
UNIT 4 THEORIES OF PROTECTIONISM

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4.0 OBJECTIVES

You have learnt, in Unit 3, Block 1 about the case for free trade and the associated gains from trade. We will now learn and understand in this Unit, why countries adopt protectionist measures despite the benefits of free trade. After going through this Unit you will be able to understand:

- what are the various tools typically used by countries to protect domestic industry from international competition?
- why countries adopt protectionist measures; and
- the way traditional tools of protectionism are evolving and giving way to newer ones.

4.1 INTRODUCTION

Economists have always acknowledged the benefits of international trade. Gains from trade arise due to specialisation in production along lines of comparative advantage, leading to efficient allocation of scarce resources within nations. Gains also arise from exchange between countries, with each country exporting the goods, which it produces relatively most efficiently and importing goods at a cost lower than that of domestic production.

Therefore, trade can potentially be welfare improving for the world as a whole. Yet, in practice, trade barriers restricting the cross-border flow of goods and services, are erected by virtually every trading nation in the world.

What justifies the use of protectionist measures, given the many benefits of

free trade? What are the various ways in which countries practice trade protection? These are the central questions we will address in this Unit¹.

4.2 THE INSTRUMENTS OF TRADE PROTECTION²

Before addressing the question of why countries use protectionist measures, let us learn what are the tools or instruments of trade protection? The tools of trade protection that countries typically use to restrict imports can be broadly classified into price related measures such as tariffs and non-price measures or non-tariff barriers (NTBs).

A tariff is a tax levied on imports. Tariffs may be applied to imports of both final and intermediate goods. This aspect is taken into account while assessing the extent of protection extended to domestic industry by the tariff. We will learn about a concept called the 'effective rate of protection', which is used to measure the extent of actual protection granted to value added in a particular industry by the entire tariff structure (covering final and intermediate goods).

Non-tariff barriers (NTBs) are applied to quantities and other attributes of traded goods and services.

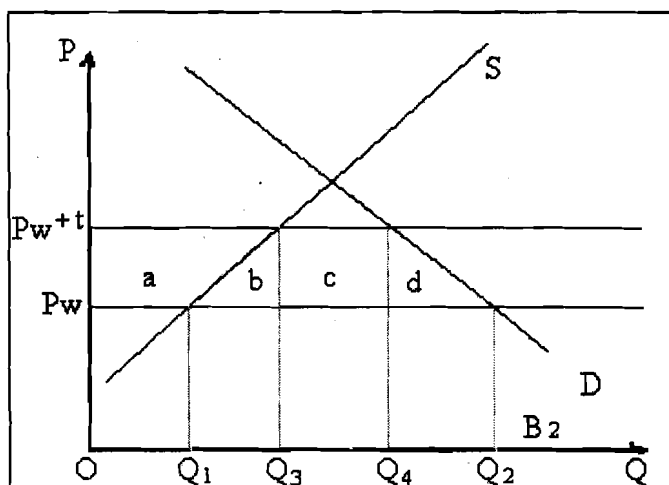
We discuss each of these instruments of trade protection, in turn.

4.2.1 Tariffs

A tariff or import duty essentially alters the relative prices of traded goods vis a vis non-traded goods in the domestic market. Tariffs may be specific or ad valorem. Specific tariffs are levied as a fixed amount per unit of the good (e.g., Rs.400 per box of imported dates). While, ad valorem duties are levied as a fixed percentage of the total value of the goods (e.g., 30% duty on imported computer parts).

Using Figure 4.1, we will carry out a simple cost-benefit analysis of the impact of a tariff on various economic agents like consumers, producers and the government in a partial equilibrium framework.

We assume that the country is a small open economy that cannot affect world market



Source : Figure 6.3 in Sikdar (2003), p. 133.

Figure 4.1 Effect of a Tariff

¹ The material in this unit is not original, but drawn from standard textbooks on the topic, references to which are cited at the end. The diagrams used here are also from standard sources, which are cited appropriately.

prices. The implication of this assumption is that the tariff leaves world market price of the good unaffected, while raising its price in the domestic market.

In the Figure 4.1 above we consider the domestic demand and supply curves of the imported good. The world market price of the good is P_w , and this is the price that would prevail in the domestic market under free trade. Thus with free trade, domestic production of the good would be Q_1 , domestic demand Q_2 , and the difference Q_1Q_2 would be imported.

A specific tariff rate of t per unit drives a wedge between the world price and domestic market price of the imported good. Post-tariff, price in the domestic market rises to $(P_w + t)$. As a result, domestic production increases from Q_1 to Q_3 , while consumption falls from Q_2 to Q_4 .

Now let us consider the costs imposed by the tariff. Owing to the tariff, domestic consumers suffer a loss in consumer surplus equal to the area $(a + b + c + d)$, compared to free trade. This loss arises because consumers must now pay a higher price $(P_w + t)$ for the good and also because they now consume Q_4Q_2 amount less of the good than with free trade.

However, domestic producers gain from the price rise, with the area a representing the increase in producer surplus. The government also gains from the tariff as it earns a revenue. The imports are now Q_3Q_4 units, each paying a tariff of t per unit, so the tariff revenue is given by the rectangle with area c .

Clearly the loss to consumers exceeds the gain to producers and the government taken together, indicating that the tariff results in a net social loss to society equal to the sum of the areas b and d .

In Figure 4.1:

- Area b measures the loss in social welfare from the production distortion due to the tariff. It represents the higher cost of producing Q_1Q_3 domestically rather than importing this amount;
- Area d is the welfare loss due to the consumption distortion created by the tariff. It represents the cost of not consuming Q_4Q_2 , an amount whose value to consumers exceeds the cost of importing it.

You should note that our partial equilibrium analysis of the impact of a tariff, focuses simply on the market for the imported good. Repercussions on a number of important issues like terms of trade, BOP, factor markets etc., are left out of this framework, as in case of our analysis of the benefits of free trade.

In particular, our analysis does not attach any weight to employment in the sector being granted tariff protection. If the import-competing sector accounts for a significant share of total employment, the measures of welfare loss would have to be adjusted accordingly. In reality, employment is often the most important reason underlying the imposition of protectionist trade policies.

4.2.1.1 Effective Rate of Protection³

So far we have concentrated on tariffs imposed on a final good. But tariffs may be imposed on intermediate goods as well. Obviously tariffs on raw materials

³ The following discussion is based on Krugman and Obstfeld (2000), Salvatore (2004) and Sikdar

and intermediates would raise the cost of production for domestic industry. This factor needs to be taken into account while measuring the extent of protection awarded to domestic industry by any given tariff structure (comprising tariffs on final goods and intermediates).

The Effective Rate of Protection (ERP) measures the extent of protection granted to domestic industry by the given structure of nominal tariff rates. It measures the change in value added in domestic industry due to tariff protection. By definition,

$$ERP_F = (V_T - V_W) / V_W,$$

where ERP_F is the ERP on the final good F; V_T , is value added in the production of F after tariff; and V_W , is value added in the production of F at world market prices, i.e. V_W is the value added under 'free trade'.

Remember, value added is the difference between the price of the final good produced by an industry, less the cost of inputs required per unit of production of the final good.

The following examples will clarify the notion of the ERP further :

Consider a final good F whose world market price is Rs.4000. To produce one unit of F, you require one unit of an intermediate good I, whose world market price is Rs.3000. Thus V_W in this case is Rs.1000 (i.e. 4000-3000).

Case 1 Suppose a tariff of 25% is imposed on the final good F, while there is no tariff on the intermediate, I. Assuming a small open economy, post tariff, the price of F in the domestic market rises by 25% (to Rs.5000) and V_T is Rs. 2000 (i.e. 5000-3000). Hence ERP is 100% [i.e. $((2000-1000) / 1000)*100$], which is much higher than the nominal rate of protection of 25%.

Case 2 Suppose there is no tariff on the final good F and a tariff of 10% is imposed on the intermediate I. The small economy assumption means there will be no change in the world market price of I after the tariff, while its domestic price will increase by 10% (to Rs.3300). Now, V_T is Rs. 700 (i.e., 4000-3300) and ERP is - 30% [i.e. $((700 - 1000) / 1000)*100$].

Intuitively the following should be clear to you :

- under free trade, value added in domestic industry would be determined by world market prices of the final good and imported inputs ;
- with a tariff, domestic prices can exceed the world market prices. How this affects domestic value added would depend on the extent of price increase of the final good vis a vis that of intermediates and on the importance of the intermediates in the production process ;
- if production of the final good requires no intermediates, then the ERP equals the nominal rate of tariff on the final good;
- if the tariff on final goods is higher than that on intermediates, then the ERP would be higher than the nominal rate of protection;
- ERP could actually be negative, when tariffs on imports are too high compared to the tariff on the final good. Negative ERP indicates that trade protection could actually lower domestic value added as compared to free trade.

Actual calculation of ERP may be difficult, owing to the fact that different inputs used by a single industry may be subjected to differential rates of tariff and also owing to the difficulty of obtaining reliable 'free trade' prices of the final and intermediate goods.

You should also note a couple of shortcomings of the concept of ERP. *First*, ERP calculations assume fixed coefficients of production (i.e. input requirements per unit of output are taken to be fixed), which do not allow for factor substitution possibilities. *Secondly*, the underlying assumption of a small open economy that cannot affect world market prices, may not apply in practice.

4.2.2 Non-Tariff Barriers

Non Tariff Barriers (NTBs), unlike tariffs, may impose direct restrictions on the inflow of imported goods. For instance, conventional NTBs like import quotas directly restrict the quantum of imports into the domestic country. While other NTBs discussed below restrict the flow of traded goods in a more indirect manner.

From the following discussion you will see how countries are resorting to newer, more indirect forms of NTBs, most often in order to circumvent the directives of multilateral trade agreements like the WTO

4.2.2.1 Quotas

Import quotas impose direct restrictions on the quantum of imports into a country. In practice quotas are administered through a system of import licenses. Only license holders are given permission to import specified quantities of the imported good into the domestic market.

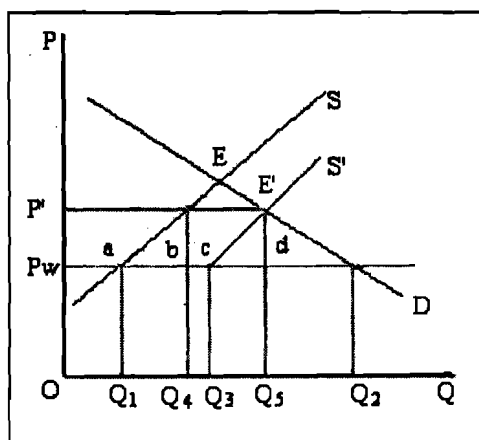
You will see that with a quota the domestic price of an imported good will always be higher than its world market price. License holders buy the imported goods at world market prices and then sell at higher prices in the domestic market.

In what follows we will examine the impact of an import quota under different market structures in the domestic economy. We first discuss the case of perfectly competitive markets and then that of monopoly.

(i) Import Quotas with Perfect Competition

Figure 4.2 demonstrates the effect of an import quota when markets are perfectly competitive. D and S represent the demand and supply curves for the good before quota imposition. Under free trade, the world price P_w prevails and total domestic production is Q_1 , demand is Q_2 , and $Q_1 Q_2$ amount is imported.

Now suppose an import quota is imposed, which restricts imports to $Q_1 Q_3$ (where, $Q_1 Q_3 < Q_1 Q_2$). Immediately with quota imposition, at



Source : Figure 6.4 in Sikdar (2003), p.136.

Figure 4.2: Effects of import Quota with

the world price P_w , domestic demand falls short of total domestic production plus imports. This excess domestic demand drives up prices in the domestic market, till the market clears.

The quota effectively shifts the domestic supply curve to S' , by the amount of the quota. The economy moves to the new equilibrium E' , where price has risen from P_w to P' , domestic production has increased from Q_1 to Q_4 , while domestic demand has fallen from Q_2 to Q_5 . At E' , imports, restricted by the quota, are equal to the amount $Q_4 - Q_5$ (note that $Q_3 - Q_1 = Q_5 - Q_4 = \text{import quota}$).

A tariff rate equal to $P' - P_w$, is the tariff equivalent of the quota. It would have restricted imports to the same level as the quota and had the same effect on domestic prices. However, it may not always be feasible to implement the tariff equivalent of a quota, as the rate may be too high to be acceptable.

You should see that as in case of a tariff, a quota involves a loss in consumer surplus equal to the area $(a + b + c + d)$. This is offset by a rise in producer surplus equal to the area a . But an important difference between tariffs and quotas arises from the fact that with a quota the government does not earn revenues as in case of a tariff. The area c therefore does not accrue to the government, rather it represents the quota rent, which may be captured by the import-license holders, who buy at the world price P_w and sell at a higher price P' , making a profit of $(P' - P_w)$ per unit of imports. If c accrues to the license holders and is counted as part of social gain, then the social loss from the quota is equal to the area $(b + d)$, same as in case of a tariff.

Often foreign exporters have the right to sell directly in the domestic market. In that case the quota rent c would accrue to foreigners and it would be a social loss from the domestic country's point of view.

Another disturbing possibility, and one that is often observed in practice, is that the quota rent may not accrue to license holders. Rather it may be dissipated in rent-seeking activities, like paying bribes to acquire import licenses and so on. In that case, the area c would be a social loss and the total cost imposed by the quota would equal the area $(b + c + d)$, which is more than in case of an equivalent tariff. In fact quota rents have been estimated to be as high as 24% of GNP in developing countries like Kenya (cited in Sikdar (2003), p.137).

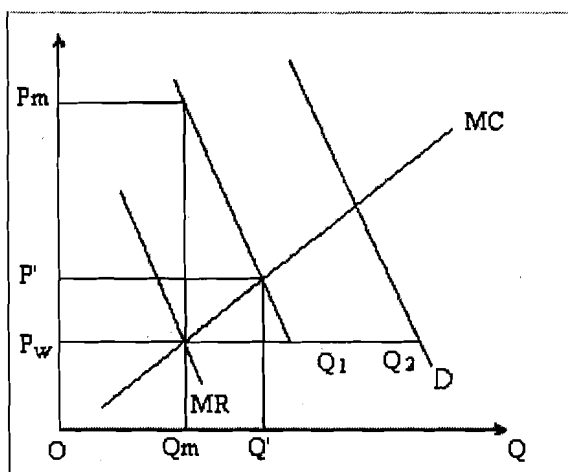
Governments in developing countries have the option to auction import licenses. A competitive bidding process would drive the price of licenses up to $(P' - P_w)$ per unit of imports and the government would earn revenue equal to the area c . If this process worked smoothly, the effects of a tariff and quota would be equivalent. However, developing country experiences demonstrate that in reality the auction process may also run into difficulties (see Sikdar, 2003, p.138). The auctions may not be competitive and collusion among bidders might subvert the entire process.

(ii) Import Quotas with Monopoly

When there is a domestic monopoly, an import quota leads to greater loss in social welfare, as compared to perfect competition. In fact we will see that in the presence of monopoly, an import tariff should be preferred to a quota from the efficiency and social welfare point of view.

When there is a tariff t , imports are freely available at a price $(P_w + t)$. So the monopolist cannot charge a higher price than this level, for if he did domestic consumers would go for imports and his sales would be reduced to zero. Thus a tariff effectively imposes a price ceiling. However, with a quota, the monopolist can charge a price higher than the import price. In this case he will not lose his entire market share, since imports cannot exceed the limit set by the quota. Thus a quota preserves the monopolist's price setting power to a large extent.

This argument is illustrated in Figure 4.3. Under free trade D is the demand curve facing the monopolist and the domestic price of the good is the world market price, P_w . Now an import quota is set, limiting imports to the amount $Q_1 Q_2$. With the quota the demand curve facing the monopolist shifts inwards by the amount of the quota, at all prices above P_w , because imports have reduced the monopolist's market by $Q_1 Q_2$.



Source : Figure 6.5 in Sikdar (2003), p.138.

Figure 4.3: Effects of Import Quota with monopoly

Post quota imposition, the relevant marginal revenue curve facing the monopolist is MR , corresponding to the new demand curve.

In this situation the monopolist will maximise profits by producing an output of Q_m , at which marginal revenue equals marginal cost. This output will be sold at the price P_m , read off the demand curve. Now $(P_m - P_w)$ is the tariff equivalent of the quota or the quota rent earned by the import license holders.

Note that with perfect competition in the domestic market, the MC curve would have been the supply curve, and the market price would have been P' and output, Q' . Clearly with a monopoly the outcome is more inefficient, compared to perfect competition. The monopoly output is lower ($Q_m < Q'$) and price is higher ($P_m > P'$), leading to greater welfare losses.

From this analysis it should be clear to you why tariffs are preferred to quotas, especially when the domestic producer wields monopoly power. In fact GATT negotiations have tried to phase out quantitative restrictions and replace quotas with tariffs.

4.2.2.2 Other Non Tariff Barriers⁴

The following are some of the other important NTBs commonly used by countries following protectionist policies:

- **Exchange controls:** Exchange controls are restrictions imposed by countries' Central Banks that directly limit domestic residents' ability to acquire foreign currency in exchange for domestic currency. For instance, one method of imposing exchange controls, involved acquiring the Central Bank's permission to hold foreign currency bank accounts.

- **Import deposit schemes:** These are rules imposed by countries' Central Banks, which tend to restrict imports by making them more expensive. For instance, under the rules importers are required to deposit a certain amount (usually in proportion to the value of the imported good) with the Central Bank, which effectively raises the cost of importing.
- **Health and safety standards:** Often importing countries insist that imported goods meet certain minimum health, safety and environmental standards. Meeting the standards would obviously raise costs for the exporting country. Presumably the underlying motive for standard imposition is to safeguard the health and general welfare of domestic residents of the importing nation. However in practice these standards are often used by developed nations to restrict imports originating from low-wage developing countries. For instance, faced with cheap manufactures imports from low-wage countries like Malaysia, Indonesia and Thailand, developed countries are now insisting that these countries comply with certain minimum labour and environmental standards, which would raise their costs of production.
- **Customs valuation procedure:** Under this procedure the importing country would artificially enhance the value of the imported goods under some pretext, which would raise the duty on it, under a system of ad valorem tariffs. For instance, Sikdar (2003, p.141) cites the example of the US valuing certain chemical imports at the 'American selling price' (rather than at the 'invoice' price or the 'world market' price) in the post-war period. However this practice was discontinued since the Tokyo Round of negotiations.
- **Local content requirements:** This is a practice followed especially in developing countries, which requires that some stipulated portion of a final good be produced domestically. Or it may be stated that a certain specified fraction of the final goods price must represent domestic value added. The underlying logic is to promote local production of certain intermediate goods. From the importing firms viewpoint, there is no restriction on imports. For they can import more, as long as they also buy more from local firms. From the domestic intermediate industries' point of view a local content requirement provides trade protection in the same way as an import quota.

Check Your Progress 1

- 1) What is the main difference between tariffs and non-tariff barriers to trade?

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- 2) What are the benefits and costs of a tariff ?

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3) What do you mean by the term 'effective rate of protection'?

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4) What are the implications when the effective rate of protection is : (i) equal to the nominal rate of protection ; (ii) greater than the nominal rate of protection; and (iii) negative ?

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5) What are the effects of an import quota, when there is perfect competition in the domestic market ?

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6) What are the effects of an import quota, when there is monopoly in the domestic market ?

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7) What is the tariff equivalent of a quota?

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8) What justification is often used by economists to give preference to tariffs over quotas ?

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9) Mention five non-tariff barriers that countries use to restrict trade flows.

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4.3 THE CASE FOR TRADE PROTECTION⁵

We can show that although free trade is beneficial for all countries taken together, unilateral movement towards free trade may not be desirable. That is, very often a country stands to gain by deviating from a strategy of free trade and adopting protectionist measures, even when all other countries have adopted free trade

The theories of protectionism outlined below will show you that countries often apply protectionist measures to restrict the inflow of imported goods, as domestic economic agents stand to gain from these measures. The gains may arise from the resultant improvement in terms of trade. Or, protectionist measures may improve welfare by correcting domestic market failures that arise due to the existence of externalities.

Further, from the common justifications provided for adopting protectionist measures, you will see that often, individual countries have a strong incentive to deviate from a strategy of free trade. For instance, protectionist policies may be used to protect infant industries, prevent dumping, and induce foreign investment in the domestic economy.

Therefore intervention of a third party is required to induce countries to adopt policies of free trade. Third party intervention is also called for to ensure that countries actually stick to their commitment to free trade subsequently and do not revert to their dominant strategy of protection. This provides a justification for supranational coordinating bodies like the World Trade Organisation (WTO).

Each of these cases is discussed below in turn.

4.3.1 Theories of Protectionism

Having examined the case for free trade, we will now look at some of the reasons why countries deviate from a strategy of free trade and adopt protectionist measures.

You will see that protectionist policies are often undertaken primarily to protect the incomes of particular interest groups within society. Also there are theoretical arguments that show that sometimes protectionist policies can increase national welfare.

We now discuss some of these theories justifying the use of protectionist measures.

4.3.1.1 The Terms of Trade Argument

One argument for adopting protectionist measures is based on cost-benefit analysis. This applies in the context of large countries. In the context of international trade a large country is one whose actions regarding the decision whether or not to restrict trade flows has direct repercussions on the world price of goods.

When a large country imposes import restrictions (say, via an import tariff), this serves to reduce world demand for the importable and thus the price of the importable good in the world market. That is, by imposing tariff restriction on imports, a large country is able to affect the price of foreign exporters. The tariff leads to a lowering of the price of imports and thus results in a terms of trade benefit for the country.

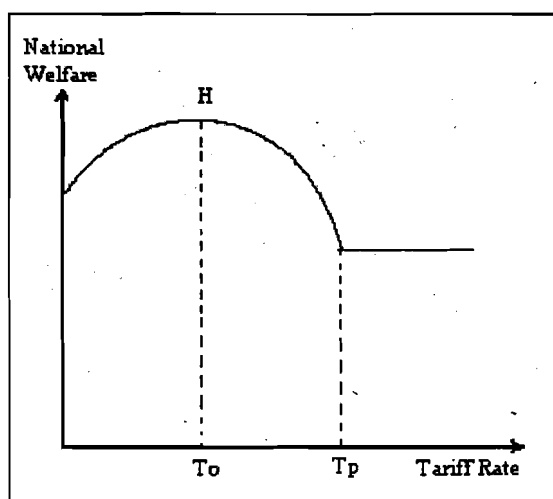
However this benefit must be compared with the cost of the tariff. As we will see in the next section, a tariff impacts on the price of the importable good and changes relative prices of the importable vis a vis the exportable goods. Thus the costs of a tariff are measured by the distortion in production and consumption incentives, associated with the change in domestic relative price ratios.

Under certain conditions it can be shown that the benefits of a tariff, due to the improvement in terms of trade, outweighs the costs of the tariff. This is the terms of trade argument for protectionism. In fact it can be shown that there exists a sufficiently small but positive tariff-rate, at which the terms of trade benefits must outweigh the costs.

This means that at small tariff rates a large country's welfare is actually higher as compared to a free trade situation. As the tariff rate is increased, however, the costs of protection begin to grow more rapidly than the benefits. That is, the Welfare Curve, that relates national welfare to the rate of tariff rises initially, reaches a maximum and then turns downwards (Figure 4.4 below).

With reference to Figure 4.4 you should note the following:

- T_p is the prohibitive tariff rate. This rate is so high, that it completely prohibits all trade. So the country is actually worse off than with free trade. For, with free trade consumers would have had access to a wide variety of goods at lower prices. Tariff rates higher than T_p have no effect on social welfare, so the welfare curve is completely flat beyond this point.



Source: Figure 9.2, Krugman et.al. (2000), p.24

Figure 4.4: The Optimum Tariff

- The tariff rate T_O , corresponding to point H on the Welfare Curve, is the tariff rate at which national welfare is maximised. This tariff rate T_O is the optimum tariff. For a large country there is an optimum tariff T_O at which the marginal gain from improved terms of trade just equals the marginal efficiency loss from production and consumption distortions. It can be shown that the optimum tariff rate is always positive but less than the prohibitive rate T_p .

Applying the terms of trade argument to the export sector, in the context of a large country, an export subsidy serves to lower the world price of the

exportable good. This would actually worsen the terms of trade of the exporting country and reduce national welfare.

Therefore the optimal policy in the export sector would be to impose a negative subsidy or a tax on exports that raises the price of exports in the world market. Like the optimum tariff, the optimum export tax is always positive but less than the prohibitive tax rate that completely reduces exports to zero. Note that the actual policy of oil exporters like Saudi Arabia has been to tax their exports of oil, raising the price of oil to the rest of the world.

A limitation of the terms of trade argument is that it does not apply to small countries that do not have price setting power in the world market.

Another shortcoming of this argument relates to its limited practical relevance. Consider the consequences, if large countries like the USA were to actually impose an optimal tariff, in a bid to gain from trade, at the expense of other trading nations. Obviously this would bring forth retaliatory action from other large trading partners, leading to a situation that would thoroughly undermine the commitment to free trade embodied in multilateral organisations like the WTO.

4.3.1.2 The Market Failure Argument

Our discussion on the merits of free trade in the previous Unit 3 was based on cost-benefit analysis using the concepts of consumer and producer surplus. However, under certain circumstances these concepts fail to accurately capture actual costs and benefits.

This could happen for instance, in the presence of domestic market failures. A market failure occurs whenever markets fail to allocate resources optimally. There can be several examples of domestic market failures. For instance, the presence of unemployment clearly indicates that the labour market is not clearing. Structural rigidities in capital or labour markets may prevent resources from being transferred rapidly to sectors yielding highest returns, resulting in inefficient resource allocation.

In the presence of market failure, producer surplus would not properly measure the benefits of producing a good. In this case, if resources are unemployed, their private costs to employers exceeds their opportunity cost to society. This means that private firms will produce such goods at a level that is less than what is optimal for society.

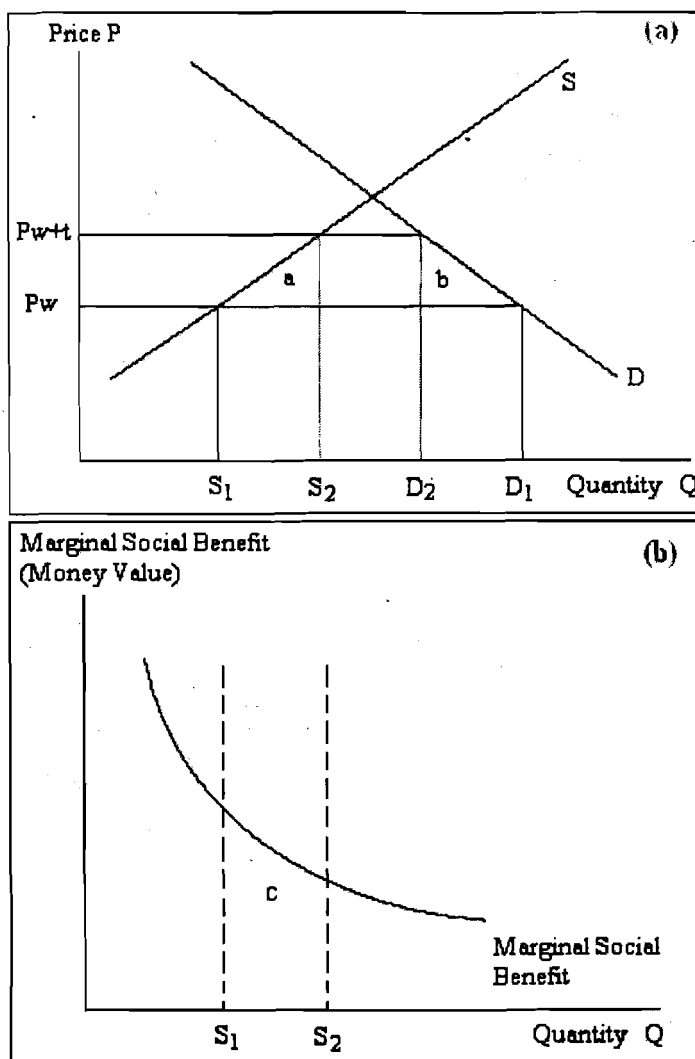
Externalities are another type of market failure. For example, a new technique developed in a certain sector may potentially improve the technology of the economy as a whole. However if firms producing this good do not directly benefit from the economy-wide application of their technology, they do not take this 'potential gain' into account while deciding how much to produce. This is what we call a positive externality. In this case the producer surplus fails to capture the marginal social benefit of additional production. This implies that the government should institute some policy that encourages firms to expand their output.

The existence of marginal social benefit can be used as a justification for adopting protectionist trade policies.

Figure 4.5, (a) and (b) illustrates the domestic market failure argument for

protectionism. Figure 4.5(a) shows the conventional cost-benefit analysis of a tariff. It applies to a small country, which takes international prices as given – i.e., terms of trade effects of the kind discussed above, are ruled out. Figure 4.5(b) shows the marginal social benefit from production, not captured in the producer surplus.

You should study these two figures carefully. Note that a tariff on imports, raises the domestic price of the importable from P_w to $P_w + t$ (Figure 4.5 (a)), reduces domestic consumption (from D_1 to D_2) and raises production (from S_1 to S_2). In terms of the conventional measures of consumer and producer surplus, the sum of the triangles a and b (Figure 4.5 (a)) measures the net loss to society from these distortions in production and consumption.



Source: Figure 9-3, Krugman and Obstfeld (2000), p.226.

Figure 4.5: The Domestic Market Failure Argument for a Tariff

However, the increase in production from S_1 to S_2 yields an additional social benefit. This is measured by the area c under the marginal social benefit curve between S_1 and S_2 (Figure 4.5 (b)). Taking this into account, the benefits of the tariff may exceed its associated costs.

In fact it can be shown that for a small enough tariff rate, the social benefit of a tariff c , would always exceed its costs measured by the area $(a + b)$. Also it can be proved that there is some welfare-maximising tariff rate that yields a higher level of social welfare as compared to free trade, making protection preferable to free trade.

The domestic market failure argument for protectionism is a particular case of a more general concept in economics known as the theory of the second best. This theory provides a justification for government intervention in a given market, in order to correct a market failure in a second market.

The domestic market failure argument for protection amounts to applying the theory of the second best to trade policy. In this case *internal* market

imperfections justify the adoption of trade policies affecting the *external* sector. Thus, even when international trade is not the source of the problem, trade policy measures can provide at least a second best solution.

There are at least a couple of limitations to using the domestic market failure argument as a justification for trade protection.

First, note that trade policies are second-best policies for dealing with the problem of domestic market failures. Ideally such market failures should be corrected directly using first-best domestic policies. For, second best policies are inefficient, as they create distortions and lead to welfare losses. Very often first-best policies appear too costly, while the costs of second-best policies are far less apparent.

For example, using Figure 4.5 (a) and (b) above we showed that the social welfare of a tariff would exceed costs when there are significant social benefits from increased production. However, note that the same increase in production could have been effected by a domestic policy, viz. a production subsidy. With a subsidy, the price paid by consumers would not have increased and thus the loss b , associated with a tariff could have been avoided.

A second critique of the domestic market failure argument relates to the fact that in reality market failures are hard to identify precisely and it is difficult to be sure about the most appropriate policy response to correct the problem.

For instance, in the presence urban unemployment, a tariff to protect urban industrial sectors may solve the problem to some extent. The social benefit of the rise in employment may more than offset the costs imposed by the tariff. But this policy may also encourage rural-urban migration, in which case the problem of urban unemployment may actually increase. Economic theory does not provide enough insight on this issue as which is the best policy to use in this case.

4.3.2 Other Common Justifications for Protectionism

4.3.2.1 The Infant Industry Argument

The infant industry argument for trade protection has been frequently used to justify trade protection, especially in the context of developing countries. The logic being, manufacturing firms in poor countries cannot withstand competition from more mature firms based in industrialised nations, unless they are granted trade protection in their initial stages of development.

You should note that using the infant industry argument to justify trade protection amounts to adopting a second best policy. In this case there is a domestic market failure, which prevents infant industries from attaining their full potential. This domestic market failure could arise due to imperfections in the labour market (labour market rigidities), capital market (underdeveloped financial markets) or due to a flawed system of property rights (e.g., lack of patent regime).

A negative aspect of trade protection is that very often, the absence of competition tends to breed inefficient domestic firms. Also a regime of discretionary controls like import licenses and quotas promote wasteful rent-seeking activities which result in welfare losses.

Further, in principle, the protection granted should be temporary and is normally to be withdrawn once firms mature and are able to compete in the world market. However, in practice it is extremely difficult to withdraw protection, once granted, generating a “perpetual infancy syndrome” Sikdar (2000, p.145).

4.3.2.2 Protection against Dumping

Dumping is said to occur when firms sell goods at significantly lower prices in export markets than in their domestic markets, in a bid to capture a larger share of the foreign market.

Economic theory provides an insight into why dumping occurs in the first place. It can be shown that when markets are imperfectly competitive, firms have an incentive to carry out price discrimination, whenever they face segmented markets for their products.

Typically international markets are imperfectly competitive and naturally segmented, owing to high transport costs and so on, thereby providing a classic opportunity for price discrimination.

Firms in the importing country consider dumping an unfair, predatory practice. By charging a lower price foreign firms may suffer losses in the short term, but eventually they stand to earn monopoly profits if they successfully drive out domestic firms. In that case, consumers who benefit from lower prices in the short run, also stand to lose in the long run when the monopolist sets prices.

Therefore firms in the importing country lobby for imposition of antidumping duties as protection against dumping. In fact the WTO has put in place an elaborate procedure for investigation of anti-dumping charges brought by domestic firms. Antidumping duties may be levied if the charges are found to be true. A few safeguards have also been built into the WTO Anti-dumping Agreement, in a bid to curb the protectionist bias inherent in anti-dumping duties. You will learn more about this in Unit 5.

However there are two problems with using antidumping as a justification for protection. The first relates to the misuse of this argument for protection. Inefficient firms may get protection by successfully bringing antidumping charges against efficient foreign firms. In this case domestic consumers lose out as they would have to pay higher prices.

A second problem relates to the way antidumping charges are investigated in practice. There is quite some ambiguity regarding calculation of the ‘dumping margin’, which is the difference between the ‘fair price’ (the average cost of production of the foreign firm plus a ‘reasonable margin of profit’) and the price it actually charges in the domestic market. However, most often foreign costs of production are not exactly known and approximate figures used instead, making the procedure somewhat arbitrary.

4.3.2.3 Protectionism and FDI

Protectionist trade policies are often used strategically by countries competing to attract FDI (foreign direct investment) flows. In developing countries especially, FDI flows are considered desirable as they bring in scarce capital,

technological know how and newer products. Foreign multinational firms view protected markets favorably, as protection limits competition and it allows them to charge higher than world market prices.

Trade protection enhances social welfare when FDI flows result in significant employment creation. However, there are also associated losses. For one, consumers suffer welfare losses when the entrant firms charge higher prices, owing to the tariff.

Another potential for welfare loss arises in the long run, if the FDI results in very little permanent transfer of knowledge and capability from the foreign firm to the host country. Moreover, if FDI flows are simply to take advantage of protected markets, which in fact, may prove counterproductive for the host country in the long run. For it means protection would have to be granted indefinitely, as any reduction in tariffs may lead to FDI outflows, as was observed in case of Canada. Sikdar (2000, p.146) cites the example of American firms located in Canada, which shut down and relocated after USA and Canada signed a free trade agreement.

Therefore using trade protection as a strategy to attract FDI may not be the most efficient way to gain from FDI flows. Rather, developing countries should attempt to agreements with foreign firms that result in real transfers of resources, as they allow them direct access to domestic markets.

Check Your Progress 2

- 1) Explain how large countries can gain by imposing tariff restrictions on imports.

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- 2) Explain the terms, 'prohibitive' tariff and 'optimum' tariff.

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- 3) Mention at least two criticisms of the terms of trade argument for protectionism.

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- 4) Clearly explain the market failure argument justifying trade protection.

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- 5) Explain the logic underlying the infant industry argument for restricting imports.

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- 6) What is the relation between the infant industry and the market failure arguments for protection ?

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- 7) What do we mean by the term 'dumping' ? Why do countries impose anti-dumping duties ?

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- 8) Do you think developing countries should use protectionist measures to attract inflows of foreign direct investment ?

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4.4 LET US SUM UP

After learning about benefits of free trade, in this Unit we learn about protectionism. Before starting with the explanation on the case for protectionism, where we surveyed the theoretical literature that shows how countries stand to gain from unilateral deviations from free trade, we first learnt about the instruments of protectionism. We discussed the various tools that countries typically use to restrict trade flows. We reviewed traditional tools like tariffs and import quotas and newer measures like voluntary export restrictions and the imposition of health and safety standards.

Our analysis indicates that tariffs lead to more efficient outcomes compared to non-tariff barriers like quotas, as in addition to restricting the flows of imported goods, tariffs also impose a price discipline on domestic firms.

Further, while the government directly benefits from tariff revenues, the quota rent may be completely dissipated in wasteful rent-seeking activities, leading to a social loss.

Our discussion highlighted another important point. In many cases, conventional trade restrictions like tariffs and quotas are giving way to newer, more indirect measures like imposition of health and safety standards. When viewed in the context of countries' commitments to move towards a more free and fair world trade, this tendency appears opposite in spirit to the very principle embodied in multilateral organisations like the WTO.

After understanding the various instruments of protectionism, we showed that large countries especially stand to gain by imposing protectionist measures like import tariffs, as they can affect the world price and hence their terms of trade by restricting imports. However, the notion of gains arising from imposition of the optimum tariff applies only to large economies, for smaller nations cannot influence the world price through their actions. Moreover, given that tariff imposition by one country may lead to retaliation by other trade partners, it is not clear to what extent the notion of optimum tariffs can be used in reality, by large countries to improve their terms of trade situation.

Another theoretical argument justifying trade protection rests on the effects of market failures in the domestic economy. In case of domestic market failures, often the outcome can be improved, by imposing trade restrictions. For instance, granting protection to certain industries may result in marginal social benefits that enhance social welfare.

Other common justifications for trade protection include the infant industry argument, which makes a case for granting protection to new industries, especially in developing countries, till they are mature and able to compete with established firms from developed countries. However, there is a tendency for such protection, once granted, to be continued indefinitely and the absence of competition may breed inefficiencies in the industrial structure.

Fear of dumping by foreign firms and the desire to attract foreign direct investment are other common incentives that induce countries to impose protectionist measures.

4.5 KEY WORDS

Comparative Advantage: A country is said to have comparative advantage in the production of a good, when it can produce the good relatively more efficiently (i.e. at relatively lower cost) than its trading partners.

Free Trade: A situation when countries engage in international trade without imposing any policy restrictions on the free flow of goods and services across international boundaries.

Perfect Competition: Perfect Competition is a market condition characterised by perfect information among buyers and sellers. It consists of a large number of firms who are price takers and who sell a homogeneous product to a large number of buyers.

Consumer Surplus: The gain to consumers when the price they are willing to

pay for a given quantity of a good exceeds the amount they have to actually pay for that quantity.

Producers Surplus: The gain to producers arising from the difference between the minimum price at which they are willing to supply a given quantity of a good and the price they actually receive by selling that quantity in the market.

Market Failure: It is a situation when the free market equilibrium outcome does not lead to maximisation of social welfare.

Marginal Social Benefit: Incremental benefit to society, from additional units of an economic activity, that is not reflected in market prices.

Terms of Trade: The ratio of the price received for a country's exports to the price paid for its imports

Tariff: A tax imposed on imported goods, that raises the price of such goods in the domestic market.

Quota: A quantitative restriction on the quantum of imports permissible, that is often administered via the distribution of import licenses.

4.6 SOME USEFUL REFERENCES

Krugman, P. and M.Obstfeld. 2000. *International Economics : Theory and Policy*, Addison Wesley Longman : Singapore. Chapters 8, 9 and 10,

Salvatore, D. 2004. *International Economics*, Eighth Edition, John Wiley & Sons : Singapore. Chapter 8.

Sikdar, S. 2003. *Contemporary Issues in Globalisation : An Introduction to Theory and Policy in India*, Oxford University Press : New Delhi. Chapter 6.

4.7 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Read Section 4.2
- 2) Read Sub-section 4.2.1
- 3) Read Sub-section 4.2.1.1
- 4) Read Sub-section 4.2.1.1
- 5) Read Sub-section 4.2.2.1, (i)
- 6) Read Sub-section 4.2.2.1, (ii)
- 7) Read Sub-section 4.2.2.1
- 8) Read Sub-section 4.2.2.1
- 9) Read Sub-section 4.2.2.2

Check Your Progress 2

- 1) Read Sub-section 4.3.1.1
- 2) Read Sub-section 4.3.1.1
- 3) Read Sub-section 4.3.1.1
- 4) Read Sub-section 4.3.1.2
- 5) Read Sub-section 4.3.2.1
- 6) Read Sub-section 4.3.2.1
- 7) Read Sub-section 4.3.2.2
- 8) Read Sub-section 4.3.2.3

UNIT 5 ROLE OF THE WTO IN TRADE POLICY

Structure

- 5.0 Objectives
- 5.1 Introduction
- 5.2 Goods
 - 5.2.1 Basic Principles
 - 5.2.2 Restraint on Trade
 - 5.2.2.1 Tariff
 - 5.2.2.2 Safeguard
 - 5.2.2.3 Balance of Payment (BOP) Provision
 - 5.2.2.4 General Exceptions
 - 5.2.3 Unfair Trade
 - 5.2.3.1 Subsidy
 - 5.2.3.2 Anti-dumping
 - 5.2.4 Some Specific Sectors
 - 5.2.4.1 Agriculture
 - 5.2.4.2 Textiles
- 5.3 Services
- 5.4 Intellectual Property Rights (IPR)
- 5.5 Dispute Settlement Process
- 5.6 Institutions and Decision Making
- 5.7 Let Us Sum Up
- 5.8 Key Words
- 5.9 Some Useful References
- 5.10 Answers/Hints to Check Your Progress Exercises

5.0 OBJECTIVES

After reading this Unit, you will be able to

- explain the main features of the multilateral framework of international trade; and
- understand the flexibility and constraints on governments in formulating and implementing international trade policy.

5.1 INTRODUCTION

You have learnt in international trade theory that buying and selling of goods and services between the countries enhances efficiency and welfare in the countries. You have also learnt that countries sometimes put restraints on imports and sometimes even on exports in certain circumstances. But if countries put such restraints erratically or at their will, it will cause major uncertainty in international trading transactions. Industry and trade cannot plan out their operations and strategy of growth in such unstable situation. Hence countries have come together and mutually agreed to have a set of rules that will guide them in formulation and conduct of their international trade policy. The World Trade Organisation (WTO) agreements provide such set of rules.

Actually the exercise for establishing a multilateral framework for international trade started towards the end of the Second World War. The US and the UK started working out a blue print for such a framework which emerged in 1947 as a multilateral agreement in the form of the General Agreement on Tariffs and Trade (GATT). It contained provisions on the export and import of goods across countries.

Thereafter several “rounds” of multilateral trade negotiations (MTN) among countries have taken place in GATT for liberalisation of international trade. These are listed below: (i) Geneva (1947), (ii) Annecy (1948), (iii) Torquay (1950), (iv) Geneva (1956), (v) Dillon (1960-1961), (vi) Kennedy (1964-1967), (vii) Tokyo (1973 -1979), and (viii) Uruguay (1986-1994). Currently, negotiations are going on since the end of 2001 as a follow up of Doha Work Programme (launched in Doha in 2001). It has not been formally called MTN, but it is as exhaustive and detailed as any MTN.

After a process of protracted negotiations during the Uruguay Round of MTN, the framework was expanded and strengthened in 1995. The GATT was expanded to form the World Trade Organisation (WTO). It strengthened the disciplines on international trade of goods and also included disciplines on trade in services. Besides, a new area that has no direct link with trade, viz., intellectual property rights (IPR), was also included in this framework. In this way the WTO subsumes the GATT totally and it also covers other areas.

A large number of the agreements are there in the WTO. It is helpful to put them into some groups. The original GATT of 1947, its later amendments and also the decisions taken under it are now clubbed into the entity called GATT 1994. Thus when we refer to an article of GATT, e.g., Article I, we call it “Article I of GATT 1994”. The disciplines in the area of goods are contained in the GATT 1994 and a number of agreements on specific subjects in this area. Those in the area of services are contained in the General Agreement on Trade in Services (GATS). Those in the area of intellectual property are contained in the Agreement on Trade Related Intellectual Property Rights (Agreement on TRIPS). The process of enforcement of the rights and obligations, i.e., the dispute settlement process, is given in the Dispute Settlement Understanding (DSU).

The disciplines contained in these agreements are generally in the form of rights and obligations of governments. The governments of the countries that are members of the WTO are responsible for implementation of these agreements. In case of a perceived violation of any provision of the agreements, a government (not a firm) can make a complaint in the WTO. Then a process of settlement of dispute sets in, as will be explained later. First, we should see what the disciplines are in the three areas: goods, services and IPR.

5.2 GOODS

The most basic approach in relation to the trade in goods is that competition should be the prime deciding factor for import and export. The consumer should have the freedom to choose a product based on price, quality and other related considerations. The rules centre around this concept. The deviations from this central concept are there only in the form of exceptions which will be explained later.

5.2.1 Basic principles

Towards the objective of ensuring free competition, there are two basic principles in the area of trade in goods in the WTO: (i) the Most Favoured Nation (MFN) Treatment principle and (ii) the National Treatment principle.

MFN treatment:

It prohibits discrimination between one country and another. A country that is a member of the WTO cannot provide an especially beneficial treatment to any country in the matter of export and import. In specific terms, this provision (Article I of the GATT 1994) says that when a country that is a member of the WTO (now on called simply “Member”) gives any benefit in the matter of export and import to any country (whether Member or not), it must provide the same benefit to all other Members immediately and unconditionally. The title is derived from the fact that any concession given by a Member to the most favoured country has also to be extended to all Members.

Examples:

1. A Member cannot give lower tariff on a product to a country as a reward for receiving some aid or investment from that country. Such form of reward will violate the MFN treatment principle.
2. If a Member is annoyed with another Member for criticising it in the UN and punishes it by stopping import from that Member country, it is violating the MFN treatment principle.

All tariffs and import rules have to be non-discriminatory as between the Members of the WTO.

There are some exceptions to the MFN rule. For example:

1. Two countries or a group of countries may form regional trading arrangement among themselves and extend lower tariffs to one another without giving this benefit to those outside the arrangement. (Article XXIV of GATT 1994)
2. Developing countries may get special benefits from other countries and they may have special arrangements among themselves without others getting the benefits.

Commonly called “enabling clause” and more technically called “Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries”)

National treatment:

It is the principle of non-discrimination as between an imported product and a like domestic product. A Member is prohibited from providing less favourable treatment to an imported product than provided to a like domestic product (Article III of GATT 1994).

Examples:

1. A Member cannot prescribe tougher quality control for an imported

2. A Member is prohibited from insisting on a particular packaging for an imported product when it does not ask for similar packaging for a like domestic product.

An exception to the national treatment is: provision of subsidy for the production of domestic products under certain disciplines without providing such subsidy to the like imported product.

You can easily notice that these two basic principles are meant to ensure that there is unhindered competition in trade. MFN principle ensures competition as between goods coming from different countries. National treatment principle ensures competition as between an imported product and a domestic product.

5.2.2 Restraint on trade

Following the principle of open and free competition, the WTO rules prohibit governments from imposing any form of restriction on import or export of goods. (Article XI of the GATT 1994).

Restraint on export is permissible only as a temporary measure applied to prevent or relieve critical shortages of food or other essential products. Export duty can also be imposed by government. Such duty is imposed when government wants to have a general curb on the export of some products, for example, critical industrial raw materials, or when government wants to take away a part of profit from the export of a product.

Restraint on import is generally allowed only in the form of tariff, i.e., the customs duty, imposed at the time of import. Any other form of import restraint, for example by stopping the import of a product or by limiting the import quantity of a product (Quantitative Restriction, QR for short) is prohibited except under very special contingencies or as exceptions, as will be explained later. First, let us understand the disciplines on tariff in some detail as it forms an important part of government trade policy.

5.2.2.1 Tariff

As you have read in the theory of protection in Unit 4, tariff has three functions: (i) it provides revenue to the government, (ii) it protects the domestic product from competition with the imported product as the latter becomes more costly because of the tariff and (iii) it is an instrument in development policy for discouraging non-priority import e.g., luxury goods, and encouraging priority imports, e.g., capital goods and industrial intermediates.

Normally tariff is fixed as a percentage of the price of a product. Thus when we say that the tariff on a product in a country is 15 percent, it means that the government charges customs duty at the rate of 15 percent of the price. This type of charging of tariff is called "*ad valorem*" tariff, signifying that it is based on the value of the product. There are some instances of another form of charging of tariff which is called "specific" tariff. In this method, the tariff is fixed at the rate of some amount per unit of quantity, for example, Rupees 10 per kilogram. Now there is a decision in the WTO that all tariffs must be fixed on *ad valorem* basis. The customs duty is charged at the time of entry of the

Tariffs have been substantially reduced over the several rounds of multilateral trade negotiations (MTN) in the GATT/WTO system. Generally the developed countries have low tariffs; on an average about 4 percent. The developing countries have comparatively high tariffs, on an average about 27 percent. The developed countries, however, have retained tariffs much higher than their average on the products which are of main export interest to the developing countries.

The developing countries have reasons for maintaining higher tariff. For them, it is an important and convenient source of revenue. It also helps them to ration their scarce foreign exchange among competing imports; for example as mentioned earlier, they can discourage the import of luxury products and encourage the import of industrial raw materials by having high tariffs on the former and low tariffs on the latter. More importantly, tariffs are virtually the only instrument for protecting their industries from competing imports.

In the course of the multilateral trade negotiations (MTN), countries undertake obligations not to raise tariffs on specified products beyond specified limits. These tariffs are said to be “bound”. A country may apply a tariff lower than the bound level on that product, but it cannot generally go beyond the bound level, except as a temporary measure under some contingency provisions that will be explained later. When it wants to raise the bound tariff level on a regular basis, it has to negotiate with other countries and has to offer compensation in the form of reducing its tariffs on certain other products of interest to other countries.

There are two contingency situations in which the tariff can be raised higher than the bound level and a country can also put quantitative limits to the import of particular products. These situations are: firstly, providing “safeguard” to the domestic industry against sudden surge of imports, and secondly, tiding over the problem of the shortage of inflow and reserve of foreign exchange, technically called the “balance of payment (BOP)” problem.

5.2.2.2 Safeguard

If the domestic industry of a country suffers serious injury because of increased imports or if there is even a threat of serious injury, the country may put restriction on import, either by raising import duty beyond the bound level or by putting quantitative restrictions on the import.

Detailed rules have been laid down for taking safeguard measures. (Article XIX of GATT 1994 and Agreement on Safeguard). A country, before actually imposing import restrictions under this provision, has to undertake a transparent, objective and detailed investigation to determine whether there has been a surge in import and whether there is serious injury (or threat of serious injury) to the domestic industry because of such surge in import.

A safeguard action has to be taken on the import of the product as a whole and not against the import from a particular country. Thus if additional tariff is applied as a safeguard measure, it will be applicable to imports from all countries. If quantitative restriction is applied, an annual global limit of import will be fixed, based on the past imports; and then this quantity will be allocated to all the countries generally in proportion to the past imports. There is a provision for deviation from this normal rule of quota division in very specific

circumstances, for example, if there has been very rapid rise in exports from a particular country.

A safeguard measure is a temporary measure. It can continue only so long as the injury continues. Generally the maximum duration of application of a safeguard measure is four years. In certain circumstances, it can be extended; but the total maximum period must not exceed eight years.

When a country applies a safeguard measure, it has to give some compensatory benefit to countries that have substantial interest in the export of that product. In absence of compensation, those countries can take retaliatory measures (generally in the form of raising the tariffs on some products of that country). But no retaliatory measure can generally be taken during the first three years of the safeguard measure.

The safeguard is an example of burden-sharing in the GATT/WTO system. When a country faces sudden rise in imports and its industry is required to adjust to the emerging situation, the safeguard provision ensures that the burden is shared by all the countries, so that it does not fall totally on the country facing the surge in imports. In some ways, it is the counterpart of the MFN provision which ensures the sharing of benefit of lower tariff on a non-discriminatory basis among the countries, as mentioned earlier.

5.2.2.3 Balance of Payment (BOP) Provision

A country is allowed to restrict its imports if it faces a BOP problem (the problem of the foreign exchange reserve and flow). There are two separate provisions in the WTO for this purpose. The general provision (Article XII of the GATT 1994) applies to all countries, both developed and developing. The special provision (Article XVIII B of the GATT 1994) applies only to the developing countries. The developed countries have discontinued resort to this facility. Developing countries continue to have this option, but actual utilisation of the provision has become very difficult for them and lately they have not been resorting to it.

The economic rationale for such provision for the developing countries is that in course of their economic development they may have to import a lot, whereas their export prospects are not high. This may result in severe problem of shortage of foreign exchange which will curtail their option for further import. Hence in order to give them some breathing time for recovery to a more comfortable foreign exchange situation, they are allowed to curtail their imports. This is to enable them to spend their scarce foreign exchange on only essential imports. The measure is to be temporary and is to be continued only until the BOP problem persists.

The developing country applying a BOP measure is called upon to have consultations with the BOP Committee of the WTO, where it is subjected to a great deal of detailed scrutiny on its BOP situation and also on its need to impose trade restrictions for BOP reasons. Generally the International Monetary Fund (IMF) gives a report during such consultations on the BOP situation of the country.

Like the safeguard action, a BOP measure also has to be non-discriminatory as between different exporting countries. The restriction has to be applied to the import of selected products from all countries. A country cannot use this

5.2.2.4 General Exceptions

A country may stop import of a product from a particular country under certain conditions covered by the general exceptions (Article XX of GATT 1994). For example, a country may restrain import for the reason of protection of public morals (e.g., indecent books and magazines), protection of life and health of human beings, animals and plants (e.g., injurious food articles or those with improper packaging), protection of environment (e.g., relating to articles that may pollute water or air while in use or during disposal and relating to the preservation of exhaustible natural resources).

The most frequently used provisions are those for protection of life and health and for other environmental reasons. The provisions of this article are further elaborated, clarified and supplemented by the Agreement on Technical Barriers to Trade (TBT) and the Agreement on the Application of Sanitary and Phytosanitary (SPS) Measures.

The agreements on TBT and SPS stipulate the formulation of international standards and give pre-eminence to them. If a country formulates its own standards or SPS measures, it has to justify that these are not in the nature of unnecessary obstacles to international trade. Also it has to follow elaborate procedures for prior notification of the standards, for opportunities to others to make comments and for consideration of these comments.

The measures explained above are at the core of the problem of environmental protection. But the measures have been taken by the major developed countries rather frequently and with less rigour, giving rise to the apprehension that these have been taken for protectionist reasons rather than for environmental reasons. As was mentioned in the previous Unit, such measures often act as non-tariff barriers (NTBs).

Check Your Progress 1

- 1) A country A has received substantial support from country B in providing relief to Tsunami victims. As a token of appreciation, the government of country A decides to take following steps:
 - (i) reduce the tariff on textile to be imported from B,
 - (ii) ask its importers to import from B at least one million dollar worth of products in a year.

Will such decisions be consistent with the WTO rules? Discuss.

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- 2) A country prescribes that wheat imported from any country must be in plastic bags. It does not make any such requirement for the domestically produced wheat. Will it be violating any WTO rules? Explain.

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- 3) A country receives alarming complaints from its footwear industry that sudden imports of footwear is displacing their products from the market and they are likely to close down. Can the government at once order that no footwear will be imported for the next one month? Give explanation.
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5.2.3 Unfair Trade

The principle of free trade and pre-eminence of competition implies that there should be fair competition among the firms. The underlying principle is that the products should be able to compete in the international market on their own without any prop of direct subsidy from the government. And the prices should not be kept artificially low to kill competition; for example, a firm should not “dump” its goods, i.e., should not generally export products at prices below the cost of production. These two situations, i.e., subsidy by government and “dumping” by firms are considered to be examples of unfair trade. The WTO contains detailed rules on them.

5.2.3.1 Subsidy

Elaborate provisions have been made in the Agreement on Subsidies and Countervailing Measures in the WTO for dealing with subsidy in industry. There are separate rules for subsidy in agriculture, as will be explained later.

If a government provides benefits on production or export in the form of financial contribution or income support or price support, it is said to be providing a subsidy. Certain subsidies are prohibited, while others are permitted, either fully or within some limitations and disciplines.

Prohibited subsidies are: (i) subsidies for export and (ii) subsidies for the use of domestic products in preference to the like imported products (i.e., for import substitution). The Least Developed Countries (LDC) and other developing countries having gross national product (GNP) per capita less than US\$ 1000 per annum are exempted from the prohibition of export subsidy.

While export subsidy is prohibited, domestic subsidy, i.e., subsidy for production is permitted within certain limits as explained below.

The category of domestic subsidy permitted entirely is what is called non-specific or general subsidy, i.e., the subsidy given for production across the board to all industrial sectors based on some generally applied criteria. For example, subsidy without any restriction can be given to small firms, based on the criterion of the maximum number of employees or maximum annual value of output etc. applicable to all industrial sectors.

Specific subsidy, i.e., subsidy given for domestic production in specific industrial sector (as for example, for food processing industry) or to specific

only if it is not: (i) causing material injury or threatening to cause material injury to the industry of another country or (ii) causing serious prejudice to the industry of another country.

The factors for determining injury are: decline in output, sale, price, profit, return on investment, capacity utilisation, employment, wages etc. The factors for determining serious prejudice are somewhat less stringent. These are: displacing or impeding the import in the subsidising country, displacing or impeding the export in a third country market, price undercutting, etc.

Detailed procedures have been provided for relief against subsidy causing material injury or serious prejudice. In case of existence of material injury or its threat, a country may impose countervailing duty on the subsidised product to compensate for the effect of subsidy. Or a country may take to the dispute settlement route (to be explained later) and have the subsidy removed. A country proposing to impose countervailing duty has to conduct an objective and transparent investigation to determine the existence of subsidy and of material injury as well as a direct causal linkage between injury and the subsidised import.

Though there are two alternative courses for relief against material injury, generally a country prefers to follow the countervailing duty route, as it is more direct and effective. Another motivating factor is that, in this case, the process of investigation is carried out inside the country, whereas the dispute settlement process involves a multilateral panel procedure as will be explained later.

In case of serious prejudice, a country may take to the dispute settlement route to have the subsidy removed. The route of countervailing duty is not available in this case.

5.2.3.2 Anti-dumping

It was briefly mentioned in the preceding Unit 4, that a firm is said to dump its product if it exports the product at an artificially low price. There are criteria for determining the price below which the exported product will be considered to have been dumped into the importing country. Generally if the export price is lower than the price of a like product in the exporting country, the product is said to have been dumped. The difference between the export price and the price in the exporting country is said to be the dumping margin. In case it is not possible or practical to compare these two prices, alternatives have been provided for determining dumping. For example, in such cases dumping may be determined on the basis of comparing the export price with the cost of production plus administrative and selling expenses and a reasonable profit.

It is presumed that a firm, while indulging in dumping, is trying to eliminate competition by undercutting its competitors; and as such, dumping is considered to be an unfair practice.

Remedial action against dumping is generally taken by imposition of an anti-dumping duty by the government of the importing country. Before taking such action, the government has to establish in an objective and transparent investigation that there is dumping and also that it is causing or threatening to cause material injury to the domestic industry. The process of determining material injury to the domestic industry is similar to that in case of subsidy

The developing countries have quite frequently been the targets of anti-dumping action in major developed countries and have been subjected to severe harassment. In fact there are frequent complaints that the developed countries have been using anti-dumping action as an instrument of protection for their industry. Merely starting the investigation on dumping is sometimes enough to disrupt exports from the developing countries as all this creates an atmosphere of uncertainty. In recent years, some developing countries, especially India, have also been frequently resorting to anti-dumping actions.

5.2.4 Some Specific Sectors

There are special disciplines in some specific sectors. Agriculture is covered by a separate set of rules contained in the *Agreement on Agriculture*. There were separate set of rules for textiles; but since the beginning of 2005, this sector is governed by the general disciplines of the WTO. Considering the importance of agriculture for the economy, particularly of the developing countries, it is useful to understand the disciplines in this sector in some detail. Further, it is also useful to recall in brief the experience in textiles in order to illustrate the potential of the protectionist lobbies in the developed countries.

5.2.4.1 Agriculture

Agriculture had been under soft discipline from the inception of the GATT. Efforts were made right from the 1970s to bring agriculture under stricter discipline. Ultimately, all this has resulted in the Agreement on Agriculture (AOA) in the Uruguay Round.

Obligations in this sector are in the fields of (i) market access, i.e. tariff and import restrictions, (ii) domestic support to producers, i.e., domestic subsidy, and (iii) export competition, i.e. export subsidy, etc.

Market Access

The restrictions on market access were earlier in the form of tariff and non-tariff measures, e.g., quantitative restrictions, etc. AOA made it incumbent on the countries to “tariffify” their non-tariff measures, i.e. they had to remove these measures and replace them with equivalent tariffs. Several countries calculated very high levels of equivalent tariffs in replacement for non-tariff measures. Thus now the only restraints on import in this sector are through tariffs which are, of course, very high in most of the cases. One important feature is that all countries, including the developing countries (even the least developed countries), have to bind (explained in the section on “tariff” earlier) all tariffs on agricultural items. This condition is much more stringent than in case of industrial goods where the developing countries have not covered all products by commitment of binding of tariff. There is a provision for a mechanism called “tariff quota”. When a country has very high tariff on some product, it may allow imports up to some quantity in a year on very low tariff. This level is the tariff quota. Tariff is at the normal rates beyond this level. Generally when domestic production is suffering because of imports, a country may take safeguard action as explained in the section on safeguards earlier. In the agriculture sector too this remedy is available. And, in addition, there is a provision for Special Safeguard (SSG) in agriculture. A country can take SSG action without having to establish injury to the domestic production, as is compulsory in the case of the general safeguard provision.

Only the countries which have converted their non-tariff measures to equivalent tariffs can take SSG. The developing countries, with very few exceptions, did not have any such non-tariff restraints and thus did not have to undertake the process of conversion. In this way, they lost the right to use SSG.

SSG is in the form of additional duty imposed on the import of a product. SSG can be taken either when the quantity of import in a particular year exceeds a trigger level or when the price of the imported product is below a trigger price. While an elaborate formula has been prescribed for defining the quantity trigger level, a country may itself define the trigger price for a product.

Domestic Support

Domestic support, i.e., domestic subsidy, in agriculture is broadly of two types in the AOA. One type is reducible over a period and the other type is not reducible. Both these types of subsidies are mainly used by the developed countries. Currently negotiations are going on to reduce the reducible subsidies further and also reduce some of the present non-reducible subsidies and put them under more rigorous discipline. This has become a very hotly debated subject in the WTO and the international trade circles.

Export Subsidy

Export subsidy in agriculture is in the form of direct payment to the exporter or in the form of export credit and food aid. Mostly export subsidy is paid by the major developed countries. A decision has been taken recently that the export subsidy will be eliminated latest by 2013.

5.2.4.2 Textiles

Normal rules of free trade were suspended in the sector of textiles for over three decades. This sector is an example of protectionist pressures in the major developed countries gaining ground over the principle of free and open trade.

Within just over a decade of the start of the GATT, the textile industry in the major developed countries was unable to compete with the imports from Japan and the developing countries. An option within the GATT which the developed countries had at that time was to take safeguard action under the GATT. But, following the principle of the MFN, this would have required a developed country to restrict the imports from all countries, including the developed countries too, which they did not want to do.

The major developed countries neither allowed the normal market forces to operate freely nor followed the path allowed by the GATT. They simply decided to ignore their obligations under the GATT and bypass it. They decided to carve out special trade rules in the textiles sector in derogation of the normal GATT rules. They got a special restrictive regime established in this sector which would permit having predetermined limits to the export of textile items from a developing country to a developed country.

The special regime in this sector took the form of the Short-Term Agreement (STA), Long-Term Agreement (LTA), Multi-Fibre Agreement (MFA, 1973-94) and the Uruguay Round Agreement on Textiles and Clothing (ATC, 1995- 2004). The developed countries went on insisting on extending the MFA, which had been initially installed for four years, i.e., 1973-77. The special trade regime in

this area, instead of gradually progressing towards trade liberalisation, became increasingly more restrictive. The product coverage expanded from cotton in the STA and LTA to wool and man-made fibres in the MFA, which was further enhanced to cover some other fibres like jute and silk blend. And finally the ATC added to it, by including pure silk.

Finally the special trade rules in this sector ended at the end of 2004 and now the normal rules of the WTO apply to this sector.

Check Your Progress 2

- 1) There is enormous stock of steel rods in the steel factories of a country and the industry is finding it financially very difficult to hold on to the stock. There is not enough demand in the domestic market for such steel rods. Can the government, as a temporary and one time measure, give financial assistance to the industry to export a part of the stock?

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- 2) Can a government write off a part of the income tax of a factory on the condition that it uses domestic raw material instead of imported raw material?

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- 3) Can a foot ball factory, having the problem of huge surplus stock, export a part of the stock at a big discount as a one time emergency measure?

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- 4) Is a developed country totally stopped from giving export subsidy and domestic subsidy for agricultural products?

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- 5) A country has 30 percent bound tariff on ceramic product, but it applies only 15 percent tariff. In the event of protecting its domestic ceramic industry from sudden surges of import, can it raise the applied tariff to 25 percent at once without investigating about the injury to the domestic industry from the import surge?

5.3 SERVICES

Services sector is covered by the General Agreement on Trade in Services (GATS). This subject came into the multilateral trading system in the beginning of 1995, as mentioned earlier. It had been introduced at the initiative of the developed countries that perceived significant benefits to their economies by liberalisation of services import in the world.

The GATS is centred around liberalisation of services, which entails curtailment of the functions of government to regulate the entry and operation of foreign services and service providers in the country. There are two broad categories of obligation on liberalisation: (i) general obligations that are applicable to all services sectors and (ii) specific commitments of liberalisation in specific services sectors.

The examples of general obligations are: the principle of non-discrimination, MFN, which has been explained earlier in section 5.2.1 and also the rules regarding recognition of qualifications and standards for supply of service.

The obligations on specific sectoral commitments are in terms of the modes of supply of service. Four modes of supply have been envisaged:

Mode 1: supply of service from one country to another country, for example, supply of a software programme or an engineering design of a machine by a person/firm from one country to a person/firm in another country;

Mode 2: provision of service in a country to the consumer of another country, for example, providing medical treatment in a country to a person of another country;

Mode 3: supply of service by the service supplier of one country to another country through commercial presence in that country, for example, supply of financial service by a banking firm by opening a branch in another country; and

Mode 4: supply of service by one country to another country through presence of natural persons there, for example, providing advice or repairing a machine in another country by an expert travelling to that country.

By specific sectoral commitment a country undertakes the obligation to allow the provision of service in the particular sector by a foreign service provider. A country chooses the sectors in which to allow import, i.e., the provision of service by a foreign supplier. The choice is technically with the country that makes it; but in actual practice, the countries enter into negotiations to persuade one another to liberalise their respective service sectors.

While agreeing to include a sector in its commitment of liberalisation, a country may prescribe some conditions and limitations on market access and

national treatment (this term has been explained earlier). If no condition or limitation is laid down at the time of taking commitment, the presumption is that the country has allowed totally unrestrained liberalisation in that sector. If a country has not included a sector in its commitment, it has no obligation on market access and national treatment in that sector.

With a wide gap between the opportunities of the developed and developing countries, an agreement on the framework for liberalisation of import of services is *ab initio* unbalanced. Because of the widely differing supply capacity between the developed countries and the developing countries, there will naturally be a big difference in the potential export benefits.

The GATS, however, includes some intent and objectives for the benefit of the developing countries. For example, it includes the objective of strengthening the domestic service capacity of the developing countries and liberalisation in sectors of export interest to the developing countries. It also permits them to have liberalisation in fewer sectors and fewer transactions in line with their development situation.

The GATS envisages progressive liberalisation in services sectors through negotiations from time to time. The first set of negotiations took place during the Uruguay Round. Now another round of negotiations is going on as a part of the Doha Work Programme.

5.4 INTELLECTUAL PROPERTY RIGHTS (IPR)

This is another area like services that was brought into the multilateral trading system at the instance of the major developed countries. The subject of IPR is very much different from trade. Also, it is about the protection of monopoly on the IPR and is thus far removed from the principle of free trade that is the basis of the WTO. Hence it just does not have a place in the WTO; and yet it is there because the major developed countries insisted on it.

The framework for the protection of IPR in the WTO is contained in the Agreement on TRIPS. It lays down disciplines in *seven areas of the IPR*: patent, copyright, trademark, geographical indication, industrial design, integrated circuits and undisclosed information. Some of these were already covered by some earlier international agreements; yet there was seen to be a need for this new agreement. This is mainly because the earlier agreements, most of which were within the framework of the World Intellectual Property Organisation, did not have provisions for effective implementation. Now all these can be implemented and enforced through the dispute settlement mechanism of the WTO (to be explained later in section 5.5). The earlier treaties, which are still valid and operational, are: the *Paris Convention* for patents, trademarks and industrial designs, *Berne Convention* and *Rome Convention* for copyright, and *Washington Treaty* for layout-designs of integrated circuits.

Need of protection of IPR which is a creation of mind arises from the fact that the inventor/creator should get adequate returns in order to have incentive for innovation. The protection in the form of exclusive right for production and marketing, for example in case of a patent, results in relatively high price for the product which is borne by the consumer of the IPR product. There is a need of a proper balance between the return to the innovator and the cost to the

consumer. The Agreement on TRIPS prescribes the minimum standard of protection of the IPR; thus the options for a country to choose its own balance get restricted to that extent. A country cannot have a lower level of protection; it may, however, have higher levels of protection.

Of the seven areas of IPR listed covered by the Agreement on TRIPS, the patent and the copyright are the most important from the development angle. Hence these are explained here in some detail.

Patent

An invention is eligible for patent, if it is new, involves an inventive step (it is non-obvious) and is capable of industrial application (it is useful). If an application is made for patent of an invention, a country has to enquire if it fulfils all these conditions and has to register the patent if the conditions are fulfilled.

Invention of both a product and a process can be patented. It is not obligatory for a country to register patents for: (i) diagnostic, therapeutic and surgical methods and (ii) plants and animals and essentially biological processes for the production of plants and animals. But a country may, if it so wishes, include them also in its patents registration system. It is not obligatory for a country to provide patent registration for plant varieties, but it is obligatory to provide protection to it through what is called a *sui generis* system, meaning thereby that a country may devise its own method to provide protection for plant varieties.

A country may refuse patent on the grounds of protection of: (i) public morality, (ii) human, animal or plant life or health and (iii) environment.

The period of patent is at least twenty years from the date of filing of the application for the patent.

In the case of patent on a product, the IPR owner has the right to prevent anybody from producing, selling or importing the product without the consent of the IPR owner. For the process, the IPR owner has the right to prevent anybody from using the process without the IPR owner's consent. Thus a product cannot be manufactured using that process without the IPR owner consenting to it.

The government can give a license to a person to use a patent without the authorisation of the IPR owner. This is called compulsory license to distinguish it from the voluntary license given by the IPR owner. The Agreement on TRIPS does not prescribe the grounds on which compulsory license can be given by government; but it prescribes certain conditions, procedures and limitations regarding compulsory license.

One important condition is that the proposed user of the patent should have made efforts to get authorisation from the IPR owner and would have failed to get it within a reasonable period (the period has not been defined in the Agreement). Also, the IPR owner has to be paid adequate remuneration (what is adequate has not been specified in the agreement).

As many provisions have not been specified in the agreement, the governments have the flexibility to prescribe them. Many countries have formulated legislation to incorporate their own provisions on these subjects.

Copyright

The copyright covers the protection of the right of authors in their literary and artistic works and the protection of cinematographic works, works of architecture, computer programme and compilation of data and rights of performers, phonograms and broadcasting.

The term of protection of a literary or artistic work, generally, is the life of the author and 50 years after his/her death. For cinematographic work, the term is 50 years after the work has been made available to the public; for the photographic work, it is 25 years from the making of the work; for performers and producers of phonograms, it is 50 years from the year of performance or fixation and for broadcasting, it is 20 years from the end of the broadcast. The term of protection of computer programme is same as that for literary work.

While the patent is for a specific jurisdiction, e.g., a country, the copyright is not limited in jurisdiction. After its creation, it applies to all countries. Further, one does not have to apply for registration of copyright and get the registration as in case of patents. It starts applying on its own after creation in accordance with the law of a country.

Elaborate provisions have been made in the agreement regarding the legal processes and other aspects of domestic practices in pursuance of implementing the legislation on IPRs.

5.5 DISPUTE SETTLEMENT PROCESS

Enforcement of the rules in the WTO is through the dispute settlement process contained in the Dispute Settlement Understanding (DSU). The cause of action normally arises when a country perceives that any benefit accruing to it under an agreement is being nullified or impaired by an action of another country or by its failure to carry out its obligation under the WTO. The settlement of disputes is handled by a WTO body, called the Dispute Settlement Body (DSB). All countries of the WTO are members of the DSB.

Once the process starts, it moves efficiently. There are fixed time limits for various steps.

The very first step is to give notice to the other country and seek consultation with it. The objective is to find solution to the problem without entering into formal dispute process. If no agreement is arrived at within 60 days, the country moves the Dispute Settlement Body (DSB) to form a panel for the settlement of dispute. The DSB must decide on it immediately; it cannot delay the formation of the panel beyond two meetings.

The panel is normally composed of three independent experts. It considers the case of both sides and gives its report within 6 months. If a party decides to go in appeal against the report, a bench of three of the standing Appellate Body (AB) considers the report of the panel and gives its own report within 60 days.

The report of the panel/AB is considered by the DSB. The report is adopted by the DSB unless there is consensus that it should not be adopted. This "negative consensus" provision assures its acceptance, as it is not likely that there will be a consensus not to adopt it. At least one country, the one in whose favour the

report goes, is bound to oppose rejection of the report, hence there cannot be a consensus not to adopt the report.

If the report of the panel/AB has found the complaint substantiated, it generally recommends that the defendant country should take corrective action. That country then gives its time frame for implementation of the recommendation of the panel/AB. This gets discussed between the two parties. In case of disagreement on the time frame, there is a provision for arbitration within 90 days. Generally the arbitrator has the guideline in the DSU that a reasonable time for full implementation should not exceed 15 months.

In case the defendant country does not implement the recommendation of the panel/AB or if the implementation is found to be deficient, the complainant country is allowed to take retaliatory measures against it. Usually the retaliatory measure is in the form of increased tariffs on some products from that country.

5.6 INSTITUTIONS AND DECISION MAKING

The highest decision making body in the WTO is the ministerial conference that meets at least once in two years. So far, these conferences have been held in Singapore (1996), Geneva (1998), Seattle (1999), Doha (2001), Cancun (2003) and Hong Kong (2005).

In between the ministerial conferences, the functions of the ministerial conference are conducted by the General Council.

There are councils for specific areas: Council for Trade in Goods for the implementation of agreements on goods, Council for Trade in Services for implementation of the GATS and Council for TRIPS for implementation of the Agreement on TRIPS.

The Dispute Settlement Body (DSB) operates the DSU, as mentioned earlier.

All countries in the WTO are members of all these bodies.

Decisions are generally taken in the WTO by consensus, which has been specifically defined. A decision will be deemed to be made by consensus "if no Member, present at the meeting when the decision is being taken, formally objects to the proposed decision". If consensus is not possible, the decision is to be taken by voting. There is the system of one-country-one-vote and decision generally by majority. For very special purposes, higher majority is prescribed. For example, a decision on interpretation of an agreement or on waivers of an obligation needs three-fourths majority. Amendments require two-thirds majority or in some matters acceptance by all countries.

In actual practice, voting is not resorted to; differences are settled by prolonged consultations and discussions.

Check Your Progress 3

- 1) Can a country refuse to act in accordance with the recommendations of the dispute panel/Appellate Body?

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- 2) A country has not inscribed banking services in its services commitment. Can it stop a foreign bank from opening a branch in the country? If it later inscribes banking sector in its commitments and prescribes no limitation or condition, can it then stop a foreign bank from opening a branch in the country?

- 3) A scientist has applied for patenting a machine. What all has to be ascertained by the authority handling such cases before registering the patent?

- 4) Can a government give permission to a domestic firm to manufacture and sell a medicine that has been patented by a foreign firm?

5.7 LET US SUM UP

In this Unit you have learnt about the mechanism and functioning of the multi-lateral framework of international trade under the aegis of World Trade Organisation (WTO). The Unit explains to you how WTO influences the trade policy during the course of multilateral negotiations among the countries. It also explains the kind of flexibility and constraints; WTO gives to the respective countries in formulating and implementing their trade policies. The Unit explains in detail the issues involved in the trade in goods, services, IPRs. It also explains the dispute settlement mechanism and institutional setup for decision making.

5.8 KEY WORDS

Ad Valorem Tariff: Ad Valorem Tariff is calculated based on the value of the product

Bound Tariff: Bound tariffs are those when countries agree not to raise the level of tariffs on specified products beyond specified limits agreed in the process of multilateral trade negotiations (MTN). A country may apply a tariff lower than the bound level on that product, but it cannot generally go beyond

the bound level, except as a temporary measure under some contingency provisions.

Countervailing Duty: A tariff levied against imports that are subsidised by the exporting country's government, designed to offset (countervail) the effect of the subsidy.

Dispute Settlement Body: The entity within the WTO that formally deals with disputes between members. It consists of all WTO members meeting together to consider reports of panels and the Appellate Body. This body is the standing committee of the WTO that reviews decisions of dispute settlement panels.

Doha Round: The round of multilateral trade negotiations that begun in January 2002 as a result of agreement at the Doha Ministerial meeting held in Doha, Qatar, in November 2001. The document agreed upon by the trade ministers of the member countries of the WTO at the Doha Ministerial meeting is popularly called *Doha Declaration*. This round as per the declaration has initiated negotiations on 21 subjects. A distinctive feature is the emphasis placed on the interests of developing countries. This round is also called the Doha Development Round

Intellectual Property Right: The right to control and derive the benefits from something one has invented, discovered, or created.

Subsidy: Subsidy is a payment by government, perhaps implicit, to the private sector in return for some activity that it wants to reward, encourage, or assist. Under WTO rules, subsidies may be prohibited, actionable, or non-actionable.

Sui generis: *Sui generis* is a (post) Latin expression, literally meaning *of its own kind/genus* or unique in its characteristics. In intellectual property there are rights which are known as being *sui generis* to owners of a small class of works, such as intellectual property rights in mask works, databases, or plant species.

Tariffication: It is the process of conversion of NTBs to tariffs at the level of their tariff equivalents. In the Uruguay Round, agricultural NTBs were tariffed and bound, the purpose was to replace unwieldy NTBs with tariffs that can then become the subject of negotiation.

Trade Policy: Trade policy is the policy that affects international trade of countries and includes especially tariffs and non-tariff barriers.

World Trade Organisation (WTO): A global international organisation that specifies and enforces rules for the conduct of international trade policies and serves as a forum for negotiations to reduce barriers to trade. Formed in 1995 as the successor to the GATT, it had 149 member countries as of April 2006.

5.9 SOME USEFUL REFERENCES

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5.10 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Read Sub-section 5.2.1
- 2) Read Sub-section 5.2.1
- 3) Read Sub-section 5.2.3.1

Check Your Progress 2

- 1) Read Sub-section 5.2.3.1
- 2) Read Sub-section 5.2.3.1
- 3) Read Sub-section 5.2.3.2
- 4) Read Sub-section 5.2.4.1
- 5) Read Sub-section 5.2.2.1, 5.2.2.2

Check Your Progress 3

- 1) Read Sub-section 5.5
- 2) Read Sub-section. 5.3
- 3) Read Sub-section. 5.4
- 4) Read Sub-section 5.5

UNIT 6 MULTILATERALISM AND PROBLEMS OF DEVELOPING COUNTRIES WITH WTO

Structure

- 6.0 Objectives
- 6.1 Introduction
- 6.2 Utility of the System for the Developing Countries
- 6.3 Some Basic Problems
 - 6.3.1 Structural Problems
 - 6.3.2 Problems with Specific Rules
 - 6.3.3 Problems with Implementation
- 6.4 Special and Differential Treatment
- 6.5 Differential Treatment in Reverse
 - 6.5.1 Special Trade Restrictions
 - 6.5.2 Interest of Developing Countries Ignored
 - 6.5.3 Priority Treatment of Developed Countries
- 6.6 WTO Process and the Developing Countries
- 6.7 Way Forward for Developing Countries
- 6.8 Let Us Sum Up
- 6.9 Key Words
- 6.10 Some Useful References
- 6.11 Answers/Hints to Check Your Progress Exercises

6.0 OBJECTIVES

After Reading this Unit, you will be able to

- explain the situation of the developing countries in the international trading system;
- describe the benefits of the system and also its problems; and
- learn in detail their experiences in the system and the moves to improve their position.

6.1 INTRODUCTION

Generally the existence and operation of multilateral trade rules should be of advantage to the developing countries that are the weaker partners in the system. A rule based system is specially of advantage to those members that do not have much economic, strategic and political clout. Multilateral rules are meant to provide an umbrella of collective security.

But the experiences of the developing countries in the multilateral trading system have not been altogether happy. Though they derive some benefits from the system, their general feeling is that the system has been used by the major developed countries to derive benefits for themselves, often at the cost of the developing countries. Partly this plight of the developing countries is because of the pressures from the developed countries driven by their short term self-interest, but to some extent it is also because of the action and inaction of the developing countries themselves. It is important for the developing countries to analyse these problems so that they can use their strength and maximise their benefits in the system.

6.2 UTILITY OF THE SYSTEM FOR THE DEVELOPING COUNTRIES

Main utility of the system arises out of compulsions. If a country has to engage in import and export, it must have agreements with other countries, as its goods and services cannot automatically enter other countries; there has to be permission for it. Thus to send exports to other countries, a developing country will need to have bilateral agreements with all of them. The need for such multitudinous agreements is obviated by having a multilateral framework like the WTO, where the member countries allow import and export of goods and services among themselves.

And the developing countries need to export, because (i) they need foreign exchange to pay for their essential imports, like fuel, technology, capital goods, industrial intermediates, some times even food, etc. and (ii) they need markets in other countries for their goods and services to expand their production, employment and profit. Thus the compulsions of export and import make the multilateral trading system relevant and useful to the countries.

It is unlikely that a developing country will get a better deal in a bilateral agreement than what it gets in the multilateral framework. This feature further reinforces the importance of the multilateral trading framework.

Further, the multilateral system provides collective security. The mechanism for enforcement of rights and obligations in the WTO, embodied in its dispute settlement system, provides some protection against unilateral actions of other countries.

Besides, there are some other fringe benefits. Being a member of the community of countries, a country has the opportunity to learn from the experiences of other countries and also influence the process to some extent.

Finally, as the GATT/WTO framework for conducting international trade has been in existence for nearly six decades now, it will be odd for a country to remain out of it and it may even be seen with suspicion by others.

For all these reasons the developing countries are motivated to be a part of this system. Now a large number of them are members and many more are in the process of joining it. The developing countries are nearly four times in numerical strength in the WTO compared to the developed countries.

6.3 SOME BASIC PROBLEMS

The numerical advantage of the developing countries has, however, not helped them to shape the GATT/WTO in accordance with their needs and priorities. The rule of decision-making in the WTO based on one-country-one-vote and the system of decision by the majority (explained in Unit 5) has ironically not given the developing countries a decisive voice. This has resulted in: (i) structural problems, (ii) some rules not being conducive to development and (iii) unfavourable operation of some rules. We shall go into the reasons later. First let us consider some of these adverse features in some detail.

6.3.1 Structural Problems

The WTO has the basic objective of liberalisation of trade in goods and services and protection of intellectual property rights (IPR) as explained in Unit 5. Liberalisation of trade results in expansion of exports and directly benefits the countries with developed supply capacity. Protection of IPR gives monopoly privileges resulting in high financial returns to the owners of IPR and thus benefits the countries having IPR. Most of the developing countries have neither a good supply base for goods and services and nor much of the IPR. Thus the very objective of the WTO is such that the prospects for direct gains for the developing countries are much smaller than those for the developed countries.

Then the process of liberalisation, as specified in the preamble to the WTO Agreement, is “reciprocal and mutually advantageous arrangements”. Reciprocity in liberalisation can be useful among countries at nearly similar level of development. It has severe limitations when the participating countries cover a wide range of levels of development as is the case in the WTO. Reciprocity implies “getting more by giving more”. If a country is capable of giving only “less”, it is bound to get “less”. Such a system clearly enhances disparity between the countries which can give and those which cannot. The widening cycle of giving and getting will bring ever increasing benefit to the strong parties; whereas the weaker ones will remain on the fringe as they have not much to offer. Some correctives have been attempted from time to time, like the special and differential (S&D) treatment of the developing countries explained later in section 6.4 in this Unit; but all this has not worked quite satisfactorily, as will be explained in the later section.

Further, there is a basic and structural handicap of the developing countries in enforcing their rights in the WTO. When they perceive that their rights have been violated and they take to the dispute settlement process, the ultimate weapon for enforcing their right is through retaliation, as has been explained in the Unit 5. It may be appropriate in a system where the members have similar strength, but it is grossly inadequate in the WTO system, where the membership is spread over a vastly differing economic and political strength. It puts the developing countries that are the weak partners in the system, at a serious disadvantage. For them, retaliation against a major developed country has both economic cost and political cost. Thus their capacity for enforcement of rights and obligations gets very much constrained.

6.3.2 Problems with Specific Rules

There are several rules in the system that operate against the development process in the developing countries, at least in the short term. It is relevant to enumerate and explain some of the important ones.

The principle of national treatment in the WTO, i.e., non-discrimination between an imported product and a like domestic product as explained in Unit 5, prohibits a country to give preferential treatment to a domestic product in comparison to an imported product. For the developing countries, such a prohibition may be a handicap in their process of development. It constrains their efforts to encourage the use of a domestic product and thus inhibits them in encouraging domestic production. When the domestic product has to face competition from an imported product backed by the immense economic

strength of the producer and exporter of a developed country, the former naturally suffers a great disadvantage and handicap. The prohibition imposed by the national-treatment provision has the potential of hindering the industrialisation process in the developing countries. A new product that is only beginning to be produced in a developing country requires special treatment and facilities; but this provision of the WTO does not permit it.

The WTO rules prohibit the countries from stipulating “domestic content requirement”, i.e., laying down the condition that at least some minimum portion of the raw materials and industrial intermediates used by a factory must be obtained from domestic sources. In this way, an opportunity to encourage consumption of domestic products is lost. Also it may result in an avoidable outgo of scarce foreign exchange that is spent in importing the materials that could have been very well sourced domestically.

The WTO rules also prohibit “foreign exchange balancing”, i.e., laying down the condition that a firm must export a part of its products to balance the outgoing foreign exchange spent on the purchase of the raw materials, industrial intermediates, technology, consultancy services etc.

Then bringing agriculture within the folds of WTO disciplines is very much anomalous considering the position of agriculture in the developing countries. The WTO rules on agriculture are based on the principle that treats agriculture as a commercial operation, as is the case with industrial products. This approach is basically flawed in respect of the developing countries. In most of the developing countries, agriculture is generally not a commercial operation. Farmers take to it because the land has been with their family for generations and they have no other profession as an alternative. Agriculture is thus not an exercise in maximising profit, but a means of sustenance for the family. For this reason, it is not quite rational to envelop it within the principles of commercial operation and international competition, as is the case by its being covered by WTO disciplines.

6.3.3 Problems with Implementation

Apart from the rules themselves, the experience of the developing countries with the implementation of some of the important rules by the developed countries has not been happy. The developed countries discharged their obligations in some areas in purely technical sense and yet no benefit flowed to the developing countries, much to their dismay. Some examples will illustrate this feature.

It was expected that the developed countries would reduce their domestic subsidy in agriculture. This would have saved the poor farmers of the developing countries against competition from the import of highly subsidised products from the major developed countries. Also it would have given the farmers of the developing countries a fair chance to export to third country markets. The developed countries fulfilled their obligation of reducing some subsidy in agriculture as was required by the rules, but they actually increased the quantum of total subsidy. This was possible because, as we saw in Unit 5, the agreement stipulates some subsidies that are immune from reduction. While reducing some subsidy that was to be reduced, they increased the subsidies that were immune from reduction, making the resulting total subsidy higher.

special trade restrictive regime in this sector, the Agreement on Textile and Clothing required the developed countries to progressively liberalise their import of textile as explained to you in Unit 5. The developed countries fulfilled their obligation of liberalisation, but, in effect, there was only very partial liberalisation for nearly ten years of the implementation of the agreement on textiles (1995-2004). This was made possible, because the developed countries took advantage of a loophole in the annex to the Agreement on Textiles in the WTO. The annex contains a huge list of textile items. The agreement left the choice of products for liberalisation to the importing countries and the developed countries, that were importers and had been imposing restraints, chose only such products from the annex for liberalisation that were not under import restraint. In this manner they fulfilled their obligation in a technical sense, but without significantly liberalising their textile import until the end of 2004 when all the restraints got automatically abolished.

Check Your Progress 1

- 1) What are the advantages of a developing country in joining the WTO?

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- 2) Is the principle of reciprocity helpful to the developing countries?

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- 3) Are national treatment principle and domestic content requirement supportive of development process in a typical developing country?

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6.4 SPECIAL AND DIFFERENTIAL TREATMENT

It has been explained in section 6.3.1 that certain basic features of the multilateral trading system, e.g., reciprocity, are not quite appropriate when countries at vastly different levels of development are the members. From time to time, efforts have been made to rectify this lacuna by taking corrective actions, commonly called "special and differential treatment" (S&D treatment) of the developing countries.

Right since the 1960's, some new provisions were included in the GATT,

whereby the developed countries undertook the obligation to accord high priority to the reduction and elimination of trade barriers to products currently or potentially of particular export interest to the developing countries. They also resolved to refrain from introducing, or increasing the incidence of, customs duties or other import barriers on products currently or potentially of particular export interest to the developing countries. (Articles XXXVI, XXXVII and XXXVIII of the GATT 1994). And all this was to be done without expectation of reciprocity from the developing countries. These commitments are, however, not of a contractual nature and as such they cannot be enforced through the dispute settlement system of the WTO. The developed countries never took them seriously and the developing countries have not derived much benefit from them in reality.

In the WTO agreements emerging out of the Uruguay Round of multilateral trade negotiations (MTN) (1986-94) there are very few substantial provisions for S&D treatment. In many cases, these are merely in the form of longer periods of implementation of the obligations. [One important example of substantial special provision is the permission in the Agreement on Subsidies for the developing countries to give export subsidy if their gross national product (GNP) is less than US\$ 1000 per annum.]

Special and differential treatment of the developing countries has been wrongly considered by the developed countries as being something like a grant or charity. In actual fact, it should be the essential and integral element of the system in order to ensure that the developing countries that constitute such large majority in the multilateral trading system have the opportunity to share the benefits of the system. A multilateral system is stable only if the members have a stake in it. For this to happen, it is important that the developing countries have confidence that they will derive adequate benefit from the system.

In the current negotiations in the WTO following from the Doha Work Programme emerging out of the WTO Ministerial Conference in Doha in 2001, there is a mandate to strengthen the S & D treatment of the developing countries and make them more precise, effective and operational. Negotiations are currently (March 2006) going on in the WTO on this subject.

6.5 DIFFERENTIAL TREATMENT IN REVERSE

As mentioned above, the developing countries have not benefited significantly from the S & D treatment. Irony is that, instead, they have been subjected to special trade restrictions in various forms in critical areas of their export interest. Also they get, in fact, less than equal treatment in some matters. Some examples are given below.

6.5.1 Special Trade Restrictions

From time to time, the major developed countries adopted various methods to put special trade restrictions on the imports from the developing countries. Some important ones are discussed below.

Direct Trade Restrictions

As some developing countries built up their supply capacity in some sectors and started expanding their exports to the developed countries, they faced

serious problems. An important example is the textile sector where some developing countries had made investments and built up supply capacity strong enough to give competition to the domestic industry of the developed countries. Their textile exports were curtailed by the introduction of a special trade regime in this sector as explained in Unit 5. Annual exports of specific textile products from individual developing exporting countries were capped. Thus, the prospects of future expansion of industrial production in this area, where competitiveness had been achieved by these developing countries, were effectively curbed.

The developing countries also faced similar problems in some other areas. Special restrictions were imposed in sectors, like jute, leather and steel. Thus, future expansion in these areas too was made almost impossible; and in fact even the existing production was threatened, as the confidence in the future of these sectors in the developing countries was very much shaken.

Neo-protectionism

The textile sector has been brought under normal WTO rules from the beginning of 2005. A time schedule was prescribed for abolition of trade restrictions in other sectors and future actions of this type outside the normal WTO rules have been stopped.

But the protectionist pressures in the developed countries are still active. Now new ways of restricting exports from the developing countries have been introduced. Thus the developing countries continue to suffer serious harassment. As you have learned in Unit 5, large number of anti-dumping investigations were started in respect of the export products of the developing countries. Even if the anti-dumping duties were not imposed finally, the trade and production of the developing countries would still get hampered because of the uncertainty caused by the initiation of investigations. Some time the major developed countries would start investigations of anti-dumping repeatedly against the same product, resulting in serious harassment to the developing countries. It was very much noticed in the textile sector in the wake of removal of special trade restrictive regime in this sector.

Some more innovative methods of protection have also been used. The major developed countries started restraining the exports from the developing countries ostensibly to protect the environment. A number of investigations were started by the developed countries and in several cases imports were stopped. In many cases, the GATT/WTO dispute settlement panels later found the actions of the major developed countries to be wrong. Even though the measures were thus lifted, a lot of damage had already been done.

Future Windows of Protectionism

The major developed countries are trying to link trade with a social clause, in particular, labour standards. Their argument is that the benefits of trade should be shared by labour too; and as such, there should be an obligation on the part of the countries to abide by labour standards including on wages, welfare, etc. This appears attractive from the labour-welfare angle. But the fear among the developing countries is that such provisions will become another fast track to protectionist import controls on the products of the developing countries on

6.5.2 Interests of Developing Countries Ignored

Developing countries have taken some initiatives in some areas for putting forth their positive proposals for improving their situation in international trade. But their proposals have not received priority attention in the WTO. Important among them is the treatment given to what has been called the “implementation issues”, as explained below.

With the experience of the operation of the WTO agreements for nearly five years in end 1999, the developing countries prepared a set of nearly one hundred proposals to remedy the imbalances and iniquities in the WTO agreements. These proposals formed an integral part of the official document for the Seattle Ministerial Conference in December 1999 and came to be known as “implementation issues”. The Doha Ministerial Declaration (2001) attached “the utmost importance” to them and yet they have not been on the central stage in the WTO. They have been mired in technical and procedural squabbles.

Similar has been the fate of the proposal for checking bio-piracy. Some times the multinational firms get patents registered for some products and processes based on the plant and animal resources of the developing countries. They derive huge financial gain out of this process, but they do not share it with the country of origin of such resources. In fact, in several cases the country of origin comes to know about the patents much later. The developing countries have given proposals that the country of origin must be disclosed at the time of making application for the patent and it should be the obligation of the applicant to share the financial benefit of patent with the country of origin. Though this important proposal is on record, it has not received adequate attention and has not been taken up with priority.

Several similar proposals of the developing countries have met with similar fate.

6.5.3 Priority Treatment of Developed Countries

While the developing countries’ proposals remain ignored, the developed countries get special attention and treatment. Some examples will illustrate this point.

The developed countries brought a proposal in the Singapore Ministerial Conference (1996) for having duty free import of information technology products. The supply capacity for such products is mostly with the developed countries, as is the case with high technology products in general. Thus this proposal was clearly meant to give benefit to the developed countries. It got immediately approved right in the same meeting.

Similar was the case with another class of trade. The major developed countries placed the proposal for virtually duty free electronic commerce, i.e., trade through electronic medium. Here again, it is mostly the developed countries that have the supply capacity for such trade. The proposal was tabled in the Geneva Ministerial Conference (1998) and it was approved in the same meeting.

In the negotiations in the area of services, the sectors that are of great interest to the developed countries were taken up for priority negotiation and agreement, e.g., financial services and telecommunication services. The

subjects of interest to the developing countries, e.g., providing services through the movement of persons, are met with stiff resistance from the major developed countries.

Apart from the cases of priority attention to the proposals of the developed countries, some times the rules give special consideration and position to the developed countries' practices. For example, in the area of subsidies, the measures mostly used by the developed countries were made immune from counter-action, e.g., subsidies for research and development, adaptation to new environmental standards and regional development. (This special provision got expired at the end of 1999.) But the subsidies normally needed by the developing countries for their industrial diversification and technological upgradation did not get such favoured treatment. Further, though export subsidy is generally disallowed in the industrial sector, there is a special immunity to export credits (which is a form of export subsidy) granted in accordance with OECD norms. These are the norms followed by the developed countries and they have now got special dispensation for this practice in the WTO.

All this indeed appears to be special and differential treatment in reverse.

Check Your Progress 2

- 1) Are the provisions of the special and differential treatment working to the full advantage of the developing countries?

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- 2) Give two examples of protectionist measures taken by the developed countries.

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- 3) Are implementation issues receiving adequate attention in the negotiations?

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- 4) Give two examples of prompt decisions on the proposals of the developed countries.

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6.6 WTO PROCESS AND THE DEVELOPING COUNTRIES

The WTO process is mainly led by the major developed countries. Very often they are the driving force in the negotiations. They take initiatives and largely determine the subjects of negotiations. Accordingly, the WTO process gets influenced by their perceptions and priorities.

The developed countries are very effective in the WTO process. They use their political and economic strength to achieve their objectives, coordinate fully among themselves while preparing proposals and while negotiating. They also combine the political and strategic strength of their governments with the economic and technological muscle of their firms.

The developing countries are, on the other hand, weak in the WTO. Their task is also very difficult. The subjects of negotiations have become complex and they do not have adequate technical support to formulate concrete positions and pursue them in the negotiations. They are also under tremendous pressure from the developed countries that are much better prepared and much more focussed in their objectives. The environment in which the economic negotiations are now taking place has also changed significantly. In the 1960s, 1970s and early 1980s, the developed countries perceived the developing countries as partners in economic progress and growth. During that period, the problems of developing countries received sympathetic and serious consideration on the basis of enlightened self-interest. The negotiations these days are more for extracting concessions from the developing countries. Thus the developing countries are usually on the defensive in these negotiations.

However some experiences show that when the developing countries move with determination and with clear objective, they are able to achieve results. The latest example is the exclusion of the subjects of investment and government procurement from the negotiating agenda of the Doha Work Programme. The developed countries perceived big gains to their investors in opening up investment prospects in the developing countries. Also they saw major prospects for their manufacturers and traders in supplies of products for the use of governments (government procurement) in the developing countries. They had initiated these subjects along with some others in 1996 and pursued them thereafter. The developing countries assessed that multilateral negotiation and agreement in these areas in the WTO would be damaging to them. They opposed these proposals resolutely. Finally, in 2004, they were able to remove these subjects from the agenda of the current negotiations. But it is not very often that they move with such result oriented and focussed attention.

The negotiating process in the WTO is such that full participation of the developing countries is normally not possible. The meeting schedules are too crowded. Most of the developing countries' missions in Geneva are understaffed. They find it physically impossible even to attend all these meetings. Effective participation is indeed difficult with such busy schedules of meetings.

The WTO has the system of one-country-one-vote and the developing countries are in large number there, but still their actual and effective participation

Important decisions are taken in informal meetings in small groups where only very few developing countries are present. These decisions are then brought forth in the open meetings for approval. It is very difficult for a developing country to explicitly and formally oppose the decision at that stage, even if it has not participated in the decision making and even if the decision is not fully favourable to it. Such formal opposition at that stage would single that country out as an obstructionist country. It has naturally high political cost. Thus a developing country simply keeps silent while the decisions are adopted. In this way, the developing countries get saddled with new obligations even without having full opportunity to participate in the negotiations. Recently, there has been strong criticism of this manner of non-participative decision making in the WTO.

6.7 WAY FORWARD FOR DEVELOPING COUNTRIES

The developing countries have become aware of the risks and the problems. It is important for them to consolidate their strength in the WTO and work towards making the WTO supportive of their development goals.

The very first step is to work out the position of the country on important issues. In respect of a matter under consideration in the WTO, a country has to determine its national interest after weighing the pros and cons. Almost all decisions in the WTO will have differential impacts on different sections in the country. Also, there may be a loss/gain in the short run for the domestic economy, but a gain/loss in the long run. The country should weigh these differing impacts and implications and then decide on its approach and position on a proposal, taking an overall view of the issues from the national angle. The greatest strength of a country in multilateral negotiations lies in the clarity of its own interests and resulting clarity of its position.

Next comes the need for in-depth and comprehensive preparation for putting forward country's position and points of view in the negotiations with clarity and force. The preparation process needs detailed analytical studies of various aspects of the proposal. Naturally, it needs the support of research institutes and universities.

A developing country should also strive to form coalitions within the developing countries' group and also with some developed countries, if possible. Formation of coalitions on specific subjects and issues is, of course, a necessity; but it is also useful to have continuing coalitions among some countries across the spectrum of subjects and issues.

Of course, the most important step in multilateral negotiations is for a country to participate in the formal and informal meetings during the negotiation and speak out its position clearly. If it remains silent, its views remain unheard and decisions are taken without its views being considered.

Finally, when negotiations yield an outcome, a developing country should examine whether it is balanced, i.e., whether it has got benefits commensurate with the obligations it has undertaken. Also it should examine whether the result is in consonance with its development objective and whether it will hinder or harm the development process. Besides, it should assess the cost involved in the implementation. These are essential criteria for testing a result before

Check Your Progress 3

- 1) Give two examples of assertiveness of the developing countries in keeping some subjects out of the agenda of negotiations.

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- 2) Are negotiations in the WTO held in a transparent manner?

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- 3) How should a developing country formulate its position on any particular subject of negotiation?

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- 4) What points should a developing country examine while assessing the final outcome of a negotiation?

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6.8 LET US SUM UP

After reading this Unit, you have learnt about the situation of the developing countries in the international trading system. You have also learnt the benefits of the system and also its problems, and learn in detail their experiences in the system and the moves to improve their position. The Unit explains to you the Utility of the international trading system for developing countries. It elaborates some basic problems relating at structural and implementation level. It also discusses the issues regarding special and differential treatment of the developing countries. Lastly the Unit explains the way forward for developing countries.

6.9 KEY WORDS

National Treatment: The principle of national treatment in the WTO, implies non-discrimination between an imported product and alike domestic product. It prohibits a country to give preferential treatment to a domestic product in

comparison to an imported product. This principle is a handicap in their process of development as it constrains their efforts to encourage the use of a domestic product as against imported products.

Special and Differential (S&D) Treatment: The GATT principle that developing countries be accorded special privileges, exempting them from some requirements of developed countries. It also permits tariff preferences among developing countries and by developed countries in favour of developing countries, as under the Generalised System of Tariff Preferences, by which developed countries let certain manufactured and semi-manufactured imports from developing countries enter at lower tariffs than the same products from developed countries.

6.10 SOME USEFUL REFERENCES

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6.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Read Section 6.2
- 2) Read Sub-section 6.3.1
- 3) Read Sub-section 6.3.2

Check Your Progress 2

- 1) Read Section 6.4
- 2) Read Sub-section 6.5.1
- 3) Read Sub-section 6.5.2
4. Read Sub-section 6.5.3

Check Your Progress 3

- 1) Read Section 6.6
- 2) Read Section 6.6
- 3) Read Section 6.7
- 4) Read Section 6.7