

The Estey

Journal of International Law and Trade Policy

Dismantling Trade Agreements: Why Is It so Difficult?

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Both the United States and the United Kingdom wish to revamp the arrangements under which their international trade is conducted. In both cases, the objective is to achieve an improvement in the performance of their economies through these new arrangements. As yet, how this is to be achieved has not been well articulated by the proponents of changing the existing arrangements. The article examines what can be gleaned from the process thus far. It does not appear likely that the goal of either the United States or the United Kingdom can be achieved by altering international trade arrangements.

Keywords: Brexit, history, renegotiation, strategy, Trump administration

Introduction

Now, ... what is the remedy for existing evils? What is the course of policy suited to our actual condition? Certainly it is not our wisdom to adopt any system that may be offered to us, without examination, and in the blind hope that whatever changes our condition may improve it. It is better that we should "bear those ills we have, than fly to others that we know not of." We are bound to see that there is a fitness and an aptitude in whatever measures may be recommended to relieve the evils that afflict us; and before we adopt a system that professes to make great alterations, it is our duty to look

carefully to each leading interest of the community, and see how it may probably be affected by our proposed legislation (p. 83).

Daniel Webster, 1824¹

Contrary to the advice of Daniel Webster, two countries that represent major economic players globally have set in motion negotiations to radically alter the arrangements under which they undertake their international trade and other facets of their international commerce. For the most part, these changes represent large leaps of faith that disentangling their countries from “foreign” entanglements will enhance their economic performance in ways that improve the lot of those “left behind” over the long period of slow but relatively steady trade liberalization.² This goal should be accomplished while also making those who benefited from existing trade arrangements better off going forward. No new groups of domestic constituents were to be “left behind” with the new trade arrangements that are expected to arise.³ *Making America Great Again* and Brexit were not premised on a redistributive agenda but rather a “lifting of all”, although lifting those previously “left behind” might, it is hoped by those proposing change, take place at a more rapid pace. Neither those in the United States accepting Donald Trump’s vision nor those in the United Kingdom engaging in the *Leave* campaign espoused protectionist strategies such as import substitution.⁴ They put considerable store in alternatives to their country’s existing trade arrangements. Donald Trump, for example, when he cancelled the already agreed Trans-Pacific Partnership (TPP) suggested that he would like the United States to immediately begin bi-lateral trade negotiations with a number of the countries that had been part of the TPP. Those supporting Brexit have been extolling the potential for new trade agreements with Commonwealth countries, India, China and the US to more than counter the negative effects of the loss of the “single market” as a result of Brexit. Trade is clearly a central theme in their vision of the future. Hence, in both cases, it is the perceived bias against either the US or the UK in existing trade arrangements that is the spur for seeking alternative arrangements. For Donald Trump there is a perception that previous US trade agreements have been incompetently negotiated and have not had “America First” as the underlying principle of the negotiation strategy. In the case of Brexit, it is that Britain has not been able to prevent EU arrangements evolving in ways that put an unacceptable regulatory burden on British industry – in particular environmental regulations and labour standards. The arrangements with the EU also allowed for relatively unfettered immigration into the UK from other EU member states, which many voters also deemed unacceptable.⁵

Both during the Presidential campaign in the United States and in the lead up to the Brexit vote in the UK, the proponents of eschewing exiting agreements in favour of new arrangements were vague about what new trading arrangements would entail and how they would lead to better economic outcomes for all. With the passage of time, the strategy of the Trump administration has become less opaque. In the UK there is, as of the end of 2017, little clarity as to what type of arrangements will be sought. It seems clear that the chaotic approach of the British government to Brexit is, in large part, due to disagreements within the governing Conservative party as to which approach should be followed – to a “hard” Brexit or a “soft” Brexit. The type of measured analysis advised by Daniel Webster seem almost totally absent. For example, David Davis the UK’s Brexit Minister, the admitted that there had been no “systematic impact assessment” of Brexit (BBC News, December 6, 2017).⁶

Hence, it seems clear that one of the reasons why finding new arrangements has not been easy thus far is that little thought has been given to it by the proponents. Further, appropriate human capital is relatively scarce. The trade policy⁷ expertise to devise the nature of any new trade arrangements that are desired and the trade negotiating skills needed to achieve those desired arrangements are limited (Kerr, 2007b). In the case of the administration of President Trump, the distrust of expertise of any type, particularly in the “Beltway” around Washington where most of US trade policy professionals work – as personified in the campaign slogan “drain the swamp” – means that they do not want to draw from that pool of talent. It is very difficult for the administration to find people that they trust to fill those posts. As a result, for example, it took a very long time for the United States to put any concrete proposals on the table at the NAFTA negotiations.

In the United Kingdom, the shortage of trade policy expertise is particularly acute. As the EU had had responsibility for the development of trade policy rather than the individual member states, there is hardly any local expertise to draw on. A new Ministry of International Trade has had to be created from scratch.

Few Precedents

Another reason that determining how to extract a country from a long-standing trade agreement is difficult is that there are very few examples which are comparable to, for example, withdrawal from (or renegotiation of) the NAFTA or exiting from the European Union. For the most part, historically, once having entered into a trading arrangement, countries tended to remain in them. Certainly, renegotiation takes place, but such instances, by and large, are aimed at further reductions in trade barriers and the deepening of economic ties. The World Trade Organization operates on this premise

and, in fact, has prohibitions against backsliding in future negotiations formally built into its agreements (Kerr, 2000). In the case of the NAFTA, the United States is seeking a rebalancing whereby it benefits to the detriment of Mexico and Canada. This is a departure from the norm of furthering liberalization through renegotiation.

The European Union has followed an evolutionary path towards further trade liberalization and latterly has been on a trajectory towards increasing degrees of integration, including regulatory harmonization and the unfettered movement among member states for citizens of all member states. The European Union has developed a unique institutional structure that fosters the movement toward further integration. The European Commission is comprised of commissioners who are supposed to eschew their particular national interest and “speak for Europe” once having accepted their post. The European Commission’s staff are also expected to have a European rather than a national outlook. The Commission has also been given the institutional role of proposing changes to the treaties that are the legal foundations of the EU, as well as regulatory changes. The European Council of Ministers and the European Parliament can accept or reject proposed changes put forth by the Commission. As it has a European-wide focus, the Commission is a force for greater integration (Kerr, 2006). Given the intrinsic and deeply held belief in having the European Union move forward with deeper integration embedded in European Union institutions, it is probably not surprising that Prime Minister David Cameron could not wring sufficient concessions – essentially moving backward – to satisfy the Euro-sceptics in his own party or British voters in the run-up to the Brexit vote. From that perspective, leaving the European Union was the only option, as “going backward” was not on the table to any significant degree.

There have been some examples of formally cancelled trade agreements, but they are rare.⁸ Rather than abrogating trade agreements, countries simply let them atrophy or go dormant. In such cases, there is no dramatic break or change to trading arrangements; rather, the existing agreement simply loses relevance over time. Further, many trade agreements don’t have much impact past the photo-op associated with their signing. This is either because their clauses actually exhibited very little ambition, or protectionists could use their political influence to inhibit implementation or to convince their government not to actively pursue enforcement (Kimbugwe et al., 2012). As such agreements never have much impact, neither does letting them atrophy.

Trade agreements also lapse or collapse due to cataclysmic events such as wars. In such cases the disruptions that perpetrate the demise of the existing trading arrangements are likely far more disruptive than anything that might arise from changes to trading arrangements. For example, one long-standing set of trading arrangements

that collapsed was those embodied in the Council for Mutual Economic Assistance (CEMA), which were the trade arrangements among the economies dominated by the Soviet Union in the period before the fall of the Berlin Wall and the end of the Soviet empire. The changes brought by the abandonment of central planning and allocation by command were far more disruptive than anything brought by the subsequent withdrawal of countries from the CEMA (Hobbs et al., 1997).⁹ The process of transition to market-based economies meant that readiness to enter into new trade arrangements was considerably delayed for what had been command economies (Gaisford and Iourkova, 2007). For a number of the former CEMA countries, effective new trading relationships had to wait until their accession to the European Union (Gaisford et al., 2003).

In short, there are few examples for either the United States or the United Kingdom to examine to garner insights into how either to achieve their desired outcomes or to avoid significant adjustment costs. The absence of pre-investigation and pre-planning by both Donald Trump and the advocates of Brexit is understandable because there was, in both cases, the expectation that they might not win. Both the victory over Hillary Clinton and the Brexit referendum result were far from sure things. Subsequently, their short-run activities had the distinct feel of genuine surprise at having to come up with a viable strategy for achieving the new, desired trade arrangements.

Moving from Current Trade Arrangements to New, Desired Trade Relations

With no previous similar events to provide guidance, the attempts by the United States and the United Kingdom to alter their trading arrangements in significant ways can provide some important lessons. In some ways the new trade agendas of the administration of President Trump and Brexit represent radically different events. In the case of the United States, one has a major economic power attempting to rebalance its trade arrangements with a number of much smaller economies. In the short run the administration of President Trump wants to reverse some of the existing trade arrangements which they perceived as having been poorly negotiated from the perspective of garnering trade advantages for the United States. In contrast, Brexit represents the attempt of a relatively small economy¹⁰ trying to leave a much larger economic market. It is analogous of a country such as Mexico attempting to leave the NAFTA with the objective of being better off economically.

What does “being better off” economically after a change in trade relations actually mean? If one accepts for the moment that more open trade is welfare enhancing, a move backward to more protectionism and less economic integration should be welfare decreasing. In other words, the size of the economic pie should shrink. For the country

seeking to alter its economic arrangements, however, it still may be possible to be better off if the total absolute size of its share of the smaller economic pie is larger than the total size of what it received from the pre-change economic pie. In other words, even if the total economy of the NAFTA countries shrinks, as long as the United States can gain concessions from Canada and Mexico that more than offset the decrease in its economic activity from the shrinkage of the North American economy in total, then the United States will be better off. Otherwise, the United States will be worse off.

Similarly, the United Kingdom must have the objective of obtaining a much larger share of a smaller EU plus UK total pie than the absolute size of its economic share of the EU pie when it was a member of the EU. Otherwise, it will be worse off after Brexit. For the United Kingdom this would seem a tall order, but it may also be a difficult objective for the United States to reach. In either case, only garnering a larger share of the post-change smaller economic pie will not be sufficient to justify altering the existing economic arrangements.

Now that the United Kingdom has initiated the Brexit process, the remaining members of the European Union must also have the objective of obtaining a result that more than offsets the decline in the size of the entire economic pie that results from the withdrawal of the United Kingdom. As the economies of the rump of the European Union shrink, in their negotiations they must seek to ensure that they obtain additional economic activity that more than offsets the shrinkage.¹¹ With both sides in the negotiations looking for a result that compensates for the inevitable losses, one can expect acrimonious negotiations. While it may be difficult to achieve, both Canada and Mexico should have similar objectives for their NAFTA negotiations.

Underlying the entire process of renegotiating trade arrangements is an unstated assumption that being the bigger economic entity imparts an advantage in the negotiations. This assumption is very evident in the strategy of the United States, where there has been a stated objective of moving away from multilateral or regional arrangements with multiple trade partners, to bilateral agreements. This was one of the motives for the U.S. withdrawal from the TPP and the subsequent pledge to begin bilateral negotiations with a number of the countries that had been part of the TPP group. In the negotiations over the NAFTA the United States has proposed that the NAFTA disputes system be removed from any “updated” agreement. This would unfetter U.S. antidumping and countervail mechanisms from super-national oversight. In a similar fashion, the United States has been refusing to cooperate in the appointment of members of the WTO’s appellate panels. Presumably, once the number of available panel members falls below the required minimum for appellate panels, they will not be able

to hear cases, thus nullifying the WTO disputes system. The result would again be the removal of super-national oversight of U.S. antidumping and countervail mechanisms.

There is some evidence that the move by the United States from managing its trade relationships almost exclusively through the multilateral GATT to an approach based on bilateral, regional and multilateral agreements¹² has led to the United States being able to use its economic power effectively to obtain “U.S. friendly” agreements (Kerr and Hobbs, 2006).

The assumption that economic size gives an advantage in negotiations has been less overt in the Brexit case. The European Union has, however, been acting as if this is the case. First, it has assessed that the United Kingdom will have little leverage in the negotiations over new trading arrangements. On the other hand, it perceived that the United Kingdom did have some leverage over the issues of the rights of EU citizens living in the United Kingdom and in how much it would pay to extricate itself from the financial obligations associated with its EU membership.¹³ Hence, the EU refused to negotiate on future trade relationships until substantial concessions were obtained on these issues from the UK.

In essence, the negotiations that are being entered into both by the United States over the NAFTA and the European Union over Brexit have elements that can be interpreted as a strategic “trade war”. While there has been only limited examination of the expected outcome from participation in a trade war, one such theoretical analysis can be found in Gaisford and Kerr (1992), who examined the question, Who loses least in a trade war?

Their conclusion was somewhat counterintuitive and worth noting. They note that it is a common perception that large countries will be victors in such contests. On the contrary, their results show that neither a favourable terms of trade movement, nor a flatter import demand curve nor a larger population is, on its own, a sufficient condition for a relative victory in a trade war. This result has implications for smaller countries’ trade strategies. They conclude that “Bigger is not necessarily better” (Gaisford and Kerr, 1992, 271). Hence, it is not wise for large countries to assume they will be the automatic winners in the trade negotiations surrounding the NAFTA¹⁴ or Brexit. It also suggests that the smaller economy in the negotiations should not take the victory of the large country for granted, and should instead have a well-thought-out strategy.

The Difficult Process of Cutting Ties

One of the intents of trade agreements is to foster long-run and predictable trade rules that can be used by firms interested in engaging in international trade (Kerr and

Perdikis, 2014). Trade agreements are not negotiated with the intent that they should only last for a short period. If the agreement appears to be secure, then firms are likely to have the incentives to make major and asset-specific investments¹⁵ in trade-related projects. Given the length of time the NAFTA has been in place and period the United Kingdom has been a member of the European Union and that, until recently, businesses could have safely assumed that those arrangements would continue, it is not surprising that many and major asset-specific investments have been made. Those investments range from the trilateral auto sector arrangements in North America to the financial architecture that allows London to function as the major financial centre for the European Union. Such ties cannot be broken without firms incurring considerable costs. For firms, there will be considerable negative impacts because of the asset-specific nature of their investments over the length of the previous trade and other international commercial arrangements.

Conclusions

Achieving an economic “victory” for either of the perpetrators of the renegotiation of international trade arrangements will not be easy. The road to superior economic outcomes from renegotiating the previous “bad” trade agreement entered into by the United States and the “overly restrictive” participation of the United Kingdom in the European Union is far from clear. How to overcome the loss of the previous gains from trade that will arise from the retreat from the existing liberal trade arrangements has not been well articulated by those who have promoted such a strategy. In the United Kingdom, there has been little strategy articulated; instead, there is a vision. According to that vision, the United Kingdom should secure continued unfettered access to the single market but escape from the regulatory burden arising from EU membership. This vision, however, is a nonstarter, as the single market, or access to it, is premised on firms facing similar regulatory burdens. Otherwise, governments could endow their firms with an economic advantage over their still burdened competitors by lowering their regulatory costs.¹⁶ This is why countries such as Norway and Switzerland, which have relatively unfettered access to the EU’s single market, must also accept the EU’s regulatory regime for, as an example, their environment and labour practices. If the United Kingdom wishes regulatory autonomy, it will not be able to negotiate unfettered access to the single market. The other part of the announced strategy of the United Kingdom is, once freed from EU constraints, to negotiate new trade agreements with non-EU countries. They seem to think that they will be able to negotiate better arrangements with these countries than they could get from those countries when they were part of the EU. Maybe the United Kingdom strategists believe that, given the size

of their economy, they will garner an advantage from being a large economy.¹⁷ They should heed the “bigger is not best” warning developed above.

The United States has, as yet, not articulated a strategy other than renegotiation. In the NAFTA negotiations they have proposed raising the “rules of origin” requirements for the entry of Mexican and Canadian-made automobiles into the United States but not how the resulting rise in the price of automobiles in the United States would not simply provide an incentive for larger imports from Japan, Korea, the EU and possibly China. There has been some suggestion that wages in the Mexican automobile industry need to rise, as if that is something that could be accomplished through Mexican government fiat.¹⁸ The strategy toward China, the other major problem country on the trade front from the Trump administration’s perception, thus far appears to be more aggressive use of U.S. contingent protection measures targeting “unfair” trade practices. The strategy of releasing U.S. domestic antidumping and countervail mechanisms from WTO oversight may be part of this strategy. Taken as a whole, these measures seem unlikely to achieve the goals of President Trump’s administration.

Neither the Brexit nor the renegotiation of U.S. trade arrangements has, as yet, fully played out. They are still at the phase of renegotiation. What is clear is that dismantling the existing international trade arrangements of the United States or the United Kingdom is proving far more complex than simply electing an administration with a new approach in the United States or voting to leave the EU. Further, there is no guide to how to garner a win from renegotiating existing arrangements and no clear road regarding how to achieve that objective.

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Endnotes

¹ Published in Webster (1882).

² Trade liberalization may not be the major reason why there have been groups left behind. Economists are still trying to sort out what can be attributed to labour-saving technological change and what can be attributed to trade arrangements. The attributing of being “left behind” to trade arrangements is part of the leap of faith that has been made in choosing to seek alternative international arrangements.

³ That it is well known that changes in trading relationships will create both winners and losers (Kerr and Perdakis, 2014) does not appear to be known, or at least acknowledged, by those promoting changes to trading arrangements.

⁴ See Gerber (2007) for a discussion of import substitution as a policy to promote economic development.

⁵ The United States has also experienced large-scale immigration, which had become increasingly contentious. It is somewhat ironic that the NAFTA was “sold” in part to voters on the basis that it would lead to economic growth in Mexico. Rising Mexican living standards would reduce the incentives to move to the United States illegally. To the extent that this is true, cancelling the NAFTA may well lead to an even greater flood of Mexicans crossing into the United States illegally.

⁶ The British government has commissioned a number of sectoral studies, which Mr. Davis has been reluctant to share widely. Presumably the effects of Brexit on some sectors would be politically sensitive.

⁷ The academic study of international trade in economics is loosely segmented into three sub-disciplines: (1) trade theory; (2) empirical studies of trade; and (3) trade policy. In recent decades, trade theory and empirical examinations have been on the ascendency while trade policy has languished in a relative sense. As a result, little trade policy is found in graduate curricula in economics. See Kerr (2007a) for a discussion of this division in the economics profession.

⁸ One example is the trade agreement between the United States and the colonies in British North America, signed in 1854. The United States exercised its option to cancel the agreement in 1866 (Kerr, 1986).

⁹ This does not mean the demise of the CEMA had no effect. The CEMA structure promoted a degree of specialization among countries such that, for example, some lines of tractors across all of the former CEMA countries suffered shortages of spare parts when authorities in newly re-unified Germany closed the East German tractor plant that was the previous source of the parts. In another case, there was a centralized centre for dairy research across the entire CEMA located in one of the smaller central European countries that had upwards of five hundred employees. The country where the research facility was located had no need for such a large establishment.

¹⁰ Compared to the remaining block of countries that retain membership in the EU.

¹¹ Note, this is not the decline in the size of the European Union market absent the United Kingdom, it is the loss associated from the European Union moving from a cohesive economic unit that includes the United Kingdom to a fractured economic unit – that is, the gains from trade forgone.

¹² This shift in U.S. trade policy took place near the end of the Clinton administration and was taken up enthusiastically by the Bush administration. Prior to that time, the United States did not engage in regional or bilateral trade agreements. The only exceptions were one with Israel, and the NAFTA. These were entered into, to a considerable degree, for political as well as economic reasons. In essence, the previous U.S. policy was that if a country wanted better access to the U.S. market it should work through the processes of GATT rounds (Kerr, 2005).

¹³ The third issue – that of the Ireland–Northern Ireland border once the UK leaves the single market, is relatively intractable and was not a leverage issue. Despite the papering over of this issue in the lead-up to the start of negotiations over the future trading relationship, either there must be a “hard” border between Ireland and Northern Ireland or a “hard” border on the UK side of the Irish Sea.

¹⁴ In this article we have focused on the U.S. approach to the NAFTA, but the United States has also said it wants to renegotiate the U.S.–South Korea trade agreement as well as the Dominican Republic–Central America Free Trade Agreement (CAFTA-DR).

¹⁵ In this case, specific to the opportunities created by the trade agreements. See Hobbs (1996) for a discussion of asset-specific investments.

¹⁶ Some British firms seem to believe that they will move from chafing under the EU regulatory regime to a situation of no regulations. The reality is that EU regulations will be replaced by regulations developed in the UK. There also seems to be considerable faith that UK regulations will be less burdensome than those of the EU. There may be little basis for such faith.

¹⁷ They also suggest they will pursue agreements with larger economies such as the United States, India and China. It is not clear why they think they would be able to garner superior agreements with those countries.

¹⁸ They have also demanded more market access to Canada's heavily protected dairy and poultry markets. This is a natural target for the United States, as Canada successfully defended its protectionist policies for these industries in the original NAFTA negotiations, the WTO negotiations, the Comprehensive Economic and Trade Agreement with the EU and most recently during the TPP negotiations. Hence, it is a more traditional trade policy demand.