From the Board: The Nativist Turn One Year On: Is the System Holding?

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Publication date
2018

Document Version
Final published version

Published in
Legal Issues of Economic Integration

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We would like to begin this issue by sharing with our readers some recent internal changes in the Board of Editors of *Legal Issues of Economic Integration*. These began with our long-time Managing Editor, Jim Mathis, stepping down from his coordination functions, taken up already in the last issue by Geraldo Vidigal. The process is now completed with Annette Schrauwen succeeding Pieter Jan Kuijper as Chair of our Board. Over the past decade, Jim and Pieter Jan have imprinted their dynamic and no-nonsense style on this journal, making it into the great repository of scholarship it is today. Both remain firmly on the Board and *Legal Issues* will continue to benefit from their invaluable expertise for the time to come.

As the editors finalize this issue in mid-February 2018, an appraisal of the status of international economic integration seems in order. This appraisal is inevitably marked by the choices made in Britain and the United States in 2016 in what was, in some ways, a call for 'economic disintegration', disengagement from international institutions and establishment of preferences for 'natives'. This nativist turn – the European version is discussed by Kamala Dawar in this issue – continues to pose challenges to the global economic architecture as administrations in these countries and elsewhere attempt to implement them while minimizing what many see as their unavoidably negative economic consequences.

In Europe, negotiations continue between the European Union and the United Kingdom to determine the nature and form of EU–UK relations after 29 March 2019, when the UK's departure from the European Union should take effect. In the United States, Donald Trump persists in his campaign to renegotiate the terms of the US's international trade relations, on grounds that the current rules have allowed other countries to take advantage of the United States. Besides withdrawing from the Trans-Pacific Partnership (TPP) on the first day of his Presidency, Mr Trump is seeking renegotiation of the North American Free Trade Agreement (NAFTA) and has doubled down on the United States' challenge to the rules-based multilateral trading system enshrined in the agreements of the World Trade Organization (WTO). The new US stance, which views trade as a zero-sum game to be 'won'

'From the Board: The Nativist Turn One Year On: Is the System Holding?'. *Legal Issues of Economic Integration* 45, no. 2 (2018): 111–120.

against trade partners, has already been called the 'Lighthizer Doctrine', after US Trade Representative Robert Lighthizer.[1]

These moves raise justifiable concerns. At the same time, they present observers with a unique opportunity to assess how robust the global economic architecture really is. Can near-consensus among economists over the welfare benefits of trade prevail over a strongly held sentiment among some populations that trade damages their livelihoods? To what extent will domestic constituencies accept leaders 'shooting their own countries in the foot' to reach an elusive feeling of autonomy? Can international institutions hold in the face of a wave of discontent in some of their key members, or do they depend on active support by leaders in the leading economies?

1 BREXIT, ECONOMIC RATIONALITY, AND THE ROLE OF TRADE AGREEMENTS

The negotiations between the EU and the UK to reach an agreement with respect to their post-Brexit relations raise two important questions. The first one concerns the extent to which the European Union and its integration project can withstand the blow of losing a Member State. In this respect, the loss of a Euro-area Member State, even a much smaller one, might present a greater threat to the Union's endurance than the loss of the United Kingdom, which was already not a party to several of the Union's key agreements. While the EU will certainly miss a Member State whose economy represented 15% of the EU's (and the economic clout that comes with having four of the world's ten largest economies within its single market), the EU institutions themselves seem not to be threatened. On the other hand, the departure of the Member State most vocally opposed to EU joint decision-making, positive regulatory integration and market intervention may tilt the scales in favour of the stricter market regulation policies favoured by Berlin and Paris. This could prove worrying to Member States that favour a free market model, which were previously able to rely on the balance between the largest economies to prevent EU encroachment into their pro-market economic policies.

The second question concerns the ability of the United Kingdom to make itself better off by leaving the European Union, investing in the idea of a 'global Britain' and trading with the rest of the world. While one may wonder whether more global integration was in fact what Brexiteers voted for in 2016, Theresa May's government's interpretation of the referendum is that they resented not trade itself but intra-European trade preferences, and called instead for a 'truly global' approach to free trade.[2] The UK is in a better position to pursue this route than most other Member States, already having

1 Shawn Donnan, *We Need to Talk About the Lighthizer Doctrine*, Fin. Times (12 Feb. 2018).
2 Ben Wright, *Theresa May Declares Brexit Will Make a 'Truly Global Britain' at Davos*, Tel. (19 Jan. 2018).

a large portion of its trade with the non-EU world and having specialized in an activity (financial services) for which traditional gravity models of trade, in which physical proximity plays a large factor, may be less relevant. Nonetheless, if the UK were able to attain its objective of securing access to the EU single market without contributing to the EU's budget, submitting its regulations to decisions of the Court of Justice (CJEU), or accepting free movement of labour, other Member States could justifiably question their own acceptance of the single market package deal.

This scenario, however, seems unlikely. Focusing on the UK's trade deficit with the EU, many Brexiteers still cling to the notion that the EU needs the British market more than the reverse and that therefore the UK should be able to dictate the terms of its new relations with the Union. This makes little sense, not only because EU institutions would want to avoid the incentives that allowing this cherry-picking would generate for other Member States but also because this is not how economics works – certainly not in the age of global value chains.

The issue can be explained well with the case of auto production. An automotive assembly plant in the United Kingdom that produces cars for export to Asia or the Americas using mostly car parts made in, say, France, Poland and the Netherlands, depends on the free flow of car parts to produce efficiently in the UK. Without easy access to input goods and a common regulatory framework, the plant's owners will be left with two alternatives: trusting that barriers to trade will remain negligible, and that regulatory alignment between the EU and the UK will continue, or shifting their production to make sure that any future barriers to trade do not disrupt their plant's production. Even if managers trust the current administrations in all the relevant countries, they are unlikely to base thirty-year investment decisions on this personal trust.[3] Thus, economic decisions will be based not only on present regulatory alignment but also on regulatory alignment backed by legal security.

Judicial integration is essential to safeguard legal security, ensuring not only that governments abide by their commitments and refrain from raising barriers but also that regulations are interpreted consistently. Without a form of integrated judicial oversight, so-called regulatory drift would take place even where two parties committed to using the same text for their laws and regulations, as soon as the courts of one party determined that a certain requirement encroached too much on the freedom of economic agents while the courts of the other party determined the opposite. Absent an institution capable of resolving conflicts of interpretation, which the CJEU does today, regulatory drift is a matter of when rather than if.

The way in which EU law ensures regulatory integration is important, too. The combination of supremacy of EU law and direct effect means that, in case of divergence, regulatory integration is re-established by CJEU decisions, implemented

[3] Peggy Hollinger, *Brexit Alarm Bells Are Ringing for British Industry*, Fin. Times (13 Feb. 2018).

directly by local courts in each Member State. In the alternative system used in most trade agreements, including some of the EU's 'deep integration' agreements with Canada and Korea, a decision from the adjudicators requires active implementation by political authorities at the domestic level. Some decisions may take a decade to get implemented; others may face open-ended non-compliance.

Worse still for producers, the means of enforcement of decisions in the face of non-compliance is for an aggrieved party to raise reciprocal barriers to trade, often in a different sector than the one affected by the violation. In the absence of a CJEU-type decision-maker, not only would car assembly owners be subject to regulatory divergence within their own sector, they would also be subject to their industry being targeted by economic sanctions aimed at enforcing judgments concerning other sectors. They would have no remedy for the ensuing economic harm.

In addition to the difficulty of retaining UK-EU trade, there is the issue of trade with the outside world. Over the past decades, the EU has negotiated preferential trade agreements with many of its key trade partners. It has concluded deals with countries such as South Korea, Canada, Mexico and Chile, is finalizing talks with Japan and Mercosur, and has a number of deeper trade agreements with countries in its immediate vicinity. These agreements, including those with countries in the European Economic Area, Switzerland, and Eastern Europe, involve a high level of regulatory approximation (often outright acceptance of EU rules and CJEU interpretations) in exchange for reciprocal market access. If the British government carries out its plan of withdrawing the UK from the EU customs union, none of these agreements will apply to the United Kingdom on 30 March 2019.

This means not only that the UK will have to negotiate new agreements with all of these third countries (which will presumably ask for concessions in return) but also that portions of products made in the UK no longer qualify for 'EU status' under rules of origin in these agreements. In other words, once Britain is no longer in the EU, British cars are British cars and EU cars are EU cars. Under the EU-Canada deal, for example, an EU car assembled in Germany may be made of parts made in the UK, France or Poland, but only 45% of its value can come from outside the EU. Following Brexit, British car parts will be competing with parts made in Mexico, Korea or China to be among the 45% of non-EU car parts allowed into a 'made in EU' car with preferential access to the Canadian market. Similar rules will limit the proportion of British parts in every EU product exported under every EU FTA.

Equally important, the same logic limits the access to preferential treatment of British products with EU parts. This may seem like an advantage to British production at first sight, but this is not necessarily the case. Producers that find British plants unable to take advantage of FTA preferences due to an excess of EU parts are as likely to move production elsewhere entirely as to invest into increasing the portion of products produced in the UK. And, as Japan's ambassador to the UK made clear just recently, legal certainty will be key in this choice.[4]

Many of these issues can be solved with clever legal drafting and creative institutional arrangements. This, however, presupposes not only that third countries accept the post-Brexit arrangements negotiated between the EU and the UK but also that the British government and the EU can reach an agreement on regulatory alignment that will allow the lowering of reciprocal trade barriers. While the British government has grudgingly accepted that it is now negotiating with an economy six times its own size, there is still doubt about the extent to which the British public, and a significant number of leading Brexiteers, are ready to acknowledge this fact and its consequences in terms of which party determines the menu.

2 THE ENDURANCE OF NAFTA: FROM EXIT TO VOICE

The situation is almost reversed in the context of NAFTA. The United States is responsible for 87% of the GDP of North America, 75% of Canada's exports and 81% of Mexico's. Economic rationality would suggest that, in order to safeguard access to their largest export market, Mexico and Canada should generally accede to demands made by the United States. Donald Trump's demands for renegotiation, backed by a threat of withdrawal, should therefore find more fertile ground. Agreeing to less advantageous terms could be the price to pay for Canada and Mexico to keep some legal protection for their economic interests, since without international institutions they would be left with a fully power-based relation with a neighbour on which they depend heavily.

One year on, NAFTA is in its sixth round of renegotiation talks and only minor reforms have been agreed on. Two reasons appear to be preventing the US strategy from bearing fruit. First is the fact that at the heart of the US's demands is a proposal to remove institutional safeguards entirely. The United States, which has de facto nullified NAFTA state-to-state dispute settlement under NAFTA Chapter 20 (by failing to cooperate in the composition of panels), proposes to eliminate adjudication on trade remedies under Chapter 19 and to create an opt-out (presumably for the United States) to investor-state dispute settlement under Chapter 11. Eliminating all adjudicatory oversight over NAFTA would put Canada and Mexico in the same situation they would be in the absence of NAFTA: depending entirely on the political process, i.e. on the decision by the US to open its market and maintain its openness, either because it is in its interest or in exchange for reciprocal openness.

[4] *See* e.g. Rob Merrick, *Japan Warns Theresa May Its Giant Firms Will Quit UK If Botched Brexit Makes It 'Unprofitable' to Stay*, Indep. (8 Feb. 2018).

The second reason is that NAFTA is in fact beneficial to the US private sector – it would be surprising if it were not. NAFTA does not set rules against the interests of its parties, but enshrines these parties' agreement on reciprocal market opening. Representatives of the private sector in the United States, including in Congress, defend NAFTA not because they support international governance but because NAFTA allows them access to imports from, and markets in, Mexico and Canada. While market access may be replaceable, access to inputs (and, in particular, cheaper labour in Mexico) may be key to maintaining the competitiveness of US products both in US markets and abroad. The auto makers in Detroit urging the President not to withdraw from NAFTA[5] are not defending Mexico's interest but their own. Similarly, Members of Congress from farm states who show concern about Mexican retaliation[6] are defending their states' economic interests. As the long-standing disputes over sugar and softwood lumber reveal, the two smaller NAFTA parties have not shied away from enforcing the agreement through reciprocal non-performance in the face of perceived violations. Thus, while the President himself might wish to resort to exit as a negotiating tactic, the interest of US firms (and politicians) limit the credibility of the threat.

3 WITHDRAWING FROM THE GLOBAL RULES: TESTING THE LIGHTHIZER DOCTRINE

A third reason Mexico and Canada are able to resist US pressures is that the three countries remain Members of the WTO, which provides an alternative forum for adjudicating trade disputes. Indeed, since the de facto nullification of NAFTA dispute settlement in 2001, the WTO has been seized of no less than twenty-eight disputes between NAFTA parties. Of these, twenty-two were brought against the United States (fourteen by Canada, eight by Mexico) and six were brought by the United States (four against Canada, two against Mexico). There are no disputes between Canada and Mexico, which is unsurprising given that they only account for around 2% of each other's trade.

Withdrawing from the WTO would be a far riskier move than withdrawing from NAFTA. While within North America the United States' centrality is clear, within the broader context of global trade flows the economic and political dominance of the US is tempered by the existence of other large economies – traditionally

5 David Shepardson, *Major Automakers Urge Trump Administration: Don't Ditch NAFTA*, Reuters (15 Jan. 2018), https://www.reuters.com/article/us-autoshow-detroit-nafta/major-automakers-urge-trump-administration-dont-ditch-nafta-idUSKBN1F42MI (accessed 18 Feb. 2018).

6 Jeff Daniels, *Trump Risks Backlash in Farm Belt States If NAFTA Gets Scrapped*, CNBC (23 Aug. 2017), https://www.cnbc.com/2017/08/23/trump-risks-backlash-in-farm-belt-states-if-nafta-gets-ripped-up-entirely.html (accessed 18 Feb. 2018).

the European Union and increasingly China – whose dependence on the US market is less pronounced. While the US was clearly the driving force behind the establishment of the General Agreement on Tariffs and Trade in 1947 as well as its transformation into the WTO in 1995, it is less clear that the WTO today would not survive a US withdrawal. Such withdrawal, and the closing of the US market, could in fact accelerate an already visible shift whereby an increasing number of countries across the globe have China, not the US, as their main trade partner. And, while a US outside the WTO would retain market significant power over most WTO Members, it would also lose the sole legal basis for its relationship with China, which would devolve into a bilateral retaliation-based trade relation.

For this reason, the US strategy for the WTO has been to asphyxiate its dispute settlement system,[7] blocking the appointment of members to the organization's Appellate Body with the apparent aim of convincing other Members to agree to a return to the GATT's diplomatic dispute settlement system, whereby dispute settlement reports would depend on positive consensus by WTO Members to acquire legal force. Absent agreement on new (re-)appointments, the seven-member-strong WTO Appellate Body should shrink to one member at the end of 2019. While it may be able to continue to settle disputes that are on its docket by that time, parties will de facto be able to block subsequent panel reports by appealing them to an Appellate Body incapable of forming a three-member division to hear appeals.

It is unclear what would happen then. Other Members may find a workaround for their bilateral disputes, but absent a collective decision to confront the United States (which could prompt full US withdrawal) the system would lose much of its strength as the focal point for establishing and interpreting multilateral trade rules. The US's calculation appears to be that, in the absence of an Appellate Body, Members' only alternative would be a de facto return to the GATT system, as a defending Member could decide whether to consent to a panel report (and not appeal it) or to reject it (and appeal it into oblivion).

Perhaps ironically, this stance overstates the importance of the legal and adjudicatory framework provided by the WTO for trade relations. Would a WTO Member that has had a victory at the panel level simply accept that the Member found in breach can avoid all the consequences of its WTO-inconsistent conduct by resorting to a procedural quirk? Would China, which is now questioning the new anti-dumping methodologies applied by the US and the EU, act forcefully against the EU after an unappealed and unimplemented panel report and at the same time fail to act on an equally condemnatory report against the United States, because the EU's report was adopted and the US appealed its own report into oblivion?

7 *See* the Editorial in our last issue: *From the Board: The US Attack on the WTO Appellate Body*, 45(1) Legal Issues Econ. Integration 1–12 (2018).

This seems unlikely. Internationally agreed upon rules, and international dispute settlement, are unable to impose results on states. All adjudicators do is provide states with an alternative to mutually harmful retaliation as a means of dispute resolution. In the absence of binding reports, WTO Members would simply act on their best understanding of what the rules require another Member to do. This may be an unadopted panel report or a report adopted in a different case; in the absence of even these sources of authoritative interpretation, the logical consequence is that each country will act on its own understanding of what constitutes a breach.

These complications may explain why President Trump's threats to withdraw from NAFTA and the WTO have not materialized. It cannot be excluded that withdrawal is being reserved for a future moment, when it would cause maximum political effect. Still, withdrawing from agreements does not mean withdrawing from the economic and political system that supports them, which will continue to operate regardless of the legal status of written agreements and dispute settlement systems. In this case, the operation of this system can be expected to be far rougher, jeopardizing both carefully planned value chains and the security and predictability that economic actors enjoy when the terms of coexistence are written down and economic relations are institutionalized.

4 WILL THE SYSTEM HOLD?

If history is any guide, the most likely result of an implosion of the rules-based multilateral system would not be a world of peaceful cooperation between free-trading sovereign nations but a system in which each state attempts to divert economic activity from its neighbours to itself, leading to overall impoverishment and the exacerbation of political tensions.

So far, the system appears to have held reasonably well. In the case of Britain, there is decreasing confidence in the notion that the European Union would be willing to bend the rules of the single market and agree to terms dictated by the United Kingdom merely to save a trade surplus in goods. Neither political difficulties in Germany nor arguments over respect for the rule of law in some Eastern European countries have broken the single front presented by the EU negotiating team, which has affirmed the integrity of the single market and maintained its position of not allowing an outgoing Member State to retain the parts of EU law it believes are in its interest while ditching the obligations it dislikes. This is made easier by the difficulties the UK government itself has been having putting together a proposal for the future EU–UK relations. Behind talks of a 'bespoke deal' (every deal is a bespoke deal) are not only hopes that the UK can obtain a one-sided agreement from an economy six times as big as its own but also demands that are fundamentally contradictory, such as the desire for regulatory integration without shared judicial oversight.

As for Mr Trump's initiatives, it remains to be seen whether and to what extent they will be successful. Some of the US's grudges are at least defensible (and precede the Trump administration). These include the nullification by the Appellate Body of a provision of the WTO Anti-Dumping Agreement that requires WTO adjudicators to defer to national investigating authorities in case the rules are ambiguous, as well as China's lack of progress towards allowing domestic prices to be determined by the market rather than by state- and party-controlled institutions. The more fundamental concern of the United States, however, seems to be similar to that which led the UK to renounce its EU Membership: many are disgruntled by the very fact of having the legality of national measures assessed by an international body whose actions the government does not control.

As in the UK's case, the concretization of the US's threat may lead to disappointment for those who had concluded from the existence of international institutions that it is these institutions that prevent national governments from doing as they please. The challenges of economic interdependence, shifting power relations and limited resources do not exist because of international agreements or institutions. Instead, institutions flourish because they help countries deal with these challenges, allowing them to settle their differences without harming each other and themselves. While sovereignty ultimately permits governments to free themselves from treaties, judgments and reports, it is the underlying economic and political reality – the existence of other states, the ability of capital to choose the most favourable location for production, resource scarcity, and conflicting interests among domestic constituencies – that sets objective limits to individual states' freedom of action. Contrary to treaties, these aspects of the international system do not come with a withdrawal clause.

G.V.
February 2018