge pay rises over recent years, the labour costs are still less than twenty per cent of the German levels.

Viewed on their own, the absolute wage level says very little about the competitiveness of companies in individual countries. Switzerland, for example, pays very high wages, but local companies still manage to export a lot.

The decisive factor for a country's competitiveness is the ratio between wages and productivity. Unit labour costs express the amount of wages or salary, including non-wage labour costs, that are paid for one product or service unit. This means that the ratio between wages and productivity is decisive for the competitiveness of a company or an economy and not the absolute wage level. Optimising production processes is a recognised method to improve productivity. Higher productivity can also be achieved by improving the education of available human resources.

The issue of inequality in industrial countries frequently crops up in the discussions on the consequences of international trade. Although this is only indirectly related to the consequences of globalisation, many citizens do ask themselves whether there is a connection between the international division of labour and inequality.

In doing so, they frequently fail to appreciate that European welfare states are making successful corrections to the distribution of income. This becomes apparent by using the Gini coefficient, which measures inequality, to compare Denmark, Germany and France with the Anglo-Saxon countries of the United Kingdom and the USA. Two indicators are compared, namely market income before tax and social benefits, as well as income distribution after tax and social transfers.

**Table 2: Distribution of income (Gini coefficient) in selected OECD countries (2018 or latest figures)**

Country	Income distribution before taxes and transfers	Income distribution after taxes and transfers
Denmark	0.45	0.26
Germany	0.50	0.29
France	0.52	0.29
United Kingdom	0.51	0.38
USA	0.51	0.39

Source: Tax Policy Reforms 2020: OECD and Selected Partner Economies, OECD iLibrary ([oecd-ilibrary.org](https://oecd-ilibrary.org)).

The data in Table 3 plainly reveal inequality in the distribution of income in OECD countries before taxes and transfers. It is important to consider that the Gini coefficient is between 0 and 1 and that a higher value indicates greater inequality. Only Denmark records a value of less than 0.50 before taxes and transfers.

Of far greater relevance, however, is the distribution of income after taxes and transfers: how much net income do people have and how unequal is the distribution of income after the payment of taxes? This perspective clearly reveals that massive redistribution takes place in both Germany and France. Recording a Gini coefficient of 0.26, income distribution in Denmark shows the lowest degree of inequality. The difference between the two distributions is the smallest in the United States and income levels remain relatively unequal, even after taxes and transfers.

Advocates of liberal trade policies expect this freedom to create greater prosperity. They believe that some may be placed at a disadvantage within national economies, but that the disadvantages will not extend to entire economies. Socio-political measures should be applied to cushion the negative consequences of liberalisation. In this regard, cutbacks in socio-political programmes in Germany and elsewhere over recent years, which were intended to reduce national debt and provide incen-



tives to accept or resume employment, have created a highly sensitive societal situation. Many of the unemployed in the structurally weak North of England or in the old industrial regions of the USA were unable to find new employment after losing their jobs and at the same time were forced to accept significant social decline and even impoverishment.

It is clear that while international division of labour can be beneficial, political measures are still necessary in order to correct unwanted developments. These include, first and foremost, opportunities for the unemployed to access the job market, incentives to improve vocational qualifications, redistribution of market incomes through taxes and social benefits and the elimination of encrusted economic structures. Many continental European countries seem to be doing a better job of this than the United Kingdom and the US.

In Germany, redistribution is currently proving successful without much resistance from those who pay taxes and social benefits and in doing so support the less fortunate. Germany's robust economic growth, which is enabled by structural change in particular sectors and internationalisation of the economy, has nourished this trend over recent years.

## 2.5 International trade policies and crisis of the WTO

Today's trade order is a rules-based political system. The member countries of the World Trade Organization (WTO), which began its work in January 1995, have committed themselves to complying with this international set of rules. This regulation aims to curb protectionist measures, prevent unequal treatment between states, and reduce the uncertainty and unpredictability of international trade.

On the one hand, multilateral trade policy has been very successful. More and more countries are joining the WTO. The most recent member is Afghanistan, which became number 164 in July 2016. On the other hand, however, the WTO is facing increasing competition from regional and discriminatory free trade agreements that regulate international trade outside the WTO but are allowed within the WTO order under certain conditions.

A makeshift organisation was used to regulate global trade until the WTO was founded in 1995. The General Agreement on Tariffs and Trade – GATT was a provisional treaty that applied exclusively to the trade in goods, so without services, and which did not possess its own organisation. A slightly modified version of the old GATT treaty continues to apply within the WTO and remains at the heart of its activities.

GATT is built around its legendary Article 1, the most-favoured-nation clause. This states that trade concessions between two contracting parties to the GATT must automatically be granted to all other contracting parties. Its purpose was to overcome the discrimination of the 1930s, when distinctions were made between friends and foes. The benefits of this rule cannot be overstated. Not only does the most-favoured-nation clause have considerable economic benefits by intro-

ducing, as it were, an automatic approach to liberalisation, it also prevents the division of trade relations into different political categories. The national treatment principle is a second mainstay of the GATT: imported goods must be subject to the same set of rules as domestically produced products.

The WTO has regulated the trade relations of its member countries for 25 years. Unlike the GATT Secretariat, the WTO is an international organisation with its own legal personality, i.e. it possesses legal competency. But it does not wield power of its own: it mediates between member states and seeks to bring about consensus. The WTO has no authority to impose measures against the wishes of its member countries. It is a member-driven organisation. Indeed, the WTO is powerless without the support of its members.

The WTO essentially consists of a set of three individual agreements: Besides the agreement on goods (GATT), there is another one for services (GATS: *General Agreement on Trade in Services*) and one for the protection of intellectual property (TRIPS: *Trade-Related Intellectual Property Rights*). Rules are defined in each of these three agreements. A comparatively robust dispute settlement mechanism exists as well.

The WTO does not have a particularly evolved political structure. Its most important body is the Ministerial Conference, which most recently convened in 2017 in Argentina's capital Buenos Aires. Originally scheduled for 2020, the Kazakhstan conference has been postponed to 2021. The WTO is domiciled in Geneva and has relatively few staff: an almost paltry 600 people work for the organisation.

The WTO dispute settlement system is of particular importance, especially for poorer countries. Members such as the USA or the EU can assert their interests without a neutral court, but not developing countries. Whereas respondents needed to agree to the proceedings under GATT, states can now bring complaints directly against any other member country. Decisions are binding for the respondent country. Retaliatory measures can be applied until the trade barrier has been dismantled.

Nevertheless, it can be observed that poorer member states rarely bring action against rich countries, even if doing so would obviously be justified. This is because rich countries do not particularly appreciate being confronted with these complaints, the proceedings are lengthy and expensive and the poorer countries – if a ruling is issued in their favour – are lacking the material wherewithal to impose effective retaliatory measures. WTO dispute settlement therefore takes place mainly between industrialised countries or between industrialised and emerging countries.

Shared rules for the regulation of trade in goods and services are a sensible approach in principle. They benefit all actors, provided the rules are the same. The United States must abide by the same rules as Costa Rica. However, WTO rules have to be developed by consensus, which makes their negotiation more complicated. All member countries of the WTO must agree during a round of negotiations. The rules can only be introduced once the entire package has been unanimously approved (*"Nothing is agreed until everything is agreed"*).

The WTO makes an important contribution to equal opportunities in international economic relations. It provides a forum for member states to agree on a set of rules, and the main beneficiaries of the WTO tend to be the less developed states which would be entirely at the mercy of the interests and pressures of more powerful states without the organisation's legal framework. The failure of the Doha Round is therefore all the more disappointing. In general, though, the WTO provides the opportunity to restrict the power of the United States, the EU and others – which is why they prefer to turn away from the multilateral trade order and embrace free trade agreements.

## 2.6 Free trade agreements: Competition for the multilateral order

Free trade agreements have frequently provoked controversy in the debate on trade policies. The trade order established after the Second World War is based on the key principle that countries must not be discriminated against. That is why the aforementioned Article 1 is the centrepiece of GATT, which remained the legal basis of the trade regime even after the establishment of the WTO in 1995: If two countries agree on trade concessions, this automatically applies to all other WTO member countries (most-favoured-nation clause).

Article 24 determines that free trade zones and customs unions are the only permitted exceptions. The difference between these two stages of regional integration is that the participating countries in a free trade zone retain their own external tariff regimes, whereas the customs union is defined by a common external tariff. Free trade zones therefore require complex rules for and certificates of origins of traded goods and services, which frequently negate the benefits of tariff reductions. In order to engage in trade without tariffs in free trade zones, companies must document the origins of the goods, which is often associated with substantial costs.

Article 24 was originally intended less for the large members. Instead, regional agreements, mostly referred to as regional integration, were predominantly seen from the 1960s onwards as an economic policy instrument for developing and emerging countries to achieve greater convergence with the global market. The concept was wholeheartedly welcomed during the first wave of regional integration and was viewed as an important building block in a successful development strategy. Even small national economies hoped that the larger domestic market would help them achieve economies of scale in production. This term means that the unit costs of manufacturing are reduced by mass production.

In the meantime, many hundreds of special agreements have been concluded with reference to Article 24. They are often called free trade agreements, although the term itself is misleading. This is because they only liberalise trade between the participating national economies, while continuing to exclude all other countries in the global economy. It would therefore seem more accurate to call them preferential agreements, as participating countries grant each other trade preferences.

But this trend is associated with numerous problems. World trade is becoming increasingly complex because all agreements show significant differences, which forces companies to spend more and more time on familiarising themselves with and applying the specific sets of rules. Moreover, excluded economies are placed at a commercial disadvantage.

Free trade zones are no more than the second-best trade policy solution, despite their current popularity. A single set of rules – the multilateral order – offers weaker economies in particular the opportunity to harness the benefits of a liberalised trading system in their own favour.

### 2.7 International trade from the perspective of developing countries

A common assessment is that developing countries belong to the losers of globalisation, and it is therefore assumed that their domestic populations will adopt a critical stance to this trend. This assessment is based on earlier theories of development policy, which presupposed the exploitation of what at the time were Third World countries.

There is of course no paucity of reasons to criticise today's world economic order and the role of developing countries in international economic relations. In many cases, workers earn only paltry wages, environmental standards are frequently much laxer than in industrial countries and child labour remains commonplace in many poor countries. But the perception of international economic relations is nevertheless surprisingly positive in the countries concerned.

The successes in fighting poverty that have already been discussed draw a more nuanced and generally positive picture. A survey published in November 2016 confirms that many people in developing countries have adopted a more favourable stance towards the international division of labour than their counterparts in industrial nations. There is a relationship between poverty and the expectations placed in globalisation: the poorer the country, the more positive its attitude towards globalisation. Many people hope that it will improve their life circumstances, especially in Asia.

**Table 3: Agreement with the question that globalisation has a positive impact (as a per centage of respondents)\***

Country	Agreement rate
France	37
USA	40
United Kingdom	46
Australia	48
Norway	49
Finland	56
Germany	60
Hong Kong	63
Denmark	68
Indonesia	72
Malaysia	73
Thailand	76
India	83
Philippines	85
Vietnam	91

*\* The question was: Globalisation is the term used to describe the growing movement of goods, ideas, money, jobs, culture and people around the world. Is this globalisation a force for good?*

Source: YouGov Survey, November 2016, retrieved at <https://yougov.co.uk/news/2016/11/17/international-survey/>.

Globalisation is a promising trend for people in countries like India and Vietnam. By contrast, more widespread scepticism can be observed in the traditional industrialised countries. Great Britain's exit from the European Union and the success of the US presidential candidate Donald Trump – a critic of globalisation – can also be traced back to this scepticism. Joe Biden is likely to continue his predecessor's trade policy and can count on broad support both in the Democratic Party and among the US population.

## 2.8 Perspectives for the future of international trade

Criticism has been levelled at various effects of globalisation, and broad swathes of the population no longer show unconditional support for the broadening of international division of labour, at least in the OECD countries. Many citizens view globalisation as a project initiated by the political elites and the rich.

Hence, the greatest challenge to liberal trade policy today comes not only from the outside, from authoritarian regimes like Russia or China. A new hardening of positions is emerging instead in the US, the UK and continental Europe: between the advocates of economically and socially liberalised trade policies and those who reject this order.

In 2005, the US journalist Thomas Friedman described the process of globalisation as the unstoppable implementation of a fixed economic policy. According to this interpretation, the individual societies are on a fixed path and only differ in the extent to which they have implemented the individual components of this economic policy concept. But increasing numbers of citizens in industrialised countries are rejecting this hyper-globalisation as a “golden straight jacket”.

At the same time, though, international division of labour and liberal trade remain the best recipe to elevate people from impoverishment. The severe economic crisis of 2020 will set many people in developing and emerging countries back by years and return them to the clutches of poverty. It follows that a liberalisation drive might be among the possible measures that the European Union could initiate in 2021. Compared to donations or government transfers, liberalised trade policies built on clear and transparent rules offer people in developing countries a greater chance of improving their material living conditions.

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3 United States Census Bureau, Trade with China, retrieved at <https://www.census.gov/foreign-trade/balance/c5700.html#2019>.

4 The Stability and Growth Act (StabG) of 1968 calls for “balanced foreign trade”.

5 World Bank data, retrieved at <http://databank.worldbank.org/data/download/GDP.pdf>.

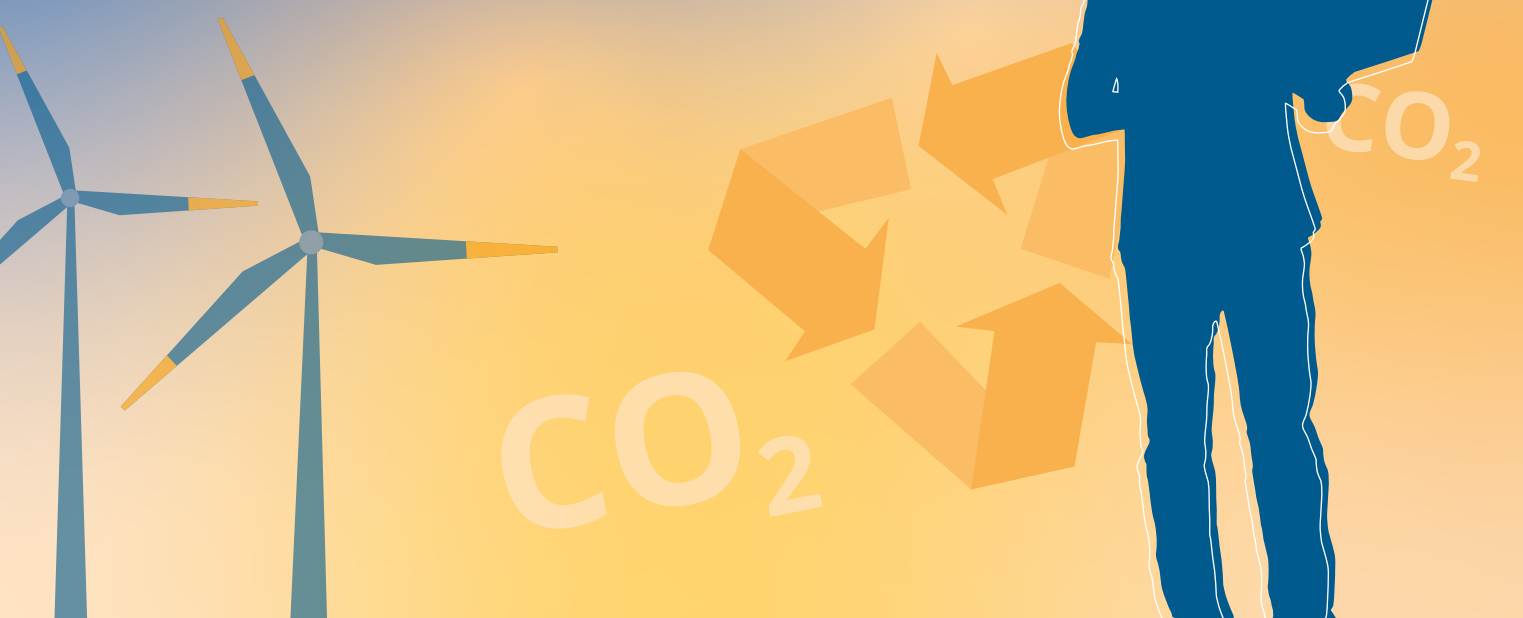
6 World Factbook data, retrieved at <https://www.cia.gov/the-world-factbook/field/real-gdp-per-capita/country-comparison>.

7 Author's calculations based on World Bank data.

8 Income of US\$ 1.90 or less per day (adjusted for purchasing power, in 2011 US dollars).

9 Glocalities: Global poverty survey, retrieved at <http://www.glocalities.com/news/poverty.html>.

# 3 Free trade and climate protection



*Galina Kolev*

## 3.1 Introduction

The last 50 years have been shaped by an unprecedented intensification of trade relations worldwide. Lower transport and telecommunication costs precipitated by technological advancement, trade liberalisation and the rise of important emerging economies, first and foremost China, helped numerous countries worldwide to expand their specialisation advantages and increase their prosperity, especially in the period prior to the economic crisis of 2009. Global value chains enabled international companies to access not only low-cost or technologically superior primary products, but also fast-growing markets, without neglecting customer proximity within the development and production process. The outcome: international trade in goods and services in 2019 outstripped the 1970 levels by a factor of 64 (World Bank, 2020a). Expressed as a share of global gross domestic product (GDP), the value of international trade increased from 27 per cent in 1970 to 60 per cent in 2019. This was accompanied by substantial changes in the composition of traded products and also the participating countries. While high-income countries accounted for about 82 per cent of international trade in 1970, the share of low- and middle-income, developing and emerging countries had grown to 31 per cent by 2019.

However, the greater exploitation of natural resources, increasing mobility, the energy demand associated with rising prosperity and other factors led to a 2.4-fold increase in global greenhouse gas emissions during the same period (World Bank, 2020a, available data up to 2016). The associated climate change is one of the greatest challenges facing the international community today. As early as 2009, the World Trade Organi-

zation (WTO) and the UN Environment Programme (UNEP) described climate change as a threat to future development, peace and prosperity that must be addressed by the entire international community as a matter of the utmost urgency (Tamiotti et al., 2009). The necessary urgency calls for a major commitment in all relevant policy areas in order to come close to the global climate goals – defined for instance in the Paris Climate Agreement – and to secure the future viability of a habitable planet.

The roles of international trade and global trade policies must also be analysed to ascertain whether synergy between trade and climate policy objectives can be harnessed and to initiate suitable measures that would mitigate or even eradicate negative interactions. In this regard, the Organisation for Economic Co-operation and Development (OECD) estimates that almost one third of transport-related CO<sub>2</sub> emissions, or seven per cent of CO<sub>2</sub> emissions worldwide, are attributable to international trade, and the trend is rising (OECD, 2015). At best, such figures provide orientation as they frequently neglect numerous other relevant factors, such as the positive contribution that international trade can make to climate protection. But the sheer magnitude of the estimated figures is reason enough to analyse the ties between international trade and climate change and on this basis to analyse recommendations for economic policies that attempt to find solutions to the challenges of climate change.

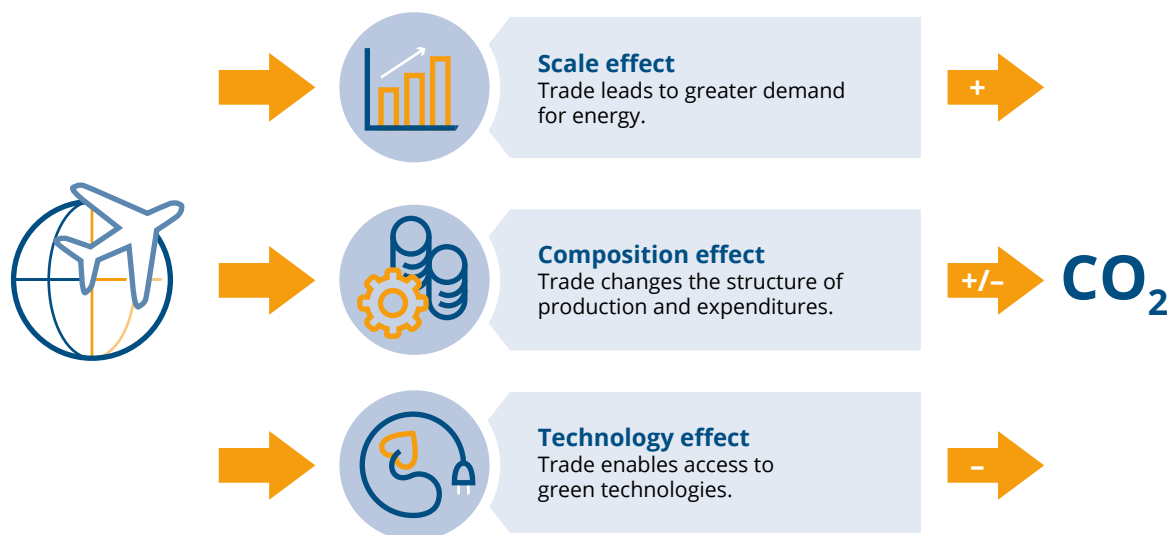
The following chapter initially addresses the theoretical connecting channels between international trade and climate change. It then proceeds to offer insight into a few empirical observations. It questions the clarity of links between CO<sub>2</sub> emissions and international trade and discusses practised but also potential approaches within national and multilateral trade policies in the fight against climate change.

## 3.2 Climate effects of international trade

Viewed theoretically, the connection between international trade and greenhouse gas emissions can be described using the three channels shown in Figure 1 (Tamiotti et al., 2009). First and foremost is the scale effect that occurs when the economy expands in the wake of trade liberalisation. Broadening economic activities requires greater energy consumption and hence leads to an uptick in greenhouse gas emissions. Moreover, greenhouse gas emissions also rise due to the transportation services associated with an intensification of international trade.



**Fig. 1: Impact channels between international trade and the volume of CO<sub>2</sub> emissions**



Source: author's diagram based on Tamiotti et al., 2009.

Secondly, the composition effect of international trade precipitates a change in production and expenditure structures in the countries involved, although the impact of rising trade on the volume of CO<sub>2</sub> emissions cannot be determined unequivocally. Trade liberalisation usually prompts countries to specialise according to their relative advantages in the sense of David Ricardo's model or according to their resource endowments as in Heckscher and Ohlin's model, or to exploit economies of scale by focusing on particular product variants as outlined by Paul Krugman. The patterns associated with specialisation are based on efficiency considerations and may lead to a rise or fall in greenhouse gas emissions – depending on whether the countries' relative economic advantages differ from their relative advantages, based on the CO<sub>2</sub> efficiency of production. In principle, the exploitation of economic specialisation advantages expedites greater resource efficiency that may reduce CO<sub>2</sub> emissions by cutting the use of materials and energy. But if a country's economy exploits its relative advantages to specialise in the production and export of goods and services that are manufactured on the domestic market and that involve higher CO<sub>2</sub> emissions relative to other countries, then international trade would logically entail an increase in global CO<sub>2</sub> emissions (and vice versa). This outcome may also occur if different climate protection requirements in the trading countries cause changes to the relative economic advantages and create incentives for companies to source their intermediate products from countries with lower CO<sub>2</sub>-related costs of production or to relocate their production there, a phenomenon that is known as *carbon leakage*.

Finally, the technology effect refers to improvements in the product life cycle's CO<sub>2</sub> emission intensity – from production technology to distribution channels – that are enabled by opening up to international trade and foreign investment. This is the main impact channel by which international trade can contribute to reducing global green-

house gas emissions. The technology effect can precipitate a drop in CO<sub>2</sub> emissions in two ways. Firstly, liberalised trade can increase the availability and reduce the prices of climate-friendly goods and services. This is a particularly important factor in developing and emerging countries, where climate-friendly products are not produced in sufficient quantities. Secondly, technological advancement and the associated higher incomes within a country will cause the population to shift preferences towards more climate protection, which can also increase political pressure and raise the overall demand for green goods and services. The technology effect may also occur if trade liberalisation increases the fierceness of competition, manufacturers optimise their production technology for efficiency reasons and in this way exploit greater resource efficiency as a means of reducing CO<sub>2</sub> emissions.

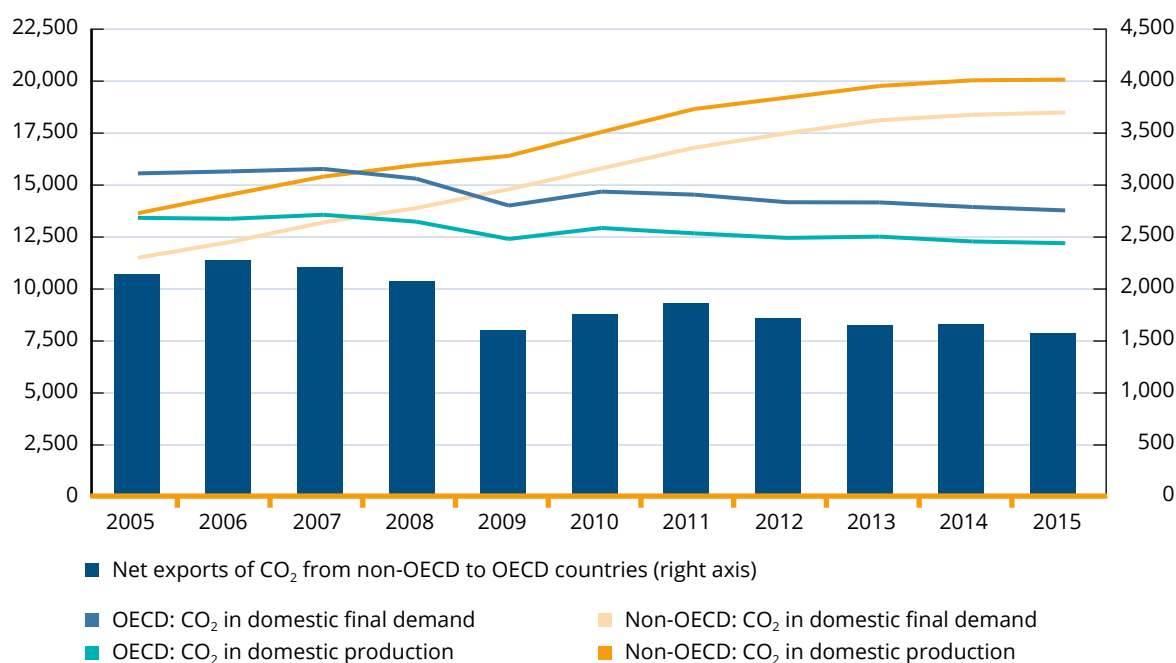
Overall, these theoretical considerations are unable to yield any clear signs of the connection between international trade and the volume of global greenhouse gas emissions. The scale effect and technology effect act in opposite directions, while the composition effect intrinsically depends on the comparative advantages of the countries involved in the trade. Empirical research, which investigates the data-based evidence of this correlation, also fails to deliver clear findings. While the scale effect of international trade on climate change can hardly be called into question, empirical investigation of the other impact channels faces the challenge of establishing relational causality and ruling out the influence of other factors on this relationship.

A first branch of empirical literature deals with the issue of carbon leakage. World Bank data (2020a) reveals that CO<sub>2</sub> emissions in low- and middle-income countries almost quadrupled between 1970 and 2016, while emissions from high-income countries, especially those in OECD member countries, increased to a far lower extent over the same period, namely by 33 per cent. It follows, therefore, that OECD countries accounted for only one-third of global CO<sub>2</sub> emissions in 2016, compared to 63 per cent in 1970 (World Bank, 2020a). Admittedly, some of this empirical observation is due to other trends associated with the growth process in developing and emerging countries and is not necessarily related to the intensification of international trade. Nonetheless, according to Kanemoto et al. (2014), many industrialised countries were only able to achieve their CO<sub>2</sub> emissions by relocating their high-emission production facilities abroad. Peters et al. (2011) estimate that net emissions transfers due to international trade between industrialised countries on the one hand and emerging and developing countries on the other roughly quadrupled between 1990 and 2008.

In order to measure the extent of the CO<sub>2</sub> transfer that takes place via international trade, the OECD has created a database that uses input-output tables to determine this net CO<sub>2</sub> transfer. The calculated net exports of carbon dioxide emissions match the difference between CO<sub>2</sub> emissions resulting from domestic production and domestic demand (Wiebe/Yamano, 2016). Figure 2 outlines the development of net exports, i.e. net CO<sub>2</sub> transfers, from non-OECD countries to OECD members between 2005 and 2015. The diagram visualises the growth in greenhouse gas emissions in countries outside the OECD in terms of both production and domestic demand. Production-related CO<sub>2</sub> emissions in these countries exceed the amount of CO<sub>2</sub> emissions caused by final demand over the entire period – the difference between the two metrics corresponds to net CO<sub>2</sub> exports and is shown by the green bars in the figure. The data therefore demonstrates that non-OECD countries are still net suppliers of CO<sub>2</sub> emission intensive

products for those within the OECD. But the green bar nevertheless describes a downward trend. While the volume of CO<sub>2</sub> transferred between the two groups of countries due to international trade reached a good 2,100 million tonnes in 2005, it had fallen by more than a quarter to just under 1,600 by 2015. This trend can doubtless be explained by the technology effect, partly at least.

**Fig. 2: Decreasing net CO<sub>2</sub> transfer via international trade in millions of tonnes of CO<sub>2</sub>**



Source: author's calculations based on data from OECD, 2020 and UNCTAD, 2020.

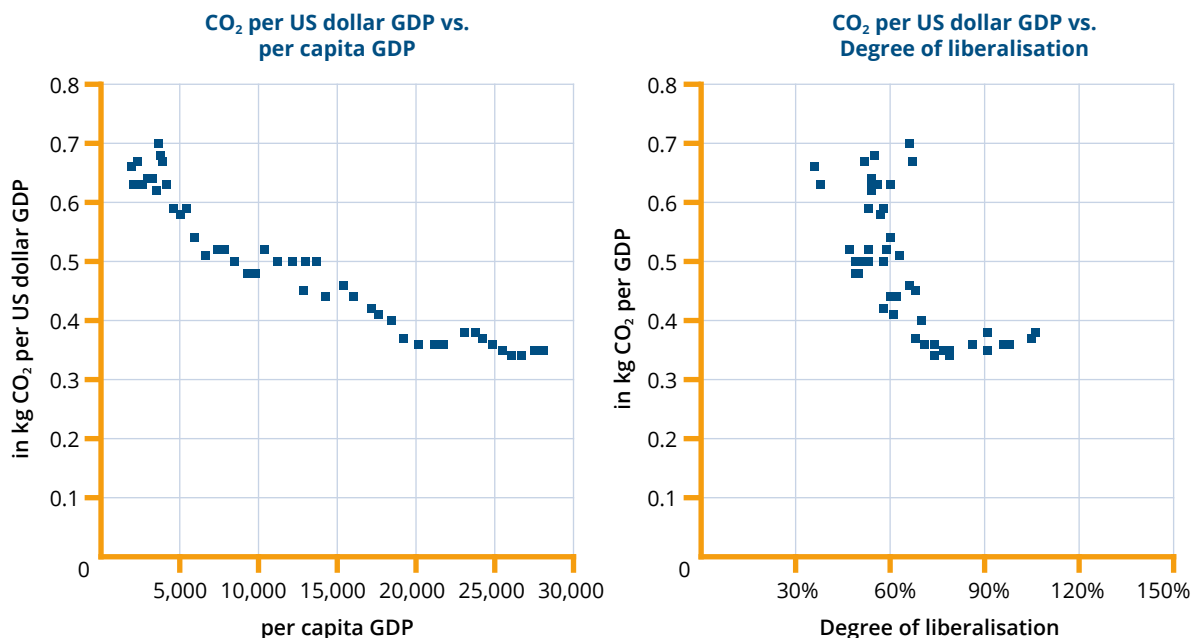
However, the plethora of additional influencing factors make it largely impossible to quantify the technology effect of international trade on global greenhouse gas emissions with any degree of precision. Literature on the Environmental Kuznets Curve (EKC) deals with this indirectly, but the findings are unclear. The Australian economist David Stern writes in this context that the empiricism around the EKC is a prime example of how error-prone empirical estimates can be (Stern, 2004). The EKC hypothesises that increasing per capita income (through intensified trade relations, among other things) will initially lead to a rise in CO<sub>2</sub> emissions, but that they will subsequently fall if, for example, access to better production technologies is enabled, improvements in resource efficiency lead to lower CO<sub>2</sub> emissions and/or the preferences of the population shift towards stricter climate protection. Although EKC-based empiricism remains controversial, data from fast-growing countries suggest that higher per capita income is at least associated with a decrease in the CO<sub>2</sub> emission intensity of aggregate economic production as measured by CO<sub>2</sub> emissions per US dollar earned. Figure 3 describes this connection for South Korea. Whereas 0.6 to 0.7 kg of CO<sub>2</sub> were emitted per US dollar earned during the 1970s, the volume of CO<sub>2</sub> per US dollar was approximately halved during the 2010s. Liberalisation of the Korean economy more

than doubled over the same period, measured as the share of international trade in GDP. Whether improved access to green production technologies or a shift in the population's preferences towards improved climate protection was more decisive here cannot be determined from the data. But further studies do show that South Korea's share of global patent applications in the field of environmental protection goods rose from below one per cent in the mid-1990s to around seven per cent in 2016 (Eckermann, 2020).

It is undisputed in literature that integration of developing and emerging countries within the global value chains goes hand in hand with improved access to more advanced technologies. World Bank data (2020a) on the portfolios of direct foreign investments in these countries as an auxiliary variable for technology transfer indicate impressive dynamism over the last forty years. For example, the portfolio of direct foreign investment in low-income countries has increased by a factor of 61 since 1980, while the portfolio in middle-income countries in 2019 was even eighty times higher than in 1980. Measured as a share of GDP in each country group, direct foreign investment now amounts to 23 per cent in middle-income countries and as much as 40 per cent in low-income countries.

**Fig. 3: CO<sub>2</sub> emissions in South Korea**

1971 to 2018; CO<sub>2</sub> emissions in relation to GDP: in kilograms of CO<sub>2</sub> per US dollar; degree of liberalisation defined as share of international trade in GDP.



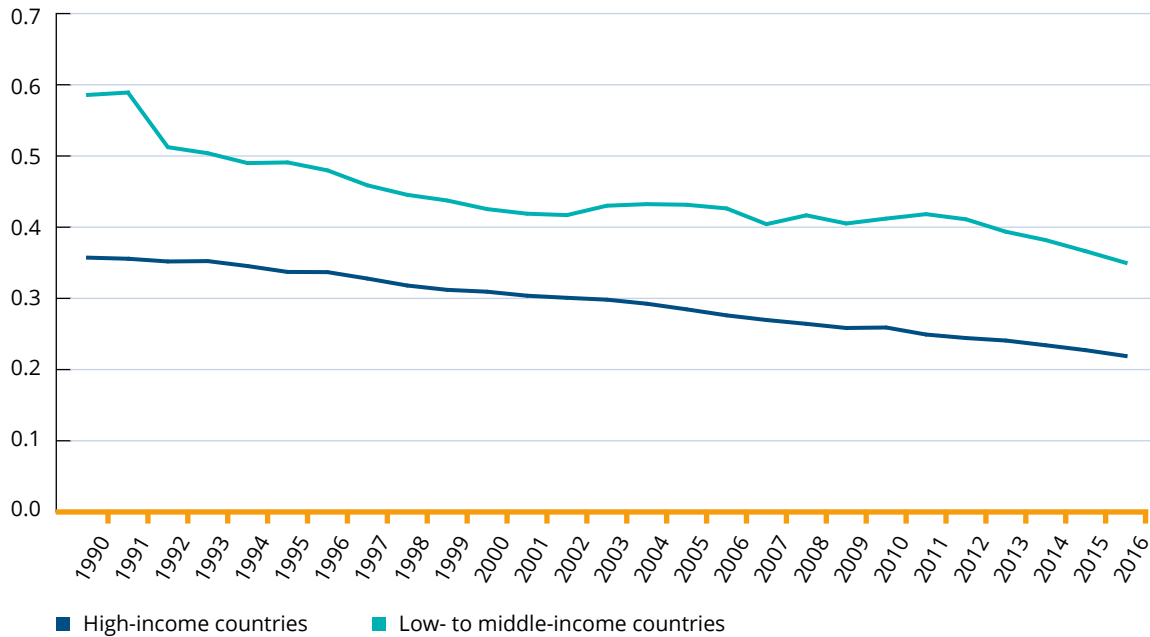
Source: author's calculations based on data from the World Bank, 2020a.

The **foreign trade figures** also point to the increasing importance of developing and emerging countries in the export of environmental and climate protection goods. A study by the Federal Environment Agency shows that Germany produced environmental protection goods worth €86 billion in 2017, including climate protection goods for over €34 billion (Eckermann, 2020). The value of German exports in the same year for environmental protection goods was €58 billion and €21 billion for climate protection goods. Although Germany mainly exports to other EU and OECD countries, the principal focuses have shifted away from the developed industrialised countries towards the developing and emerging countries. Germany was the world's largest exporter of climate protection goods until 2008. It has been ranked second since 2009, accounting for an eleven per cent share of the world market in 2017. With a global market share of nineteen per cent in 2017, China is by far the largest exporter of climate protection goods. China's share of global trade in climate goods more than tripled between 2002 and 2017 alone (Eckermann, 2020). The country now exports around as many climate protection goods as the United States, Italy and Japan together. China also launched a huge support programme to promote electromobility, which aims to ensure that electric vehicles account for a quarter of the country's new registrations by 2025 (FS-UNEP/BloombergNEF, 2020). With an investment volume of US\$ 83 billion, China also took the lead in the expansion of renewable energies in 2019 – ahead of the United States and Europe.

These empirical observations suggest that climate protection goods, technological advances and resource efficiency are also playing an increasing role in developing and emerging countries, which is partly because they have now been given access to these goods and technologies through international trade and integration into the world market. The data in Figure 4 permits the assumption that this has led to an improvement in the CO<sub>2</sub> efficiency of their aggregate economic production over time. For instance, aggregate economic CO<sub>2</sub> efficiency improved to a greater extent in low- and middle-income countries over the period 1990–2016 (the CO<sub>2</sub> emission intensity values in Figure 4 have decreased more) in comparison to high-income countries.

**Fig. 4: CO<sub>2</sub> emissions per GDP unit**

CO<sub>2</sub> emissions relative to GDP generated, expressed in kilograms of CO<sub>2</sub> per US dollar in 2017 (Purchasing power standards)



Source: World Bank, 2020a.

### 3.3 Trade policy approaches to climate policy challenges

Analysis so far suggests that the integration of developing and emerging countries into world economic structures in the course of the globalisation process may have led to these countries specialising in relatively CO<sub>2</sub>-intensive products and to an indirect transfer of CO<sub>2</sub> emissions from these countries to countries with higher incomes via the pathway of international trade. But this trend appears to be subsiding, and some developing and emerging countries are seizing the opportunity to lower their CO<sub>2</sub> intensity using green technology and investments in renewable energies. Overall, however, CO<sub>2</sub> emissions in these countries remain at a record level. Trade policy measures can not only improve access to climate protection products, but also level the playing field between countries with strict and more relaxed environmental regulations.

The discussion on a potential border adjustment mechanism seeks to identify solutions to precisely this asymmetry in global climate regulations. At present, merely twenty per cent of global CO<sub>2</sub> emissions are subject to direct pricing, for example in the form of the purchase of CO<sub>2</sub> certificates under the EU Emissions Trading System (World Bank, 2020b). This represents a competitive disadvantage for manufacturers confronted with these additional costs, both on the domestic market and in their exports on the global market. Border adjustment therefore seems to be a necessary trade policy measure in countries with high CO<sub>2</sub> prices as it would balance competition and reduce the incentive for carbon leakage. However, relevant literature elucidates that the introduction of any such measure would present stiff challenges with regard

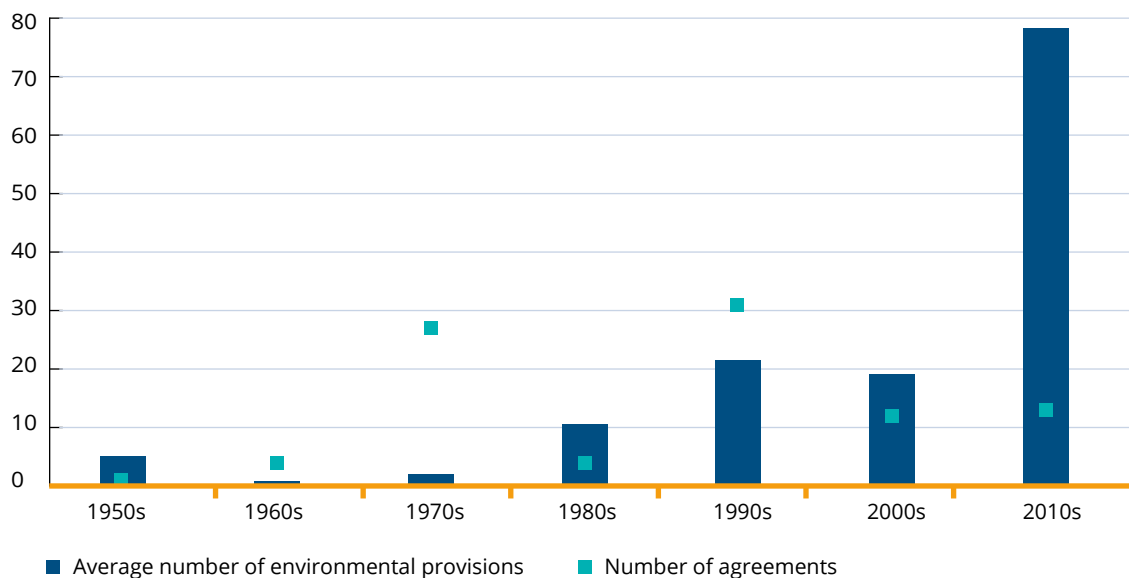
to recording the CO<sub>2</sub> content of goods, as well as their WTO conformity and scope, and must be examined very carefully to avoid unnecessarily provoking trade partners and sparking trade conflicts (Cernicky/Hartlieb, 2020; Kolev et al., 2020).

Even if it prioritises other objectives, trade policy has the potential to make a significant contribution to the pursuit of climate policy goals. Aside from a border adjustment tax, it would also be conceivable to base tariff levels for different goods on their CO<sub>2</sub> content, as proposed by Joseph Shapiro (2020). Shapiro ascertains that the current thrust of global trade policies indirectly subsidises CO<sub>2</sub> emissions, as products with a high CO<sub>2</sub> content enjoy the benefits of particularly favourable customs tariffs. It is hence reasonable to assume that, in particular, a corresponding tariff reduction would improve the availability of climate-friendly goods for a larger group of countries and stimulate demand for the corresponding products through falling prices. If – in a hypothetical world – the tariff levels applicable to traded goods were based on their CO<sub>2</sub> content, specialisation would also shift in such a way that relative CO<sub>2</sub> efficiency would play a more weighty role in companies' decisions. It is even conceivable that the specialisation advantages of individual countries, like in the model by David Ricardo and elsewhere, might be defined based on their CO<sub>2</sub> efficiency instead of their cost efficiency (Kolev, 2020a). So if countries around the world were to embrace specialisation according to the CO<sub>2</sub> efficiency of production, this would lead to a decline in global CO<sub>2</sub> emissions, without curtailing the available volumes of goods and services. Green growth might also be possible in this way: the amount of goods and services produced and consumed could be increased for a given volume of CO<sub>2</sub> emissions.

The environmental and climate protection clauses now included in the numerous trade agreements provide additional trade policy measures in the fight against climate change. Figure 5 illustrates the exponential rise in the importance of these provisions over recent years. While the average finished agreement included around twenty environmental provisions in the 1990s and 2000s, the number has risen to almost eighty over the last decade (Kolev, 2020b). It is now standard practice for modern trade agreements to emphasise environmental protection even in the preamble and to point out in numerous places in their texts that free trade and foreign investment must not take place at the expense of protecting the environment.

**Fig. 5: Environmental provisions in EU agreements**

Average number of environmental protection provisions per agreement; number of concluded agreements



Source: Kolev, 2020b; Morin et al., 2018; Trade & Environment Database (TREND).

Non-discriminatory subsidies for the development of climate-friendly technologies or the development of renewable energy sources represent additional trade policy instruments that can support countries on their way to achieving climate neutrality. However, these subsidies must be examined very closely to ensure WTO conformity and must not be misused for protectionist purposes.

### 3.4 Multilateral trade policy approaches for improved climate protection

Beyond the trade policy measures of individual countries and their trade agreements, the WTO provides a platform for further trade policy initiatives, for example to bolster trade in climate and environmental goods and in this way to strengthen the technology effect of international trade on CO<sub>2</sub> emissions. Even at the inception of the WTO, the Marrakesh Agreement stipulated that WTO member states may adopt trade policy measures to pursue environmental and climate policy goals, provided they are not misused for protectionist purposes. The negotiations on a global WTO agreement for environmental goods (Environmental Goods Agreement – EGA) that were launched during the Doha Round represent the next step towards a multilateral approach in addressing climate policy challenges by means of trade liberalisation measures. Negotiations are currently being conducted by 18 participants representing 46 WTO member states (the EU and 17 other countries, including China and the US) with the aim of eliminating tariffs on environmentally and climate-sensitive products, such as those used to generate energy from clean and renewable sources or to improve energy and



resource efficiency (WTO, 2020a). Moreover, discussions also centre on the elimination of harmful subsidies for fossil fuels and the introduction of a voluntary labelling system for ecological products in order to control their consumption. The intention of the countries involved is to provide all WTO members with improved access to the relevant environmental and climate protection products as well as to further agreements once the negotiations have been concluded. The EGA negotiations began in July 2014, but the most recent round came to an end in December 2016, and the future of the negotiation process has been uncertain ever since.

But the WTO's contribution to climate protection extends way beyond the EGA negotiations. For example, the Trade and Environment Committee, which was established as far back as 1994, regularly discusses the impact of international trade on the environment with the aim of contributing to sustainable development through trade policy measures (WTO, 2020b). The committee's meetings specifically address issues such as the WTO's role in efforts for the global implementation of a circular economy or in the regulation of subsidies for green or climate-friendly products.

In addition, the WTO also published the brochure *Short Answers to Big Questions on the WTO and the Environment* in October 2020. It is a detailed publication written in non-technical language that seeks to improve understanding of the relationship between international trade and trade policy on the one hand and environmental issues on the other (WTO, 2020c).

Aside from the work at WTO level, other meetings are also held to intensify the contribution made by trade policies to climate protection. One of these initiatives is the informal **FAST Group** (Friend Advancing Sustainable Trade), which addresses issues such as climate change, circular economy or reforms of fossil fuel subsidies and emphasises environmental sustainability as one of the key principles in the WTO reform process (WTO, 2020d).

The ACCTS (Agreement on Climate Change, Trade and Sustainability) negotiations initiated in September 2019 between New Zealand, Costa Rica, Fiji, Iceland, Norway and Switzerland, which joined the negotiations shortly afterwards, also illustrate that trade liberalisation, trade policy and climate protection are perfectly comfortable bedfellows (MFAT, 2020). Here too, the intention once the negotiations have been concluded is to make the achievements of trade-driven climate protection accessible to other countries, provided they meet certain criteria.

### 3.5 Summary

The elaborations contained in this paper provide an overview of climate-relevant aspects within international trade and trade policies. The data and a review of the relevant literature suggest that a link between international trade and global greenhouse gas emissions is far from clear. Suitable trade policy instruments, international trade flows and trade policies themselves can not only offset CO<sub>2</sub> emissions caused by the extended transport routes, they can in fact contribute positively to a transformation of climate policy as well. But the available methods of trade policy can only be used as accompanying measures – similar to international cooperation

with developing and emerging countries, which can strengthen trade relations with industrialised nations and enable these countries' access to climate-friendly technologies. Climate policies carry the principal responsibility for resolving this global problem, as they possess effective instruments to quantify in monetary terms the negative implications of climate change and hence to deliver the most auspicious solution to the problem at hand.

Global efforts are needed to resolve a global problem of this magnitude. It is immensely important in this context that the largest CO<sub>2</sub> emitters, China and the USA, are involved in the discussion and, through their commitment to climate protection, increase the motivation of other countries to engage in climate protection in addition to their own contribution. China has set itself the goal of achieving climate neutrality by 2060. Viewed from this perspective, the outcome of the US presidential election in November 2020 is also positive news for the global climate community and raises expectations for improved cooperation and greater progress over the four years ahead.

# 4

## Sustainability chapters in EU free trade agreements: Motivation, structure and effects

*Axel Berger*

### 4.1 Introduction

Modern trade policies extend far beyond the dismantling of tariffs and quotas. Indeed, they regulate trade in services, contain rules on the protection of foreign investors or intellectual property rights and set standards, for example for health and plant protection. (Dür/Elsig, 2015; Mattoo et al., 2020). Trade agreements are used increasingly to enforce political objectives that are unrelated to trade policies in a narrower sense. These agreements are therefore no longer called just *free trade* agreements, but economic partnership agreements, as in the case for the agreements between the European Union (EU) and Japan or the African, Caribbean and Pacific (ACP) countries, or comprehensive economic and trade agreements, as in the case with the EU-Canada agreement.

Trade policies are used more and more to promote sustainable development. Besides the USA, Canada or New Zealand, the EU in particular uses trade agreements to promote human rights, labour and environmental standards in partner countries. The EU is frequently referred to as a “normative trade power” that is not (exclusively) interested in the assertion of commercial interests (Manners, 2002). This normative element of European trade policy is rooted in the EU’s self-perception, which dictates that political, social and ecological standards and rights apply not only within the European common market, but also to the EU’s external relations. This self-perception was made legally binding in Article 21 of the Treaty of Lisbon in 2009:

*“The Union’s actions on the international scene shall be guided by the principles which have inspired its creation, development and enlargement, and which it seeks to advance in the wider world: democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, the principles of equality and solidarity, and respect for the principles of the United Nations Charter and international law.”<sup>10</sup>*

Integration of global sustainability aspects into EU trade agreements began as early as the late 1980s.<sup>11</sup> The Lomé IV Convention of 1989 between the EU and the ACP countries was the first to contain provisions on the protection of human rights (Bartels, 2005). These human rights clauses are perceived by the EU as “essential elements”, so any violation is considered a breach. Labour and environmental protection clauses have also been incorporated into EU trade practice since the 1990s. The Economic Partnership Agreement with the Caribbean Forum (CARIFORUM), a subgroup of ACP countries, which entered into force in 2008, contained numerous provisions to protect humanitarian, social and environmental rights. All newly negotiated EU free trade, association or economic partnership agreements have included comprehensive sustainability chapters since the agreement between the EU and South Korea in 2012. Increasingly, the free access to the EU market granted to developing countries is also being linked to the implementation of sustainability goals within the framework of the Generalised System of Preferences (GSP).<sup>12</sup>

The integration of sustainability aspects into trade agreements is the subject of controversial debate, also within the EU. Some perceive sustainability chapters as just lip service that does little to protect human and labour rights or the environment in partner countries and are merely a fig leaf for policies aimed at reducing trade restrictions. Others hold that trade agreements and access to the attractive European domestic market can act as leverage (pressure) to promote sustainability goals in partner countries. In particular, these arguments currently feature with regard to the EU’s agreement with the South American Common Market (MERCOSUR), which includes Brazil, a country engaged in the widespread clearing of rainforest areas for commercial exploitation (especially for animal husbandry).

Developing countries often level the accusation that these policies are environmental or social protectionism, i.e. that human rights, labour and environmental clauses in trade agreements are used to impose additional, non-tariff trade barriers on developing countries.

Viewed within the framework of these controversies, this article addresses the motives, contents and effects of increasingly intertwined trade and sustainability policies as they relate to the EU. It focuses on free trade agreements (FTAs) to reflect their current status as the most important trade policy instrument for the implementation of sustainability aspects. The analysis is based on recent research findings and is therefore, to the greatest possible extent, empirically substantiated.

The following chapter 2 provides an overview of the spread of sustainability aspects in international trade policies and analyses current research on the impact of sustainability chapters on both the implementation of labour and environmental standards and on trade flows. The chapter comes to the conclusion that the integration of

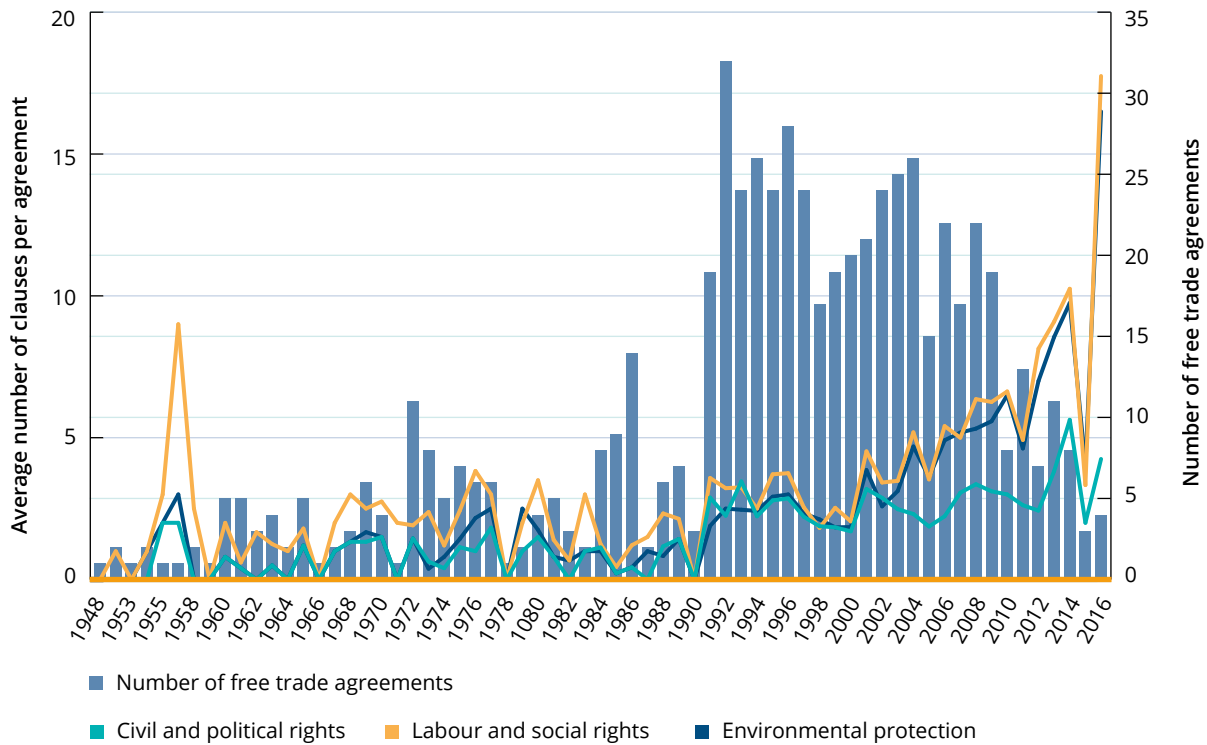
labour and environmental clauses especially has risen considerably over recent years and that developing countries are increasingly including these rules in their agreements as well. They can contribute to the implementation of labour and environmental standards, without any negative impact on trade flows. Chapter 3 presents the European approach to integrating sustainability aspects, which, unlike the “sanctions-based” methods of the United States, relies to a greater extent on cooperation and dialogue with partner countries. The EU’s collaborative approach can be effective, given the need for long-term initiatives to promote labour and environmental standards in partner countries. However, the EU should provide more technical and financial support for transformation processes in partner countries and make more extensive use of civil society’s potential for implementing the sustainability clauses in European trade agreements. Chapter 4 summarises the article’s most important findings and contextualises them against the backdrop of the current discussions on the EU-MERCOSUR agreement.

## 4.2 Sustainability aspects of free trade agreements

While multilateral trade integration under the auspices of the World Trade Organization is engulfed in crisis, many countries have turned to bilateral or regional FTAs as their preferred instrument. The number of these agreements has spiralled since the early 1990s, remaining at a high level for the next two decades (figure 1). Since the beginning of the 2010s, the number of newly concluded FTAs has been falling, while the average number of sustainability clauses in these agreements has risen in leaps and bounds. Attempts have failed to achieve multilateral incorporation of environmental and labour standards within the WTO, especially due to the resistance mounted by developing countries. They feared that these standards could be used by industrialised countries as a form of back-door protectionism (Leary, 1997; Morin et al., 2019).

Sustainability aspects within FTAs can be divided into three groups: civil and political rights, labour and social rights and environmental protection (Lechner, 2016). Figure 1 shows that a few FTAs included sustainability aspects as far back as the early 1940s. One of the first agreements to incorporate sweeping labour and environmental clauses was the North American Free Trade Agreement (NAFTA) that was concluded between the USA, Canada and Mexico in 1992. NAFTA can be seen as a blueprint not only for additional US FTAs, but also for other industrialised countries that are increasingly integrating sustainability aspects into their FTAs. Modern FTAs such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), concluded between eleven littoral states in the Asia-Pacific region, or the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada, contain more and more clauses for labour and social rights as well as environmental protection, which are also more frequently legally binding. By contrast, the number of clauses in trade agreements stipulating civil and political rights is stagnating. Chapter 3 provides a detailed description of the contents of sustainability chapters, using the EU as an example.

**Fig. 1: Degree of legalisation in sustainability clauses contained in EU FTAs (ten-year average)**



Source: author's diagram based on data in Lechner, 2016.

Sustainability clauses are traditionally found most commonly in agreements negotiated between countries of the Global North and countries of the Global South (Morin et al., 2018; Raess/Sari, 2020). The fewest number of provisions addressing sustainability issues are found in agreements that are negotiated between countries belonging to the Global South. It was industrial nations that included greater numbers of increasingly binding sustainability clauses in free trade agreements with developing countries. This pattern is unsurprising given that the greatest discrepancy in the regulation of environmental and social policies exists between the countries of the Global South and North. However, recent years have seen more harmonisation, and clauses on labour and social rights as well as environmental protection are increasingly found in South-South agreements as well (Lechner, 2019).

Why are sustainability aspects increasingly considered in international trade policies? One argument that is frequently proposed by economists for the integration of sustainability aspects into trade agreements is the protection of producers in industrialised countries (Bhagwati/Hudec, 1996; Krugman, 1997). Based on this logic, the purpose is to prevent free trade from eroding social and ecological standards, which might give producers in developing countries an “unfair” advantage. Empirical studies show that labour and environmental clauses are included in FTAs above all when national companies are engaged in intensive import competition and there are particularly high wage differences between the contracting parties (Lechner, 2016). Against this

backdrop, it is hardly surprising that many developing countries criticise the integration of sustainability aspects in trade agreements as “hidden protectionism” (Harrison et al., 2019).

A related argument in regard to economic policy is that the industrial countries seek to use trade agreements as a means of establishing their standards and regulatory systems in partner countries (Lavenex/Schimmelfennig, 2009) and that the partners accept these export rules to avoid placing their own access to the industrialised markets at risk. Empirical studies have shown in this context that the frequency of “aggressive” environmental clauses stipulating particular policies and guaranteeing their enforcement in trade agreements rises proportionately to the imbalance in economic power between the contracting parties (Blümer et al., 2020).

Another argument for the integration of sustainability aspects into trade agreements is the pressure exerted by environmentally conscious citizens. The majority of the population in many countries believes that the government should do more to protect the environment (Bättig/Bernauer, 2009) and therefore support the inclusion of environmental provisions in the FTAs (Bernauer/Nguyen, 2015). At the same time, citizens who care most about the environment tend to prefer protectionist trade policies (Bechtel et al., 2012). In many cases, therefore, it has become a political necessity for proponents of free trade to include environmental clauses – and this argument can be extended to labour provisions as well (Postnikov/Bastiaens, 2020) – in trade agreements in order to secure a majority (Esty, 2001; Van Den Putte/Orbie, 2015). So it is hardly surprising that on average, democratic countries include six times as many environmental protection clauses in their trade agreements as autocratic countries (Morin et al., 2018).

A final argument that can help to explain the integration of environmental and labour protection clauses into trade agreements is the hope that environmental and labour standards are easier to implement in trade agreements than in specialised environmental or labour forums, such as the United Nations’ subsidiary organisations. In other words, trade agreements can contribute to the more widespread adoption of sustainability policies (Jinnah/Lindsay, 2016). It follows that the sustainability clauses in trade agreements are sometimes more comprehensive or binding than those in specialised agreements, e.g. for species protection or biodiversity.<sup>13</sup>

But irrespective of the motives, it is reasonable to ask whether the integration of sustainability chapters in trade agreements actually leads to improvements in the ecological and social situation in the partner countries and whether this takes place at the expense of promoting trade. When considering the impact of labour clauses, it is important to distinguish between the negotiation phase prior to the conclusion of the contract and the subsequent implementation phase. This distinction is often made with regard to the sanction-based environmental and labour clauses in US agreements on the one hand and EU agreements on the other, whose implementation relies on cooperation and dialogue. An early study by Kim (2012) shows that partner countries in US trade agreements improve their labour standards *prior to* concluding the contracts and that they do so in order to qualify for negotiating an agreement with the United States (refer also to *International Labour Organization/International Institute for Labour Studies*, 2013). By comparison, a study by Postnikov and Bastiaens (2014) reveals that

EU agreements show particularly positive effects on the labour standards in partner countries during the implementation phase *after* conclusion of the contracts. Another study by the *International Labour Organization* (2016) demonstrates that while labour clauses in trade agreements may help to stimulate participation in the job market, they have no effect on the wage levels. By contrast, a further empirical study by Kamata (2016) emphasises that there are no positive effects, as do a number of qualitative studies that focus on a few countries as case examples (refer to Harrison et al., 2019).

Research on environmental clauses reveals positive impact on environmental quality and legislation. Recent studies suggest that trade agreements with environmental clauses are subsequently associated with lower emissions of greenhouse gases and air pollution<sup>14</sup> (Baghdadi et al., 2013; Martínez-Zarzoso/Oueslati, 2016; Zhou et al., 2017). A study by Brandi, Blümer and Morin (2019) shows that trade agreements with environmental clauses promote domestic environmental legislation, especially in developing countries. Like with the impact of labour standards, Bastiaens and Postnikov (2017) demonstrate that US agreements more probably lead to a reduction in environmental pollution *prior to* ratification, while European agreements – with their collaborative approach – reveal positive effects on the environment *after* ratification.

Given the positive impact of environmental and labour clauses in trade agreements, the question arises whether this comes at the expense of the volume of trade flows, i.e. whether sustainability aspects in trade agreements actually have a protectionist effect, as many developing countries fear. With a view to the sustainability clauses themselves, it becomes apparent that they do not call into question the fundamentally positive impact of free trade agreements (Baier et al., 2014; Dür et al., 2014; Mattoo et al., 2017) and that they may even place additional export opportunities within the reach of developing countries. Carrère, Olarreaga und Raess (2020) elucidate that while the integration of labour clauses in trade agreements has no (additional) positive effect on trade flows in general, it does not reduce them, either. But labour clauses have a significant positive impact on the export opportunities of developing countries, especially to industrialised nations. Agreements that build on cooperative mechanisms to implement labour standards stimulate trade in particular.

In their assessment of environmental clauses, Berger, Brandi, Morin und Schwab (2020) come to the conclusion that the number of these clauses leads to a (marginal) reduction in trade flows, especially in the case of developing countries. In other words, the inclusion of environmental clauses diminishes the fundamentally positive impact these agreements have on trade, albeit only slightly. Environmental clauses in trade agreements can however reduce exports of environmentally harmful products and increase exports of sustainable products from developing countries, but only if they already have a higher level of environmental regulation (Brandi et al., 2020).

This chapter has made clear that environmental and sustainability clauses have become integral elements in modern trade agreements. More recent empirical research demonstrates that interweaving trade and sustainability policies in this way may have positive implications for environmental and social standards in partner countries and also does not inhibit the positive effect of FTAs on trade flows.



### 4.3 Sustainability in EU trade agreements

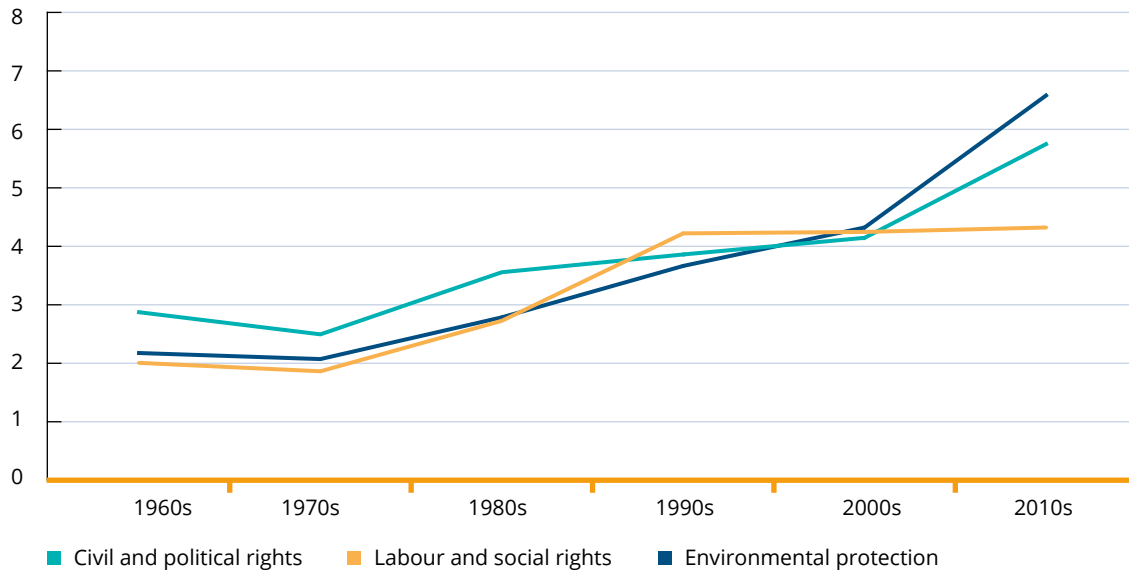
The EU perceives itself as a normative power that seeks to apply trade policies in order to underpin the humanitarian, social and ecological dimensions of globalisation. The European Commission's trade strategy "Trade for Everyone" states:

*"One of the EU's objectives is to ensure that economic growth goes hand in hand with social justice, respect for human rights, high labour and environmental standards and health and safety. This applies to both external and internal policies and therefore includes trade and investment policy as well."*<sup>15</sup>

The Treaty of Lisbon defined sustainable development as one of the core principles of European trade policies. But the EU started to integrate sustainability aspects in its trade agreements long before the treaty entered into force. The EU adopted an official foreign human rights policy in 1991. Since then, human rights clauses have been incorporated into trade agreements with ACP countries, Argentina and central and eastern European countries, as well as into the GSP. These human rights clauses are perceived by the EU as "essential elements" of the agreements, so that any violation is considered a breach of contract. The EU's 1993 agreement with Hungary marked the first time that the concept of sustainability was explicitly included in an EU trade agreement (Bartels, 2013). The EU-CARIFORUM agreement contains comprehensive sustainability clauses, while the FTA between the EU and South Korea places all these provisions in a sustainability chapter for the first time. Unlike the "essential" character of human rights clauses, environmental and labour clauses in EU trade agreements are not perceived as obligations for which any violation is tantamount to a breach of the agreement (Bartels, 2013). At the same time, the EU relies on cooperation and dialogue rather than formal dispute settlement procedures to implement sustainability clauses.

Nevertheless, EU trade agreements should not be (mis)interpreted as toothless tigers. The social and environmental regulations in EU trade agreements have become increasingly detailed and binding over the years. On the other hand, it cannot be assumed that the option of initiating a formal dispute settlement procedure will automatically lead to the regulatory contents of environmental and social clauses being implemented.

**Fig. 2: Overview of substantive provisions in the sustainability chapter of the EU-Vietnam FTA**



Source: author's diagram based on data in Lechner, 2016.

Figure 2 visualises the structure of sustainability clauses in EU FTAs – based on their degree of institutionalisation.<sup>16</sup> It becomes clear at this point that sustainability aspects in the EU's trade agreements have not only become more comprehensive over the years, but also more legally binding, more enforceable and also more precisely defined. Figure 2 shows that from a historical perspective, this applied mainly to labour and social rights, but that the degree of legalisation of environmental clauses has increased considerably since the turn of the millennium. In contrast, the legalisation of civil and political rights has stagnated at the level of the 1990s.

**Table 1: Overview of substantive provisions in the sustainability chapter of the EU-Vietnam FTA**

Miscellaneous	Labour and social rights	Environmental protection
Goal to promote sustainable development		
Right to regulation		
Prohibition of lowering standards to promote trade		
Commitment to enforce national laws		
Prohibition of the discriminatory application of standards		
	Ratification and implementation of international labour standards, in particular the ILO fundamental labour conventions	Implementation of multilateral environmental agreements
		Implementation of the Kyoto Protocol and the Paris Agreement
		Promotion of biodiversity
		Promotion of sustainable forestry
		Sustainable use of marine resources

Source: author's diagram based on the contractual text of the EU-Vietnam FTA; refer to <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2020:186:FULL&from=EN#page=132> (last retrieved: 05/12/2020).

Which contents are written into the sustainability chapters of European FTAs? Three overarching themes can be distinguished in the sustainability chapters of EU FTAs: substantive standards, procedural obligations and institutional mechanisms. (Harrison et al., 2019). Figure 3 uses the EU FTA with Vietnam that entered into force in 2020 as an example to summarise the most important, substantive sustainability standards. It becomes clear that the sustainability chapters of current European trade agreements oblige the contracting parties to maintain national environmental and labour laws, as well as to implement multilateral labour and environmental agreements. They also contain a series of detailed environmental policy provisions. It is conspicuous to note that the lion's share of these rules are legally binding.<sup>17</sup>

The sustainability chapters in EU trade agreements also contain a large number of procedural obligations. For example, the sustainability chapter of the EU-Vietnam FTA includes a commitment to apply the precautionary principle, to transparency in the introduction of new environmental and labour regulations, to reviewing how the agreement impacts sustainability and to dialogue and cooperation between the parties involving social actors in both countries.

It is often argued that, compared to the US, the EU's approach to integrating sustainability issues is less effective in regard to the enforcement of environmental and labour standards. In this context, it is pointed out that the US makes the environmental and labour clauses subject to sanctions under the normal dispute settlement procedure. In contrast, the EU only relies on cooperation and dialogue to promote enforcement (Postnikov/Bastiaens, 2014).<sup>18</sup> A more thorough examination of the institutional mechanisms reveals that EU agreements set out a series of strict procedures for the implementation of rules. In addition to a committee on trade and sustainable development that includes government representatives from both parties, national advisory bodies must also be established to advise on the implementation of the sustainability chapter. Representatives of independent economic, labour and environmental organisations sit on these national advisory bodies.

The sustainability chapters in EU agreements hence do not rely solely on government cooperation, but can be used to mobilise civil society in partner countries to implement environmental and labour rules. The contracting parties can initiate government consultations if disputes arise as to the interpretation or implementation of sustainability clauses. If they fail to produce to an amicable agreement, either of the contracting parties can convene a panel of experts to investigate the possible violation of the agreement and submit an independent report, which – as in the case of the EU-Vietnam Agreement – is published and becomes the basis for further government consultations.

Is this mechanism to enforce rules in EU agreements less effective compared to those included in US agreements? The latter option naturally packs more of a punch as the violation of labour or environmental clauses can lead to suspension of the entire agreement, which means, for instance, that the partner country will no longer be able to export on the basis of the lower tariffs. But it runs the risk that the punch would be too powerful to ever be used. So far, the dispute settlement procedure in a US agreement has only been invoked in one case to enforce a labour clause. The US lost this case as the complainant.<sup>19</sup> Moreover, this pure sanctioning instrument is not particularly suitable to promote long-term policy adjustments in the partner countries. In view of this, it is hardly surprising that US agreements also contain many of the cooperative and dialogue-based procedures traditionally found in EU agreements.

This chapter has shown that labour and environmental clauses in trade agreements can contribute to improving the social and environmental situation in partner countries, without detracting from the positive trade effects of these agreements. Nonetheless, trade agreements should not be viewed as a panacea that is used to improve environmental and labour standards in developing countries. This is why there is also a range of case-specific research on the challenges of promoting sustainable development in partner countries (Marx et al., 2016). Ecological and social transformation

processes are inherently long term, and sustainability chapters in trade agreements are just *one* element of a comprehensive strategy. The impact of sustainability chapters depends on a long-term strategy that also relies on cooperation and dialogue. Participation and pressure from civil society in the EU and partner countries are just as important as promoting environmental and labour standards in partner countries through technical and financial support (Harrison et al., 2019; Van Den Putte/Orbie, 2015). The sustainability chapters in trade agreements can provide a legally binding framework for these long-term political dialogues and supportive measures. They are therefore an important building block for a rule-based and coherent (with the international environmental and labour system) international trade system.<sup>20</sup>

#### 4.4 Summary and outlook

Criticism is currently being levelled at the agreement negotiated between the EU and the MERCOSUR countries: its environmental clauses were not sufficient to stop Brazil's rapid destruction of the rainforest. In light of this criticism, it is important to keep in mind that the EU-MERCOSUR agreement contains a mechanism to bind Brazil to the Paris Agreement and prevent its withdrawal. The EU is breaking new ground on the international stage with the commitment to implement the Paris Agreement in its trade agreements. The contract also includes clauses on sustainable forestry, which are intended to help prevent illegal logging. Irrespective of the inclusion of sustainability aspects in the MERCOSUR agreement, it is necessary to ask nonetheless whether a trade agreement can be expected to change Brazil's long-standing slash-and-burn policy in the short term? Certainly, the anticipated conclusion of the contract has not shown any effects so far. But can trade policy succeed where environmental and climate policy have failed? Critics demand that the sustainability clauses in the EU-MERCOSUR agreement be underpinned by sanctions, as is the case in US agreements. In view of the current research findings presented in this article and the political practice in which this severe sanctioning instrument is rarely if ever used, it is reasonable to raise doubts that sanctioning will be successful in promoting lasting policy changes in a country like Brazil.

Trade agreements with comprehensive and binding environmental and sustainability clauses can act as an important building block for international sustainability policies. It is important to note nevertheless that their direct effectiveness is by no means guaranteed and that changes towards greater sustainability require a long-term strategy and support measures. The commitment to regular cooperation and dialogue included in EU trade agreements can offer support to this kind of strategy. EU trade platforms can become a valuable communication platform for enduring change processes. These change processes should be supported with incentives in the form of technical and financial cooperation, and monitoring mechanisms should also be strengthened. The EU Commission's proposals to strengthen the role of social actors in treaty implementation and to install a Chief Trade Enforcement Officer are certainly a step in the right direction. But there should be no doubt that these changes will require staying power.

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- 10 Refer to <https://eur-lex.europa.eu/legal-content/DE/TXT/HTML/?uri=CELEX:12012M/TXT&from=EN> (last retrieved: 05/12/2020).
  - 11 A broad understanding of sustainability is adopted, which is based on the Agenda 2030 for Sustainable Development and its seventeen goals. Besides economic, ecological and social aspects, sustainability is also interpreted to include human rights, democracy and the rule of law.
  - 12 The EU's GSP+ grants developing countries greater market access compared to the "ordinary" GSP, provided the partner countries ratify and implement 27 international conventions on the protection of human and labour rights and environmental standards.
  - 13 Examples include rules for the protection of endangered species or genetic resources and traditional ecological knowledge (Morin/Jinnah, 2018).
  - 14 Cf. in this regard to detailed discussion of the relationship between trade and the climate in chapter 3 of this book.
  - 15 Refer to [https://trade.ec.europa.eu/doclib/docs/2015/october/tradoc\\_153880.PDF](https://trade.ec.europa.eu/doclib/docs/2015/october/tradoc_153880.PDF) (last retrieved: 05/12/2020).
  - 16 The degree to which environmental and labour clauses are institutionalised in FTAs echoes the political science concept of legalisation. Legalisation measures the degree of commitment, delegation and precision of international rules, regimes or organisations (Abbott et al., 2000). Applied to sustainability aspects in trade agreements, commitment is the degree of legal obligation inherent to pure declarations of intent up to the possibility of sanctions; delegation measures the degree to which third parties such as non-governmental organisations are involved in monitoring and enforcing the rules; and precision describes the exactness of wording in sustainability clauses (Lechner, 2016). Refer to [https://trade.ec.europa.eu/doclib/docs/2015/october/tradoc\\_153880.PDF](https://trade.ec.europa.eu/doclib/docs/2015/october/tradoc_153880.PDF) (last retrieved: 05/12/2020).
  - 17 The word "shall", which implies that the parties are highly committed to implementing the matter, appears over seventy times in the sustainability chapter of the ten-page EU-Vietnam FTA.
  - 18 The Economic Partnership Agreement between the EU and CARIFORUM is an exception, as it makes the sustainability rules enforceable under the dispute settlement procedure.
  - 19 U. S. loses to Guatemala in first-ever FTA labor dispute settlement case, Inside US Trade, 20.6.2017, in: <https://insidetradetrade.com/daily-news/sources-us-loses-guatemala-first-ever-fta-labor-dispute-settlement-case>, (last retrieved: 05/12/2020).
  - 20 Cf. in this regard the sections on a rule-based trade system in the second chapter of this book.

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With its focus on the social market economy, the Konrad-Adenauer-Stiftung perceives this publication as a means of injecting objectivity into the debate on “globalisation”. It uses resilient facts to discuss the issues of economic growth, justice and climate change in their relation to globalisation. Within this framework, the authors primarily contradict the argument that gains from trade only occur to the detriment of the other side.

On the contrary, they show that rules-based free trade raises the prosperity of all population groups in each participating country and at the same time increases labour protection and transparency, especially in developing countries. In regard to climate protection, free trade is – in equal measure – part of the problem and the solution.