

## GATT or CAP: Must the EC Decide?

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This paper analyses the issues pertaining to the recent breakdown of the Uruguay round of GATT negotiations. It will be argued that, while the weight of popular opinion finds the EC culpable on a number of grounds, it is possible to discern a rationale underpinning its stance.

The analysis is divided into four sections. The first of these sets the stage by outlining the circumstances surrounding the Uruguay round. Section two then delimits the economic justification for free trade, and the problems which obtain in practice. Section three takes the services sector as a case in point, and contends that the prospective efficiency gains from a services agreement remain moot. Finally, section four discusses the credibility of the US position.

### **The Uruguay Round**

The negotiations of the Uruguay round began in earnest in 1986. It was then proposed to widen the scope of GATT agreements to include 15 new sectors. Of these, the agriculture and services industries were undoubtedly the most important. Initial negotiations, while complex, were fruitful, and there was no indication that a successful outcome could not be reached.

By mid-1990, however, it was clear that the level of cuts in the CAP being sought by the US far exceeded what would be on offer by the EC. The American negotiators demanded cuts of 75% in farm income supports and as much as 90% in export subsidies, and they viewed the EC's offer of cuts of 30% with patent disdain.

This divergence of views spawned divisions within the Community itself, notably between Commissioner Ray McSharry, and, the Commissioner for External Affairs, Mr. Frans Andriesson. With a compromise seeming further than ever away, the talks stalled, and commentators portentously forecast a return to 1930s style protectionism.

The popular perception of this breakdown was damning in its indictment of the EC. Once again, it was argued, the behaviour of the Community highlighted the fact that it was willing to flagrantly promote the interests of the powerful farming lobby to the detriment of every other industry. Such a stance was seen by many to be both short-sighted and unjustifiable. However on closer inspection, it is possible to vindicate, at least in part, the EC position. The economic arguments invoked by the US negotiators are open to criticism. The true value of GATT agreements is questionable. Finally, the credibility of the stance taken by the U.S. is debatable. These issues are taken up in the following three sections.

### **The economics of free trade**

The economic arguments in favour of free trade are best couched in the terms of consumer and producer surplus (Salvatore, 1983). Consider Figure I.  $p^*$  represents the price on world markets of the commodity in question, while  $p^*+t$  is the price in the protected home market. Consumer surplus  $1+2+3+4$  is lost subsequent to the imposition of the tariff, while gains are producer surplus 1 and tariff revenue 3. It is clear that the loss in

efficiency is 2+4.

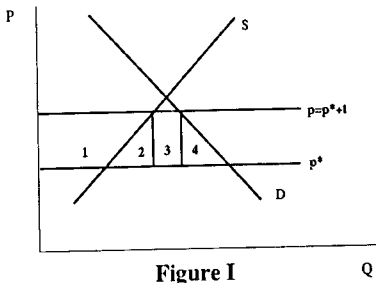


Figure I

In this context, tariffs are clearly undesirable. Overall welfare is maximized if, instead of extending protection to certain sectors of industry, the benefits of free trade are allowed to accrue, and redistributed as necessary to those sectors that are adversely affected.

However, too often, this argument has been used without adequate account being taken of special circumstances. In the presence of distortions in one market, when the optimum response of removing them is not possible, a second-best approach should be used (see Appendix). Partial removal of protectionism debilitates rather than improves welfare. Neary (1989) provides an original diagrammatic exposition of this conclusion. He applies the Concertina rule to show that the optimal second-best tariff rate is a weighted average of all the fixed tariffs on other goods. It is arguable, therefore, that the GATT talks should optimally proceed by lowering, but not eliminating, the distortions present. A gradualist approach is requisite.

In addition, in recent years, cognizance of the fact that international trade does not take place in a world of perfect competition has been taken (Brander and Spencer, 1985; de Meza, 1986; Dixit and Grossman, 1986; Krugman, 1984). Imperfectly competitive or monopolistic market structures obtain. In can thus plausibly be argued that the

economic justifications of free trade perform poorly in the context of real world phenomena. The case for free-trade is thus considerably weakened.

### The services sector

In the light of the above, it is worth considering the services industry. Some would contend that the elimination of all distortions in this is desirable (Feketekuty, 1989). Yet this view can plausibly be contested.

Consequent on the importance of ensuring quality of service, governments have concluded many agreements which have, and will continue to have, distortionary effects. Rules concluded under the aegis of the Bank for International Settlements, insurance agreements, guidelines from the European Civil Aviation Conference, and technical rules established by International Telecommunications Unions, all represent examples of such distortionary agreements. In addition, since services require close interaction between producers and consumers, much of the international services trade takes place between the subsidiaries of multi-national corporations. In this context, the assertion that large benefits would accrue consequent on the conclusion of a GATT agreement on services appears to be without solid foundation.

If a worthwhile assessment of the prospects for a services agreement is to be made, consideration must also be given to the relative success of the GATT in the goods sector over the past 40 years. Much of the growth in world trade that has taken place is not due to the GATT, but rather to the concomitant improvement in transport and communication facilities. Indeed, in recent years, a tendency to contravene the principles upon which the GATT was founded has emerged. This is revealed most vividly in the efforts of the Americans to curtail Japanese encroachment into their

domestic market. Voluntary export restraints (VERs) have been introduced which are highly distortionary but legal within the GATT (Neary, 1988). Other types of distortion have also proliferated. Most members of GATT now feel quite at ease providing incentives to private investors, tax concessions, grants, research and development support and export subsidies.

As Messerlin (1990) notes, the EC already has negative trade balances with the rest of the world in many of the major service industries such as telecommunications, films and broadcasting, shipping and air transport. Only banking has shown a strong balance in the EC's favour in recent years. The implementation of a services agreement is not likely to have the sweeping impact often cited as its justification, as such, the relative efficacy of a services agreement is in doubt.

### The political balance - American credibility

The arguments expounded above make it easier to question the belief that the EC was simply bowing to political pressure in its intransigence. Yet it is worth exploring another aspect of the debate. If the stance of the U.S. were not credible, it is unlikely that the EC would accede to its demands. On one interpretation, it is precisely this factor that led to the stalled talks.

In the days preceding the collapse of the talks, Ms Hills and the other U.S. delegates were threatening a debilitating trade war if negotiations broke down. Yet the issue of whether the U.S. ever want to implement such a policy is moot. Shutt (1985) endeavours to furnish an answer:

"...the degree to which national economies have become locked into a position of mutual interdependence as a result of 30 years of rapid expansion by the multinationals...is such that a

reversion to separate economic development seems virtually inconceivable for industrialized countries" (1985:62).

Thus, given the initial position, at a very basic level, it seems unlikely that the U.S. would unilaterally pursue isolationist policies. This is borne out by an analysis of American deportment during the talks.

Schelling (1960) lays out the necessary precautions which a negotiator must take when making a threat. It is essential *inter alia* that clear concise language that is difficult to reverse be used. It is also necessary to have a reputation for actually carrying out threats or using them to good effect. Yet Dixit writes: "The theoretical prediction that compellence is harder to achieve [than prevention] is borne out in practice. The United States has not been very successful in inducing others to open their markets" (1987). In addition, the "clear language" prerequisite was not observed by the American negotiators. For example, despite the fact that no concessions had been intimated, on December the 14, 1990, the U.S. agriculture secretary, Clayton Yeutter pronounced: "It seems to me that the [EC] attitude has changed from what it was ten days ago" (*The Independent*, 1990).

The most compelling challenge of American credibility, however, is provided by a consideration of motive. The Uruguay round was convened primarily because of pressure by the U.S. to ensure as free a market as possible for the service industries in which it has a comparative advantage. It is arguable that such a liberalized market would debilitate the economies of developing economies (Fischer, 1990). Thus the U.S. had to offer a concession to these countries in return.

Two alternatives presented themselves. One was to grant concomitant reciprocal access to the low-technology services industries of the developing countries to

the U.S. market. This, however, would be politically difficult, since it would necessitate substantial revision of U.S. immigration laws. A much more attractive alternative was to open up the EC market agricultural market. This would not only confer significant advantages on the less developed countries, but it would also allow American farmers and their counterparts in the Cairns Group countries access to the EC market, while simultaneously preventing EC dumping on the world market.

Given this interpretation of motive, it is clear that the U.S. had more to lose than to gain by allowing the EC to retain the CAP and allowing GATT to fail. Of primary importance to the US negotiators was the securing of a services accord, with the opening up of the EC markets an objective of ancillary importance. The credibility of the American threat was thus diminished, and the rationale underpinning the EC's view concomitantly strengthened.

### Conclusion

In this paper, it has been argued that the stance adopted by the EC during the GATT trade talks remains tenable. It can be justified on economic grounds, on the evidence of the relative merit of previous GATT agreements, and in the context of the poor credibility of the U.S. position.

Given this, it is ironic that, with the resumption of negotiations, members of the GATT are most likely about to embark on a costly and acrimonious program of readjustment and reform. Such is the distortionary and pervasive effect of the CAP, that to agree to abandon 90% of price supports over 5 years could have catastrophic effects on the economies of the EC countries, quite apart from the social impact. The EC did not succumb to a powerful sectional interest in its decision to confront the US, even at the risk, be it real or imaginary, of the failure of the Uruguay

round. Rather, it took a rational decision, based on sound economic, social and political grounds. If this stance is now abandoned for the sake of reaching agreement in the Uruguay round, a costly mistake will have been made.

### Appendix

Assume an open economy trading in a competitive environment. The use of the trade expenditure function  $E(P,U,V)$  is derived from Dixit and Norman (1980) who term it the excess expenditure function. The analysis and notation follows Neary (1989).

The use of tariffs in this analysis does not mean the results derived cannot be applied to other forms of protection. Indeed, in the GATT talk, it was agreed that all forms of protection will be converted to their tariff equivalent to facilitate negotiation.

Define  $E(P,U,V) = e(P,U) - g(P,V)$   
 where:  $e(P,U) = \min_x [P.X:U(X) > U]$   
 ...expenditure function  
 and  $g(P,V) = \max_z [P.Z: (Z,V) \text{ is feasible}]$   
 ...value of national output function

Thus:  $E_p = e_p - g_p$   
 ...Shepard's Lemma; Hotelling's Lemma

From this:  $E_p = E(P,U) - Z(P,V)$   
 ...demand less production

Thus  $E_p = M(P,U,V)$   
 where:  $M(P,U,V)$  is a Hicksian net import demand function

$$E_{pp} = e_{pp} - g_{pp}$$

This implies that the effect on demand for exports when price changes will equal the effect on expenditure less the effect on production due to that price change.  $E_{pp}$  is

a negative semi-definite Hessian indicating, as expected, that Hicksian net import demand functions are downward sloping.

Using this function, it can be shown that welfare effects following the introduction of a tariff will be given by the expression

$$(1 - t'X_1)dy = dT + t'E_{pp} dt + (W' - t'g_{pp})dv$$

For the purpose of this analysis, it will suffice to say that the change in welfare ( $dy$ ) will be of the same sign as the term  $t'E_{pp} dt$ .

Since Epp is negative semi-definite, we can conclude that a uniform decrease in tariffs will improve welfare. However, as claimed in the text, when a tariff on one good is given, the optimum tariff on good 2 is positive in the case of substitutes. We can demonstrate this as follows.

Assume a fixed tariff on good 2 only.

$$t_2 = \bar{t}_2; dt_1 \text{ is non-zero.}$$

$$t'E_{pp} dt = \begin{bmatrix} t_1 & \bar{t}_2 \end{bmatrix} \begin{bmatrix} E_{11} & E_{12} \\ E_{21} & E_{22} \end{bmatrix} \begin{bmatrix} dt_1 \\ 0 \end{bmatrix}$$

Therefore  $dy$  is approximated by

$$t'E_{pp} dt = (t_1 E_{11} + \bar{t}_2 E_{21}) dt_1$$

Let  $\bar{t}_2$  be the optimal tariff on good 1.  $E_{21}$  must be positive in a 2 good economy since the two goods must be substitutes. Trivially,  $dy/dt_1$  is either less than, equal to, or greater than 0. If it equals 0, then:

$$t_1^0 = -\bar{t}_2 E_{21} / E_{11}$$

We know  $\bar{t}_2$  is non-zero, and  $E_{21} > 0$ . Hence  $t_1^0 > 0$ .

In a multi-good economy, and  $E_{ij}$  equals 0 only in the extreme case of two completely

separable goods. Therefore the optimal tariff on a good is zero only in the case where no substitutes have tariffs. Broadly similar results will be obtained in either VER's or tariffs and quotas apply rather than just tariffs as assumed here. Thus we arrive at the argument in the text that the possible gains from a GATT agreement on services are likely to have been exaggerated due to the improbability of all protection being removed.

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