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POLICY BRIEF

Supply Chains Are Making It Hard for Countries to Manage Their New Trade Rules

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Today's global trading system, forged between the late 1940s and mid-1990s, was not carefully adapted to a world of globally distributed supply chains. The international community achieved the pinnacle of multilateral trade coordination when the current system of globally distributed production was still in its infancy. Yet that older system was still better adapted to supply chains than the fragmented governance that we have now.

Since the 1990s, manufacturers have increasingly relied on completing different stages of production in countries around the globe, while the World Trade Organization (WTO) has faced mounting challenges to its preeminence as the regulator and facilitator of global trade. In this paper, I discuss some of the challenges of the current state of trade-governance disrepair and examine whether the needs of global supply chains can be well served by prominent alternatives such as unilateral measures or less ambitious regional agreements. I also consider what diminished multilateral governance means for governments, producers, and consumers.

The Decline in Global Trade Governance

Regarding global trade governance, since the mid-1990s, there has been a steady shift away from uniform, multilateral measures and towards bilateral and regional decisions. We can readily identify the peak of multilateral trade cooperation as the creation of the WTO in 1995.[1] This new organization superseded the General Agreement on Tariffs and Trade (GATT), which had overseen decades of trade negotiations that grew increasingly broad in both topics and members. The WTO was to bring the sometimes-disparate agreements into a unified whole. It was meant to enhance the two interlinked pillars of trade governance: negotiation and dispute resolution.

Despite the initial optimism, each pillar faltered in the decades that followed. The first and only significant "round" of negotiations launched under the WTO—the Doha Development Agenda[2]—

never fulfilled its initial grand ambitions of a broad agreement. Meanwhile, the upgraded Dispute Settlement Mechanism ran into trouble when key WTO members could not agree on staffing the Appellate Body: without a functioning Appellate Body, appellants could effectively steer the case into limbo.[3]

While policy discussions stalled at the multilateral level, there was ample activity in plurilateral, regional, and national bodies. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) came into force,[4] though with substantially smaller global coverage after the United States withdrew under President Donald Trump. The North American Free Trade Agreement (NAFTA) was renegotiated as the US–Mexico–Canada Agreement (USMCA). The European Union put forth regulations with a direct effect on trade, such as its Carbon Border Adjustment Mechanism (CBAM).[5] The United States' embrace of discriminatory trade measures, from the Section 301 tariffs on China to its Section 232 tariffs on steel and aluminum, with different tariffs applied to different countries, underscored the disintegration of global trade governance.[6]

The Growth of Global Supply Chains

Global supply chains (or global value chains) have become more prevalent, while trade governance has become more disunited. One of the first indications of awkwardness between supply chains and global trade governance is that it is surprisingly difficult to measure the prevalence of supply chains. Intuitively, the development of global supply chains meant that we went from a world in which a product was manufactured in a single country to one in which a popular product like an iPhone could contain components from all over the world.[7] Globally distributed production is not simple; it involves extra coordination to move parts around the world. Furthermore, global supply chains can only flourish if communication and transport costs are not too high. Companies deal with such complications because the specialization of component production allows for the production of more sophisticated final products at significantly lower cost. Measurement is a problem because trade statistics track the total value of products shipped across borders, not the value-added—much less the entire breakdown of—components within a product. Nonetheless, a number of credible empirical work-arounds show a significant increase in the relative importance of supply chains in global trade.[8]

But what do these two trends—a turn away from multilateralism and the emergence of global supply chains—have to do with one another? I can offer a few examples why the prevalence of global supply chains causes problems for unilateral or plurilateral governance and vice versa.

New Challenges for Trade Governance

First, let's start with an instance in which one trading power wishes to block imports from another. There could be any number of reasons for this, but the recent US tariffs on Chinese goods offer a clear example. If all goods are produced in a single country, a high tariff on a good in the target country either compels the payment of the tariff or, if the tariff is high enough, eliminates the sanctioning country as a market for the good.

With global supply chains, this changes. The tariff is still directed at final goods emerging from the target country. But what if the supply chain is reworked so that the first 80 percent of the value added occurs in the target country, but the final 20 percent occurs in a third country. As an oversimplification, the "country of origin" is the last one in which a "substantial transformation" takes place. Thus, if the 20 percent contribution of the third country counts as a substantial transformation, the product becomes a third-country good, not a target-country good, and it would not be subject to the tariff.

To be fair, such problems could exist under multilateral governance, to the extent that the WTO allowed the imposition of bilateral measures (as it did with policies such as safeguards, antidumping, or countervailing duties). But the more uniform the application of tariffs across trading partners, the less this sort of "tariff engineering" is a problem.

Companies usually know their first-tier suppliers, but often not beyond that. Sticking with this example, why could the sanctioning country not simply slap tariffs on any product that had target-country components? There are two main reasons for this. First, information about components is not readily available, as noted above. This is not due to lackadaisical statistics agencies. Rather, it's because companies know their first-tier suppliers—the ones from whom they buy directly—but often do not know their second- or third-tier suppliers.

Second, attacking target-country components whenever they appear in third-country products is likely to provoke conflict with third-country producers. One of the virtues of multilateral governance is that it seeks a degree of harmonization of policies and standards. If the sanction is based on a rationale that the third country does not accept, then it may see the action as an unjustified commercial attack and retaliate.

Third, and as a final example of how supply chains affect governance in the absence of multilateral agreement, consider a variant on the example above. Imagine that a Chinese firm makes a key component of a medical device. Suppose the component is used in competing products made in Germany and the United States that are sold around the world. Now imagine that the United States applies a 25 percent tariff on the Chinese component. This raises costs for the US producer but not for its German competitor. It leaves the US firm with several unappealing choices: swallow the tariff cost, find the next-best component from elsewhere, raise prices, or move production outside of the United States—for example, Canada—to avoid the tariff on the component. These impacts are very different from those that one would see in a world without extensive global supply chains.

Challenges to Global Supply Chains

What about the effect of diminished multilateral governance on supply chains? As the examples above show, to the extent that companies need to rework supply chains to avoid tariffs, their costs will generally rise—or else they would have reworked supply chains without being prompted to by tariffs. Another complication emerges, however, around standards and regulation, an important area of negotiation in the rounds leading up to the creation of the WTO. Whatever the costs of complying with regulatory requirements, those costs may increase substantially if standards are set at the national or regional level and if those standards conflict. The prevalence of global supply chains further complicates matters. If the United States and Europe, for example, have different environmental requirements on component parts, then a component producer may have to produce additional variants. This can directly undermine the original supply chain incentive of specialization and economies of scale.

A related concern is that the complication of keeping track of overlapping and potentially conflicting requirements likely disadvantages small firms and new entrants relative to large established companies, if only because fixed compliance costs are lower per unit for large producers. This, in turn, discourages new entrants and competition. Both effects likely serve to increase production costs and thus raise prices for consumers. In short, the emerging chaos in global trade governance disadvantages smaller companies and results in higher prices for everyone.

Conclusions

The argument that multilateral policy harmonization has important benefits for economic efficiency is not new; one version was described in the 1950s by economist Jacob Viner as the distinction between *trade creation* (new trade from lower barriers) and *trade diversion* (costly distortions introduced by differential policies).[9] The potential for distortions—often in intricate and opaque ways—has grown with the development of global supply chains. Supply chains have affected the efficacy of unilateral policies, and as a result, costs have risen for producers and consumers. Whether efficiency and efficacy concerns are currently driving trade policy decisions, however, is another question.

About the Author

Philip Levy is the former chief economist at Flexport. The views expressed in this article are the author's and do not necessarily reflect those of Flexport.

Notes

1. "What is the World Trade Organization?," World Trade Organization, accessed August 22, 2024, https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact1_e.htm.
2. "Doha Development Agenda," World Trade Organization, accessed August 22, 2024, https://www.wto.org/english/thewto_e/whatis_e/tif_e/doha1_e.htm.

3. Gerhard Erasmus, “The WTO Dispute Settlement Impasse: What Is Happening?,” *tralac* (blog), February 12, 2024.

4. “Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP),” Australian Government, Department of Foreign Affairs and Trade, accessed August 22,2024, https://www.dfat.gov.au/trade/agreements/in-force/cptpp/comprehensive-and-progressive-agreement-for-trans-pacific-partnership.

5. “Carbon Border Adjustment Mechanism,” European Commission, accessed August 22, 2024, https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en.

6. “Section 301 Tariffs on Goods from China: International and Domestic Legal Challenges,” *Congressional Research Service*, LSB10553, updated April 5, 2022; “Section 232 of the Trade Expansion Act of 1962,” *Congressional Research Service*, updated April 1, 2022.

7. “The iPhone Supply Chain,” PAT Research, accessed August 22, 2024, https://www.predictiveanalyticstoday.com/iphone-supply-chain/.

8. Pol Antràs and Davin Chor, “Chapter 5: Global Value Chains,” in *Handbook of International Economics*, vol. 5, ed. Gita Gopinath, Elhanan Helpman, Kenneth Rogoff (North Holland, 2022), 297-376.

9. Jacob Viner, *The Customs Union Issue* (Oxford University Press, 2014).