

COUNCIL *on* FOREIGN RELATIONS



POLICY INNOVATION MEMORANDUM NO. 22

Date: June 19, 2012
From: Thomas J. Bollyky
Re: Better Regulation for Freer Trade

Changes in the way the world trades have increased the importance of regulation in international commerce. Fewer goods and services originate “from” any one place or any one supplier, but rather consist of components and tasks from multiple suppliers scattered across several countries. Consistent, adequate, and predictable regulation is essential to the success of these global supply chains, but remains elusive. Without international coordination, national regulations and private standards have proliferated. The resulting cacophony has done little to promote U.S. exports or effective regulatory oversight. The United States should pursue regulatory integration on a regional basis and in the areas where the interests of trade officials, national regulatory authorities, and exporting nations overlap. A new White House initiative on international regulatory cooperation launched this month provides the opportunity to implement this strategy.

THE ERA OF GLOBAL SUPPLY CHAINS

Over the past three decades, the production of goods—from electronics to food, clothing to cars, and medicines to furniture—has changed. Low-cost shipping, fast and reliable information communication technologies, and tariff reductions have allowed companies to unbundle and outsource manufacturing stages and intermediate services to specialist suppliers around the world. These global production models now dominate international commerce, with intermediate products comprising 56 percent of the global goods trade and 73 percent of global services trade.

These changes have produced significant benefits for U.S. businesses and consumers alike. Unbundling allows businesses to scale economies, institute just-in-time production, and have greater flexibility in meeting consumer demand. Consumers benefit from more affordable goods. U.S. firms often coordinate and lead production networks and specialize in design, branding, and other high-margin activities. Economists estimate that Apple captures nearly 60 percent of the value-added in iPad production, while the dozens of firms that manufacture and assemble the iPad components and parts split the remainder. Unbundled production models keep the prices of U.S. goods low and competitive globally.

Less developed economies benefit as well. Once, Japan, Taiwan, and South Korea needed to build a broad and deep industrial base in order to produce and export finished products that could compete in the world economy. The unbundling of production has reduced the barriers to competition, enabling China, Vietnam, and other less developed nations to industrialize through participation in global supply chains, lifting millions of their citizens out of abject poverty.

THE CHALLENGES OF GLOBAL REGULATION

Sustaining the benefits of global supply chains will depend on the adequacy, predictability, and efficiency of the regulatory oversight in the countries involved. The mechanisms that ensured accountability for products in the past—tort liability and companies' investments in the good reputation of their brands—do not easily extend to intermediate suppliers in countries where access to courts can be limited. Regulation and product standards are essential tools for promoting public health and safety, safeguarding the environment and rights of citizens, and ensuring the proper functioning of markets. But regulating effectively is far more difficult in this new global market.

Unclear, excessive, or duplicative regulatory requirements can impede new global production. In unbundled global supply chains, intermediate services and parts crisscross borders multiple times. As the number of countries and transactions multiply, so do the costs of inefficient and divergent regulations. The proliferation of uncoordinated regulations can challenge even sophisticated multinationals. The high costs of regulatory compliance can keep small and medium-sized U.S. businesses from entering new markets altogether. The White House has cited unwarranted health, safety, and technical regulations as the largest obstacle to achieving its goal of doubling U.S. exports by 2014.

The scale and complexity of global supply chains are also overwhelming U.S. regulatory authorities. The volume of U.S. Food and Drug Administration (FDA)-regulated imports, for example, quadrupled (from six to twenty-four million shipments) over the past decade and now involves more than 300,000 facilities in 150 different countries. There are legal and practical limits on the ability of the U.S. regulatory authorities to conduct inspections of these producers and suppliers.

With the worldwide growth in trade, other national regulatory authorities face the same daunting challenges. The adequacy of health, safety, and environmental regulations in one country increasingly depends on the adequacy of those regulations in other countries. Inefficient or ineffective regulatory systems can keep developing countries from participating in international commerce, undermining development and delaying their citizens' access to medical and agricultural technologies.

Efforts to address these problems have been inadequate. U.S. trade and regulatory officials have traditionally gone about their respective duties in wary parallel. Trade officials have looked to reduce barriers to international commerce and have not concerned themselves with the adequacy of trading partners' regulations or their enforcement. Regulators have sought to implement the most effective domestic regulation, usually without consulting other trading partners.

This approach is no longer sustainable. National regulations and private standards have proliferated without international coordination. U.S. trade initiatives have not succeeded in reducing the inefficient, duplicative, but otherwise nondiscriminatory regulations that increasingly hinder trade in multicountry supply chains. The White House estimates that the divergence of safety labeling requirements internationally, for example, costs the U.S. chemical industry \$475 million annually. And U.S. popular support for trade liberalization is diminishing without accompanying efforts to ensure that liberalized goods and services benefit the U.S. public health and welfare. A recent public opinion poll found that more than two-thirds of Americans worry about import safety, ranking it higher than concerns about pandemic flu or natural disasters.

THE WAY FORWARD

In early May 2012, President Barack Obama issued an executive order establishing an interagency working group, led by the White House's Office of Information and Regulatory Affairs, to promote international regulatory cooperation in order to reduce unnecessary cross-border differences. Participating U.S. agencies are charged with implementing its recommendations. To address the challenges of global supply chains, this working group should adopt the following strategy.

1. *Focus first on international standards and regulatory burden sharing in the food, drug, and biotechnology sectors.* The working group should focus its efforts on the sectors and approaches where the interests of the critical actors most overlap. U.S. and other national regulatory authorities will participate more meaningfully in international regulatory

initiatives if the objective is also to address their transnational regulatory challenges. Cooperation must likewise be in the economic interests of exporters and their governments if it is to succeed. An early priority should be improving international cooperation on food and drug safety regulations, a step that the Institute of Medicine recently concluded would have compound benefits for U.S. trade, global health, and international economic development. The White House initiative should also seek reductions in the international regulatory inconsistencies on biotechnology, which would help U.S. exports and improve agricultural productivity in poor countries. Promoting the adoption of international standards and pursuing agreements to rely on trading partners' testing of goods and inspection production facilities are ways that the United States can provide predictability for exporters and investors, improve and simplify regulatory compliance, and reduce duplication of scarce regulatory resources.

2. *Use trade talks to drive adoption of international standards in these priority sectors.* Asia-Pacific Economic Cooperation (APEC) has pioneered a successful model in which member economies commit to adopt international standards, agree on the priority areas for doing so, and establish the reporting requirements that hold countries accountable for following through. Trade agreements can establish the structures and incentives necessary to implement this model successfully. According to the 2011 World Trade Organization (WTO) annual report, trade agreements that have adopted this model to reduce regulatory barriers have yielded significant benefits for production networks, increasing trade between member countries by an average of almost 8 percent. New U.S. trade talks, known as the Trans-Pacific Partnership (TPP), provide an excellent opportunity for the new White House working group to implement this model to improve regulatory cooperation in the food, drugs, and biotechnology sectors. U.S. trade officials have already identified improving regulatory coherence as one of their TPP negotiation objectives. Since all the TPP parties are also members of APEC, the reception to this model should be favorable. The model is consistent with U.S. law, since TPP member governments retain their full authority to adopt and enforce standards and regulations.
3. *Increase the ability of U.S. regulators to engage in burden sharing with foreign counterparts.* Sharing knowledge and collaborative regulatory decision-making are powerful ways to promote regulatory convergence and better oversight among trading partners in priority sectors such as food, drug, and biotechnology. Congress should grant the FDA and the U.S. Department of Agriculture more authority to share with foreign counterparts inspection reports and proprietary information concerning important public health risks. Modest travel and training support would help developing countries to participate effectively in international standard-setting organizations. Increasing U.S. technical assistance to regulatory cooperation initiatives, such as the African Regulatory Harmonization initiative, would be a low-cost way to expedite the delivery of U.S.-funded medical and agricultural technologies to the poor.
4. *Focus on the regional level.* U.S. policymakers should implement these trade and regulatory burden-sharing initiatives regionally. Improvements in shipping and information communication technology have made the world smaller, but proximity still matters. Supply chains are generally regional in nature. Regional institutions are also more promising venues for regulatory cooperation than multilateral institutions, such as the WTO, which require agreement among many more states with diverse economic and regulatory interests. The TPP talks, which include mostly Asian countries, and the Pan American Health Organization are examples of promising regional platforms for regulatory cooperation.

CONCLUSION

In the era of global supply chains, U.S. trade, regulatory, and development objectives are mutually dependent. Pursuing them as such in the new White House initiative would help U.S. policymakers avoid the race to the bottom on regulation that many public health advocates fear, and increase international adoption of the consistent, predictable, and science-based regulations needed to achieve U.S. trade goals, protect U.S. consumers, and advance the prospects of the poorest countries.

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